

10/9/01

UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF INDIANA  
INDIANAPOLIS DIVISION

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

Plaintiffs,

v.

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

Defendants.

Cause No: IP01-1168-C-T/K

**DEFENDANTS' ROBERTS/ALLIANCE BRIEF IN  
SUPPORT OF THEIR MOTION TO DISMISS**

**I. Introduction.**

In the present action, James A. Knauer, as the Court Appointed Receiver for Heartland Financial Services, Inc. ("Heartland") and JMS Investment Group, LLC ("JMS") has filed a five count Complaint seeking damages from the Defendants, various brokerage firms, alleging that they improperly permitted Kenneth R. Payne and/or Daniel Danker to bilk the investors in Heartland and JMS of millions of dollars. The Agreed Order Appointing Receiver for Heartland Financial Services entered in SEC v. Kenneth R. Payne, et al., Cause No. IP00-1265-C<sup>1</sup> provides that the Receiver is, "for the benefit of investors to

<sup>1</sup> A copy of which is attached to the Memorandum in Support of FFP Securities, Inc.'s Motion to Dismiss Plaintiff's Complaint as Exhibit "A". The JMS order contains identical language.

marshal, conserve, protect, hold funds, operate, and, with the approval of the Court, dispose of any wasting assets, wherever those assets may be found, of Heartland.” (Agreed Order, ¶ 1) The Agreed order does not authorize the Receiver to act in the stead of the investors. (*Id.*)

Notwithstanding this limitation on the Receiver’s powers, in Count I the Receiver alleges that Kenneth R. Payne and Richard Danker committed securities fraud in violation of state and federal law with respect to Heartland and JMS investors and seeks damages on behalf of these investors. The Receiver seeks to hold Jonathan Roberts, Inc. and Alliance Capital Management Corporation (hereinafter collectively “Jonathan Roberts”) liable for the actions of Mr. Payne and Mr. Danker as “controlling persons” under Section 20 of the Securities and Exchange Act and Indiana law governing securities (I.C. § 23-2-1-1 *et seq.*). In Count II the Receiver seeks to hold Jonathan Roberts liable under state and federal securities laws because Mr. Payne and Mr. Danker improperly sold unregistered securities. Again, the Receiver seeks damages on behalf of the defrauded investors. In Count III, brought under state law, the Receiver alleges that Mr. Payne and Mr. Danker acted fraudulently towards the investors and thus breached their fiduciary duty to them. The Receiver seeks to hold Jonathan Roberts liable for these acts under a *respondeat superior* theory, and seeks damages for the investors. In Count IV the Receiver seeks treble damages, attorney’s fees and costs under Indiana law as a crime victim despite the fact that Heartland/JMS was the perpetrator of the crime, not the victim. Finally, in Count V the Receiver presents a state law claim for negligent supervision contending that

Jonathan Roberts' negligent supervision of Mr. Payne and Mr. Danker proximately caused the investors losses.

In connection with these five counts the Receiver seeks to recover a wide range of damages from the Defendants "the amount of the actual loss of each person to whom Payne and Danker sold securities, for pre and post judgment interest, costs, attorney's fees, punitive damages and such other relief as may be just." (Complaint, p. 13)

The problem with the Receiver's claims in this action is that Heartland/JMS was not the victim and was not damaged by the illegal activities of Mr. Payne and Mr. Danker. In filing this Complaint the Receiver has confused his duties on behalf of Heartland and JMS to "marshal, conserve, protect, hold funds, operate ... Heartland[/JMS]" (Agreed Order Appointing Receiver for Heartland Financial Services, Inc., p. 1) with those of a class representative for the defrauded investors whose job it is to recover compensation for the investors themselves.<sup>2</sup> Since the Receiver had not been authorized to act on behalf of the defrauded investors, he lacks standing to present their claims. Moreover, even if standing somehow existed, the fact that Heartland/JMS was not the victim of these activities serves to negate an essential element of each of the five claims that the Receiver seeks to present. The Co-Defendants, FFP Securities, Inc. has presented an excellent discussion of the standing issues in its Memorandum in Support of FFP Securities, Inc.'s Motion to Dismiss Plaintiff's Complaint, and that memorandum and the arguments therein are

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<sup>2</sup> In fact there is already just such a pending class action. In Agnes N. Conder, as trustee for the Conder Living Trust, on behalf of herself and all others similarly situated v. Union Planters Bank, N.A., currently pending in the United States District Court for the Southern District of Indiana, Indianapolis Division under Cause No. IP01-C-0086-D/F where the defrauded investors are seeking just this type of relief albeit against other Defendants.

incorporated herein by reference. The purpose of this brief is to discuss the second item, the impact of the limitation on the Receivers' powers on the five claims set forth in the Complaint.

## **II. Discussion.**

### **A. Standard of Review.**

Jonathan Roberts brings this Motion to Dismiss pursuant to the provisions of Rule 12(b)(6) of the Federal Rules of Civil Procedure. In Dewalt v. LaMark Carter, Correctional Officer Young, et al., 224 F.3d 607 (7<sup>th</sup> Cir. 1999) the court succinctly set forth the standard of review for motions under Rule 12(b)(6):

In evaluating whether a plaintiff's complaint fails to state a claim, a court must take the plaintiff's factual allegations as true and draw all reasonable inferences in his favor. See *Strasburger v. Board of Educ.*, 143 F.3d 351, 359 (7th Cir. 1998), *cert. denied*, 525 U.S. 1069, 142 L. Ed. 2d 661, 119 S. Ct. 800 (1999). A complaint should be dismissed for failure to state a claim only if "no relief could be granted 'under any set of facts that could be proved consistent with the allegations.'" *Nance v. Vieregge*, 147 F.3d 589, 590 (7th Cir.) (quoting *Hishon v. King & Spalding*, 467 U.S. 69, 73, 81 L. Ed. 2d 59, 104 S. Ct. 2229 (1984)), *cert. denied*, 525 U.S. 973, 142 L. Ed. 2d 347, 119 S. Ct. 427 (1998).

Dewalt, 224 F.3d at 609.

### **B. Counts I and II: Controlling Person Liability.**

In Count I of the Complaint the Receiver alleges that Mr. Payne and Mr. Danker committed various fraudulent acts in connection with their sale of securities to the investors that violated §10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 and Indiana law. The Receiver then seeks to hold the Defendants liable for these violations as "controlling persons." (Complaint, ¶38). The Receiver contends that as a consequence

of the controlling person relationship the Defendants “had a duty to monitor the conduct of Payne and Danker during the time period Payne or Danker was an employee and/or agent of that Broker Dealer ... .” (*Id.*, ¶ 35) Similarly, in Count II of the Complaint the Receiver seeks to hold the Defendant liable as controlling persons for the actions of Mr. Payne and Mr. Danker for selling unregistered securities to the investors. (*Id.*, ¶ 40-41) The problem with these claims is that the Receiver is not a defrauded purchaser or seller of securities as required under the predicate federal and state statutes.

#### 1. Federal Claims.

The federal securities claims contained in Count I of the Complaint are premised on alleged violations of §10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934. (Complaint, ¶ 28) Count II finds its base in “Sections 5(a) and 5(b) of the Securities Act.” (*Id.*, ¶ 40) However the United States Supreme Court has made it clear on several occasions that such claims are “limited to actual purchasers and sellers of securities.” Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-732 (1975). See also The Wharf (Holdings) Limited v. United International Holdings, Inc., 532 U.S. 588, 121 S.Ct. 1776, 1781, 149 L.Ed.2d 845, 852 (2001). The Seventh Circuit has also recognized this proposition. For example, in Davidson v. Belcor, Inc., 933 F.2d 603 (7<sup>th</sup> Cir. 1991) the court cited Blue Chip Stamps and affirmed the dismissal of claims by an individual who was “not a purchaser or seller as required by Blue Chip Stamps.” Davidson, 933 F.2d at 608. The Seventh Circuit did so relying upon the fact that Blue Chip Stamps the Supreme Court “held that only actual purchasers and sellers of securities have standing to pursue private

causes of action under the anti-fraud provisions of the Securities Exchange Act of 1934.” Davidson, 933 F.2d at 606.

Similarly, in Isquith v. Caremark International, Inc., 136 F.3d 531 (7<sup>th</sup> Cir. 1998) Judge Posner noted that “[i]t is implicit in the decisions that hold that there can be no suit under the securities laws by someone who has not made an investment decision, that is, who has not made a *choice*, a voluntary decision, albeit one induced by the fraud, to buy or sell securities.” *Id.*, 136 F.3d at 536.

As discussed in detail in the introduction to this brief, and at pages 2-4 of FFP’s Brief, neither Heartland/JMS nor the Receiver are a defrauded “purchaser or seller as required by Blue Chip Stamps.” Davidson, 933 F.2d at 608. As a consequence the Receiver may not present “private causes of action under the anti-fraud provisions of the Securities Exchange Act of 1934.” *Id.*, 933 F.2d at 606. Thus the federal securities claims in Counts I and II fail to state a claim for which relief can be granted. Since controlling party liability is premised upon an underlying violation of the Securities Act, in the absence of an underlying claim, there can be no controlling person liability and Counts I and II of the Plaintiff’s Complaint are subject to dismissal as a matter of law.

## 2. State Law Claims.

The state law securities claims contained in Counts I and II of the Complaint are premised on an application of the provisions of I.C. §23-2-1-19. (Complaint, ¶¶ 38, 40) I.C. §23-2-1-19(a) creates a private cause of action for defrauded securities investors:

A person who offers or sells a security in violation of this chapter, and who does not sustain the burden of proof that the person did not know and in the exercise of reasonable care could not have known of the violation is liable to any other party to the transaction who did not knowingly participate in the

violation or who did not have, at the time of the transaction, knowledge of the violation, who may sue either at law or in equity to rescind the transaction or to recover the consideration paid, together, in either case, with interest as computed in subsection (g)(1), plus costs, and reasonable attorney's fees, less the amount of any cash or other property received ... .

(Emphasis supplied).

The statute presents two rather obvious problems for the Receiver acting on behalf of Heartland/JMS. First, the statute limits its provisions to an individual who is a "party to the transaction." The problem for the Receiver is the same one noted above, he is acting in the stead of Heartland/JMS, not the defrauded investors. In contrast with the investors, Heartland/JMS was not a party to the transactions that allegedly violated I.C. §23-2-1-1 *et seq.* and thus may not sue under I.C. §23-2-1-19(a). In Manns v. Bradley W. Skolnik, Securities Commissioner, 666 N.E.2d 1236 (Ind.App. 1996) the state securities commissioner brought suit against Manns under several sections of Indiana's securities laws including I.C. § 23-2-1-19 seeking damages from Manns. Manns argued that Skolnik was not a "party to the transaction" and therefore could not invoke the provisions of I.C. § 23-2-1-19. The court agreed. It noted that the statutory right to sue contained in I.C. § 23-2-1-19(a) was applicable only to "any other party to the transaction" and not to the [securities] division." *Id.*, 666 N.E.2d at 1251 *citing* I.C. § 23-2-1-19(a). The intent of the statute, the Court noted, was to create a cause of action on behalf of defrauded investors and not third parties such as Heartland/JMS. *Id.* Based on Manns the state claims presented by the Receiver under this same statute fail to state a claim for which relief can be granted as neither the Receiver nor Heartland/JMS falls with the ambit of persons entitled to sue under I.C. § 23-2-1-19(a).

The second problem for the Receiver also comes directly from the text of the statute. The statute requires that the entity invoking the statute must be a “party to the transaction who did not knowingly participate in the violation or who did not have, at the time of the transaction, knowledge of the violation ... .” I.C. § 23-2-1-19(a). The Receiver standing in the shoes of Heartland/JMS as a matter of law simply cannot meet this standard. Heartland/JMS through their officers and directors including Mr. Payne and Mr. Danker actually conducted the allegedly improper securities transactions. The Complaint in this action as well as the Complaints in Knauer, et al. v. Payne, Danker, et al., Cause No. IP00-1629-C-T/G and SEC v. Payne, Danker, et al., Cause No. IP00-1265-C-T/G which are incorporated in this Complaint by reference (Complaint, ¶¶ 25-28), make this quite clear. Since Heartland/JMS through its officers and directors had full and complete knowledge of the fraudulent and improper actions, they cannot as a matter of law demonstrate that they “did not knowingly participate in the violation or who did not have, at the time of the transaction, knowledge of the violation.” Thus the state claims under I.C. § 23-2-1-19 fail for this reason as well.

**C. Count III: Breach of Fiduciary Duty and Fraud.**

In Count III of the Complaint the Receiver alleges that “investors [ ] were induced by fraud and deceit of Payne and Danker” to purchase unregistered securities. (Complaint, ¶ 44) The Receiver seeks to hold Jonathan Roberts liable for the fraudulent acts by Mr. Payne and Mr. Danker alleging that “[a]t no time did any Defendant notify any of the persons to whom Payne and Danker fraudulently sold securities that Payne and/or Danker were not authorized to offer and sell securities, nor did any Defendants disassociate itself

from such transaction.” (*Id.*, ¶ 46) The Receiver also presents a claim for breach of fiduciary duty noting that “Payne, Danker and the Broker Dealers breached their fiduciary duty to investors and to Heartland and JMS ... .” (*Id.*, ¶ 50) The problem with the fraud and breach of fiduciary claims is the same. Heartland/JMS were not the persons to whom the fraudulent and false statements were made, nor did they rely upon them. In fact, quite the opposite. As noted in the Complaint, Mr. Payne and Mr. Danker were actually Heartland/JMS at the time the allegedly fraudulent representations were made. Because they could not have made false representations to themselves, this precludes the fraud and breach of fiduciary duty claims.

#### 1. Fraud.

The problem for the Receiver is simple, he has not pled and as a matter of law cannot prove two elements of his fraud claim. The five elements of a fraud claim in Indiana are as follows:

The elements of actual fraud are: (1) the fraud feisor must have made at least one representation of past or existing fact; (2) which was false; (3) which the fraud feisor knew to be false or made with reckless disregard as to its truth or falsity; (4) upon which the plaintiff reasonably relied; (5) and which harmed the Plaintiff.

Wright v. Pennamped, 657 N.E.2d 1223, 1230 (Ind.App. 1995). See also Pippenger v. McQuik’s Oilube, Inc., 854 F. Supp. 1411, 1427 (S.D. Ind. 1994).

The fourth and fifth elements of a fraud claim are that the allegedly fraudulent statements were ones “upon which the plaintiff reasonably relied; and which harmed the plaintiff.” Wright v. Pennamped, 657 at 1230. “In order for the plaintiff to recover under a fraud theory, it must show both that it had a right to rely on the defendants’

misrepresentations and that it did in fact rely on the misrepresentations to its detriment.”

Scott v. Bodor, Inc., 571 N.E.2d 313, 321 (Ind.App. 1991).

In the present case, as alleged in the Complaint, any misrepresentations made by Mr. Danker and Mr. Payne were to the investors in Heartland and JMS, not to Heartland or JMS themselves.<sup>3</sup> In fact such a contention would be absurd since the Complaint specifically states that Mr. Payne and Mr. Danker were acting as principals of Heartland and JMS at the time they made such misrepresentations. (Complaint, ¶¶ 24-26) Specifically, as noted in the SEC Complaint “Payne is the president and owner of Heartland.” (SEC Complaint, ¶¶ 12, 14) “Danker is the vice-president and office manager of Heartland.” (*Id.*, ¶ 16) Mr. Payne and Mr. Danker were also principals in JMS. (*Id.*, ¶¶ 24, 28-39) Thus they would have had to make false representation to themselves and then they would have had to rely upon those false representations to their own detriment. They of course could not have done that and thus their fraud claims must fail.

The Indiana Court of Appeals addressed this defense, that there must have been reliance on the fraudulent statements, in Baxter v. ISTA Insurance Trust, 749 N.E.2d 47 (Ind.App. 2001). In that case, as in the present case, the statements were made by the defendant to someone other than the plaintiff. *Id.*, 749 N.E. 2d at 49. The defendant

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<sup>3</sup> If in fact the Receiver believes that fraudulent statements were made to Heartland and JMS by Mr. Payne and Mr. Danker upon which Heartland and JMS reasonably relied to their detriment, then the Receiver had a duty to specifically plead those statements in the Complaint. No such averments are contained in the Complaint. Rule 9(b) of the Federal Rules of Civil Procedure imposes a heightened pleading requirement with respect to fraud: “In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.” Fed. R. Civ. P. Rule 9(b). Specifically, a plaintiff is required to identify (1) who made the misrepresentation; (2) the time, place, and content of the misrepresentation; and (3) the method used to communicate the misrepresentation. UniQuality, Inc. v. Infotronx, Inc., 974 F. 2d 918, 923 (7<sup>th</sup> Cir. 1992). Under the *Private Securities Litigation Reform Act*, a complaint must specify each statement “alleged to have been misleading, [and] the reason or reasons why the statement is misleading.” 15 U.S.C. § 78u-4(b)(1).

sought summary judgment arguing that “[n]umerous Indiana cases restate the essential element that the plaintiff must have relied upon the defendant’s representations.” *Id.*, 749 N.E. 2d at 53. The plaintiff responded “that Indiana should recognize a fraud claim by a third person injured by some deceit.” *Id.* After reviewing the applicable case law, the Indiana Court of Appeals concluded summary judgment should have been granted to the defendant:

In summary, we are presented with distinguishable and/or unhelpful authority from other jurisdictions, a lack of any binding authority on the subject, and persuasive guidance from the Southern District supporting the longstanding statement in Indiana that recovery cannot be had for fraud unless the plaintiff relied on the fraudulent inducements or representations of the defendant. Given all this, we are not inclined to recognize an exception to the longstanding rule. Accordingly, we conclude that the trial court should have granted summary judgment to Fraternal and GAB on ISTA’s fraud claim.

*Id.*, 749 N.E.2d 54. The District Court case cited as persuasive by Baxter said it succinctly: “Simply stated, Plaintiffs cannot premise their fraud claim on statements that were not made to them.” *Id.*, 749 N.E.2d 54 *citing* Lyman v. Walters, 904 F.Supp. 884, 897 (S.D.Ind. 1995).

The present case is no different. Because the Receiver cannot demonstrate elements four or five of the fraud claim, *i.e.* that Heartland or JMS relied upon the allegedly fraudulent statements to their own detriment, Jonathan Roberts is entitled to judgment as a matter of law with respect to the fraud claim contained in Count III of the Complaint.

## 2. Breach of Fiduciary Duty.

“As a general rule, officers and directors owe a fiduciary duty to a corporation as well as corporate stockholders. However, this is so only regarding matters that affect the

general well-being of the corporation. Where the actions of a director affect the individual rights of a stockholder rather than the interests of the corporation or stockholders generally, no fiduciary duty exists.” Biberstine v. New York Blower Company, 625 N.E. 2d 1308, 1318. (Ind.App. 1993). This distinction is made, of course, because the fiduciary duty owed by officers and directors to a corporation and corporate stockholders is as a consequence of their position as officers and directors. Thus if they act outside of that capacity, no such duty is owed to the corporation, but instead to the individual investor.

There is no doubt that the Complaint is rife with allegations that Mr. Payne and Mr. Danker acted grossly inappropriately with respect to the investors and Heartland/JMS in the manner in which they handled Heartland/JMS funds. There is also no doubt that they undertook these actions in their capacities as officers and directors of Heartland/JMS. They should certainly bear personal and individual liability if those facts turn out to be true.<sup>4</sup> See e.g. G&N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 240 (Ind. 2001)(“The fiduciary must deal fairly, honestly and openly with his corporation and fellow stockholders. He must not be distracted from the performance of his official duties by personal interests.”) However, in Count III of the Complaint the Receiver seeks to hold not Mr. Danker and Mr. Payne liable for their breach of a corporate fiduciary duty, but rather Jonathan Roberts. The problem with this proposition is very simple. Any fiduciary duty which exists and which may have been breached arises not as a consequence of Mr. Payne and Mr. Danker’s relationships with Jonathan Roberts, but as a consequence of their status as officers and

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<sup>4</sup> In fact the Receiver has filed just such a suit against Mr. Payne and Mr. Danker making these very allegations. See Knauer, et al. v. Payne, Danker, et al., Cause No. IP00-1629-C-T/G, currently pending in this Court.

