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UNITED STATES BANKRUPTCY COURT

DISTRICT OF ARIZONA

In re MORTGAGES LTD., Debtor.	No. 2:08-bk-07465-RJH RESPONSE IN PARTIAL SUPPORT AND PARTIAL OPPOSITION TO ML MANAGER'S NOTICE AND MOTION REGARDING PROPOSED ALLOCATION MODEL Hearing Date: Sept. 21, 2010 Hearing Time: 1:30 p.m.

Leah Lewis and Robert Facciola[1] (the "Oxford Investors"), through undersigned counsel, hereby file this *Response* to the *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* (the "Notice"). The Oxford Investors support efforts to create an allocation model, which, if designed properly, could fairly and equitable allocate necessary costs while protecting the interests of investors. However, as presently designed and noticed to interested parties, the ML Manager's proposed allocation model does not provide the necessary protections for investors.

[1] We anticipate that additional "Oxford Investors" may join in this Response prior to the September 21 hearing.

I. OXFORD'S SUPPORT FOR PARTS OF THE PROPOSED ALLOCATION MODEL

The Oxford Investors support the establishment of a flexible allocation model, and believe that many components of ML Manager's proposed allocation model are fair and equitable and should be contained in the allocation model ultimately approved by the Court. In particular, the Oxford Investors support ML Manager's proposal that costs be allocated to the specific loan which incurred those costs. (*See Notice, p. 23*). Furthermore, investors should not be required to make additional capital contributions. (*See Notice, p.14*). Also, investors should have the opportunity to pay the appropriate allocation in order to halt the accrual of any additional interest charges or general administrative costs against the investor's loan interest. (*See Notice, p. 13, and p. 14, fn. 9*).

While the general framework outlined in the Notice appears fair and equitable, it appears that ML Manager intends to apply certain aspects of that framework in an arbitrary and inequitable fashion. Furthermore, the Notice infers that broad discretion will be granted to ML Manager in allocating expenses. As set forth below, the Oxford Investors have identified certain unwarranted assumptions made by ML Manager and analyzed each of the ten proposed steps of ML Manager's proposed allocation model and addressed certain specific issues that must be rectified in order for the proposed allocation model to be truly fair and equitable..

II. OXFORD'S OPPOSITION TO PARTS OF THE PROPOSED ALLOCATION MODEL

A. Business Judgment Standard is Not Appropriate Basis for Allocation Model.

ML Manager relies heavily on the business judgment rule as justification for approving the proposed allocation model and for giving ML Manager broad discretion in allocating expenses. While it may be appropriate to defer to ML Manager's business judgment in estimating future costs and potential recoveries, it is not appropriate to grant ML Manager unilateral discretion to allocate costs between investors guided solely by its business judgment.

The business judgment rule grants deference to corporate officers only as to ordinary business decisions. *See, e.g., Tovrea Land and Cattle Company v.* Linsenmeyer, 100 Ariz. 107, 129-130, 412 P.2d 47, 62 (1966); *In re Pomona Valley Medical Group, Inc.*, 476 F.3d 665, 670 (9th Cir. 2007); *FDIC v. Jackson*, 133 F.3d 694, 699, fn. 5 (9th Cir. 1998). However, the proposed allocation model goes beyond those ordinary business decisions to which ML Manager's business judgment would apply. In fact, ML Manager's proposed allocation model includes provisions for unilaterally altering the property rights of investors. The ML Manager's business judgment cannot be used to trump an individual investor's property rights.

The proposed allocation model would give ML Manager the ability to take funds that one investor is entitled to receive in distributions, and instead use them to cover costs incurred solely to benefit other investors. (*See Notice, p. 23*). In addition, ML Manager proposes it have the discretion to unilaterally offset litigation costs against specific investors absent any judicial finding of fault. (*See Notice, p. 28*). Altering property rights based solely on ML Manager's business judgment is improper. In fact, the Bankruptcy Code and constitutional considerations of due process require notice and an opportunity to be heard on the modification of property rights except when explicitly authorized by the Plan, the Order Confirming Plan, or an agency or other agreement between the investor and ML Manager or its predecessors. Furthermore, the Federal Rules of Bankruptcy Procedure provide that altering property interests may only be done pursuant to an adversary proceeding. *See Federal Rules of Bankruptcy Procedure 7001, et seq*. Initiating an adversary proceeding is fundamental to protecting property rights and ensuring investors receive due process. The Notice by which ML Manager seeks to alter such rights, on an expedited basis, does not provide these same safeguards. As a result, pending an adversary proceeding to determine property rights, this Court should reject any part of a proposed allocation model that would alter investors' interests in loans or real estate.

B. Non-Transferring Pass-Through Investors are Not Liable for Exit Financing.

Through its Notice, ML Manager is also seeking to impose the costs of exit financing on the non-

transferring investors ("NTIs"), despite the fact that the NTIs explicitly elected not to have access to that exit financing by electing not to transfer into the Loan LLCs. As stated in the Disclosure Statement at page 7: "The benefits and protections of the Loan LLC and the use of the Exit Financing will not be available to [the "NTIs"]…". Furthermore, the Inter-Borrower Agreement recognized that all Lender costs would be borne solely by the borrowers under that Agreement, none of whom are NTIs. Recital E of the Inter-Borrower Agreement states:

> Each Borrower will borrow differing amounts under the Loan at different times and repay its share of the Loan from different sources. This Agreement is the Inter-Borrower Agreement contemplated under the Plan. Pursuant to this Agreement, the Borrowers are agreeing to (among other things) the manner in which (i) advances will be requested and made under the Loan; and (ii) **all obligations due to Lender under the Loan will be allocated among and paid by, the various Borrowers so that each Borrower is only paying its Allocated Loan Share**. (Emphasis added).

Pursuant to the Inter-Borrower Agreement, only the Liquidating Trustee, the ML Manager, and the Loan LLCs are "Borrowers" under the agreement, and therefore liable for the borrowed amounts.

Despite the quoted language of the Disclosure Statement and the Inter-Borrower Agreement, ML Manager argues that "Pass-Through Investors are to be treated the same as the Investors in the Loan LLCs" and makes no distinction for allocating exit financing costs only to those investors who elected to be liable for such costs. (*See Notice, p. 16*).

C. Ambiguities in the Proposed Allocation Model Must be Resolved. ML Manager's allocation model, as proposed, contains numerous ambiguities. First it does not provide the methodology for determining which costs will be General Costs or Specific Costs, and instead appears to leave such decisions to the arbitrary decision of ML Manager. (*See Notice, p. 23, "ML Manager has the discretion to allocate Servicing Costs as General Costs or Specific Costs based upon the level of servicing needs for a particular Loan*."). To mask this nondisclosure of its methodology, or perhaps to avoid revelation of it, ML Manager, by use of the nomenclature "Specific Costs", seeks to project an image of having allocated specifically where it could to

“General Costs” only where it could not. But in fact there is clear evidence of very loan specific costs appearing as General Costs. Given that these allocations will directly affect the distributions Investors ultimately receive, an explicit identification of the process by which costs will be allocated to one of the categories is required, and a consistent application of that process must be assured before this Court can approce the process and resulting allocations.

The Notice also does not address whether allocations will be done in a timely and cost-effective manner. Rather, it appears to give ML Manager an open-ended timeframe in which to evaluate expenses and make distributions. The allocation model should hold ML Manager accountable to timely and promptly allocate expenses and make distributions, as well as to regularly review the assumptions on which reserves are based so that the conservative cushion that ML Manager seeks today can be reduced as matters progress.

Furthermore, Oxford Investors have reviewed each step of the general framework proposed by ML Manager, and have identified the following issues that need clarification or modification before the proposed allocation model would be fair and equitable:

1. Determine Outstanding Loan Balances

The Oxford Investors agree that an appropriate basis for allocating costs to loans starts with the loan amount. Adding to each loan investment amount such accruals as late charges and default interest as of the date Mortgages Ltd. filed bankruptcy distorts this simple fairness. Establishing loan values as of the filing date means that the loan balance was determined not solely by the amount invested, but by the borrower’s performance, the date of default and Mortgages Ltd.’s decisions about when and how to enforce the lenders’ remedies. To keep the allocation model simple and fair, the Oxford Investors urge the court to allocate based on the funded loan amount as of the date Mortgages Ltd. filed bankruptcy.

2. Loan Recovery Analysis

The Oxford Investors agree that it is prudent for ML Manager to project net sales proceeds from property sales to establish operating budgets. As indicated by ML Manager, these projections

of revenue and expenses should be updated as appropriate. These updates should also include adjustments in the amount of operating expense cushion, currently set at 20%. The updated projections should also allow flexibility to include Liquidating Trust recoveries should any become likely and estimable. The high hurdle of "reasonable certainty" sets the standard to estimate Liquidating Trust recoveries higher than loan Recoveries.

3. Recalculate the Sharing Ratio

Creating a reallocation process to tax loans that can pay their costs with a portion of the costs of those that can't is arbitrary, unfair and impermissible.

The proposal is arbitrary in that the Sharing Ratio recalculation is based not on actual loan cost deficits, but on pro forma deficits determined using conservative assumptions that reduce projected sales revenue and increase projected expenses. (*See Notice, p. 20*). One of the objectives of the Loan Recovery Analysis is that "it is better to withhold too much money than too little money . . . to assure . . . that sufficient funds are available . . . to pay all Costs" so the Allocation Model budgets for more money than it actually expects to use. (*See Notice, p. 21*). While this conservative approach may be appropriate to create operating reserves, it does not accurately reflect ML Manager's best estimate of the actual costs, proceeds and potential loan deficits based on the Allocation Model's arbitrary budgeting assumptions.

The proposal is also unfair in that there is no mechanism to return the funds arbitrarily allocated to the better loans should the deficit loan net greater proceeds than the conservative assumptions budget. Without such a mechanism, loans that sell early with a Positive Recovery will be "stuck" with the allocated "Negative Recoveries" even if those Negative Recoveries never actually occur.

The allocation of liabilities from one loan to another is also impermissible under state law. Each investor's liability is limited to her investment. Accordingly, each investor who faces a Negative Recovery has no liability to fund that Negative Recovery. If the investors in each Negative Recovery loan are not liable for the Negative Recovery, how can the Allocation Model

make other investors liable for it? There is simply no obligation to transfer. Furthermore, the proposed allocation model does not account for the possibility that Negative Recoveries could be paid out of future proceeds due those investors from personal guaranties, third-party litigation or other potential recoveries.

Therefore, recalculating the Sharing Ratio does not promote equality or fairness, but the opposite. As such, this third step should be eliminated.

4. Estimate the Disposition Period

It is appropriate to estimate the timing of sales proceeds for budgeting purposes and these estimates should be made in tandem with the Loan Recovery Analysis. Like the Loan Recovery Analysis, the Disposition Period estimate should be reviewed and updated as appropriate.

5. Estimate the Expected Costs

Accounting for actual costs and estimating the total costs over the lifespan of the loan portfolio is appropriate. While the proposed allocation model does not appear to call for it, the Expected Costs estimate, like the Loan Recovery Analysis and the Disposition Period Estimate, should be reviewed and updated as appropriate.

6. Separate Expected Costs into General and Specific Costs

. Fundamental to the fairness of any allocation model is allocating costs to the specific loans which incurred such costs. Accommodating that principal appears to be the rationale for ML Manager's identification of one of the categories of costs as being "Specific Costs". While certain administrative costs may benefit all loans and therefore should be applied generally, any cost which relates to a specific loan or specific group of loans should be allocated accordingly. When a cost is clearly specifically allocable to a particular loan (e.g. "cost of appraisel for Sojac collateral") to do otherwise is arbitrary and unfair.

However, it is our understanding that there were a number of costs that could be allocated to specific loans, but have not been, and which the proposed allocation model would inequitably spread across all loans. In fact, it is our understanding that no pre-confirmation costs have been

allocated specifically, which is particularly troubling in light of ML Manager recognizing that such costs account for "several multiples" of the post-confirmation costs. (*See Notice, p. 29*). With minimal effort, the majority of pre-confirmation costs could be allocated to specific loans, or to a small group of loans directly associated with the requisite costs. For example, approximately $2.8 million of additional financing was secured pre-confirmation for the Centerpoint loan, and this cost is therefore a "Specific Cost" allocable solely to that loan. But this cost was not allocated to that loan. Similarly, the Rightpath loan incurred loan-specific costs which were not allocated to Rightpath. It is our understanding that ML Manager has already allocated many similar post-confirmation costs to specific loans or to a small group of specific loans.

Furthermore, Exit Financing Costs should not be treated as General Costs but rather first allocated to the loans which incurred the costs financed by the Exit Financing. And as to any Exit Financing Costs allocated to a loan, as discussed above, such costs are investor-specific. Certain investors (conveying or transferring investors) agreed to the benefits and liabilities associated with the Exit Financing, while the NTIs did not. Accordingly, the Exit Financing Costs should be allocated specifically to those investors who chose to transfer their interests to a Loan LLC which Loan LLC, not the NTIs, is a party to the Inter-Borrower Agreement. Similarly, any Replacement Loans should be allocated specifically by investor.

7. <u>Spread the Separated Costs</u>

If costs are properly characterized as Specific Costs, then allocating such Specific Costs to the requisite loans is appropriate. While the concept of allocating General Costs to each loan based on the loan value may seem correct, allocating Exit Financing Costs to each loan without considering the number of investors who utilized the Exit Financing is arbitrary and unfair. As indicated above, Exit Financing Costs are an expense incurred at the option of investors who chose to utilize Exit Financing. As such, it is unfair to allocate these investor-specific voluntary costs to investors who elected not to incur the cost. Moreover, allocating these investor-specific costs to each loan regardless of how many investors chose to incur this cost makes the allocation arbitrary.

Additionally, the proposed Allocation Model arbitrarily allows ML Manager discretion to withhold or distribute net proceeds to investors if a recalculation of Total Estimated Costs reveals that the investors' allocation should be less than previously withheld. Allowing ML Manager to withhold reserves over and above the level indicated by its own Allocation Model allows the model's protocols to be sidestepped.

8. Determine Withholding from Distributions

It is appropriate to determine the amount to be withheld from proceeds to cover allocable costs.

9. Repayment of Replacement Loans and Permitted Reserves prior to Final Settlement

The Allocation Model should focus first on paying down allocations and then distributing remaining proceeds or making those further withholdings of Loan LLC proceeds required by the Inter-Borrower Agreement. Instead, ML Manager seeks to turn each Loan LLC into a Replacement Loan lender, complicating and delaying the fulfillment of the Allocation Model.

10. Final Settlement and True Up

It is appropriate for any reserve to be allocated and distributed to the appropriate investors at the conclusion of ML Manager's work.

D. A Prerequisite to any Allocation Model is the Availability of the Underlying Financial Analysis of ML Manager. Many of the facts necessary to critically review the proposed allocation model, including the underlying financial assumptions and analysis, are solely within the custody and control of ML Manager, and are now subject to a protective order entered on September 2, 2010.[2] Since the entry of the Protective Order, the Oxford Investors have been

[2] Allocable costs should have been filed regularly with the Court pursuant to the Inter-Borrower Agreement. Had this been done, the investors would have had more information on which to evaluate the proposed allocation model and possibly resolving many ambiguities and objections. The Inter-Borrower Agreement at Paragraph 2.2 states that "Each Loan Advance will be specifically allocated and documented between the Liquidating Trustee and the Loan LLC Group at the time advanced or as soon thereafter as possible based upon the purpose for which the money is drawn." The Inter-Borrower Agreement at Paragraph 2.3 then provides that "The Liquidating Trustee and the ML M manager shall jointly file with the Bankruptcy Court a schedule of allocated items which are determined from time to time." Even if such allocations were documented between the Trustee and ML Manager, they were never filed with the Court.

working with ML Manager's counsel, pursuant to the terms of the Protective Order, to obtain access to the underlying financial analysis. To date, the Oxford Investors have not been able to obtain such access. The Oxford Investors will continue to work with ML Manager in advance of the September 21, 2010 hearing to gain access to the necessary financial analysis and to see if the Oxford Investors concerns can be alleviated. The Oxford Investors reserve the right to supplement this Response and Objection after obtaining access to the underlying financial assumptions and analysis.

III. CONCLUSION

The Oxford Investors believe that an allocation model could ultimately be beneficial in providing a framework for disposing of the loans and related property, the proposed allocation model is not appropriate. Any approved allocation model must be based on more than just ML Manager's business judgment, and cannot alter the property interests of investors absent an adversary proceeding. Furthermore, the proposed allocation model appears to lack the flexibility needed to account for the differing terms of the agency agreements and the corresponding differing rights of the no-transferring pass-through investors. No allocation model can allocates costs equally to all investors regardless of the agreements they did or did not enter into. Finally, the proposed allocation model is ambiguous and does not contain information necessary for investors and the Court to evaluate whether the model can be fair and equitable to investors. As a result, the Court should deny ML Manager's motion for approval of the proposed allocation model.

DATED: September 10, 2010.

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