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,	)	
Plaintiff,	)	
v.	)	CAUSE NO.: IP01-1168C T/G
JONATHON ROBERTS FINANCIAL GROUP, INC., ALLIANCE CAPITAL MANAGEMENT CORP., ANDOVER SECURITIES INC., FSC SECURITIES CORPORATION, and FFP SECURITIES, INC.,	)	
Defendants.	)	

FSC SECURITIES CORPORATION BRIEF IN SUPPORT OF MOTION TO DISMISS

I. SUMMARY

Plaintiff is the Receiver for two entities, Heartland Financial Services, Inc. ("Heartland") and JMS Investment Group, LLC ("JMS"). Those two entities were formed and controlled by persons who masterminded a Ponzi fraud scheme. Heartland and JMS also engaged in other fraudulent activities to steal money from investors.

While the Plaintiff seeks to recover the investors' money in this lawsuit, Plaintiff can only bring those claims that Heartland and JMS could have brought in their own names. Heartland and JMS could not have sued third parties for damages caused by the theft of money by Heartland, JMS, and their principals. Only the investors themselves hold those claims.

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Plaintiff alleges that the Defendants were negligent in failing to uncover the fraud of Heartland and JMS and its principals or are liable as a result of a respondeat superior theory. Heartland and JMS are *in pari delicto* and are barred from pursuing these claims regardless of their standing.

The allegations of the Plaintiff's Complaint demonstrate that the elements of the causes of action cannot be fulfilled by this Plaintiff.

Finally, the defenses that would have been applicable against Heartland and JMS are applicable against the Receiver. Heartland and JMS were aware of the fraudulent activities since their inception. Thus, Plaintiff's claims are barred by the statute of limitations.

II. ALLEGATIONS OF THE COMPLAINT AND MATERIALS IN SUPPORT OF 12(B)(1) AND 12(B)(6) MOTION

For purposes of this Motion, the court need not credit general conclusory allegations which are belied by more specific allegations. The burden to prove standings rests upon the party claiming it exists. Hirsch v. Arthur Anderson & Co., 72 F.3d 1085 (2nd Cir. 1995). Plaintiff cannot rely upon bold assertions or unsupportable conclusions. General allegations have to be supported by a specific factual basis and pleadings are not sufficient where they rest on subjective characterizations or unsubstantiated conclusions. Flemming v. Lind Waldcock & Co., 922 F.2d 20, 23 (1st Cir. 1990)

It is important to note certain things that are not alleged before the court considers the allegations of the Complaint. Plaintiff does not allege that money defrauded from investors was ever transferred to FSC Securities Corporation. The complaint does not allege that there was any contractual relationship of any kind between Heartland, JMS, and FSC Securities Corporation.

Kenneth Payne formed Heartland Financial Services, Inc. in approximately 1991. (SEC Complaint, ¶ 12, 14). Kenneth Payne was the President and owner of Heartland. (Id.).

Kenneth Payne was a registered representative (stockbroker) for Andover Securities, Inc. from December 12, 1991 to January 1, 1996, for FSC Securities Corporation from January 1, 1996 to February 14, 1997, for FFP Securities from February 26, 1997 to October 1, 1998, for Jonathon Roberts Financial Group from March 15, 1999 to August 10, 2000 and for Alliance for some undetermined amount of time thereafter. (Complaint, ¶ 20). JMS Investment Group, LLC did not come into existence until October 1997. (SEC Complaint, ¶ 13). Heartland and JMS engaged in a Ponzi Scheme. (SEC Complaint, ¶ 1). Heartland and JMS made false and misleading statements, omitted to state material facts to investors for the purpose of defrauding the investors of their money. (SEC Complaint, ¶ 72).

The complaint does not allege that false and misleading statements were ever made to Heartland or JMS by FSC.

The funds that were stolen were the investors' money. (Complaint, ¶ 63, 64 (Designated in the Complaint as 23 and 24); SEC Complaint, ¶ 51, 55, 57, 59 RICO Complaint, ¶ 42, 187).

III. THE PLAINTIFF LACKS STANDING UNDER BOTH STATE AND FEDERAL LAW.

A. BECAUSE THE LOSSES ARE DISTINCT, PALPABLE AND PARTICULAR TO THE INVESTORS, THE RECEIVER CANNOT BRING CLAIMS ON THEIR BEHALF.

Whether a particular Plaintiff has standing to bring suit in federal court is a constitutional issue. Article III, Section 2 Clause 1 of the Constitution gives the power to the federal courts to decide cases or controversies, and thus, the party bringing the suit must have standing to bring it. See Allen v. Wright, 468 U.S. 737, 751 (1985). Although Indiana's Constitution does not have a

mirror image to Article III, its standing requirements are essentially similar to federal court. Pence v. State, 652 N.E.2d 486 (Ind. 1995). See also Hirsch v. Arthur Anderson & Co., 72 F.3d 1085 (2nd Cir. 1995):

> To have standing, a plaintiff must (1) allege personal injury . . . (2) fairly traceable to the defendant's allegedly unlawful conduct and (3) likely to be redressed by the requested relief . . . A plaintiff must always have suffered a distinct and palpable injury to himself'..... The injury must be 'concrete in nature and particularized to [the plaintiff], and not 'abstract,' 'conjectural,' or 'hypothetical'.

Hirsch, 72 F.3d at 1091 (Citations omitted) (quoting Allen 104 S.Ct. At 3324; Gladstone Realtors v. Village of Bellwood, 441 U.S. 91, 100, 99 S.Ct. 1601, 1608 (1979). The application of this analysis is not mechanical or formulaic, and the Supreme Court instructs that prior standing decisions should be examined to come to the correct determination. See Allen, 468 U.S. at 751-52.

In factually similar situations wherein either a receiver or a trustee in bankruptcy attempted to bring claims to recover money for defrauded investors, the courts have focused on the fact that the injury is not distinct or palpable to the entity in receivership nor is it particular to the entity in receivership. This is because the injury is distinct, palpable and particular to the defrauded investors.

To determine if there is a cause of action properly held by a receiver, it must be determined whether a creditor of the corporation in receivership could bring the same cause of action. If the cause of action is personal to the creditor such that the creditor could sue in the creditor's own name, then it is not a cause of action held by the receiver. Marion Trust Co. v. Blish, 170 Ind. 686 (1908); Reel v. Brammer, 56 Ind. App. 180 (1913); Hirsch v. Arthur

Anderson & Co., 72 F.3d 1085 (2nd Cir. 1995); Caplin v. Marine Midland Grace Trust Co. of New York, 406 U.S. 416, 32 L.Ed. 2d 195 (1972); Cook Refining v. Farmer's Union Central Exchange, 831 F.2d 1339 (7th Cir. 1987); Flemming v. Lind Waldcock & Co., 922 F.2d 20 (1st Cir. 1990); Scholes v. Schroeder, 744 F.Supp. 1419 (N.D. Ill. 1990).

First, the Indiana decisions and authorities will be examined to show that no action rests with the Plaintiff. Next, factually similar federal cases will be examined to show that the courts that have applied this reasoning to factually similar cases have found that the receiver lacks standing to bring these types of claims.

B. THE CAUSES OF ACTION HELD BY THE RECEIVER ARE DETERMINED BY STATE LAW AND INDIANA WOULD PROVIDE NO AUTHORITY FOR THE RECEIVER TO PURSUE THESE ACTIONS.

A receiver holds the powers directly stated in a court order appointing the receiver, those powers directly granted by state or federal statutes, and those powers that are clearly and reasonably necessary to carry out the orders of the court. See State Ex Rel Shephard v. Sullivan, 120 Ind. 197, 21 N.E. 1093 (1889); Clark on Receivers § 355. If a court order grants 0a receiver the ability to bring an action that the receiver has no legitimate standing to bring then that order itself cannot stand. See Scholes v. Schroeder, 744 F.Supp. 1419, 1421 (N.D. Ill. 1990) ("To the extent that the orders tendered to Judge Alesia for his signature, purport to authorize suit on behalf of the investors, those orders are at odds with the fundamental command of Article III"); State Ex Rel. Shephard v. Sullivan, 120 Ind. 197, 21 N.E.1093 (1889) ("The general rule is that a receiver cannot have, nor be made to have, any right of action not vested in the debtor, and there are, as we now remember, only two exceptions to this general rule."). The ability to bring a claim and what causes of action the Receiver actually holds are matters of state law. Hirsch v.

Arthur Anderson & Co., 72 F.3d 1085, 1093 (2nd Cir. 1995).

In Indiana, a receiver cannot bring a claim when the creditor to whose benefit the money would inure could bring his own claim. In State Ex Rel. Shephard v. Sullivan, 120 Ind. 197, 21 N.E. 1093 (1889), the court stated:

> It is our judgment that, upon the facts appearing of record, the persons to whom the money appropriated by the defaulting clerk belonged are the only ones who can maintain actions on his official bond, and that there is no right of action in the Receiver. The enforcement of the bond against [the entity in receivership] and his sureties is not the collection of a claim due [the entity in receivership], but, on the contrary, is the enforcement of a claim against him.

Id. at 1093.

In Shephard, Shephard was appointed the Receiver for John E. Sullivan, the clerk of Marion County who had misappropriated funds that had been paid to him as Clerk but were actually due to be paid to other persons. Id. As Clerk of Marion County, Sullivan had executed a bond, and the receiver was seeking the full amount of the bond from the surety companies on the bond. The receiver argued that by collecting on this bond, it would increase the size of the receivership estate and thus, would be able to distribute the money to the creditors. However, the court held that it was the *persons who had actually lost the money* who possessed the right to collect on the bond and not the person who had placed the bond. Because it was not a claim that Mr. Sullivan could have sued on himself, it was not a claim that the receiver could bring.

There are only two exceptions to this general rule:

> One is that a receiver may maintain a suit to set aside a fraudulent conveyance, and the other is that, where the statute authorizes it, the receiver of an insolvent corporation may sue the stockholders.

Id. at 1093.

In the present action, Plaintiff is not seeking to set aside a fraudulent conveyance and is not attempting to bring suit against the stockholders and thus, has no standing to maintain an action against the Defendants in this matter.

Similarly, in Reel v. Brammer, 56 Ind. App. 180, 101 N.E. 243 (1913), a receiver was appointed for an insolvent corporation. There were certain persons who had stock issued to them for less than the par value and the receiver brought suit against these persons to have them pay the full par value of the stock. The receiver argued that this would increase the receivership estate for the benefit of the creditors as a whole. The trial court's finding against the receiver and in favor of the defendants was upheld on appeal. In holding that the receiver cannot pursue actions that actually vest in the creditors themselves, the court stated:

> We think it may be stated generally that the primary purpose in the appointment of a receiver is not to do for creditors the things which they may do for themselves, but to do the things which creditors cannot do. . . but a receiver, for purposes of litigation, can assert only such rights as the corporation might have asserted at the time of his appointment.

Id. at 1046.

In a case where a trial court allowed a receiver to pursue a lawsuit and the receiver received a verdict in his favor, the Court of Appeals reversed the verdict because the claim was one that did not vest in the receiver but vested directly in the creditors to the corporation in receivership. In Turner v. Henshaw, 86 Ind. App. 565, 155 N.E. 222 (1927), Henshaw was appointed the receiver for the Hudson Motor Indemnity Exchange and brought suit to collect on a note that was on file with the Indiana Insurance Commissioner (the note was required for the protection of the Indiana policyholders). The receiver argued that it should be able to collect on this note to increase the size of the receivership estate for the general benefit of the creditors.

However, the Court of Appeals found that the note was subject to suit by the damaged Indiana Insurance subscribers. Regardless of the receiver's claims that it could increase the size of the receivership estate, it was not a claim held directly by the corporation and therefore, could not be pursued by the receiver. See also Marion Trust Co. v. Blish, 170 Ind. 686, 84 N.E. 814 (1908).

In sum, because investors have the right to sue when they have been defrauded, a receiver does not hold that right.

The Shephard, Turner and Blish cases also highlight a problem that will confront this court and this receiver if this case is allowed to proceed forward. A receiver cannot prefer one class of creditors over another and cannot seek to recover items solely for the benefit of certain creditors but not others. Obviously, in this lawsuit, Plaintiff is seeking to assert a variety of different claims held by hundreds of different people. One can only assume that Plaintiff plans to distribute this money out to those persons. However, Plaintiff will be forced to favor classes of creditors, be they suppliers to the corporations in receivership versus equity holders or by one class of equity holders against another (those being more recent such that statute of limitations does not bar their claims versus those further back in time that no longer have the right to bring their claims.)

These cases also illustrate the problems that could arise by allowing the Receiver, who does not truly hold these actions, to pursue them. If in the future, some settlement or is even if a judgment is rendered in favor of the Receiver, there is no bar to actions by the investors themselves and FSC could be subjected to multiple suits for the same injury. Thus, any settlement or judgment would bring the Defendants no relief from duplicator claims. This is another reason why the Receiver has no standing to bring these claims against FSC.

C. FEDERAL INTERPRETATIONS OF SIMILAR SITUATIONS SHOW THAT THIS RECEIVER LACKS STANDING.

There have been other situations where a court appointed receiver in federal court has attempted to aggregate and recourse multiple claims of tort creditors of the entity in receivership. The federal courts at all levels, from the district courts to the United States Supreme Court, have rejected such attempts to bypass federal class action procedural requirements and the requirements of the Private Litigation Securities Act, consistently holding that the receiver lacks standing. The receivers frequently argue that they somehow have the right to represent the creditors for their claims or make public policy arguments that the receiver's action would be more efficient because the receiver is in a better position to pursue the claims than individual tort creditors, but federal courts routinely reject these arguments and none of these arguments can remove the constitutional bar to Plaintiff's Complaint.

In Caplin v. Marine Midland Grace Trust Co. of New York, 406 U.S. 416, 32 L.E.2d 195 (1972), the Supreme Court upheld the Second Circuit's finding that a trustee in bankruptcy lacked standing to recover on the claims of tort creditors. That trustee was presumed to hold the powers of a receiver pursuant to 11 U.S.C. § 587. The tort creditors were debenture holders of the corporation in receivership. There had previously been an indenture trustee who had the responsibility of insuring that certain safeguards were in place for certain assets of the corporation. The court found that it was the debenture holders who held the right to bring suit against the indenture trustee in that regard and therefore, the trustee in reorganization plan, regardless of his right to act as a receiver, did not have standing to bring claim. See also Deitrick v. Standard Surety Co., 303 U.S. 471, 480-81 (1938) ("'the whole business, from beginning to

end, was and was intended to be a mere juggle with books and papers to deceive the bank examiner,' this Court denied the receiver's claim and said: 'If the Guthrie Bank had sued while it was a going concern, it could not have recovered and the receiver stands no better than the bank.'") Id. quoting Rankin v. City National Bank, 208 U.S. 541 (1908)

In Fleming, 922 F.2d 20, the Seventh Circuit discussed a receiver's right to bring claims on behalf of investors for their mismanaged accounts. The court stated:

> The funds allegedly mismanaged by Lind-Waldcock in accounts established by Kent belonged entirely to investors, not to USIC. Hence, Flemming, as equity receiver cannot assert these investors' claims. Nor can he succeed in a class action as a putative representative of these same investors.

Id. at 25.

Scholes v. Schroeder, 744 F.Supp. 1419 (N.D. Ill. 1990) also succinctly rejected a receiver's attempt to recover money in behalf of investors:

> And that identical principle precludes Scholes, as the designated receiver for three corporate entities, from bringing causes of action that belonged to their investors as such, as contrasted with claims that belong directly to those three companies for whom Scholes is the appointed representative.

Id. at 1421.

These applications of principles similar to Indiana's show that the receiver's claims must be dismissed.

D. THE COURT ORDER APPOINTING KNAUER AS RECEIVER DID NOT GIVE HIM THE AUTHORITY TO PURSUE THIS SUIT AND NO SUCH AUTHORITY IS GRANTED BY STATUTE.

On August 21, 2000, Judge Tinder, United States District Court Judge for the Southern District of Indiana, under cause number IP00-1265C, signed an Agreed Order appointing James

A. Knauer as the Receiver for Heartland Financial Services, Inc. The Court's order stated as follows:

> 1. That the Court appointed Receiver for the benefit of investors to 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.

August 21, 2000 (Order, ¶ 1)

To fulfill this power, the Receiver was given the ability to bring legal actions.

The cause presently before the court is not marshaling assets, it is not conserving assets, it is not protecting assets, and it is not holding the funds or operating Heartland. The concept of marshaling assets is an equitable doctrine to be applied when an asset of a debtor is subject to attachment by two or more creditors. In this situation equity requires that the funds be put in proper line for exhaustion so as not to injure a creditor who only has access to a junior fund. Before marshaling can occur there must be 1) multiple creditors of same debtor, 2) two funds that belong to that debtor and 3) only one of the creditors has the right to resort to both funds. Indiana Lawrence Bank v. PSB Credit Services, 706 N.E.2d 570, 573 (Ind. App. 1999) This doctrine has no application to the Defendants in this matter.

IV. PLAINTIFFS ARE IN PARI DELICTO

Plaintiffs' Complaint alleges and acknowledges that "commencing in 1994 and continuing through August 2001, Payne, Danker and others, directly and indirectly, through Heartland, JMS and other related and affiliated companies (collectively the "Heartland Companies") and otherwise, engaged in a massive fraudulent "Ponzi" scheme whereby, having held themselves out as licensed securities registered representatives, they induced investors to pay them millions of dollars through the fraudulent sale of securities (the "Ponzi Scheme").

(Plaintiffs' Complaint, ¶24.) Thus the Plaintiffs' own Complaint acknowledges that the Plaintiffs themselves were engaged in illegal and fraudulent conduct that led to the losses of millions of dollars of investors' money. In making such acknowledgment and allegations, the Plaintiff admits that Heartland and JMS themselves are guilty of crimes and violations statutory in common law.

Plaintiffs' Complaint alleges that Defendant, FSC Securities, is guilty of the same acts as a result of their position as broker dealers. Specifically, Plaintiff alleges that FSC 1)should be liable for the acts of Heartland and JMS as a result of being a "controlling person" pursuant to Section 15 of the Securities Act of the Indiana Securities Act (Plaintiffs' Complaint, ¶41); 2) is vicariously liable as a result of "apparent" authority vested in the Plaintiff by FSC; (Plaintiffs' Complaint, ¶¶43-48); 3) breached a fiduciary duty to Plaintiffs (Plaintiffs' Complaint, ¶¶50-51); 4) is responsible under the doctrine of respondeat superior (Plaintiffs' Complaint, ¶52.); and 5) is responsible for the admitted acts of Heartland and JMS under Indiana Code §34-24-3-1 (civil action by crime victim) as a result of Indiana Code §35-41-2-3(a), a statutory version of the doctrine of *respondeat superior* (Plaintiffs' Complaint, ¶¶53-58). All of the above allegations found in Plaintiff's Complaint are premised upon the concept that Heartland and JMS committed criminal acts themselves and that FSC either participated in or is somehow otherwise liable to Plaintiff for Plaintiffs' <u>own</u> wrongful acts.

The facts alleged and acknowledged by the Plaintiffs are a classic case for the application of the equitable doctrine of *in pari delicto*. Courts in similar fact scenarios have applied the doctrine of *in pari delicto* and refused to aid Plaintiffs who have committed immoral or illegal acts in attempting to recover monies from others. "*In pari delicto* refers to the plaintiff's participation in the same wrongdoing as the defendant." <u>Bubis v. Blanton</u>, 885 F.2d 317, 321