

IN THE DISTRICT COURT OF OKLAHOMA COUNTY  
STATE OF OKLAHOMA

OKLAHOMA DEPARTMENT OF SECURITIES )  
*ex rel.* Irving L. Faught, Administrator, )  
 )  
Plaintiff, )  
 )  
vs. )  
 )  
FARMERS & MERCHANTS BANK, et al. )  
 )  
Defendants, )  
 )  
and )  
 )  
ROBERT LYNN POURCHOT, Trustee of the )  
Robert Lynn Pourchot Trust, et al., )  
 )  
Intervenors. )

Case No. CJ-2006-3311

**FILED IN THE DISTRICT COURT  
OKLAHOMA COUNTY, OKLA.**

**AUG 13 2008**

**PATRICIA PRESLEY, COURT CLERK**  
by \_\_\_\_\_  
DEPUTY

**PLAINTIFF'S RESPONSE TO DEFENDANTS' BRIEF IN SUPPORT OF  
OUTSTANDING DISCOVERY ISSUES**

Plaintiff, Oklahoma Department of Securities *ex rel.* Irving L. Faught, Administrator (Department), respectfully submits this response to *Defendants' Brief In Support of Outstanding Discovery Issues*. In accordance with Oklahoma law, the Department fully complied with the Defendants' discovery requests in November of 2007 and made available for inspection all responsive and non-privileged documents in its possession, custody or control.

Defendants maintain the need to take depositions and obtain personal information of all the investors who lost money in Marsha Schubert's "Ponzi" scheme (Short Investors). The Department believes the Short Investors' information is irrelevant to the

determination of whether Defendants materially aided the “Ponzi” scheme as well as developing the necessary evidence to support any defenses thereto.

**I. DISCOVERY RELATING DIRECTLY TO VICTIMS WILL NOT RESULT IN ADMISSIBLE EVIDENCE**

A major issue pending before the Court involves the relevancy of Defendants’ discovery requests relating to the Short Investors in Marsha Schubert’s fraudulent investment scheme. Plaintiff contends that this labor-intensive, time consuming exercise will not result in relevant evidence regarding the issue of Defendants’ material aid to Marsha Schubert.

**Only Defendants’ conduct coupled with that of Marsha Schubert is pertinent.**

Plaintiff’s burden at trial is to prove (i) that a securities violation occurred; (ii) that the Defendants rendered substantial assistance to Marsha Schubert’s fraudulent conduct; and (iii) that the Defendants had knowledge or, in the exercise of reasonable care, could have known of the violation. *See* 71 O.S. § 1-509(G)(5); *see also State ex rel. Goettsch v. Diacide Distributors, Inc.*, 561 N.W.2d 369, 377 (Iowa 1997)<sup>1</sup>. Accordingly, the only evidence relating to knowledge and conduct that is relevant is that of Marsha Schubert and the Defendants – not that of Marsha Schubert’s victims.

Defendants attempt to minimize their involvement in Marsha Schubert’s “Ponzi” scheme as “simply” the maintenance of one or more depository accounts and the lending of money – ordinary banking activities that do not rise to the level of material participation or aid under the securities laws. However, the allegations in Plaintiff’s *Petition* describe in extensive detail the Defendants’ atypical conduct in servicing the F&M Bank accounts controlled by Marsha Schubert. The bank’s conduct included: (i)

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<sup>1</sup> Like the Oklahoma statutes, the Iowa securities laws are modeled after the state uniform securities act.

allowing Marsha Schubert to operate on uncollected funds in amounts exceeding One Million Dollars (\$1,000,000) for an extended period of time; (ii) allowing Marsha Schubert to exchange numerous checks with three particular individuals with knowledge that the incoming *and* outgoing checks were drawn on uncollected funds; (iii) ignoring the lack of evidence of actual investments being made with over Two Hundred Million Dollars (\$200,000,000) of investor proceeds deposited by Marsha Schubert into her F&M Bank accounts; (iv) allowing Marsha Schubert to conduct transactions in accounts over which she had no authority and to deposit the proceeds of such transactions into the F&M Bank accounts she did control; (v) allowing Marsha Schubert to use loan proceeds for purposes other than those for which F&M Bank approved the loans; and (vi) allowing the diversion of investor funds to a gift shop's business account at F&M Bank controlled by Marsha Schubert.

**The discovery requested by Defendants will not affect final result.**

As this Court previously ruled, if Defendants have materially aided the "Ponzi" scheme, they are jointly and severally liable *with and to the same extent as* Marsha Schubert. This means that Defendants are liable "in the same, identical way, and to the same extent and degree" as Marsha Schubert. *See Barsch v. Mullins*, 1959 OK 2, 338 P.2d 845, 856. Marsha Schubert's liability to make restitution has been determined by the Logan County court in Case No. CJ-2004-256. Likewise, the Short Investors to whom such restitution shall be made and the amounts due each Short Investor have already been determined. Therefore, since any recovery from Plaintiff's case against Defendants will be distributed through the Logan County receivership, no amount of

discovery by Defendants will affect those established determinations relating to distributions to the Short Investors.

Further, due to the nature and magnitude of Defendants' involvement in this "Ponzi" scheme, the facts and circumstances surrounding *each and every investor transaction* with Marsha Schubert and any direct communications relating thereto are not at all relevant. When a fraud, to include a "Ponzi" scheme, involves a series of transactions and/or spans an extended period of time, any misrepresentation made to less than all investors equates to harm to every investor because the misrepresentation allowed the primary wrongdoer to continue the "Ponzi" scheme." *Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101, 1132 (C.D. Calif. 2003). Therefore, discovery as to each and every investor transaction in this case would be superfluous and irrelevant.

**"Material aid" is not limited to direct, personal contact with investors.**

As Defendants' state in their brief, the courts must make a determination of "material participation or aid" on a case-by-case basis as there is no "fixed rule of law." *Luallin v. Koehler*, 644 N.W.2d 591, 596. (N.D. 2002). Defendants cite to various cases in which the courts determined whether the scope and degree of the defendants' conduct was deemed to be material participation or aid to the primary wrongdoer. For example, Defendants cite to *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okla. 1976), in which the defendant attorneys' activity in connection with the offer and sale of industrial revenue bonds was to provide an opinion of counsel as to the legality of the bond issue and to verify the tax exempt status of the bonds. The court held that, under Section 408 of the Oklahoma Securities Act, the defendant attorneys did not materially participate or aid in the sale of the bonds. *Id.* at 726. The following were the

reasons stated by the *Franke* court for its decision: (i) the plaintiff never met the defendant attorneys; (ii) the plaintiff made his purchase before he received information about the bonds; and (iii) the plaintiff received the bonds prior to reading the legal opinion issued by the defendant attorneys. *Id.* The *Franke* court decision infers that even without direct contact, secondary liability could have been imposed had the defendant attorneys' opinion been faulty or deficient and had the plaintiff read the opinion prior to his purchase of the bonds.

Defendants mistakenly conclude that a determination of "material participation or aid" requires (i) a finding of their active involvement in the actual transaction, *i.e.* personal and direct communication with the Short Investor, and (ii) that such involvement "induced" the Short Investor to make the purchase. This conclusion is the apparent justification for Defendants' discovery requests relating to the individual backgrounds and investment activities of Marsha Schubert's victims. However, a finding of material participation or aid is not dependent on direct, personal contact with investors.

- **Defendants' accommodation of the "Ponzi" scheme through its service of Marsha Schubert's bank accounts constitutes material aid.**

Plaintiff respectfully directs the Court's attention to the following cases in which a defendant bank was alleged to have materially participated in or aided a fraudulent investment scheme. In *Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101, 1109 (C.D. Cal. 2003), the plaintiff alleged that without the assistance of the defendant banks, the operator of a "Ponzi" scheme (Slatkin) could not have successfully perpetrated his fraud. Plaintiff Neilson described the banks' assistance as, *inter alia*, providing a "steady flow of new money" by allowing Slatkin to overdraw his account by hundreds of thousands of dollars and extending him a \$4,000,000 unsecured line of credit. *Id.* The

banks were also alleged to have provided an “aura of legitimacy that allowed the scheme to flourish.” *Id.* Based on these allegations, the *Neilson* court denied the defendant banks’ motions to dismiss the plaintiff’s aiding and abetting claims. *Id.* at 1153.

In *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273 (2<sup>nd</sup> Cir. 2006), a New York lawyer operated a “Ponzi” scheme through his attorney trust fund maintained at defendant bank. Although the *Lerner* court was considering a negligence claim, its holding is germane.

The court held that:

causation existed between the investors’ loss of money through attorney’s Ponzi scheme and [defendant bank] allowing itself to become conduit for attorney’s “Ponzi” scheme by ignoring evidence of attorney’s misconduct and allowing him to continue to use trust fund accounts at [defendant bank] without reporting misconduct to attorney disciplinary board.

*Id.* at 273.

- **Defendants’ involvement induced investments with Schubert.**

A “Ponzi” scheme involves “funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.” *In re United Energy Corp.*, 944 F.2d 589, 590 (9<sup>th</sup> Cir. 1991). *See also Freeman v. First Union National Bank*, 865 So.2d 1271, 1274 (Fla. 2004) (“the illusion of profits induced new investors to ‘deposit’ money and caused older investors to reinvest”); *Donnell v. Kowell*, 2008 WL 2579200 at \*10 (9<sup>th</sup> Cir. 2008) (“the appearance of a profitable business venture is used to convince early investors to ‘roll over’ their investment instead of withdrawing it, and to convince new investors that the promised returns are guaranteed”).

By her own admission, and contrary to her representations to investors, Marsha Schubert did not invest the money of those participating in her investment program. Rather, Marsha Schubert orchestrated a multi-million dollar "Ponzi" scheme through which she fulfilled her exaggerated promises to investors of 30% investment returns using wires or checks drawn on the F&M Bank accounts in which investors' monies were deposited. Marsha Schubert did not advertise or otherwise market her investment program. Marsha Schubert's scheme flourished by word-of-mouth through the investors who were initially involved - investors who were in receipt of payments of extraordinary, but nonexistent, profits from accounts maintained at F&M Bank.

For more than three years, Marsha Schubert wrote checks and/or wired monies to investors, which she falsely represented to be investment returns, on chronically overdrawn accounts and/or seven figured uncollected balances. In spite of the volume of transactions, extensive time period, and large dollar amounts involved, F&M Bank surprisingly transmitted the wires and honored the checks when presented for payment. Such actions by Marsha Schubert, and inaction by F&M Bank, provided the "false appearance of profitability in order to obtain new investors" and maintained the viability of the scheme. *See U.S. v. Edwards*, 526 F.3d 747, 761 (11<sup>th</sup> Cir. 2008).

Had Defendants decided not to accommodate Marsha Schubert by disapproving wires and returning checks to the Short Investors "unpaid," the fraudulent scheme would have come to a screeching halt many months before it did. Defendants' conduct only served to prolong the discovery of the truth about Marsha Schubert's criminal activities and induced further investments.

The success of any "Ponzi" scheme "depends upon keeping the people who are being defrauded at bay, so the scheme can continue. Under such a scheme, deceptions that stall or prohibit the discovery of the truth are material to the continuing vitality of the fraud." *Accousti v. Wolas*, 1996 WL 1088218 at \*2 (E.D.N.Y. 1996). Therefore, evidence relating to Defendants' conduct is the gravamen of this case. A Short Investor's personal background, investment history and/or direct communications with Marsha Schubert, the Defendants or any other person are not relevant to the matter at hand. Defendants should not be permitted to conduct such discovery.

**II. SHOULD THE COURT DEEM SHORT INVESTORS' INFORMATION PERTINENT, DEFENDANTS ARE RESPONSIBLE FOR CONDUCTING THEIR OWN DISCOVERY**

There is no precedent for compelling a state agency to use its statutory investigative powers to seek discovery from a non-party to benefit another party's discovery. Pursuant to the Oklahoma Uniform Securities Act of 2004 (Act), Okla. Stat. tit. 71, §§1-101 through 1-701 (Supp. 2003), the Administrator of the Department has discretion on whether and how to conduct an investigation. Section 1-602 of the Act. Courts have traditionally recognized the discretionary nature of a state agency's enforcement powers and declined to compel an agency to act. *Heckler v. Chaney*, 470 U.S. 821 (1985). The United States Supreme Court recognized that agencies must prioritize their enforcement efforts and the agency itself is better equipped than the courts to determine how best to enforce its statutory mandate. *Id.* at 831-832.

Nevertheless, the Department recognizes that once it files a civil lawsuit, it stands in the same position as any other party and that this Court has the authority to determine whether the Department controls the documents in the possession of the Short Investors.

A party is deemed to have control of documents if “the party has the right, authority or practical ability to obtain the documents from a non-party.” *The Bank of New York v. Meridien Biao Bank Tanzania Limited*, 171 F.R.D. 135, 146-147 (S.D.N.Y. 1997)

In the applicable caselaw, including those cases cited by the Defendants, there is a relationship between the party and the non-party who has possession of the documents that supports the inference of control. See *The Bank of New York v. Meridien Biao Bank Tanzania Limited*, 171 F.R.D. 135 (S.D.N.Y. 1997) (assignee had control over the successor in interest of assignor); *S.E.C. v. Credit Bancorp, Ltd.*, 194 F.R.D. 469 (S.D.N.Y. 2000) (corporation would have control over sister corporation’s records if corporation had access in the ordinary course of business); *U.S. International Trade Commission v. Asat, Inc.* 411 F.3d 245 (D.C. Cir. 2005) (subsidiary corporation would have control of parent corporations’ documents where the subsidiary was an alter ego or agent of the parent, where the subsidiary can acquire the documents in the ordinary course of business, and where the subsidiary marketed the parent’s products); *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 236 F.R.D. 177 (S.D.N.Y. 2006) (former corporate officer has control of corporation’s records); *Rosie D. v. Romney*, 256 F.Supp.2d 115 (D. Mass. 2003), (contracts between state agency and service providers specifically allowed the state agency to review and copy documents).

Here the Department has no special relationship with the Short Investors to give it a right to demand their personal and confidential documents. The Department has not been assigned any of the rights of the Short Investors. The Department does not have a business relationship with the Short Investors that allows it to review their records in the ordinary course of business. The Department has no contracts with the Short Investors.

Although the Administrator has statutory authority to “require the production of any records that the Administrator considers relevant or material to the investigation or proceeding”, the Administrator does not have the authority to compel such documents. Some of the Short Investors may very well respond to the Department’s request for their personal confidential information, however, the Department believes that some are likely to refuse. Because the Department does not have any control over the Short Investors, the Department would have to pursue subpoena enforcement proceedings in district court to enforce its requests for production.

In *Chaveriat v. Williams Pipe Line Company*, 11 F.3d 1420, 1427 (7<sup>th</sup> Cir. 1993), the court found that “the fact that a party could obtain a document if it tried hard enough and maybe if it didn’t try hard at all does not mean that the document is in its possession, custody or control; in fact it means the opposite.” That court recognized that if the party seeking the information really wanted the pertinent documents, they only had to issue a subpoena. *Id.*

The court in *Shcherbakovskiy v. Da Capo Al Fine, Ltd.*, 490 F.3d 130, 138 (2<sup>nd</sup> Cir. 2007) stated:

We also think it fairly obvious that a party also need not seek such documents from third parties if compulsory process against the third parties is available to the party seeking the documents. However, if a party has access and the practical ability to possess documents not available to the party seeking them, production may be required.

In this case, the Defendants have available to them the compulsory process of this court. Furthermore, most of the third parties are located in Oklahoma and therefore, not out of reach of the Defendants. The Department has no more access or practical ability to obtain these documents than do the Defendants.

In *U.S. v. Kilroy*, 523 F.Supp. 206, 215 (D.C.Wis. 1981), the court declined to compel the government to obtain documents on behalf of the defendant. The court considered that both parties had equal access to the requested records, that the government considered the documents to be irrelevant, and that if the defendant believed otherwise, he should bear the burden of obtaining those records.

Although it may be within this Court's authority to compel the Department to gather the documents from the Short Investors, it sets a bad precedent. Requiring the Defendants to conduct their own discovery would be far less troublesome than forcing the Administrator to use his statutory powers and limited agency resources to do Defendants' discovery for them.

### **III. UNDER OKLAHOMA LAW, DEFENDANTS ARE NOT ENTITLED TO PRIVILEGED OR CONFIDENTIAL INFORMATION**

The Department has claimed various privileges in its response to Defendants' interrogatories and requests for production of documents. By statute, certain of the records requested by Defendants are protected from discovery by Defendants. Those records include (i) records obtained by the Administrator or created by a representative of the Administrator in connection with an audit or inspection or an investigation; (ii) records in a litigation file; and (iii) non-public records received from other regulators. Under the common law, the "deliberative process privilege", a privilege unique to government, protects the Department's inter and intra agency communications. The attorney-client privilege protects internal communications between the Department's lawyers and between the lawyers and the Administrator as well as communications with co-counsel. Finally, any materials prepared "in anticipation of litigation" are protected by the work product privilege. The Department's internal examination and investigation

reports, analysis, spreadsheets, inter-agency and intra-agency communications, and notes involve the mental impressions, opinions and legal theories of the Department's investigation of Defendants and were prepared in anticipation of litigation.

Contrary to Defendants' position, a district court does not have a "duty" to order the preparation and service of a privilege log. Rather, when and how to order a privilege log is within the court's discretion.

When a claim of privilege or other protection from discovery is made in response to any request or subpoena for documents, and the court, **in its discretion**, determines that a privilege log is necessary in order to determine the validity of the claim, the court shall order the party claiming the privilege to prepare and serve a privilege log upon the terms and conditions deemed appropriate to the court.

*See* 12 O.S. §3237(A) (emphasis added). *See also Scott v. Peterson*, 2005 OK 84, 126 P.3d 1232.

To require a privilege log of every document responsive to Defendants' requests for production would be highly burdensome to the Department. In addition, detailed descriptions of the documents are irrelevant and unnecessary to determine the applicability of each privilege. For instance, Defendants have requested the Department's communications with its co-counsel in a related case. There are hundreds of emails that would be responsive to that request. It would take a substantial amount of time and state resources to create a log for each of those documents. Those documents are protected by the attorney client privilege. The Department does not believe the Defendants can show a substantial need for those communications that outweighs the privilege.

Should this Court order a privilege log, the Department requests that it be allowed to initially produce a privilege log categorizing the documents sought by Defendants.

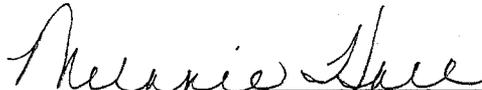
While a privilege log identifies each and every document, a court can use discretion to permit less detailed disclosure especially when it would be unduly burdensome. *See In re Imperial Corporation of America v. Durkin* 174 F.R.D. 475, 477-78 (Cal. 1997) citing 1996 WL 125661 (S.D.N.Y. 1996). The court continued that "in appropriate circumstances, the court may permit the holder of withheld documents to provide summaries of the documents by category or otherwise limit the extent of his disclosure." *Id.* at 478.

### Conclusion

The Department requests that this Court deny Defendants the opportunity to conduct discovery relating to the Short Investors as the evidence they will provide is not relevant to a determination of the merits of this matter and would only serve to delay the commencement of the trial. In the alternative, the Department requests that this Court find that it is the Defendants' responsibility to conduct their own discovery directly through the Short Investors and any other relevant third party.

Respectfully submitted,

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## CERTIFICATE OF MAILING

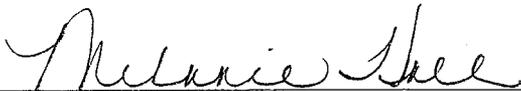
I hereby certify that a true and correct copy of the *Plaintiff's Response to Defendants' Brief in Support of Outstanding Discovery Issues*, was mailed this 13<sup>th</sup> day of August, 2008, by depositing it in the U.S. Mails, postage prepaid, to the following counsel of record:

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