UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

MICHAEL J. QUILLING, Receiver for ABC VIATICALS, INC., and Related Entities,	)	
Plaintiff,	)	**Civil Action No. 3:07-CV-1153-P**
v.	)	
	)	**ECF**
ERWIN & JOHNSON, LLP, and CHRISTOPHER R. ERWIN,	)	
Defendants.	)	

DEFENDANTS' REPLY IN SUPPORT OF THEIR MOTION FOR RECONSIDERATION OF FEBRUARY 25, 2008 ORDER

Erwin and Johnson, LLP ("E&J"), and Christopher R. Erwin ("Mr. Erwin") (collectively, "Defendants"), file this Reply in Support of Their Motion for Reconsideration of February 25, 2008 Order ("Order"), and in support respectfully show the Court as follows:

I.
SUMMARY OF REPLY

The response filed by Michael J. Quilling ("Plaintiff") misses six key points. First, Plaintiff misconstrues his burden when facing a factual attack on standing. He failed to produce the requisite preponderant evidence to satisfy all three elements: (1) that ABC suffered an injury in fact; (2) caused by E&J and Mr. Erwin separately; (3) which would be redressed through the claims asserted. His allegations are not evidence, and the requirement that he provide evidence is not a merits-question.

Second, Plaintiff asks the Court to agree that the difference between a trustee/escrow agent and an attorney rests on "an exercise in semantics." (Resp. at 2).

Plaintiff offers nothing else to support his belief that these capacities are the same under the applicable California law; indeed, they are not and carry important distinctions on roles and limitations. This argument cannot be disregarded.

Third, Plaintiff's arguments that he can bring any claim because a trustee like him could do so should be rejected. It cannot be overstated that he did not sue in the capacity of a trustee, but solely as Receiver. Nor could he, as there are no individual trusts left on which to advance his (flawed) claims.

Fourth, the contractual choice of law argument mandates determination, as it bears on showing the applicable elements for purposes of proving standing and stating a claim. A proper claim analysis must begin with the proper law.

Fifth, in his zeal to find Mr. Erwin responsible, Plaintiff again relies on allegations, only two of which pertain to Mr. Erwin, while ignoring that hard and concrete evidence is necessary to survive a factual attack on his standing to sue Mr. Erwin. The Court should reject Plaintiff's claims as speculation and unsupported by preponderant evidence and misguided and misleading.

Sixth, contrary to the response's footnote one, Defendants have asked the Court to reconsider its rulings on Defendants' Rule 12(b)(6) motion. Because Plaintiff failed to show standing – a prerequisite to stating a claim – the Court need not have reached the failure to state a claim analysis. To the extent that it did, Defendants would ask the Court to reconsider whether Plaintiff has stated a claim against each defendant under California law. Defendants' motion for reconsideration of the Court's February 25, 2008 Order should, therefore, be granted.

II.
ARGUMENTS & AUTHORITIES IN REPLY

A. Plaintiff Misstates the Factual Attack Burden that he Carries

Plaintiff misstates the Rule 12(b)(1) standard to create the illusory situation where all he needs to do is clearly "allege" facts. The decisional framework for a factual attack on standing required Plaintiff to prove standing ***by a preponderance of the evidence*** by also submitting facts through some evidentiary method. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Greystone Servicing Corp. Inc.*, 2006 WL 2285638, at *2 (N.D. Tex. Jul 31, 2006) (Solis, J.) (citation omitted).

Plaintiff had the chance to show, through the introduction of competent evidence, that ABC (1) suffered an injury in fact; (2) which had a causal connection to Defendants' actions; and (3) which would be redressed through the claims asserted against Defendants separately. The Court did not put Plaintiff to his burden. Instead, it disregarded the factual attack as a challenge "to the merits." But as this Court has previously stated, evidence is key: "when a party presents evidence outside the pleadings to challenge jurisdiction, a court should offer the nonmoving party protection by allowing it to present opposing evidence the Court can weigh to satisfy itself that it has jurisdiction." *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 2006 WL 2285638, at *2 (citing *Williamson v. Tucker*, 645 F.2d 404, 412 (5th Cir. 1981)). Defendants moved for reconsideration based on Plaintiff's lack of necessary evidentiary support on all elements of standing for each and every claim against both Defendants. Plaintiff's lack of preponderant evidence supports reconsideration of the Court's findings of standing.

B. Defendants were not ABC's Legal Counsel

Defendants strenuously dispute Plaintiff's two-paragraph belief that E&J and Mr. Erwin can be held to the standard of a law firm and attorney even though neither E&J nor Mr. Erwin was employed as an attorney for ABC. This is an important point, not "immaterial" as Plaintiff dismissively characterizes it, because a large majority of the Court's reasoning rests on the mischaracterization of Defendants as ABC's legal counsel.

Plaintiff argues that *Sanders v. Casa View Baptist Church*, 898 F. Supp. 1169, 1175 (N.D. Tex. 1995) (Solis, J.), means that Defendants "should be held to the same standard as other professional performing the same duties." (Resp. at 2). If by the vague reference to "same duties," Plaintiff means to say the duties owed by attorneys to clients, Plaintiff is wrong. Further, as the Court is aware, *Sanders* concerned the denial of summary judgment on a fiduciary claim under Texas law against the plaintiffs' marriage counselor. The applicable law here is California's – not Texas' – and Plaintiff certainly cannot claim that *Sanders* means that the distinction between an attorney and any other fiduciary (such as a marriage counselor or trustee) is an "exercise in semantics."

Sanders actually supports the very position advocated by Defendants: that their contractual agreement established their business relationship. *Sanders* cited the Fifth Circuit's opinion in *Texas Real Estate Counselors*, which stated that the duty owed by a professional to a client derives from their contractual relationship:

> The duty owed by a professional to his client **derives from their contractual relationship** and requires that the professional 'use the skill and care in the performance of his duties commensurate with the requirements of his profession.'

Fed'l Sav. and Loan Insurance Corp. v. Texas Real Estate Counselors, 955 F.2d 261, 265 (5th Cir. 1992) (emphasis added). Following the Fifth Circuit's reasoning, the duties

owed to ABC must arise from, and ***only*** arise from under California law, the operative trust and escrow agreements, which clearly define E&J as the trustee and escrow agent. Plaintiff cannot contend that E&J should have disregarded the written agreements.

That E&J was a law firm and Mr. Erwin an attorney does not mean that Defendants are held to the standards of legal professionalism while providing non-legal services. *See e.g., Von Rott v. Johnson*, 148 Cal. App. 3d 608, 612-13 (Cal. App. 1983) (holding that attorney acting as pledgeholder was performing escrow services, not legal services); *Quintilliani v. Mannerino*, 62 Cal. App. 4th 64 (Cal. App. 1998) ("Accordingly legal malpractice must be limited to negligence in the providing of legal services. While some lawyers are undoubtedly successful concert promoters, they are not held to the standard of a lawyer in producing concerts because the standard is stated in terms of skills possessed by a lawyer and the professional services provided by the lawyer, not the business standards by which concert promoters are judged."). Thus, it is "immaterial" that E&J was a law firm and Mr. Erwin an attorney when weighing the performance of their trustee and escrow duties.

Moreover, the distinction between an attorney and trustee is all the more important here because, while an attorney can use his judgment to undertake the best course of action for the client, a trustee cannot overstep its contractual bounds. *See Estate of Bothwell*, 65 Cal. App. 2d 598, 683 (Cal. 1944) ("[t]he plan of the grantor must be followed. It may not be departed from in particulars wherein it is specific, merely because it may be considered in those particulars to be unwise. The trustee cannot substitute his own plan because he thinks it is a better one."). Defendants could not have substituted their own judgment should they have thought that it was a better course of

action. Had Defendants substituted their judgments for that of ABC, they would have breached their contractual obligations. As clearly stated in Defendants' motion for reconsideration, the Court's analysis that rests on the characterization of Defendants as ABC's legal counsel should be reconsidered.

C. Plaintiff did not Sue Defendants as a Trustee

Defendants do not present a "new" challenge by contesting the Court's finding that Plaintiff's standing arises from the Order Clarifying and Modifying Order Appointing Receiver. Although neither party argued the application of this order, the Court relied heavily on it as the basis for concluding that Plaintiff had standing to sue on behalf of the investors' trusts themselves, even if not on behalf of the investors. By addressing the Court's characterization of standing under that particular order, Defendants are not presenting a new challenge. But even if they were, objections to standing are jurisdictional and can be raised at any time. *See Bankston v. Burch*, 27 F.3d 164, 167 (5th Cir. 1994) ("objections to standing are jurisdictional in nature and can be raised at any time."). Plaintiff's argument that Defendants somehow waived this jurisdictional argument should be denied.

Plaintiff further attempts to mislead the Court by arguing that his claims are fine because they can be brought by a trustee like Plaintiff. The insurmountable problem with this approach is that Plaintiff simply has not sued Defendants in his capacity as a trustee. The Complaint and everything that Plaintiff has since filed, including his response that precedes this reply, state that they are filed by "Michael J. Quilling, Receiver for ABC Viaticals, Inc. and Related Entities." Plaintiff cannot alter his capacity by arguments in a response to a motion for reconsideration. But perhaps what is even more telling on this

point is that Plaintiff certainly knows the difference between suing as a receiver and as a trustee. *Compare Quilling v. McDuff*, No. 3:06-CV-0959-L, 2006 WL 3026104, at *1 (N.D. Tex. Oct. 23, 2006) ("Michael J. QUILLING, **Receiver** for Megafund Corporation and Lancorp Financial Group, LLC") (emphasis added); *with Quilling v. Compass Bank*, No. 3:03-CV-2180-R, 2004 WL 2093117, at *1 (N.D. Tex. Sept. 17, 2004) ("Michael J. QUILLING (**Solely in His Capacity as Trustee** for the Estate of Northstar Securities, Inc.)") (emphasis added). So whatever the validity of Plaintiff's trustee argument, which has its own share of problems, it has no application here, because he assuredly has not brought this suit as a trustee, nor can he, as he has dissolved the trusts already.

Another mistake that Plaintiff makes along these lines is in failing to recognize what Defendants meant by arguing that the trusts themselves are not jural entities. This is not a challenge to their existence ("metaphysical" or otherwise), but whether a trust is a legal entity capable of being represented by a receiver. Under California law, trusts are not legal entities. *See, e.g., Galdjie v. Darwish*, 113 Cal. App. 4th 1331, 1343 (Cal. App. 2003) ("a trust is not a legal entity"). A trust represents a fiduciary relationship with respect to property. REST. 3D, TRUSTS, § 2; *Hobbs v. Buck*, 115 Cal. App. 3d 176, 180 (Cal. App. 1981). The trusts themselves are not capable of suing and being sued. (Resp. at 3). Thus, there is no entity – no jural existence – in whose stead Plaintiff could stand as receiver. To the extent that the investors are the real parties in interest, Plaintiff was not appointed as representative for the investors, either. The ineluctable conclusion is that Plaintiff, as receiver, lacks standing to sue ***on behalf of the trusts***.

Finally, in a fundamental footnote, Plaintiff asserts that the Court has prohibited the investors from suing for damage to the trusts that held their money. (Resp. at 3 n.4).

Plaintiff's belief conflicts with the Court's rulings on Kaplan's motion to dismiss and the motion to dismiss here, both of which recognized recourse only by the investors for harm that ABC allegedly caused to the trusts. *See* 9/26/07 Order in *Quilling v. Int'l Fidelity & Surety, Ltd., et al.*, "Plaintiff argues that he has standing to assert breach of fiduciary duty on behalf of the investor trusts against ABC. The Court does not agree with Plaintiff." (citation omitted); *see also* 2/25/08 Order, "Therefore, the Court finds that only the investors have standing to assert claims based on a breach of fiduciary duty." (emphasis added). How would ABC have harmed the investors if not through the trusts? Plaintiff himself states that the money that he collects will benefit the investors: "10. Suits have been prepared for filing against others involved in this matter for the recovery of assets that will benefit the investors."[2] To argue that he is supplanting the investors by suing for the "trusts" fails both factually and legally.

D. Contractual Choice of California Law is Ripe for Determination

The application of California law does not rest on competing footnotes alone. Defendants' motion specifically referenced the contractual choice of law provisions in the escrow and trust agreements and attached these agreements as exhibits. The issue has been sufficiently briefed in Defendants' motion for reconsideration. That Plaintiff chose not to contest this briefing should not delay the Court's application of the proper state's substantive law.

The application of a particular state's law necessarily bears on the proper analysis of Plaintiff's claims. This is particularly evident with respect to the discussion of trustee's duties versus the duties of an attorney under California law, and the lack of jural existence of a trust under California law. When would Plaintiff have this decision made,

[2] http://www.secreceiver.com/abc/general_info/2007.06.14.Investor%20Update.htm (emphasis added).

during summary judgment proceedings? At that point, if California law applies, would it not be necessary for the Court to revisit its jurisdictional and other rulings made on the basis of Texas law? The contractual choice of law provisions are clear and the time to make the decision is now: California law applies.

E. Plaintiff's Allegations are not Evidence

For the first time, Plaintiff sets out a list of allegations that are ostensibly directed at Mr. Erwin. Despite the title given to this part of Plaintiff's reply, none of the allegations set forth any tortious conduct on the part of Mr. Erwin. At most, only two allegations rise above vaguely implied claims against E&J: (1) and (8).

Again though, Plaintiff only offers up more allegations, presumably hoping that stacking allegations upon allegations will suffice as preponderant evidence to overcome Defendants' factual attack on Plaintiff's standing to assert any claims against Mr. Erwin individually. "[N]o presumptive truthfulness attaches to plaintiff's allegations, and the existence of disputed material facts will not preclude the trial court from evaluating for itself the merits of jurisdictional claims." *Williamson v. Tucker*, 645 F.2d 404, 413 (5th Cir. 1981). A plaintiff responding to a factual attack on the court's jurisdiction generally bears the burden of proving by a preponderance of the evidence that the court has subject matter jurisdiction. *Paterson v. Weinberger*, 644 F.2d 521, 523 (5th Cir.1981).

Defendants challenged the lack of **evidence** in their initial reply and in the current motion for reconsideration. A preponderance of ***evidence*** of Mr. Erwin's individual liability is ***necessary*** as to each claim against Mr. Erwin individually. A factual attack on standing should not be defeated when the respondent fails to comply with the proper jurisdictional standard, choosing instead to rely exclusively on self-serving allegations

and implied claims. The Court should reconsider its rulings as to Mr. Erwin and deny these claims as unsupported by any evidence required by the factual attack standard.

F. Plaintiff Failed to Show Standing, so the Court Should Not Have Reached the Rule 12(b)(6) Motion

Plaintiff must show by a preponderance of the evidence, each element of standing on every claim to survive a Rule 12(b)(1) motion ***before*** the plausibility of a claim according to the Rule 12(b)(6) motion may be considered. "[T]he court must find jurisdiction before determining the validity of a claim." *Moran v. Kingdom of Saudi Arabia*, 27 F.3d 169, 172 (5th Cir. 1994) (internal citation omitted). Because Plaintiff failed to produce the required evidence to show standing – a prerequisite to stating a claim – the Court need not have reached the failure to state a claim analysis at all.[3]

Further, several of the Court's rulings simply concluded that the "motion" was denied, without referencing which motion was actually denied (12(b)(1), 12(b)(6), or both). To the extent that the Court denied both motions, meaning that it reached the 12(b)(6) motion after finding standing, Defendants have argued that Plaintiff cannot state a claim for relief under California law on any of his claims.

WHEREFORE, PREMISES CONSIDERED, the Court should grant Defendants' Motion for Reconsideration, Dismiss Plaintiff's Complaint in its entirety, enter an order dismissing the Complaint, and enter judgment for Christopher R. Erwin and Erwin & Johnson, LLP.

[3] A Rule 12(b)(1) motion must be considered before any other challenge because "the court must find jurisdiction before determining the validity of a claim." *Moran v. Kingdom of Saudi Arabia*, 27 F.3d 169, 172 (5th Cir. 1994) (internal citation omitted).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing document has been served on this 15th day of April, 2008, to all known counsel of record as required by the Federal Rules of Civil Procedure.

William J. Akins

EXHIBIT A

For Opinion See 242 F.3d 325

United States Court of Appeals,Fifth Circuit.
SECURITIES AND EXCHANGE COMMISSION, Plaintiff - Appellee,
v.
FOREX ASSET MANAGEMENT LLC, et al., Defendants,
v.
Michael WHITBECK and Donna Whitbeck, Movants - Appellants.
No. 00-10224.
May 19, 2000.

Appeal from the United States District Court for the Northern District of Texas, Dallas Division

Brief of Appellants

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***1** *JURISDICTIONAL STATEMENT*

This appeal is from a final order of the United States District Court for the Northern District of Texas (the "District Court"). The District Court had subject matter jurisdiction under 28 U.S.C. §§ 1331 and 1345. The Securities and Exchange Commission ("SEC") filed the underlying suit against Jason N. Kosova ("Kosova") and Forex Asset Management, L.L.C. ("Forex") based upon violations of the federal securities laws. (R. 1-14.) At the SEC's request, the District Court appointed Dan R. Waller as receiver (the "Receiver") over the defendants' assets. (R. 29-34.)

On November 1, 1999, the Receiver filed a Motion to Approve Receiver's Proposed Plan of Distribution of Assets of Forex Asset Management, L.L.C. (the "Motion"). (R. 497-512.) In the Motion, the Receiver proposed to take the funds in the accounts of FAM Preferred Trading Corp. ("FAM Preferred"), all of which came from the Whitbecks and had never been commingled with any other funds, and distribute them pro rata among the Whitbecks and the Forex investors. (R. 498-99.)

The Whitbecks filed an objection to the Receiver's proposed plan of distribution, arguing that they should receive all of the funds from the FAM Preferred accounts rather than having their claim diluted by the claims of the Forex investors. (R. 614-721.) On February 8, 2000, the District Court entered an Order overruling the Whitbecks' objection. (R. 570-583.) The Whitbecks filed this appeal on February 23, 2000. (R. 588.) This Court has jurisdiction under 28 U.S.C. § 1291.

STATEMENT OF THE ISSUE PRESENTED FOR REVIEW

When a corporation holds an investor's funds in a completely segregated account, where no other funds are ever deposited or commingled, can a receiver take those funds and distribute them pro rata among the investors in a second corporation?

STATEMENT OF THE CASE

This case was decided upon stipulated facts, deposition testimony, and written arguments submitted by the parties. The SEC filed the underlying suit against Kosova and Forex based upon violations of the federal securities laws. (R. 1-14.) At the SEC's request, the District Court appointed the Receiver as a federal receiver over the defendants' assets. (R. 29-34.)

The Receiver filed his Motion, in which he proposed to take the funds in the FAM Preferred accounts, all of which came from the Whitbecks and had never been commingled with any other funds, and distribute them pro rata among the Whitbecks and the Forex investors. (R. 497-512.) The Whitbecks filed an objection to the Receiver's proposed plan, arguing that they should receive all of the funds from the FAM Preferred accounts. (R. 614-721.) On February 8, 2000, the District Court entered an Order overruling the Whitbecks' objection. (R.570-583.) The Whitbecks filed this appeal on February 23, 2000. (R. 588.)

***3** *STATEMENT OF FACTS*

A. The Whitbecks' Dealings with Forex.

Mr. and Mrs. Whitbeck are residents of the State of Washington. In early to mid-1998, they heard a radio infomercial presented by Jason Kosova ("Kosova") describing a program for trading in foreign currency though Forex Asset Management, L.L.C. ("Forex"). Shortly after hearing the infomercial, they attended a seminar in Seattle, Washington, which was put on by Forex. Mr. Kosova and others spoke at the seminar and described the profits Forex was able to achieve with very little risk through trading in foreign currency. After the seminar, Mr. and Mrs. Whitbeck delivered $100,000 to Forex by personal check dated July 1, 1998. (R. 628-641.)

The Whitbecks received several statements from Forex, which purported to show profits on their $100,000 investment. Kosova and at least one other representative of Forex contacted Mr. Whitbeck numerous times to solicit additional investments. Later in 1998, Mr. and Mrs. Whitbeck attended another Forex presentation in Seattle, Washington, at which Kosova and other representatives of Forex solicited additional investments. (R. 643-650.)

B. The Whitbecks' Dealings with FAM Preferred.

After the November seminar, the Whitbecks took out a loan of $800,000.00 secured by the equity in their business, and they delivered a personal check dated ***4** December 3, 1998 in the amount of $800,000.00 to Kosova. When the Whitbecks took out the $800,000.00 loan, they planned to use the profits from the investment to repay the loan, or alternatively to withdraw part of the principal if and when necessary to meet the loan payments. Kosova assured the Whitbecks that their $800,000.00

investment would be kept in a "preferred" account that would be segregated from all other investors' funds. (R. 641-643, 646-658.)

Kosova deposited the Whitbeck's $800,000.00 check into a separate account at NationsBank, N.A. held in the name of "FAM Preferred Trading Corp.," account no. 0047 7206 3550. That deposit is confirmed by the notation on the back of the $800,000.00 check and the January 1999 bank statement. (R. 527-533, 689-690.)

The records of the Texas Secretary of State and the Texas Comptroller of Public Accounts show that FAM Preferred is a Texas corporation and is entirely separate and distinct from Forex. (R. 536-546, 720-721.)

None of the Forex investors' funds were ever deposited into the FAM Preferred account. The NationsBank account statement confirms that the Whitbecks' $800,000.00 check was the only deposit that was ever made into that account. (R. 527-533.)

FAM Preferred also set up a separate brokerage account with Rosenthal Collins Group, L.P. in Chicago, Illinois, account no. G 002 70061. The account statements for the FAM Preferred accounts at NationsBank and Rosenthal Collins Group show ***5** that $750,000.00 was wire transferred from the FAM Preferred account at NationsBank into the FAM Preferred account at Rosenthal Collins Group on January 11, 1999. (R. 535, 547-550.)

None of the Forex investors' funds were ever deposited into the FAM Preferred account at Rosenthal Collins Group. The Rosenthal Collins account statement confirms that no funds other than the $750,000.00 wire transfer were ever deposited into that account, and no funds were ever withdrawn from that account. (R. 547-550.)

The only withdrawals from the FAM Preferred account at NationsBank were the $750,000.00 wire transfer to the FAM Preferred account at Rosenthal Collins, wire transfer fees, and an $8,500.00 cashier's check to the Whitbecks. (R. 527-535, 547-550.)

None of the proceeds from the Whitbecks' $800,000.00 were used for foreign currency investments as represented by Kosova. The Whitbecks' $800,000.00 was never commingled with any other funds and was never deposited into any account held in the name of Kosova or Forex. (R. 527-535, 547-550.)

The receiver froze the FAM Preferred accounts with NationsBank and Rosenthal Collins. When the accounts were frozen, there was $777,372.00 remaining in the FAM Preferred accounts ($27,372.00 at NationsBank and $750,000.00 at Rosenthal Collins). (R. 532, 549.)

***6** *STANDARD OF REVIEW*

Findings of fact are reviewed under the clearly erroneous standard. *E.g.*, *Bridges v. Bossier*, 92 F.3d 329, 332 (5th Cir. 1996). On the other hand, conclusions of law are reviewed *de novo*. *E.g.*, *Id.* The facts relevant to the instant case are not in dispute. The Whitbecks appeal only the conclusions reached by the District Court in

applying the law to the undisputed facts.

A district court's action in supervising an equity receivership is reviewed for abuse of discretion. *S.E.C. v. Safety Fin. Svc., Inc.*, 647 F.2d 368, 372 (5th Cir. 1982). However, a district court must follow legal and equitable principles in ruling on a federal receiver's proposed plan of distribution. *Anderson v. Stephens*, 875 F.2d 76, 79 (4th Cir. 1989). Approval of a plan that improperly divides funds among defrauded investors pro rata rather than repaying particular investors the full amount to which they are entitled constitutes an abuse of discretion that requires reversal. *Id.*

SUMMARY OF THE ARGUMENT

The Whitbecks are entitled to the entire $777,372.00, which is the full balance remaining in the FAM Preferred accounts from their $800,000 investment. No other funds were ever deposited into the FAM Preferred Accounts, so there is no issue of tracing or commingling.

This result is compelled under federal receivership law, Texas common law, and analogous bankruptcy law. The District Court did not rely upon any valid authority to allow the Receiver to pool the Whitbecks' funds in the FAM Preferred accounts with Forex funds and then distribute all of the funds pro rata among the Whitbecks and the Forex investors.

ARGUMENT

A. Under Federal Receivership Law, the Whitbecks are Entitled to All Funds in the FAM Preferred Accounts.

"In essence, those who are victims of theft or fraud expect to receive their property back if it is possible to identify what property is theirs ... those whose stolen property is no longer traceable feel fortunate to receive any compensation for their loss." *Commodities Futures Trading Comm'n v. Richwell Int'l, Ltd.*, 163 B.R. 161, 164 (N.D. Cal. 1994). That sound reasoning applies in the case at bar. The Whitbecks are entitled to the entire balance of their funds ($777,372.00) that remained in the FAM Preferred accounts.

The equitable doctrine of restitution provides that "Where the wrongdoer has effectively separated the money of one of the claimants, that claimant is entitled to, and only to, his own money or its product." Restatement of Restitution § 213(2). The Fourth Circuit Court of Appeals applied that principle in a federal receivership action. *Anderson v. Stephens*, 875 F.2d 76 (4th Cir. 1989). In that case, the Commodity ***8** Futures Trading Corporation filed a receivership action in federal court against a fraudulent unregistered commodity futures group. *Id.* at 77. The district court froze all assets of the commodity futures group and appointed a receiver to liquidate and distribute assets to investors. *Id.* at 77-78. The commodity futures group was holding approximately $200,000 worth of checks from investors at the time of the freeze, and the group deposited the checks after the freeze. *Id.* at 77.

In *Anderson*, the district court ruled that the proceeds of the checks had to be

included in the receivership estate and distributed pro rata among all investors. *Id.* at 78. On appeal, the Fourth Circuit reversed, relying on section 213(2) of the Restatement of Restitution. *Id.* at 78-79. The court reasoned that the checks were effectively segregated from other investors' funds (by being held rather than being deposited into the commingled bank account) and, therefore, the proceeds had to be returned to the investors. *Id.* at 79. Although the court was sympathetic to the plight of the other investors who would suffer because of fortuitous actions of the wrongdoer, "both law and equity" required the full proceeds of the segregated checks to be returned to those investors (less administrative costs). *Id.* at 79, 81.

Anderson is closely analogous to the instant case, where the Whitbecks' funds were segregated in accounts of FAM Preferred, totally separate from the funds of Forex investors. Like the instant case, *Anderson* was a federal receivership liquidation involving a fraudulent investment scheme. Like the investors in *Anderson* ***9** whose checks were segregated, the Whitbecks are entitled to a full return of all of their segregated funds.

Moreover, the Whitbecks are entitled to priority to the FAM Preferred funds over the Forex investors. FAM Preferred is a separate legal entity from Forex, and there has been no ruling to disregard the corporate fiction. (*See, generally,* Record.)

When a fraudulent investment scheme involves more than one investment program, the investors in each program are entitled to priority in the assets of their particular program before the assets are distributed to investors from other programs. *S.E.C. v. P.B. Ventures,* 1991 WL 269982, *3 (E.D. Pa. 1991). That case involved a single investment club with two investment programs. *Id.* at *2. The court held that the investors in the second program had priority to the proceeds from the assets in the second program over claims of investors from the first program. *Id.* at *3. The Whitbecks' position is much stronger than the situation in *P.B. Ventures,* because their funds were held by a separate legal entity in completely segregated accounts.

B. Under Texas Common Law, the Whitbecks are Entitled to All Funds in the FAM Preferred Accounts.

Under Texas common law, the Whitbecks are entitled to a constructive trust on the entire $777,372.00 held in the separate FAM Preferred accounts. A constructive trust is an equitable remedy imposed by law to allow the rightful owner to recover his ***10** property. *E.g.,* *Omohundro v. Matthews,* 341 S.W.2d 401, 405 (Tex. 1960). The elements for imposing a constructive trust are:
1. an identifiable *res* to which the property can be traced; and
2. actual fraud or breach of fiduciary duty by the person holding the property.

E.g., *Meadows v. Bierschwale,* 516 S.W.2d 125, 128-29 (Tex. 1974). No agreement is necessary to create a constructive trust; it is purely a creation of equity after-the-fact. *Omohundro,* 341 S.W.2d at 405. Once a constructive trust is imposed, it is effective as of the date of inception of the wrongful holding it remedies. GEORGE T. BOGERT, TRUSTS 287 (6th ed. 1987).

In the instant case, the first element for a constructive trust is easily

satisfied. The entire $777,372.00 remaining from the Whitbecks' $800,000 investment was held in the FAM Preferred accounts, and no other funds were ever deposited into those accounts. There is no problem with commingling, so the funds are clearly identifiable.

The second element for a constructive trust is also clearly satisfied in this case. There is no question that Kosova committed fraud. The Whitbecks' $800,000 investment was supposed to be used for trading in foreign currency, but no such transaction were ever effected. Kosova's prior course of dealing, through Forex, demonstrates that he never intended to invest the Whitbecks' money as represented. ***11** Furthermore, FAM Preferred breached its fiduciary duty to the Whitbecks. Under Texas law, a broker owes a fiduciary duty to the investor. *E.g.*, *Rauscher Pierce Refsnes, Inc. v. Great Southwest Sav., F.A.*, 923 S.W.2d 112, 115-16 (Tex. App.-Houston[14th Dist.] 1996, writ ref'd n.r.e.). FAM Preferred breached its fiduciary duty to the Whitbecks in numerous ways, including misrepresenting how the funds would be used and issuing false account statements.

A constructive trust should be applied in a federal securities receivership case to allow defrauded investors to recover their property or proceeds. *S.E.C. v. P.B. Ventures*, 1991 WL 269982, *3 (E.D. Pa. 1991). The elements of constructive trust are satisfied in the case at bar, and the Whitbecks are entitled to all of their funds remaining in the FAM Preferred accounts.

C. Under Analogous Federal Bankruptcy Law, the Whitbecks Would be Entitled to All Funds in the FAM Preferred Accounts.

Under analogous concepts of federal bankruptcy law, the Whitbecks are also entitled to the entire $777,372.00 held in the separate FAM Preferred accounts. Federal bankruptcy law is analogous and should be used for guidance in making distributions in federal securities receivership cases. *S.E.C. v. P.B. Ventures*, 1991 WL 269982, *3 (E.D. Pa. 1991). Like a federal equity receivership, bankruptcy is an equitable proceeding, *e.g.*, *Mendoza v. Temple-Inland Mortgage Corp. (In re Mendoza)*, 111 F.3d 1264, 1270 (5th Cir. 1997), and is based on the overriding policy ***12** of ratable distribution among all creditors, *e.g.*, *Haber Oil Co. v Swinehart (In re Haber Oil Co.)*, 12 F.3d 426, 435 (5th Cir. 1994).

In a bankruptcy liquidation, the funds in the FAM Preferred accounts would be excluded from the bankruptcy estate. Section 541 of the Bankruptcy Code defines property of the estate very broadly, but it specifically excludes property in which the debtor holds only legal title and not an equitable interest. 11 U.S.C. § 541(d).

FAM Preferred held only bare legal title (at most), and had no equitable interest in the Whitbecks' funds. The Whitbecks did not lend the money to FAM Preferred or buy stock in FAM Preferred. It was the Whitbecks' money all along; FAM Preferred was only supposed to use it to buy and sell foreign currency *on behalf of and for the benefit of the Whitbecks*. When a person turns over funds to another to be held and later returned, the party receiving the funds holds them in an implied trust. *Firestone Tire & Rubber Co. v. Goldblatt Bros., Inc. (In re Goldblatt Bros., Inc.)*, 33 B.R. 1011, 1013-14 (N.D. Ill. 1983).

When a debtor in bankruptcy holds funds segregated in trust for another, the funds are excluded from the bankruptcy estate and are turned over to the trust beneficiary. *E.g., Dolph Clothiers, Inc. v. Salomon (In re Martin Fein & Co., Inc.)*, 34 B.R. 333, 336-37 (Bankr. S.D.N.Y. 1983); *In re Russman's, Inc.*, 125 B.R. 520, 525 (Bankr. E.D. Tenn. 1991). In *Martin Fein*, the debtor was an auctioneer and segregated auction proceeds for two clients by putting the cash in envelopes, marking ***13** the envelopes with the clients' names, and then placing the envelopes in a safe deposit box. 34 B.R. at 335. The court held that the auctioneer-debtor was the agent of the clients and, because the funds were clearly segregated and identifiable, the two clients were entitled to the cash in the envelopes. *Id.* at 337. In *Russman's* the debtor held trust fund taxes in a segregated bank account, and the court held that the state was entitled to the segregated funds. 125 B.R. at 525. In the instant case, FAM Preferred held the Whitbecks' $800,000 in an implied trust, in accounts that were clearly and completely segregated from any other funds.

The same result occurs when the trust at issue is a constructive trust. *E.g., Haber Oil Co. v. Swinehart (In re Haber Oil Co.)*, 12 F.3d 426, 436 (5th Cir. 1994). In that case, the Fifth Circuit explained "We have thus consistently recognized that Sec. 541(d) accords the beneficiary of a constructive trust, properly imposed under state law, the right to recover the trust property from the bankruptcy trustee or the debtor." *Id.* For the reasons set forth above, the Whitbecks are entitled to a constructive trust under Texas law on the FAM Preferred accounts. Therefore, in a bankruptcy liquidation, those accounts would be excluded from the bankruptcy estate and the Whitbecks would be entitled to all of the funds. By analogy, the result should be the same in this receivership liquidation.

***14** D. No Receivership Expenses Should be Deducted from the Whitbecks' Funds in the FAM Preferred Accounts.

The Whitbecks also objected to the proposed plan of distribution to the extent it proposes to deduct any expenses of the receivership from their funds in the FAM Preferred accounts. The receivership did not benefit the Whitbecks with respect to those funds, but instead has forced them to incur substantial legal expenses to protect their interests. The District Court did not reach that issue, apparently because of its unprecedented and unjustified decision to effectively collapse FAM Preferred into Forex.

CONCLUSION

For all of the foregoing reasons, the Order of the District Court should be REVERSED and rendered and/or remanded as appropriate.

SECURITIES AND EXCHANGE COMMISSION, Plaintiff - Appellee, v. FOREX ASSET MANAGEMENT LLC, et al., Defendants, v. Michael WHITBECK and Donna Whitbeck, Movants - Appellants.
2000 WL 33978066 (C.A.5)

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