

UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF VIRGINIA  
Alexandria Virginia

UNITED STATES SECURITIES AND )  
EXCHANGE COMMISSION, )  
 )  
  *Plaintiff,* )  
 )  
  v. ) Civil Action No. 1:06-cv-01354 GBL/TRJ  
 )  
INTERNATIONAL FIDUCIARY )  
CORP., S.A. et al., )  
 )  
  *Defendants,* )  
 )  
TERRY MARTIN et al., )  
 )  
  *Relief Defendants.* )

**Relief Defendants CD2E, Inc. and Winchell Corp.’s  
Objection in Part to Receiver’s Motion  
for Approval of Proposed Distribution Plan**

Relief defendants CD2E, Inc. and Winchell Corp. object to the receiver’s proposed plan for distributing receivership assets, as follows:

*First*, CD2E and Winchell object to the provisions in § 3.05 of the Plan regarding claims filed by persons the receiver deems “Marketers.” Under those provisions, the amount that such a person could claim from the estate would be drastically reduced, even apart from the crediting of payments that person might have received from IFC. This provision would exceed the Court’s power, because it would impose a form of liability that is not otherwise authorized by law.

*Second*, the procedures established by § 3.11 create an undue risk that claimants’ rights will be violated and that the receiver will improperly exercise judicial power.

*Third*, CD2E and Winchell object to § 4.09, which provides that the receiver’s payment of a claim acts to discharge certain claims that the investor-claimant could otherwise assert. There is no basis for requiring investors, as a condition of obtaining a distribution that will consist mostly if not entirely of a return of what they invested, to give up any rights they might have against third parties.

*Fourth*, the proposed bar-date provision could unfairly force CD2E and Winchell to choose between waiving substantive rights on the one hand and waiving procedural rights on the other.

## **Background**

### **A. The proposed distribution plan**

Distributions to investors under the plan will be limited to the return of their investments and, if enough money is left, the payment of interest on the amounts invested.<sup>1</sup> Any amounts an investor has received from IFC will be credited against the amount invested, so that the investor’s allowed claim will be limited to the un-repaid balance of his investment.<sup>2</sup> So far, so good.

The proposed plan makes special provision for investors who the receiver determines were “Marketers”—i.e., persons who received “any compensation or commissions or any other financial benefits in connection with obtaining investor funds ultimately invested in any trading program involving [IFC].”<sup>3</sup> Anyone classified as a Marketer will, for purposes of computing his allowed claim, have the amount of his investment cut by 90% in the case of “Substantial Marketers” and by 50% in the case of

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1. Proposed Plan, Art. 4.

2. Proposed Plan § 3.05; *see id.* Appx. A for the definitions of capitalized words.

3. Proposed Plan § 3.05 & Appx. A.

“Insubstantial Marketers.”<sup>4</sup> (A Substantial Marketer is someone who received more than \$1,000 in commissions or other compensation, and a Substantial Marketer is someone who received less than \$1,000.<sup>5</sup>) However, the receiver would be authorized to reclassify a Marketer as a Non-Marketer, or to change the amount of the percentage reduction, for a Marketer who “substantially cooperates” with the receiver.<sup>6</sup>

The proposed plan also provides that once the amount of an investor’s Allowed Claim is determined, the receiver may set off against that amount “any claims which the Receiver has, directly or indirectly, against the Claimant, as well as any Principal Returns, Profit Payments, or Commission Payments received, from any source, directly or indirectly, by the Claimant.”<sup>7</sup> As far as we can tell, nothing in the proposed plan would prevent the receiver from double-counting payments received by the claimant. In other words, the proposed plan seems to allow the receiver to offset such payments against the amount invested, as part of determining the amount of the claimant’s Allowed Claim under § 3.05, and then to offset those amounts a second time under § 3.03. In this regard, § 3.05 states, “Set-offs as provided for in Section 3.03 shall be applied after the calculations are made pursuant to this section to determine an Allowed Claim.”

#### **B. CD2E and Winchell’s status as potential claimants**

It is unclear at this point whether CD2E or Winchell will have claims against the receivership estate as IFC investors. They payments they received from IFC exceeded the

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4. Proposed Plan § 3.05.B, -C.

5. Proposed Plan Appx. A.

6. Proposed Plan § 3.05.

7. Proposed Plan § 3.03.

amounts that they invested. So under the formula for allowing claims, they would receive no distribution based on the facts as they exist today.

But the situation may change in the future, depending in large part on the outcome of this litigation. While CD2E and Winchell believe that they have no liability to the SEC, we obviously cannot predict the future and therefore cannot rule out the possibility that the SEC might ultimately prevail. In that event, CD2E would potentially be liable for the full amount of the payments they received from IFC, and possibly without any credit for the amounts they invested. That is what the SEC is seeking to recover, and when we argued that the CD2E and Winchell should at least be entitled to keep an amount equal to their respective investments, the SEC's response was that they could file a claim against the receivership estate—the legal equivalent of “tell it to the chaplain.”

There is also another possible change in the status quo that might result in CD2E and Winchell having a viable claim against the receivership estate. The receiver has referred to the possibility of his asserting claims against investors who received more money back from IFC than they invested. We do not know at this time whether he will assert such a claim against CD2E and/or Winchell, nor do we know how any such claim would be resolved. So we cannot rule out the possibility that CD2E and Winchell might be held liable to the receiver and might as a result have a claim against the receivership estate.

### **Argument**

What the receiver seeks from the Court is in essence a ruling—made without the benefit of evidence or legal argument—that anyone who the receiver deems a Marketer be penalized by drastically reducing the amount of money that he may receive from the receivership estate. While it is of course appropriate to take account of any money a

claimant may have received from IFC, the proposed penalty is in addition to any credit or setoff for amounts the claimant has already received. Under § 3.05, the percentage reduction is applied to the amount of the claimant's investment, *before* any reduction for "Principal Returns," "Profit," or "Commission Payments."

For the reasons that follow, there is no legal basis for authorizing such a penalty.

**A. The proposed plan's special provisions regarding Marketers exceed the Court's authority.**

Although a receivership court has broad equitable power, there are nevertheless limits to what it may do. The provisions at issue here exceed those limits.

***1. The Court has no power to create new rights or liabilities.***

A receivership court's power is purely remedial, and does not extend to creating or imposing liabilities not otherwise authorized by law. As the Supreme Court has explained, "[T]he appointment of a receiver is merely an ancillary and incidental remedy. . . . The appointment determines no substantive right, nor is it a step in the determination of such a right."<sup>8</sup> This is consistent with more general principles of equity. More than a century ago, the Supreme Court held that "wherever the rights or the situation of parties are clearly defined and established by law, equity has no power to change or unsettle those rights or that situation, but in all such instances, the maxim '*equitas sequitur legem*' [equity follows the law] is strictly applicable."<sup>9</sup> That principle remains valid. In the words of the Fourth Circuit, "Equity may not be used to create new substantive rights."<sup>10</sup>

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8. *Pusey & Jones Co. v. Hanssen*, 261 U.S. 491, 497, 43 S. Ct. 454, 456 (1923).

9. *Hedges v. Dixon*, 150 U.S. 182, 192 (1893) (internal quotation marks omitted).

10. *East Tennessee Natural Gas Co. v. Sage*, 361 F.3d 808, 823 (4th Cir. 2004).

Furthermore, a receiver stands in the shoes of the receivership entity and may not assert any rights or remedies the entity itself could not have asserted.<sup>11</sup> This rule applies not only in commercial receiverships, but also in receiverships (such as this one) that are ancillary to a governmental enforcement action.<sup>12</sup> And the rule represents a limitation on the court's power, so that an order purporting to grant the receiver broader property or contract rights than the receivership entity had is invalid.<sup>13</sup>

**2. *The provisions in dispute would impermissibly create a form of liability not otherwise authorized by law.***

It follows from the fact that a court may not use its equitable power to create new rights that it may not use that power to create new liabilities. But that is exactly what the proposed plan would do: create a new form of liability, to be imposed on any claimant who is deemed a Marketer. Moreover, the proposed plan conflicts with the principle that a receiver stands in the shoes of the receivership entity, because it authorizes the receiver to withhold money from investors under circumstances in which the receivership entity, IFC, could not have done so.

The receiver's apparent purpose in proposing the provisions at issue is to obtain a club with which he can bludgeon reluctant claimants into "cooperating" with him. This is

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11. *E.g.*, *White v. Ewing*, 159 U.S. 36, 39 (1895); *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 625 (6th Cir. 2003); *Fleming v. Lind-Waldock & Co.*, 922 F.2d 20, 25 (1st Cir. 1990).

12. *E.g.*, *United States v. Goodman*, 182 F.3d 987, 991-92 (D.C. Cir. 1999) (FTC receivership); *Troelstrup v. Index Futures Group, Inc.*, 130 F.3d 1274, 1277 (7th Cir. 1997) (CFTC receivership); *Jarrett v. Kassel*, 972 F.2d 1415, 1426-27 (6th Cir. 1992) (CFTC receivership); *Fleming*, 922 F.2d at 25 (CFTC receivership).

13. *E.g.*, *Liberte Capital Group, LLC v. Capwill*, 2007 WL 2733335 at \*5-8 (6th Cir. Sept. 20, 2007); *Jarrett*, 972 F.2d at 1418, 1425, 1426; *Marwil v. Farah*, 2003 WL 23095657 at \*5-6 (S.D. Ind. 2003); *Scholes v. Tomlinson*, 1991 WL 152062 at \*2 (N.D. Ill. 1991); *Scholes v. Schroeder*, 744 F. Supp. 1419, 1421-23 (N.D. Ill. 1990).

suggested by provision granting the receiver's power to reclassify Marketers as Non-Marketers, or to change the amount of the percentage reduction, based on their "substantial cooperation."<sup>14</sup> Thus, by imposing a penalty on those deemed to be Marketers, the plan would enable the receiver to offer an incentive for cooperation, the incentive being the reduction or elimination of the penalty. But while there is nothing wrong with encouraging people to cooperate with the receiver, any such encouragement must occur within the limits of the law. There is to our knowledge no legal principle that authorizes a receiver to pressure people into cooperation by demanding cooperation as the price of obtaining money to which they would otherwise be entitled. Indeed, in different circumstances such conduct might even be tortious.<sup>15</sup>

Nor can the penalty be justified on the theory that those deemed to be Marketers were acting illegally. The penalty would apply whether or not the claimant was previously found to have broken the law or was even charged with having broken the law. And more fundamentally, the receiver is not permitted to assert claims arising from alleged participation in IFC's fraudulent scheme. As previously noted, the receiver stands in IFC's shoes, and IFC could not have asserted any such claim against a Marketer. It was not damaged by any "marketing" activity, but was benefited by it. Furthermore, any claim that might otherwise have been asserted by IFC—the primary wrongdoer—would have been barred by the doctrine of *in pari delicto*, and that defense could be asserted against the

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14. Proposed Plan § 3.05.

15. It is also worth noting that the receiver has at his disposal other means of obtaining information he needs in order to carry out his duties, for the order of appointment grants him subpoena power. (DE 121 at 9.)

receiver.<sup>16</sup> Finally, the receiver is not an agent or representative of the SEC and is not a law-enforcement agent.<sup>17</sup>

#### **B. The provisions regarding Marketers are procedurally problematic**

Under the proposed distribution plan, the initial determination whether a claimant is a Marketer would be made by the receiver, who would not be required to conduct an evidentiary hearing or indeed to follow any particular procedures. Moreover, the receiver would apparently be given unrestrained discretion with regard to the decision whether to reclassify someone deemed a Marketer as a Non-Marketer or to change the percentage reduction as someone deemed a Marketer. And although the receiver's determination would be subject to the Court's review, the burden of proof would be on the objecting claimant, and the plan provides no guarantee that the claimant would be afforded discovery or an evidentiary hearing.<sup>18</sup>

Because of these issues, there is a substantial risk that the proposed procedures would violate claimants' right to due process or that the plan would operate as an improper delegation of judicial power. Although the plan might be administered in a way that would

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16. See, e.g., *SEC v. Elliott*, 953 F.2d 1560, 1575 (11th Cir. 1992) (applying this principle but not using the term *in pari delicto*); *In re Wiand*, 2007 WL 963162 at \*13–14 (M.D. Fl. 2007) (Mag. Judge recommendation), *recommendation adopted in part and rejected in pertinent part on different grounds*, 2007 WL 963165 (M.D. Fl. 2007) (see \*7); *Johnson v. Studholme*, 619 F. Supp. 1347 (D. Colo. 1985) (not using the term *in pari delicto*), *aff'd sub nom. Johnson v. Hendricks*, 833 F.2d 908 (10th Cir. 1987); *In re Greater Southeast Community Hosp. Corp. I*, 353 B.R. 324, 366–67 (Bankr. D.D.C. 2006).

17. See, e.g., *Atlantic Trust Co. v. Chapman*, 208 U.S. 360, 370–71 (1908); *United States v. Smallwood*, 443 F.2d 535, 539 (8th Cir. 1971); *Litton Industries, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 125 F.R.D. 51, 53–54 (S.D.N.Y. 1989).

18. Proposed Plan § 3.11.

avoid those problems, it would be preferable to set up procedures that did not raise these risks in the first place.

**C. Investor-claimants should not be required, as a condition of receiving distributions from the receivership estate, to give up any claims they might have against any other person or entity.**

Section 4.09 provides that the receiver's payment of a claim acts to discharge any claims that the investor-claimant (or anyone else!) could assert against "the Receiver or its agents, the SEC or any Defendant or Relief Defendant[.]" This provision is entirely unjustified. Distributions to investor-claimants will consist of the return of money they invested in IFC and possibly or interest on that money. Investors will be lucky if they get back one hundred cents on the dollar. There is no reason that we can think of why investors should be required, as a condition of getting back their own money, to give up any claims they might wish to assert.

It would be especially inappropriate to provide that the receiver's payment of a claim acts to discharge any claim that might be asserted *against him*. The receiver is supposed to be working for the investors' benefit, and paying claims is a central part of the job he is being paid to perform. He should not be using his control over the return of their money as means of protecting himself (or anyone else) from liability or litigation.

**D. The distribution plan could adversely affect CD2E, Winchell, and any other investors in their position, given that any claim they may have against the receivership estate might not accrue until after the bar date.**

The possibility exists that this litigation, and any claim that may be asserted by the receiver, will not be resolved by the time of the bar date. Under the proposed plan, CD2E and Winchell would arguably be time-barred from asserting claims with regard to the money they invested in IFC, even as a defense against claims asserted by the SEC or the

receiver. Under the proposed plan, anyone who does not file a timely claim “shall be forever barred from asserting a claim against the Receivership Property.”<sup>19</sup> While we believe that any assets that the receiver or the SEC might seek to recover from CD2E or Winchell would not constitute receivership property, the receiver might take a contrary position, and we cannot predict what the outcome would be if he were to do so.

Although it might (or might not) be possible for CD2E and Winchell to avoid this problem by filing contingent claims before the bar date, they would be adversely affected by having to do so. If they file claims, they might be deemed to have consented to the use of summary procedures to resolve, not only their claim against the estate, but any counterclaims that the receiver might assert against them.<sup>20</sup> Such consent would result in a waiver of the procedural rights they would otherwise have under the Federal Rules of Civil Procedure, as well as their right to a jury trial. Thus, CD2E and Winchell might be placed in a situation in which the only way they could preserve their substantive rights would be to waive their procedural rights. That would be unfair and unconstitutional.

### **Conclusion**

For the reasons given above, the Court should deny approval to the provisions of the proposed plan regarding Marketers and that provide that payment of a claim constitutes a discharge of claims that may be asserted against the receiver and others. In addition, the Court should order the receiver to formulate procedures and protections that would address the problems that we have identified.

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19. Proposed Plan § 3.02.

20. *Cf. Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989) (filing of proof of claim in bankruptcy constitutes consent to summary procedures, and waiver of jury trial, as to trustee’s counterclaim).

Respectfully submitted,

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## Certificate of Service

I HEREBY CERTIFY that a copy of the foregoing opposition was served on the following by the means indicated, on this 11th day of June, 2008:

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