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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** **OBJECTION AND RESERVATION OF RIGHTS OF THE MORTGAGES LTD. 401(K) PLAN TO ML MANAGER'S PROPOSED ALLOCATION MODEL** **Hearing Date: September 21, 2010** **Hearing Time:**

The Mortgages Ltd. 401(k) Plan (the "Plan") hereby objects to ML Manager's (1) Notice of Lodging Allocation Model to be Used With Regard to the Disbursement of Proceeds to the Newman Loan Investors, (2) Notice That Allocation Model Has General Applicability to all Investors, and (3) Motion to Approve Allocation Model ("Allocation Motion") filed on September 1, 2010 (Dkt. 2913), and reserves its right to file additional objections as further information about the model becomes available or apparent.

As a preliminary matter, the Plan objects to the assessment of any costs or expenses, including for exit financing, against the Plan's assets. In two recent filings, Dkts. 2871 and 2902, the Plan has explained in detail the reasons that it is not subject to such assessment, and these filings are incorporated herein by reference. Simply put,

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under the plain language of the Plan of Reorganization and the Court's Confirmation Order, the Plan is not subject to assessment because it is not a "Pass-Through Investor," and its loans are not "ML Loans." Further, assessment against the assets of the Plan would violate the Employee Retirement Income Security Act of 1974 ("ERISA").[1] ML Manager apparently acknowledges the unique position of the Plan, as it has created two allocations models, one excluding the Plan. *E.g.*, Allocation Motion, at 4 n.6. If the Plan is excluded from the Allocation Model, or ML Manager uses a model that does not assess the Plan for any costs, the Plan would have no further objection to the Allocation Model.

Further, the Plan notes that the Allocation Model is extremely complex and that the Allocation Motion provides an inadequate description of many critical features of the Model, so it is impossible at this point to complete a meaningful review thereof or prepare a thorough objection thereto. Subject to the foregoing, and subject to the Plan's reservation of its right to supplement its Objection as further details regarding the Allocation Model become available or apparent, the Plan objects as follows:

1. The Allocation Model Is a Radical Departure From The Plan of Reorganization and the Confirmation Order

Under the Plan of Reorganization and the Confirmation Order, any cost allocation must be "fair, equitable, and proportionate." The proposed Allocation Model is none of those things, for several reasons:

First, the Allocation Model discriminates against investors based on when the property securing the mortgages they invested in are sold. ML Manager admits that

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[1] The Plan has also filed a Motion to Partially Withdraw the Reference Dkt. 2901. To the extent that the Court does not conclude that the Plan is not subject to assessment under the language of the Plan of Reorganization and the Confirmation Order, the Plan respectfully requests that the Court abstain from ruling further with respect to the Plan so that the ERISA issues pertaining to such assessment can be adjudicated by the District Court.

"more money will be paid to the Exit Financier from loans that are resolved earlier than loans that are paid later." Allocation Motion at 19. However, investors in loans that are sold later will have to pay investors in loans that sell earlier so called "Replacement Loan Interest" based on the rate of the exit financing. Id.

Second, Step 3 of the Allocation Model calls for investors in loans that have funds sufficient to pay their allocable share of expenses to cover any shortfalls in other loans. This is in effect a rewriting of the Plan of Reorganization to effectively pool all of the loans and deprive investors of their ownership interest in identified loans. And it is the worst kind of pooling, because it exposes investors to downside independent of their properties (i.e., the risk that the properties securing other loans may decline in value and experience shortfalls with respect to their allocable costs), without the upside of potential gains in those properties. This is not the Plan of Reorganization for which investors voted or which the Court confirmed, nor is this approach equitable, fair, or proportionate.

Third, the Allocation Model would assess costs against loans with no Loan LLC, in contravention of the Plan of Reorganization. Section 4.13 of the Plan of Reorganization is the provision that covers the concept of assessment of costs and it applies only with respect to Loan LLCs and non-opt in investors with respect to the loans with Loan LLCs. The Plan of Reorganization has no mechanism for the assessment of costs in non-Loan LLC loans, yet the Allocation Model applies to them. Again, ML Manager is attempting to rewrite the Plan of Reorganization.

Fourth, ML Manager claims that it has complete "discretion" to allocate costs as General Costs or Specific Costs. Allocation Motion at 23. Such a bold claim is wholly inappropriate given the complete absence of any explanation or accounting of where such costs originated and what specifically they were used for. Not only is this method utterly ambiguous, rendering it impossible to determine whether the

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Allocation Model is "fair, reasonable, and proportionate," but moreover, because ML Manager admits that such an allocation is *at its discretion*, the allocation by definition is not fair, reasonable, or proportionate, but *discretionary*.

2. The Allocation Model Is Impossible to Evaluate Based on ML Manager's Filings

The Plan generally objects to the Allocation Model because it is impossible to determine how much any individual investor would be charged, thus any determination of whether the Allocation Model is acceptable based on this record would be unwarranted. There are a number of serious ambiguities in the Model as described to the Court in the Allocation Motion.

First, at this stage, no investor can know how much they will have to pay, because ML Manager has not provided any guidance on how costs are assessed, how much they think these costs will be, any even if this was known, any investor in any loan will have to wait until all the properties are sold before they can truly know how much they will receive and how much they will have to pay.

Even a preliminary review of the allocation model reveals numerous areas of unexplained factors, which could radically alter the costs. ML Manager calls many of its estimates "conservative" because they subtract 20% from expected proceeds or add 15% to costs – but not only is there no explanation of how these percentages were arrived at, and why they are "conservative", there is also no hint at what the costs or expected proceeds might be for any of the loans except the Newman loan, or how these numbers were arrived at. Subtracting 20% from a black box does not make it less of a black box, nor does it give anyone (this Court included) a basis for understanding what the real costs or proceeds of this Allocation might be.

On Page 19 of the Allocation Motion, ML Manager states that "This means that

more money will be paid to the Exit Financier from loans that are resolved earlier than loans that are paid later." But nothing in the previous sentence provides any clue as to why more money will be paid earlier rather than later.

ML Manager essentially admits that the disposition period in its model is completely speculative, noting that the length of the period is subject to "many risks." *Id.* at 23. Yet this disposition period has profound implications for various calculations under the Allocation Model. The Allocation Model as presented thus far is little more than a series of conjectures and guesses that ultimately depend on ML Manager's sole discretion. Approving this Plan of Allocation would give ML Manager a blank check to convert any investor's assets for its own uses, with no requirement that these expenses be explained or accounted for.

3. ML Manager Should Not Receive The Benefit of the Business Judgment Rule With Respect to the 401(K) Plan Because ML Manager Would Be Subject to ERISA's Fiduciary Duties If It Were the Plan's Agent

As explained in the 401(k) Plan's other filings (Dkts. 2871 and 2902), if ML Manager has the agency relationship with the Plan that it claims (which the Plan denies categorically), ML Manager would be subject to ERISA's fiduciary duties as a result. There is simply no basis in ERISA to provide fiduciaries the benefit of the business judgment rule. Instead, ERISA fiduciaries are subject to strict fiduciary duties as explained in ERISA § 404(a), *codified at* 29 U.S.C. § 1104(a). These duties are the highest known to law. *E.g.*, *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996).

In the exercise of fiduciary duties, an ERISA fiduciary is not permitted to simply exercise business judgment, but must instead discharge its duties solely in the interests of the participants and beneficiaries of the plan, for the exclusive purpose of providing benefits to participants and their beneficiaries, with the care, skill, prudence,

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and diligence that a prudent man acting in a like capacity and familiar with such matters would use for the conduct of an enterprise of like character with like aims, and in accordance with the plan documents. ERISA § 404(a), 29 U.S.C. § 1104(a).

In addition to the fiduciary duties described in ERISA § 404, certain transactions involving fiduciaries are prohibited by ERISA § 406, 29 U.S.C. 1106. Such transactions include the dealing by a fiduciary with plan assets for the fiduciary's benefit, or the transfer of plan assets for the benefit of a party in interest (which includes a fiduciary).

Against the backdrop of these fiduciary obligations and statutory prohibitions, ML Manager's business judgment rule arguments make no sense. If the Plan is subject to assessment, then ML Manager is an ERISA fiduciary and it cannot compromise the rights of the Plan or use the assets of the Plan for its benefit[2] based on an alleged exercise of "business judgment." Rather, it must justify its actions under the exacting fiduciary standards of ERISA and must act consistently with ERISA's prohibited transaction provisions.

DATED this 10th day of September, 2010.

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[2] ML Manager is a co-borrower on the exit financing, so any assessment of exit financing costs against Plan assets plainly benefits ML Manager.

CERTIFICATION

I hereby certify that this Objection and Reservation of Rights 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 September 10, 2010. Paper copies, if any, will be sent by first class mail to those indicated as non-registered participants on September 13, 2010.

By /s/ Karen L. Trumpower

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