

No. 02-3926

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UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT

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JAMES A. KNAUER as the Court Appointed  
Receiver for HEARTLAND FINANCIAL SERVICES, INC.  
and JMS INVESTMENT GROUP, LLC,

Plaintiff-Appellant,

vs.

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

Defendants-Appellees.

U.S.C.A. - 7th Circuit  
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Appeal from The United States District Court  
For the Southern District of Indiana  
Indianapolis Division  
Case No. IP01-1168-C-T/K  
The Honorable John Daniel Tinder

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REPLY BRIEF FOR  
PLAINTIFF-APPELLANT JAMES A. KNAUER

---

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## ARGUMENT

### I. Introduction

Throughout much of their response, the Broker Dealers avoid the fundamental issue in this appeal which is whether the doctrine of *in pari delicto* bars Heartland's Receiver from pursuing Heartland's claims against the Broker Dealers. Instead, most of the Broker Dealers' brief is devoted to attempting to identify alternative grounds for upholding the District Court's decision.

In the relatively brief portions of their response in which they touch upon the central issue in this appeal, it is apparent that the Broker Dealers have now retreated from the basis for arguing the *in pari delicto* defense applies which they raised in the District Court and upon which the District Court exclusively relied. In their reply brief in support of their motion to dismiss before the District Court the Broker Dealers identified a line of bankruptcy cases holding that the *in pari delicto* defense could bar certain claims of a bankruptcy trustee.<sup>1</sup> Relying exclusively on

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<sup>1</sup>Despite the fact that it was the Broker Dealers who waited until their *reply brief* before the District Court to unveil their bankruptcy case law based argument for application of the *in pari delicto* defense, the Broker Dealers now shamelessly assert that the Receiver "failed to present below" the Receiver's "comparison between the powers of bankruptcy trustees and receivers" and that the "argument" has now been waived. (Docket No. 75 – Reply Brief, pgs. 10-17; Appellees' Brief at 14). Thus, Appellees' position is that they should be rewarded for waiting to insert a new line of case law in their reply brief and now that the District Court relied upon their late coming cases such cases cannot (according to Appellees) be addressed by the Receiver. (Appellees' Brief, 14). This conclusion turns logic (and fairness) on its head. The Receiver is aware of no case (and the Broker Dealers have not cited any) where an appellate court has held that a party on appeal was barred from discussing cases cited in the lower court's opinion. In any case, the Receiver's analysis of the bankruptcy case law relied upon by the District Court is not a new "argument" but rather is simply further explication of the Receiver's consistent

(continued...)

bankruptcy case law cited to it by the Broker Dealers and repeating virtually verbatim inaccurate statements of the law provided by the Broker Dealers<sup>2</sup> the District Court held that the *in pari delicto* doctrine constituted a valid defense to the Receiver's state law claims and dismissed those claims with prejudice. However, the bankruptcy cases relied upon by the District Court have now apparently been abandoned by the Broker Dealers as they were not discussed in the Broker Dealers' brief on appeal. If the Broker Dealers in any way contest the Receiver's position that the bankruptcy cases cited by the District Court were an insufficient basis upon which to apply the *in pari delicto* doctrine and dismiss the Receiver's complaint, the Broker Dealers have failed to make an argument in this regard to the Court.

As explained in the Receiver's initial brief and further herein, the District Court's conclusion that the *in pari delicto* defense bars the Receiver's claims in this case is fundamentally at odds with this Court's holding in *Scholes v. Lehmann*, 56 F.3d 750 (7<sup>th</sup> Cir. 1995) and with principles of Indiana receivership law. The

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<sup>1</sup>(...continued)

position which has been that pursuant to this Court's teachings in *Scholes v. Lehmann*, 56 F.3d 750 (7<sup>th</sup> Cir. 1995) and applicable principles of Indiana receivership law the receiver is not subject to the *in pari delicto* defense based on the actions of Payne and Danker.

<sup>2</sup> For instance, in their reply brief in the District Court the Broker Dealers stated: "there is no distinction between bankruptcy trustees and receivers pursuant to Bankruptcy Code § 541." (Docket No. 75 – Reply Brief, pg. 12). The Broker Dealers also represented to the District Court that: "Like a trustee in bankruptcy, a receiver's rights in the property and the ability to bring claims are fixed as the same way a trustee in bankruptcy at the time of the appointment." (*Id.*, pg. 13). As explained in Appellant's Brief, pgs. 29-42, in making these representations to the District Court in their reply brief, the Broker Dealers ignored a wealth of case law to the contrary.

District Court misapplied the law and its decision should be reversed.<sup>3</sup>

## II. The Broker Dealers' Position is Based on a Fundamental Misunderstanding of Receivership Law

Before the District Court, the Broker Dealers took the position that, “[t]he *Scholes* reasoning that the appointment of a receiver somehow completely removes the wrongdoers from any involvement in the corporation is simply inaccurate.” (Docket No. 75 – Reply Brief, pg. 14). While the Broker Dealers are more tactful before this Court in their references to the *Scholes* decision, their brief evidences the same fundamental misunderstanding of receivership law.

For instance, the Broker Dealers insist that any recovery by the Receiver “could benefit” Payne and Danker and that a recovery “in excess of actual damage to Heartland/JMS [could], leav[e] a financial windfall for the two crooks.” (Appellee’s Brief, pg. 29). Thus, the Broker Dealers are still apparently unwilling to accept the teaching of the *Scholes* case that once a Receiver is appointed “the wrongdoer is removed from the scene.” *Scholes*, at 754-755.<sup>4</sup>

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<sup>3</sup> The District Court’s opinion presents a risk of confusion for other courts applying the *Scholes* decisions in receivership cases as it is currently being described on Westlaw as “distinguishing” this Court’s decisions in the *Scholes* case. (Westlaw’s key cite of *Scholes v. Lehmann* shows *Knauer v. Jonathon Roberts Financial Group, Inc.*, 2002 WL 31431484 (S.D. Ind. 2002) as distinguishing.).

<sup>4</sup> The Broker Dealers also assert without any citation to the record that “[a]ny recovery by Heartland/JMS would reduce the amount of restitution owed by Mr. Payne and Mr. Danker to the corporate creditors.” (Appellees’ Brief at 29). No restitution order in either Mr. Payne or Mr. Danker’s criminal case was part of the record before the District Court. Thus, there is no factual support in the record for this assertion. In any case, the Broker Dealers fail to explain why payment to Heartland’s innocent creditors is a bad thing or conflicts with any relevant legal principles. Pursuant to established Indiana  
(continued...)

However, the fact that the wrongdoers have been removed from the scene is the fundamental reason that the defense of *in pari delicto* “loses its sting.” *Scholes*, at 754-755. When the wrongdoers have been removed from the scene and can no longer benefit from their involvement with the corporation there is no longer any reason to permit a defendant to invoke the defense of *in pari delicto*. Applying the defense here would not work to preclude wrongdoers from profiting but rather would permit the Broker Dealers to use the defense as a shield and escape liability for the harm that they and their agents Payne and Danker inflicted upon Heartland.

The Broker Dealers’ statement that “the Receiver argues that he holds greater rights than Heartland”<sup>5</sup> gets the proper analysis exactly backwards. *In pari delicto* is a *defense* not a right or claim of Heartland. The Receiver does not contend that his rights or claims are different than the rights or claims of Heartland. Rather, the Receiver contends that because the wrongdoers have been removed from Heartland the defense of *in pari delicto* is no longer available *to the Broker Dealers*.<sup>6</sup>

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<sup>4</sup>(...continued)  
receivership law, the Receiver exists to collect, assemble, protect and preserve the assets of the receivership entity for the benefit of its creditors. *Voorhees v. Indianapolis Car & Mfg. Co.*, 39 N.E. 738 (Ind. 1895); *Marcovich v. O’Brien*, 114 N.E. 100, 104 (Ind. Ct. App. 1916).

<sup>5</sup> Appellees’ Brief at 11.

<sup>6</sup> The Broker Dealers’ backwards analysis lead them to the erroneous conclusion that the Receiver is maintaining that “receivers have much more power to bring claims than bankruptcy trustees because receivers are not limited by §541.” (Appellees’ Brief at (continued...))

The Broker Dealers complain that “[t]he appointment of a receiver does not and should not affect the merits of claims, defenses or equities.”<sup>7</sup> The appointment of a Receiver did not add to Heartland’s potential claims. What the appointment of a Receiver did do, however, was to provide conclusive evidence that the wrongdoers who once controlled Heartland are no longer in charge of Heartland and will not benefit from any recovery. Therefore, the appointment removed the underlying rationale for applying the *in pari delicto* defense in this particular receivership case

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<sup>6</sup>(...continued)

30). The issue, however, is not the scope of a Receiver’s power or authority. The issue, rather, is whether *the Broker Dealers* are entitled to assert the *in pari delicto* defense. In receivership cases, courts focus on the fact that at the time the claims are brought by a receiver, post-appointment, the wrongdoer is no longer associated with the corporation. Whereas in bankruptcy cases, §541 requires courts to focus on the fact that “as of the commencement” of the underlying bankruptcy case from which a trustee is eventually appointed, the wrongdoer was still associated with the corporation.

The Broker Dealers also suggest that the Receiver should have responded differently to the District Court’s question at oral argument in which the Court asked:

“Do you think the receiver has as much authority as a bankruptcy trustee in terms of pursuing claims on behalf of JMS and Heartland as a bankruptcy trustee would?”

The Receiver responded that:

“We don’t believe the receiver has all the power a bankruptcy trustee [has], Judge.

Clearly it doesn’t. The bankruptcy code gives the trustee certain powers that arise by operation of law. The bankruptcy filings that are somewhat attached to the trustee and don’t belong to the receiver in any other context, such as preferences, the bankruptcy fraudulent conveyance law, which is separate and apart from state laws and some kinds of lien avoidance mechanisms.” (Docket No. 96-Transcript of Hearing, pgs. 54-55; Appellant’s Appendix, Exhibit C).

The Receiver’s response was completely accurate. As a matter of bankruptcy law, a trustee has the certain statutory powers that are not expressly provided to a receiver through a similar statutory scheme: such as setting aside asset transfers that are preferences and fraudulent conveyances and using lien avoidance mechanisms. In terms of the applicability of the *in pari delicto* defense, however, the proper analytical focus is not upon the receiver’s power or authority but rather is upon whether the underlying rationale for permitting the *in pari delicto* defense still exists after a receiver’s appointment at which point the wrongdoers have been removed from control of the corporation.

<sup>7</sup> Appellees’ Brief at 11.

as the *Scholes* case clearly teaches.

### III. The Broker Dealers' Response Fails to Address Their Liability Under the Doctrine of *Respondeat Superior*

In fact, the case for not permitting the Broker Dealers to rely upon the defense of *in pari delicto* is even stronger in this case than it was in the *Scholes* case and in the district court opinions that resulted from that case. In the *Scholes* receivership, the District Court for the Northern District of Illinois permitted the receiver to pursue claims on behalf of the corporation against attorneys and accountants whose negligence and malpractice substantially furthered the Ponzi scheme. *Scholes v. Stone, McGuire & Benjamin*, 82 F. Supp. 533 (N.D. Ill. 1993). It does not appear from the opinions of the district court that those attorneys and accountants had actual knowledge of the wrongdoer's conduct.

However, in this case the Receiver has alleged that Payne and Danker were the agents of the Broker Dealers. Thus, not only did the Broker Dealers, like the attorney and accountants in *Scholes*, fail to detect the Ponzi scheme—the Broker Dealers through their agents Payne and Danker were active participants in the Ponzi scheme and took part in stripping Heartland of its assets.

The response of the Broker Dealers reflects that they either do not understand or have overlooked this fundamental basis of the Receiver's claims against them, i.e., the doctrine of *respondeat superior*. The Broker Dealers strain desperately to distance themselves from Payne and Danker, contending that the guilty knowledge of Payne and Danker is imputable to Heartland/JMS but

(according to the Broker Dealers) not to the Broker Dealers. For instance, the Broker Dealers contend emphatically—but erroneously—“there is no allegation that the defendants participated in any fraud at all.”<sup>8</sup>

The Broker Dealers have ignored or forgotten, however, that the Receiver has alleged that at all times Payne and Danker were acting within the scope of their agency with the Broker Dealers. (See Docket No. 1—Complaint, ¶¶ 47, 55, 56; Appellant’s Appendix, Exhibit B). Thus, it is the Receiver’s position that the Broker Dealers are directly liable for *every* wrongful act undertaken by Payne and Danker because Payne and Danker were the Broker Dealers’ agents and were at all relevant times acting within the scope of their agency or employment with the Broker Dealers. Clearly then, the Receiver has alleged that the Broker Dealers “participated in . . . fraud.”

Pursuant to the doctrine of *respondeat superior*, Payne and Danker’s actions were the Broker Dealer’s actions. How much of Payne and Danker’s conduct was known to others agents or employees of the Broker Dealers and whether additional employees of the Broker Dealers actively participated in the wrongful conduct remains to be seen--no discovery in this case has yet been undertaken. However, the knowledge of other employees of the Broker Dealers of Payne and Danker’s actions is not essential to the Receiver’s claims against the Broker Dealers.

Thus, the facts in the case of *Schacht v. Brown*, 711 F.2d 1343 (7<sup>th</sup> Cir. 1983)

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<sup>8</sup> Appellees’ Brief at 27.

are not “radically different from those involved here” as the Broker Dealers assert.<sup>9</sup> The Receiver has alleged that through Payne and Danker “the defendants participated in [the] fraud.”<sup>10</sup> Moreover, like the receivership entity in *Schacht*, Heartland was injured. Therefore, as this Court noted in the *Schacht* case, the receiver should be permitted to pursue claims against outside wrongdoers and is not barred by the actions of former corporate wrongdoers.

The Broker Dealers’ participation in the fraud through Payne and Danker distinguishes the case of *Mid-Continent v. Brady, Ware & Schenfeld*, 715 N.E.2d 906 (Ind. Ct. App. 1999), relied upon in Appellee’s brief. The *Mid-Continent* case involved rejection of a claim against an auditor who was unaware of the fraud being perpetrated within a corporation by the corporation’s vice president of finance. The audit firm, however, assuredly would not have avoided liability if its employee was aware of the fraud and participated in it, which would have been a situation more analogous to the facts in this case.

As the Receiver pointed out to the District Court, Danker was designated by at least one of the Broker Dealers as a Supervising Agent for the Broker Dealers.<sup>11</sup> Thus, Danker was specifically entrusted with the authority and responsibility to ensure that Payne was complying with N.A.S.D. regulations and the procedures of

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<sup>9</sup> Appellees’ Brief at 26.

<sup>10</sup> Appellees’ Brief at 27.

<sup>11</sup> (Docket No. 96–Transcript of Hearing, pgs.44-46, power-point slide nos. 13 & 14; Appellant’s Appendix, Exhibit C).

