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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

SOUTHERN DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

MEDICAL CAPITAL HOLDINGS, INC.; MEDICAL CAPITAL CORPORATION; MEDICAL PROVIDER FUNDING CORPORATION VI; SIDNEY M. FIELD; and JOSEPH J. LAMPARIELLO,

Defendants.

Case No. SACV 09-818 DOC (RNBx)

RECEIVER'S REPLY MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF SETTLEMENT WITH WELLS FARGO AND BANK OF NEW YORK MELLON

Date: October 15, 2012
Time: 8:30 a.m.
Ct Rm: 9D
Judge: Hon. David O. Carter

Docket
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Thomas Seaman, Federal Equity Receiver (the "Receiver") submits this Reply Memorandum in response to the Noteholders' Joint Objection To The Receiver's Motion For Approval Of Settlement Wells Fargo And Bank Of New York Mellon (the "Objection" or "Obj.").

I. INTRODUCTION

The Receiver's settlement with the Trustees is nearly ten times higher than the recovery in any other case against indenture trustees that the Receiver or any other party has been able to identify. The settlement will nearly double the amount of money available to distribute from the Receivership Estate. The Receiver accomplished the settlement through careful analysis of the facts, the law, and the governing contracts, and through nearly a year of vigorous and arm's-length negotiations and mediations with the Trustees. The Receiver consulted with the Securities and Exchange Commission before initiating those negotiations and while the negotiations were ongoing, and the SEC supports the settlement.

The Class and Mass Action Plaintiffs attack the settlement (and also attack the Receiver and his counsel), arguing that the Trustees are liable for many times more than the $106 million the Receiver has obtained. But after three years of litigation, those Plaintiffs still do not address fundamental obstacles to their claims that are posed by the provisions of the NISAs and the governing law. The Class and Mass Plaintiffs' primary theory rests largely on the *Bankers Trust* case, but Plaintiffs do not acknowledge that the indenture agreement in that case imposed obligations on the trustee that simply do not exist in any but one of the seven NISAs at issue here. Nor do Plaintiffs acknowledge that the *Bankers Trust* case, in which the defendant defaulted on $300 million of notes, ended in summary judgment with the plaintiff recovering just one dollar, exactly the kind of disaster the Receiver sought to avoid and will avoid with the $106 million settlement here.

The Receiver's settlement is reasonable and more than sufficient to meet the standard for approval. By pursuing and settling his claims, moreover, the Receiver

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extinguishes noteholder claims that are based on injuries that are entirely derivative of the injuries to the Receivership entities. The Court should grant the Approval Motion and allow the Receiver to collect and disburse these funds.

DISCUSSION AND ARGUMENT

II. THE PARTIES' ANALYSIS OF CLAIMS AND POTENTIAL DAMAGES.

A. The Receiver's $106 Million Settlement Far Exceeds The Recovery In Any Known Indenture Trustee Case.

The Class and Mass Plaintiffs do not and cannot cite any case where any recovery against indenture trustees comes anywhere close to what the Receiver has accomplished here. Even when such claims have survived motions to dismiss, they have often ended with summary judgment in the trustees' favor. *See, e.g., Cruden v. Bank of New York*, 957 F.2d 961 (2d Cir. 1992); *In re E.F. Hutton Southwest Properties II, LTD. v Union Planters National Bank*, 953 F.2d 963 (5th Cir. 1992); *Meckel v. Continental Resources Co.*, 758 F.2d 811 (2d Cir. 1985); *Peak Partners, LP v. Republic Bank,* 191 Fed. Appx. 118 (3rd Cir. 2006); *Craig v. Bank of N.Y.*, 59 Fed. Appx. 388 (2nd Cir. 2003); *Ameriks v. Zions First Nat'l Bank*, 2000 U.S. App. LEXIS 7198 (10th Cir. 2000); *Harriet & Henderson Yarns, Inc., v. Castle*, 75 F. Supp. 2d 818 (W.D. Tenn. 1999). Indenture trustees have also prevailed completely at trial. *See, e.g., LNC Invs., Inc. v. Nat'l Westminister Bank*, 308 F.3d 169 (2d Cir. 2002) (jury trial); *Elliott Assoc. v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66 (2d Cir. 1988) (bench trial); *Abraham v Bank of America*, 1997 Jury Verdicts LEXIS 67287 (N.D. Cal. Sept 15, 1997) (jury trial; plaintiffs claimed $20 million, rejected $4 million offer, and lost at trial).

Even where plaintiffs have prevailed or have settled with indenture trustees, their recoveries have been significantly lower than the Receiver's settlement in terms of both dollars and percentage of loss. *See, e.g.*, *Dresner Co. Profit Sharing Plan v. First Fid. Bank*, *N.A.,* 1996 U.S. Dist. LEXIS 17913 (S.D.N.Y Dec. 4, 1996) ($7.4 million settlement, where issuer of $350 million in bonds went

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1 bankrupt); *Neilson v. Union Bank of Cal.*, 290 F. Supp. 2d 1101 (C.D. Cal. 2003)
2 ($11.1 million settlement on claim that exceeded $250 million); *Dell'Oca v. Bank of*
3 *New York Trust Co., N.A.,* 159 Cal. App. 4th 531 (2008) ($15.7 million verdict
4 reduced to $3.05 million on appeal). And in the case most relevant to Plaintiffs'
5 primary theory – failure to declare an Event of Default – an indenture trustee
6 consistently failed to review compliance documents and breached its contractual
7 and statutory duty to give notice of defaults, and the court imposed a judgment of
8 ***one dollar***. *In re Bankers Trust Co., Semi-Tech Litig., LLC v. Bankers Trust Co.*,
9 450 F.3d 121 (2d Cir. 2006) (discussed in detail below).

10 **B. <u>Claims Based On Failure To Declare Events Of Default.</u>**

11 Plaintiffs focus their analysis on the Trustees' "failure to recognize Events of
12 Default" (*see* Obj. at 33 *et seq.*) where the MPFCs had materially breached the
13 NISAs or made material false statements in certificates. The Receiver considered
14 those theories and included such allegations in his own Complaint. But the
15 Receiver also recognized that such claims face three major obstacles, which
16 Plaintiffs do not adequately address.

17 Below, the Receiver discusses the provisions of the NISAs that define Events
18 of Default. The Receiver then discusses the three obstacles to proving the claim on
19 which Plaintiffs focus: (1) demonstrating that there was a material breach or false
20 statement by the MPFC as of a given date; (2) establishing that the Trustees were
21 obligated to give notice to the MPFC of the material breach or false statement, and
22 (3) establishing that the failure to do so caused damages. Before discussing the
23 second and third obstacles, the Receiver will discuss in detail the *Bankers Trust*
24 holdings that are of central importance here.

25 **1. The Default Provisions Of The NISAs.**

26 The NISAs identify two types of Events of Default that are relevant here.
27 First, an Event of Default occurs where the MPFC provides "any certificate or
28 determination [that is] false or misleading as of the date made in any material

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respect and which, within thirty (30) days of notice by the Trustee, the [MPFC] fails to cure such inaccuracy." Declaration of Thomas A. Seaman in Support of Motion for Approval of Settlement ("Seaman Decl.") [Doc. No. 732], Ex. A, § 6.01(b). Second, an Event of Default occurs where the MPFC "materially breaches any other covenant or provision" of the NISA. *Id.*, § 6.01(c).

Under the NISAs, an Event of Default does ***not*** arise solely because the MPFC commits a material breach or makes a material false statement. A condition precedent to an Event of Default is that the Trustee provide notice (which, under the NISA, cannot be an email but must be a writing delivered personally, by facsimile, or by registered or overnight mail; *id.*, § 9.03(b)), and that the MPFC fails to cure within 30 days of such notice. In contrast, the NISAs define other Events of Default where no action by the Trustee is required to fulfill a condition precedent, including failure to make principal and interest payments to Noteholders that remains unremedied for 15 days, and provision of an NCCR report that shows a Collateral Coverage Default (*i.e.*, liabilities exceeding assets) that remains unremedied for more than 5 days. *Id.*, §§ 6.01 (a) and (k). Neither such provision is relevant here.[1]

As discussed below, only one NISA (for MPFC II) requires the Trustee to take action in response to a material breach or material false statement (*i.e.*, a "default" with a lower-case "d") that is not yet an Event of Default. The other

[1] MPFC II did default on payments to Noteholders in August 2008. Plaintiffs have alleged that BNYM failed to give notice of the Event of Default until November 10, 2008. Class Complaint, ¶ 148. That timing was consistent with the MPFC II NISA, § 7.05, which required the Trustee to wait 60 days and allowed the Trustee to wait up to 90 days to give notice of a payment default. This was not a breach and Plaintiffs do not discuss this allegation or identify any claimed damages in their Objection.

Also, as discussed below, BNYM should have given notice of a default where the NCCR reports for MPFC II, had they been submitted and in the form required by the NISAs, would have shown a Collateral Coverage Default. But this occurred in August 2007, approximately two years after the last Notes in MPFC II were sold, and would not have supported any significant damages even under Plaintiffs' theories. *See* p. 11, *below*.

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1 NISAs differ significantly on this critical issue.

2 **2. First Obstacle: Materiality.**

3 To establish a claim based on failure to recognize or give notice of an Event
4 of Default, the Plaintiffs or the Receiver first need to show that the MPFCs
5 materially breached their obligations under the NISAs or provided a material false
6 statement or determination. Plaintiffs contend that this occurred the first time an
7 MPFC requested administrative fees without having provided an NCCR report, or
8 the first time an MPFC requested funds to purchase assets without providing all
9 required documents. Obj. at 35-36. Those contentions are flawed.

10 The first question is whether there was a breach. This is far less certain than
11 Plaintiffs suggest. With respect to administrative fees, the NISAs do not state that
12 the MPFC must provide an NCCR report before MCC, the administrator, can
13 request fees. Rather, they state that any request for administrative fees must include
14 "a certification to the Trustee with [the] request, to the effect that the Collateral
15 Coverage Requirement is satisfied (after giving effect to the requested
16 disbursement) on the basis of the Net Collateral Coverage Ratio calculated and
17 provided by the Debtor to the Trustee as of the last day of the month preceding the
18 month in which such request is made." Seaman Decl., Ex. A, § 3.05(h). In most
19 instances, MCC "provided" the coverage ratio in the fee request itself. Moreover,
20 NCCR reports were not even due until the 15th of each month, and the NISAs do
21 not state that fee requests could not be made before the 15th.

22 Even if a fee request was improper because the NCCR report for that month
23 was not yet due or the NCCR report was overdue, simply requesting fees under
24 those circumstances was likely not a breach by the MPFC, let alone a material
25 breach. Certainly, the Trustees should not have paid the fees when requests were
26 deficient in this or any other regard, and such deficiencies are at the heart of the
27 Receiver's transaction-by-transaction analysis.[2] But Plaintiffs go much further,

28 [2] With respect to asset purchases, Plaintiffs do not state which documents they

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asserting for example that MPFC VI was in default on August 13, 2008 – six days after the NISA for MPFC VI was signed – because MPFC VI did not provide an NCCR report by that date. In fact, no NCCR report for MPFC VI was due until August 15 or, more likely, September 15, 2008.[3] Again, BNYM should not have disbursed any administrative fees from MPFC VI in August 2008, and the fact that BNYM disbursed $3.2 million that month is one reason why the Receiver demanded and received a substantial settlement from BNYM. But Plaintiffs' claim that the failure to provide an NCCR report by August 13, 2008, required BNYM immediately to give notice of default is inconsistent with the NISAs and to the law.

In *Masonek*, the Court held that "[b]ecause tardiness in submitting documents does not go to the essence of the agreement, it is not a material breach." *Masonek* Doc. No. 143 at 11. In *Abbate*, the Court found that materiality may be provable here because "certain required documents were, in fact, ***never*** submitted to Defendants." *Abbate* Doc. 227 at 9 (emphasis added). Together, these two rulings show that, while the failure to provide required documents is not immediately a material breach, at some point it may become a material breach because the documents are not merely late but missing entirely. But nothing in the Court's

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contend were missing that would trigger the claimed Event of Default. Plaintiffs have previously focused on failure to provide purchase documents, but the NISAs for MPFC III (Series II), MPFC V, and MPFC VI did not require the MPFC to provide purchase documents in requesting funds for the purchase of receivables. *E.g.*, Declaration of Frank A. Cialone in Support of Reply Declaration ("Cialone Reply Decl."), Ex. C at §5.08(a)(ii)(E) and Exhibit A-1. In any event, the same analysis applies: If the MPFCs requested funds for an asset purchase without providing proper documentation, then the request for funds was deficient and the Trustee should not have released the funds. But the failure to provide documents that are not otherwise required under the NISA, but only required in conjunction with a request to release funds to make an asset purchase, is not likely to be seen as a material breach of the NISA. Rather, it is more likely seen as a failure to satisfy the conditions precedent to the requested release of funds.

[3] The NISA for MPFC VI requires that an NCCR report be provided on the 15th day of each month and state the coverage ratio as of the first day of that month. Arguably the first such report was due on August 15, 2008, but because there were zero assets and zero liabilities as of August 1, 2008 no coverage ratio could have been calculated that month. A more plausible interpretation of the NISA is that the first NCCR report was due on September 15.

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holdings supports Plaintiffs' contention that a material breach occurred on the first day a required document was not provided. And if there was no material breach, then the MPFC's statement in various certificates that it was not in default on any of its obligations was also not materially false.

The Receiver agrees with the Plaintiffs that, at some point, the number of late and missing certificates and the extent to which they were late became material. But when that occurred is a question of fact (subject to the Court's holding that merely late documents are immaterial as a matter of law) and that determination will have a dramatic effect on the Plaintiffs' damages theories. If a jury determines that one month could pass before the Trustees were required to deem a missing document to be a material breach, that reduces the damages on Plaintiffs' default theory (based on Noteholder funds received after the claimed Event of Default) by more than $150 million.[4] If the jury decides that a breach became material after three months – a reasonable likelihood, since many of the compliance documents were due quarterly – those damages drop by approximately $500 million. And if the jury decides that the Trustees could have waited six months before giving notice of a default (assuming they were ever obligated to give such notice, a flawed premise, as discussed below), then those damages are essentially eliminated. *See*

[4] Materiality is not the only reason why a jury might find that the "default" date occurred later than Plaintiffs claim. For example, as discussed above, Plaintiffs assert that MPFC-VI breached its obligation to provide an NCCR report on August 13, 2008 (six days after the entity was formed), but under the NISA it appears more likely that no breach occurred until September 15, 2008, more than 30 days later.

In his Reply Declaration, the Receiver provides figures, based on the methodology used by Plaintiffs' expert James Skorheim, for Noteholder funds received and administrative fees paid after the default dates claimed by Plaintiffs, and then shows what those amounts will be if the Event of Default is found to have occurred one, three, or six months later than Plaintiffs contend.

The Receiver questions Mr. Skorheim's contention that damages for failure to declare Events of Default can include both Noteholder funds received and administrative fees paid after the date in question, as this appears to double-count the same dollars (because fees were paid from the Noteholder funds received), but the Receiver nonetheless provides that information in his declaration.

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Declaration of Thomas A. Seaman in Support of Reply Brief ("Seaman Reply Decl."), ¶ 12-16, Ex. A.

Plaintiffs cite the Trustees' own statements as evidence that missing documents were material and constituted a default. But the documents Plaintiffs cite were from late 2008 or early 2009. *See* Obj. at 15 ("[B]y at least December 2008, BNYM knew that Medcap was past due with periodic compliance reports, which it acknowledged were defaults under the Agreements."); *id.* ("Wells … was aware of defaults under the Agreements" when it made disbursements in March and April 2009). By those late dates virtually all the damage had been done: From December 2008 on, the principal amount of notes sold by all the MPFCs combined was $15.2 million, and the net amount of administrative fees paid was $11.2 million. *See* Seaman Reply Decl. ¶ 18.

3. Second Obstacle: Duty To Provide Notice.

The next obstacle to establishing a claim based on Events of Default is showing that the Trustees had a duty to take action in response to a material breach or material false statement. Here, again, the Receiver believes that the Trustees' duty was to not disburse funds in response to deficient requests. Plaintiffs, in contrast, assert that any deficient request for funds by an MPFC constituted a material breach of the NISA, and that the Trustee was required (and immediately required) to give notice of the breach or misstatement to the MPFC, giving the MPFC 30 days to cure in order to avoid an Event of Default. But the NISAs and the controlling law do not support the Class and Mass Plaintiffs' argument.

The holdings in *Bankers Trust,* which the Court cited in allowing default-based claims to proceed (*see Abbate* Doc. No. 227 at 10-11), bear close scrutiny here. The indenture agreement at issue in *Bankers Trust* provided that "the duties and responsibilities of the Trustee shall be as provided in the Trust Indenture Act [the 'TIA']." *Semi-Tech Litig., LLC v. Bankers Trust Co.*, 353 F. Supp. 2d 460, 463 (S.D.N.Y. 2005). This included the obligation to examine submitted certifications

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"to determine whether or not such evidence conforms to the requirements of the indenture." *Id.* at 465. The agreement also provided that "the trustee shall give the Holders notice of any default hereunder as and to the extent provided by the Trust Indenture Act" and that "[f]or the purpose of this Section, the term 'default' means any event which is, or after notice or lapse of time or both would become, an Event of Default." *Id.* at 463. The latter provision required the defendant to give qualified notice to the noteholders of every 'default,' not just of Events of Default. *Id.* at 481-82. Thus, there were two duties at issue: the defendant's duty to examine certificates, and the defendant's duty to give notice of any defect in those certificates. Both duties were expressly imposed on the defendant by the agreement and the TIA.

On motion for summary judgment, the district court found that the defendant breached the indenture agreement when it failed to examine certificates submitted by the issuer to ensure that they conformed to the requirements of the indenture. *Id.* at 478-79. The court further found that the indenture trustee's failure to notify the noteholders of the issuer's default did not constitute a breach because the indenture required the trustee to provide notice of only known defaults and the trustee did not know about the default since it did not examine the submissions. *Id.* at 479-80. In short, the condition precedent to providing notice of default – the trustee having knowledge that certificates did not contain required language – never occurred. The court further held that, because the defendant's failure to examine certificates did not actually cause the loss (in which a company that had issued $300,000,000 of notes went bankrupt before the notes reached maturity), the plaintiff was entitled only to nominal damages of one dollar. *Id.* at 482-487.

On appeal, the Second Circuit affirmed the result, but disagreed with the reasoning that led the district court to conclude that the defendant did not breach its duty to give notice of default. *Bankers Trust*, 450 F.3d at 127. The reason the defendant did not know that the certificates were defective, and thus the reason the

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condition precedent to the notice obligation was not fulfilled, was because the defendant breached its duty to examine those certificates, and "its failure to do so cannot excuse its failure to comply with the duty under § 315(b) [of the TIA] to take action with respect to known defaults." *Id.* at 127. In so holding, the Second Circuit addressed *Amies v. Wesnofske*, 255 N.Y. 156, 163, 174 N.E. 436 (1931), a case the defendant cited for its "position that only its active hindrance, not passive hindrance, can result in its waiver of the condition precedent." 450 F.3d at 127..

In *Amies*, real estate brokers for the buyer had sued the sellers of the property for fees after the buyer backed out of the deal. 255 N.Y. at 158-59. The court held that, while a party claiming non-occurrence of a condition precedent cannot engage in "active conduct . . . preventing or hindering the fulfillment of the condition," the doctrine does not "compel positive action" where no such duty or promise exists. *Id.* at 163. Finding that the defendant sellers were under no duty to demand specific performance when the buyer backed out of the purchase, the court held that the sellers had "neither prevented nor hindered performance [by the buyer]." *Id.* at 164-65. "Passive acquiescence in a declared default and its consequences was not an act of prevention or hindrance." *Id.* at 165.

The Second Circuit in *Bankers Trust* distinguished *Amies* on the ground that the defendants in that case did not have a duty to bring about the condition precedent, whereas the defendant in *Bankers Trust* did have such a duty:

> The sellers had made no promise to the brokers to take steps to enforce the buyers' performance. Had there been such a promise, it is clear the result would have been the opposite. [The trustee's] case differs from *Amies* in just this respect. The sellers in *Amies* had made no promise (and had no duty) to the brokers to sue for specific performance. In those circumstances, according to the *Amies* court, only active frustration of the occurrence of the condition precedent would constitute waiver of the precondition. [The trustee], in contrast, was under a statutory and contractual duty to examine the certificates furnished by [the debtor] to determine whether they conformed to the requirements of the Indenture.

Bankers Trust, 450 F. 3d at 128. Since the indenture trustee had a contractual duty to bring about the condition precedent, it could not rely on the rule requiring active

interference with the condition precedent to constitute waiver of the condition. *Id.* at 128-29. The Second Circuit further stated that, under the Restatement, which post-dates the 1931 *Amies* decision by 50 years, if there is no duty to bring about the condition precedent then "the promisor's frustration of the occurrence of the condition, even by active conduct, should not occasion a waiver." *Id.* at 128, n.4.

In *Bankers Trust*, then, the only condition precedent to notice being required was that the trustee know the certificates were defective, and since the trustee was required to review all certificates it was effectively charged with that knowledge. No intermediate step between having that knowledge and providing notice to noteholders was required, because under both the agreement and the TIA the trustee was required to give notice of "any violation, no matter how small or irrelevant to the parties' rights and obligations." 353 F. Supp. 2d at 481-82.

The agreements in this case are very different, with one exception.[5] The NISA for MPFC II (for which Zion's Bank was the original trustee) is similar to the agreement in *Bankers Trust*: It requires the Trustee to give notice to Noteholders of any "default," which is defined as an event or condition "which ... after notice or lapse of time or both would become an Event of Default." Cialone Reply Decl., Ex. B, § 7.05.[6] But in all six subsequent NISAs, the Trustee is required to give notice ***only of an Event of Default***. *E.g.*, Seaman Decl., Ex. A, § 6.05. This may be because, as *Bankers Trust* itself states, industry practice is not to provide notice of every late or defective certificate and the Trustees did not want to face a lawsuit,

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[5] As for the TIA, it does not apply here. *See Abbate* Doc. No. 196 at 3-4.

[6] That provision supports a default-based claim as to MPFC II. But there are virtually no damages, because (according to Plaintiffs) the first material breach by MPFC II occurred on October 28, 2005. *See* Obj. at 35-36 (asserting that MPFC II was in default, after breach went uncured for 30 days, as of November 27, 2005). BNYM had 90 days to provide notice of the breach to Noteholders, or until January 26, 2006. Cialone Reply Decl., Ex. B, § 7.05. After January 26, 2006, MPFC II sold no notes, paid $22.7 million in administrative fees, and was refunded $26.5 million of administrative fees. *See* Seaman Reply Decl., ¶ 19. And as discussed below, *Bankers Trust* suggests that causation issues could preclude any damages award on this claim.

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like the defendant in *Bankers Trust*, for conforming to industry practice. *See* 450 F.3d at 129 (noting that even the plaintiffs' expert "could not recall any instance in which an indenture trustee gave notice of default because it had received nonconforming documentation."); *see also* Landau and Krueger, Corporate Trust Administration and Management (5th Edition), at 181 ("It is important that the trustee be given broad discretion in the matter of withholding notice of default and that it be protected in the exercise of this discretion. The primary objective of all parties should, however, be to prevent a default or to remedy the situation. If this is possible, then too hasty action in publicizing the default can cause irreparable damage."). Or it may be because the principals of MedCap, intent on pursuing a Ponzi scheme, wanted to minimize the incidence of notices. But regardless of the reason, the provisions are materially different: the NISA for MPFC II (like the agreement in *Bankers Trust*) requires the Trustee to give notice to Noteholders of any condition or event that could become an Event of Default with notice and failure to cure, while the other NISAs require the Trustees to give notice to Noteholders only when all conditions precedent to an Event of Default, including the notice and cure conditions, have actually been fulfilled. Plaintiffs do not acknowledge or account for these differences in the NISAs; instead, they incorrectly assert that "the NISAs are substantially similar." Obj. at 7. But when the earliest NISA at issue has a materially different term than the other NISAs, that difference is meaningful and must be taken into account.

As discussed above, the two default provisions relevant here – material breach and material misrepresentation – do not trigger Events of Default unless and until the Trustee gives notice to the MPFC and allows 30 days to cure. And critically, the NISAs do not expressly require the Trustees to give such notice under ***any*** circumstances – a significant problem because the NISAs also provide that "the Trustee undertakes to perform such duties and only such duties as are specifically set forth … and no implied covenants or obligations shall be read into this Note

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Agreement against the Trustee." Seaman Decl., Ex. A, § 5.06. Thus, while the Trustees were required to review certificates and while they certainly knew that many certificates were missing, late, and/or defective, that alone did not constitute an Event of Default or trigger any express duty under the NISAs (other than the obligation to not release funds in response to defective certificates, the heart of the Receiver's transaction-by-transaction analysis). Rather, before an Event of Default occurred, the Trustees would first have to give notice to the MPFC (and the default would have to remain uncured for 30 days), which the NISAs do not expressly require. That fact makes this case substantially different than *Bankers Trust*, and makes any claim based on failure to declare Events of Default very difficult.

The Receiver is aware that the Court, in allowing the *Abbate* default-based claim to proceed, held that "like the Defendant in *In re Bankers Trust Co.*, BNYM cannot rely on its decision not to provide MedCap notice of the inaccuracy as justification not to declare an Event of Default if, in fact, a material breach occurred." *Abbate* Doc. No. 227 at 9. But the distinction between this case and *Bankers Trust* was not fully briefed on that motion, and the difference between the NISA for MPFC II and all subsequent NISAs was not even mentioned. After a year of negotiations, it was clear that the Trustees fully understand these issues and would raise them on summary judgment and/or at trial, and if necessary on appeal. Certainly, it is possible that the Court, a jury, and the Ninth Circuit will find that the persistent failure of the MPFCs to provide timely and contract-compliant documents *at some point* obligated the Trustees to provide notice and demand that the MPFCs cure these defaults, despite the absence of any NISA provision expressly imposing such an obligation (and despite the Court's holding that the covenant of good faith and fair dealing will not allow imposition of new obligations; *see, e.g.*, *Abbate* Doc. No. 196 at 8). But even if that occurs, the point at which the MPFCs' failure to perform not only became material but imposed an extra-contractual obligation on the Trustees to give notice to cure would almost

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certainly not arise on the first day an MPFC submitted a deficient request for funds, as Plaintiffs would have it, but only after a period of months, thus greatly reducing or even eliminating the damages available on Plaintiffs' theory.

4. Third Obstacle: Causation.

A further hurdle in establishing a default-based claim is causation. The holding in *Bankers Trust* is again instructive:

> [E]ven if BT had been punctilious in its inspection of the certificates and had scrupulously performed its duties under the TIA, this would not have prevented the Noteholders' losses. … Plaintiff failed to submit evidence that could support a finding that BT's breach of its duty … to inspect the certificates was a cause-in-fact of plaintiff's losses. … So far as the evidence shows, had BT been aware of the nonconforming language, it would have sought and received conforming certificates from Semi-Tech….

450 F.3d at 129-130. Accordingly, the court awarded only nominal damages.[7]

Proof of causation in breach of contract actions requires proof of both factual ("but for") causation and legal (proximate) causation. *Bankers Trust*, 353 F. Supp. 2d at 482; *US Ecology, Inc. v. State of California*, 129 Cal. App. 4th 887, 909 (2005) ("Causation of damages in contract cases, as in tort cases, requires that the damages be proximately caused by the defendant's breach, and that their causal occurrence be at least reasonably certain.") (citation omitted); *Husband v. Colorado Mountain Cellars*, 867 P.2d 57, 59-60 (Colo. Ct. App. 1993) ("[A] claimant must establish that the damages he seeks are traceable to and are the direct result of the wrong sought to be redressed." (citation omitted); *Barnes v. Andrews*, 298 F. 614, 616 (.D.N.Y. 1924) ("The plaintiff must accept the burden of showing that the ***performance of the defendant's duties would have avoided loss***, and what loss it

[7] The Second Circuit relied in part on the fact that the TIA permits a trustee to withhold notice of default if it determines in good faith that doing so is in the interests of the noteholders, and the defendant had a general policy to that effect. *Id.* at 129. The NISA for MPFC II, the only NISA that requires notice of any default, contains a similar provision allowing the Trustee to withhold notice based on a good faith determination that doing so is in the Noteholders' interest. Cialone Reply Decl., Ex. B, § 7.05.

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would have avoided.") (emphasis added). "Thus, a plaintiff establishes factual causation by demonstrating that, 'but for' the allegedly unlawful act, it is more likely than not that the injury for which redress is sought would not have occurred." *RSL Communs. PLC v. Bildirici*, 649 F. Supp. 2d 184, 209 (S.D.N.Y. 2009); *see also People v. Jennings*, 50 Cal. 4th 616, 643-644 (2010) ("'But for'or 'sine qua non' causation provides that '[t]he defendant's conduct is a cause of the event if the event would not have occurred but for that conduct; conversely, ***the defendant's conduct is not a cause of the event, if the event would have occurred without it***.'") (citation omitted). (Emphasis added).

The central causation question posed by the default claim, then, is whether the MPFCs would have cured their breaches or misrepresentations, by providing NISA-compliant certificates, upon notice. Plaintiffs argue that the facts of this case demonstrate that the MPFCs would not have cured, because "[i]n the rare instances when the Banks did inform Medcap of its breaches of the NISAs, Medcap usually failed to cure those breaches within the required 30 days." Obj. at 34.[8] But in none of those instances did the Trustees refuse to release funds until the requested documents were provided. Nor did the Trustees provide formal notice in accordance with the notice provisions of the NISAs, or otherwise assert that an Event of Default would arise unless the MPFC provided NISA-compliant documents. The causation element here requires consideration of those facts.

To take one example, Plaintiffs assert that Wells Fargo should have recognized an Event of Default as to MPFC V on January 3, 2008, because 30 days earlier MCC requested administrative fees from MPFC V without first providing an

[8] Failure to cure within 30 days would not necessarily lead to the damages Plaintiffs claim. Under the NISAs, an Event of Default arose if a material breach or material misstatement remained uncured for 30 days after notice. But the Trustees had another 90 days to notify Noteholders of the Event of Default, and did not have to provide such notice if the Event of Default was cured in the interim. Seaman Decl., Ex. A, ¶§ 6.05. Similarly, the Trustees had "prudent person" duties only where "an Event of Default has occurred ***and is continuing***." *Id.*, § 5.06(a)(iii) (emphasis added). If the MPFC failed to cure within 30 days of notice but cured sometime thereafter, the consequences (and damages) could well be limited.

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NCCR report. Obj. at 34-35. Plaintiffs claim that Wells Fargo's failure caused nearly $300 million in damages. Skorheim Report, Schedule F. The fee request at issue was made on December 4, 2007, for $450,000, and was the first fee request made from MPFC V. *See* Seaman Reply Decl., ¶ 20. Over the next few months, MPFC V sold more than $300 million in notes, and MPFC V eventually paid more than $48 million in administrative fees to MCC (net of refunds). Under these facts, if Wells Fargo had refused to pay administrative fees on December 4, 2007, but instead provided notice (by hand delivery, fax, overnight or certified mail) that the absence of an NCCR report constituted a material breach of the NISA, which if left uncured for thirty days would result in an Event of Default, what would most likely have occurred: That the principals of Medcap – who were perpetrating a huge and lucrative Ponzi scheme, who would ultimately take $48 million in administrative fees from MPFC V alone, and who would face lawsuits and criminal prosecution once the scheme collapsed – would have created, signed, and provided to Wells a half-page NCCR report stating MPFC V's liabilities and the value of its assets (a value based largely on what Medcap said the assets were worth (*see* section II.C., *below*))? Or that those same principals of Medcap would have chosen to let an Event of Default arise, let their fraudulent scheme end, forgo the chance to defraud investors of another $300 million and to collect $48 million in administrative fees, and face the civil and criminal actions that would inevitably follow?[9]

C. Other Breaches Claimed By Plaintiffs.

While Plaintiffs now focus on the default-based claims, their complaints alleged numerous other breaches. In many instances those allegations were contrary to known facts or the terms of the NISAs, a fact that influenced the Receiver's view of the case and his belief that the Class and Mass Plaintiffs' views

[9] In contrast, the Receiver's transaction-based analysis did not face nearly such significant causation issues, because the breach and the damages happened simultaneously. For example, when Wells released $450,000 on December 4, 2007 in response to a deficient fee request, MPFC V was immediately damaged in the amount of $450,000.

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were unrealistic. While the Receiver tried to avoid undermining specific claims in his Approval Motion because of the possibility that Motion would be denied, the Receiver will provide some examples here, now that Plaintiffs appear to have abandoned such claims in favor of the default theory, to illustrate the issue.

In their most recent complaints, both the Class and Mass Plaintiffs allege that the Trustees breached their duties by paying administrative fees from noteholder funds. *E.g.*, *Masonek* Doc. No. 147 ("Class Complaint"), ¶ 65 ("Defendants repeatedly disbursed payments for administrative fees from investor funds despite knowing that the MPFCs had not collected sufficient proceeds to cover the requested fees."); *Abbate* Doc. No. 207 ("Mass Complaint"), ¶ 336. But the NISAs do not preclude paying administrative fees from noteholder funds. Rather, they entitle MCC to administrative fees equal to the difference between the MPFC's assets and liabilities (*i.e.*, the amount by which the coverage ratio exceeds 100%). *E.g.*, Seaman Decl., Ex. A at 1. The "assets" of the MPFCs include the Expected Net Receivable Amount of all Eligible Receivables and the Value of all Non-Receivables – amounts determined by MCC itself, as the agent of the MPFC. *Id.* at 2-9. Thus, under the NISAs, if an MPFC sold notes on which the principal and interest ultimately due totaled $10 million, used $6 million of the proceeds to buy receivables, and stated that the receivables were Eligible Receivables on which it expected eventually to collect $8 million, the MPFC's purported assets would exceed its liabilities by $2 million (minus small amounts to pay trustee fees and other fees), and the MPFC could immediately pay that amount in administrative fees. *Id.* This may seem astounding, and it certainly is not a sound business practice, but those are the terms of the contracts at issue in this case.

Plaintiffs also alleged that the MPFCs sometimes calculated the NCCR incorrectly, by subtracting from liabilities the principal payments due within 30 days. Class Complaint, ¶¶ 79-80; Mass Complaint, §§ 241-47. This is true but it rarely made any difference. For example, in the Class Complaint Plaintiffs cite four

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NCCR reports containing that error, but in each instance if the error had been corrected the NCCR report still would have shown that the amount of administrative fees to which MCC was entitled vastly exceeded the amount of administrative fees that MCC requested. *See* Class Complaint, Ex. 4.[10] In the Objection, Plaintiffs state that sometimes this error "proved the tipping point that purported to show the MPC was not in default," citing four examples. Plaintiffs are incorrect as to their first example (Furakawa Decl., Ex. 16): on that NCCR, the amount of principal due within 30 days, and incorrectly subtracted from liabilities, was $15 million, but the stated assets exceeded liabilities by more than $60 million. Plaintiffs are correct as to the remaining examples (Furakawa Decl., Ex. 17), but those are for MPFC II from the period July-September 2007. Had BNYM demanded correct certificates (as it certainly should have), it would have received the first certificate no earlier than August 15, 2007, and an Event of Default would have arisen on August 21, 2007. Cialone Reply Decl., Ex. B, § 7.01(k). But MPFC II did not sell any notes after August 21, 2007, and it paid $3.5 million in administrative fees while receiving $26.5 million in administrative fee refunds. Seaman Reply Decl., ¶ 22.

In Paragraph 78 of the Class Complaint, Plaintiffs allege that Wells Fargo could have avoided problems with loans to Trace Life Sciences if Wells Fargo had "obtained the Purchase Documents and certifications required under the NISAs," and further allege "on information and belief" that Wells did not do so. But documents that Wells Fargo produced before the Class Complaint was filed (and that the Receiver received and reviewed in order to evaluate this and other claims) demonstrate that Wells Fargo did demand and receive the purchase documents, the

[10] The cited exhibit contains four NCCR reports from MPFC III (Series 1). Three are from months where MCC took no administrative fees at all (August 2005, November 2007, and March 2008). Seaman Reply Decl., ¶ 21. The fourth is from December 2006, the NCCR incorrectly subtracts $3.7 million in liabilities and states that the maximum fees due are $35.8 million. Had the error been corrected, the fees due would have been $32.1 million. MCC requested $1.3 million in fees that month. *Id.*

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required certification, and an opinion of counsel from the Sedgwick firm before the loan was funded. *See* Cialone Reply Decl., ¶ 14.

Again, the above are just examples to illustrate the Receiver's concern about the nature of claims the Class and Mass Plaintiffs were asserting, in complaints that were filed well into the litigation and after the Class and Mass Plaintiffs had received documents that refuted such claims.

D. The Class and Mass Plaintiffs' Claim For $1.3 Billion In Damages.

The Class and Mass Plaintiffs continue to assert that the Trustees' breaches support a damages claim of $1.3 billion – the full amount of outstanding principal and interest on the notes. The only causal link that Plaintiffs provide for this claim is that, had the Trustees given notice of Events of Default, Plaintiffs could have exercised their right to accelerate the notes and demand immediate repayment of their principal and interest. Obj. at 36. This claim suffers from the same problems as the other default-related claims discussed above. And it suffers from a further problem: If the Trustees had declared Events of Default, they would not have been obligated to use their own money to guaranty that the Notes were fully paid. By the time any Event of Default occurred (assuming it ever occurred), much of the damage had already been done.

To the extent Plaintiffs have other grounds for the claim that they are likely to recover 100% of their principal and income losses as damages against the Trustees, those grounds have never been explained. While the Receiver would be more than happy to hold the Trustees responsible for the full amount lost to Noteholders, neither the Receiver nor his counsel see how that is possible or more than remotely likely in light of the terms of the NISAs, the governing law, and the results of previous cases against indenture trustees.

E. The Receiver's Analysis Of Claims And Potential Damages.

The Class and Mass Plaintiffs' attack on the Receiver for not providing more information about his analysis of claims and damages is unwarranted. As set forth

in the Motion, the Court's responsibility when considering whether to approve the settlement "is not to decide the numerous questions of law and fact raised . . . but rather to canvass the issues and see whether the settlement 'fall[s] below the lowest point in the range of reasonableness.'" *In re Solafide, Inc.*, 2008 U.S. Dist. LEXIS 74851, at *4 (C.D. Cal. Sept. 22, 2008) (quoting in part *In re W.T. Grant Co.*, 699 F.2d 599, 608 (2d Cir. 1983)). The cases Plaintiffs cite do not modify or question that standard. Indeed, the cases they cite expressly agree with this standard and do not support the "mini-trial" that Plaintiffs seem to believe is necessary. *See, e.g., In re Wiley*, 2010 Bankr. LEXIS 781 at *11 (Bankr. D.N.M. Mar. 11, 2010) ("A mini-trial is not required; instead the Court must 'canvas the issues' raised by the parties."); *In re Coonrod*, 2010 Bankr. LEXIS 4717 at *19 (Bankr. D. Idaho Dec. 17, 2010) ("The case law requires Trustee to establish, in light of all the *A&C Props.* factors, that the settlement is based on 'proper business judgment' and 'falls above the lowest point in the range of reasonableness.'"). The Receiver was appropriately concerned that he not provide too much detail about the weaknesses of claims against the Trustees because he did not want to undermine Plaintiffs' claims, or his own, if the motion is denied.

Plaintiffs' specific criticisms of the Receiver's analysis are no more warranted. In many instances, Plaintiffs incorrectly suggest that the Receiver naively "accepted" the Trustees' arguments, when in fact the Receiver merely acknowledged the risk that those arguments might succeed and the consequences for the case if they did. In other instances, Plaintiffs assert arguments that the Receiver made (and that are reflected in his complaint) and for which he received value in the settlement. And in other instances, Plaintiffs' critique suggests a continued failure to acknowledge and address the facts or governing law.

1. The Receiver's Investigation and Discovery.

The Receiver and his counsel conducted a thorough investigation before entering into the settlement with the Trustees. Before settlement discussions began,

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the Trustees provided all of the documents that they had produced in the litigation to the Receiver's counsel and documents that had been produced to the SEC. Cialone Reply Decl., ¶ 13. The Receiver's counsel also had access to the Receiver's files, staff, and work-product. This work-product included, for example, the forensic accounting database that Plaintiffs' expert used for his damages analysis, which Plaintiffs' counsel received only in June or July 2012. *Id.* The Receiver's counsel reviewed innumerable documents in the course of analyzing the claims, including every single document that Plaintiffs submit with their Objection as exhibits to the Furakawa Declaration. *Id.* In light of the wealth of documentary evidence, the Receiver did not depose or interview witnesses employed by the Trustees, and Plaintiffs have not identified any deposition testimony that would overcome the obstacles to any default-based claim that are discussed above or that otherwise undermines the Receiver's view about the risks of further litigation.

2. Administrative Fees.

Plaintiffs assert that the Receiver, in analyzing the claims relating to payment of administrative fees, starts "[w]ith a baseline figure of $325 million, [then] quickly slashes well more than half to a range of $60 to $151 million, applying discounts for fees paid by MPI, whose investors were paid in full, and 'refunds' back to the MPFCs." Obj. at 29. Plaintiffs assert that "such 'offsets' have no bearing on the injured Noteholders here." Plaintiffs are wrong.

Nearly $90 million of the $325 million in administrative fees was paid by MPFC I. Seaman Reply Decl., ¶ 23. Neither the Receiver nor the Noteholders can seek damages based on fees paid by MPFC I, because that MPFC paid all noteholders in full. Plaintiffs admit that they do not represent the noteholders in MPFC I. Skorheim Decl., ¶13. They are not third-party beneficiaries of the NISA for MPFC I, and they do not have a basis on which to recover damages for money that was paid by MPFC I. Similarly, $60 million of administrative fees ($31 million from MPFC I and $29 million from MPFC II) was paid by Zion's, the

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original trustee for those MPFCs. Seaman Reply Decl., ¶ 24. Plaintiffs have never stated a theory on which they could recover damages from BNYM or Wells Fargo based on conduct by Zion's. Contrary to Plaintiffs' accusation, the Receiver did not start with a "baseline" claim of $325 million, and did not "quickly slash" from that claim the fees that were paid from MPFC I and/or paid by Zion's. Rather, the Receiver correctly recognized that those fees were never part of a claim against BNYM or Wells Fargo in the first place.

The claim was further reduced by refunds of administrative fees. In the Receiver's view, the maximum amount that any MPFC, or the noteholders in any MPFC, can recover based on improperly disbursed administrative fees is the *net* amount of administrative fees paid by that MPFC; a plaintiff cannot seek money that has already been refunded. Plaintiffs acknowledge that those refunds were used to pay noteholders, thus reducing their potential damages. Obj. at 14. But Plaintiffs nonetheless suggest that they or the Receiver should be entitled to seek compensation for administrative fees that were paid and later returned.

Plaintiffs base this argument on two theories. They claim that the Trustees improperly accepted these refunds "even though they were not permitted under the Agreements' specific lists of funds that could be deposited into the trust accounts." Obj. at 14, *citing* MPFC IV NISA, § 5.08(a). But those "specific lists" include "all other amounts to be deposited therein upon receipt of a direction in writing from the Debtor." MPFC IV NISA, § 5.08(a)(i)(C). Medical Capital Corporation ("MCC") was the agent for each of the MPFCs, and MCC wired these refunds directly into the Trust account (Seaman Reply Decl., ¶ 25) with wire instructions that constituted writings. Plaintiffs further argue that such refunds were part of perpetuating the Ponzi scheme. That may be true here, but that was not the only reason why administrative fees might have been returned. As discussed above, the NISAs allowed MCC to take administrative fees equal to the difference between the MPFCs' assets and liabilities, with the assets based on MCC's own determinations

and without leaving any cushion. *See supra* at 17. Even a legitimate business with this structure could face a shortfall as debtors unexpectedly defaulted or asset values changed and decide to return funds to prevent a default. In any event, the NISAs did not require the Trustees to determine the reasons why the Debtor's agent directed a deposit into the trust.[11] The Receiver correctly limited his claim to administrative fees that were paid by, and not returned to, MPFC II through MPFC VI while BNYM or Wells was Trustee.

The only true "offset" that the Receiver discussed in his Approval Motion was the potential offset for administrative fees that were used to pay broker-dealer commissions, which commissions could have been paid directly from the MPFCs under the NISAs. *See* Approval Motion at 9. Plaintiffs do not mention this offset or suggest any reason why it was inappropriate to take into account the risk that such offsets would apply to reduce the claims based on administrative fees from a high of $151 million to just $61 million of potential claims.

As for the rest of Plaintiffs' assertions regarding administrative fees, these are issues that the Receiver took into account and that are reflected in his Complaint. The Receiver also took into account the specific defenses to those issues. The Receiver alleged, for example, that administrative fees were to be paid only monthly. The Trustees would assert in response that, so long as the amount of fees paid in a given month did not exceed the total fees allowable for that month, this was not a breach or did not cause damages. The Receiver knows that administrative fees were improperly paid to Prodata and Medical Tracking Services, but the amounts involved were very small. And the Receiver secured a settlement that significantly exceeds any previous recovery against indenture

[11] Plaintiffs correctly note that Medcap shuffled money between MPFCs to provide such refunds. But Medcap almost uniformly moved money out of an MPFC for which Wells was Trustee and into an MPFC for which BNYM was Trustee (or *vice versa*), with the likely purpose of concealing their conduct.

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trustees, and that is $45 million higher than the net administrative fees paid by MPFC II through MPFC VI that were not used to pay broker-dealer commissions.

3. Offsets Based On Intercompany Transactions.

The Receiver disagrees with Plaintiffs' contention that their claims are not potentially subject to any offsets based on intercompany transactions. For example, between 2006 and 2008, MPFC III Series 1 advanced $25 million to Velocity. In May 2008, MPFC III Series 1 sold the loan, on which the entire principal and some interest was still due, to MPFC V for $25.3 million. Assuming both transactions were improper, do the Class and Mass Plaintiffs claim that those two transactions give rise to $50.3 million in damages? If not, then Plaintiffs' suggestion that every improper transaction between MPFCs creates recoverable damages with no offsets is incorrect.

Plaintiffs may believe that the Receiver's concern about such potential offsets was based on the view that he could not recover damages where money was paid to MPFC I. Skorheim Declaration, ¶9(b) ("Since the selling MPFC and the noteholders who were made whole are not members of the Plaintiff Class, the so-called 'offsets' are in fact irrelevant….") That belief would be incorrect. While the Receiver believes that payments *by* MPFC I are outside the scope of any party's claims, payments *to* MPFC I are not. This is one reason why the Receiver's Complaint is not brought on MPFC I's behalf. The intercompany transactions to which the Receiver referred in his Approval Motion are transactions between the later MPFCs, from MPFC II on. Cialone Reply Decl., ¶ 16.

4. Defenses Apply to Third Party Beneficiaries.

Plaintiffs' contend that certain "offsets" and defenses asserted by the Trustees only apply to the Receiver' claims, not their claims. *See, e.g.,* Obj. at 2, 22. This is incorrect. An intended beneficiary of a contract cannot assert greater rights against the "promisor" (the Trustees) than the rights available to the "promisee" (the MPFCs). *Souza v. Westlands Water Dist.*, 135 Cal. App. 4th 879,

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894 (Cal. App. 2006); *see also Marina Tenants Assn. v. Deauville Marina Development Co.*, 181 Cal. App. 3d 122, 132 (1986) ("Because the foundation of any right the third person may have is the promisor's contract, '[w]hen [a] plaintiff seeks to secure benefits under a contract as to which he is a third-party beneficiary, he must take the contract as he finds it." (citations omitted)). "[A] third party beneficiary that brings a contract claim steps into the shoes of the promisee and is therefore subject to any claim or defense that the promisor would have against the promisee." *Bituminous Coal Operators' Ass'n v. Connors*, 867 F.2d 625, 632 (1989); *see also First Hartford Corp. Pension Plan & Trust v. United States*, 194 F.3d 1279, 1289 (Fed. Cir. 1999) ("[A] party standing outside of privity by contractual obligation stands in the shoes of a party within privity."); *Benson v. Brower's Moving & Storage, Inc.*, 907 F.2d 310, 313 (2d Cir. 1990) ("Third party beneficiaries generally are subject to defenses that the promisor could raise in a suit by the promisee.") (citing J. Calamari & J. Perillo, The Law of Contracts § 17-8, at 623-24 (2d ed. 1977)). As third party beneficiaries, Plaintiffs stand in the shoes of the Receivership Entities and are subject to the same defenses as the Receiver.

5. Indemnity.

Plaintiffs also mistakenly suggest that the Receiver simply accepted the Trustees' indemnity claims and assumed they would prevail. The Receiver and his counsel are well aware of the factual and legal arguments by which he can oppose those claims. The Receiver pointed to the indemnity claims as part of his "worst-case scenario," which (by definition) assumes that the Trustees prevail on their indemnity claims. While that possibility may be unlikely, it still exists, and the Receiver cannot ignore the risk that the Noteholders who were already victimized by the principals of Medical Capital could lose a significant portion of the money the Receiver has already raised through his efforts to marshal and sell assets.

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6. Monte Carlo Simulation Or Other Statistical Analysis.

Plaintiffs also fault the Receiver for not conducting a "statistical" analysis, such as a Monte Carlo simulation. As discussed in the declaration of Christian Tregillis, such an approach is inappropriate here. Plaintiffs cite a case where a Monte Carlo analysis was allowed for calculating the volume of waste dumped by a chemical company at a particular site. *See Lyondell Chem. Co. v. Occidental Chem. Corp.*, 608 F.3d 284, 293-94 (5th Cir. 2010). But Plaintiffs do not and cannot cite any authority suggesting that a Monte Carlo simulation is appropriate to determine the likelihood of prevailing or obtaining any particular recovery on breach of contract claims, particularly where the contracts in question are unique and extremely complicated, as here. Nor does Plaintiffs' expert, James Skorheim, identify any instance in which Monte Carlo simulations were applied to estimate damages or outcomes in litigation involving breaches of contract by indenture trustees. Skorheim does not cite any data nor offer any basis for the inputs that he used to construct the simulation. Instead, he simply assumed, without any foundation or analysis whatsoever, that the range of possible outcomes fits neatly on a "bell-curve" and then ran a "simulation" based on such fictional assumptions.

Worse yet, Plaintiffs misconstrue Skorheim's report. Plaintiffs assert that Skorheim's simulation demonstrates that "the probability that the damages, net of litigation costs, are less than or equal to $104 million, is only 3.5%...." Obj. at 30. But Plaintiffs completely ignore that Skorheim himself assumed that ***the probability of losing the litigation entirely is 49.845%.*** Skorheim Report, Schedule H.[12] Thus, Plaintiffs' own expert believes, or is at least willing to assume, that the Trustees have nearly a 50% chance of winning at trial or on summary judgment, leaving the Noteholders with nothing and putting the money the Receiver has already raised in

[12] Mr. Skorheim incorrectly attributes his estimates of the probability of winning or losing the litigation to the Receiver. *Id.* In fact, these probability estimates are numbers that Mr. Skorheim appears to have simply made up, like the rest of the statistical inputs he used for his Monte Carlo simulation.

jeopardy by the Trustees' potential indemnity claims.

III. THE PROPOSED SETTLEMENT IS PROCEDURALLY FAIR.

A. Noteholder Objections.

Plaintiffs assert that the Court must deny the Approval motion because the Noteholders object to the settlement. As the discussion above shows, the objections submitted by counsel for the Class and Mass Action rest on the view that Plaintiffs can recover vastly more money, which view is largely based on assumptions about Plaintiffs' default theory that are not warranted under the contracts at issue and the applicable law. The objections submitted by individual Noteholders reflect the view that the Trustees were supposed to serve as a gatekeeper and protect their investments – a view that is understandable, given the lies that Medcap principals told their victims, but a view that is not supported by the law or the NISAs and that the Court has already rejected.

Plaintiffs cite several cases regarding objections to proposed settlements in the bankruptcy context, but those cases are easily distinguished and do not support Plaintiffs' position. In *Walsh v. Hefren-Tillotson, Inc. (In re Devon Capital Mgmt.)*, 261 B.R. 619 (Bankr. W.D. Pa. 2001), the settlement agreement was approved but the request for a bar order was denied because the objectors were third parties who were neither members of the class nor creditors of the entity in bankruptcy. As the court stated, the bar order would preclude their claims against the settling parties but "[n]o consideration flows to them in exchange for the bar order." *Id.* at 624. In *Connecticut Gen. Life Ins. Co. v. United Cos. Fin. Corp. (In re Foster Mortgage Corp.)*, 68 F.3d 914 (5th Cir. 1995), the appellate court vacated a settlement between a debtor subsidiary and its parent company that was opposed by nearly all creditors. The appellate court was "trouble[d]" by the relationship between parent and subsidiary and the nature of the compromise and held that the lower court did not adequately scrutinize the settlement between "insiders" as required. *Id.* at 918-19. The court was "careful to add that we are creating no per

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se rule allowing a majority of creditors in interest to veto a settlement." *Id*. at 919. In *In re Qmect, Inc.*, 359 B.R. 270 (Bankr. N. D. Cal. 2007), the proposed settlement was not likely to result in any distribution to any non-superpriority creditors. Moreover, the court agreed with the objecting creditors that the trustee, who apparently entered into the settlement only three weeks after being appointed, had engaged in only a cursory review of the merits of the litigation proposed to be settled. *Id*. at 272.

The facts of this case are distinctly different from the facts in *Devon*, *Foster*, and *Qmect*. First, the Receiver engaged in an extensive analysis of the claims against the Trustees, from the time conflicts counsel was appointed in mid-2010 to the time the settlements were reached at mediations in early 2012. Second, the settlement between the Receiver and the Trustees was an arms-length agreement that was reviewed and approved by the SEC. Finally, most of the net proceeds of the settlement will flow to the Noteholders in exchange for the bar order, and thus anyone affected by the bar order will receive consideration.

In re AWECO, *Inc.,* 725 F.2d 293 (5th Cir. 1984) and *In re Masters Mates & Pilots Pension Plan*, 957 F.2d 1020 (2d Cir. 1992), are likewise inapposite. In *AWECO*, the appellate court vacated the bankruptcy court's approval of a settlement because the court did not receive adequate information regarding the value of the debtor's assets and the settlement favored junior over senior creditor claims. In *Masters Mates*, the party objecting to the settlement was a non-settling defendant who argued that the court had not adequately considered the relative fault of the jointly and severally liable defendants before approving the plaintiff's settlement with the other defendants. Those cases have no application here.

B. <u>The Decision Not To Involve Plaintiffs' Counsel.</u>

The Receiver has already set forth his reasons for not involving Class and Mass Action counsel in discussions with the Trustees. The parties' entirely different views of the litigation, the intense disputes between the groups of

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Plaintiffs' counsel, and the express threats from affiliates of Mass Action counsel fully justified that decision. The Receiver informed all parties through his public Reports that he intended to engage in pre-litigation settlement discussions with the Trustees, before those discussions even began. Moreover, all of the parties have now participated in mediation, in sessions held in July and August (*see* Doc. No. 363), but the results have not changed.

The cases Plaintiffs cite do not call the Receiver's decision into question. Plaintiffs mischaracterize two of those cases, *In re Wiley* and *In re Coonrod*. In *Wiley*, the proposed settlement was rejected because the trustee "had not sufficiently addressed" the factors of the applicable test to allow the court "to determine the strengths and weaknesses of the various claims as a whole," not, as Plaintiffs contend, because the creditors were not consulted during the negotiation process. 2010 Bankr. LEXIS 781 at *16. While the court stated "[a]s a final note" that the other creditors objected to the proposed settlement, it also stated, citing *Foster*, the following:

> No case holds that the creditors have an absolute "veto power." Instead, the court should consider the creditors' reasonable views.

Id. (Citations omitted).

The facts of *Coonrod* are likewise significantly different than the facts here, despite Plaintiffs' attempt to align the two. First and foremost, the debtors' bankruptcy counsel failed to represent the debtors at the settlement approval hearing. . 2010 Bankr. LEXIS 4717 at *7, 13-14. The court held that "[t]he extent of prejudice [the debtors] have suffered prohibits the Court from validating the compromise over their pro se objection." *Id.* at *13-14. Second, the trustee proposed the settlement of the debtor's discrimination claim without having consulted the debtors or the attorney representing the debtors in the discrimination suit. *Id.* at *9-10. Third, the proposed settlement failed to address important aspects of the discrimination claim, including nonmonetary claims and ongoing

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retaliation claims. *Id*. at *16.

Finally, Plaintiffs' reference to a number of cases addressing due process rights in the class action context is a red herring. *See* Obj. at 38. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985), *Hanlon v. Chrysler Corp*., 150 F.3d 1011 (9th Cir. 1998), and *Brown v. Ticor Title Ins. Co.*, 982 F.2d 386 (9th Cir. 1992) are part of a body of law requiring adequate representation of class members by class counsel and named plaintiffs. The Receiver does not dispute this law, but it is not at issue here. There is no due process concern where the Class and Mass are vigorously represented by counsel and the Receiver has entered into a settlement that will benefit all Noteholders – both the Class and Mass Plaintiffs and unrepresented Noteholders – and that was reviewed and approved by the SEC.

C. Alleged Conflicts.

Plaintiffs attack not only the settlement, but the Receiver himself and his counsel. Those attacks are unwarranted and do not undermine the validity of the settlement with Wells Fargo (let alone the validity of the settlement with BNYM). As shown in the declaration of Robert Kehr, and supported by the declarations of John Bulgozdy, Frank Cialone, Michael Farrell, and Thomas Seaman, the Receiver did not have a conflict in pursuing claims against Wells Fargo, the Receiver appropriately relied on conflicts counsel to investigate and pursue claims against the Trustees and to negotiate the terms of the settlement, and the Receiver's conflicts counsel at Shartsis Friese appropriately consulted with the Receiver's counsel at Allen Matkins regarding specific receivership procedural issues.

IV. EXTINGUISHING PLAINTIFFS' AND NOTEHOLDERS' DERIVATIVE CLAIMS IS NECESSARY AND PROPER.

A. The Receiver's Exclusive Standing.

The legal basis for the Receiver's assertion that he has the exclusive authority to settle claims against the Trustees based on breach of the NISAs and that Plaintiffs cannot continue their own claims for breach has been briefed in detail by

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the Receiver and the Trustees. Plaintiffs, nevertheless, continue to deny the compelling legal authority and contend that their status as third-party beneficiaries trumps the Receiver's argument and necessitates that their claims be allowed to continue. Plaintiffs are wrong as to the facts and the law.

The Receiver does not deny that Plaintiffs are third-party beneficiaries, that third-party beneficiaries typically have standing to sue for breach of contract, and that Plaintiffs would have standing against the Trustees but for the Receiver's decision to pursue and settle the Receivership Entities' claims against the Trustees. Plaintiffs' status as third party beneficiaries does not, however, change the fact that their injury (the nonpayment of the Notes) flows from the injury to the Receivership Entities (the dissipation of the MPFCs' funds). The injury to the MPFCs is what prevented them from making the required payments to the Noteholders and caused them to default on the Notes. Even if, as Plaintiffs contend, the NISAs provide them with certain rights and create certain obligations of the Trustees toward them, including rights and duties related to Events of Default, the injury to them is derivative of the injury to the MPFCs.

Since breaches of the NISAs caused direct injury to the Receivership Entities and indirect injury to all Noteholders, the Receiver has sole authority to resolve this claim. *See SEC v. Sharp Capital, Inc.*, 315 F.3d 541, 544 (5th Cir. 2003) ("If a cause of action alleges ***only indirect harm to a creditor (i.e., an injury that derives from harm to the debtor***), and the debtor could have raised a claim for its direct injury under the applicable law, then the cause of action ***belongs to the estate*** . . .. Conversely, if the cause of action does not explicitly or implicitly allege harm to the debtor, then the cause of action could not have been asserted by the debtor as of the commencement of the case, and thus is not property of the estate.'") (emphasis added; citation omitted)).

The derivative nature of the Plaintiffs' claims is likewise evident from the fact that none of their claims are unique or personal to any one Noteholder. *See,*

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e.g, Schimmelpenninck v. Byrne (In re Schimmelpenninck), 183 F.3d 347, 359-60 (5th Cir. 1999) (holding that a "common claim" is one that asserts "a generalized injury" that affects all claimants and that allowing only a receiver or trustee to bring common claims serves policy goals, including ensuring that funds rightfully owed to all claimants are distributed to all claimants). A common claim belongs to a receiver, not a creditor, even when the creditor is a third-party beneficiary of a contract bringing breach of contract claims. *See* Restat. 2d of Judgments, § 56, Com. (b) ("Although a person who is a third party beneficiary of a contract is not as such bound by the judgment in an action between the promisor and the promisee, he may be bound by virtue of other rules. Thus, if the promisee is also a trustee for the beneficiary, an action by the former is preclusive on the latter under the rule of § 41."); Restat. 2d of Judgments, § 41(1) ("A person who is not a party to an action but who is represented by a party is bound by and entitled to the benefits of a judgment as though he were a party. A person is represented by a party who is . . . [t]he trustee of an estate or interest of which the person is a beneficiary; or . . . [t]he executor, administrator, guardian, conservator, or similar fiduciary manager of an interest of which the person is a beneficiary . . ..").

Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972), on which Plaintiffs rely heavily, does not change this analysis. In fact, it supports it. In *Caplin*, the Court held that a reorganization trustee lacked standing to sue an indenture trustee on behalf of the debenture holders. *Id.* at 416. The primary basis for the *Caplin* Court's decision was that only the debenture holders, and not the corporation in reorganization, had claims against the indenture trustee. *Id.* at 429. The reorganization trustee sought to bring a claim on behalf of the debenture holders, not on behalf of the corporation. *Id.* Since the reorganization trustee only represented the corporation, the trustee could not bring a claim that did not belong to the corporation. *Id.*

Here, the situation is, of course, quite different. The Receiver is bringing

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1 contractual claims that belong to the Receivership Entities, based on breaches of the
2 NISAs entered into between the Receivership Entities and the Trustees and arising
3 out of injuries to the Receivership Entities. *Caplin* does not stand for the
4 proposition that the Receiver cannot bring such claims. *Caplin* stands only for the
5 unassailable proposition that a receiver or trustee cannot bring claims that belong to
6 creditors and not to the debtor/receivership entity. *Caplin*, moreover, is silent on
7 the important issue here as to whether a trustee or receiver has exclusive authority
8 to bring claims that arise from injury to the debtor/receivership entity.

9 It is important to note that another basis for the Court's decision in *Caplin*
10 was that a suit by the reorganization trustee "on behalf of debenture holders may be
11 inconsistent with any independent actions that [the debenture holders] might bring
12 themselves. Petitioner and the SEC make very plain their position that a suit by the
13 trustee in reorganization does not pre-empt suits by individual debenture holders."
14 *Id*. at 431-32. Thus, "if the indenture trustee wins the suit brought by the trustee in
15 reorganization, unless the debenture holders are bound by that victory, the
16 proliferation of litigation that petitioner seeks to avoid would then ensue." *Id*. at
17 432. This, of course, is precisely the situation that the law regarding the exclusive
18 authority of the receiver is designed to address.

19 **B. <u>The Requested Injunction</u>.**

20 Plaintiffs also contend that the injunction against derivative Noteholder
21 claims provided for in the settlement is improper, but this contention is conclusory
22 and unsupported by the case law. Plaintiffs do not offer any compelling reason
23 why the cases cited by the Receiver in the Approval Motion – in which similar
24 injunctions were issued in similar situations – should not be followed here. Instead,
25 Plaintiffs attempt to rely on cases based on vastly different factual situations and
26 entirely different governing law.

27 Plaintiffs first refer to a series of bankruptcy cases: *In re Lowenschuss*, 67 F.
28 3d 1394 (9th Cir. 1995), *In re Maxitile Inc.*, 237 Fed. Appx. 274 (9th Cir. 2007), *In*

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re Digital Impact, 223 B.R. 1 (Bankr. N.D. Okla. 1998), *In re Coram Healthcare Corp.*, 315 B.R. 321 (Bankr. D. Del. 2004), and *In re Arrowmill Dev. Corp.*, 211 B.R. 497 (Bankr. D.N.J. 1998). These cases all hold that a bankruptcy court does not have the authority under the Bankruptcy Code to release non-debtors from third-party claims. However, these cases do not hold that a bar order is *per se* improper or otherwise support Plaintiffs' claim that a bar order is unjustified here.[13]

The other body of cases that Plaintiffs rely on to contest the injunction is likewise inapposite and unhelpful to their argument. Those cases all address bar orders in the context of partial settlements involving some but not all defendants. *See, e.g., In re Heritage Bond Litig. v. U.S. Trust Corp.*, 546 F.3d 667, 671 (9th Cir. 2008) ("We hold that bar orders issued pursuant to the PSLRA or section 877.6 may only bar claims for contribution and indemnity or disguised claims for such relief."); *TBG, Inc. v. Bendis*, 36 F.3d 916,928 (10th Cir. 1994) (holding orders barring contribution claims permissible if proportional fault is determined). As with the bankruptcy court cases above, none of these partial settlement bar order cases requires or militates in favor of denying the injunction requested here.

Unlike Plaintiffs, the Receiver has cited in the Approval Motion cases where courts facing factual situations similar to the situation here, including two cases involving SEC receiverships, have issued bar orders. *See* Motion at 23-25. Plaintiffs ignore some of these cases and their attempts to distinguish the others are without merit. The requested injunction is a proper and necessary means to promote the orderly and efficient administration of the Receivership Estate.

V. CONCLUSION

The Receiver respects the zeal of counsel for the Class and Mass Action Plaintiffs to do justice for the Noteholders. The Receiver shares their desire to

[13] In fact, the *Digital Impact* court notes, in *dicta*, that non-debtor releases are allowed where "claimants are channeled to a fund or trust" because the "salient feature" of these cases is that they do not result in claimants "being denied a right to recovery." 223 B.R. at 9. Here, the result is the same: Noteholders are not denied recovery because they will benefit from the Receiver's settlement.

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achieve the greatest benefit for the stakeholders in Medical Capital, but the approach to these claims must be tempered by the law and the facts, and by the need to minimize further costs, risks, and delays. The Receiver and his conflicts counsel worked long and hard examining the facts and the law for sustainable bases to hold the Trustees liable for the losses suffered directly by the Receivership Entities and indirectly by the Noteholders. The Receiver's analysis was guided by the following incontrovertible factors, among others:

- The duties of an indenture trustee are limited to the terms of the indenture agreement, and the rights of the Receivership Entities and the Noteholders are limited by the terms of the NISAs.
- Indenture agreements in general, and these NISAs in particular, are drafted to insulate the indenture trustees from liability and to minimize the factual situations giving rise to a claim for breach of the indenture agreements.
- Wells Fargo and BNYM, as indenture trustees, are legally responsible only for damages proximately caused by their breaches of the NISAs.
- The Noteholders suffered losses exceeding $800 million in principal (MI/MO) at the hands of the managers of MedCap, some of which was due to fraud and some of which was due to market conditions, poor investment decisions, and under-utilization of capital.
- The ultimate inquiry in this case is whether the indenture trustees released MPFC money to MedCap in breach of the terms of the NISAs or committed other breaches of the NISAs, and whether and to what extent those breaches proximately caused damage to the MPFCs (and, through the MPFCs, to the Noteholders).

By evaluating the issues and vigorously pursuing his claims through an arm's-length mediation, the Receiver secured a $106 million settlement that far exceeds the results in any known case involving indenture trustees and that will allow for the return of substantial funds to the Noteholders without more months and years of delay. The Receiver would like to see the Noteholders get more, but the Receiver needed to acknowledge, and the Court should recognize, that there is a significant chance that further litigation would only result in the Noteholders getting much less. For the foregoing reasons, the Receiver's Motion to Approve the Settlement should be GRANTED and the Court should approve the Receiver's Settlement with Wells Fargo and BNYM.

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Responses, Replies and Other Motion Related Documents

8:09-cv-00818-DOC-RNB Securities and Exchange Commission v. Medical Capital Holdings Inc et al
(RNBx), DISCOVERY

UNITED STATES DISTRICT COURT for the CENTRAL DISTRICT OF CALIFORNIA

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Docket Text:
REPLY in support MOTION for Settlement Approval of Settlement with Wells Fargo Bank, National Association and Bank of New York Mellon *Proof of Service of Notice of Motion and Motion for Approval of Settlement with Wells Fargo Bank National Association and Bank of N[726] Receiver's Reply Memorandum of Points And Authorities In Support of Receiver's Motion for Approval of Settlement with Wells Fargo and Bank of New York Mellon filed by Receiver Thomas A Seaman. (Cialone, Frank)*

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