



is slim, too tenuous as a matter of law to require them to repay what the Heartland thieves took.

Defendants have filed motions to dismiss. Plaintiff opposes the motions. Having reviewed the parties' briefs and heard oral argument, the court decides as follows.

### **I. Background**

Following are the Complaint's allegations, which the court accepts as true for purposes of the motions to dismiss. Plaintiff, James A. Knauer, is the court-appointed receiver (the "Receiver") for Heartland Financial Services, Inc. ("Heartland"), an Indiana corporation, and JMS Investment Group, LLC ("JMS"), an Indiana limited liability company. Defendants, Jonathon Roberts Financial Group, Inc. ("Jonathon Roberts"), Alliance Capital Management Corporation ("Alliance"), Andover Securities, Inc. ("Andover"), FSC Securities Corporation ("FSC"), and FFP Securities, Inc. ("FFP"), at all times relevant were broker dealers registered under Section 15 of the Securities and Exchange Act ("SEA") and with the National Association of Securities Dealers.<sup>2</sup>

Kenneth R. Payne was a licensed securities registered representative with Defendants for the following time periods: Andover - December 12, 1991 to January 1, 1996; FSC - January 1, 1996 to February 14, 1997; FFP - February 26, 1997 to October 1, 1998; Jonathon Roberts - March 15, 1999 to August 10, 2000; and Alliance - March

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<sup>2</sup> Jonathon Roberts is the successor in interest to Alliance and Andover is the predecessor to Andover Brokerage, L.L.C. and Andover Brokerage Corporation (collectively "Andover Brokerage").

15, 1999 to unknown date. Daniel G. Danker was a licensed securities registered representative with Defendants for the following time periods: Andover - October 28, 1991 to January 1, 1996; FSC - January 1, 1996 to February 14, 1997; FFP - February 26, 1997 to October 1, 1998; Jonathon Roberts - March 12, 1999 to March 27, 2000; Alliance - March 15, 1999 to unknown date. During these time periods, Payne and Danker were employees and agents of Andover, FSC, FFP, Jonathon Roberts, and Alliance (collectively the "Broker Dealers"). Each Broker Dealer was able to control Payne and Danker during the time period in which they maintained their securities licenses with such Broker Dealer. (Compl. ¶ 35.)

Heartland was founded by Payne and holds itself out as a brokerage, insurance and estate planning firm. Payne owns and was the president of Heartland. Heartland was not registered with the United States Securities and Exchange Commission ("SEC"). JMS was founded in 1997 by Johann M. Smith. Smith was the manager of and attorney for JMS and made the investment decisions for JMS. Danker was the vice president and office manager of Heartland. He maintained Heartland's books and records. Constance Brooks-Kiefer was an administrative assistant at Heartland. She was responsible at both Heartland and JMS for preparing and issuing checks, depositing investor funds, preparing and issuing account statements, and maintaining the books and records.

Beginning in 1994 and continuing through August 2001, Payne, Danker, Smith, Brooks-Kiefer, Heartland, JMS and others engaged in a fraudulent Ponzi scheme in which "induced investors to pay them millions of dollars through the fraudulent sale of

securities (the Ponzi Scheme).” (Compl. ¶ 24; SEC Compl. ¶ 1.) Investors were told that their investments would be used to purchase securities and were promised a high rate of return. Payne and Danker sold the securities without registration under the SEA and in violation of the SEA and the Indiana Securities Act. Investors were sent fraudulent confirmations and monthly statements on Heartland letterhead and/or that of Heartland’s alter ego entities which indicated the investments were earning high rates of return.

Most investor funds in Heartland and JMS were deposited into an account in the name of Lincoln Fidelity Escrow (the “Lincoln account”) and commingled with other investor funds. Smith and Brooks-Kiefer are the signatories on the Lincoln account. Some investor funds were deposited directly into Payne’s bank account; some investor funds were transferred from the Lincoln account to Heartland’s corporate account. Payne and Danker are signatories on Heartland’s account. Though a limited amount of investor funds in Heartland, JMS and other related entities were used to purchase securities, most investments were never made and were used in the Ponzi scheme and/or to pay the personal and business expenses of Heartland, JMS, Payne, Danker, Smith, and Brooks-Kiefer. Payne, Danker, Smith and Brooks-Kiefer wrongfully converted Heartland funds to their own use and personal benefit or to that of others. Also, assets of Heartland and JMS were fraudulently transferred to a number of persons and other entities controlled by Payne, Danker, Smith, Brooks-Kiefer and others. Danker has been convicted of wire fraud and money laundering. Payne has been convicted of mail fraud and money laundering.

The investors were induced by the fraud and deceit of Payne and Danker. The investors believed that Payne and Danker were acting with the knowledge, consent and approval of the Broker Dealers and that the investments offered by Payne and Danker were approved and authorized by the Broker Dealers. No Broker Dealer notified the investors "to whom Payne and Danker fraudulently sold securities that Payne and/or Danker were not authorized to offer and sell such securities." (Compl. ¶ 46.)

It is alleged that "Payne, Danker and the Broker/Dealers owed a fiduciary duty to each of the investors and to Heartland and JMS to act honestly and openly and in good faith in the conduct of their affairs and in handling investor funds." (*Id.* ¶ 49.) They breached this fiduciary duty "when, among other things, Payne and/or Danker commingled funds invested, . . . converted funds in bank accounts and other invested funds to their own use and benefit, fraudulently misrepresented the value of securities and how investor funds would be invested or used and when the Broker Dealers failed to exercise adequate and reasonable oversight over the conduct of Payne and Danker." (*Id.* ¶ 50.)

The Broker Dealers, as licensed securities broker dealers, had a duty to supervise, monitor and control the securities sales activities of Payne and Danker, including the duty to ascertain what securities they were selling, the handling of the proceeds of such sales, and whether Payne and Danker were engaging in other business activity. (*Id.* ¶ 60.) This duty was owed to those persons to whom Payne and Danker sold securities and to Heartland and JMS; and the Broker Dealers breached this

duty, causing the losses to the investors and the losses and liabilities of Heartland and JMS. (*Id.* ¶¶ 61-63.)<sup>3</sup>

The Complaint incorporates by reference the 95 rhetorical paragraphs of the complaint filed against Payne, Danker and others in the case of *United States Securities and Exchange Commission v. Payne*, Cause No. IP00-1265-C-T/G (the "SEC Complaint"). (Compl. ¶ 26.) The Complaint also incorporates by reference rhetorical paragraphs 41 through 206 of the complaint filed by the Receiver against Payne, Danker and others in *Knauer v. Payne*, Cause No. IP00-1629-C-T/G (the "RICO Complaint"). (Compl. ¶ 27.)

The SEC Complaint alleges that Heartland and JMS engaged in acts which violated federal securities laws and made false and misleading statements and knew or were reckless in not knowing about the Ponzi scheme including the false and misleading statements of Heartland, JMS, Payne, Danker, and Brooks-Kiefer. (See, e.g., SEC Compl. ¶¶ 4-5, 72-74, 76-77, 79-81, 82-86, 89-93.) The SEC Complaint further alleges, *inter alia*, that all investor funds were deposited in the Lincoln account (*id.* ¶¶ 21, 57), JMS never purchased the promised stocks or purchased only a limited number of shares to show investors and the remaining funds were deposited into the Lincoln account and commingled with funds from the other investment schemes, (*id.* ¶ 35). In addition, it is alleged that Heartland investor money was not deposited into the Heartland bank account (*id.* ¶ 55) and most of that money was commingled with other

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<sup>3</sup> The Complaint designates the paragraph as 23, but this appears to be a typographical error.

investor funds in the Lincoln account, which account was used to operate the Ponzi scheme and allocated to Payne, Danker, Smith, Brooks-Kiefer, Heartland, JMS, and for travel, entertainment and clothing allowances for employees, (*id.* ¶¶ 51, 62, 63). The SEC Complaint also alleges that investor money was deposited directly into Payne's banking account; only a small percentage of all money deposited into the Lincoln and Payne accounts and transferred to the Heartland account was used to purchase legitimate securities; and much of the money deposited into the Heartland account was used to pay Payne and his personal expenses, paid to Smith or converted to cash. (*Id.* ¶¶ 59-65.) The SEC Complaint alleges that "JMS and Heartland knew, or were reckless in not knowing, of the activities described in Paragraphs 89 [which realleges and incorporates by reference paragraphs 1 through 65] through 91 above." (SEC Compl. ¶ 92; *see also id.* ¶¶ 70-73, 78-80.)

Count I of the Receiver's Complaint in this case alleges that the Broker Dealers were "controlling persons" under the SEA and the Indiana Securities Act, Indiana Code § 23-2-1-19(d), and are therefore liable for the associated wrongful conduct of Payne and Danker pursuant to Section 20 of the SEA and the Indiana Securities Act. Count II alleges that the Broker Dealers were "controlling persons" and thus liable for the sale of unregistered, non exempt securities by Payne and Danker pursuant to Section 15 of the SEA and Indiana Securities Act. Count III alleges that the Broker Dealers are "directly liable to each investor and to Heartland and JMS for breach of fiduciary duty and fraud" (Compl. ¶ 51) and are liable "for the fraudulent and wrongful conduct of Payne and Danker . . . under the doctrine of *respondeat superior*." (*Id.* ¶ 52.) Count IV is brought

under Indiana's civil actions by crime victim statute and alleges that the Broker Dealers conducted or participated directly or indirectly in the commission of several criminal acts in violation of state law which caused pecuniary loss to Heartland, JMS and their investors. Count V alleges that the Broker Dealers negligently supervised the securities sales activities of Payne and Danker.

## II. Discussion

The Broker Dealers move pursuant to Rules 12(b)(1) and 12(b)(6) to dismiss the Complaint for lack of subject matter jurisdiction, contending that the Receiver lacks standing. They also argue that the Receiver's claims are barred under the doctrine of *in pari delicto*. FSC contends that the Receiver's claims against it on behalf of JMS must be dismissed because JMS did not exist until the affiliation of Payne and Danker with FSC had ceased. The Broker Dealers offer several other arguments in support of their motions, but the court need not reach them here for reasons that become apparent in this entry.

### A. Legal Standard Under Rules 12(b)(1) and 12(b)(6)

In ruling on a Rule 12(b)(1) motion to dismiss for lack of standing, the court accepts as true the factual allegations of the complaint, construes the complaint in favor of the plaintiff, *Perry v. Village of Arlington Heights*, 186 F.3d 826, 829 (7<sup>th</sup> Cir. 1999); *Am. Fed'n of Gov't Employees, Local 2119 v. Cohen*, 171 F.3d 460, 465 (7<sup>th</sup> Cir. 1999),

and considers whether relief is possible under any set of facts that could be established consistent with the complaint, *Cohen*, 171 F.3d at 465.

Similarly, a Rule 12(b)(6) motion to dismiss should not be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). A plaintiff is not required to plead the facts or elements of a claim, unless the claim falls within the exceptions in Rule 9. *Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, —, 122 S. Ct. 992, 998 (2002); *Walker v. Thompson*, 288 F. 3d 1005, 1007 (7<sup>th</sup> Cir. 2002). However, if a plaintiff "plead[s] particulars, and they show he has no claim, then he is out of luck—he has pleaded himself out of court." *Jefferson v. Ambroz*, 90 F.3d 1291, 1296 (7<sup>th</sup> Cir. 1996) (quoting *Thomas v. Farley*, 31 F.3d 557, 558-559 (7<sup>th</sup> Cir. 1994)) (alteration added). The same as with a Rule 12(b)(1) motion, in ruling on a 12(b)(6) motion, the court views the complaint in the light most favorable to the plaintiff and accepts the complaint's allegations as true. *Doherty v. City of Chicago*, 75 F.3d 318, 322 (7<sup>th</sup> Cir. 1996).

### *B. The Receiver's Standing*

The first issue is whether the Receiver has standing to bring the claims asserted in this case. The party invoking the federal court's jurisdiction bears the burden of establishing standing. *Perry v. Village of Arlington Heights*, 186 F.3d 826, 829 (7<sup>th</sup> Cir. 1999). At the pleading stage, general factual allegations of injury resulting from the

defendant's conduct may suffice for purposes of establishing standing. *Family & Children's Ctr., Inc. v. Sch. City of Mishawaka*, 13 F.3d 1052, 1058 (7<sup>th</sup> Cir. 1994).

The Receiver lacks standing to assert claims on behalf of the defrauded investors and has standing to assert claims on behalf of the receivership entities, namely Heartland and JMS. See *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416, 429 (1972); *Scholes v. Lehmann*, 56 F.3d 750, 754-55 (7<sup>th</sup> Cir. 1995). In *Scholes v. Schroeder*, 744 F. Supp. 1419 (N.D. Ill. 1990), the court relying on *Caplin* said that "a 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." *Id.* at 1422. In that case, a receiver, Steven Scholes, brought suit on behalf of corporations in receivership, asserting *inter alia* federal securities claims under § 10(b) and Rule 10b-5 and common law fraud, emphasizing the injury to investors. *Id.* at 1423-24. The court held that the receiver could not bring claims on behalf of investors in the corporate entities. *Id.* at 1422. The court explained:

Fraud on *investors* that damages those *investors* is for those *investors* to pursue—not the receiver," and "by contrast, fraud on the *receivership entity* that operates to *its* damage is for the *receiver* to pursue (and to the extent that investors as the holders of equity interests in the entity may ultimately benefit from such pursuit, that does not alter the proposition that the receiver is the proper party to enforce the claim).

*Id.* (emphasis in original).

The Seventh Circuit applied the same rule in *Troelstrup v. Index Futures Group, Inc.*, 130 F.3d 1274 (7<sup>th</sup> Cir. 1997), in which the Commodity Futures Trading

Commission sued John Tobin, a trader alleged to have defrauded investors. At the Commission's request, the court appointed John Troelstrup as Tobin's receiver. Troelstrup filed a claim against a registered futures commission merchant through which Tobin had traded on behalf of four commodities trading accounts (hereinafter referred to as the Phoenix Pharynol account) established by Tobin with the merchant. Troelstrup alleged that the merchant's negligence facilitated Tobin's fraud. *Id.* at 1275-76. The Seventh Circuit held that the receiver lacked standing to sue on behalf of the Phoenix Pharynol account or the investors "because he was not *their* receiver." *Id.* at 1277 (emphasis in original).

Thus, the question is whether the claims asserted by the Receiver are claims of the investors or Heartland and JMS. The Broker Dealers argue that the claims are of the investors, whereas, the Receiver argues the claims are of Heartland and JMS. Neither side gets it completely right; the answer is that some of the claims alleged are claims of the investors and others are of Heartland and JMS.

The Complaint alleges that Payne and Danker engaged in a fraudulent and deceptive Ponzi scheme in connection with the sale of securities to the investors that violated federal and state securities laws. The Broker Dealers contend that the securities claims asserted in Counts I and II fail because there is no injury to Heartland or JMS from the securities transactions. In response to the challenges to his standing, the Receiver shifts the theories and focus of his Complaint from the injury to the defrauded investors to the injury to Heartland and JMS. Though there ultimately are sufficient allegations in the Complaint to support this shift in theories, the court is

required to ignore the vast majority of the allegations in the Complaint which focus on the rights of and injury to the defrauded investors, which, despite the Receiver's position, appear to be more than mere background allegations.

At oral argument in direct response to a question by the court, counsel for the Receiver conceded that the harm to Heartland and JMS came not from the sales of securities but from the conversion of the funds of Heartland and JMS by Payne and Danker. This concession and the relevant case law cited above dictate the conclusion that the Receiver lacks standing to maintain the federal and state securities claims asserted in Counts I and II.

In his response brief, the Receiver maintains that the decisions in the *Scholes* cases support the conclusion that he has standing to pursue the claims of Heartland and JMS against the Broker Dealers, see *Scholes v. Lehmann*, 56 F.3d 750 (7<sup>th</sup> Cir. 1995), *cert. denied*, *African Enterp., Inc. v. Scholes*, 516 U.S. 1028 (1995); *Scholes v. African Enterp., Inc.*, 838 F. Supp. 349 (N.D. Ill. 1994); *Scholes v. Stone, McGuire & Benjamin*, 821 F. Supp. 533 (N.D. Ill. 1993). Though these decisions may lend support to the Receiver's claim to standing to assert claims for breach of fiduciary duty, fraud, negligent supervision, and action by a crime victim, none supports his claim to standing to bring the securities claims.<sup>4</sup>

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<sup>4</sup> *Lehmann* and *African Enterprises* involved fraudulent conveyance claims, and the courts concluded that the unauthorized removal of assets from the corporations caused injury to the corporations. *Lehmann*, 56 F.3d at 754; *African Enterp.*, 838 F. Supp. at 353. *Stone, McGuire* involved legal malpractice, negligence and breach of fiduciary duty claims against the attorneys and law firm for the schemer and the receivership entities, and there was a factual issue regarding the damages to the

