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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re:	Chapter 11
THE 1031 TAX GROUP, LLC, *et al.*, (MG)	Case No. 07-B-11448
	Jointly Administered

--x

	Chapter 11
In re: INVESTMENT PROPERTIES OF AMERICA, LLC, *et al.*	Case No. 07-13621 (MG) Jointly Administered
Debtors	

--x

OPPOSITION TO CORDELL CONSULTANTS, INC.'S MONEY PURCHASE PLAN, A QUALIFIED RETIREMENT PLAN TRUST AND CORDELL FUNDING LLLP'S MOTION TO ENFORCE CHANNELING INJUNCTION AND CONFIRMATION ORDER

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I. PRELIMINARY STATEMENT

Anita Hunter ("Hunter"), as creditor and Class Action Plaintiff hereby opposes Cordell Consultants, Inc., Money Purchase Plan's and Cordell Funding LLLP's (collectively, "Cordell") Motion to Enforce Channeling Injunction and Confirmation Order as being beyond constitutional limits.

Hunter and the other 1031 Exchangers are creditors of the 1031 Debtors. Being a creditor of a debtor in bankruptcy does not cause the waiver of one's due process rights to pursue third party non-debtors who contributed to one's losses. The culpable third parties must also file a petition in bankruptcy to obtain such protection under the U.S. C. A.

The 1031 Debtors were defalcating trustees who converted the Exchanger's Exchange Funds to their own use by transferring them to Okun. Cordell then assisted Okun in operating a Ponzi scheme which entrapped Hunter and the other Exchangers. The 1031 Debtors, as defalcators, cannot settle Plaintiffs' claims against Cordell, another defalcator, and then assert that Plaintiffs, as innocent parties, are barred from further proceedings. The 1031 Debtors can only settle their own case or controversy against Cordell, not Plaintiffs' case or controversy. Plaintiffs' case against Cordell belongs to Plaintiffs and is not derivative of any case that the 1031 Debtors could have brought against Cordell.

II. RELEVANT FACTUAL AND PROCEEDURAL HISTORY

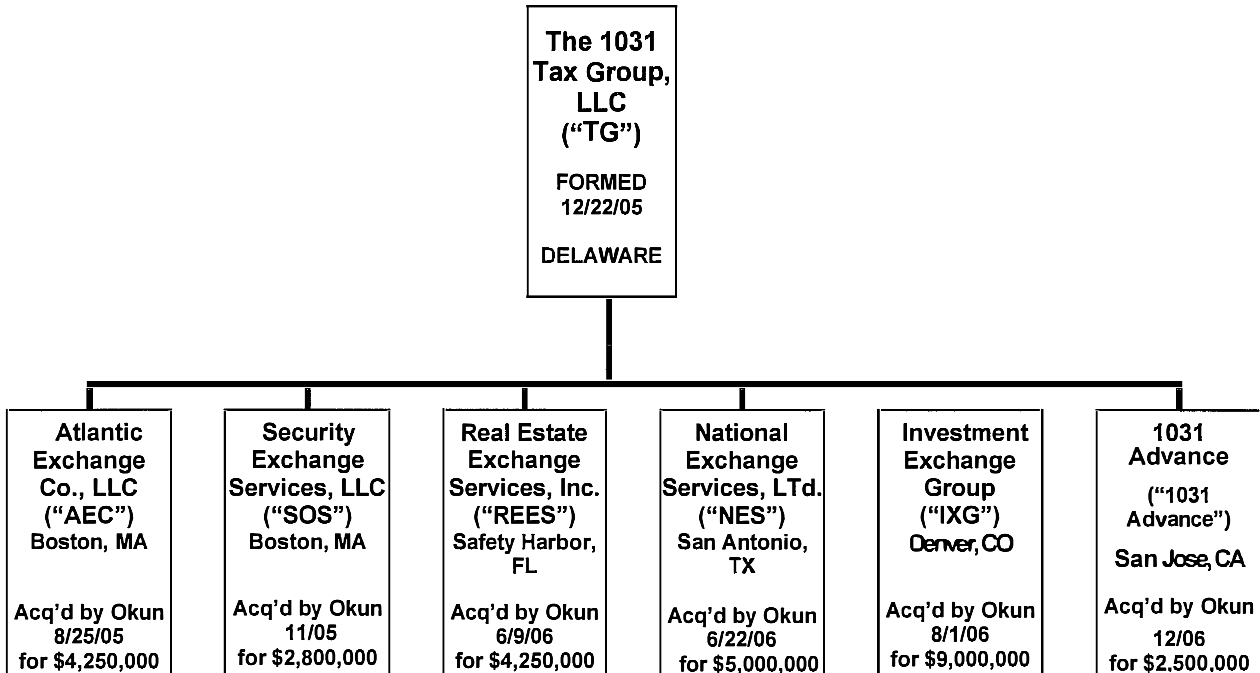
(i) The 1031 Debtors[1] are in bankruptcy and Hunter is a creditor.

Hunter, as a representative of the Class of 1031 Exchangers, contends that the 1031 Debtors, as Qualified Intermediaries ("QIs") are defalcating corporate trustees that committed fraud and converted the Plaintiffs' 1031 Exchange Funds at the direction of Edward Okun ("Okun") and with the assistance of Cordell. As such (with all due respect to Gerard McHale) it would be a legal impossibility for the 1031 Debtors (as defalcators) to prosecute, settle, and extinguish the direct claims of innocent Class Plaintiffs against other defalcators such as Okun

[1] The 1031 Debtors are: The 1031 Tax Group, LLC; 1031 Advance 132 LLC; 1031 Advance, Inc.; 1031 TG Oak Harbor LLC; Atlantic Exchange Company, Inc.; Atlantic Exchange Company LLC; Investment Exchange Group, LLC (aka "IXG"); National Exchange Accommodators, LLC; National Exchange Services QI, Ltd; NRC 1031, LLC; Real Estate Exchange Services, Inc.; Rutherford Investment LLC; Security 1031 Services, LLC; Shamrock Holdings Group, LLC; and AEC Exchange Company, LLC

or Cordell. Article III of the Constitution forbids such mischief.

The 1031 Debtors controlled by Okun, who owe the 1031 Exchangers more than $140 million in Exchange Funds looted by Okun, include, among others:



From May 2006 to April 2007, Cordell made a series of loans to Okun and the IPofA Debtors[2] totaling more than $52 million, secured by, among other collateral, real property that Okun had purchased using Exchange Funds converted by the 1031 Debtors from Exchangers and transferred to Okun. Proceeds from these loans were used by Okun, in part, to fund Exchanges closing at the 1031 Debtors to perpetuate a Ponzi scheme with the knowledge and assistance of Cordell. This Ponzi scheme entrapped the current roster of Exchangers who are now creditors of the 1031 Debtors. Cordell did not file a claim against the 1031 Debtors in bankruptcy. Cordell filed a claim against the borrowers of its money, the IPofA Debtors. (See Docket No.129). Cordell then settled the case or controversy it had with Jerry McHale ("McHale") as the court-appointed representative of the IPofA Debtors. The settlement

[2] The IPofA Debtors consist of IPofA LLC; 100 Corporate Drive, LLC; Crossroads Miami Logistics, Center Lease Co, LLC; Crossroads Miami Logistics Center, LLC; CW Acquisition, LLC; IPofA 5201 Lender, LLC; IPofA Columbus Works Lease Co; IPofA Shreveport Industrial Park, LLC; IPofA West 86th Street Lease Co., LLC; Simone Condo I, LLC; Simone Condo II, LLC; Columbus Works Virginia Trust; and Parkway Virginia Trust.

includes a release of all potential claims the 1031 Debtors held against Cordell. Cordell asserts that this settlement of the 1031 Debtors' claims against Cordell is binding, and serves as a full release of the Class of Exchangers' claims against Cordell seeking to recover damages for lost Exchange Funds.

(ii) The Class of Exchangers have sued Cordell for aiding and abetting Okun's Ponzi scheme which caused over $140 million in damages to these Exchangers.

On May 12, 2009, Hunter, along with other representative Exchangers that did business with AEC, SOS, REES, NES, IXG, 1031 Advance, and The 1031 Tax Group filed a class action against numerous defendants, including Cordell, in an action styled *Hunter, et al. v. Citibank, N.A., et al.*, Case No. 09-cv-2079-JW (hereinafter "*Hunter II*"). The Complaint is attached to Cordell's motion.

Previous to the filing of *Hunter II*, Hunter and other representative Plaintiffs filed a RICO action against Edward Okun which was consolidated with another action (filed in Massachusetts) before the Multi-District Litigation Panel ("MDL") as MDL No. 2028, styled *In re: Edward H. Okun Internal Revenue Service § 1031 Tax Deferred Exchange Litigation*, now pending in the United States District Court for the Northern District of California, Case No. 07-cv-2795-JW (hereinafter "*Hunter I*"). *Hunter I* and *Hunter II* are both pending before Hon. James Ware in the San Jose Federal District Court. Cordell has filed a Motion to Dismiss *Hunter II* based on the same arguments made in the instant Motion before the Bankruptcy Court.

Hunter and the Class Plaintiffs entered into a Common Interest Sharing Agreement ("Sharing Agreement") with Gerard A. McHale ("McHale"), the Trustee of the 1031 Debtors which was approved by this Court. The Sharing Agreement excludes Cordell so there will be no additional recovery to the 1031 Debtors Estates out of the Class litigation against Cordell. The Class Plaintiffs and McHale settled with the majority of the Defendants in *Hunter I* and these settlements were approved by this Court and by Judge Ware, who issued Rule 23 bar orders precluding 1031 Exchangers from suing any of the defendants who settled simultaneously with McHale and the Class. Cordell was not included in these settlements with

the Class. Cordell settled with McHale as Trustee of the 1031 Debtors and the representative of IPofA Debtors.

Hunter and the Class Plaintiffs in *Hunter II* allege that (i) each QI acted as a trustee of the Exchange Funds on deposit at each QI, and (ii) the Exchangers were the beneficiaries of the trusts established at each QI. The Class Plaintiffs allege further that Okun, as the person in control of each QI, converted the Exchange Funds for his own personal use. Once a deficit existed in each trust account, Okun operated a Ponzi scheme by inducing new Exchangers to deposit Exchange Funds which were used to fund older Exchanges pending at each QI. The current Plaintiffs are victims of this Ponzi scheme.

Plaintiffs allege that Cordell was fully aware of the prior looting of trust funds by Okun, and in May of 2006 began assisting Okun in perpetuating his Ponzi scheme by making loans to Okun and his entities, so that Okun could continue to make lulling payments to close pending Exchanges at the various QIs, and to acquire 1031 Advance, the last QI purchased by Okun. It was known by Cordell and Okun that the failure to close one Exchange on a timely basis at any of the QIs would end Okun's scheme. Plaintiffs allege that, beginning in May of 2006, Cordell was a knowing participant in Okun's scheme, creating joint and several tort liability for Cordell with Okun and his QIs. The Class Plaintiffs allege seven causes of action against Cordell to recover damages measured in part by the amount of their lost Exchange Funds. The causes of action include:

- First cause of action - Conversion;
- Second cause of action -Aiding and abetting a conversion;
- Fourth cause of action -Aiding and abetting breach of fiduciary duty;
- Fifth cause of action - Aiding and abetting fraud;
- Sixth cause of action - Conspiracy to convert Exchange Funds and to commit fraud;
- Seventh cause of action -Interference with Contract; and
- Ninth cause of action - Negligence.

(iii) Under established trust law, Exchange Funds are deposited with QIs in trust.

As beneficiaries of a trust relationship with the QIs, the 1031 Exchangers have

direct causes of action against Cordell which belong only to them. Everyone, including Cordell, has a duty to refrain and abstain from assisting a fiduciary in the breach of its fiduciary duties owed to the beneficiaries of the fiduciary relationship. The Exchangers were not shareholders of the 1031 Debtors seeking to prosecute derivative claims against Cordell for damages suffered by the 1031 Debtors. The 1031 Debtors were defalcating corporate trustees that, through Okun, conspired with Cordell to injure Hunter and other Exchangers. The Plaintiffs' damages are measured, in part, by the amount of their lost Exchange Funds, which damages belong to them, not to the QIs. As such, the 1031 Exchangers have exclusive standing to sue Cordell. The settlement of claims the 1031 Debtors held against Cordell cannot constitutionally bind these Plaintiffs. The allegations in the Hunter II Amended Complaint state in no uncertain terms that the Plaintiffs deposited their Exchange Funds in trust with each QI, that Plaintiffs are trust beneficiaries, and that Plaintiffs have sued Cordell in their capacity as trust beneficiaries.[3]

Plaintiffs' allegations are supported by the law of trusts.

The elements of a trust are:

> (i) a Trustee, who holds the trust property and is subject to duties to manage the trust for the benefit of one or more persons;
>
> (ii) one or more beneficiaries, to whom and for whose benefit the Trustee owes the duties with respect to the trust property; and
>
> (iii) the trust property, which is held by the Trustee on behalf of the beneficiaries.[4]

Pursuant to the express terms of each Exchange Agreement, a trust was created by (i) a transfer *inter vivos* by a property owner [each Exchanger] to another person [the QI] as trustee for one or more persons [each Exchanger], and, (ii) by a declaration from the QI, which held legal title to the property[5] that it holds the property as Trustee for one or more

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[3] See Complaint (attached to Cordell's Motion) ¶¶ 1, 2, 4, 6, 40, 41, 42, 43, 44, and 49, among others.

[4] Restatement of the Law (Third), Trusts § 2 at 21.

[5] 26 C.F.R. § 1.1031(k)-1 subsection (g)(4)(iv)(A) provides that "an intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers ***legal title*** to that property." *Id.*

persons [the Exchangers].[6] Such a declaration of trust creates a trust enforceable by the Exchangers as ascertainable beneficiaries.[7]

Each Exchange Agreement necessarily creates an express trust because there is no legally cognizable alternative. The Exchange Agreements do not describe a gift, a loan, a bailment, or a purchase of stocks, bonds or widgets. The Exchange Agreements describe a personal service contract, whereby the Exchangers pay a nominal fee for services rendered by the QI. There is no return of consideration for the transfer of Exchange Funds (ranging from thousands to millions of dollars) to the QI. Thus, a trust relationship is created as to the Exchange Funds and there is no alternative legal way to describe the transaction. Restatement of the Law (Third), Trusts § 5 at 57 is on point, providing:

> If [relinquished] property transferred by one person [the Exchanger] to another [the QI] and the transferee [the QI] agrees to sell that property and to pay its proceeds or a certain amount of proceeds to a third person [the seller of the replacement property], ordinarily a trust of the property is created. If, however, property is transferred by one person [the Exchanger] to another [the QI] who agrees in consideration thereof to assume a personal liability to a third person [the seller of the replacement property], a contract for the benefit of the third person and not a trust is created.[8]

In the case at bar, the QIs assumed no personal liability to the seller of the replacement property. Thus, a contract for the benefit of another was not created, leaving only a trust relationship. The QIs owed only one obligation to the Exchangers: to hold the Exchange Funds safely and then use them to purchase the replacement property as directed by the Exchanger. These elements clearly create a trust and not a contract for the benefit of another.

Each Exchange Agreement states that the QI will act as a qualified intermediary, as that term is defined in IRC Regulation 1.1031(k)-1(g)(4), in connection with Exchanger's exchange. 26 C.F.R. § 1.1031(k)-1 subsection (g)(4)(iv)(A) provides that "an intermediary is

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(emphasis added).

[6] Restatement of the Law (Third), Trusts § 10, 145.

[7] Restatement of the Law (Third), Trusts §§ 10 & 145; *Reagh v. Kelly,* 10 Cal. App. 3d 1082, 1092 (Cal. App. 1st Dist. 1970).

[8] *Id* at 57.

treated as acquiring and transferring property if the intermediary acquires and transfers ***legal title*** to that property."[9] The inclusion of "legal" to qualify "title" shows legislative intent that the transfer of equitable title to the QI is never necessary.

Courts ruling on the relationship between an Exchanger and a QI have agreed that §1.1031(k)-1 does not require the taxpayer to transfer its equitable interest in the relinquished property or the Exchange Funds derived from the sale of the relinquished property to the QI. "A taxpayer need not abandon all equitable interest in the proceeds from the downleg property for a transaction to qualify as a non-taxable event under section 1031."[10] Instead of requiring the taxpayer to abandon all equitable interests in the property, the regulations only require that the taxpayer not be in "constructive receipt" of the sale proceeds.[11]

The Exchangers were "at risk" for an unforeseen event when they purchased and held the relinquished property. The Exchangers would be again "at risk" for an unforeseen event when they purchased and held the replacement property. During the 180-day exchange window, there was no intended assumption of an investment risk by the Exchangers. The Exchangers agreed only to allow the QIs to "hold" their Exchange Funds until they were ready to close on replacement properties. Thus, the Exchange Agreements expressly articulate a relationship of trust.

In addition to express trusts, all of the states where the QIs in this case operated recognize the existence of resulting trusts in favor of the person who advances money for the purchase of real property, which each of the Exchangers did in this case. The QIs paid no consideration for the assignment of the relinquished property and Exchange Funds to them to effectuate the 1031 tax deferred Exchange. For AEC in Massachusetts see *Batty v. Greene*, 206 Mass. 561 (Mass. 1910); *Broomfield v. Kosow*, 249 Mass. 749, 758 (Mass. 1965); for SOS in Connecticut with a New York choice of law clause in its Exchange Agreements see

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[9] 26 C.F.R. § 1.1031(k)-1 subsection (g)(4)(iv)(A) (emphasis added).

[10] *Cook v. Garcia*, 1997 U.S. App. LEXIS 5980, *4 (9th Cir. Cal. Mar. 27, 1997); *See also State of Washington v. Grimes,* 111 Wn. App. 544, 46 P.3d 801 (Wash Ct. App. 2002).

[11] *DeGroot v. Exchanged Titles (In re Exchanged Titles)*, 159 B.R. 303, 306 (Bankr. C.D. Cal. 1993) (quoting *Alderson v. Commissioner of Internal Revenue Service,* 317 F. 2d 790, 795 (9th Cir. 1963).

Beatty v. Guggenheim Exploration Co., 225 N.Y. 380 (N.Y. 1919) ("When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee."); for REES in Florida see *Collinson v. Miller*, 903 So.2d 221, 228 (Fla. Dist.Ct.App.2d Dist. 2005); for NES in Texas see *Andrews v. Andrews*, 677 S.W. 2d 171 (Tex. App. Austin 1984) for IXG in Colorado, see *Ralston Oil & Gas Co. v. July Corp.*, 719 P. 2d 334 (Colo. Ct. App. 1985); for 1031 Advance in California, see *Siegel v. Boston (In re Sale Guar. Corp.*), 220 B.R. 660 (B.A.P. 9th Cir. Cal. 1998), *aff'd*, *Siegel v. Newman* (*In re Sale Guar. Corp.*), 199 F. 3d 1375 (9th Cir. Cal.2000) for The 1031 Tax Group in Virginia see *Morris v. Morris*, 248 Va. 590, 593, 449, S.E. 2d 816 (Va. 1994); *Gibbens v. Hardin*, 239 Va. 425, 389 (VA.1990); *Gifford v. Dennis*, 230 Va. 193, 198-199, (Va. 1985). The **civil law presumption** of the establishment of a trust is applied even when such presumption contravenes the express language of the written transaction documents (which is not the fact pattern here). *1924 Leonard Rd., LLC v. Van Roekel*, 272 Va. 543, 552 (Va. 2006).

III. LEGAL DISCUSSION

A. Plaintiffs' claims are not barred by the Settlement Approval Order or Chapter 11 Plan confirmation.

Cordell contends that the Bankruptcy Court's language in the Settlement Approval Order bars the Plaintiffs' direct claims against Cordell in *Hunter II*. Cordell's interpretation of the Settlement Approval Order is wrong. The Settlement Approval Order states, in relevant part, as follows:

> "all persons...are permanently enjoined from...commencing, conducting or continuing...any suit...against...Cordell...that is based upon or derivative of any claim or cause of action that could have been asserted against...Cordell ...by...the estates."

Hunter and the other Class Plaintiffs do not assert any claim against Cordell that is based on or derivative of any claim that could be asserted by the 1031 Debtors against Cordell. The Hunter Plaintiffs contend that Cordell was aiding the 1031 Debtors in breaching fiduciary duties owed directly to Exchangers, which resulted in their loss of over $140 million in Exchange Funds. There is no case or controversy between the 1031 Debtors and Cordell

arising out of this claim. To the extent that the 1031 Debtors had any claim against Cordell for lost fee income (as contrasted with lost Exchange Funds) this claim could have been asserted and was settled by the Trustee. *McHale v. Citibank, N.A. (In re: 1031 Tax Group, LLC)* 2009 Bankr. LEXIS 3810 (Bankr. S.D.N.Y. Dec. 3, 2009), at p. 39.

Cordell contends that its settlement with McHale as the Trustee for the 1031 Debtors bars Plaintiffs' direct claims against Cordell for lost Exchange Funds. Plaintiffs contend that their claims are distinct and direct claims against Cordell as contrasted with derivative claims brought by McHale on behalf of the 1031 Debtors. As such, McHale did not have standing to settle Plaintiffs' direct claims and the Bankruptcy Court does not have jurisdiction to issue an injunction barring Plaintiffs' direct claims. The other settling Defendants in Hunter I were aware of this fundamental limitation in the Bankruptcy Court's authority, and therefore insisted on a Rule 23 bar order issued by the Class court in Hunter I before agreeing to settle any of the outstanding claims asserted by McHale or the Class against the settling defendants.

The language employed by the Bankruptcy Court plainly limits the scope of the Settlement Approval Order issued in favor of Cordell so that it bars only those claims which could have been asserted by the Trustee on behalf of the 1031 Debtors against Cordell. The Bankruptcy Court did not limit the scope of the Settlement Approval Order arbitrarily. In fact, the Court could not have issued a full, comprehensive, "non-debtor release" in favor of Cordell (barring all claims, not just those which the Trustee could assert), because that would have been prohibited by law. *See, e.g., Deutsche Bank, AG, London Branch v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.*), 416 F. 3d, 136 (2d Cir. N.Y. 2005) (comprehensive non-debtor releases only issuable in "rare" and "extraordinary cases", only after the Court has determined that the release itself is important to the Plan [Judge Glenn issued no such determination with respect to the Cordell settlement) and where the Plan otherwise provides for the full payment of the enjoined claims [Plaintiffs claims are not paid in full]); *Resorts Int'l v. Lowenschuss (In re Lowenschuss)* 67 F.3d 1394, 1401-1402 (9th Cir. Nev. 1995) (bankruptcy courts prohibited from barring creditors' direct claims against non-debtors except in asbestos cases); and *In re At Home Corp.*, 154 Fed. Appx. 666, 668 (9th Cir. Cal. 2005).

B. The Bankruptcy Trustee can only settle the 1031 Debtors' claims and derivative claims against Cordell.

The Trustee stands in the shoes of the debtor, and may bring any suit that the debtor could have brought before bankruptcy. *Goldin v. Primavera Familienstiftung Tag Assoc.* (*In re Granite Partners, L.P.*), 194 B.R. 318, 323-24 (Bankr, S.D.N.Y. 1996) (citing *Hirsch v. Arthur Andersen & Co.,* 72 F.3d 1085, 1093 (2d Cir. Conn. 1995)). Under § 544(a) of the Bankruptcy Code, the trustee also stands in the shoes of creditors, and grants the trustee the status of a hypothetical judgment lien creditor as of the petition date. 11 U.S.C. § 544(a). "Section 544, however, does not extend beyond avoidance actions, and does not permit the trustee to assert the personal, direct claims of creditors for the benefit of the estate or for a particular class of creditors." *Granite Partners supra,* 194 BR. at 324 (citing *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F.2d 114, 118 (2d Cir. Conn. 1991)); *Hirsch v. Arthur Andersen &* Co., 72 F.3d 1085, 1093 (2d Cir.Conn.1995). Under Cordell's theory of due process, the Trustee of the 1031 Debtors can prosecute the Exchangers' direct claims against Cordell, recover money in settlement, and then distribute the Exchangers' recovery to other general creditors of the 1031 Debtors. The Bankruptcy Code does not provide for such a taking.

This Court must look to state law to determine which claims are direct and belong to the 1031 Exchangers, and which claims are derivative and belong exclusively to the trustee. *Johns Manville Corp. v. Chubb Indem. Ins. Co.(In re Johns-Manville Corp.),* 517 F.3d 52, 63 (2d Cir. N.Y. 2008); *Sobchaek v. American Nat'l Bank & Trust Co.* (*In re Ionosphere Clubs, Inc.,* 17 F.3d 600, 604 (2d Cir. N.Y.1994); *Granite Partners,* 194 BR. at 324; *Keene Corp. v. Coleman* (*In re Keene Corp.*), 164 B.R. 844, 849 (Bankr. S.D.N.Y. 1994).

If the Exchangers' causes of action against Cordell belong to the Debtors' estates, the Trustee has exclusive standing to assert them. Conversely, if the seven causes of action listed above belong solely to a distinct group of creditors (the Exchangers), the trustee has no standing to assert them. *Granite Partners,* 194 BR. at 324-25. When the Trustee has standing to sue, the automatic stay prevents creditors or shareholders from asserting the claim notwithstanding that outside of bankruptcy, they have a right to do so. *Id.* at 325; *Keene,* 164

BR. at 851-52.

To determine standing, or ownership of the seven causes of action, the Court must look to the underlying wrongs as plead in the Complaint and determine whether the Plaintiffs allege a particularized injury they suffered, rather than injury suffered by the 1031 Debtors. *Johns-Manville,* 517 F.3d at 63; *Granite Partners,* 194 BR. at 325 ("To determine standing, the Court must look to the nature of the wrongs alleged in the Complaint without regard to the plaintiffs' designation, and the nature of the injury for which relief is sought.") (citations omitted). The Court therefore only looks to the allegations as they are stated in the Complaint, not as they are characterized in the Plaintiffs' motion before this Court. *Granite Partners,* 194 BR. at 325-26; *Apostolou v. Fisher (In re Lake States Commodities, Inc.),* 188 BR. 958 (N.D. III. 1995). The Court also does not pass on the legal sufficiency of the claims. *Granite Partners,* 194 BR., at 326.

C. As alleged in the amended Complaint, the Class claims against Cordell in *Hunter II* are direct claims that can only be prosecuted by the Exchangers. The Class claims are not derivative claims that could be brought by the 1031 Debtors against Cordell.

(i) Conversion and aiding and abetting a conversion of Exchange Funds.

Hunter and the Class Plaintiffs allege that using their Exchange Funds to pay off older Exchanges pending at each QI (which could not close because prior clients' Exchange Funds had been used by Okun to purchase luxury items and real property) amounted to a conversion of Plaintiffs' Exchange Funds. The 1031 Debtors cannot maintain a conversion claim against Okun or Cordell because the 1031 Debtors, as entities controlled by Okun, consented to the use of Exchange Funds to operate Okun's Ponzi scheme. Under state law, the embezzlement [*State v. Grimes*, 2002 Wash App. LEXIS 3407 (Wash. Ct. App. Feb. 19, 2002)][12] or

[12] Embezzlement is the fraudulent appropriation of property by a person to whom it has been entrusted. Cal. Penal Code § 503. "The gist of the offense is the appropriation to the defendant's own use of property delivered to him for a specified purpose other than his own enjoyment of it:" *People v. Parker,* 235 Cal.App.2d 100,108-109 (Cal.App.3d Dist.1965*).* Embezzlement occurs where a relationship of trust and confidence exists between the defendant and another person, the defendant accepts property entrusted to him by the other person, and the defendant fraudulently appropriates or converts the property to his own use or purpose with the specific intent to deprive the other person of the property, at least temporarily. *People v. Talbot,* 220 Cal. 3, 13-16 (Cal. 1934); *People v. Miller,* 188 Cal. App. 2d 156 (Cal.App. 2d Dist. 1961).

commingling of 1031 Exchange Funds on deposit at a QI gives rise to a tort claim against the QI for conversion. *Manty v. Miller & Holmes, Inc. (In re Nation-Wide Exch. Servs.),* 291 B.R. 131 (Bankr. D. Minn. 2003). When a trustee co-mingles trust funds with his own and uses them in his private business, the transaction can be a breach of trust on two theories, namely, that of conversion of the trust property or disloyalty. Bogart, The Law of Trusts and Trustees, 2d Ed. § 533; 1 Perry on Trusts, Sec.128, 2 Pomeroy, Equity Juris., Sec. 1076, p. 654.

Managers of the QIs who knowingly participate with the QI in the conversion of Exchange Funds are directly liable to the Exchangers for aiding and abetting the conversion. *Cook v. The 1031 Exchange Corp.*, 29 Va. Cir. 302 (Va. Cir. Ct. 1992).

It is widely recognized that tortious acts committed by corporate officers on behalf of the corporation, including intentional torts, will subject the officers to direct liability to third parties.

> Corporate officers whose acts result in conversion by the corporation are personally liable though receiving no personal benefit. Good intentions are no defense to conversion. Further, it is not necessary that the corporate veil be pierced in order to impose personal liability when the records shows that the corporate officer knowingly participated in the conversion. . .A corporate officer's individual liability for conversion committed on behalf of the corporation is established in the same manner as liability for any other tort -by proof of active participation in the conversion.

3A Fletcher, Cyclopedia of the Law of Corporations § 1140 (Rev. Ed. 1994)(footnotes omitted). See also, P.H. Vartanian, Personal liability of corporate directors or officers to third persons for restitution, or for damages for conversion, under circumstances rendering the corporation itself liable, 152 A.L.R. 696 (1944).

Similarly, third parties doing business with the QI who assist in the conversion of Exchange Funds are also jointly and severally liable with the QI to the Exchangers for the conversion of Exchange Funds. In *Cahaly v. Benistar Property Exchange Trust Co.*, 68 Mass. App. Ct. 668; 864 N.E. 2d 548 (2007), the court stated:

> Conversion consists of a wrongful exercise of dominion or control over the personal property of another. The record fully supports the Judge's conclusions. The Benistar client agreements

[Exchange Agreements] transferred the plaintiffs' control over their sale proceeds [Exchange Funds] to Benistar, with a time limit on that control and restrictions on the use of those funds during the time of Benistar's possession. Benistar not only exceeded its authorization but also seriously violated the right of the plaintiffs to control their property. The unauthorized use in this case was sufficiently serious to amount to conversion. *Id.*

The fact that Hunter and the other Class Plaintiffs transferred legal title to their Exchange Funds to the QIs for a period between 1 and 180 days is no defense to a cause of action for conversion against Okun and Cordell as aiders and abettors. There are several well-recognized and practical exceptions to the "immediate right to possession" element of a conversion cause of action. One exception applies when the funds are held in trust. Restatement of Torts 2d, §243. Courts have established three exceptions to the "immediacy" requirement for the tort of conversion:

(1) Where the plaintiff has a special interest in the funds;[13]

(2) Where the plaintiff has relinquished possession of the funds to another for an express purpose and the recipient puts the property to a use different from that for which it was received;[14] and

(3) Where a fiduciary relationship exists because:

(a) the recipient of the funds is "bound to return to the owner the identical money";[15] or

(b) in an agency relationship, the agent has "knowledge of another's right to receive a specific amount of money" but applies that money "for his own use".[16]

In this case, Hunter and the Class Plaintiffs had a "special interest" in their Exchange Funds, the Exchange Funds were held in trust, the QIs were bound by the Exchange Agreements to use the Exchange Funds to purchase each clients' respective replacement

[13] *Util. Consumers' Action Network v. Sprint Solutions, Inc.*, 2008 U.S. Dist. LEXIS 34159 (S.D. Cal. Apr. 25, 2008

[14] *National Bank of New Zealand, Ltd. v. Finn*, 81 Cal.App. 317, 345-7 (1927).

[15] *Watson v. Stockton Morris Plan Co.*, 34 Cal.App.2d 393, 403 (Cal. App. 1939).

[16] *Fischer v. Machado*, 50 Cal.App. 4th 1069, 1072-4 (Cal. App. 3d Dist.1996).

property or return the funds to each Exchanger, and the QIs were the agents of the Exchangers but applied the money to their own use. Finally, money can be the subject of a claim of conversion if the plaintiff seeks to recover a specific, identifiable amount entrusted to the defendant. (*PCO, Inc. v. Christensen, Miller, Fink, Jacobs, Glaser, Weil & Shapiro*, LLP, 150 Cal. App. 4th 384, 396 (Cal. App.2d Dist. 2007).

In summary, under state law, Hunter and the Class Plaintiffs have a direct cause of action against Okun, and against Cordell for aiding and abetting the conversion of Exchange Funds committed by the 1031 Debtors. It is a direct injury suffered by these Plaintiffs, caused by the defalcation by the QIs (as trustees) and assisted by Okun and Cordell. The damages suffered by the 1031 Exchangers are measured, in part, by the value of their lost Exchange Funds, which damages are unique to the Exchangers, and not suffered by the QIs or other trade creditors of the 1031 Debtors. *In re: The 1031 Tax Group, LLC*, 2009 Bankr. LEXIS 3810; 52 Bankr. Ct. Doc. 138 (Dec. 2009).

Hunter and the Class Plaintiffs are cognizant of this Court's ruling in *In re: The 1031 Tax Group*, 397 B.R. 670; 2008 Bankr. LEXIS 3382 (Dec. 2008), wherein the Court enforced the IXG Exchangers' settlement stipulation that their Exchange Funds deposited at Colorado Capital Bank ("CCB") were the 1031 Debtors' property, a holding which ostensibly prevented this sub-class of Plaintiffs from prosecuting a conversion claim against Okun and the McCabe Group (the sellers of IXG to Okun). Hunter and the other Class members doing business with AEC, SOS, REES, NES, 1031 Advance, and The 1031 Tax Group did not enter such a judicially noticed concession, and therefore they may still maintain an aiding and abetting conversion claim against Cordell.

(ii) Aiding a breach of trust or breach of fiduciary duty which caused the loss of Exchange Funds.

Every owner of a legal interest in property has the right that others shall not, without lawful excuse, interfere with his possession of or enjoyment of the property or adversely affect its value. Accordingly, the beneficiary of a trust as its equitable owner, has the right that third persons shall not knowingly join with the trustee in a breach of trust. One acting with a trustee in performing an act that such person knows or should know is a breach of trust

becomes a participant in the breach and is subject to liability for any damages that result. Bogert, The Law of Trusts and Trustees, § 910 citing *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 68 Cal. App. 4th 445 (Cal. App. 1st Dist. 1998). A breach of trust is the same as a breach of fiduciary duty because a trustee is a fiduciary with duties articulated in the trust documents, the applicable statutory codes, and the common law. A claim for aiding and abetting the breach of a fiduciary duty generally requires that the plaintiff show:

> (1) the plaintiff was in a fiduciary relationship with a third party;
>
> (2) there was a breach of the fiduciary's duty by the third party;
>
> (3) there was a knowing participation in the breach by a defendant who is not a fiduciary; and
>
> (4) there are damages proximately caused by the breach.

RESTATEMENT (SECOND) TORTS § 876 (b).

The common law in all of the relevant states would impose fiduciary duties on the QIs which runs directly to the Exchangers doing business with each QI. Also, in all states, this fiduciary duty owed by each QI to each client Exchanger cannot lawfully be breached with the knowing participation and assistance of a third party. The third party's duty not to assist the fiduciary in a breach of a trust runs directly to the beneficiary of the fiduciary relationship.

The famous words of Justice Benjamin Cardozo describe the fundamental difference between the law governing commerce and the law applicable to fiduciaries:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctillo of an honor the most sensitive is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (*Wendt v. Fischer*, 243 N.Y. 439, 444 (N.Y. 1926). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 547 (N.Y. 1928). As a society, we must have people or institutions in whom we may place our trust and confidence. We must be able to hand our money over to someone we trust and receive nothing in return but the promise by the fiduciary that he will keep it safe and return it when directed. Our economic viability depends on this paradigm and the economic instability of other societies is the direct result of the lack of trust in others.

Statutes in the applicable states impose fiduciary duties on QIs consistent with the common law. These duties run directly to the Exchangers and may not be interfered with by Okun, Cordell, or others. For instance, in Massachusetts, where AEC operated, the Massachusetts' statutory definition of a trust includes "any arrangement under which a person is nominee or escrow for another." ALM GL ch.190B §1-201(54). Therefore, the AEC Exchange Agreement, which required that the Exchange Funds were to be held in "escrow" established a trust under Massachusetts law with the QI as a trustee. Mass. Gen. Laws. ch. 203C § 2(a) states that "a trustee who invests and manages trust assets shall owe a duty to the beneficiaries of a trust to comply with the prudent investor rule. . .ALM GL ch. 203C, §2." The Massachusetts Prudent Investor Rule requires a trustee to "invest and manage assets as a prudent investor would, considering the purposes, terms, and other circumstances of the trust .... In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." . ALM GL.ch. 203C, §3. Such a rule would preclude using Exchange Funds of newer clients to pay off older Exchanges where a deficit existed in the trust account.

The common law in Massachusetts is in accord with Plaintiffs' direct claims against Cordell. See *Cahaly v. Benistar Prop. Exch. Trust Co.*, 16 Mass. L. Rep. 220 (Mass. Super. Ct.2003) *remanded,* 18 Mass. L. Rep. 375 (Mass.Super. Ct. 2004), *aff'd*, 68 Mass.App.Ct. 668 (Mass.App.Ct. 2007), *aff'd*, 451 Mass. 343 (Mass.2008); *In re Lupron Mktg. & Sales Practices Litig.*, 2004 U.S. Dist. LEXIS 18512 *17-18 (D. Mass. Sept. 16, 2004); *Arcidi v. NAGE, Inc.*, 447 Mass. 616, 623-24 (Mass.2006).

SOS operated out of Connecticut but had a New York choice of law clause in its Exchange Agreements. N.Y. Banking Law § 641 provides that "no person shall engage in the business of receiving money for transmission or transmitting the same, without a license

obtained from the [New York superintendent of banks]." Performing QI services constitutes "receiving money for transmission" as SOS received money from one party with instructions to "transmit" the funds to another party.

As a money transmitter, N.Y. Banking Law § 651 required SOS to invest Exchange Funds only in "permissive investments" such as cash and certificates of deposit from a commercial bank. N.Y. Banking Law § 640(9). In addition, SOS, while conducting business under New York law was required:

> . . .[A]t all times [to] maintain permissible investments having (i) a market value. . .at least equal to the aggregate amount of all its outstanding payment instruments. . .(ii) a net carrying value. . . at least equal to the aggregate of the amount of all its outstanding payment instruments. . .so long as the market value of such permissible investments is at least eighty per centum of the net carrying value.

N.Y. Banking Law § 651. The SOS Exchange Agreements also created trusts under New York statutory law. N.Y. Est. Powers & Trusts § 11-1.1(a)(2) defines the term "trust" to include: "any express trust of property, created by a will, deed or other instrument, whereby there is imposed upon a trustee a duty to administer property for the benefit of a named or otherwise described income or principal beneficiary, or both." Because the SOS Exchange Agreements established a trust under New York statutory law, SOS by definition was a "fiduciary" according to N.Y. Est. Powers & Trusts § 11-1.1(a)(3).

As a "fiduciary," SOS had the power to "invest and reinvest property of the trust under the provisions of the [trust] instrument or as otherwise provided by law." N.Y. Est. Powers & Trusts § 11-1.1(b)(3). The trust instrument -- the SOS Exchange Agreement-- inherently prohibited the use of Exchange Funds to run a Ponzi scheme.

REES operated as a QI in Florida. QIs doing business in Florida are considered fiduciaries and must adhere to a prudent investor standard. Fla. Stat. § 518.10 defines the term "fiduciary" to include "a person, whether individual or corporate, who by reason of a written agreement. . . has the responsibility for the acquisition. . . **exchange** . . . sale or management of money or property of another." (emphasis added). REES, while doing business in Florida, was required to observe the Prudent Investor Rule when investing

escrowed funds. Fla. Stat. § 518.11(1)(a).

NES operated as a QI in Texas. Tex. Fin. Code § 151.301(b)(4) defines "money transmission" as "the receipt of money . . .by any means in exchange for a promise to make the money. . .available at a later time or different location." NES, while conducting business in Texas, was subject to the Texas money transmitter statutes. Tex. Fin. Code § 151 .404(a) imposes a trust upon escrowed funds. "A license holder shall hold in trust all money received for transmission directly from the time of receipt until the time the transmission obligation is discharged. A trust resulting from the license holder's actions is in favor of the person to whom the related money transmission obligations are owed." *Id.*

In addition to the restrictions of the Texas money transmitter statutes, Texas imposes further restrictions upon QIs through its Prudent Investor Rule. An Exchange Agreement falls within Tex. Prop. Code §111.004(4)'s definition of an "express trust" and NES qualifies as a "trustee" under Tex. Prop. Code § 111.004(18), which defines a "trustee" as "the person holding property in trust."

Tex. Prop. Code § 117.003(a) requires that "a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the Prudent Investor Rule." Several Texas appellate courts have indicated that QIs, as escrow agents, owe a general fiduciary duty to the parties involved in an Exchange Agreement:

> ...The escrow agent owes a fiduciary duty to both parties of the escrow contract. The fiduciary duty consists of (1) the duty of loyalty, (2) the duty to make full disclosure, and (3) the duty to exercise a high degree of care to conserve the money and pay it only to those persons entitled to receive it. A fiduciary must act with utmost good faith and avoid any act of self dealing that places his personal interest in conflict with his obligations to the beneficiaries.

Bell v. Safeco Title Ins. Co., 830 S.W.2d 157, 161 (Tex. App.Dallas, 1992). See also *Home Loan Corp. v. Texas Am. Title Co.*, 191 S.W.3d 728, 733 (Tex. App. Houston, 2000); *Chapman Children's Trust v. Porter & Hedges, L.L.P.*, 32 S.W.3d 429, 438 (Tex. App. Houston 14th Dist. 2006).

IXG operated out of Colorado where Colo. Rev. Stat. § 6-1-721(3)(c) provides that the QI is a fiduciary, akin to a trustee. According to Colo. Rev. Stat. § 15-10-201(56), the definition of a "trust" includes "any arrangement under which a person is nominee or escrowee for another." Therefore, the IXG Exchange Agreement established a trust under Colorado statutory law with IXG as a trustee. As a trustee, IXG was also included within Colo. Rev. Stat. § 15-1-301's definition of "fiduciary" for purposes of the Colorado Uniform Prudent Investor Act: "The word 'fiduciary'. . . means. . .guardians, conservators, and *trustees, whether of express or implied trusts*." According to Colo. Rev. Stat. § 15-1-304.1, fiduciaries shall be governed by the standard for trustees set forth in the 'Colorado Uniform Prudent Investor Act, as set out in Colo. Rev. Stat. § 15-1.1-102(a).

1031 Advance operated out of California, whose statutes require that all funds deposited in "escrow" must be deposited in qualifying financial institutions. Cal. Fin. Code § 17003 defines the term "escrow" as:

> . . .[A]ny transaction in which one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by that third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by that person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the latter.

Additionally, Cal. Fin. Code § 17003 defines the term "escrow agent" as "any person engaged in the business of receiving escrows for deposit or delivery." Cal. Fin. Code §17004. California law requires that QIs invest their escrowed funds in certain financial institutions according to Cal. Fin. Code § 17409(a).

Cal. Prob. Code § 82(b)(14) defines a "trust" as "any arrangement under which a person is nominee or escrowee for another." Therefore, 1031 Advance's Exchange Agreement established a trust and 1031 Advance was a trustee under California statutory law. According to Cal. Prob. Code § 39, the term fiduciary includes a trustee which means that 1031 Advance was a trustee and also a fiduciary. Cal. Prob. Code § 16046 (California's adopted version of the Uniform Prudent Investor Act) requires that "a trustee who invests and manages trust

assets owes a duty to the beneficiaries of the trust to comply with the Prudent Investor Rule." According to this statute, "[a] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." Cal. Prob. Code § 16047.

The California Probate Code also articulates the general duties of a trustee relevant here and they include: (i) the duty to administer the trust in accordance with the trust instrument; (§ 16000); (ii) the duty of undivided loyalty (§16002); (iii) the duty to avoid conflicts (§16004); (iv) the duty to take control and preserve trust property (§16006); (v) the duty to keep trust property separate and identified (§16009); and (vi) the duty not to delegate trustee duties or to transfer the office of the trustee to another person (§16012).

The 1031 Tax Group operated as a QI out of Virginia. Virginia's Consumer Real Estate Settlement Protection Act ("CRESPA") requires that Virginia escrow agents deposit escrow funds "in a financial institution licensed to do business in [Virginia]." Va. Code Ann. § 6.1-2.23(A). CRESPA also requires that escrow funds "shall be segregated for each depository by escrow, settlement, or closing." Va. Code Ann. § 6.1-2.23(A)(l). CRESPA includes the provision that "all funds deposited with the settlement agent in connection with an escrow shall be handled in a fiduciary capacity." Va. Code Ann. § 6.1-2.23(A). Va. Code Ann. § 6.1-2.20 defines "escrow" as "written instruments, money or other items deposited by a party with a settlement agent for delivery to other persons upon the performance of specified conditions or the happening of a certain event." The Code also defines "escrow services" to include "receiving and disbursing funds." Va. Code Ann. § 6.1-2.20.

The 1031 Tax Group is considered an "escrow agent" under Virginia statutory law, it is also considered a "trustee." Va. Code Ann. § 26-45.3, Virginia's Prudent Investor Rule, requires that "a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the Prudent Investor Rule." Va. Code Ann. § 26-45.4.

Va. Code Ann. § 54.1-2100 defines a "Real Estate Broker" as:

> any person or business entity. . .who, for compensation or valuable consideration (i) sells or offers for sale, buys or offers to buy, or

> negotiates the purchase or sale or **exchange of real estate**. . .

Under Virginia law, The 1031 Tax Group would qualify as a real estate broker:

> ***One acting*** for compensation or valuable consideration *of buying or selling real estate of or for another,* or *offering for another to buy or sell* ***or exchange real estate***. . .shall constitute. . .a real estate broker or real estate salesperson.

Va. Code Ann. § 54.1-2107 (Emphasis added).

Virginia's real estate broker statutes mandate how a real estate broker is to deal with its client's funds. Va. Code Ann. § 54.1-2108 provides that "[n]o licensee or any agent of the licensee shall divert or misuse any funds held in escrow or otherwise held by him. . ." This statute also requires brokers to exercise ordinary care, account in a timely manner for all money and property received to and disclose material facts related to the property or concerning the transaction of which the licensee has actual knowledge. *See* Va. Code Ann. § 54.1-2131.

The common law and statutory laws of the applicable states made AEC, SOS, REES, NES, IXG, 1031 Advance and The 1031 Tax Group fiduciaries, rendered the Exchangers beneficiaries of the relationship, and imposed fiduciary duties on each QI's use of the Exchange Funds. Exchange Funds could not be loaned to Okun. Once Exchange Funds were loaned to Okun and a deficit existed in each trust account, new Exchange Funds could not be "invested" by the QI by paying off old Exchanges as that would be a breach of fiduciary duty. Cordell's assistance in each QI's breach by loaning money to Okun to make lulling payments to keep the stream of money flowing constitutes assisting in the breach of each QI's fiduciary duty. This was a breach by Cordell of a duty running directly to the Exchangers, and not a legal duty owed to the QIs.

(iii) Assisting in a fraud

A QI who pays older 1031 Exchanges with after-acquired funds when the trust is in a deficit operates a Ponzi scheme which is a fraud. *See Taxel v. Vaca (In re San Diego Realty Exch., Inc.),* 132 B.R. 424, 429 (Bankr. S.D. Cal. 1991), *rev'd on other grounds, sub. nom. Taxel v. Surnow,* 1994 U.S. App. LEXIS 10317 (9th Cir. Cal. May 2, 1994). Even when a QI does not start out as a Ponzi scheme, once [the company] mismanaged and converted the

funds of some clients, and kept taking in the business and assets of others, it quickly became that." *Manty v. Miller & Holmes, Inc. (In re Nation- Wide Exch. Servs.),* 291 B.R. 131, 149 n. 20 (Bankr. D. Minn. 2003) (stating that these facts could be termed a "resulting Ponzi scheme or Ponzi schemes by performance").

The very nature of a Ponzi scheme guarantees that the persons who are harmed are not those who deposit money in the beginning, but those who make their deposits just prior to its collapse. Courts recognize that the Ponzi scheme itself presupposes proximate causation (or foreseeability) because the intent to defraud future victims can be inferred as a matter of law. *Emerson v. Maples* (*In re Mark Benskin & Co.*), 1995 U.S. App. LEXIS 16053, *12-13 (6th Cir. Tenn. June 26, 1995); *Merrill v. Abbott* (*In re Indep. Clearing House Co.*), 77 B.R.843, 853 (D. Utah 1987). *Cahaly v. Benistar*, *supra,* also identifies the point where aiding and abetting liability attaches to claims of unidentified future 1031 Exchangers who deposit Exchange Funds after the prior clients Exchange Funds were lost due to speculative investments, in uncovered calls and option trading during the dot com bubble.

Once Okun borrowed Exchange Funds (as Okun told Cordell he had done and thus needed loans from Cordell to make lulling payments because of his borrowing) a deficit would exist in the trust accounts. Trust assets would not equal trust liabilities. Once a deficit existed, new Exchangers would be defrauded (as a matter of law) by the promises made by the 1031 Debtors which the QIs had no ability or intention to perform. The QIs' promises that Exchange Funds would be used **solely** to close escrows would naturally be false because the 1031 Debtors would have to use new Exchangers' money to pay off older Exchanges that could not close because Okun had "borrowed" their money.

Cordell knew that the 1031 Debtors would and did continue on as going concerns after the loans to Okun because Cordell received Okun's ownership interest in the QIs as collateral for the loans. Cordell knew that the 1031 Debtors would continue to utilize Exchange Agreements to induce new clients to do business with them because that is how the business works. Once a deficit existed in the various trust accounts, there was no possibility of curing the Ponzi scheme at the ongoing business of the 1031 Debtors, without a miracle infusion of new, unencumbered capital to eliminate the deficit in the trust account. *Taxel*, *supra*, at 429.

No potential new client of any of the 1031 Debtors would ever execute a truthful Exchange Agreement because such a truthful Exchange Agreement would disclose that new funds were being used to pay off older Exchanges, and that the prospective client's 1031 Exchange might close if Okun paid back the $100 million he had borrowed from the prior Exchangers without their knowledge or consent. No 1031 Exchanger would ever sign such a document and Cordell knew it.

Ponzi scheme cases (fraudulent inducements to part with money) are always considered direct actions belonging to the defrauded depositors and are to be prosecuted by

them and not the debtor-in-possession or a subsequently-appointed trustee. See, e.g., *Hirsch v. Arthur Anderson & Co.*, 72 F. 3d 1085 (2nd Cir. Conn. 1995); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979 (11th Cir. Fla.1990).

(iv) The Exchangers have exclusive standing to prosecute their direct claims against Cordell.

The law in the Ninth Circuit is that a QI is a trustee of a trust. *Siegel v. Boston (In re Sale Guar. Corp.*), 220 B.R. 660 (B.A.P. 9th Cir. Cal. 1998), *aff'd, Siegel v. Newman* (*In re Sale Guar. Corp.*), 199 F. 3d 1375 (9th Cir. Cal.2000). Generally, the trustee of an express trust is the real party in interest with legal title to any cause of action on behalf of or in the name of the trust. The important exception to the general rule is when a trustee has committed a breach of trust. See *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 68 Cal. App. 4th 445, 462 (Cal. App. 1st Dist.1998). The exception applies in this case. Because the trustees (the 1031 Debtors) themselves breached the trust, the trust beneficiaries must have standing to prosecute actions against third persons who actively participated with, and aided or abetted the Trustee in that breach. *Saks v. Damon Raike & Co.,* 7 Cal. App. 4th 419, 427-428 (Cal. App. 1st Dist. 1992) ("The beneficiary may also sue third persons who directly participated with the trustee in breaches of trust".); *Pierce v. Lyman,* 1 Cal. App. 4th 1093, 1103 (Cal. App. 2d 1991); RESTATEMENT (SECOND) OF TRUSTS § 291-93, 295, 326, pp. 57-73, 124-125; 4 Scott on Trusts, § 282, 291, 294.1, pp. 27-28, 77-87, 98-101; Bogert, The Law of Trusts and Trustees, § 868-869, 901, pp. 103-123, 304-320.

A case on point where beneficiaries of a trust having standing to sue is *City of Dubuque v. Iowa Trust,* 519 N.W. 2d 786 (Iowa 1994). In that case, the lawyer defendants for the trust (the Iowa Trust) moved to dismiss the beneficiaries' case against them for lack of standing. A receiver had been appointed and the lawyers claimed that only the receiver had standing to sue them. The court noted the general rule that the trustee of a trust was the real party in interest to sue third parties who injured the trust. But, the Receiver (like McHale) was not a successor trustee. In that instance, the beneficiaries had standing to sue, and class action certification of the beneficiaries' case was proper. *Id.*, at 790. Likewise, here, the Plaintiffs have standing to sue as beneficiaries of the trust.

The Hunter Plaintiffs must have standing because they are the ones who lost the Exchange Funds. *Cahaly v. Benistar, supra,* fully supports Plaintiffs' standing to assert claims against Cordell. In the *Cahaly* case, the QI used older clients Exchange Funds to trade technology stocks with the assistance of brokers at Merrill Lynch. The Exchange Funds were lost, but Benistar stayed in business running a Ponzi scheme. Cahaly, an Exchanger, sued Merrill Lynch for assisting the QI in breaching its fiduciary duty owed directly to Cahaly. Cahaly prevailed in front of a jury, but the trial court granted Judgment Notwithstanding the Verdict (JNOV), concluding that the facts presented at trial did not establish that Merrill Lynch knew that Benistar was a QI or that the money used to buy the risky stocks was not the property of Benistar, but Exchange Funds. After the JNOV, Cahaly's attorneys discovered new evidence that showed Merrill Lynch had lied on the stand, as it did know that Benistar was a QI, that it was familiar with the nature of 1031 exchanges, and that it had seen a copy of Benistar' s Exchange Agreement. With this new evidence, the trial court granted Cahaly's motion for a new trial. *Id.* Re-trial resulted in a verdict against Merrill Lynch or aiding and abetting the breach of fiduciary duty that the QI owed to the Exchangers.

The **only** contested issues of importance in *Cahaly* were whether Merrill knew: (i) Benistar was a QI; (ii) it was Exchange Funds being invested in risky stocks; and (iii) such investments would violate the terms of the Exchange Agreements. **All** of these three facts are established here. Cordell knew the 1031 Debtors were QIs and Cordell had received the applicable Exchange Agreements when it took Okun's membership interest in the 1031

Debtors as collateral security for the loans. Cordell is liable as a matter of law pursuant to *Cahaly* and Plaintiffs have exclusive standing to prosecute to recover damages for lost Exchange Funds.

D. The Channeling Injunction does not bar Plaintiffs' direct claims.

As a general matter, bankruptcy trustees do not have standing to sue third parties on behalf of a bankruptcy estate's creditors, but may only assert claims held by the bankrupt corporation itself. While McHale may bring and settle the 1031 Debtors' claims against Cordell, he does not have constitutional standing to recover damages for injuries that are unique to the Exchangers doing business with the 1031 Debtors. Specifically, McHale does not have constitutional standing to recover from Cordell the damages measured by the Exchange Funds lost by the Exchangers.

Courts have good reason to reject a trustee's attempt to recover damages for injuries particular to certain creditors. When a party lacks a personal stake in the outcome of a matter, the party does not meet the constitution's case or controversy requirement. In addition, McHales's claims against Cordell on behalf of the 1031 Debtors are subject to defenses such as *in pari delicto* and the Wagoner Rule. These defenses are not available to Cordell to stop or diminish the claims brought by the Exchangers.

McHale's settlement with Cordell bars claims brought by Exchangers which are related to or derivative of the claims that could be brought by the 1031 Debtors against Cordell. Such claims would not include damages measured by lost Exchange Funds as these claims belong solely to the Exchangers. As the Bankruptcy Court stated in its opinion dismissing McHale's case against Citibank:

> It is highly unlikely that a successful suit by the Trustee would resolve injuries suffered by the customers of the 1031 Debtors. (citation omitted). No matter how the Trustee's suit is resolved, the injured customers would in all likelihood still have claims for their injuries, although the amount of their damages may not be fixed until distributions from the now-confirmed chapter 11 plan are fixed.

McHale v. Citibank, Supra, at 35.

To the extent that Cordell paid consideration to settle with McHale acting on behalf of the 1031 Debtors, these funds will be distributed to all of the creditors of the

1031 Debtors, including the Exchangers. There is no chance of a double recovery for the Exchangers because any distribution by the 1031 Debtors will reduce the amount of the Exchangers' claims against Cordell in *Hunter II*. There is no chance of double recovery for the 1031 Debtors, because the Sharing Agreement between the Class and McHale excludes the recovery obtained by the Class against Cordell in Hunter II. Cordell's alleged mistaken belief that it settled the Exchangers' claims by settling with McHale is of no moment to the Class as the law does not allow it.

IV. CONCLUSION

For the forgoing reasons, the motion filed by Cordell seeking to restrain the Class litigation by an unconstitutional reading of the court's channeling injunction should be denied.

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Respectfully submitted,

HOLLISTER & BRACE

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