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

MICHAEL J. QUILLING, as Receiver for Megafund Corporation and Lancorp Financial Group, LLC	§	
Plaintiff,	§	
VS.	§	NO. 3-06-CV-0299-L
KENNETH WAYNE HUMPHRIES	§	
Defendant.	§	

FINDINGS AND RECOMMENDATION OF THE UNITED STATES MAGISTRATE JUDGE

Plaintiff Michael J. Quilling, as Receiver for Megafund Corporation and Lancorp Financial Group, LLC, has filed a motion for summary judgment in this case brought under the Texas Uniform Fraudulent Transfer Act ("TUFTA"), Tex. Bus. & Comm. Code Ann. § 24.001, *et seq*., and for negligent misrepresentation. For the reasons stated herein, the motion should be granted.

I.

This case arises out of a lawsuit brought by the Securities and Exchange Commission ("SEC") against various defendants and relief-defendants involving the sale of unregistered securities. *SEC v. Megafund Corp.*, No. 3-05-CV-1328-L ("the *Megafund* Litigation"). In that case, the SEC alleges that the defendants, including Megafund, raised more than $13 million from unwitting investors by making false representations about the expected rate of return on their investments and by promising that a portion of the profits generated from the sale of securities would be used to benefit charitable causes. On July 5, 2005, the court appointed Michael J. Quilling as the Receiver for all defendants in the *Megafund* Litigation. In that capacity, Quilling was authorized to:

> take[ ] exclusive jurisdiction and possession of the assets, monies, securities, claims in action, and properties, real and personal, tangible and intangible, of whatever kind and description, wherever situated, of [the named defendants and relief defendant] and any entities they control ("Receivership Assets"), and the books and records of the Defendants and Relief Defendant ("Receivership Records").

See Order, 7/5/05 at 1-2, ¶ I(1)). The order further provides:

> The Receiver is hereby authorized to institute, defend, compromise or adjust such actions or proceedings in state or federal courts now pending and hereafter instituted, as may in his discretion be advisable or proper for the protection of Receivership Assets or proceeds therefrom, and to institute, prosecute, compromise or adjust such actions or proceedings in state or federal court as may in his judgment be necessary or proper for the collection, preservation and maintenance of Receivership Assets.
>
> The Receiver is hereby authorized to institute such actions or proceedings to impose a constructive trust, obtain possession and/or recover judgment with respect to person or entities who received assets or funds traceable to investor monies. All such actions shall be filed in this Court.

Id. at 5-6, ¶ I(12) & (13)).

On February 16, 2006, the Receiver filed this action against Kenneth Wayne Humphries, a Kentucky lawyer who served as general counsel to Megafund, to recover more than $9 million invested by Lancorp Financial Group as a result of false statements contained in an opinion letter signed by Humphries. The Receiver also seeks another $19,000 in investor funds paid to Humphries by Megafund. In his answer, Humphries admits that the representations in his opinion letter were "inaccurate, false, and misleading," and acknowledges receipt of the $19,000. (Def. Ans. at 5-6, ¶¶ 11, 19). The Receiver now moves for summary judgment on his negligent misrepresentation and fraudulent transfer claims.[1] Humphries was ordered to file a written response to the motion by

[1] As part of his answer, Humphries asserts a counterclaim against Megafund for contribution and indemnity. The Receiver does not move for summary judgment with respect to that counterclaim.

August 7, 2006, but failed to do so. The court therefore considers the motion without the benefit of a response.

II.

Summary judgment is proper when there is no genuine issue as to any material fact and the movant is entitled to judgment as a matter of law. FED.R.CIV.P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 2552, 91 L.Ed.2d 265 (1986). A movant who has the burden of proof at trial must establish "beyond peradventure all of the essential elements of the claim or defense to warrant judgment in his favor." *Fontenot v. Upjohn Co.*, 780 F.2d 1190, 1194 (5th Cir. 1986). Once the movant meets its initial burden, the non-movant must show that summary judgment is not proper. *See Duckett v. City of Cedar Park*, 950 F.2d 272, 276 (5th Cir. 1992). The parties may satisfy their respective burdens by tendering depositions, affidavits, and other competent evidence. *See Topalian v. Ehrman*, 954 F.2d 1125, 1131 (5th Cir.), *cert. denied*, 113 S.Ct. 82 (1992). Where, as here, the non-movant has not filed a summary judgment response or submitted any controverting evidence, the court may accept as true the undisputed facts adduced by the movant. *See Tillison v. Trinity Valley Electric Cooperative, Inc.*, No. 3-03-CV-2480-D, 2005 WL 292423 at *1 (N.D. Tex. Feb. 7, 2005), *citing Bookman v. Shubzda*, 945 F.Supp. 999, 1002 (N.D. Tex. 1996). All evidence must be viewed in the light most favorable to the party opposing the motion. *Rosado v. Deters*, 5 F.3d 119, 122 (5th Cir. 1993).

A.

Both Texas and Kentucky have adopted the Restatement (Second) of Torts § 552, which allows a non-client to sue an attorney for negligent misrepresentation based on the issuance of an opinion letter. *See McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787,

791-93 (Tex. 1999) (Texas law); *Seigle v. Jasper*, 867 S.W.2d 476, 482 (Ky. App. 1993) (Kentucky law). Section 552 of the Restatement provides:

> One who, in the course of his business, profession or employment, or in any transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

McCamish, 991 S.W.2d at 791, *citing* Restatement (Second) of Torts § 552(1); *see also Federal Land Bank Ass'n v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991).

The Receiver has established "beyond peradventure" the essential elements of his negligent misrepresentation claim. The summary judgment evidence shows that Gary Lancaster, President of Lancorp Financial Group, requested an opinion letter from Megafund before investing any funds in the investment program. (Plf. MSJ App. at 21, ¶¶ 1-2). In response to that request, Lancaster received a letter from Kenneth Humphries, general counsel to Megafund, which states, *inter alia*, that "[a]ll funds involved in the 'trading program' are secured in a brokerage account at a major investment institution" and that "[t]he principal amount of the funds are insured against losses of every description." (*Id.* at 24). Even Humphries admits that those statements were "inaccurate, false, and misleading." (Def. Ans. at 6, ¶ 19). In reliance on the opinion letter, Lancorp contributed $9,365,000 to the Megafund investment program. (Plf. MSJ App. at 22, ¶ 6). Those funds are now lost because Megafund is in receivership and cannot repay the principal amount of the investment. (*Id.* at 22, ¶ 7).

The only remaining issue is whether Humphries exercised "reasonable care or competence" in communicating the information in his opinion letter. At his deposition, Humphries testified that the information contained in his letter came directly from Stanley Leitner, President of Megafund.

In fact, Leitner drafted the opinion letter and Humphries merely copied the letter onto his stationery. (*Id.* at 27). No independent investigation was undertaken by Humphries before representing to Lancorp that its funds would be placed in a "secured [] brokerage account at a major investment institution" and that the principal amount of the funds would be "insured against losses of every description." (*Id.* at 24, 28). Without any evidence or argument from Humphries to controvert or explain these facts, the court has little difficultly in concluding that his failure to investigate the statements contained in his opinion letter amounts to negligence. Accordingly, the Receiver is entitled to summary judgment on his negligent misrepresentation claim.

B.

The Receiver further alleges that the $19,000 in payments made to Humphries constitute voidable transfers under TUFTA. This statute provides, in pertinent part:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor.

TEX. BUS. & COMM. CODE ANN. § 24.005(a) (Vernon 2002). Ordinarily, the creditor must prove that the challenged transfer was made with the intent to defraud. *See Quilling v. Gilliland*, 3-01-CV-1617-BD, 2002 WL 373560 at *2 (N.D.Tex. Mar. 6, 2002) (Kaplan, J.), *appeal dism'd*, No. 02-10415 (5th Cir. Jun. 3, 2002). However, in the case of a *Ponzi* scheme,[2] courts have found that the debtor's intent to hinder, delay, or defraud is established by the mere existence of the *Ponzi*

[2] A *Ponzi* scheme is a fraudulent investment scheme where money from new investors is used to pay "profits" on the money contributed by earlier investors, without the operation of an actual revenue-producing business other than the raising of new funds by finding more investors. *See* BLACK'S LAW DICTIONARY 1180 (7th ed. 1999).

scheme. *Id.*; *see also Warfield v. Byron*, 436 F.3d 551, 558 (5th Cir. 2006) (burden of proving that transfers were made with actual intent to defraud is satisfied by establishing the existence of a *Ponzi* scheme "which is, as a matter of law, insolvent from its inception"); *SEC v. Cook*, No. 3-00-CV-0272-R, 2001 WL 256172 at *3 (N.D. Tex. Mar. 8, 2001), *citing In re Independent Clearing House Co.*, 77 B.R. 843, 860 (Bankr. D. Utah 1987) (finding requisite intent to defraud from fact that debtor must have known that *Ponzi* scheme would inevitably collapse and that later investors would lose their investment).

The summary judgment evidence conclusively establishes that investor funds were the only real source of Megafund's revenue. (Plf. MSJ App. at 4, ¶ 7). As Megafund received those funds, the investments were commingled and used to pay "returns" to earlier investors. (*Id.*; *see also id.* at 7-19). This type of arrangement is a classic *Ponzi* scheme. (*Id.* at 4, ¶ 7). Records from the Megafund operating account at Wells Fargo Bank show five payments totaling $19,000 to Humphries between March 1, 2005 and May 19, 2005. (*Id.* at 10-15). Humphries has not offered any argument, much less evidence, to refute any of these facts. To the contrary, he admits receiving a total of $19,000 from Megafund. (Def. Ans. at 5, ¶ 11). Because there is no genuine issue of material fact for trial, the Receiver is entitled to judgment as a matter of law on his fraudulent transfer claim.

RECOMMENDATION

Plaintiff's motion for summary judgment [Doc. #21] should be granted. The court should enter judgment against Kenneth Wayne Humphries in the amount of $9,365,000 on the Receiver's negligent misrepresentation claim and in the amount of $19,000 on the Receiver's fraudulent transfer claim, together with prejudgment and post-judgment interest as allowed by law. The Receiver also should recover costs and reasonable attorney's fees with respect to his fraudulent transfer claim. *See*

TEX. BUS. & COMM. CODE ANN. § 24.013. An application for attorney's fees shall be filed within 14 days after entry of a final judgment in accordance with Fed. R. Civ. P. 54(d)(2).

A copy of this report and recommendation shall be served on all parties in the manner provided by law. Any party may file written objections to the recommendation within 10 days after being served with a copy. *See* 28 U.S.C. § 636(b)(1); FED. R. CIV. P. 72(b). The failure to file written objections will bar the aggrieved party from appealing the factual findings and legal conclusions of the magistrate judge that are accepted or adopted by the district court, except upon grounds of plain error. *See Douglass v. United Services Automobile Ass'n*, 79 F.3d 1415, 1417 (5th Cir. 1996).

DATED: August 14, 2006.

JEFF KAPLAN
UNITED STATES MAGISTRATE JUDGE