

IN THE DISTRICT COURT OF OKLAHOMA COUNTY
STATE OF OKLAHOMA

AUG 13 2008

PATRICIA PRESLEY, COURT CLERK
by _____
DEPUTY

OKLAHOMA DEPARTMENT OF SECURITIES,)
ex rel., Irving L. Faught, Administrator,)

Plaintiffs,)

v.)

Case No.: CJ-2006-3311

FARMERS & MERCHANTS BANK, an)
Oklahoma banking entity; JOHN V. ANDERSON,)
Individually, and as Officer and Director of)
Farmers & Merchants Bank; and JOHN TOM)
ANDERSON, Individually, and as Officer)
and Director of Farmers & Merchants Bank,)

Defendants,)

and)

ROBERT LYNN POURCHOT, Trustee of the)
Robert Lynn Pourchot Trust; DONALD W. ORR,)
Trustee of the Pourchot Trust; THE WILL)
FOUNDATION; POURCHOT INVESTMENTS,)
LP; PHILLIP M. POURCHOT, Trustee of the)
Phillip M. Pourchot Revocable Trust; RICHARD)
REYNOLDS; RICHARD REYNOLDS, Trustee of)
the Richard Reynolds Living Trust; ANNENDA)
REYNOLDS; STEVEN B. SANDERS; VICKI L.)
SANDERS; and CRANDALL & SANDERS, INC.,)

Intervenors.)

REPLY BRIEF IN SUPPORT OF INADMISSIBILITY OF INVESTORS' NEGLIGENCE

The Intervenors submit this Response Brief to address the contentions raised by Defendants' Brief in Support of Outstanding Discovery Issues.

I. Defendants' Brief Concedes That Investors' Alleged Negligence Is Not Relevant To Either the Plaintiff's Claim or Any Valid Defense To Plaintiff's Claim.

The Intervenors drafted their brief to address the issue set forth by the Court as to whether evidence of the Investors' alleged negligence could be fairly presented in this trial. The

Intervenors' Brief and the Plaintiff's brief both noted that in order to prove its claim that the Defendants materially aided Schubert's fraudulent conduct, the Oklahoma Department of Securities (ODS) must show that: (1) a securities violation occurred; (2) the Defendants rendered substantial assistance to Schubert; and (3) the Defendants had knowledge, or in the exercise of reasonable care, could have known of Schubert's fraudulent conduct. *See* 71 Okla. Stat. § 1-509(G)(5). As previously stated, any evidence requested by the Defendants "must be relevant since a defendant does not have a constitutional right to present irrelevant evidence." *U.S. v. Munoz*, 233 F.3d 1117, 1134 (9th Cir. 2000). Both briefs concluded that the Investors' negligence is not relevant to any of the three elements necessary to prove Defendants' civil liability for aiding and abetting Schubert's fraudulent conduct. *See* Intervenors' Brief; ODS Brief, p. 2-3.

By not even attempting to respond to these propositions, the Defendants have clearly conceded that any allegedly negligent conduct on the part of the Investors is irrelevant and cannot fairly be raised as part of any defense to the claim filed against them by the ODS.

II. An Analysis of Investors' Possible Negligence Is Irrelevant In a Claim Based Upon a Broker's Affirmative Misstatement

In their Brief, Defendants contend that they are entitled to discover information concerning the individual investor's educational background and investment sophistication to determine each Investor's actual reliance upon Schubert's fraudulent misrepresentations. *See* Defendants' Brief, p. 8. The "education and investment sophistication" test is only relevant, however, if the Plaintiffs are relying upon claims that the fraudulent party intentionally omitted material facts that would have alerted the investors to the fraudulent nature of the securities transactions at issue. *See Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983).

Neither the Plaintiffs nor the Investors are relying on claims of material omissions. Instead, Plaintiff's claims against Schubert allege that she made multiple affirmative, fraudulent misrepresentations to investors that she would invest funds entrusted to her when in fact she never intended to invest a cent. This resulted in her federal criminal conviction for fraud.

Oklahoma law provides no support for Defendants' apparent contention that individual investors have a duty to investigate whether their fiduciary made an affirmative fraudulent misstatement regarding the location and amount of the investments made with the funds provided to the broker. *See* Defendants' Brief, p. 8. In its opinion regarding liability for facilitating fraudulent securities transactions, the Tenth Circuit Court of Appeals noted that "the policy of prevention of fraud is the core of the securities laws and must not be overlooked simply because other conflicting policies are also implicated. Indeed, not only in the area of securities but generally the policy of deterring intentional misconduct outweighs that of deterring negligent or reckless conduct." *Zobrist*, 708 F.2d at 1538. Thus, the "omissions analysis"¹ cited and analyzed by Defendants to support the relevance of the Investors' conduct relating to their investment decisions cannot be fairly applied to the case at hand.

III. The Cases From Foreign Jurisdictions Cited In Defendants' Brief Do Not Have Any Bearing On The Current State Of Oklahoma Law

Defendants cite various state court cases from around the country to support their contention that the level of reliance each investor placed upon Defendants' actions in aiding and abetting the fraudulent conduct masterminded by Schubert is relevant and discoverable. *See* Defendants' Brief, p. 13-15. The foreign cases cited by Defendant, however, each construe state statutes that differ materially from the Oklahoma Securities Act.

¹ Defendants' Brief, p. 8-9.

For example, the Florida statute thoroughly discussed and relied upon by Defendants in their brief states that joint and several liability may only be imposed if the potentially liable parties have “personally participated or aided in making the sale or purchase” of a fraudulent security. *See Fla. Stat. Ann. § 517.211.* The Defendants’ Brief uses these cases to suggest that the discovery of Investor’s personal investment history is relevant because the Florida statute requires “personal participation” in the process of selling fraudulent securities and investors’ reliance upon the third-parties’ actions to hold a third party liable for aiding and abetting such fraudulent conduct. Although Defendants’ Brief accurately analyzes the current state of Florida law, the Oklahoma statute providing for civil liability for aiding and abetting the sale of fraudulent securities does not create any requirement that a third party’s aiding and abetting must consist of personal participation in the sales process. *See 71 Okla. Stat. § 1-509.*

Under the Oklahoma Securities Act, a third party is liable if it “materially aids in the conduct giving rise to the [securities fraud claim].” *Id.* Unlike the Florida statute, which focuses on the level of the investors’ conscious reliance upon the third party’s participation in the fraudulent securities scheme, the Oklahoma statute creates liability solely based on whether the assistance of the third party aided the fraudulent broker in carrying out her fraudulent conduct. *Id.* Clearly, this material difference demonstrates why evidence of defrauded investors’ investment histories could potentially be relevant to a securities fraud case arising in Florida, but would be completely irrelevant to a similar case arising under Oklahoma law.

The Defendants’ Brief also cited dicta from *Schollmeyer v. Saxowsky*, 211 N.W.2d 377 (N.D. 1973), a North Dakota state court case, to contend that only participation in “the selling process [of a fraudulent security]...triggered concerns for investor protection.” *See Defendants’ Brief*, p. 13. Although not stated in Defendants’ Brief, the *Schollmeyer* court actually held that

“[t]he Securities Act providing for liability of officers and directors and others of seller of illegal securities *does not require that participation or aid in making an illegal sale be by personal contact with the buyer* but is sufficient if, in any way, *the directors' or officers' participation or aid made the sale possible.*” *Id.*; see NDCC § 10-04-17.

In the case at hand, the extensive material participation of the Defendants, whether intentional or grossly negligent, was the key element that made Schubert's fraudulent securities scheme possible. Without the Bank's involvement in both transferring funds between accounts and Schubert's fraudulent check-kiting, Schubert's scheme would never have survived past the planning stages. The Defendant's reliance upon the North Dakota securities liability statute does not support its contention that the Investors' investment histories and background are relevant and discoverable. Instead, a careful examination of the *Schollmeyer* opinion supports both the Plaintiff's and Intervenors' position that the court must only examine whether the actions of the abetting third party materially aided the fraudulent broker's securities scheme.

IV. The Individual Investors' Negligence is Not Relevant to Determining the Length of the Statute of Limitations on this Claim

As noted in Defendants' Brief, the Oklahoma Securities Act, similar to the federal securities laws, states that the statute of limitations for civil actions based on affirmative misrepresentations or failure to disclose material information regarding transactions involving the purchase or sale of securities is the earlier of two years after discovery of the violation or five years after such violation. See 71 Okla. Stat. Sec. 1-509(J)(2). Under well-established Oklahoma law, although each individual's **actual knowledge** of the Defendants' participation in Schubert's fraudulent conduct may be relevant to the suit at hand, any evidence of the individual

investors' alleged negligence in discovering the Defendants' participation in Schubert's fraudulent behavior is irrelevant.

The Defendants do not contend in their brief that the calculation of the applicable statute of limitations should be based on the Investors actual knowledge of the material aid Defendants provided to Schubert, presumably because the Defendants know that the Investors only fairly recently gained any actual knowledge of the Defendants' involvement in Schubert's fraudulent actions. Instead, the Defendants argue that the individual investors' educational background and investment histories are relevant in determining when the Investors should have known of Schubert's fraudulent conduct. *See* Defendants' Brief, p. 7-8. This contention is simply not supported by Oklahoma law. As an initial matter, the relevant inquiry is related to the discovery of the Defendants' role in materially aiding Schubert's fraudulent conduct because the claim being asserted in this action is against the Defendants, not Schubert. Moreover, in supporting a statute of limitations defense, Defendants may only examine whether a reasonable person would have been able to discover Defendants' involvement in Schubert's fraudulent conduct at an earlier date.

Oklahoma follows the discovery rule allowing limitations in tort cases to be tolled until the injured party knows or, in the exercise of reasonable diligence, should have known of the injury. *Samuel Roberts Noble Found., Inc. v. Vick*, 840 P.2d 619, 623 (Okla. 1992) ("a discovery rule should encompass the precept that acquisition of sufficient information which, if pursued, would lead to the true condition of things will be held as sufficient knowledge to start the running of the statute of limitations. This rule obtains because a *reasonably prudent person* is required to pursue his claim with diligence") (emphasis added); *Reynolds v. Porter*, 760 P.2d 816, 820 (Okla. 1988); *Seitz v. Jones*, 370 P.2d 300, 302 (Okla. 1961); *Continental Oil Co. v.*

Williams, 250 P.2d 439, 441 (Okla. 1952). The discovery rule is intended to exclude the period of time during which the injured party is reasonably unaware that they have incurred an injury to their person or property. *Resolution Trust Corp. v. Grant*, 1995 OK 68, 901 P.2d 807; *see also In re John Deere 4030 Tractor*, 816 P.2d 1126, 1133 (Okla. 1991); *Resolution Trust Corp. v. Farmer*, 865 F. Supp. 1143, 1151 (E.D.Pa. 1994).

Under Oklahoma law, the standard for determining when the statute of limitation begins to run on a claim for fraud is based upon when a **reasonable person** would have discovered information causing them to become suspicious of such fraudulent conduct or when a person should reasonably have discovered fraudulent conduct. *N.C. Corff Partnership, Ltd. v. OXY USA, Inc.*, 1996 OK CIV APP 92, 929 P.2d 288 (Okla. Civ. App. 1996)(quoting *Weathers v. Fulgenzi*, 884 P.2d 538, 541 (Okla.1994))("if the means of knowledge exist and the circumstances are such as to put a **reasonable person** upon inquiry, it will be held that there was knowledge of what could have been readily ascertained by such inquiry" (emphasis added)).

The "inquiry notice" doctrine is fairly-uniformly applied around the country in securities fraud actions to determine when a reasonable investor would have discovered a fraudulent securities transaction. In *Great Rivers Co-op. of SE Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, (8th Cir. 1997), the Eight Circuit Court of Appeals held that to test for the existence of "inquiry notice" a court must determine: (1) the facts of which the victim was aware; (2) whether a reasonable person with knowledge of those facts would have investigated the situation further; and (3) upon investigation, whether a reasonable person would have acquired actual notice of the defendant's misrepresentations. *See Roberson v. PaineWebber, Inc.*, 2000 OK CIV APP 17 at ¶7, 998 P.2d 193; *Smith v. Layon*, 2007 OK CIV APP 98 at ¶4, 170 P.3d 1046.

Under Oklahoma law, Schubert's fraudulent agreement to invest the Investors' funds in fictional investment vehicles while she instead deposited those funds in various F & M Bank accounts effectively created a constructive trust, with Schubert being deemed trustee, for those funds. *Raper v. Thorn*, 1949 OK 208 at ¶9, 211 P.2d 1007("A person who agrees with another to purchase property on behalf of the other and purchases the property for himself individually holds it upon a constructive trust for the other, even though he is not under a duty to purchase the property for the other.") In *Smith v. Baptist Foundation of Oklahoma*, 2002 OK 57 at ¶18, 50 P.3d 1132, the Oklahoma Supreme Court stated that "[w]here a trustee mishandles the subject matter of a trust or where the actions taken by the trustee are self-concealing, a cause of action will not accrue until the trustee-instituted actions are discovered or until they could have been unearthed by the exercise of due diligence." See *American Nat'l Bank of Enid v. Crews*, 1942 OK 182, ¶21, 126 P.2d 733. Therefore, a trustee (and, by implication, one who is held joint and severally liable for the trustee's fraudulent conduct) cannot rely on a statute of limitations defense without first showing that the defrauded parties knew of the fraudulent conduct when it occurred or were given sufficient information that reasonable party should have discovered the conduct. *Id.*

In its well-reasoned opinion, the Seventh Circuit Court of Appeals analyzed the level to which suspicious circumstances must rise in order to commence the statute of limitations in a securities fraud case. *Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332 (7th Cir. 1997). The court noted that "the facts constituting such notice must be sufficiently probative of fraud—sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated...." The Second Circuit Court of Appeals has also stated that only "where the circumstances are such as to suggest to a person of ordinary intelligence the probability that he

has been defrauded, a duty of inquiry arises....” *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir.1983).

The U.S. District Court for the Southern District of New York has dealt with a securities fraud suit with facts similar to the suit at hand. *Zola v. Gordon*, 685 F.Supp. 354 (S.D.N.Y. 1988). In *Zola*, certain individuals invested in the production of a film, and were informed by their investment advisor that the film’s valuation was \$3,150,000.00. The next year, the investors all received reports from the Internal Revenue Service which valued the film at \$60,000.00, much less than the advisors’ valuation. The investors chose to not rely upon the IRS’ valuation, and did not bring suit against their advisor for fraudulent conduct relating to the knowing overvaluation of the film until a much later date. In its analysis, the *Zola* court noted that the investors “receipt of the IRS report is sufficient to impute constructive knowledge of the probability of fraud to plaintiffs. A reasonable person of ordinary intelligence would have considered the IRS report, which valued "The Romantic Englishwoman" at \$60,000.00, a figure 95.6% less than the \$3,150,000.00 at which Arlington valued the film, to suggest the probability plaintiffs had been defrauded.” *Id.*

In the instant suit, the Defendants’ involvement in Schubert’s actions and affirmative misrepresentations could not have been seen as “sufficiently probative of fraud” until March 23, 2005, at the earliest, the date on which the Receiver’s Report of Schubert Financial Analysis (the “Report”), a court-ordered undertaking performed during the original suit filed by the Oklahoma Department of Securities against Schubert, was filed. *See* Receiver’s Report, attached as Exhibit A. In the Report, Douglas L. Jackson (the “Receiver”) states that he analyzed “all bank and other financial records obtained by the Receiver and Oklahoma Department of Securities,” including nine named third parties. *See* Report, p. 1. After the Receiver detailed the level of

each Investors' funds lost by Schubert, the Report states that the source of a significant amount of funds had still not been identified, as many checks were "transacted without payees or endorsements..., all of which have made it very difficult for the accounting firm to trace these funds at this point and time." *Id.* at 2.

If the court-ordered Receiver, a professional financial professional, could not affirmatively conclude that certain funds were missing from the Investors' accounts because Defendants were "routinely accepting" checks "without payees or endorsements" until March 23, 2005, the Investors certainly cannot be charged with "probable knowledge" of the Defendants' involvement in the scheme as the facilitating bank. Until the filing of that report no investor could have known that massive amounts of funds were being kited between banks, that banks were approving payment of checks without confirmation of funds or that Defendants watched and daily approved payment of checks from a bank account that took in massive amounts of investor funds but never wrote a check for a plausible business purpose that could generate income. Even if the Investors were aware that something could be wrong concerning their investments with Schubert, "the facts constituting such notice must be...*sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated....*" (emphasis added) *Armstrong*, 699 F.2d at 88. Knowledge of the loss is vastly different from the elusive knowledge of the Defendants extensive involvement in the scheme through the facilitating bank.

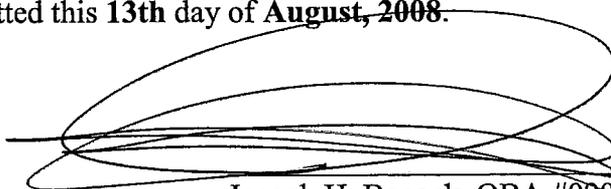
Schubert's daily theft of funds was effectively concealed by the conduct of all Defendants. This participation in concealment would be fatal to a statute of limitation defense even if there were any way for a reasonable person to know about the misconduct of the defendants until month after the Receiver's Report could be pieced together to reveal bank

misconduct. In *Waugh v. Guthrie Gas, Light, Fuel & Improvement Co.*, 1913 OK 42 at ¶0, 131 P. 174 (Okla. 1913), the Oklahoma Supreme Court noted the well-established Oklahoma law that

fraudulent concealment constitutes an implied exception to the statute of limitations, and a party who wrongfully conceals material facts, and thereby prevents a discovery of his wrong, or the fact that a cause of action has accrued against him, is not allowed to take advantage of his own wrong by pleading the statute [of limitations], the purpose of which is to prevent wrong and fraud.

See Kansas City Life Ins. Co. v. Nipper, 1935 OK 1127, 51 P.2d 741; *Liberty Natl. Bank of Weatherford v. Lewis*, 1935 OK 492, 44 P.2d 127; *Brookshire v. Burkhart*, 1929 OK 428, 283 P. 571. This suit was filed on April 21, 2006, well within both the two-year period after the publication of the Receiver's Report and the five-year period following the occurrence of Schubert's fraudulent transactions, as required by 71 Okla. Stat. § 1-509(J)(2). Thus, the Defendants have no grounds upon which they may raise a valid affirmative defense based on the running of the statute of limitations.

Respectfully submitted this 13th day of August, 2008.



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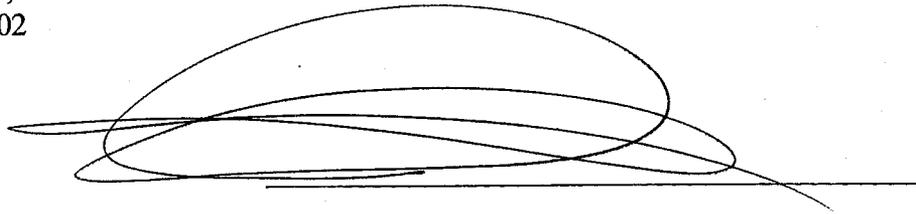
ATTORNEYS FOR INTERVENORS

CERTIFICATE OF SERVICE

I hereby certify that on this **13th** day of **August, 2008**, a true and correct copy of the foregoing was emailed and sent via U.S. Mail, postage prepaid, to the following:

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A large, stylized handwritten signature in black ink, consisting of several overlapping loops and a long horizontal stroke at the bottom.