Honorable Thomas S. Zilly

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON

FIRST SOUND BANK, a Washington corporation,

Plaintiff,

v.

LARASCO, INC., a Washington corporation; LOUIS A. SECORD, JR., an individual; and RICHARD A. SECORD, an individual,

Defendants.

No. C09-0056 TSZ

FIRST SOUND BANK'S MOTION FOR WRIT OF ATTACHMENT AND PRELIMINARY INJUNCTION FREEZING ASSETS

NOTE ON MOTION CALENDAR: March 6, 2009

ORAL ARGUMENT REQUESTED

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PRELIMINARY STATEMENT

This Motion seeks an order preserving the Court's ability to order rescission at the end of this litigation. As explained herein, defendants defrauded plaintiff First Sound Bank when they sold it a business based on manipulated financial information and undisclosed illegal and unethical business practices. Under federal and Washington law, rescission is the appropriate remedy for the plaintiff in transactions as permeated by fraud as this one. If rescission is ordered, First Sound Bank will be entitled, among other things, to the return of the consideration it transferred the defendants in exchange for their tainted assets. To this end, First Sound Bank moves the Court to invoke under Federal Rule 64 Washington's prejudgment attachment statute and Federal Rule 65 to attach or freeze the assets that will be returned to First Sound Bank in the event of rescission.

By a separate motion noted for contemporaneous consideration, First Sound Bank is moving to expedite the case schedule to provide for trial within six months. Because this Motion provides background information relevant to both motions, First Sound Bank suggests that this Motion be reviewed before First Sound Bank's Motion to Expedite Trial.

I. INTRODUCTION

Plaintiff First Sound Bank ("FSB") is a commercial bank servicing the local business community. On March 1, 2008, FSB purchased from defendants substantially all of the assets of defendants' leasing business, Puget Sound Leasing Co. Inc. ("PSL"). PSL's owners, defendants Louis Secord and Richard Secord, persuaded FSB to purchase PSL by touting its extremely low delinquency rate (a key measure of a leasing company's lease quality), and by providing financial information reflecting the company's substantial assets and historic profitability. *See* Section II.B.2, *infra*.

On March 1, 2008, and after a period of due diligence and analysis of PSL's financial condition, FSB purchased substantially all of PSL's assets, including PSL's rights to payments under thousands of lease agreements, PSL's receivables, and the name "Puget

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Sound Leasing." In return for these assets, FSB paid defendants $4.5 million in cash, over $6 million in FSB stock, future compensation packages worth over $5 million, and other substantial benefits. *See* Section II.C, *infra.* After the asset transfer, the leasing business operated as FSB's "Puget Sound Leasing Division," and the Secords renamed their corporation (which held the transferred assets) as "Larasco."

In the months since the asset purchase, FSB has discovered that defendants intentionally manipulated their financial records and engaged in other illegal and unethical behavior to induce FSB to purchase their business. In the first quarter after the asset sale, FSB's new Leasing Division discovered, and was required to write off, over $2 million of delinquent leases that defendants had disguised as current at the time of the asset purchase. *See* Section II.E*, infra*. These bad debt chargeoffs for this single quarter amounted to almost 10 times what defendants had previously represented they charged off in the entire year before the asset purchase. *Id.* FSB soon also learned that most of the inventory of repossessed equipment PSL had sold it did not even belong to PSL—it belonged to other financial institutions (called Investor Banks) that had interests in leases originated by PSL. *See* Section II.F.3, *infra.* Similarly, $250,000 in receivables from lessees that FSB had purchased from PSL belonged not to PSL but to third-party brokers. *Id.*

The parties had originally contemplated that defendants Louis Secord and Richard Secord would manage FSB's new Leasing Division after the asset purchase. But by November 2008 it became clear to FSB management that it could not trust the Secords. Accordingly, FSB relieved them of all authority and posted FSB President Steve Shaughnessy to oversee the Leasing Division.

With the Secords absent from PSL's headquarters for the first time, long-time PSL employees began coming forward to FSB's Shaughnessy with shocking disclosures about fraudulent and illegal business practices the Secords had ordered them to undertake. *See* Section II.F, *infra.* The recently-discovered practices, which pervaded PSL's accounts, are

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described in declarations submitted herewith of the PSL employees who conducted the fraudulent practices at defendants' direction. These practices included: the posting of fictitious payments on PSL's accounting system and the use of other fraudulent accounting techniques to disguise defaulted leases, *see* Section II.F.1, *infra*; the fraudulent forfeiture of customers' security deposits for the purpose of creating millions of dollars of additional "income" to PSL, even when the customers' accounts were current and there was no basis for the forfeitures, *see* Section II.F.2, *infra*; and tax fraud and the illegal destruction of thousands of tax-related documents, *see* Section II.F.2.b, *infra.*

To place PSL's business practices in context, FSB has retained John Deane, a leading expert in the leasing industry. Mr. Deane has served as CEO of three leasing companies, as chairman of the leasing industry's national trade association, and has testified on leasing issues numerous times for the United States Department of Justice. Mr. Deane has identified ten separate practices of PSL that he concludes are "fraudulent," "egregious," and caused the overvaluation of PSL. *See generally* Declaration of John Deane.

Defendants' conduct violates federal securities laws and the Washington State Securities Act, and gives rise to common law liability for fraud, breach of contract and breach of fiduciary duty. *See* Section III.B and C, *infra.* These sources of liability provide FSB the right to rescind the asset sale. *See* Section III.E, *infra.* Because of the scope of the fraud and FSB's potential liability to third parties arising from defendants' activities, rescission is the only remedy that can protect FSB and make it whole.

Rescission will be possible only if the assets FSB transferred to defendants are available for return to FSB at the end of this litigation. There is reason to believe, however, that defendants are attempting to secrete these assets (including attempts to open a bank account in the Bahamas, a popular location for hiding money). *See* Section II.G, *infra.*

To preserve the Court's ability to order rescission at the end of the litigation, it is necessary to attach or freeze the assets FSB transferred to PSL while this matter is pending.

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Both Washington's prejudgment attachment statute, RCW 6.25, and Federal Rule 65 provide the Court with this authority. *See* Section III, *infra*. As shown below, FSB can more than satisfy the legal standards necessary for this relief.

II. BACKGROUND

A. First Sound Bank

First Sound Bank is a Seattle-based commercial bank. Decl. of Donald L. Hirtzel ¶ 2. FSB was founded in July, 2004 by its current CEO, Don Hirtzel, and its President, Steve Shaughnessy, two local bankers with extensive banking and finance experience. *Id.* ¶ 6-12. FSB serves businesses and organizations, particularly small and medium-sized businesses, professionals, and not-for-profit organizations. *Id.* ¶ 17. FSB is publicly traded and insured by the Federal Deposit Insurance Corporation. *Id.* ¶ 12.

FSB has been highly successful from the outset. Hirtzel Decl. ¶ 13. The bank's initial offering raised $20 million in start-up capital—the most equity ever raised by a startup bank in the Northwest. *Id.* In 2005 FSB turned its first profit, two quarters ahead of schedule, and its 2006 earnings were twice as high as expected. *Id.* FSB has gone from $20 million in initial equity to $43 million in equity, and from zero assets to $270 million in assets since it opened in 2004. *Id.* It is an important resource for local businesses, serving 1,200 customers with approximately $200 million on deposit. *Id.*

B. Puget Sound Leasing

Defendants Louis Secord and Richard Secord (the "Secord Defendants") founded Puget Sound Leasing Co., Inc. ("PSL") in 1985. Blair Decl. ¶ 3. On March 1, 2008, FSB acquired substantially all of PSL's assets, including the name "Puget Sound Leasing." The company formerly known as Puget Sound Leasing, Inc. was re-named Larasco. *Id*.

1. PSL's Leasing Business

Before FSB acquired its assets, PSL was in the business of originating and servicing equipment leases, typically to small businesses. Blair Decl. ¶ 4. PSL entered into leasing

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agreements with its customers under which PSL agreed to purchase the needed equipment and provide it to the customer. *Id*. In return, the customer agreed to make monthly payments to PSL and, at the at the end of the lease, to purchase the leased equipment for a "residual" payment. *Id*. PSL required its customers to provide it with a security deposit in the amount of two monthly lease payments. Steven M. Shaughnessy Decl. Ex. F (p. 80). The lease agreements provide that the security deposit will be returned at the end of the term if the lessee has made all scheduled payments. *Id*. The value of the average lease was about $30,000, and lease terms were typically three to five years. Blair Decl. ¶ 4.

After PSL originated leases, it packaged many of the leases into lease portfolios for banks, known as Investor Banks. Blair Decl. ¶ 5. FSB was one of PSL's eleven Investor Banks; other Investor Banks included Wells Fargo, Washington Federal and Bank of the West. *Id*. PSL sold the portfolios pursuant to "Program Agreements" between PSL and the Investor Banks. *Id*. ¶ 6. Under the Program Agreements, PSL would sell Investor Banks the payment streams (the right to collect the monthly lease payments) associated with the leases in the portfolio. *Id*. PSL retained the remaining rights under the leases, including the right to collect the residual payment at the end of the lease and the right to collect certain fees. *Id*. The Program Agreements provided PSL would continue to service the leases, collecting lease payments and forwarding them to the Investor Banks. *Id*.

2. PSL's Reported Delinquency Rate

A leasing company such as PSL can command favorable prices when it sells its portfolios to Investor Banks if the leasing company can demonstrate that the leases it originates are of high quality. Deane Decl. ¶¶ 4-5. Two important measures of lease quality are (1) the firm's delinquency rate (the percentage of leases that are delinquent at any given time), and (2) the value of its chargeoffs (nonperforming leases written off as bad debt). *Id*. If a leasing company has a low delinquency rate and low chargeoffs, Investor Banks will pay a premium to buy portfolios of the company's leases. *Id*.

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In marketing its portfolios to Investor Banks, including FSB, PSL emphasized that PSL's delinquency rate was very low. Blair Decl. ¶ 9. On numerous occasions, Louis Secord told FSB executives Don Hirtzel, Steve Shaughnessy and Jan Gould that PSL's delinquency rate was less than 1%. Hirtzel Decl. ¶ 37; Shaughnessy Decl. ¶ 16; Gould Decl. ¶ 3. In discussions during 2007 about purchasing lease portfolios, Louis Secord provided FSB management with an illustration showing that PSL's delinquency rate had been below 1% every month since late 2003—an extraordinary record. Shaughnessy Decl. Ex. A (p. 12). Similarly, Louis Secord told FSB on numerous occasions that PSL's chargeoffs were "insignificant." Hirtzel Decl. ¶ 37; Shaughnessy Decl. ¶ 17; Gould Decl. ¶ 3.

Louis Secord also boasted about PSL's accounting and management practices. Louis Secord told FSB that he and his brother were both former bankers (at Seattle-First National Bank), and that he served on the board of Issaquah Bank. Shaughnessy Decl. ¶ 18. Louis Secord told FSB management that PSL was "run like a bank" and "reported like a bank." Hirtzel Decl. ¶ 37; Shaughnessy Decl. ¶ 18.

C. FSB's Acquisition of PSL Assets

PSL underwent substantial growth over the period 2003 through 2007. Blair Decl. ¶ 10. In 2003, PSL originated about $30 million in new leases; in 2007 PSL's new lease originations increased to about $80 million. *Id.* Over the same period, PSL began looking for a buyer. *Id.* ¶ 11. PSL discussed a possible merger with, or acquisition by, Banner Bank and Columbia Bank, but neither transaction was consummated. *Id*.

FSB management had developed a favorable impression of PSL based on Louis Secord's past representations about PSL, particularly the quality of the leases PSL originated, and because the two companies had numerous business relationships: Richard Secord had served as an FSB board member since FSB's inception, PSL's former accountant served on FSB's board, and PSL was a banking client of FSB. Hirtzel Decl. ¶ 25; Shaughnessy Decl. ¶ 13, 15.

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In early 2007, FSB and PSL began to discuss a transaction under which FSB would purchase substantially all of PSL's assets, and Louis Secord would continue to run the leasing business as a division of FSB. Hirtzel Decl. ¶ 29. In the context of these discussions, PSL provided additional financial information to FSB, including PSL's 2006 audited financial statements and PSL's unaudited general ledger balance sheets. Gould Decl. ¶ 4, Ex. A, B (p. 11-76). Louis Secord reiterated that PSL had extraordinary lease quality, excellent profitability, a delinquency rate of less than 1% and chargeoffs that were "insignificant." Shaughnessy Decl ¶ 16-17; Hirtzel Decl. ¶ 37; Gould Decl. ¶ 3. In a May, 2007 letter accompanying PSL's 2006 financial statements, Louis Secord stated that PSL's 2006 delinquency rate was 0.29%, and chargeoffs for all of 2006 were only $229,000. Shaughnessy Decl. Ex. B (p. 14-15).

Using this information, FSB conducted an analysis of the potential economic benefit to FSB of purchasing PSL. Gould Decl. ¶ 8. FSB also hired McAdams Wright Ragen, an investment bank, to analyze the potential transaction. *Id.* ¶ 9. Based on these analyses, FSB management determined that acquiring PSL's assets would be highly profitable for FSB. Hirtzel Decl ¶ 34. On September 24, 2007, FSB, PSL and the Secord Defendants signed an Asset Purchase Agreement. Shaughnessy Decl. Ex. C (p. 17). Under the Asset Purchase Agreement, FSB purchased most of PSL's assets, including:

(1) PSL's "Held Portfolio" of leases (the leases whose payments streams had not been sold to Investor Banks), which were valued at $52 million in the transaction,[1]

(2) PSL's rights pertaining to most leases in PSL's "Sold Portfolio" (leases for which PSL had sold payment streams to Investor Banks), which included account receivables for residual payments and other fees in the amount of $3.8 million; and

[1] In addition to the monies paid to defendants, FSB paid $42 million to PSL's financing sources for a release of their interests in the Held Portfolio.

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(3) PSL's inventory of repossessed property, which PSL represented to be worth $476,513. *Id*. (p. 28-29). The assets not sold to FSB were retained in PSL, which was renamed "Larasco," and which is owned by the Secord Defendants. Blair Decl. ¶ 3.

The values of the transferred assets, as represented by PSL, were set out on a PSL balance sheet attached to the Asset Purchase Agreement. Shaughnessy Decl. Ex. D (p. 67). As part of the Agreement, defendants expressly warranted that this balance sheet, and all other information provided in connection with the transaction, was complete and correct. Shaughnessy Decl. Ex. C (p. 38-41). Defendants further warranted that they had no undisclosed liabilities, that they were in compliance with all of their contracts (including PSL's agreements with lessees), and all requirements of state and federal law. *Id*.

The Asset Purchase Agreement provided that, in exchange for the assets purchased by FSB, FSB would convey to PSL:

(1) 437,500 shares of First Sound Bank stock (valued at $6,278,125);

(2) $4,500,000 in cash;

(3) an agreement for FSB to make certain future "earnout" payments to Larasco (contingent upon the earnings of the purchased assets); and

(4) employment and consulting agreements with the Secord Defendants worth a total of $5 million. *Id.* (p. 31-32).

D. PSL's Accounting Conversion

The Asset Purchase Agreement's closing was conditioned on PSL upgrading its accounting system. Shaughnessy Decl. Ex. C (p. 45). Over the course of PSL's history, PSL had performed its day-to-day accounting functions, including its calculation of the delinquency rate, on a "non-transactional system" that lacked double-entry accounting and other safeguards against manipulation and fraud. Sutphen Decl. ¶ 5. While FSB had no reason at the time of the asset purchase to believe that fraud had occurred at PSL, FSB required the accounting upgrade to ensure the business would meet regulatory standards that

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would take effect when the business became part of a bank. Shaughnessy Decl. ¶ 24. Louis Secord assured Shaughnessy that neither the accounting upgrade nor the increased regulation would pose a problem because PSL was already "run like a bank." *Id*.

In November 1, 2007, PSL upgraded to a lease accounting system called InfoLease, which employs double-entry accounting and other safeguards against fraud. Sutphen Decl. ¶ 6. In its first month under the new system, PSL—which had reported a delinquency rate of less than 1% for 47 straight months—immediately saw its delinquency rate more than triple, from 0.82 % to 2.54%. Shaughnessy Decl. Ex. J (p. 101). When FSB President Shaughnessy asked Louis Secord to explain the spike in delinquencies, Louis Secord told him the new system's numbers were not correct, and the increase was a consequence of "inaccuracies" in the new system. Shaughnessy Decl. ¶ 26. Louis Secord similarly told FSB CFO Jan Gould that the new system was not generating accurate numbers. Gould Decl. ¶ 11. Shaughnessy and Gould believed Louis Secord because they had been involved in accounting conversions in the past and knew that accounting conversions often generate anomalous data for a period of time after the conversion. Shaughnessy Decl. ¶ 26; Gould Decl. ¶ 11. Based on these assurances, FSB allowed the asset purchase transaction to close on March 1, 2008. Shaughnessy Decl. ¶ 26.

E. FSB Discovers Undisclosed Delinquencies and Replaces the Secords.

After closing, FSB named Louis Secord as president of FSB's new Puget Sound Leasing Division ("Leasing Division") and appointed him to FSB's board. Shaughnessy Decl. ¶ 27. FSB management did not want to interfere in what they understood be a well-run business, so FSB planned to leave management of the Leasing Division to the Secords. *Id*. Developments over the following months, however, raised serious questions for FSB management about the integrity of the Secords and PSL's operations.

First, FSB's CFO, Jan Gould, discovered that payments made in March, 2008 to Investor Banks for payoffs and chargeoffs accrued in February exceeded the corresponding

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cash flows collected from lessees that month by approximately $1 million. Gould Decl. ¶ 12. The loss was the responsibility of PSL (not FSB) because it was incurred before closing. *Id.* ¶ 13. Larasco had reimbursed FSB only $447,000, leaving a shortfall of $400,000. *Id.* ¶ 12. Gould was concerned, both because the Secords had failed to disclose this, and because the $1 million shortfall was inconsistent with PSL's past reported performance: PSL had reported chargeoffs of only $229,000 for the entire year of 2006. *Id.* ¶ 13; Ex. A (p. 27). When Gould confronted Louis Secord with her finding, he initially refused to make up the shortfall. Gould Decl. ¶ 13. When other members of FSB management later raised the issue with Louis Secord, however, he agreed to reimburse FSB (although he later reneged). *Id.*

Then, in June or July 2008, after a review of the Leasing Division's performance for its first quarter as part of FSB, Gould made a startling additional discovery: about $2 million of leases on the Leasing Division's books were more than 180 days overdue and had to be charged off as nonperforming. Gould Decl. ¶ 15. The great majority of these leases had been delinquent at the time of the asset purchase, but PSL had not reported these as delinquent either at closing or in the four months following closing. *Id.* ¶ 14. Gould told Louis Secord that the Leasing Division was required to immediately charge off all accounts over 180 days overdue, as required by generally accepted accounting principles. *Id.* ¶ 15. When this was completed, the Leasing Division's second-quarter chargeoffs were $2,085,000—almost ten times PSL's reported chargeoffs for the entire previous year. *Id*.

The Secords did not dispute that the delinquent leases had to be charged off, and they initially told FSB management that they would take responsibility for the losses. Shaughnessy Decl. ¶ 28, 30. At an FSB board meeting, Louis Secord told the Board that he would "make the bank whole" for these losses. *Id.* ¶ 30. To reflect this commitment, the Secords and their business, Larasco, entered into an agreement (the "Clarification Agreement") on July 26, 2008, which stated that defendants would cover the losses associated with the delinquent leases. Shaughnessy Decl. Ex. E (p. 74). As part of the

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Clarification Agreement, FSB agreed to provide the Secords and Larasco a $2 million line of credit to help them finance the reimbursement. *Id*. (p. 75). The Secords have since disclaimed this commitment, however, contending the Clarification Agreement is unenforceable. [2]

F. FSB Discovers Defendants' Business Was Fraudulent.

FSB management began to have serious concerns about the Secords, despite their promises to cover the losses in the portfolio. In the fall of 2008, Louis Secord made various additional statements to FSB management it later learned were untrue. Shaughnessy Decl. ¶ 32. In late October, FSB management learned that Louis Secord had modified the September reports issued Investor Banks to remove information about delinquencies of more than 90 days in their portfolios. Shaughnessy Decl. ¶ 33. On November 19, 2008, having lost all trust and confidence in the Secords, FSB relieved both of them of authority for the Leasing Division. *Id.* ¶ 34. FSB appointed Steve Shaughnessy to act as the Leasing Division's president. *Id*.

Shortly after FSB removed the Secords, long-term PSL employees began voluntarily coming forward to members of FSB management with startling disclosures of blatant fraud by the Secords in the course of running PSL's business. These practices, which are summarized below, are thoroughly described in the declarations of employees Jennifer Wright, Theas St. Pierre, Tammy Kady, and Douglas Blair. FSB has also submitted the declarations of John Deane, a leading expert in leasing, and Paul Sutphen, a forensic accountant and fraud examiner. As explained by Mr. Deane, the practices described by the PSL employees are "not consistent with accepted equipment leasing/lending industry

[2] The Secords now contend the Clarification Agreement is void for want of consideration. In fact, the Clarification Agreement provided the Secords with a $2 million line of credit and a $500,000 adjustment they had requested to the value assigned to goodwill under the Asset Purchase Agreement. Shaughnessy Decl. Ex. E.

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standards," are "so egregious that [they] represent fraudulent business practices," and caused the overvaluation of PSL's assets and profitability. Deane Decl. ¶¶ 9-16.

1. Defendants Misrepresented the Quality of Their Leases.

a. Defendants Manipulated Their Delinquency Rate.

Jennifer Wright, PSL's Assistant Vice-President and Administration Officer, was the PSL employee principally responsible for accounting for PSL's delinquency rate. Wright Decl. ¶ 2. Ms. Wright summarizes PSL's practices as follows:

> Louis Secord, Steve Twidwell, and others regularly impressed upon me the importance to PSL's business of ensuring that the delinquency rate (the percentage of leases that were delinquent at any given time) shown on PSL's accounting reports was less than 1%. . . .
>
> During the period before FSB purchased PSL's assets, PSL manipulated its accounting records to artificially maintain a reported delinquency rate of 1% or lower. Louis Secord, Richard Secord, and Steve Twidwell regularly told me to take steps, which are specifically described below, that made delinquent leases on PSL's accounting system appear as if they were not delinquent, artificially decreasing the reported delinquency rate.

Id. ¶¶ 4-5. Ms. Wright's statement and the practices she describes are corroborated by her co-workers, Theas St. Pierre and Tammy Kady, who also performed accounting functions for PSL. St. Pierre Decl. ¶¶ 4-5; Kady Decl. ¶¶ 7, 10. The Secords ordered these employees to perform the following practices to artificially depress the delinquency rate.

Fictitious Payments: Beginning in about 1998, PSL management regularly instructed its accounting employees (Ms. St. Pierre and Ms. Wright) to post fictitious payments to lessees' accounts, falsely making it appear as if the leases were performing when, in fact, they were in default. Wright Decl. ¶ 7; St. Pierre Decl. ¶ 6; Kady Decl. ¶ 6. Ms. St. Pierre explains:

> Soon after Steve Twidwell joined PSL in about 1998, Mr. Twidwell told me to make an entry showing that a lease payment had been received, when in fact it had not. This made me uncomfortable because I believed it was wrong to make a false entry in the accounting system. Mr. Twidwell and I "butted heads" over this issue, but he insisted that I make the entry. I then raised this issue with Richard Secord, who directed me to Louis Secord. I told Louis Secord that I was not comfortable posting false payments on the system. Louis Secord told me that I should make the entry, and that if I

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> refused to do so, PSL "would find someone who would." I could not afford to lose my job, so I followed Mr. Twidwell and Louis Secord's instructions.
>
> After this incident, Mr. Twidwell would give me a list of accounts each month for which he wanted me to post payments, when in fact no payment had been received on the account. He referred to these accounts as "runoffs." I posted these false "runoff" payments each month until 1999, when Jennifer Wright took over a number of my responsibilities, including this one.

St. Pierre Decl. ¶¶ 7-8. This practice continued after Jennifer Wright replaced Ms. St. Pierre, and up until the time of the asset sale. According to Ms. Wright, "[o]n a monthly basis, Louis Secord or Steve Twidwell would tell me to post false payments to make delinquent accounts appear as if they were current." Wright Decl. ¶ 7. These fictitious payments were often posted to accounts where the client had gone bankrupt or dissolved, when it was clear that no further lease payments would in fact be received. St. Pierre Decl. ¶ 8; Wright Decl. ¶ 7. Posting these payments prevented the accounts from appearing as part of PSL's monthly delinquency rate. Wright Decl. ¶ 8.

***"Paid Ahead" Leases*:** PSL further suppressed its delinquency rate by using the proceeds of repossessed equipment to "fund" delinquent leases. Wright Decl. ¶ 21. Equipment leases are generally secured by the leased equipment. When the lessee defaults on a lease, leasing companies typically repossess, and then sell, the collateral. Deane Decl. ¶ 9. At this point, because of the default, lease accounting principles dictate that the defaulted lease be "charged off," *i.e.,* taken off the books, and the loss associated with the default recognized. *Id.* The proceeds of the repossessed property are used to offset the loss associated with the chargeoff. This accounting treatment accurately reflects that the lease is no longer performing, is unsecured, and is unlikely to produce future lease payments. *Id.*

Unlike other leasing companies, PSL used the proceeds from repossessions to make delinquent leases appear current on its books. According to PSL employee Tammy Kady:

> When a PSL customer defaulted on a lease, PSL acted quickly to repossess the leased equipment. PSL often applied the proceeds of the sale of the equipment toward future payments on the lease. This would prevent the account from appearing delinquent on PSL's monthly reports. The proceeds

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> from the repossession were sometimes sufficient to "fund" the lease payments for as long as two years, allowing PSL to prevent the account from appearing to be delinquent for that period of time. . . . PSL's practice of "paying ahead" leases misrepresented the status of defaulted, unsecured leases by falsely making them appear current.

Kady Decl. ¶¶ 8, 10; *see* Wright Decl. ¶ 21. Sometimes the collateral sale would generate enough money to make the account appear "current" for as long as two years after the lessee defaulted. Kady Decl. ¶ 8; Wright Decl. ¶ 21. FSB has now identified approximately $1.9 million worth of "paid ahead" delinquent leases that falsely appeared current on PSL's books at the time FSB purchased PSL's assets. Shaughnessy Decl. ¶ 29.

Applying Security Deposits to Delinquent Payments: PSL's lease agreements required customers to provide PSL with security deposits, typically in the amount of two monthly payments. Wright Decl. ¶ 9. Under PSL's lease agreements, PSL was entitled to forfeit the security deposits if the lessee defaulted on the lease. Shaughnessy Decl. Ex. F (p. 80). As Mr. Deane explains, "the appropriate and industry standard manner for dealing with such leases would be to report them as delinquent" and stop accruing income on the lease. Deane Decl. ¶ 12. The captured security deposit is used to offset the loss when the lease is charged off. *Id.*

PSL, however, used these security deposits to make delinquent accounts appear current. As explained by PSL employee Jennifer Wright, when an account became delinquent, "Steve Twidwell would direct me to cause the security deposit to be forfeited and applied to past due (delinquent) payments on the lease. This would prevent these leases from appearing as delinquent on that month's report." Wright Decl. ¶ 16; *see* St. Pierre Decl. ¶ 18. The effect was to "artificially and incorrectly inflate revenue" and "cause the misstatement of the actual delinquency and chargeoff performance." Deane Decl. ¶ 12.

Backdating Payments: PSL further reduced its reported delinquency rate by backdating lease payments received after their due date. PSL would leave its books open at the end of each month. Wright Decl. ¶ 23. Ms. Wright was instructed that, if an overdue

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payment was received during the first part of the following month, she should "backdate" the payment to make it appear as if the payment had been received on time. This prevented the account in question from contributing to that month's delinquency rate. *Id*.

"Extensions": PSL also disguised delinquent accounts by giving "extensions" to customers, sometimes without the lessee's request or knowledge. Wright Decl. ¶ 22. Louis Secord would instruct Jennifer Wright to "extend the terms of the lease by adding the delinquent payments onto the end of the lease." *Id.* "For example, if a lease set to terminate in January, 2010 was three months overdue, Louis Secord would instruct me to re-set the term to expire in April, 2010, effectively changing the status of the payment from an overdue payment to a payment due in the future." *Id.* This caused a further artificial reduction in the delinquency rate. Deane Decl. ¶ 16.

b. The Misrepresented Delinquency Rate Damaged FSB.

FSB would not have purchased PSL's assets had it known that PSL had manipulated its delinquency rate in these ways. Hirtzel Decl. ¶ 66; Shaughnessy Decl. ¶ 35. As explained in Sections II.B.2 and II.C, *supra*, PSL's low reported delinquency rate was a key factor in FSB's decision to purchase PSL assets, as well as in determining the price it would pay.

PSL's manipulation of its delinquency rate misrepresented the value of the purchased assets in at least two ways. First, understating the delinquency rate caused FSB to dramatically overvalue the quality of, and therefore undervalue the expected losses of, the leases it acquired in the asset purchase transaction. Deane Decl. ¶ 4. Second, understating the delinquency rate caused FSB to overvalue the profits it could expect to receive from selling lease portfolios to Investor Banks. The price a leasing company receives for a lease portfolio is based, in part, on its historical delinquency rate. *Id*. ¶ 5. In forecasting the profits it expected to receive from the asset purchase, FSB relied on PSL's historical delinquency rate and the premium PSL had received as a result of that rate when it sold

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portfolios in the past. Gould Decl. ¶ 10. The Leasing Division will not be able to realize the expected profits on these transactions because the delinquency rate, when properly disclosed, is substantially higher than was represented to FSB.

2. Defendants Misrepresented PSL's Profitability.

a. PSL Claimed Improperly Forfeited Security Deposits as Income.

PSL's lease agreements provided that PSL would return customers' security deposits to them at the end of the lease if the lessee had satisfied its lease obligations. Shaughnessy Decl. Ex F. However, Louis Secord (typically referring to these deposits as "our money") routinely caused customers to forfeit their security deposits—even where there was no basis for the forfeiture—as a way of increasing PSL's revenue. Wright Decl. ¶ 13. According to PSL employee Ms. St. Pierre, "Louis Secord's decision to forfeit a particular security deposit was based not on the status of the account, but on his judgment about how much additional income he wanted to generate in this manner." St. Pierre Decl. ¶ 15.

Near the end of each quarter, Louis Secord and PSL CFO Doug Blair would review PSL's financial performance for the quarter. Blair Decl. ¶ 12. Based on those results, Louis Secord would make a determination of how much income he wanted PSL to "earn" through the capture of security deposits. *Id.* As explained by Ms. St. Pierre:

> Louis Secord would ask me or someone in my department to print a report listing all of PSL's leases and the amount of the security deposit being held on behalf of each lessee. Louis Secord would then go down the list and make checkmarks next to the lessees whose deposits he wanted to forfeit.
>
> After Louis Secord finished making his selections of security deposits to forfeit, he would ask me or Jennifer Wright to add up the total amount of income that would be generated by his selection. After we told him the total, he would sometimes ask for the list back and select additional deposits to be forfeited. For this reason, it was my impression that Louis Secord had a goal in mind of the amount of income he wanted to generate through security deposit forfeitures.
>
> Once Louis Secord was satisfied with the amount of security deposits he had selected, he would instruct me or Jennifer Wright to cause the accounting system to forfeit the selected deposits, crediting them to PSL's income. Before we forfeited a security deposit, the security deposit would appear as a PSL liability because it was money owed to the lessee. After we forfeited

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> the security deposit, the security deposit would show as income to PSL for that quarter.

St. Pierre Decl. ¶¶ 12-14; *see* Wright Decl. ¶ 10-14.

Critically, however, many of the security deposits Louis Secord selected for forfeiture were not delinquent. Wright Decl. ¶ 11; St. Pierre Decl. ¶ 15. PSL generated a huge amount of income through this practice: forfeitures exceeded $1 million per quarter on multiple occasions, and reached as much as $1.4 million one quarter. Wright Decl. ¶ 14; St. Pierre Decl. ¶ 16. Ironically, at the same time it was improperly forfeiting deposits of this magnitude, PSL was boasting to Investor Banks that less than 1% of PSL's leases were delinquent. Shaughnessy Decl. Ex. A (p. 12); Blair Decl. ¶ 9.

PSL did not notify customers that it had forfeited their security deposits. Wright Decl. ¶ 15. Sometimes, however, customers would call PSL at the end of their lease term to find out why the deposit had not been returned. Jennifer Wright explains:

> PSL regularly received phone calls from customers asking why they had not received refunds for their security deposits. Steve Twidwell directed me and other PSL employees to tell the customer that an oversight had occurred and that we would issue the refund. However, Richard Secord, who was responsible for making out the checks, would generally not issue the refund unless the customer called two or three more times (a total of three or four calls) asking for payment.
>
> However, it was my experience that most customers whose security deposits had been incorrectly forfeited never called or otherwise asked for their deposits to be returned. Almost all of PSL's customers were businesses, and many were small businesses. Often, the representative of the customer responsible for entering into the lease was no longer employed by the customer by the time the lease concluded. For this reason, it was my observation that many of our customers did not know they were entitled to return of security deposits, and others simply forgot about the security deposits.

Wright Decl. ¶¶ 19-20; St. Pierre Decl. ¶ 19.

FSB never would have purchased PSL's assets if it had known that PSL was cheating its customers in this manner. Hirtzel Decl ¶ 66; Shaughnessy Decl. ¶ 35. PSL's improper capture of security deposits also caused FSB to overvalue the business because these improper revenues were reflected on the financial statements FSB used to assess the

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business's profitability. Deane Decl. ¶ 12(b). Furthermore, the Leasing Division, on a daily or near-daily basis, currently receives requests for the return of security deposits by customers with perfect payment records whose security deposits the Secords forfeited and removed from the company during their control of PSL. Kady Decl. ¶ 4. The Leasing Division is honoring these requests, at great expense to FSB. Shaughnessy Decl. ¶ 36.

Defendants' practices regarding security deposits have poisoned PSL's relationships with many of its customers. A major benefit FSB hoped to realize as part of the asset purchase was PSL's customer relationships, which FSB understood to be very positive. Shaughnessy Decl. ¶ 14. Because PSL's customer's were the same kind of small and medium-sized businesses served by FSB, FSB expected that PSL's relationships would translate into new customers for FSB. *Id.* As a consequence of PSL's security deposit practices however, PSL's salespeople have been told that PSL is regarded as having the "worst customer service in the industry." Olah Decl. ¶ 4. Accordingly, FSB will not gain the customers it had hoped to gain as a benefit of the transaction.[3]

b. Defendants Misrepresented the Tax Benefits of PSL.

In the discussions leading up to the Asset Purchase Agreement, Louis Secord told FSB management that PSL's contracts with its lessees allowed PSL to capture, for tax purposes, the depreciation associated with the equipment it leases. Shaughnessy Decl. ¶ 20. Louis Secord said, and FSB management believed, that this would provide a valuable tax benefit to FSB. *Id.* Since the asset purchase, however, FSB has discovered that PSL had knowingly accepted this tax benefit in violation of federal tax law and destroyed evidence of having done so.

[3] In addition, PSL's employees have recently disclosed that the Secords employed discriminatory lending and hiring practices, preferring not to lend to businesses owned by woman or minorities, and preferring not to hire minorities. Kady Decl. ¶ 23; St. Pierre Dec. ¶ 24. These practices (which breached PSL's warranty of compliance with federal and state laws) are particularly offensive to FSB, which would never have knowingly acquired a business employing discriminatory practices. Hirtzel Decl. ¶ 61.

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Under federal tax laws, only one party to a lease agreement (the lessor or the lessee) may take the tax benefit of depreciation associated with the leased equipment. Deane Decl. ¶ 14(e). Which party may do so depends on whether the lessee has a right to purchase the property at the end of the lease for a nominal charge. *Id.* If the lessee does have right to purchase the equipment for a nominal charge, the lessee is entitled to take the depreciation. *Id.* If the lessee does not have the right to purchase the equipment, the lessor is entitled to take the depreciation. *Id*.

PSL's lease agreements did not provide the lessees the right to purchase the leased equipment. Shaughnessy Decl. Ex. F (p. 80). But, at the time PSL lessees signed the lease agreements, PSL and the lessee executed a rider (a "Put Rider") stating that the lessee would purchase the leased equipment at the end of the lease term. Shaughnessy Decl. Ex. G (p. 85). PSL issued two types of Put Riders: "Dollar Put Riders" provided that the lessee would purchase the equipment for one dollar, and "FMV Put Riders" provided that the Lessee would purchase the equipment for fair market value. Wright Decl. ¶ 24.

Because Put Riders gave the lessees the right to take depreciation, their existence made it improper for PSL to take depreciation on the leased equipment. Deane Decl. ¶ 14(e). FSB recently learned that PSL "solved" this problem by ordering that all of the Put Riders be destroyed, leaving no evidence of them in the leasing files in case of an audit. As is explained in the Declaration of Jennifer Wright:

> In about 2001, I was told that PSL was concerned that the existence of the Put Riders could cause tax problems for PSL in the event of an audit. PSL held a "pizza party," where PSL employees went though all of the leasing files and pulled out the Put Riders. The Dollar Put Riders were destroyed, and the FMV Put Riders were given to Louis Secord, who maintained them in his office. It was my impression that Louis Secord wanted to keep copies of the FMV Put Riders because it was desirable to PSL to be able to require the lessee to purchase the leased equipment at fair market value at the end of the lease term.
>
> In the years following the "pizza party" described above, PSL continued to create and sign Put Riders when the customer executed lease documents. However, after the papers were signed (but before they were scanned and copied) the processing staff was directed to destroy the Dollar Put Riders

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> and give the FMV Put Riders to Louis Secord to keep in his office. However, members of the processing staff were uncomfortable doing so and, without the knowledge of PSL management, secretly maintained the Dollar Put Riders in their desks. I recently collected these riders and provided them to counsel for FSB.

Wright Decl. ¶¶ 25-26; *see also* St. Pierre Decl. ¶¶ 22-23; Kady Decl. ¶¶ 20-22.

FSB plans to continue PSL's practice of executing Put Riders (though not the practice of destroying them). Shaughnessy Decl. ¶ 38. However, in compliance with the tax laws, FSB will not receive the significant depreciation benefit represented by defendants in the sale.

3. PSL Misrepresented its Assets.

a. PSL Misrepresented the Value of its Right to Residual Payments.

Among the assets PSL sold to FSB was PSL's right to collect residual payments from lessees at the end of the lease term. PSL valued this receivable at $1,322,848 at the time of closing. Gould Decl. Ex. C (p. 79). FSB has discovered that PSL significantly overstated this receivable in two regards.

First, many of these residual payments were owed to brokers, not to PSL. While the residual payment PSL customers owed PSL were generally set at $1, some of PSL's brokers were authorized by PSL to collect an additional residual equal to 10% of the leased equipment from the customer at the end of the lease. Kady Decl. ¶ 17. This receivable belonged to the broker, but PSL accounted for broker residuals as if they were payments due to PSL. *Id.* FSB estimates that $250,000 of the residuals it purchased belonged to brokers. Shaughnessy Decl. ¶ 37.

Second, PSL improperly included "boosted residuals" as receivables. The Dollar Put Riders provided that, if the customer defaulted on the lease, the customer lost its option to purchase the equipment for $1, and that "any option to purchase, if offered by the Lessor, will be based on the fair market value of the equipment." Shaughnessy Decl Ex. G (p. 85). Under this provision, PSL had no legal entitlement to collect a fair market value residual at the end of the lease, and it was unlikely that it would do so because the lessee was in default.

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Nonetheless, at the time of the lessee's default, FSB would treat the "boosted residual" as immediate income, accounting for it as a receivable. Blair Decl. ¶ 13. As explained by John Deane, this practice "artificially and incorrectly inflat[ed] reported revenue" and "inflate[d] the total level of assets with accounts receivable." Deane Decl. ¶ 12(c)-(d).

b. PSL Misrepresented the Value of "Interim Rent" Receivables.

Another of the overvalued assets purchased by FSB was PSL's receivable for "Interim Rental," which PSL valued at $1,930,028. Gould Decl. Ex. C (p. 78). "Interim Rentals" reflected a charge for the period, usually 25 days, between the day the equipment was delivered and the day the lease term commenced. Blair Decl. ¶ 14. If the customer did not pay the "interim rent," payment, PSL usually did not try to collect the interim rental payment, instead tracking the debt and attempting to recover it at the end of the lease period. *Id.* PSL accounted for this payment as a receivable, leaving it on its books until the end of the lease period. *Id.* Under basic accounting principles, receivables are written off if they are not paid within a certain period of time, usually 180 days, of their due date. Deane Decl. ¶ 13. But because lease periods typically ranged from three to five years, PSL left "interim rent" as receivables for up five years instead of writing them off at 180 days. Blair Decl. ¶ 14. This practice "inflated" the value of PSL's receivables and overstated PSL's profitability. Deane Decl. ¶ 13.

c. PSL Misrepresented the Value of Its Repossessed Inventory.

Finally, PSL misrepresented the value of the repossessed property it was selling FSB. At the time of closing, PSL's balance sheet represented that PSL owned $476,513.90 in equipment that had been repossessed, denoted "Assets Held for Resale." Gould Decl. Ex. C (p. 72). In fact, $408,000 of these assets were either owned not by PSL, but by the Investor Banks whose portfolios includes the defaulted leases that had produced the repossessed property, or had been "double counted" because they were listed as lease assets elsewhere on PSL's financial statements. Gould Decl. ¶ 17.

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G. FSB Has Reason to Believe Defendants Will Secrete Their Assets.

As explained in Section III.A, *infra*, plaintiff is entitled to a writ of attachment regardless of whether defendants intend to secrete their assets. Nonetheless, the Secords' recent comments and actions suggest that they are attempting to do so.

On October 9, 2008, as tension between FSB and the Secords was growing, Richard Secord sent an email to FSB Operations Manager Dinah Quick asking her to prepare a letter to a bank in the Bahamas stating that Mr. Secord and his wife were customers in good standing of First Sound Bank. Quick Decl. Ex A. Secord told Quick that he wanted to open the account to "deposit a little money." *Id.* ¶ 3. The Bahamas is a well-known destination for secreting assets: the Internal Revenue Service and the Government Accountability Office have identified the Bahamas one of the principal offshore "financial privacy jurisdictions," and an investment firm specializing in offshore banking has identified the Bahamas as one of the four "best places to open an offshore account." Wilkinson Decl. Ex. A (Declaration of IRS Revenue Agent Barbara Kallenberg at 3) (p. 9-11); Ex. B (p. 54-56).[4]

Just a month after Richard Secord's inquiry about a Bahamian bank account, the Secords contacted an attorney seeking assistance in placing their multi-million dollar vacation home near Lake Chelan into trust. Shaughnessy Decl. Ex. C (p. 87). And, in early December, 2008, Richard Secord said to Don Hirtzel in a private moment: "Don, don't share this with anyone but, you know, I cannot lose everything over all of this." Mr. Hirtzel understood Mr. Secord to be communicating to him that Mr. Secord intended to take steps to protect his assets from FSB. Hirtzel Decl. ¶ 55.

[4] Revenue Agent Kallenberg's Declaration was submitted to the U.S. District Court for the Northern District of California in *In the Matter of the Tax Liabilities of John Does,* No. 5:05-cv-04167-PVT (N.D. Cal. 2005).

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III. AUTHORITY

A. FSB is Entitled to a Writ of Attachment if its Fraud or Contract Claims Have "Probable Validity."

Federal Rule 64 provides that "all remedies providing for the seizure of person or property for the purpose of securing satisfaction of the judgment ultimately to be entered in the action are available under the circumstances and in the manner provided by the law of the state in which the district court is held . . ." FSB therefore is entitled to the same prejudgment remedies it could seek in the Washington courts.

Under Washington law, a plaintiff is entitled to a writ of attachment if it demonstrates the "probable validity of the claim sued on" and if one of the ten statutory grounds for attachment is present. RCW 6.25.030 (statutory grounds); RCW 6.25.070 ("probable validity"). Grounds for attachment include fraud and breach of contract.[5] RCW 6.25.030(8), (10).

Prejudgment attachment is therefore available for at least four of FSB's claims: (1) securities fraud under the Exchange Act of 1934, (2) securities fraud under the Washington State Securities Act, (3) fraudulent inducement of contract, and (4) breach of contract. *Id.* Federal courts have employed state prejudgment attachment procedures in federal securities fraud claims. *Darrah-Wantz v. Brown*, 138 F.R.D. 20, 23-25 (D. Conn. 1991) (attaching defendants' assets under Connecticut prejudgment attachment statute after finding "probable cause" that plaintiffs' federal securities claims were valid).

Under Washington law, FSB is entitled to this writ of attachment if it can demonstrate the "probable validity" of its fraud or contract claims. RCW 6.25.070. When considering probable validity, the court "evaluates the chances of the plaintiff prevailing at trial." *Van Blaricom v. Kronenberg*, 112 Wn. App. 501, 506 n.8 (2002); *see also Orange*

[5] In addition to the fraud and breach of contract claims upon which FSB bases its request for writ of attachment, attachment is also appropriate under RCW 6.25.030(7) given defendants' apparent efforts to secrete assets. *See* Section II.G, *supra*.

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County v. Hong Kong and Shanghai Corp., 52 F.3d 821, 824 (9th Cir. 1995) (under California law, "probable validity" means "it is more likely than not that the claimant will obtain a judgment against the defendant on the claim."). As explained in sections III.B and C, *infra,* each of the four claims that can support attachment satisfies the "probable validity" standard.

FSB's motion also satisfies the attachment statute's procedural requirements. As required by statute, FSB is filing and serving a declaration stating it believes that a debt is due and that the writ is not being sought for an improper purpose. Hirtzel Decl. ¶ 75; *see* RCW 6.25.060. At oral argument on this motion, defendants will have the opportunity to show cause, if any, why the writ should not be issued. *See* RCW 6.25.070; *see also Rogowski v. Hammond*, 9 Wn. App. 500 (1973) (show cause hearing favored procedure before issuing writ of attachment); 1A Wash. Prac. § 51.25 (2008) (*Rogowski* "continues to the leading source of guidance for hearings on prejudgment writs").

B. FSB's Fraud Claims Have Probable Validity.

As described in Section II.F, *supra*, defendants' operation of PSL and sale of its assets were pervaded by fraud. To obtain attachment, FSB need only establish that it is more likely than not that it will prevail on one of its fraud claims against defendants. FSB submits, however, that the record FSB has presented demonstrates to a near certainty that FSB will prevail on all three fraud claims against defendants.

1. Elements of FSB's Fraud Claims

Securities Exchange Act: To prevail on a claim under Section 10(b) of the Exchange Act of 1934 and SEC Rule 10b-5, the plaintiffs must establish "(1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss." *In re Daou Systems, Inc.*, 411 F.3d 1006, 1015 (9th Cir. 2005); *see* 15 U.S.C. § 78j(b). "To prove transaction causation, the plaintiff must show that but for the fraud, the plaintiff would not have engaged

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in the transaction." *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1027 (9th Cir. 1999). "To prove loss causation, the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff." *Id.* A plaintiff need not "show 'that a misrepresentation was the *sole* reason for the investment's decline in value'" to establish loss causation. *Daou*, 411 F.3d at 1025 (quoting *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997)) (emphasis added by *Daou* Court).

Washington State Securities Act: WSSA's anti-fraud provisions make it unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." *Go2Net v. Freeyellow.com, Inc.*, 126 Wn. App. 769, 775; RCW 21.20.010(2). An undisclosed fact is material if there is a substantial likelihood that its disclosure would reasonably have been viewed as having "significantly altered the 'total mix' of information made available." *Guarino v. Interactive Objects, Inc.*, 122 Wn. App. 95, 114 (2004) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)). If a plaintiff establishes a material omission, a rebuttable presumption arises that the plaintiff relied upon the omission. *Id.* at 119.

Fraudulent Inducement: To prove common law fraud in Washington, the plaintiff must show that the defendant intentionally misrepresented a material fact with the intent that the plaintiff act upon the misrepresentation, and the plaintiff, lacking knowledge of the statement's falsity, relied on the statement and suffered damages. *Stiley v. Block*, 130 Wn.2d 486, 505 (1997). A contract is voidable as fraudulently induced when (1) there is an assertion or representation not in accord with the facts, (2) the assertion is either fraudulent or material, (3) the assertion was relied upon in manifesting assent, and (4) the reliance was

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justified. *Yakima County (West Valley) Fire Protection Dist. No. 12 v. City of Yakima*, 122 Wn.2d 371, 390 (1993).

2. FSB Has Shown That the Elements of the Fraud Claims are Satisfied.

As explained in Section II.F, *supra*, defendants made a series of misrepresentations and omissions about PSL's delinquency rate (*see* Section II.F.1, *supra*), its profitability (*see* Section II.F.2, *supra*), and the value of its assets and receivables (*see* Section II.F.3, *supra*). Most, if not all, of these misrepresentations could only have been intentional. FSB relied on defendants' misrepresentations in assessing the value of PSL's assets and in deciding to enter into the Asset Purchase Agreement. *See* Section II.C, *supra.* Had FSB known that PSL's true delinquency had been manipulated, or that it had defrauded its customers, Investor Banks, and the IRS, FSB would not have entered into the Asset Purchase Agreement. Hirtzel Decl. ¶ 66; Shaughnessy Decl. ¶ 35. Moreover, the misrepresentations caused FSB to substantially overvalue PSL. *See generally* Deane Decl.; Sutphen Decl. ¶¶ 8, 10. The Leasing Division's extensive chargeoffs and other out-of-pocket losses, have resulted in substantial economic loss to FSB. Gould Decl. ¶ 20.

C. FSB's Breach of Contract Claims Have Probable Validity.

To establish liability for breach of contract, the plaintiff must establish the existence of an enforceable contract, breach, and damages. *Lehrer v. DSHS*, 101 Wn. App. 509, 516 (2000). As described above in Section II.C, *supra*, defendants warranted, as part of the Asset Purchase Agreement, that (1) PSL's financial statements fairly represented in all material respect's the company's financial condition, (2) PSL had disclosed all the company's liabilities, (3) they had not provided FSB with any information containing untrue statements of material fact or omitted to state material facts, and (4) PSL was in compliance with all lease agreements and all state and federal law.

As established in Section II.F, *supra*, defendants breached each of these warranties: for example, their financial statements overstated their profitability and the value of their

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assets; they failed to disclose liabilities such as improperly-forfeited security deposits; they misrepresented their delinquency rates, and they had violated federal tax laws, as well as the lease agreements with their customers. Therefore, FSB has also established "probable validity" of its contract claims.

D. In the Alternative, FSB is Entitled to an Asset Freeze Under Fed. R. Civ. P. 65

Federal Rule 65 entitles FSB to essentially the same remedy as it is due under Rule 64 and the Washington attachment statute. Under Rule 65, this Court has authority to issue provisional remedies—including a freeze of assets—ancillary to its authority to provide final equitable relief. *Reebok Int'l, Ltd. v. Marnatech Enter., Inc.*, 970 F.2d 552, 559 (9th Cir. 1992); *see also United States ex rel. Rahman v. Oncology Assocs.*, 198 F.3d 489, 496-97 (4th Cir. 1999). FSB seeks rescission of the Asset Purchase Agreement as a remedy for defendants' violations of state and federal securities laws, their fraudulent inducement of the asset sale, and their breach of that agreement. Because rescission is an equitable remedy, this Court may freeze assets to preserve that remedy. *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 289 (1940).

As the Fourth Circuit noted in *Rahman*, when a plaintiff creditor asserts a cognizable claim to specific assets of the defendant, or seeks a remedy involving those assets, a court may invoke equity to preserve the *status quo* pending judgment if the preliminary relief furthers the court's ability to grant the final relief requested. *Rahman*, 198 F.3d at 496; *see also CSC Holdings, Inc. v. Redisi*, 309 F.3d 988, 996 (7th Cir. 2002) (upholding freeze on business and personal assets to preserve equitable remedy, even when plaintiff had alternative legal remedy). Indeed, the Supreme Court has held that a court may use its inherent equitable powers to freeze assets in a Securities Act claim for which the plaintiff seeks rescission. *Deckert*, 311 U.S. at 290.

In the Ninth Circuit, a party is entitled to a preliminary injunction "by demonstrating either (1) a combination of probable success on the merits and the possibility of irreparable

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injury or (2) that serious questions are raised and the balance of hardships tips sharply in its favor." *Textile Unlimited, Inc. v. A..BMH and Co., Inc.*, 240 F.3d 781, 786 (9th Cir. 2001). FSB has assembled clear and compelling evidence that defendants engaged in a massive, multi-faceted fraud both in running their business and selling that business to FSB. This record shows not only that FSB's claims against defendants have "probable validity," but that FSB is highly likely to prevail on the merits of those claims.

Moreover, FSB faces the possibility of irreparable injury if defendants are not ordered to preserve the assets they obtained through their fraud. It appears that defendants have already taken steps to shield those assets from recovery, opening an offshore bank account and taking steps to put their real property in trust. *See* Section III.G, *supra.* To preserve the equitable remedy to which FSB is entitled – rescission of the fraudulently induced Asset Purchase Agreement – this Court should freeze the assets defendants obtained by their fraud.

E. The Court Should Attach or Freeze the Assets Sufficient to Preserve a Rescission Remedy.

FSB will be entitled to rescind the Asset Purchase Agreement if it prevails on any of the four claims discussed in this motion. *Ah Moo v. A.G. Becker Paribas, Inc.*, 857 F.2d 615, 623 (9th Cir. 1988) ("[R]escission with prejudgment interest is often the remedy for violation of federal securities laws."); *Helenius v. Chelius*, 131 Wn. App. 421, 432 (2005) (under WSSA, "money damages are available only if the security cannot be recovered; in all other cases, rescission is the applicable remedy"); *Yakima County*, 122 Wn.2d at 390 (rescission available for fraudulent inducement of contract); *Mitchell v. Straith*, 40 Wn. App. 405, 410 (1985) (rescission available for material breach of contract).

FSB respectfully requests that the Court attach or freeze assets sufficient to preserve a rescission remedy. This includes all assets transferred to FSB in connection with the Asset Purchase Agreement, plus an allowance for additional out-of-pocket losses. *Ambassador Hotel*, 189 F.3d at 1031 ("Rescission reverses the fraudulent transaction and returns the

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parties to the position they occupied prior to the fraud."). *Glick v. Campagna*, 613 F.2d 31, 37 (3d Cir. 1980) (rescission includes return of assets plus "restitution so that the plaintiff would be in the same position he would have been had no sale occurred.")

The assets transferred to defendants as part of the Asset Purchase Agreement include 437,500 shares of First Sound Bank stock and $5,655,354 in cash.[6] Gould Decl. ¶ 18. In addition, FSB has to date sustained $2,904,260 in out-of-pocket losses, including payoffs to Investor Banks, security deposit refunds to customers, and acquisition fees associated with the Asset Purchase Agreement. *Id.* ¶ 20. Therefore, FSB seeks an order authorizing it to attach (a) 437,500 shares of First Sound Bank stock, and (b) assets equal to $8,599,614.

IV. CONCLUSION

FSB respectfully requests that its Motion for Attachment and Preliminary Injunction Freezing Assets should be granted.

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[6] This includes $4,500,000 in cash paid at the time of closing, $305,490 in earnout payments, $427,477 in connection with Richard Secord's consulting agreement, and $422,387 in connection with Louis Secord's employment agreement. Gould Decl. ¶ 18.