

Secondly, I think this is a matter of where you are talking about fraud here, which is the underlying theory of this case. You always have the Rule 9, Federal Rule of Procedure 9 requirement to plead fraud with particularity. So I think there is both the substantive and procedural response to your question.

Substantively, I think no amount of facts or proof will come out in this matter that can undermine the admissions already made. And secondly, there are insufficient facts pled that are required by the law to establish the control that they have to allege and prove is necessary under the section 20 control liability. So that's why I believe that on this record. It's not even a matter of allowing a receiver perhaps to replead. I think there are enough facts admitted and of record in this matter already that are incorporated into the complaint that the result is clear and the law will be clear on how the law should apply to these facts.

Since we're probably using up more of our time, unless you have any further questions, I'm going to allow Mr. Wheeler to make some similar and related arguments for the state law claims.

THE COURT: I have no additional questions for you.

MR. HELWIG: Thank you, Judge.

MR. WHEELER: Your Honor, I will of necessity be very brief with the three state law claims. As the Court knows,

these are common law tort claims, the three state law claims, in tort of course, are premised upon the idea that you have breached duty and proximate cause.

The problem in this case with the investor, with the receiver switching legal theories from relying upon the claims of the investors to relying on the damage to Heartland/JMS is that they cannot show there was a duty owed from the broker dealers to Heartland/JMS. There may in fact be a duty owed to the investors under these various state common law duties. And in fact there is currently pending in the Southern District of Indiana before Judge McKinney an investor lawsuit making these identical claims; in fact, it's a carbon copy of the receiver claims.

The problem is in this case, and this is why this isn't a factual question, this is what is pled and what is claimed in the brief, and I'm quoting from page 4 of the receiver's brief, the injury to Heartland occurred when Payne and Danker misappropriated Heartland funds that had previously been paid to Heartland by the investors. So the reliance on the investors, this walling in the false sense of security, the investors paid their money, it was put into Heartland funds. Then the criminal act took place, the crime victim act, the breach of the fiduciary duty took place when they pulled that money out of the Heartland/JMS till and converted it to their own use.

The problem with this switch, while this may give them standing as a receiver, this switch eliminates the -- it breaks the link, the duty theory. Yes, we may owe as broker dealers duties to the investors, and the investors assert that in their own separate litigation which is currently pending before Judge McKinney. What this does is this breaks the chain. We do not owe and they cannot either allege or prove that there is any duty running from the broker dealers to control Payne and Danker in the manner in which they operate at Heartland Financial. And the most eloquent speech on that particular issue is their own fiduciary duty argument.

They argue that there was a breach of fiduciary duty.

Question: What fiduciary duty was breached? It was the fiduciary, their fiduciary duty as officers and directors in Heartland/JMS not to steal, not to put that money in those accounts and then not to misappropriate those Heartland funds, Your Honor. That's why this switch in legal theories, while it may support standing on the federal securities action, undercuts their entire state law claims in counts 3, 4 and 5 because there simply is no duty from the broker dealers to Heartland/JMS.

Unless the Court has any questions, I'll reserve the remainder of my time for rebuttal, Your Honor.

THE COURT: I have no questions for you.

MR. WHEELER: Thank you, Your Honor.

THE COURT: Mr. Bock's going to argue for the receivers; is that right?

MR. BOCK: Yes, Your Honor. Take a moment to get a few things up there --

THE COURT: All right.

MR. O'CONNOR: Your Honor.

THE COURT: Yes, Mr. O'Connor.

MR. O'CONNOR: By my count we have fifteen minutes left?

THE COURT: You can have all the time left you'd like.

I'd like to ask a question. Andover Securities has not appeared or they have appeared?

MR. O'CONNOR: Have not.

MR. BOCK: We have been unable to locate them, Your Honor.

THE COURT: So they have been not been served?

MR. BOCK: Yes, sir.

THE COURT: The 120 days for service has long expired I take it?

MR. BOCK: Yes. And we can dismiss them without prejudice.

THE COURT: Okay. Well, while we're moving along those lines, do you buy Mr. O'Connor's argument regarding FSC and JMS, that the JMS didn't come into existence until after FSC's relationship with Heartland terminated?

MR. BOCK: No, Your Honor. I was going to address that at the end.

THE COURT: Well, I'll wait.

MR. BOCK: I wanted to when -- apparently my computer shut down when I closed the top.

THE COURT: Would you like to take a minute and get that set up?

MR. BOCK: That would be fine. I think -- well, it's rebooting right now. So that usually takes about 60 seconds, maybe two minutes. Okay. I'm up.

Before I switch to the power point, which the staff here has helped me a great deal with getting set up so we can present it, I'd like to take a minute and take a look at the exhibits of the defendants that they have left here. And actually I think that these exhibits are quite illustrative of a couple of changes and will help us to visualize what in fact is the state of the authority of the broker dealers to control the actions of Payne and Danker. And all that is necessary to make these exhibits accurate is to draw some lines from the broker dealers to Danker and Payne and to JMS and Heartland.

As the Court has noted throughout the argument today, this is not a summary judgment proceeding, but at the same time a lot of facts have been alleged about what sort of control the broker dealers had over Heartland and JMS and over Payne and Danker. And it's easy to make lot of allegations when you

filed the motion to cut off discovery and not permit the receiver to obtain any of the documents that would further show that control; but fortunately, although Payne and Danker destroyed many of the records of Heartland, they didn't destroy all of them, and we have enough records to know and there is enough law out there to know that the broker dealers did have the responsibility to control Payne and Danker and they did have a duty to Heartland and JMS. And if this diagram were accurate, it would have arrows pointing back from the broker dealers to Danker and Payne and to JMS and Heartland.

Your Honor, may it please the Court, my name is Bill Bock and I'm with the law firm of Kroger Gardis & Regas. I do represent the receiver Jim Knauer, and with me today sitting at counsel table is Reynolds Brissenden. And I take this moment to recognize him because of the great deal of work that he did on the brief and in preparing for the hearing today. And I view him as something like Curt Schilling in the bullpen and who may be at an appropriate time for him to respond to questions.

THE COURT: If your arm goes bad in pushing the button, we'll just bring him in to relieve you.

MR. BOCK: It could happen, but his arms and his mind are suited to much weightier matters than pushing the button.

You, Your Honor, are well aware of the fraudulent scheme in which Ken Payne, Daniel Danker and others were immeshed. And

much has been said by the attorneys for the broker dealers on what extent they believe that Jonathon Roberts, Alliance Capital Management, FFP Securities and FSC Securities were not involved in this scheme, but I hope over just the next couple minutes to demonstrate that in fact the role of these broker dealers was very significant, that at best these broker dealers were incredibly naive and grossly negligent in their duties. They were clearly enablers without whom this massive scheme to defraud could not have existed and possibly, and we have some evidence of this, possibly they were active and knowing participants in all or some of the fraud and misconduct.

We have not had an opportunity to discover the background facts; and typically on a motion to dismiss the background facts are not relevant, but repeatedly throughout the arguments today we heard statements like the broker dealers had no ability to control Payne or Danker.

Mr. Wheeler, the last attorney representing the defendants, and I quote him, said that the receiver "cannot prove a duty of the broker dealers to control." The effort has been made apparently by the defendants without submitting an iota of factual material to change this or convert this subtly into a summary judgment proceeding. And many things are alleged in the hundreds of paragraphs that are either in the receiver's complaint and in the other complaints that are incorporated in that complaint and made a part of it. And we believe, and I

think I can demonstrate to the Court, that all of the facts necessary to state a claim against the defendants on all of the theories presented have been and are contained in the complaint.

Each of these broker dealers was a member of the National -- or the NASD, National Association of Securities Dealers. And the National Association of Securities Dealers has a manual that sets out some of the duties that these broker dealers owed to the public and Heartland and JMS as members of the public and as entities that were affiliated with these broker dealers. One of the responsibilities of the broker dealers was to "establish and maintain a system to supervise the activities of each registered representative..." That's in section 3010 of the NASD manual.

Section 3010(e) says, "Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application...for registration..."

The duty of these broker dealers began at the very moment that Mr. Payne and Mr. Danker applied to them to be registered securities agents, operating through Heartland Financial Services and to be recognized as licensed agents of each of these broker dealers. The duty began at that point and that is when the violations of that duty began as well, because an

adequate investigation at that point would have shown that Mr. Danker and Mr. Payne had in fact been disbarred for conduct involving poor character.

But the duty didn't end with that initial responsibility. It goes on, there is a duty of the broker dealers to make sure in their responsibility as a member of the National Association of Securities Dealers to make sure that Payne and Danker were not receiving income outside of the scope of their relationship as registered agents for the broker dealers. So they had a duty to oversee how Payne and Danker were making a living. And that's set forth in 3030 of the NASD Manual.

It says, "No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm..."

There have been a lot of statements about the scope and there are many statements in the briefs about the scope of the agency relationship between Payne and Danker and how all of their conduct in terms of taking money out of the bank accounts and using it for improper purposes and paying themselves extraordinary salaries are outside the scope of their relationship or responsibilities with the broker dealers. Not so. The broker dealers had a duty to ensure that the income that Payne and Danker were receiving were part of, were as the

result of income from legitimate, appropriate securities transactions for Heartland Financial Services.

There is an affirmative duty for each member, and again each member here means every broker dealer including each of the defendants, to "conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses."

If the broker dealers had fulfilled the duties that are clearly imposed upon them as members of the NASD, the massive fraudulent scheme would not have existed. Because they did not fulfill those duties and responsibilities, Heartland, the financial services and JMS were used, and the assets of those companies which should have been used to purchase legitimate securities were taken and used for illegitimate purposes. The broker dealers were in a position to detect that fraud, they were required by their duties as broker dealers and members of the NASD to detect that fraud and they didn't do it.

Here is a statement that the Heartland Financial Services Organization, which Mr. Knauer is the receiver for, put out during the tenure of Payne and Danker. This is an account

statement, it reflects at the bottom as you can see, securities offered through FFP Securities, Inc. These securities relate to the Atlas scheme that is described in the receiver's RICO complaint that is incorporated into the complaint in this case. If the broker dealers had simply fulfilled their responsibilities to conduct an investigation they would have seen numerous documents like this reflecting transactions that they say, and we haven't had discovery, they say their records do not reflect. And they would have been in a position to put an end to unauthorized securities transactions in violation of the law which caused injury to Heartland.

THE COURT: Well, perhaps you're getting to this, but how does this argument fit with your allegations of paragraph 44 of your complaint? And I understand from the document you just showed me that Ms. Crawford was deceived, arguably deceived and harmed by that document. How does that show Heartland was?

MR. BOCK: Heartland was injured by the failure of the broker dealers to exercise the duty of care that they owed to Heartland. Heartland was further injured through each of the illegitimate securities transactions because that created a claim in each investor against Heartland, which the Court has recognized.

THE COURT: Isn't that -- aren't you arguing to just get around this whole concept that the receiver only can sue

for the entity or entities for which he or she is a receiver? Aren't you incorporating all the investors' claims as to harm to Heartland by saying, Well, since they can't sue Heartland that they have a claim against Heartland or JMS, then the receiver can pursue that claim? Aren't you trying to go through the back door what you can't through the front?

MR. BOCK: No. There's several answers to that question.

Number one, there's no back door because the allegations on which our claim is based are clearly set forth in the original complaint, and I'll refer to those. And you asked me to look at paragraph 44, and I'll do that in a second.

THE COURT: In short, it's the one which you allege that the investments were not approved or authorized by the brokerage firms with whom Payne and Danker were licensed.

MR. BOCK: Well, it says those -- they did not know that Payne and Danker were offering investments that were not approved or authorized by the brokerage firms. We expect that some of the investments, perhaps the Atlas income fund investments that were reflected on the prior exhibit may not have been known about because the broker dealers failed to exercise their responsibility to oversee the Heartland operation and Payne and Danker. So that is not an allegation that Heartland has not been injured. And that is not an allegation that the injury or the claims are solely those of

the investors.

The unfortunate thing is that the scheme was so successful that almost all of the money that was invested was -- with Heartland and JMS was eventually withdrawn from the Heartland/JMS accounts and was stolen. And the fact that Heartland and JMS suffered similar monetary, amounts of monetary losses, is nothing more than recognition of the success of the scheme. It could have been ended through better conduct by the broker dealers.

THE COURT: So the harm to Heartland and JMS didn't come from the sales, it came from the embezzlement or taking of the funds by Payne and Danker?

MR. BOCK: That is correct.

THE COURT: It sounds like you're arguing that broker dealers have I guess what you might call a strict liability responsibility to make sure that anyone licensed by them maintains all the money they have received, invested exactly as they say they're going to and so forth; am I reading your argument correctly or hearing correctly?

A Absolutely not. If we thought there were strict liability, we would have pled it and that would have made life a lot easier, but I don't think that there is strict liability. And there is a duty, however, and we have pled negligent supervision. We have pled breach of fiduciary duty. And we have pled civil action by crime victim and fraud claims. And

