EFiled: Feb 08 2017 01:12PM EST
Transaction ID 60182624
Case No. 12843-VCL

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

B.E. CAPITAL MANAGEMENT FUND LP,	)	
Petitioner,	)	
	)	C.A. No. 12843-VCL
- against -	)	
FUND.COM INC.,	)	
Respondent.	)	

MEMORANDUM OF LAW IN SUPPORT OF RECEIVER'S MOTION TO EQUITABLY SUBORDINATE LOANS AND PREFERRED AND CLASS B SHARES TO CLASS A SHARES AND FOR ALTERNATIVE RELIEF

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Thomas Braziel, as receiver (the "Receiver") of Fund.com Inc. (the "Company"), by and through his undersigned counsel, submits this memorandum of law in support of his motion for an order equitably subordinating in right to payment from the receivership estate loans purportedly extended by Jason Galanis ("Galanis") to the Company and the Company's Class B and Preferred Shares to the Company's publicly traded Class A Shares, or alternatively, declaring the loans illegal and the loan instruments void under New York law. In support this motion, the Receiver incorporates the Affidavit of Jeffrey Chubak (the "Chubak Aff."), filed concurrently herewith.

PRELIMINARY STATEMENT

1. Galanis controlled the Company through his indirect ownership of its Class B shares. Galanis used that control to perpetrate a pump-and-dump scheme on holders of the Company's Class A Shares, which trade publicly under ticker symbol FNDM, between 2007 and 2011. He did this by causing the Company to issue fraudulent SEC filings stating that the Company owned fictitious assets, most notably a $20 million CD held at an Antiguan bank.

2. Galanis also caused the Company to file SEC filings confirming prior alleged advances by him to the Company as loans, and used those purported loans to improve his position within the Company's capital structure relative to Class A Shareholders by awarding himself 400,000 Preferred Shares with a very generous

$100 per share liquidation preference, in the event the Company's few non-fictitious assets were liquidated.

3. Following Galanis's successful execution of the pump-and-dump scheme, the SEC commenced an investigation into the Company. That investigation spawned a second SEC investigation into another pump-and-dump scheme perpetrated by Galanis, this one involving the stock of Gerova Financial Group, Ltd, a NYSE-listed public company that was also included in the Russell 2000 Index.

4. In 2015 the SEC and United States commenced civil and criminal actions against Galanis relating to the Gerova fraud. To pay, among other things, legal bills incurred in connection with the Gerova investigation and litigation, Galanis looted the Company of its few non-fictitious assets of any value, namely, the fund.com domain name (the "URL"), which it sold to a third party in a non-market tested private sale, for an amount far less than its stated purchase price, and proceeds of litigation against an ETF sponsor in which the Company owned a 60% interest, AdvisorShares Investments, LLC.

5. The Receiver filed this motion to obtain an order equitably subordinating the Class B and Preferred Shares and the loans, all vehicles through which Galanis perpetrated the fraud and breached his fiduciary duty as controlling shareholder. Such relief is needed to ensure the Receiver can make a distribution from AdvisorShares settlement proceeds (discussed below) to Class A Shareholders

once he is in a position to do so, notwithstanding the fact that the loans and Preferred Shares, all held by Galanis, stand ahead of the Class A Shares in the Company's capital structure, and the fact that the Class A and B Shares are pari passu in right to payment under the Company's charter. As alternative relief, the Receiver requests a determination that the loans are void and that no principal or interest is owed on account of the same.

BACKGROUND

I. THE COMPANY'S "BUSINESS"

6. The Company stated it was formed in September 2007 as a private Delaware corporation and capitalized with two principal assets: a $20 million CD held at an Antiguan bank and the URL, which it stated it purchased for $10 million in October 2007. (Form 8-K, Jan. 17, 2008, attached to the Chubak Aff." as Exhibit 1.)

7. The CD was fictitious, and was the main subject of the SEC's investigation, but the Company owned the URL.

8. The Company further stated that on January 15, 2008 it consummated a reverse merger with Eastern Services Holdings, Inc. (a public shell), which then changed its name to that of the Company. (*Id*.)

9. Post-merger the Company held itself out as a "provider of fund management products and risk management solutions that help financial advisors, wealth managers, institutions, and ultra-high-net-worth families create and manage

wealth" that also "offer[s] services and investment fund information to the mass market individual investor over the internet at www.fund.com." (Chubak Aff. Exhibit 2.)

10. In reality, the Company was just a holding company for financial services companies it purchased interests in, most notably AdvisorShares, an actively managed ETF sponsor it purchased a 60% stake of in October 2008 and which now has approximately $1.2 billion AUM, and the URL.

II. CAPITAL STRUCTURE

A. Loans; Preferred Shares

11. The Company stated it borrowed $2.5 million from Equities Media Acquisition Corp. Inc. "and/or" IP Global Investors, Ltd. pursuant to a Revolving Credit Loan Agreement and Revolving Credit Convertible Note, each dated August 28, 2009, which superseded a "revolving credit convertible note in the amount of $1,343,000 issued by the Company to IP Global … in April 2009" and a "Prior Note" in the amount of $325,000 and payable on demand issued by the Company to IP Global. (Form 8-K, Sept. 3, 2009, Chubak Aff. Exhibit 3 and Exhibit 4.)

12. Equities Media and IP Global are both owned and controlled by Galanis. (Chubak Aff. Exhibit 5.)

13. The Company also stated it entered into a Debt Restructuring Letter Agreement, dated December 28, 2009, pursuant to which it issued 400,000 Preferred

Shares to the lenders in consideration for a loan modification. (Form 8-K, Jan. 26, 2010, Chubak Aff. Exhibit 6.)

14. A Forbearance Agreement, dated April 8, 2014 signed by Galanis on behalf of IP Global and David Berke (a puppet purported director and officer appointed by Galanis, discussed below) on behalf of the Company ("Forbearance Agreement") states that as of February 6, 2014, IP Global held 395,000 of the foregoing shares. (Chubak Aff. Exhibit 7.) Equities Media presumably holds the remaining 5,000. (Form 10-K, April 23, 2010, Chubak Aff. Exhibit 8.)

15. The Company also stated it borrowed an additional $1 million from IP Global pursuant to a Secured Promissory Note, dated July 27, 2010. (Form 8-K, July 30, 2010, Chubak Aff. Exhibit 9.)

16. Pursuant to Section 2(d) of the Forbearance Agreement, in exchange for IP Global forbearing from enforcing contractual rights under the above-referenced notes (together, the "Loans"), the Company purportedly agreed to transfer to IP Global the URL (and all other domain names owned by it) in consideration for an additional 70,000 Preferred Shares.

17. In short, the Receiver's records reflect that all Loans and Preferred Shares were held by Galanis.[1]

[1] The corporate records in the Receiver's possession do not reflect the Loans were ever extended. Indeed, David Berke disclaimed knowledge of any bank account ever maintained by the Company, and IP Global acknowledged in a demand letter

B. Class A and B Shares

18. The Company's most recent Form 10-Q states it had 104,137,905 Class A Shares and 5,462,665 Class B Shares issued and outstanding. (Form 10-Q, May 24, 2010, Chubak Aff. Exhibit 11.)

19. The Company's amended charter provides Class A and B Shares are pari passu in right to payment, but that Class A Shares have one vote per share while Class B Shares have ten. (Form 8-K, Sept. 3, 2009, Chubak Aff. Exhibit 12.)

20. The Company's most recent Form 10-K (Chubak Aff. Exhibit 8) states the Class B Shares are beneficially owned by Equities Media and "Barry Feiner, Esq. as Escrow Agent," a known Galanis associate (*see, e.g.*, *Szulik v. Tagliaferri*, 966 F. Supp. 2d 339, 353 (S.D.N.Y. 2013); *Accordia Northeast, Inc. v. Thesseus Int'l Asset Fund, N.V.*, 205 F. Supp. 2d 176 (S.D.N.Y. 2002)), and stated as a risk factor "Class B holders … have significant influence over management and affairs and over all matters requiring stockholder approval … The Class B common shareholders are able to control the outcome of shareholder votes."

21. The Company subsequently effected a 120:1 reverse split of its Class A and B Shares. (Form 8-K, Oct. 1, 2010, Chubak Aff. Exhibit 13.) In addition,

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that "it was difficult to determine the precise amount due under the Loan[s] because of [the Company's] lack of executive support and financial management and poor recordkeeping." (Chubak Aff. Exhibit 10.)

Galanis filed a Form 4 purporting to reflect IP Global's exercise of its right to convert Loan debt into Class B Shares. (Form 4, Nov. 12, 2012, Chubak Aff. Exhibit 14.)

22. In short, the Receiver's records reflect that all Class B Shares are held by Galanis.

III. THE PUMP-AND-DUMP SCHEME

23. Galanis caused the Company to advertise its ownership of fictitious assets, such as a $20 million CD, as a means of marketing its Class A shares. (Chubak Aff. Exhibit 1.) Following disclosure of its ownership of the CD and other fictitious assets, the Class A Share price climbed as high as $546/share in July 2008.

24. The share price subsequently collapsed, and the Company later disclosed the CD was converted to an annuity issued by a British Virgin Islands insurance company. The Company later disclosed that the $20 million annuity may have to be written down by $15 million and that the Company's financial statements would have to be restated. (Form 8-K, Dec. 3, 2010, Chubak Aff. Exhibit 15.)

25. The Company never issued a restatement and has not filed a Form 10-K or Form 10-Q since May 2010. Thereafter, the Class A Share price fell as low as $.04/share.

IV. GALANIS LOOTS THE COMPANY'S FEW NON-FICTITIOUS ASSETS

A. Puppet Director #1 Commences AdvisorShares Litigation

26. In or about 2011, the Company's directors resigned or were terminated. Galanis then tried to install Robert Levin, then a student at Columbia College in New York, as the Company's sole director or officer, pursuant to a stockholder consent under 8 Del. C. § 228, dated November 10, 2011. (Chubak Aff. Exhibit 16.)[2]

27. That instrument was ineffective because, *inter alia*, the consent did not comply with the requirements of section 228.

28. Nevertheless, Levin signed attorney engagement letters with each of Stuart Gross and Benjamin Klein on November 10, 2011 and January 27, 2012, respectively, purporting to employ their respective law firms, which have since merged into Gross & Klein LLP, for the purpose of prosecuting litigation on behalf of the Company against AdvisorShares, whose AUM had by then grown substantially since the Company purchased its 60% interest in the same.

29. On February 1, 2012, Gross and Klein commenced an action against AdvisorShares, its manager, and its principal on behalf of the Company. (*Fund.com Inc. v. AdvisorShares Investments, LLC, et al.*, Index No. 650321/2012 (Sup. Ct. N.Y. Co.)).

[2] Levin also (unsuccessfully) attempted to terminate the Company's SEC filing obligations. (Chubak Aff. Exhibit 17, which was never filed.)

B. Puppet Director #2 Transfers the URL to Galanis

30. When Levin resigned two years later, Galanis subsequently tried to install an attorney/sports photographer named David Berke as the Company's replacement sole director and officer, by arranging for Levin to sign another written consent, and for Berke to sign a Board of Directors Services Agreement, dated March 6, 2014. (Chubak Aff. Exhibit 18 and Exhibit 19.)[3]

31. The attempt to install Berke was ineffective because, among other things, Levin had no authority to confer on Berke.

32. Promptly following his "appointment," Galanis instructed Berke to execute the Forbearance Agreement conveying the URL to IP Global and all other domain names owned by the Company in exchange for forbearing from exercising alleged enforcement rights under the Loans. Berke obliged. (Chubak Aff. Exhibit 7.)

33. IP Global subsequently flipped the URL to a third party without any market testing to raise cash to pay attorneys' fees owed to his attorneys in the Gerova investigation and subsequent criminal action, Murphy, Pearson, Bradley & Feeney, Inc., a Professional Corporation and law firm with three offices in California. The

[3] Berke also executed a "Side Letter" pursuant to which he indicated he expected to be paid a $5,000/month salary in cash for his "services," with $20,000 due on signing. (Chubak Aff. Exhibit 20.)

purchasers engaged Igloo.com Limited to market the URL. (Chubak Aff. Exhibit 21 and Exhibit 22.)

C. Puppet Director #2 Settles AdvisorShares Litigation and, at Murphy Pearson's Request and with its Assistance, Agrees to Pay Galanis's Legal Bill

34. On October 26, 2015, the parties to the AdvisorShares litigation entered into a Confidential Settlement Agreement and So-Ordered Stipulation, so ordered on October 26, 2015. Berke signed that agreement on behalf of the Company, and shared a copy with Galanis (but not any other shareholders, at Galanis's insistence). Pursuant to the settlement, AdvisorShares agreed to pay the Company a fixed amount in four installments, plus interest at the rate of 6% per annum on the later installments, with the "Installment 1 Payment" of $1.3 million due on or about March 12, 2016.

35. On February 29, 2016, Murphy Pearson sent Berke a letter demanding that he turn over the AdvisorShares settlement proceeds to satisfy the Company's purported indebtedness to IP Global. (Chubak Aff. Exhibit 10.) Then on March 10, 2016, Murphy Pearson e-mailed Berke a form of unanimous written consent for him to execute, purporting to authorize the disbursement of settlement proceeds to IP Global, together with "sample irrevocable payment instructions" to send to Gross & Klein LLP, as initial transferees of such proceeds. (Chubak Aff. Exhibit 23.)

36. On March 10, 2016, Berke sent Gross & Klein LLP purportedly irrevocable payment instructions (Chubak Aff. Exhibit 24) directing the firm to disburse $469,356.07 of the Installment 1 Payment to Murphy Pearson, for IP Global's benefit, and roughly $200,000 to himself, both individually and through an entity he established for the purpose of receiving settlement proceeds for himself (FNDM, LLC).

ARGUMENT

I. THE LOANS AND PREFERRED AND CLASS B SHARES SHOULD BE EQUITABLY SUBORDINATED TO THE CLASS A SHARES

37. The Loans and Preferred and Class B Shares should be equitably subordinated in right to payment from the receivership estate to the Class A Shares. As explained by the Supreme Court in *Pepper v. Litton*, 308 U.S. 295 (1939):

> A director is a fiduciary … So is a dominant or controlling stockholder … Their powers are powers in trust … Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein …
>
> As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence, these rules governing the fiduciary responsibilities of directors or stockholders come into play on allowance of their claims in bankruptcy, in the exercise of tis equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the

bankruptcy estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. In Taylor v. Standard Gas & Electric Co., 306 U.S. 307 … this Court held that the claim of Standard against its subsidiary … should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Similar results have properly been reached in ordinary bankruptcy proceedings. Thus, salary claims of officers, directors, and stockholders in the bankruptcy of 'one-man' or family corporations have been disallowed or subordinated where the courts have been satisfied that allowance of the claims would not be fair or equitable to other creditors.

And that result … is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitation on the part of the claimant. It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan …

At times equity has ordered disallowance or subordination by disregarding the corporate entity. That is to say, it has treated the debtor-corporation simply as a part of the stockholder's own enterprise, consistently with the course of conduct of the stockholder. But in that situation as well

> as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty … He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

Id. at 307-10.

38. Equitable subordination is appropriate here because Galanis used his control of the Company through his ownership of the Class B Shares to perpetrate a fraudulent pump-and-dump scheme on the Class A Shareholders and loot the Company of its few non-fictitious assets after the pump-and-dump scheme ran its course, in each case in violation of his fiduciary obligations and to the detriment of the Class A Shareholders.

39. Although *Pepper v. Litton* was a bankruptcy case, the Supreme Court made clear the doctrine is rooted in state law, and applies in receivership

proceedings. The state court origins of the doctrine are discussed at length by David Gray Carlson in The Logical Structure of Fraudulent Transfers and Equitable Subordination, 45 WM. & MARY L. REV. 157 (2004).

40. As noted by Professor Carlson:

> A close examination of Pepper v. Litton shows that the Supreme Court relied at least in part on state law in constructing the federal doctrine of equitable subordination. The reliance on state law antecedents strongly suggests that the Supreme Court viewed equitable subordination as already implicit in the state law at the time …
>
> The Court … emphasize[d] that equitable subordination was simply the ordinary exercise of equity powers. Equity is not limited to bankruptcy proceedings and so the Court conceived that it was simply adapting nonbankruptcy law to the context of bankruptcy liquidations.
>
> In further explaining the doctrine of equitable subordination, the Pepper Court wrote: "The applicable principal is that, where a corporation is so organized and controlled as to make it a mere instrumentality or adjunct of another, and the subsidiary becomes bankrupt, the parent corporation cannot have its claim paid until all other claims are first satisfied...." Immediately following this remark, Justice Douglas added: "The same result has been reached in equity receiverships." At least after Erie, equity receiverships arise under state, not federal, law. Hence, the Supreme Court itself recognized that the doctrine of equitable subordination was founded on state law principles.

Id. at 212-16 (emphasis added).[4]

[4] *See also Paradis v. Cariho-Exeter Credit Union*, C.A. No. 91-5773, 1992 WL 813551, at *4 (R.I. Sup. Ct., Prov. Co. April 2, 1992) ("The directors' further

41. That the relief sought by the Receiver would deprive Galanis of any right to payment from the receivership estate (*i.e.*, result in equitable disallowance) is irrelevant. As noted by Professor Carlson, the Supreme Court disallowed the claim at issue in *Pepper v. Litton* in the name of equitable subordination. 45 WM. & MARY L. REV. at 201 ("In Pepper, the Court permitted complete disallowance of X's claim, an act the Pepper Court called subordination. The legislative history to the Bankruptcy Code specifically endorses the disallowance remedy as a mode of equitable subordination"), citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977) ("Nor does this subsection [section 510(c), which codifies *Pepper v. Litton*] preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances"); *id*. at 210 ("the Supreme Court [found] res judicata [to be] no impediment to disallowance of X's claim under the name of equitable subordination").

II. ALTERNATIVELY, THE LOANS ARE USURIOUS AND SHOULD BE DECLARED VOID

42. If the Forbearance Agreement is treated as valid, as intended by Galanis, the Loans are usurious under applicable New York law. As a result, the Loans should be considered illegal, the Loan instruments should be considered void,

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argument—that they are being impermissibly and inequitably singled out by the Receiver—is untenable. Such heightened scrutiny of these claimants is warranted precisely because of their fiduciary positions").

and this Court should declare no debt is due and owing by the Company to the purported lenders (Galanis).

43. The Loans provide they are governed by New York law. The maximum per annum interest rate for a loan is 16% and 25% under New York's civil and criminal usury statutes. Gen. Oblig. Law § 5-501 (civil); Penal Law §§ 190.40, 42 (criminal). Notes providing for usurious loans are void, and borrowers under loans determined to be usurious are relieved of all further obligations to repay principal and interest. Gen. Oblig. Law § 5-511.

44. Section 6 of the Loans provides for default interest at the rate of 15% per annum, compounded monthly. Section 2(b)(i) of the Forbearance Agreement purported to amend the Loans to impose default interest retroactive to August 2009. The resulting effective interest rate far exceeds that permitted by New York's usury laws.[5] As a result, the Company has no obligation to repay principal or interest. *Giventer v. Arnow*, 37 N.Y.2d 305, 368-69 (1975) ("If the penalty for making a usurious agreement is loss of principal and interest it should not matter whether the illegal rate is boldly stated or indirectly arrived at by periodically compounding a legal rate").

[5] Murphy Pearson's letter (Chubak Aff. Exhibit 10) sent on IP Global's behalf to Berke acknowledges as much ("Pursuant to this literal reading [of Section 6], Default interest is therefore $27,034,000").

45. This is true notwithstanding the fact that the Loans include a savings clause purporting to reduce the relevant interest rate to the highest rate consistent with New York's usury laws, as such clause does not render the Loans non-usurious. *Bakhash v. Winston*, 134 A.D.3d 468, 469 (N.Y. App. Div. 1st Dep't 2015) (citing *Simsbury Fund v. New St. Louis Assoc.*, 204 A.D.2d 182 (N.Y. App. Div. 1st Dep't 1994)) (savings clause "does not make the subject note nonusurious").

CONCLUSION

The Loans and Preferred and Class B Shares should be equitably subordinated in right to payment from the receivership estate to the Class A Shares, or alternatively, the Loans should be declared illegal and void under New York law.

Dated: February 8, 2017

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