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 RESPONDENT REPUBLIC BANK OF CHICAGO

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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 THE CASE

This litigation arises from the receivership of First United Funding, LLC, ("FUF") in Dakota County, Minnesota. Over the course of seven years, FUF defrauded over a dozen financial institutions, with losses totaling in the millions. The issue presented by this appeal is how the district court should distribute proceeds from remaining loans administered by the receiver as well as funds recovered in the receivership to the victim banks. There are no specific statutes at issue but rather the parties and the district court have relied on equitable principles developed in similar cases.

One of the primary issues in the receivership is the type of distribution scheme the district court should adopt for those "net loser" banks who were unpaid participant lenders when FUF's operations ended.[1] Early-on, the parties argued whether the receiver should pool all the remaining participated loans so that the victims would share in the distribution scheme on a *pro rata* basis, or whether victim banks could only recover monies derived from the specific loans for which they had purchased participations. On September 30, 2010, the district court approved the receiver's recommendation to pool the remaining loans and ordered that the distribution scheme should follow a *pro rata* method of distribution.

The district court also considered competing proposals as to which method of *pro rata* distribution scheme to adopt. The proposals included a "principal and interest"

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1 "Net winner" banks would be those who received full payment of their participations plus interest. The receiver has commenced lawsuits to recover interest payments from the "net winner" banks in order to increase the recovery for the net loser banks involved in this proceeding.

approach, and a "net investment" approach. The methods differ due to how the banks calculate their claim amounts, which in turn determines their *pro rata* share. Under the principal and interest approach, each bank calculates its claim based on the outstanding principal and interest balances for each bank's participations on the date the receivership commenced. Under the net investment approach, the receiver determines the net sum of all transactions between each participant with FUF on a cash basis.

Republic is the primary advocate for the net investment method, and the receiver supports the net investment method. Appellant is the primary advocate for the principal and interest method.

The district court extensively considered the arguments and evidence related to net investment method at four separate hearings in September 23, 2010, November 15, 2010, May 24, 2011 and September 16, 2011. In an Order entered on November 22, 2010, the district court ruled that "other considerations being equal, the 'net investment' plan provides a more equitable distribution of assets to the victims." The district court conditioned formal adoption of the net investment method on the receiver acquiring certain records from the FDIC related to a bank in receivership in order to calculate a sufficiently accurate net investment claim for each bank. Republic sued the FDIC to obtain such documents and with such documents the receiver moved for final approval of the distribution scheme.

At the hearing on May 24, 2011, the receiver's counsel stated a preference for the net investment method. The district court formally adopted the net investment method by order entered on July 21, 2011. On November 17, 2011, the district court confirmed the receiver's calculation of each bank's claim under the net investment method and entered judgment.

STATEMENT OF FACTS

First United Funding, LLC ("FUF") conducted a fraudulent scheme whereby it sold loan participations to banks in amounts exceeding the underlying loans originated by FUF. *RBC A. 5.* To fully service the claims created by the loan participations it oversold, FUF relied on diverting funds advanced from participants to pay other participants in a classic Ponzi scheme pattern. *RBC A. 5 through RBC A. 7.* FUF and its principal, Corey Johnston, also diverted funds generated by the scheme to create a lavish, but fictional, lifestyle for himself and his family members. *RBC A. 13 through RBC A. 14.*

Like all Ponzi schemes, FUF eventually found it impossible to maintain a sufficient flow of new participants to satisfy the claims of the existing participants. *See Generally RBC A. 1 through RBC A. 14.* Similar to Petters, Madoff, and dozens of others, FUF's scheme collapsed shortly after the economic recession took hold in 2008 and 2009, which resulted in the receiver's appointment on October 23, 2009. *AA – 1 through AA – 11.* When FUF tipped, the participant banks were owed approximately $135 million with unpaid principal, interest and fees. *AA – 60.* The receiver estimates that it will recover $77,000,000. *AA – 69.*

Numerous banks, such as Appellant, had relationships with FUF which carried on for up to seven years prior to FUF's collapse. *See RBC A. 122 through RBC A. 138.* During this time, FUF paid tens of millions of dollars of interest to those banks collectively. *See Id.* These banks received the contractual benefits for a number of years in their dealings with FUF. *See Id.* They enjoyed income from their relationship with FUF and could earn additional income on those gains. *See Id.*

Other banks only became acquainted with FUF near the end of its run. *See Id.* These banks realized little of the contractual benefits they bargained for and yet face a substantial cash loss. *See Id.* Latecomers to FUF's scheme suffered a higher cash loss as a percentage of their total cash advance than those who rode with FUF on the way up. *See Id.*; *Compare RBC A. 134 and RBC A. 138 with RBC A. 136.*

FUF conducted a fraudulent scheme from the beginning. *RBC A. 75 through RBC A. 77.* The receiver traces the onset of fraudulent activity to FUF's early existence in 2002, and presented numerous instances of fraudulent activity since FUF's inception to the district court. *Id.* Indeed, the receiver concluded that without fraudulent activity, FUF lacked sufficient cash flow to survive its first year of operations. *RBC A. 77 through RBC A. 78.* As a result, the district court concluded "the Receiver correctly used March 11, 2002, as the start date to begin its [net investment] calculations because that is the earliest date of activity as reflected in First United's checking accounts." *ADD - 6.*

The victims of FUF's fraud are similarly situated to the extent that they all purchased loan participations from FUF and exposed themselves to FUF's fraud. *RBC A. 12.* FUF certainly made its share of real loans, but administered those loans and the income from those loans in a fraudulent manner. *See Generally RBC A. 1 through RBC A. 14.* The receiver found that no participant had taken any action which would have protected itself from FUF's fraud. *RBC A. 13.* The receiver could not identify any particular activities by the banks that increased or decreased the risk that FUF would oversell the loans, but rather the overselling by FUF appears to have been random. *RBC A. 12 through RBC A. 13.*

The amount of overselling impacted each lender differently, and these differences could have resulted in dramatically different levels of recovery among the similarly-situated lenders. *See RBC A. 17 through RBC A. 23.* Republic purchased interests in the Fort Worth Property, LLC (Waldo) and Lancaster Land Holdings, LLC (Waldo) loans.[2] *RBC A. 19.* Those loans had a total face value of $7,210,000 but participants' claims against these two loans totaled $9,685,000, and thus the two loans claimed by Republic were oversold by 134%. *Id.*; *RBC A. 21 through RBC. A. 23.*

By comparison, Western National Bank held participation interests totaling $24,150,000 in Whiteout Way Investments, LLC ($7,000,000); Naupaka Investments, LLC ($6,650,000); JM Land Development II, LLC ($8,000,000); and CB Ranch South, LLC ($2,500,000), but FUF had sold interests of these loans to other banks totaling $86,100,000, and thus loans participated in by Western were oversold by 356%. *See RBC A. 17 through 23.*

Appellant held participation loans in Whiteout Way Investments, LLC ($7,000,000); two loans with JM Land Development II, LLC ($10,000,000); Jerry Moyes ($2,500,000) and CB Ranch South, LLC ($2,500,000) totaling $22,000,000, but FUF sold interests of those loans to other banks totaling $70,300,000, and thus loans participated in by Appellant were oversold by 319%. *See Id.*

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[2] Republic purchased these specific loans which were secured by a trucking facility and land in the Dallas / Fort Worth area as opposed to purchasing other offerings which were largely secured by real estate development land primarily in the Phoenix metro area. *RBC A. 53 – RBC A. 66.* Some of the loans Republic rejected ended up among the most oversold. *RBC A. 60.*

By ordering a *pro rata* distribution scheme, the district court pooled all remaining loans owned by FUF to be shared ratably among participants, regardless of which loans participants originally selected in which to purchase participations. *AA – 12 through AA – 19.* This ruling enabled the district court to select a distribution method which would equalize the remaining recovery of each lender in an equitable manner. *AA – 7.*

The district court adopted the net investment method to determine future payouts from the receivership estate. *ADD – 1 through ADD – 18.* The net investment method accounts for pre-receivership payments FUF made to participants. *ADD – 5.* As noted by the district court, the net investment method is the typical method to calculate claims when remedying a Ponzi scheme. *AA – 22* (stating "other considerations being equal, a 'net investment' plan provides a more equitable distribution of assets to the victims of a ponzi scheme"). The greater equity of a net investment claim calculation can be seen from comparing Republic and Appellant's prior dealings with FUF.

As noted above, Republic purchased a total of three loan participations from FUF. The total cost was $20,210,000. *RBC A. 134.* The total cash received by Republic (both principal and interest) from FUF totaled $13,954,317, leaving a "net investment" at the start of the receivership of $6,255,683. *See Id.* Of the cash paid to Republic, interest and fees totaled $717,068. *See Id.* As of the commencement of the receivership, Republic had collected only 69 percent of its investment in the fraudulent participations. *See Id.*

Since 2002, Appellant purchased approximately 30 loan participations from FUF at a cost of $91,750,324. *RBC A. 136.* Appellant received full payment on approximately

20 loan participations.[3] *Id.* During this time Appellant collected interest and fees from FUF totaling $11,639,475. *See Id.* The total cash received by Appellant from FUF totaled $81,823,416. *See Id.* Thus, at the commencement of the receivership, Appellant had collected 89 percent of the amount it invested in the fraudulent participations. *See Id.* Appellant's remaining net cash investment was $9,926,908. *See Id.*

If the receiver calculated claims on a principal and interest method and recovered $77,000,000 for all participants, Appellant would recover an additional $10,390,848. *See Id & AA – 60.*[4] Thus, the Appellant would collect 100.5 percent of its investment in the fraudulent participations, and it would enjoy a cash positive recovery of its dealings with FUF in the amount of $463,940. *See Id.* In other words, by using the principal and interest method Appellant would become a cash winner from its dealings with FUF. *See Id.* Under the principal and interest method, Republic would recover $4,124,411. *See*

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[3] As noted below, Appellant conducted additional business with FUF and suffered some additional loss from FUF's fraud. Some transactions between Appellant and FUF are not included in the claim, including the transaction with Carefree Capital Investments, LLC, which was a loan Appellant sought to include in its net investment claim, but the district court denied the request. Appellant referred to the Carefree Capital Investments loan in its Statement of the Case filed with the appeal, but has not otherwise briefed the issue. As argued by Republic to the district court and in its prior Statement of the Case, the Carefree Capital Investments loan was made to a borrower totally unrelated to FUF. FUF took a brief assignment of the loan, but in effect, only a small amount of cash changed hands between Appellant and FUF, and that is why the transaction has no significant bearing on Appellant's claim under a net investment calculation. *ADD – 24 through ADD – 25.*

[4] The equation to determine recovery multiplies $77,000,000 by the percentage of the participant's claim amount. The percentage amount changes under either the principal and interest method or net investment method and can be found either at *AA – 60* or *RBC A. 122.* The recovery amount can be then added to the cash previously recovered to determine overall recovery by the participant in its dealings with FUF.

RBC A. 134 & AA – 60. Republic would collect only 89.5 percent of its initial investment in the fraudulent participations and would suffer a cash loss from its dealings with FUF of $2,131,272. *See Id.* The principal and interest method advocated by Appellant results in greatly disparate results for Appellant and Republic. All of the other lenders would also be treated in the same random manner under the principal and interest method. For this reason, the principal and interest method is generally not favored as a means of providing equity.

Under the net investment method, both Republic and Appellant and all other participants would collect an equal percentage of their remaining net cash investment. If the receiver recovered $77 million under the net investment method, Appellant would recover $8,381,288 and suffer a cash loss of $1,545,619, for a total recovery on a cash basis of 84.43% of its remaining net cash investment. *See RBC A. 122 & RBC A. 136.* Similarly, under the net investment method, Republic would recover $5,281,673 and suffer a cash loss of $974,009, for a total recovery on a cash basis of 84.43% of its remaining net cash investment.[5] *See RBC A. 122 & RBC A. 134.*

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[5] Even under the net investment method, Appellant suffers a lesser loss than Republic when the cash loss is measured against the total capital advanced to FUF. Appellant's cash loss ($1,545,619.58) measured as a percentage of the total amounts it advanced to FUF ($91,750,324) is 1.68%. Republic's cash loss ($974,009.84) measured as a percentage of the total amounts it advanced to FUF ($20,210,000) is 4.81%. Thus, even though the net investment method greatly equalizes the treatment of similarly-situated victims of the FUF Ponzi scheme, there is still some inequity in favor of those who conducted larger volumes of business with FUF. The net investment method does not equalize losses. It merely equalizes the distribution percentage from the remaining receivership estate under the Court's control.

The net investment method does not require Appellant to return any payments it previously received. *See Generally, Addendum.* Nor does the net investment method factor any further return Appellant earned from payments it received from FUF. *See Id.* In other words, Appellant will keep the payments and any subsequent earnings it made on those payments. *See Id.* Appellant retains the benefit of the time value of money on the payments it received from FUF. *See Id.*

The receiver concluded, and the district court agreed, that FUF hopelessly commingled all funds in its bank accounts, both with respect to most loan payments and incoming advances from lenders. *AA – 15 through AA – 19; RBC A. 12.* No participant bank has distinguished itself to demonstrate that it took steps to assure the money it received was from a legitimate loan payment from a borrower as opposed to a fraudulent Ponzi payment from the funds advanced, but diverted, from another lender. *RBC A. 1 through RBC A. 14; RBC A. 73 through RBC A. 80; ADD – 8 through ADD – 12.* FUF at its own arbitrary discretion decided whom to pay with legitimate revenue or fraudulently diverted funds. *RBC A. 1 through RBC A. 14; RBC A. 73 through RBC A. 80; ADD – 8 through ADD – 12.*

The concerns initially offered by the receiver with respect to adopting the net investment method related to the cost and ability of the receiver to obtain sufficient documentation to determine the cash payments in and out of FUF. *AA – 22.* The Receiver has since obtained adequate documentation to calculate the claim amounts. *AA – 64.* While many parties, but not Republic, endorsed a principal and interest method early in the case, the voting took place in February 2010, before the receiver provided figures on a net investment method in March 2011. *RBC A. 12 through RBC A. 13; AA – 54 through AA – 87.* The district court never adopted a principal and interest approach.

The district court adopted a net investment method after conducting several hearings on September 23, 2010, November 15, 2010, May 24, 2011 and September 16, 2011, and considering numerous rounds of written submissions preceding the hearings. *See AA – 23; AA – 29; ADDENDUM.* The district court issued several orders which demonstrated an understanding of the facts and pertinent legal authorities and equitable principles to approve a reasonable distribution method.

ARGUMENT

I. Applicable Standard for Appellate Court's Review

Appellant appeals the district court's orders regarding distribution of assets gathered by the receiver. A receivership is an equitable proceeding, and the standard of review of a district court's exercise of its equitable powers is abuse of discretion. *Mutual Benefit Life Ins. Co. v. Franz Klodt & Son, Inc.,* 237 N.W. 2d 350, 352 (Minn. 1975). In receivership proceedings, district courts exercise their discretionary powers to "do what is best for all concerned." *Minnesota Hotel Company, Inc. v. ROSA Development Co.,* 495 N.W. 2d 888, 893 (Minn. App. 1993). "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. 1999), *citing Edin v. Jostens's, Inc.*, 343 N.W. 2d 692, 693 (Minn. App. 1984). *See also Cramond v. AFof L CIO,* 162 N.W. 2d 252, 256-57 (Minn. 1964) (stating "A lower court's ruling on a motion for a temporary injunction is largely an exercise of judicial discretion and the sole question presented on appeal is whether there was a clear abuse of such discretion by the trial court by a disregard of either the facts or the applicable principles of equity").

While there is little case law in Minnesota specifically addressing distribution methods to remedy a Ponzi scheme, federal case law provides substantial guidance, particularly with respect to an appellate court's standard of review. *See Sonenstahl v. L.E.L.S., Inc.*, 372 N.W.2d 1, 4 (Minn. App. 1985) (stating "federal decisions may be persuasive where the Minnesota courts have not addressed a subject"). Federal decisions confirm that when determining the manner in which the assets would be distributed, the district court acts "pursuant to its inherent equitable powers." *See S.E.C. v. Forex Asset Management LLC*, 242 F. 3d 325, 331 (5th Cir. 2001). Federal appellate courts have reviewed a district court's adoption of a distribution scheme with respect to victims of a Ponzi scheme under an abuse of discretion standard. *CFTC v. Topworth Int'l , Ltd.*, 205 F.3d 1107, 1115 (9th Cir. 1999). In such proceedings, the appellate court "affords 'broad deference' to the court's supervisory role." *Id., quoting United States v. Stonehill,* 83 F.3d 1156, 1159 (9th Cir. 1996); *SEC v. Wealth Management LLC*, 628 F.2d 323, 332-33 (7th Cir. 2010) (stating that appellate scrutiny of a district court's distribution plan is "narrow").

This Court may consider only whether the district court clearly abused its discretion. There are no "mixed questions of law and fact" to raise a different standard of review, and none of the decisions cited by Appellant suggesting a mixed question of fact or law involve the district court exercising its equitable powers in a receivership proceeding. Instead, the only question for this Court is whether the district court correctly exercised its discretionary and equitable powers.

II. The District Court Correctly Exercised Its Discretion in Adopting a Net Investment Method as Opposed to a Principal and Interest Method.

The district court adopted a distribution scheme after careful consideration of the facts and circumstances of the claimants in the case, as well as the equitable principles established in case law with respect to distribution methods. It acted within its discretion in adopting a net investment method for calculating claims, which is the common method used in a Ponzi scheme case because it factors payments participants received from the Ponzi schemer.

A. A Net Investment Method is the Standard Method to Calculate Claims in Distributing Property to Victims of a Ponzi Scheme.

The "principal and interest" method and the "net investment" method are names for very basic methods of calculating claims. The principal and interest method bases the claim amounts on the accrued account balance of the participants as of the day the receivership commences, including all principal, interest, and fees accrued. It is a method which strives to meet the contractual expectations sought by the claimants.

The net investment method bases the claim amount on the difference between the cash the participant has paid to the defrauder versus the cash returned from the defrauder. The net investment method's goal is restitution in seeking to reduce the cash loss to the broadest class of claimants as possible. *Official Cattle Contract Holders Committee v. Commons (In re Tedlock Cattle Company, Inc.)*, 552 F.2d 1351, 1352 (9th Cir. 1977). The district court considered the nature of the scheme and the facts and circumstances of the unpaid claimants and wisely chose a distribution scheme which favored restitution versus meeting the contractual expectations of the parties.

Under the net investment method, all claimants will suffer a similar cash loss in their dealings with FUF. But under the principal and interest method, some claimants, such as Appellant, may actually receive a portion of the bargained interest payments, while others, such as Republic, will still suffer a loss of principal. Thus, the net investment method treats similarly-situated parties equivalently while the principal and interest method does not.

The "fundamental principle governing adoption of a distribution plan is that it should be equitable and fair, with similarly situated investors treated alike." *SEC v. Credit Bancorp., Ltd.* No. 99-11395, 2000 WL 1752979, *28 (S.D.N.Y. 2000) (citations omitted). Courts favor a *pro rata* distribution of assets in fraud cases where "the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders." *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 88-89 (2d Cir. 2002). As the district court in this case held, "[t]he goal of the *pro rata* distribution plan is to treat every lending institution equitably *as they relate to each other.*" *Order of the Hon. Joseph T. Carter*, Sept. 29, 2010, p. 4. The mantra of the receiver and many of the participants throughout this case has been "equality is equity," which is a principle endorsed by the United States Supreme Court in the original Ponzi scheme case. *Cunningham v. Brown*, 265 U.S. 1, 13 (1924) (approving *pro rata* distribution of commingled funds obtained through an illegal scheme perpetrated by Charles Ponzi).

Equality is not achieved in this case by calculating claims based on the outstanding principal and interest at the time the receiver was appointed while totally disregarding the prior payment of ill-gotten Ponzi funds by the FUF fraudster. This methodology has also been referred to as the "benefit of the bargain" or "last account statement" methodology in the case law and has been almost universally rejected when considered by courts. *See, Tedlock Cattle Co.*, 552 F.2d at 1352-53; *Abrams v. Eby (In re*

Young), 294 F. 1, 2-4 (4th Cir. 1923); *SIPA v. Bernard L. Madoff Investment Securities, LLC (In re Bernard L. Madoff Investment Securities, LLC) ("BLMIS"),* 424 B.R. 122, 140-143(Bankr. S.D.N.Y. 2010), *aff'd,* 654 F.3d 229 (2d Cir. 2011).

To use the principal and interest or benefit of the bargain methodology ignores the inequality in the distribution of commingled funds by FUF prior to the appointment of the receiver, which is the precise arbitrary inequality that a *pro rata* distribution plan is meant to help correct. *In Re Teltronics, Ltd.,* 649 F.2d 1236, 1241 (7th Cir. 1981) ("since all the funds were obtained by fraud, to allow some investors to stand behind the fiction that Ponzi had legitimately withdrawn money to pay them 'would be carrying the fiction to a fantastic conclusion'" (*quoting Cunningham*, 265 U.S. at 13)).

Equality must be determined based on all of the funds actually invested by each participant since the time of its initial investment, minus all funds actually received by each participant on account of its investments, the "net investment" methodology. The net investment methodology is a standard and straight-forward method which accounts for all funds received by the participants during the reign of the FUF fraudster, and results in equality in treatment of all participants as they relate to each other in this Ponzi scheme. The net investment methodology, also referred to as "money-in/money-out," has been adopted by the vast majority of courts that have considered the proper methodology to calculate *pro rata* distribution claims. *Young*, 294 F. at 4; *Tedlock Cattle Co.*, 552 F.2d at 1351-53; (9th Cir. 1977); *CFTC v. Topworth Int'l, Ltd.*, 205 F.3d 1107 (9th Cir. 1999); *SEC v. Capital Consultants, LLC* 397 F.3d 733, 738 (9th Cir. 2005); see also *SEC v. Credit Bancorp, Ltd.* 290 F.3d 80, 89 (2nd Cir. 2002); *SEC v. Byers*, 637 F.Supp.2d

166, 182 (S.D.N.Y. 2009); *In re Financial Partners Class Action Litigation,* 73 B.R. 49 (N.D. Ill. 1987); *In re Taubman,* 160 B.R. 964, 980 (S.D. Ohio 1993).

In *SEC v. Byers,* a case routinely cited for numerous equitable propositions in this case, the court stated that "ignoring distributions would inequitably reward those who already received some money back at the expense of those who never received a distribution" in rejecting an alternative methodology that did not take account of prior distributions. 637 F.Supp.2d at 181-82. The court approved a net investment methodology where "any cash distributions received prior to the SEC's filing of this suit would be subtracted from the total amount invested and that would be the starting point for the *pro rata* distribution" in approving a distribution plan that "would provide the greatest number of investors with the greatest recovery possible without inequitably rewarding some investors at the expense of others." *Id.* at 182.

In *CFTC v. Topworth Int'l, Ltd.*, the Ninth Circuit affirmed a *pro rata* distribution plan based on the claimants' net investment "[d]efined as the total amount deposited by the claimant with the Receivership Entities less amounts returned to the claimant by the Receivership Entities and less any illegal trading profits reinvested by or credited to the claimant." *Id.* at 1110. In *Capital Consultants, LLC* the Ninth Circuit affirmed approval of a receiver's distribution plan that employed a modified net investment approach. 397 F.3d at 738.

Furthermore, allowing participants to keep the ill-gotten funds paid to them by the FUF fraudster prior to the Receiver's appointment without any recognition of such payments in a claim calculation methodology is contrary to public policy. *See, Credit*

Bancorp, Ltd., 2000 WL 1752979 at 40. Equity and public policy, under these circumstances, necessarily require that each participant's *pro rata* share be determined on a net investment basis, and not based solely on the principal and accrued interest due each participant using the benefit of the bargain methodology. The undisputed facts show that FUF committed a fraudulent scheme which involved complete commingling of victims' funds and Ponzi-style payments among claimants to keep the scheme afloat. Each claimant is similarly situated with respect to the fraud committed by FUF, except to the extent certain claimants received far greater payments from FUF than others. The net investment method largely remedies that disparity.

The principal and interest method fails to take account of prior payments and Appellant cites to no cases where a court has adopted a similar method in light of a Ponzi scheme as operated in this case. Appellant cites *Beacon Associates Management Corp. v. Beacon Associates, LLC I,* 725 F.Supp.2d 451 (S.D.N.Y. 2010), as an example of a court adopting a principal and interest claims calculation in the face of losses resulting from a Ponzi scheme. *Beacon* involved a feeder fund to Madoff and is readily distinguishable because there was no evidence that Beacon itself operated a Ponzi scheme where it arbitrarily distributed monies among its investors to hide its underlying loss or perpetuate its insolvent operation. *Id.* at 464 (finding that "Beacon itself was not a Ponzi scheme"). By all appearances, Beacon conducted regular business operations, where previous gains were unassailably legitimate, so there was no need to remedy any fraud in disbursing its funds through a net investment method. Unlike Beacon, FUF's operations were unprofitable from its inception and only survived based on its fraudulent conduct.

Beacon approved a distribution plan based on the contractual rights of Beacon's members under its operating agreement because no fraudulent activity by Beacon or its members undermined the integrity of those contractual rights. *Id.*

The receiver has adequate records and calculated net investment amounts. Appellant does not dispute the accuracy of the calculations. While Appellant and a number of other parties initially voted for a principal and interest approach, the district court never adopted that approach. Once the receiver supplied the calculations for a net investment approach, only a few parties have opposed adoption of that approach.

B. The Net Investment Method Enables the Recovery of Fraudulent Transfers from Third-Parties.

In this case, the receiver has also commenced fraudulent transfer actions to recover gains received by lenders who had terminated their relationship with FUF prior to the receivership. The recovery of fraudulent transfers against banks who are not part of this receivership increases the recovery for all remaining parties. As recognized in case law, the net investment method, which discounts a claim amount based on prior distributions, operates in harmony with the receiver's attempt to recover gains by those lenders who benefited from FUF's scheme. *BLMIS,* 424 B.R. at 136-37. The principal and interest method, however, conflicts with the receiver's ability to recover interest payments from prior participants of the FUF scheme because current claimants of FUF under a principal and interest method are not required to account for past interest payments. *Cf. Id.* As a result, the net investment method contributes to additional recoveries to the receivership as a whole.

C. Legitimate Business Revenue Does Not Require Rejection of the Net Investment Method.

The fact that FUF generated revenue from actual loans does not prohibit the district court from adopting an equitable remedy. Ponzi activity is fraud and creates an unrecoverable loss regardless of concurrent legitimate revenue. It is not uncommon for Ponzi schemers to conduct some legitimate business activity in connection with operating a fraudulent scheme. *Byers*, 637 F.Supp.2d at 169; *In re Bayou Group, LLC*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007); *In re Corporate Financing, Inc.* 221 B.R. 671, 681-82 (Bankr. E.D.N.Y. 1998). Similar to FUF, other Ponzi schemers cannot operate successful businesses and, as a result, turn to fraud to make up the shortfall. Regardless of the extent of legitimate activities underlying the fraud, once the Ponzi scheme begins, it can only deepen the overall insolvency of the schemer over time, and increase the ultimate cash losses of its victims. The fact that FUF entered into some legitimate transactions on one end with its borrowers does not change the fact that it entered to fraudulent transactions on the other end with the participants financing those loans. That FUF may have generated some legitimate revenue does not defeat the fact that the claimants in this case fairly attribute their losses to FUF's fraudulent activities. Not one bank can demonstrate that it adequately quarantined itself from FUF's fraudulent activity as against any other bank.

The receiver determined that parties in this action are similarly situated to the extent they were fraud victims of FUF, and that whether they received interests in legitimate assets or disbursements traceable to legitimate revenue is simply due to the random acts of FUF. All funds advanced to FUF were subject to its fraudulent scheme. The case law is clear that the net investment method remedies the fraudster's arbitrary disbursement or conversion of funds. *BLMIS*, 424 B.R. at 140 (holding "the net investment method is appropriate because it relies solely on unmanipulated withdrawals and deposits and refuses to permit [the schemer] to arbitrarily decide who wins and who loses"); *see also CFTC v. Franklin*, 652 F.Supp. 163, 168-69 (W.D. Va. 1986) (finding a distribution method which did not account for prior payments from a Ponzi schemer to be "inequitable because it rewards some investors for their random good fortune while depleting the share available to investors who were equally situated but merely less lucky"). Failing to adopt a net investment method which accounts for past payments maintains the arbitrary scheme.

Appellant offers no theory as to how it can justify differentiating between those who would receive legitimate revenue from those who received diverted loan advances. The receiver's sworn contention that FUF randomly conducted fraud on its victims stands uncontroverted. As a result the district court rejected any distribution scheme based on tracing or allocating based on the specific loan a participant intended to purchase.

Based on the above, the district court reasonably evaluated competing distributions schemes over the course of a number of hearings and rounds of written submissions. The district court's findings reflect a thorough understanding of the factual record and are consistent with the equitable principles found in a majority of cases resolving distribution scheme issues. Appellant cannot demonstrate the district court committed a "clear" abuse of discretion and therefore this Court should affirm.

III. <u>The District Court Correctly Exercised Its Discretion in Denying Further Modifications to the Net Investment Method</u>.

Appellant proposed two modifications to the net investment method which the district court considered and correctly denied. Contrary to Appellant's assertion, the modifications are less equitable than the plan adopted by the district court. They also present more complexity and largely defeat the net investment method's ability to properly account for prior payments.

First, Appellant attempts to water down the net investment method by adding and allocating FUF's "legitimate" loan revenue to the participants. The modification does little more than undermine the equity of the net investment method. Second, Appellant seeks to set a later date for beginning calculation of net investment claims, notwithstanding the ample evidence in the record demonstrating the commission of fraud from FUF's beginning in 2002. Setting an arbitrary date in the middle of the Ponzi scheme unjustifiably discriminates against those who conducted business with FUF only towards the end of the scheme.

Demonstrating the broad discretion to approve equitable distribution plans, courts have also approved different variations on the net investment methodology based on the particular case circumstances. *Taubman*, 160 B.R. at 980 (court upheld dividing investor claims into "A" and "B" claims: "A" claims received priority and represented the actual pecuniary loss of a claimant, defined as the difference between what the investor gave the debtor on a combined basis, minus all amounts returned to or for the benefit of that claimant at any time; "B" claims represented all promised profit, interest or other amounts in excess of the actual pecuniary loss). Even with variations, however, past cash payments remain the driving factor in determining a claim based on a net investment methodology. *Id.,*; *CFTC v. Barki, LLC*, 2009 WL 3839389, *1-2 (W.D. N. Car. 2009) (assessing five possible distributions methods under which only one method, which court summarily rejected, did not account for past distributions from Ponzi schemer); *CFTC v. Equity Financial Group, LLC*, 2005 WL 2143975, *22-26 (D. N.J. 2005); *Franklin*, 652 F.2d at 168-69 (same), *partially rev'd on other grounds, Anderson v. Stephens*, 875 F.2d 76 (4th Cir. 1989); *Byers*, 637 F.Supp.2d at 181-82 (same); *In re Financial Partners Class Action Litigation,* 73 B.R. at 52 (claims calculated as all payments made by the investor to the debtor reduced by all payments received by the investor whether designated as interest, principal or otherwise). Accordingly, courts generally reject any form of distribution scheme that fails to account for prior payments. *BLMIS*, 424 B.R. at 140-43; *Byers*, 637 F.Supp.2d at 181-82; *Barki, LLC*, 2009 WL 3839389, *1-2; *Franklin,* 652 F.Supp. at 168. As noted below, Appellant's modifications fail to adhere to these equitable principles and the district court properly rejected the modifications.

A. The District Court Properly Rejected Appellant's Modified Net Investment Model.

Appellant's first proposed distribution scheme modification attempts to increase each claimant's net investment claim amount by allocating loan revenue earned by FUF during the years that particular claimant conducted business with FUF. On its face, the proposal would seek to prefer those participants, such as Appellant, who conducted greater business with FUF for a longer period of time. Further, Appellant's proposal confusingly mixes cash and accrual accounting principles only with the aim of increasing its own claim.

As noted above, in Ponzi scheme cases, distribution methods generally account for past *payments* made to a claimant. Appellant cites no case where a court modifies a net investment remedy by factoring or allocating revenue received by the Ponzi schemer to offset cash distributions made by the Ponzi schemer to the victims. Revenue received by the Ponzi schemer is not a "payment" or a "rollover" to a participant that would factor into a cash-based claims calculation.[6]

Appellant's modification is not a true modification to a net investment method, but incorporates a new element beyond simply analyzing cash flows. Appellant's modification instead endeavors to calculate claims amounts by allocating the business performance of FUF among the participants, as if they were members of FUF attempting to account for partnership income tax liability or carry-forward losses. In allocating business performance, however, one does not simply allocate revenue, but instead one allocates income or loss. While FUF generated loan revenue, it also incurred significant business expenses, including paying its participants. FUF also suffered loan losses, and

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6 Certain equitable modifications to a net investment method include that adopted in *Byers* where the court treated roll-over amounts as distributions in order to equalize an investor's decision whether to reinvest gains with the schemer or take a distribution. 637 F.Supp.2d at 182-83. In addition, a rising tide method discussed in the case law is similar to a net investment calculation, but further equalizes recovery by subtracting distributions after the *pro rata* multiplier is applied to a claimant's overall cash advance. *See e.g., CFTC v. Lake Shore Asset Management Ltd.*, 2010 WL 960392, *7-9 (N.D. Ill. 2010).

suffered the diversion of funds by its officer – both which would be treated as expenses in a true accounting.

Appellant ignores the receiver's uncontroverted findings that FUF in fact *lost* money every year of operation and only sustained itself from 2002 onward due to its fraudulent diversion of new lender money. Appellant's method of allocating revenue creates as similar a fiction as the business operations of FUF. While Appellant asserts that its substantial advances of funds enabled FUF to generate further loan revenue, it could be equally said that substantial advances of funds fueled the greater fraud. *See e.g., Taubman*, 160 B.R. at 981 (finding "an investor in a ponzi scheme is not only a victim but at the same time is a perpetrator, for without the continual influx of new funds the scheme quickly collapses the Debtor is unable to perpetuate the scheme and create harm to new creditors").

Appellant's revised method flies in the face of the purpose of a net investment method as Appellant's prior cash receipts are essentially offset by revenue it claims from FUF. Appellant cannot demonstrate it cordoned off FUF's legitimate revenue stream so that it recovered legitimate revenue as opposed to illegitimate diversions. In other words, Appellant cannot establish the cash payments it received are traceable to legitimate revenue, and even if it could it would still not be equitable to offset legitimately-sourced cash disbursements when it was the discretion of the fraudster as to which funds to disburse to Appellant. Because of FUF's Ponzi scheme, it is not possible to allocate its business performance to the participants because it arbitrarily passed the revenue and losses to the participants and, as the district court found, it is not equitable to permit parties to stake a claim against the legitimate revenue.

Appellant's "legitimate income" modification proposal further conflicts with the district court's decision to pool all remaining loans and share the proceeds of the loans across the participant group irrespective of which loans participants initially selected to fund. On the petition date, Republic's share of legitimate loans as based on a percentage of its claim exceeded Appellant's share of legitimate loans held by the receiver. Without equity, Appellant could only stake a claim to hopelessly oversold assets. Nonetheless, the district court found that the pervasiveness of the fraud trumped upholding the banks' expectations in particular loans. Similarly, the district court rejected Appellant's attempts to distinguish itself because it claims to have conducted more business with FUF to generate revenue. Appellant did not quarantine itself from the fraud of FUF nor can differentiate its position from the remaining participants. In light of these considerations, the district court correctly concluded:

> National Bank protests that the compounding value of those initial investments would be unfairly wiped clean by a net investment methodology.[7] But a methodology must be adopted, and no matter which is chosen, some of the parties' expectations will have been frustrated, whether with respect to their original investments or with respect to their expected "legitimate" earnings that accumulated over the course of their relationship with First United Funding. For the same reasons that a *pro rata* distribution was embraced in general terms, it would be inequitable to reward the parties who were fortunate enough to experience "legitimate" profits in the midst of a

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[7] Although not acknowledged by the district court, the net investment method wipes away no payment or time value of money related to the payment. The net investment method does not require Appellant to disgorge any payments previously received or account for any further appreciation earned on such payments.

> pervasive fraud...Ultimately, according to the same reasoning that has driven this Court's adoption of a *pro rata* distribution, it would be inequitable to separate the "legitimate" and "illegitimate" activities of First United, and to functionally trace the alleged profits of the victims. Rather, it is better to view each of the parties as similarly situated, victims of a scheme whereby the fraudster indiscriminately worked towards a dishonest end. For the same reasons, the modified net investment methodology presented in the alternative by National Bank must also be rejected.

Appellant's suggestion that failing to adopt its modification provides a substantial windfall to those banks which benefit from the net investment method is belied by the fact that every bank still is, as Appellant acknowledges, a net loser in this proceeding. Further, Appellant's revised method increases Appellant's recovery beyond what it would recover based on a principal and interest method. *AA – 119.* Respondent's recovery decreases from what it would recover under a principal and interest method. *Id.* Appellant essentially offsets all of the payments it received by staking claim to a large share of loan revenue received by FUF. The revised approach would pay Appellant $10,857,000 based on projected recoveries of $77,000,000, and thus Appellant's dealings with FUF would result in a cash gain of $930,092, based on its actual $9,926,908 cash claim to date. Thus, Appellant would receive the potential windfall from offsetting cash payments with a claim to revenue. As a result, Appellant's proposed modified distribution scheme is not more equitable than a simple net investment method, as determined by the district court. This Court should affirm the district court's decision in this regard.

The district court looked beyond Appellant's artful but incomplete attempt to allocate revenue to offset the cash payments received by Appellant. Instead, the district court took the simpler and more equitable approach of measuring the true cash positions of the similarly-situated victims of FUF and adopted a distribution method which elevates restitution over expectation of gain. In offsetting its cash payments, Appellant's proposal defeats the very purpose of the net investment method to deduct prior cash payments to participants. Therefore, Appellant's proposal is not an equitable modification to a net investment method, and the Court should affirm the district court's rejection of the modification.

B. The District Court Correctly Established March 11, 2002 as the Date to Commence a Net Investment Calculation.

The district court established the start date for calculating net investment claims as March 11, 2002, which coincides with the receiver's findings of the commencement of FUF's fraud. Appellant argues that a net investment method can adopt a cut-off date, and that the Court should also consider the statute of limitations for fraudulent transfer actions in establishing a cut-off date.

There is no equitable basis to establish a cut-off date. The receiver has sufficient records to calculate accurate net investment amounts back to 2002 and has established fraud commenced at that time. Further, Appellant offered no facts contesting the receiver's conclusion that FUF never would have survived past its first year of operation without fraud. For the purpose of calculating net investment claim amounts there is no merit to distinguishing between payments made in 2002 or in 2008.

In support of arguing in favor of a cutoff date, Appellant cites *SEC v. Wealth Management LLC,* 628 F.3d 323 (7th Cir. 2010) as an example where a court established a cut-off date for a net investment *pro rata* distribution scheme. *Wealth Management* is inapposite to the present issue. *Wealth Management* was not a Ponzi scheme case. *Wealth Management* dealt with a fund that committed fraud against its investors by changing its investment mix from a safe portfolio to a high-risk portfolio, and subsequently lost most of the invested assets. Like *Beacon* discussed above, there is nothing in the facts of *Wealth Management* suggesting that Wealth Management sought to hide its losses and continue unprofitable operations by making Ponzi-style payments to its investors. There is no indication redemption requests were funded with new investor monies in a Ponzi scheme. The court in *Wealth Management* set a cut-off date for payments made from the fund to investors who made redemption requests in purposes of calculating claims based on the date the fund's financial woes became public, which triggered a spike in redemption requests.[8] Because redemption requests prior to the cut-off date were made and honored in the ordinary course of business, and without the aid of diverted funds in a Ponzi fashion, there was less need to factor those payments into the claim calculations. Unlike Wealth Management, however, FUF operated fraudulently since its inception, and there is no basis to impose a cut-off date because it always distributed money to and dealt with its participants in a fraudulent manner.

The Court further need not consider the statute of limitations for fraudulent transfer actions under Minnesota law when considering the equities of the district court

[8] Unlike here, in *Wealth Management* redemption requests honored after the cutoff date would be offset against claim amounts calculated after the *pro rata* multiplier. This method more resembles a rising tide distribution method than a pure net investment distribution method. 628 F.3d at 327.

requiring the receiver to account for payments back to 2002. *See also BLMIS*, 424 B.R. at 136-37 (finding that the court need not consider defenses to fraudulent transfer claims such as statute of limitations when assessing the equity of a net investment method distribution proposal).

The district court's distribution method does not require Appellant to return any property. Rather, the distribution scheme permits Appellant to retain all previous payments, as well as any further gains made on those payments. Appellant has not been sued or requested to return funds. Accordingly, on November 17, 2011, the district court confirmed the net investment claim amounts which include payments from 2002, notwithstanding its ruling in *Finn v. Alliance Bank* that the statute of limitations for recovery of fraudulent transfers was six years.[9]

Finally, the net investment method strives to treat Appellant and other participant banks equally, and pursuant to this goal required the receiver to account for all payments from the FUF accounts in the receiver's possession. The receiver justified this finding by demonstrating fraudulent activity from FUF's inception. The district court's refusal to impose a later cut-off date minimizes any disparate treatment that could arise between

[9] Republic notes there are a number of Minnesota cases over the past century stating that the statute of limitations for fraudulent transfers includes a discovery rule, which in this case would presumably prevent the accrual of the standard six-year limitation until the time a party could reasonably discover the fraud. *See Johnston v. Johnston*, 119 N.W. 652, 654 (Minn. 1909); *Schmitt v. Hager*, 93 N.W. 110, 111 (Minn. 1903); *Brasie v. Minneapolis Brewing Co.*, 92 N.W. 340, 342 (Minn. 1902); *Duxbury v. Boice,* 72 N.W. 838, 839 (Minn. 1897); *see also Bergquist v. Vista Dev., Inc.* (*In re Quality Pontiac Buick GMC Truck, Inc.*), 222 B.R. 865, 869 (Bankr. D. Minn. 1998); *In re Curry*, 160 B.R. 813, 819 (Bankr. D. Minn. 1993); *Palatine Nat'l Bank of Palatine v. Strom (In re Strom)*, 97 B.R. 532, 539–40 (Bankr. D. Minn. 1989).

otherwise similarly-situated participants based on when a participant received payments. Under the distribution scheme adopted by the district court, all parties receive nearly equal treatment whether they received a payment in 2002 or 2008. In this respect, the district court best protects the interests of the later participants caught in FUF's web, who normally suffer greater harm as they advanced money to the Ponzi scheme shortly before its collapse and did not receive the benefits that Appellant received.

CONCLUSION

Regardless of any legitimate revenue or assets held by FUF, the participants in this case will suffer some measure of cash loss resulting from FUF's Ponzi scheme. The receiver estimates that the ultimate cash loss should be around $15,000,000. It could be lower depending on fraudulent transfer claims (which may only be viable if the Court affirms a net investment method) or could be higher if loans held by the receiver do not perform up to expectations. The district court had to determine how to spread this cash loss among participants. First, the district court pooled all the assets to undo FUF's fraud in overselling participations. Second, the district court adopted a net investment method to undo the discriminating nature of Ponzi payments made by FUF to grow its scheme and maintain it for up to seven years. Third, the district court refused to adopt inequitable modifications proposed by Appellant, which were not supported by the factual record, but would have created new and unwarranted disparities among similarly-situated participants. In taking these steps, the district court conducted a number of hearings, as well as considered volumes of legal argument and a detailed factual record. The record offered by Appellant falls far from even suggesting that the district court ignored facts or equitable principles, or abused its discretion in crafting its equitable remedy. Rather, the record demonstrates the district court proceeded with prudence, gave due consideration to opposing points of view, properly considered the abundance of evidence, and rendered a decision within the parameters of prevailing articulations of equity in the case law. As a result, this Court must affirm the actions of the district court in full.

Dated: March 5, 2012

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The undersigned hereby acknowledges that costs, disbursements, and reasonable attorney and witness fees may be awarded pursuant to *MINN. STAT. Sec. 549.211, Subdivision 1*, to the party against whom the allegations in this pleading are asserted.

Dated: March 5, 2012

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with the type-volume limitations of Minn. R. App. Pro. 132.01, subds. 1 and 3, contains 8,711 words and was prepared using Microsoft Office Word 2007.

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