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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re MORTGAGES LTD., Debtor.	**Chapter 11** **Case No. 2:08-bk-07465-RJH** **MOTION OF MORTGAGES LIMITED 401(k) PLAN FOR PARTIAL WITHDRAWAL OF THE REFERENCE AND MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF**

Pursuant to 28 U.S.C. § 157(d), D. Ariz. Gen. Order 01-15, and Bankr. L. R. 5011-2, James Cordello and Ryan Walter, the trustees (the "Trustees") of the Mortgages Ltd. 401(k) Plan (the "Plan" or the "401(k) Plan") respectfully move this Court, *i.e.*, the United States District Court for the District of Arizona (the "District Court"), to partially withdraw the reference from United States Bankruptcy Court for the District of Arizona (the "Bankruptcy Court") with respect to the above-captioned bankruptcy case.

The requested withdrawal of the reference is with respect to controversies between the 401(k) Plan and ML Manager, LLC ("ML Manager"). These controversies

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stem from ML Manager's claimed irrevocable agency relationship with the Plan, its claimed rights to use, control, and sell the 401(k) Plan's assets and to charge the costs of the bankruptcy against the assets of the 401(k) Plan, and its claimed right to collect and retain any unpaid late fees, default interest, and interest spread owing on loans made by the 401(k) Plan. *See* ML Manager's August 16, 2010 Supplemental Brief in GP Loan Matter re: (1) ML Manager's Interest in Agency Post-Foreclosure and (2) Investor's Ability to Terminate Agency Post-Foreclosure, dated August 16, 2010 (Dkt. 2877). These assertions by ML Manager clearly implicate numerous provisions of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* ("ERISA").

In light of the contentions made by ML Manager, the Trustees timely seek withdrawal of the reference hereby, and have separately filed a Complaint in the District Court (*see Cordello, et al. v. ML Manager, et al.*, No. 10-99908, attached hereto as Ex. A) seeking declaratory and injunctive relief pursuant to ERISA § 502(a)(3), *codified at* 29 U.S.C. §1132(a)(3). The Trustees file this Motion because ML Manager has made the assertions described above in pending proceedings before the Bankruptcy Court, and those assertions are based on fundamental misunderstandings of non-bankruptcy federal law, *i.e.*, ERISA, and thus the reference to the Bankruptcy Court, as to these issues, falls within the mandatory withdrawal provision in 28 U.S.C. § 157(d).

The Trustees therefore respectfully request that this Court partially withdraw the reference of consideration of these issues from the Bankruptcy Court, and consolidate the withdrawn matters with the action filed by Trustees in this Court, No. 10-99908. The following Memorandum of Points and Authorities supports this Motion.

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MEMORANDUM OF POINTS AND AUTHORITIES

I. FACTUAL BACKGROUND

A. The Plan and the Plan Loans

Mortgages Ltd. established the 401(k) Plan in 2001. The 401(k) Plan is an "employee pension benefit plan" as defined by ERISA § 3(2)(A), 29 U.S.C. § 1002(2)(A). The Plan was sponsored by Mortgages Ltd. until December 31, 2008, when the Plan was "terminated." However, the Plan remains in existence while the current Trustees (the Movants herein) liquidate the assets of the Plan.

By 2008, the 401(k) Plan's non-cash investments consisted exclusively of mortgage loans that the Plan made to third parties (the "Plan Loans"). The Plan transferred undivided interests in some of the Plan Loans to Mortgages Ltd. or others. As of June of 2008, the Plan held eight loans, three of which were owned exclusively by the Plan. Those loans are:

Loan Number	Borrower/ Loan Name	Percent of Loan Owned by Plan	Value of Plan's Share as of June, 2008
859606	Vanderbilt Farms ("Vanderbilt")	64.08%	$7,048,356.56
861005	Hurst & Hurst ("Hurst")	93.52%	$3,974,667.84
861405	CDIG LLC and JW Maricopa Holdings ("CDIG")	100.00%	$3,139,308.71
859705	Ecco Holdings ("Ecco")	100.00%	$2,521,100.00
860206	GP Properties Carefree Cave Creek ("GP Properties")	46.86%	$2,132,320.57
854706	43rd & Olney LLC ("43rd & Olney")	87.50%	$1,400,000.00
860306	Downtown Community Builders ("Downtown Community Builders")	100.00%	$1,250,000.00
852806	Bisontown LLC and Gary Martinson ("Bisontown")	63.99%	$959,924.10

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Pursuant to Servicing Agent Agreements ("SAAs") among Mortgages Ltd., the Plan and the Plan's borrower, Mortgages Ltd. serviced the Plan Loans by collecting payments from the borrowers when they were made and depositing these funds into the Plan's account.

The Plan assigned undivided interests in certain of the Plan loans to Mortgages Ltd. or other persons, pursuant to promissory note indorsements. Under these indorsements, the Plan itself retained the right to all late fees, default interest and other charges on each of the Plan loans. Despite this, ML Manager claims a right to such default interest and late charges.

Scott Coles, the CEO and beneficial owner of Mortgages Ltd., committed suicide in June of 2008. Within a few months, all eight of the Plan Loans were in default. Since December 2008, seven of the eight Plan Loans have been foreclosed, and title has vested in the Plan to the extent of the Plan's interest in the loan set forth in the table above. The only Plan Loan that has not yet been foreclosed is the CDIG loan.

B. The Bankruptcy Proceeding

The Mortgages Ltd. bankruptcy case was commenced on June 20, 2008. On April 6, 2009, the Official Committee of Investors (the "OCI") filed a proposed Plan of Reorganization ("POR") (Dkt. 1532) and Disclosure Statement. In general, the POR provided that parties who had invested in "ML Loans" (as defined therein), referred to in the POR as "Pass-Through Investors," had the right and option to transfer their interests in those loans to newly-formed "Loan LLCs," that would be managed by ML Manager. Pass-Through Investors who opted not to so transfer their interests would retain them. Under the Bankruptcy Court's May 20, 2009 Order confirming the POR (Dkt. 1755), as clarified on October 21, 2009 (Dkt. 2323), the interests of Pass-Through Investors who did not opt in to the Loan LLCs could be

assessed for a fair and equitable share of certain expenses of ML Manager, including the repayment of the exit financing that funded the POR.

As was explained in the Disclosure Statement attached by the OCI to the POR, a significant controversy existed with respect to the interests in loans held by the Pass-Through Investors. Certain creditors claimed these interests were actually assets of Mortgages Ltd, while the Pass-Through Investors generally claimed they held title to those interests. The structure of the POR reflected a compromise of this dispute: "The Plan Proponent [the OCI] believes this is fair and equitable way to resolve the dispute and other issues are resolved in favor of the other parties as a compromise." Amended Disclosure Statement at 62 (Dkt. 1471).

But the 401(k) Plan was in a very different position from the Pass-Through Investors, and the controversy concerning ownership of the interest in loans did not extend to it. Unlike the Pass-Through Investors, the 401(k) Plan itself had made its loans to the borrowers, it did not obtain its interests via assignments from Mortgages Ltd. No party disputed the 401(k) Plan's ownership of its interest in its loans.

The POR's plain language reflected this. Under the POR, a "Pass-Through Investor" must hold a "direct fractional or participating interest in the ML Loans . . . ." POR at ¶ 2.63. "ML Loans" are the loans evidenced by "ML Notes" and "ML Deeds of Trust." *Id.* ¶ 2.52. "ML Notes" are promissory notes evidencing loans *from the Debtor* to third-party Borrowers . . . ." *Id*., ¶ 2.54 (emphasis added). "ML Deeds of Trust" secure "ML Notes." *Id*., ¶2.50. Thus, to be a "Pass-Through Investor," one must hold an interest in a loan from Mortgages, Ltd. to a third party. The 401(k) Plan does not hold such an interest. Each of the loans in the 401(k) Portfolio was made *by the 401(k) Plan*, not by Mortgages, Ltd.

The Disclosure Statement confirmed that the POR would not affect the 401(k) Plan's loans:

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> the Loans in which the Mortgages Ltd., 401(k) Plan holds the ownership interest will not be transferred to Loan LLCs. Instead, the trustee(s) of the Mortgages Ltd. 401(k) Plan shall make their own decisions and decide who will service the Loans.

Disclosure Statement at 7, n.1.

Thus the 401(k) Plan is in a fundamentally different position from the investors who acquired interests in loans made by Mortgages, Ltd., and it is not subject to assessment for exit financing or other costs under the POR or the Bankruptcy Court's Confirmation Order.

On June 8, 2010, the Trustees of the 401(k) Plan filed an application for order to show cause, seeking an order compelling the Liquidating Trustee[1] to release to the 401(k) Plan funds held in certain impound accounts related to two of the 401(k) Plan's loans. In response, the Liquidating Trustee and ML Manager alleged that ML Manager had the right to assess these funds for exit financing under the POR and the Bankruptcy Court's confirmation order, as clarified, and they argued that the matter could be resolved only through an adversary proceeding. At a hearing on July 15, 2010, the Bankruptcy Court stated that the matter would at least initially be heard as a contested matter and established a briefing schedule. Pursuant to the Bankruptcy Court's order, the 401(k) Plan filed a motion for release of the funds on August 9, 2010 (Dkt. 2872).

On August 16, 2010, in connection with a motion filed by a participant in the 401(k) Plan, ML Manager submitted a brief to the Bankruptcy Court (Dkt. 2877) that asserted far reaching rights to manage and control the 401(k) Plan's assets as well as assess those assets for exit financing and other costs. In light of these positions taken by ML Manager, the Trustees of the 401(k) Plan have commenced the action in

[1] The Liquidating Trustee is the trustee of the bankruptcy estate of Mortgages Ltd.

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District Court referenced above and have filed this Motion seeking to partially withdraw the reference.

In the meantime, however, the Bankruptcy Court has scheduled a hearing with respect to the participant's motion on September 8, 2010. To ensure that the Bankruptcy Court is fully apprised of the developments in the District Court, the 401(k) Plan is also filing a brief in the Bankruptcy Court informing the Bankruptcy Court of this motion and the new District Court action, requesting that the Bankruptcy Court refrain from ruling on any matter that implicates the 401(k) Plan or its assets, and responding to the arguments made by ML Manager in its brief.

C. The Controversy To Be Withdrawn

In view of all this, the Trustees seek to withdraw the issues of whether there is an on-going, interminable and irrevocable agency relationship between the 401(k) Plan and ML Manager as ML Manager asserts (in which event, ML Manager would be an ERISA fiduciary with respect to the 401(k) Plan), whether ML Manager has the right under the applicable documents and ERISA to use, control or assess costs against any assets of the 401(k) Plan (which would also result in ML Manager being a fiduciary for the 401(k) Plan), whether ML Manager has the right to collect or retain default interest, late charges and "interest spread" on the Plan Loans, whether ML Manager's actions have resulted in or would result in breaches of ERISA fiduciary duty or prohibited transactions under ERISA, whether the Trustees are entitled to relief pursuant to ERISA §§ 502(a)(2) and (3) and ERISA § 409, 29 U.S.C. §§ 1132(a)(2)&(3) and § 1109, as well as any other ERISA issues that may arise between the Trustees and ML Manager.

The Trustees of the 401(k) Plan have presented these issues to the District Court for resolution through their Complaint. Resolution of these issues will require detailed consideration of a number of ERISA's most critical provisions, including those governing fiduciary status (ERISA § 3(21), 29 U.S.C. § 1002(21)), fiduciary duties

(ERISA § 404, 29 U.S.C. § 1104)), prohibited transactions (ERISA § 406, 29 U.S.C. § 1106)), remedies (ERISA §§ 409, 502(a)(2) and 502(a)(3), 29 U.S.C. §§ 1109, 1132(a)(2) and 1132(a)(3)), and preemption (ERISA § 514, 29 U.S.C. § 1144)). Further, the Court will be obliged to consider not only the statutory text, but the associated regulations and other administrative guidance promulgated by the Department of Labor and the substantial body of case law interpreting the statute and regulations. These are all matters that arise regularly in District Court in ERISA litigation.

II. ARGUMENT

A. The Statutory Basis for Withdrawal of the Reference

Under 28 U.S.C. § 157(a), "[e]ach district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judge for the district." This Court has referred all such cases to the bankruptcy judges by its June 29, 2001 General Order, number 01-15: "[T]he court hereby refers to the bankruptcy judges for this district all cases under Title 11 and all proceedings under Title 11 or arising in or related to a case under Title 11 as of the effective date of the Bankruptcy Act."

Though reference to the bankruptcy judges is the rule, there is an important exception in which matters pending in a bankruptcy court may be transferred back to the district court by a withdrawal of the reference. 28 U.S.C. § 157(d) states:

> The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce.

This statutory basis for withdrawal is implemented in this district by Bankr. L. R. 5011-2 pursuant to which the present Motion is made.

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B. Withdrawal of the Reference Is Mandatory

Section 157 contemplates both permissive and mandatory withdrawals of the reference. Here, because the matters at issue implicate ERISA, withdrawal of the reference is mandatory.[2] The Ninth Circuit has explained that sec. 157(d) "mandates withdrawal in cases requiring material consideration of non-bankruptcy federal law." *Security Farms v. International Broth. of Teamsters, Chauffeurs, Warehousemen & Helpers*, 124 F.3d 999, 1008 (9th Cir. 1997).

As the Supreme Court has often noted, ERISA regulates and protects employee pension benefits through a "comprehensive and reticulated" statutory scheme. *E.g., Mertens v. Hewitt Assocs.*, 508 U.S. 238, 251 (1993). Exclusive jurisdiction over most ERISA actions, including the Trustees' Action, is reposed in the District Courts. ERISA § 502(e), 29 U.S.C. § 1132(e).

Here, as explained above, the Trustees seek to withdraw the issues of whether ML Manager is an ERISA fiduciary or a party in interest with respect to the Mortgages Ltd. 401(k) Plan (ERISA §§ 3(14)&(21), 29 U.S.C. §§ 1002(14)&(21)), whether ML Manager's actions have resulted in or would result in breaches of ERISA fiduciary duty or prohibited transactions under ERISA (ERISA §§ 404, 406, 408, 29 U.S.C. §§ 1104, 1006, 1108), and whether the Trustees are entitled to relief pursuant to ERISA §§ 502(a)(2) and (3), 29 U.S.C. §§ 1132(a)(2) and (3), and ERISA § 409, 29 U.S.C. § 1104. Resolution of these issues turns exclusively on considerations of ERISA.

Resolution of these issues plainly requires both substantial and "material consideration" of non-bankruptcy federal law, and therefore fall within § 157(d)'s

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[2] Withdrawal of the reference would also be appropriate in this matter on a permissive basis. *See Vacation Village, Inc. v. Clark County*, 497 F.3d 902, 914 (9th Cir. 2007); *Equipoint Financial Network, Inc. v. Network Appraisal Servs., Inc.*, 2009 WL 2135873 (S.D. Cal. 2009). In fact, the Bankruptcy Court has already ruled that it has "no jurisdiction over the Mortgages Ltd. 401(k) Plan" (Order dated September 23, 2009, Dkt. 2206), and resolution of these issues would not otherwise substantially delay or hinder the administration of the bankruptcy estate.

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mandatory withdrawal provision. *See, e.g.*, *In re Kiefer*, 276 B.R. 196 (E.D. Mich. 2002) (withdrawal mandatory in action involving claims of ERISA fiduciary status and breach). Because withdrawal is mandatory, the Trustees respectfully request that this Court grant this Motion and partially withdrawal the reference to the Bankruptcy Court as to the dispute between ML Manager and the Trustees.

As explained above, the Trustees have filed an action in this Court seeking declaratory and injunctive relief pursuant to ERISA with respect to these issues. The Trustees therefore also request that once withdrawn, these issues be consolidated with the ERISA action filed by the Trustees.

III. CONCLUSION

For the reasons listed above, the Trustees respectfully request that this Court grant this Motion to partially withdraw the reference to the Bankruptcy Court of *In re Mortgages Ltd.* with respect to the controversies between the 401(k) Plan and ML Manager as described above, and to consolidate the withdrawn issues with *Cordello, et al. v. ML Manager, et al.*, No. 10-99908. A proposed form of order is attached as Ex. B.

DATED this 30th day of August, 2010.

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CERTIFICATION

I hereby certify that this **Motion of Mortgages Limited 401(k) Plan for Partial Withdrawal of the Reference and Memorandum of Points and Authorities in Support Thereof** was filed through the ECF system for the United States Bankruptcy Court in Arizona, and will be sent electronically to the registered participants on the Notice of Electronic Filing on August 30, 2010. Paper and/or disk copies, if any, will be sent by first class mail to those indicated as non-registered participants on August 31, 2010.

By /s/ Karen L. Trumpower