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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 REPLY IN SUPPORT OF ITS:** **(1) NOTICE OF INTENT TO DISTRIBUTE PROCEEDS IN ACCORDANCE WITH ALLOCATION MODEL,** **And** **(2) MOTION TO APPROVE TREATMENT OF DISTRIBUTION OF DISPUTED PROCEEDS** **Hearing Date: January 11, 2011** **Hearing Time: 1:30 p.m.**

Only two responses were filed to ML Manager's *(1) Notice of Intent to Distribute Proceeds in accordance with Allocation Model, and (2) Motion to Approve Treatment of Distribution of Disputed Proceeds* (Docket No. 3017) (the "Distribution Motion"), and neither justify further delay or denial of the distributions of approximately $8 million to approximately 1500 investors.

The ML Liquidating Trust filed an objection to the distribution of proceeds to "Insiders" and asks that the money be escrowed. As indicated in the Distribution Motion, ML Manager does not object to such a treatment and no other party, including the Insiders, have asserted or demanded other treatment so this issue can be resolved in the form of Order. The only substantive objection was filed by Bill Hawkins' entities and

four other members of the so-called "Rev-Op Group."[1] Significantly, the Rev-Op Group primarily rehashes arguments and objections that have already been considered and rejected by the Court, and otherwise presents no valid reason to further delay or withhold distributions. The Rev-Op Group's Objection should be overruled in total, or, at the very least, it should be overruled with regard to the distribution of everything but so-called current "Offset Claim."

The current Rev-Op Group makes three arguments. They argue that (1) the Liquidating Trust's share of the costs should not be included, (2) the pre-confirmation costs should not all be allocated as a general cost, and (3) they should not be assessed the "Offset Claim." Based on these arguments, they ask the Court to either deny or delay the distribution of over $8 million to 1500 or more investors. In making their arguments, the Rev-Op Group ignore many prior rulings and decisions by this Court, ignore operative provisions of the Plan, loan documents, and other applicable agreements that have already been approved by the Court, and, in many ways, ignore reality. It is understandable that the Rev-Op Group does not like or want to pay the costs that are being allocated. What the Rev-Op Group ignores, however, is the fact that these costs must be paid. The Exit Loan must be repaid. The operating costs to liquidate the portfolio must be paid. The attorneys' fees, costs and damages caused by all the litigation that the Rev-Op Group have caused through their conduct must be paid. The question before the Court is not whether these costs should be incurred or paid; the sole question before the Court is how those costs should be allocated so that distributions can be made at this time based on the present circumstances. ML Manager has presented and the Court has already approved an Allocation Model that allocates those costs in a fair, equitable and non-discriminatory manner.

[1] Apparently, the Rev-Op Group continues to shrink. Only eleven individuals or entities have joined this objection and seven of them are owned or controlled by Bill Hawkins. As such, there are in actuality only five investors that are now objecting.

I. **THE COURT SHOULD NOT RECONSIDER OR MODIFY ITS PRIOR RULINGS**

The Distribution Motion merely seeks approval of distributions made pursuant to the Allocation Model the Court has already approved. The Distribution Motion was only necessary because of the fact that some Objectors to the Allocation Model indicated that there may have been some factual objections to "loan specific costs" that were not considered when the Court approved the "formula" set forth in the Allocation Model. The approval of the Distribution Motion is not and should not be a chance for a second bite at the apple or reconsideration of decisions already made by this Court. Specifically, after considering the arguments in regard to the Allocation Model, the Court indicated:

> Although there's nothing in the plan that specifically says the Court shall approve an allocation model, **I think what we're doing here is akin to dealing with a partial summary judgment deciding issues that can be decided as legal issues** before getting to what fact issues need to be resolved at an evidentiary hearing. *We may then have fact issues about what various variables in that formula are for a specific loan*. **But what is before me today is to determine what the formula is. And I think that's entirely appropriate, and I think it's something that can and should be accomplished at this point**. On the specific objections, and first of all, a lot of them I believe are law in the case. And whether I'm required to or not, I'm not about to reverse rulings that I've previously made. I've reviewed the arguments on them, and considered them, but don't see any basis to change anything that I have previously ruled. (9/21/2010 Transcript, at p. 22-23, Docket No. 2964)(emphasis added).

In other words, the Court has (1) already approved the "formula" or the structure of the Allocation Model, and (2) resolved all of the objections that could be resolved as legal issues. The only thing the Court left open for possible further consideration was "fact issues about what various variables in that formula are for a specific loan." (*Id.*) Indeed, after discussing the objections to the "formula" or Allocation Model that had been previously presented, the Court concluded:

> And with that, I think the procedure that you're suggesting is appropriate. And that is, we set up a schedule **for anyone to**

> **raise any fact issues they may have as to how any of the variables in the formula are determined in any specific case**. But that we would be in a position today to in effect approve the formula. (9/21/2010 Transcript, at p. 25-26, Docket No. 2964)(emphasis added).

As such, the only legitimate or remaining objections that should be considered are "*fact issues*" with regard to variables created by the six specific Loans at issue. Significantly, however, the Rev-Op Group's current Objections do not challenge any of the loan specific costs for the six Loans at issue. Despite hours of additional meetings, and substantial details being provided, there are no new facts specific issues asserted with respect to these six Loans (or any other) that require an evidentiary hearing. The Rev-Op Group's Objection is primarily based on generic arguments that were already asserted back in September. In other words, the Rev-Op Group is simply taking yet another shot at the Allocation Model as a whole. These untimely and recycled arguments should be overruled again.

II. THE BUSINESS JUDGMENT STANDARD

The Rev-Op Group once again ask the Court to reconsider its decision on the business judgment rule and to view the Allocation Model purely from their perspective under a fiduciary duty standard, ignoring the fact that many other investors to whom ML Manager owes the exact same duty have different interests, and the fact that ML Manager has an agency coupled with an interest. In rehashing their same tired argument, the Rev-Op Group once again merely cites to generic agency law that is inapposite. *See* Rev-Op Objection at p.3 citing *Musselman v. Southwinds Realty, Inc.* 146 Ariz. 173, 175, 704 P.2d 814, 816 (App. 1984).[2] There has still been no fiduciary duty case cited similar to the

[2] The Rev-Op Group's citation to *Musselman* is particularly unpersuasive and even misleading. *Musselman* involved a property seller who, after a sale was consummated at the seller's asking price, sued its real estate agent because the agent didn't inform the seller that other properties were selling for much more. The trial court entered a directed verdict in favor of the real estate agent on the fraud claim, and the jury found in favor of the agent on all other claims. The appellate court **affirmed** the judgments in the agent's favor. The point of law quoted by the Rev-Op Group is taken out of context and, as a

facts in this case where an agent was created and is acting pursuant to a Court approved plan of reorganization on behalf of a multitude of principals with disparate interests under a agency coupled with an interest. The Court's determination that the business judgment standard should be applied under these facts and is consistent with and satisfies ML Manager's duty is not only correct, but the only logical conclusion.

More importantly, the Court has already conclusively determined this issue. At the September 21, 2010 hearing, the Court stated:

> I do agree, as I've said on a number of occasions, that what ML Manager is required to do here in coming up with the formula is to come up with a formula that's fair, equitable, and non-discriminatory, **and it can't be modified according to a fiduciary duty argument**, at least going so far as to say, "And as a fiduciary you must follow the beneficiary's wishes."
>
> **I've ruled on that on a number of occasions**, and I think that's the rule that's going to apply here.
>
> * * *
>
> **On the business judgment rule**, I do think it is fair and appropriate for ML Manager to determine that costs should be allocated based upon the outstanding loan balance as of the bankruptcy date.
>
> Similarly, I think **it's appropriate determination that ML Manager has made as to how uncovered costs shall be shared among the other loans that are able to cover their costs**. (9/21/2010 Transcript, at pp. 23, 24 Docket No. 2964)(emphasis added).

These decisions were and are correct, and should not be reconsidered at this time.

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result, is misleading. The actual language used by the *Musselman* Court was: "**While** an agency relationship imposes on an agent the duty of utmost good faith, integrity, honesty, and loyalty in her transactions with the principal, **it yet remains a question for the finder of fact to determine whether such duty was breached**.")(emphasis added) The Rev-Op Group conveniently omits the context of the quote, which undercuts their entire argument because the *Musselman* Court found that the agent's sale of the property at the asking price despite the fact that the agent knew other properties were selling much higher was not a breach of the fiduciary duty. Moreover, *Musselman* did not involve an agent that was created pursuant to a plan or reorganization, representing a multitude of principals with diverse and disparate interests under an agency coupled with an interest.

III. THE OBJECTION WITH REGARD TO THE ALLOCATION TO THE TRUST IS NONSENSICAL

Perhaps the easiest objection to dispose of is the Rev-Op Group's arguments that the distributions should not proceed because costs that should be paid by the Liquidating Trust are included in the Allocation Model.[3] First, this objection has already been overruled. This objection was made by several parties (*see e.g.,* Docket Nos. 2937 (Exit Lending costs should not be allocated), 2939 (Objecting to allocation of Exit Lending costs and uncovered costs), 2949 (Objection to allocation of Exit Lending, assertion that only loan specific costs can be allocated, ***objection that the Liquidating Trust's share of costs cannot be allocated***)), and rejected by the Court back in September when the Court approved the Allocation Model. (Docket No. 2959) So, it can be dismissed on this basis. Moreover, the argument is **not** one of the loan specific factual issues the Court reserved for future proceedings, but an untimely attack on the overall structure of the Allocation Model that the Court has already approved. So, it can be dismissed for this reason. Finally, and most important, the argument is nonsensical, ignores reality, and the operative documents, and should be rejected out of hand.

The Rev-Op Group essentially argues that any cost that is supposed to be paid by the Liquidating Trust under the Interborrower Agreement should not be included in the Allocation Model. In other words, the Rev-Op Group is saying that if the Trust cannot pay an expense, it simply will not be paid. This is ludicrous. The Interborrower Agreement, and the Loan Documents make it absolutely clear that both the Loan LLCs and the Trust have a joint and several obligation to pay the Exit Lender. The Interborrower Agreement contemplates "Overpayments and Repayments" (section 2.5) and provides a true-up mechanism resolve that after the payments were made. Moreover,

[3] The Rev-Op Group did not include this objection when they reserved objections to the Distribution on November 12, 2010. For this reason the objection could be rejected as untimely.

the testimony at the confirmation hearing clearly established that the Exit Lender was providing the loan based on the collateral related to the loans and the real property. (*See, e.g.,* 5/18/2009 Transcript, at pp. 42-44, Docket 2136) Even the Disclosure Statement makes it clear that the interest the ML Loans will be pledged as security for the Exit Loan even though the final obligation to repay the loan will be allocated between the Trust and the Investors. (*See* Disclosure Statement, at § VIII(F)). The fact that the Allocation Model initially contemplates that all costs will be paid by resolution of the ML Loans, but leaves open a mechanism to adjust the allocations if and when the Trust recovers money is not a reason to delay distributions now. It makes no sense to withhold any distributions now because it is uncertain how much the Trust will ultimately contribute.

IV. THE ARGUMENT WITH REGARD TO THE VTL ADMINISTRATIVE EXPENSES SHOULD BE REJECTED

As a subset of their argument about inclusion of costs that should be allocated to the Trust, the Rev-Op Group makes a confusing argument about administrative expenses that they argue should be allocated to the VTL (Value to Loan) investors. Again, this argument is untimely because it was not reserved by November 12, 2010, it was previously raised prior to (*see, e.g.,* Docket No. 2940 (objection that expenses are not allocated to the VTL)), and rejected at the September 21, 2010 hearing, and it is based on a mischaracterization or misunderstanding of the Plan.

First, the so-called VTL expenses were actually administrative pre-confirmation expenses that were the obligation of the Debtor and required to be paid upon confirmation of the Plan. The VTL committee was an official committee appointed by the Court. The Rev-Op Group did not object to the appointment of the committee, to the Plan provisions to pay the VTL expenses as an administrative expense, or even the VTL fee application. It is simply two years too late to argue that the VTL expenses were not a legitimate expense of the Debtor's estate that had to be paid.

Second, as previously explained, the VTL Investors were treated differently in the Plan because they were secured lenders to the MP Funds, and not investors in or creditors of the Debtor. The approved treatment under the Plan is that they receive an agreed upon payment from the MP Funds if and when the MP Funds get a distribution from the Loan LLCs. So, after the allocation of costs and expenses under the Allocation Model, the Loan LLCs will distribute proceeds to their respective members, which includes the MP Funds. Once the MP Funds receive a distribution, they will need to make the payments they agreed to make in the Plan to the VTL investors. After that, they will distribute the remainder to their members, the MP Fund investors. The argument that the VTL investors should be assessed additional costs and expenses is counter to the operation of section 3.6(i) of the Plan, which was fully disclosed in the Disclosure Statement at pages 33-34. This objection has no merit.

V. THE PRE-CONFIRMATION COSTS WERE APPROPRIATELY CHARACTERIZED AS GENERAL COSTS

As indicated in the Distribution Motion, on or prior to November 12, 2010 the Rev-Op Group purported to reserve an objection based on the fact that the Allocation Model characterizes all pre-confirmation costs as general costs. Even though they purported to reserve this argument, it is still inappropriate at this juncture as it is not a factual challenge to a specific loan cost. Instead, it is another general attack on the entire structure of the Allocation Model, an Objection that was fully briefed and argued in September 21, 2010 hearing (*see, e.g.* Docket Nos. (2939)), and the Court has already resolved those types of objections.

Although the Rev-Op Group overstates their role in the negotiation of the Interborrower Agreement and the allocation of the pre-confirmation costs,[4] it is true that

[4] The Rev-Op Group's argument on the negotiation of the Interborrower Agreement is curious inasmuch as it is completely inconsistent with their argument that they never thought they were responsible for the Exit Financing. The Interborrower Agreement relates solely to the obligation to repay Exit Financing. The Rev-Op Group now claims to

they were involved in the process. The significance of this fact merely underscores the fallacy of their arguments.

The Rev-Op Group does not dispute the fact that all of the pre-confirmation costs that are now being allocated as general costs were administrative claims or expenses of the Debtor allocated to the Trust under the Interborrower Agreement.[5] In fact, they admit this in their argument at page 3 of their Objection. They also acknowledge that they were involved in these pre-confirmation negotiations. What the fail to recognize, however, is they cannot have the pre-confirmation costs deemed to be both the responsibility of the Liquidating Trust and at the same time a loan specific cost. The operative documents make it very clear that the Liquidating Trust is responsible for general costs, administrative claims and other pre-confirmation obligations of the Debtor. The Liquidating Trust is not responsible for loan specific costs. As demonstrated in the original Allocation Model briefing and in the Distribution Motion, that was a primary factor ML Manager considered in determining to have the pre-confirmation costs treated as a general cost. It is important to allow these costs to be allocated to and paid by the Trust if and when the Trust has the money to pay them. It would be foolish to allocate them to one loan and destroy the obligation the Trust would have to repay them. Moreover, because the obligation to repay the expense is joint and several with all Loan LLCs, such treatment would be irrelevant to the current allocation model.

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be the driving force in these negotiations. This assertion makes no sense if the Rev-Op Group never believed, as they claim, that they were liable for the Exit Financing. The fact that the Rev-Op Group was involved in these negotiations simply illustrates that they knew that they would be proportionately liable for the repayment of the Exit Loan.

[5] The Rev-Op Group erroneously argues that the "Stratera DIP is not defined or even mentioned in the Interborrower Agreement. They are simply wrong. The definition of "Claims Required to be Paid" clearly includes "Class 3 (Stratera Claims) and "Administrative Claims … required to be paid by the Plan." Under the Plan, the Stratera DIP is dealt with in Class 3, and is an Administrative Claim that was required to be paid upon the effective date of the Plan. In Section 2.2, all of the "Claims Required to be Paid" are then allocated to the Trust. There is simply no legitimate dispute that the Interborrower Agreement, which the Rev-Op Group acknowledge they negotiated, identified the Stratera DIP, and allocated it to the Trust.

At the present time, the mechanic liens asserted against the Centerpoint project exceed the value of the property and even the value of any legitimate offers received on the property. Moreover, the title insurance company has recently asserted a coverage defense to the payment of the mechanic liens. As such, this calls into question the ability of Centerpoint to pay any of the costs. Indeed, this is what the current Allocation Model assumes. This means that Centerpoint's share of the general costs and even the loan specific costs that have already been incurred are "uncovered costs." As the Court will recall, the Allocation Model spreads "uncovered costs" to the other loans. *See e.g.,* 9/21/2010 Transcript, at pp. 23, 24 (Docket No. 2964)([The Court:] "Similarly, I think it's appropriate determination that ML Manager has made as to how uncovered costs shall be shared among the other loans that are able to cover their costs). As such, for purposes of the distributions for these six Loans, whether Centerpoint's share of the costs are allocated as general costs, or uncovered loan specific costs is functionally irrelevant.

The Rev-Op Group simply ignores or dismisses without analysis the four separate arguments presented in the Distribution Motion as to why ML Manager determined to treat these administrative costs and expenses of the Debtor as general costs. These arguments included the fact that ML Manager considered (1) that these issues had been negotiated and agreed to prior to confirmation, (2) that these costs were obligations of Mortgages Ltd, the Debtor as post-petition financing and administrative expense claims, and not any individual investor, (3) that there was common benefit to or at least impact on all investors related to the activities in question, and (4) that any allocation would be in large measure arbitrary and subjective based on the compromised nature of the payments and the "test case" implications of the work.

Although ML Manager believes and contends that its determination of the merits of these issues is the correct determination that is not the question before the Court. The sole question before the Court is whether ML Manager exercised its business judgment in an

arbitrary and capricious manner such that a Court should set it aside. *See Tovrea Land and Cattle Company v. Linsenmeyer*, 100 Ariz. 107, 129-30, 412 P.2d 47, 62 (1966). "It is the general rule that officers and directors of a corporation are authorized to handle the ordinary business affairs of the corporation according to their best judgments. . . ." *Id.* (quoting *Fagerberg v. Phoenix Flour Mills Co.*, 50 Ariz. 227, 71 P.2d 1022 (1937). Stated somewhat differently, whether there is any debate as to whether someone else might come to a different conclusion than ML Manager did is not the question. The question is whether ML Manager satisfied its obligation to carefully consider the issue. On the record before the Court, there has been no serious dispute created or objection lodged as to whether ML Manager carefully and deliberately considered these issues in the fulfillment of its business judgment obligations. As such, there can be no legitimate debate about this issue and no need to delay the distribution of over $8 million to approximately 1500 investors pending an evidentiary hearing on the satisfaction of ML Manager's business judgment.

VI. THE OFFSET CLAIM SHOULD BE AUTHORIZED, OR AN EVIDENTIARY HEARING SET ON JUST THIS CLAIM

As noted, there are over $8 million to be distributed even after deducting for three categories of the "Disputed Distribution." Notably, this includes over $1.08 million to be distributed to the Rev-Op Group that is not included in the $310,000 current Offset Claim. As has been repeatedly stated, there is no need to delay or deny the distribution of over $8 million to 1500 investors, including the distribution of approximately $1.08 million to the Rev-Op Group pending the resolution of the current Offset Claim. Even though it was thoroughly briefed prior to the September 21, 2010 hearing, ML Manager understood that the Offset Claim is being disputed, which is why ML Manager put the issue under the heading of "Disputed Distributions." Accordingly, regardless of the Court's determination of the current Offset Claim, all distributions other than the "Disputed

Distributions" should be approved.

As for the current Offset Claim, it is simply disingenuous for the Rev-Op Group to assert that they do not fully understand the Claim. The current Offset Claim consists solely of attorneys' fees that have been incurred in litigation with the Rev-Op Group and approximately $24,000 in additional interest that was incurred when two sales could not be closed due to the claims asserted by the Rev-Op Group and a new title insurance company had to be found that was willing to insure over those claims. The Rev-Op Group has been given an exact itemization of the claim and even spent a morning deposing Mr. Winkleman in depth about the claim, including all of the documents to support the claim. As such, the Rev-Op Group cannot claim surprise or that they do not know the basis of the claim.

Given the deposition that they took of Mr. Winkleman, the failure of the Rev-Op Group to raise specific factual objections to the current Offset Claim can and should be determinative at this point. Moreover, the Rev-Op Group completely ignores the most salient issue, which was that ML Manager has the right to assert the Offset Claim under the Agency Agreement. In the Distribution Motion, ML Manager quoted the exact authority for them to assert and demand payment of the Offset Claim. These provisions do not require Court approval or an award of fees or damages to be implemented. They are self-executing. As such, there is really no need for an evidentiary hearing. There is no dispute that ML Manager has actually incurred these fees and damages. There is also no dispute that the Agency Agreement allows ML Manager to assess them against the Rev-Op Group. As such, reasonability of the fees is not an issue and ML Manager does not believe that, on this record, there is a need for an evidentiary hearing. If an evidentiary hearing is necessary, it should not delay or deny the remaining distributions.

VII. CONCLUSION

ML Manager should be allowed to distribute everything but the "Disputed

Distributions." With regard to the Disputed Distributions, there was no objection asserted with regard to the distribution of the interest of Barnes and Barness to their judgment creditors, and ML Manager requests that the Court order such distributions be given to the judgment creditors. Because there was no objection or position from the so-called "Insiders" and because of the Liquidating Trust's stated position, ML Manager requests that the Court order distributions to the Insiders to be subject to the Allocation Model expenses,[6] but that the net distributions that would otherwise go to the Insiders be continued to be held in an escrow. Finally, ML Manager requests that the Court order that ML Manager is allowed to deduct the current Offset Claim of approximately $310,000 from distributions to the current Rev-Op Group. Alternatively, the Court should set a hearing on just this claim and allow all other distributions to be made.

DATED: January 10, 2011.

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[6] As discussed in connection with the Allocation Model, this would not apply to the Mortgages Ltd 401(k). The parties have agreed to reserve all claims with regard to the application of the Allocation Model to distributions to the 401(k) Plan until those issues are resolved in the pending District Court litigation.

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