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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
SUPPLEMENT TO STATEMENT OF
POSITION ON AUTHORITY AND
AGENCY BY INVESTORS
COMMITTEE

Date: November 10, 2008
Time: 1:00 p.m.

The Official Committee of Investors (“Investors Committee”) hereby files its Supplement to its Statement of Position on Authority and Agency. The Investors Committee incorporates and joins in the “Objection of Parties in Interest Eva Sperber-Porter, Litchfield Road Associates Limited Partnership, and Baseline & Val Vista Associates Limited Partnership to Debtor’s Motion For Final Approval of DIP Financing with Stratera Portfolio Advisors re CenterPoint Project” and “Robert Furst’s Response To Debtor’s Statement of Position Regarding Debtor’s Authority To Renegotiate the Terms of Certain Loans and To Enter Into Settlements.”

I. THE DEBTOR IMPROPERLY TREATS ALL INVESTORS THE SAME

There are three fatal flaws with the Debtor’s construction of the contractual grant of authority in the operative documents. First, the Debtor has failed to identify all of the investors, or at least all of the relevant forms of the operative documents involved in the particular loans at issue. Second, the Debtor ignores the fact that some investors refused

1 to grant or revoked the very authority the Debtor is now attempting to exercise. Third, the
2 Debtor ignores the fact that the Documents evolved over time and that earlier versions did
3 not grant the same authority as the later versions. Because the Debtor is asking the Court
4 to rule that it has authority to bind all investors, it must establish that all investors gave it
5 the same authority. The Debtor cannot do this.

6 **A. The Debtor Must Establish Foundation for all of the Relevant Versions**
7 **of the Operative Documents**

8 Debtor in its Statement of Position discusses some of the operative documents
9 relevant to the Debtor's authority, but fails to address or even acknowledge that there are
10 substantial differences in the various versions of the documents. Indeed, the Debtor
11 essentially assumes that all of the operative documents are identical, interchangeable and
12 currently in force. This is simply not the case. As the Court knows, there were thousands
13 of investors. More important, the form of the documents changed over time, and the
14 amount of authority or restrictions on authority changed. Indeed, Mr. Robert Furst has
15 already testified by this Court that the Debtor intentionally changed the form of the
16 documents to provide more discretion and authority to the Debtor and that there were
17 internal discussions and concerns that the Debtor did not have the requisite authority. The
18 Debtor's argument, however, ignores these changes and essentially assumes every
19 investor granted the same level of authority to the Debtor. As such, the Debtor's
20 argument is not based on a correct assumption and ignores the reality.

21 To prevail on an argument that it has the authority at issue, the Debtor must
22 identify all of the different forms of the operative documents involved in the various loans
23 at issue and establish that all of these different forms provided the authority asserted. The
24 Debtor cannot ignore, for example, that there are multiple forms of the subscription
25 agreements and agency agreements and that the different versions have material
26 differences with respect to the Debtor's authority. Moreover, the Debtor cannot ignore

1 that the description of the authority evolved over time and that the earlier documents do
2 not grant as much authority as the more recent documents. Instead of identifying the
3 forms of all the investor agreements related to a particular loan or settlement, the Debtor
4 takes a high altitude overview of the documents in general and argues from documents
5 which have evolved and changed over time that it has authority. Without identifying all
6 of the relevant forms of agreements, the Debtor has not met its burden and the Court
7 cannot make a definitive decision that all of the investors impacted granted to the Debtor
8 the authority at issue.

9 **B. Debtor Cannot Ignore the Fact that Some Investors Refused to Grant**
10 **the Debtor Authority**

11 In addition to the general failure to meet its burden, there are many investors who
12 refused to grant the authority the Debtor is seeking to employ. For example, Robert Furst
13 indicated in his Response and in his testimony, that most of the Subscription Agreements
14 had a paragraph that the allowed an investor to “withhold” discretion so that the Debtor
15 had to obtain written consent for almost any action prior to execution, including placing
16 the purchase of a note, or even modifications of the note. He testified that there were a
17 number of investors who withheld discretion. This fact has been reluctantly
18 acknowledged in open court by the Debtor.

19 Specifically, one common form of the Investor Subscription Agreements provides
20 in paragraph 4(e):

21 Unless authorization is withheld by so indicating below or in
22 another written document to Mortgages Ltd. and MLS, the
23 undersigned hereby authorizes Mortgages Ltd. to be named as
24 the lender/payee/beneficiary as agent for the undersigned in
the deed of trust or deeds of trust or mortgage or mortgages
securing the Loan or Loans and other documentation relating
to the Loans.

25 At paragraph 7, the same form of Subscription Agreement provides:

26 **Grant of Discretion.** Until revoked at any time in writing,
the undersigned hereby grants discretion to Mortgages Ltd.,

1 in its sole discretion, to select for purchase or sale the Loan or
2 Loans with respect to which the undersigned acquires
3 Participations. Without limiting the foregoing, the
4 undersigned understands that his grant of discretion will give
5 Mortgages Ltd. the authority, in its sole discretion, to make
6 various determinations and take various actions with Loans
7 with respect to Participations to be acquired, acquired [sic], or
8 sold by the undersigned.

9 Finally, paragraph 8 indicated whether the investor “granted a power of attorney with
10 respect to Mortgages Ltd. investment products.” It is clear that some investors took this
11 option. Mr. Furst testified as much. Further some of the investors have sent an objection
12 to the Court indicating that they also withheld discretion, such as the letter objection.
13 Moreover, these agreements allowed the investors the right to revoke the authority and
14 other investors exercised this right. The Debtor does not address this provision and does
15 not inform the Court who those investors are and what loan they are in. Instead of
16 addressing the fact that some investors refused to give the Debtor or revoked the very
17 authority the Debtor now seeks to implement and what such lack of authority means with
18 regard to the proposed settlements, the Debtor simply ignores the issue. It cannot be
19 ignored.

20 **C. The Amount of Authority Changed Over Time**

21 Mr. Furst testified that the documents changed over time, and the Debtor’s
22 interpretation of the authority granted also changed over time. Obviously, if the Debtor
23 felt it was necessary to change the form of its documents to grant it more authority, this
24 means that the prior version of the documents did not grant as much authority. An
25 example is the changes to the documents related to Opportunity Fund 15. In the Private
26 Offering Memorandum for Opportunity Fund 15, the Debtor, included in 2007 the
following at page 14:

Among other things, the Manager will have the right to revise
the terms of outstanding Loans regardless of their
performance, which may include increasing the principal
amount, modifying the interest rate and payment terms,
changing the collateral, adding fees and costs to the principal

1 balance, or substituting borrowers.

2 The Debtor also added this exact same language at page 62 where it was describing the
3 authority of the Debtor to manage the Funds. Because this was an addition to the form of
4 the documents, it is disingenuous to argue that all of the documents provide the exact
5 same level of authority.

6 Another example of incomplete disclosure by the Debtor relates to the Centerpoint
7 financing, although this argument is applicable to each and every deal. The first
8 Centerpoint note is dated March 20, 2007. The Debtor started selling fractional interests
9 in the note immediately thereafter and continued to sell pieces of the note until June of
10 2008. Some of the current holders of fractional interests in the Centerpoint note might
11 have signed the subscription agreement applicable in March 2007 and might not have
12 signed any later version. As a result to determine the authority issue as to that investor on
13 that loan, the Court would have to look at that specific applicable subscription agreement,
14 not the unsigned one used in 2008. Further an Investor might have withheld discretion in
15 March 2007 and not have changed the agreement. So again the Court would have to look
16 at the specific subscription agreement, not the unsigned one used in 2008. It is the
17 operative subscription agreement or agency agreement or other document which was
18 signed by the individual investor and which is still in effect that the Court needs to see and
19 which is important. Debtor has made no attempt to identify and provide this level of
20 detail to the Court for making this decision.

21 Finally, since no new loans were made after February 2008, it is unlikely that the
22 documents which the Debtor has given to the Court with changes effective February 2008
23 are even the applicable documents to be applied to an investor or the loan in question.
24 Without more disclosure and explanation, the Debtor is not presenting a proper question
25 to the Court in its pleading.

26

1 **II. DEBTOR IS OVERSTATING ITS AUTHORITY**

2 As fully explained and set forth in the “Robert Furst’s Response to Debtor’s
3 Statement of Position ...” filed with the Court October 8, 2008 (“Furst Response”), the
4 Debtor is authorized to administer, service and collect the loans on behalf of the investors
5 and the MP Funds. It was not granted unlimited and unfettered discretion.

6 As argued in previous pleadings, the notes are owned in undivided fractional
7 interests by the investors and/or the Debtor. In some loans the Debtor may own a
8 percentage of the loan, but in others the Debtor owns zero percent. The Debtor has not
9 provided the Court with a copy of any of the notes to be modified along with the
10 endorsements made out to the investors. The point is, however, that the Debtor does not
11 own the interest in the note, it only services that interest. In other words, the Debtor is not
12 playing with its own money, it is attempting to use its status as an agent to make
13 modifications to the investor’s property (the notes and deeds of trust). Debtor claims that
14 it has the right to do this because the investors gave it authority to do so. Even under the
15 documents relied upon by the Debtor, however, the grant of authority is not so unlimited
16 and broad.

17 All the activities and actions identified in the agreements for the agent to perform
18 are related to and are constrained by the purposes of administering, servicing and
19 collecting the loans. Nowhere in the agreements are the powers or responsibilities given
20 to the Debtor to undertake such activities as broad as subordination to new financing,
21 granting a security interest in the investor’s interest in the loan, release of liens on
22 collateral without payment, reduction of principal because of the settlement of causes of
23 actions arising from the Debtor’s conduct, and other such broad activities contemplated by
24 the Debtor. As explained in detail in the Furst Response, the language must be read in
25 context within the sections and sentences and cannot be taken out of context. The
26 Investors Committee asserts that when read in its entirety and in context the agreements

1 provide the reasonable parameters set for a servicing and collection agent, such as the
2 Debtor.

3 **III. THE AGENCY AGREEMENTS ARE TO BE NARROWLY AND**
4 **STRICTLY CONSTRUED AGAINST DEBTOR**

5 Contrary to the Debtor's position, silence in the agreements should not and do not
6 constitute authority to be able to make all the decisions without the consent of the
7 investors, or constitute a grant of unlimited and unfettered discretion.

8 It is well established that courts must strictly construe the grant of authority in a
9 power of attorney. *Lightning Delivery Co. v. Matteson*, 45 Ariz. 92, 97 39 P.2d 938, 941
10 (1935) ("It must be kept in mind that under all the authorities powers of attorney should
11 be strictly construed and that the courts should never by construction extend the power
12 they confer beyond that given in terms, or is absolutely necessary to carry that conferred
13 into effect"); *Archbold v. Reifenrath*, 744 N.W.2d 701, 708 (Neb. 2008) ("Powers of
14 attorney are by necessity strictly construed, and broad encompassing grants of power are
15 to be discounted"). In this case, while the investor signed a subscription agreement
16 adopting the agency agreement or operating agreement which would have been attached
17 to a lengthy private offering memorandum and granting a power of attorney, the Debtor
18 signed the agency agreement or operating agreement on behalf of the investor. As such,
19 the scope of the Debtor's power of attorney or agency powers must be strictly and
20 narrowly construed.

21 Further, it is black letter law that any ambiguities in a contract are to be construed
22 against the drafter. *See, e.g., United California Bank v. Prudential Ins. Co. of America*,
23 140 Ariz. 238, 260, 681 P.2d 390, 412 (App. 1983) ("even if Prudential were able to
24 demonstrate that the incorporation clause of the commitment letter which it drafted is
25 ambiguous, such a demonstration would be self-defeating because ambiguities will be
26 construed against the drafter"). This rule of construction carries even greater weight in

1 this case, because as noted above, the Debtor drafted the agreements, served in multiple
2 capacities in the agreements and signed agreements on behalf of the principals. The
3 Investors did not even sign the agency agreements. The Debtor exercising the power of
4 attorney signed on their behalf pursuant to a subscription agreement.

5 The agreements are also contracts of adhesion that contain unreasonable and
6 therefore unenforceable terms. “[A] contract of adhesion signifies a standardized
7 contract, which, imposed and drafted by the party of superior bargaining strength,
8 relegates to the subscribing party only the opportunity to adhere to the contract or to reject
9 it.” *Huff v. Bekins Moving & Storage Co.*, 145 Ariz. 496, 498, 702 P.2d 1341, 1343 (App.
10 1985). Generally speaking, “there are two judicially imposed limitations on the
11 enforcement of adhesion contracts or provisions thereof. The first is that such a contract
12 or provision which does not fall within the reasonable expectations of the weaker or
13 ‘adhering’ party will not be enforced against him. The second—a principle of equity
14 applicable to all contracts generally—is that a contract or provision, even if consistent with
15 the reasonable expectations of the parties, will be denied enforcement if, considered in its
16 context, it is unduly oppressive or ‘unconscionable.’” *Id.* (citations and quotations
17 omitted). The Debtor has not shown, and cannot show, that there is any provision of the
18 agreements that gave the Investors the reasonable expectation that the Debtor was entitled
19 to enter into these broad of settlements or transactions on behalf of the Investors that
20 permitted the Debtor’s interests in continuing in business over the Investors’ property
21 interests or that allowed the Debtor to settle causes of actions against it for its own
22 misconduct at the expense of the Investors. In this case, there is no mention in any of the
23 documents that the principal amount of loans might be forgiven, that that loans might be
24 subordinated to third parties, that the personal guarantees might be released, that separate
25 loans might be combined, or many of the other things the Debtor is now trying to do.
26 Rather than interpreting general phrases in the agreements broadly in favor of Debtor, all

1 terms need to be narrowly and strictly construed in favor of the investors.

2 **IV. ALLOWING THE DEBTOR TO EFFECTUATE THE SETTLEMENTS**
3 **WOULD IN SOME SITUATIONS AMOUNT TO A SUB ROSA OR**
4 **CREEPING PLAN**

5 The Debtor argues that the agreements have to be broadly construed or the results
6 will be “disastrous” and “unworkable” and that there is no reasonable alternative. On the
7 contrary, the reasonable alternative is that the Debtor needs to obtain the consent of the
8 investors before any such onerous and drastic changes can be made in the Loans. More
9 important, this argument simply demonstrates that the Debtor is attempting to resolve the
10 significant outstanding issues in its favor before being obligated to fulfill the requirements
11 of presenting a plan of reorganization and obtaining approval.

12 It is well established that a settlement which has the effect of dictating the terms of
13 the debtor’s plan of reorganization prior to the confirmation process cannot not be
14 approved. *See In re Braniff*, 700 F.2d 935, 940 (5th Cir.1983) (“The debtor and the
15 bankruptcy court should not be able to short circuit the requirements of Chapter 11 for
16 confirmation of a reorganization plan by establishing the terms of the plan sub rosa ...”);
17 *In re Iridium*, 2005 WL 756900 at *7 (“the trustee *169 is not authorized to enter into a
18 settlement if it results into a de facto or sub rosa plan of reorganization”); *In re Crowthers*
19 *McCall Pattern, Inc.*, 114 B.R. 877, 887 (Bankr.S.D.N.Y.1990) (“A transaction which
20 would effect a lock-up of the terms of a plan will not be permitted”).

21 The *Braniff* Court, for instance, refused to approve two settlements by the debtor
22 that purported to resolve disputes with certain of its secured and unsecured creditors.
23 Those settlements involved a complex transfer of cash, aircraft, equipment, leases and
24 landing slots in exchange for travel scrip, notes and a profit participation in the purchaser.
25 *Braniff*, 700 F.2d at 938. The proposed agreements would have required the debtor to
26 distribute travel scrip in any plan of reorganization, a requirement the Fifth Circuit
declared impermissibly “had the practical effect of dictating some of the terms of any

1 future reorganization plan.” *Id.* at 939-40. As that court recognized, “[t]he debtor and the
2 Bankruptcy Court should not be able to short circuit the requirements of chapter 11 for
3 confirmation of a reorganization plan” by establishing the essential terms of a plan in
4 connection with a separate agreement. *Id.* at 940.

5 Following *Braniff*, courts have refused to condone settlement agreements that do
6 far less than Debtor’s sweeping proposals to modify the protections otherwise afforded its
7 investors. In the *Continental Air Lines* case, for instance, the bankruptcy court approved
8 two of the debtor’s post-petition aircraft leases. Creditors appealed, contending that the
9 proposed leases “represent pieces of a creeping plan of reorganization” and that they
10 “could have defeated a plan of reorganization containing the leases.” 780 F.2d at 1227,
11 1228. The Fifth Circuit vacated the bankruptcy court’s decision, noting that the
12 protections afforded by the confirmation process “might become meaningless” if they
13 could be avoided piecemeal through agreements reached prior to confirmation. *Id.* at
14 1227-28 (“Undertaking reorganization piecemeal pursuant to § 363(b) should not deny
15 creditors the protection they would receive if the proposals were first raised in the
16 reorganization plan”).

17 Here, Debtor’s attempt to summarily and significantly modify millions of dollars in
18 loans is beyond the pale. And while the investors may eventually vote on a plan, that
19 right will be meaningless if Debtor effectuates pre-plan settlements that irrevocably limit
20 the options and assets available at the time of confirmation. For example, the proposed
21 settlements ask the Court to approve the transformation of debt into equity, subordinate
22 first and second liens to other loans, delegate agency responsibilities (such as foreclosure)
23 to other entities, subject the investors to direct contractual liability to other lenders,
24 consolidate the loans for several borrowers and from many investors into a single loan,
25 and assume that future loans and subordination will be forthcoming or approved in a plan.
26 As such, many aspects of these settlements clearly anticipate, dictate and restrict plans of

1 reorganization. Debtor's settlement proposals are little more than an attempted "end run"
2 around the protections afforded to the investors under the Bankruptcy Code, and as they
3 are *sub rosa*, they cannot be approved.

4 **V. MANY OF THE SETTLEMENTS VIOLATE THE OPERATING**
5 **AGREEMENTS OF THE FUNDS, AND EXCEED THE DEBTOR'S**
6 **RIGHTS AS MANAGER**

7 The Operating Agreement for each of the Opportunity Funds (the "Funds") states
8 an express purpose of the Fund and then requires that a 75% vote of the members to
9 change that purpose, or to amend the Operating Agreement. The settlements the Debtors
10 propose violate these restrictions without the required vote.

11 Section 2.3 of the Operating Agreement provides that the purpose of the LLC is to:

12 fund loans to borrowers or own interests in new or existing
13 loans from third parties and to collect principal and interest
14 payments due thereunder, or to the extent not received, pursue
15 collection or realize on any collateral; for such loan, including
16 the ownership and operation of any such collateral
17 (collectively, "Loans", and individually, a "Loan").

18 In other words, the purpose of the Fund is to make and collect on loans. Then Section 6.4
19 provides that without the affirmative vote of 75% vote of the Members that the Manager
20 shall not in subsection (a) amend the Operating Agreement, in subsection (c) change "any
21 of the [LLCs] purposes as set forth in Section 2.3", in subsection (d) "us[e] [LLCs] funds
22 or capital other for a business purpose of [the LLC] as set forth in Section 2.3", and in
23 subsection (e) "commingling any Company funds or capital with the funds of any other
24 Person". To the extent that any of the settlement changes debt to equity, combines
25 multiple loans into one loan, or uses money for any purpose other than a loan, it violates
26 the agreement and exceeds the Debtor's authority.

27 In another section of the Operating Agreement there are express "Limitations on
28 the Manager". Section 6.5 requires the Manager to acquire and manage all Loans (which
29 was defined in Section 2.3) of the LLC subject to certain policies and criteria, expressly
30 that "All Loans shall be secured by a first or second lien encumbrance on real property

1 (and improvements if any) and such other collateral as the Manager deems appropriate to
2 fully secure the Loan.” The Manager cannot release collateral or liens if the loan is not
3 fully secured or put the security in anything less than a second position. Several of the
4 proposed settlements violate this restriction by either changing debt to equity or simply
5 putting the investors into a third or fourth position.

6 Finally, some of the settlements delegate to other entities obligations that are
7 exclusive the Manager. For example, Section 6.2 indicates that certain obligations are
8 exclusive to the Manager, including the obligation to “dispose of any real property” and
9 Section 6.3 provides that the Manager is obligated to “perform all normal business
10 functions” of the Fund. Nevertheless, some of the settlements include a delegation of
11 things such as foreclosure responsibilities to other entities.

12 Consequently, to the extent, any of the settlements remove liens, convert debt to
13 equity, combine loans, delegate foreclosure obligations to third parties, or put the
14 investors in a third position or worse, among other things, those actions would be in
15 violation of the Operating Agreement would not be permitted.

16 **VI. THE DEBTOR’S CONFLICT OF INTEREST VITIATES ITS AUTHORITY**

17 In agreeing to settlements in order to eliminate its own liability, the Debtor, which
18 is acting in the capacity of an agent, has a conflict of interest with the interest of the
19 investors, its principal. The law is clear. Such a situation vitiates the agent’s authority.

20 An agent has a fiduciary duty of loyalty to his or her principal and is bound to
21 exercise the utmost good faith in his or her conduct of agency. *Mallamo v. Hartman*, 70
22 Ariz. 294, 298, 219 P.2d 1039, 1041 (1950). According to Arizona law, “[v]iolating the
23 duty of loyalty, or failing to disclose adverse interest, *voids the agency relationship.*”
24 *State v. DiGiulio*, 172 Ariz. 156, 160, 835 P.2d 488, 492 (App. 1992) (emphasis added).
25 Voiding the agency relationship also voids any acts undertaken by the agent on behalf of
26 the principal. *See id.*; *see also In re JJJ Inc.*, 988 F.2d 1112, 1116 (11th Cir. 1993)

1 (applying Alabama law) (“[T]he general rule is that an agent’s act against the interest of
2 the principal is void ...”).

3 The general rule that acts taken where there is a conflict of interest between the
4 agent and the principal voids the relationship is also set forth by the *Restatement of*
5 *Agency*. The *Restatement (Second) of Agency*, § 112 states that “Unless otherwise agreed,
6 the authority of an agent terminates if, without knowledge of the principal, he acquires
7 adverse interests or if he is otherwise guilty of a serious breach of loyalty to the
8 principal.” Here, there is absolutely no evidence or document that provides that the
9 Debtor may compromise the investor’s property in order to settle the claims against itself.
10 The Debtor is proposing settlements in order to, or at least have the effect of eliminating
11 substantial claims against the Debtor. The primary, if not sole consideration that the
12 Debtor is offering for these releases is the compromise of the investor’s property. Under
13 the *Restatement* and other well established law, such a conflict of interest voids the
14 agency relationship between the Debtor and the investors. This means that the Debtor
15 simply does not have the authority to use the investors’ property as consideration to
16 eliminate claims against it.

17 Moreover, the *Restatement* also provides that, “an agent’s actual authority
18 terminates ... (2) upon the occurrence of circumstances on the basis of which the agent
19 should reasonably conclude that the principal no longer would assent to the agent’s taking
20 action on the principal’s behalf.” *Restatement (Third) Agency*, § 3.09. Here, the
21 investors, through the Court appointed Committee, and through dozens and dozens of
22 objections have made it clear that they do not assent to the actions taken by the Debtor.
23 As such, the actual evidence shows that the investors, or at least many of them, no longer
24 assent to the Debtor’s actions. As to these investors, the Debtor simply no longer has the
25 authority to compromise their property. Moreover, the evidence shows that it is
26 objectively unreasonable that the investors would continue to consent to the Debtor’s

1 actions in compromising their property in order to obtain a release for itself.

2 Finally, the conflict constitutes a change of circumstances upon which the Debtor
3 should reasonably know that the investors no longer consent to the Debtor acting on their
4 behalf. *Restatement (Second) of Agency* § 108 provides that the authority of an agent
5 terminates or is suspended when the agent has notice of the happening of an event or of a
6 change in circumstances from which he should reasonably infer that the principal does not
7 consent to the further exercise of authority or would not consent if he knew the facts.
8 *Comment a* to this section provides if the agent has notice or he should realize that the
9 principal would not wish him to act, the authority terminates. Section 109 covers Change
10 in value or Business Conditions. It provides: “The authority of an agent terminates or is
11 suspended when he has notice of a change in value of the subject matter or a change in
12 business conditions from which he should infer that the principal, if he knew of it, would
13 not consent to the further exercise of the authority.” *Comment c* provides that “a business
14 agent is subject to a duty to the principal to use care and skill in ascertaining business
15 conditions, and he is not authorized to do the directed act, unless his orders are
16 peremptory, if he reasonably should realize in light of facts which he would ascertain by
17 the use of the skill which he has or purports to have that the principal would not desire
18 him to act if the facts were known.”

19 This concept is reinforced in the *Restatement (Third) of Agency*. Section 3.06 –
20 Termination of Actual Authority – provides that “[a]n agent’s actual authority may be
21 terminated by ... (4) an agreement between the agent and the principal or the occurrence
22 of circumstances on the basis of which the agent should reasonably conclude that the
23 principal no longer would assent to the agent’s taking action on the principal’s behalf”
24 *Comment b.* – provides insight that is directly on point. It states: “For example, the agent
25 may become insolvent and have notice that it is important to the principal to be
26 represented by a solvent agent. The agent may lose capacity to bind itself by a contract or

1 to become subject to other obligations and have notice that it is important to the principal
2 that the agent retain such capacity.” In other words, the Debtor cannot simply ignore the
3 investors’ wishes and continue with settlements that the investors reject when there are
4 such fundamental changes. *See also Restatement (Third) of Agency § 3.09.* (termination
5 by occurrence of changed circumstances).

6 The disloyalty of the Debtor also vitiates the agency authority. Section 112 of
7 *Restatement (Second) of Agency* provides that “[u]nless otherwise agreed, the authority of
8 an agent terminates if, without knowledge of the principal, he acquires adverse interests or
9 if he is otherwise guilty of a serious breach of loyalty to the principal.” There was never
10 any agreement that the Debtor could use the loans to settle claims against the Debtor.
11 *Comment b* makes it clear that agents are appointed to forward the principal’s interest, and
12 when the agent ceases to do this and prefers his own or another’s interests it terminates his
13 authority.

14 Finally, because the Debtor’s bankruptcy, by itself, terminates the Debtor’s
15 authority to act on behalf of the investors where the investors are disadvantaged because
16 the Debtor’s credit. Section 113 of the *Restatement (Second) of Agency – Bankruptcy of*
17 *Agent*, provides:

18 The bankruptcy or insolvency of an agent terminates his
19 authority to conduct transactions in which the state of his
20 credit would so affect the interests of the principal that the
agent should infer that the principal, if he knew the facts,
would not consent to the further exercise of the authority.

21 In this case, the Debtor’s bankruptcy or insolvency is the primary or inextricably
22 intertwined with the settlements. Primary to many of the claims being settled is the
23 Debtor’s inability to fund loan commitments. As such, the Debtor’s insolvency has now
24 placed the investors in a position that their property is being compromised. *See also*
25 *Restatement (Third) of Agency, § 3.09, cmt. B.* In this situation, the Debtor’s bankruptcy
26 terminates its authority.

1 **VII. THE AGENCY AGREEMENTS ARE EXECUTORY CONTRACTS AND**
2 **MAY BE TERMINATED**

3 Most courts, including the Ninth Circuit, have adopted Professor Vern
4 Countryman's definition of an executory contract that a contract is executory if the
5 "obligations of both parties are so far unperformed that the failure of either party to
6 complete performance would constitute a material breach and thus excuse the
7 performance of the other." *Commercial Union Ins. Co. v. Texscan Corp. (In re Texscan*
8 *Corp.)*, 976 F.2d 1269, 1272 (9th Cir. 1992).

9 **A. The Agreements Are Executory**

10 To determine whether failure to perform the remaining obligations would
11 constitute a material breach, courts need to consider contract principles under the relevant
12 non-bankruptcy law. *Enterprise Energy Corp. v. U.S. (In re Columbia Gas Sys. Inc.)*, 50
13 F.3d 233, 239-40 n.10 (3d Cir. 1995). The Court in *Hall v. Perry (In re Cochise College*
14 *Park, Inc.)*, 703 F.2d 1339 (9th Cir. 1983), noted that "a bankruptcy court should
15 determine whether one of the parties' failure to perform its remaining obligations would
16 give rise to a 'material breach' excusing performance by [the] other party under the
17 contract law applicable to the contract..." *Id.* at 1348, n.4.

18 There are numerous provisions in the Agency Agreements that set forth obligations
19 for the Debtor, but there are also several provisions with continuing investor obligations
20 and with remedies in the event of a default, including the confidentiality provisions in
21 Section 6, the indemnity provisions in Section 4, the obligation to execute documents in
22 Section 5 and the obligations to reimburse for expenses, among others. In the Operating
23 Agreements there are several provisions with continuing member obligations, including
24 the tax indemnity obligation in Section 8 and the meeting and voting requirements in
25 Section 6, among others, and with remedies in the event of a default, such as Section 7.6.
26 Because a breach of these obligations by an individual investor would excuse the Debtor

1 from performing under the agreements vis-à-vis that investor, those agreements are
2 executory. *See, e.g., Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va.
3 1996); *In re Daughtery Constr. Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995). Because the
4 agency relationship is executory in nature, the filing of the bankruptcy by the Debtor has
5 the effect of terminating the agency relationship and prevents Debtor from assuming the
6 agreements under Section 365(c) or (e).

7 **B. Under Section 365(c) the Agreements Cannot be Assumed**

8 Although executory, the Agency Agreements cannot be assumed because they are
9 personal and confidential in nature and under applicable non-bankruptcy law are
10 nondelegable. *See Knudsen v. Torrington Co.*, 254 F.2d 283, 286 (2d Cir. 1958).

11 **C. Under Section 365(e) the Agreements Are Not Assumable**

12 Although executory, the Operating Agreements also cannot be assumed because
13 they contain clauses providing for their termination upon the Debtor's bankruptcy filing
14 (*See Funds' Operating Agreement*, at § 7.3(a), and Article XII Definition of Bankruptcy.)
15 Although so-called *ipso facto* clauses are generally not enforceable in bankruptcy law,
16 Section 365(e)(2)(A) provides for their enforceability where:

17 (A) (i) applicable law excuses a party, other than the debtor, to
18 such contract or lease from accepting performance from or
19 rendering performance to the trustee or to an assignee of such
20 contract or lease, whether or not such contract or lease
prohibits or restricts assignment of rights or delegation of
duties; and

21 (ii) such party does not consent to such assumption or
assignment....

22 As demonstrated above, applicable law here allows the investors to terminate the agency
23 relationship. Therefore, the Operating Agreement allows the termination of the Debtor's
24 rights as Manager, and the executory contracts cannot be assumed.

25 **VIII. ADDITIONAL ISSUES RAISED BY THE COURT**

26 The Court has asked the parties to brief some additional issues with regard to

1 authority such as the applicability of Section 363(h), and law regarding participation
2 agreements.

3 **A. Section 363(h) Is Not Helpful Or Applicable**

4 The Court has inquired about the application of Section 363(h) to this case. In
5 short, it is not applicable. The assets implicated in all of the settlements that are in
6 question are notes and deeds of trust, not real property. The concept of “tenant in
7 common” is applicable to real property. *See, e.g.,* A.R.S. § 12-1252. There is no
8 authority for the proposition that tenancy in common or Section 363(h) even applies to
9 fractionalized interests in promissory notes and deeds of trust. Moreover, the notes and
10 deeds of trust are not even property of the bankruptcy estate. As such, the authorization in
11 section 363(h) to for a Debtor to sale real property that is the subject of a co-tenancy is not
12 applicable. Furthermore, section 363(h) permits the “sale” of the property. None of the
13 settlements are seeking a sale of the promissory notes and deeds of trust. Because nothing
14 other than the “sale” of co-owned real property is authorized by section 363 (h), it is
15 simply not applicable.

16 **B. Participation Cases Are Not Helpful**

17 The Court also asked if “participation” cases are applicable and again the case law
18 in this area is almost nonexistent. The case cited by the Debtor is not applicable to our
19 situation. There are many cases regarding participation agreement between banks or
20 insurance companies in the context of excess insurance, but these cases simply construe
21 the participation agreements at issue. The Investors’ Committee could find no additional
22 propositions that were relevant or persuasive for this situation. In short it is the terms of
23 the specific documents at issue and the general agency principles that determine the extent
24 and scope of authority of an agent in conjunction with applicable bankruptcy law, as
25 indicated above, that governs in this case.

26

1 **IX. CONCLUSION**

2 In addition to the previous briefing provided to the Court and the arguments and
3 facts from the briefs incorporated herein, the Debtor's claims for authority to conclude the
4 settlement agreements at issue fails. The Debtor improperly assumes that it has the same
5 authority to act for all investors. The Debtor overstates the authority granted to it by the
6 operative documents. The Debtor's authority has been vitiated by the clear conflict of
7 interest, and its bankruptcy. The Debtor does not have authority to take the actions under
8 the Bankruptcy Code. Finally, the additional issues raised by the Court do not provide
9 authority for the Debtor's actions. Accordingly, the Investors Committee submits its
10 position on the authority and agency issues but reserves the right to supplement or modify
11 this pleading further.

12 DATED this 7th day of November, 2008.

13 FENNEMORE CRAIG, P.C.

14
15 By /s/ Cathy L. Reece (005932)
16 Cathy L. Reece
17 Keith L. Hendricks
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18 COPY of the foregoing emailed or mailed
19 this 7th day of November, 2008 to the parties
20 on the attached Service List.

21 /s/ Susan Stanczak-Ingram

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

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Supplemental Statement of Position *on Authority and Agency by Investors Committee* filed by CATHY L. REECE of FENNEMORE CRAIG on behalf of Official Committee of Investors. (related document (s)[788] Statement of Position) (Attachments: # (1) Service List)(REECE, CATHY)

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