UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

U.S. COMMODITY FUTURES TRADING COMMISSION, **Plaintiff,** **v.** **BARKI, LLC, a North Carolina limited liability company;** **BRUCE C. KRAMER, an individual,** **Defendants, and** **RHONDA A. KRAMER, an individual, and FOREST GLEN FARM, LLC, a North Carolina limited liability company,** **Relief Defendants.**	**CASE NO. 3:09-CV-106(GCM)**

MEMORANDUM OF LAW IN SUPPORT OF RESPONSE (OBJECTION) OF HARRIS, WRAY, BOYLES AND PUCKETT TO RECEIVER'S MOTION

Tony C. Harris ("Harris"), David Wray ("Wray"), Boyles, LLC ("Boyles"), and Don and Jan Puckett (collectively "Puckett"), all of whom were investors in Barki, LLC ("Investors") objected to the Receiver's Motion for (1) Approval of Proposed Claims Verification Procedures, Claims Bar Date, and Proposed Claims Distribution Method; and (2) for Authority to Make Interim Distributions to Investors (the "Motion") in that certain Response (Objection) of Harris, Wray, Boyles and Puckett to the Motion ("Response") filed with this Court on July 13, 2009. As set forth in the Response, the objection of Investors relates solely to the proposed claims distribution method. More specifically, the Response advocates application of the "net investment method," as opposed to the "rising tide method" proposed by the Receiver, as those terms are used in the Motion and Response.

The purpose of the Response was to set forth the logic and arguments which support Investors' position. The purpose of this Memorandum of Law is to set forth the relevant legal authority which supports Investors' position. Accordingly, Investors incorporate the Response by reference herein and intend to reiterate portions of it only as necessary to facilitate the application of the facts to the law and to emphasize the core of Investors' position.

LEGAL ANALYSIS

The net investment method and the rising tide method

> are the only equitable approaches because they both require the fortunate investors to account for payments received before they can obtain the benefit of a pro rata division of the residual receivership assets. In choosing between these two approaches previous case law provides little guidance. Only three previous American cases apparently have considered similar distribution problems. All three cases are ambiguous and do not precisely define whether the 'profits' should be subtracted before or after determining the investors' pro rata share. See In re Young, 294 F.1, 4 (4th Cir. 1923); accord In re Tedlock Cattle Co., Inc., 552 F.2d 1351, 1353-54 (9th Cir. 1977); In re Trending Cycles for Commodities, Inc., 27 B.R. 709, 711 (Bankr. S.D. Fla. 1985).

Commodity Futures Trading Commission v. Franklin, 652 F.Supp. 163, 169 (W.D. Va. 1986). Scant as the case law may be, however, this Court's task has been made much simpler by reason of the fact that the Fourth Circuit Court of Appeals has actually adopted the net investment method as the proper method of distribution in federal receivership cases such as the instant one. A decision of the Circuit Court binds all lower courts within the circuit as well as the Circuit Court itself. Hart v. Massanari, 266 F.3d 1155, 1171 (9th Cir. 2001) (containing lengthy discussion on the subject of precedent).

Franklin arose out of the United States District Court for the Western District of Virginia (not, unfortunately, the Western District of North Carolina, as indicated in the Receiver's Motion). On facts virtually identical to those here the Receiver in Franklin sought to employ the rising tide method. The Court, however, disagreed with the Receiver's position. After noting that the rising tide method formula "is problematic . . . because it treats the 'profits' as actual

profits, a return exceeding the initial investment, as opposed to the reshuffled capital funds that they really were," the Franklin Court went on to state the following:

> . . . it appears that the court's approach will lead to some inequality that would not result in using the Receiver's proposed formula. Under the Receiver's formula, all investors will end up with the same proportional total recovered. Under the court's formula, the investor who received profits will receive a somewhat greater total recovery than their less fortunate co-investors. Nonetheless, the court notes that both approaches do attain the equitable goal of forcing some accounting for the improperly distributed profits.
>
> Of the two approaches, however, the formula that the court previously employed [the net investment method] is the only one that leads to a relatively equitable economic division but also accurately treats the fake 'profits' as merely redistributed capital. Not only is the court's approach therefore fair, it is also consistent with the factual findings in this opinion. Arguably, the solution proposed by the Receiver is economically even-handed. It, however, fails to address the problem posed by the fake 'profits.' The court prefers the more encompassing result reached by the formula proposed in the original memorandum opinion [the net investment method]. When calculating the pro rata share of investors who have received 'profits,' the Receiver will therefore subtract the 'profits' from the initial investment *before* determining the pro rata share.

652 F.Supp. at 170 (emphasis added).

As the Receiver's Motion notes, Franklin was appealed to the Fourth Circuit of Appeals under the name of Anderson v. Stephens, 875 F.2d 76 (4th Cir. 1989). What is not clear from the Receiver's Motion, however, is that the "part" of the Franklin decision reversed by the Fourth Circuit had nothing whatsoever to do with the foregoing issue, but simply a dispute involving checks deposited into the wrongdoer's bank account after the fraudulent scheme had come to light and a freeze order had been entered by the Court. 875 F. 2d at 78. No appeal was taken as to the lower court's decision to apply the net investment method. Nevertheless, two points are worth making about the Fourth Circuit's opinion: (i) in order to rule on the relatively narrow issue before it, the Fourth Circuit found it "necessary to review the rationale of the Receiver's plan and the district court opinion," id., and was in no way critical of the District Court's decision

to apply the net investment method, and (ii) by reversing the District Court and holding that any checks deposited after the freeze order was entered should, in essence, be returned to the particular investors who issued the checks and not be distributed pro rata among all investors, it is at least arguable, if not apparent, that the Fourth Circuit favors a distribution method which does not penalize investors for having received other distributions, consistent with the District Court's opinion.

> We are not unmindful of what may be interpreted as a disparity and treatment between those individuals whose money was deposited before the freeze order and those individuals whose checks were deposited on March 28. We recognize that all FIG Investors will suffer because of Franklin's illegal activities. Yet because of Franklin's random selection of certain checks for deposit on March 28, some investors may suffer less than others. Ultimately, our decision means that each individual whose check was deposited on March 28 will get back the amount of that check, minus the administrative expenses, while those individuals whose checks were deposited before the freeze order will most likely recover about 25-30 cents on each dollar invested. However sympathetic we may be to the pre-freeze depositors, we cannot uphold the district court's order to include the post-freeze deposit in the pool of assets to be distributed on a pro rata basis.

875 F.2d at 81.

Investors, however, do not rely on Anderson as the sole expression of the Fourth Circuit on the issue at bar. In United States v. Vanguard Inv. Co., 6 F.3d 222 (4th Cir. 1993), the Court of Appeals stated, with reference to the Franklin and Anderson decisions that

> although we reversed that [District Court] judgment based on our conclusion that plaintiff investors weren't in fact similarly situated with the others, we did not disapprove the general approach taken by the district court.
>
> We reaffirm that position here . . . .

6 F.3d at 227 (emphasis added). See also Securities and Exchange Commission v. Elliott, 953 F.2d 1560 (11th Cir. 1992), decided a year before Vanguard, approving of and harmonizing both Franklin and Anderson:

> The Fourth Circuit reversed on narrow grounds, holding that the checks did not become part of the account because

> Franklin could not legally deposit them after the freeze order went into effect. 875 F.2d at 78. Thus, the Fourth Circuit did not reach the district court's equitable analysis, which we find to be convincing.

953 F.2d at 1570 (emphasis added). The Ninth Circuit Court of Appeals reached a similar result in Commodity Futures Trading Commission v. Topworth International, 205 F.3d 1107, 1116 (9th Cir. 1999) (court endorses Receiver's plan calling for the "net investment" method of reimbursement and finding analogous Section 761 of the Bankruptcy Code (11 U.S.C. §761), which provides that "the trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers' allowed net equity claims" in Commodity Broker Liquidation cases). Accord, Securities and Exchange Commission v. Capital Consultants, LLC, 397 F.3d 733, 737 (9th Cir. 2005) (net investment method, referred to by Court as "Money-in" less "Money-out," used to determine pro rata share paid to each claimant). Investors are aware of no Circuit Court of Appeals decisions favoring the rising tide method.

Thus, regardless of the few federal district courts outside the Fourth Circuit which have reached an opposite result, it is clear that the Fourth Circuit has adopted the net investment method as advocated by Investors herein, that at least two other Circuit Courts of Appeal support that position, and that this Court is constrained to rule in like fashion. Nevertheless, several comments are in order with respect to the cases cited in the Receiver's Motion which have come to a contrary conclusion.

The Motion identifies only three cases that support the rising tide method of distribution, none of which is a published decision and one of which appears to exist only in the form of a closed file somewhere in eastern Michigan. The cases are Commodity Futures Trading Commission v. Equity Financial Group, LLC, 2005 WL 2143975 (D.N.J.); Commodity Futures Trading Commission v. Hoffberg, 1993 WL 441984 (N.D. Ill.); and CFTC v. Skorupskas, No. 83-CV-1885 DT (E.D. Mich. Aug. 22, 1988). The Skorupskas case is known by the parties hereto only because it is cited in the Hoffberg decision, and the Receiver's office has advised the

undersigned that the opinion is not (or is no longer) accessible on the Pacer system. Both Equity Financial Group and Hoffberg are Westlaw cases and it is indicated at the top of each opinion that they were not reported in F. Supp. 2d. Citations to unpublished pre-2007 decisions are discouraged absent compelling circumstances to the contrary not present here. See 4th Cir. R. 32.1; F.R.A.P. 32.1, Hart v. Massanari, supra, at 1175 (upholding constitutionality of rule prohibiting citation of unpublished opinions and supporting rationale thereof). Even if Equity Financial Group and Hoffberg were published decisions and controlling law to the contrary did not exist, however, this Court should still decline to follow them as the facts of those cases are distinguishable from the facts of the instant action.

The primary distinguishing factor in Hoffberg is that of the 39 investors in that case, 30 received no distributions prior to the time the scheme came to light (i.e., only 9 of the 39 investors received prior distributions). That is a far cry from what happened in this case where, as indicated in the Supplement to Receiver's Motion Relative to Proposed Claims Distribution Method, only 13 of the 75 Barki investors did not receive prior distributions and 47 of the 75 total Barki investors would receive absolutely nothing under the rising tide method. The Hoffberg Court posed the following question in its opinion:

> Is it more equitable to return 15% of the initial investment to 30 investors and return no additional money to 9 investors or to return 10% of the 'net investment' to each of the 39 investors?

1993 WL 441984 at p. 2. The Court answered that question in favor of the 30 investors. In this case, however, the Court would be hard pressed to conclude that 47 of the 75 total investors should receive absolutely nothing under the claims distribution method proposed by the Receiver, so that the other 28 can receive all of the funds available for distribution.

The underlying investor mix is not as easy to determine from the Court's opinion in Equity Financial Group. However, the Court's holding in that case reads as follows:

> The Court agrees with the Receiver that the rising tide method is the most equitable. Under this method, the Court finds that as a

result of crediting prior withdrawals, there will be more funds available to the investors with allowable claims.

2005 WL 2143975 at p. 23. The undersigned fails to understand the logic in the second sentence quoted above. There cannot, by definition, be "more funds available" to "investors with allowable claims" under the rising tide method because regardless of what distribution method is employed, only "allowable claims" will receive a distribution from the Receiver and the "funds available" to satisfy such claims will be the same finite number regardless of what claims are paid. Perhaps the Court meant to say that more funds will be available to investors who didn't receive distributions prior to the collapse of the scheme, but that is nothing more than a restatement of the formula which defines the rising tide method. Regardless of whether the rising tide method or the net investment method is ordered by this or any other Court, all available funds will be used to satisfy allowable claims to the extent such claims can be paid with the limited funds available.

Interestingly, the most recent decision cited in the Receiver's Motion[1] is Securities and Exchange Commission v. Amerifirst Funding, Inc., 2008 WL 919546 (N.D. Tex.). The Amerifirst

[1] In its Notice of Additional Authority Relative to Distribution Methodology filed by the Receiver on October 5, 2009, the Receiver cites and discusses the case of SEC v. Byers, 2009 WL 2185491 (S.D.N.Y. July 23, 2009). The undersigned is unable to conclude from its content whether the Notice was filed because (i) the case was decided after the Receiver filed the Motion; (ii) as an officer of the court, the Receiver wanted to make this Court aware that yet another case had been decided in favor of implementing the net investment method (with a twist); or (iii) the case somehow supports the Receiver's position herein, or is distinguishable from Barki, because the Receiver in Byers was in favor of the net investment method and the Court ruled consistent with the Receiver's position. If (iii) is ultimately behind the filing of the Notice, in addition to the obvious logic challenge, it should be pointed out that the Franklin Court had no problem whatsoever taking a position contrary to that of the Receiver. "Although the court adopts the Receiver's proposed distribution formula, see id. at 20, the court adheres to its own interpretation of that formula as set out in Part D supra [the portion of the opinion approving the net investment method of distribution]. The court rejects the interpretation of the formula that the Receiver advocates in his motion . . . ." Franklin, supra, at 170. On appeal in Anderson v. Stephens, supra, the Fourth Circuit, quoting CFTC v. Muller, 570 F.2d 1296, 1300 (5th Cir. 1978), stated that "[i]t is well settled that in an action brought to enforce the requirements of remedial statutes such as [the Commodity Exchange] Act a district court has broad discretion to fashion appropriate relief." Stephens, supra, at 79. No mention is made therein about any special deference being afforded to the Receiver. See Johnson v. Studholme, 619 F.Supp. 1347 (D.Colo. 1985) (aff'd sub nom, Johnson v. Hendricks, 833 F.2d 908 (10th Cir. 1987)), cited in the Receiver's Motion (District Court rather pointedly disagrees with Receiver's proposed method of distribution in Ponzi scheme case).

Funding case not only rejects the rising tide method and adopts the net investment method but, in addition, does so on grounds that call for the same result in the instant action.

> A few courts have opted in favor of the rising tide method. Id. [citing Equity Financial Group, supra] But these courts were dealing with pure withdrawals of principal rather than a re-characterization of interest payments as a return of principal to put investors on equal footing. Plan B, which relies on the rising tide method, is more beneficial to those investors who did not receive interest payments because the interest payments that some investors did receive are effectively taken away from them, put back into the pool of receivership assets, and distributed pro rata based on the Investor's original investment amount. Under Plan A, those investors who received interest payments keep these interest payments as a return of principal without a pro rata reduction on them, although these Investors' pro rata share of the remaining receivership funds is reduced.

2008 WL 919546 at p. 6. That is exactly what has happened in the instant action for distributional purposes – virtually all of the investors in Barki, LLC received statements on a monthly basis showing the "interest" ("profits") with which they were being credited and any and all distributions of such amounts have been re-characterized by the Receiver as principal for distributional purposes.

CONCLUSION

This Court should adopt the net investment method as the method of distribution in this case. Not only is such a result virtually mandated by the precedent heretofore established in this Circuit (and the lack of any published decisions to the contrary) but, as set forth in the Response, it is also the fairest and most logical approach, especially under the particular facts (i.e., the Investor mix) of this case. In conclusion, perhaps the inequity of employing the rising tide method in the instant action is best illustrated by a quick review of the Receiver's fee petitions which have been submitted and/or approved to date. A total of $193,350.91 has now been (or shortly will be) paid to the Receiver's office with, in all likelihood, a substantial additional amount to be submitted, approved and paid thereafter. To put the issue in the vernacular of the Hoffberg Court: "Is it equitable that the approximately $200,000.00 -

$300,000.00 paid or to be paid to the Receiver for his good work in this case benefit only approximately one-third of all of the investors in this case (i.e., 28 out of 75), or should it benefit 85% of the investors in this case (i.e., 64 out of 75)? The answer should be "the latter."

This the 8th day of October, 2009

Respectfully submitted,

/s/ Marc R. Gordon
Marc R. Gordon
Attorney for Investors Harris, Wray, Boyles and Puckett
319 S. Sharon Amity Road, Suite 230
Charlotte, North Carolina 28211
(704) 364-3558 Telephone
(704) 365-3696 Telecopier
(State Bar No. 9241)

OF COUNSEL:

GIORDANO, GORDON & BURNS, P.L.L.C.

CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that the foregoing Memorandum of Law in Support of Response (Objection) of Harris, Wray, Boyles and Puckett to Receiver's Motion was served through the CM/ECF system upon

Joseph W. Grier III
A. Cotten Wright
Grier, Furr & Crisp, P.A.
101 N. Tryon Street, Suite 1240
Charlotte, NC 28246

and all other parties servable through said system.

This the 8th day of October, 2009.

/s/ Marc R. Gordon
Marc R. Gordon
Attorney for Investors Harris, Wray, Boyles and Puckett