IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

MICHAEL J. QUILLING, RECEIVER for FREDERICK J. GILLILAND, Plaintiff,	§	
v.	§	Civil Action No. 3:04-CV-251
GRAND STREET TRUST, HEARTLAND CONTROL TRUST, FUTURE CONTROL TRUST, MARIE MARGARITE GUECO MERCADO PAQUETTE, REIN EVANS SESTANOVICH, f/k/a DRESSLER REIN EVANS & SESTANOVICH, MELROSE ESCROW, INC. AND PAUL J. COHEN, Defendants.	§	

RECEIVER'S RESPONSE TO DEFENDANT REIN EVANS' MOTION TO DISMISS AND BRIEF IN SUPPORT

TO THE HONORABLE JUDGE OF SAID COURT:

COMES NOW, Michael J. Quilling, in his capacity as Receiver for Frederick J. Gilliland, and responds to the Motion to Dismiss filed by Rein Evans Sestanovich, L.L.P. f/k/a Dressler Rein Evans & Sestanovich, L.L.P. ("Rein Evans") and would respectfully show this Court as follows:

I.
Introduction

In March 2002, the Securities and Exchange Commission instituted suit against Frederick Gilliland in connection with a Ponzi scheme Gilliland had orchestrated to defraud and fleece investors out of in excess of $29 million. Gilliland has been indicted by the United States and is currently a fugitive in Canada awaiting extradition. On May 21, 2003, Michael J. Quilling was

appointed as receiver for the estate of Frederick J. Gilliland, including entities such as Sterling Assets Services, Ltd. and Sterling Management Services, Inc. that were owned or controlled by Gilliland. The purpose of this receivership was to preserve and protect the assets of the Receivership Estate for the benefit of all creditors of the Receivership Estate including investors who had been defrauded by Gilliland's Ponzi scheme.

By this lawsuit, the Receiver seeks to recover assets of the Receivership Estate that were fraudulently transferred to Rein Evans as part of Gilliland's Ponzi scheme. Specifically, the Receiver seeks to recover in excess of $1,500,000 of investor funds that were fraudulently diverted to Rein Evans in October 1998. These funds were fraudulently transferred from entities owned or controlled by Gilliland to Rein Evans.

Rein Evans brought its motion seeking to have the Receiver's claims dismissed on several grounds, each of which is baseless. Rein Evans' arguments ignore the purpose of federal equitable receiverships and the procedures in place to meet that purpose. Once these equitable procedures and principles are examined, it is apparent that (1) this Court properly has jurisdiction over the claims brought by the Receiver in this lawsuit; (2) the Receiver has standing to assert the claims brought in this lawsuit; (3) the Receiver's claims are not barred by limitations principles; and (4) the dominion and control arguments presented by Rein Evans are premature and do not justify dismissing the Receiver's claims. Accordingly, Rein Evans' Motion to Dismiss should be denied, and the Receiver should be permitted to proceed with prosecuting his claims against Rein Evans.

II.
Arguments and Authorities

A. This Court May Properly Exercise Personal Jurisdiction Over Rein Evans.

The *in personam* jurisdiction of a Court in a federal equity receivership proceeding is not governed by traditional minimum contacts analysis. Rather, in cases involving federal equity receiverships, the receivership court acquires nationwide jurisdiction based on the interplay of 28 U.S.C. § 754 and 28 U.S.C. § 1692. *S.E.C. v. Vision Comm., Inc.*, 74 F.3d 287, 290 (D.C. Cir. 1996); *American Freedom Train Foundation v. Spurney*, 747 F.2d 1069, 1073 (1st Cir. 1984); *Haile v. Henderson Nat'l. Bank*, 657 F.2d 816, 823-24 (6th Cir. 1981); *Wing v. Storms*, Cause No. 1:02CV127DAK, 2004 WL 724448, *1 (D. Utah February 5, 2004); *Terry v. June*, No. Civ. A. 303CV00052, 2003 WL 22125300, *5 (W.D. Va. Sept. 12, 2003); *S.E.C. v. Cook*, Cause No. 3-01-CV-0480-R, 2001 WL 803791, *2-3 (N.D. Tex. July 11, 2001); *Select Creations, Inc. v. Paliafito America, Inc.*, 852 F. Supp. 740, 780-81 (E.D. Wis. 1994).

Federal Rule of Civil Procedure 4 contemplates that a district court may acquire personal jurisdiction through the use of statutes of the United States which provide for service of process upon a party not an inhabitant of or found within the state in which the district court is located. FED. R. CIV. P. 4(k)(1)(D); *see also Haile v. Henderson Nat'l. Bank*, 657 F.2d 816, 824 (6th Cir. 1981). Thus, if a congressional statute provides for extraterritorial or nationwide service of process, the district court has personal jurisdiction over all served within the extended territory of the district court. In receiverships, 28 U.S.C. § 754 and § 1692 provide for such extra-territorial service of process.

Section 754 extends the territorial jurisdiction of the district court to any territory where property of the receivership estate is present so long as the filing requirements of section 754 are met. Section 754 provides in pertinent part:

> A receiver appointed in any civil action or proceeding involving property, real, personal or mixed, situated in different districts shall, upon giving bond as required by the court, be vested with complete jurisdiction and control of all such property with the right to take possession thereof.
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> ***
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> Such receiver shall, within ten days after the entry of the his order of appointment, file copies of the complaint and such order of appointment in the district court for each district in which property is located.

Section 1692 then provides for service of process in any such district where 754 filings are properly made. Section 1692 provides in pertinent part:

> In proceedings in a district court where a receiver is appointed for property, real, personal or mixed, situated in different districts, process may issue and be executed in any such district, but orders affecting the property shall be entered of record in each such district.

Through the interaction of sections 754 and 1692 the receivership court acquires both *in rem* and *in personam* jurisdictions in all districts where section 754 filings are timely made. *Vision Comm., Inc.*, 74 F.3d at 290; *Haile*, 657 F.2d at 823-24. Courts which have recognized this interplay of Rule 4 and sections 754 and 1692 recognize that these provisions for extraterritorial service are "made to facilitate judicial efficiency by permitting courts to manage claims regarding receivership property in a single forum." *Terry v. June*, No. Civ. A. 303CV00052, 2003 WL 22125300, *5 (W.D. Va. Sept. 12, 2003).

In this case, the Receiver was originally appointed on May 21, 2003 and was then reappointed by order dated November 24, 2003.[1] On December 3, 2003, within the ten day period, the appropriate 754 filings were made in the Central District of California where Rein Evans is located.[2] Because such filings were made within ten days of the Receiver's reappointment, such filings are effective to extend the jurisdiction of this Court to the Central District of California. *Vision Comm., Inc.*, 74 F.3d at 291; *Terry*, 2003 WL 22125300 at *3 ("Courts having addressed this issue unanimously suggest that an order of reappointment will renew the ten-day filing deadline mandated by section 754."). Thus, by virtue of the timely made 754 filings and the provisions of section 1692, this Court has personal jurisdiction over Rein Evans who is located in the Central District of California.

Rein Evans attempts to avoid the effect of the application of sections 754 and 1692 by arguing that sections 754 and 1692 only apply to the extra-territorial extension of *in rem* jurisdiction. In making this argument, Rein Evans misstates the holding of *American Freedom Train Foundation v. Spurney*, 747 F.2d 1069 (1st Cir. 1984). Rein Evans represents to this Court that the First Circuit "held that 28 U.S.C. § 754 only governed property claims made in a receivership and did not apply at all to a claim that required *in personam* jurisdiction." *Memorandum in Support of Motion to*

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[1] The stated purpose in the Motion for Order of Reappointment [Docket No. 33] was so that the Receiver could institute these proceedings after complying with section 754.

[2] A copy of the transmittal letter, the first page of the Complaint (bearing file mark), and the first page of the Order Reappointing Receiver of the 754 filing that was made in the Central District of California are collectively attached hereto as Exhibit 1 to the Affidavit of Michael J. Quilling which is attached hereto as Exhibit A. Though the Receiver recognizes that Motions to Dismiss are not ordinarily determined on outside evidence, he is including these 754 filing materials so that the Court can confirm that the 754 filing requirements were met.

Dismiss at 13. In *American Freedom Train Foundation*, the receiver sought *in personam* jurisdiction over defendants, though no 754 filing had been made in the districts where the defendants were located. The district court held that because no 754 filings had been made in those districts, the court could not obtain *in personam* jurisdiction over the defendants. On appeal, the First Circuit clarified that the use of a 754 filing was not the exclusive means to gain *in personam* jurisdiction over defendants. *Id.* ("We think the district court erred when it concluded . . . that jurisdiction in an *in personam* receivership action . . . is governed exclusively by section 754."). Thus, the First Circuit did not hold that 754 cannot extend *in personam* jurisdiction, but rather acknowledged that section 754 will provide *in personam* jurisdiction so long as the filing requirements are met in the district where the defendant resides.

Rein Evans also relies on an unreported decision out of the United Stated District Court for the Northern District of Illinois for this proposition.[3] This case and an identical case out of the Northern District of Illinois are the only two cases that have held that the interaction of sections 754 and 1692 do not extend *in personam* as well as *in rem* jurisdiction. Not only are these decisions not binding on this Court, they fly squarely in the face of overwhelming authority cited above to the contrary.

Rein Evans also relies on *Gilchrist v. GE Capital Corp.* to support its argument that section 754 and section 1692 do not extend *in personam* jurisdiction. Admittedly, in *Gilchrist v. GE Capital*

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[3] The case cited by Rein Evans for this proposition is *Stenger v. World Harvest Church, Inc.*, No. 02 C 8036, 2003 WL 22048047 (N.D. Ill. Aug. 29, 2003). The holding and rationale of that case was repeated in another case from the Northern District of Illinois that was not cited by Rein Evans. *See Stenger v. Leadenhall Bank &Trust Co., Ltd.*, No. 02 C 8655, 2004 WL 609795 (N.D. Ill. Mar. 19, 2004)

Corp., the Fourth Circuit held that section 754 alone does not provide *in personam* jurisdiction unless there is an express congressional grant of personal jurisdiction. However, the Court did not consider (nor was it briefed or argued) whether section 1692 would provide such a congressional grant of personal jurisdiction (as has been held by each of the cases cited above), and instead the Court expressly refused to rule on the issue of personal jurisdiction as it had not properly been raised by the parties. In that the issue has never been expressly ruled on by the Fourth Circuit, there is no reason for this Court to conclude, as Rein Evans suggests, that the Fourth Circuit has held that there is no *in personam* jurisdiction. There is no indication that the Fourth Circuit would follow the interpretation of two unreported cases from the Northern District of Illinois rather than reported decisions from at least three Circuits. Additionally, a district court opinion from within the Fourth Circuit indicates that under Fourth Circuit precedent, it is proper to rely on sections 754 and 1692 to assert personal jurisdiction. *Terry v. June*, No. Civ. A. 303CV00052, 2003 WL 22125300, at *4 (W.D. Va. Sept. 12, 2003).

The facts of *Terry* are indistinguishable from the facts presented by this case. *Id.* at *1. Terry was appointed receiver for an individual and his entities that had engaged in a Ponzi scheme. *Id.* Terry filed suit against June to recover receivership assets that were transferred to June. *Id.* June sought to dismiss the claims on the grounds that the Virginia court lacked personal jurisdiction over him as he was a resident of Michigan who had no contacts with the state of Virginia. *Id.* Relying on the interplay of section 754 and 1692, the court held that the assertion of jurisdiction would be proper so long as "the assertion of jurisdiction over the defendant is compatible with due process." *Id.* at *4. In conducting this analysis, "the congressionally articulated policy permitting the assertion

of *in personam* jurisdiction should prevail except in cases of extreme inconvenience or unfairness." *Id.* at *5. "Such cases arise where the burden of distant litigation is so great as to put the defendant at a severe disadvantage." *Id.* at *4. "When the defendant is located within the United States, however, any inconvenience will rarely rise to a level of constitutional concern." *Id.* at *4. Though June would encounter some inconvenience in defending the suit in Virginia as he was a Michigan resident, the court held that this inconvenience did not rise to the level of extreme inconvenience or unfairness so as to implicate due process concerns. *Id.* at *5.

In the same way, in this case, although Rein Evans may be inconvenienced by litigating this matter in North Carolina, such inconvenience is not so extreme as to justify thwarting the congressionally articulated policy that allows for extraterritorial jurisdiction in receivership cases. Rein Evans attempts to magnify its inconvenience by arguing that litigation of this matter will be difficult given the distance from California to North Carolina. Given that Rein Evans has counsel in North Carolina and given that Rein Evans will not likely be required to travel to North Carolina for discovery purposes, this distance does not create an inconvenience that is so extreme as to justify thwarting the congressionally articulated policy that allows for extraterritorial jurisdiction in receivership cases. To hold otherwise would ignore and undermine the policy of facilitating judicial efficiency by permitting courts to manage claims regarding receivership property in a single forum. Therefore, it is proper for this receivership court to exercise *in personam* jurisdiction over Rein Evans.

B. The Receiver Has Standing to Assert the Fraudulent Transfer Claims.

Rein Evans' arguments regarding standing are based on the faulty premise that the Receiver is bringing claims that belong to the defrauded investors rather than claims belonging to the receivership estate. By this lawsuit, the Receiver is asserting fraudulent transfer claims that belong to Sterling Asset Services, Ltd., a corporate entity from whom the assets were fraudulently transferred. The funds at issue were transferred from an account in the name of Sterling Asset Services, Ltd. to a NationsBank account in the name of MM ACMC Banque Commerce, Inc. (the "NationsBank Account"). While the funds were in the NationsBank Account, Sterling Asset Services, Ltd. retained ownership and control of the funds. The funds were then transferred from the NationsBank Account at the direction of Gilliland.

The Receiver has standing to assert the fraudulent transfer claim at issue in this lawsuit because he was appointed receiver not only for Gilliland, but also for the "Receivership Estate" which is defined as including all assets of Sterling Assets Services, Ltd. and Sterling Management Services, Inc. and the assets of any other entity owned or controlled by Gilliland. Thus, the Receiver is the receiver for Gilliland and all corporate entities that were owned and/or controlled by him, including Sterling Asset Services, Ltd. In this case, the fraudulently transferred funds were owned by Sterling Asset Services, Ltd., an entity owned and controlled by Gilliland. Therefore, the Receiver has standing to assert the fraudulent transfer claims on behalf of Sterling Asset Services, Ltd. to recover funds and assets that were wrongfully diverted by Gilliland while he was in control of Sterling Asset Services, Ltd.

Rein Evans relies heavily on *Fleming v. Lind-Waldock & Co.*, in support of its arguments regarding standing. The holdings of *Fleming* are not persuasive or applicable given the facts of the present case. In *Fleming*, a receiver was appointed for USIC, a corporation. 922 F.2d 20, 22 (1st Cir. 1990). The receiver filed claims against third-parties alleging violations of the Commodity Exchange Act with regard to accounts that contained investor funds that were maintained with the third parties. *Id.* The receiver filed the claims both on behalf of USIC and on behalf of the investors. *Id.* The court dismissed the receiver's claims on two grounds. First, the court found that because USIC did not own the funds in the account, it had not and could not plead that it had suffered damages relating to the account. *Id.* at 24. Significantly, the receiver had been given two previous opportunities to amend its pleadings to state a claim on behalf of USIC by alleging facts relating to how USIC was damaged, and it had failed to do so.[4] *Id.* Second, the court held that the receiver could not assert the investors' claims because it not have any rights or powers over the investor's claims. *Id.* at 24-25.

The present case is clearly distinguishable from *Fleming*. First, the transferred funds were owned by Sterling Asset Services, Ltd. When these funds were fraudulently transferred, Sterling Asset Services, Ltd. was clearly damaged due to the loss of these funds as it was thereafter denied the use and control of these funds. Second, the Receiver has not brought any claims on behalf of the

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[4] If the Court does not believe that the Complaint states a claim against Rein Evans on behalf of Sterling Asset Services, Ltd., the Receiver requests leave to file an amended Complaint that will explicitly set forth the matters that are presented in this pleading. A motion to dismiss for failure to state a claim "should not be granted unless it appears certain that the plaintiff can prove no set of facts which would support its claim and would entitle it to relief." *Franks v. Ross*, 313 F.3d 184, 193 (4th Cir. 2002). Further, leave to amend should be freely given. FED. R. CIV. R. 4.

investors. Admittedly, the Receiver's Complaint indicates that the investors were ultimately harmed and defrauded by Gilliland's actions. However, that does not change the fact that Sterling Asset Services, Ltd. has a valid claim for damages. That these funds will ultimately be used to benefit the investors is of no moment and has no impact on this case.[5]

In a case analogous to this one, the Seventh Circuit has approved of a receiver bringing fraudulent transfer claims against third-parties. *Scholes v. Lehmann*, 56 F.3d 750, 754-55 (7th Cir. 1995). Scholes was appointed receiver for Michael Douglas and corporations controlled by him that had participated in a Ponzi scheme. *Id.* at 752. Scholes brought fraudulent transfer claims against third parties who had received transfers from the corporate entities. *Id.* at 753. The court held that because the corporate entities were harmed when assets were diverted through the fraudulent transfer, the receiver, as the holder of claims belonging to the corporations, had standing to assert these claims. *Id.* at 754-55.

The third parties argued that principles of *in pari delicto* should bar the claims of these corporations because they had been participants in the wrongdoing. *Id.* The court rejected this argument stating that "[t]he defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated." *Id.* at 754. "The appointment of the receiver removed the wrongdoer from

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[5] The United States District Court for Oregon recently issued an opinion in *In re Alpha Telcom, Inc.*, that supports the Receiver's position. A copy of the August 18, 2004 Opinion and Order of the Court is attached hereto as Exhibit B. In *Alpha Telcom*, the Receiver sought disgorgement of funds that had been transferred pursuant to a Ponzi scheme. The transferees argued that the Receiver could not bring the claims because the claims belonged to the initial investors. The Court rejected this argument. "Technically, the Receiver is not seeking restitution for the investors, but to recover funds belonging to Alpha Telcom. Most of those recovered funds will ultimately be paid to the investors, but that doesn't impair the Receiver's right to seek disgorgement from the agents." *Id.* at 20.

the scene. The corporations were no more Douglas's evil zombies. Freed from his spell they became entitled to the return of the moneys–for the benefit not of Douglas but of innocent investors–that Douglas had made the corporations divert to unauthorized purposes." *Id.*

Similarly, in this case, once the Receiver was appointed, Sterling Asset Services, Ltd. was freed from the control of Gilliland, and it became entitled to the return of the funds that were wrongfully diverted to Rein Evans. Under the clear and persuasive reasoning of the court in *Scholes*, the Receiver, as receiver for all entities owned or controlled by Gilliland, including Sterling Asset Services, Ltd., properly has standing to bring the fraudulent transfer claims that he is asserting against Rein Evans.

C. The Statute of Limitations Does Not Bar the Receiver's Claims.

Both California and North Carolina law provide that causes of action seeking to recover assets that have been fraudulently transferred may be brought within four years of the transfer, or in the case of transfers made with the intent to hinder, delay or defraud creditors, within one year of when the transfer was or could have reasonably been discovered by the claimant. CAL. CIV. CODE § 3439.09; N.C. STAT. § 39-23.9.

This case clearly involves a transaction that Gilliland directed with the intent to hinder, delay or defraud creditors. In cases involving Ponzi schemes, fraudulent intent on the part of the transferor is inferred. *In re World Vision Entertainment, Inc.*, 275 B.R. 641, 656 (M.D. Fla. 2002)(holding that payments made pursuant to a Ponzi scheme were made with the intent to defraud creditors and were as such fraudulent conveyances under section 726.105(a) of the Florida Fraudulent Transfers Act); *Quilling v. Gilliland*, Cause No. 3-01-CV-1617, 2002 WL 373560, *2 (N.D. Tex. March 6,

2002)(recognizing that a transferor's "intent to hinder, delay or defraud is established by the mere existence of the Ponzi scheme."); *S.E.C. v.* Cook, 2001 WL 256172, *3 (N.D. Tex. March 8, 2001)(same); *In re Ramirez*, 209 B.R. 424, 434 (Bankr. S.D. Tex. 1997)(holding that as a matter of law, payments of commissions and profits in a Ponzi scheme constituted transfers made with actual intent to hinder, delay and defraud); *Merrill v. Abbott (In re Independent Clearing House Company)*, 77 B.R. 843, 860 (D. Utah 1987).

The Receiver brought the claims in this suit within one year of when the fraudulent transfer was or could reasonably have been discovered. The Receiver was appointed by order dated May 21, 2003. The fraudulent transfers involved in this lawsuit could not have been discovered prior to that time. Prior to the time the Receiver was appointed, Gilliland remained in control of Sterling Asset Services, Ltd. Equitable tolling principles recognize that so long as a corporation remains under the control of wrongdoers, it cannot be expected to take action to vindicate the harms and injustices perpetrated by the wrongdoers. *Martin Marietta Corp. v. Gould, Inc.*, 70 F.3d 768, 772 (4th Cir. 1995). "The wrongdoers' control results in the concealment of any causes of action from those who otherwise might be able to protect the corporation." *F.D.I.C. v. Gonzalez-Gorrondona*, 833 F. Supp. 1545, 1557 (S.D. Fla. 1993). Thus, while Gilliland remained in control of Sterling Asset Services, Ltd., the fraudulent transfers were concealed and could not reasonably be discovered. These transfers only became discoverable when the Receiver was appointed and placed in control of Sterling Asset Services, Ltd. *In re Blackburn*, 209 B.R. 4, 13 (Bankr. M.D. Fla. 1997)(holding that under the principles of adverse domination, the statute of limitations was tolled until the appointment of the receiver).

The Receiver was appointed on May 21, 2003. It was only when the Receiver was appointed that the transfers involved in this lawsuit could be discovered by Sterling Asset Services, Ltd. This lawsuit was filed on May 20, 2004. Because this lawsuit was filed within one year of when the fraudulent transfer was or reasonably could have been discovered, the Receiver's claims are not barred by the statute of limitations. CAL. CIV. CODE § 3439.09; N.C. STAT. § 39-23.9.

D. Rein Evans' Arguments Premised on Dominion and Control Do Not Provide a Proper Basis for Dismissing Receiver's Claims.

A rule 12(b)(6) motion to dismiss for failure to state a claim "should not be granted unless it appears certain that the plaintiff can prove no set of facts which would support its claim and would entitle it to relief." *Franks v. Ross*, 313 F.3d 184, 193 (4th Cir. 2002). Rein Evans argues that the Receiver's claims should be dismissed because the allegations in the Complaint affirmatively establish that Rein Evans did not have dominion and control of the transferred funds and is therefore not a proper fraudulent transfer defendant. To the contrary, the allegations of the Complaint do not conclusively reveal that Rein Evans did not have dominion and control over these funds. Instead, the allegations support a finding that reveal that Rein Evans came into possession of funds that belonged to Sterling Asset Services, Ltd. and that at least with regard to a portion of these funds Rein Evans had control. Because these allegations are sufficient to meet the Receiver's pleading requirement, it is not proper to dismiss these claims premised on a 12(b)(6) motion.

Moreover, both the factual recitations and the case law cited by Rein Evans in its motion reveal that a rule 12(b)(6) motion to dismiss is not the proper procedural device to challenge whether Rein Evans was an initial transferee for purposes of the fraudulent transfer statutes. Each case that Rein Evans cited in support of its motion to dismiss on this issue was a case in which the Court was

considering the initial transferee issue as a fact question, not in the context of a motion to dismiss for failure to state a claim under Rule 12(b)(6).[6] Additionally, Rein Evans makes several unsupported factual allegations regarding its dominion and control over the funds in question. For example, it states that "Rein Evans did not have the right to use those funds for its own purposes." *Memorandum in Support of Motion to Dismiss* at 28. By making this and other statements, Rein Evans implicitly acknowledges that the issue of dominion and control is a fact question that must be resolved by this Court based on the evidence that is developed and presented by the parties.

To determine whether and to what extent Rein Evans exercised dominion and control over the transferred funds, this Court must examine the facts related to the transfers. Without competent evidence regarding the nature of the relationship between Rein Evans and the various entities involved in these transfers and the detailed nature of the transfers themselves, it is impossible to know the extent to which Rein Evans exercised dominion and control over the funds in question. Thus, because this issue is necessarily a fact issue that must be examined by the Court, it is not proper to consider Rein Evan's arguments regarding its status as an initial transferee in the context

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[6] *Bowers v. Atlanta Motor Speedway*, 99 F.3d 151 (4th Cir. 1996)(summary judgment); *Bowers v. Juse Enterprises, Inc.*; *Rupp v. Markgraf*, 95 F.3d 936 (10th Cir. 1996)(motion for judgment as a matter of law after conclusion of trial); *Security First National Bank v. Bruson (In re Coutee)*, 984 F.2d 138 (5th Cir. 1993)(submitted on stipulated facts for the Court's determination); *In re Lifecare Tech., Inc. v. Berman Law Firm, P.A.*, 305 B.R. 88 (M.D. Fla. 2003)(summary judgment); *In re Medical Cost Management, Inc.*, 115 B.R. 406 (D. Conn. 1990)(procedural context unclear, but court was considering testimony so clearly not a 12(b)(6) motion); *Gropper v. Unitrac, S.A. (In re Fabric Buys of Jericho, Inc.)*, 33 B.R. 334 (S.D.N.Y. 1983)(summary judgment).

of a 12(b)(6) motion to dismiss for failure to state a claim.[7] Because it does not appear certain that the Receiver can prove no set of facts which would support his claim and would entitle him to relief, the 12(b)(6) motion premised on Rein Evans dominion and control argument must be denied.

WHEREFORE, PREMISES CONSIDERED, Plaintiff prays that the Court deny Defendant Rein Evans' Motion to Dismiss and for such other and further relief, general or special, at law or in equity, to which he may show himself justly entitled.

Respectfully submitted,

QUILLING SELANDER CUMMISKEY & LOWNDS, P.C.
2001 Bryan Street, Suite 1800
Dallas, Texas 75201-4240
(214) 871-2100 (Telephone)
(214) 871-2111 (Facsimile)

By: _____
Michael J. Quilling
Texas Bar No. 16432300
D. Dee Raibourn, III
Texas Bar No. 24009495

ATTORNEYS FOR PLAINTIFF

[7] It would of course be proper for Rein Evans to raise its arguments at a later date in the context of a motion for summary judgment. However, before such a motion is considered, the Receiver should be given an opportunity to conduct discovery to determine the true nature of the underlying transactions so that a comprehensive evaluation of the extent of Rein Evans' control and dominion over the subject funds can be made.

CERTIFICATE OF SERVICE

I hereby certify that on the 30th day of August, 2004 a true and correct copy of the foregoing document was served via first class mail, postage pre-paid, on:

James B. Gatehouse
Rayburn, Cooper & Durham, P.A.
Suite 1200, the Carillon
227 WestTrade Street
Charlotte, NC 28202

Michael J. Quilling

Exhibit A

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

MICHAEL J. QUILLING, RECEIVER for FREDERICK J. GILLILAND, Plaintiff,	§	
v.	§	Civil Action No. 3:04-CV-251
GRAND STREET TRUST, HEARTLAND CONTROL TRUST, FUTURE CONTROL TRUST, MARIE MARGARITE GUECO MERCADO PAQUETTE, REIN EVANS SESTANOVICH, f/k/a DRESSLER REIN EVANS & SESTANOVICH, MELROSE ESCROW, INC. AND PAUL J. COHEN, Defendants.	§	

AFFIDAVIT OF MICHAEL J. QUILLING

Before me, the undersigned Notary Public, personally appeared Michael J. Quilling, who, upon his oath, deposed and said:

1. My name is Michael J. Quilling. I am over 21 years of age. I have never been convicted of a felony. I have personal knowledge of the facts set forth in this affidavit.

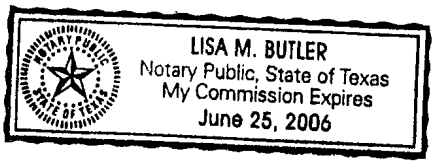
2. I am the Receiver appointed in these proceedings as to Frederick J. Gilliland. I was reappointed by Order dated November 24, 2003. On December 3, 2004, I caused a copy of the complaint in this matter and a such order of appointment to be filed in the United States District Court for the Central District of California. A true and correct copy of the cover page transmitting these materials to the Court and the filed marked first page of the complaint and order of appointment are attached hereto as Exhibit 1.

Further Affiant sayeth naught.

Michael J. Quilling

STATE OF TEXAS)
)
COUNTY OF DALLAS)

Sworn and subscribed to before me, the undersigned Notary Public, by Michael J. Quilling on this 30th day of August, 2004.



Lisa M. Butler
NOTARY PUBLIC in and for the State of Texas

Exhibit 1

Laura G. Scurlock
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QSCL
QUILLING · SELANDER · CUMMISKEY · LOWNDS

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December 2, 2003

Via Federal Express,
Priority Overnight Delivery

MISC 03-132

Office of the Clerk
United States District Court
Central District of California
255 East Temple Street
Los Angeles, CA 90012

Re: Civil Action No. 3:02CV128-MCK; *Securities & Exchange Commission, vs. Frederick J. Gilliland, and MM ACMC Banque De Commerce, Inc.*

Dear U.S. Clerk:

Pursuant to 28 U.S.C. Section 754, please find enclosed certified copies of the following pleadings:

1. Order Reappointing Receiver; and
2. Original Securities and Exchange Commission's Complaint.

Under 28 U.S.C. Section 754, a federal receiver appointed in one district may sue in any federal district court and/or be vested with complete jurisdiction and control of all such property in that district. However, Section 754 requires that the receiver file, within ten days of his/her order of appointment (or reappointment in this case), copies of the complaint and order of appointment (or reappointment) in the district court for each district in which the receiver plans to sue or the subject property is located. Based on past experience, these documents are filed as miscellaneous actions. Accordingly, **please file these documents, including this cover letter, and return a file-stamped copy to me in the provided fed-ex package.**

Also please find enclosed a check in the amount of $39.00 for the necessary filing fee under 28 U.S.C. Section 754. Should this fee be inadequate, please file the documents (since there is a short time frame for filing) and contact me regarding the proper fee. I will send the necessary fee immediately. Thank you for your assistance in this matter and please do not hesitate to contact me should you have any questions at (214) 871-2100 or (214) 871-2111 (fax).

Very truly yours,

Laura G. Scurlock

LGS/cp
Enclosures

COPY

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. FREDERICK J. GILLILAND, Defendant, and MM ACMC BANQUE DE COMMERCE, INC., Relief Defendant.	MISC 03-132 CIVIL ACTION FILE NO. 3:03CV128-H

COMPLAINT FOR INJUNCTIVE AND OTHER RELIEF

The plaintiff, Securities and Exchange Commission ("Commission" or the "Plaintiff"), files this complaint and alleges the following:

SUMMARY

1. This case involves a multimillion-dollar, prime bank securities fraud promoted by Defendant Frederick J. Gilliland ("Gilliland") throughout the United States, Canada and the United Kingdom. Relief Defendant MM ACMC Banque De Commerce, Inc. ("MBC"), a North Carolina corporation controlled by an acquaintance of Gilliland, was unjustly enriched by the receipt of $20 million of the ill-gotten gains Gilliland raised through his fraudulent schemes.

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

SECURITIES & EXCHANGE COMMISSION,
Plaintiff,

vs.

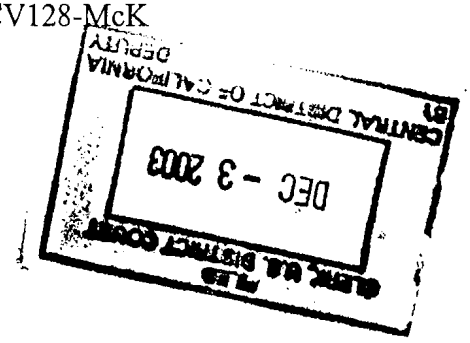
FREDERICK J. GILLILAND,
Defendant,

and

MM ACMC BANQUE DE COMMERCE, INC.,
Relief Defendant.

MISC 03-132

CIVIL ACTION FILE
NO. 3:02CV128-McK



ORDER REAPPOINTING RECEIVER

On May 21, 2003 the Court signed an Order Appointing Receiver pursuant to which Michael J. Quilling was appointed to act as the Receiver for Defendant Frederick J. Gilliland and all entities owned or controlled by him. Since his appointment the Receiver has been tracing funds relating to this case and believes he may have identified choses in action and other potential receivership assets in other federal districts. In order to comply with the requirements of 28 U.S.C. § 754 and to confer jurisdiction upon this Court regardless of the location of the receivership assets, the Receiver has filed a Motion for Order Reappointing Receiver. The Court, having carefully considered the Motion and relevant case law, concludes that the Motion should be granted.

Therefore, it is Ordered that Michael J. Quilling is hereby REAPPOINTED as Receiver in these proceedings as to Frederick J. Gilliland and all entities owned or controlled by him. This

Exhibit B

UNITED STATES DISTRICT COURT

DISTRICT OF OREGON

IN RE ALPHA TELCOM, INC., et al.	)	CV 01-1283-PA
	)	
	)	OPINION AND ORDER

PANNER, J.

The Receiver appointed to manage the affairs of Alpha Telcom, Inc., moves for disgorgement of approximately $21 million, plus interest, from 165 former sales agents.[1] The Securities and Exchange Commission ("SEC") joins in that motion. The background facts are discussed in SEC v. Rubera, 187 F. Supp.2d 1250 (D. Or. 2002), aff'd, 350 F.3d 1084 (9th Cir. 2003).

The motion targets only those agents who allegedly received at least $25,000 in commissions. Other agents were excluded after the Receiver concluded it would cost more to pursue them than was likely to be recovered, or the agent could not be located. An agent who received $25,000 in commissions would have

[1] For various reasons, Plaintiffs have now dismissed the motion as to former agents Judie Allen Dow, Ralph Shaul, Frank Sloan, Ivan Shepard, Joe Combest, Rick Dyer, Roger Goodwin, and James Grimes. The SEC, but not the Receiver, also withdrew the motion as to Dennis Watts.

sold approximately $250,000 worth of payphones, at $5,000 each (*i.e.*, at least 50 payphones). Some agents received considerably more than $25,000 in commissions.

The court has received numerous objections to the motion.

1. Personal Jurisdiction and Venue:

Many agents assert they have no ties to Oregon, hence any proceedings must be commenced in their respective home states. They are mistaken. The claims by the Receiver and the SEC (hereafter, "Plaintiffs") are ancillary to the Receivership this court is administering. This court necessarily has jurisdiction over matters pertaining to that Receivership, and the assets thereof. The Bankruptcy case also is situated in Oregon. In addition, Alpha Telcom was based in Oregon, the agent's sales contracts were with a company headquartered in Oregon and contemplated an ongoing relationship, and the contracts specified that Oregon law would govern any dispute. Finally, I note that nationwide service is authorized in most securities law cases. See 15 U.S.C. § 77v(a); 15 U.S.C. § 78aa. Ties to the United States, as a whole, are sufficient to support jurisdiction under a nationwide service statute.

The court also must decide whether Oregon is a proper venue. With 165 agents scattered across the country, no single venue will be convenient for everyone, yet the motion must be heard somewhere. It is not practical for many courts to each decide the same questions, and perhaps reach inconsistent results. SEC v. Vigman, 764 F.2d 1309, 1317-18 (9th Cir. 1985). Oregon is the most logical choice. This will not cause undue hardship for the

agents. There is no need for them to appear in person in Oregon, and little occasion for discovery or live testimony.

2. Summary Procedures and Failure to Serve Summons:

The Receiver tried to save money by not formally serving a summons upon each agent. Instead, the Receiver mailed copies of the motion to the agents' last known addresses. The agents contend the failure to serve them with summons is fatal. I disagree. A formal summons and complaint are required to commence an "action." SEC v. McCarthy, 322 F.3d 650, 656-57 (9th Cir. 2003). The motion before the court is not an independent action. It is part of the Receivership proceeding, and seeks to recover funds the agents received from Alpha Telcom that they allegedly have no legitimate claim to possess. The agents are what is sometimes referred to as "nominal defendants." See SEC v. Colello, 139 F.3d 674, 676-77 (9th Cir. 1998).

What is important here is not the precise form of notice, but that the agents received notice of the motion, were advised what was at stake, and given a meaningful opportunity to be heard. See SEC v. Wencke, 783 F.2d 829, 838 (9th Cir. 1986).[2]

A more serious flaw is the difficulty in proving that an agent actually received notice of the motion. The Receiver did not even send the motions by certified mail. Many agents

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[2] Although the procedure employed was not fatally deficient, it should not be emulated. The Receiver seemingly could have accomplished the same result, with far less risk, by invoking FRCP 4(d) and asking the agents to waive service, or else they must pay the additional cost incurred for personal service. In most cases in which summary procedures have been employed, the individuals were already participating in the litigation in some capacity. Even certified mail would have been preferable, supplying some proof that the mailing was received.

responded to the motion by filing objections or other material. The court can infer they received actual notice. In addition, the Receiver previously sent multiple mailings to the same list, and updated it when necessary. The court also required the Receiver to send a follow-up mailing to the agents. There is a rebuttable presumption that mail, properly addressed, has been delivered. In addition, the agent contracts often specified an address for serving notice upon the agent in connection with the contract. Finally, many agents are in regular contact with each other, as evidenced by communications the court has received.

It appears that the vast majority, if not all, of the agents received actual notice of the pending motion. For that reason, I will assume the motion is properly before the court. See EEOC v. Pan American World Airways, Inc., 897 F.2d 1499, 1508 (9th Cir. 1990) ("Actual knowledge of the pendency of an action removes any due process concerns about notice of the litigation"). However, I express no opinion regarding the result if a disgorgement order were collaterally attacked by an agent who truly was unaware of the motion, and had no opportunity to defend. The Receiver assumed that risk by proceeding in this manner.

The Receiver further complicated matters by mailing the motions on December 24, addressed to locations scattered around the country, and advising the agents that any opposition had to be received by this court within 11 calendar days, *i.e.*, by January 4. Given the holidays and bad weather, many agents were fortunate even to receive the motion by that date, let alone to have an opportunity to retain counsel and mount a defense. This

deadline was not calculated to afford the agents a meaningful opportunity to be heard. Cf. Mullane v. Hanover, 339 U.S. 306, 314-15 (1950).

The court then interceded, giving the agents an extension of time until February 2, 2004, and requiring the Receiver to furnish them notice of that extension. The court heard oral argument on February 18, 2004, and then gave the agents until March 9, 2004, to file any additional materials. That deadline was later extended to April 26, 2004. With the court's permission, additional materials also were filed on May 4, 2004.

Over the Receiver's objections, the agents were allowed to intervene as defendants in this case, and many have done so. Discovery was very limited, as most issues implicated by this motion are legal, not factual. However, the court did establish a procedure for agents to contest the amount of commissions allegedly received. Many agents are represented by counsel, who capably briefed and argued their defense.

Ultimately, the agents had a meaningful opportunity to be heard regarding the motion, the Receiver's missteps notwithstanding.

3. Statute of Limitations, Laches:

The disgorgement motion is not barred by the statute of limitations or laches. See SEC v. Rind, 991 F.2d 1486 (9th Cir. 1993). Nor was the motion unduly delayed. The Ninth Circuit's opinion, affirming my determination that Alpha Telcom was selling unregistered securities, was issued December 5, 2003. The disgorgement motion was filed later that month.

4. Bankruptcy

Some agents have filed for bankruptcy. Plaintiffs dismissed their motion as to three. As for the other agents in bankruptcy, the SEC may recover a judgment against them, notwithstanding the automatic stay; however, any attempt to collect on that judgment remains subject to the bankruptcy proceeding. See SEC v. Cross Financial Services, 908 F. Supp. 718 (C.D. Calif. 1995).

5. Default

Plaintiffs contend they are entitled to prevail, by default, against any agent who did not respond to the motion. I disagree. Plaintiffs still must establish that they are entitled to the relief sought. The rulings I make regarding the agents who did appear will apply to the absent agents as well.

6. Theories on Which the Plaintiffs Seek Relief

Plaintiffs seek relief under two theories: unjust enrichment and fraudulent transfer. Typically, in securities cases, disgorgement is employed to deter violations of securities laws by depriving violators of their ill-gotten gains. Although disgorged funds may be used to compensate victims for their losses, such compensation is a distinctly secondary goal. SEC v. Fischbach Corp., 133 F.3d 170, 175 (2nd Cir. 1997).

Plaintiffs elected not to formally[3] accuse the agents of any

[3] Despite that, the Receiver's briefs and letters to the court are permeated with accusations of wrongdoing. That is inappropriate. The Receiver has not sought to prove those accusations, nor are they germane to the legal theories he advances. The only apparent reason for including those allegations is to bias the court. The Receiver's briefs are similarly permeated with assertions that the investors are all impoverished and elderly. That, too, is not germane to the legal theories the Receiver asserts in this motion. It also is an

wrongdoing, or to shoulder the burden of proving malfeasance. Instead, Plaintiffs' request for disgorgement assumes the agents received money from a wrongdoer (Alpha Telcom), which the agents have no legitimate claim to, and must therefore return. In other words, they are alleged to have been a gratuitous donee of Alpha Telcom's ill-gotten gains. Ordinarily, the gratuitous donee theory is invoked when third parties received gifts from the wrongdoer, or were helping to hide assets for him, or perhaps received payments for aiding in an illicit scheme. Cf. SEC v. Better Life Club of America, Inc., 995 F. Supp. 167, 181-84 (D. D.C. 1998) (operator of Ponzi scheme used proceeds to buy expensive gifts for girlfriend, and to establish trust fund for benefit of wrongdoer's children; disgorgement ordered). The present case is different.

Crucial to the Plaintiffs' case is the contention that the agents have no legitimate claim to the funds they received. "[T]he creditor plaintiff must show that the nominal defendant has received ill gotten funds *and* that he does not have a legitimate claim to those funds." SEC v. Colello, 139 F.3d at 677 (emphasis in original). Plaintiffs bear the burden of proving the absence of a legitimate claim. It is not an affirmative defense. Id.

The agents deny they were gratuitous donees, or unjustly enriched. They contend they earned the commissions. Any money

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oversimplification. Many investors undoubtedly suffered great harm. I've received numerous letters from them. However, the investors also include wealthy doctors, large trust funds, and others who were not impoverished. The reality is more complex than the black and white portrait the Receiver paints.

received was in accordance with their agent contracts, and paid only after Alpha Telcom received money from the investor. The agents also note that other employees of Alpha Telcom were not asked to return their salaries, nor were equipment suppliers required to return the payments they received.

Plaintiffs argue that Alpha Telcom lost money on its telephone operations, and was a Ponzi scheme and an unregistered security. Consequently, they reason, the company received no value from sales of new phones, notwithstanding that Alpha Telcom received large infusions of cash as a result of those sales. Rather, each sale merely increased the company's liabilities and legal exposure. That's an interesting theory, but not persuasive. If a salesman generated large orders for his company, but for reasons beyond his control the company eventually lost money on those orders, we wouldn't say that the salesman provided no value to the company, and therefore must return his salary and commission.

Plaintiffs argue that it is different here, because the agents were participants in a Ponzi scheme. However, Plaintiffs haven't charged the agents with wrongdoing, nor shouldered the burden of proving scienter.

Plaintiffs also contend that the services of the agents were of no value because those services helped to perpetrate a fraud. The same might be said of every person who furnished goods or services to Alpha Telcom, from the company that provided the payphones, to the people who serviced them, on down to the pizza delivery driver who brought food to meetings attended by Alpha

Telcom's key players. They all allegedly helped to perpetrate a fraud, knowingly or otherwise.

There is one critical distinction, however. The services provided by the agents were, in hindsight, illegal. They could not lawfully sell unregistered securities. It is a strict liability offense, regardless of whether they knew it was wrong. By contrast, it was not illegal to deliver pizza or to install telephones, even if those services may unknowingly have helped to perpetrate a fraud.

The agents were paid for furnishing illegal services. The law cannot permit them to benefit from the sale of unregistered securities. Consequently, the agents must disgorge the amount by which they were unjustly enriched.

Admittedly, this tends to make the agents guarantors of the products they sell. However, it also will make sales agents cautious, and they are in an ideal position to curb abuses. If an agent has doubts about the integrity of the product, or whether it is an unregistered security, the agent should not sell the product. Faced with the risk of disgorgement, due diligence might really be diligent, instead of an exercise in papering the file. This approach is not unprecedented in the law. For instance, modern product liability laws make retailers strictly liable, not just the manufacturer of the product.

Plaintiffs' alternative theory is fraudulent transfer. I do not find that theory persuasive. However, there is little to be gained from an extensive discussion, as the end result is the same under either theory.

7. Computing the Amount Owed

Plaintiffs bear the initial burden of showing that disgorgement is proper, and the approximate amount by which each agent was unjustly enriched. The agents can then attempt to refute this evidence. "The SEC bears the ultimate burden of persuasion that its disgorgement figures reasonably approximate the amount of unjust enrichment." SEC v. Thomas James Associates, Inc., 738 F. Supp. 88, 93 (W.D.N.Y. 1990).

Some agents dispute the amount of commissions received, or the purpose for which they received those payments. I previously established a process for resolving such disputes. If an agent received $50,000 or less, and in good faith disputed the amount claimed, the Receiver had to furnish evidence of the amounts paid. For those agents who allegedly received more than $50,000, the burden was shifted to the agent to furnish evidence of a discrepancy, and the Receiver then had to verify the amounts.

In several cases, the Receiver accepted the amounts acknowledged by the agent, rather than litigate over a few thousand dollar discrepancy, and adjusted his claims accordingly. In a few cases, the Receiver declined to reduce the claim, and furnished the agent with the records that allegedly support the Receiver's computations.

I will not resolve those few remaining disputes in this opinion, preferring to focus upon issues applicable to all agents. Within 20 days after this opinion is filed, any agent who disputes the amount of commissions attributed to that agent may submit affidavits and documentary evidence supporting their

position. The Receiver then has 10 days to respond. The court will decide the amount the agent is accountable for.[4]

8. Good Faith and Due Diligence

The agents contend they acted in good faith, relying upon legal opinions furnished by Alpha Telcom from two attorneys who said it was not a security, and an opinion from an accounting firm that said everything was kosher and the claimed tax credits were proper. Some agents say they made other inquiries, such as contacting the Better Business Bureau, Dun & Bradstreet, speaking to people in the industry, touring Alpha Telcom's facilities, reading decisions by state agencies dismissing claims against Alpha Telcom, contacting their state's attorney general, etc.

Some of this "due diligence" is clearly malarkey. For instance, some agents say they relied upon a court decision issued a year *after* Alpha Telcom went bankrupt.[5] Some agents undoubtedly were sophisticated enough to have known something was likely amiss, but didn't care so long as they continued to receive large commissions. Still, Plaintiffs chose not to shoulder the burden of proving bad faith. Accordingly, for purposes of this motion I assume the agents acted in good faith.

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[4] The court is aware of disputes regarding agents Neil Bagchi, Allan Gasper, Manuel Mendoza, William Orcutt, Mary Abdallah, Secured Financial Concepts, Steven LeBaron, West Coast Distributors, and Robert Phillips. Any challenge to the amount received must be in good faith, or sanctions may be imposed.

[5] SEC v. ETS Payphones, Inc., 300 F.3d 1281 (11th Cir. 2002), reversed *sub nom.* SEC v. Edwards, ___ U.S. ___, 124 S. Ct. 892 (2004). Prior to August 2002, an agent searching for published decisions regarding payphones would have found the district court opinion, which held that ETS was illegally selling securities and defrauding investors, and enjoined further sales. SEC v. ETS Payphones, Inc., 123 F. Supp. 2d 1349 (N.D. Ga. Nov. 20, 2000).

Good faith is not a defense, in itself. See SEC v. Harwyn Industries Corp., 326 F. Supp. 943, 956 (S.D.N.Y. 1971) (bona fide but mistaken belief in the legality of a transaction is no defense to an action by the SEC). Nevertheless, the agent's good faith may be considered as a factor in balancing any equities, and in deciding whether to allow a setoff for expenses.

9. Setoff for Expenses

The agents contend they are entitled to a setoff for expenses they incurred in selling payphones. They are not "entitled" to a setoff. However, the court has some discretion to allow a reasonable setoff, if appropriate under the circumstances. See SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1474-75 (2d Cir. 1996); SEC v. Huffman, 996 F.2d 800, 803 (5th Cir. 1993); Thomas James, 738 F. Supp. at 93.

Disgorgement may not exceed the amount by which the agent was unjustly enriched, plus interest. Hateley v. SEC, 8 F.3d 653 (9th Cir. 1993); SEC v. Softpoint, Inc., 958 F. Supp. 846, 867 (S.D.N.Y. 1997). "Any further sum would constitute a penalty assessment." SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978). To the extent an agent necessarily and reasonably incurred expenses to earn the commissions he must now disgorge, a setoff may be appropriate in some instances. Otherwise, disgorgement might exceed the amount by which the agent was unjustly enriched. See Thomas James, 738 F. Supp. at 92-94.

Plaintiffs cite numerous cases in which a setoff for expenses was denied. In each case, the defendant was found liable for intentional wrongdoing, e.g., securities fraud or

insider trading. Typical of those cases--and one often cited by other courts--is SEC v. Great Lakes Equities Co., 775 F. Supp. 211 (E.D. Mich. 1991), which declared that "it is within the district court's authority to disallow expenses incurred in perpetration of a fraud . . . ." Id. at 214, n. 20.

This line of cases is not on point. Despite the mud Plaintiffs hurl at the agents, there has been no finding of intentional wrongdoing. Plaintiffs also rely upon SEC v. Benson, 657 F. Supp. 1122 (S.D.N.Y. 1987), but it is not on point either. In Benson, a CEO who fraudulently diverted corporate funds for personal use was ordered to disgorge the money he stole. The court denied a setoff for expenses incurred in perpetrating the fraud, such as payments made to co-conspirators. The CEO also argued that he should be required to return only the money still in his possession; he had donated some to his favorite charities, and spent some to expand his stamp collection. The court understandably denied that request. "The manner in which Benson chose to spend his misappropriations is irrelevant . . . Whether he chose to use this money to enhance his social standing through charitable contributions, to travel around the world, or to keep his co-conspirators happy is his own business." Id. at 1134. This is very different from the facts of the instant case.

I conclude that the court has discretion in this instance to allow at least some credit for expenses. I next consider the amount of that credit.

The expenses claimed by the agents varies widely. Some of the agent tax returns viewed by the court would have difficulty

withstanding an audit. Some agents appear to have claimed much of their personal living expenses as business deductions. There also were claims for auto expenses exceeding $20,000 a year, or large travel expenses, even though many agents worked out of their homes and sold the product by telephone. Some agents, who sold more than one product, seek to setoff a large percentage of their total business expenses for that year, even though most of those expenses would have been incurred regardless of whether they were selling this particular product.

I seriously considered asking the Receiver to review the claimed expenses, for each agent, and determine which were necessarily and reasonably incurred to earn the disputed commissions. Ultimately, I concluded this was not practical, both in terms of administrative expense and the difficulty in determining which expenses were proper and which were not. Instead, I will establish a uniform setoff for expenses: 10 percent of the first $50,000 in commissions received by an agent, and 5 percent of all commissions over that amount. For example, an agent who received $75,000 in commissions may claim a setoff of $6,250 for out-of-pocket expenses. Some may feel that figure is too high, others will think it too low. The short answer is that this is equity, not rocket science.

10. Payments to Sub-Agents

Some agents employed sub-agents to sell the product. Alpha Telcom remitted commissions to the master agent, who passed a portion on to the sub-agent. The master agents contend they should be responsible only for amounts they personally retained,

and not for the amounts they passed through to the sub-agents.

These pass-throughs are essentially a private matter between the master agent and his sub-agents. It is not the Plaintiffs' problem. This also is partly subsumed within the setoff for business expenses.[6]

Of course, if Plaintiffs recover money directly from the sub-agents, they can't collect the identical funds from the master agent. That would be duplicative.[7] However, I'm not aware of any situation in which the same money is being sought from both.

11. Income Tax

The agents request a setoff for taxes paid on the income they are now being required to disgorge. That request is denied. It is a matter between the agents and the IRS (or state officials). The court will not interfere.

12. Setoff if Agent Lost Money Buying Payphones

Some agents purchased payphones for themselves or sold them to immediate family members, and lost those funds when Alpha Telcom went bankrupt. The Receiver has generously offered to credit those agents with a setoff against their disgorgement obligation, for up to the full amount lost, upon satisfactory

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[6] I also note that some sub-agents were family members of the master agent. In other cases, the master agent was a business, and the sub-agent was the sole shareholder of the business, who passed the money through to himself. Furthermore, many pass-throughs have already been deducted as "business expenses" on the master agent's tax return, partly offsetting that expense.

[7] To hedge against a possible bankruptcy, Plaintiffs can obtain a disgorgement order against both the master agent and sub-agent. They just can't collect twice for the identical commission.

proof. The Receiver has already dismissed claims against several agents who lost more money buying telephones than they received in commissions.

I will leave these (and other) adjustments to the discretion of the Receiver, subject to review by the court if an agent challenges the Receiver's decision.

13. Client Obtained a Refund from Alpha Telcom

Some agents say the people to whom they sold payphones eventually were reimbursed, selling their phones back to Alpha Telcom before all the money was gone. A few agents say they even warned clients to get out. That is good to hear, but not a defense to disgorgement of commissions retained by those agents.

14. Agent Personally Reimbursed Client for Losses

One agent says he personally (and voluntarily) repaid the losses incurred by the clients to whom he sold payphones. The Receiver has indicated that, upon satisfactory proof, he will credit those amounts. In the meantime, the court will enter a disgorgement order against the agent for the full amount due, and let the Receiver make any appropriate adjustments.

15. Being Sued Directly By Former Clients

Many agents say they are being sued by former clients, and contend they should not also be liable for disgorgement. I disagree. The injuries sustained by the former clients are entirely distinct from the commissions that the agent received. The agent can be liable for both. See SEC v. Penn Central Co., 425 F. Supp. 593, 599 (E.D. Pa. 1976). It is analogous to a malpractice claim against a surgeon. He may be required to

refund the amount paid for the surgery, and also be liable for any injury sustained by the patient.

Nevertheless, the Receiver has agreed to credit agents with a setoff for amounts they actually paid to those former clients (as opposed to an unpaid judgment), upon satisfactory proof. Again, the court will enter a disgorgement order for the full amount, and let the Receiver decide whether, and how much, to credit, subject to review by the court. Any such claims must be scrutinized closely, to ensure the payment is a legitimate arm's length transaction, and not collusional.

16. Agent is Being Pursued by Regulatory Agencies

Some agents say they are being sued, or have been disciplined, by regulatory agencies such as the NASD and SEC or by various state regulatory bodies. To the extent an agent has been fined, suspended, or otherwise disciplined by a regulatory body, that is a separate matter from the requested disgorgement. The remedies are cumulative, not mutually exclusive.

The Receiver has agreed to credit agents for amounts paid to a regulatory body as disgorgement of profits, but not amounts paid for penalties, fines, etc.

Many agents also say they are being pursued by the IRS, for having falsely promoted the telephones as a tax shelter. That does not warrant a setoff.

17. Financial Hardship

Every agent who responded to the motion insisted it would be a terrible hardship to disgorge the commissions, every penny of which had already been spent to pay day-to-day living expenses

for their family. A few agents provided details, but for many it was just a boilerplate assertion. Even fewer agents provided the detailed net worth statements and other documents required to truly evaluate their ability to pay. A debtor examination might also be required in some cases.

Present income, by itself, is not dispositive. An agent may have limited income yet retain substantial assets, or assets may have been placed in other names to hide them from creditors. An agent can also have limited assets today, yet stand to inherit a million dollars tomorrow. Even if an agent cannot pay the full amount now, he may at least be capable of making monthly payments. Agents also differ greatly in their standard of living. Inability to pay and still fund the comfortable lifestyle to which one has become accustomed should not be confused with a true inability to pay. I also note that many payphone investors have endured serious hardship, had their standard of living significantly reduced, and often have fewer opportunities to start anew given their advanced age.

Most published decisions treat inability to pay as being relevant only as a defense to a contempt charge once a disgorgement order has been entered, rather than a defense to entry of the order itself. See, e.g., SEC v. AMX, Int'l, Inc., 7 F.3d 71, 73 (5th Cir. 1993); SEC v. Musella, 818 F. Supp. 600 (S.D.N.Y. 1993); SEC v. Robinson, 2002 US Dist LEXIS 12811 (S.D.N.Y. 2002); SEC v. Thorn, 2002 WL 31412439 (S.D. Ohio 2002); SEC v. Inorganic Recycling Corp., 2002 WL 1968341 (S.D.N.Y. 2002); SEC v. Grossman, 1997 US Dist LEXIS 6225 (S.D.N.Y. 1997).

Cf. Steffen v. Gray, Harris & Robinson, P.A., 283 F. Supp.2d 1272, 1282 (M.D. Fla. 2003) (inability to pay is not a defense to enforcement of a disgorgement order if the contemnor voluntarily created the inability to pay).

I will order disgorgement without regard to an individual agent's present ability to pay the full amount. The Receiver will decide who to collect from, and in what amount, and may negotiate settlements and payment plans when appropriate. I am concerned about some inflammatory statements in the Receiver's briefs and letters that essentially characterize the agents as thieves. Some are, some aren't, but none are charged with fraud in this proceeding. Nevertheless, I am confident that the Receiver can set any personal feelings aside and will fairly and professionally discharge his obligations. The court remains available to resolve any dispute, but these determinations will be made by the Receiver in the first instance.

18. **Miscellaneous Objections**

Some agents argue that the person to whom they sold payphones is wealthy, and could afford the loss. That is not a defense to disgorgement.

One agent claims he spent $16,000 "to join an organization to recover phones from the Alpha Telcom estate" and attempt to recoup losses (for myself and clients), and requests a setoff in that amount. That request is denied.

Some agents argue that disgorgement is not appropriate because the investors have an adequate remedy at law, namely, a direct action for sale of an unregistered security, citing 15

U.S.C. § 771(c). They contend this provides a fairer remedy, and any money recovered would go directly to the investors, not the Receiver. Even if that were true, the potential availability of other remedies would not preclude Plaintiffs from seeking disgorgement, or a combination of legal and equitable remedies.

Some agents argue that the Receiver stands in the shoes of Alpha Telcom, and has no authority to assert claims on behalf of the investors. Technically, the Receiver is not seeking restitution for the investors, but to recover funds belonging to Alpha Telcom. Most of those recovered funds will ultimately be paid to the investors, but that doesn't impair the Receiver's right to seek disgorgement from the agents.

Many agents also question why disgorgement should be paid to Alpha Telcom, a wrongdoer, for the benefit of the company's successors. It is not my intent that this money be paid to the persons who ran the company into the ground. Rather, most of the money recovered should eventually go to the payphone purchasers, and to pay appropriate expenses. For legal reasons, however, the Receiver must bring the motion in the name of Alpha Telcom.

19. **Misleading the Investors**

At least one agent has been making a concerted effort to persuade payphone purchasers to fund the agent's legal defense. The statements made to justify this are utter nonsense, *e.g.*, that supporting the agent's legal defense is legally required so the payphone owners can prove they attempted to mitigate damages. To quote the old adage, "Fool me once, shame on you. Fool me twice, shame on me."

As a result of this deceptive campaign, the court has received numerous letters from payphone purchasers who fear the motion for disgorgement will somehow prevent them from seeking relief directly from the agents. It will not.

20. Request for Bar Order

Two agents seek a "bar order" precluding other persons, such as former clients, from bringing claims against the agents once they have disgorged commissions to Plaintiffs. See Fluck v. Blevins, 969 F. Supp. 1231 (D. Or. 1997) (explaining concept). The request is denied. First, this is not a settlement. Second, the agents are disgorging only retained commissions, which may be just a fraction of the losses sustained by the clients. Finally, the wide variety of potential claimants and legal theories makes it impractical to anticipate every scenario that may arise. The judge in any hypothetical future case can better determine the effect, if any, of disgorgement.

21. Prejudgment Interest

Plaintiffs want prejudgment interest assessed against each agent, at the rates provided by statute for post-judgment interest, 28 U.S.C. § 1961. Whether to award prejudgment interest, and the rate, are discretionary. Wessel v. Buhler, 437 F.2d 279, 284 (9th Cir. 1971); SEC v. Hughes Capital Corp., 917 F. Supp. 1080, 1089 (D. N.J. 1996). Computing prejudgment interest would be a complex task. The particular interest rate suggested by the Receiver varies weekly and is primarily intended for use when the principal is a fixed amount accruing on a specific date. By contrast, each agent received differing

amounts on differing dates spread over several years. For both logistical and equitable reasons, prejudgment interest is not appropriate in this instance. Any resulting savings can be applied toward defraying the agent's expenses.

Conclusion

The Motion (## 214 and 219) for Disgorgement is granted as modified above. The Receiver shall furnish the court with an updated spreadsheet showing the amounts to be disgorged from each agent, after deducting the setoff for expenses.

Within 20 days after this opinion is filed, any agent who disputes the amount of commissions attributed to that agent may submit affidavits and documentary evidence supporting their position. The Receiver then has 10 days to respond.

A copy of this opinion and order shall be sent to the attorneys of record, and any agents who appeared pro se. The Receiver shall also send a copy to all agents who have not yet appeared.

IT IS SO ORDERED.

DATED this 16 day of August, 2004.

HONORABLE OWEN M. PANNER
U.S. DISTRICT COURT JUDGE