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NO. A12-0040

State of Minnesota
In Court of Appeals

The National Bank, intervenor,

Appellant,

vs.

Community First Bank, a Wisconsin banking corporation; Lighthouse Management Group, Inc., as Receiver for First United Funding, LLC; Corey N. Johnston; Hillcrest Bank, a Kansas banking corporation; Community Financial Bank, a Wisconsin banking corporation, intervenor; Community State Bank of Prentice, a Wisconsin banking corporation, intervenor; Choice Financial Group, intervenor; Minn West Bank Luverne, intervenor; First International Bank and Trust, a North Dakota banking corporation, intervenor; Maple Bank, intervenor; The Bank, Weatherford Texas, intervenor; LNV Corporation, intervenor; Republic Bank of Chicago, intervenor,

Respondents,

vs.

First United Funding, LLC, and John Doe, et al.,

Additional Defendants.

BRIEF AND APPENDIX OF APPELLANT THE NATIONAL BANK

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The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2).

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STATEMENT OF LEGAL ISSUES

The issues presented to this Court for review are the following:

I. Did the district court err in approving the Net Investment Distribution method as the appropriate distribution scheme upon which the Receiver should distribute the final damages in this matter?

Description of the Issue:

The Receiver moved the district court to determine the appropriate method of distribution to the Participant Banks through its Motion to Approve Calculation of Claims. *AA46-47*. Appellant THE National Bank asserted that the Principal & Interest Method and not the Net Investment Distribution Method would result in the most equitable outcome in this case. *AA97-109.*

District Court's Ruling:

District Court held in the negative approving distribution under the Net Investment Method on July 21, 2011 and entering judgment on the final claim calculations on November 17, 2011.

Preservation of Issue:

A Notice of Appeal was filed by Appellant THE National Bank on January 5, 2012 preserving the issue for appeal. *AA144-148*

Apposite Authorities:

In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).
Beacon Assoc. Manag. Corp. v. Beacon Assoc. LLC I, 725 F. Supp. 2d 451 (2010).

II. Did the district court err in approving the final claim calculations of the Receiver as related to Appellant THE National Bank under the Net Investment Distribution method?

Description of the Issue:

The Receiver moved the district court to approve the final calculation of claims under the Net Investment method of distribution. *AA120-132*. Appellant THE National Bank objected to the Receiver's final claim calculations under the Net Investment method as an inequitable distribution. *AA133-143*

District Court's Ruling:

District Court held in the negative approving distribution under the Net Investment Method on July 21, 2011 and entering judgment on the final claim calculations on November 17, 2011.

Preservation of Issue:

A Notice of Appeal was filed by Appellant THE National Bank on January 5, 2012 preserving the issue for appeal. *AA144-148*.

Apposite Authorities:

S.E.C. v. Credit Bancorp, Ltd., 290 F.3d 80 (2d Cir. 2002).
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S.E.C. v. Wealth Management, L.L.C., 628 F.3d 323 (7th Cir. 2010).
First Natl. Bank of Milaca v. Benson, 192 Minn. 90, 255 N.W. 482 (1934).

STATEMENT OF THE CASE

This appeal arises out of an action venued in the First Judicial District, County of Dakota, State of Minnesota before the Honorable Joseph T. Carter, Judge of District Court.

On October 23, 2009 a receivership was established over First United Funding, LLC ("FUF") and its principal Corey Johnston ("Johnston") as a result of FUF and Johnston's mismanagement and fraudulent handling, execution and delivery of loans to several lending institutions ("Participant Banks") including Appellant THE National Bank ("TNB"). *AA1-11.* On September 30, 2010 the district court issued an Order authorizing preliminary distributions to the Participant Banks upon calculations made by the Receiver based upon the Principal & Interest Method of distribution. *AA12-19.* On November 22, 2010, the district court directed the Receiver to determine whether sufficient records could be recovered to calculate the distributions under the alternative Net Investment Method of distribution. *AA20-24.* Appellant TNB opposed the application of the Net Investment Method. *AA97-109.* On July 21, 2011 the district court issued an Order abandoning the previously adopted Principal & Interest Method and instead found that the Net Investment Method should be applied to this case. *ADD1-18.* Thereafter, on November 17, 2011, the district court entered judgment approving the Receiver's final claim calculations under the Net Investment Method. *ADD19-25.*

This appeal was taken within 60 days from entry of that judgment by way of the Notice of Appeal filed on January 5, 2012. *AA144-148.*

STATEMENT OF FACTS

Shortly before this case was commenced, several banks discovered that FUF and Johnston were perpetrating a massive fraud by "overselling" loan participations to the Participant Banks. *ADD*-4. Upon discovering the fraud, several Participants Banks commenced this action seeking appointment of a receiver to take possession and control of FUF's and Johnston's assets. *ADD*-4. Lighthouse Management Group ("Receiver") was appointed as Receiver for FUF and Johnston on October 23, 2009. *AA1-11.* The Receiver now controls 36 loans totaling over $115 million. *AA*-29. Not all of these loans are collectible. *AA-29.*

The Participant Banks' claims are substantially in excess of the assets which are likely to be recovered by the Receiver.[1] On March 21, 2011 the Receiver filed a Motion to Approve a Calculation of Claims requesting the District Court determine the appropriate method of distribution. *AA48-62.* "In doing so, the Receiver is not advocating any particular outcome, rather, it is highlighting material issues that affect the calculation among equally deserving victims of Johnston's Ponzi scheme." *AA-49.*

The Receiver initially proposed use of the Principal and Interest distribution method ("P&I Method") and, at the time, did not have sufficient records available to calculate a claims distribution under any other method. *AA-51.* All but three of the

[1] The Receiver has begun to assert fraudulent transfer claims against the "net winners" who held loan participations purchased from FUF but were paid in full. It is uncertain at this time what amounts will be recovered from these fraudulent transfer claims. The Receiver has identified several million dollars of potentially recoverable fraudulent transfer claims which, if successful, could recover sufficient funds to repay all of the shortfall of the Participant Banks – approximately $13,000,000. *AA-69.*

Participant Banks *requested* the District Court utilize the P&I Method; to be calculated upon each party's outstanding balance of principal and interest as of October 23, 2009, the date of appointment of the Receiver. *AA14-15*. In an Order dated September 30, 2010, the District Court approved the P&I Method of distribution. *AA12-19*. However, following an evidentiary hearing, the District Court entered a further Order on November 22, 2010 directing the Receiver to determine whether sufficient records could be recovered to use an alternate distribution scheme known as the Net Investment Method (the "Net Investment Method," sometimes also referred to in case law as "money-in/money-out"). *AA20-24*. The Receiver located most, but not all, records to calculate a distribution using the Net Investment Method. *AA-55*; *ADD-6*. On April 7, 2011, the Receiver filed its Second Amended Motion to Approve a Calculation of Claims. *ADD-6*.

On July 21, 2011, the District Court entered its Order Approving a Net Investment Distribution Method. *ADD1-18*. Thereafter, on November 17, 2011 the district court approved the final claim calculations under the Net Investment Distribution Method and entered judgment thereon. *ADD19-25*. Abandoning the Principal and Interest Method and adopting instead the Net Investment Method produces dramatically different outcomes for some Participant Banks. *AA-60*. For example, under the Principal & Interest Method, Appellant TNB would recover $10,390,304, whereas under the Net Investment Method, TNB would recover $8,562,513. *AA-60*. This results in a $1,827,790 difference in Appellant TNB's recovery. *AA-60*.

Accordingly, it is of great importance to establish a fair and equitable methodology for distribution of the funds among the Participant Banks.

STANDARD OF REVIEW

"The standard of review of a district court's exercise of equity is abuse of discretion; an abuse of discretion is shown if the court disregarded the facts or applicable principles of equity." *Tom Thumb Food Markets, Inc. v. TLH Properties*, 1999 WL 31168 at *3 (Minn. App. Jan. 26, 1999). *AA-151.* "In a receivership matter the court is constantly using its discretionary power. It does that which it deems best for all interested." *Sibley County Bank of Henderson v. Crescent Mill. Co.*, 161 Minn. 360, 201 N.W. 618, 620 (1925). Expansion of the receivership, appointment of a receiver and the terms of a receiver's appointment are each reviewed under an abuse of discretion standard. *See Equity Trust Company Custodian FBO Heather Eisenmenger IRA v. Cole*, 766 N.W.2d 334 (Minn. App. 2009); *Minnesota Hotel Company, Inc. v. ROSA Development Co*, 495 N.W.2d 888 (Minn. App. 1993). In this case, the District Court abused its discretion by disregarding the facts, disregarding applicable principles of equity, and failing to do what is best for all concerned.

It is the duty of the district court in receiverships to act within its discretion to do what is best for all concerned and in that regard sits in the seat of equity. *Id.* Such discretionary power generally garners a review under the abuse of discretion standard by this Court. *Id.* Although generally decisions involving a receivership are reviewed for an abuse of discretion, the appeal before this Court is unique and does present factual and legal circumstances under which a de novo standard of review should be considered.

When there is a mixed question of law and fact, courts must carefully review the trial court's ultimate conclusions to determine misapplication of the law. *Maxfield v.*

Maxfield, 452 N.W.2d 219, 221 (Minn. 1990). The concern is not with the findings of fact but with the conclusions drawn from those facts. *Id.* Where a district court "predicates conclusions of law upon a variety of findings...mixed questions of law and fact" are presented. *Estate of Whish v. Bienfang,* 622 N.W.2d 847, 849 (Minn. App. 2001). In the review of a district court's decision on mixed questions of law and fact, the district court's rulings are not binding on this Court, and should be reviewed independently. *Id.* When the trial court's treatment of mixed questions of law and fact and its treatment of the ultimate issues may involve a misapplication of the law, the appellate court should carefully review the trial court's explanation of how the factors led to its conclusion. *Maxfield,* 452 N.W.2d at 221. Trial court rulings on mixed questions of law and fact are not binding on an appellate court. *Meyering v. Wessels,* 383 N.W.2d 670, 672 (Minn. 1986).

Appellant TNB seeks review of the district court's application of the law encompassing distributions of assets in receivership cases and asserts that the district court's application of that law was in error. As such, TNB requests this Court consider reviewing the district court's Orders approving the Net Investment Method distribution scheme and the Receiver's final claim calculations de novo.

ARGUMENT

I. THE DISTRICT COURT ERRED IN APPROVING THE NET INVESTMENT DISTRIBUTION METHOD AS THE APPROPRIATE DISTRIBUTION SCHEME.

The district court's abandonment of the previously adopted Principal and Interest method in favor of the Net Investment distribution method in this case resulting in a

dramatic change in the amount of funds recovered by some participant banks was in error.

A. Comparison of the P&I Method to the Net Investment Method.

Because all of the Participant Banks now before the Court are "net losers" (*i.e.*, nobody will recover the full amount of their original investment) the debate between P&I and Net Investment is somewhat akin to re-arranging the deck chairs on the Titanic. Comparing the results of the P&I Method to the Net Investment Method in this case produces dramatically different outcomes for some Participant Banks. For example, under the P&I Method TNB would recover $10,190,304, whereas under the Net Investment Method, TNB would recover $8,562,513, a stunning $1,827,790 difference in TNB's recovery. *AA-60.*

The principal reason for the differing distributions is the amount each Participant Bank collected in interest and fees over its entire course of dealings with FUF. Participant Banks who dealt with FUF for many years, necessarily, received more interest and fees and will, therefore, receive significantly less under the Net Investment Method. *AA-60.* In contrast, Participant Banks that dealt with FUF for a relatively shorter period of time and collected less in interest and fees will receive dramatically more under the Net Investment Method. *AA-60.* For example, TNB had dealings with FUF since 2002 and collected substantial interest and fees in the early years. *AA-111.* However, its claim under the Net Investment Method is reduced by the total amount of interest and fees TNB

collected, $8,300,775.[2] *AA-60.* By contrast, Republic Bank, which began dealing with FUF only in 2007, has its claim reduced by only $1,000,494 and Western National Bank, which began dealing with FUF in 2005, has its claim reduced by only $4,098,683. *AA-60.* This results in a dramatic increase in their recoveries; Republic's recovery increases by $1,242,923 and Western's increases by $3,401,966. *AA-60.*

In theory, the Net Investment Method rests on the premise that *all* money received from FUF at any time should be applied as a recovery against the *principal* of the victim's original investment. The Net Investment Method assumes *all* money paid by FUF *at any time* constitutes "false or fictitious profits" because a Ponzi scheme is *a zero-sum gain.*

Indeed, in a typical Ponzi scheme there is no "legitimate profit" because, as each new victim invests money, that same money is paid out to earlier victims in the form of "false or fictitious profits". Every dollar paid out is a dollar taken in from another victim; *a zero-sum gain.* Hence, the fictitious profits are rightfully deducted from the victims' original investment as a return of *principal.*

The circumstances of this case are dramatically different, since this case is $84 million *to the good.* FUF had legitimate loans to legitimate borrowers who paid legitimate interest and fees totaling over $84.6 million (the "Legitimate Income").[3] The *vast majority* of payments made by FUF to Participant Banks over the years constituted

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[2] Moreover, TNB voluntarily agreed to reduce its P&I claim by $2.5 million. *AA-57.* If the $2.5 million is added back, TNB's P&I claim is reduced by $10,832,025 under the Net Investment Method.

[3] The Receiver provided TNB with a table showing legitimate interest and fees collected by FUF from legitimate borrowers totaled $84.6 million. *AA114-115.*

repayment of legitimate principal, interest and fees collected by FUF from *legitimate* borrowers, not false or fictitious Ponzi scheme "profits."

Under these facts, the Participant Banks who dealt with FUF earlier and longer are penalized under the Net Investment Method because it does not differentiate between legitimate profits and "fictitious profits." Thus, under these facts, the Net Investment Method, rather than producing greater equality, *magnifies the inequality* because the $84 million in Legitimate Income is treated as a *reduction of principal*. Participant Banks that conducted business with FUF earlier and longer receive less and Participant Banks who came in later receive more -- rearranging the deck chairs on the Titanic because all parties here are "net losers." Thus, the "pure" Net Investment Method produces dramatically different payouts for similarly situated Participant Banks, based solely on timing of their investment and is wholly unfair and inequitable.

The goal of the Court must be to arrive at a methodology which is fair and equitable to all. The Court should adopt one of the following methodologies (listed in order of preference) in order to fairly and equitably distribute the funds recovered by the Receiver:

1. P&I Method, as requested by the vast majority of the Participant Banks;
2. *Modified* Net Investment Method, by crediting Participant Banks with *pro rata* share of the Legitimate Income, as described below.
3. *Modified* Net Investment Method, by utilizing a cutoff date so that each Participant Bank's claim is evaluated at the same point in time.

B. Participant Banks Overwhelmingly Requested the P&I Method.

The Participant Banks overwhelmingly supported the P&I Method. *AA14-15.* TNB even agreed to give up a $2.5 million dollar claim to induce other Participant Banks to approve the P&I Method. *AA-67.* However, TNB will not and has not given up this claim because the rules were changed in the middle of the game. *AA-67.* The P&I Method will bring finality to this matter. The Net Investment Method will extend this action for years because every Participant Bank will be forced to trace every penny sent to and received from FUF; no simple task.

Inevitably, the tracing will result in errors and overwhelmingly document-intensive, never-ending litigation, perhaps costing hundreds of thousands of dollars. There is no valid reason to extend this litigation, thereby increasing everyone's costs, when nearly everyone involved has agreed to the P&I Method.

The District Court ignored these facts and, rather than doing what was in the best interest of all concerned, did what was in the best interest of only a few latecomers. There is no good factual or equitable reason for the District Court to reject the P&I Method when all Participants/Banks except Republic Bank were on board with the P&I Method, and instead adopt a method only supported by Republic Bank. The decision to reject the agreed P&I Method in favor of the Net Investment Method is an abuse of discretion.

C. The District Court's Adoption of the "Pure" Net Investment Method is Inequitable Due to the $84 million of Legitimate Income.

In In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122 (Bankr. S.D.N.Y. 2010) *aff'd, In re Bernard L. Madoff Inv. Sec. LLC,* 654 F.3d 229 (2d Cir. N.Y., 2011), the Court lays out the mechanics of a "pure" or unmodified net investment method. Every dollar paid out to a victim is subtracted from the principal of the victim's original investment. *Id.* However, the *Madoff* decision itself does not support the use of the pure Net Investment Method here, for two obvious reasons: (i) the *Madoff* court was applying the Securities Investor Protection Act ("SIPA") which <u>*requires*</u> receivership property to be distributed to claimants to the extent of their "net equity" (*i.e.*, net investment); and (ii) 100% of the "profits" at issue in *Madoff* were part of a Ponzi scheme (*i.e.*, false or fictitious profits). *Id.* The *Madoff* case was a zero-sum gain. *Id.* Here, the Court is not applying SIPA and this case is not a zero-sum gain. [4] [5] This case is $84.6 million to the good.

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[4] The Receiver does not advocate any particular method of distribution and has left it to the Court's discretion to determine the appropriate method of distribution of the recovered funds. *AA-49.*

[5] Three of the cases cited by the Receiver as supporting the Net Investment Method are distinguishable for a very similar reason. Local Rule 66.1(a) of the Northern District of Illinois (*Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995)), Local Rule 66-8 of the Central District of California (*Donell v. Kowell*, 533 F.3d 762 (9th Cir. 2008)), and Local Rule 66.1(d) of the Northern District of Ohio (*Gordon v. Dadante*, 2010 WL 148131 (N.D. Ohio Jan. 11, 2010)) all require a receiver appointed by their respective federal courts to distribute assets in accordance with the bankruptcy laws. In this regard, Sections 752(a) and 766(h) of the Bankruptcy Code require the distribution of stockbroker and commodity broker assets to be made on a "net equity" basis (*i.e.*, net investment). It should therefore come as no surprise that those federal courts applied the net equity / net investment method. This Court is not so constrained by any such rule or statute.

Less than six (6) months after the *Madoff* decision, another court in a related case in the Southern District of New York *rejected* the use of the Net Investment Method where, as here, legitimate profits existed. *Beacon Assoc. Manag. Corp. v. Beacon Assoc. LLC I*, 725 F. Supp. 2d 451 (2010). In *Beacon*, an investment fund that had invested with Madoff as well as other unrelated *legitimate* investments sought the appropriate method for distribution of its remaining assets. *Id.* at 452-458. The fund's investors, as here, overwhelmingly favored the "valuation method" (which is identical to the P&I Method) (everyone shares *pro rata* according to their total loss including profits *as of a* <u>*specific date*</u>). *Id.* at 454, 458. Notably, the *Beacon* court rejected the use of the net investment method, holding:

> First, unlike BLMIS, where every dollar invested was subject to Madoff's fraud, Beacon invested approximately thirty percent of its assets with legitimate managers who consistently made profits. (*See* page 453-54 above; Dkt. No. 53: H. 38-39, 71-72, 76-77.) Thus, while application of the Valuation Method allows Madoff-related "fictitious profits" to inflate member interests, *application of the Net Investment Method would strip investors of legitimate gains from Beacon's significant non-Madoff investments*. [emphasis added]

Id. at 464.[6] The same is true here. Not every dollar paid to the Participant Banks was due to FUF's fraud; far from it. The Participant Banks received Legitimate Income of over $84 million. *AA-111*. Stripping these profits from Participant Banks will unjustly inflate the recovery of other Participants, just as in *Beacon*. These profits are not "fictitious profits" and, therefore, the justification for the use of the Net Investment

[6] In *Beacon Assoc.*, the court also rejected Net Investment on the basis that the *Madoff* court was applying the SIPA which was not applicable to *Beacon Assoc.* and is not applicable here.

Method collapses like a house of cards. This Court should reject the Net Investment Method and approve the P&I Method, just as in *Beacon.*

Furthermore, a little more than one year after the decision in *Beacon*, the Second Circuit Court of Appeals affirmed the use of the Net Investment Method in *Madoff* but only because of the extraordinary circumstances involved in Madoff's Ponzi scheme. The Second Circuit stated the "last statement method" (which is identical to the P&I Method) is more appropriate in conventional cases:

> In holding that it was proper for Mr. Picard to reject the Last Statement Method, we expressly do not hold that such a method of calculating "net equity" is inherently impermissible. To the contrary, a customer's last account statement will likely be the most appropriate means of calculating "net equity" in more conventional cases. We would expect that resort to the Net Investment Method would be rare because this method wipes out all events of a customer's investment history except for cash deposits and withdrawals. The extraordinary facts of this case make the Net Investment Method appropriate, whereas in many instances, it would not be. The Last Statement Method, for example, may be appropriate when securities were actually purchased by the debtor, but then converted by the debtor. Indeed, the Last Statement Method may be especially appropriate where--unlike with the BLMIS accounts at issue in this appeal-- customers authorize or direct purchases of specific stocks. *See generally Miller v. DeQuine (In re Stratton Oakmont, Inc.)*, 2003 WL 22698876 (S.D.N.Y. Nov. 14, 2003).

In re Bernard L. Madoff Inv. Securities LLC, 2011 WL 3568936 at *238 (2d Cir. Aug. 16, 2011). *AA-233.* In other words, like *Beacon*, where, as here, there are *legitimate* transactions with *legitimate* profits the P&I Method is the appropriate method of distribution.

The District Court's reasoning for rejecting the P&I Method is that "it would be inequitable to reward the parties who were fortunate enough to experience 'legitimate' profits in the midst of a pervasive fraud." *ADD-9.* The District Court's conclusion

misses the point: the legitimate profits were not part of the fraud. The District Court then noted "there was a time when First United engaged in entirely 'legitimate' transactions with banks who are not a party to these proceedings." *ADD-9*. True, but even if those banks were before the District Court they would not be impacted in any way because the transactions were entirely legitimate (they suffered no loss and there are no illegal or illegitimate "profits" to retrieve from), and that is the whole point. It is imprudent to mix legitimate profits with fictitious Ponzi scheme "profits" because it inappropriately punishes lenders who received legitimate profits and magnifies their losses.

The District Court's decision ignores the facts and misapplies the principles of equity by adopting an inequitable methodology that is only in the best interest of a few, rather than doing what is in the best interest of all concerned. The District Court's decision is an abuse of discretion.

D. The District Court Failed To Follow Principals of Equity under Minnesota Law.

Under Minnesota law, "as a general rule, equity favors the ratable distribution of assets of insolvent [entities] to the end that all creditors may be treated alike. 'He who claims a departure from this rule must establish his right clearly.' " *First Natl. Bank of Milaca v. Benson*, 192 Minn. 90, 255 N.W. 482, 483 (1934) (quoted citation omitted). This is a principle of equity long-recognized by the Minnesota courts and long-incorporated into the laws of the State of Minnesota. *Farmers' & Merchants' State Bank of Thief River Falls, Inc., v. Roark*, 172 Minn. 80, 214 N.W. 792 (1927) (creditors are

entitled to a ratable distribution of insolvent bank's assets, a right that "has been repeatedly observed"); *Veigel v. Converse*, 168 Minn. 408, 210 N.W. 162 (1926) (when a bank becomes insolvent and goes into the hands of a receiver its assets "are subject to 'disposal and ratable distribution among all its general creditors, upon the principle of equality' " (quoted citation omitted)); *In re Owatonna Coop. Mercantile Co.,* 157 Minn. 482, 196 N.W. 654 (1924) ("There is nothing in [the Court's prior decisions], or anywhere in the law of corporations, giving stockholders the right to prevent the ratable distribution to creditors of the assets of an insolvent corporation"); *Kalkhoff v. Nelson*, 60 Minn. 284, 62 N.W. 332, 334 (1895) (Minnesota statutes authorize a corporation to be placed into receivership to pay the corporation's debts and, if such assets are insufficient, "to distribute the same ratably among the creditors"); *St. Paul & Minneapolis Trust Co. v. Leck*, 57 Minn. 87, 58 N.W. 826 (1894) ("whenever a debtor is insolvent, all of his creditors are interested in the equality of distribution" and in having the estate ratably distributed among the creditors); *Kinney v. Sharvey*, 48 Minn. 93, 50 N.W. 1025 (1892) (the Minnesota Supreme Court "has repeatedly held" the purpose of Minnesota's insolvency law is "to secure an equal distribution of the debtor's property among his creditors"); *Arthur v. Willius*, 44 Minn. 409, 46 N.W. 851 (1890) (the purpose of Minnesota's corporate dissolution statute is to wind up the affairs of the corporation, collect and convert its assets, and distribute them ratably among its creditors); *Hospes v. Northwestern Mfg. & Car Co.*, 41 Minn. 256, 43 N.W. 180 (1889) (same); *Balch v. Wilson*, 25 Minn. 299 (1878) (insolvent bank was placed in receivership first for the

satisfaction of any claim of the United States government and, second, "for a ratable distribution of the balance among its general creditors, upon the principle of equality").

This principle of equity was not followed in this case. The district court did not institute an equal, pro rata distribution of the assets of FUF. The district court adopted an unequal distribution of assets that inequitably prefers those banks who have had more recent dealings with FUF over those banks who have had dealings with FUF over a longer period of time. Simply put, the district court went well beyond the most basic principle of equity: equality. The net investment method adopted by the district court does not treat everyone equal because its principles collapse like a house of cards in the presence of legitimate income (as discussed in the preceding). There is nothing ratable, equitable, or equal about the district court's net investment calculation. The district court has failed to apply Minnesota law by failing to approve a ratable, equal distribution of FUF's assets and by instituting a back-door claw back beyond the six year statute of limitations. Such errors of law are subject to de novo review by this Court. *Alpha Real Estate Co. of Rochester v. Delta Dental Plan of Minnesota*, 664 N.W.2d 303, 311 (Minn. 2003) ("we do not give deference to the district court's conclusions of law and we review questions of law de novo").

E. The District Failed to Consider the Applicable Statute of Limitations.

Under the Net Investment Method approved by the district court, the Participant Banks will have all the income and fees they collected offset against the principal amount of their claims, effectively "clawing back" all of the interest collected back to day one. This inequity is further magnified by the six (6) year statute of limitations. Under the

district court's ruling, every Participant Bank in this case is subjected to *unlimited* claw back of the funds received from FUF, regardless of when the funds were received. However, the "net winners" who are parties in the separate claw back litigation brought by the receiver are protected by Minnesota's six (6) year statute of limitations as an absolute bar to the fraudulent transfer claims asserted by the receiver. Minn. Stat. § 541.05(1)(6) (2011); *Lamson v. Cohn*, 1997 WL 733869 at *3 (Minn. App. Nov. 18, 1997). *AA170-172.* Thus, the folly of the district court's net investment methodology is readily apparent; Participant Banks who are "net losers" have every penny received from FUF counted as the recovery of principal while "net winners" are entitled to keep every penny they received more than six (6) years ago. This is precisely the outcome that has occurred in Dakota County.

In Dakota County Case No. 19HA-CV-11-2856, Judge Joseph T. Carter (*the same judge who approved the Net Investment Method in this case with an unlimited claw back*) ruled the receiver's fraudulent transfer claims were *barred* by the six year statute of limitations. *AA237-257.* There is no rational explanation for banks in the claw back case to receive the benefit of the six year statute of limitations and for banks in another case before the court to be denied the benefit of the six year statute of limitations. The bottom line is this: the banks in Dakota County Case No. 19HA-CV-11-2856 were allowed to keep all net earnings accumulated more than six years ago; the banks in this case were not allowed to keep any net earnings accumulated more than six years ago due to the district court's net investment distribution. Such a result constitutes blatant inequity and is a clear abuse of discretion.

II. THE DISTRICT COURT ERRED IN APPROVING THE FINAL CLAIM CALCULATIONS OF THE RECEIVER UNDER THE NET INVESTMENT METHOD OF DISTRIBUTION.

The district court erred in approving the final claim calculations presented by the Receiver where if the Net Investment Method governs distribution in this case, the equitable distribution scheme is found under a modified Net Investment method and not the pure method adopted by the district court.

A. One Size Does Not Fit All; Modification of the Net Investment Method Is Necessary If Net Investment is Used At All.

The District Court overlooked the fact that most of the cases rely upon a *modified* form of the Net Investment Method. In *S.E.C. v. Credit Bancorp, Ltd.*, 290 F.3d 80, 88-90 (2d Cir. 2002), the Second Circuit approved the modified form of the Net Investment Method adopted by the district court, utilizing a claim valuation date based on the *current market value* of securities held by the Receiver and taking into account the market appreciation since the original date of investment by the victim. *See S.E.C. v. Credit Bancorp, Ltd.*, 2000 WL 1752979 at **37-40 (S.D.N.Y. 2000). *AA210-215.* Thus, the *modified* Net Investment Method in *Credit Bancorp* is based, essentially, on the time value of money, recognizing that a dollar invested earlier is not the same as a dollar invested later.

Likewise, in *S.E.C. v. Beyers*, 637 F. Supp. 2d 166, 172 (S.D.N.Y. 2009), the Court approved a *modified* net investment distribution which differs significantly from a "pure" net investment method by allowing victims to add back their "rolled-over" distributions to their claims because "ignoring the rolled over amounts would further

penalize investors who chose to roll over their investments rather than receive them in cash." *Id.* at 183.

What is clear from the case law is that one size does not fit all. The Court must carefully craft a distribution plan that is fair and equitable to all. As the court recognized in *Credit Bancorp:*

> What is equitable and fair will depend on the circumstances. Thus, courts have approved different types of plans in different situations. *Compare, e.g., Durham*, 70, 73 (approving pro rata distribution of receivership cash assets even though most of those assets were traceable to specific claimants) *with, e.g., P.B. Ventures*, 191 W.L. 269982 at **2-3 (approving customer recovery of shares through tracing). In equity, remedies to which claimants might be entitled under other law may be suspended if such a measure is consistent with treating all claimants fairly.

Credit Bancorp. 2000 WL 1752979 at *28. *AA173-223.*

B. Any *Modified* Net Investment Method Must Credit Participant Banks with a Pro Rata Share of the Legitimate Income.

If the Court rejects the P&I Method, then a *modified* Net Investment method must be utilized to prevent a windfall to some Participants because of the $84 million in Legitimate Income. The table furnished by the Receiver shows Legitimate Income (interest and fees) received from legitimate borrowers collected by FUF exceeding $84 million. *AA-111.* Simple mathematical computations can <u>*prorate*</u> the $84 million of Legitimate Income among the Participant Banks, on a equitable basis, based on each Participant's net investment balance each year, thereby giving credit for the time value of money. *AA-111.* The data to allocate the $84 million of Legitimate Income among Participant Banks is contained within the Receiver's spreadsheet and, in fact, the Receiver has already made the necessary calculations and provided a spreadsheet to

accomplish this proration. *AA-111.* The table below shows the re-computation of a *modified* Net Investment Method allocating, on a pro rata basis, a share of the $84 million of legitimate interest and fee income. (the "TNB Modified Net Investment Method").

TNB's MODIFIED NET INVESTMENT METHOD COMPAIRED TO P & I METHOD

Claimant	P&I Claim Amount	%	P&I Recovery	Net Investment Claim Amount	%	Net Investment Recovery	Difference	Diff %	Recovery %
The National Bank	$18,280,874	13.5%	$10,388,489	$17,599,754	14.1%	$10,861,468	$472,979	5%	59%
First International Bank & Trust	$2,454,904	1.8%	$1,395,050	$1,491,697	1.2%	$920,582	($474,468)	-34%	37%
Charter Bank	$8,483,725	6.3%	$4,821,054	$6,159,241	4.9%	$3,801,099	($1,019,955)	-21%	45%
LNV Corp	$16,729,026	12.3%	$9,506,619	$15,270,174	12.2%	$9,423,797	($82,822)	-1%	56%
Minnwest Bank Luverne	$10,150,982	7.5%	$5,768,508	$9,549,786	7.7%	$5,893,531	$125,023	2%	58%
Community Financial Bank	$925,692	0.7%	$526,044	$410,473	0.3%	$253,318	($272,726)	-52%	27%
FDIC	$6,310,958	4.7%	$3,586,334	$6,090,459	4.9%	$3,758,651	$172,317	5%	60%
Labette County State Bank	$1,021,656	0.8%	$580,578	$940,204	0.8%	$580,235	($343)	0%	57%
Choice Financial Group	$23,987,557	17.7%	$13,631,431	$21,466,750	17.2%	$13,247,936	($383,495)	-3%	55%
Border State Bank	$2,000,000	1.5%	$1,136,542	$1,903,552	1.5%	$1,174,754	$38,212	3%	59%
Tiffany & Bosco, P.A.	$8,570	0.0%	$4,870	$8,570	0.0%	$5,289	$419	9%	62%
First Southern Bankcorp	$2,509,583	1.9%	$1,426,123	$2,621,692	2.1%	$1,617,944	$191,821	13%	64%
Sonoran Bank	$1,071,106	0.8%	$608,678	$1,103,555	0.9%	$681,045	$72,367	12%	64%
Community First Bank	$5,201,425	3.8%	$2,955,819	$4,872,759	3.9%	$3,007,162	$51,344	2%	58%
The Bank of Weatherford	$905,760	0.7%	$514,717	$825,036	0.7%	$509,161	($5,556)	-1%	56%
Maple Bank	$976,928	0.7%	$555,160	$934,821	0.7%	$576,913	$21,753	4%	59%
Bank Forward	$3,313,534	2.4%	$1,882,985	$3,353,776	2.7%	$2,069,741	$186,756	10%	62%
Republic Bank	$7,256,177	5.4%	$4,123,474	$6,518,981	5.2%	$4,023,107	($100,367)	-2%	55%
Western National Bank	$23,910,296	17.6%	$13,587,526	$23,648,322	19.0%	$14,594,266	$1,006,740	7%	61%
	$135,498,752	100.0%	$77,000,000	$124,769,603	100.0%	$77,000,000	($0)	100.0%	

A *Modified* Net Investment Method produces a fair and equitable result for all parties because it does not *redistribute* the $84 million of Legitimate Income, but rather takes into account the time value of the money that allowed FUF to generate the $84 million in Legitimate Income, as provided in *Credit Bancorp.*, 2000 WL 1752979 at **37-40. *AA210-215.*

It is absolutely incongruous for some Participant Banks to argue that this Court should entirely disregard the $84 million of Legitimate Income and should instead pretend the $84 million is "fictitious" and "false" Ponzi scheme profits. If a Modified Net Investment Method is not used, each Participant's share of the Legitimate Income is

charged against principal when, in fact, the Legitimate Income constitutes payment for the use of the Participant's money. If the Court rejects a *Modified* Net Investment Method, an $84 million windfall will accrue to those Participants who invested their money years later, thus providing payment w*hen their money was not in use* (*i.e.*, Republic will receive a share of Legitimate Income paid for the use of TNB's money in 2002, since Republic did not invest until 2007).

C. The Net Investment Method Should Use a Hard Cut-off Date.

Because of the existence of the enormous $84 million of Legitimate Income, the Net Investment Method imposes an unlimited a "claw back" against the Participant Banks who invested earlier and longer. The Receiver is now pursuing "claw-backs" (known as fraudulent transfers under the Minnesota Uniform Fraudulent Transfer Act) against the "net winners" to recover their share of the "profits" that FUF paid out. *AA-61, 237-257.* However, under Minnesota law "claw-backs" are only recoverable if payment was made within the six (6) year statute of limitations. Minn. Stat. § 541.05(1)(6) (2011); *Lamson v. Cohn*, 1997 WL 733869 at *3 (Minn. App. Nov. 18, 1997). *AA170-172.*

Other courts have dealt with the issue by imposing a hard cutoff date. In *S.E.C. v. Wealth Management, L.L.C.*, 628 F.3d 323 (7th Cir. 2010), the Court utilized a *modified* net investment method by employing a hard cutoff date. Payouts (profits) received after the cutoff date were deducted from the victim's claim, while payouts received prior to the cutoff date were not offset against the victim's claim. The court explained that:

> Specifically, the [district court] judge recognized that the receiver basically had three options – offset all redemptions [payouts], offset no redemptions, or select a cutoff date to determine which redemptions to offset. The judge acknowledged that any cutoff date would be both over- and under-inclusive but thought it was more equitable to use a cutoff date and to either offset all or no redemptions. That is, offsetting all redemptions would penalize investors who made earlier redemptions requests; offsetting none would reward redeeming investors at the expense of non-redeeming investors. *Id.* at 336.

Similar circumstances exist here. Any use of the Net Investment Method must also impose a hard cutoff date whereby the payments of principal, interest and fees prior to the hard cutoff date (presumably six years) would not be offset against principal of the Participant Bank's claim, but payments received after the cutoff date would continue to be offset against principal.[7] This would partially prevent the illogical penalization of Participant Banks who had earlier and longer dealings with FUF, but would allow a modified form of the Net Investment Method as to later payments after the cutoff date.

CONCLUSION

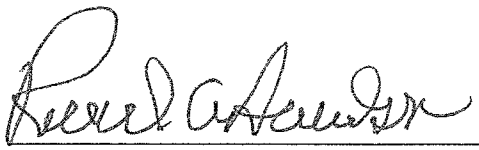
The Participant Banks, with one exception, asked the District Court to approve the P&I Method of distribution. After months of waiting and hundreds of thousands of dollars of additional expense while the Receiver hunted for records and made the calculations, the P&I Method is still the preferred, most equitable method of distributing the funds collected by the Receiver. The P&I Method is fair, certain, quick and final. Without modification, Participant Banks who put their money in later will reap an $84 million windfall at the expense of those Participant Banks who put in their money earlier.

[7] This will not affect the fraudulent transfer claims brought by the receiver because those Banks are "net winners" whereas all the parties now before the Court in this case are "net losers."

This Court should reverse the District Court's Order and direct the Receiver to utilize the P&I Method of distribution.

Respectfully submitted,

Dated: February 3, 2012



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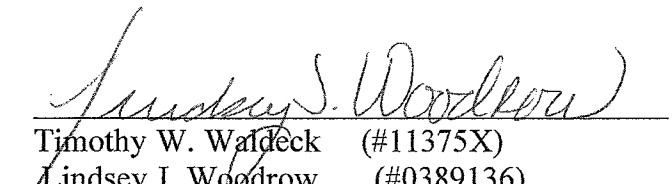

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief conforms to Minn. R. Civ. App. P. 132.01 subds. 1 and 3, for a brief produced using the following font: Times New Roman, 13 point or larger. The length of this brief is 6,239 words. This brief was prepared using Microsoft Office Word 2007.

Respectfully submitted,

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