UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, vs. AR CAPITAL, LLC, NICHOLAS S. SCHORSCH, and BRIAN S. BLOCK, Defendants.	Civil Action No.: 1:19-cv-06603-AT

VEREIT, INC.'S OBJECTIONS AND COMMENTS TO THE SECURITIES AND EXCHANGE COMMISSION'S PROPOSED PLAN OF DISTRIBUTION OF SETTLEMENT FUNDS PAID BY AR CAPITAL, LLC, NICHOLAS S. SCHORSCH, AND BRIAN S. BLOCK

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Pursuant to the Notice of Motion filed by the Securities and Exchange Commission ("SEC") on September 14, 2020 and the Court's Order dated October 1, 2020, VEREIT, Inc. ("VEREIT" or the "Company"), formerly known as American Realty Capital Properties, Inc. ("ARCP"), respectfully submits these objections and comments to the SEC's proposed plan of distribution of the settlement funds obtained in *SEC v. AR Capital, LLC, Nicholas S. Schorsch and Brian S. Block*, 19-cv-06603-AT.

PRELIMINARY STATEMENT

On July 16, 2019, the Securities and Exchange Commission (the "SEC" or "Commission") filed a Complaint against AR Capital, LLC, Nicholas S. Schorsch and Brian S. Block (Dkt. No. 1) (the "Complaint"), alleging that the defendants misappropriated assets of VEREIT while serving as managers of VEREIT. The parties simultaneously presented to the Court proposed settlement orders that would resolve all claims against the defendants. (Dkt. Nos. 5, 6, 7.) Among other relief, the settlement orders call for AR Capital, Schorsch, and Block (collectively, the "AR Capital Parties" or "Defendants") to pay $12,313,856 in disgorgement and prejudgment interest and $21,750,000 in penalties for a total of $34,063,856. (Dkt. Nos. 8 at 2-4, 9 at 4-5, 11 at 4-5.)

The Complaint alleges that Defendants engaged in two schemes to embezzle funds from VEREIT. First, in connection with two mergers in which VEREIT merged with companies controlled by the Defendants, the Defendants allegedly inflated an incentive fee calculation that had the effect of awarding them a greater number of units in an operating partnership partially owned by VEREIT than the Defendants would have otherwise received. (Complaint ¶ 3.) In connection with the SEC's settlement, the Defendants were ordered to return the underlying units to VEREIT and to disgorge approximately $4 million in dividends that VEREIT previously paid the Defendants on those improperly-awarded units. (*See* Declaration of Lauren Goldberg ("Goldberg Decl.") ¶ 23.) Second, in connection with those same mergers, the Defendants

allegedly created or approved misleading asset purchase and sale agreements pertaining to a transaction by which Defendants caused VEREIT to purchase purported furniture, fixtures, and equipment ("FF&E") from AR Capital. (Complaint ¶ 4.) Pursuant to this scheme, Defendants allegedly caused VEREIT to overpay AR Capital for the FF&E it received by at least $7.27 million. (*Id.*) Again, this amount was cash directly misappropriated from VEREIT.

On September 14, 2020, the SEC filed a proposed plan of distribution that would distribute the settlement funds to certain shareholders of VEREIT instead of to VEREIT itself. (Dkt. No. 42-1 at 4.) The plan of distribution seeks to distribute funds to shareholders on a *pro rata* basis if they purchased stock between February 28, 2013 and October 28, 2014 and continued to hold that stock on October 28, 2014. (*Id.* at 4, 12, 19.) The SEC has selected this period because it coincides with the "Class Period" that pertained to a consolidated class action and derivative actions that were filed against VEREIT for unrelated conduct—accounting fraud for which Defendant Block was criminally charged and convicted—and settled by the defendants in the class action in 2019 for a payment of over $1 billion to the shareholders. (*See* Dkt. No. 42 at 7, 12.) But aside from the convenience of piggy-backing on the existing class action distribution apparatus, the SEC's distribution plan does not withstand scrutiny.

Under equitable principles and precedent—as underscored by the Supreme Court's landmark decision in *Liu v. SEC*, 140 S. Ct. 1936 (2020)—the only appropriate beneficiary of the funds is the party from whom the Defendants misappropriated those funds: VEREIT. As the Supreme Court emphasized, a district court may order defendants to disgorge ill-gotten gains only as part of the imposition of a traditional equitable remedy, such as an accounting for profits, constructive trust, or rescission. *Id*. at 1948-50. The SEC has no ability to redirect such funds to the Treasury or victims of a different scheme. The SEC cites no equitable authority that would

permit the Court to take funds stolen from VEREIT and award the money to a group of VEREIT's former shareholders—most of whom were not even shareholders when the funds were misappropriated. Although VEREIT—like every corporation—is owned by its shareholders (many of which are themselves corporations and owned by other shareholders), it is a legal entity that is distinct from its shareholders. That is especially so given that VEREIT is a public company with millions of shares of its stock trading every single day. There is no authority for the Court to "look through" the corporation to its shareholders—a constantly changing mix of investors with their own constantly changing mix of investors—and award the corporation's money to its former shareholders.

Moreover, the SEC's proposed plan of distribution does not even purport to award VEREIT's money to those shareholders who owned stock at the time the money was wrongfully taken from VEREIT. Instead, the SEC seeks to distribute the embezzled funds to shareholders who purchased VEREIT stock ***after*** the embezzlement took place and ***before*** October 28, 2014 (the date when VEREIT publicly announced a ***different*** fraud perpetrated by some of the Defendants). While this approach would allow the SEC to take advantage of the class action distribution apparatus, it would wholly arbitrarily exclude the seemingly most eligible shareholders—those who held stock ***when*** the embezzlement took place, regardless of when they purchased their stock. It would also exclude those shareholders who purchased their stock after October 28, 2014 despite the fact that the embezzlement was not revealed until March 2015—and even then only partially revealed—and not fully revealed until July 2019, when the SEC commenced this action. At the same time, the SEC's proposed plan would distribute VEREIT's funds to those it designates on a ***pro rata*** basis even though the embezzlement took place at various different times between February 2013 and December 15, 2014—the date when the Defendants

received their last dividends on operating partnership units that had been misappropriated from VEREIT—and thus fell unevenly on VEREIT and its shareholders at different times throughout that period.

Most absurdly, pursuant to the settlement orders proposed by the SEC and entered by the Court on July 17, 2019, the Defendants have already been required to surrender to VEREIT the operating partnership units that they misappropriated from VEREIT. (Dkt. Nos. 8, 9, 11.) Yet one third of the disgorged funds that the SEC now proposes to distribute to its favored group of shareholders—rather than to VEREIT itself—consists of cash dividends that VEREIT paid to Defendants on the very same operating partnership units that the SEC required be returned to VEREIT. Thus, the SEC would distribute to the proposed shareholder group the dividends wrongfully received by Defendants on the very units it has already awarded to VEREIT. That result would make no sense and cannot possibly be justified as an exercise of equitable discretion.

These anomalies underscore the legal distinction between a corporation and its shareholders and explain why our laws treat a corporation as a person with rights and obligations that are different from those of its shareholders. We respectfully submit that the SEC's proposed plan of distribution defies precedent, cannot be squared with the controlling principles articulated by the Supreme Court in *Liu v. SEC*, and is not fair and reasonable by any measure. Under any applicable equitable doctrine, the $12,313,856 of funds misappropriated from VEREIT should be restored to VEREIT, the rightful owner, and ultimately benefit all constituents of VEREIT, including its shareholders and creditors. VEREIT takes no position on whether and how the penalties assessed against the Defendants should be distributed.

BACKGROUND

VEREIT is a publicly traded real estate investment trust ("REIT") with a market capitalization of approximately $7 billion and more than one billion outstanding shares. (Goldberg

Decl. ¶ 4.) From its formation until January 8, 2014, while it was known as ARCP, VEREIT was externally managed by ARC Properties Advisors, LLC, a subsidiary of AR Capital, LLC ("AR Capital").[1] (*Id.*) Throughout the same period, Nicholas S. Schorsch and Brian S. Block served as the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") respectively of both ARCP and its manager, AR Capital. (Complaint ¶¶ 2, 10-15.) Schorsch was also the principal owner of AR Capital, and Block held a minority interest in the company. (*Id.* ¶ 2.)

A. ARCP's Private Civil Actions

On October 29, 2014, ARCP publicly announced that its Audit Committee had identified errors in its financial statements for the first and second quarters of 2014 and that its CFO, Mr. Block, and Chief Accounting Officer had departed the company (the "October 2014 Disclosure"). (Goldberg Decl. ¶¶ 7, 9.) ARCP's stock price declined following the announcement. (*Id.* ¶ 8.) Shortly afterwards, multiple putative class actions (which were later consolidated), individual securities actions, and derivative actions were filed in the Southern District of New York ("SDNY") and elsewhere (collectively, the "Private Civil Actions"). (*Id.*) The Private Civil Actions collectively named nearly 50 defendants, including ARCP and the Defendants in this action. (*Id.*)

The Audit Committee continued its investigation following the October 2014 Disclosure and on March 2, 2015, ARCP issued restatements for prior periods, namely fiscal year 2013 and the first and second quarters of 2014 (the "March 2015 Restatements"). (*Id.* ¶ 9.) The March 2015 Restatements announced for the first time that ARCP, through its Operating Partnership, entered into agreements to acquire FF&E in connection with two mergers with affiliates, and that the Audit Committee concluded that "there was no evidence of the receipt and it could not support the value

[1] Consistent with the SEC Complaint, AR Capital and its wholly-owned subsidiaries are collectively referred to as "AR Capital" throughout this memorandum.

of the FF&E." (*Id.*; ARCP's 2013 10-K/A filed with the SEC on March 2, 2015 ("Restated 2013 10-K") (attached to the Goldberg Decl. as Exhibit B) at F-11; ARCP's Form 10-Q/A for the quarterly period ended March 31, 2014, filed with the SEC on March 2, 2015 ("Restated Q1 2014 10-Q") (attached to the Goldberg Decl. as Exhibit C) at 8, 9, 66.) The March 2015 Restatements also disclosed for the first time that the Audit Committee's investigation identified payments by ARCP to its former manager (AR Capital) and affiliates that "were not sufficiently documented or that otherwise might warrant scrutiny" and that the company was considering whether it had a right to seek recovery for such payments. (Goldberg Decl. ¶ 9; Restated 2013 10-K at 81-82; Restated Q1 2014 10-Q at 82). Notwithstanding these disclosures (among others), ARCP's stock price actually ***rose*** following the issuance of the March 2015 Restatements. (Goldberg Decl. ¶ 9.)

The consolidated class action alleged violations of the antifraud provisions of the federal securities laws based on numerous alleged misstatements and omissions relating to accounting errors between February 28, 2013 and October 28, 2014 (the "Class Period"). (*Id.* ¶ 8.) The derivative actions brought claims for breach of fiduciary duty against various executives, including Defendants Schorsch and Block, based on the same allegations. (*Id.*)

On September 9, 2019, after nearly five years of litigation, the parties in the consolidated class action and derivative actions in the SDNY entered into settlement agreements in which the total settlement amount was $1.025 billion. (*Id.*) In both the consolidated class action and the SDNY derivative actions, the plaintiff shareholders provided full releases of *all* of the shareholder claims in the combined actions for the Class Period. (*Id.*) These proposed agreements were subsequently approved by the Honorable Alvin K. Hellerstein. *See In re American Realty Capital Properties, Inc. Litigation*, 15-mc-00040, Dkt. No. 1309 (S.D.N.Y. Jan. 22, 2020); *Witchko v. Schorsch et al.*,15-cv-06043, Dkt. No. 307 (S.D.N.Y. Jan. 22, 2020).

In connection with this global settlement, VEREIT and the Defendants in this case also settled potential cross-claims that they had against each other, which had been tolled during the pendency of the Private Civil Actions.[2] (*Id.*) However, VEREIT specifically carved out of its settlement with the AR Capital Parties its right to pursue and retain any amounts paid to the SEC in connection with this action. (*Id.*) This settlement agreement was disclosed to the class action and derivative action plaintiffs, and was attached as an exhibit to the derivative action settlement agreement that was publicly filed with the district court. *See Witchko v. Schorsch et al.*,15-cv-06043, Dkt. No. 287-1, Exhibit E § 7 (S.D.N.Y. Jan. 22, 2020).

B. The Two Mergers With Affiliates That Are The Subject of the Complaint

Through its subsidiaries, AR Capital externally managed other REITs in addition to ARCP. As relevant here, AR Capital externally managed American Realty Capital Trust III, Inc. ("T3") and American Realty Capital Trust IV, Inc. ("T4"). (Complaint ¶¶ 14-15.) Messrs. Schorsch and Block also served as the CEO and CFO of T3 and T4 during all relevant periods and held interests in those companies. (*Id.* ¶¶ 2, 10-15.) The SEC's Complaint alleges that the Defendants used their management control over VEREIT, T3, and T4 to "improperly obtain[] millions of dollars [from VEREIT] to which they were not entitled." (*Id.* ¶¶ 1-2.) Specifically, as part of VEREIT's mergers with T3 on February 28, 2013 (the "T3 Merger") and with T4 on January 3, 2014 (the "T4 Merger"), the Defendants allegedly inflated an incentive fee calculation and obtained millions of dollars in unsupported charges related to purported purchases of FF&E. (*Id.* ¶¶ 3-4, 14-15.) Because these amounts were allegedly misappropriated from VEREIT, the Company was

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[2] For example, VEREIT could have brought claims against its former manager AR Capital for mismanagement and fraud based in part on the alleged misconduct that forms the basis of the present SEC action.

victimized in the same amount, dollar-for-dollar, as the Defendants wrongfully benefited from the actions alleged in the Complaint.

1. The Promotes

T3 and T4, like ARCP, conducted most of their businesses through operating partnerships (individually "OP" and collectively "OPs"). (*Id.* ¶ 17.) Each REIT owned units in each respective OP entity ("OP Units"), which generally constituted more than 95% ownership of each OP. (*Id.* ¶ 18.) The T3 and T4 OPs were governed by limited partnership agreements ("LPAs"). (*Id.* ¶ 17.) In relevant part, the LPAs for both the T3 OP and T4 OP set forth conditions under which AR Capital would receive a performance fee, known as either a "subordinated distribution" or "promote fee," at the consummation of a liquidity event, such as a merger. (*Id.* ¶ 20.) The promote fee would be triggered if the liquidity event provided shareholders of T3 and T4 a return in excess of a 6% hurdle rate, with AR Capital receiving 15% of returns to T3 and T4 shareholders above the hurdle rate. (*Id.* ¶ 21.) The LPAs specified that the return would be determined "in good faith" based on the "fair market value" of T3 or T4 shares as of each merger's closing date. (*Id.*) Pursuant to the merger agreements and side letters executed in connection with both mergers, AR Capital agreed to take the promote fees in the form of OP Units in the T3 and T4 OPs, which would then be converted into OP Units in the ARCP OP when the mergers were consummated. (*Id.* ¶ 22.) Since the OP Units were exchangeable into shares of VEREIT stock on a one-for-one basis and diluted VEREIT's ownership of the Operating Partnership on a one-for-one basis, the promote fees were paid directly at the expense of VEREIT. (*See id.* ¶ 18.)

With respect to the T3 Merger, the Complaint alleges that the AR Capital Parties improperly inflated their promote fees in three ways. First, Defendants allegedly used a five-day average price of VEREIT stock to calculate the fee. (*Id.* ¶¶ 36-42.) Second, the AR Capital Parties allegedly ignored the actual cash/stock elections of T3's shareholders (16.5% cash election and

83.5% stock election), and instead used a 100% stock election scenario. (*Id.* ¶¶ 43-48.) Under the relevant merger agreement, T3 shareholders, could elect to receive, for every T3 share, either 0.95 shares of ARCP common stock or $12.00 in cash (capped at 30% of the aggregate merger consideration). (*Id.* ¶ 25.) When the merger closed, shareholders representing 16.5% of T3 shares elected to receive cash, with 83.5% receiving shares in VEREIT. (*Id.* ¶ 43.) Lastly, the AR Capital Parties allegedly used an unsupported multiplier when converting the T3 promote fee cash value into VEREIT/ARCP OP Units. (*Id.* ¶¶ 49-54.) Combined, this had the effect of awarding 7,261,559 ARCP OP Units—1,135,360 more than the 6,126,199 OP Units that the SEC alleges that the AR Capital Parties would have otherwise received. (*Id.* ¶¶ 52, 55.)

As part of the T4 Merger, the Complaint alleges that the AR Capital Parties also improperly inflated their promote fees, this time when converting the promote fee into T4 OP Units. (Complaint ¶ 72.) Under the governing agreements, the dollar value of the promote fee would be converted into T4 OP Units by dividing the cash value of the fee by the implied value per share of T4 common stock. (*Id.* ¶ 71.) Instead, Defendants allegedly used the insider initial T4 offering price of $22.50 to calculate the number of T4 OP Units rather than using the implied price of T4 common stock. (*Id.* ¶ 72.) As alleged in the Complaint, the implied price should have been based on the closing price of ARCP's common stock on the day immediately prior to the merger closing date. (*Id.* ¶ 71.) The improper calculation resulted in the issuance of 6,734,148 ARCP OP Units—1,787,085 more than the 4,947,063OP Units that the SEC alleges the AR Capital Parties would have otherwise received. *(Id.* ¶ 75, 78.)

For both mergers combined, these allegedly improper computations resulted in the issuance of 13,995,707 ARCP OP Units—2,922,445 more than the 11,073,262 OP Units that they would

have otherwise received. (*Id.* ¶ 20.) VEREIT also paid dividends on these OP units to the Defendants until the end of 2014. (Goldberg Decl. ¶ 23.)

2. FF&E

The Complaint describes additional alleged improper conduct related to the T3 Merger and T4 Merger. As part of these two mergers, the Defendants allegedly "directed the creation of and/or approved misleading asset purchase and sale agreements with ARCP pursuant to which ARCP would purportedly purchase from AR Capital [FF&E] . . . and reimburse AR Capital for certain 'unreimbursed expenses.'" (Complaint ¶ 82.) Pursuant to the relevant agreements, VEREIT paid AR Capital $5.8 million in connection with each merger, resulting in a total payment of $11.6 million for purported FF&E. (*Id.* ¶ 84.) According to the Complaint, however, at least $7.27 million of this amounted to "unsupported compensation." (*Id.* ¶ 84.) In other words, the Defendants allegedly paid themselves at least $7.27 million more than they were entitled to receive from VEREIT in connection with the T3 and T4 mergers.

C. VEREIT's Cooperation With the SEC

Immediately upon the Audit Committee uncovering errors in the Company's financial statements, VEREIT notified the SEC of the irregularities and has cooperated extensively with the SEC's investigation ever since.[3] As noted by the SEC in its settlement order with VEREIT, the Company "promptly self-reported to the Commission" the Audit Committee's findings. *See In the Matter of VEREIT, Inc.*, Exchange Act Release No. 89133 at *9 (June 23, 2020). The Audit Committee "continued its investigation thereafter and provided timely updates to the Commission Staff." *Id.* VEREIT "also voluntarily produced compilations of documents and other information

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[3] VEREIT also cooperated with the Department of Justice investigation which ultimately led to the conviction of its former CFO, Brian Block, and former CAO, Lisa McAlister. *See United States v. McAlister*, 16-cr-00653, Dkt. No. 21 (Mar. 26, 2018); *United States v. Block*, 16-cr-00595, Dkt. No. 235 (May 4, 2020); Goldberg Decl. ¶ 9.

at the staff's request, made timely disclosure of relevant factual information, and facilitated making its employees available for interviews with the staff." *Id.* VEREIT "continued to cooperate with the Commission staff's investigation" after VEREIT restated its financials in March 2015, including by "providing certain information relevant to" the instant enforcement action against the AR Capital Parties. *Id.* In particular, VEREIT brought to the SEC's attention the Defendants' improper conduct with respect to the T3 and T4 promote fees. *Witchko v. Schorsch et al.*,15-cv-06043, Dkt. No. 294 (S.D.N.Y. Dec. 31, 2019) at 2-3.

D. The SEC's Enforcement Action and Plan of Distribution

In July 2019, based in large part on information provided by VEREIT, the Commission filed its Complaint against AR Capital, Schorsch, and Block in this matter. (*See generally* Complaint.) Simultaneous with its Complaint, the Commission filed Settlement Agreements with the AR Capital Parties. (Dkt. Nos. 5, 6, 7) Shortly afterwards, this Court entered Final Judgments ordering AR Capital, Schorsch, and Block to forfeit 2,922,445 OP Units to VEREIT and to pay $12,313,856 in disgorgement and prejudgment interest and $21,750,000 in penalties to the SEC. (Dkt. Nos. 8 at 2-3, 9 at 4-5, 11 at 4.) The monetary amounts paid by the AR Capital parties have been held by the SEC in an interest-bearing account "pending further order of the Court" to be potentially distributed "pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002." (Dkt. Nos. 8 at 5, 9 at 6, 11 at 6, 13, 42 at 4.)

On September 11, 2019, VEREIT filed a Motion to Intervene and for Disbursement of Settlement Funds, arguing that it was entitled to the moneys paid by the AR Capital Parties to the Commission because it was the victim of the AR Capital Parties' improper conduct. (Dkt. Nos. 14-16.) On October 10, 2019, after conferring with the SEC, VEREIT withdrew its motion, and reserved its "rights to move to intervene or make an appropriate application to the Court at a

subsequent date in the event VEREIT and SEC cannot reach an agreement as to the appropriate distribution of the funds." (Dkt. No. 25.)

On September 14, 2020, the Commission moved this Court to approve its Plan of Distribution of Fair Fund. (Dkt. No. 41.) The SEC's plan allows for those "who purchased or otherwise acquired ARCP common stock on or after February 28, 2013, including in the T3 Merger, and held that stock at the close of trading October 28, 2014," to receive the amounts paid to the SEC by the AR Capital Parties. (Dkt. No. 42-1 at 4). The proposed plan, however, excludes VEREIT from collecting any of the funds at issue. (*Id.*) Among those who are eligible to receive funds are professionals investing in a pooled investment fund or entity on behalf of potential claimants, so long as such funds are allocated for the benefit of such pooled investors and not management. (*Id.* at 8-9.) The proposed plan would distribute funds to claimants on a *pro rata* basis, based on the number of eligible shares owned by an eligible claimant divided by the total eligible shares of all eligible claimants. (*Id.* at 12, 19.)

ARGUMENT

A. The Applicable Standard of Review

It is well settled that federal courts possess the equitable power to order that disgorged funds be distributed to victims of securities violations when doing so is "fair and reasonable." *See Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC,* 467 F.3d 73, 81 (2d Cir. 2006) (holding that the "'fair and reasonable'" standard of review applied to the district court's approval of the Fair Fund plan proposed in that case and stating that one goal of disgorgement is to ensure "compensation of fraud victims"); *SEC v. Wang*, 944 F.2d 80, 81 (2d Cir. 1991) (approving a plan to disburse disgorged amounts to certain victims of an insider trading scheme only after "the district court reviewed an SEC-sponsored disgorgement plan, heard testimony, [and] determined the plan was 'fair and reasonable'"); *SEC v. Certain Unknown Purchasers of the Common Stock*

of and Call Options for the Common Stock of Santa Fe Int'l Corp., 817 F.2d 1018 (2d Cir.1987) (affirming lower court's approval of distribution plan that was "fair in all respects").

The SEC contends that it has broad discretion to fashion a distribution plan as it sees fit. (Dkt. No. 42 at 8.) In support, the SEC cites two decades-old cases—*SEC v. Wang*, 944 F.2d 80, 83-84 (2d Cir. 1991) and *SEC v. Levine*, 881 F.2d 1165 (2d Cir. 1989)—that are out of step with modern doctrine on deference to the SEC. (*Id*.) In defending its proposed plan, the SEC implicitly acknowledges its arbitrary reach when it quotes *Wang*'s statement that "[t]his kind of line-drawing—which inevitably leaves out some potential claimants—is . . . appropriately left to the experience and expertise of the SEC in the first instance." *Wang*, 944 F.2d at 83-84, 88. Crucially, the SEC omits the next sentence of *Wang*, which reaffirms the Court's power to judge a distribution plan: "The district court's task is to decide whether, in the aggregate, the plan is equitable and reasonable." *Wang*, 944 F.2d at 88. Despite citing *Levine* alongside *Wang,* the SEC also fails to note that *Wang* explicitly rejected the SEC's suggestion that *Levine* requires courts to defer to the SEC when fashioning distribution of disgorged funds. *Wang*, 944 F.2d at 84 ("The SEC misreads [*Levine*] . . . as limiting judicial review of proposed plans to deciding whether the plans are against public policy or are arbitrary."). Moreover, it is well settled that the *Chevron* framework—which accords deference to agency applications of law—is "inapplicable where . . . the agency's interpretation is presented in the course of litigation and has not been articulated before in a rule or regulation." *SEC v. Rosenthal*, 650 F.3d 156, 160 (2d Cir. 2011) (internal quotation marks and citation omitted).

Federal courts have rejected or altered distribution plans proposed by the SEC when such action is warranted. *SEC v. J.P. Morgan Sec. LLC*, No. CV 12-1862 (JEB), 2017 WL 44209, at *8 (D.D.C. Jan. 4, 2017) (rejecting the SEC's initial plan of distribution of disgorged funds for

failing to adhere to the governing settlement); *SEC v. Felix Investments, LLC*, 16-cv-01386, Dkt. No. 443 at 1 (N.D. Cal. Dec, 29, 2018) (approving distribution plan incorporating elements of a plan proposed by SEC and court-appointed Receiver and a plan proposed by an interested party). Courts also possess the power to direct the SEC to show cause if they choose not to distribute disgorged funds to a victim of the violation at issue. *SEC. v. Suman*, 684 F. Supp. 2d 378, 393 (S.D.N.Y. 2010), *aff'd*, 421 F. App'x 86 (2d Cir. 2011) (directing the "SEC to show cause why distribution of any monies collected to the Defendants' victims is not feasible or otherwise unreasonable").

The Supreme Court's most recent ruling on the SEC's disgorgement power—which the SEC entirely fails to address in its memorandum of law—strongly emphasizes the court's duty to scrutinize efforts to "test the bounds of equity practice" and to confine any award of disgorgement to traditional equitable remedies. *Liu,* 140 S. Ct. at 1946. In discussing the limitations on what it referred to as the equitable "profits remedy," the Supreme Court in *Liu* surveyed precedents from the 19th century and earlier that construed the equitable doctrines of constructive trust or accounting-for-profits. *Id.* at 1942-46. The Court then made clear that Congress imported the restrictions contained in these precedents when it enacted 15 U.S.C. § 78u(d)(5)—which provides that "the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." *See Liu* at 1947 ("[S]uch 'statutory reference[s]' to a remedy grounded in equity 'must, absent other indication,' be deemed to contain the limitations upon its availability that equity typically imposes.'") (quoting *Great West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 211 n. 2 (2002)); *see also id.* at 1946 ("By incorporating these longstanding equitable principles into § 78u(d)(5), Congress prohibited the SEC from seeking an equity remedy in excess of a defendant's net profits from wrongdoing.").

Although the Supreme Court was not required to address any particular plan of distribution in *Liu*, it viewed as a limit on a disgorgement award the statutory directive that the SEC can only seek equitable relief that "may be appropriate or necessary for the benefit of investors." *Id.* at 1947 (*citing* 15 U.S.C. § 78u(d)(5)). Given the need to tether any award of disgorgement to traditional equitable principles, the Court considered it an "open question" whether it is ever justifiable for a court to direct disgorgement funds to the Treasury. *Id*. at 1948. The Court stressed that "[t]he parties have not identified authorities revealing what traditional equitable principles govern when, for instance, the wrongdoer's profits cannot practically be disbursed to the victims." *Id*. Thus, *Liu* leaves no room for the SEC to contrive its own remedy or otherwise depart from traditional equitable principles in the handling or distribution of funds misappropriated from VEREIT.

B. VEREIT is Equitably Entitled to the Funds Misappropriated from VEREIT

Under any equitable doctrine that could possibly be invoked here—e.g., constructive trust, accounting for profits, rescission, equitable lien, replevin—VEREIT is the rightful recipient of funds that the Defendants misappropriated from VEREIT. All such remedies would require funds misappropriated by faithless fiduciaries to be returned to the company from which they took the money. Where corporations have been victimized by similar misconduct, courts have routinely ordered funds to be restored to the corporate victim. For example, in *SEC v. Gupta*, Vinod Gupta, the founder and former CEO and Chairman of infoUSA Inc. (now InfoGroup Inc.) ("InfoGroup"), awarded himself millions of dollars of unauthorized and undisclosed perquisites and caused InfoGroup to engage in improper related-party transactions with entities that Gupta either controlled or was affiliated with, causing InfoGroup to include material misstatements in its annual reports and proxy statements. *SEC v. Gupta*, 10-cv-00100, at Dkt. No. 1, 1-2, 4-8 (D. Neb. Mar. 15, 2010). The Commission and Gupta reached a settlement, and Gupta was required to pay

disgorgement representing his ill-gotten gains, along with prejudgment interest, to InfoGroup. *Id.*, Dkt. No. 2 at 1 (Mar. 15, 2010), Dkt. No. 9 at 6-7 (Mar. 17, 2010); *see also Peter R. Culpepper, CPA*, Release No. 82293, Admin. Proceeding File No. 3-18308, at *2, 9 (Dec. 12, 2017) (ordering senior executive to pay disgorgement and prejudgment interest to his company).

Similarly, in its action against senior executives of iPayment, Inc. ("iPayment"), the SEC sought to ensure that funds misappropriated from a public company were restored to the company. There, five executives of iPayment, a credit card payment processor, were charged with engaging in a scheme to embezzle funds from iPayment, causing the company to materially misstate its 10-Qs and 10-Ks. *SEC v. Shakouri et al.*, 17-cv-01929, Dkt. No. 1 at 2-4, 6-8 (C.D. Cal. Mar. 10, 2017); *see also id*. at Dkt. No. 27 at 1-2 (Sept. 13, 2017), Dkt. No. 32 at 8-9 (Sept. 26, 2017), Dkt. No. 34 at 6-7 (Sept. 26, 2017), Dkt. No. 38 at 6-7 (Oct. 5, 2017), Dkt. No. 39 at 8-9 (Oct. 05, 2017), Dkt. No. 40 at 2-3 (July 11, 2018), Dkt. No. 40-1 at 2, 8, 14, 20 (July 11, 2018) (ordering senior executives who embezzled funds from iPayment to pay disgorgement and prejudgment interest and considering such obligations satisfied by, *inter alia*, payments to the company).

Likewise, in *SEC v. Sachdeva and Mulvaney*, the court approved disbursement of disgorged funds to a company where accounting employees embezzled those funds from the company. 10-cv-00747, Dkt. No. 1 at 1-3 (E.D. Wis. Aug. 31, 2010), Dkt. No. 48 at 1-4 (Mar. 5, 2013), Dkt. No. 49 (Mar. 6, 2013).

VEREIT stands in the same position as the corporate victims in these cases. Indeed, the SEC has acknowledged as much by requiring the Defendants to forfeit ***to VEREIT*** the 2,922,445 OP Units that were ordered to be disgorged by the Defendants. The same logic that applies to the OP Units themselves should apply to the dividends that VEREIT paid to the Defendants on those

same OP Units. As noted above, these dividends amount to approximately $4 million of the approximately $12 million of disgorged funds.

Similarly, VEREIT is the victim of the Defendants' improper conduct with respect to the purchase and sale of FF&E in connection with the two mergers. In each case, VEREIT paid money to the Defendants for assets that it did not receive. The SEC Complaint alleges that VEREIT paid at least $7.27 million over and above the value of the assets VEREIT received in connection with the mergers. (*See* Complaint ¶ 84 (alleging that at least $7.27 of the $11.6 million paid by VEREIT to AR Capital for the FF&E amounted to "unsupported compensation").) Having been misappropriated from VEREIT, this money too should be returned to VEREIT.

The SEC attempts to justify an alternative plan of distribution by asserting that "the primary violations alleged in the Complaint are of the antifraud provisions of the federal securities laws" and that "[t]he facts alleged in the Complaint contemplate that the victims of the Defendants' fraudulent conduct are the investors who purchased or otherwise acquired ARCP shares and were misled by the fraudulent misrepresentations and omissions made in connection with the T3 and T4 mergers." (Dkt. No. 42 at 9.) There are three problems with this argument.

First, the SEC Complaint does not contain "primary" and "secondary" charges. Rather, it contains three types of charges: (1) fraud in connection with securities transactions, in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-5, and Section 17(a) of the Securities Act; (2) knowing falsification of books, records and accounts of VEREIT, in violation of Section 13(b)(2)(A) of the Exchange Act; and (3) falsifying and causing the falsification, directly or indirectly, of books, records and accounts of VEREIT. (Complaint ¶ 97-111.) No one cause of action is more or less important than the others.

Second, the facts alleged in the Complaint do not "contemplate" that the victims are investors who purchased or otherwise acquired VEREIT stock in connection with the T3 and T4 mergers. Rather, "the facts alleged in the Complaint" could not be more clear that VEREIT was the victim of the Defendants' alleged misconduct. As described above, the Complaint unquestionably alleges that the Defendants misappropriated assets that belonged to VEREIT by selling VEREIT nonexistent or overvalued FF&E and miscomputing the amount of incentive fees that they awarded to themselves. *See supra* Background. This misconduct is actionable under the securities laws because it violated Defendants' fiduciary duties to VEREIT and was accomplished by means of alleged misrepresentations contained in "FF&E Agreements" and "Contribution and Exchange Agreements" that were publicly filed as exhibits to Form 8-Ks and resided in the books and records of VEREIT, a public company. (Complaint ¶¶ 77, 85-88.)

Nothing about these "facts" contemplate that VEREIT's shareholders were the victims of the alleged misconduct. Indeed, the investor most centrally involved in purchasing and selling securities in connection with the T3 and T4 mergers was VEREIT itself, which consummated the mergers by purchasing the stock of T3 and T4 from their preexisting shareholders. Moreover, the securities most centrally involved in the alleged fraud perpetrated by the Defendants were the OP Units, which were issued (sold) to the Defendants as purported compensation for their services at the direct expense of VEREIT. Finally, two of the causes of action in the Complaint—those predicated on falsification of a public company's records—impact VEREIT and have nothing to do with the purchase or sale of securities. The section of the Exchange Act alleged to have been violated in connection with those causes of action—Section 13(b)(2) of the Exchange Act—is a provision of the Foreign Corrupt Practices Act "designed to prevent the use of corporate funds for corrupt purposes." S. REP. 95-114, 2, 1977 U.S.C.C.A.N. 4098, 4100. In this regard, it should

also be emphasized that, while the T3 and T4 mergers required the approval of certain of the shareholders of the companies involved, the Complaint does not allege fraud in connection with proxy disclosures to shareholders, in violation of Section 14 of the Exchange Act.[4]

Third, the Court's task in this matter is not to decide who was deceived by the Defendants' misrepresentations. Many forms of misconduct—such as falsification of the books and records of a public company—are actionable under the securities laws without regard to whether anyone was deceived. *See, e.g.*, 15 U.S.C. § 78m(b)(2)(5); 17 C.F.R. § 13b2-1. Other forms of misconduct—such as insider trading—deceive one party (*e.g.*, the party from whom information was misappropriated) while victimizing another (*e.g.*, the trader on the other side of the transaction). Notably, fraud "in connection with" the purchase or sale of securities merely requires that fraud "coincide" with the purchase or sale of securities. *United States v. O'Hagan*, 521 U.S. 642, 656 (1997). To be actionable, fraud does not have to be perpetrated ***against*** the person who purchased or sold the security. *Id.* And other types of misconduct—such as corporate embezzlement and other forms of undisclosed fiduciary breach—deceive many different parties, such as the board of directors of the victim, shareholders, bondholders, regulators, and the public.

Instead, the Court's task in this matter is to determine the appropriate beneficiary of the funds surrendered by the Defendants under traditional equitable principles. As *Liu* emphasizes, the Court's authority to grant equitable relief is circumscribed, not enlarged, by Section 78u(d)(5) and must be confined to remedies available to the courts of equity under the common law. These principles mandate that funds misappropriated from VEREIT be restored to VEREIT. That is particularly so given that the federal securities laws reflect a strong Congressional intent to protect

[4] The T3 Merger required approval by both ARCP and ARCT III shareholders, while the T4 Merger ultimately required approval only by ARCT IV shareholders—not ARCP shareholders. (Goldberg ¶ 5.)

public companies like VEREIT from management abuse and self-dealing through required disclosures of executive compensation and related party transactions, prohibitions on falsification of public company records, as well as provisions that expressly require managers to reimburse public companies—not their present or former shareholders—for various types of actual or potential corporate abuse. For example, Section 304 of the Sarbanes-Oxley Act requires the chief executive officer and chief financial officer of a public company to reimburse the company for any bonus or other incentive-based or equity-based compensation received over a 12-month period in the event that the company is required to restate its financial results in that period. 15 U.S.C § 7243. Similarly, Section 16 of the Exchange Act requires any director, officer or 10% owner of a public company to pay the company any short-swing profit that such person earns from buying and selling the company's equity securities within a 6-month period. 15 U.S.C § 78p(b).

C. The SEC's Proposed Distribution Plan is Not Fair and Reasonable

The SEC's proposed distribution plan must be rejected for the simple reason that it seeks to distribute funds misappropriated from VEREIT to parties other than VEREIT. As discussed above, the fact that certain shareholders of VEREIT may have been deceived by the Defendants' false contracts—as were many representatives of VEREIT—does not answer the question of whether they are equitably entitled to funds misappropriated from VEREIT. Under no potentially applicable equitable doctrine are the shareholders designated by the SEC entitled to an award of these funds. Notably, the SEC offers no basis for the Court to pierce the corporate veil and ignore the distinction between VEREIT and its shareholders. And, even if there were a proper basis to pierce the corporate veil, the SEC's plan of distribution could not possibly be sustained as a fair and reasonable exercise of equitable discretion.

As alleged, the Defendants misappropriated assets from VEREIT on the following dates: (1) February 28, 2013, when the Defendants awarded themselves OP Units as a purported incentive

fee and paid themselves millions of dollars for worthless or overvalued FF&E in connection with the closing of the T3 merger; (2) January 3, 2014, when the Defendants did the exact same thing in connection with the closing of the T4 merger; and (3) every month between February 28, 2013 and December 15, 2014, when the Defendants received monthly dividends on the OP Units that they misappropriated from VEREIT. (Goldberg Decl. ¶¶ 5, 23). Yet the SEC's proposed distribution plan does not seek to restore the misappropriated funds to the investors who held stock on the dates when the funds were misappropriated. Instead, in the interest of piggybacking off the class action distribution apparatus in a different case, the SEC proposes to award this money, on a ***pro rata*** basis, to those who ***purchased*** stock between February 28, 2013 (the closing date of the T3 merger) and October 28, 2014 (the date when VEREIT announced that it had discovered an overstatement of an earnings metric and that VEREIT's Audit Committee was conducting an internal investigation). But, even if the Court could ignore the separate legal existence of VEREIT—which it cannot—these investors would not be eligible recipients of VEREIT's funds under any fair and reasonable application of traditional equitable principles.

First, the SEC's proposed distribution plan entirely excludes longstanding investors who ***owned*** VEREIT stock at the times when the Defendants misappropriated funds from VEREIT but purchased those shares prior to February 28, 2013. Such investors were affected by the embezzlement just as much or more than those who purchased shares on a later date. For example, a shareholder who purchased in 2012, and then suffered a diminution in value of its shareholding because ARCP paid too much to acquire T3 (whether through excessive incentive awards or unsupported FF&E), would be harmed to the same extent as an investor who purchased in the merger itself. And such an investor would be harmed to a greater extent than an investor who purchased after the merger because the promote fees by then had already been paid to the

Defendants, the amount had been disclosed, and the price of ARCP stock impounded this information. The latter investor would pay a lower price reflecting that assets that once belonged to ARCP had been paid to the Defendants as an incentive fee.

Second, the *pro rata* distribution does not take account of the different amounts that were misappropriated from VEREIT over time. As described above, the amounts that the Defendants were required to disgorge under the Court's order in this matter represent the cumulative sum of amounts misappropriated from VEREIT over close to a two-year period, plus prejudgment interest. Not all the money was taken at one time. The dividends themselves were paid on a monthly basis during this period. Even if one were to ignore the separate corporate existence of VEREIT, therefore, the impact of the loss of these funds fell unevenly on shareholders at different times.

Third, although equitable entitlement to funds misappropriated from VEREIT should not turn on when the misappropriation was publicly exposed, the SEC's use of an October 28, 2014 cutoff date is arbitrary and indefensible. The SEC suggests that ARCP made a corrective disclosure prior to market open the next day. (Dkt. No. 42 at 5-6.) But the October 2014 Disclosure said nothing about the promote fees or FF&E that are at issue in this case. Instead, the October 2014 Disclosure identified specific accounting errors (unrelated to the promote fees or FF&E) that resulted in an overstatement of a REIT metric for income called "Adjusted Funds From Operation" or "AFFO" during the first and second quarters of 2014, an overstatement of AFFO by a total of four cents per share for the first half of 2014 (that is, instead of reporting 49 cents for the first half, ARCP should have reported 45 cents). (Goldberg Decl. ¶ 7.) ARCP also announced that certain of these errors were intentionally made and that its CFO and CAO had resigned. The Company disclosed that the Audit Committee was continuing its investigation as to prior periods but advised that "[n]othing ha[d] come to the attention of the Audit Committee that [led] it to

believe that there [were] any errors in the Company's previously issued audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013." (ARCP's From 8-K and Exhibits attached thereto filed on October 29, 2014 (attached to the Goldberg Decl. as Exhibit A) at Item 4.02.) The first time anything about the T3 and T4 mergers, the accompanying incentive payments or FF&E transactions, was mentioned was in the March 2015 Restatement. Even then, all that was disclosed was that: (1) ARCP, through its OP, had entered into agreements to acquire FF&E in connection with two mergers with affiliates for which "there was no evidence of the receipt and it could not support [its] value"; and (2) the Audit Committee's investigation identified payments by ARCP to its former manager (AR Capital) and affiliates that "were not sufficiently documented or that otherwise might warrant scrutiny" and the company was considering whether it had a right to seek recovery for such payments. *Supra* Background. It was not until the filing of this action in July 2019 that the particulars of the Defendants' allegedly wrongful conduct was exposed in the public realm.

CONCLUSION

VEREIT discovered the conduct charged in this case through an investigation by its Audit Committee and took prompt action, including referring the matter to the SEC. Under equitable principles, VEREIT is entitled to recovery of the funds misappropriated by its former managers through fraud and breach of fiduciary duty alleged by the SEC, along with any post-judgment interest that has been earned on these funds. Indeed, it is black letter law that funds misappropriated by faithless fiduciaries are deemed to be held in constructive trust for the benefit of the defrauded principal. *B.A.S.S. Grp., LLC* v. *Coastal Supply Co.*, No. CIV.A 3743-VCP, 2009 WL 1743730, at *7 (Del. Ch. June 19, 2009); *see also Adams v. Jankouskas,* 452 A.2d 148, 152 (Del.1982) ("[A] constructive trust . . . is imposed when a defendant's fraudulent, unfair or

unconscionable conduct causes him to be unjustly enriched at the expense of another to whom he owed some duty."); Caryl A. Yzenbaard, George Gleason Bogert, George Taylor Bogert, Bogert's The Law of Trusts and Trustees § 484 (June 2020) ("In order to deter fiduciaries from engaging in acts of disloyalty which are either injurious or dangerous to the beneficiaries . . . the courts often decree a constructive trust as to the property obtained by the disloyal conduct."). The fact that the Court has secured custody of the misappropriated funds as part of an action brought by the SEC does not change the analysis and certainly does not justify depriving VEREIT of the recovery of its own funds. To the contrary, as the Supreme Court made clear in *Liu*, the Court's authority in an action brought by the SEC to grant "any equitable relief that may be appropriate or necessary for the benefit of investors" does not create a new cause of action or alter the principles of equity. It merely allows the Court to exercise its traditional equitable authority to aid investors and public companies like VEREIT, which suffered vast harm as a result of the misconduct of its former managers. It cannot be that VEREIT will end up worse off for having brought Defendants' misconduct to the attention of the SEC than it would have been if it instead pursued its own action in equity to recover the misappropriated funds. And it cannot be that Congress intended its grant of authority to impose equitable relief in actions commenced by the SEC to be used as a means of stripping victims of the right to recover such misappropriated funds or as license for the SEC to redirect those funds to different parties. For the reasons set forth above, we respectfully submit that the Court should distribute to VEREIT the paid by the Defendants in disgorgement and prejudgment interest, plus any post-judgment interest that has been earned on these funds.

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