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6
7 IN THE UNITED STATES BANKRUPTCY COURT
8 FOR THE DISTRICT OF ARIZONA

9 In re
10 MORTGAGES LTD.,
11 Debtor.

Chapter 11
Case No. 2:08-bk-07465-RJH
OBJECTION TO CS 11 and CGSR
SETTLEMENTS BY INVESTORS
COMMITTEE
Date: November 18, 2008
Time: 11:30 a.m.

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14 The Official Committee of Investors (“Investors Committee”) hereby files its
15 Objection to the CS 11 and CGSR Settlements (“Settlements”) which are currently
16 scheduled to be heard November 18, 2008.¹ The Investors Committee objects on the
17 grounds that the fees to be paid to the Debtor by the Borrowers in the total amount of
18 \$3,476,258 amount to self-dealing at the expense of the investors who own the loans. The
19 Investors Committee joins in the Response in Opposition filed by The William C. Lewis
20 Trust on the CS 11 settlement and the Objection filed by Radical Bunny LLC filed on
21 both Settlements.

22 The Investors Committee does not object to the Borrowers being granted the
23 extensions on a one year basis with partial deferral of interest, however, the Investors
24 Committee vehemently opposes the payment of the these large fees to the Debtor at the
25 expense of the investors and disputes the Debtor’s right to take such fees to the detriment

26
27 ¹ The settlement motion for CDIG, LLC is also set for hearing. The Mortgages Ltd.
28 Employees 401k Plan is the 100% owner of that loan and so the Investors Committee
expresses no opinion on that settlement.

1 of the investors in the loans. While a reasonable fee could be earned by the Debtor, these
2 fees are unfair and create a conflict with their investors. The fees should instead be paid
3 to the investors to reduce their risk.

4 **CS 11 Loan and Settlement** — The investors own 100% of the CS 11 loan in the
5 amount of \$16,000,000. The investors include pass-through investors as well as MP
6 Funds. As a part of this settlement, the Debtor proposes to pay itself loan extension fees
7 and work out fees in excess of \$1,200,000 on the CS loan and proposes to receive its pro
8 rata share of the interest spread each month. First, the CS 11 loan is not even due until
9 June 2009. Thus the “settlement” or modification is eight months early. The question is,
10 why would the Debtor propose to do this at this time? Simply, the Debtor needs to
11 generate income for itself and to create a pro forma for its plan to give the appearance that
12 it is able to stay in business for three years. This puts it directly in conflict with the
13 investors to whom it owes a duty of care and loyalty. Second, under the “settlement”, the
14 maturity date is extended three years. However since the loan does not mature until June
15 2009, the loan is now due June 2012. That is three and two-thirds years from now.
16 During that time, the investors do not receive any principal payments and have to defer
17 such principal payment three and two-thirds years. Rather than using the money to pay
18 itself, the Debtor should have allowed that money to be paid to investors as principal or
19 interest to reduce the investors risk and to get back some of the money to the investors. A
20 one year extension might have been appropriate when the investors receive no principal,
21 but extending it more than three years without any reduction of risk to the investors when
22 cash is being paid to the Debtor is another matter. Third, the interest paid to investors for
23 this three and two-thirds year is being reduced to 7% per year with 5.75% per year being
24 deferred. That cuts their monthly interest payment almost in half. During the three and
25 two-thirds years the Borrower pays about \$4,200,000 in interest payments. However, the
26 Debtor receives its pro rata share of the monthly interest so the investors are not getting
27 the full 7% per year. Fourth, during the three and two-thirds years, the Borrower is
28 accruing unpaid interest of \$3,450,000 which is being added to the balance. That means

1 with this negative amortization, the debt will get larger to the detriment of the investors
2 while the Debtor takes fees of \$1,200,000 plus its pro rata interest spread. The investors
3 will not receive interest on their deferred interest to compensate them for the delay. The
4 Debtor explains in Section 9 of the Letter (which is attached to the Motion) that the
5 “participation” fee (which in the Motion is called a “workout” fee) is in exchange for the
6 deferral of the interest but the money will go to the Debtor, not to the investors who have
7 to wait for their interest. The Operating Agreements do not provide for the payment of
8 these fees. The Agency Agreement does not provide for the payment of a participation or
9 workout fee either. Also the Private Offering Memorandums say that a loan extension fee
10 may be paid and retained when the defaulted loan is reinstated. As indicated, there was no
11 defaulted loan. Instead, this loan was renewed eight months prior to maturity. Finally,
12 there is no explanation or analysis in the Motion concerning the ability of the Borrower to
13 pay in three and two-thirds years or whether there is a likelihood that with the unpaid
14 interest added to the principal (which increases the balance due to \$23,650,000) this
15 property can sustain such negative amortization. With over \$1,200,000 plus pro rata
16 interest being paid in cash to the Debtor, and with the debt increasing by \$3,450,000 the
17 investors could be left in a worse position in three and two-thirds years than they are
18 today.

19 **CGSR Loan and Settlement** — The Investors own 99.49% of the CGSR loan in
20 the amount of \$30,350,104. The investors are pass-through investors and members of MP
21 Funds. The Debtor holds only \$153,668 as an investment. As a part of the settlement, the
22 Debtor proposes to pay itself loan extension fees and workout fees in excess of
23 \$2,276,258 on the CGSR loan. First, the CGSR loan is being extended for three years and
24 will mature September 2011. The question, again, is why would the Debtor do a three
25 year extension at this time? Simply, the Debtor needs to generate income and to create a
26 pro forma for its plan to give the appearance that it is able to stay in business for three
27 years. This puts it directly in conflict with the investors to whom it owes a duty of care
28 and loyalty. Second, under the “settlement”, the investors do not receive any principal

1 payments and have to defer such principal payment three years. Rather than using the
2 money to pay itself, the Debtor should have allowed that money to be paid to investors as
3 principal reduction or interest. A one-year extension might have been acceptable, but
4 extending it for three years without any reduction of risk to the investors when cash is
5 being paid to the Debtor is another matter. Third, the interest paid to investors for this
6 three-year period is being reduced to 7% per year with 6.25% per year being deferred.
7 That cuts their monthly interest payment almost in half while the Debtor receives fees of
8 \$2,276,258. During the three years the Borrower pays about \$6,373,522 in interest
9 payments. However, the Debtor receives its pro rata share of the monthly interest so the
10 investors are not getting the full 7% per year. Fourth, during the three years, the Borrower
11 is accruing unpaid interest of \$5,690,645 which is being added to the balance. That means
12 with this negative amortization, the debt will get larger to the detriment of the investors
13 while the Debtor takes fees of \$2,276,258 plus its pro rata interest spread. The investors
14 will not receive interest on their deferred interest to compensate them for the delay. The
15 Debtor explains in Section 9 of the Letter (which is attached to the Motion) that the
16 “participation” fee (which in the Motion is called a “workout” fee) is in exchange for the
17 deferral of the interest but the money will go to the Debtor, not to the investors who have
18 to wait for their interest. The Operating Agreements do not provide for the payment of
19 these fees. The Agency Agreement does not provide for the payment of a participation or
20 workout fee either. Also, the Private Offering Memorandums say that a loan extension
21 fee may be paid and retained when the defaulted loan is reinstated. As indicated, there
22 was no defaulted loan that was cured and reinstated here. Instead, all default interest was
23 waived. Finally, there is no explanation or analysis in the Motion concerning the ability
24 of the Borrower to pay in three years or whether there is a likelihood that with the unpaid
25 interest added to the principal (which increases the balance due to \$42,414,270) this
26 property can sustain such negative amortization. With over \$2,276,258 plus pro rata
27 interest being paid in cash to the Debtor, the investors could be left in a worse position in
28 three years.

1 **Debtor has not satisfied its reasonable business judgment while meeting its**
2 **duties of care, competence or diligence and loyalty to the investors** — This Motion
3 does not satisfy Debtor’s obligation as agent or under the business judgment rule to act
4 with the care, competence, loyalty and diligence required of agents in similar
5 circumstances, for a variety of reasons.

6 The Debtor has no interest in one of the loans and about a 0.51% interest in the
7 other loan. Yet it appears that the Debtor is entering into this “settlement” because of its
8 desire to generate large fees so that it can stay in business and create a pro forma for its
9 plan. As the Court is aware, there are very few loans where the principal is being paid and
10 full interest is being paid. The investors therefore have received very little money since
11 the Debtor’s bankruptcy. Under the other proposed settlements to date, the Debtor is
12 extending the maturity for years. Here the investors could have received some of the
13 \$3,476,258 cash being paid to the Debtor during the next three years, but rather, the
14 Debtor has chosen to take almost all the cash and reduce the monthly interest rate for the
15 investors so that the Borrowers can afford the large cash fees. This is not right. This
16 conflict of interest violates the Debtor’s fiduciary duty to the principals it serves, increases
17 their risk through a negative amortization and could irreparably damage the investors.

18 The investors unfairly bear the risk of this settlement. Significantly, there is no
19 analysis by the Debtor in the Motion of the increased risk and the likelihood of repayment
20 by the Borrowers.

21 The Settlements violate the Debtor’s obligation to act with the care, competence
22 and diligence exercised by agents in similar circumstances. Specifically, Section 8.08 of
23 the *Restatement (Third) Agency* provides:

24 Subject to any agreement with the principal, an agent has a
25 duty to the principal to act with the care, competence, and
26 diligence normally exercised by agents in similar
27 circumstances. Special skills or knowledge possessed by an
28 agent are circumstances to be taken into account in
 determining whether the agent acted with due care and
 diligence. If an agent claims to possess special skills or
 knowledge, the agent has a duty to the principal to act with the

1 care, competence, and diligence normally exercised by agents
2 with such skills or knowledge.

3 The Debtor serves as an agent, or otherwise manages a loan portfolio of nearly \$1 billion,
4 substantially all of the portfolio being comprised of other people's money (the investors,
5 etc.). The Debtor should accordingly be held to a high standard of care. Although the
6 Debtor's breach of its duty of loyalty is addressed below, it's duties of care, competence
7 and diligence are expressly implicated here. It has not met those duties.

8 The Settlements do not satisfy the business judgment rule. In this case, the Debtor
9 has a duty to act on behalf of the investors, with whose money it is making deals. By
10 acting as set forth above, the Debtor has placed its own interests above the interests of the
11 investors. This conflict for the Debtor prevents this decision from being a reasonable
12 exercise of the business judgment rule and constitutes a breach of the Debtor's duty to its
13 principals.

14 The Debtor also owes a duty of loyalty and a duty to not self deal to the investors
15 and should be required to live up to that standard. In particular, Section 8.02 of the
16 *Restatement (Third) of Agency* provides that "[a]n agent has a duty not to acquire a
17 material benefit from a third party in connection with transactions conducted or other
18 actions taken on behalf of the principal or otherwise through the agent's use of the agent's
19 position." Similarly, Section 8.05(1) of the *Restatement (Third) of Agency* provides that,
20 "[a]n agent has a duty (1) not to use property of the principal for the agent's own purposes
21 or those of a third party." As noted above, the Debtor will be collecting over \$3,476,258
22 in fees while the loans are negatively amortized. The money should have been used to
23 reduce principal, thereby reducing the investor risk; or should have been used to pay the
24 monthly interest to investors instead of deferring it to the loan balance, thereby reducing
25 the risk to investors. The Debtor, however, decided to pay almost all the cash to itself
26 rather than to its investors. This is the very definition of an agent using its principal's
27 property for the agent's own purposes.

28 Therefore, the Investors Committee requests that the Motion as presented be denied

1 unless the settlements are revised to provide the Debtor receive a limited fee with the rest
2 of the fees being paid to the investors.

3 DATED this 14th day of November, 2008.

4 FENNEMORE CRAIG, P.C.

5
6 By /s/ Cathy Reece (005932)

7 Cathy L. Reece
8 Keith L. Hendricks
9 Attorneys for the Official Committee of
Investors

10 COPY of the foregoing emailed or mailed
11 this 14th day of November, 2008 to the parties
on the attached Service List.

12 /s/ Susan Stanczak-Ingram

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File an Answer/Response/Objection to a Motion:2:08-bk-07465-RJH Mortgages Ltd. CASE CONVERTED on 06/24/2008

Type: bk

Chapter: 11 i

Office: 2 (Phoenix)

Judge: RJH

Assets: y

Case Flag: Appeal, Exhibits

U.S. Bankruptcy Court**District of Arizona**

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The following transaction was received from CATHY L. REECE entered on 11/14/2008 at 8:37 PM AZ and filed on 11/14/2008

Case Name: Mortgages Ltd.**Case Number:** 2:08-bk-07465-RJH**Document Number:** 994**Docket Text:**

Objection to Motion/Application to *CS11 and CGSR Settlements by Investors Committee* (related to motions(s)[900]) filed by CATHY L. REECE of FENNEMORE CRAIG on behalf of Official Committee of Investors (related document(s)[900] motion Motion to Approve Compromise/Settlement) (Attachments: # (1) Service List). (REECE, CATHY)

The following document(s) are associated with this transaction:

Document description:Main Document**Original filename:**C:\Documents and Settings\sstancza\My Documents\Mtg Ltd - Objection to CS 11 and CGSR Settlements (hearing date 11 18 2008).pdf**Electronic document Stamp:**

[STAMP bkecfStamp_ID=875559564 [Date=11/14/2008] [FileNumber=12621645-0] [51ff884189df6792d805ac05e844c0a0a5df403709939be3593c9db6188c53f59c4eb79374fbbe68f1cd4d6c0ad12ce63b79c20a195a3af349eb81d8fa3940df]]

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