UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-v.-

COLLECTOR'S COFFEE INC., et al.,

Defendants.
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REPORT AND RECOMMENDATION

19 Civ. 4355 (VM) (GWG)

GABRIEL W. GORENSTEIN, UNITED STATES MAGISTRATE JUDGE

This lawsuit was brought by the Securities and Exchange Commission ("SEC") against Collector's Coffee Inc., d/b/a Collectors Café ("CCI"), and Mykalai Kontilai, the founder, President, and Chief Executive Officer of CCI, alleging that the defendants violated federal securities laws by defrauding investors. See Amended Complaint, filed November 4, 2019 (Docket # 134) ("AC").

Before the Court is CCI and Kontilai's consolidated motion "to dismiss, strike portions of, and enter judgment on the pleadings" of the Amended Complaint.[1] For the reasons stated below, the motion should be denied.

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[1] See Notice of Consolidated Motions, filed June 26, 2020 (Docket # 416); Memorandum of Points and Authorities in Support, filed June 26, 2020 (Docket # 417) ("Def. Br."); Declaration of James Vahl in Support, filed June 26, 2020 (Docket # 418); Memorandum of Law in Opposition, filed July 24, 2020 (Docket # 479); Consolidated Reply in Support, filed August 3, 2020 (Docket # 506) ("Def. Reply").

I. BACKGROUND

A. Procedural History

The SEC filed the original complaint in this action on May 14, 2019, and filed the amended complaint on November 4, 2019. Kontilai answered the Amended Complaint on March 6, 2020 (Docket # 241). CCI did not answer the Amended Complaint but instead stated its intention to file a motion to dismiss and strike portions of it. See Letter from Stanley Morris, filed May 19, 2020 (Docket # 339). Kontilai then announced that he intended to file a motion to strike and a motion for judgment on the pleadings asserting grounds similar to those raised by CCI. See Letter from Steven Sessa, filed May 30, 2020 (Docket # 355). The district judge then assigned to the case, Judge Schofield, directed the parties to file a consolidated motion. See Order, filed June 1, 2020 (Docket # 357). Judge Marrero was later assigned to the case and referred the motion to the undersigned for a report and recommendation. See Amended Order of Reference, filed December 10, 2020 (Docket # 711).

B. Allegations of the Amended Complaint

The following facts are taken from the Amended Complaint and assumed to be true for purposes of this motion.

Kontilai is the founder of CCI. AC ¶ 20. CCI was incorporated in 2007. Id. ¶ 22. CCI planned at the time "to build brick-and-mortar coffee houses at which collectors would congregate and have the ability to purchase collectibles." Id. However, around 2009, CCI decided to move away from this plan and focus on building an "online website for collectibles and an associated television show." Id. ¶ 23. To finance this venture, CCI sold "convertible promissory notes and Series A Preferred shares" between 2007 to 2013, raising $7.75 million. Id. ¶ 24. CCI raised money from April 2014 to December 2018 by selling "Series A Preferred

Shares and Series B Preferred Shares," along with "Series B Promissory Notes," collectively raising an additional $23 million. Id. It used at least "two different versions of a Private Placement Memorandum" to raise money from investors, one of which, used before and during 2014, described CCI's intent "to build coffee houses where collectors would meet." Id. ¶¶ 25-26. The other focused on CCI's social media plans (the "Social Media PPM") and was used from 2015 onwards. Id. ¶¶ 27-28.

While raising these funds, CCI and Kontilai "made numerous written and oral material [sic] false and misleading statements and omissions." Id. ¶ 29. Defendants told investors that CCI "would use investor funds to pursue its stated business plan," but in fact Kontilai made "personal use of [the investors'] money." Id. ¶¶ 31-32. Kontilai allegedly misappropriated "more than 25% of the money raised, including $6.1 million in cash" for "personal use." Id. ¶ 33. Kontilai took this money despite telling potential investors on multiple occasions that "he was not taking a salary or being compensated." Id. ¶ 36(a).

Kontilai also misrepresented his own investment in CCI. Id. ¶ 43. He told investors repeatedly that he "had personally invested $5 million" in CCI, but in fact never invested or loaned such an amount. Id. ¶¶ 44-46. He misrepresented the state of CCI's business by telling investors that "hundreds of dealers" had committed to sell "billions of dollars of inventory" on CCI's website, and that the dealers had signed 10-year contracts committing them to the enterprise. Id. ¶ 54. In fact, only three dealers had signed up by 2016, under 180-day long contracts that did not obligate them to sell inventory on the website, and "only three dealers had ever posted inventory" to the website by August 2018. Id. ¶¶ 55-56.

Kontilai further misrepresented the value of CCI's sole significant asset: two baseball contracts signed by Jackie Robinson. Id. ¶ 64. The Social Media PPM described the contracts as

having "been appraised at $36,000,000" and "likely to generate millions of dollars of additional cash flow upon its liquidation." Id. ¶ 65. CCI and Kontilai failed to inform investors that CCI owned only "a fraction of the Jackie Robinson contracts, was only entitled to a fraction of the proceeds . . . and the sale of the contracts was expected to be for far less than $36 million." Id. ¶ 66.

Kontilai concealed his misappropriation of CCI's funds by engaging in an elaborate scheme with an associate by which he transferred money to her bank account and then had her withdraw the same amount in cash, after which she would pass it along to him. See id. ¶¶ 83-94. The scheme at one point involved his associate buying gold bars online, which Kontilai picked up and then sold for cash. Id. ¶¶ 95-97. He further concealed this misappropriation by fabricating employment and loan agreements, which he produced to the SEC when they began investigating CCI. See id. ¶¶ 101-09.

When investors confronted Kontilai about his misrepresentations in 2015, Kontilai arranged for the investors' stock to be bought back for $50,000, conditioned on the investors agreeing that they would not contact any governmental body about CCI and Kontilai's actions. Id. ¶¶ 112-17. In 2017, two more investors filed suit against CCI alleging securities fraud. Id. ¶ 119. CCI and Kontilai settled their claims with an agreement that required the investors not to initiate any communications with the SEC. Id. ¶ 121. When the SEC contacted the investors' counsel, the SEC's attorneys were told that the agreement "prevented his clients from speaking to SEC staff voluntarily." Id. ¶ 126. Kontilai and CCI eventually sued the investors, alleging that they breached the agreement by speaking with the SEC. Id. ¶¶ 129-31.

After the SEC filed the original complaint in this case, Kontilai and CCI hosted a telephone meeting with investors on June 18, 2019. Id. ¶ 137. On the call, Kontilai disputed the

SEC's claims and asserted that the SEC had failed to subpoena all of CCI's bank records which would "show the money that I put in." Id. ¶ 140. He also claimed that a former employee of CCI had fabricated the employment agreement produced to the SEC, id. ¶ 143, and that CCI possessed "a massive intellectual property portfolio with close to 100 trademarks pending," id. ¶ 146. In fact, CCI had abandoned those applications a year earlier. Id. ¶ 147. Kontilai repeated his prior false claims about CCI's inventory, id. ¶ 148, and claimed that the Jackie Robinson Contracts could be sold once CCI's assets were unfrozen and the LA Dodgers agreed to the sale, while neglecting to mention that the Dodgers were contesting CCI's claim to the contracts, id. ¶¶ 150-51.

The amended complaint also alleges that Veronica Kontilai, Mykalai Kontilai's wife, had illegitimately received funds from CCI. Id. ¶ 158.

The amended complaint makes the following six claims: (1) CCI and Kontilai violated Section 10(b) of the Exchange Act, Rule 10b-5(b), by making fraudulent misstatements and omissions in connection with the sale or purchase of securities, id. ¶¶171-73; (2) CCI and Kontilai violated Section 17(a)(2) of the Securities Act through the same fraudulent misstatements and omissions, id. ¶¶ 174-76; (3) CCI and Kontilai's actions amount to a prohibited fraudulent scheme under Section 10(b) and Rule 10b-5(a) and (c), id. ¶¶ 177-79; (4) these same actions violated Section 17(a)(1) and (3), id. ¶¶ 180-82; (5) CCI and Kontilai's actions violated Rule 21F-17 of the Exchange Act, id. ¶¶ 183-85; and (6) Veronica Kontilai received funds traceable to CCI and Kontilai's violations, and those funds must be equitably disgorged, id. ¶¶ 186-89.

As for relief, the SEC seeks a judicial finding that CCI and Kontilai violated the securities laws, an injunction restraining them from further violations, disgorgement of any ill-

gotten gains acquired by CCI and the Kontilais, and civil monetary penalties against CCI and Kontilai. Id. at 40-41.

II. DISCUSSION

A. Standard Governing a Motion for Judgment on the Pleadings

The standard for analyzing a motion for judgment on the pleadings pursuant to Fed. R. Civ. P. 12(c) is identical to the standard for a motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6). See Cleveland v. Caplaw Enters., 448 F.3d 518, 521 (2d Cir. 2006).

A party may move to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) when the opposing party's complaint "fail[s] to state a claim upon which relief can be granted." While a court must accept as true all of the allegations contained in a complaint, that principle does not apply to legal conclusions. See Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009); Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007) ("[A] plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do.") (punctuation omitted). In other words, "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice," Iqbal, 556 U.S. at 678, and thus a court's first task is to disregard any conclusory statements in a complaint, id. at 679.

Next, a court must determine if the complaint contains "sufficient factual matter" which, if accepted as true, states a claim that is "plausible on its face." Id. at 678 (punctuation omitted). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully." Id. (punctuation omitted). "[W]here the well-

pleaded facts do not permit the court to infer more than the mere possibility of misconduct," a complaint is insufficient under Fed. R. Civ. P. 8(a) because it has merely "alleged" but not "'show[n]' . . . that the pleader is entitled to relief." Id. at 679 (quoting Fed. R. Civ. P. 8(a)(2)).

While a court typically examines only the allegations of a pleading on a motion to dismiss, "[d]ocuments that are attached to the complaint or incorporated in it by reference are deemed part of the pleading and may be considered." Roth v. Jennings, 489 F.3d 499, 509 (2d Cir. 2007).

B. Analysis of the Motion to Dismiss

CCI and Kontilai seek to dismiss the Amended Complaint's fifth claim for relief — CCI and Kontilai's alleged violation of Rule 21F-17 — as barred by the "litigation privilege," or alternatively as barred because Rule 21F-17 is invalid. See Def. Br. at 3-12, 17. They also make a number of arguments attacking the sufficiency of the pleading of the other claims.

1. 21F-17 Claim

The SEC's claim based on Rule 21F-17 revolves around CCI and Kontilai's settlement agreements with various investors in 2015 and 2017 that contained provisions that barred the investors from communicating with the SEC. See AC ¶¶ 110-11. The SEC claims that, by drawing up these agreements, and then trying to enforce them, CCI and Kontilai violated Rule 21F-17 of the Exchange Act, which prohibits any "person" from taking "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." 17 C.F.R. § 240.21F-17(a).

a. The "Litigation Privilege"

Defendants first argue that the 21F-17 claim is "barred by the litigation privilege" and must be dismissed. Def. Br. at 3. They cite to New York case law for the proposition that "statements made in the course of litigation are entitled to absolute privilege." Id. at 4 (citing Front, Inc. v. Khalil, 24 N.Y.3d 713, 718 (2015)). Eventually, however, they assert that this Court should "borrow law on the litigation privilege" from Nevada law instead. Id. at 7. In the end, they argue that the Court should recognize a federal litigation privilege that would "insulate litigants and counsel from collateral claims by the SEC over the settlement terms of litigation." Id. at 8.

As recognized by the cases cited in defendants' brief, see Def. Br. at 6-7, the "litigation privilege" doctrine has been used as a defense to state law tort claims -- nearly always in cases involving some form of defamation. See Front, Inc. v. Khalil, 24 N.Y.3d 713, 718 (2015) (defamation); Kelly v. Albarino, 485 F.3d 664, 666 (2d Cir. 2007) (defamation); In re Davis, 312 B.R. 681, 689 (Bankr. D. Nev. 2004) (defamation); Greenberg Traurig v. Frias Holding Co., 130 Nev. 627, 629-30 (2014) (adopting the "legal malpractice" exception to the litigation privilege, in case where defendants argued plaintiffs' "claims actually allege defamation, which the litigation privilege clearly bars"); Fink v. Oshins, 118 Nev. 428, 430 (2002) (defamation); Clark Cty. Sch. Dist. v. Virtual Educ. Software, Inc., 125 Nev. 374, 378 (2009) (defamation); Clark v. Druckman, 218 W. Va. 427, 435 (2005) (litigation privilege "generally operates to preclude actions for civil damages arising from an attorney's conduct in the litigation process" but "privilege does not apply to claims of malicious prosecution and fraud"); Maness v. Star-Kist Foods, Inc., 7 F.3d 704, 709 (8th Cir. 1993) (discussing whether attorney actions could result in liability for "a claim of intentional interference with contract"); Levin, Middlebrooks, Mabie,

Thomas, Mayes & Mitchell, P.A. v. U.S. Fire Ins. Co., 639 So. 2d 606, 608 (Fla. 1994) (extending privilege to cover "tortious interference with a business relationship"). While a federal court hearing a defamation action would apply an applicable state law litigation privilege to statements even if the statements were made during the course of federal court proceedings, see, e.g., NSB Techs., Inc. v. Specialty Direct Mktg., Inc., 2004 WL 1918708, at *4 (N.D. Ill. Aug. 20, 2004), defendants point to no case where the litigation privilege has been applied to bar a federal cause of action. In fact, case law holds that such an application is improper. See Steffes v. Stepan Co., 144 F.3d 1070, 1074 (7th Cir. 1998) ("A state absolute litigation privilege purporting to confer immunity from suit cannot defeat a federal cause of action.") (citing cases); accord Sorensen v. Polukoff, 2020 WL 1692815, at *4 (D. Utah Apr. 7, 2020) ("Several courts, including this one, have declined to apply state-law privileges to federal causes of action.") (citing cases); Equal Emp. Opportunity Comm'n v. Day & Zimmerman NPS, Inc., 265 F. Supp. 3d 179, 197 (D. Conn. 2017) (refusing to apply Connecticut privilege and writing that "courts in other circuits have found that the litigation privilege under state law does not protect parties from liability in lawsuits brought under federal statutes"). In the end, defendants point to no case in which a court has created a federal "litigation privilege" to bar a federal cause of action. They also provide no argument that such a privilege could be recognized. Thus, defendants' contention that the Rule 21F-17 must be barred by such a privilege is unfounded.

b. Application of Rule 21F-17

As noted above, Rule 21F-17 prohibits any "person" from taking "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." 17 C.F.R. § 240.21F-17(a). This Rule was promulgated

pursuant to the SEC's authority under Section 21F of the Dodd-Frank Act, codified at 15 U.S.C. § 78u-6. That section, entitled "Securities whistleblower incentives and protection," defined "whistleblower" as "any individual who provides . . . information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." Id. § 78u-6(a)(6). The section provides for an award system for whistleblowers who gave the SEC information resulting in a "successful enforcement" action by the SEC (id. § 78u-6(b)(1)). It also prohibits retaliation against whistleblowers by employers (id. § 78u-6(h)). The statute gave the SEC "the authority to issue such rules and regulations as may be necessary or appropriate to implement the provisions of this section consistent with the purposes of this section." Id. § 78u-6(j).

Defendants' argument regarding Rule 21F-17 is hopelessly unclear. While the heading of the section containing the argument asserts that the section addresses the SEC's "Rule Making Authority," Def. Br. at 8, the defendants' brief does not address the scope of that authority at all. The closest it comes is a single sentence in which it cites Chevron, U.S.A. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). But defendants cite Chevron only to say that "[g]enerally, a court should defer to a responsible executive agency's permissible construction of a statute where the statutory language is ambiguous or otherwise does not speak precisely to the question at issue." Def. Br. at. 9. Defendants' brief never even addresses whether the statutory language delegating rulemaking authority to the SEC is ambiguous. The defendants do not contest the notion that Congress left a gap to be filled when it delegated rulemaking authority to the SEC on the reporting of securities fraud. Thus, their brief fails to address the portion of Chevron that might actually apply here. That portion states:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the

> statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute

467 U.S. at 844-45; accord United States v. Mead Corp., 533 U.S. 218, 227 (2001); Catskill Mountains Chapter of Trout Unlimited, Inc. v. Env't Prot. Agency, 846 F.3d 492, 507 (2d Cir. 2017). The defendants' brief never cites to the "arbitrary, capricious, or manifestly contrary to the statute" standard and thus offers no case law or other legal argument to support the notion that the rule was improperly enacted. We do not reach the question of whether there may be arguments that the rule violated the applicable standard because defendants' brief fails to supply such arguments.[2] Accordingly, we assume arguendo that Rule 21F-17 was properly promulgated.[3]

The remainder of defendants' argument appears to be that the SEC has "wrongfully interpret[ed]" its rule as "granting it the power to forbid the waiver of the right to report alleged wrongdoing under the circumstances." Def. Br. at 9. But the SEC's "interpretation" of its rule is not at issue in this litigation given that a court owes no deference to the position taken by an agency in the course of litigation. See, e.g., Martin v. Occupational Safety & Health Rev. Comm'n, 499 U.S. 144, 156 (1991); Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 212 (1988). What is at issue, rather, is whether the conduct alleged in the complaint violates the text of the rule. Defendants do not deny that the literal text of the rule applies to the conduct alleged in the complaint. Instead, they argue that "settlement agreements are binding and enforceable,"

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[2] The brief also gives a history of the promulgation of the rule, Def. Br. at 11-12, but fails to cite to any case or other legal authority as to why that process was improper.

[3] Defendants' reply brief argues that the rule violates the First Amendment (see Def. Reply at 4-7). We decline to reach this argument as it was made for the first time in defendants' reply. See, e.g., Sabel v. Halsted Fin. Services, LLC, 2020 WL 6274986, at *6 n.3 (S.D.N.Y. Oct. 26, 2020); Fisher v. Kanas, 487 F. Supp. 2d 270, 278 (E.D.N.Y. 2007) (citing cases); Estate of Ungar v. Palestinian Auth., 451 F. Supp. 2d 607, 611 (S.D.N.Y. 2006).

Def. Br. at 10, and that the investors who settled with the defendants could properly "waive[] their right to report disputed allegations of wrongdoing for financial compensation to settle litigation," id. at 11. But the only legal principle cited by defendants that would actually invalidate a law or regulation is Article I, Section 10, Clause 1 of the United States Constitution, which provides that "[n]o state shall . . . pass any . . . Law impairing the Obligation of Contracts." See Def. Br. at 12. We reject the argument that this provision has any bearing on this case because "[t]he obligation of contracts clause does not, of course, apply to the federal government." Ames v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 567 F.2d 1174, 1179 (2d Cir. 1977); accord Union Pac. R. Co. v. United States, 99 U.S. 700, 718 (1878) ("The United States . . . are not included within the constitutional prohibition which prevents States from passing laws impairing the obligation of contracts . . . ."). We note, in any event, that the enforceability of a settlement agreement would have to give way to a valid law or regulation forbidding a particular provision of a settlement agreement. See, e.g., United States v. Bonanno Organized Crime Family of La Cosa Nostra, 879 F.2d 20, 28 (2d Cir. 1989) ("illegal agreements . . . have long been held to be unenforceable and void").

Accordingly, defendants' motion to dismiss the fifth claim should be denied.

2. "Particularity"

While confusingly framed, defendants make a number of arguments to support their contention that that the Amended Complaint lacks "sufficient allegations, with particularity, to make out any claim for relief against Collector's and Kontilai." Def. Br. at 17. In the course of their argument, defendants insist, without citation to authority, that the Amended Complaint must "tie the investments that it seeks to have disgorged" with a "particular misrepresentation or omission allegedly impacting that investment." Id. at 19. They also argue that the SEC's claims

should fail because the pleading does not "attribute the specific omission or misrepresentation made to any specific transaction or private placement," id. at 22, and that "risk disclosures in [private placement memoranda ("PPMs")] negate claims asserted in" the Amended Complaint, id. at 19.

With regard to the so-called "risk disclosures" contained in the PPMs quoted in defendants' brief, see id. at 19-22, this portion of the defendants' memorandum addressing this argument does not cite a single case and thus it is unclear what legal doctrine defendants are relying on. It is sufficient to say that nothing in the quoted portions of the PPMs (which largely warn investors of the riskiness of the investment in CCI) could relieve defendants of liability if the scheme to defraud alleged in the complaint is accepted as true.

With regard to the remaining points, defendants' arguments about a lack of "particularity" in the SEC's allegations call to mind the requirements of Fed. R. Civ. P. 9(b) — a provision they do not actually cite in their brief. Defendants do, however, cite to case law applying the Rule 9(b) standard. Thus, as defendants argue, Def. Br. at 26, a securities fraud complaint based on misstatements must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." Charles Schwab Corp. v. Bank of Am. Corp., 883 F.3d 68, 94 (2d Cir. 2018) (punctuation omitted). Defendants' reference to a lack of "nexus . . . between the alleged misrepresentations and the speaker or timing of the misrepresentation," Def. Reply at 10, appears to suggest that the SEC has failed to satisfy the "in connection with" element of 15 U.S.C. § 78j(b) as stated in the SEC's first and third claims for relief. See AC ¶¶ 172, 178.

The amended complaint, however, satisfies the Rule 9(b) standard and demonstrates that the misstatements were made "in connection with the purchase or sale of any security," as required to make out its claims. 15 U.S.C. § 78j(b). The AC repeatedly specifies which statements of Kontilai and CCI's were fraudulent, where and when the statements were made, and why the statements were fraudulent. See, e.g., AC ¶¶ 32d-e, 33, 36-38, 44-46, 49-50, 54-57, 65-68. The amended complaint contains numerous allegations that the misrepresentations were made in connection with solicitations to buy CCI securities. Id. ¶¶ 25-74. The "in connection with" requirement was explained in another case in this district, Nathel v. Siegal, 592 F. Supp. 2d 452 (S.D.N.Y. 2008):

> [T]he misrepresentations and omissions need not coincide precisely with a securities transaction. The Supreme Court has given the "in connection with" phrase a "broad interpretation" such that "it is enough that the fraud alleged 'coincide[s]' with a securities transaction." Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 84 (2006).

Id. at 463. The defendants in Nathel made the same argument defendants advance here: that the "complaint does not tie any of [defendant's] statements to any particular investment." Id. at 463 n.2. We reject the argument for the same reasons — namely, that the law simply does not require such allegations in order to state a claim of fraud. The SEC has alleged in detail numerous misrepresentations and omissions by Kontilai and CCI about the financial circumstances of CCI and has alleged that they raised money by means of those representations and omissions. There is no obligation to tie the misrepresentations or omissions to particular purchases.

Defendants also argue that the SEC failed to adequately allege scienter. Def. Br. at 29. The argument is hard to follow but appears to be premised on the notion that the Amended Complaint supposedly alleged "that Kontilai was entitled to no compensation," and since this "is implausible, so too is the AC's allegations of scienter." Id. The Amended Complaint does not

make such an allegation, however. The Amended Complaint alleges, among other things, that Kontilai told investors "he was not taking a salary or being compensated," that he was "very frugal and ha[s] not taken a dime of salary to date," and that he "had not taken a salary in over 10 years." AC ¶ 36. Contrary to defendants' argument that "none of these representations address other lawful compensation," Def. Br. at 29, Kontilai in fact represented that he was not "being compensated." AC ¶ 36a. It is a reasonable inference that he meant that he was not being compensated at all. Because the allegations reflect that Kontilai had in fact taken $6.1 million dollars of investor money for his own personal use, id. ¶ 82, and obviously knew he had done so, Kontilai knowingly misled investors. Thus, the complaint has plausibly alleged Kontilai's scienter — that is, that Kontilai acted with "intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

3. 17(a)(2)

Section 17(a)(2) of the Securities Act requires proof that the defendant "obtain[ed] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order make the statements made, in light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77q(a)(2). As the Second Circuit has held, "[t]he requirements for a violation of Section 17(a) apply only to a sale of securities but in other respects are the same as Section 10(b) [of the Exchange Act] and Rule 10b-5 [thereunder], except that 'no showing of scienter is required for the [Commission] to obtain an injunction under [Section 17] (a)(2) or (a)(3).'" S.E.C. v. Pentagon Cap. Mgmt. PLC, 725 F.3d 279, 285 (2d Cir. 2013) (quoting SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999)); accord SEC v. Honig, 2021 WL 276155, at *5 (S.D.N.Y. Jan. 27, 2021). Citing section 17(a)(2), defendants argue that the SEC has only alleged that "Collector's obtained money or property by

means of the alleged omissions," and that the Amended Complaint "must specify the causal connection between the misrepresentation and specific disbursements to Kontilai made 'by means of' such misrepresentations." Def. Br. at 30 (emphasis in original). They claim that the Amended Complaint does not do so, and thus the 17(a)(2) claim must be dismissed, citing SEC v. Burns, 1986 WL 36318, at *3-4 (S.D. Cal. February 19, 1986), for support. In Burns, the court found, following trial, that no violation of Section 17(a)(2) had been proven because there was "no evidence before this Court that Mr. Burns personally acquired money or property." Id. at *4. Burns is irrelevant, however, because Amended Complaint alleges that Kontilai himself obtained money as a result of his and CCI's fraud and describes in detail how he went about doing so. See AC ¶¶ 82-100.

Defendants also argue that the section 17(a) claim fails because it must "specify the causal connection between the misrepresentation and specific disbursements to Kontilai." Def. Br. at 30. But the same elements are required for suits under section 17(a) as for suits under section 10(b). See Monarch Funding, 192 F.3d at 308 ("essentially the same elements are required under Section 17(a)(1)-(3)" as under Section 10(b) and Rule 10b-5). Thus, for the same reasons that we rejected defendants' argument on causal connection as to section 10(b), we reject those arguments as to the section 17(a) claim.

Thus, the 17(a)(2) claim should not be dismissed.

4. Scheme Liability

In just two sentences, defendants argue that the Amended Complaint fails to allege "scheme liability" under Rule 10(b)(5). See Def. Br. at 30. Subsection "(b)" of Rule 10(b)(5) contains a provision that applies to misrepresentation or omission claims (10b-5(b)) that is separate from the two sections that apply to schemes to defraud (Rule 10b-5(a) and (c)). See 17

C.F.R. § 240.10b-5. Claims for "scheme liability" are "premised on deceptive conduct that is independent of misrepresentations or omissions." In re Mindbody, Inc. Sec. Litig., 489 F. Supp. 3d 188, 216 (S.D.N.Y. 2020). "[T]he three subsections of Rule 10b-5 are distinct, and courts must scrutinize pleadings to ensure that misrepresentation or omission claims do not proceed under the scheme liability rubric." In re Smith Barney Transfer Agent Litig., 884 F. Supp. 2d 152, 161 (S.D.N.Y. 2012).

Defendants sole argument consists of the following:

> The SEC may not simply invoke the word "scheme" to try to recast a "statement that is, in essence, a misrepresentation (or omission) claim under subsection (b) . . . as a claim under subsection (a) or (c) so as to evade the pleading requirements which apply in misrepresentation cases." . . . Scheme liability is "not a back door into liability for those who help others make a false statement or omission in violation of subsection (b) of Rule 10b-5."

Def. Br. at 30 (quoting Steed v. Warrior Cap., LLC, 2007 WL 1110757, at *5 (W.D. Okla. Apr. 11, 2007) and In re Parmalat Sec. Litig., 376 F. Supp. 2d 472, 503 (S.D.N.Y. 2005)). Defendants do nothing to apply this legal argument to the allegations of the amended complaint and thus their argument that it fails to allege scheme liability is rejected for this reason alone.

In any event, the SEC's case against CCI and Kontilai goes far beyond mere making of misrepresentations. Rather, the amended complaint alleges that Kontilai concealed his misappropriation of investor funds by a variety of devices, such as transferring money to his associate's bank account, which was then paid to him in cash, AC ¶ 84, and by having his associate buy gold bars with the transferred money which were then sold by Kontilai, id. ¶¶ 95-97. These allegations suffice to establish scheme liability under Section 10(b), Rule 10b-5(a) and (c), and Section 17(a)(1) and (3) as they are "distinct from an alleged misstatement." S.E.C. v. Kelly, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011).

In conclusion, defendants' motion to dismiss should be denied in its entirety.

C. Analysis of the Motion to Strike

Fed. R. Civ. P. 12(f) provides that "the court may strike from a pleading an insufficient defense or any redundant, immaterial, impertinent, or scandalous matter." "An allegation is impertinent or immaterial when it is neither responsive nor relevant to the issues involved in the action." Anderson v. Davis Polk & Wardwell LLP, 850 F. Supp. 2d 392, 416 (S.D.N.Y. 2012) (punctuation omitted). "Scandalous generally refers to any allegation that unnecessarily reflects on the moral character of an individual or states anything in repulsive language that detracts from the dignity of the court." Id. (punctuation omitted).

A motion to strike "on the ground that the matter is impertinent and immaterial" should not be granted, "unless it can be shown that no evidence in support of the allegation would be admissible." Lipsky v. Commonwealth United Corp., 551 F.2d 887, 893 (2d Cir. 1976). "Rule 12(f) should be construed strictly against striking portions of the pleadings on the grounds of immateriality, and if the motion is granted at all, the complaint should be pruned with care." Id. at 894. In general, "courts should not tamper with the pleadings unless there is a strong reason for so doing." Id. at 893; accord Slue v. N.Y. Univ. Med. Ctr., 409 F. Supp. 2d 349, 374 (S.D.N.Y. 2006) ("[m]otions to strike are generally disfavored and will not be granted unless the matter asserted clearly has no bearing on the issue in dispute") (quoting Zinaman v. USTS N.Y. Inc., 798 F. Supp. 128, 135 (S.D.N.Y. 1992)).

1. Disgorgement and *Liu v. Sec. & Exch. Comm'n*

Defendants argue that the SEC's request for disgorgement in the prayer for relief — which seeks disgorgement of "all of the ill-gotten gains," AC at 41 — is at odds with the Supreme Court's decision in Liu v. Sec. and Exch. Comm'n, 140 S. Ct. 1936 (2020). Def. Br. at 13. They thus move to "strike the third prayer for relief." Id. As one case held in denying a

motion to strike a prayer for relief, "motions to strike are generally disfavored and no prejudice to the Defendant will result from allowing the prayer for relief to stand." Strategic Growth Intern., Inc. v. RemoteMDx, Inc., 2008 WL 4179235, at *4 (S.D.N.Y. Sept. 10, 2008) (citing cases). The same is true here. The SEC's ability to obtain disgorgement will be limited by Liu and any other law applicable to its claim. There is no reason to tamper with the wording of the prayer for relief.

2. Allegations Made in Response to the SEC's Complaint

Defendants argue that the SEC's allegations about Kontilai's statements "after and in response to the SEC's Complaint" should be stricken because they were not "made in connection with the purchase or sale of a security or the offer of a security" and are therefore irrelevant. Def. Br. at 12. They further argue that including these statements in the Amended Complaint prevents Kontilai "from exercising his First Amendment right of free speech to rehabilitate his reputation." Id. at 13.[4]

The high standard for granting a motion to strike has not been met. As noted above, such motions should not be granted "unless it can be shown that no evidence in support of the allegation would be admissible." Lipsky v. Commonwealth United Corp., 551 F.2d 887, 893 (2d Cir. 1976) (punctuation omitted); accord Ainette v. Mkt. Basket Inc., 2021 WL 1022590, at *8 (S.D.N.Y. Mar. 16, 2021). Defendants have made no such showing. While Kontilai's statements, as alleged in the Amended Complaint, do not appear to relate to "the purchase or sale of a security," Def. Br. at 12, they are relevant to the issue of scienter. If Kontilai's statements to

[4] Defendants also argue that the allegations are "scandalous matters under Rule 12(f)," Def. Br. at 12-13, but make no attempt to explain how the allegations qualify as such, given that the standard is an allegation that "unnecessarily reflects on the moral character of an individual or states anything in repulsive language that detracts from the dignity of the court." Anderson,

the investors are shown to be false, they would demonstrate Kontilai's continued attempts to deceive investors.

As for defendants' claim that the inclusion of the allegations infringes upon Kontilai's First Amendment rights, id. at 13, Kontilai points to no case or legal principle that prevent a governmental entity from filing a complaint alleging that a person's words formed part of a violation of a federal statute. And it is well settled that the First Amendment does not prevent the Government from seeking to hold a defendant liable for speech constituting an element of fraudulent conduct. See, e.g., U.S. v. Stevens, 559 U.S. 460, 468 (2010) ("the First Amendment has permitted restrictions upon the content of speech in a few limited areas . . . long familiar to the bar . . . including . . . fraud") (punctuation omitted).

III. CONCLUSION

For the foregoing reasons, defendants' consolidated motion to dismiss and strike (Docket # 416) should be denied.

PROCEDURE FOR FILING OBJECTIONS TO THIS REPORT AND RECOMMENDATION

Pursuant to 28 U.S.C. § 636(b)(1) and Rule 72(b) of the Federal Rules of Civil Procedure, the parties have fourteen (14) days (including weekends and holidays) from service of this Report and Recommendation to file any objections. See also Fed. R. Civ. P. 6(a), (b), (d). A party may respond to any objections within 14 days after being served. Any objections and responses shall be filed with the Clerk of the Court. Any request for an extension of time to file objections or responses must be directed to Judge Marrero. If a party fails to file timely objections, that party will not be permitted to raise any objections to this Report and

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850 F. Supp. 2d at 416. This conclusory statement is accordingly rejected as unsupported by any actual argument.

Recommendation on appeal. See Thomas v. Arn, 474 U.S. 140 (1985); Wagner & Wagner, LLP v. Atkinson, Haskins, Nellis, Brittingham, Gladd & Carwile, P.C., 596 F.3d 84, 92 (2d Cir. 2010).

Dated: May 17, 2021
New York, NY

GABRIEL W. GORENSTEIN
United States Magistrate Judge