

FEB 19 2002

IN THE UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF INDIANA
Indianapolis Division

UNITED STATES SECURITIES and)	
EXCHANGE COMMISSION,)	
)	
Plaintiff,)	
)	
v.)	Civil No. IP00-1265 C-T/K
)	
KENNETH R. PAYNE, ET AL.,)	
)	
Defendants.)	

**UNITED STATES' RESPONSE TO RECEIVER'S MOTION FOR DISALLOWANCE OF
PROOF OF CLAIM OF INTERNAL REVENUE SERVICE**

The United States, by undersigned counsel, responds to the receiver's motion to disallow the Proof of Claim of the Internal Revenue Service (IRS) for \$42,961.63 as follows.

The receiver objects to the IRS's Proof of Claim on the ground that the "[c]laim is subject to offset for fraudulent transfer of funds of Heartland companies made to IRS in May 2000." The objection should be overruled. There is no evidence that the United States accepted monies other than in good faith and for value, and as such, the receiver cannot recover the monies or use them to offset a current claim of the IRS.

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ARGUMENT

As a general rule, one who receives money in good faith for valuable consideration prevails over the victim. Ohio Casualty Ins. Co. v. Smith, 297 F.2d 265, 266 (7th Cir. 1962); Knapp v First Nat. Bank & Trust Co. of Oklahoma City, 154 F.2d 395 (10th Cir. 1946) (Though procured by fraud, money cannot be reclaimed after a creditor has received and applied it in the ordinary course of business and in good faith, in satisfaction of a pre-existing debt). See also 4 Scott on Trusts § 304.1 at pp. 172-173 (4th ed. 1989) (“[W]here money is paid in satisfaction of an antecedent debt or other claim, the creditor is entitled to keep the money if he had no notice that it was subject to any equity”).¹

This rule is premised on the “recognized public policy that money must be permitted to flow freely in our economy.” Ohio Casualty Insurance Co. v. Smith, 297 F.2d at 266 (footnote omitted). As was stated in Scott, supra, § 304.1 at p. 173, quoting the leading New York case, Stephens v. Board of Education, 79 N.Y.183,187 (1879):

It is absolutely necessary for practical business transactions that the payee of money in due course of business shall not be put upon inquiry at his peril as to the title of the payor It would introduce great confusion into commercial dealings if the creditor who receives money in payment of a debt is subject to the risk of accounting therefor to a third person who may be able to show that the debtor obtained it from him by felony or fraud. The law wisely, from considerations of public policy and convenience, and to give security and certainty to business transactions, adjudges that the possession of money vests the title in the holder as to third persons dealing with him and receiving it in due course of business and in good faith upon a valid consideration.

¹ Whether payments are made in cash or by means of a negotiable instrument, the result is the same. A holder in due course takes free of any claim to the instrument. Ind. Code Ann. § 26-1-3.1-306. A holder in due course, is, among other things, a holder of an instrument who acquired the instrument for value, in good faith, and without notice of any claim to the instrument. Ind. Code Ann. § 26-1-3.1-302. Under § 26-1-3.1-303, “value” includes “payment of . . . an antecedent claim against any person, whether or not the claim is due.”

Accord, Holly v. Missionary Society of the Protestant Episcopal Church, 180 U.S. 284, 293 (1901); In re Preston, 76 B.R. 654, 658-659 (C.D. Ill. 1987); see also In re Brainard Hotel Co., 75 F.2d 481 (2d Cir. 1935). The rule that the innocent recipient of misappropriated funds is entitled to retain them is also premised on the policy that a court of equity will not transfer a loss that has already fallen upon one innocent party to another party equally innocent. Holly v. Missionary Society of the Protestant Episcopal Church, 180 U.S. at 295; Taggart v. Keim, 103 F.2d 194, 199 (3d Cir. 1939); Transamerica Insurance Co. v. Long, 318 F.Supp. 156 (W.D. Pa. 1970).

The principle that the recipient of money received in good faith and in the ordinary course of business is not obligated to return it to the victim of criminal activity has been applied where the Government was the recipient of the misappropriated funds. In State National Bank v. United States, 114 U.S. 401 (1885), a clerk in the office of the Assistant Treasurer of the United States had wrongfully given Government money to a private individual, who repaid this money with a fraudulently-obtained bank draft. The Court held that the Government did not have to refund the fraudulently-obtained money to the bank because the government clerk, when he received the draft, was unaware that it had been fraudulently obtained. The Court reasoned, "Upon its [the bank draft's] receipt. . . , the government acquired the same rights, in reference to it, that any private citizen, receiving it in the ordinary course of business, would have acquired." Id. at 410.

The Government has been accorded the same protection with respect to income taxes paid with stolen money. In Transamerica Insurance Co. v. Long, 318 F.Supp. at 161, a bank robber used the proceeds of robbery to pay outstanding tax liabilities for previous years. However, the IRS employee who accepted the payment had no knowledge of the robbery. Eventually, the bank's surety, which had reimbursed the bank for its loss, sued the IRS district director for damages from the alleged wrongful seizure and appropriation of the bank's money. The district court dismissed the suit for lack of jurisdiction on the ground that there was no wrongful conduct in receiving voluntary tax payments that would confer jurisdiction on the court. Id. at 161. In the alternative, the court ruled that if jurisdiction existed, the district director's summary judgment motion would have to be granted because of the strong public policy in favor of free negotiability of money, cashier's checks, and money orders. Id. at 160-161. It held this policy as applicable when money was used to pay an income tax liability as when it was used to pay a contractual obligation (id. at 160):

It is a rule of law that title to currency passes with delivery to the person who receives it in good faith and for valuable consideration. It seems clear that an obligation to pay income taxes constitutes a valid preexisting debt, and the transfer of currency in payment of that debt is for value Thus, we hold that Hanzl's obligation to pay income taxes constituted a valid debt, and his transfer of currency in payment of those taxes was for value.

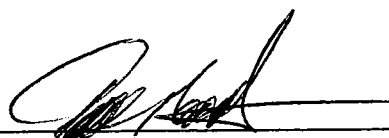
Here, the Internal Revenue Service allegedly received Heartland payments without any knowledge of Heartland's alleged wrongdoing, and it allegedly credited those payments against past due and accruing tax liabilities (thereby giving "value" for those payments). There is no evidence that the United States accepted the alleged Heartland payments other than in good faith and for value.

Under the above authorities, the IRS is entitled to keep the payments, without offset against liabilities now due and owing, and the receiver's objection fails to state a claim upon which relief can be granted.

CONCLUSION

For the foregoing reasons, the receiver's motion to disallow the Proof of Claim of the IRS should be denied.

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Dated: 2-11-02

CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing United States' Response to Receiver's Motion for Disallowance of Proof of Claim of Internal Revenue Service has been made upon the following by depositing a copy in the United States mail, postage prepaid, this 11th day of February, 2002:

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