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.

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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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INTRODUCTION

Appellant THE National Bank ("TNB" or "Appellant") respectfully submits this Brief in reply to the Brief and Appendix of Respondent Republic Bank of Chicago ("Republic Bank") and the Brief and Appendix of Respondent Lighthouse Management Group, Inc. as Receiver for First United Funding, LLC and the Non-Exempt Assets of Corey N. Johnston ("Receiver"). Appellant has also filed with this Court a Motion to Strike the Appellate Brief of Receiver. Appellant's references and direct responses to the arguments made in Receiver's brief is in no way intended to constitute a waiver of any arguments contained within its Motion to Strike.

STANDARD OF REVIEW

The district court committed an error of law by concluding it could order distribution using the Net Investment Method. An error of law constitutes an abuse of discretion. *Whitaker v. 3M,* 764 N.W.2d 631, 635-363 (Minn. App. 2009), *review denied* (Minn. 2009). 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"). Under Minnesota law, equity demands equality and the district court adopted an unequal and therefore inequitable distribution of assets. The district court adopted a Net Investment Method that (i) fails to account for legitimate income and thereby magnifies losses and inflates gains, and (ii) imposes a back-door claw back beyond the statutorily required six year statute of limitations. Such errors of law are subject to de novo review by this Court. *Id.* These specific arguments were raised in the TNB's opening appeal brief and were not addressed by Republic Bank or the Receiver in their appeal briefs. (TNB Brief, p.17).

ARGUMENT

I. MINNESOTA LAW REQUIRES A RATABLE DISTRIBUTION OF ASSETS UPON THE PRINCIPLE OF EQUALITY.

All of the cases cited by Republic Bank and the Receiver to support their Net Investment Method arguments are irrelevant for one over-arching reason: none of them involve a liquidation by a receiver in Minnesota or the application of Minnesota law. Minnesota law demands an equal, ratable distribution of assets to the creditors of an insolvent entity. *Swanson v. Tomlinson Lumber Mills, Inc.*, 307 Minn. 180, 239 N.W.2d 216, 218-219 (1976) (receivership assets are to be distributed *pro rata*); *Timmer v. Hardwick State Bank*, 194 Minn. 586, 261 N.W. 456, 458 (1935) (a creditor "is entitled to receive his pro rata share of the assets placed in the trust fund, thereby treating all creditors alike and without favoritism to any one"); *Overvold v. Nelson*, 186 Minn. 359, 243 N.W. 439, 443 (1932) (general creditors share pro rata in the remaining assets); *Hallam v. Southern Surety Co.*, 173 Minn. 133, 216 N.W. 546, 548 (1927) (unsecured creditors share pro rata in the remaining assets); *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)); *Taylor v. Fanning*, 87 Minn. 52, 91 N.W. 269, 270 (1902) (assets of insolvent corporation are to be applied "to the payment of all debts, pro rate and equally"). There is nothing unique about this principle; it is a basic principle of equity.

> It is one of the purposes of a court-supervised dissolution to assure a ratable distribution of assets. Those charged with the liquidation of the corporation may not lawfully prefer one creditor or group of creditors over others of the same class, especially when the corporation's assets are less than its liabilities.

19 Am. Jur. 2d *Corporations* § 2454 (2012).

At one time, Receiver was in favor of the P&I Method (before the Receiver was against it), a memo attached to the Receiver's recommendation to the district court dated February 17, 2010 provided as follows:

> In *First American Title Insurance Co. v. Countrywide Home Loans*, No. 27-CV-05-7830 (Minn. State Dist. February 15, 2007), an unpublished decision from Hennepin County District Court, the defendant misappropriated billions of dollars from at least 18 claimants and an insurance scheme. Because the defendant had comingled the claimants' funds, the court cited the Restatement (First) of Restitution, and ordered all recovered funds to be distributed to claimants on a *pro rata* basis. *Id.* (citing Restatement of Restitution § 213). The court explained:
>
>> Under the Restatement, courts favor pro rata distribution method [sic], which has the appeal of being a fair and equitable method in which all eligible creditors stand on equal footing. This method also has the appeal of arithmetic simplicity and avoids undue conflict within the class of eligible creditors. Finally, "equity favors proration."
>
> *Id.* (quoting *Roberts v. Johnson*, 200 N.W.2d 316, 320 (Minn. 1972).
>
> Other courts have held that, following a fraudulent scheme, a district court overseeing a receivership proceeding has the equitable authority to treat all fraud victims alike, in proportion to their investments, and order a *pro rata* distribution of the remaining assets.

(AA-274).

The Receiver has now changed his position, primarily to protect the claw back cases rather than out of any sympathy for the plight of the victims of FUF's fraud.

As detailed below, the Net Investment Method adopted by the district court departs from the principle of equality because the participant banks are not treated equally; some get the benefit of the statute of limitations and some do not; some have their losses magnified and others have their claims inflated. The Net Investment Method adopted by district court is not ratable, equal nor equitable and must be rejected based upon the proper application of Minnesota law.

II. THE NET INVESTMENT METHOD SHOULD BE REJECTED OR MODIFIED.

The primary argument against the P&I Method is a sweeping and unsupported generalization that "the vast majority of courts" have adopted the Net Investment Method and "almost universally rejected" the principal and interest method. (Republic Bank Brief, pp.16, 17; Receiver Brief, p.17). Republic Bank boldly claims "courts generally reject any form of distribution scheme that fails to account for prior payments." (Republic Bank Brief, p.24). None of these statements are true nor are they applying Minnesota law. Indeed, the most prominent decision rejecting these sweeping generalizations by the Second Circuit Court of Appeals in *Madoff*. The Second Circuit concluded that "a customer's last account statement [similar to the P&I Method here] will likely be the *most appropriate means* of calculating 'net equity' in more conventional cases." *In re Bernard L. Madoff Inv. Securities LLC*, 2011 WL 3568936 at *238 (2d Cir. Aug. 16, 2011) (emphasis added) *(AA224-236)*. Moreover, the Second Circuit expected any "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." *Id.* (emphasis added). In other words, the P&I Method advanced by TNB is the rule of general application and the Net Investment Method is the rare exception.

Republic Bank cites three cases to support the proposition that the "benefit of the bargain" or "last account statement" methods (similar to the P&I Method) have "been almost universally rejected when considered by courts." (Republic Bank Brief, pp.16-17). In *Tedlock Cattle*, the court *permitted* a bankruptcy trustee to *consider* a "cash-in-cash-out plan" in addition to the "benefit of the bargain" method but did not mandate either. *In re Tedlock Cattle Co., Inc.*, 552 F.2d 1351, 1354 (9th Cir. 1977) (applying Federal bankruptcy law, not Minnesota law). The court made no determination as to the most equitable method of distribution. *Id.* ("We express no opinion upon the merits of the various claims, or on the details of subrogation plans, if any, the trustee may devise for the various classes of investors. We hold only that the trustee can follow *In re Young*, *supra*, if the equities of the parties so indicate.").

In re Young involved a pure Ponzi scheme with no legitimate profits at all, unlike this case. *In re Young*, 294 F. 1, 4 (4th Cir. 1923) (applying Federal bankruptcy law) ("Again it is to be borne in mind that there were no profits, and that all the payments made by Young were from the capital fund paid in by customers."). Furthermore, *Young* decided whether to allow a single proof of claim of a "net winner," not the entire distribution method applied in the bankruptcy estate with respect to the "net losers." No distribution scheme was approved or disapproved by *In re Young*.

Finally, *Madoff* involved the proper definition of "net equity" under Federal securities law in the SIPA which has nothing to do with this case. The *Madoff* court held the Net Investment Method was required by statute. *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).

None of these cases support Republic Bank's "universal rejection" theory, nor do they reflect the application of Minnesota law, as opposed to Federal bankruptcy or securities law.

Republic Bank also cites other cases to support its claim that "the vast majority of courts" have adopted the Net Investment Method. (Republic Bank Brief, pp.17-18).[1] *CFTC v. Topworth Intl., Ltd.*, 205 F.3d 1107 (9th Cir. 1999) applied a "net equity method" because it was mandated by local court rules; *SEC v. Capital Consultants, LLC,* 397 F.3d 733 (9th Cir. 2005) applied a *modified* Net Investment Method in a Federal securities case; *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80 (2d Cir. 2002) approved a "compromise plan" but *rejected a pure net investment plan*; *SEC v. Byers*, 637 F. Supp. 2d 166 (S.D.N.Y. 2009) did not involve the payment of legitimate income; *In re Financial Partners Class Action Litigation*, 73 B.R. 49 (N.D. Ill. 1987) was a pure Ponzi scheme with no legitimate income; and *In re Taubman*, 160 B.R. 964 (S.D. Ohio 1993) also a pure Ponzi scheme with no legitimate income ("*Funds paid to prior investors were not financed by any business ventures or from any other 'legitimate' source but were financed from new investors' monies.*") *Id.*

[1] These cases are also cited by the Receiver. (Receiver Brief, p.17).

This case is different for one simple reason, the presence of $84 million of legitimate income. *Beacon Assoc. Manag. Corp. v. Beacon Assoc. LLC I*, 725 F. Supp. 2d 451 (2010). Not all of the payments received by participant banks were funded solely from funds received from other participant banks; there existed, and still exist, millions of dollars of legitimate loans with legitimate borrowers who paid legitimate interest and fees on their loans. The interest and fees paid by these legitimate borrowers on legitimate loans are not "ill-gotten funds" as asserted by Republic Bank. (Republic Bank Brief, p.18). Simply put, FUF was not entirely a Ponzi scheme. This simple but important distinction is lost on Republic Bank and their claim FUF did not turn a profit is a "red herring". (Republic Bank Brief, pp.19, 25-26; Receiver Brief, pp.20-23). Whether FUF turned a profit is not the point. The point is that FUF generated *legitimate income* that must be taken into account that did not come from funds contributed by other participants. The district court made no provision for the proper accounting of the $84 million in legitimate interest and fees, but rather lumped everything together based upon an erroneous view of Minnesota law.

Labeling legitimate income as a *return of principal* is nonsensical because (i) it is not part of the Ponzi scheme because it did not come from another victim, (ii) it prejudices and magnifies the losses of participant bank victims who dealt with FUF for many years like TNB, and (iii) it inflates the recovery of the newest participant banks like Republic Bank. *Beacon*, 725 F. Supp. 2d at 464 ("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"). The P&I Method requested by TNB avoids this problem. Even a modified Net Investment Method with an equitable allocation of the legitimate income would remedy the problem.

Republic Bank's claim that "[t]he Net Investment Method does not require [TNB] to disgorge any payments previously received" or "return any property" is contrary to the very definition of the Net Investment Method. (Republic Bank Brief, p.27, n.7; p.31); (Receiver Brief, p.25). By definition, the Net Investment Method "disgorges" and "returns" prior interest payments by debiting them against TNB's *principal* even though the funds were received and applied as interest many years ago. The fact that money does not physically change hands is irrelevant because TNB is stripped of its prior interest income by having it subtracted from its share of future distributions.

Finally, the Receiver's claim that "[b]ut for the Ponzi scheme, no loans would have ever been funded and no revenues would have been generated from any loans" is simply untrue and unfounded. (Receiver Brief, p.22). There is no support in the record for this bald claim. The statement that even the legitimate loans made by FUF were dependent upon the Ponzi scheme is completely without any factual basis or support in the record. In fact, the opposite is true. The Receiver's unsupported "but for" claim is a fallacy, rather, the legitimate loans were made in spite of the Ponzi scheme not because of it. The receipt of the legitimate interest and fees by legitimate borrowers was in no way the product of the Ponzi scheme.[2]

[2] The Receiver's own spreadsheets show the majority of the funds passing through FUF's checking account from 2002 through 2009 to the participant banks were greatly in excess

III. THE DISTRICT COURT IGNORED THE SIX-YEAR STATUTE OF LIMITATIONS.

Republic Bank claims the use of the P&I Method may interfere with the Receiver's ability to recover payments from other persons who are not parties to this action (*i.e.*, net winners) in the claw back litigation.[3] First, the impact of the outcome in this case on the claw back litigation brought by the Receiver against other persons who are not parties in this case is utterly *irrelevant.* (Republic Bank Brief, p.20). Secondly, the assets of FUF can be distributed to the parties in this case (all of whom are net losers) using the P&I Method and ***if*** the Receiver is able to recover additional funds in Claw Back Cases, then the District Court can also distribute those additional funds also using the P&I Method.

Moreover, the Receiver recently ran into a buzz saw in the statute of limitations when trying to recover from net winners in the Claw Back Cases. (Dakota County Case No. 19HA-CV-11-2856) (*AA237-257*). That decision was also rendered by the Honorable Joseph T. Carter, the same judge who approved the Net Investment Method in this case. Republic Bank fails to explain why or how it can possibly be equitable for TNB to be subjected to an *unlimited claw-back* going back to 2001 while the "net winners" are entitled to the shield of the six-year statute of limitations in the Claw Back Cases. (Republic Bank Brief, p.31). There is no rational explanation because it is not

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of the final P&I Method loss of $135,475,092. Thus, the loss ratio is significantly below 50%.

[3] The Receiver has brought claw back cases ("Claw Back Cases") against "net winners" who received more funds from FUF than their initial investment seeking to recover their "profit." These cases are pending.

equitable. The banks in the Claw Back Cases are entitled to keep all money they received more than six years ago, but TNB will have its earnings stripped back to 2001 and subtracted from its final distribution. *(AA 237-257).* How can it be equitable for a "net loser" like TNB to be stripped of earnings it received more than six (6) years ago while "net winners" get to keep all their earnings? This highlights the inequity of the Net Investment Method as applied by the district court in this case.

If the Net Investment Method were applied equally across the board to both the "net winners" and the "net losers" there may be some legitimacy to the argument. However, to apply the Net Investment Method only to the "net losers" and to give the "net winners" a free pass creates an entirely inequitable scheme of distribution among the similarly situated parties. For example, if TNB had received $1,000 of interest income in 2002, TNB will have that $1,000 subtracted from its net investment distribution. If a net winner, Bank X, also received a $1,000 interest income in 2002, that Bank X will be allowed to keep its $1,000 of earnings and will not be subject to a claw back action by the Receiver because of the six-year statute of limitations. Accordingly, TNB will receive $1,000 less than Bank X simply because TNB had the misfortune of being a "net loser" when FUF collapsed. To completely ignore the applicable statute of limitations in fashioning the distribution scheme in this case amounts to an abuse of discretion and must be reversed by this Court.

The Receiver addresses the issue by simply repeating the same arguments that were rejected in the Claw Back Cases. (Receiver Brief, pp.24-37). Those arguments were not persuasive to the district court then and they are not persuasive here. The Receiver suggests equitable tolling may apply under Minn. Stat. § 541.05, subd. 1(6) by virtue of the discovery rule, but that argument has already flopped in the Claw Back Cases. (*AA252-253*).

Here, the district court has created through the backdoor what it ruled in the Claw Back Cases cannot be done through the front door. TNB and the other banks in this case are being subjected to an unlimited claw back as to funds they received many years before the six-year statute of limitations. On the other hand, other banks who are parties in the Claw Back Cases receive the benefit of the six-year limitations period.

The result is that some banks are more equal than others and is not a result that is permitted by Minnesota law. Equity is equality and the participants banks *in this case* are not being treated equally or equitably.

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CERTIFICATE OF COMPLIANCE

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