A12-0040

STATE OF MINNESOTA
IN COURT OF APPEALS

The National Bank, intervenor,

Appellant,

v.

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.

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

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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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II. Did the District Court abuse by discretion by adopting a net investment *pro rata* distribution method to apportion the receivership assets among the victims of Corey N. Johnston and First United Funding, LLC's Ponzi scheme?

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STATEMENT OF THE CASE

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

The District Court appointed Respondent Lighthouse Management Group, Inc. as "Receiver" for First United Funding, LLC ("First United") and Corey N. Johnston ("Johnston") following the discovery that First United and Johnston were operating a scheme to defraud banks. (App. 1-11; R.App. 1-17.)[1] Johnston pleaded to operating an $80 million Ponzi scheme. (R.App. 19-20, 27-40.) The Receiver's investigation confirmed that admission and determined that the Ponzi scheme began in 2002. (R.App. 43-46.) Based on the Receiver's investigation, the District Court approved a *pro rata* distribution of the limited receivership assets to approved creditors of First United and Johnston. (App. 12-19.)

Certain creditors, however, disputed the type of *pro rata* distribution plan that the District Court should implement. Some creditors, including Appellant The National Bank ("National Bank"), asserted that the District Court should adopt a principle and interest distribution methodology—which measures "the amount each claimant was owed [by agreement] on the date the Receiver was appointed." (Add. 5.) Other creditors, including Respondent Republic Bank of Chicago, argued that the District Court should

[1] Citations to "App." are to National Bank's Appendix. Citations to "Add." are to National Bank's Addendum. Citations to "R.App." are to the Receiver's Appendix. Pursuant to Minnesota Rule of Civil Appellate Procedure 128.03, citations to portions of the District Court record that are not included in the parties' appendices are identified by date, designation, and page number.

adopt a net investment distribution methodology—which measures "the funds that each claimant has invested, minus any funds it has recovered" from First United and Johnston. (*Id.*) The Receiver ultimately recommended that the District Court adopt a net investment distribution plan. (*Id.* at 8.)

After nearly two years of litigation, including an evidentiary hearing, multiple rounds of briefing, and many oral arguments, the District Court entered an Order adopting a net investment distribution methodology. (Add. 1-18.) The District Court subsequently entered an Order and Judgment approving each creditor's claim amount under the net investment distribution method. (*Id.* at 19-25.)

National Bank filed a notice of appeal from the District Court's November 17, 2011 Order and Judgment on January 5, 2012. (App. 144-48.)

STATEMENT OF THE FACTS

I. THE PARTIES.

A. The Perpetrators Of The Ponzi Scheme: Corey Johnston And First United Funding, LLC.

Johnston is a resident of Minnesota. First United is a Minnesota limited liability company with its principal place of business in Lakeville, Minnesota. Johnston owned and controlled First United. (App. 2; R.App. 2.)

In August 2010, the United States Attorney's Office charged Johnston "with operating a $80 million Ponzi scheme[2] with bank money." (R.App. 27-29.) Johnston pleaded guilty, admitting that he used First United to engage in a scheme to defraud banks through the overselling of loan participations. (*Id.* at 30-40.) Johnston admitted to fraudulently obtaining millions of dollars from banks and using that money to continue overselling loan participations and maintain his lavish lifestyle—a classic Ponzi scheme. (*Id.*) Johnston was sentenced to 6 years in prison and is serving his prison term in the federal penitentiary in Duluth. (June 6, 2011 Fourth Receiver's Report, p. 2.)

B. The Receiver: Lighthouse Management Group, Inc.

In October 2009, the Dakota County District Court appointed Lighthouse Management Group, Inc. as "Receiver" of First United and Johnston. (App. 1-11;

[2] The expression "Ponzi scheme" has become common parlance for a fraudulent scheme in which funds taken from later participants are paid to early participants to create the false appearance that the scheme is generating returns. The expression takes its name from Charles Ponzi, a famous Boston swindler. *See Cunningham v. Brown,* 265 U.S. 1, 7-9 (1924) (detailing Ponzi's fraudulent scheme).

R.App. 1-17.) The Receiver was charged with recovering assets and proposing a plan to distribute those assets to First United and Johnston's creditors. (R.App. 7-11.)

C. The Appellant: The National Bank.

National Bank is a banking corporation that operates in Iowa, Illinois, and Wisconsin. It is one of the 18 participant banks that were defrauded by First United and Johnston. (TNB Brief, 3.)

D. The Other Participant Banks.

The other 17 banks defrauded by First United and Johnston are: Bank Forward, Border State Bank, Charter Bank, Community Financial Bank, Community First Bank, Community State Bank of Prentice, Choice Financial Group, the Federal Deposit Insurance Corporation (as successor to a failed bank), First Southern Bank, Labette County State Bank, LNV Corporation, Maple Bank, Minnwest Bank Luverne, Republic Bank of Chicago, Sonoran Bank, N.A., The Bank of Weatherford, Texas, and Western National Bank (collectively, with National Bank, the "Participants"). Each is a party to or filed a claim in the underlying action. (Add. 19-25.)

II. JOHNSTON AND FIRST UNITED'S PONZI SCHEME.

A. Johnston And First United's Purported Business.

First United and Johnston loaned funds or purported to loan funds to borrowers in exchange for promissory notes and other assurances of payment, including mortgages and guarantees. The promissory notes and related loan documents were between the borrower or purported borrower and First United. (March 18, 2010 Affidavit of Patrick Finn, ¶¶ 6-8.) First United then entered into participation agreements with the

Participants, whereby each purchased a percentage of a purported promissory note. (*Id.*) A loan participation is generally described as follows:

> [A]n institution, acting as a co-lender or which otherwise acquired contractual privity with the borrower lends money to a borrower pursuant to a loan agreement. After the loan agreement is executed and the documentation is otherwise complete, the lead lender then sells all or part of the loan to one or more purchasers. These purchasers are typically called participants . . . . Only the lead lender or its assignee maintain a direct contractual privity with the borrower. The participant's relationship is solely with the lead lender.

W. Crews Lott, et al., "Structuring Multiple Lender Transactions," 112 Banking L.J. 734, 735-36 (1995).

B. The Ponzi Scheme.

In reality, Johnston and First United were operating a Ponzi scheme that began at least by August 2002 and continued until the appointment of the Receiver in October 2009. (R.App. 43-46.) Johnston conducted the Ponzi scheme by selling participation interests that exceeded the loan amount, selling participations in loans that did not exist, and engaging in other fraudulent conduct. (*Id.*) The funds realized from the Ponzi scheme were used by Johnston to perpetuate the scheme and to support his lavish lifestyle. (R.App. 33.)

The transfers between First United and the Participants were commingled and flowed through First United's common bank accounts. (R.App. 46.) First United engaged in financial transactions totaling over $1.4 billion. (R.App. 25.) By pooling Participant funds and borrower payments, First United and Johnston were able to perpetuate the Ponzi scheme by making payments to the Participants, even when no loan existed or where the loan was oversold. Johnston and First United's Ponzi scheme affected all, or nearly all, loans and participations. (R.App. 43-46.)

III. THE RECEIVERSHIP PROCESS.

A. The District Court Appointed A Receiver.

In September 2009, one of the Participants commenced this action and moved to appoint a receiver after discovering that First United had oversold participations in a loan. (App. 1-11.) On October 23, 2009, the District Court appointed Lighthouse Management Group, Inc. as "Receiver" of the assets of First United. (*Id.*)

As the scope of Johnston and First United's fraud became known, the District Court expanded the role of the Receiver to include "the management and operation of the assets and debts of First United Funding, LLC" and the non-exempt assets of Johnston. (R.App. 7.) The District Court specifically directed the Receiver to:

> [D]evelop a claims process to manage the claims of First United's creditors and the disposition of First United's assets, provided that any claims process is subject to the approval of the Court.

(*Id.* at 11.)

B. The District Court Approved A Claims Process.

In March 2010, the Receiver filed a motion to establish a process to identify creditors and the amount of their claims. The District Court granted the Receiver's motion and required all claimants to file proofs of claim with the Receiver by May 31, 2010. (May 3, 2010 Order Approving Claims Process, p. 3.) On June 15, 2010, the Receiver filed and served on all creditors a pleading that identified the claims filed by 23 claimants against First United or Johnston. (June 15, 2010 Amended Notice of Proofs of Claim Filed.)

C. The District Court Approved A *Pro Rata* Distribution Of The Receivership Assets To First United And Johnston's Creditors.

Based on the scope and nature of First United and Johnston's Ponzi scheme, the Receiver filed a Motion in March 2010 recommending that the District Court approve a *pro rata* distribution of assets to creditors. (March 18, 2010 Motion to Approve a *Pro Rata* Distribution.) The vast majority of Participants favored a *pro rata* distribution; however, three Participants, Republic Bank of Chicago, LNV Corporation, and The Bank, Weatherford, Texas, initially opposed the Receiver's motion. They contended that District Court should distribute the receivership assets on a "contractual" basis.[3]

After conducting extensive discovery, Republic Bank of Chicago and The Bank, Weatherford, Texas withdrew their objections to a *pro rata* distribution on the morning that the parties were scheduled to begin an evidentiary hearing. (App. 15.) Republic Bank of Chicago, however, objected to the specific *pro rata* distribution methodology proposed by the Receiver, which based each approved creditor's claim on the outstanding

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[3] These Participants asserted that, under the participation agreements, First United was required to assign the loan documents and collateral to the Participants following a default. Accordingly, they sought to force the Receiver to assign each of them the respective loan documents and collateral related to each participation agreement they entered into with First United. (*See, e.g.*, Sept. 2, 2010 Motion by Republic Bank of Chicago for Order Requiring Receiver to Assign Fort Worth and Lancaster Loans to Republic Bank of Chicago.) The Receiver opposed these efforts because the loans these Participants sought to remove from the receivership were inextricably intertwined with Johnston and First United's Ponzi scheme (the loans involved oversold participations, commingling of funds, and other fraudulent conduct) and it would be inequitable to allow these Participants to recover at the expense of the other creditors. (R.App. 20-29.)

amount of principle and interest First United and/or Johnston owed that creditor on the date of the appointment of the Receiver—a "principle and interest" distribution methodology. (*Id.*) Instead, Republic Bank asserted that, because of the scope and nature of the Ponzi scheme, the District Court should adopt a *pro rata* distribution methodology that based each claim amount on the difference between all funds a creditor transferred to First United, and all funds First United transferred to the creditor—a "net investment" distribution methodology. (App. 20-24.)

On September 29, 2010, the District Court rejected LNV Corporation's request to distribute the receivership assets on a contractual basis and entered an "Order Approving a *Pro Rata* Distribution Plan." The District Court also ordered further briefing on the specific *pro rata* distribution methodology that it should adopt.[4] (App. 12-19.)

D. The District Court Approved A Net Investment *Pro Rata* Distribution Methodology.

After additional briefing, the District Court held an evidentiary hearing on November 15, 2010 to determine whether the Court should adopt a principle and interest or net investment *pro rata* distribution methodology. The Receiver submitted evidence that it could not, at that time, calculate a net investment distribution methodology because it did not possess sufficient records. (App. 22-23.) Republic Bank submitted evidence

[4] National Bank represents that the District Court "approved the P&I Method of distribution" in the September 29, 2010 Order. (TNB Brief, 5.) This is not accurate. The District Court approved a "*pro rata* distribution" in the Order, but withheld approving a specific *pro rata* distribution methodology. (App. 13.) By separate order, the District Court approved "interim distributions" to Participants pending a final determination on the specific *pro rata* distribution methodology. (App. 20-24.)

that First United made transfers, including interest payments, to certain, but not all, Participants immediately prior to the appointment of the Receiver. (*Id.* at 21.)

Following the evidentiary hearing, the District Court found that "[o]ther considerations being equal, a 'net investment' plan provides a more equitable distribution of assets to the victims of a ponzi scheme." (App. 22.) The District Court also instructed the Receiver to attempt to obtain the records necessary to calculate a net investment distribution methodology. (*Id.* at 22-24.)

After obtaining the records,[5] the Receiver filed a motion that provided the District Court and Participants calculations for both a principle and interest and a net investment distribution methodology, as well as a comparison of both methods. (App. 46-62.) Certain Participants, including National Bank, argued in favor of a principle and interest distribution methodology. Other Participants, principally Republic Bank of Chicago, argued in favor of a net investment distribution methodology. (Add. 5-10.) Although the Receiver did not take a position in its motion, at the hearing, counsel for the Receiver stated that the Receiver "slightly favored" a net investment methodology. (*Id.* at 8.)

On July 21, 2011, the District Court entered an order approving a net investment distribution method. (Add. 1-18.) The District Court recognized that courts in other jurisdictions have approved "different variations of *pro rata* distribution plans . . . based on the parties' unique circumstances." (*Id.* at 8.) After analysis, the District Court

[5] National Bank inaccurately stated in its Brief that the Receiver did not locate all records necessary to accurately calculate a net investment distribution. (TNB Brief, 5.) The Receiver, however, informed the parties and the District Court on May 20, 2011 that it had obtained all records necessary to calculate each Participant's claim amount under a net investment methodology. (R.App. 42.)

rejected National Bank's assertions that a net investment distribution methodology (1) does not account for the "time value" of money, (2) does not account for "legitimate" income earned by First United, and (3) if adopted, should be modified to account for "legitimate income" or based on the statute of limitations. (*Id.* at 6-10.)

E. The District Court Approved A Calculation Of Claim Amounts And Entered Judgment.

On August 31, 2011, the Receiver filed a motion to allow a final claim calculation. The Receiver provided the Participants and the District Court a detailed calculation of each creditor's claim amount under the net investment *pro rata* distribution methodology, along with documentation supporting each claim calculation. (App. 120-32; R.App. 49-74.) National Bank opposed the Receiver's motion, again asserting that the Court should adopt a principle and interest distribution methodology. National Bank also objected to the Receiver's calculation of National Bank's net investment claim amount because it did not include transfers related to a loan National Bank made directly to Mustang Island, LLC. (App. 133-43.)

On November 17, 2011, the District Court entered a final order and judgment approving the net investment *pro rata* distribution claim calculations prepared by the Receiver. (Add. 19-25.) The District Court also rejected each of National Bank's objections. (*Id.* at 22-25.) The approved claims against First United and Johnston total $91,193,042. (*Id.* at 20-21.)

F. The Receiver Continues To Manage Loans And Recover Assets For The Benefit Of Creditors.

Since appointment, the Receiver has actively managed First United's remaining loan portfolio and other assets. The Receiver has also commenced breach of contract, foreclosure, and fraudulent transfer actions for the benefit of creditors. These claims include fraudulent transfer claims against approximately 40 past participants that realized over $40 million in profits from the Ponzi scheme. (*See generally* Feb. 27, 2012 Fifth Receiver's Report; June 6, 2011 Fourth Receiver's Report, p. 6.) The Receiver has distributed approximately $31 million to the Participants, including National Bank. (Feb. 27, 2012 Fifth Receiver's Report, Ex. 4.) The Receiver continues to collect payments from borrowers and pursue other recoveries and expects to make additional distributions to the Participants. The Receiver will not, however, be able to recover sufficient funds to satisfy all losses suffered by the Participants. (App. 69; TNB Brief, 4 ("The Participant Banks' claims are substantially in excess of the assets which are likely to be recovered by the Receiver.").)

ARGUMENT

I. THE DISTRICT COURT'S ORDERS ARE REVIEWED FOR ABUSE OF DISCRETION.

Minnesota courts are vested with broad discretion in receivership proceedings "to do what is best for all concerned." *Minnesota Hotel Co. v. ROSA Dev. Co.*, 495 N.W.2d 888, 893 (Minn. Ct. App. 1993); *see also Sibley County Bank v. Crescent Milling Co.*, 201 N.W. 618, 620 (Minn. 1925) ("In a receivership matter the court is constantly using its discretionary power. It does that which it deems best for all interested.") "A district court's exercise of its equitable powers is reviewed for an abuse of discretion." *Equity Trust Co. v. Cole*, 766 N.W.2d 334, 338 (Minn. Ct. App. 2009). An abuse of discretion occurs if the district court disregards facts or the applicable principles of equity. *Edin v. Josten's, Inc.*, 343 N.W.2d 691, 693 (Minn. Ct. App. 1984). The Minnesota Supreme Court has held that a district court overseeing a receivership does not abuse its discretion, even when the Supreme Court disagrees with an action taken by the district court. *See Sibley County Bank*, 201 N.W. at 620 ("[c]onceding and holding as we do that the court had this power [to issue certificate without notice to creditors], we disapprove of its using such power in such a case as this [but we] cannot say that the court abused its discretion").

National Bank acknowledges that an abuse of discretion standard of review applies to the District Court's exercise of equity within the receivership proceeding. (TNB Brief, 6-7.) National Bank, however, "requests this Court consider reviewing the district court's Orders approving the Net Investment Method distribution scheme and the

Receiver's final claim calculation de novo." (*Id.* at 7.) National Bank's request to amend the standard of review is beyond the relief available from this Court. *See Lake George Park, LLC v. IBM Mid-America Emps. Fed. Credit Union*, 576 N.W.2d 463, 466 (Minn. Ct. App. 1998) ("This court, as an error correcting court, is without authority to change the law.")

In addition, National Bank's request is contrary to the overwhelming weight of authority from other jurisdictions, which recognize the broad discretion granted to district courts when fashioning a plan of distribution. *See SEC v. Wealth Mgmt., LLC*, 628 F.3d 323, 332-33 (7th Cir. 2010) ("In supervising an equitable receivership, the primary job of the district court is to ensure that the proposed plan of distribution is fair and reasonable. The district court has broad equitable power in this area, so appellate scrutiny is narrow; we review the decision below for abuse of discretion." (internal citations omitted)); *Quilling v. Trade Partners, Inc.*, 572 F.3d 293, 298 (6th Cir. 2009) ("a district court's decision relating to the choice of distribution plan for the receivership is reviewed for abuse of discretion"); *SEC v. Credit Bancorp Ltd.,* 290 F.3d 80, 87 (2d Cir. 2002) ("We review the District Court's decision relating to the choice of distribution plan for the receivership estate for abuse of discretion.").

National Bank has not provided any applicable authority or persuasive reason to alter Minnesota law and limit this Court's deference to the broad equitable power of the District Court. Accordingly, this Court should review the District Court's adoption of a distribution plan and calculation of claims for an abuse of discretion.

II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN ADOPTING A NET INVESTMENT *PRO RATA* DISTRIBUTION METHOD TO APPORTION THE RECEIVERSHIP ASSETS AMONG THE VICTIMS OF FIRST UNITED AND JOHNSTON'S PONZI SCHEME.

A. First United And Johnston Operated A Ponzi Scheme.

A "classic" Ponzi scheme involves paying participants out of assets transferred by later participants. *Credit Bancorp,* 290 F.3d at 83. Many Ponzi schemes involve a mix of legitimate and illegitimate business activities. *See United States v. Real Prop. Located at 13328 & 13324 State Highway 75 N.*, 89 F.3d 551, 553-54 (9th Cir. 1996); *SEC v. Byers*, 637 F. Supp. 2d 166, 169 (S.D.N.Y. 2009), *aff'd sub nom. SEC v. Malek*, 397 Fed. App'x 711 (2d Cir. 2010), ("In some instances the perpetrators of the scheme actually did use the investor money to buy specific pieces of property, but in many instances they did not, and used the money investors thought was to buy real estate for unauthorized purposes instead"); *In re Bayou Group, LLC*, 362 B.R. 624, 633 (Bankr. S.D.N.Y. 2007) (collecting cases). Courts reject the view that a Ponzi scheme is not a "typical Ponzi scheme" simply because some underlying business transactions took place. *In re Bayou*, 362 B.R. at 633; *see also United States v. Murray*, 648 F.3d 251, 256 (5th Cir. 2011) (rejecting criminal defendant's argument that he had not operated a Ponzi scheme).

Johnston pleaded guilty to overselling $79 million in loan participations and using the proceeds to repay earlier participants, thereby perpetuating the scheme. (R.App. 30-40); *see also In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 12 (Bankr. S.D.N.Y. 2007) (holding that admissions in guilty plea supported finding that individual was operating a Ponzi scheme). Johnston also admitted that he diverted fraudulently obtained funds from the scheme to his personal and family's use. (R.App. 27-29.) The funds diverted total over $25 million. (*Id.* at 46.)

The Receiver's investigation confirmed Johnston and First United operated a Ponzi scheme. The Receiver presented evidence that from at least 2002 until 2009, First United and Johnston oversold loan participations, sold participations in loans that did not exist, and used the fraudulently obtained funds to pay off earlier participants. Absent this fraudulent activity, First United would not have had sufficient cash to continue operations and perpetuate the Ponzi scheme beginning in 2002. Further, the Ponzi scheme affected most, if not all, of First United's loans and participations.

Despite repeated opportunities to challenge the evidence submitted by the Receiver over almost two years, <u>none</u> of the Participants, including National Bank, presented any evidence to refute the fact that Johnston and First United operated a Ponzi scheme since 2002. (*Compare* TNB Brief, 9 (arguing that this is not a "typical Ponzi scheme.") Based on the undisputed evidence, the District Court found that "First United, through Corey Johnston, designed and executed a classic Ponzi scheme; that is, Johnston used funds obtained from recent participants to pay previous participants and to pay his personal expenses." (Add. 13.) National Bank has not established any basis to disturb the District Court's finding.

B. In Ponzi Schemes, Courts Approve Net Investment *Pro Rata* Distribution Methodologies.

Courts analyze multiple methods of calculating *pro rata* distributions and may consider the recommendation of the receiver when determining the method that is appropriate in an individual case. *Byers*, 637 F. Supp. 2d at 181-82. "[T]he facts of a given case dictate which method would be most equitable." *United States CFTC v. Barki, LLC*, 2009 U.S. Dist. LEXIS 112998, *4 (W.D.N.C. Nov. 12, 2009) (R.App. 85-87). The fundamental reality following a fraudulent scheme is that no proposal can be perfect. *Gordon v. Dadante*, 2010 WL 148131, at *3 (N.D. Ohio Jan. 11, 2010) (App. 153-62.) Accordingly, "[a]n equitable plan is not necessarily a plan that everyone will like." *Byers*, 637 F. Supp. 2d at 168 (quotations omitted).

The net-investment method of calculating a *pro rata* distribution is the most commonly utilized method for calculating claims following a Ponzi, or other fraudulent, scheme. *Byers*, 637 F. Supp. 2d at 181-83 (selecting net investment distribution methodology from among three proposals made by the receiver); *see also In re Bernard L. Madoff Inv. Sec. LLC*, 424 B.R. 122, 140-43 (Bankr. S.D.N.Y. 2010), *aff'd*, 654 F.3d 229 (2d Cir. 2011); *SEC v. Capital Consultants, LLC*, 397 F.3d 733, 737 (9th Cir. 2005); *SEC v. Credit Bancorp, Ltd.*, 2000 WL 1752979, **34-43 (S.D.N.Y. Nov. 29, 2000), *aff'd*, 290 F.3d 80 (2d Cir. 2002) (App. 173-223); *CFTC v. Topworth Int'l, Ltd.*, 205 F.3d 1107, 1110, 1115-16 (9th Cir. 2000); *SEC v. American Capital Inv., Inc.*, 98 F.3d 1133, 1136 (9th Cir. 1996) (noting that district court had approved a net investment distribution in fraudulent scheme where "[m]uch of the money raised was used for unrelated, extravagant expenses and to pay off prior investors"); *In re Old Naples Secs., Inc.*, 311 B.R. 607, 617 (M.D. Fla. 2002) (Magnuson, J., under inter-circuit assignment); *In re C.J. Wright & Co.*, 162 B.R. 597, 609-10 (Bankr. M.D. Fla. 1993).

The net investment method is favored because it implements in Ponzi scheme cases the guiding principles that equality is equity and early participants should not benefit at the expense of later ones. *Cunningham*, 265 U.S. at 13; *Abrams v. Eby (In re Young)*, 294 F. 1 (4th Cir. 1923). Because there is not enough money to repay all the funds stolen from victims, the victims should recover proportionately in accordance with their respective actual losses—their remaining unpaid principal investments. *Topworth Int'l*, 205 F.3d at 1115-16.

"Any dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested." *In re Madoff*, 424 B.R. at 141; *see also In re Old Naples*, 311 B.R. at 617 ("[P]ermitting claimants to recover not only their initial capital investment but also the phony 'interest' payments they received and rolled into another transaction is illogical. No one disputes that the interest payments were not in fact interest at all, but were merely portions of other victims' capital investments."). Courts reject principle and interest distribution methodologies because they ignore profits creditors obtained during the Ponzi scheme from later victims' principal. *In re Madoff*, 424 B.R. at 141 ("If the Last Statement Method was adopted, Net Winners would receive more favorable treatment by profiting from the principal investment of Net Losers, yielding an inequitable result.") Additionally, allowing claims based on the principle and interest method would legitimize the illegal scheme, contrary to public policy. *See Credit Bancorp*, 2000 WL 1752979 at *40 ("recognizing claims to profits from an illegal financial scheme is contrary to public policy because it legitimizes the scheme") (App. 215).

The District Court analyzed three competing methodologies: (1) a principal and interest method, pursuant to which the amount of a claim is determined by the unpaid principal and interest as established by contract with the Ponzi-schemer, (2) a net-investment method, pursuant to which the amount of a claim is determined by adding the amount of all the claimant's transfers to the Ponzi-schemer, and then subtracting all money paid out to the claimant, and (3) National Bank's modified net investment method pursuant to which "$84 million in legitimate income" is allocated among the claimants. (TNB Brief, 20.)

It is undisputed that there will be insufficient funds to repay victims in full, so the victims should recover proportionately in accordance with their respective actual losses. As has been consistently found in other Ponzi scheme and fraud cases, the net investment method best identifies the actual loss. This method also balances the competing interests of earlier and later Participants. It allows earlier Participants to retain their interest payments. (TNB Brief, 8 ("TNB had dealings with [First United] since 2002 and collected substantial interest and fees in the early years.") To compensate later Participants that received fewer interest payments, it increases their proportionate share of the remaining limited assets. In contrast, the principle and interest method would cede control of a plan of distribution to Johnston.

Based on the undisputed evidence regarding the scope and nature of First United and Johnston's Ponzi scheme, the District Court concluded that a "net investment plan would provide a more equitable distribution of assets to the participants than a principle and interest plan." (Add. 8.) The District Court's implementation of the net investment method was a proper exercise of its discretion.

C. National Bank Cannot Show That The District Court Abused Its Discretion In Adopting A Net Investment Distribution Methodology.

National Bank advances five arguments in an attempt to demonstrate that the District Court impermissibly adopted a net investment method. The arguments fail to show that the District Court abused its discretion.

1. Johnston and First United conducted a Ponzi scheme and did not generate "$84 million in legitimate income."

Despite the scope and nature of First United and Johnson's Ponzi scheme, National Bank asserts that the net investment distribution methodology is not appropriate because First United generated "$84 million in Legitimate Income." (TNB Brief, 9-10.) This argument is both factually and legally incorrect.

First, National Bank's argument that First United earned "$84 million in Legitimate Income" lacks any record support.[6] (TNB Brief, 9-10.) In fact, the $84 million figure is revenue, not income, and is dwarfed by the losses First United sustained on loans and funds withdrawn by Johnston to fund his lavish lifestyle.

At the request of National Bank, the Receiver attempted to identify and calculate all interest and fees First United collected from borrowers. According to the Receiver's

[6] National Bank infrequently supports statements in its Brief with citations to the record, including its assertion that "[t]he *vast majority* of payments made by [First United] to Participant Banks over the years constituted repayment of legitimate principal, interest and fees collected by [First United] from *legitimate* borrowers, not false or fictitious Ponzi scheme 'profits.'" (TNB Brief, 9 (emphasis in original).) The Receiver is not aware of any basis in the record for this statement.

analysis (which was conducted as of May 2011), First United collected $84 million in interest and fees between 2002 and 2009. (R.App. 46; App. 115.) The Receiver's analysis, however, shows that First United actually advanced $21 million more to borrowers that it collected, including interest and fees:

Transaction Type	Borrowers
Loan Funding	($587,209,804)
Loan Principal Payment	$418,391,540
Loan Interest Payment	$70,605,713
Loan Fee	$14,023,441
Loan Payment	$63,068,536
Grand Total	**($21,120,575)**

(App. 115.)

Moreover, the table prepared by the Receiver did not account for the more than $25 million that Johnston withdrew for personal or family expenses since 2002. (R.App. 46.) Further, the analysis did not take into account the over $40 million in profits that were paid to participants that were fortunate enough to have ceased doing business with First United before the scheme collapsed and, accordingly, are not creditors. (June 6, 2011 Fourth Receiver's Report, p. 6.) Even taking into account what the Receiver projects to collect on First United's loan, First United sustained millions in losses. (App. 69.)

Second, National Bank's argument is without legal basis. As noted above, many Ponzi schemes involve a mix of legitimate and illegitimate business activities. *See Byers*, 637 F. Supp. 2d at 169. The presence of some real underlying business transactions, however, does not preclude courts from adopting a net investment distribution methodology. *See id.* at 169, 181-82 (approving "net investor" *pro rata* distribution methodology in case where Ponzi-schemers conducted some real business transactions with investor funds); *Wealth Mgmt.*, 628 F.3d at 335-36 (approving a net investment distribution methodology in non-Ponzi scheme receivership).

It is inaccurate to classify any revenue realized by First United and Johnston as "legitimate." Without cash flow from the Ponzi scheme, First United would not have had sufficient cash to continue to operate in 2002. But for the Ponzi scheme, no loans would have been funded and no revenues would have been generated from any loans. As a consequence, all loans beginning in 2002 were either oversold, counterfeit, or otherwise the product of First United's Ponzi scheme. Indeed, National Bank fails to cite to any loan that was not affected by the Ponzi scheme.

The District Court acknowledged that First United did generate revenue based on actual lending transactions.[7] (Add. 9-10.) Because of the pervasive nature of First United and Johnston's Ponzi scheme, the Court concluded that it would be inequitable to credit that revenue to the Participants:

> 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.

[7] In support of its "legitimate income" argument, National Bank references the District Court's statement that "there was a time when First United engaged in entirely 'legitimate' transactions with banks who are not a party to these proceedings." (Add. 9.) The Receiver is aware of no evidence to support that statement.

(Add. 10.) The District Court correctly disregarded National Bank's unsupported argument that the presence of "legitimate income" mandated the adoption of a principal and interest distribution methodology.

2. The authorities cited by National Bank do not support holding that the District Court abused its discretion.

National Bank cites a series of Minnesota Supreme Court decisions that stand for the straightforward proposition that Minnesota Courts should generally approve a "ratable" distribution in receivership proceedings. (TNB Brief, 15-17.) The District Court, however, did approve a *pro rata* distribution in this case, so as "to treat every lending institution equitably as they relate to each other." (App. 4.) None of the Minnesota cases cited by National Bank address the issue raised by its appeal—whether the District Court abused its discretion by adopting a net investment *pro rata* distribution methodology over a principle and interest *pro rata* distribution methodology.

National Bank also cites *Beacon Assoc. Mgmt. Corp. v. Beacon Assoc. LLC I*, 725 F. Supp. 2d 451 (S.D.N.Y. 2010) in support of its contention that the District Court should have adopted a principle and interest distribution methodology. (TNB Brief, 13-14.) The Court in *Beacon*, explained that it adopted a "valuation method" distribution for two reasons that are not present in this case. First, the entity in receivership—Beacon Associates—was "not itself a Ponzi scheme." *Id.* at 463. Instead, Beacon Associates had invested some of its assets in the Madoff Ponzi-scheme. *Id.* at 454-55. Based on that significant distinction, the Court held that "cases employing the net investment method of distribution are inapplicable because Beacon itself was not a Ponzi scheme." *Id.* at 463.

In addition, the parties had entered into an operating agreement that required implementation of a "valuation method" distribution, even in the event of a fraud loss. *Id.* at 460-63. The Court held that it was bound by the operating agreement to adopt the valuation method for distributions. *Id.*

National Bank has not cited any applicable authority to support its claim that the District Court abused its discretion when adopting a net investment method.[8] The District Court should be affirmed.

3. The District Court did not abuse its discretion when it declined to disregard transfers made to creditors more than six years before the establishment of the receivership based on the statute of limitations.

National Bank asserts that the District Court erred in approving the net investment distribution methodology because that methodology violates the six-year limitations period for claims asserted under Minnesota's Uniform Fraudulent Transfer Act ("MUFTA"), Minnesota Statutes § 513.41, *et seq.* According to National Bank, the District Court's adoption of a net investment distribution constitutes an "unlimited claw back of the funds received from [First United], regardless of when the funds were

[8] National Bank contends that some of the cases relied on by the District Court are distinguishable because they analyze the Securities Investor Protection Act and Bankruptcy Code. (TNB Brief, 12.) The District Court recognized it was "not bound" by these cases, but they did offer "some guidance in deciding this matter." (Add. 7-8.) And these cases are in fact instructive because they address the issue presented to the District Court—how to equitably apportion limited assets among creditors following a Ponzi scheme. Moreover, the net investment method implements the guiding principles that have been employed by courts dating back to Charles Ponzi himself; in Ponzi-scheme cases, equality is equity and early investors should not benefit at the expense of later ones. *Cunningham*, 265 U.S. at 13; *Abrams v. Eby (In re Young)*, 294 F. 1 (4th Cir. 1923).

received." (TNB Brief, 17-18.); *see Donnell v. Kowell*, 533 F.3d 762, 770-72 (9th Cir. 2008) (holding that "profits" that participants realized from a Ponzi scheme constitute "actual" and "constructive" fraudulent transfers and may be recovered by a receiver).

National Bank's argument is without merit because the District Court is not "clawing back" any funds from National Bank. Accordingly, the statute of limitations for fraudulent transfer claims simply does not apply. Moreover, even if the statute of limitations period did apply, the six-year limitation period did not begin to run until, at the earliest, October 23, 2009, when the Receiver was appointed and could have discovered Johnston and First United's fraudulent conduct.

a. The statute of limitations is irrelevant to National Bank's claim amount.

Statutes of limitations are designed to prevent a party from waiting an unreasonable amount of time before commencing an action against another party. *Bustad v. Bustad*, 116 N.W.2d 552, 556 (Minn. 1962). Accordingly, Minnesota Statutes § 541.01 mandates that "[a]ctions can only be commenced within the periods prescribed in this chapter, after the cause of action accrues." (emphasis added); *see also* Minn. Stat. § 541.05, subd. 1(6) ("the following actions shall be commenced within six years . . . for relief on the ground of fraud, in which case the cause of action shall not be deemed to have accrued until the discovery by the aggrieved party of the facts constituting the fraud" (emphasis added)).

No action has been commenced against National Bank. Rather, National Bank sought affirmative relief from the District Court by submitting a proof of claim form describing its loss and requesting a recovery from First United's limited assets. In adopting the net investment method, no party asserted a fraudulent transfer claim against National Bank. Instead, the District Court properly accounted for all transfers between National Bank and First United for purposes of calculating National Bank's equitable portion of the limited assets available to First United's equally deserving creditors. The statute of limitations simply does not apply to the District Court's selection of a distribution methodology.

Consistent with the District Court's July 21, 2011 Order (Add. 1-18), courts in other jurisdictions have held that the statute of limitations does not prevent the court from limiting the claim of a party that is seeking affirmative relief from the court based on transfers that occurred outside of the limitations period. *See In re Mid Atlantic Fund, Inc.*, 60 B.R. 604, 609-10 (Bankr. S.D.N.Y. 1986) (holding that a bankruptcy trustee may disallow a claim based on transfers received by claimant, even if the trustee could not commence an avoidance action to recover those transfers because of the statute of limitations); *In re Madoff*, 424 B.R. at 136-37 (holding that statute of limitations did not prevent trustee from accounting for all transfers received by a claimant for purposes of selecting a distribution methodology, even those that occurred outside of the limitations period).

b. Even if the statute of limitations did apply, the six year limitations period did not begin to run until the Receiver was appointed in October 2009.

Even if National Bank's general premise was correct—that a district court cannot adopt a distribution methodology that reduces a creditor's claim amount by funds the creditor received outside of the limitations period—National Bank cannot establish that the District Court abused its discretion because the six-year limitations period for fraudulent transfer claims did not begin to run until the appointment of the Receiver on October 23, 2009.

i. The limitations period for fraudulent transfer claims is established by Minnesota Statutes § 541.05, subd. 1(6).

MUFTA does not contain a specific statute of limitations. Accordingly, the statute of limitations for claims brought under MUFTA is set by Minnesota Statutes § 541.05. *In re Quality Pontiac Buick GMC Truck, Inc.*, 222 B.R. 865, 869 n.6 (Bankr. D. Minn. 1998) ("The Minnesota UFTA does not contain its own statute of limitations. Its remedies are thus subject to the general statutes of limitation."). Minnesota Statute § 541.05 provides that all actions subject to that provision have a statute of limitations of six years. Subdivision 1(6) further provides that for claims arising in "fraud," the six-year statute of limitations does not begin to run until discovery of the factual basis of the fraud.

Courts addressing Minnesota law have held for over 100 years that fraudulent transfer claims are governed by section 541.05, subd. 1(6) and its predecessors, and have given plaintiffs six years from discovery of the fraud to commence suit.[9] *See Schmitt v. Hager*, 93 N.W. 110, 111 (Minn. 1903) (holding that fraudulent conveyance claim must be commenced within six years after discovery); *Brasie v. Minneapolis Brewing Co.*, 92 N.W. 340, 342 (Minn. 1902) (same); *Duxbury v. Boice*, 72 N.W. 838, 839-40 (Minn. 1897) (same); *see also Georgen v. Grimlie*, 439 B.R. 710, 720 n.25 (B.A.P. 8th Cir. 2010) (citing *In re Curry*, 160 B.R. 813, 819 n.5 (Bankr. D. Minn. 1993)) (noting that fraudulent conveyance actions under MUFTA have a statute of limitations of six years pursuant to Minn. Stat. § 541.01, subd. 1(6); *Palatine Nat'l Bank v. Strom (In re Strom)*, 97 B.R. 532, 539-40 (Bankr. D. Minn. 1989) ("An action to set aside a fraudulent conveyance is one for relief on the ground of fraud and must be commenced within six years after discovery by the aggrieved party of the facts constituting the fraud." (quotations omitted)); *Lamson v. Cohn*, 1997 WL 733869, *3 (Minn. Ct. App. Nov. 18, 1997) (App. 172) ("When a creditor becomes aware of or should have become aware of a fraudulent conveyance, the statute of limitations begins to run and it expires against that creditor in six years unless facts are alleged and presented that would toll the limitation period."); 22 Dunnell Minn. Digest, *Fraudulent Transfers* §§ 8.03b, 10.01 (5th ed. 2006) (stating that a "[fraudulent transfer] action must be begun within six years of the discovery of the fraud. . . ."). Thus, under long-standing Minnesota law, fraudulent transfer claims are governed by Minnesota Statutes § 541.05, subd. 1(6).

[9] National Bank does not appear to dispute this fact because it cites Minnesota Statutes § 541.05(1)(6) as the applicable limitations provision. (TNB Brief, 18.)

Because subdivision 1(6) applies, the six-year statute of limitations did not begin to run until discovery of the fraud. A receiver is not charged with knowledge of fraudulent transfers until the receiver is appointed and the corporate wrongdoers are ousted from control. *See, e.g.*, *Hecht v. Malvern Preparatory Sch.*, 716 F. Supp. 2d 395, 399-400 (E.D. Pa. 2010) ("[p]lainly, the earliest conceivable date [the Receiver] could have known of the purportedly fraudulent transfers [to the defendant] was the day I appointed her"); *In re Taubman*, 160 B.R. 964, 989 (Bankr. S.D. Ohio 1993) (holding that no limitations period barred Ponzi scheme trustee's fraudulent transfer claims because the discovery rule applied and trustee timely brought claims after discovering the fraud). In this case, the Receiver was appointed on October 23, 2009. (App. 1-11.) Accordingly, the six-year limitation period for fraudulent transfer claims will not run until October 23, 2015.

ii. Minnesota Statutes § 541.05, subd. 1(2) does not apply to MUFTA claims because fraudulent transfer claims are not liabilities created by statute.

National Bank cites the case captioned, *Finn et al. v. Alliance Bank et al.*, Ct. File No. 19HA-CV-11-2856 (Dakota Cnty., Minn. Dist. Ct. Aug. 16, 2011) to support its assertion that the statute of limitations precluded the District Court from adopting a net investment distribution methodology. (TNB Brief, 18 (citing App. 237-57).) In that decision, the District Court held that MUFTA was subject to the six year limitation period set forth in Minnesota Statutes § 541.05, subd. 1(2), which does not expressly include a discovery rule.

Minnesota Statutes § 541.05, subd. 1(2) provides the limitations period for claims based on "liability created by statute." In *McDaniel v. United Hardware Distrib. Co.*, 469 N.W.2d 84 (Minn. 1991), the Minnesota Supreme Court held that Minnesota Statutes § 541.05, subd. 1(2) "applies to liabilities imposed by statute, not liabilities existing at common law which have been recognized by statute." *Id.* at 85; *see also Manteuffel v. City of North St. Paul*, 570 N.W.2d 807, 812 (Minn. Ct. App. 1997) ("A cause of action is a "liability created by statute" for limitations purposes when it is imposed by a statute that does not merely recognize or codify liabilities existing at common law."). Accordingly, if the liabilities recognized by statute existed before the statutory claim was enacted, they are not liabilities "created by statute" and subdivision 1(2) does not apply. *See McDaniel*, 469 N.W.2d at 85.

The history of fraudulent transfer claims in Minnesota makes clear that these claims existed at common law and are <u>not</u> liabilities created by statute. Specifically, the history of fraudulent transfer claims establishes that: (1) Minnesota's first fraudulent transfer statute codified common law; (2) when Minnesota's fraudulent transfer statute was partially repealed, the common law continued to recognize fraudulent transfer claims; and (3) MUFTA and its predecessor codified common law.

iii. Minnesota's first fraudulent transfer statute codified common law.

Minnesota enacted its first fraudulent transfer statute in 1858, when the Minnesota Legislature declared that "[e]very conveyance of assignment in writing or otherwise, or any estate or interest in lands or of goods, chattels, or things in action, or of any rents, issues or profits, made with the intent to hinder, delay or defraud creditors . . . shall be void." Minn. Stat. Ch. 51, § 1 (1858). From the outset, the Minnesota Supreme Court recognized that Minnesota's fraudulent transfer statute was a codification of common law. In *Blackman v. Wheaton*, 13 Minn. 326 (Minn. 1868), the Court held that "[t]he statute of 13 Eliz. C. 5, and the statute of our state rendering void certain conveyances made with a fraudulent intent, are but declaratory of the common law." *Id.* at 330.

iv. Fraudulent transfer claims in Minnesota reverted to the common law for 58-years.

Five years after codifying the common law of fraudulent transfers, the Minnesota Legislature deleted the phrase "goods, chattels, or things in action" from Minnesota Statutes Chapter 51. The Legislature's repeal of this language did not eliminate claims for fraudulent transfer claims involving personal property. To the contrary, fraudulent transfer claims involving personal property simply reverted to the pre-existing common law. *Blackman*, 13 Minn. at 331. The Minnesota Legislature did not address fraudulent transfers of personal property again until 1921, when it enacted the Uniform Fraudulent Conveyance Act. In the intervening 58 years, between 1858 and 1921, when only the common law applied, the Minnesota Supreme Court repeatedly recognized actual and constructive fraudulent transfer claims. *See, e.g.*, *Sovell v. Lincoln County*, 152 N.W. 727, 727-28 (Minn. 1915) (affirming judgment avoiding transfer made with actual intent to defraud creditor); *Underleak v. Scott*, 134 N.W. 731, 733 (Minn. 1912) (explaining that a debtor's fraudulent intent may be "implied conclusively from the circumstances surrounding the transfer, as where a debtor is insolvent, or fails to retain sufficient property to amply satisfy existing claims against him. . . . The rule undoubtedly is that the debtor must retain enough property to amply satisfy his creditors"); Donald E. Bridgman, *Uniform Fraudulent Conveyance Act in Minnesota*, 7 Minn. L. Rev. 530, 530 (1922-23) (citing *Henry v. Himnan*, 25 Minn. 199 (1878); *Walsh v. Byrnes*, 40 N.W. 831 (Minn. 1888); *McCord v. Knowlton*, 82 N.W. 589 (Minn. 1900); *Underleak*, 134 N.W. 731; *Thysell v. McDonald*, 159 N.W. 958 (Minn. 1916)) (noting that, before Minnesota adopted the Uniform Fraudulent Conveyance Act, Minnesota cases "held that where a person is insolvent and makes a voluntary conveyance, the necessary effect of his act is to defraud creditors, and the debtor will be presumed to have intended this necessary effect"); *Nat'l Sur. Co. v. Wittich*, 237 N.W. 690 (Minn. 1931) (explaining that the constructive fraudulent transfer claim recognized in the UFCA was previously set forth by common law as explained in *Underleak*). If Minnesota common law did not recognize constructive and actual fraud claims, such claims would have ceased to exist as to personal property transfers for 58 years. They did not.

It is also significant that during this 58-year period Minnesota courts applied the discovery rule to the six-year statute of limitations for fraudulent transfer claims, relying on the predecessor to Minnesota Statutes § 541.05, subd. 1(6). *See, e.g.*, *Schmitt*, 93 N.W. at 111 (holding that fraudulent conveyance claim must be commenced within six years after discovery); *Brasie*, 92 N.W. at 342 (same); *Duxbury*, 72 N.W. at 839-40 (same). Thus, actual and constructive fraudulent transfer claims existed at common law and were subject to a six-year statute of limitations and the discovery rule.

v. MUFTA and its predecessor codified common law claims.

In 1921, the Minnesota Legislature adopted the Minnesota Uniform Fraudulent Conveyance Act ("MUFCA"). The history of MUFCA and its modern-day successor, MUFTA, makes clear that both codified Minnesota common law.

The origins of MUFCA began with the National Conference of Commissioners on Uniform State Laws (the "NCCUSL"). The NCCUSL recognized that many states, like Minnesota, had recognized fraudulent transfer claims. UFCA, Prefatory Note, 7A U.L.A. Part II, p. 247. In recognition of this common-law development, the NCCUSL drafted the Uniform Fraudulent Conveyance Action. UFCA, § 4 n.1; UFCA, Prefatory Note, 7A U.L.A. Part II, p. 247.

After the Minnesota Legislature enacted MUFCA, the Minnesota Supreme Court recognized that MUFCA was "a <u>codification</u> and an extension of our former law. The new act simply adds an efficient, optional, and additional remedy to a creditor who has not reduced his claim to judgment." *Lind v. O.N. Johnson Co.*, 282 N.W. 661, 667 (Minn. 1938) (emphasis added). The additional remedy identified by the *Lind* court permitted a creditor to pursue a fraudulent transfer claim before judgment. It did not alter the fact that, both before and after MUFCA was enacted, actual and constructive fraudulent transfer claims existed under Minnesota law. Thus, MUFCA did not "create" new liability in Minnesota.

In 1987, Minnesota replaced MUFCA with MUFTA. MUFTA preserved "[t]he basic structure and approach of [MUFCA]," and made changes only where needed to be consistent with other law. *See* UFTA, Prefatory Note, U.L.A., 7A, part II, p. 5. Courts applying Minnesota law have expressly held that MUFTA was a codification of Minnesota common law. *Girard v. Michener (In re Michener)*, 217 B.R. 263, 268 (Bankr. D. Minn. 1998) (stating that the remedies of MUFTA "are traceable through the legislation's predecessor, Minn. Stat. § 513.20, 513.32, *and prior common law*. . . . [T]he Act did not abrogate the prior law") (emphasis added)).[10] Consistent with this fact, MUFTA did not alter the liabilities for actual or constructive fraudulent transfer claims available under MUFCA. *Compare* Minn. Stat. §§ 513.23-.26 (1986) *with* Minn. Stat. §§ 541.44-.45 (1987).

Simply stated, MUFCA was "a codification and extension of [Minnesota's] former law" – and MUFTA preserved "the basic structure and approach of [MUFCA]." UFTA, Prefatory Note, U.L.A., 7A, part II, p. 5; *see Michener*, 217 B.R. at 268; *Lind*, 282 N.W.2d at 667. Accordingly, MUFTA claims are not subject to the limitations period set forth in Minnesota Statutes § 541.05, subd. 1(2).

[10] UFTA included an express limitations period for fraudulent transfer claims. *See* UFTA, § 9. The Minnesota Legislature, however, did not adopt the limitations period contained in UFTA and, in doing so, chose not to change the applicable common law fraud limitations period when it adopted MUFTA. *Pecinovsky v. AMCO Ins. Co.*, 613 N.W.2d 804, 809 (Minn. Ct. App. 2000) ("Courts presume that the legislature acts with full knowledge of previous statutes and existing case law."). Accordingly, subdivision 1(6) continues to be the applicable limitations period to fraudulent transfer claims.

vi. The District Court's opinion in *Finn et al. v. Alliance Bank et al.* erroneously relied on consumer fraud case law to hold that Minnesota Statutes § 541.01, subd. 1(2) applies to MUFTA claims.

The District Court in *Finn v. Alliance Bank*, held that subd. 1(2) applied principally on the ground that MUFTA claims are like statutory consumer fraud claims that "create" new liabilities. (App. 248-49.) The analogy is incorrect, and the District Court's holding should not be adopted by this Court.

First, there is no dispute that consumer fraud claims were created by statute. The Minnesota Supreme Court has explained:

> In the late 1950's many state legislatures enacted statutes designed to prohibit deceptive practices and to address the unequal bargaining power often present in consumer transactions. . . . By 1981, every state in the United States had statutes providing for consumer protection enforcement by a state agency-commonly, as in Minnesota, the state attorney general-with broad enforcement authority. . . . Minnesota's Consumer Fraud Act was adopted in 1963 to achieve the same purpose and provides the attorney general with authority to seek and obtain injunctive relief to protect consumers from unlawful and fraudulent trade practices in the marketplace.

Ly v. Nystrom, 615 N.W.2d 302, 308 (Minn. 2000) (internal citations omitted). Accordingly, "[c]onsumer protection laws were not intended to codify the common law; rather they were intended to broaden the cause of action to counteract the disproportionate bargaining power present in consumer transactions." *State by Humphrey v. Alpine Air Prods., Inc.*, 490 N.W.2d 888, 892 (Minn. Ct. App. 1992) (emphasis added) *aff'd*, 500 N.W.2d 788, 790 (Minn. 1993); *Grp. Health Plan, Inc. v. Philip Morris Inc.*, 621 N.W.2d 2, 12 (Minn. 2001) (explaining that, "[i]n passing consumer fraud statutes, the legislature clearly intended to make it easier to sue for consumer fraud than it had been to sue for fraud at common law."). Indeed, the Minnesota Supreme Court recognized that the effect of the enactment of the consumer fraud statute was "the *elimination* of common law fraud, such as proof of damages or reliance on misrepresentations." *Grp. Health Plan*, 621 N.W.2d at 12 (emphasis in original).

Second, as set forth above, fraudulent transfer claims (unlike consumer fraud claims) existed at common law and were not created by statute. Accordingly, since the liabilities recognized by statute existed before the statutory claim was enacted, they are not liabilities "created by statute" and subdivision 1(2) does not apply. *See McDaniel*, 469 N.W.2d at 85.

vii. Courts in other jurisdictions have consistently held that the UFTA does not create new liabilities.

Finally, substantial case law in other jurisdictions supports the view that MUFTA did not create new liabilities and, therefore, is subject to the limitations period in Minnesota Statutes § 541.05, subd. 1(6). Courts in other states that adopted UFTA have consistently held that fraudulent transfer claims existed at common law and that UFTA did not create new liabilities. *See Orr v. Kinderhill Corp.*, 991 F.2d 31, 34-35 (2d Cir. 1993) (holding that because fraudulent conveyance actions were common in New York before the state's fraudulent conveyance statute was enacted, the court concluded the limitations period applicable to liability created by statute did not apply to the claim); *In re Taubman*, 160 B.R. at 989 (holding that no limitations period barred Ponzi scheme trustee's fraudulent transfer claims because discovery rule applied and trustee timely brought claims after discovering the fraud); *United States v. Shepherd*, 834 F. Supp. 175, 178 (N.D. Tex. 1993) *rev'd on other grounds*, 23 F.3d 923 (5th Cir. 1994) (citing *Hadlock v. Eric*, 23 F. Supp. 692, 693 (S.D.N.Y. 1938)) ("The principles codified by the UFTA and its predecessor . . . were established by case law prior to their effective dates and, indeed, the right to recovery for fraudulent conveyances is a common law right which exists independent of statute.")).

Even if National Bank were correct that its claim amount cannot be reduced based on transfers National Bank received from First United outside of the limitations period, the limitations period did not begin to run until the appointment of the Receiver. Accordingly, the six-year limitation period applicable to fraudulent transfer claims, Minnesota Statutes § 541.05, subd. 1(6), did not bar the District Court from adopting a distribution methodology that considers all transfers a Participant received from First United.

4. The net investment method will not result in additional costs.

National Bank also challenges the District Court's adoption of a net investment method on the grounds that it will result in "never-ending litigation" and "will extend this action for years because every Participant will be forced to trace every penny sent to and received from [First United]." (TNB Brief, 11.) National Bank's arguments are without merit because the Receiver has already calculated, and the District Court has entered a final order and judgment establishing, each Participant's net investment claim amount. (Add. 19-25.)

The Receiver obtained all the records necessary to perform a net investment claim calculation for each of the Participants, including National Bank. (R.App. 42.) The Receiver performed the calculation and published its calculation to the Participants, including in the Receiver's motions to approve the specific calculation of claims under the net investment method. (App. 122; R.App. 57-74.) After two hearings, the Court entered a final order and judgment approving the Receiver's calculation of claims under this method. (Add. 19-25.) Notably, no party other than National Bank has contested any specific claim calculation. In fact, as described below, National Bank has failed to raise a single argument concerning how its net investment claim was miscalculated. (Section II, *infra.*) Accordingly, affirming the District Court's order adopting the net investment method and the Receiver's calculation of claims will not lead to costly litigation; rather, it will conclude it.

5. The District Court did not abuse its discretion in rejecting National Bank's alternative net investment method.

National Bank asserts that, even if the District Court did not abuse its discretion when it adopted a net investment method, the District Court should have modified it in one of two ways the would be beneficial to National Bank. Specifically, National Bank asserts that the District Court should have adopted its proposed modified net investment methodology that credited Participants with a portion of First United's "legitimate income" or imposed a "cut-off" date. (TNB Brief, 19-23.)

"To implement an effective pro rata distribution, district courts supervising receiverships have the power to classify claims sensibly." *Wealth Mgmt.,* 628 F.3d at 333 (quotations omitted). Here, the District Court properly exercised its broad discretion in crafting a net investment distribution methodology that corresponded to the facts and circumstances of First United and Johnston's Ponzi scheme. *See Barki,* 2009 U.S. Dist. LEXIS, at *4 ("the facts of a given case dictate which method would be most equitable") (R.App. 85-87).

a. First United did not earn "$84 million in legitimate income."

First, National Bank argues that the District Court abused its discretion when it declined to adopt National Bank's proposed "modified" net investment distribution methodology, which would have credited Participants with $84 million in "legitimate income" earned by First United. (TNB Brief, 20-21.) As set forth above, First United transferred $21 million more to borrowers than it collected (without even considering the more than $25 million Johnston misappropriated and $40 million in interest paid as profits to past participants). (R.App. 46; App. 115; June 6, 2011 Fourth Receiver's Report, p. 6.) In addition, the revenue First United generated from loan transactions cannot be classified as "legitimate" because all loans were either oversold, counterfeit, or otherwise the product of First United's Ponzi scheme. (R.App. 43-46.) In light of these uncontroverted facts, the District Court properly declined to modify the net investment distribution methodology to credit any portion of First United's "income" or revenue to the Participants. (Add. 9-10.)

b. The District Court did not abuse its discretion in applying March 11, 2002 as the cut-off date for calculating claim amounts.

Alternatively, National Bank asserts that the District Court abused its discretion when it declined to adopt a net investment distribution methodology that imposed a "cut-off" date. (TNB Brief, 22-23.) The District Court, however, did impose a cut-off date, just not the cut-off date advocated by National Bank. Specifically, based on the recommendation of the Receiver, the District Court imposed a cut-off date of March 11, 2002—which is the first date of activity in First United's checking accounts. (Add. 6.) *see Wealth Mgmt.*, 628 F.3d at 335-36 (holding that district court had not abused its discretion in approving a net investment distribution methodology that disregarded transfers made before a cut-off date). That date was chosen because the Receiver possessed "extremely limited records before March 2002." (App. 66; Add. 6.) The District Court imposed this cut-off date despite the fact that National Bank and another Participant received transfers from First United prior to March 11, 2002 which, if accounted for, would have further reduced their net investment claim amounts. (App. 66.) The District Court's decision to use March 11, 2002 as a cut-off date for purposes of calculating Participants' claims under the net investment method was not an abuse of discretion.

II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION WHEN IT DECLINED TO INCREASE NATIONAL BANK'S CLAIM BASED ON A LOAN NATIONAL BANK MADE DIRECTLY TO MUSTANG ISLAND DEVELOPMENT, LLC.

In its Statement of the Case, National Bank asserted that the District Court erred by declining to include a loan transaction between National Bank and Mustang Island Development, LLC ("Mustang Island") / Carefree Capital Investments, LLC ("Carefree Capital") for purposes of calculating National Bank's claim amount. (Jan. 5, 2012 Statement of the Case of The National Bank, p. 6.) National Bank, however, has not addressed this argument in its Brief and, accordingly, it has been waived. *See State v. Butcher*, 563 N.W.2d 776, 780-81 (Minn. Ct. App. 1997) (holding that arguments not addressed within an appellate brief are waived); *Schoepke v. Alexander Smith & Sons Carpet Co.*, 187 N.W.2d 133, 135 (Minn. 1971) ("An assignment of error based on mere assertion and not supported by any argument or authorities in appellant's brief is waived and will not be considered on appeal unless prejudicial error is obvious on mere inspection.")

Even if not waived, the District Court did not abuse its discretion in excluding the Mustang Island loan transaction from National Bank's net investment claim calculation.

A. Factual Background Related To The Mustang Island Loan.

On December 11, 2006, National Bank made a $7 million loan directly to Mustang Island. (R.App. 76.) First United was not a party to this loan transaction. It appears that the borrower defaulted on the loan by March 2009. (*Id.*) Thereafter, National Bank arranged a transaction with First United that resulted in a "pay-off" on the Mustang Island loan.

Specifically, National Bank assigned the Mustang Island loan and collateral to Carefree Capital in exchange for a payment of $7 million. (R.App. 76.) To fund Carefree Capital's purchase, National Bank transferred $7,258,191 to First United to purchase a 100% participation interest in a $8 million loan from First United to Carefree Capital. (*Id.*) In effect, National Bank wired First United $7,258,191 so that First United could, that same day, return $7 million to National Bank (and a $50,000 loan fee 11 days later)—replacing the non-performing Mustang Island loan on National Bank's books with a "new" participation interest in a loan that was not in default. (*Id.*) The collateral securing the new loan was the same as the original Mustang Island loan. (*Id.*)

The Carefree Capital loan, however, was fabricated. Carefree Capital claims that it had no knowledge that First United purportedly loaned Carefree Capital $8 million or that it was assigned the Mustang Island loan. (R.App. 76-77.) First United's records are consistent with Carefree Capital's position. There are no cash transactions showing First United loaned these funds to Carefree Capital. Instead, First United wired $7,050,000 of the $7,258,191 it received from National Bank back to National Bank and retained the remaining $208,191. (*Id.*)

In April 2010, National Bank reached an agreement directly with Carefree Capital to reverse this counterfeit loan transaction. Carefree Capital re-conveyed the mortgage and other loan documents securing the Mustang Island loan directly to National Bank. (R.App. 77.) National Bank subsequently acquired title to the real property securing the

Mustang Island loan from the borrower, apparently through a deed in lieu of foreclosure. (*Id.*)

B. The Receiver Did Not Include The Mustang Island Loan Transaction In The Net Investment *Pro Rata* Claim Calculation Approved By The District Court.

National's Banks proof of claim form included $7,488,556.15 related to the Mustang Island/Carefree Capital loan transaction. (R.App. 77.) The Receiver objected to this portion of National Bank's claim. (June 25, 2010 Receiver's Objections to Claims, p. 7.) In its Motion to Approve a Calculation of Claims, the Receiver explained that it increased National Bank's net investment claim by $208,191—the net funds First United retained from National Bank in connection with the fabricated Carefree Capital loan. (App. 57-58.)

National Bank responded to the Receiver's Motion on May 23, 2011, but did not object to the Receiver's treatment of the Mustang Island/Carefree Capital loan in the net investment claim calculation. (App. 97-109.) On July 21, 2011, the net investment *pro rata* distribution methodology detailed by the Receiver in its Motion to Approve a Calculation of Claims (with minor adjustments) was approved by the District Court. (Add. 1-18.)

The net investment methodology approved by the District Court required the Receiver to "use the cumulative amount each bank invested with First United to calculate each participant's distribution." (Add. 5.) The approximately $7 million claim increase that National Bank sought in the District Court arose from a direct loan from National Bank to Mustang Island. Because First United was not a party to that loan transaction and National Bank had already exercised its remedies against the collateral securing the loan, the District Court concluded that "the loan should not be included in the receivership estate." (Add. 25.) This was not an abuse of discretion.

CONCLUSION

The District Court properly exercised its equitable powers in this case and adopted a net investment *pro rata* distribution methodology to compensate the victims of First United Funding, LLC and Corey Johnston's Ponzi scheme. The National Bank cannot establish that, in adopting the net investment distribution methodology, the District Court abused its discretion. The District Court should be affirmed.

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CERTIFICATE OF BRIEF LENGTH

I hereby certify that this brief conforms to the requirements of Minn. R. Civ. App. P., 132.01, subd. 1 and 3, for a brief produced with proportional font. The length of this brief is 11,182 words. This brief was prepared using Microsoft Word 2003 and the word processing program has been applied specifically to include all text, including headings, footnotes, and quotations for word count purposes.

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