UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:	**Jointly Administered under Case No. 08-45257**
Petters Company, Inc., et al,	Court File No. 08-45257
Debtors.	Court File Nos:
(includes:	
Petters Group Worldwide, LLC;	08-45258 (GFK)
PC Funding, LLC;	08-45326 (GFK)
Thousand Lakes, LLC;	08-45327 (GFK)
SPF Funding, LLC;	08-45328 (GFK)
PL Ltd, Inc.;	08-45329 (GFK)
Edge One LLC;	08-45330 (GFK)
MGC Finance, LLC;	08-45331 (GFK)
PAC Funding, LLC;	08-45371 (GFK)
Palm Beach Finance Holdings, Inc.)	08-45392 (GFK)
	Chapter 11 Cases
	Judge Gregory F. Kishel

NOTICE OF HEARING AND VERIFIED MOTION BY APRIVEN PARTNERS, LP; C&C CAPITAL, LLC; AND TRUE NORTH FUNDING, LLC, FOR LEAVE TO CONDUCT CONSTRUCTIVE-TRUST DISCOVERY PURSUANT TO FEDERAL RULE OF BANKRUPTCY PROCEDURE 2004

To : The Debtors and other entities and persons specified in Local Rule 9013-3.

1. Pursuant to Fed. R. Bankr. P. 2004, Apriven Partners, LP; C&C Capital, LLC; and True North Funding, LLC (jointly the "Trust Beneficiaries") move the Court for the relief requested below and give notice of hearing.

2. The Court will hold a hearing on the motion on Tuesday, December 9, 2008, at 1:30 p.m., in Courtroom 2A of the United States Bankruptcy Court, District of Minnesota, Warren E. Burger Federal Building and U.S. Courthouse, 316 North Robert Street, Saint Paul, Minnesota 55101, or as soon thereafter as counsel may be heard.

3. Any response to the motion must be filed and served for delivery no later than 1:30 p.m. on Thursday, December 4, 2008, which is three days before the time set for the hearing (excluding Saturdays, Sundays, and holidays), or filed and served by mail not later than December 2, 2008, which is seven days before the time set for the hearing (excluding Saturdays, Sundays, and holidays). **UNLESS ONE OR MORE RESPONSES OPPOSING THE MOTION ARE TIMELY FILED, THE COURT MAY GRANT THE MOTION WITHOUT A HEARING.**

4. The Trust Beneficiaries are creditors in the above-captioned Chapter 11 case. The Court has jurisdiction over this motion pursuant to 28 U.S.C. §§ 157 and 1334, Fed. R. Bankr. P. 5005, and Local Rule 1070-1. Venue is proper in this Court under 28 U.S.C. § 1409. This is a core matter within the meaning of 28 U.S.C. § 157(b)(2)(A) and Fed. R. Bankr. P. 2004. The petitions commencing this jointly administered case were filed on October 11, 17, and 19, 2008. The case is now pending in this Court.

5. This application arises under Fed. R. Bankr. P. 2004 and Local rule 2004-1. This application is filed under Fed. R. Bankr. P. 9014 and Local rule 2004-1. The Trust Beneficiaries move for entry of an order allowing the Rule 2004 examination of bank records and depose necessary witnesses to determine the fate of their recent payments into the Petters ponzi scheme and determine their present custodians, which may include

the debtors in this bankruptcy, to whom the following payments were originally made:

Apriven Partners	06/05/08	$7,350,000.00
	06/06/08	$3,000,000.00
	06/09/08	$6,650,000.00
	07/03/08	$4,500,000.00
	08/05/08	$10,000,000.00
	08/07/08	$10,000,000.00
Apriven Subtotal		**$41,500,000.00**
C&C Capital	07/17/08	$1,500,000.00
C&C Subtotal		**$1,500,000.00**
True North Funding	06/20/08	$2,000,000.00
	06/20/08	$1,100,000.00
	06/23/08	$500,000.00
True North Subtotal		**$3,600,000.00**
Total		**$46,600,000.00**

6. The motion is supported by the memorandum of law and the Declaration of Marc A. Al with Exhibits submitted herewith.

Wherefore, Apriven Partners, LP; C&C Capital, LLC; and True North Funding, LLC move the Court for an Order allowing undersigned counsel to serve subpoenas and take such depositions as are necessary, subject to compliance with Bankr. Rule 9016 and Fed. R. Civ. P. 45 as applicable, to trace deposits made by them on the dates set forth below into Petters Company, Inc.'s M&I Bank account number 195-9018.

Dated: November 19, 2008

STOEL RIVES LLP

/e/ Marc A. Al

Eric A. Bartsch (#243723)
Marc A. Al (#247923)
Steven R. Kluz (#286588)
33 South Sixth Street, Suite 4200
Minneapolis, MN 55402
Telephone: 612-373-8800
Facsimile: 612-373-8881

ATTORNEYS FOR APRIVEN PARTNERS, LP; C&C CAPITAL, LLC; AND TRUE NORTH FUNDING, LLC

VERIFICATION

I, J. Martin Tate, the General Counsel of True North Funding, LLC, acting on behalf of all Trust Beneficiaries as defined in the foregoing notice of hearing and application, declare under penalty of perjury that the foregoing and the factual representations in the accompanying memorandum of law are true and correct according to the best of my knowledge, information, and belief.

Executed on November 18, 2008.

J. Martin Tate
True North Funding, LLC
7659 South 700 West
Midvale, Utah 84047

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

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Petters Company, Inc., et al.,	Court File No. 08-45257
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	Chapter 11 Cases
	Judge Gregory F. Kishel

MEMORANDUM OF LAW IN SUPPORT OF MOTION BY APRIVEN PARTNERS, LP; C&C CAPITAL, LLC; AND TRUE NORTH FUNDING, LLC, FOR LEAVE TO CONDUCT CONSTRUCTIVE-TRUST DISCOVERY PURSUANT TO FEDERAL RULE OF BANKRUPTCY PROCEDURE 2004

INTRODUCTION AND RELIEF SOUGHT

Pursuant to the District Court's October 22, 2008, Injunction Order, (Declaration of Marc A. Al Ex. 5), Federal Rule of Bankruptcy Procedure 2004(a), and Local Rule 2004-1, Apriven Partners, LP; C&C Capital, LLC; and True North Funding, LLC

(jointly, "Trust Beneficiaries") move for entry of an order pursuant to Rule 2004(a) of the Federal Rules of Bankruptcy Procedure allowing the examination of and issuance of subpoenas to banks and other third parties to establish a factual basis for the Court's recognition of a constructive trust in favor of the Trust Beneficiaries, which deposited $46.6 million into Petters Company, Inc.'s M&I Bank account during the last weeks of the conspiracy.

JURISDICTION

The Bankruptcy Court has jurisdiction over this motion pursuant to 28 U.S.C. §§ 157, 1334, Fed. R. Bankr. P. 5005, and Local Rule 1070-1. Venue is proper in this Court under 28 U.S.C. § 1409. This is a core matter within the meaning of 28 U.S.C. § 157(b)(2)(A) and Fed. R. Bankr. P. 2004.

STANDARD FOR RULE 2004 DISCOVERY

Pursuant to Rule 2004, the Court may order an examination into the "acts, conduct, or property or . . . the liabilities and financial condition of the debtor, or . . . any matter which may affect the administration of the debtor's estate." Fed. R. Bankr. P. 2004. Additionally, in Chapter 11 cases, "the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan." Fed. R. Bankr. P. 2004.

Rule 2004 allows examination of any entity on a motion filed with the Court. The scope of a Rule 2004 examination is "unfettered and broad." In re GHR Energy Corp., 33 B.R. 451, 453 (Bankr. D. Mass. 1983). Examinations under Rule 2004 are allowed for the "purpose of discovering assets and unearthing frauds." Id. at 453 (citing In re Foerst, 93 F. 190, 191 (S.D.N.Y. 1899)). A party's allegation that it has no information to divulge is not a basis to deny the Rule 2004 motion. The purpose of the rule is to allow discovery to establish the scope of knowledge. In re Arkin-Medo, Inc., 44 B.R. 138 (Bankr. S.D.N.Y. 1984).

BACKGROUND

In October 2008, principals and key executives of the Debtors pleaded guilty to engineering and orchestrating a ponzi scheme designed to swindle lenders. (See criminal informations, minutes of guilty-plea hearings, and search warrant applications, Al Declaration Ex. 4.) The Debtors pretended to seek financing for electronic equipment inventories purchased for resale to large retailers on committed retailer purchase orders, with the inventories and purchase orders pledged as security. Information disclosed to date suggests that the ponzi scheme was carried out for over a decade and potentially implicates over $3 billion in swindled monies. (Id.) The Trust Beneficiaries were latecomers to the ponzi scheme and were defrauded by it. (Complaint, Al Decl. Ex. 6.)

Under the ponzi scheme, lenders provided funds for, and financing to, debtors. Agents of debtors created fictitious documents that gave the appearance of large inventory stocking orders and correlating sales of those inventories to famous retailers.

The transactions required short-term working capital financing. Ponzi victims were invited to provide that financing for the inventories via short-term debt instruments secured by purchase money liens and, in some instances, signature guarantees by Thomas Petters. Contrary to the representations made by debtors, the financing procured by debtors was not used to enable the purported underlying transactions, which were in fact fictitious, but was diverted for criminal purposes. (Al Decl. Exs. 4 & 6.)

From June 5, 2008, through August 7, 2008, and pursuant to promissory notes ostensibly secured by sold inventories, the Trust Beneficiaries wired funds directly to an M&I Bank account for Petters Company, Inc. Specifically, the following wires were sent by the Trust Beneficiaries:

Apriven Partners	06/05/08	$7,350,000.00
	06/06/08	$3,000,000.00
	06/09/08	$6,650,000.00
	07/03/08	$4,500,000.00
	08/05/08	$10,000,000.00
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	06/23/08	$500,000.00
True North Subtotal		**$3,600,000.00**
Total		**$46,600,000.00**

(Al Decl. Ex. 6; Verified Notice of Hearing and Motion at 3.)

On September 8, 2008, less than three months after the last wire, the ponzi scheme was discovered by federal authorities. Shortly thereafter, the Trust Beneficiaries

commenced civil litigation. (Apriven Partners LP v. Petters Group Worldwide, LLC, 08-CV-5373 (ADM/JSM) (D. Minn.), Al Decl. Ex. 6.) That portion of the case dealing with various corporate defendants was stayed automatically when those debtors filed bankruptcy petitions in the Bankruptcy Court on October 11, 17, and 19, 2008. The remainder of the case was stayed by operation of an injunction entered by Judge Montgomery before the Rule 26 conference could take place and before discovery could be undertaken. United States v. Petters, 08-CV-5348 (ADM/JSM), Docket No. 70 (D. Minn. Oct. 22, 2008), Al Declaration Ex. 5. Judge Montgomery's October 22, 2008 Order allows litigation, such as this motion for Rule 2004 discovery, to take place within the context of the bankruptcy proceeding. Id. at 19.

To the extent the Trust Beneficiaries' payments can be traced to assets in the possession or control of the Receiver, Debtors, or certain third parties, including any of the individuals involved in the fraudulent scheme, those assets are subject to a constructive trust because, as a matter of law, equitable title to the proceeds from each wire has since the date of each wire been held by the possessor on behalf of the Trust Beneficiaries. Because those assets are and continue to be subject to loss, however, time is of the essence in tracing the specific assets. Doing so requires leave to take discovery, which is hereby sought.

ISSUE

Are the Trust Beneficiaries entitled to conduct limited discovery under Rule 2004 and the Federal Rules of Bankruptcy and Civil Procedure for the purpose of showing that their deposits into the Petters ponzi scheme survive in traceable assets?

ARGUMENT

I. RULE 2004 DISCOVERY WILL ALLOW THE TRUST BENEFICIARIES TO DETERMINE IF THEIR PAYMENTS CAN BE TRACED FOR THE PURPOSE OF IMPOSING A CONSTRUCTIVE TRUST IN THEIR FAVOR

A. All Potentially Applicable Laws Impose a Constructive Trust Prepetition at the Time of the Fraud and Without Court Action

The Trust Beneficiaries made wire payments directly to Petters Company, Inc.'s Minnesota-based M&I Bank account from Texas, Idaho, and Utah. (Al Decl. Ex. 6.) Minnesota courts have held that "whenever the legal title to property is obtained through fraud, oppression, duress, undue influence, force, crime, or similar means, or by taking improper advantage of a confidential or fiduciary relationship, a constructive trust arises in favor of the person equitably entitled to the property." Wright v. Wright, 311 N.W.2d 484, 485 (Minn. 1981). Constructive trusts have also been imposed "to prevent unjust enrichment of a person holding property under a duty to convey it or use it for a specific purpose." Id.; Koberg v. Jones, 157 N.W.2d 47 (Minn. 1968); Iverson v. Fjoslien, 213 N.W.2d 627, 628-29 (Minn. 1973) (explaining that court will establish constructive trust where unjust enrichment would otherwise result).

To create a constructive trust, there must be "some specific property identified as belonging, in equity and conscience, to the plaintiff." Rock v. Hennepin Broad. Assocs.,

Inc., 359 N.W.2d 735, 739 (Minn. Ct. App. 1984). "A constructive trust does not arise unless there is property on which the trust can be fastened, and the property is held by the person to be charged as constructive trustee." Id.; Spiess v. Schumm, 448 N.W.2d 106 (Minn. Ct. App. 1989) (allowing imposition of constructive trust on account funds).

Minnesota law recognizes that a constructive trust is imposed—automatically and as a matter of law—in favor of the victim at the time of a misappropriation. Knox v. Knox, 25 N.W.2d 225, 232 (Minn. 1946) ("[T]he act of the adverse and inequitable withholding, which brings the constructive trust into being, is not a fiction, but a reality, which in point of time is not to be related either backward or forward. It is the act by which a defendant becomes chargeable as a constructive trustee . . . ."). Because the constructive trust arises at the time of the wrong and as a matter of law, it arose prepetition in this case.

The results are no different if the Court looks to the laws of the states where the wire payments originated, as opposed to Minnesota law. In Texas, Idaho, and Utah, the constructive trust is similarly imposed in favor of the victim at the time of misappropriation. Murphree v. United States, 867 F.2d 883, 885 (5th Cir. 1989) ("Texas law does impose a constructive trust in favor of the [defrauded party] from the time of the misappropriation.") (citing Searle-Taylor Mach. Co. v. Brown Oil Tools, Inc., 512 S.W.2d 335, 338 (Tex. Civ. App. 1974)); Andre v. Morrow, 680 P.2d 1355, 1363 (Idaho 1984) ("[A] constructive trust takes effect at the time of the wrongful act, and traces funds gained by the act until the rightful recovery is made."); First Sec. Bank of Utah v. Gillman, 158 B.R. 498, 507 (D. Utah 1993) ("[T]he effective date of the constructive

trust is the date the wrongful act occurred.") (citing In re Seneca Oil Co., 906 F.2d 1445, 1453 (10th Cir. 1990) ("a constructive trust relates back to the date of the wrongful act regardless of whether the constructive trust exists before it is recognized by a court of equity")).

It is a well-established legal principle that where one person misappropriates or defrauds another and converts the proceeds into another species of property, the defrauded party can assert equitable rights in the traceable product. In re Dartco, Inc., 197 B.R. 860, 867 (Bankr. D. Minn. 1996) (Kishel, J.) (citing Thompson v. Nesheim, 159 N.W.2d 910, 916 (Minn. 1968)). All personal property traceable to the original fraudulent transfer is subject to the constructive trust regardless of its present form:

> It is elementary that a person obtaining property by fraud acquires no title to it, but it is held by him, and by all persons claiming under him, with notice, in trust for the original owner. So long as the property can be identified in its original or in a substituted form, it belongs to the original owner, if he elects to claim it; and, if it passes into the hands of an innocent purchaser for value, the title of the defrauded owner, at his option, at once attaches to the avails, so long as their identity is preserved, no matter how many transmutations of form the property has passed through. So long as the trust property can be traced and followed into other property into which it has been converted, that remains subject to the trust. The product or substitute has the nature of the original imparted to it.

Third Nat'l. Bank of St. Paul v. Stillwater Gas Co., 30 N.W. 440, 440-41 (Minn. 1886). The mere fact that converted assets have been commingled with other assets belonging to the purported (constructive) trustee, or even with assets of a third party, will not defeat the finding of a constructive trust. In re Dartco, 197 B.R. at 868 (citing Petersen v. Swan,

57 N.W.2d 842, 846 (Minn. 1953); Thompson, 159 N.W.2d at 910; Cisewski v. Cisewski, 152 N.W. 642, 643 (Minn. 1915)).

B. Rule 2004 Discovery Will Allow the Trust Beneficiaries to Determine the Traceability of Their Funds

Petters Company, Inc. obtained the Trust Beneficiaries' funds by operating a ponzi scheme. In the scheme, the Trust Beneficiaries were fraudulently induced to loan Petters money to finance electronic equipment inventories for resale at retail stores. (Al Decl. Exs. 4 & 6.) Petters took legal title to the Trust Beneficiaries' property through fraud, giving rise to a constructive trust in favor of the Trust Beneficiaries, which are equitably entitled to the property. Wright, 311 N.W.2d at 485. To impose a constructive trust, the only state-law question remaining on these facts is whether the fraudulently obtained funds are traceable. This question can be answered by allowing the Trust Beneficiaries to take limited Rule 2004 discovery and by applying judicial tracing rules.

Here, the fraudulently obtained funds were wired into a particular M&I Bank account owned by Petters Company, Inc., to wit, M&I Account No. 195-9018. Rule 2004 discovery is needed to determine the balance in that account prior to each of the wire deposits and to locate the subsequent transfers or transmutation of the funds.[1] An initial destination determination can be made simply by analyzing Petters Company, Inc.'s M&I Bank statements from May 31, 2008 through September 19, 2008, as well as corresponding outgoing wire and check data. From there, the destination bank account

[1] The Trust Beneficiaries' counsel have been advised by counsel for the court-appointed Receiver that only $9,000 remained in the Petters Company, Inc. M&I Bank account into which the Trust Beneficiaries wired their funds. (Al Declaration ¶ 7.)

data must be examined. At that point, judicial tracing rules can be used to determine if any of the funds are remaining and their locations.

Minnesota law on judicial tracing of fraudulently obtained assets is well-established. Any commingling by Petters Company, Inc. of the Trust Beneficiaries' funds in a mixed bank account will not destroy their identity so as to prevent their reclamation. Blythe v. Kujawa, 220 N.W. 168, 169 (Minn. 1928). To aid in this reclamation, courts recognize judicial tracing rules to determine the location of constructive trust funds after they have been mixed with other funds. Id.

Judicial tracing rules lessen considerably the claimant's burden in proving the location and identity of misappropriated funds. Id. (claimant's burden of proof goes no further than to require claimant to show that claimed trust fund commingled with other funds reached bank's hands). When a claimant traces funds into the trustee's hands, it is presumed to remain there, and it is up to the trustee to show otherwise. Id.; Stein v. Kemp, 155 N.W. 1052 (Minn. 1916). By requiring a trustee to explain any ambiguity in accounting for trust property, the presumption operates to encourage clear and diligent accounting of trust property. In re Revocable Trust of Margolis, 731 N.W.2d 539, 548 (Minn. Ct. App. 2007).

There are three principal tracing rules recognized by the courts that may be used in this case. First, in situations where one defrauded party's funds have been commingled with the wrongdoer's funds, the lowest intermediate balance test is to be used. In re MJK Clearing, Inc., 371 F.3d 397, 401 (8th Cir. 2004); In re BMC Indus. Inc., 359 B.R. 725,

730-31 (Bankr. D. Minn. 2007).[2] Under the lowest intermediate balance test, the restitution occurs from the account where the amount on deposit has at all times since the commingling of the funds equaled or exceeded the amount of the trust fund. In re BMC Indus. Inc., 359 B.R. at 730-31 The intermediate balance test relies on the presumption that the trust funds are the last funds that are withdrawn from the account. Id. at 731. Thus, if the amount is reduced lower than the trust amount, then the claimant is entitled to the lowest intermediate balance of the account. Id. If the account is depleted after the trust fund has been deposited, the trust fund is treated as lost unless the proceeds can be traced into another asset. Id.; Third Nat'l Bank, 30 N.W. at 440-41. The purpose of tracing is to identify a particular entrusted asset, not just to identify some assets, because a constructive trust creates a trust in specific property, not an amorphous amount that may be imposed against any of the debtors' property. In re BMC Indus. Inc., 359 B.R. at 731

The intermediate balance test may not be appropriate where a commingled account largely comprises funds acquired from multiple fraud victims. Cunningham v. Brown, 265 U.S. 1, 13 (1924) ("The rule is useful to work out equity between a wrongdoer and a victim; but when the fund with which the wrongdoer is dealing is

[2] American Law Reports summarizes the Minnesota intermediate balance test as follows: "Under Minnesota law, when cash is the property upon which a party wants the court to impose a constructive trust, it is not necessary for the party to trace the identical funds; instead, it is sufficient to show that the balance in the account into which the funds were deposited has not fallen below the amount claimed to be held in trust." Following Trust Funds Deposited in Mixed Account Of Trustee, 102 A.L.R. 372 (citing In re BMC Indus. Inc., 328 B.R. 792 (Bankr. D. Minn. 2005)).

wholly made up of the fruits of frauds perpetrated against a myriad of victims, the case is different."). In such cases, courts recognize the applicability of the first-in-first-out method, sometimes called the rule of Clayton's Case:

> Lord Chancellor Eldon, in Clayton's Case, [1816] Ch. 1 Merivale, 572, held that, in a fund in which were mingled the moneys of several defrauded claimants insufficient to satisfy them all, the first withdrawals were to be charged against the first deposits, and the claimants were entitled to be paid in the inverse order in which their moneys went into the account.

Brown, 265 U.S. at 12.

Minnesota has embraced the first-in-first-out method: "When frequent settlements of accounts, with debit and credit, are made between the parties, and balance carried forward to new accounts, and no appropriation has been expressly made by the parties, [precisely this case] the law will appropriate the credits to the extinguishment of the oldest charges." Hersey v. Bennett, 9 N.W. 590, 592-93 (Minn. 1881); see also U.S. Fid. & Guar. Co. v. Metro. Nat'l Bank, 1 F. Supp. 514, 525-26 (D. Minn. 1932) (first-in-first-out is well-recognized rule for tracing commingled trust funds) (citing In re A. Bolognesi & Co., 254 F. 770 (2d Cir. 1918)).

The first-in-first-out method is particularly suitable when some of the commingled funds have been dissipated, leaving a balance insufficient to satisfy all trust claims. See, e.g., In re A. Bolognesi & Co., 254 F. at 773 (where trustee commingled funds of several trust beneficiaries in single bank account along with his own funds, made subsequent deposits into and withdrawals from account, and then went bankrupt, trust beneficiaries were held entitled to preferences in remaining trust fund in inverse order of times of their

respective payments into fund—reversing order that had awarded to claimant pro rata shares of entire amount remaining in bank account).

A third tracing rule is the proportionate distribution test. Under such a rule, the remaining balance of an account with commingled trust funds is distributed according to the trust beneficiaries' pro rata shares. See, e.g., Reichert v. Fid. Bank & Trust Co., 245 N.W. 808 (Mich. 1932). The trust beneficiaries take payment of their claims in priority to the claims of other creditors. See Restatement of Restitution § 213 (1937). This analysis is not altered by the acquisition of other property with the commingled fund. In such a situation, the trust beneficiaries are entitled to share in the after-acquired property in such proportion as their money bore to the whole amount of the fund. Id. There does not appear to be authority suggesting that Minnesota has accepted the proportionate distribution method.[3]

Without discovery, the Trust Beneficiaries do not know which tracing rule governs the particular circumstances. If the funds were deposited into a single account along with funds from the trustee, Petters Company, Inc., it is likely that the lowest intermediate balance test will apply. If other fraud victims' funds were commingled with the Trust Beneficiaries' funds without trustee funds, then a first-in-first-out rule will apply,

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[3] A minority of other jurisdictions use the pro rata distribution method, rather than the first-in-first-out method, even if an unfair outcome results. See, e.g., SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 88-89 (2d Cir. 2002) (court found no abuse of discretion by lower court's order treating all fraud victims alike and approving distribution plan based on pro rata method); United States v. Durham, 86 F.3d 70, 73 (5th Cir. 1996) (in interest of equity, court distributed funds to defrauded consumers pro rata despite fact that majority of funds could be traced to particular claimant).

recognizing that the residual assets in an account belong to the last persons to deposit funds into the scheme. If the trustee also had significant funds on deposit in the account, a mix of the lowest intermediate balance and the first-in-first-out rule may be applied, so as to maximize the fraud victims' recovery and minimize the trustee's unlawful benefit from his fraud.

It may similarly be appropriate to apply more than one tracing rule if the funds have been transferred out of the M&I account to other locations and commingled, necessitating a layering of different tracing rules.

The Rule 2004 discovery will shed light on which tracing rule, if any, will apply and whether the Trust Beneficiaries are entitled to a court-imposed constructive trust on their surviving assets.

C. This Motion Is Appropriate and Warranted Because Property Subject to a Prepetition Constructive Trust Falls Outside the Bankruptcy Estate

Under 11 U.S.C. § 541(a)(1), a debtor's estate in bankruptcy consists of "all legal or equitable interests of the debtor in property as of the commencement of the case." But section 541 of the Bankruptcy Code does not specify what is or is not an "interest of the debtor in property." In re Poffenbarger, 281 B.R. 379, 386 (Bankr. S.D. Ala. 2002); In re Rine & Rine Auctioneers, Inc., 74 F.3d 854, 857 (8th Cir. 1996) (citing 4 Lawrence P. King et al., Collier on Bankruptcy ¶ 547.03 (15th ed. 1995)). Consequently, it is a well "settled principle that property interests and rights [in bankruptcy] are defined by state law." Redwing Carriers, Inc. v. Saraland Apartments, 94 F.3d 1489, 1498 (11th Cir. 1996) (citing Butner v. United States, 440 U.S. 48, 55 (1979)); In re Ealy, 148 Fed. Appx.

564, 565 (8th Cir. 2005) (whether debtors have equitable interest in property is determined based on state law); In re MJK Clearing, Inc., 371 F.3d at 401 ("State law governs the resolution of property rights within a bankruptcy proceeding.") (quoting Chiu v. Wong, 16 F.3d 306, 309 (8th Cir. 1994)). In other words, "'[t]he extent and validity of the debtor's interest in property is a question of state law.'" In re Poffenbarger, 281 B.R. at 386 (brackets in original) (quoting T & B Scottsdale Contractors v. United States, 866 F.2d 1372, 1376 (11th Cir. 1989)); In re Tri-River Trading, LLC, 329 B.R. 252, 263 (8th Cir. BAP 2005) ("... if, under Missouri state law, [managing member of debtor] owned 7/8 of the net proceeds of the settlement at the commencement of the case, then that 7/8 interest was not property of the estate and the bankruptcy court had no authority to make it property of the estate."), aff'd DeBold v. Case, 452 F.3d 756 (8th Cir. 2006) ("The bankruptcy court erred in its legal conclusions regarding the allocation of the settlement proceeds, erroneously focusing instead on the rights of [the debtor]'s creditors [and erroneously concluding that equity demanded that creditors be paid before the managing member received her damages].").

The priority of state property law is enshrined in Article I, section 8, of the U.S. Constitution. "This provision gives Congress the power to establish uniform laws on the subject of bankruptcy throughout the United States." Butner, 440 U.S. at 54 n.9. "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." Id. at 55. The Supreme Court has held that important legal principles demand the role

accorded state law in the analysis of property rights, even in bankruptcy proceedings. "Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'" Butner, 440 U.S. at 55 (quoting Lewis v. Mfrs. Nat'l Bank of Detroit, 364 U.S. 603, 609 (1961)).

As recently as 2007, the Supreme Court has stressed the need to protect interests arising under state law that do not directly conflict with the Bankruptcy Code. See Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 127 S. Ct. 1199 (2007). Reversing the Bankruptcy Court, the District Court, and the Ninth Circuit Court of Appeals, the Supreme Court in Travelers held that a contract provision allocating attorneys' fees, enforceable under substantive state law, is allowable in bankruptcy unless the Bankruptcy Code specifically provides otherwise. Travelers, 127 S. Ct. at 1205. The Supreme Court criticized the lower courts for relying on a court-created rule to deny the attorneys' fee claim, rather than looking to applicable non-bankruptcy law or a provision of the Bankruptcy Code. Id. The Court explained that where the Bankruptcy Code is silent about a creditor's claim, the courts must look to state law to determine the legitimacy of the claim. Id. at 1206.

The significance of the constructive trust doctrine in the bankruptcy court derives primarily from section 541(d) of the Code. This provision provides:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to

> such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

It is generally held that this provision excludes from the bankruptcy estate property that is subject to a constructive or other trust and, as such, cannot be used to pay the debtor's general creditors. In re DVI, Inc., 306 B.R. 496 (Bankr. D. Del. 2004) (citing In re Columbia Gas Sys. Inc., 997 F.2d 1039, 1059 (3d Cir. 1993) ("Congress clearly intended the exclusion created by section 541(d) to include not only funds held in express trust, but also funds held in constructive trust[.]"); Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc., 960 F.2d 366, 372 (3d Cir. 1992); In re Edison Bros., Inc., 243 B.R. 231, 235 (Bankr. D. Del. 2000); In re DeLauro, 207 B.R. 412, 416 (Bankr. D.N.J. 1997)); Begier v. Internal Revenue Service, 496 U.S. 53, 59 (1990) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'"). "Subdivision (d) of the statute makes clear that the estate can only succeed to the same property interest that the debtor possesses, and cannot achieve a greater interest. Thus, if the debtor [possesses] only legal title to but not equitable interest in the property, the estate will likewise include only the debtor's legal title and not the equitable interest in such property." 5 Collier on Bankruptcy ¶ 541.01 at 541-8.3 (15th Ed. revised 2008). Because trust property is not part of the estate under § 541(d), the beneficiary of the constructive trust is entitled to recover such property from the bankruptcy trustee or debtor. Id. ¶ 541.11[3] ("When the existence of a prepetition constructive or resulting trust is established, the assets subject to the trust will typically be found. . . *not* to be property of the estate.") (emphasis in original).

It is anticipated that the receiver or other parties in interest will argue that the analysis is not complete without considering the effects of § 544 of the Bankruptcy Code. As shown below, however, § 544 does not under the circumstances at bar change the analysis.

D. The Strong-Arm Powers of 11 U.S.C. § 544(a)(1) and (a)(2) Do Not Reach Personal Property Subject to a Prepetition Constructive Trust

Section 544(a)(1) of the Bankruptcy Code gives the bankruptcy trustee the status of a hypothetical lien creditor. Section 544(a)(2) of the Code gives the bankruptcy trustee the status of a creditor who extended credit at the time of the commencement of the case and obtained at such time and with respect to that credit an execution against the debtor that is returned unsatisfied. Similarly, with respect to real property, section 544(a)(3) gives the trustee the status of a bona fide purchaser, without actual, but with constructive, knowledge of title impairments. 11 U.S.C. § 544; 5 Collier on Bankruptcy ¶ 544.03 at 544-9. Section 1107(a) of the Code confers these same avoidance powers on a Chapter 11 debtor-in-possession (here, the Receiver). However, while it is bankruptcy law that provides the trustee and the debtor with their "strong-arm" powers, their exercise of such powers and the extent of such powers are governed entirely by the applicable state law. Butner, 440 U.S. at 54; 5 Collier on Bankruptcy ¶ 544.02 at 544-6. This is true because § 544(a)(1) through (3) confers on the trustee and the debtor no greater rights than those accorded by the applicable state law. Havee v. Belk, 775 F.2d 1209, 1218-19 (4th Cir. 1985); In re Marlar, 252 B.R. 743, 752 (8th Cir. BAP 2000) ("[T]he trustee's powers under § 544(a) are subject to the law of the locus of the

property."), aff'd 267 F.3d 749 (8th Cir. 2001); 5 Collier on Bankruptcy ¶ 544.02 at 544-5. Thus, if state law upholds equitable liens and gives equitable liens priority over the hypothetical judgment lien creditor created by § 544(a)(1), then a creditor with an equitable lien may prevail over the trustee in bankruptcy despite his powers under § 544(a)(1). Angeles Real Estate Co. v. Kerxton, 737 F.2d 416, 418 (4th Cir. 1984) ("Thus, if under applicable state law a judgment lien creditor would prevail over an adverse claimant, the trustee in bankruptcy will prevail; if not, he will not.").

In some states, a constructive trust does not come into existence until it is created by a court order, and until there is such a court order, there can be no constructive trust in existence at the time of commencement of the bankruptcy case. See, e.g., XL/Datacomp v. Wilson (In re Omegas Group, Inc.), 16 F.3d 1443, 1455 (6th Cir. 1994) (under Kentucky law, constructive trust only comes into being at time of its judicial creation). In other states, including, as reviewed above, Minnesota, see Knox, 25 N.W.2d at 232, Texas, Idaho, and Utaha, constructive trust arises when the wrong occurs. See supra at 6-8. In the second type of states, "the trustee's section 544(a)(1) and (2) avoidance powers will not prevail because they arise on the petition date." 5 Collier on Bankruptcy ¶ 544.04 at 544-11, 12 (citing In re DVI, 306 B.R. 496 (recognizing that constructive trust arises under Illinois law at time of the wrong, i.e., prepetition)).

As stated, under § 544(a)(1), upon commencement of a case, the trustee (or debtor-in-possession) has the status of a creditor with a "judicial lien." The term "judicial lien" is defined in 11 U.S.C. § 101(36) as a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding." In Minnesota,

judgments create a lien upon real estate, but not upon personal property. Minn. Stat. §§ 548.09, 550.10; Heberling v. Jaggar, 46 Minn. 70, 49 N.W. 396 (Minn. 1891).[4] As in Illinois, the existence of a judicial lien does not allow the trustee to avoid a prepetition constructive trust in Minnesota. In re DVI, 306 B.R. at 503. The rights of a hypothetical judicial lienholder are not equivalent to those of an innocent purchaser for value. Compare 11 U.S.C. § 544(a)(1) with § 544(a)(3); In re DVI, 306 B.R. at 503 (citing In re Bullet Jet Charter, Inc., 177 B.R. 593, 605 (Bankr. D. Ill. 1995)); 5 Collier on Bankruptcy ¶ 544.08 at 544-17. "The equitable rights of [the constructive trust beneficiary], being first in time, take priority over any right that might arise from the avoiding powers." In re DVI, 306 B.R. at 503 (citing In re Bullet Jet, 177 B.R. at 605). As a judgment creditor, the trustee takes subject to all interests of other, earlier claimants. See, e.g., Enright v. Lehmann, 735 N.W.2d 326, 331 (Minn. 2007) (garnishor cannot garnish more than debtor's interest in account); Henderson v. Nw. Airlines, Inc., 231 Minn. 503, 507, 43 N.W.2d 786, 790 (Minn. 1950) ("[T]he plaintiff by garnishment acquires no greater rights against the garnishee than those enjoyed by the defendant.").[5]

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[4] Unperfected security interests are subordinated to lien creditors, under section 9-317(a)(2) of the Uniform Commercial Code, Minn. Stat. § 336.9-317(a)(2). Constructive liens are not subject to recording and perfection, however, and § 9-317 does not apply to such liens.

[5] In In re MJK Clearing, Inc., 286 B.R. 862, 875-76 (Bankr. D. Minn. 2002) (Kressel, J.), the court considered that "the holder of a judicial lien against the debtor or a judgment creditor of the debtor would have the right to garnish any funds on deposit in any of the debtor's deposit accounts to satisfy such lien or judgment," and concluded that the trustee could therefore avoid any interest in such funds under § 544(a). While the court cited to the garnishment statutes generally, MJK apparently overlooked the well-

(continued . . .)

Similarly, the right of a trustee as a "creditor with an unsatisfied and returned execution" does not give the trustee a lien on any specific property. 5 Collier on Bankruptcy ¶ 544.06 at 544-14. "Generally, a writ of execution . . . does not create a lien on property until the time a levy is made by the proper judicial officer on specific property by taking it into custody, tagging it or showing dominion over it by some other method." Id. See also Minn. Stat. § 550.10. While the delivery of a writ of execution to the sheriff creates a lien on the debtor's chattels and/or intangibles in some states (Collier mentions Arkansas, Colorado, the District of Columbia, Florida, Illinois, Indiana, Kentucky, New Jersey, and New York), other states do not recognize a lien until a levy is made. Minnesota is one of the latter type of states. Minn. Stat. § 550.10; 5 Collier on Bankruptcy ¶ 544.06 at 544-14 (listing Minnesota). Moreover, even in states where there is an inchoate lien by virtue of the mere issuance of the writ, the return *nulla bona* extinguishes the lien. Id.

11 U.S.C. § 544(a)(2) is a restatement of language added in 1966 to § 70c of the former Bankruptcy Act to ensure that trustees would have the same rights accorded to

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(. . . continued)
established legal principle that a judgment creditor's ability to seize assets goes no further than the debtor's rights to those assets. Enright, 735 N.W.2d at 331 (garnishor cannot garnish more than debtor's interest in account); Henderson, 231 Minn. at 507, 43 N.W.2d at 790 ("[T]he plaintiff by garnishment acquires no greater rights against the garnishee than those enjoyed by the defendant."). MJK also overlooked Minn. Stat. § 571.83, which expressly provides for mandatory intervention by third parties who claim an interest in the personal property at issue, so that they may protect those interests. See Mount Sinai Hosp. v. Blue Cross & Blue Shield of Minn., No. C2-99-59, 1999 WL 672818 (Minn. Ct. App. Aug. 31, 1999). In short, MJK contains unsupported generalizations of Minnesota post-judgment collection law that are contradicted by both the judgment-lien and garnishment statutes and by many decades of case law.

creditors holding executions returned unsatisfied, specifically rights relating to the discovery of assets and rights triggered by a showing of exhaustion of remedies. 5 Collier on Bankruptcy ¶ 544.06 at 544-15 (citing H. Rep. No. 89-686 (1965); S. Rep. No. 89-1159 (1966), reprinted in 1966 U.S.C.C.A.N. 2032). Collier expressly rejects those cases that have read § 544(a)(2) as giving the trustee the rights of a creditor who has actually levied on and seized all the personal property of the debtor. 5 Collier on Bankruptcy ¶ 544.06 at 544-15. See also 11 U.S.C. § 544(a)(2) (providing the trustee the rights of a "creditor with an unsatisfied and returned execution" which is anathema to the rights of a creditor to property execution upon) (emphasis added).

The above analysis shows that if the Trust Beneficiaries can trace their deposits, those deposits are then subject to an indefeasible constructive trust in their favor. Bankruptcy Rule 2004 plainly allows that inquiry, and the Trust Beneficiaries accordingly seek leave to undertake appropriate discovery.

II. THERE IS NO ALTERNATIVE TO RULE 2004 DISCOVERY

To avoid the present motion, counsel for the Trust Beneficiaries has informally sought to obtain basic information from the court-appointed Receiver, counsel for the court-appointed Receiver, Deanna Coleman (through both her criminal and civil counsel), and the Office of the U.S. Attorney to trace the Trust Beneficiaries' deposits through the Debtors' accounts. (Al Decl. ¶¶ 3-5 & Exs. 1 & 2.) No information has been received, (Al Decl. ¶¶ 3-5), necessitating a more formal Rule 2004 inquiry.

Because the Receiver is required to inventory assets, retain counsel, retain forensic accountants, and keep the debtor companies running, the tracing of assets will become

more and more difficult as time goes by. Additionally, assets belonging to the Trust Beneficiaries may be spent or further commingled. Accordingly, it is imperative that the Trust Beneficiaries be granted leave to undertake the Rule 2004 examination without delay.

CONCLUSION

Apriven Partners, LP; C&C Capital, LLC; and True North Funding, LLC, respectfully submit that they are entitled to undertake a Rule 2004 examination of bank records, depose necessary witnesses to determine the fate of their recent payments into the Petters ponzi scheme, and determine the present custodians of their assets, which may include the debtors in this bankruptcy, to whom the payments were originally made.

Dated: November 19, 2008

Respectfully submitted,

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