

2/20/02

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

JAMES A. KNAUER as the Court)
Appointed Receiver for HEARTLAND)
FINANCIAL SERVICES, INC., and)
JMS INVESTMENT GROUP, LLC,)

Plaintiffs,)

v.)

Cause No: IP01-1168-C-T/K

JONATHAN ROBERTS FINANCIAL)
GROUP, INC., ALLIANCE CAPITAL)
MANAGEMENT CORP., ANDOVER)
SECURITIES, CORPORATION, FSC)
SECURITIES CORPORATION, and)
FFP SECURITIES, INC.,)

Defendants.)

_____)

DEFENDANT JONATHAN ROBERTS' REPLY BRIEF
IN SUPPORT OF ITS MOTION TO DISMISS

I. Introduction.

In the materials in opposition to the various Defendants' motions to dismiss, the Receiver has taken a sharp left-hand turn with respect to his theories of liability and damages from that which was pled in the Complaint. Instead of pleading claims based upon torts committed upon and damages done to the individual Investors, the Receiver now seeks to present claims based upon torts committed upon and damages done directly to Heartland/JMS. Thus in his Brief he claims that Payne and Danker engaged in "the theft of millions of dollars from Heartland's bank account" and seeks to impose liability on the

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Broker/Dealers under various *respondeat superior* theories. (Receiver's Brief, p. 37) He explains his new legal theory as follows:

The failure of the securities brokers to adequately monitor Payne and Danker was therefore the key ingredient that enabled Payne and Danker to take Heartland and JMS funds that should have been invested for the benefit of Heartland, JMS and their investors but were instead used by Payne and Danker for private pleasure and non-corporate purposes. Thus, the actions of the Broker Dealers directly caused substantial injury to Heartland and JMS.

(Receiver's Brief, p. 1-2).

By switching legal theories from a liability model based upon the illegal actions of Payne and Danker towards the investors (the "Investors' Claims") to one based upon the illegal activities of Payne and Danker directly towards Heartland/JMS (the "Heartland/JMS Claims") the Receiver seeks to foil the Broker/Dealers' standing defenses and survive the various motions to dismiss. Unfortunately this switch, while perhaps addressing the standing problems, now undercuts the entire premise of liability against the Broker/Dealers since Payne and Danker's actions in looting the Heartland/JMS coffers were done as principals in those organizations, and not as employees or agents of the Broker/Dealers. Nor can it conceivably be argued that looting the coffers of Heartland/JMS was within the actual or apparent authority of the agency of Payne and Danker. As a consequence, the Receiver's claims against the Broker/Dealers fail as a matter of law.

II. Discussion.

By arguing that the Broker/Dealers should have prevented Payne and Danker from looting money from their own corporations, the Receiver is essentially arguing that the Broker/Dealers are insurers of any actions taken by Payne and Danker. This proposition is incorrect. The Seventh Circuit has been very clear when it articulates the duties owed

by Broker/Dealers with respect to their agents, to also note that “[t]his interpretation does not make the broker-dealer an insurer of its registered representatives.” Harrison v. Dean Witter Reynolds, Inc., 79 F.3d 609 (7th Cir. 1996). In so doing, the Seventh Circuit specifically articulated the view that in order to hold a broker/dealer liable for the actions of its agent, a plaintiff must show that the broker/dealer possessed the power or ability to control the specific transaction upon which liability is predicated:

We have looked to whether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised.

Id., 79 F.3d at 614 *quoting* Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992).

Thus, in the present case, in order to survive this motion to dismiss the Receiver must demonstrate that Jonathan Roberts “possessed the power or ability to control” Payne and Danker not when they made the sales to the Investors, but rather when they engaged in “the theft of millions of dollars from Heartland’s bank account.” (Receiver’s Brief, p. 37) This they have not and cannot do.

A. Standing

While Jonathan Roberts adopts and incorporates by reference the Co-Defendants’ standing arguments, its motion to dismiss is not dependent on a favorable ruling on those issues. In fact if the Receiver is successful in avoiding the Co-Defendants’ standing arguments, then Jonathan Roberts’ arguments in support of dismissal apply with even more force.

In his standing argument the Receiver clings to the various Scholes decisions as a life preserver in the turbulent waters of the Defendants' motions. In each of the Scholes cases the Courts held that a receiver does not have standing to recover damages on behalf of the investors for injuries done to them. Instead, "an equity receiver may sue only to redress injuries to the entity in receivership" and may "bring [] suit to recover corporate assets unlawfully dissipated." Scholes v. Lehman, 56 F.3d 750, 753-755 (7th Cir. 1995). In that case the receiver was permitted to bring the suits not based upon the fraud committed on the investors, but based upon the second theft from the corporations by its own officers: "The three sets of transfers removed assets from the corporations for an unauthorized purpose and by doing so injured the corporations." *Id.*, 56 F.3d at 754.

Utilizing this theory to avoid the impact of the standing argument, the Receiver in this case contends that Heartland/JMS fall into this same situation because Investor funds that had been transferred to Heartland/JMS and placed into the Lincoln Escrow Account were in turn stolen from that account by Payne and Danker to Heartland/JMS's detriment. Thus the Receiver cites Scholes v. Stone, McGuire and Benjamin, 821 F.Supp. 533 (N.D.Ill. 1993) for the following proposition:

The court noted that, while the receiver claimed to be suing on behalf of the receivership entities, the only damages alleged were losses of the funds invested in the entities and increased liabilities to creditors. *Id.* at 535. The court reasoned that if the funds were deposited by the investors into the receivership entities became funds belonging to the entities, then a claim of legal malpractice or breach of fiduciary duty resulting in the loss of those funds would sufficiently allege damage to the entities. *Id.* at 536. The court went on to state that once investor funds had been invested, the entities had some claim to the investor funds and thus any wrongful actions of the defendants resulting in the loss of the funds invested damaged the entities to the extent the loss was attributable to the wrongful acts and, 'merely because the losses alleged include funds contributed by the investors does not negate that fact.' *Id.*

(Receiver's Brief, p. 13). The Receiver contends that what permits him to get past the standing argument is the fact that he is not pursuing the "Investor Claims" but instead is pursuing the "Heartland/JMS Claims" which matured only after the Investor funds, which were placed in Heartland/JMS accounts, were later stolen directly from those accounts by Payne and Danker.

This proposition is reinforced when the Receiver cites the last Scholes case, Scholes v. African Enterprise, Inc., 838 F.Supp. 349 (N.D.Ill. 19993). In that case, according to the Receiver's Brief, "[t]he court noted further that once the funds were invested with the entities, the investor funds became property of the entity. Therefore, the court concluded that when funds were misappropriated and transferred that the entities were directly injured." (Receiver's Brief, p. 14 *citing* Scholes v. African Enterprises, Inc., 838 F.Supp. at 353)

Thus it is the Receiver's contention that he has standing because Heartland/JMS suffered a direct injury when, after the Investor funds had been placed into the Lincoln Escrow account, Payne and Danker later stole the money from that account: "(2) that injury to Heartland occurred when Payne and Danker misappropriated Heartland funds that had previously been paid to Heartland to investors." (Receiver's Brief, p. 4) The problem with this, as noted earlier, is that although it arguably solves the standing problem, it also subjects the entire Complaint to dismissal as the Broker/Dealers were not and could not be responsible for Payne and Danker's actions in stealing the money from the Heartland/JMS funds as these acts were perpetrated by Payne and Danker as officers and directors of Heartland/JMS, and not as agents of the Broker/Dealers.

B. Counts I and II: Controlling Person Liability.

In Counts I and II of the Complaint the Receiver seeks to hold the Defendants liable for Payne and Danker's actions as "controlling persons." (Complaint, ¶38). The Receiver contends that as a consequence of the controlling person relationship the Defendants "had a duty to monitor the conduct of Payne and Danker during the time period Payne or Danker was an employee and/or agent of that Broker Dealer" (*Id.*, ¶ 35)

In its initial brief Jonathan Roberts sought the dismissal of the Federal and State "controlling person" claims based upon the fact that the Receiver was not a defrauded purchaser or seller of securities as required under the predicate federal and state statutes. In response, the Receiver now contends that, "the Defendants were in a position to supervise, influence, ability to control Payne and Danker and permitted them to operate largely unsupervised. Therefore, pursuant to Section 20a of the Securities Exchange Act of 1934, Defendants are jointly and severally liable as 'controlling persons' to the same extent that Payne and Danker are liable" (Receiver's Brief, p. 27) The Receiver thus seeks damages "because the Broker Dealers permitted Payne and Danker to abscond with the money invested in Heartland and JMS." (*Id.*, p. 13)

Thus the Receiver seeks to impose liability on the Broker/Dealers for the actions of Payne and Danker in looting funds from the Heartland/JMS accounts based upon the Broker/Dealers' alleged status as controlling persons. As noted earlier, in Harrison, the Seventh Circuit stated its view on controlling person liability:

We have looked to whether the alleged control-person actually participated in, that is, exercised control over, the operations of the person in general and, then, to whether the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised.

Id., 79 F.3d at 614 *quoting* Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992).

Applying the standard for control person liability set out in Harrison to the facts of this case, the issue is whether “the [Broker/Dealers] possessed the power or ability to control the [theft of the money from the Heartland/JMS accounts] upon which the primary violation was predicated.” *Id.* (parenthetical supplied) Unfortunately for the Receiver, the pleadings do not allege that the Broker/Dealers had any control whatsoever over the Heartland/JMS accounts. The control of those accounts, according to the Complaint in this action and the SEC Complaint, rested solely in the hands of Payne, Danker, Johann Smith, and Constance Brooks-Kiefer. (SEC Complaint, ¶¶ 22, 35, 42, 51, 55, 57, 62-65) With respect to the Broker/Dealers’ connection to the theft, the Complaint simply states that the Broker/Dealers were controlling persons with respect to the sales of securities and that “[n]umerous investors in securities sold by Payne and/or Danker were lulled into a false sense of security by Payne and Danker’s association with one or more of the Broker Dealers” (Complaint, Count I, ¶ 34) Similarly, in Count II the claim is that the Broker/Dealers were controlling persons with respect to “securities sold by Payne and Danker [that] were sold without registration under the Securities Act.” (*Id.*, Count II, ¶ 40)

Thus the Complaint is limited to allegations that the Broker/Dealers controlled the sale of securities. The Complaint says nothing about the Brokers/Dealers controlling the Heartland/JMS accounts, nor does it really even mention the theft of the money from the Heartland/JMS accounts. As the Receiver notes in his Brief “[o]nce the investor’s funds were received by Heartland and JMS the funds became property of the entities.”

(Receiver's Brief, p. 31) It was these funds that Payne and Danker stole, and for which the Receiver seeks to hold the Broker/Dealers liable. The problem is that the Broker/Dealers had absolutely no control over the Heartland/JMS bank accounts or Payne and Danker's actions towards those accounts.¹

Under Harrison, unless "the alleged control-person possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated," there can be no controlling person liability under state or federal law. *Id.*, 79 F.3d at 614. Because the Complaint does not even allege that the Broker/Dealers possessed the power to control Payne and Danker's access to the Heartland/JMS accounts, the controlling person theories must fail as a matter of law and Counts I and II should be dismissed.

C. Count III: Breach of Fiduciary Duty and Fraud.

Perhaps the most illustrative of the flaws in the new legal theory is the Receiver's reliance on the "Heartland/JMS Claims" are the breach of fiduciary duty and fraud claims. In Count III of the Complaint the Receiver presents a claim for breach of fiduciary duty noting that "Payne, Danker and the Broker Dealers breached their fiduciary duty to investors and to Heartland and JMS" (Complaint, ¶ 50) They also allege fraud and seek to hold the Broker/Dealers responsible for the actions of Payne and Danker under

¹ This is far different from the situation in Harrison where the agents worked for Dean Witter Reynolds, Inc., and stole money directly from an investor's account with Dean Witter. Moreover, unlike the present case, Dean Witter financially benefited from the "specific predicate transactions" through brokerage fees on those transactions: "the security transactions at issue were the supposed purchase of municipal bonds through the Dean Witter Trading account" *Id.* 79 F.3d at 618.

“standard agency principals and the doctrine of *respondeat superior*” (Receiver’s Brief, p. 34)

However, once again the problem that surfaces with the breach of fiduciary duty and fraud claims is that Payne and Danker, at the time they stole money from the Heartland/JMS accounts, were not and could not have been acting within the course and scope of their agency with the Broker/Dealers. Instead, when they stole the money from the Lincoln Escrow account they were acting solely as directors and officers in Heartland/JMS. Interestingly, the Receiver even admits this proposition, noting as the legal basis for this claim the fact that “Indiana courts have frequently authorized actions for breaches of fiduciary duty against unfaithful officers, directors and shareholders.” (Receiver’s Brief, p. 35)

While the parties are in agreement that Indiana law would impose liability on Payne and Danker for breaching their fiduciary duties and defrauding Heartland/JMS by looting money from the Heartland/JMS accounts, Jonathan Roberts differs sharply that such conduct could possibly be “within the scope of their agency with the Broker Dealers.” (Receiver’s Brief, p. 34-35) The Receiver claims that by the above notation, Jonathan Roberts has made a “concession [that] establishes that the Receiver has stated a claim for breach of fiduciary duty.” (*Id.*, p. 36) Jonathan Roberts has conceded that the Receiver has a breach of fiduciary duty and fraud claims **against** Payne and Danker as officers in Heartland/JMS, **not** against the Broker/Dealers. The Receiver apparently believes that by simply reciting the mantra of “*respondeat superior*” this makes the Broker/Dealers responsible for anything Payne and Danker might do. This is not the case and in fact is belied by the Receiver’s own brief: “Therefore, it is clear that the Receiver can hold the

Broker Dealers liable for Payne and Danker's conduct if Payne and Danker were acting within the course and scope of their agency with the Broker Dealers." (*Id.*; emphasis supplied)

This is a very big "if." As discussed in great detail in the following subsection, Payne and Danker were not acting as agents of the Broker/Dealers when they stole the money from the Heartland/JMS accounts. Instead they were acting as officers and directors of Heartland/JMS. As a consequence, the Broker/Dealers cannot as a matter of law be liable for their actions in stealing this money regardless of the legal theory, be it breach of fiduciary duty, fraud, or negligent supervision.

D. Count IV: Civil Action by Crime Victim.

In Count IV of the Complaint the Receiver contends that Heartland/JMS, as the victims of a crime, are permitted to recover "specified damages, including treble damages, attorneys fees, and certain costs" under I.C. § 34-24-3-1 (Indiana's Crime Victims Relief Act) as the result of the criminal conduct of Danker and Payne. (Complaint, ¶ 54). The Receiver further alleges that under a statutory version of *respondet superior* (I.C. § 35-41-2-3(a)) Jonathan Roberts is monetarily liable for the criminal acts of Danker and Payne in stealing funds from Heartland/JMS's bank accounts. (Complaint, ¶ 56).

In Jonathan Roberts' initial Brief it contended that Heartland/JMS were not entitled to recover damages under this statute because "neither the Receiver nor Heartland/JMS is a crime victim" based upon the allegations in the Complaint which were limited to crimes perpetrated on the Investors. (Jonathan Roberts' Brief, p. 14) The Receiver found this argument "incredible . . . [a]pparently the theft of millions of dollars from Heartland's bank account, among other things, does not constitute victimization by Payne and Danker."

(Receiver's Brief, p. 37) For purposes of this argument, Jonathan Roberts does not dispute that Payne and Danker looted millions from the Heartland/JMS accounts and that as a consequence Heartland/JMS were the victims of a crime. Instead, and what the Receiver misses entirely, is that the criminal actions of Payne and Danker which were directed towards Heartland/JMS were not and could not have been "within the scope of [their] authority" with the Broker/Dealers but instead were made possible by and committed while Payne and Danker were officers in Heartland/JMS. I.C. § 35-41-2-3(a).

The only crimes that Payne and Danker committed that could even arguably have been within the scope of their authority as agents for the Broker/Dealers would have been those acts towards the Investors who, the Receiver contends, "were lulled into a false sense of security by Payne and Danker's association with one or more of the Broker Dealers and by Payne and Danker's ability to advertise NASD membership and SEC protection." (Complaint, ¶ 34) However, these are the Investors' Claims and at this point the Receiver has conceded he cannot assert those claims due to standing problems. Instead, the Receiver now seeks to hold the Broker/Dealers liable for acts that Payne and Danker took in their capacities as officers of Heartland/JMS. Essentially, the Receiver is asking that this Court hold the Broker/Dealers to be insurers of Payne and Danker's actions regardless of the capacity in which those actions were taken. This argument completely ignores the limitations Indiana law places on the liability of a principal for the actions of its agent.

The parties are in agreement about the general standard to be applied in agency cases such as this. Broker/Dealers may only be held liable if "the agent [Payne and Danker] was acting within the scope of the agent's actual or apparent authority. [E]ven

though that [agent's] predominant motive in performing the act is to benefit himself, the act may still fall within the 'scope of [the agency] if the [agent's] purpose, to an appreciable extent, was also to further his master's business." (Receiver's Brief, p. 39; see also U.S. ex rel. Durcholz v. FKW Incorporated, 997 F.Supp. 1143, 1150 (S.D.Ind. 1998)).

Utilizing the framework noted above, the Receiver chooses to simply boldly proclaim that "Payne and Danker were acting within the scope of their authority for the Broker/Dealers when they committed the criminal acts against Heartland and JMS." (Receiver's Brief, p. 39) However, the facts as pled in the Receiver's Complaint as well as in the SEC Complaint which is incorporated therein bely this assertion. Nowhere in any of those documents is there an allegation that Payne and Danker's "purpose [when looting the Heartland/JMS accounts], to an appreciable extent, was also to further his master's business." (*Id.*) The reason that the Receiver has not pled such a claim is that it would be ludicrous. As the two Complaints make very clear, when Payne and Danker stole the money from the Heartland/JMS accounts, they did so solely to line their own pockets: "Payne and Danker, among others, 'intentionally misappropriated the personal property of Heartland.'" (Receiver's Brief, p. 37)

Thus it is clear that the criminal acts committed towards Heartland/JMS which the Receiver characterizes in his Brief as "the theft of millions of dollars from Heartland's bank account . . . by Payne and Danker" were committed by them in their capacity as officers of Heartland/JMS and not as agents of the Broker/Dealers. (Receiver's Brief, p. 37; SEC Complaint, ¶¶ 20-23, 61-65) The SEC Complaint² notes that Payne and Danker solicited

² The SEC Complaint is attached to and incorporated by reference into the Receiver's Complaint. (Complaint, ¶ 25)