

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

MICHAEL J. QUILLING, RECEIVER
FOR MEGAFUND CORPORATION
AND LANCORP FINANCIAL GROUP,
LLC,

Plaintiff,

vs.

KENNETH WAYNE HUMPHRIES,

Defendant.

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Civil Action No. 3:06-CV-0299-L (BD)

ECF
Referred to U.S. Magistrate Judge

**BRIEF IN SUPPORT OF PLAINTIFF’S
MOTION FOR PARTIAL SUMMARY JUDGMENT**

TO THE HONORABLE JEFF KAPLAN, UNITED STATES MAGISTRATE JUDGE:

COMES NOW, Michael J. Quilling in his capacity as Receiver for Megafund Corporation and Lancorp Financial Group, LLC, (“Receiver”) and files this his Brief in Support of Plaintiff’s Motion for Partial Summary Judgment against Kenneth Wayne Humphries (“Defendant”) and would respectfully show the Court as follows:

I.
INTRODUCTION

The Receiver brings this action on behalf of Megafund Corporation and Lancorp Financial Group LLC, two entities now in receivership according to orders entered in *Securities and Exchange Commission v. Megafund et al.*, Cause No. 3:05-CV-1328 (N.D. Tex.). Megafund Corporation was an unregistered securities broker that solicited investor funds and then systematically diverted large amounts for *Ponzi* payments to earlier investors and other undisclosed expenditures. To build

investor confidence, Megafund retained Defendant to serve as its legal counsel and prepare an opinion letter making false representations to its largest investor, Lancorp Financial Group, LLC. Relying on Defendant's representations, Lancorp contributed over \$9 million to this scheme and did not realize any return for its investors. For his services, Humphries received \$19,000.00 in compensation.

The Receiver is now entitled to summary judgment for damages caused by Humphries' negligent misrepresentation to Lancorp. The undisputed material facts show that: (1) Defendant admits making these representations in the course of his profession; (2) these representations conveyed false information for Lancorp's guidance in the course of its business; (3) Defendant admits he did not investigate the truthfulness of his statements and, in later conversations, did not warn Lancorp that they were false; and (4) Lancorp justifiably relied on Defendant's misrepresentations, as a result, suffered over \$9 million in damages.

The Receiver is further entitled to summary judgment against Defendant for the money he received out of a *Ponzi* scheme. Transfers out of a *Ponzi* scheme are fraudulent as a matter of law and voidable under the Uniform Fraudulent Transfer Act ("UFTA"). In this case, Defendant admits receiving \$19,000.00 from Megafund. Megafund's own bank statements provide a detailed record of those transfers and further demonstrate that its directors operated Megafund as a *Ponzi* scheme. In particular, the undisputed material facts show that: (1) investor funds constituted virtually all of Megafund's revenue; (2) those funds were commingled and used for expenses unrelated to any legitimate investments; and (3) all investment "returns" to earlier contributors were in fact *Ponzi* payments from the commingled funds of later contributors.

The Receiver's Motion clearly sets forth undisputed material facts supporting his claims for

negligent misrepresentation and fraudulent transfer. Accordingly, summary judgment is appropriate in this case and the Court should enter judgment in favor of the Receiver and against Defendant.

II. ARGUMENTS AND ANALYSIS

A. Summary Judgment is Appropriate in this Case Because There is No Genuine Issue of Material Fact.

The material facts in this case are undisputed and, therefore, the Receiver is entitled to summary judgment as a matter of law. A party is entitled to summary judgment if there is no genuine issue as to any material fact. Fed. R. Civ. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). A fact is “material” only if it might affect the outcome of the case. *MacDonald v. Delta Air Lines, Inc.*, 94 F.3d 1437, 1440 (10th Cir. 1996); *see also Poulis-Minot v. Smith*, 388 F.3d 354, 363 (1st Cir. 2004). An issue is “genuine” only if a reasonable jury could return a verdict for the non-movant on the evidence. *MacDonald*, 94 F.3d at 1440; *Poulis-Minot*, 388 F.3d at 363. Stated another way, the Court should award summary judgment where the record, taken as a whole, could not lead a rational jury to find for the non-moving party. *See Logan v. Commercial Un. Ins. Co.*, 96 F.3d 971 978 (7th Cir. 1996).

There is no genuine issue of material fact regarding the Receiver’s negligent misrepresentation claim. Defendant admits preparing a letter that contained inaccurate, false, and misleading representations intended for Lancorp’s benefit. Lancorp’s director confirms that he relied on these representations and that Lancorp suffered over \$9 million in damages as a result. Clearly, the undisputed material facts compel a judgment in the Receiver’s favor.

Similarly, with respect to the fraudulent transfer claim, Defendant already admits that he received \$19,000.00 from Megafund. Therefore, the only material issue remaining is whether

Megafund was managed as a *Ponzi* scheme. As explained more fully below, bank records unquestionably establish this fact, entitling the Receiver to summary judgment.

B. The Receiver is Entitled to Summary Judgment on his Negligent Misrepresentation Claim.

Without question, Lancorp relied on the false statements in Defendant's letter when it lost over \$9 million through Megafund's investment scheme. Both Texas and Kentucky have clearly extended the tort of negligent misrepresentation to include cases where attorneys make false representations to non-clients. *See McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*, 991 S.W.2d 787, 791-93 (Tex. 1999); *Presnell Construction Managers, Inc. v. EH Construction, LLC*, 134 S.W.3d 575, 580-81 (Ky. 2004) (citing *Seigle v. Jasper*, 867 S.W.2d 476 (Ky. App. 1993)). Furthermore, in stating a negligent misrepresentation claim, both states follow the Restatement (Second) of Torts § 552. *See F.E. Appling Interests*, 991 S.W.2d at 791-93; *Presnell Construction Managers, Inc.*, 134 S.W.3d at 576-77. Accordingly, no choice of law analysis is necessary in this case because the applicable law is identical. *See Condrey v. SunTrust Bank of Ga.*, 429 F.3d 556, 566 (5th Cir.2005) (federal courts need not conduct a choice of law analysis when either state's law produces the same result).

Therefore, in this case, the Receiver is entitled to judgment on his negligent misrepresentation claim because: (1) Defendant made representations in the course of his business, profession, or in a transaction in which he has a pecuniary interest; (2) these representations conveyed false information for Lancorp's guidance in the course of its business; (3) Defendant admits he undertook no investigation as to the truthfulness of his statements and, in later conversations, did not warn Lancorp that they were false; and (4) Lancorp justifiably relied on

Defendant's misrepresentations and suffered over \$9 million in damages as a result. *Henry Schein, Inc. v. Stromboe*, 102 S.W.3d 675, 686 n.24 (Tex. 2002) (citing *Fed. Land Bank Ass'n v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991)); *F.E. Appling Interests*, 991 S.W.2d 787, 791 (citing the Restatement (Second) of Torts § 552). The Receiver need not prove knowing or reckless disregard for the truth—only that Defendant failed to exercise reasonable care in obtaining the information or communicating it to Lancorp. See *Fed. Land Bank*, 825 S.W.2d at 442.

A typical negligent misrepresentation case involves one party to a transaction receiving and relying on an opinion letter prepared by another party's attorney. *F.E. Appling Interests*, 991 S.W.2d at 793. That is exactly the situation presented here. In this case, Humphries clearly made several affirmative representations to Lancorp while serving as Megafund's legal counsel. *Defendant's Answer* [Dkt. No. 9] at ¶ 8. His opinion letter clearly assures that "all funds involved in the 'trading program' are secured in a brokerage account at a major investment institution" and that the principal amount of any funds invested would be "insured against losses of every description". *Humphries' Letter*, Exhibit "B-1" (App. at 24); see also *Defendant's Answer* [Dkt. No. 9] at ¶ 8; *Lancaster's Declaration*, Exhibit "B" at ¶ 4 (App. at 21-22). Defendant now admits that "the representations in that letter were incorrect" as well as "inaccurate, false, and misleading." *Defendant's Answer* [Dkt. No. 9] at ¶¶ 8, 19. Defendant also admits that he did not investigate those statements, even though he knew this letter was addressed to Lancorp's director and intended to secure an investment of several million dollars. *Defendant's Answer* [Dkt. No. 9] at ¶ 15 ("Defendant admits Lancorp was an intended beneficiary of his letter"); *Humphries' Deposition*, Exhibit "C" at 29-30, 32, 37-38 (App. at 26-31). Lancorp's director confirms that he did, in fact, rely on the Defendant's letter and, but for the representations stated therein, Lancorp would not have invested any money in the

Megafund investment scheme. *See Lancaster Declaration*, Exhibit “B” at ¶ 6 (App. at 22). As a result of Defendant’s conduct, Lancorp relied on these misrepresentations and suffered at least \$9,635,000.00 in damages. *Id.* at ¶¶ 6-7 (App. at 22); *see also Receiver’s Declaration*, Exhibit “A” at ¶ 4 (App. at 4). These undisputed material facts—including Defendant’s own admissions—clearly establish the Receiver’s claim for negligent misrepresentation and compel a summary judgment in his favor.

C. The Receiver is Entitled to Summary Judgment on his Fraudulent Transfer Claim.

(1) Transfers from a Ponzi Scheme are Made with Fraudulent Intent as a Matter of Law.

The Receiver claims that all transfers from Megafund to Defendant are voidable under the Uniform Fraudulent Transfer Act (“UFTA”) or the supplemental provisions of common law. In relevant part, that statute provides:

(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose within a reasonable time before or 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. & Com. C. § 24.005.¹ While creditors must ordinarily prove fraudulent intent to recover under this provision of the UFTA, that element is automatically established for transfers out of a Ponzi scheme. *Quilling v. Gilliland*, Civil Cause No. 3:01-CV-1617 (N.D. Tex. Mar. 6, 2002); *S.E.C. v. Cook*, 2001 WL 256172, *3 (N.D. Tex. Mar. 8, 2001); *see also, In re Ramirez Rodriguez*,

¹ The Kentucky Fraudulent Transfer Act also forbids transfers made with the intent to “delay, hinder, or defraud.” *See* Ky. Rev. Stat. § 378.010.

209 B.R. 424, 434 (Bankr. S.D. Tex.1997); *In re Independent Clearing House Co.*, 77 B.R. 843 (Bankr. D. Utah 1987). This presumption is necessarily true because a *Ponzi* scheme is insolvent from conception. *Warfield v. Byron*, 2006 WL 118250, *5 (5th Cir. Jan. 17, 2006), *citing Cunningham v. Brown*, 265 U.S. 1, 7-8 (1924). Accordingly, all payments from a *Ponzi* scheme—including compensation—are fraudulent transfers hindering, delaying and defrauding any creditors. *See Cook*, 2001 WL 256172 at *3, 4 (granting Receiver's motion for summary judgment to recover commissions paid from a *Ponzi* scheme); *see also Warfield*, 2006 WL 118250 at *6-7 (disgorging commissions skimmed from investor payments into a *Ponzi* scheme); *In re Alpha Telecom, Inc.*, 2004 WL 3142555, *4 (D. Or. Aug. 18, 2004) (disgorging commissions for selling securities for a *Ponzi* scheme). Therefore, to the extent that Megafund was a *Ponzi* scheme, Defendant has no legal basis to retain the assets transferred from investor funds.

(2) Bank Records Demonstrate that Defendant Received Transfers from a *Ponzi* Scheme.

The attached evidence conclusively shows that Megafund was, in fact, operated as a *Ponzi* scheme. The Receiver has taken possession of Megafund's accounts at Wells Fargo Bank and Southtrust Bank where Leitner received all known contributions from Megafund investors. *Receiver's Declaration*, Exhibit "A" at ¶ 5 (App. at 4). The account records are voluminous, so the Receiver directed his accountants to prepare a spreadsheet summary. *Id.*; *Account Summary*, Exhibit "A-1" (App. at 7-19). These bank records not only document the transfers to Defendant, but they also irrefutably prove that Megafund was operated as a *Ponzi* scheme. *Receiver's Declaration*, Exhibit "A" at ¶¶ 6-8 (App. at 4); *see also Cook*, 2001 WL 256172 at *3 (establishing a *Ponzi* scheme's existence through the receiver's undisputed affidavit).

A *Ponzi* scheme exists where money from new investors is used to pay “profits” to earlier investors, without the operation of an actual revenue-producing business. *See* Black’s Law Dictionary 1180 (7th ed. 1999); *Receiver’s Declaration*, Exhibit “A” at ¶ 7 (App. at 4) The bank records clearly show that investor funds constitute Megafunds’s only real revenue. *Receiver’s Declaration*, Exhibit “A” at ¶ 7 (App. at 4); *Account Summary*, Exhibit “A-1” (App. at 7-19). As Megafund received those funds, however, the investments were commingled and used to pay “returns” to earlier investors. *Receiver’s Declaration*, Exhibit “A” at ¶ 7 (App. at 4); *Account Summary*, Exhibit “A-1” (App. at 7-19). This kind of arrangement illustrates a classic *Ponzi* scheme. *Receiver’s Declaration*, Exhibit “A” at ¶ 7 (App. at 4).

Megafund’s bank records stand on their own in establishing the existence of this *Ponzi* scheme. *Id.* They show conclusively that: (1) investor funds constituted virtually all of Megafund’s revenue; (2) those funds were commingled and used for personal expenses rather than legitimate investments; and (3) any investment “returns” to earlier contributors were actually *Ponzi* payments from the commingled funds of later contributors. *Id.* at ¶ 8 (App. at 4). Defendant admits receiving \$19,000.00 of transfers from that account and has provided no evidence refuting the existence of this *Ponzi* scheme. *Id.* at ¶ 9 (App. at 4-5); *Defendant’s Answer* [Dkt. No. 9] at ¶ 11. Therefore, under the settled law of this district and the UFTA, the Receiver is entitled to judgment as a matter of law based on the undisputed material facts.

IV. CONCLUSION

For the above reasons, the Receiver respectfully requests that this Court enter summary judgment in his favor and against Kenneth W. Humphries, and enter an order (1) for judgment

against the Defendant for \$9,365,000.00; (2) disgorging the \$19,000.00 that he received from a *Ponzi* scheme; and (3) awarding the Receiver his reasonable attorneys' fees, expenses, costs, and interest, and such other and further relief, at law or in equity, to which he is justly entitled.

Respectfully submitted,

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ATTORNEYS FOR PLAINTIFF

CERTIFICATE OF SERVICE

On the 7th day of July, 2006 a true and correct copy of the above and foregoing was sent via first class mail, with full and proper postage prepaid thereon, to:

Kenneth Wayne Humphries
Post Office Box 74
110 East Ninth Street
Hopkinsvile, Kentucky 42241-0074

 /s/ Michael J. Quilling