

**UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA**

United States of America,

Court File No. 08-CV-5348
(ADM/JSM)

Plaintiff,

v.

Thomas J. Petters, *et al.*,

**MEMORANDUM OF LAW IN
SUPPORT OF MOTION TO
INTERVENE AND FOR RELIEF
UNDER ORDER**

Defendants.

INTRODUCTION

J.P. Morgan Chase Bank, N.A., along with its affiliate, Chase Equipment Finance, Inc.¹ (collectively, “JPMC”), has moved to intervene in this action and/or invoke the provisions of Fed. R. Civ. P. 71 for the limited purpose of seeking relief under the Court’s Second Amended Order For Entry of Preliminary Injunction entered December 8, 2008 (the “Order”) [Docket No. 127].²

As a secured creditor of defendant Thomas J. Petters (“Petters”), JPMC has repeatedly asked receiver Douglas A. Kelley (the “Receiver”) to acknowledge JPMC’s lawful right to foreclose on its collateral and apply the resulting proceeds to Petters’ outstanding obligations. Although consenting to collateral liquidation, the Receiver continues to deny JPMC the right to apply the proceeds to Petters’

¹ Formerly known as Chase Equipment Leasing, Inc.

² Although the Court has issued various iterations of receivership orders, all have included substantively identical commands insofar as the issues in this motion are concerned.

debt. The Receiver's conduct is contrary to binding precedent and leaves JPMC no alternative but to request such authority from the Court.

In addition to contravening precedent, the Receiver's unwillingness to allow JPMC to apply collateral proceeds to Petters' debt runs contrary to the interests of the receivership estate. If JPMC is not allowed to apply such proceeds, interest and expenses will continue to mount and JPMC's ability to fully satisfy Petters' obligations is diminished. As the claim of JPMC increases, the potential for surplus to the estate decreases.

The Order contemplates that a party like JPMC may move the Court for relief from restrictions on assets otherwise subject to the Court's injunction and part of the receivership estate. *See, e.g.*, Order at p. 7 (prohibiting transfer of assets held by financial institutions "unless specifically authorized by Order of this Court"); *id.* at 9 (limiting transfers, withdrawals, etc. of assets except as "directed by the Receiver" or "by further Order of this Court"). This Court has repeatedly honored other secured creditors' rights in the disposition of receivership property, and there is no basis to treat JPMC differently. JPMC therefore requests that it be allowed to intervene in this action and/or invoke the provisions of Fed. R. Civ. P. 71 to ask the Court for relief under the Order authorizing JPMC to continue to liquidate its collateral and apply the proceeds to Petters' outstanding debt.

BACKGROUND

I. JPMC's Secured Rights

JPMC is a secured creditor of Petters. Petters is indebted to JPMC pursuant to the terms of two guaranties (the "Guaranties") that he executed and delivered to JPMC in connection with certain financial accommodations (the "Facilities") provided by JPMC to Petters Group Worldwide, LLC ("PGW") and Petters Aviation, LLC ("Aviation"). See Affidavit of John McDonald at Exhibit A.

To secure the payment and performance of all of Petters' obligations to JPMC, Petters granted to JPMC, and JPMC currently holds, a security interest in, among other things, all of his interest in JPMC asset accounts Q17438005, A72735003, A81794009, and A56676009, and the proceeds thereof (collectively, the "Collateral"), pursuant to an Assignment and Pledge of LP and LLC Interest and Collateral (the "Assignment") and other documents, instruments and agreements in favor of JPMC. *Id.* at Exhibit B. (The Guaranties, the Assignment, and all other documents, instruments and agreements which evidence, secure, or relate in whole or in part to, the Facilities or the Collateral shall be hereinafter collectively referred to as the "Loan and Security Documents.")

PGW and Aviation defaulted on the Facilities, which defaults triggered JPMC's rights under the Guaranties and other Loan and Security Documents, including the right to foreclose on the Collateral pledged by Petters. *Id.* at Exhibit C. Pursuant to the terms of the Loan and Security Documents and

applicable law, on September 30, 2008, JPMC immediately began liquidating the Collateral to cover Petters' outstanding obligations in respect of the Facilities. *Id.*

While in the process of liquidating the Collateral to pay down the Facilities, this case was filed on October 2, 2008. On October 3, 2008, the Court entered a Temporary Restraining Order (the "TRO") [Docket No. 6] placing certain temporary disposition restrictions on Petters' assets. When JPMC learned of such restrictions, it ceased liquidating the Collateral to the extent practical.

On October 6, 2008, Aviation filed a petition for relief under Chapter 11 of the Bankruptcy Code. *In re Petters Aviation, LLC*, No. 08-45136 (Bankr. D. Minn. Oct. 6, 2008) [Docket No. 1]. JPMC obtained relief from the stay in that bankruptcy case, thereby enabling it to conduct a distressed sale of the aircraft. *In re Petters Aviation, LLC*, No. 08-45136, slip order (Bankr. D. Minn. Oct. 23, 2008) [Docket No. 42]. The resulting deficiency from the aircraft sale is approximately \$2.3 million.

The majority of the Collateral consists of interests in hedge funds redeemable on a quarterly basis. Additionally, the applicable hedge fund documents may permit the fund to restrict the extent to which JPMC's position may be liquidated. JPMC is unable to control whether and to what extent to which such limitations will be invoked, but JPMC has been taking, and will continue to take, necessary steps to request complete liquidation of these hedge fund interests. The Collateral also consists of certain structured finance products that will not mature for some time and may impose penalties for early

liquidation. Finally, the Collateral consists of proceeds derived from the continued liquidation of the asset accounts after this case was filed, as directed by the Receiver.

As of April 17, 2009, the Collateral amounts to \$4,148,057.55,³ while Petters' outstanding indebtedness to JPMC totals approximately \$3,800,000, plus interest and expenses. Affidavit of David Mook at ¶¶ 3-4. Interest, expenses, and attorneys' fees continue to accrue.

II. JPMC's Cooperation

Although the Receiver has not provided a basis for his refusal to allow JPMC's full exercise of its legal rights, JPMC recognizes the Receiver's obligation to investigate before permitting JPMC to apply any proceeds to its debt. That is why JPMC has cooperated, and continues to cooperate, with the Receiver's reasonable requests for information.

In December 2008, the Receiver requested that JPMC provide statements regarding the Collateral. JPMC responded on December 22 with (1) detailed documentation relating to a line of credit (the "Line of Credit") Petters had with JPMC, (2) an Assignment and Pledge of LP and LLP Interests and Collateral, (3) Petters' personal Guaranty, (4) a Notice of Event of Default, and (5) brokerage account statements for August, September, October and November 2008 representing the Collateral. *Id.* at Exhibit D. JPMC followed up on January 12

³ The value of the Collateral (consisting of hedge fund and other security interests) fluctuates with the market.

with Line of Credit statements covering the credit arrangement from its inception up through the then-current time. *Id.* at Exhibit E.

On January 23, 2009, a representative from JPMC flew into town at the Receiver's request to meet with the Receiver's colleagues, lawyers, and accountant to further explain the Collateral and Line of Credit. *Id.* at Exhibit F. At that meeting, the Receiver's representatives demanded that JPMC immediately turn over all Collateral. *Id.* The Receiver asserted that 28 U.S.C. § 754 authorized such a demand, and challenged JPMC to refute that authority within one week. *Id.*

On January 30, JPMC provided to the Receiver several United States Supreme Court and Eighth Circuit precedents (set forth below) and respectfully rejected the Receiver's claims of entitlement to the Collateral. *Id.* Consistent with the Receiver's request that JPMC provide such authorities within one week of the parties' prior meeting, JPMC requested that the Receiver's office respond in kind. *Id.*

Rather than provide a legal justification for his posture, however, the Receiver demanded additional underlying documentation, including:

- Trade confirmations from September 24, 2008 to present;
- All correspondence regarding the investment accounts and the PGW loan from September 24, 2008, to present;
- Current Investment Holdings-Holistic Summary reports for the months of September 2008 to present;
- Liquidation schedule and plan for assets not yet liquidated, including a description of the value of the asset, liquidation

date and any costs, fees, penalties and restrictions associated with the asset;

- The complete loan file for the PGW loan.

Id. at Exhibit G.

On February 5, 2009, JPMC informed the Receiver that there were no trade confirmations for the accounts and time period requested, and days later JPMC confirmed that the Receiver already possessed all correspondence (brokerage accounts and letters) from JPMC to Petters regarding the Collateral and Line of Credit from September 24, 2008, to present. *Id.* at Exhibit H and Exhibit I. JPMC also informed the Receiver that the Holistic Summary was simply an internally-prepared summary of underlying data and that summaries for other months had not been prepared, but JPMC nonetheless undertook the effort to create and provide such summaries for August, September, October, and November 2008. *Id.* at Exhibit I.

Additionally, JPMC committed to creating a liquidation schedule of investments (which was subsequently provided on February 17). *Id.* at Exhibit I and Exhibit J. JPMC further explained that the Receiver already possessed extensive loan information for the Line of Credit; JPMC requested more specificity regarding what else the Receiver could be looking for. *Id.* at Exhibit I. Finally, JPMC reiterated the request that the Receiver provide any legal authorities that might trump the United States Supreme Court and Eighth Circuit precedents confirming JPMC's rights. *Id.*

While awaiting the Receiver's legal argument, JPMC continued to comply with the Receiver's requests. On April 1, 2009, JPMC provided the closest thing it has to the "trade confirmations" that the Receiver requested, disclosing detailed information for transactions in August, September, and October of 2008. *Id.* at Exhibit K. Additionally, JPMC committed to developing appropriate search criteria to identify any correspondence that associates of Petters may have had with JPMC relating to the Collateral and/or Line of Credit. *Id.*

JPMC has provided the Receiver numerous opportunities to acknowledge JPMC's legal rights short of involving this Court, but the Receiver has provided only continuing requests for information. To this day, JPMC has not received from the Receiver any purported legal authority or factual basis upon which to override JPMC's secured creditor status and priority right to the Collateral. The Receiver has left JPMC no choice but to seek the Court's assistance.

DISCUSSION

I. JPMC Has a Right To Intervene.

In light of the Receiver's unwillingness to permit JPMC the full exercise of its rights as a secured creditor, JPMC seeks to intervene and/or invoke the provisions of Fed. R. Civ. P. 71 for the limited purpose of obtaining the Court's authorization to continue to liquidate its collateral and apply the proceeds to Petters' outstanding debt. *See, e.g.*, Order at p. 7 (prohibiting transfer of assets held by financial institutions "unless specifically authorized by Order of this Court"). For intervention purposes, JPMC is in the same position as other third

parties who have been allowed to intervene under Fed. R. Civ. P. 24 to question the scope of the Court's Order. *United States v. Petters*, No. 08-5348, slip op. (D. Minn. Dec. 12, 2008) ("*Intervention Order*") [Docket No. 143].

The *Intervention Order* granted the participation requests of several creditors of Polaroid Corporation seeking relief from the Order's stay components. *Id.* at p. 6. In doing so, the Court concluded that "a practical, commonsense application of Rule 24 suggests intervention ... is appropriate here." *Id.* at p. 5. The Court reasoned that the parties should be allowed to intervene because the Order contemplated that affected parties could question the Order's application to specific circumstances. *Id.* In that respect, "considerations of fairness and due process require the presence of a mechanism to permit nonparties affected by the stay to petition for the Court for relief." *Id.* at p. 6.

JPMC is entitled to intervene as provided for in the *Intervention Order*. JPMC seeks to participate for the limited purpose of clarifying that (contrary to the Receiver's misreading) the Order does not vest the Receiver with authority to preclude JPMC's application of the Collateral toward Petters' deficiencies. The Order expressly contemplates that a nonparty like JPMC may seek authorization from the Court with respect to the handling of receivership assets. Order at p. 7 (authorizing transfer of receivership assets if "specifically authorized by Order of this Court"); *id.* at 9 (limiting transfers, withdrawals, etc. of assets except as "directed by the Receiver" or "by further Order of this Court"). Fairness and due

process dictate that JPMC be allowed to intervene clarify that the Order does not restrict JPMC's fundamental rights. *Intervention Order* at pp. 5-6.

Moreover, Fed. R. Civ. P. 71 authorizes JPMC to seek relief from this Court relating to the Order. Rule 71 provides: "When an order grants relief for a nonparty or *may be enforced against a nonparty*, the procedure for enforcing the order is the same as for a party." (Emphasis added). In this case, the Receiver has invoked the Order against JPMC as a "financial and banking institution" subject to the Court's directives. Consequently, just as if it were a party to the action, JPMC is entitled to be heard regarding its rights and obligations under the Order.

II. The Court Should Authorize JPMC to Continue to Liquidate the Collateral and Apply the Proceeds to Petters' Outstanding Debt.

The Federal Rules recognize that a receivership such as this is subject to established law. Fed. R. Civ. P. 66 ("[T]he practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts ..."). In this case the law of the federal courts, and the law of this Court in particular, confirm that JPMC – not the Receiver – is entitled to the Collateral.

A. The Receiver Cannot Trump a Secured Creditor's Rights.

Courts uniformly accept that a receiver "stands in the shoes of the corporation and can assert only those claims which the corporation could have asserted." *Lank v. New York Stock Exchange*, 548 F.2d 61, 67 (2d Cir. 1977). *Accord Eberhard v. Marcu*, 530 F.3d 122, 132 (2d Cir. 2008) ("the plaintiff in his

capacity of receiver has no greater rights or powers than the corporation itself would have.”) (quoting *Fleming v. Lind-Waldock & Co.*, 922 F.2d 20, 25 (1st Cir. 1990)); *Tosco Corp. v. Fed. Deposit Ins. Corp.*, 723 F.2d 1242, 1247 (6th Cir. 1983) (receiver “stands in the shoes of the [entity within the receivership] and enjoys no greater rights against creditors than the [underlying entity] enjoyed”) (quotation omitted). Minnesota courts adhere to the rule. *Dirks v. Clayton Brokerage Co. of St. Louis, Inc.*, 105 F.R.D. 125, 135 (D. Minn. 1985) (“A receiver stands in the shoes of the corporation and can assert only those claims which the corporation could have asserted.”) (quoting *Lank*, 548 F.2d at 67); *In re M.W. Ettinger Transfer Co.*, No. 4-88-3020, 1988 WL 129334, at *4 (Bkcty. D. Minn. Nov. 29, 1988) (“[A] receiver is understood to stand in the shoes of his predecessor, in this case the lessor/mortgagor, charged with both the burdens and the benefits of the lease encumbering the property and the defenses thereto.”).

Using a receiver’s power to sue as an example, the Second Circuit expressed the underlying rationale that limits receiver authority: “to allow the receiver but not the corporation to sue would create the anomalous situation of allowing recovery only where the corporation becomes insolvent and enters receivership, while denying recovery by a going concern which suffered the same sort of injury.” *Lank*, 548 F.2d at 67. Thus a receiver acquires no greater power over assets than the party in receivership would have.

A receiver's limited powers have been repeatedly confirmed in the context of third-party rights. The United States Supreme Court itself holds that "a receiver appointed by a federal court takes property *subject to all liens, priorities, or privileges* existing or accruing under the laws of the state." *Marshall v. People of State of New York*, 254 U.S. 380, 385 (1920) (emphasis added). Like other circuit courts around the country, the Eighth Circuit has enforced such limitations upon a receiver when dealing with third parties like JPMC. *East v. Crowdus*, 302 F.2d 645, 650 (8th Cir. 1962); *Citizens Banking Co. v. Monticello State Bank*, 143 F.2d 261 (8th Cir. 1944).

East concerned stock certificates that had been held by a banker on his client's behalf. 302 F.2d at 645-46. The banker became insolvent, a receiver was appointed, and the receiver attempted to hold onto the stock certificates as assets of the receivership. *Id.* at 648-49. The appellate court framed the issue as follows:

The only question for decision by us is whether the sixty (60) shares ... found in the possession of this receiver as above stated are to be declared a part of the general receivership estate for the benefit of all creditors, or whether they should be turned over to appellants in recognition of their priority claim.

Id. at 649.

The Eighth Circuit embraced the "theory that a receiver acquires no rights greater than those of the estate to which he has succeeded and *must recognize liens and equities existing at the time of the receivership.*" *Id.* at 650 (emphasis added) (quotation omitted). "Therefore, it appears in the case at bar that unless

[the insolvent banker], if functioning as a going concern, could have prevailed against appellants' claim, neither can his receiver." *Id. See also id.* ("No creditor (can) justly demand that (a receivership) estate be augmented by a wrongful conversion of the property of another, ... or the application to the general estate of property which never rightfully belonged to it.") (quoting *Gorman v. Littlefield*, 229 U.S. 19, 25 (1913)).

Indistinguishable from present circumstances is the Eighth Circuit's decision in *Citizens Banking*. The case arose after the holders of collateral trust notes sued to recover collateral that had been transferred to the receiver for the insolvent issuer of the notes. 143 F.2d at 261. The underlying trust indenture expressly stated that the notes were "secured by collateral deposited with the Trustee." *Id.* The court found that the collateral had been reduced in value "to about \$30,000 from the required minimum of \$235,100 (the aggregate of outstanding notes); that this collateral had, under court order, been turned over to a receiver of the company appointed by an Iowa state court." *Id.*

In assessing the creditors' claim the Eighth Circuit observed: "This Court has determined that the funds and administration of mortgaged property does not pass to a receiver of the mortgagor *until the mortgaged debt is entirely satisfied.*" *Id.* (emphasis added) (citations omitted). The appellate court expressed no doubt that the creditors were entitled to the collateral (notwithstanding the receivership)

because (1) a receiver takes the property subject to all liens and encumbrances; (2) he is interested only in any balance over and above the security necessary to and used in full satisfying the secured debt; (3) under the allegations here there can be no such balance[.]

*Id.*⁴

Binding federal law is clear that a receiver is not entitled to take control of assets subject to creditor rights. *Marshall*, 254 U.S. at 385; *East*, 302 F.2d at 648-50. Courts have repeatedly held that a creditor does not lose its interest in pledged collateral simply because other assets of a debtor may be subject to a receivership order. *Citizens Banking*, 143 F.2d at 261; *In re Hollins*, 215 F. at 41. The *Citizens Banking* facts mirror the exact circumstances here: JPMC is a secured creditor of Petters, JPMC holds Collateral sufficient to satisfy Petters' obligations to JPMC, and the Receiver is at best stalling, and at worst overreaching, in an attempt to pull more assets into the receivership estate than legally allowed. Such a plainly governing precedent leads inescapably to the conclusion that JPMC is entitled to the Collateral — all of it including proceeds — and, conversely, that the Receiver has no right to the same. 143 F.2d at 261. *See also East*, 302 F.2d at 650 (no receiver authority over encumbered assets).⁵

⁴ Reaching the same result is *In re Hollins*, 215 F. 41 (2d Cir. 1914), in which the circuit court held that collateral securities underlying a line of credit belong to the creditor, not the receiver.

⁵ Notably, the Receiver has been pressed numerous times to provide authority that contradicts these binding precedents, but has never offered a single authority supporting his insistence that JPMC simply turn over its Collateral to him. Clearly, such silence reflects the Receiver's untenable position.

B. As With Other Secured Creditors' Rights in this Case, the Court Should Permit the Full Enforcement of JPMC's Protections.

Consistent with established law and the Order, the Court has in this very proceeding repeatedly recognized and permitted the full enforcement of the rights of creditors with secured claims encumbering assets otherwise included in the receivership estate:

- *United States v. Petters*, No. 08-5348, slip order at 2 (D. Minn. Nov. 6, 2008) [Docket No. 78]: approving the sale of real property in Tequesta, Florida and authorizing the payment of “settlement charges, taxes, a first mortgage in the amount of approximately \$3,042,600.80 held by J.P. Morgan Chase Bank NA, and a second mortgage in the amount of approximately \$965,080.00 held by Chase” (emphasis added);
- *United States v. Petters*, No. 08-5348, slip order at 3-4 (D. Minn. Dec. 19, 2008) [Docket No. 158]: authorizing Home Federal Savings Bank to foreclose and collect proceeds from the sale of real property in Rice County and Winona County, Minnesota;
- *United States v. Petters*, No. 08-5348, slip order at 2-3 (D. Minn. Dec. 24, 2008) [Docket No. 167]: approving the sale of real property and business in Excelsior, Minnesota and authorizing the “payment of settlement charges, taxes and other closing costs, and a mortgage held by Flagship Bank”; and

- *United States v. Petters*, No. 08-5348, slip order at 2 (D. Minn. Feb. 5, 2009): approving the sale of certain real property located in Williston, North Dakota and authorizing the “payment of any encumbrances, settlement charges, and other adjustments”.

There is no principled basis by which to distinguish JPMC’s security interest in the Collateral from the legal rights of creditors enforced in the above orders. Indeed, as highlighted above, the Court has already honored JPMC’s lien rights in collateral (in that case, the collateral being real property in Florida). In none of these examples did the Court grant the Receiver superior rights over the collateral that secured the creditor’s interest. To the contrary, the secured creditors were afforded their due right to satisfaction of their liens and encumbrances. This is all that JPMC seeks. JPMC is entitled to equal treatment under the law.

CONCLUSION

Neither the Order, nor the law upon which the Order must be based, authorize the Receiver to arbitrarily refuse to permit JPMC to fully exercise its rights as a secured creditor of Petters. The Court should, therefore, confirm that the Receiver’s appointment did not vest the Receiver with any greater rights in the Collateral than Petters enjoyed and should authorize JPMC’s continued liquidation of the Collateral and the application of all proceeds thereof to Petters’ outstanding debts.

Dated: April 17, 2009

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