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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Consumer Financial Protection Bureau, Plaintiff, v. Morgan Drexen, Inc., and Walter Ledda, individually, and as owner, officer, or manager of Morgan Drexen, Inc., Defendants.	Case No. SACV13-01267 JLS (JEMx) **PLAINTIFF'S MEMORANDUM IN SUPPORT OF MOTION FOR SANCTIONS** **HON. JOSEPHINE L. STATON** **Final Pretrial Hearing Date: January 27, 2015** **Place: Courtroom 10-A (Santa Ana)**

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I. INTRODUCTION

Since the Bureau filed this action in August 2013, Defendants Morgan Drexen, Inc. ("Morgan Drexen") and Walter Ledda have engaged in all manner of delay and obfuscation to thwart this case.[1] They failed to produce documents, forcing the Consumer Financial Protection Bureau ("Bureau") to file a motion to compel.[2] Magistrate Judge McDermott granted that motion and ordered Defendants to produce responsive documents.[3] They violated that order. Magistrate Judge McDermott then issued another order requiring production.[4] Defendants violated that order, too. The Bureau then filed a motion seeking sanctions.[5] In response, Judge McDermott again ordered Morgan Drexen to complete its production and stated that the Court intends to impose monetary sanctions on Morgan Drexen.[6]

In response to the Judge McDermott's first order to produce documents, Morgan Drexen requested an extension of time.[7] It is now clear why. Instead of producing consumer files in a timely manner, as required, Defendants were busy manipulating evidence by: (1) creating bankruptcy petitions that did not exist at the time of the Bureau's document request and adding them to consumer files before producing the files to the Bureau; (2) altering bankruptcy petitions in consumer files that did exist at the time of the Bureau's document request by inputting information into the petitions to make it look like Morgan Drexen had performed more work on the petitions than it actually had prior to the Bureau's document request; and (3) altering log notes in consumer files to hide the fact that it had created and altered petitions prior to producing the files to the Bureau.

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[1] *See* Doc. No. 1.
[2] *See* Doc. No. 81.
[3] *See* Doc. No. 84.
[4] *See* Doc. No. 88.
[5] *See* Doc. No. 95.
[6] *See* Doc. No. 115.
[7] *See* Doc. No. 85.

Morgan Drexen's outrageous conduct is a flagrant contravention of the most basic rule of civil litigation – honest dealing under the Federal Rules of Civil Procedure – and constitutes fraud on the Court. Its actions were premeditated and performed with a bad faith intent to pervert justice. Such conduct warrants the most severe sanction. Accordingly, this Court should grant the Bureau's request for an order of default judgment against Defendants.[8]

II. STATEMENT OF RELEVANT FACTS

A. Procedural Background

On August 20, 2013, the Bureau commenced this action against Morgan Drexen and Walter Ledda.[9]

On February 25, 2014, the Bureau served Morgan Drexen with Plaintiff's First Request for Production of Documents to Morgan Drexen, Inc.[10] Document request 20 called for all documents for a random sampling of files for more than 450 consumers enrolled in a Morgan Drexen program between 2010 and 2014.[11]

In April 2014, after discussions with Morgan Drexen's counsel about the scope of document request 20, the Bureau proposed that Morgan Drexen produce 25 randomly selected consumer files from each fiscal quarter, from the third fiscal quarter of 2010 to the first fiscal quarter of 2014.[12] Morgan Drexen agreed to produce consumer files, but by May 19, 2014, it still had not produced any.[13]

On May 19, 2014, Morgan Drexen represented that it would begin producing documents immediately, but stated that it had not even begun to review any

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[8] The Bureau attaches a proposed order hereto as Exhibit A. The Bureau has submitted a Word version of the proposed order to the Court.

[9] *See* Doc. No. 1.

[10] *See* Ex. 1 of the Declaration of R. Gabriel D. O'Malley, dated January 23, 2015, ("O'Malley Decl."), attached hereto as Ex. B, at ¶¶ 3-4, Ex.1.

[11] *Id.*at 4, Ex. 1.

[12] *Id*. at ¶¶ 5-6, Ex. 2.

[13] *Id*. at ¶¶ 9-10, Ex. 4.

documents responsive to document request 20.[14] On May 22, 2014, Morgan Drexen represented to the Bureau that it would "take approximately thirty days" to redact consumers' names and identifying information from documents responsive to document request 20 and it could "roll files out" to the Bureau as the redactions were completed.[15] On May 24, 2014, Morgan Drexen stated it would produce the majority of the outstanding responsive documents–including consumer files–by the end of the month.[16] It stated that it would begin producing documents responsive to document request 20 in a "rolling production."[17] On May 27, 2014, the Bureau filed a Motion to Compel Discovery Responses.[18] At the time of the filing, Morgan Drexen still had not produced any documents responsive to document request 20.[19]

On June 3, 2014, Morgan Drexen notified the Bureau that is was concerned about its ability to produce metadata relating to documents responsive to document request 20.[20] Defense counsel stated, "from what I understand, the only metadata for pdf documents (the form in which consumer files were exported) are generally the date of creation of the document and the author."[21] Between June 3 and June 13, 2014, Morgan Drexen did not produce any documents.[22] On June 13, 2014, the Court ordered Morgan Drexen to complete its production of all non-privileged documents responsive to all document request by June 20, 2014.[23] On June 19, 2014, Morgan Drexen filed an *Ex Parte* Application seeking 3 ½ additional weeks

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[14] *Id*.
[15] *Id*. at ¶¶ 11-12, Ex. 5.
[16] *Id*. at ¶¶ 13-14, Ex. 6.
[17] *Id*.
[18] *See* Doc. No. 81.
[19] O'Malley Decl. at ¶ 15.
[20] *Id*. at ¶¶ 16-17, Ex. 7.
[21] *Id*.
[22] *Id*. at ¶ 9.
[23] *See* Doc. No. 84.

to respond to document requests 20 and 25.[24] On June 24, 2014, the Court denied Morgan Drexen's *Ex Parte* application, ordered Morgan Drexen to immediately begin producing documents on a rolling basis, and extended Morgan Drexen's time to respond to document requests 20 and 25 to July 7, 2014.[25] Morgan Drexen did not produce any consumer files between June 20, 2014 and June 23, 2014.[26] On June 24, 2014, the Bureau requested that Morgan Drexen immediately produce 401 consumer files that Morgan Drexen had represented to the Court that it had already reviewed and redacted.[27] Morgan Drexen did not produce any consumer files between June 24, 2014 and July 6, 2014.[28]

On July 7, 2014, Morgan Drexen made *some* of the responsive consumer files available on an File Transfer Protocol website for the Bureau's review, but did not produce 70 of the consumer files.[29] On July 11, 2014, counsel for Morgan Drexen represented that the company still had not produced all nonprivileged documents responsive to document requests 20.[30] On July 15, 2014, the Bureau filed a Motion for Litigation Sanctions.[31] On July 24, 2014, the Bureau filed a Supplemental Memorandum in Support of Its Motion For Litigation Sanctions, which noted that the consumer files produced by Morgan Drexen were incomplete.[32] For example, Morgan Drexen represented that every consumer's file contains a log sheet, which details actions Morgan Drexen took in connection with account—yet only some, but not all, of the consumer files that Morgan Drexen

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[24] *See* Doc. No. 85.
[25] *See* Doc. No. 86.
[26] O'Malley Decl. at ¶ 23.
[27] *Id*. at ¶¶ 22-23, Ex. 9.
[28] *Id*. at ¶24.
[29] *Id*. at ¶¶ 25-26, Ex. 10.
[30] *Id*.
[31] *See* Doc. No. 95.
[32] *See* Doc. No. 101.

produced contained log sheets.[33] Many files also contained an incomplete set of monthly statements, while some files contained no monthly statements at all.[34]

In an August 4, 2014 Order, Magistrate Judge McDermott recognized that Defendants had violated the Court's orders, ordered Morgan Drexen to complete its production, and expressed his intention to impose monetary sanctions on Morgan Drexen. [35]

B. Evidence That Morgan Drexen Altered Documents Responsive to the Bureau's Document Requests

Rita Augusta has been a Morgan Drexen shareholder of Morgan Drexen since its founding in 2007.[36] She currently owns roughly 4 percent of the company.[37] From 2007 until September 25, 2014, Augusta was a member of the Morgan Drexen's Board of Directors.[38] She was employed by Morgan Drexen from 2007 until November 2014, during which time she held different job titles.[39] From in or around 2010 to November 2014, Augusta was the company's Chief Operating Officer.[40] In that capacity, she oversaw the following departments at different times: Facilities, Mail Room, some portions of the Call Center, Processing, Human Resources, Client Services, Settlements, and portions of Preferred Creditors.[41] Augusta also often interacted with members of other departments that she did not directly oversee by providing advice and indirectly

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[33] *Id*.
[34] *Id*.
[35] *See* Doc. No. 115.
[36] Declaration of Rita Augusta ("Augusta Decl.") attached hereto as Exhibit C, at ¶ 3.
[37] *Id*.at ¶¶4-5, Ex. 1.
[38] *Id*. at ¶ 4.
[39] *Id*. at ¶ 6.
[40] *Id*.
[41] *Id*.

overseeing the work of these departments.[42] Augusta was a member of the Morgan Drexen Executive Committee from its inception, in or around 2009, to November 2014, when Defendant Ledda, after hearing of Augusta's concerns about the company, placed her on administrative leave without pay, effectively firing her.[43]

The Bureau spoke with Augusta for the first time in late December 2014.[44] In January 2015, Augusta informed the Bureau that, at some point in mid-June 2014, after the Court ordered Morgan Drexen to produce documents responsive to document request 20 and other requests, Jeffrey Katz, the company's Chief Legal Officer, called Augusta and told her that he needed help with the document production.[45] He then instructed Augusta to assign Morgan Drexen employees to work with a woman named Nancy Jin to review all of the consumer files that Morgan Drexen was going to produce to the Bureau that related to a consumer enrolled in either the dual program or the bankruptcy-only program.[46] Katz instructed Augusta and Jin to: (1) create bankruptcy petitions for the consumer if there was no petition in the consumer's file; and (2) add whatever information was available about consumers to bankruptcy petitions that were already in the files to make the petitions appear more complete.[47] Katz told Augusta and Jin that he wanted them do this because Morgan Drexen needed petitions to appear as complete as possible in order to make it seem like Morgan Drexen was actually performing bankruptcy-related work for consumers enrolled in the dual program.[48]

Katz told Augusta and Jin that the project had to be completed by July 3, 2014 so that Morgan Drexen could produce documents to the Bureau by July 7,

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[42] *Id*. at ¶ 7.
[43] *Id*. at ¶¶ 8, 9.
[44] O'Malley Decl. at ¶ 31.
[45] *Id*. at ¶ 9.
[46] *Id*. at ¶ 13.
[47] *Id*.
[48] *Id*.

2014.[49] At Katz's request, Augusta assigned Morgan Drexen employees to work with Jin on the assignment.[50] When the employees, known as "processors," worked on bankruptcy petitions to be produced to the Bureau, they back-dated the date on the petition to make it look like it had been created or modified at an earlier time.[51] For files that were closed, processors listed the last date an Automated Clearing House ("ACH") withdrawal had been made from the consumer's account as the date of the petition.[52] The Morgan Drexen database in which all documents relating to a consumer file are housed generates log notes that reflect, among other things, each time a Morgan Drexen employee creates or alters a document in a consumer's file.[53] To hide the fact that Morgan Drexen had created and/or altered bankruptcy petitions, Katz directed a Morgan Drexen employee and shareholder named Avi Gupta to delete or "suppress" entries in the log notes showing that Morgan Drexen had created or altered bankruptcy petitions after receiving the Bureau's document request.[54]

The newly created or altered petitions were placed on a shared drive to be bates numbered and were included as part of the consumer files Morgan Drexen produced to the Bureau in response to the Bureau's document request.[55] Walter Ledda was aware of the project to create and alter bankruptcy petitions prior to producing them to the Bureau.[56]

As soon as the Bureau learned of Morgan Drexen's spoliation, it began analyzing the metadata for the consumer files Defendants produced in this

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[49] *Id.* at ¶ 14.
[50] *Id.* at ¶ 16.
[51] *Id.* at ¶ 24.
[52] *Id.*
[53] *Id.* at ¶ 27.
[54] *Id.*
[55] *Id.* at ¶ 28.
[56] *Id.* at ¶ 23.

litigation.[57] Joe Calvarese, an e-law litigation support specialist at the Bureau, reviewed the metadata of bankruptcy petitions in 150 consumer files produced by Morgan Drexen in response to document request 20.[58] The metadata confirm that Morgan Drexen created huge numbers of bankruptcy petitions *after* the Bureau filed suit and *after* Morgan Drexen received the Bureau's document request.[59] In total, the Bureau found 222 petitions in the 150 consumer files it reviewed.[60] The metadata show that Morgan Drexen created 145 petitions between June 27, 2014 and July 3, 2014, just days before Morgan Drexen made a large production of documents that included the petitions.[61] Many of these petitions were for consumers who were no longer enrolled in a Morgan Drexen-supported program.[62]

On January 21, 2015, the Bureau contacted counsel for Defendants to discuss its concerns about Morgan Drexen's production of consumer files.[63] After this conversation, the Bureau sent defense counsel an e-mail in which it requested that defense counsel to provide any explanation Defendants had in response to the Bureau's concerns within 24 hours.[64] In response, Morgan Drexen provided a sworn statement by an employee named Linh Tran.[65] Tran's declaration – and defense counsel's explanation of it – does not contradict anything in Augusta's declaration and does not explain metadata inconsistencies. What it does show is that Morgan Drexen did not produce the documents requested in discovery.[66]

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[57] O'Malley Decl. at ¶ 23.
[58] *See generally* Declaration of Joseph Calvarese ("Calvarese Decl."), attached hereto as Exhibit D.
[59] *Id*. at ¶¶ 13-14.
[60] *Id*. at ¶ 8.
[61] *Id*. at ¶ 17; O'Malley Decl. at ¶¶ 25-26. .
[62] Calvarese Decl. ¶¶ 18-22.
[63] O'Malley Decl. at ¶ 32.
[64] *Id*. at ¶ 33, Ex. 13.
[65] *Id*. at ¶¶ 34-35, Ex. 14.
[66] *Id*. at ¶ 35, Ex. 14.

Rather, they used consumers' information in their possession to create bankruptcy petitions that did not previously exist. Defendants did not disclose that these petitions were recently created or that they were not created in the ordinary course of business.

Now that they have been confronted with evidence of spoliation, Defendants contend that the bankruptcy petitions produced were essentially just a vehicle for producing consumer information housed in their systems.[67] Tran states that Morgan Drexen chose to export consumer information into bankruptcy petitions and produce it that way because it was "the most accessible readable format for some of the information culled in connection" with consumers.[68] In other words, as explained by defense counsel, Morgan Drexen does *not* create bankruptcy petitions in the ordinary course of business for consumers. According to Tran, because the bankruptcy petitions for consumers were "generated in June or July 2014 . . . the metadata on the documents would show a creation date of June or July 2014; regardless of whether the consumer terminated his/her legal representation with the attorney(s)."[69]

The metadata contradicts Tran's statement. Sixty-eight of the petitions Morgan Drexen produced have a creation date in 2011, 2012, or 2013, not "in June or July 2014," as claimed by Tran.[70] If Morgan Drexen had created the petitions simply to export data to the Bureau, as Defendants now claim, then all of the petitions would have a creation date in June or July, 2014. They do not.

The metadata confirms Augusta's statements that Morgan Drexen created new petitions where none existed and updated existing but incomplete petitions. It also corroborates Augusta's testimony that Morgan Drexen employee Jeffrey Katz

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[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] Calvarese Decl., at ¶¶ 10-12, Ex.1.

told her that Morgan Drexen needed to make petitions it was producing appear as complete as possible in order to make it seem like Morgan Drexen was actually performing bankruptcy-related work for consumers enrolled in the dual program. Katz's interest in making petitions appear as complete as possible is clear when seen in the light of Morgan Drexen's statements to the Bureau in this litigation about the bankruptcy work it performs, and why, in Morgan Drexen's view, the work is a defense to the Bureau's TSR claim.[71] For example, in its response to Interrogatory 6, Morgan Drexen states:

- "Morgan Drexen accumulates all of the data necessary to file a bankruptcy petition."
- "After the data has been entered appropriately on the forms, Morgan Drexen employees upload the forms into the attorney's computer system, so the attorney can review the petition and make any changes he or she believes necessary."
- "While exceptions may apply, for the most part, Morgan Drexen employees do all of the work necessary to prepare the bankruptcy petitions at the outset of the engagement by the clients, so that the petitions can be sent to creditors giving the attorney a credible threat of filing bankruptcy to prevent further litigation efforts by creditors."[72]

[71] Though Defendants now seem to disavow their previous claims that they engaged in significant bankruptcy-related work by creating and populating bankruptcy petitions in the ordinary course of business, the Bureau notes that Morgan Drexen's previous trumpeting of their bankruptcy work ignores the actual definition of "debt relief services" in the TSR, which makes clear that, regardless of whether any bankruptcy-related work has been performed, Morgan Drexen can be held liable for charging up-front fees for any "program" that it represents will renegotiate, settle, or alter the terms of consumers' unsecured debts.

[72] O'Malley Decl. at ¶ 36, Ex. 15. In declarations submitted in opposition to the Bureau's motion for summary judgment, Ledda, Morgan Drexen employee Laura Wiegman, and Morgan Drexen-affiliated attorney Vincent Howard all parrot Morgan Drexen's interrogatory responses. *See* O'Malley Decl. ¶ 37, Ex. 16 (Excerpts of Ledda, Wiegman, and Howard declarations). Similarly, in depositions, Morgan Drexen employees repeatedly described the preparation and creation of actual petitions and state that there are specific Morgan Drexen

Tellingly, Defendants never stated that petitions they produced to the Bureau were not actual petitions created in the normal course of business until now, when faced with allegations of spoliation. The absurdity of Morgan Drexen's silence is made stunningly clear in the case of the Bureau's expert, Professor Katherine Porter, who reviewed petitions produced by Defendants and concluded that they were deficient. Defense counsel deposed Porter. Never once – not before, during, or after the deposition – did he inform the Bureau or Porter that the petitions she was opining about were not actually petitions at all, but rather simply "the most accessible readable format" for consumer data to be produced to the Bureau. The petitions were also presented as exhibits in the deposition of Vincent Howard, an attorney affiliated with Morgan Drexen. Again, defense counsel did not alert the Bureau that the deposition exhibits were not actual bankruptcy petitions that had been created in the normal course of business. And Morgan Drexen itself has listed petitions as trial exhibits.[73]

The documents attached to Augusta's declaration demonstrate that Defendants' position is not credible. They not only show that the bankruptcy petitions were created for this litigation, but that Morgan Drexen instructed its employees to insert past dates into the petition and use past versions of forms to create the appearance that they were contemporaneous to when the clients were paying for their services. For example, in the email attached as Exhibit 2 to Augusta's Declaration, Nancy Jin states that, when creating a petition to be produced to the Bureau, processors should select the petition form in use at the time of the last cleared Automated Clearing House ("ACH") payment by the

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employees called "petition processors" who input information from consumers into bankruptcy petitions. *Id*. at ¶ 38, Ex. 17 (excerpts of Katz and Walker depositions).

[73] *See* Doc. No. 240, Tr. Exs. 202, 738, 767, 852, 888, 895, 1028-1033, 1047, 1049.

consumer.[74] In that email, Jin specifically instructs the processor to "select the correct form based on the last cleared positive ACH" alongside a graphic showing the various petition forms. If Morgan Drexen was simply using the bankruptcy petitions as a vehicle to provide the Bureau with information, there would be no need to ensure that the petition form selected was in use at the time of the consumer's last ACH payment. The Exhibit also shows that processors were running means tests – *i.e.*, performing substantive bankruptcy-related work – and that Jin advised them on what time period to use, again, the last cleared ACH payment date.[75] This shows that Morgan Drexen was not just exporting existing data, as it now contends, but creating new information to be used in the bankruptcy petitions produced to the Bureau. Again, were the bankruptcy petitions merely a method of providing the Bureau with static consumer information – rather than an attempt to misrepresent the amount of bankruptcy work Morgan Drexen performs for consumers who are allegedly paying up-front fees for that work – there would be no need to ensure that the form used corresponded to the time period in which the consumer was enrolled in the dual program or to add new means test information for a consumer prior to producing his or her file.

When viewed collectively, the metadata and petitions confirm Augusta's testimony that Morgan Drexen was creating and/or inputting new information into petitions after the fact to show that it had performed bankruptcy work. The metadata and petition relating to consumer file number no. 2995694108 are an example. The metadata indicate that the consumer's bankruptcy petition was created on July 3, 2014.[76] The petition used is the B1 (Official Form), dated 12/11, in the Northern District of Texas. The petition contains information that is only applicable if the petition is intended to appear real, rather than a vehicle to export

[74] Augusta Decl. ¶ 18, Ex. 2.
[75] *Id.*
[76] Calvarese Decl., Ex. 1.

data to the Bureau.[77] For example, on the first page, Morgan Drexen checked a box indicating, "Full Filing Fee attached."[78] There are numerous places in the petition that show an electronic signature of an attorney named "Seth Crosland," and a redacted signature of the consumer. Morgan Drexen also performed a "Means-Test Calculation," in which it filled out the section entitled, "Part III. Application of § 707(b)(7) Exclusion," checked a box indicting, "The presumption does not arise," and entered, among other information, the "family income for the applicable state and household size," to determine that it was appropriate to check the presumption-does-not-apply box.[79] This work makes clear that Morgan Drexen did not simply use bankruptcy petitions to export consumer information—it manufactured bankruptcy petitions by doing substantive work after the Bureau requested consumer files.

III. ARGUMENT

A. Legal Standard For The Imposition of Terminating Sanctions

As this Court set forth in *Pringle v. Adams*, a court "can sanction a party who has despoiled evidence" under its "'inherent power . . . to levy sanctions in response to abusive litigation practices.'"[80] This Court's authority to sanction

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[77] O'Malley Decl., at ¶ 39, Ex. 18.

[78] *Id.*

[79] *Id.*

[80] *Pringle v. Adams*, Case No. SACV 10-1656-JST, 2012 WL 1103939, at *7 (C.D. Cal. March 30, 2012) (quoting *Leon v. IDX Sys. Corp.*, 464 F.3d 951, 958 (9th Cir. 2006)). A Court may also sanction a party who has despoiled evidence under F.R.C.P. 37, which allows for sanctions against a party that "fails to obey an order to provide or permit discovery." Fed. R. Civ. P. 37(b)(2)(A); *see also Leon*, 464 F.3d at 958; *Fjelstad v. Am. Honda Motor Co.*, 762 F.2d at 1337, 1337-38 (9th Cir. 1995).

defendants includes the power to impose terminating sanctions in response to abusive litigation practices.[81]

When choosing among possible sanctions, the Ninth Circuit has instructed district courts to consider the following factors: "'(1) the public's interest in expeditious resolution of litigation; (2) the court's need to manage its dockets; (3) the risk of prejudice to the party seeking sanctions; (4) the public policy favoring disposition of cases on their merits; and (5) the availability of less drastic sanctions.'"[82] In addition, "a finding of willfulness, fault, or bad faith is required" for a terminating sanction to be proper.[83]

As explained below, all five factors for determining sanctions weigh heavily in favor of imposing terminating sanctions in this case. There are few litigation practices as egregious as manufacturing, forging, destroying, and altering evidence. Defendants' actions threaten the integrity of our civil justice system and should not be taken lightly. The Court should therefore issue an Order of Default Judgment against Defendants in favor of the Bureau.[84]

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[81] *Pringle*, 2012 WL 1103939, at *10 (imposing dismissal sanction upon a party who destroyed electronic documents); *Leon*, 464 F.3d at 958 (imposing dismissal sanction upon a party who destroyed electronic documents).

[82] *Pringle*, 2012 WL 1103939, at * 7 (quoting *Leon*, 464 F.3d at 958 (citing *Anheuser–Busch, Inc. v. Natural Beverage Distribs.*, 69 F.3d 337, 348 (9th Cir.1995))).

[83] *Id*. (citation and internal quotation marks omitted).

[84] In addition to holding Ledda accountable for his own conduct, as set forth in the Augusta Declaration, it is appropriate for the Court to apply any sanction against Morgan Drexen to Ledda. On May 6, 2014, the Bureau served document requests on Ledda. O'Malley Decl. at ¶¶ 7-8, Ex. 3. Ledda's counsel, who also represents Morgan Drexen, stated to the Bureau that Mr. Ledda "has no personal documents that would not be included in the documents [Morgan Drexen] is producing" and did not produce any documents. *Id*. at ¶ 18. Ex. 8.The Bureau accepted this position on the understanding that Morgan Drexen would meet its discovery obligations and produce the documents the Bureau requested. Having chosen to rely on Morgan Drexen to produce documents Ledda is personally obligated to

B. Morgan Drexen's Intentional Destruction Of Evidence Warrants The Terminating Sanction Of Default Judgment

1. Uncontroverted Evidence Shows That Morgan Drexen Willfully Altered Consumers' Files

"A party's destruction of evidence qualifies as willful spoliation if the party has some notice that the documents were potentially relevant to the litigation before they were destroyed."[85] In this case, the declaration of former Morgan Drexen Chief Operating Officer and board member and current shareholder Rita Augusta makes clear that Morgan Drexen knowingly and intentionally altered consumer files prior to producing them to the Bureau. Morgan Drexen: (1) created bankruptcy petitions in consumer files where none existed before; and (2) added information to bankruptcy petitions in consumer files where some form of a bankruptcy petition already existed. Morgan Drexen then attempted to conceal its unlawful conduct by altering log notes in consumer files. The Declaration from Bureau employee Joe Calvarese corroborates Augusta's declaration. And, as noted above, Morgan Drexen's explanation of its production of bankruptcy petitions does nothing to undermine Augusta's testimony, emails corroborating her testimony, or the Bureau's metadata analysis – all of which show that Morgan Drexen manipulated evidence in this case.

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produce, Ledda must be held accountable for Morgan Drexen's failure even if the Court finds that Ledda was not aware of Morgan Drexen's bad faith conduct; Ledda should not be able to be to escape the conduct of a company of which he is the President, CEO, and the controlling shareholder – and over which, defense counsel concede at the summary judgment stage, "he is a control person." *See* Doc. No. 188, at 23.

[85] *Pringle*, 2012 WL 1103939, at * 7 (quoting *Leon*, 464 F.3d at 959) (citation and internal quotation marks omitted)).

2. Morgan Drexen's Alteration Of Evidence Is Highly Prejudicial To Plaintiff And Prevents A Rightful Decision In The Case

In assessing the risk of prejudice, the Court should consider "'whether the spoiling party's actions impaired the non-spoiling party's ability to go to trial or threatened to interfere with the rightful decision of the case.'"[86] Prejudice sufficient to support sanctions has been found where a party's withholding of evidence forced the opposing party to "rely on incomplete and spotty evidence" at trial (*Anheuser-Busch*, 69 F.3d at 354), or when the spoliation threatens "'to distort the resolution' of the case."[87] Some courts have observed, however, that prejudice is only an optional consideration when determining the appropriateness of default sanctions.[88] Where a party engages in "outrageous" destruction of evidence, a court is justified in imposing terminating sanctions even when the resulting prejudice from such destruction cannot be ascertained.[89]

Morgan Drexen's outrageous conduct is not only an affront to the Court, it is highly prejudicial to the Bureau. Defendants' entire defense to the Bureau's up-front fee claim relies on: (1) the existence of timely-created bankruptcy petitions in consumer files; and (2) those petitions containing information that allow Defendants to claim that they are performing some sort of bankruptcy work. As such, the Bureau has been seriously prejudiced by Defendants' after-the-fact

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[86] *Pringle*, 2012 WL 1103939, at * 9 (quoting *Leon*, 464 F. 3d at 959) (citation and internal quotation marks omitted).

[87] *Id*. (quoting *Leon*, 464 F.3d at 960).

[88] *See, e.g., Anheuser-Busch*, 69 F.3d at 353; *Halaco Eng'g Co. v. Costle,* 843 F.2d 376, 382 (9th Cir. 1988); *Leon*, 464 F.3d at 959 (finding that the relevance of destroyed documents cannot be clearly ascertained because the documents no longer exist); *In re Napster, Inc. Copyright Litig.*, 462 F. Supp. 2d at 1066 (N.D. Cal. 2006) ("District courts may impose sanctions against a party that merely had notice that the destroyed evidence was potentially relevant to litigation.").

[89] *Alexander v. Nat'l Farmers Org.,* 687 F.2d 1173, 1205 (8th Cir. 1982).

creation of bankruptcy petitions, alteration of bankruptcy petitions, and alteration of log notes to conceal their creation and alteration of bankruptcy petitions.

3. A Terminating Sanction Is An Appropriate Remedy In Light Of Morgan Drexen's Willful Spoliation

In *Pringle*, this Court recognized that case-terminating sanctions are an appropriate response to willful spoliation.[90] In that case, the defendant requested that this Court dismiss a copyright claim against him on the ground that the plaintiff destroyed hard drives that may have contained evidence about when the song that was the subject of the copyright claim was actually created.[91] Even though it was unclear whether the hard drives contained relevant information, the Court still found it appropriate to dismiss the case against the defendant due to the plaintiff's willful spoliation of evidence.[92]

Other courts have likewise ruled that default judgment is an appropriate remedy in response to willful spoliation. For example, in *Southern New England Telephone Co. v. Global NAPS Inc.*, 624 F.3d 123 (2d Cir. 2010), the Second Circuit upheld the district court's decision to grant a motion for a default judgment and impose liability in the amount of $5.89 million on all defendants jointly and severally. The court explained that defendants had "willfully violated the court's discovery orders," by, among other things, "failing to turn over records," "lying to the court about the inability to obtain documents from third parties," and "destroying and withholding documents that were within the scope of the court's discovery orders."[93]

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[90] *Pringle*, 2012 WL 1103939, at *10.

[91] *Id.*

[92] *Id.*

[93] *Id.* at 143; *see also Nat'l Hockey League v. Metropolitan Hockey Club. Inc.*, 427 U.S. 639, 643 (1976) ("[T]he most severe in the spectrum of sanctions provided by statute or rule must be available to the district court in appropriate cases, not merely to penalize those whose conduct may be deemed to warrant such a

In this case, Morgan Drexen manipulated evidence that it knew was relevant to this litigation and responsive to a pending document request. This outrageous conduct warrants the harshest sanction. A terminating sanction is also warranted in order to deter those who might be tempted to engage in similar conduct.[94] If a defendant knows that he or she can destroy or manipulate critical evidence, and that even if caught, he or she will be no worse off than if such evidence had not been destroyed or manipulated, there will be no incentive for any defendant to preserve relevant evidence.

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sanction, but to deter those who might be tempted to such conduct in the absence of such a deterrent."); *Phoceene Sous-Marine, S.A. v. U.S. Phosmarine, Inc.*, 682 F.2d at 806 (9th Cir. 1982) (noting "[i]t is firmly established that the courts have inherent power to dismiss an action or enter a default judgment to ensure the orderly administration of justice and the integrity of their orders[,]" but reversing entry of default because the deception was "peripheral" to the merits of the controversy); *Emerick v. Fenick Indus., Inc.*, 539 F.2d 1379, 1381 (5th Cir. 1976) ("[W]hen a defendant demonstrates flagrant bad faith and callous disregard of its responsibilities, the district court's choice of the extreme sanction is not an abuse of discretion."); *William T. Thompson Co. v. Gen'l Nutrition Corp.*, 593 F.Supp. 1443, 1456 (C.D. Cal.1984) (holding that default and dismissal were proper sanctions in view of party's "willful destruction of documents and records that deprived [the opposing party] of the opportunity to present critical evidence on its key claims to the jury"); *see also Combs v. Rockwell Int'l Corp*., 927 F.2d 486 (9th Cir. 1991) (affirming dismissal under the court's inherent power as appropriate sanction for falsifying a deposition), *cert. denied*, 502 U.S. 859, 112 S.Ct. 176, 116 L.Ed.2d 138 (1991); *Halaco Eng'g Co.*, 843 F.2d at 380 (reversing dismissal where alleged misconduct peripheral to merits of case, but observing, "[d]ismissal under a court's inherent powers is justified ... in response to abusive litigation practices ... and to insure the orderly administration of justice and the integrity of the court's orders."); *North Am. Watch Corp. v. Princess Ermine Jewels*, 786 F.2d 1447, 1451 (9th Cir.1986) (affirming dismissal of defendant's counterclaim under court's inherent power for concealing documents and violating court's discovery order).

[94] *Nat'l Hockey league*, 427 U.S. at 643.

4. Lesser Sanctions Are Inadequate To Punish Defendants Or Deter Other Parties From Engaging In The Same Conduct

The Court may terminate a case based on spoliation of evidence where: (1) less drastic sanctions would be inappropriate, (2) the Court implemented alternative sanctions before ordering dismissal, and (3) the Court warned the party of dismissal before ordering dismissal.[95]

As to the first criterion, lesser sanctions are not appropriate. No lesser sanction could both punish Morgan Drexen and deter others similarly tempted to manipulate and manufacture evidence. Because the case will be tried before Court, the remedy of fashioning a jury instruction in favor of the Bureau is inapplicable. Even if the Court were to fashion an instruction for itself, the Bureau would remain in the helpless position of dealing with trial exhibits that have been corrupted as it presents the evidence in this case. The Court could exclude Defendants from introducing any evidence that bankruptcy petitions were ever created for consumers, but this would allow Defendants to put on other defenses after falsifying evidence, a result that would neither sufficiently punish Defendants nor sufficiently deter others inclined to manipulate and manufacture evidence..

The second and third factors also counsel in favor of a default judgment. Morgan Drexen has already violated two Court orders in this case when they delayed producing the files they later corrupted. In response to the Bureau's request for sanctions, Magistrate Judge McDermott recognized that Defendants had violated his orders and indicated his intention to order monetary sanctions.

5. The Other Factors Favor Default Judgment

The public interest in expeditious resolution of litigation and the Court's need to manage its docket both favor the issuance of a default judgment. The only other factor to be considered is the public policy favoring disposition of cases on

[95] *Pringle*, 2012 WL 1103939, at *10; *Leon*, 464 F.3d at 960.

their merits. This factor will always weigh against terminating sanctions. However, it is not enough to preclude terminating sanctions where, as here, the other factors weigh so heavily in favor of such sanctions.[96] In this case, Morgan Drexen should not be able to avoid terminating sanctions because the situation it created prevents a decision on the merits.[97]

C. If The Court Determines That Terminating Sanctions Are Inappropriate, The Court Should Still Sanction Morgan Drexen

Morgan Drexen's conduct strongly supports an order of default judgment. However, if the Court is inclined to issue lessor sanctions, the Bureau requests the following.

1. The Court Should Conclude That Morgan Drexen Provides "Debt Relief Services" as defined in the TSR

Morgan Drexen has engaged in the highest form of fraud on the government and the Court by manipulating documents and then attempting to use them as a defense. For this reason, it would be appropriate for the Court to find that Defendants' "dual program," in which consumers are provided debt settlement services and required to sign an agreement for purported bankruptcy services, is a "debt relief service," as that term is broadly defined under the TSR. This conclusion relates directly to Defendant's bad faith conduct, which was designed to rebut the Bureau's evidence that Morgan Drexen's dual model program is a "debt relief service."

If the Court declines to make a conclusion of law at this stage, the Bureau requests that the Court make a finding of fact that Morgan Drexen did not create or

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[96] *See Leon*, 464 F. 3d at 960-61; *Toth v. Trans World Airlines, Inc.*, 862 F.2d 1381, 1385 (9th Cir. 1988); *Pringle*, 2012 WL 1103939, at * 8, 10.

[97] *See Hill Design Group v. Wang*, No. C 04-521 JF (RS), 2006 U.S. Dist. LEXIS 93449, at *14 (N.D. Cal. Dec. 11, 2006) (Where there is "little chance of this case being resolved on the merits," the public policy favoring disposition of cases on their merits does not weigh against terminating sanctions.).

populate bankruptcy petitions for consumers enrolled in the dual program. Such a finding would also directly relate to Morgan Drexen's bad faith conduct.

If the Court declines to make a finding of fact at this stage, the Bureau requests that the Court issue an order precluding Defendants from offering any evidence at trial that they created or populated bankruptcy petitions for consumers enrolled in the dual program. The Court's inherent authority to impose sanctions for the wrongful destruction of evidence includes the power to exclude evidence that, given the spoliation, would "unfairly prejudice an opposing party."[98] "The propriety of preclusion sanctions . . . depends on the extent to which" the moving party is prejudiced.[99] As set forth *supra*, the Bureau has been seriously prejudiced by Morgan Drexen's bad faith conduct. A remedy of preclusion of evidence is also warranted to ensure that tainted consumer files and bankruptcy petitions are not presented to the Court as evidence.

If the Court will not bar Defendants from entering such evidence, the Bureau requests that the Court apply an adverse inference to any evidence relating to the creation and population of bankruptcy petitions by Morgan Drexen. In order to impose such a sanction, a party must show:

> (1) that the party having control over the evidence had an obligation to preserve it at the time it was destroyed; (2) that [evidence was] destroyed with a culpable state of mind; and (3) that the destroyed evidence was relevant to the party's claim or defense such that a reasonable trier of fact could find that it would support that claim or defense.[100]

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[98] *Napster*, 462 F. Supp. at 1077-78 (quoting *Unigard Sec. Ins. Co. v. Lakewood Engineering & Mfg. Corp.*, 982 F.2d 363, 368 (9th Cir. 1992); *see also Glover v. BIC Corp.*, 6 F.3d 1318, 1329 (9th Cir. 1993).

[99] *Napster*, 462 F. Supp. at 1077-78.

[100] *Id.* at 1078 (finding that an adverse inference instruction was appropriate where defendant deleted relevant e-mail communications).

The Bureau has made this showing. First, "the duty to preserve documents attaches when a party should have known that the evidence may be relevant to future litigation."[101] The Bureau filed suit in August 2013, at which point Morgan Drexen had notice that consumer files might be relevant to *pending litigation*. Then, in February 2014, the Bureau issued a document request that called for, among other things, a subset of consumer files in Morgan Drexen's possession. At that point, Morgan Drexen had actual knowledge not just that consumer files were relevant to *pending litigation, but that they were responsive to a specific document request in pending litigation*. Morgan Drexen clearly had an obligation to preserve consumer files and whatever bankruptcy petitions existed within them even before the litigation began – an obligation it violated by willfully tampering with them.[102]

Second, to show a culpable state of mind, a party need only demonstrate negligence.[103] This is not a case where a party accidentally destroyed relevant documents. The only inference to be drawn from Morgan Drexen's conduct here is

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[101] *Pringle*, 2012 WL 1103939, at *7 (quoting *Napster*, 462 F.Supp.2d. 1060, 1068 (citation and internal quotation marks omitted); *see also Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003); *Realnetworks, Inc. v. DVD Copy Control Ass'n,* 264 F.R.D. 517, 523 (N.D. Cal. 2009).

[102] While some ongoing work might be expected on files for consumers still enrolled in a Morgan Drexen program, what Augusta describes is an after-the-fact attempt to fabricate evidence that Morgan Drexen had created and/or properly populated bankruptcy petitions in consumer files.

[103] *Residential Funding Corp. v. DeGeorge Fin. Corp.*, 306 F.3d 99, 108 (culpable state of mind requirement satisfied by demonstrating that destruction of or failure to produce evidence was negligent); *Napster*, 462 F. Supp. 2d at 1078 (finding gross negligence to be sufficient culpability to justify an adverse inference); *In re NTL, Inc. Sec. Litig.*, 244 F.R.D. 179,198 (S.D.N.Y. 2007) (culpable state of mind requirement satisfied where no adequate litigation hold was ever put in place); *but see Vicente v. City of Prescott*, Case No. CIV-11-08204, 2014 WL 3894131 (D.Ariz. Aug. 8, 2014) ("the Court now tends to think that bad faith should be required before the severe sanctions of adverse inference instructions, dismissal, or default are imposed.").

that it intentionally and deliberately created and altered documents in consumer files to manufacture evidence it believes will benefit its defense. Such conduct easily satisfies a negligence, gross negligence *and* willfulness standard.

Finally, the Bureau has demonstrated that a trier-of-fact could find that the destroyed evidence would support the Bureau's claims or, at the very least, would be detrimental to Morgan Drexen's defense. As set forth above, the evidence here – bankruptcy petitions – is the pretext Morgan Drexen has relied upon to charge impermissible up-front fees. Courts have held that where a party destroys evidence with knowledge of impending litigation, such "behavior suggests that the evidence would have been threatening to the defense of the case and that it is therefore relevant in an evidentiary sense."[104] Moreover, where, as here, bad faith manipulation or destruction is evident, "that bad faith alone is sufficient circumstantial evidence from which a reasonable fact finder could conclude that the missing evidence was unfavorable to that party."[105]

The same holds true for evidence destroyed in a grossly negligent manner or the grossly negligent untimely production of evidence.[106] Because the Bureau has demonstrated that bankruptcy petitions in consumer files (or the lack thereof) are relevant to this action, and because Morgan Drexen intentionally manipulated evidence *it was under Court order to produce*, there is no question that the Bureau has established the relevance of the manipulated evidence. Therefore, even if the Court is unwilling to order any of the other sanctions requested by the Bureau, it should, at the very least, apply an adverse inference to any evidence relating to the

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[104] *AdvantaCare Health Partners v. Access IV*, Case No. C 03-04496, 2004 WL 1837997, at *7 (N.D. Cal. Aug. 17, 2004).
[105] *NTL*, 244 F.R.D. at 199 (quoting *Residential*, 306 F.3d 99, 109 (2d Cir. 2002)).
[106] *Id*. at 199-200; *Residential*, 306 F.3d at 109.

creation and population of bankruptcy petitions presented by Morgan Drexen.[107] In addition, the Court should not allow Defendants any presumption granted to *bona fide* business records, and instead require Defendants to prove the authenticity and admissibility of each proposed exhibit not stipulated to by the Bureau through the testimony of each person who created the document.

2. The Court Should Issue An Order To Prevent Any Further Spoliation Of Evidence

In her declaration, Rita Augusta states that she has documents in her possession relating to Morgan Drexen, including, but not limited to, e-mails concerning Morgan Drexen's decision to support the dual model, executive committee meeting agendas, and e-mails confirming that Morgan Drexen's employees misrepresented the dual program to consumers during the enrollment process. Some of these documents are responsive to the Bureau's document requests but were not produced by Defendants.

With the exception of a limited group of documents that relate directly to spoliation of evidence, the Bureau is not in possession of any of Augusta's documents and has not reviewed any of the documents. Given Morgan Drexen's bad faith conduct and demonstrated record of destroying evidence, the Bureau requests that the Court order that:

- Morgan Drexen may not request any documents or information from Augusta until at least thirty days after trial and only after the Court has authorized such a request;
- Augusta may share all non-privileged documents and information in her possession with the Bureau; and
- The Bureau may supplement its Exhibit List until February 6, 2015 with documents or other material it receives from Augusta.

[107] *See Napster*, 462 F. Supp. at 1078 (ordering adverse inference instruction because defendant deleted e-mails relevant to the action); *see also Glover*, 6 F.3d at1329; *Akiona vs. U.S.*, 938 F.2d 158, 161 (9th Cir. 1991).

- The Bureau may supplement its Witness List until January 28, 2015 with witnesses who may testify about Morgan Drexen's spoliation of discovery material.

To date, the Bureau has not requested that Augusta produce all of the material in her possession. Given Morgan Drexen's egregious conduct in this case, however, it would be appropriate for the Court to allow the Bureau to request this material, for Augusta to produce non-privileged material, and for the Bureau to use that at trial.

IV. CONCLUSION

For the foregoing reasons, Plaintiff respectfully requests that this Court grant the Bureau's Motion For Sanctions and issue an Order of Default Judgment against Defendants or a lesser sanction, as discussed above.

Respectfully submitted,

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