

UNITED STATE DISTRICT COURT  
SOUTHERN DISTRICT OF INDIANA  
INDIANAPOLIS DIVISION

JAMES A. KNAUER, ET AL.,                    )  
  )  
  Plaintiff                    ) **CAUSE NO. IP 01-1168-C-K/T**  
  )  
  -v-                                ) Indianapolis, Indiana  
  )  
  )  
JONATHON ROBERTS FINANCIAL                )  
GROUP,    )  
  Defendant.                    )

Before the Honorable

JOHN DANIEL TINDER, JUDGE

OFFICIAL REPORTER'S TRANSCRIPT OF  
ORAL ARGUMENT

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PROCEEDINGS TAKEN BY MACHINE SHORTHAND  
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TRANSCRIPTION

(Court opened 10:05 a.m.)

THE COURT: Please be seated. Good morning. We're here for the arguments. I scheduled it earlier and I understand that the defendants have figured out the organization they want to go with. I wasn't clear in the notice. I was presuming that the defendants in total would use one hour, but I suppose you could have read that to believe that each set of defendants could have one hour. Tell me, as a group is that what you thought, did you think you each had an hour?

MR. WACK: Your Honor, Tom Wack, I represent one of the defendants. It was our intention to take one hour among us.

THE COURT: Okay. So you can argue it within that.

MR. WACK: Yes.

THE COURT: So, Mr. Wack, you're going to go first. I have read all of the briefs. I do have some background related to the various Heartland litigation that has been pending before me. So, you can assume that familiarity. I have looked at a number of the cases that you have all cited.

MR. WACK: Okay.

THE COURT: You're making good use of your local counsel I see.

MR. RILEY: Yes, indeed. Your Honor, good morning.

MR. WACK: Your Honor, I represent the Defendant FFP Securities. I will direct my remarks primarily to the issue of standing.

Mr. O'Connor will follow me; I believe he will speak principally about damages.

Mr. Helwig will address the issues under the Federal Securities laws; and

Mr. Wheeler will address some state law issues. That's the way we intended to allocate it.

THE COURT: That will be fine.

MR. WACK: What I will say, however, is that I think what I say on behalf of FFP applies to all broker dealers unless somebody indicates otherwise. So, by way of clarification, Your Honor, I think the receiver's brief tries to create the impression here that these broker dealers were deeply mired in this Ponzi scheme and that's the reason that I have presented this graphic here. In fact, there were really two separate things going on.

On line one, there was the fraud perpetrated by danger and pain upon the Ponzi scheme victims; and according to exhibit A to Mr. Payne's plea agreement, which Your Honor may take judicial notice of, there are some 416 defrauded investors with claims of about 28 and a half million dollars. I'm sure you know all these numbers better than I do.

Paragraph 24 of the complaint states that the Ponzi scheme

started in 1994 and continued through August of 2001 for a period of about two years. On line 2, that's intended to show that at the same time Mr. Danker and Mr. Payne were also licensed registered representatives for the defendant broker dealers at various times. And in that capacity they took orders on behalf of customers who bought and sold legitimate securities through the broker dealers.

Now, the complaint alleges that Danker and Payne were licensed through my client, the FFP Securities, for only about nineteen months, and that would be from February of 1997 to October 1 of 1998, not seven years, nineteen months. And they were licensed with the other defendants for comparable periods of time, which were generally, I think in every case, less than two years. What is significant here is that there is no allegation that those people who lost money through Heartland and JMS, these people, were customers of these people. No such allegation anywhere in the complaint. And in fact we've done a little homework on that matter and I think the other defendants have as well. What we're able to tell is that only eight -- I will repeat that, eight FFP customers appear on Mr. Knauer's list of 416 Danker/Payne victims of the Ponzi scheme.

THE COURT: Isn't that a matter of proof that goes well beyond what I could evaluate?

MR. WACK: It does, Your Honor. And I don't want to speak outside the record, but I can represent to you that there

is no allegation anywhere in these pleadings that these people have any relationship to these people.

Now we will acknowledge that receivers are supposed to be aggressive in trying to recover monies for the estate, but if the Court please, I think if you're overly aggressive the chances are you may be, you may well be wrong. The pleaded claim here is that the stolen funds were the investors' money and that the receiver can recover it for them. There is no legal basis for that claim, Your Honor.

Under the pleaded theory there are at least three problems with it. First of all, each of the broker dealers would be jointly and severally liable for all the losses in the seven and a half year period. Now remember we have a relationship with Danker and Payne for less than two years, so does everybody else. Under this joint and several theory of the receiver we would be liable for all losses that occurred in the seven and a half year period.

And also it doesn't -- it goes beyond our own customers and it goes beyond the customers of the other broker dealers. The claim covers all of these 416 investors, even those who were never customers of any of the broker dealers.

The second problem with the pleaded claim is that it doesn't end around the class action rules. If the receiver could sue on behalf of all the Danker/Payne investors and avoid having to meet the class certification rules, then these broker

dealers would be subject to double recovery, Your Honor.

Let's just assume hypothetically that Mr. Knauer were to try this case and he fails to recover anything or he doesn't recover enough to satisfy some of these investors, there would be nothing, absolutely nothing to stop those people from saying, We never agreed to have Knauer represent us. Who is this guy Knauer? We're not bound by his lawsuit; we're going to bring our own case.

THE COURT: Mr. Wack, maybe I didn't get your brief on these points. Is this included in your opening brief or your reply brief, the argument about the failure to comply with class action requirements or --

MR. WACK: Your Honor, I think it was mentioned perhaps in Mr. O'Connor's brief, but it is mentioned that -- I know it's specifically, it is discussed in the Caplin case from the United States Supreme Court, which is cited in our brief, and I think is cited in the brief of all the defendants. So my point is this lawsuit provides no res judicata protection to the broker dealers from separate class or individual suits by these investors.

The third problem is that in suing on behalf of the investors the receiver can't simply come in and put a claim before you and say this is our lawsuit. We would be mired down in litigation of each one of these people individually. I think Mr. Wheeler is going to talk a little bit more about

that, but in effect he would be talking about bringing 416 claims with individual questions of damages, reliance and so forth.

Now, it's because of problems like those that both Federal and Indiana cases hold that a receiver can sue only on behalf of the entity for whom he is appointed to act and not for the benefit of third parties who are investors or creditors. And I think the principal cases that we're relying on for that in that regard are the Caplin case from U. S. Supreme Court; there's an excellent discussion of the decision of the Fleming case from the First Circuit; from the Johnson case, which was a District Court decision in Colorado. And under Indiana law it's been a law in this state since Turner v. Henshaw in 1927 that a receiver cannot sue on the basis that a recovery could increase the size of a receivership estate and thereby benefit the creditors of the corporation.

THE COURT: Mr. Wack, let me ask you about your reference to Indiana cases on receivership, the authority of Indiana receivers. What difference does that make? Isn't -- Mr. Knauer pointed strictly under federal law. Doesn't federal law control his authority --

MR. WACK: Certainly. I think we have both federal and state claims involved in this case, as Your Honor knows, and I think the question of standing, certainly with respect to the federal claims, is governed by federal law, which is why we

have primarily relied on federal cases.

To the extent that an argument may be made that under the state law claims the issue of standing is substantive rather than procedural, I don't really know the answer to that question. Indiana law would control and Indiana law would govern the substantive capacity of receiver in what his rights were.

THE COURT: Well, Mr. Knauer was appointed because the SEC filed its action and sought the receiver through the SEC's action, which is federal action.

MR. WACK: Right.

THE COURT: And the appointment, correct me if I'm wrong, I believe was under the federal law.

MR. WACK: I don't quarrel with that, Your Honor. I would simply point out that to the extent that this complaint relies on Indiana state law, we think that those cases may be relevant there.

Now when I pointed out, when we pointed out all these problems and these cases with respect to the pleaded theory of this case, the receiver did a complete about face. He changed his theory so that his brief now says he's not suing on behalf of these investors, he's suing on behalf of JMS and Heartland rather than on behalf of the individuals who lost money. And I believe the reason he's done that, Your Honor, is that he believes that if he can claim Heartland and JMS were the

victims rather than the investors that the Seventh Circuit's decision in Scholes v. Lehmann will save the day for him. And I would respectfully suggest to you that it won't. Scholes v. Lehmann was a fraudulent conveyance case and it is based upon the rule which allows a receiver to sue for the recovery of corporate assets, which may benefit third party investors, by the way, where those fraudulently -- where those corporate assets were fraudulently transferred by the wrongdoer to a third party. In other words, these would be assets that belong to the receivership estate and there's been a fraudulent transfer and the estate is entitled to marshal those assets and bring them back into the estate.

Mr. Knauer's claim against these broker dealers has nothing to do with any fraudulent transfer. In fact, there is no allegation anywhere in this complaint that the broker dealers received any funds or any assets belonging to JMS or Heartland.

Now, Your Honor, Judge Posner wrote Scholes v. Lehmann, but I would also point out to you he wrote a subsequent decision in a case called Troelstrup, which we have cited some more recent case, 130 F.3d 1274. And in Troelstrup the Court distinguished Scholes v. Lehmann, stating that the receiver in Scholes had standing to sue to recover back from the defendant funds that had been fraudulently transferred from the receivership entities.

Now let me just -- at page 1277 of the opinion in

Troelstrup --

THE COURT: By the way, Mr. Wack, would you make sure the court reporter gets the spellings of the cases that you cite.

MR. WACK: I will. The Troelstrup case, T-R-O-E-L-S-T-R-U-P, v. Index Futures Group at 130 F.3d, 1274, and the Court said at page 1277, the receiver could not sue the broker on behalf of the defrauder because the defrauder had no claim against the broker. And he could not sue on behalf of the investors because he was not their receiver.

That's precisely the situation that we have here today. He can't sue on behalf of the investors because he's not their receiver. He's the receiver for JMS and Heartland and the rub for him is that in suing on behalf Heartland and JMS he has no claim against the broker dealers.

And I would like to go back in my chart for a moment and point out, you know, there are duties that flow from these relationships. Certainly Danker and Payne had a duty to the victims in taking care of their money. JMS and Heartland, on whose behalf they were acting, also had duties to those people. The broker dealers, our clients, clearly have duties to our own customers to the extent that they are acting as customers of ours. At this level the Ponzi scheme victims were, they were in suit as a class action or individually, would have a much tougher case against the broker dealers. We think they

couldn't make that case because there's no customer relationship at all there.

But the one thing that we can say for certain, Your Honor, looking at this chart, the one place where there is no duty whatever is at the level of JMS and Heartland with the broker dealers, which is the theory of this case at this point in time. There were no transactions between them, no transactions alleged, no transfers of funds, no business relationships. Nothing.

Now the fact is, and this is alleged in paragraph 24 of the complaint, Messrs. Payne and Danker, their actions in looting Heartland and in converting the funds, which allegedly belong to Heartland and JMS, were done on behalf of those organizations and not as registered representatives of the defendants. That's the whole problem here.

There is, I think it's significant in analyzing whether a complaint states an actionable claim to look at what it does not allege. And this complaint does not allege any of the following things, and our position would be consistent with Rule 11, it could not, the plaintiff could not do so. There is no allegation here that Messrs. Danker and Payne were acting to further any business interests of the broker dealer. None.

To the contrary, paragraph 44 of the complaint says, "Payne and Danker were offering investments that were not approved or authorized by the brokerage firms with whom Payne and Danker

were licensed. Those are the receiver's own words. There is no allegation in this case that the broker dealers ever received a dime from anybody here. There is no allegation of any contractual or other business relationship between Heartland and JMS and the broker dealers, no allegation that we were complicit or conspired with them. No allegation that broker dealers had any control over the accounts that were ultimately used here. And also it's very important there was no allegation that Heartland and JMS relied in any way upon the broker dealers.

What the complaint --

THE COURT: Is it necessary to be that specific in a complaint to satisfy the Rule 20(b)(6)?

MR. WACK: Your Honor, this is a complaint case based on fraud. This a fraud case.

THE COURT: So absent those allegations there's not a sufficient statement of fraud or assertion.

MR. WACK: There was no allegation of fraud against our client in this case. I would point this out to you, Your Honor. Paragraph 34 of the complaint. What the complaint does say, and this is the whole theory of the case from what we can tell. The whole theory of the case is that the victims were lulled into a false sense of security by Messrs Danker and Payne because, by their association with the broker dealers and by their ability to advertise the fact that they were NESD

members and had protection under the Securities Investment Protection Corporation.

Now, Your Honor, that's a complaint of course on behalf of the Ponzi scheme victims, not on behalf of JMS and Heartland. But the point I'm making is, there is no such cause of action for lulling somebody into a false sense of security. The fact that that may have happened is not actionable.

I want to just conclude by saying the following: Your Honor, we are under no illusions about this matter. You appointed Mr. Knauer as the receiver here, and we suspect that you did so because he is -- you respect him and because he's a respected member of the bar. You have also been through these criminal proceedings and you know better than any of us how bad this conduct really was. And finally, we recognize that a lot of people lost a lot of money here. And what I would say though in response to all of that is what many of us heard from professors in law school the aphorism about hard cases making bad law. This is one of those cases.

We ask you to decline this invitation to just grab the first wallet that comes along here. The fact of the matter is that these broker dealers could have looked at their own records until they were blue in the face and never discovered what was going on because it was totally off the books. Everybody here would concede that. And if the theory is that Danker and Payne should never have been allowed to become stock

