Leonard E. Starr, III (VSB # 9203)
LEONARD STARR, P.C.
P. O. Box 468
119 West Williamsburg Road
Sandston, Virginia 23150
Telephone: (804) 737-5216

-and-

Robert L. Brace, CBN. 122240
(Admitted *Pro Hac Vice*)
Michael P. Denver, CBN. 199279
(Admitted *Pro Hac Vice*)
HOLLISTER & BRACE
P.O Box 630
Santa Barbara, California 93102
(805) 963-6711 Telephone

James R. Gilreath,. SC Bar # 2133
(Admitted *Pro Hac Vice*)
William M. Hogan, SC Bar # 65272
Admitted *Pro Hac Vice*)
THE GILREATH LAW FIRM, P.A.
110 Lavinia Avenue (29601)
Post Office Box 2147
Greenville, South Carolina 29602
(864) 242-4727 Telephone

Cheryl F. Perkins, SC Bar # 2078
(Admitted *Pro Hac Vice*)
Charles W. Whetstone, Jr., SC Bar # 6059
(Admitted *Pro Hac Vice*)
WHETSTONE MYERS PERKINS & YOUNG LLC
601 Devine Street (29201)
Post Office Box 8086
Columbia, South Carolina 29202
(803) 799-9400 Telephone

IN THE UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

In re: LandAmerica Financial Group, Inc., et al. Debtors.	Chapter 11 Case No. 08-35994 (KRH) (Jointly Administered)
LANDAMERICA 1031 EXCHANGE SERVICES, INC., and LANDAMERICA FINANCIAL GROUP, INC., Plaintiffs,	
ANGELA M. ARTHUR, AS TRUSTEE OF THE ARTHUR DECLARATION OF TRUST, DATED DECEMBER 29, 1988; VIVIAN R. HAYS, LEAPIN EAGLE, LLC; DENISE J. WILSON; GERALD R. TERRY; ANN T. ROBBINS; JANE T. EVANS, on behalf of themselves individually and on behalf of a class of others similarly situated, Defendants**.**	Adv. Proc. No. 09-3146 (KRH)

MEMORANDUM OF LAW IN OPPOSITION TO DEBTORS' MOTION FOR A PRELIMINARY INJUNCTION STAYING THE PROSECUTION OF CERTAIN NON-BANKRUPTCY COURT PROCEEDINGS PURSUANT TO §§362(a) AND 105(a) OF THE BANKRUPTCY CODE AND 28 U.S.C. §1334

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Defendants Angela M. Arthur, Trustee of the Arthur Declaration of Trust dated December 29, 1988 ("Arthur"), Vivian R. Hays ("Hays"), Leapin Eagle, LLC ("Leapin Eagle"), Denise J. Wilson ("Wilson"), Gerald R. Terry ("Terry") Ann T. Robbins ("Robbins"), and Jane T. Evans ("Evans") hereby oppose the motion filed by Debtors LandAmerica Financial Group, Inc. ("LFG") and LandAmerica 1031 Exchange Services, Inc. ("LES") for a preliminary injunction staying in part[1] prosecution of the MDL Class Action styled *In Re: LandAmerica 1031 Exchange Services, Inc. Internal Revenue Services §1031 Tax Deferred Exchange Litigation*, pending before the United States District Court for the District of South Carolina, Anderson Division, Case No. MDL No. 2054 (hereinafter the "MDL Class Action"). Defendants oppose this motion.

PRELIMINARY STATEMENT

The Defendants herein are Commingled LES Exchangers and Plaintiffs in the MDL Class Action. The Commingled Exchangers are a unique sub-class of LES creditors because their Exchange Funds were deposited at SunTrust Bank and then used by LES to operate a Ponzi scheme, with the knowing assistance of SunTrust Bank, after the collapse of the auction rate securities ("ARS") market in February 2008.[2] As of the Petition date, the 400

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[1] Contrary to the broad language of the Adversary Complaint and Motion for Preliminary Injunction, Debtors agree that they are not moving to stay the MDL Class Action against SunTrust Banks. See Exhibit 2 to Defendants' Answer to Adversary Complaint, previously filed: Email from Debtors' attorney stipulating that the adversary proceeding and motion do not relate to pursuit of claims against SunTrust. The Debtors are moving to stay the MDL Class Action **solely** as to the non-debtor former officers and directors of LES and/or LFG, Theodore L. Chandler, Jr. ("Chandler"), G. William Evans ("Evans"), and Stephen Connor ("Connor"). Christine Vlahcevic was dropped from the MDL litigation by the Amended Consolidated Complaint filed on August 3, 2009.

[2] A QI who pays older exchanges with after-acquired funds when the trust is in a deficit operates a Ponzi scheme. See *Taxel v. Vaca* (*In re San Diego Realty Exch.*), 132 B.R. 424, 429 (Bankr. S.D. Cal. 1991), *rev'd on other grounds*, 1994 U.S. App. LEXIS 10317 (9th Cir. 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, 148 (Bankr. D. Minn. 2003) (stating that the case could be termed a resulting Ponzi scheme or Ponzi scheme by performance).

Commingled Exchangers' claims represented by the lost Exchange Funds totaled approximately $191 million. LES's parent (LFG) owed SunTrust $100 million. SunTrust participated in the scheme because it wanted to get repaid the $100 million.

The creditors of LES consist of four categories: (a) Commingled LES Exchangers; (b) Segregated LES Exchangers; (c) LFG; and (d) *de minimus* trade creditors. The MDL Class Action is brought on behalf of the Commingled LES Exchangers and is intended to prosecute **direct** claims for **damages** against non-Debtors, including SunTrust Bank and the Individual MDL defendants.

Defendants herein filed an Amended Consolidated Complaint in the MDL on August 3, 2009, a copy of which is attached and incorporated herein as Exhibit 1. The MDL causes of action are predicated, in part, on the irrefutable conclusion that the Exchangers were owed fiduciary duties with regard to the Exchange Transactions. The Exchange Agreements, pursuant to choice of law clauses, are interpreted according to the laws of the Commonwealth of Virginia. See typical Exchange Agreement which is attached as an exhibit to the Amended Consolidated Complaint. In the MDL Class Action, Defendants contend that: (i) LES acted as their agent in the Exchange Transactions under Virginia statutory law and common law, with commensurate fiduciary duties; (ii) Virginia Code §§54.1-2100 and 2107 define LES's role in the Exchange Transactions as a real estate broker, while §54.1-2008 created fiduciary duties with regard to the Exchange Funds, and §§54.1-2131 through 2135 outlawed LES's admitted conduct with regard to the Exchange Funds; (iii) under the common law applicable to the MDL Class Action, there is a presumption that LES created a trust consisting of the Exchange Funds because the

Exchangers advanced the money to purchase replacement property, not LES;[3] and (iv) Treasury Regulation §1.1031(k) - 1(n) affirmatively negates any inference to be derived from the mandatory control and dominion language other than for the purpose of analyzing actual or constructive receipt for tax purposes under the Treasury Regulation.

Debtors seek a stay as to their non-debtor former officers and directors pursuant to 11 U.S.C. §§362(a) and 105(a), as well as 28 U.S.C. §1334. Debtors seek relief based on the erroneous conclusion that the proceeds of certain policies of insurance covering their former officers and directors are property of their estates, and also based on supposed indemnification rights of the former officers and directors. Debtors claim that a stay is warranted to ensure that administration of the Debtors' estates is not undermined by the MDL litigation.

A stay is not warranted. The insurance coverage applicable to the MDL claims is not an asset of the Debtors' estates. Triggering the coverage by pursuit of the claims in the MDL, far from prejudicing the Debtors' estates, benefits the Debtors by providing a potential new source of funds to pay Exchangers' claims. Debtors' dogged reliance on *A.H. Robins Corp., Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986) misses the mark. As will be explained *infra*, *Robins* involved a products liability policy and officers and directors who were mere additional insureds and who had indisputable rights to indemnification from the Debtor, which is not the case here. In addition, unlike *Robins*, the supposed indemnification rights of

[3] *See, e.g.,; Gibbens v. Hardin*, 239 Va. 425, 389 S.E.2d 478 (1990); *Gifford v. Dennis*, 230 Va. 193, 198-199, 335 S.E. 2d 371 (1985). The **civil law presumption** of the establishment of a trust is applied even when to do so contravenes the express language of the written transaction documents (which is not the case here). *1924 Leonard Rd., L.L.C. v. Van Roekel*, 272 Va. 543, 552, 636 S.E. 2d 378 (2006).; see also, *Restatement (Third) of Trusts*, §5 at 57; Defendants recognize that this Court applied a contrary **bankruptcy presumption** to find that the Exchange Funds held on deposit in LES accounts were assets of the Debtors' estate. Defendants respectfully disagree with this Court's conclusion; however, it has no impact on the issues raised in the MDL.

the Individual MDL defendants are not absolute, but highly speculative and insufficient to warrant the extraordinary relief of staying a non-debtor proceeding and depriving the Exchangers of the opportunity to recoup devastating losses from non-debtor sources. See *Winters by & Through McMahon v. George Mason Bank*, 94 F.3d 130 (4th Cir. 1996) (characterizing the holding in *A.H. Robins v. Piccinin* as creating a "**narrow exception** to the general rule that the automatic stay is **not** available to third parties) (emphasis added). Finally, allowing the MDL to proceed against the individual officers and directors can in no way undermine administration of the Debtor's estate. Despite what they claimed when the bankruptcy petition was filed, Debtors are not operating as a going concern and never will.

STATEMENT OF FACTS

A. The MDL Class Action Against the Individual Defendants

The allegations contained in the MDL Class Action Amended Consolidated Complaint (attached to hereto as Exhibit 1) are incorporated herein by reference. Briefly, the facts pled[4] with regard to the Individual MDL defendants include:

1. MDL Defendant G. William Evans

G. William Evans served on the Board of Directors of LES, was an officer of LES, and served as Executive Vice President and Chief Financial Officer of LFG. Evans was responsible for the integrity of all financial information underlying LFG's balance sheet and was the primary spokesperson on all financial matters necessary to meet public financial reporting requirements mandated by the Securities and Exchange Commission (SEC). He

[4] All of the facts pled in the MDL Amended Consolidated Complaint referenced herein are taken from documents already on file and a part of the records in the LFG/LES bankruptcy proceeding and associated adversary proceedings, including but not limited to, the summary judgment filings in *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*, APV. 08-03147-KRH.

was also responsible for budgeting, business planning and performance, and improving profitability. He directed the day-to-day activities of LFG/LES Treasurer Ronald Ramos. [5]

Evans was responsible for SEC filings that described how LFG's subsidiary, LES, facilitated tax-deferred property exchanges. The filings declared to unsuspecting members of the public that "[d]ue to the structure utilized to facilitate these transactions, reverse exchanges, and like-kind exchanges not held at Centennial [Bank] are not considered [LFG] assets and are not included in the accompanying consolidated balance sheets." Evans and LFG/LES now claim ownership of the funds.

Evans was informed of the "freeze" of LES's ARS investments in February of 2008. The resulting liquidity crisis at LES was evident for many months prior to its November 2008 bankruptcy filing. Evans, along with other LFG/LES officers and directors was privy to weekly reports prepared by Assistant Treasurer Devon Jones, showing when and whether LES would run out of funds if it did not secure a sufficient influx of new, uninformed Exchangers to keep the money flowing.[6] These reports were essentially a roadmap for operation of the Ponzi scheme. What they showed was that in March, 2008 LES's commingled account had a deficit of $70 million. Deficits thereafter ranged from $29 million to $62 million in September, 2008. These account deficits were unprecedented.

Evans was privy to an Executive Summary as of June 17, 2008 showing a projected cash shortfall at LES unless there was an increase in new Exchangers to fund older exchange

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[5] By their Amended Consolidated Complaint, in the MDL Class Action, MDL Plaintiffs have added as new party defendants LFG/LES Treasurer Ronald Ramos, LFG/LES Assistant Treasurer Devon Jones, and LES Vice President and National Underwriting Counsel Brenton J. Allen.

[6] Based on its role as a fiduciary, LES was obligated to stop soliciting new clients once there was a deficit balance caused by its bad investments in ARS. *Williams v. Dickenson County Bank, Inc.*, 175 Va. 359, 75 S.E.2d 885 (1940).

commitments. Evans was involved in on-going discussions with other officers and directors concerning these liquidity problems at LES at least by August of 2008.

Evans participated in decisions in the third and fourth quarters of 2008 to have LFG transfer funds to LES to make "lulling" payments to close exchanges when LES did not have sufficient funds, even using new Exchangers' money. The Ponzi scheme nature of the enterprise and the need to make lulling payments is described in an October 17, 2008 email to Evans from his subordinate Ramos: "I made the decision to move $25 million from LFG Holdco to LandAmerica Exchange [LES] this afternoon in anticipation of meeting 1031 Exchange disbursement requests we received totaling approximately $22 million for early next week . . . Also contributing to this decision was my concern that the bank group, SunTrust in particular, might 'freeze' the LandAmerica holdco [LFG] account and not permit a transfer of funds to the exchange Company [LES] triggering a liquidity event early next week. At close of business today, following the activity outlined above, LandAmerica holdco [LFG] has about $17 million on hand. The Exchange Company [LES] has about $30 million in cash on hand, a $10 million par value bond (worth about $9 million) and the $290.5 million in ARS. With the decision not to open any more commingled accounts and the large disbursements early next week, I suspect we have a week, two at most before the Exchange Company [LES] runs out of cash if we make all remaining Holdco [LFG] cash available." The lulling payments fraudulently concealed LES's illiquidity from new Exchangers entering into new Exchange Agreements with LES.

Evans executed an Affidavit, dated November 26, 2008, which was filed in support of the Chapter 11 Petitions and First Day Pleadings in the LFG/LES bankruptcy. This Affidavit failed to discuss or disclose that the bankruptcy was the culmination of a Ponzi scheme, which Evans was obviously aware of. For instance in Paragraph 20 of his Affidavit Evans

says that "Prior to making [the determination to file Chapter 11 Bankruptcy] LES pursued numerous other liquidity options;" however, he failed to make the Court aware that the main "liquidity option" was the operation of a Ponzi scheme.

Another misleading aspect of Evans' Affidavit is found in Paragraph 16 where Evans discusses the funds held in LES bank accounts. He failed to disclose that LFG, in all of its Quarterly 10Q filings with the SEC for the first three quarters of 2008, had reported that like-kind exchange funds held in its subsidiary, LES, were "held by us for the benefit of our customers and are therefore not included as our assets in the accompanying consolidated balance sheets."

Even more disturbing is Evan's revelation in Paragraph 21 of his Affidavit that a national financial advisor, JP Morgan and others were engaged in mid-September 2008 by the LFG board of directors to assist in pursuing various "strategic financial alternatives." It would be beyond belief that these well-known Wall Street financial advisors were unaware of the ongoing Ponzi scheme, which was then well into its seventh month of operation. If in fact JP Morgan was aware of the Ponzi scheme, which it must have been, then one must ask whether it acted in concert to help continue the Ponzi scheme. Any stay issued by this Court at this time against the Individual MDL defendants could impede efforts by the Plaintiffs in the MDL to identify and recover from other responsible parties who aided and abetted the officers and directors in continuing the Ponzi scheme up to the filing of this bankruptcy.

Evans also was copied on correspondence of Peter Kolbe, LFG Senior Vice President for Governmental Affairs, addressed to the Chief Examiner of the Nebraska Department of Insurance. Kolbe verified that "the Exchange Company engages in a specialized form of escrow," and "the essential function of a Qualified Intermediary is to hold in escrow the proceeds." Kolbe also verified the elements of the Ponzi scheme, stating that "[a]lthough

the Exchange Company [LES] is taking in approximately $50 million a month in new 1031 exchange funds, that level of influx will likely prove insufficient to cover the expected liability aging schedule. In short, without either an infusion of new capital or the substitution of liquid assets for the auction rate securities, the Exchange Company may not be able to meet its obligations in the near future." In other words, LES needed a miracle or it would go out of business and take LFG with it.

In October of 2008, Evans participated in discussions with officers and directors of LES and LFG regarding a directive that would have stopped the commingling of incoming Exchange Funds. He authorized the rescission of that directive because otherwise the cash in LES's commingled SunTrust account would not be sufficient to meet LES's prior obligations. The high level discussion also involved the manner in which LES should respond to due-diligence inquiries. Evans, along with MDL Defendants Conner and Chandler, made the decision that LES would continue business as usual. These discussions also involved whether there were changes that could be made to make the exchange documents more advantageous to LES.

Evans never advised marketing and sales personnel that they should inform Exchangers that their incoming monies would be used to satisfy obligations owed to older Exchangers or that LES was insolvent.

2. MDL Defendant Conner

Steven Conner was senior vice president of LES and LFG and responsible for the day-to-day running of LES. Conner's duties were to manage growth, profitability, and servicing capabilities of LES. He was responsible for presentation of the company to the public, design of marketing content, and messaging.

Conner approved all marketing materials of LES, as well as website content. In the wake of the highly publicized failure of several qualified intermediaries ("QIs") around the country (see fn. 9 *infra*), LES disseminated an Internet advertisement, also reduced to the form of a hard copy brochure sent to its field offices, entitled "The Financial Stability of LandAmerica." This brochure referenced "Funds Held in Trust" followed by the statement: "escrow and 1031 Exchange customers entrusted more than $3.2 billion to LandAmerica as of December 31, 2007." In this same Internet ad, LES represented that "in connection with each IRC §1031 exchange involving LandAmerica 1031 Exchange Services, LandAmerica provides its clients with a signed, written guaranty of the availability of the full amount of exchange funds received under the Exchange Agreement." Conner knew this representation was false because LES never provided such a written guaranty unless a specific request was made; nor could it truthfully make such a guaranty to a "commingled" exchanger since at any given point in time after March 2008, its commingled funds account operated at a deficit. Conner approved the brochure anyway, but has since denied that the reference to "funds held in trust" meant that LES held funds in trust.

By at least October 2008, Conner had learned that the ARS had created a liquidity crisis for LES. Instead of altering the fraudulent way LES was conducting business *vis-a-vis* Exchangers, Conner signed a non-disclosure agreement with LFG to keep quiet about the ARS and the liquidity crisis.

3. MDL Defendant Chandler

Theodore L. Chandler, Jr. was Chairman of the Board of Directors and Chief Executive Officer of LFG, the corporate parent of LES. Throughout 2008, Chandler was kept in the loop concerning LES's dire liquidity problems. In August 2008, Chandler was a part of on-going discussions with Evans and other officers and directors about LES's lack of

liquidity and that it was running out of cash. On October 18, 2008, Chandler participated in the decision to rescind the "segregated account" directive that would have effectively halted the Ponzi scheme but also would have sealed LES's financial fate. Instead that decision sealed the fate of the Exchangers lured into commingled exchange transactions thereafter. At about the same time, Chandler was drafting a letter to Treasury Secretary Henry Paulson seeking liquidity assistance. This letter, which referred to LES "as a fiduciary to facilitate IRS Section 1031 real estate transactions," requested immediate financial assistance from the federal government and referenced the potential for "a disastrous chain reaction."

4. *The New Individual Defendants*

Defendants (as Plaintiffs in the MDL) on August 3, 2009, joined as new MDL defendants, LES/LFG officers and directors Ronald Ramos, Devon Jones and Brenton Allen.

Ramos, as Treasurer of LFG and LES, was in charge of the oversight of cash management and investment management, as well as involvement with establishing the investment guidelines, which drove acceptable investments. Jones, as Assistant Treasurer of LES and LFG, reported directly to Ramos. A part of Ramos's responsibilities as Treasurer of LES was to oversee all of the funds that LES was holding for its Exchange clients. He had full authority to direct the commingled SunTrust account where the Exchange Funds of the LES Commingled Exchangers were deposited. Ramos and Jones did not have in place any internal controls regarding the SunTrust account, but rather allowed LES to use the account as an operating account, commingling fees due to LES with Exchange Funds.

Ramos was a member of the LES Investment Committee and signed the minutes as secretary. Jones attended these meetings. Ramos and Jones made the decision to invest the Exchange Funds in ARS. The decision was made so that LES could earn additional income and be paid more interest.

Following the February 2008 market freeze on ARS, Ramos had regular conversations with SunTrust, as did Jones. These conversations involved seeking a solution from SunTrust for LES's liquidity problems. Ramos and Jones also both participated in preparation of disclosure language for LFG's quarterly reports, the 10-Qs which failed to disclose LES's dire liquidity problems and the fact that it was operating a Ponzi scheme.

In August 2008, Defendants Ramos and Jones participated in on-going discussions with Evans and Chandler regarding LES's lack of liquidity. The substance of these discussions was that LES was running out of cash.

On October 1, 2008 Ramos and Jones participated in an LFG Investment Funds Committee meeting. Ramos, as Secretary, prepared minutes of the meeting, noting that LES was appealing to be a part of the SunTrust ARS settlement, "since the company is acting in a fiduciary capacity, with the funds ultimately belonging to the retail client."

Ramos and Allen were involved in the October 18, 2008, decision to rescind the directive that commingled exchange agreements cease and to continue to encourage prospective exchangers to sign up for commingled exchanges. They agreed that responses to due-diligence inquiries should be business as usual. By mid-November 2008, Ramos was aware of the potential for an LES bankruptcy, but no changes were made to LES's business as usual Ponzi scheme.

MDL Defendant Allen routinely reviewed LES advertising materials and was responsible for editing and approving LES promotional materials. Incredibly, Allen views the reference to "funds held in trust" in LES promotional materials he approved as having been included because "it's advertising" and simply meaning "entrusted," **not** "in trust." LES's deceptive promotional materials were widely disseminated by LES at trade shows, to

real estate brokers, attorneys and developers of real estate, through direct mailings to potential customers, by email and hard copy mail.

Allen and Ramos, like Conner, submitted to non-disclosure agreements in the fall of 2008, so that LES's clients would continue entrusting their life savings in a company, touted at the bottom of its company emails as "A Fortune 2007 Most Admired Company," when absent a miracle, LES was careening toward bankruptcy and taking those life savings with it.

B. The D&O Policy Provides Insurance to the Individual MDL Defendants and Their Insurance Protection has Priority Over Insurance Available to LES/LFG.

LFG purchased insurance coverage from U.S. Specialty Insurance Company ("U.S. Specialty"), for the benefit of the Individual MDL defendants (and for the benefit of the Debtors under certain circumstances not applicable here), through a Directors, Officers and Corporate Liability Insurance policy, number 14-MGU-08-A117739, (the "D&O Policy") ($10 Million in coverage). A copy of the D&O policy is attached to the Plaintiffs' Complaint for Injunctive Relief in this action. There is also a policy of excess insurance. The Insuring Agreement under the D&O policy provides coverage under Coverages (A) and (B) as follows:

INSURING AGREEMENTS

(A) The Insurer will pay to or on behalf of the Insured Persons Loss arising from Claims first made during the Policy Period or Discovery Period (if Applicable), against the Insured Persons for Wrongful Acts, except when and to the extent that the Company has paid such Loss to or on behalf of the Insured Persons as indemnification or advancement.

(B) The Insurer will pay to or on behalf of the Company (LFG/LES) loss arising from:

(1) Claims first made during the Policy Period or the Discovery Period (if applicable) against the Insured Persons for Wrongful Acts, if the Company has paid such Loss to or on behalf of the Insured Persons as indemnification or advancement, and/or

> (2) Securities Claims first made during the Policy Period or the Discovery Period (if applicable) against the Company for Wrongful Acts. (Emphasis added).

Under Coverage (A), the "Insured Persons" (the Individual MDL defendants) are entitled to have certain legal fees and expenses advanced by U.S. Specialty and to be reimbursed for certain losses (including damages, judgments, and settlements), up to the maximum limits of the D&O Policy. Under Coverage (B), the Debtors (LES/LFG) are entitled to coverage to the extent they pay claims against the Insured Persons or are sued for Securities claims. Coverage (A) has been triggered by the Class Action brought against the Individual MDL defendants. Coverage (B) has not been triggered.

The primary D&O Policy contains a "Priority of Payments Clause" which expressly requires that U.S. Specialty pay the covered losses of all Insured Persons before it pays any covered loss of the Debtors. Clause (D)(4), which was amended in Endorsement No. 21, reads as follows:

> (4) If the Insurer is obligated to pay Loss, including Defense Costs; under more than one INSURING AGREEMENT, whether in connection with a single Claim or multiple Claims, and if the amount of all Loss, including Defense Costs, exceeds the Insurer's maximum aggregate Limit of Liability set forth in Item 3 of the Declarations;
>
> (a) the Insurer shall first pay covered Loss (if any) under the INSURING AGREEMENT (A);
>
> (b) then, if no additional Loss is payable under the INSURING AGREEMENT (A); and if the Limit of Liability has not been exhausted, the Insurer shall pay covered Loss (if any) under INSURING AGREEMENT (B)(1);
>
> (c) then, if no additional Loss is payable under INSURING AGREEMENT (A) or (B)(1) and if the Limit of Liability has not been exhausted, the Insurer shall pay covered Loss (if any) under INSURING AGREEMENT (B)(2).

Pursuant to the above language, the Individual MDL defendants are entitled to priority over the Debtors in bankruptcy because their losses are covered under Coverage (A), while any purported losses of the Debtors would be covered under Coverage (B). Coverage (A) losses take priority over Coverage (B) losses pursuant to the terms of the D&O Policy.

The Debtors assert that the Motion for Preliminary Injunction and the positions taken in their Motion are made "on behalf of" the Individual MDL defendants, as well as the Debtors. Given the Priority of Payments Clause in Endorsement No. 21, which confers insurance coverage solely on the Individual MDL defendants to the exclusion of the Debtors, it is a mystery why the Individual MDL defendants would waive their Coverage (A) rights and offer the proceeds of the policy over to LES and LFG as property of the Debtors' bankruptcy estates.

LEGAL ARGUMENT

I. INTRODUCTION

The Debtors use words and phrases throughout their motion and memorandum that are sheer rhetoric, having no factual basis or legal import. LES is not "a target" of the MDL Class Action – the MDL Class Action is filed for the purpose of seeking alternate sources for money damages since LES's assets are insufficient to make the Commingled Exchangers whole. Thus, the MDL Class Action is not "a transparent attempt to evade the automatic stay provisions of the bankruptcy code." The Defendants herein are not using the MDL Class Action lawsuit "to get their Exchange Funds back" from LES – what is left of the Exchange Funds is now under the jurisdiction of the Bankruptcy Court. The Defendants are not using the MDL Class Action to "violate the Protocol Order." The claims in the MDL are clearly distinguishable "from those that have been raised in a number of other adversary proceedings" – the MDL claims seek affirmative relief in the form of **damages** (not the

actual Exchange Funds) from **non-debtors** arising from **tort** claims outside the scope of the bankruptcy. Debtors' stated desire to settle all claims of "all Exchangers (including the purported class plaintiffs in the MDL)" "on a global basis" in the Bankruptcy Court exceeds the reach of the Bankruptcy Code. Debtors cannot force a cram-down settlement by cutting off the MDL Plaintiffs and the class of Exchangers they seek to represent from the legitimate pursuit of direct causes of action against non-debtors.

LES breached the terms of the Commingled Exchange Agreements by not returning the Exchange Funds as promised. There can be no dispute that LES owes the Exchangers the return of their Exchange Funds but does not have the assets to pay them in full. This is not an issue that requires litigation in the Bankruptcy Court or elsewhere. A finding by the MDL District Court that LES owes the Commingled Exchangers money is not prejudicial to LES because LES does not contest that its owes the Exchangers their Exchange Funds. An adjudication in the District Court that officers and directors of LES committed tortious acts is not prejudicial to LES because LES does not possess funds to respond to tort damages. The LES bankruptcy is one in which the overwhelming majority of the creditors are of one class, defrauded Exchangers, and nothing that occurs in the MDL will alter the fact that LES owes the Exchangers money in an amount exceeding its assets. That is why LES is in bankruptcy.

The Commingled LES Exchangers have filed creditors' claims and, as a result, they should receive a pro-rata distribution of their Exchange Funds comprised of ARS or cash from the LES bankruptcy. The extent of the pro-rata share will depend on what is left to distribute after payment of the Debtors' professional fees and administrative costs accrued fighting over assets once believed to be safe. The Exchangers should be protected in the bankruptcy to the extent they file a Proof of Claim requesting the return of their Exchange Funds.

The MDL Class Action is being prosecuted to recover the anticipated shortfall between the damages suffered (loss of Exchange Funds as well as consequential damages) and the funds that are available for distribution from the bankruptcy. Plaintiffs in the MDL Class Action are seeking damages **for all Commingled Exchangers,** measured in part by the amount of their unrecouped Exchange Funds; however, they are not seeking control over or a distribution of any Funds controlled by the Bankruptcy Court

The Individual MDL defendants who directed the affairs of LES in operating a Ponzi scheme are liable, along with SunTrust, for the breach of the same duties that LES owed to the Commingled LES Exchangers. *Airlines Reporting Corp. v. Pishvaian*, 155 F. Supp. 2d 659 (E.D.Va. 2001); *Sit-Set, A.G. v. Universal Jet Exchange, Inc.,* 747 F.2d 921 (4th Cir. 1984); *Cook Jr. v. The 1031 Exchange Corp*., 29 Va. Cir. 302 (1992); see *generally Restatement (Second) of Agency* §343 (1957). It is no defense that one is an employee while actively operating a Ponzi scheme. The employees of LES who directed its affairs are directly liable to the Exchangers for their own torts. *Id.* The same is true of those persons or entities who are found to have assisted them.

The Bankruptcy Court cannot bar, enjoin or release direct claims against non-Debtors, which belong solely to a unique class of creditors of the debtor. *Deutsche Bank, AG* (*In Re Metromedia Fiber Network, Inc).*, 416 F.3d 136 (2nd Cir. 2005). Non-debtors whose conduct injured a specific sub-set of creditors of the debtor must file their own bankruptcy to obtain a discharge under the Bankruptcy Code. 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 (LES) or a subsequently appointed trustee. *See, e.g., Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2nd Cir. 1995); *E.F. Hutton & Co. v. Hadley*, 901 F.2d 979 (11th Cir. 1990).

II. THE MDL CLASS ACTION AGAINST THE INDIVIDUAL MDL DEFENDANTS CANNOT BE ENJOINED PURSUANT TO §362.

A. The Proceeds of the D&O Insurance are not Property of the Debtors' Estates Because the Priority of Payment Clause Makes the Proceeds Property of the Individual MDL Defendants.

As "Insured Persons," the Individual MDL defendants have an interest in the D&O Policy, including a contractual right to be paid proceeds of the policy to fund their defense of the MDL Class Action and any covered losses they may incur as a result. Pursuant to the Priority of Payments Provision, the rights of the Individual MDL defendants to the proceeds of the D&O Policy are expressly superior to any rights of the Debtors to the proceeds of the policy. Thus, the Individual Defendants, as Insured Persons, are entitled to the insurance proceeds of the U.S. Specialty policy, subject only to the potential impact of the automatic stay.

The automatic stay typically enjoins, among other things, "[a]ny act to obtain possession of property of the estate or to exercise control over property of the estate." 11 U.S.C. §362(d)(3). Thus, the issue is whether the proceeds of the D&O policy are property of the Debtors' estates.

D&O liability **insurance policies** generally are considered property of the debtor-corporation's estate. See *In re Allied Digital Techs. Corp.*, 306 B.R. 505, 509 (Bankr. D. Del. 2004) ("*Allied Digital*"); *Youngstown Osteopathic Hospital v. Ventresco* (*In re Youngstown Osteopathic Hosp. Ass'n)*, 271 B.R. 544, 547-48 (Bankr. N.D. Ohio 2002). However, this is not necessarily the case with respect to **the proceeds** of such policies. *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 216 (3rd Cir. 2000) ("proceeds . . . should be evaluated separately from the debtor's interest in the policy itself"), citing *First Fidelity Bank v. McAteer*, 985 F.2d 114, 117 (3rd Cir. 1993). In

determining whether insurance proceeds are property of the bankruptcy estate, the overriding question is whether the debtor would have the right to receive and keep those proceeds when the insurer pays the claim. When payment by the insurer cannot inure to the debtor's pecuniary benefit, then that payment neither enhances nor decreases the bankruptcy estate. *Houston v. Edgeworth* (*In re Edgeworth*) 993 F.2d 51 (5th Cir.1993), *reh. den.* 1993 U.S. App LEXIS 17610 (5th Cir. June 30, 1993) (noting that under typical liability policy, the debtor will not have any cognizable interest in the proceeds of the policy, and those proceeds will normally be payable only for the benefit of those **harmed by** the debtor under the terms of the insurance contract).

Typically, the **proceeds** of an officers and directors liability insurance policy are **not** considered property of the bankruptcy estate. See, e.g., *La. World Exposition, Inc. v. Fed. Insurance Co*. (*In re La. World Exposition, Inc.*), 832 F.2d 1391, 1400 (5th Cir. 1987) ("the liability proceeds payable to the directors and officers are not part of the bankruptcy estate."); *In re CHS Elecs., Inc.*, 261 B.R. 538, 544 (Bankr. S.D. Fla. 2002) (D&O policy proceeds are not property of the estate); *Miller v. McDonald* (*In re World Health Alternatives, Inc.)*, 369 B.R. 805, 811 (Bankr. Del. 2007) ("[T]he proceeds of the Debtor's D&O insurance policy are not property of the estate."); *In re Global Crossing Sec. and ERISA Litig*., 225 F.R.D. 436, 463 (S.D.N. Y. 2004) ("individual insureds. . . have a right to use the policies' proceeds to cover their defense and settlement costs in litigation"); *In re Adelphia Communs. Corp*., 298 B.R. 49, 54 (S.D.N.Y. 2003) ("[debtor] Adelphia's estate cannot ascribe to hold a property interest in these [D&O] proceeds."); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 13 (Bankr. E.D.N.Y. 1999) ("the [D&O] proceeds here in question are not estate property.").

In *World Health*, the court found it likely that the "proceeds of the Debtor's [D&O] insurance policy are not property of the estate." *In re World Health Alternatives*, 369 B.R. at 811. The trustee in bankruptcy initiated an adversary proceeding in bankruptcy court in Delaware against the company's former directors and officers, alleging, among other things, breaches of fiduciary duty and unjust enrichment. The trustee petitioned the bankruptcy court to enjoin approval of a shareholder litigation settlement agreement in a case pending in Pennsylvania District Court and to direct the transfer of the proceeds of the D&O insurance policy to the trustee. The Bankruptcy Court, following the reasoning in *Allied Digital*, noted that the estate had "no right to any Coverage A proceeds, which insures only World Health's officers and directors." *Id* at 811. The court found that the existence of a priority of payment endorsement subordinating the debtor's coverage to that of the directors and officers under Coverage A rendered such subordinated coverage so remote that it was not a reasonable probability that the trustee would succeed on the merits asserting that the proceeds of the policy were property of the estate or that the trustee had even a co-equal interest in the proceeds funding the settlement. *Id.* Similar to *World Health*, the Individual MDL defendants have rights under "Coverage A," which only insures the directors and officers of the Debtors, and to which the Debtors' potential claims are expressly subordinate.

Thus, an insurance **policy** purchased by a Chapter 11 debtor is an asset of the bankruptcy estate only to the extent that it increases the debtor's worth or diminishes its liabilities. Where the corporate debtor is not **unconditionally** required to reimburse its officers and directors for legal expenses and it does not appear that any action has been initiated in **debtor's** name against the corporate directors, the officers' liability policy is not "property" within the meaning of 11 USCS §362(a)(3). *In re Zenith Laboratories, Inc.* 104 B.R. 659 (Bankr. D.N.J. 1989). *See, also, Maxwell v Megliola* (*In re marchFIRST, Inc.*) 288

B.R. 526 (Bankr. N.D.Ill. 2002), *aff'd* 293 B.R. 443 (N.D.Ill. 2003) (noting that absent a judgment requiring that the insurers issue payment, the proceeds of liability insurance policies of the debtor's directors and officers were not property of the bankruptcy estate).

In this case, the express language of the D&O policy, and in particular the Priority of Payments Provision, clearly dictates that the policy proceeds **are not** property of the Debtors' estates. As in *World Health*, the D&O policies here provide indemnification and direct coverage to the Debtors, in addition to direct coverage of the Individual MDL defendants, with a Priority of Payments Provision expressly subordinating the Debtors' claims to the insurance proceeds to all of the Coverage A. For all intents and purposes, the Priority of Payments Provision establishes that the insurance proceeds are not estate property covering a direct or indemnification claim of the Debtors, unless and until **all** covered losses of the Individual MDL defendants have been satisfied.

The Debtors' rights to proceeds under the D&O Policy are entirely subordinate. *Id.* Therefore, (i) the Debtors have no right to or interest in payments or advances that may be made under the D&O Policy Coverage A to the "Insured Persons;" (ii) the Debtors' estates are **not** worth more with than without the proceeds, which are the source of these payments or advances; and (iii) these Coverage A payments or advances cannot be said to deplete proceeds that might otherwise be available to protect other assets of the Debtors. Proceeds potentially payable to the Individual MDL defendants in accordance with the Priority of Payments Provision are **not** property of the Debtors' estates, and the Individual MDL defendants are not stayed from pursuing them. The MDL Class Action filed against the Individual MDL defendants will not deplete assets of the estate because the insurance available to these defendants will never be made available to the Debtors. There is, therefore, no reason the MDL Class Action should not be stayed.

Even if the Debtors' estates had some property interest in the D&O proceeds, that interest is at best limited, contingent and speculative. Courts have observed that "[i]n essence and at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection." *Adelphia*, 285 B.R. 589 (Bankr. S.D.N.Y. 2003), quoting *Ochs v. Lipson (In re First Cent. Financial Corp*., 238 B.R. at 16 (other citations omitted). Moreover, "bankruptcy courts should be wary of impairing the contractual rights of directors and officers even in cases where the policies provide entity coverage. . . ." *Adelphia*, 285 B.R. at 598.

In *Allied Digital*, while the court held that the D&O proceeds were not property of the estate subject to the automatic stay, the court, in the alternative, also held that even if the proceeds were property of the estate, the stay should be lifted for cause. *Id*. at 513. This Court may grant the same alternative relief, since the Debtors' estates are bound by the Priority of Payments Provision and do not have any greater interest in the policy proceeds than they had prior to the bankruptcy filings.

The Debtors rely heavily on the inapposite case of *A.H. Robins Comp., Inc. v. Piccinin*, *supra*. The *A.H. Robins* case has two fundamental distinctions making it inapplicable to the Debtors' request for an injunction: (i) it involved a products liability insurance policy with no priority of payments provision; and (ii) the directors and officers had an **absolute** right to indemnification from the debtor.

The debtor, A.H. Robins Company, Inc. ("Robins") owned a products liability insurance policy insuring it against third party product liability claims. The case did not involve a D&O policy designed specifically to benefit directors and officers. The products liability policy was issued by Aetna in favor of Robins, with certain officers and directors named as **additional** insureds, not primary insureds. As additional insureds, the directors

and employees were **sharing** in the insurance pool created principally for the benefit of Robins. The officers and directors, named as additional insureds, had no priority of payment over Robins under the policy. With no one having a payment priority over Robins, the Court thus noted it would work an inequitable hardship to permit plaintiffs "to secure as it were a preference in the distribution of the insurance pool." *Id*. at 1008.

In major contrast, in this case, the D&O policy as previously explained, specifically grants a priority of payment to the Individual MDL defendants over the Debtors, assuming the directors and officers are entitled to indemnification in the first place. In fact, the Debtors have no substantive claim for benefits at all under the D&O policy since INSURING AGREEMENT B(1) only allows reimbursement to Debtors for indemnification expenses already paid, and INSURING AGREEMENT B(2) applies to securities claims irrelevant to the MDL.

In a second significant difference, the *Robins* court, in upholding a stay, emphasized that the individual defendants there had an unquestioned right to indemnification from the debtor. As discussed below, the holding in *Robins* actually negates Debtors' entitlement to a stay in this case.

B. The Purported Indemnification Rights of the Individual MDL Defendants are Not Absolute, but Contingent and Speculative, and Do Not Warrant Enjoining the MDL Class Action.

The Fourth Circuit Court of Appeals in *A.H. Robins* stated:

> …a stay in favor of such officers, directors and employees, protected as they are by the right to indemnity from the debtor, and **the record in this case shows undisputably that these directors and employees are so protected**, was in order.

Id. at 1008, fn. 13 (emphasis added).

The *Robins* Court also held:

> . . . there are cases [under 362(a)(1)] where a bankruptcy court may properly stay the proceedings against non-bankrupt co-defendants but . . . in order for relief for such non-bankrupt defendants to be available under (a)(1), there must be "unusual circumstances" and certainly "'something more than the mere fact that one of the parties to the lawsuit has filed a Chapter 11 bankruptcy must be shown in order that proceedings be stayed against non-bankrupt parties.'" This "unusual situation," it would seem, arises when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor. An illustration of such a situation would be a suit against a third-party who is entitled to **absolute indemnity** by the debtor on account of any judgment that might result against them in the case.

Id. at 999 (emphasis added).

The requirement that the right of indemnity be absolute in order to present the "unusual circumstances" warranting a non-debtor stay is clear and undeniable. In a subsequent case, the Fourth Circuit refused to expand the automatic stay to include the guarantor of a note executed by a corporation in bankruptcy, despite the fact the guarantor would be entitled to bring claims for reimbursement or contribution through the bankruptcy proceedings. *Credit Alliance Corp. v. Williams*, 851 F.2d 119, 120-121 (4th Cir. 1988). Following a discussion of the principles set forth in *Piccinin*, the court stated that "[i]t is unnecessary to stay the proceedings or void the judgment against the non-bankrupt guarantor to protect Penn Hook [the debtor] or to prevent dissipation of its assets, since neither Penn Hook nor its estate is jeopardized by the judgment against Williams [the guarantor]." *Id.* at 121-122. See also *Holland v. High Power Energy*, 248 B.R. 53 (S.D.W.Va. 2000) (refusing to impose stay despite the agreement by the debtor to indemnify non-bankrupt co-defendant). In *Doyle v. Fleetwood Homes of Va., Inc.*, 2009 U.S. Dist. LEXIS 37297 (S.D.W.Va. April 30, 2009) the District Court for the Southern District of Virginia refused to impose a stay even though the non-debtor defendants could potentially be entitled to contribution or indemnification from the debtor because "they have not offered any evidence that they would

be entitled 'to absolute indemnity by the debtor on account of any judgment that might result against them in the case.' *Piccinin*, 788 F.2d at 1000."

The remaining cases cited by Debtors also are distinguishable, based on the presence of an absolute right to indemnity. See *Midkiff v. Lowe's Home Ctrs., Inc.*, 2007 U.S. Dist. LEXIS 54717, No. 4:07CV00017, *9 (W.D.Va. 1007) (granting stay under *Robins* because "the contract for indemnity here makes it a **certainty** that her claim will be paid from [debtor's] estate") (emphasis added); *Lomas Fin. Corp. v. N. Trust Co. (In re Lomas Fin. Corp.)* 117 B.R. 64, 68 (S.D.N.Y. 1990) (quoting "absolute indemnity" ruling of *Robins* and justifying imposition of a stay because of "indemnity clause **obligating** [debtor] to indemnify its officers") (emphasis added); *N. Star Contracting Corp. v. McSpedon (In re North Star Contracting Corp.*), 125 B.R. 368, 371 (S.D.N.Y. 1991) (applying principles of *Robins* based on right to indemnity not characterized as contingent in any way and also finding that no bona fide separate cause of action existed against the non-debtor officer so that the third party action stayed was deemed commenced solely to circumvent the automatic stay.); *Dunham v. Sportsstuff, Inc.*, 2008 U.S. Dist. LEXIS 4821, No. 3:07CV322-HEH, *7-8 (E.D. Va. Jan. 23, 2008) (finding third party product liability suit against distributor did not contain independent allegations of wrongdoing and that the claim "would **inevitably** fall within the parameters of the indemnity agreement") (emphasis added).

The Individual MDL defendants cannot claim an absolute right of indemnification against the Debtors. Any rights of indemnification of the MDL defendants, as officers and directors of LES/LFG, are conditional and speculative, not absolute. The claims to indemnification here are clearly disputable unlike the indemnification rights in *Robins.*

Maryland law forbids indemnification of directors and officers where material acts or omissions were committed in bad faith or from active and deliberate dishonesty. Md. Code Ann. §2-418(b)(1)(i)(1) & (2) (2008).

After the freeze of the auction rate securities market in February 2008, the Debtors indisputably were running a Ponzi scheme by taking deposits from new exchange clients to fund exchanges for prior clients. The Individual MDL defendants were personally involved in the Debtors' operation of the Ponzi scheme, which caused the loss to the MDL Plaintiffs and the Commingled Exchangers they seek to represent. The acts and omissions of the Individual MDL defendants in operating the Debtors' Ponzi scheme were clearly committed in bad faith and were the result of active and deliberate dishonesty. See *Landmark Land Co. v. Cone (In Re Landmark Land Co.)*, 76 F.3d 553, 565 (4th Cir. 1996) (under similar California statutory good faith requirement for indemnification, directors who authorized corporate bankruptcy filing, which violated agreement with government regulators not to place corporation in bankruptcy, intentionally participated in wrongful conduct against third parties and, thus, did not act in good faith; indemnification was prohibited even if directors' conduct benefited the corporation and did not break any laws.).

Once the ARS market froze, the Individual MDL defendants needed to stop directing other employees at LES to solicit new clients with false promises and deal with the damages caused to LES and the Exchangers already doing business with LES at that critical moment. Instead, the Individual Defendants decided to substitute the "roll call" of victims from old clients to new clients without disclosing to the current Commingled LES Exchangers that they would be an involuntary interim solution to someone else's unfortunate business situation.

Thus, the Individual MDL defendants' purported rights to indemnification from Debtors not only are disputable, but entirely speculative unlike the absolute indemnification rights required by the court in *Robins* to create the necessary "unusual circumstances" warranting a non-debtor stay.

III. THE COURT SHOULD NOT STAY THE MDL CLASS ACTION AGAINST THE INDIVIDUAL DEFENDANTS PURSUANT TO §105

To enjoin direct claims against non-debtors under §105(a), a bankruptcy court must find that the claims "threaten to thwart or frustrate the debtor's reorganization efforts," *Goldin v. Primavera Familienstiftung Tag Assoc. (In re Granite Partners)*, 194 B.R. 318, 337 (Bankr. S.D.N.Y. 1996), and that the injunction is "important" for effective reorganization. See *Macarthur v. Johns-Manville Corp.* (*In re Johns-Manville Corp*., 837 F.2d 89, 93-94 (2nd Cir. 1988); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2nd Cir. 1992); *Menard-Sandord v. Mabey* (*In re A.H. Robins Co*.), 880 F.2d 694, 701 (4th Cir. 1989).

Judge Bernstein in *Granite Partners* identified the factors a court should consider in issuing a §105 injunction to stay direct actions against non-debtors. Relying on *Manville* and *Robins*, he noted that a court should consider, among other relevant factors, whether the suits would (i) threaten the debtor's insurance coverage; (ii) increase the debtor's indemnification liability; (iii) result in inconsistent judgments; (iv) expose the debtor to risks of collateral estoppel or *res judicata*; and (v) burden and distract the debtor's management by diverting its manpower from reorganization to defending litigation. *Granite Partners*, 194 B.R. at 337. None of these five factors have been established by the Debtors to support a §105 injunction by this Court.

First, the Debtors' D&O insurance is not at risk because the Priority of Payments Clause relegates the entity coverage for LES to a subordinated position because the "Insured Persons" (the Individual Defendants sued in the MDL Class Action) have contractual priority to the proceeds of the policy. There is no coverage for the Debtors so there is no risk in losing what does not exist.

Second, neither LES nor LFG is indemnifying the Individual MDL defendants and indemnification would not be warranted under the bylaws or authorized by Maryland law for operating a Ponzi scheme. Directing the rank and file employees at LES to lie to the Commingled LES Exchangers about the existence of a trust, the financial stability of LES, and the intended use of their Exchange Funds is "bad faith," notwithstanding any possible explanation as to the reasons why. Economic expediency is not an affirmative defense to fraud, but rather the motive for it. The Individual MDL defendants cannot look to LES for indemnity, either arising from contract or in equity, for their actions in directing torts on behalf of the employer.

The Commingled LES Exchangers are attempting to bring in additional funds to supplement the payout to be received in the LES bankruptcy. Given the facts as alleged in the Amended Consolidated Complaint, any indemnity payment to the Individual MDL defendants, who devised and operated the tortious enterprise, seems speculative at best and does not warrant slowing or impeding the potentially productive efforts of the defrauded Exchangers in recovering their losses from sources outside the scope of LES's bankruptcy.

There is no threat of inconsistent judgments being obtained against the Individual MDL defendants because the MDL Class Action is the only known case pending. There is no potential impact from any ruling in the District Court on any issue to be litigated in the Bankruptcy Court either as an inconsistent judgment or based on some collateral estoppel

effect. This is because, as stated above, LES does not contest that it owes the exchange funds. An adjudication that exchangers have suffered consequential damages is not prejudicial because LES does not have the assets to pay the full exchange amounts much less consequential damages. A potential adjudication that the exchange agreements created a trust is not inconsistent with the prior ruling of this Court because this Court was guided by a bankruptcy presumption that does not apply in the civil case where a diametrically opposed presumption will apply. There is no factual or legal issue to be litigated in the MDL that will alter the course of the Bankruptcy proceeding herein.[7] This distinction makes most of the cases cited by Debtors entirely inapposite because those cases involved underlying claims contested both in the bankruptcy and in the third party actions. See e,g., *American Film Technologies v. Taritero (In re Amer. Film Technologies, Inc.)*, 175 B.R. 847 (Bankr. D. Del. 1994) (contested breach of employment contract action initially brought against employer and its officers and directors prior to bankruptcy filing of employer). While the *Lomas* case[8] was based on a loan transaction involving the debtor, subsequent Second Circuit authority limits the impact of the collateral estoppel language of this Southern District of New York opinion:

> We have not located any decision applying the stay to a non- debtor solely because of an apprehended later use against the debtor of offensive collateral estoppel or the precedential effect of an adverse decision. If such apprehension could support application of the stay, there would be vast and unwarranted interference with creditors' enforcement of their rights against non-debtor co defendants.
>
> Gardner's reliance on *Lomas Financial Corp. v. Northern Trust Co. (In re Lomas Financial Corp.)*, 117 B.R. 64 (S.D.N.Y. 1990), is unavailing. That district court decision affirmed a bankruptcy court's injunction staying a suit against a debtor

[7] Neither LES nor LFG has instituted litigation in the Bankruptcy Court against its former officers and directors. Until such an action is commenced by the Debtors, which includes allegations of operating a Ponzi scheme intended to injure only the Commingled LES Exchangers (which is not likely to happen), this factor does not support a §105 stay.

[8] *Lomas Finance Corp. v. Northern Trust Co. (In re Lomas Fin. Corp.)*,117 B.R. 64 (S.D.N.Y. 1990).

> corporation's two key officers, who were accused of fraudulently causing a creditor to make a loan to the corporation. Although the district court's opinion mentions possible collateral estoppel, the ruling is primarily explained by the existence of the debtor's indemnity obligation to the corporate officers.

Queenie, Ltd. v. Nygard Int'l, 321 F.3d 282, 288 (2nd Cir. 2003).

Also, the MDL Class Action does not expose LES or LFG to risks of collateral estoppel *or res judicata* because the Debtors are not named in the MDL Class Action. As non-parties without input in the case, they are not bound as they point out in their motion. From a practical standpoint, the risk of factual findings by a jury or legal conclusions being made by Judge Anderson, in the MDL action, and having some adverse impact on LES is non-existent for the same reasons as stated above. Unless LES is claiming that it does not owe the return of the Exchange Funds (or the equivalent) back to the Exchangers, there is no conceivable set of facts, and none offered by the Debtors in their motion, to suggest there is a dispute over the liability that LES owes its Exchangers. As currently presented by the Debtors, the fear of collateral estoppel is more rhetoric without facts or law behind it.

Lastly, the MDL does not adversely impact the ability of LFG and LES to reorganize. Although this is a Chapter 11 bankruptcy, LFG and LES are not going concerns and are not creating a plan to stay in business. Debtors' participation in the Bankruptcy Court is being effectuated by the Debtors' lawyers and professionals incurring dramatic fees, not by the Individual MDL defendants. Various courts have noted that "[t]here often is some such risk to a debtor that an action against a present or former principal or officer would hinder its reorganization in some way. Limited or theoretical risk must be insufficient, however, or else the *Teachers Ins. & Annuity Ass'n* rule against extending stays to officers and principals would be eviscerated. Accordingly, as this Court has held before, 'in the absence of evidence which demonstrates any impact upon the debtor's reorganization effort, the stay cannot be

extended to a solvent co-defendant.' *CAE Indus. Ltd., et al., v. Aerospace Holdings Co., et al.*, 116 B.R. 31, 34 (S.D.N.Y. 1990)." *Gray v. Hirsch (In re Gray)*, 230 B.R. 239, 244 (S.D.N.Y. 1999).

The Debtor's citation to *McHale v. Alvarez (In Re 1031 Tax Group, LLC)*, 397 B.R. 670, 685 (Bankr. S.D.N.Y. 2008) is misplaced. Hollister & Brace (co-counsel for the plaintiff Commingled LES Exchangers in the MDL Class Action and co-counsel to the Defendants in this adversary proceeding) is lead counsel to the class of Exchangers in that litigation arising out of the 1031 Tax Group Ponzi scheme.[9]

In the *1031 Tax Group LLC* case, pursuant to §105, Judge Glenn granted a short 90-day stay of a Colorado State Court action brought by certain Exchangers (the Alvarez Exchangers) against certain officers of Investment Exchange Group, Inc. ("IXG"). Edward H. Okun ("Okun") of the 1031 Tax Group acquired IXG from the McCabe Group, looted its assets and then operated a Ponzi scheme by paying off older clients of IXG with new clients' Exchange Funds. The 1031 Tax Group and its subsidiaries, including IXG, filed for bankruptcy.

The Trustee (Jerry McHale) of IXG sued the McCabe Group (officers of IXG before and after the acquisition by Okun) on behalf of the Debtor and so did the Alvarez Exchangers. McHale then entered into a settlement agreement with the McCabe Group and

[9] See MDL Docket No. 2078: *In Re: Edward H. Okun Internal Revenue Service §1031 Tax-Deferred Exchange Litigation*, pending before the Hon. James Ware in the United States District Court for the Northern District of California, Case No. 5:07-cv-02795-JW. Hollister & Brace represents the Class, where $150 million in trust assets were looted. Settlements reached to date are approximately $88 million and are based, in part, on the theory that Exchange Funds are held in trust by the QI. Ed Okun has been sentenced to 100 years in prison for operating a 1031 Exchange Ponzi scheme based upon similar facts to the Ponzi scheme orchestrated by the Individual Defendants under this Court's consideration. See *United States v. Edward H. Okun*, Case Number 3:08-CR-132, pending before the Honorable Robert Payne in the United States District Court, Eastern District of Virginia. Also see MDL Docket No. 1878: *In Re: Southwest Exchange Inc. Internal Revenue Service § 1031 Tax-Deferred Exchange Litigation*, pending before the Hon. Robert C. Jones in the United States District Court for the District of Nevada, Case No. 2:07-cv-01394-RCJ-LRL. Hollister & Brace also represents the Class in this case, where $97 million in trust assets were looted. Settlements reached to date are approximately $97 million and are based, in part, on the conclusion that Exchange Funds are held in trust by the QI.

their E&O insurer, Lloyd's of London, and sought to enjoin the Colorado state court litigation. Pursuant to §362, Judge Glenn attempted to parse out the derivative claims, which belonged to the Trustee and the direct claims, which belonged to the Alvarez Exchangers. He concluded that the fraud claims were direct claims that could not be released by the Trustee by way of settlement while the mismanagement claims against the McCabe Group (for allowing Okun to loot the Exchange Funds) were property of the IXG bankruptcy estate. There were competing actions filed by the Debtor and by certain exchangers and the stay was necessary to allow the Bankruptcy Court to decide who owned which claims against the McCabe Group. Judge Glenn had to include in his analysis a determination of who owned the Exchange Funds on deposit at IXG. Another distinction is that early on in the IXG bankruptcy, the Alvarez Exchangers had settled a side dispute with IXG (while a debtor-in-possession) over the allocation of $20 million in Exchange Funds frozen at Colorado Capital Bank ("CCB"). As part of that settlement and in order to get a percentage of the Exchange Funds paid to them immediately, the Alvarez Exchangers had waived their claim that the Exchange Funds on deposit at CCB were held in trust, and had allowed the money to be administered as part of the IXG bankruptcy estate. By agreeing to the characterization of the Exchange Funds as property of IXG, Judge Glenn concluded that the Alvarez Exchangers were judicially estopped to bring claims for conversion and aiding and abetting a conversion against the McCabe Group because they had voluntarily agreed that the funds belonged to IXG, and therefore, could not be converted from the Exchangers. The LES Exchangers herein have strongly disputed that issue in this bankruptcy proceeding.

Judge Glenn granted a 90-day stay pursuant to §105(a) to aid the court's jurisdiction and aid in the reorganization process, utilizing the five factors identified by Judge Berstein in *Granite Partners*. As stated above, none of those factors are present here. Most critically, in

the *1031 Tax Group LLC* case, there was litigation brought against the officers of IXG by the Trustee such that the Alvarez Exchangers' litigation was likely to cause disruption to the Trustee's case against the same defendants. Such litigation does not exist here and is not anticipated. The circumstances in *1031 Tax Group LLC* case are, thus, clearly dissimilar.

The Debtors herein argue that LES would be forced to intervene and defend in the MDL Class Action. This proposition is ludicrous. Dedicating estate assets to defending past employees who caused the bankruptcy in the first place should not be approved by the Court. The focus should be on collecting assets to pay claims from persons responsible for the loss rather than impeding Exchangers in seeking to recoup losses from a source outside the Bankruptcy.

IV. DEBTORS' REQUEST FOR AN INJUNCTION UNDER 28 U.S.C. §1334 HAS NO MERIT.

Debtors appear to assert that 28 U.S.C. §1334 creates as independent basis, aside from §362(a) and §105, to grant a preliminary injunction staying proceedings against non-debtors. Defendants respectfully disagree. If Debtors are unable to establish the prerequisites for staying the MDL Class action mandated by §362(a) and/or §105, the motion should be denied.

CONCLUSION

Defendants respectfully urge that this Court deny the Debtors' Motion for a preliminary injunction and allow them, and the Commingled Exchangers they seek to represent, to continue litigation that is their only hope for coming close to being made whole.

NOTICE

Notice of this Memorandum will be given to: (a) the Offices of the United States Trustee for the Eastern District of Virginia; (b) counsel to the agent for LFG's preparation lenders; (c) counsel for Prudential Capital Group; (d) the Securities and Exchange Commission; (e) the Internal Revenue Service; (f) the United States Attorney for the Eastern District of Virginia; (g) counsel for each of the Creditors' Committees; (h) counsel for the Defendants in the MDL; and (i) all parties who have filed requests for service of pleadings pursuant to Bankruptcy Rule 2002 as of the day prior to the service hereof.

Dated: August 18, 2009

Respectfully submitted,

LEONARD STARR, P.C.

By: /s/ Leonard E. Starr, III .

Leonard E. Starr, III (VSB # 9203)
LEONARD STARR, P.C.
P. O. Box 468
119 West Williamsburg Road
Sandston, Virginia 23150
Telephone: (804) 737-5216
Fax: (804) 737-8115
Lstarr@Starr-Law.com

-and-

/s/__James R. Gilreath .

James R. Gilreath, SC Bar No. 2133
(Admitted *Pro Hac Vice*)
William M. Hogan, SC Bar No. 65272
(Admitted *Pro Hac Vice*)
THE GILREATH LAW FIRM, P.A.
110 Lavinia Avenue (29601)
Post Office Box 2147
Greenville, South Carolina 29602
(864) 242-4727 Telephone
(864) 232-4395 Facsimile
jim@gilreatlaw.com
bhogan@gilreathlaw.com

Robert L. Brace, CBN. 122240
(Admitted *Pro Hac Vice*)
Michael P. Denver, CBN.199279
(Admitted *Pro Hac Vice*)
HOLLISTER & BRACE
P.O Box 630
Santa Barbara, California 93102
(805) 963-6711 Telephone
(805) 965-0329 Facsimile
rlbrace@hbsb.com
mpdenver@hbsb.com

Cheryl F. Perkins, SC Bar No. 2078
(Admitted *Pro Hac Vice*)
Charles W. Whetstone, Jr., SC Bar No. 6059
(Admitted *Pro Hac Vice*)
WHETSTONE MYERS PERKINS & YOUNG LLC
601 Devine Street (29201)
Post Office Box 8086
Columbia, South Carolina 29202
(803) 799-9400 Telephone
(803) 799-2017 Facsimile
cperkins@attorneyssc.com
cwhetstone@attorneyssc.com

Attorneys for Defendants Angela M. Arthur, as Trustee of the Arthur Declaration of Trust, Dated December 29, 1988; Vivian R. Hays; Leapin Eagle, LLC; Denise J. Wilson; Gerald R. Terry, Ann T. Robbins, Jane T. Evans, on behalf of themselves individually and on behalf of a class of others similarly situated.

CERTIFICATE OF SERVICE

The undersigned certifies that a true and exact copy of the **MEMORANDUM OF LAW IN OPPOSITION TO DEBTORS' MOTION FOR A PRELIMINARY INJUNCTION STAYING THE PROSECUTION OF CERTAIN NON-BANKRUPTCY COURT PROCEEDINGS PURSUANT TO §§362(a) AND 105(a) OF THE BANKRUPTCY CODE AND 28 U.S.C. §1334** was served by operation of the Court's electronic filing system to all parties entitled to receive electronic notice in this adversary proceeding on August 18, 2009 and by first class mail and facsimile to the following parties on August 18, 2009:

Terrence K. McLaughlin
WILLKIE FARR & GALLAGHER LLP
787 Seventh Avenue
New York, New York 10019
Fax: (212) 728-8111

Dion W. Hayes
John H. Maddock, III
Richard F. Blair
MCGUIREWOODS LLP
One James Center
901 East Cary Street
Richmond, Virginia 23219
Fax: (804) 775-1061

/s/ James R. Gilreath .
James R. Gilreath