

2/21/02

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,)
)
Plaintiff,)

v.)

CAUSE NO. IP01-1168C T/G

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

REPLY BRIEF IN SUPPORT OF DEFENDANT FFP SECURITIES, INC.'S ("FFP")
MOTION TO DISMISS

INTRODUCTION

Faced with insurmountable precedent establishing that he lacks standing to assert claims on behalf of investors in Heartland and JMS, plaintiff now *disavows* any attempt to seek recovery on their behalf and contends instead that he actually is suing for injury *to the corporations*. Plaintiff's newly conceived theory of relief stands in stark contrast to the actual allegations of the Complaint, which clearly seek redress for the investors' injuries. More importantly, plaintiff now has conceded that he has no standing to seek redress on behalf of the investors. As discussed in our opening memorandum, the authorities are uniform that a receiver

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may assert only the claims of the entity for whom he has been appointed. Plaintiff is not the receiver for the investors and, therefore, he cannot assert their claims. That point is undisputed.

In seeking to assert claims on behalf of Heartland and JMS rather than the investors, plaintiff has jumped from the proverbial frying pan into the fire. The corporations have no basis to assert a claim against FFP. Plaintiff does not allege *any* relationship between FFP and the corporations. Nor does he allege that FFP holds, or has ever received any assets of Heartland or JMS, or that it was in any way involved in Payne and Danker's fraud. Thus, plaintiff's reliance on cases upholding receiver suits against defendants *to whom corporate assets had been transferred*, e.g., Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995) or *who participated in the Ponzi scheme*, e.g., Scholes v. Stone, McGuire & Benjamin, 821 F. Supp. 533 (N.D. Ill. 1993), is completely misplaced.

Plaintiff asserts that FFP is *vicariously* liable for the actions of Payne and Danker as a "controlling person" under the securities laws or, alternatively, under traditional agency principles. This theory fails, however, because plaintiff is no longer attempting to sue on behalf of the investors for fraud in the sale of securities. Plaintiff now purports to sue on behalf of Heartland and JMS for the injury suffered by them when Payne and Danker absconded with their corporate funds. But nothing in the Complaint supports imposition of liability on FFP for this corporate looting. There is no allegation that Payne and Danker were acting on behalf of, or for the benefit of, FFP when they stole Heartland/JMS funds. Nor is there any allegation that FFP was in a position to control Payne and Danker's actions in their capacity as corporate officers of Heartland and JMS. While FFP may have owed a duty *to its clients* to supervise Payne and

Danker with respect to securities transactions in FFP accounts, any breach of *that* duty would create a cause of action in the *investors*, not in *Heartland* or *JMS*, and the receiver indisputably has no standing to assert those claims.¹

I. Plaintiff Has No Standing to Pursue the Claims of Investors.

The law is clear and unavoidable: a receiver cannot bring a claim personal to an investor. See Scholes v. Stone, 821 F. Supp. at 535 (receiver has no standing to bring suit representing those who had invested in the entities nor could the receiver recover losses those investors had suffered); see Cagan v. West Suburban Bank, 1992 U.S. Dist. LEXIS 5707, at *8 (N.D. Ill. Apr. 14, 1992)(the investors who purchase interests bear the “real brunt of the wrongdoing”); Scholes v. Schroeder, 744 F. Supp. 1419, 1422 (N.D. Ill. 1990)(“[f]raud on the *investors* . . . is for those *investors* to pursue — not the receiver”); see also Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 429-34 (1972)(receiver or like surrogate cannot pursue claims that belong, not to the receivership estate as such, but rather to those who may have an ultimate derivative interest in the estate); Koch Ref. v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339 (7th Cir. 1987); Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983); State ex rel. Pancol v. Cleveland, 171 N.E.2d 255 (Ind. 1961); Reel v. Brammer, 101 N.E. 1043 (Ind. Ct. App. 1913);

¹ Plaintiff does not even allege that the investors who lost money through *Heartland* and *JMS* were FFP customers. Plaintiff’s theory, apparently, is that FFP is liable for all losses caused by Payne and Danker regardless of whether the defrauded investors had a relationship with FFP or not!

Marion Trust Co. v. Blish, 84 N.E. 814 (Ind. 1908); Northwestern Mut. Life Ins. Co. v. Kidder, 70 N.E. 489 (Ind. 1904).²

While essentially conceding these points, plaintiff muddies the waters by suggesting that his “broad authority” as receiver empowers him to take whatever actions “will ultimately benefit the creditors of the receivership.” Pl. Resp. at p. 10. To be sure, the receiver’s goal is to maximize the receivership estate. But he is limited to asserting claims that belong to the receivership entities. Scholes v. Schroeder, cited by plaintiff, demonstrates this point. There, the receiver brought suit on behalf of three corporate entities for damage caused by one culprit in a Ponzi scheme. The court precluded the receiver “from bringing causes of action that belong to [corporate] investors.” 744 F. Supp. at 1421. The court limited the receiver’s standing to those situations where the receivership entity “has a claim *on its own behalf*, the recovery from which will result in the enhancement of its assets, thus ultimately benefiting the investors in that company.” (Id. at 1421 n.5) (emphasis added).

The court explained that “benefits to the shareholders or investors must be *derivative* of that marshaling of assets, and must not be obtained by direct action.” Id. (emphasis added). The court compared the analogous situation of shareholders lawsuits that must be dismissed because they actually assert claims of the corporation: “Just as shareholders cannot

² Plaintiff contends that “[h]ad the investors in Heartland and JMS sued the Broker Dealers it is likely... that the Broker Dealers would have contended these claims belong to the receivership estate.” Pl. Resp. at 20. We will represent to the court right now that, in the event of an investor action (which FFP denies would have any merit), FFP would not argue for dismissal on the grounds that the receivership estate possesses standing for these claims. Plaintiff’s speculation about the position of FFP is incorrect.

advance in their own behalf (as contrasted with derivatively) any claims that belong to their corporation, so the receiver cannot advance in his own behalf (that is, in the receivership entity's behalf) claims that belong to investors or shareholders individually." Id. (citation omitted).³

Troelstrup v. Index Futures Group, Inc., 130 F.3d 1274 (7th Cir. 1997), also cited by plaintiff, is to the same effect. There, a receiver was appointed for John Tobin, a commodity trader who was alleged to have defrauded investors in the sale of commodities. The receiver was empowered to "identify, take possession of, marshal, and administer Tobin's assets, so that they would be available to persons having claims against Tobin, primarily the defrauded investors." Id. at 1275. The receiver asserted a claim against a futures merchant through which Tobin traded alleging that its negligence facilitated the fraud. The receiver attempted to bring the claim on behalf of four commodity "accounts" that Tobin had instituted. The Seventh Circuit (Chief Judge Posner) recognized that the receiver was suing "as a practical matter, on behalf of the investors whose investments were deposited in that account." Id. at 1277. The court held that

³ The law of shareholder derivative suits provides guidance here. "An action in which the holder [i.e., the investor] can prevail only by showing an injury or breach of duty to the corporation, should be treated as a derivative action.... An action in which the holder can prevail without showing an injury or breach of duty to the corporation should be treated as a direct action that may be maintained by the holder in an individual capacity." American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, § 7.01 (1992); see generally Frank v. Hadesman & Frank, 83 F.3d 158, 160 (7th Cir. 1996). Shareholders do not have standing to sue for harms to the corporation, or even for the derivative harm to themselves that might arise from a tort or other wrong to the corporation. Hammes v. AAMCO Transmissions, Inc., 33 F.3d 774, 777 (7th Cir. 1994). Likewise, plaintiff cannot demonstrate injury to Heartland and JMS without showing injury to the investors. Therefore, plaintiff's action is derivative of the investors' claims and cannot be maintained. In contrast, the investors can straightforwardly demonstrate their specific injuries and losses without implicating any injury that may have occurred to Heartland or JMS.

the receiver lacked standing to sue “on behalf of the investors, the victims of the fraud, because *he was not their receiver.*” Id. (emphasis added). The court also held that he could not sue on behalf of the “account” because he “was just Tobin’s receiver, and so he could not sue [the futures merchant] on behalf of [the account], not having been appointed its receiver.” Id. The Court stated:

There is a sense in which [the receiver] is the investors’ agent, for he is trying to maximize the value of their debtor’s, Tobin’s, assets, just as a trustee in bankruptcy tries to maximize the value of the bankrupt’s assets for the benefit of the bankrupt’s creditors. . . . If Tobin had a claim against [the futures merchant], the analogy would be complete. But Tobin has no claim against [the futures merchant]. *The receiver is not trying to build up Tobin’s assets. He is suing a third party on behalf of Tobin’s creditors to enforce a personal right of theirs, not a right of Tobin’s in which they have an interest by virtue of being his creditors.* Id. (emphasis added).⁴

II. Plaintiff Has No Basis For a Direct Claim Against FFP.

Plaintiff has not identified any relationship between FFP and the corporations, contractual or otherwise, that would give rise to a cause of action in favor of the corporations against FFP. The cases cited by plaintiff are readily distinguishable -- either corporate assets had been fraudulently conveyed to the defendant or the defendant had a role in the underlying fraud. Neither of those situations exist here.

For example, in Scholes v. Lehmann, which plaintiff calls the “leading case on standing” (Pl. Resp. at p. 10) and on which he places primary reliance, the mastermind behind a

⁴ Plaintiff suggests that Troelstrup can be distinguished on the grounds that the “accounts” had no legal status whereas Heartland and JMS are corporations with distinct legal entities. Plaintiff misses the point. FFP does not dispute that Heartland and JMS are separate legal entities. Nor does FFP dispute that the receiver can - in the appropriate circumstances - bring actions on behalf of those corporations. But, as Troelstrup makes clear, the receiver may not bring actions on behalf of those for whom he is not the receiver. That is precisely what plaintiff is trying to do here.

Ponzi scheme had improperly paid out money to his ex-wife, her husband, five of his favorite charities and one investor he sought to “keep happy.” 56 F.3d at 754. Plaintiff sued those entities to recover the misappropriated corporate assets. See id. at 754 (“The three sets of transfers removed assets from the corporations for an unauthorized purpose and by doing so injured the corporations.”) The receiver was suing a defendant who *received or was in possession of corporate assets*. By contrast, there is no allegation here that FFP holds or and has received any assets of Heartland or JMS.

Similarly, in Scholes v. African Enter., Inc., 838 F. Supp. 349 (N.D. Ill. 1993), the receiver sought to recover partnership property that had been fraudulently transferred to the Ponzi scheme mastermind’s favorite charities. Again, unlike this case, the receiver was suing defendants who received or were in possession of corporate assets.

In Scholes v. Stone, McGuire & Benjamin, 821 F. Supp. 533 (N.D. Ill. 1993), the defendant law firm performed substantial legal work for the corporation that facilitated the Ponzi scheme. Here, however, there is no allegation that FFP had any relationship with Heartland or JMS or any role in the underlying fraud.

In Iglehart v. Todd, 178 N.E. 685 (Ind. 1931), the receiver was permitted to sue issuers of three promissory notes executed and payable to the order of an insolvent bank. The receiver simply was pursuing its contractual rights against the other party to the contract, thus acting well within the “general rule” that the receiver of an insolvent corporation has no greater rights than those possessed by the corporation itself. Id. at 690 (citation omitted). Here, FFP has no contractual or other relationship that would form the basis for an action by Heartland or JMS.

Plaintiff does not even attempt to explain the basis for his allegation that FFP owed a duty to Heartland and JMS. Instead, he repeats his allegations of negligence by FFP in connection with Payne and Danker's dealings *with investors* (i.e. the Ponzi scheme victims). That is not the issue here. Having abandoned such claims, the only issue is whether FFP owed some duty of reasonable care *to Heartland and JMS*. Plaintiff's failure to allege any relationship between FFP and these corporations dooms this claim from the start. FFP's duties *even to its clients* are limited in scope. See Caravan Mobile Homes, Inc. v. Lehman Brothers Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985) ("Normally the agency relationship created by a non-discretionary account arises when the client places an order and terminates when the transaction is complete.") To impose a duty on FFP to *non-clients* such as Heartland and JMS, with whom it has no relationship whatsoever, would be unprecedented. We are aware of no authority that would support plaintiff's position and he provides none.

III. There is No Basis To Impose Vicarious Liability on FFP.

Without any basis to sue FFP *directly*, plaintiff resorts to alleging that FFP is *vicariously* liable for the injury to Heartland and JMS caused by Payne and Danker. Specifically, plaintiff contends that Payne and Danker injured the corporations by misappropriating corporate funds to their own use, and that FFP is liable for those acts because Payne and Danker were licensed as "registered representatives" for FFP. Plaintiff misconstrues the nature of the agency created by the relationship between FFP and Payne and Danker. They certainly were "representatives" of FFP for purposes of effectuating securities transactions with FFP clients, but they were not "representing" FFP when they misappropriated the funds of Heartland and JMS.

By eschewing any intention to seek redress for investors and instead relying solely on his standing to sue for alleged injury to Heartland and JMS, plaintiff has pleaded himself out of court. As discussed below, viewed from the perspective of plaintiff's new-found theory, none of the five counts of the Complaint assert a viable cause of action in favor of the corporations against FFP.

Counts I and II

Counts I and II seek to hold FFP liable as a "controlling person" under the federal and Indiana securities laws for Payne and Danker's violations of those laws. Count I asserts that FFP is liable for their fraud in the sale of securities under Rule 10b-5 and its Indiana equivalent. Count II alleges that FFP is liable for their sale of unregistered securities in violation of federal and state registration requirements. These claims fail for two reasons.

First, there is no underlying securities law violation to which controlling person liability could attach. See 15 U.S.C. § 78t(a) (controlling person liable only to same extent as controlled person). The wrong now being alleged by plaintiff is the misappropriation of corporate funds by Payne and Danker, not fraud in the sale of securities to investors. The conversion of corporate funds did not involve the purchase or sale of securities. Hence, neither Heartland nor JMS can claim a violation of Rule 10b-5 in connection with the corporate malfeasance of Payne and Danker. Davidson v. Belcor, Inc., 933 F.2d 603, 606 (7th Cir. 1991) ("only actual purchasers and sellers of securities have standing to pursue private causes of action under the anti-fraud provisions of the Securities Exchange Act of 1934"); Isquith v. Caremark Int'l, 136 F.3d 531, 536 (7th Cir. 1998) (decision to "buy or sell securities" must have been

involved to invoke Rule 10b-5). See also Santa Fe Indus. v. Green, 430 U.S. 462, 473-76 (1977) (Congress did not intend for breach of fiduciary duty or corporate mismanagement to be covered under Rule 10b-5). The federal claim for unregistered securities sales fails for the same reason. See 15 U.S.C. § 771(a) (person who “offers or sells” an unregistered security is liable to “the person purchasing such security”).

The equivalent claims under Indiana law are deficient on the same grounds. The provision creating a private cause of action, IND. CODE §23-2-1-19(a), requires a purchase or sale of securities. The statute provides for a cause of action against “[a] person who offers or sells a security” in favor of “any other party to the transaction.” Id.⁵

Second, even if there was some arguable basis for a securities law claim arising out of Payne and Danker’s looting of the corporations, FFP could not be considered a “controlling person” under Section 20 of the 1934 Act or its Indiana equivalent with respect to these acts. Controlling person liability is limited to those transactions that the defendant “possessed the power or ability to control.” Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992). See also Hauser v. Farrell, 14 F.3d 1338, 1342 (9th Cir. 1994) (controlling person liability “limited to those transactions which could have reasonably been regulated and controlled by an employer”).⁶

⁵ Plaintiff attempts to obfuscate matters by asserting that Heartland and JMS were sellers of securities. This is true, but they were sellers *to investors*, and any claim arising out of those sales would be the investors’ to assert, not the corporations’. See Pl. Resp. 31 (“Heartland and JMS contracted *with investors*”)

⁶ The standard for controlling person liability under Indiana securities law is the same. Compare IND. CODE §23-2-1-19(d).

Plaintiff says that he has “clearly alleged” that FFP “exercised control over the operations of Heartland and JMS” (Pl. Resp. 26), but none in the allegations of the Complaint cited for this proposition (¶¶ 23, 31, 33, 35-36, 38) come even remotely close to making such an allegation. Plaintiff also contends that he has alleged that FFP had the “ability to control alleged fraudulent statements” made by Payne and Danker (Pl. Resp. 26), but that charge relates to statements made *to investors*. The issue here is whether FFP had the power to control Payne and Danker’s disposition of corporate funds. There is nothing in the Complaint that alleges they did. Accordingly, there can be no controlling person liability under Section 20, even if plaintiff could prove an underlying violation.

Count III

Count III alleges that FFP is liable for breach of fiduciary duty. Plaintiff pleads that FFP owed a duty to Heartland and JMS, but all of the allegations relate to FFP’s relationship *with investors*. See Complaint ¶¶ 43-46. As discussed above, the allegations of the Complaint arguably support the existence of an FFP duty *to investors*, but there is absolutely nothing alleged to support any such duty *to the corporations*.

Even plaintiff recognizes the futility of such an allegation as he does not press it in his opposition brief. Instead, he takes a different tack, alleging that *Payne and Danker* are liable for breach of fiduciary duty in their capacity as officers of the corporations and that FFP is *vicariously* liable under “standard agency principles” for their corporate malfeasance. Payne and Danker may have breached duties they owed to the corporations by looting them, but nothing is pleaded to establish any agency relationship between Payne and Danker and FFP that would

encompass these acts. Plaintiffs do not cite a single case that would support their claim that FFP has a duty to oversee or control, or is liable for, the acts of Payne and Danker in their capacity as corporate officers. Indeed, it appears plaintiffs looked for but could not find any such law because in the spot where such a citation would have been appropriate, all plaintiff can say is “[cite agency cases].” (Pl. Resp. 36)

Plaintiff’s inability to find any case law to support his position is not surprising. An employer is not responsible for acts done on the employee’s own initiative with no intention to perform it as part of or incident to the service for which he is employed. Stropes v. Heritage House Childrens Ctr., 547 N.E.2d 244, 247 (Ind. 1989). An employee is acting within the scope of his employment only when he is acting, at least in part, to further the interests of his employer. Konkle v. Henson, 672 N.E.2d 450, 456 (Ind. Ct. App. 1996). See City of Fort Wayne v. Moore, 706 N.E.2d 604, 607 (Ind. Ct. App. 1999) (acts must at least be “partially serving his employer’s interests.”).

Here, there is no allegation that Payne and Danker were serving FFP’s interests when they misappropriated corporate funds. Accordingly, plaintiff’s agency theory is without merit. See Harrison v. Dean Witter Reynolds, Inc., 974 F.2d at 883-84 (brokerage firm not liable *to investors* where securities fraud scheme was not a regular transaction and was not within the ordinary course of business.)⁷

⁷ Plaintiff similarly contends that FFP is vicariously liable for the fraud of Payne and Danker in stealing the corporations’ funds. For the same reasons stated above, this claim fails as a matter of law.

