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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re: MORTGAGES LTD., Debtor.	In Proceedings Under Chapter 11 Case No. 2:08-bk-07465-RJH **REPLY IN SUPPORT OF MOTION FOR DISTRIBUTION OF REV OP INVESTOR FUNDS IN ESCROW** Date of Hearing: March 10, 2011 Time of Hearing: 1:30 p.m.

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AJ Chandler 25 Acres, LLC; Bear Tooth Mountain Holdings, LLP; Cornerstone Realty & Development, Inc.; Cornerstone Realty & Development, Inc. Defined Benefit Plan and Trust; Evertson Oil Company, Inc.; Brett M. McFadden; LLJ Investments, L.L.C.; Michael Johnson Investments II, L.L.C.; Pueblo Sereno Mobile Home Park L.L.C.; Queen Creek XVIII, L.L.C.; Morley Rosenfield, M.D. P.C. Restated Profit Sharing Plan; William L. Hawkins Family L.L.P.; and/or their successors and assigns (collectively, the "Rev Op Investors") hereby file this Reply in support of the Rev Op Investors' *Motion for Distribution of Rev Op Investor Funds in Escrow* [DE #3065] filed on February 1, 2011 (the "Motion").

Pursuant to the Motion, the Rev Op Investors seek the immediate disbursement of approximately $246,000 currently held in escrow pending resolution of ML Manager LLC's ("ML Manager") asserted setoff under the form "Agent Agreement" that has been the subject of

other proceedings before this Court.[1] On February 18, 2011, ML Manager filed *ML Manager's Response to Rev Op Group's Motion for Distribution of Rev Op Investor Funds in Escrow* [DE #3090] (the "Response"). In the Response, ML Manager asserts its entitlement to setoff based on a "breach" of the Agency Agreement, indemnity under the Agency Agreement, and the Court's equitable powers under Section 105(a) of the Bankruptcy Code.

ML Manager, however, fails to address controlling law, misconstrues the language of the Agency Agreement, and generally obfuscates the issues presented to the Court in support of its effort to appropriate the escrowed funds. Stripped to its essence, the Response is little more than a recitation of unproven allegations of wrongdoing on the part of the Rev Op Investors that legally fail to support ML Manager's theories of liability. Worse yet, ML Manager is clearly intent on targeting the Rev Op Investors to quell their participation in this case and the administration of the Plan, and to chill the future exercise of their rights with respect to their interests in the loans and properties. In further support of this Reply, the Rev Op Investors respectfully submit as follows:

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I. ML MANAGER CARRIES THE BURDEN OF PROVING SETOFF.

As an initial matter, ML Manager bears the burden of proving its entitlement to offset the escrowed funds. Without citation to any relevant authority, ML Manager *incorrectly* asserts that the Rev Op Investors bear the burden of proving that ML Manager is *not* entitled to offset its asserted costs and attorneys' fees. *See* Response, p.3. This position is unsustainable. It is well settled that ML Manager bears the burden of establishing its entitlement to the relief requested under each of its asserted theories. *See, e.g., Graham v. Asbury*, 112 Ariz. 184, 185, 540 P.2d

[1] The applicability of the Agency Agreement is disputed by the Rev Op Investors and is the subject of an appeal currently pending before the United States District Court for the District of Arizona, Case No. 2:10-cv-01819-MHM. In a separate appeal pending in the same court, Case No. 2:09-cv-02698-MHM, the Rev Op Investors dispute ML Manager's ability to assess any portion of the "Exit Financing" against their property. The Rev Op Investors also have appealed the order approving the allocation of expenses and exit financing against their property. The Rev Op Investors reserve all applicable rights, and nothing herein shall be construed as an admission or waiver of any kind with respect to any of the pending appeals or other matters.

656, 657 (1975) (with respect to the breach claim, "the plaintiff has the burden of proving the existence of the contract, its breach and the resulting damages"); *INA Ins. Co. of N. Am. v. Valley Forge Ins. Co.*, 150 Ariz. 248, 255, 722 P.2d 975, 982 (Ct. App. 1986) (with respect to the indemnification claim, "[t]he burden is on the party seeking indemnity to prove he is entitled to it"); *In re Bair*, 240 B.R. 247, 252 (Bankr. W.D. Tex. 1999) (with respect to the Section 105(a) claim, the burden is on the party seeking equitable relief to prove entitlement to such relief). The Rev Op Investors bear no burden of proving that ML Manager is *not* entitled to its requested relief, and the Court must deny the requested setoff absent ML Manager's affirmative evidentiary showing that it is entitled to such relief (which it is not).

II. ML MANAGER IS NOT ENTITLED TO SETOFF UNDER THE BREACH PROVISION.

ML Manager is not entitled to its asserted setoff based on the breach provision of the Agency Agreement. The Response is replete with allegations (without a shred of evidence) that the Rev Op Investors have breached or otherwise "interfered" with ML Manager's ability to perform under the Agency Agreement. The Rev Op Investors adamantly deny these allegations, even assuming *arguendo* that they are subject to the Agency Agreement.

Importantly, ML Manager has failed to show that the Rev Op Investors have in fact committed any breach. ML Manager's position merely rests upon unilateral and unproven allegations of "interference." Not a single shred of evidence has been presented by ML Manager in support of these unfounded allegations. Indeed, ML Manager has not initiated an adversary proceeding or state court lawsuit against the Rev Op Investors asserting breach of the Agency Agreement, or sought any provisional remedy to maintain the funds in escrow pending the outcome of any judicial proceeding. Instead, ML Manager seeks setoff based on mere allegations of breach of the Agency Agreement determined in ML Manager's sole and absolute discretion. ML Manager further seeks to dispense with all due process afforded to defendants in civil litigation. The Court should not countenance ML Manager's approach.

In addition to ML Manager's failure to establish any breach, ML Manager's interpretation of the breach provision is patently unreasonable. Indeed, ML Manager's

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interpretation of "interference" would allow it to charge fees to the Rev Op Investors (or any other investors) associated with any dispute between the parties, no matter how minor, and would further render Section 7.j of the Agency Agreement superfluous. *See* Agency Agreement § 7.j (unsuccessful party to pay all costs and expenses of any litigation "to enforce or interpret any provision of this Agreement or any rights arising hereunder"); *see also Taylor v. State Farm Mut. Auto. Ins. Co.*, 175 Ariz. 148, 158 n.9, 854 P.2d 1134, 1144 n.9 ("[A] contract should be interpreted, if at all possible, in a way that does not render parts of it superfluous."); *Employer's Liability Assurance Corp. v. Lunt*, 82 Ariz. 320, 328, 313 P.2d 393, 399 (1957) (contracts should be interpreted in a manner that gives full meaning and effect to all provisions rather than leaving part of a contract meaningless or illusory). As also noted in the Motion with respect to ML Manager's interpretation of the indemnity provision, even if the Rev Op Investors were awarded fees as the prevailing party in litigation, ML Manager's payment of such award would be subject to reimbursement by the very party receiving it on account that such litigation "interfered" with ML Manager's ability to perform under the Agency Agreement. The Court should not accept such a tortured interpretation of the breach provision.

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III. ML MANAGER IS NOT ENTITLED TO SETOFF UNDER THE INDEMNITY PROVISION.

ML Manager is not entitled to its asserted setoff based on the indemnity provision of the Agency Agreement. To the extent that any of the Rev Op Investors' conduct could give rise to an indemnity claim, ML Manager's right to indemnity simply has not accrued. Furthermore, ML Manager's interpretation of the indemnity provision is unreasonable, legally unconscionable, and in violation of the fiduciary duties owed to the Rev Op Investors.

A. No Right to Indemnity Has Accrued.

The Response altogether ignores Arizona law with respect to accrual of an indemnity claim, which bars ML Manager's asserted setoff based on the indemnity provision in this case. As detailed in the Motion, Arizona law recognizes two distinct types of indemnity—liability and loss. *See, e.g., MT Builders, L.L.C. v. Fisher Roofing Inc.*, 219 Ariz. 297, 302, 197 P.3d 758,

763 (Ct. App. 2008); *INA Ins.*, 150 Ariz. at 255, 722 P.2d at 982. As explained by the Arizona Court of Appeals:

> A contractual right of indemnity may accrue upon the happening of one or both of two events. Indemnification against liability applies once liability for a cause of action is established . . . . An indemnification against loss or damages, in contrast, applies when the indemnitee has actually paid the obligation for which he was found liable.

INA Ins., 150 Ariz. at 253, 722 P.2d at 980.

A claim for liability indemnity "does not accrue until the indemnitee has suffered actual loss ***through a judgment or payment thereon***." *Levin v. Hindhaugh*, 167 Ariz. 110, 111, 804 P.2d 839, 840 (Ct. App. 1990). A claim for loss indemnity, on the other hand, does not accrue until "the indemnitee has actually paid the obligation for which he was found liable." *MT Builders*, 219 Ariz. at 302, 197 P.3d at 763. Furthermore, if the meaning of an indemnity provision remains unclear after consideration of the parties' intentions, the indemnity provision must be construed against the drafter. *Id.*

The Arizona Court of Appeals has had occasion to construe language providing for both types of indemnity. In *INA Insurance*, the indemnity provision stated: "We will indemnify and hold you harmless against *liability* you *may* become obligated to pay for damages . . . ." *INA Ins.*, 150 Ariz. at 251, 253, 722 P.2d at 978, 980 (emphasis in original). The court determined this provision to be one indemnifying against liability. *Id.* at 253, 722 P.2d at 980. In *MT Builders*, conversely, the indemnity provision obligated the defendant to "indemnify and hold harmless [plaintiff] from and against all *claims*, *damages*, *losses* and *expenses*" under certain circumstances. *MT Builders*, 219 Ariz. at 302, 197 P.3d at 763 (emphasis added). The court determined this provision to be one indemnifying against loss. *Id.*

The indemnity provision set forth in the Agency Agreement states: "Participant shall indemnify, protect, defend and hold Agent harmless for, from and against all ***liability*** incurred by Agent in performing under the terms of this Agreement or otherwise arising, directly or indirectly, from any Loan or the Loan Documents . . . ." Agency Agreement ¶ 4.a (emphasis added). This provision, much like that construed in *INA Insurance*, clearly provides for

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indemnification against *liability*. It does not include general losses and other damages, except to the extent such losses or damages are part of a *liability* that has been reduced to a judgment. It is beyond dispute that ML Manager's claim to indemnity is not based on any liability that has been reduced to judgment, and, despite ML Manager's assertion to the contrary, ML Manager bears this burden of proof. *See INA Ins.*, 150 Ariz. at 255, 722 P.2d at 982 ("The burden is on the party seeking indemnity to prove he is entitled to it."). Therefore, ML Manager's indemnity claim has not accrued and cannot support the asserted setoff of the escrowed funds.

The Response dedicates many pages to arguing that the indemnity provision, Arizona case law, and foreign case law all permit an indemnitee to recover attorneys' fees.[2] While this statement is not entirely untrue (though it is woefully incomplete), it simply places the cart before the horse. Attorneys' fees are only recoverable in connection with a liability or loss (in the case of a loss indemnity) that gives rise to accrual of an indemnity claim. *See id.* (indemnitee may recover attorneys' fees only if determined to be entitled to indemnification). Furthermore, as explained in detail in the Motion, even if the indemnity provision could be construed as one for loss (which it cannot), ML Manager still would have to establish that the asserted loss (i) falls within the scope of the indemnity provision and (ii) was actually paid by ML Manager in its capacity as agent for the Rev Op Investors. *See id.* at 253, 722 P.2d at 981 (the obligation to indemnify "cannot be imposed solely by . . . unproven allegations against the indemnity parties, but requires factual determinations"). ML Manager can satisfy neither of these requirements.

B. <u>ML Manager's Interpretation of the Indemnity Provision Is Unconscionable and Unenforceable</u>.

The indemnity provision as interpreted by ML Manager, whether on its face or through interpretation, is substantively unconscionable. Substantive unconscionability exists when terms

[2] ML Manager further misconstrues the indemnity provision by attempting to expand its ability to seek indemnity for damages caused by "interference" with its ability to perform under the Agency Agreement. *See* Response, p.10. The interference concept is not found in the indemnity provision, but is strictly limited to the breach provision in Paragraph 5.d of the Agency Agreement.

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are "so one-sided as to oppress or unfairly surprise an innocent party," or when there is "an overall imbalance in the obligations and rights imposed by the bargain." *Maxwell v. Fidelity Fin. Servs.*, 184 Ariz. 82, 89, 907 P.2d 51, 58 (1995).[3]

ML Manager asserts that the Rev Op Investors cannot claim to be unfairly surprised by an indemnity provision in the Agency Agreement; however, the Rev Op Investors do not contend they are surprised by the mere existence of an indemnity provision. Rather, they assert that the provision is substantively unconscionable to the extent that on its face, or through an interpretation of its language, it is so completely one-sided and oppressive as to allow ML Manager to seek indemnity for any costs it incurs in connection with the Agency Agreement, no matter how attenuated, even if such costs are incurred as a consequence of improper legal action commenced by ML Manager against the Rev Op Investors. As noted in the Motion, the fact that ML Manager is seeking to have the Rev Op Investors surcharged for the pleasure of having to defend against an improper order to show cause, which was quashed by this Court on motion by the Rev Op Investors, demonstrates the oppressive and one-sided nature of ML Manager's interpretation of the indemnity provision. Such an interpretation tips the scale completely in favor of ML Manager, and should be rejected as unconscionable and unenforceable.

C. <u>ML Manager's Improper Attempt to Enforce the Indemnity Provision Is a Violation of Its Fiduciary Duties to the Rev Op Investors</u>.

ML Manager has a fiduciary duty to exercise good faith and to act loyally in all matters connected with the asserted agency relationship. *See Mallamo v. Hartman*, 70 Ariz. 294, 298, 219 P.2d 1039, 1041 (1950); *Maricopa P'Ships, Inc. v. Petyak*, 163 Ariz. 624, 790 P.2d 279 (Ct. App. 1990) ("The inherent nature of the agency relationship imposes a fiduciary duty upon the agent . . . ."); *Musselman v. Southwinds Realty, Inc.*, 146 Ariz. 173, 175, 704 P.2d 814, 816 (Ct. App. 1984). That the Rev Op Investors comprise a minority of the universe of investors does not

[3] As noted in the Motion, the indemnity provision is also procedurally unconscionable, and the Rev Op Investors reserve all rights to present evidence and testimony regarding the already well known deceptive practices of Mortgages Ltd. to induce investors to supply large sums of money to an insolvent and failing enterprise.

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grant ML Manager license to ride roughshod over, and disregard fiduciary duties owed to, them. ML Manager cannot dispute that the Rev Op Investors, regardless of the number of individual investors, have approximately $50 million in the aggregate at stake in this case.

There can also be no dispute that ML Manager's board of directors has a clear and irreconcilable conflict of interest in connection with the decision to seek to offset the escrowed funds. Despite the Plan's requirements, the Rev Op program currently has no representation on ML Manager's board. *See* Disclosure Statement, pp.66–67; Confirmation Order, ¶G [DE #1755]. Now, with no oversight or check on the non-Rev Op board members' power, ML Manager's board seeks to punish the Rev Op Investors to the board members' direct benefit. This Court should not approve such a violation of the Plan and ML Manager's fiduciary obligations. *See, e.g.*, Confirmation Order ¶ U (ML Manager required to charge non-transferring pass-through investors for costs and expenses of servicing loans "in a fair, equitable and nondiscriminatory manner and shall be reimbursed in the same manner as other investors").

IV. ML MANAGER IS NOT ENTITLED TO SETOFF UNDER SECTION 105 OF THE BANKRUPTCY CODE.

Perhaps conceding the weakness of its arguments based on the language of the Agency Agreement and indemnity law, ML Manager asserts that the Court should grant the setoff request based on its equitable powers under Section 105(a) of the Bankruptcy Code. The Court's inherent powers under Section 105(a), however, "are limited and do not amount to a 'roving commission to do equity.'" *In re At Home Corp.*, 392 F.3d 1064, 1070 (9th Cir. 2004). As noted by the Ninth Circuit, a bankruptcy court's equitable powers under Section 105(a) are limited to the issuance of orders necessary or appropriate to carry out the provisions of title 11. *Id.*; *see also* 11 U.S.C. § 105(a). Therefore, "a bankruptcy court must locate its equitable authority in the Bankruptcy Code." *In re At Home Corp.*, 392 F.3d at 1070. There is no basis in the Code for ML Manager's request that the Court award to ML Manager approximately $246,000 owing to the Rev Op Investors in retaliation for the exercise of their rights in this case.

Furthermore, ML Manager mischaracterizes the Rev Op Investors' actions in this case. They have not sought to disrupt the Plan, but instead have fought to protect their rights and

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enforce the Plan according to its terms. Despite ML Manager's assertion, the Plan left many issues open, and the Rev Op Investors should not be punished for refusing to accept ML Manager's unilateral interpretation thereof. Tellingly, and as noted in the Motion, ML Manager does not seek to offset any costs or expenses incurred as a result of other investors' participation in this case, and the Court should not grant ML Manager's request to appropriate the Section 105(a) equity powers to discriminate against the Rev Op Investors for their participation in this case.

WHEREFORE, the Rev Op Investors respectfully request that the Court enter an order:

A. Granting the Motion in its entirety;

B. Directing the payment of all Rev Op Investor funds being held in escrow; and

C. For such other relief as the Court deems appropriate under the circumstances.

RESPECTFULLY SUBMITTED this ___ day of March, 2011.

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