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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re:	Chapter 11
MORTGAGES LTD.,	Case No. 2:08-bk-07465-RJH
Debtor.	**OBJECTION TO ML MANAGER'S ALLOCATION MOTION**
	Date of Hearing: Sept. 21, 2010 Time of Hearing: 1:30 p.m.

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The investors identified in Exhibit "A" hereto (collectively, the "Rev Op Group"), by and through their duly authorized counsel, hereby file this Objection to *ML Manager's (1) Notice of Lodging Allocation Model to Be Used with Regard to the Disbursement of the Proceeds to the Newman Loan Investors, (2) Notice that Allocation Model Has General Applicability to all Investors, and (3) Motion to Approve Allocation Model* filed by ML Manager LLC ("ML Manager") on September 1, 2010 (the "Allocation Motion"). In further support of this Objection, the Rev Op Group hereby submits as follows:

I. BACKGROUND.

1. The OIC's *First Amended Plan of Reorganization* was confirmed, as amended (the "Plan"), on May 20, 2009, more than one year ago. Since that time, ML Manager has repeatedly promised an accounting and "allocation" demonstrating how investors will be repaid under the Plan. The Allocation Motion does not fulfill ML Manager's repeated promises by any stretch of the imagination.

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2. It is worth recalling that this issue came before the Court after a member of the Rev Op Group, the Morley Rosenfield, M.D. P.C. Restated Profit Sharing Plan (the "MR Plan"), filed a motion to compel the turnover of certain loan proceeds that ML Manager was improperly holding [DE # 2771] (the "Turnover Motion").

3. The Turnover Motion requested an order directing ML Manager to turn over all proceeds of Loan #7987S2 (the "Newman Loan"), which loan was *not* transferred to a Loan LLC under the Plan and which was administered by a third-party servicer completely outside the Plan.

4. At hearing on June 30, 2010, this Court granted the Turnover Motion and ordered that the distribution of loan proceeds be "made by September 1, 2010 with an accounting of the charge back amounts and the methodology as to how the amounts were determined." [DE #2802] The Court also set oral argument "on the charge back issue" for September 21, 2010, and directed ML Manager to provide "notice to other investors that may be in the same situation" as the investors in the Newman Loan by September 1, 2010.

5. Rather than provide notice to investors in loans similar to the Newman Loan that were not transferred to a Loan LLC, ML Manager opportunistically sought to use the Newman Loan allocation as an opportunity to make its largely undisclosed accounting binding on all investors.

6. On Friday, August 27, 2010, ML Manager filed its *Motion for Order Approving Service by Email of Newman Loan Distribution, Accounting of Amounts and Allocation Methodology* [DE #2893]. In that motion, ML Manager acknowledged the Court's directive to provide notice to investors situated similarly to those in the Neman Loan; however, ML Manager stated that "in an abundance of caution" it had unilaterally decided "to provide the notice to all investors since they could all be impacted by a decision of the Court in the Newman Loan matter."

7. The following business day, Monday, August 30, 2010, the *Order Granting Motion to Approve Service by Email of Newman Loan Distribution, Accounting of Amounts and Allocation Methodology* was entered on the Court's docket.

8. On September 1, 2010, ML Manager filed the Allocation Motion. The Allocation Motion accomplishes very little of what the Court ordered at hearing on June 30, 2010. Although the Newman Loan is not an "ML Loan" as defined in the Plan, and although ML Manager admits that the Newman Loan investors are not borrowers of the Exit Financing under the Plan, the vague accounting set forth in the Allocation Motion withholds 3% of the principal balance of the loan to pay for the costs described in a plethora of capitalized terms, none of which is clearly defined: "Total Expected Costs, which includes Exit Loan Interest and Costs, General Costs and Uncovered Specific Costs and Covered Specific Costs." Motion, p.27.

9. Are the "Total Expected Costs" the same as the "Total Estimated Costs" [Motion, p.24] or the "Expected Costs" [*Id*., p.23] or some other figure? When is a "General Cost" "Covered" and when is a "Specific Cost" "Uncovered"? If the Newman Loan is not responsible to repay the exit financing, why is it paying the undefined "Exit Loan Interest and Costs"? Are these terms compatible with the Interborrower Agreement?

10. After what ML Manager describes as "literally hundreds of hours" of work on the allocation model, the model remains virtually undecipherable. The Newman Loan investors are still left to wonder what the chargebacks are exactly. Other investors are in an even worse position, as their actual "numbers" continue to be shrouded in secrecy by ML Manager.

11. On September 1, 2010, on the same day that ML Manager filed the Allocation Motion, it filed its *Motion (1) for Order to Allow Filing of Confidential Back-Up to Allocation Model Under Seal, (2) to Set Up Procedure for an In Camera Inspection of Confidential Documents, and (3) for a Protective Order* [DE #2915]. The motion was filed without a hearing or opportunity to object, and ML Manager failed to file a notice of lodging the proposed order approving such motion in accordance with Local Rule 9022-1.

12. An order approving the motion was entered on September 2, 2010. [DE #2920]

13. ML Manager has thus set up a procedure by which: (i) its "allocation" is stated in abstract terms, and (ii) ML Manager is able to maintain the accounting details—i.e., the actual numbers—of the total allocation concealed from any one investor. At best, an investor may see

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the allocation details for the limited number of loans in which it has fractional interests, but will never gain a full understanding of the allocation.

14. Ironically, the necessity of seeing and calculating "all the numbers at once" was ML Manager's repeated excuse for its delay in making the allocation as to specific loans. Indeed, this was the stated rationale at the hearing on June 30, 2010 for ML Manager's delay in disbursing the Newman Loan proceeds. Having finally made its "full view" allocation, ML Manager seeks to deprive individual investors of a similar insight.

II. SPECIFIC OBJECTIONS.

A. ML Manager Has No Basis to Withhold any of the Newman Loan Distributions.

The Newman Loan was never part of the Plan proposed by the OIC and confirmed by this Court, and ML Manager may not assess the costs of the Exit Financing (among other apparent costs) to the Newman Loan participants. Section 4.13 of the Plan, as modified by paragraph U of the Confirmation Order, provides that: "Any Pass-Through Investor that does not transfer its fractional interest into a Loan LLC will receive its distribution pursuant to the Existing Agency Agreement and other contracts which may be assigned to the ML Manager LLC. Before such distributions are made, Pass-Through Investors who retain their fractional interests ***in the ML Loans*** shall be assessed their proportionate share of costs, and expenses of serving and collecting the ***ML Loans*** in a fair, equitable and nondiscriminatory manner, and shall be reimbursed in the same manner as the other investors." Plan § 4.13; Confirmation Order ¶ U (emphasis added). The "ML Loans" are defined as "the loans evidenced by the ML Notes and ML Deeds of Trust and ML Loan Documents which will be ***transferred to separate Loan LLCs pursuant to the Plan*** . . . ." *See* Plan § 2.52 (emphasis added).

The Newman Loan was never transferred to a Loan LLC, as ML Manager acknowledges in the Allocation Motion. Attached to the Turnover Motion is an email from ML Manager's counsel dated June 5, 2009, expressly acknowledging that the Newman Loan was not transferred to a Loan LLC, and that the investors in such loan would "make their own decision about how to proceed." *See* Turnover Motion, Exh. A. It is clear that the Newman Loan was intended to be

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serviced and paid to the investors completely outside the context of the Plan, as ML Manager's counsel confirmed in her post-confirmation email. There simply is no basis in the Plan or elsewhere to surcharge the loan proceeds of the Newman Loan to pay ML Manager's debts and other expenses. ML Manager is again retrading and redefining the terms of the Plan to suit its needs. This cannot be tolerated. ***All*** of the Newman Loan proceeds should be turned over to the three investors immediately.

Even assuming ML Manager could make "chargebacks" to the Newman Loan (which it cannot), the proposed treatment of the MR Plan under the allocation is unjust and without legal basis. ML Manager may not withhold the MR Plan's loan distributions based on its "belief" in the exercise of its "business judgment," that the MR Plan owes ML Manager "fees, costs, and damages." ML Manager has not been awarded any attorneys' fees or costs to date, and certainly does not have a damages award against Dr. Rosenfield or the MR Plan. The Rev Op Group has made good faith objections to various motions voluntarily brought by ML Manager and has defended an adversary proceeding voluntarily commenced by ML Manager. Several issues arising from ML Manager's litigation are currently pending on appeal. There has been no determination of wrongdoing or any award of attorneys' fees in any contested matter or adversary proceeding to date.

Moreover, this Court ordered ML Manager to account for whatever "chargebacks" it believes it has against the MR Plan. Speculative, contingent, and unliquidated claims are not a "chargeback" for the costs of servicing an ML Loan, even under ML Manager's professed interpretation of the Plan and Confirmation Order. The only basis for withholding disclosed by ML Manager is a pending, contested $92,000 fee application, which itself is based on an erroneous theory of joint and several liability. *See* Motion, p.28 & n.18. To the extent ML Manager receives a final award of attorneys' fees at some point in the future, the MR Plan will pay its proportional share of such fees, but the MR Plan should not be a victim of retribution simply because the MR Plan has defended itself and its property interests in litigation that ML Manager brought against the MR Plan. The MR Plan's share of the Newman Loan proceeds should be turned over immediately.

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B. The Bankruptcy Court Has Been Divested of Jurisdiction with Respect to ML Manager's Ability to Make Chargebacks to the Rev Op Group.

A fully briefed appeal is currently pending with respect to ML Manager's ability to "charge back" the costs of the Exit Financing to the Rev Op Group. The pending appeal has divested the Bankruptcy Court of jurisdiction to approve an allocation model that assesses exit financing to the Rev Op Investors. *See Griggs v. Provident Consumer Discount Co.*, 459 U.S. 56, 58 (1982) ("The filing of a notice of appeal . . . confers jurisdiction on the court of appeals and divests the district court of its control over those aspects of the case involved in the appeal."); *In re Padilla* , 222 F.3d 1184, 1190 (9th Cir. 2000); *In re Mirzai*, 236 B.R. 8, 10 (B.A.P. 9th Cir. 1999); *McClatchy Newspapers v. Central Valley Typographical Union No. 46*, 686 F.2d 731, 734-35 (9th Cir. 1982) (a court "may not finally adjudicate substantial rights directly involved in the appeal"). While the long-awaited allocation model may be helpful in finally revealing ML Manager's intentions, it may not be approved by an order of this Court during the pendency of the exit-financing appeal.

C. The Bankruptcy Court Has Been Divested of Jurisdiction with Respect to ML Manager's Ability to Invoke the Business Judgment Standard.

The same appeal, currently pending in United States District Court, also involves ML Manager's fiduciary duties and whether a business-judgment standard is applicable when ML Manager purports to act as the agent of investors owed millions of dollars. Again in this context, the pending appeal has divested this Court of jurisdiction over such matters.

It is not coincidental that ML Manager spends more than seven pages in the Allocation Motion arguing that a business judgment standard applies. By all accounts, the allocation model appears to be utterly inconsistent with the notion of fiduciary duty, as it places ML Manager's needs as a borrower above the interests of investors. At the same time, however, it is beyond dispute that ML Manager has fiduciary obligations to the Rev Op Group. ML Manager has admitted as much in evidentiary hearings before the Bankruptcy Court. Specifically, the chief operating officer of ML Manager admitted in the evidentiary hearing on approval of the Grace settlements that ML Manager owes fiduciary duties to the Rev Op Group.

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An agent has a fiduciary duty to its principal to act loyally in all matters connected with the agency relationship. *See Musselman v. Southwinds Realty, Inc.*, 146 Ariz. 173, 175, 704 P.2d 814, 816 (Ct. App. 1984). An agent also has a fiduciary duty to act with the care, competence, and diligence normally exercised by agents in similar circumstances. *Id.* Assuming ML Manager actually possesses its asserted agency authority over the Rev Op Group (which it does not and which issue is on appeal), ML Manager would unquestionably be bound by the duties of loyalty and care. By surcharging the Rev Op Group for various vague "Costs," including the repayment of the Exit Financing, when the alleged Agency Agreements do not provide for any such surcharge, ML Manager breaches its fiduciary duties.

In addition, significant questions regarding ML Manager's duties under the Interborrower Agreement exist. The Rev Op Investors are not parties to the Interborrower Agreement and are not bound by its provisions. Yet ML Manager has given that document primacy over its duties as the asserted agent of the Rev Op Investors. Moreover, the proposed allocation model appears to be inconsistent in material respects with the Interborrower Agreement. For example, failure by the Liquidating Trust to fund certain expenses as required under the Interborrower Agreement may not be recouped through the surcharge of the Rev Op Group's assets or even shifted to the Loan LLCs, particularly when the Rev Op Group is not a party to the Interborrower Agreement nor a borrower of the Exit Financing. *See* Interborrower Agreement §§ 3.2-3.4.

In addition, as discussed below, no investor has sufficient information at this time to fully and fairly address the fiduciary issues raised by the Allocation Motion. Thus, even if this issue were not on appeal and this Court had the requisite jurisdiction, discovery and an evidentiary hearing would be necessary to vet ML Manager's compliance with its fiduciary obligations.

D. <u>The Allocation Motion Cannot Be Approved in a Vacuum of Information</u>.

As discussed above, ML Manager has failed to provide "an accounting of the charge back amounts and the methodology as to how the amounts were determined" as ordered by this Court with respect to the Newman Loan. ML Manager compounds this failure exponentially by seeking to have its general "allocation model" approved as binding on ***all*** investors, when it has failed to provide any accounting whatsoever for such investors' loans. To gain insight into any

actual accounting, investors are required to execute a confidentiality agreement that was approved without a hearing or opportunity to object. While the Rev Op Investors are sensitive to the need to protect confidential information, they question whether the measures taken unilaterally (and largely on an ex parte basis) by ML Manager are narrowly tailored to protect legitimate concerns.

Although members of the Rev Op Group have made initial inquiries with ML Manager regarding the confidentiality agreement, they have not had the opportunity to examine whatever accounting information ML Manager has in its "redacted copies." The Rev Op Group also does not wish to be rush into a confidentiality agreement if ML Manager will seek to use it offensively in future litigation or to limit future access to information. It may be appropriate for the Rev Op Group to move for reconsideration of the provisions of the confidentiality order relating to the projections in particular. It seems absurd that an investor who is subject to a confidentiality agreement and who owns real property, as a tenant in common, or owns a fractional interest in a loan is barred from possessing a copy of the projections on which their distributions largely depend.

Despite its intentional lack of disclosure in the Allocation Motion, ML Manager unilaterally expanded the allocation model to include all investors, unilaterally sought authorization to serve the Allocation Motion by email,[1] and unilaterally decided that its abstract allocation model should become binding on the universe of investors in this case on essentially one week's email notice. Investors should not be painted into a corner based on ML Manager's aggressive, unilateral actions.

Simply stated, far more time is needed for the Rev Op Group to make substantive objections to the allocation model. An evidentiary hearing may be required before any allocation model may be approved. The Rev Op Group reserves all rights with respect to these issues. To the extent the Court is inclined to entertain ML Manager's Allocation Motion as to *all* investors, the Rev Op Group requests that the Court set a continued status hearing at least sixty days from

[1] It is unclear whether email service has been effective. None of the Hawkins Entities has received an email notification of the Allocation Motion, for example.

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the currently scheduled hearing, so that the Rev Op Group may analyze the heretofore undisclosed data and allocation information, provide further comment or state further objection, and proceed toward resolution by either a consensual process or through litigation.

Without the relevant information it is impossible determine whether ML Manager will be fulfilling its fiduciary duties as agent or even complying with the business judgment standard. Without the underlying data and accounting information, it is impossible to know whether ML Manager's assumptions are reasonable or capricious. Approval of the Allocation Motion without providing the affected parties full access to information, on such limited notice, and under the present circumstances would violate basic notions of due process. Certainly, even ML Manager must agree that it would be highly prejudicial and inappropriate to investors for the Court to approve the Allocation Motion on the present record.

WHEREFORE, the Rev Op Group respectfully requests that the Court enter an order:

A. Denying the Allocation Motion; and

B. Granting to the Rev Op Group such other relief as my be just and appropriate.

DATED this 10th day of September, 2010.

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By /s/ BAS, #022721
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