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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 **ML MANAGER'S RESPONSE TO 401(k) PLAN'S BRIEF ON ITS REQUEST TO TURNOVER FUNDS** **Hearing Date: September 21, 2010** **Hearing Time: 1:30**

The Mortgages Ltd. 401(k) Plan (the "401(k) Plan") [Docket No. 2872] only tangentially addresses the issue this Court asked the parties to brief – Is the 401(k) Plan obligated, like every other party, to pay its fair share of the bankruptcy costs? This question turns on a single issue – Is the 401(k) Plan subject to the Agency Agreement? In its motion, the 401(k) Plan has attempted, through its argument, to blur the issues. Because the 401(k) Plan executed a subscription agreement, and received the benefits of the Plan, the 401(k) Plan is obligated to pay its fair share of costs associated with the Plan like every other investor.

However, at this time the principal question has been further blurred by procedural steps taken by the 401(k) Plan. In these procedural wranglings, the 401(k) Plan has both asked this Court to abstain from any issues relating to the 401(k) Plan and to rule affirmatively in its favor regarding these same issues. Before this dispute can be completely resolved, the 401(k) Plan must choose whether it consents to this Court's jurisdiction or whether it desires the District Court to hear this matter.

I. FACTUAL AND PROCEDURAL BACKGROUND

The issue in this case is whether ML Manager has some equitable interest in the impound accounts that it can use to satisfy the 401(k) Plan's pro-rata share of the bankruptcy expenses. The 401(k) Plan's assets include an interest in the loans at issue.[1]

A. The 401(k) Plan executes the Agency Agreement.

On or about December 23, 2004, Scott Coles, the trustee of the 401(k) Plan executed a Master Agency Agreement. The Master Agency Agreement appointed the Debtor as the 401(k) Plan's agent with regard to the Loans and take action relating to the administration, collection and liquidation of the 401(k) Plan's interest in the Loans. The Master Agency Agreement continued for approximately three years.[2] On November 12, 2007, the 401(k) Plan executed a Subscription Agreement. ML Manager's position is that this Subscription Agreement superseded the Master Agency Agreement and incorporated the Agency Agreement granting the Debtor broad powers to act in the name of the principle for the management of the loan. The Agency Agreement provided the Debtor with the "sole discretion" to manage loans on behalf of investors, including the following authority:

> (2) **Incur fees, costs and expenses deemed necessary** by Agent to protect Participants interests under the Loan Documents
>
> (3) **Incur fees, costs and expenses deemed necessary by Agent to protect the property** securing any Loan (each a "Trust Property"), including insurance premiums, receiver fees, property manager fees, maintenance expenses and security expense.
>
> * * *
>
> (7) Sign, file and record all documents Agent deems necessary to protect Participant's interests and/or **pursue Participant's remedies upon default** ….
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> * * *
>
> (11) **Retain attorneys**, trustees and other agents necessary **to collect the**

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[1] The 401(k) Plan argues that it originated the loans and therefore these loans do not constitute ML Loans under the Plan. However, this argument fails because it is undisputed that the loans were arranged by the Debtor personnel, by way of the Debtor intellectual property, assets and connections.

[2] The 401(k) Plan argues that the new Agency Agreement was never effectuated. If this is the case, then the Master Agency Agreement continues to be in force and was not terminated.

> **amounts due under the Loan Documents**, to protect the applicable Trust Property and/or to proceed with foreclosure of the applicable Trust Property, initiate a trustee's sale and/or **institute, defend, appear or otherwise participate in any proceeding** (legal, administrative or otherwise) that Agent deems necessary.
>
> (12) **Incur and pay such costs, expenses and fees as Agent deems appropriate** in undertaking and pursuing enforcement of the Loan Documents and/or collection of amounts owed thereunder, including attorneys' fees, receiver fees, trustee fees, expert fees, notice fees and any fees, costs and expenses incurred in an effort to collect against a guarantor of any Loan.
>
> (13) **Request and receive payments from Borrowers or Participant as advances in order to pay such fees**, costs and expenses incurred by Agent in accordance with this Agreement and/or the Loan Documents.

Agency Agreement § 1(b) (emphasis added). In other words, the Agent had authority to incur fees and costs that it believed, in its sole discretion, were necessary for the preservation of the principle's interests in the property. Additionally, in the agency agreement the 401(k) Plan agreed to broad indemnification of the Agent as follows:

> **Participant shall indemnify, protect, defend and hold Agent harmless for, from and against all liabilities incurred by Agent in performing under the terms of this Agreement** or otherwise arising, directly, indirectly, from any Loan or the Loan Documents, including all attorneys' fees, insurance premiums, expenses, costs damages and expenses.

Agency Agreement § 4(a) (emphasis added). This Court has held that the execution of the Subscription Agreement created an agency coupled with an interest and was irrevocable.

B. The Debtor's Bankruptcy embroils the assets of the 401(k) Plan.

In June 2008, creditors of the Debtor filed an involuntary bankruptcy petition forcing the Debtor into bankruptcy. As this Court is aware, during these proceedings, all of the investors, including the 401(k) Plan became embroiled in lengthy and costly disputes regarding the direction of Mortgages Ltd. and the ownership of assets previously controlled by the Debtor The loan interests held by investors, including the 401(k) Plan were also entangled in the bankruptcy. Exhibit B to the Amended Disclosure Statement clearly lists all of the ML Loans and included the Loans held in part by the 401(k) Plan. Indeed, during the bankruptcy proceedings, various parties challenged the investors' ownership of the loan interests.

C. The Court confirmed a Plan of Reorganization.

In early 2009, the Official Committee of Investors proposed a Plan of Reorganization (the "Plan"). As noted above, in its Amended Disclosure Statement, the Official Committee of Investors clearly listed all of the loans affected by the Plan. *See,* Exhibit B to the Disclosure Statement. This list included all of the loans managed by the Debtor including the loans owned by the 401(k) Plan. *Id.*

In May 2009, the Court confirmed the Plan. The Plan provided for the creation of ML Manager, which would manage the loans on behalf of all investors through the new Loan LLCs and/or the existing Agency Agreement, and provided that each of the investors would bear a fair share of the expenses of the Bankruptcy. These expenses included the costs of financing necessary to implement the Plan and exit bankruptcy. Without the Exit Financing, any plan of reorganization would have been deemed unfeasible and could not have been confirmed. *See* 11 U.S.C. § 1129(a)(9 & 11). Accordingly, the Plan sought to spread the burden of the Exit Financing proportionately to all investors.

The Confirmation of the Investor's Committee's first amended plan of reorganization resolved the ownership of these notes and deeds of trust in favor of the investors, including the 401(k) Plan. All investors, including the 401(k) Plan, benefited equally from being able to exit bankruptcy through confirmation of the Plan.

As a result, this Court later held that the Plan required all investors to be assessed an equitable share of the costs and expenses of coming out of bankruptcy and realizing the value of the loans:

> . . . [T]o the extent any clarification is needed. Paragraph U of the confirmation order permits the ML Manager to charge back to the non-opt-in participating investors their proportionate share of all of its expenses, including but not limited to the exit financing. This Plan does impose a limitation that such a charge back be fair, equitable and proportional, but within those limitations the ML Manager can exercise his business judgment whether to obtain financing to cover exit costs and operational expenses, and when to make the charge backs.

October 21, 2009 Memorandum Decision at p.1-2 [Docket No. 2323]. The bankruptcy court's decision was consistent with, and indeed was compelled by, the Plan provisions, the record in the case, and the principles of the Bankruptcy Code.

In order to exit from a chapter 11 bankruptcy, the Bankruptcy Code provides that all administrative expenses of the bankruptcy must be paid in full in cash on the effective date of the Plan, 11 U.S.C. § 1129(a)(9), and that the Plan must be economically feasible so that it will not result in a future liquidation, 11 U.S.C. § 1129(a)(11). The Code also requires the treatment of classes that do not accept the Plan to be "fair and equitable" and to not discriminate unfairly. 11 U.S.C. § 1129(b). The Confirmation Order contained express findings and conclusions that these requirements had been met. Confirmation Order at ¶¶ 14, 16, 17, 20 & ¶ A. No party appealed those findings, or any other aspect of the Confirmation Order.

Accordingly, an essential premise of the Plan was that every investor would bear a fair share of the expenses. The dispute in this case primarily concerns the $20 million provided as exit financing on the effective date of the Plan ("Exit Financing"). The Plan and the Disclosure Statement clearly stated the details, uses and need for the Exit Financing to pay, among other things, the administrative expenses of at least $7 million, the post-petition debtor financing owed to Stratera Portfolio Advisors LLC of at least $5 million, and future operating expenses for ML Manager and the Liquidating Trust, among others. The Plan could not be implemented without financing, and without proportionality, none of the other investors or creditors would have likely agreed to the Plan.

D. <u>The 401(k) Plan challenges the jurisdiction of this Court.</u>

This dispute arises out of two separate impound accounts holding funds in two loans in which the 401(k) Plan claims an interest. The 401(k) Plan sought to recover the money in these impound accounts from the ML Liquidating Trustee. The Liquidating Trustee disclaimed any interest in the funds. However, ML Manager maintained an interest in the funds pursuant to the 401(k) Plan's obligation to pay its proportionate share of the bankruptcy costs.

On August 30, 2010, the 401(k) Plan filed a motion requesting that the District Court withdraw the reference for all matters relating to the 401(k) Plan [Docket 2901]. Simultaneously, the 401(k) Plan filed a complaint in the District Court alleging that ML Manager was attempting to "hijack" the assets of the 401(k) Plan for its own benefit. Later that day, the 401(k) Plan filed a brief regarding Mr. Furst's motion relating to the GP Properties Loan arguing that this Court should abstain from making any rulings that would implicate material ERISA issues. [Docket 2902] In that same motion, however, the 401(k) Plan urged that Court to grant Mr. Furst the relief requested.[3]

II. <u>LEGAL ARGUMENT</u>

Currently ML Manager has a difficult time divining the intentions of the 401(k) Plan. Does the 401(k) Plan desire this Court to rule on the issue set forth in its motion, or does the 401(k) Plan desire that this Court abstain from making any definitive ruling regarding these matters? ML Manager requests that the 401(k) Plan clarify its position.

Regardless, this Court can establish that ML Manager has an equitable right to the funds contained in the impound account because it can charge the 401(k) Plan its proportionate share of the costs of the bankruptcy because the 401(k) Plan, like every other investor, benefited from the Plan. Accordingly, this Court need not make any ruling regarding the provisions of ERISA in order to deny the 401(k) Plan the relief requested, as it should be undisputed that the 401(k) Plan does not get a free ride solely as a result of ERISA.

A. <u>The 401(k) Plan is required to pay its pro rata share of costs like any other investor.</u>

One of the principal purposes of the bankruptcy laws is ensure uniformity in the treatment of all those who have similar claims to the assets of the debtor. *See e.g. Cent. Va. Cmty. College v. Katz*, 546 U.S. 356, 377 (2006) (holding that one purpose of

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[3] In its brief the 401(k) Plan makes many statements indicated a lack of knowledge regarding the current procedural posture of this bankruptcy case. ML Manager anticipates responding to this brief within the time permitted by the rules.

bankruptcy is "to ensure uniformity in treatment of state and private creditors") (citing *Sturges v. Crowninshield*, 17 U.S. 122, 4 Wheat. 122, 193-194, 4 L. Ed. 529 (1819)). Here, the 401(k) Plan is attempting to receive preferential treatment in the Bankruptcy by seeking to avoid paying their pro-rata share of the bankruptcy costs solely based on its status as an ERISA plan.

It is undisputed that the 401(k) Plan executed a Master Agency Agreement and a Subscription Agreement that incorporates the Agency Agreement. As noted above, this Court has already held that ML Manager can charge-back the costs of the bankruptcy so long as this charge-back is "fair, equitable and proportional." The only non-ERISA argument made by the 401(k) Plan relating to this chargeback is the argument that the 401(k) Plan loans are not ML Loans as defined by the Plan. However, this argument fails. Throughout the bankruptcy proceedings the parties treated all of the loans in which the 401(k) Plan preserved an interest as ML Loans. The Official Investor's Committee clearly listed these loans in Exhibit B to the Amended Disclosure Statement. Specifically, the Amended Disclosure Statement provided as follows: "Attached as <u>Exhibit "B"</u> is a listing of ***each of the Borrower's Loans*** and the amount owned by the Pass-Through Investors, each of the MP Funds, RBLLC and the Debtor (which is subject to RBLLC's security interest"). The 401(k) Plan's interests in loans is included as an interest owned by a pass-through investor. The 401(k) Plan's ownership of its notes and deeds of trust were resolved, like every other Investor through the confirmation of the Plan. The 401(k) Plan's loans were just as much involved in the pre-confirmation litigation as any other Investor. Indeed, during the bankruptcy, the Debtor attempted to modify the CDIG loan, which is a loan wholly owned by the 401(k) Plan. Accordingly, it cannot be disputed that the Disclosure Statement and the Plan treated the 401(k) Plan as a pass-though investor. Accordingly the 401(k) Plan's argument that their loans were not ML Loans as described by the Plan fails.

Because it is undisputed that the 401(k) Plan was treated the same as other pass-through investors during the confirmation of the Plan, it is logical that the 401(k) Plan is burdened with the same obligations of any other investors. What the 401(k) Plan is seeking to do is to force its share of the bankruptcy costs on other similarly situated investors. If the 401(k) Plan is not obligated to pay its share of the costs, these costs will be forced onto the backs of the other investors. The Plan benefited all of the investors equally. They should all bear an equal share of the costs.

B. <u>ERISA does not require that the 401(k) Plan receive special treatment under the Plan.</u>

The remainder of the 401(k) Plan's argument are all based on the faulty premise that the 401(k) is entitled to special treatment under ERISA. All of the 401(k) Plan's arguments are misplaced, as there is nothing in ERISA law that entitles the 401(k) Plan to avoid its obligations to pay for the costs of the bankruptcy. Notably, all that ML Manager is seeking is for the 401(k) Plan to pay its pro-rata shares of the costs of the bankruptcy.

1. ERISA does not shield the 401(k) Plan's from its pro-rata share of expenses.

First, the 401(k) Plan argues that ML Manager cannot allocate a pro-rata share of the expenses of the bankruptcy to the ERISA plan because the Plan's assets must be held in trust. ML Manager agrees with this doctrine. However, the argument fails because the 401(k) Plan's assets are being used pursuant to this Courts order to pay a "fair, equitable and proportionate" share of the costs of the bankruptcy. Nothing in ERISA prohibits a plan trustee from paying reasonable administrative expenses associated with protecting the plan's assets.

Here, the confirmation of the Plan protected the 401(k) Plan's assets from arguments seeking to trump the 401(k) Plan's interests and enabled the 401(k) Plan to cleave its assets from the throes of the bankruptcy proceedings. The charge-back that ML Manager is seeking to impose upon all investors, including the 401(k) Plan relates to the costs of the bankruptcy. The assets of all of the investors, including the 401(k) Plan became embroiled in this proceeding. Accordingly, these fees were necessary and reasonable for the protection of the 401(k) Plan's assets.

2. The Agency Agreement does not make ML Manager an ERISA fiduciary.

Nor is ML Manager an ERISA fiduciary because it is not exercising any discretionary control over the 401(k) Plan. As noted in the 401(k) Plan's brief, ERISA defines a fiduciary as any person who "exercises any discretionary authority or discretionary control respecting management of such plan or exercise any authority or control respecting management or disposition of its assets . . . or . . . has any discretionary authority or discretionary responsibility in the administration of such plan." 401(k) Plan's Motion at 8-9. Despite the broad nature of this definition, ML Manager is not exerting any authority or control over the management, administration or disposition of the 401(k) Plan's assets. Indeed, ML Manager does not play any role in the administration of the 401(k) Plan except to assist in the servicing of the loans pursuant to the respective Agency Agreements. The 401(k) Plan is free to make any distributions, changes in trustees, or any other administrative actions without the prior approval of ML Manager. The 401(k) Plan is also free to alienate its interests in the notes and deeds of trust provided in complies with all contractual and statutory requirements. ML Manager does not participate in these actions and is therefore not a fiduciary under the definition set forth in ERISA. In fact, pursuant to Court order, ML Manager has no responsibility over the management of the 401(k) Plan. ML Manager has tried to be sensitive to the 401(k) Plan's role and has tried to cooperate with their trustee in deciding how to handle the properties.

The 401(k) Plan contends that ML Manager is a fiduciary, because it seeks to require the 401(k) Plan to pay its share of the bankruptcy expenses. This argument is ludicrous and by extension would make every creditor of an ERISA Plan a fiduciary if that creditor sought to enforce its claims against the Plan. In participating in the bankruptcy, the 401(k) Plan incurred costs to protect its assets. However, the 401(k) Plan did not pay those costs. ML Manager is seeking, pursuant to Court order, reimbursement of the 401(k) Plan's proportionate share of these costs. These efforts do not make ML

Manager an ERISA fiduciary.[4]

3. Prohibited Transaction was not void.

As noted above, both the Master Agency Agreement, and the Agency Agreement which the 401(k) Plan executed, permit ML Manager to recover costs from the 401(k) Plan. These provisions are not prohibited by ERISA as they are not compensation, but merely a method of recovering costs rightly attributable to the 401(k) Plan.

Even if the relationship between the 401(k) Plan and Mortgages Ltd. was a prohibited transaction under ERISA, that transaction was not void under ERISA. The fact that the provision of services for compensation by Mortgages Ltd. might be a prohibited transaction at the time the contract was entered does not of itself void the contract. Under ERISA, the remedy for a prohibited transaction by a fiduciary is that the fiduciary must make good any losses to the plan and restore to the plan any profits made by the fiduciary from use of plan assets. *See,* ERISA §409; 29 U.S.C. § 1109. A court may also impose other "equitable or remedial relief" as is deems appropriate. *Id.* Conspicuously absent from the regulation is any statement indicating that the transaction is automatically or completely void. *See, id.*

More importantly, Section 409 specifically exempts a "fiduciary" from any liability under ERISA if a breach of fiduciary duty "was committed before he became a fiduciary or after he ceased to be a fiduciary." *Id.* Accordingly, even if there was a breach of fiduciary duty by Mortgages Ltd., ML Manager is not liable for that breach because such breach would have occurred prior to ML Manager's existence.

Neither does the Internal Revenue Code provide that a prohibited transaction is void. Instead section 4975(f)(5) of the Internal Revenue Code requires an excise tax, which escalates if the prohibited transaction is not "correct[ed]". Correction does not require the voiding of a transaction but instead means "undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that

[4] Currently, ML Manager is attempting to negotiate with the Department of Labor to clarify this position. To date, the Department of Labor has not taken any action against ML Manager based on its agency authority.

in which it would be if the disqualified person were acting under the highest fiduciary standards." *See also* § 141.4975-13 (providing that "correction" and "amount involved" shall have the same definitions as appear in section 53.4941(e)-1 of the regulations); Section 53.4941(e)-1(c)(6) (recognizing that performance of personal services by a disqualified person does not require the termination of the relationship).

The cases cited by the 401(k) Plan do not support their argument that the Agency Agreements are void. In *Wilson v. Perry,* 470 F.Supp.2d 610, 618-25 (E.D. Va. 2007), the District Court granted a motion to void the transaction. However, the Court did not declare that prohibited transactions are automatically void, instead, the Court referred to section 409 and recognized that the voiding of a transaction is one of the available remedies should such relief be appropriate. *Id.* Here, the 401(k) Plan has not presented any evidence demonstrating that it is necessary to void the transaction. ML Manager is not liable for the actions of Mortgages Ltd. *See* ERISA §409; 29 U.S.C. § 1109. Voiding the transaction would only seek to impose additional burdens on other similarly situated investors. Similarly, in *Ironworkers Local 25 Pension Fund v. Watson Wyatt and Co*, the Court held that the status of the law firm's fiduciary standard was a question for the jury and not appropriate for dismissal. The Court did not make any holding regarding the legal principle involved here. Accordingly, this case does not support the 401(k) Plan's proposition.

C. <u>ERISA does not preempt the Bankruptcy court's rulings.</u>

Finally, there is nothing in ERISA that requires preemption of this Court's holding that the Subscription Agreement created an irrevocable agency in favor of ML Manager. The preemption clause, § 514(a), 29 U.S.C. § 1144(a), broadly states that ERISA provisions "shall supersede . . . State laws" to the extent that those laws "relate to any employee benefit plan." The 401(k) Plan claims that the Court's application of the agency coupled with an interest doctrine is preempted by ERISA because it is a law that binds employers or plan administrators to particular choices or precludes uniform administrative practice, thereby functioning as a regulation of an ERISA plan itself." *See* Motion at 14 (citing *Metropolitan life Ins. Co. v. Pettit*, 164 F.3d 857, 862 (4th Cir. 1998). More specifically, the 401(k) Plan claims that its inability to terminate the agency is preempted by ERISA.

This Court's application of state and federal common law is not preempted by ERISA because it does not bind the trustee to any particular choices relating to the Plan. As noted above, the relevant assets of the 401(k) Plan are interests in the notes and deeds of procured, organized and established by the Debtor prior to bankruptcy. These loans were described as ML Loans in the Plan and Disclosure Statement and were associated with binding and irrevocable Agency Agreements. The Agency Agreements provided the Debtor with authority to make decisions regarding the Loans, but did not permit the Debtor to make any decisions regarding the 401(k) Plan's equitable interest in the loans. Currently, the 401(k) Plan provides direction to ML Manager regarding the servicing of the Loans. ML Manager abides by this direction. The 401(k) Plan only seeks to terminate the Agency Agreement to avoid paying its pro rata share of expenses.

III. CONCLUSION

There is nothing in ERISA that will permit the 401(k) Plan to shift its burdens onto the other investors. Accordingly, the Court should deny the 401(k) Plan's attempts to avoid its own obligations to repay its share of the administrative expenses associated with the bankruptcy.

DATED: September 21, 2010

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COPY emailed
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