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UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

SOUTHERN DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

MEDICAL CAPITAL HOLDINGS, INC., *et al.*,

Defendants.

Case No. SACV 09-818 DOC (RNBx)

REPLY MEMORANDUM OF POINTS AND AUTHORITIS OF THE BANK OF NEW YORK MELLON IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF SETTLEMENT WITH TRUSTEES

Date: October 15, 2012
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TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. THE APPROVAL MOTION SHOULD BE GRANTED 4

A. The Receiver Demonstrated His Knowledge of the Evidence that Plaintiffs Have Only Recently Learned 4

B. Plaintiffs' Newly Minted Damage Theory Is Deeply Flawed and Does Not Provide a Basis for a Finding that the Settlement Is Unfair or Inequitable 7

1. This Court Has Already Held that a Delay in the Submission of Documentation Does Not Constitute a Material Breach of the NISAs 9

2. MedCap Would Have Cured any Document Deficiency Upon Notice of a Potential Event of Default by BNYM 10

3. Plaintiffs' Counsel's Damage Analysis Does Not Account for Significant Offsets 12

4. Plaintiffs' Counsel's Analysis of the Case Ignores Fundamental Causation Issues Plaintiffs (and the Receiver) Face 16

C. The Settlement Was Negotiated in Good Faith 22

1. The Settlement Followed an Arduous, Arms-Length, Good Faith Negotiation 22

2. The Absence of Plaintiffs' Counsel from the Negotiations Was Appropriate and Did Not Alter the Arms-Length Nature of the Settlement 22

III. CONCLUSION 25

TABLE OF AUTHORITIES

Page

CASES

In re Bankers Trust Co.,
450 F.3d 121 (2d Cir. 2006) 10

Semi-Tech Litig., LLC v. Bankers Trust Co.,
353 F. Supp. 2d 460 (S.D.N.Y. 2005) 9

The Bank of New York Mellon ("BNYM") respectfully submits this Reply memorandum in support of the Receiver's Motion for Approval (the "Approval Motion") of the Settlement with BNYM and Wells Fargo Bank, N.A. ("Wells Fargo") (together, the "Trustees").[1]

I. INTRODUCTION

BNYM has agreed to contribute $57 million to the $106 million settlement negotiated by the Court-appointed Receiver, Thomas Seaman (the "Settlement"). The effectiveness of the Settlement is conditional upon this Court's approval as well as other express conditions including, among other things, the granting of the Trustees' pending motions for summary judgment in each of the three Noteholder Actions.[2]

BNYM supports the approval of the Settlement. The Settlement is fair and equitable and in the best interests of the receivership estate and all of its creditors, including the Noteholders and the SPCs on whose behalf the Receiver has asserted and resolved claims against the Trustees.

Plaintiffs' Counsel[3] in their objection to the Settlement (the "Objection") attack the Settlement, the Receiver, and his counsel with a number of arguments. Putting aside the name-calling and vitriol, only two issues are relevant to the

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[1] On July 16, 2012, BNYM filed a joinder in the Approval Motion and reserved its right to file a Reply memorandum in support of the Approval Motion.

[2] The Noteholder Actions are brought on behalf of individuals (the "Noteholders") who purchased promissory notes (the "Notes") from special purpose corporations ("SPCs") affiliated with Medical Capital Holdings, Inc. (collectively, "MedCap"). The SPCs are Medical Provider Financial/Funding Corporation ("MP") II through MP VI. The Noteholder Actions include: (1) a class action brought on behalf of Noteholders in MP II through MP VI, captioned *Masonek, et al. v. Wells Fargo Bank, National Association, et al.*, Case No. SACV 09-1048 DOC (RNBx); (2) a mass action brought on behalf of approximately 315 Noteholders, captioned *Bain, et al. v. Wells Fargo Bank, National Association, et al.*, Case No. SACV 10-0548 DOC (RNBx); and (3) a mass action brought on behalf of approximately 1,700 Noteholders, captioned *Abbate, et al. v. Wells Fargo Bank, National Association, et al.*, Case No. SACV 10-6561 DOC (RNBx).

[3] Plaintiffs' Counsel consist of counsel for the *Masonek* plaintiffs ("*Masonek* Counsel"), counsel for the *Bain* plaintiffs ("*Bain* Counsel"), and counsel for the *Abbate* plaintiffs ("*Abbate* Counsel").

Court's determination of whether the Settlement is fair, equitable, and in the best interests of the receivership estate.

First, does the amount of the Settlement fall within the range of reasonableness? Put differently, is the $106 million Settlement within the range of recovery that could be reasonably expected to be achieved if the Noteholder Actions and/or the Receiver's action were to proceed to trial? The answer to this question is a resounding "yes." The $106 million figure is clearly well within the range of the Receiver's transaction by transaction damage analysis based upon the Trustees' alleged breaches of the Note Issuance and Security Agreements ("NISAs") between each of the Trustees and each SPC. And the $106 million Settlement is also well within the range of damages under Plaintiffs' Counsel's new alternative damage theory, when properly understood.

Second, was the Settlement negotiated in good faith? The answer to this question too is, unequivocally, "yes." The record demonstrates an arms-length, good faith, vigorous negotiation pursuant to a JAMS mediation.

Accordingly, the Settlement should be approved.

BNYM recognizes that the Receiver will submit a detailed reply to Plaintiffs' Counsel's Objection. In addition to affirming that BNYM believes the Settlement should be approved by the Court, in this brief, BNYM makes three points that respond directly to the Objection.

First, Plaintiffs' Counsel spend many pages in the Objection detailing allegations of wrongdoing by the Trustees and arguing that they should pay more as a result of their alleged breaches of the NISAs. BNYM vigorously denies the allegations, but the Approval Motion is not the occasion to debate the merits of Plaintiffs' Counsel's contentions about whether BNYM breached the NISAs. The real issue for purposes of the Approval Motion is whether Plaintiffs' Counsel have raised any ***new*** material facts, ***not known to the Receiver***, that throw doubt on whether the Receiver was in a position to negotiate a fair and equitable settlement

with the Trustees. Significantly, Plaintiffs' Counsel fail to address this issue with any facts. As outlined in this brief, the issue underscores Plaintiffs' Counsel's apparent failure for nearly two years to read and understand the documents produced by the Trustees and the facts of this case. The Receiver and his counsel were not dilatory; they reviewed the documents and confronted the Trustees with allegations and arguments that at least had some connection to the documents.

Second, Plaintiffs' Counsel have proffered a newly minted damage analysis that they claim is superior to the Receiver's transaction by transaction damage analysis because it will yield a higher range of damages against the Trustees. However, Plaintiffs' Counsel's Event of Default damage analysis is, on its face, inconsistent with this Court's prior rulings and the facts adduced in this case demonstrating MedCap's behavior. More importantly, when the Event of Default damages analysis is reviewed on its own terms, it is clear that it does not yield a greater range of likely damages caused by the Trustees than the Receiver's transaction by transaction analysis. In short, the Event of Default damage analysis—the heart of Plaintiffs' Counsel's Objection—does not demonstrate that the Settlement is not within the range of reasonableness. To the contrary, it confirms that the Receiver's range of damages in a transaction by transaction approach is reasonable.

Third, the Settlement was the product of standard arms-length negotiations between adversaries, separately represented, and under the auspices of a well-respected JAMS mediator. The Receiver did not pull any punches. There were no side-deals.

The $106 million Settlement is exactly what it purports to be—a significant payment by the Trustees, following vigorous negotiations, to end contested litigation in which the parties face various legal and factual challenges. Complaints by Noteholders that the Settlement is inadequate are not a legal reason to reject it. The law supports its approval as a good faith settlement that well exceeds the lower

end of any reasonable range of damages allegedly caused by the Trustees.

II. THE APPROVAL MOTION SHOULD BE GRANTED

A. The Receiver Demonstrated His Knowledge of the Evidence that Plaintiffs Have Only Recently Learned

Plaintiffs' Counsel devote much of their Objection to reciting instances of alleged breach of the NISAs by BNYM (and by Wells Fargo). Plaintiffs' Counsel then premise their Objection on the unfounded assumption that "the amount of [the Receiver's] proposed settlement does not reflect this overwhelming evidence [of the Trustees' breaches of the NISAs]" because "the Receiver settled with minimal discovery and does not appear to have all of the information the Noteholders obtained" and "does not state that he reviewed (let alone obtained) all the Bank documents produced to the Noteholders." (Objection at 20, 22.)

Plaintiffs' Counsel's statement drips with unintended irony.

From BNYM's perspective, the most notable thing about the Noteholder Actions has been Plaintiffs' Counsel's failure to discover and develop the record in order to get to trial. BNYM is not complaining; Plaintiffs' Counsel were likely pressed by other business. However, Plaintiffs' Counsel's statement that the Receiver "does not appear to have all the information the Noteholders obtained" deserves some scrutiny.

From September 11, 2009, when the first of the Noteholder Actions was filed, until February 8, 2012, Plaintiffs' Counsel, consisting of eight separate law firms in their three related actions, did not take a single deposition of any Trustee witness.[4] Instead, Plaintiffs' Counsel spent most of that two-and-a-half years filing amended complaint after amended complaint in a futile attempt to state a tort claim and in an unending public war between the counsel for the class plaintiffs (*Masonek* Counsel) and counsel for the largest of the two mass actions (*Abbate* Counsel).

[4] Indeed, most of the depositions to that point were taken by the Trustees of the lead plaintiffs in the class action. Plaintiffs' Counsel also deposed two third-party witnesses of minor importance.

The most stunning fact that came out during those two-and-a-half years of motions to dismiss and Plaintiffs' Counsel's internecine warfare: Plaintiffs' Counsel had failed to read the documents that the Trustees had produced to them beginning in September 2010.

Thus, for example, for the first time, Plaintiffs' Counsel now parade in their Objection documentary evidence that MedCap had repeatedly failed to provide BNYM with certain compliance documentation. That evidence had been produced to Plaintiffs' Counsel many years earlier, but they never once cited to it in their complaints; they never once attached it or described it in any of their briefings on the numerous motions to dismiss and motion for class certification. And a review of those briefs will remind the Court that Plaintiffs' Counsel did not hesitate to attach evidence that they believed showed wrongdoing by the Trustees—they just never bothered to attach copies of the evidence that they now contend in their Objection makes a $106 million settlement inadequate. Equally telling, they never asked BNYM's Rule 30(b)(6) witness about it at his day-long deposition in February 2012.

Plaintiffs' Counsel's failure to make anything of this evidence for two years cannot be reasonably explained as a strategic choice or caused by the lack of an opportunity to raise it. The explanation is simpler: They had not read the documents produced to them.

Examples of Plaintiffs' Counsel's failure to read the documents produced to them abound. For instance, Plaintiffs allege BNYM released money for the purchase of non-receivable assets even though it had not received from MedCap the underlying "purchase documents" required under the NISAs. (*See, e.g.*, *Masonek* Third Am. Compl. (10-ML-2145 D.E. 147) ¶ 75.) But BNYM's files—all of which were produced to Plaintiffs over two years ago—include the requisite purchase documents in connection with MedCap's requests to purchase non-receivable

assets.[5] Accordingly, Plaintiffs' claim that BNYM breached the NISAs by releasing money for the purchase of non-receivable assets without the requisite purchase documents is factually wrong—as demonstrated by BNYM's documents produced to Plaintiffs long ago.

To the chagrin of BNYM, the Receiver did not assert such readily demonstrably false allegations in his negotiations with BNYM (or in his Complaint) that could be merely batted away by pointing to the very documents in his possession. Unlike Plaintiffs' Counsel, the Receiver read the documents produced by the Trustees (a copy of the exact same set produced earlier to Plaintiffs' Counsel) soon after he received them, and he read MedCap's documents. From BNYM's vantage point, the difference in the knowledge of the facts on the part of the Receiver and his counsel and Plaintiffs' Counsel was the difference between night and day.[6]

BNYM submits that, for purposes of determining the Approval Motion, the only relevant question about the evidence is whether Plaintiffs' Counsel can identify any new material evidence that the Receiver did not have and should have had in negotiating the Settlement. Plaintiffs' Counsel have not done that and cannot do that because there is nothing new. All the documents were in the Receiver's possession and reviewed and analyzed by his counsel. It is true that for the past month, Plaintiffs' Counsel have been scrambling to take depositions of the Trustees' current and former employees.[7] (Plaintiffs' Counsel took their first

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[5] In one instance, relating to a $13 million promissory note to Dermacia Inc., the purchase documents are in Wells Fargo's files, as the asset was transferred from MP III (for which Wells Fargo served as indenture trustee) to MP IV. Plaintiffs will not be able to prove that any failure by BNYM to receive the underlying purchase documents for this single asset resulted in any loss, particularly where another Trustee, Wells Fargo, did have copies of these documents in its files.

[6] The Court may fairly ask why, if BNYM viewed Plaintiffs' Counsel as so ignorant of the facts, BNYM chose to negotiate with the Receiver, the one adverse party that had reviewed the documents and could speak knowledgeably about the evidence. The reason is explained in Section II.C.2, *infra*.

[7] Plaintiffs' Counsel deposed BNYM's Rule 30(b)(6) witness on February 10,

deposition of a BNYM witness, other than the Rule 30(b)(6) witness, on September 7, 2012.) But those depositions have not produced any new material facts not already set forth in the documents. And that is hardly surprising. This is a case involving literally thousands of financial transactions. The gravamen of Plaintiffs' claim is that the Trustees breached the NISAs when they released funds improperly because they did not have in their possession at the time of the release of funds the proper documents, in the proper form, with the proper wording. These transactions are often more than six years old; not surprisingly, the memories of witnesses, if they exist at all, are often dependent upon the documents. It is a classic document case, and Plaintiffs' Counsel are demonstrably late to the table in reviewing and understanding the documents. By contrast, the Receiver and his counsel did their job.

B. Plaintiffs' Newly Minted Damage Theory Is Deeply Flawed and Does Not Provide a Basis for a Finding that the Settlement Is Unfair or Inequitable

Plaintiffs' Counsel claim the Noteholders have losses exceeding $1 billion. However, the Noteholders have legal and factual challenges in tying their losses to the alleged breaches of the NISAs by the Trustees because damages from a breach of contract are limited to the injury directly caused by the breach.

The Receiver attempted to solve this problem by his transaction by transaction approach to damages, examining each release of funds by the Trustees. This is the approach that was the basis for the negotiations that resulted in the $106 million Settlement.

Although Plaintiffs' Counsel make some unsupported comments about the Receiver's transaction by transaction approach, their main complaint is that the transaction by transaction approach does not yield a damage number that satisfies

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2012. Remarkably, the remainder of discovery against BNYM in this case has been jammed into the six week period of August 28, 2012 to October 19, 2012, the end of fact discovery.

them. Of course, the fact that a breach of contract theory does not result in damages equal to the Noteholders' loss is hardly a surprise to anyone. No doubt that is why Plaintiffs' Counsel toiled for nearly two years filing amended complaint after amended complaint in a futile search for a tort theory, each of which this Court rejected.

The heart of the Objection is that Plaintiffs' Counsel have a new approach to damages—a so-called Event of Default damage analysis. Under this theory, a Trustee's breach is its failure to declare an Event of Default following the failure of the MedCap SPC to provide compliance documents to the Trustee in a timely manner. Under the Event of Default damage analysis, damage is caused to those persons who purchased Notes from the MedCap SPC after the date of this hypothetical Event of Default because, according to this theory, those Noteholders would not have purchased the Notes had the Event of Default been declared by the Trustees.

On its face, the Event of Default damage analysis presents a conceptual problem of how a Noteholder can sue the Trustee for a breach of the NISA that allegedly occurred prior to the Noteholder's purchase of the Note, *i.e.*, before that individual could have standing to sue as a third-party beneficiary of the NISA. However, legal and conceptual concerns to one side, taken on its own terms, the Event of Default damage analysis is unsound.

Section 7.01(c) (or 6.01(c)) of each NISA provides that a ***material breach*** by MedCap of its obligations under the NISAs could constitute an Event of Default if that breach is not remedied by MedCap within 30 days after BNYM (or Wells Fargo) has provided notice of the breach to MedCap. This NISA provision provides the basis for Plaintiffs' Counsel's Event of Default damage analysis.[8]

Plaintiffs' Counsel make two core assumptions in their Event of Default

[8] Plaintiffs make similar arguments based upon Section 7.01(b) (or 6.01(b)) of each NISA.

damages analysis: (1) As soon as MedCap was a single day late in submitting a periodic compliance document required by the NISAs, BNYM should have provided notice of a potential Event of Default to MedCap; and (2) MedCap would have failed to cure that purported default in the requisite 30 days, which would have led BNYM to declare an Event of Default. Both of these assumptions are fundamentally wrong.

1. This Court Has Already Held that a Delay in the Submission of Documentation Does Not Constitute a Material Breach of the NISAs

Plaintiffs' Counsel's argument that a delay in the provision of documents would constitute a material breach under the NISAs that would trigger BNYM's obligation to provide notice of a potential Event of Default flies in the face of this Court's prior rulings. This Court has already held, as a matter of law, that "late-filed documents [a]re not a material breach going to the essence of the NISAs." Second *Abbate* Order (10-6561 D.E. 227) at 9. Indeed, with respect to allegations that MedCap had submitted certain required documents to Wells Fargo ***seven months late*** (*Masonek* Second Am. Compl. (10-ML-2145 D.E. 104) ¶ 145), this Court held: "Because tardiness in submitting documents does not go to the essence of the agreement, it is not a material breach. *Cf. Semi-Tech Litig., LLC v. Bankers Trust Co.*, 353 F. Supp. 2d 460, 485 (S.D.N.Y. 2005) (approving citing testimony from an expert on trust administrations stating that he could not recall a single instance in which notice to noteholders was given after a trustee received non-conforming documentation)." Second *Masonek* Order (10-ML-2145 D.E. 143) at 11; *see also* First *Abbate* Order (10-6561 D.E. 196) at 4.

Plaintiffs' Counsel insist that "[t]he Court has agreed that the Trustees' failure to obtain required documents from MedCap could constitute a material breach under the NISAs." (Objection at 31.) But the Court's opinion was far more precise than Plaintiffs' Counsel contend. The Court held that there was a question of fact as to whether "certain required documents" that "were, in fact, never

submitted" by MedCap could be "material for the purposes of declaring an Event of Default." (Second *Abbate* Order (10-6561 D.E. 227) at 9–10.) The Court has never held that a mere delay in the provision of required documents could constitute a material breach. Indeed, it has held the exact opposite. Plaintiffs' Counsel cannot twist the Court's words to support their nonsensical argument that ***any delay*** in MedCap's provision of documents, even a delay of ***a single day***, could somehow trigger an Event of Default.

2. MedCap Would Have Cured any Document Deficiency Upon Notice of a Potential Event of Default by BNYM

The second assumption of Plaintiffs Counsel's argument—that when faced with an Event of Default that would have provided BNYM with the ability to accelerate the Notes and in effect shut down MedCap's business, MedCap would have failed to cure its document deficiencies—is nothing short of absurd.

There is ***overwhelming evidence*** that, had BNYM threatened to declare an Event of Default unless and until the purported document deficiencies were cured, MedCap simply would have provided BNYM with whatever additional documentation was necessary to keep the funds flowing. *See In re Bankers Trust Co.*, 450 F.3d 121, 129–30 (2d Cir. 2006) ("Plaintiff failed to show that any breach of [indenture trustee's] duties was the cause of any loss to the Noteholders" where "[s]o far as the evidence shows, had [the indenture trustee] been aware of the nonconforming language [in the certificates submitted by the issuer], it would have sought and received conforming certificates from [the issuer]" and thus the indenture trustee "would not have been required to give the Noteholders any notice of default.").

In the first instance, each of the compliance documents that Plaintiffs' Counsel allege were provided late were certificates or schedules that ***MedCap created***, based on information that ***MedCap unilaterally determined***. It defies logic to assume that MedCap would not have simply generated and provided these

documents to BNYM if BNYM had taken the extraordinary step of noticing a potential Event of Default on the basis of late documents. This is particularly true given that MedCap knew BNYM was not obligated to look behind the paperwork it received or analyze that information in any way.

Moreover, the Receiver, the SEC, and the DOJ have alleged that the principals of MedCap engaged in fraudulent, even criminal, conduct and indeed one of MedCap's principals, Joe Lampariello, has pleaded guilty to such conduct. The Receiver has identified in his forensic accounting report numerous specific instances in which MedCap submitted fraudulent documentation to the Trustees. (*See* Receiver's Forensic Accounting Report (09-0818 D.E. 608) at 24–30.) And the Receiver has identified at least one instance where MedCap went so far as to create (and place in its internal files) fake account statements purportedly from Washington Mutual in order to make it appear that a loan funded by the SPCs was making payments. Indeed, the forgery was so good that the Receiver did not even realize these statements were fake until after he subpoenaed Washington Mutual and was informed by that bank that the statements were false and had been altered. (*Id.* at 31–32.)

Given this clear evidence that MedCap was ready, willing, and able to submit false documentation to the Trustees (and even to forge third-party documents when needed to cover up the true facts), and given that the Receiver's forensic accounting found that MedCap's principals personally profited by at least $28 million from the continued operation of their alleged scheme (*id.* at 37–38), the only reasonable conclusion is that ***MedCap would have supplied whatever documentation BNYM allegedly should have demanded in order to keep the funds flowing***.

Indeed, when BNYM and Wells Fargo did ask for late documentation from MedCap, MedCap submitted the requested documents. Plaintiffs' Counsel point to instances where MedCap did not immediately submit the requested documents to the Trustees, and argue that MedCap would not have cured the document

deficiencies within 30 days if the Trustees had provide notice of a potential Event of Default. (Objection at 34.) This is nonsense. In each of those instances, the Trustees simply made an informal request of MedCap for late documents. Surely, Plaintiffs' Counsel can appreciate the difference between an informal request for a document and a formal notice under the NISAs of a potential Event of Default, non-compliance with which would entail an actual Event of Default that would stop the flow of funds for MedCap.

3. Plaintiffs' Counsel's Damage Analysis Does Not Account for Significant Offsets

Plaintiffs' Counsel offer a simplistic damage analysis, whereby they (1) choose a date when they believe an Event of Default should have been declared by BNYM (a date that begins ***the first day*** they allege a compliance document was late), and (2) calculate all of the proceeds from the sale of Notes after that date, as well as all administrative fees released by BNYM after that date.

As set forth in the Receiver's reply brief and supporting declaration, Plaintiffs' Counsel's damage analysis suffers from significant mathematical errors (which, incidentally, have resulted in a ***far lower*** damage number than what the Receiver has calculated using Plaintiffs' Counsel's methodology). In addition, as the Receiver explains, the fundamentally flawed assumptions Plaintiffs' Counsel rely upon in selecting the date of the hypothetical Event of Default that they argue should have been declared (discussed briefly above and in more detail in the Receiver's reply brief), have resulted in a calculation for subsequent Note proceeds that is far too high. When the date of the hypothetical Event of Default is shifted back by 30, 90, and 180 days—as the Receiver has done—the amount of damages under Plaintiffs' Counsel's model ***falls drastically***, evidencing that Plaintiffs' Counsel's damage model is not a viable model for the Noteholders (or the Receiver).

Moreover, even as recalculated by the Receiver, Plaintiffs' Counsel's

damage model suffers from two additional significant deficiencies.

First, Plaintiffs' Counsel's calculation of administrative fees is necessarily duplicative of their calculation of subsequent Note proceeds. Plaintiffs' Counsel's theory is that all Notes sold after a certain date constitute damages because those Notes would not have been sold absent BNYM's alleged breach in failing to declare an Event of Default. Plaintiffs' Counsel also assume that all administrative fees released after that date constitute damages because, had BNYM declared an Event of Default, no administrative fees would have been disbursed. However, to the extent the proceeds from the sale of Notes sold after the date of the hypothetical Event of Default were used to pay administrative fees to MedCap (which Plaintiffs' Counsel insist happened regularly), then Plaintiffs' Counsel's analysis is double-counting those monies. Given the limited time available, BNYM has not been able to isolate the administrative fees that are duplicative of the Note proceeds. But BNYM believes Plaintiffs' Counsel's administrative fee figure, and the administrative fee figure recalculated by the Receiver under Plaintiffs' Counsel's damage model, is necessarily overstated because of this double-counting.

Second, Plaintiffs' Counsel's damage analysis of subsequent Notes proceeds does not account for ***significant offsets*** that must be applied under their damage model. As noted, Plaintiffs' Counsel's theory is that if BNYM had declared an Event of Default as of a certain date, no Notes would have been sold after that date. Plaintiffs' Counsel thus assume that all Notes sold after that date necessarily constitute damages because, had the individuals who bought those Notes known of an Event of Default, they would not have bought the Notes. But the Noteholders who purchased Notes after the hypothetical Event of Default date have already recovered (or will soon recover) a portion of their principal investment in three distinct ways:

1. They have earned principal and/or interest on their Notes. Of course, if Plaintiffs' Counsel' argument is that these individuals would not

have purchased the Notes absent BNYM's failure to declare an Event of Default, then they cannot be entitled to profit from those transactions by keeping the principal or interest they have already earned on the Notes. Thus, the principal and interest they have already received must be offset from any damage figure.

2. They will be entitled to a share of the Receiver's collections on behalf of the receivership estate on a *pro rata* basis depending on the value of the Notes they purchased after the hypothetical Event of Default date. Again, if these individuals never would have bought the Notes absent BNYM's alleged breach, then any recovery they will get under the Receiver's distribution plan should be offset from the ultimate damage number.

3. Many of these Noteholders will be entitled to a share of the approximately $130 million settlement with broker-dealer Securities America (discussed below). (It is likely that certain of these Noteholders will also recover monies through settlements with other broker-dealers but BNYM does not have access to that information at this time.) As with the other two categories of offsets, under Plaintiffs' Counsel's theory, these individuals should not have invested in the Notes to begin with and thus any recoveries they obtain on those Notes (including from other litigation) should be offset from the damage number.

As explained in the supporting declaration of Bruce Strombom (the "Strombom Declaration") and accompanying exhibits, when these offsets are applied, the damage number tied to subsequent Note proceeds is ***significantly reduced*** for those SPCs for which BNYM served as indenture trustee—from Plaintiffs' number of $276 million to $185 million. (*See* Strombom Decl. ¶ 13–20 & Ex. 3.) Likewise, as outlined in the Strombom Declaration, when the

hypothetical Event of Default date is shifted back by 30, 60, 90, and 180 days (similar to the Receiver's analysis), the damage number is again ***significantly reduced*** by these offsets. (*See id.* ¶¶ 21–23 & Exs. 4–7.) For example, if Plaintiffs' Counsel's hypothetical Event of Default date is moved back by just 30 days, under Plaintiffs' Counsel's model, there would be $201 million in damages from subsequent Note proceeds for the SPCs for which BNYM served as indenture trustee. But this number drops to less than $134 million when the appropriate offsets are applied. (*See id.* Ex. 4.)

Table 1 below, which is simply a summary of the exhibits attached to the Strombom Declaration, provides an analysis of potential damages tied to subsequent Note proceeds for the trusts for which BNYM served as indenture trustee (MP II, MP IV series 1, MP IV series 2, and MP VI). BNYM has provided five separate analyses based on the hypothetical Event of Default date: the dates selected by Plaintiffs' Counsel, and dates 30, 60, 90, and 180 days later.

Table 1:

Subsequent Note Proceeds for BNYM Trusts					
	Plaintiffs' Counsel's Dates	**+30 Days**	**+60 Days**	**+90 Days**	**+180 Days**
Note Proceeds	$276,516,133	$200,637,507	$126,005,437	$56,404,071	$3,726,200
Offsets to Note Proceeds					
Principal Returned	$1,226,145	$1,126,145	$976,145	$225,000	$0
Interest Paid	$32,905,245	$22,602,997	$13,002,678	$4,428,587	$44,696
Receiver's Recoveries	$23,563,958	$17,034,929	$10,780,608	$5,044,252	$415,515
Sec. Am. Settlement	$33,658,862	$26,030,332	$16,550,647	$7,077,643	$0
Note Proceeds Less Offsets	**$185,161,923**	**$133,843,104**	**$84,695,359**	**$39,628,589**	**$3,265,989**

Thus, even accepting Plaintiffs' Counsel's fundamentally flawed damage theory, it is clear that this damage model results in a far lower range of damages than the Receiver's transaction by transaction approach. And, certainly, BNYM's

$57 million contribution to the Settlement does not fall below the lowest point in the range of reasonableness of any expected recovery, even under Plaintiffs' Counsel's Event of Default damage theory.

4. Plaintiffs' Counsel's Analysis of the Case Ignores Fundamental Causation Issues Plaintiffs (and the Receiver) Face

This is a contract case. The Trustees are not alleged to be joint tortfeasors. There are other actors who clearly caused loss to the SPCs and to the Noteholders. Thus, it cannot be surprising that, despite the Noteholders' desires to the contrary, the Trustees are not legally liable to the Noteholders for the full amount of their alleged losses. A damage theory necessarily has to account for causation and tie the alleged breach to damages.

As noted above, Plaintiffs face significant—and ultimately insurmountable—hurdles in proving that any breach of the NISAs by BNYM (in not receiving requisite documents on time or not receiving facially conforming documents from MedCap) caused any loss to the Noteholders. Instead, any losses were caused by a host of other factors, including MedCap's fraud, MedCap's poor investment decisions, the complicity of broker-dealers who breached their fiduciary duties to the Noteholders, and the collapsing economy of the Great Recession.

MedCap and Its Principals. The role of MedCap itself in MedCap's demise is of course crucial. MedCap alone created the structure of the deal—the deal had no underwriter, and, as discussed below, the broker-dealers that sold the Notes did not effectuate any changes to the structure of the deal. As is customary for indenture trustees, BNYM had no role in structuring the MedCap deal.

The deal gave MedCap unfettered power to select assets that would be purchased with Noteholder funds—even if the assets were receivables that were older than 180 days (and thus more difficult to collect) or assets other than healthcare receivables (which fell outside MedCap's historical area of expertise). Moreover, MedCap had the sole power to value the assets, with no mechanism for

an independent valuation and no requirement that MedCap provide audited financial statements. And, under the terms of the deal, MedCap alone monitored the performance of each asset. MedCap also had full authority to transfer assets from one SPC to another—and to do so at values that were not the fair market value for those assets—and in fact the Private Placement Memoranda ("PPMs") issued by MedCap disclosed that such transactions were likely to occur. (*See, e.g.*, MP IV PPM at 12, 21.)

In return, MedCap collected hundreds of millions of dollars in administrative fees—fees that were paid based upon MedCap's ***unilateral determination*** that it was entitled to collect the fees, *i.e.*, that its assets exceeded its liabilities. And, as noted, its principals Sid Field and Joe Lampariello personally collected approximately $28 million.

The SEC has alleged that MedCap was engaged in securities fraud. One of MedCap's principals (Lampariello) has pleaded guilty to wire fraud and tax evasion, and charges against additional players are anticipated. The Receiver's forensic accounting has concluded that MedCap was operating a Ponzi scheme.

Thus, BNYM believes it can successfully demonstrate that MedCap is the primary cause of the alleged damages to the SPCs. Further, BNYM believes it can successfully demonstrate that MedCap's intervening fraud breaks any causal chain that could link BNYM's alleged breach of contract with the harm allegedly suffered by the SPCs.

Putting aside the criminal conduct of MedCap and its principals, it is now abundantly clear that their execution of MedCap's business plan could not support the heavy debt load created by the Notes. According to the Receiver's forensic analysis, MedCap made poor choices in its selection of accounts receivable; it did not turn over its inventory of accounts receivable fast enough to generate the cash flow required by MedCap's heavy debt obligations under the Notes; it was not diligent or efficient in the collection process; and it made bad choices in its

purchase of non-account receivable assets.

MedCap's criminal conduct and its poor business acumen are the major causes of the losses suffered by the MedCap SPCs (and, indirectly, by the Noteholders). However, as already explained, BNYM was not contractually obligated to monitor MedCap's business, to oversee or second-guess its business decisions, or to monitor its compliance with good business practices or the law. BNYM was not obligated to analyze or monitor MedCap's business plan or its execution of that plan. Indeed, as structured, the MedCap deal did not place upon any third-party the obligation to monitor or police MedCap's conduct.

Broker-Dealers. By contrast to the narrow contractual duties of the Trustees, the broker-dealers owed broad fiduciary and other duties to those individuals who bought Notes from them. But, in utter disregard of those duties, the broker-dealers did nothing to protect their clients, the Noteholders. They sold Notes to clients who were legally ineligible to buy them, often preying upon unsophisticated investors who were elderly or disabled and could not afford to lose their retirement savings (facts that would not have been known to BNYM and for which BNYM had no responsibility whatsoever). They did not conduct adequate due diligence of MedCap or of the structure of the investments in order to identify the essential risks. And, to the extent they did identify these risks, they did not bother to disclose them to their clients.

Perhaps most fundamentally, though they had the power to alter the structure of the deal, the broker-dealers did nothing to prevent abuses by MedCap or to otherwise protect the interests of their clients, such as requiring a mechanism for independent valuations of the assets, demanding audited financial statements from MedCap, or insisting on the creation of a sinking fund. This is so despite repeated warnings by due diligence firms retained to analyze MedCap's business and the

Note offerings of the significant risks of these investments.[9]

The broker-dealers' failures have not gone unnoticed by industry and state regulators, which have sanctioned some of the broker-dealers for egregious violations of industry rules. Similarly, after fact-finding hearings, Securities America (the broker-dealer that sold about one-third of the Notes) settled a lengthy investigation by the Securities Division of the Massachusetts Secretary of State with an agreement to repay investors in that state every cent of their MedCap principal losses. The Securities Division concluded after its extensive review that Securities America misled clients into believing the MedCap Notes were low risk securities and made unsuitable recommendations and sales of Notes to Massachusetts investors. Other regulatory claims are still pending.

Without the broker-dealers' improper and reprehensible sales tactics, MedCap could not have sold billions of dollars in these fundamentally high-risk investments. The broker-dealers had a legal obligation to their clients, the Noteholders, and were in effect the only line of defense for the Noteholders. Not only did the broker-dealers fail to fulfill their obligations to their clients, but they marketed the Notes in clear violation of applicable laws and regulations, including the rules of conduct promulgated by FINRA. They turned a blind eye to their obligations in favor of the easy gain of high commissions paid by MedCap—totaling almost ***$103 million*** for the sale of Notes for MP I through MP VI.

The Great Recession. One fundamental risk of the MedCap Notes was inherent in MedCap's business model and the structure of the investment—the value of the Notes turned largely on MedCap's ability to generate enormous cash flow from buying accounts receivable at a discount and then collecting on them,

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[9] For example, one due diligence firm, Mick & Associates, cautioned that some of the material risks of the MedCap investments included MedCap's ability to purchase receivables that were older than 180 days, and to invest in assets other than healthcare receivables, which had historically been MedCap's core business, and suggested that these risks be emphasized by the broker-dealers to prospective investors. The broker-dealers ignored these warnings.

and quickly purchasing a new batch of accounts receivable and collecting and turning the inventory again.

This business model focused on purchasing accounts receivable from healthcare providers who could not access traditional and often less expensive lines of credit to finance their business. As the economy sputtered beginning in 2007, those persons at or near the bottom of the healthcare provider industry felt the collapse first, making it more difficult for MedCap to generate the necessary cash flow to meet its ever larger debt burden. Likewise, many of MedCap's investments were the subject of the economic decline.

The turmoil in the economy also highlighted the economic and business risks inherent in the Notes—risks that the Noteholders necessarily accepted when they purchased the Notes, which often paid five percentage points or more over the risk-free return of Treasury Notes.

The risks inherent in the Notes included the risk that MedCap's business plan was not likely to succeed and the risk that MedCap could not execute the business plan in a manner that would generate the revenues necessary to service the Notes and MedCap's other debts. Likewise the risks included that MedCap would do a poor job in selecting or collecting assets. The Noteholders accepted the risk that the structure of the transaction—described in the PPMs issued by MedCap—was such that they would have no protection from inflated or merely mistaken valuations of assets by MedCap. The Noteholders accepted the risk that the assets owned by the MedCap SPCs would quickly lose value in a faltering economy. All of those risks came to pass and all caused loss to the SPCs (by dissipating the SPCs' assets), and in turn to the Noteholders when the SPCs could not pay off the Notes.

And all of these risks were detailed in the PPMs issued by MedCap, which each investor was required to carefully review. As the PPMs disclosed, MedCap had sole and unfettered power to select the investments and to assign a value to those investments, without any requirement for independent appraisal or any other

check on MedCap's underwriting procedures. (*See, e.g.*, MP IV PPM at 9, 20–25.) Nor was MedCap obligated to produce audited financial statements. Further, MedCap did not have a sinking fund or any requirement to maintain financial ratios. As the PPMs warned: "The lack of a requirement to maintain specified financial ratios allows us to operate our business in a relatively unrestricted manner. This increases the risk that our method of operation could turn out to be financially imprudent and could result in a decline in collateral value below the amount of notes outstanding." (*Id.* at 14.) And MedCap imposed an extremely low threshold for payment of administrative fees (*i.e.*, assets simply had to equal liabilities, with no cushion whatsoever). (*Id.* at 13.)[10]

As noted, BNYM had no role in structuring the MedCap deal. BNYM did not create these risks. Rather, these risks were part of the deal the Noteholders signed onto when they bought the Notes. And it is undeniable that BNYM was not charged with monitoring or eliminating the significant risks the Noteholders took on in exchange for the promise of a high rate of return.

* * * *

Perhaps nothing evidences the comparative roles of the various parties better than the economic reward each received for playing its part in the transactions. As noted, MedCap and its principals were paid hundreds of millions of dollars in fees. The broker-dealers received more than $103 million in commissions for their role in selling the Notes. The Noteholders anticipated receiving interest payments at

[10] Other significant risks expressly disclosed in the PPMs included the risk that MedCap's investments in non-healthcare assets, which could constitute up to 40% of its investments, could lead to investment losses (MedCap conceded that its "relative inexperience in investments other than healthcare receivables could result in higher default rates" and "might result in our inability to earn enough on our investments to pay [investors] the interest and principal that we owe [investors] under the notes"), and the risk that assets could be transferred between trusts at a price greater or less than the fair market value of the assets (MedCap disclosed that such conflicts of interest "may result in us taking actions that are not in [the investors'] best interests"). (*See, e.g.*, MP IV PPM at 11–12.) The PPMs also set forth numerous other conflicts of interest. (*Id.* at 12–13, 32–33.)

least five percentage points above the treasury bond rate. By contrast, BNYM received $35,000 per year per trust from the SPCs—totaling approximately $390,000 *over four years*.

C. The Settlement Was Negotiated in Good Faith

1. The Settlement Followed an Arduous, Arms-Length, Good Faith Negotiation

As explained more fully in the Receiver's Approval Motion, the Settlement was reached after extensive, arms-length, good faith negotiations between the Receiver and BNYM. Indeed, the Settlement has all the hallmarks of a standard good faith settlement negotiation:

- The Receiver and his Counsel were appointed by the Court.
- The Parties engaged in extensive negotiations and were assisted by an experienced mediator, Charles Bakaly of JAMS.
- The Receiver understood the factual record and legal framework and was a zealous advocate.
- There were no "secret terms" or "side deals" between the Receiver and BNYM. No promises were made that are not reflected in the parties' written agreement.

2. The Absence of Plaintiffs' Counsel from the Negotiations Was Appropriate and Did Not Alter the Arms-Length Nature of the Settlement

Plaintiffs' Counsel have criticized the Receiver and BNYM for not inviting them to participate in the settlement discussions and the mediation. But BNYM was absolutely justified in pursuing a settlement only with the Receiver.

First, as explained in detail in the Trustees' pending motion for summary judgment, the case law demonstrates the Receiver has the exclusive power to bring, prosecute, and settle claims on behalf of the MedCap SPCs against BNYM for breach of the NISAs. It was thus wholly appropriate for BNYM to pursue a settlement with the only party with *actual authority* to pursue and resolve the

claims.

Second, involvement of the three sets of Plaintiffs' Counsel in the settlement process would have created a significant impediment to any settlement. Because of the complicated structure of the Noteholder groups—a class action represented by *Masonek* Counsel, a large mass action of over 1,700 Noteholders represented by *Abbate* Counsel, and a smaller mass action represented by *Bain* Counsel—Plaintiffs' Counsel would have had to work together as a functional, unified group capable of negotiating a settlement over a prolonged period of time. Unfortunately, the relationship between representatives for the two principal Noteholder groups—*Masonek* Counsel and *Abbate* Counsel—has been highly dysfunctional. The history of this litigation has shown that they have repeatedly and continually refused to work together on the most basic issues. Indeed, much of this litigation has been dominated by the aggressive tactics that *Masonek* Counsel and *Abbate* Counsel have visited upon each other. Plaintiffs' Counsel now insist that they are united, but their long history of internecine warfare is very real and cannot be ignored.

For example, *Masonek* Counsel's first battle in this case was not against the Trustees. It was against *Abbate* Counsel. The *Masonek* action was filed in September 2009. Soon thereafter, *Masonek* Counsel learned that Waverton Group LLC ("Waverton") was soliciting Noteholders (who would in the first instance be members of *Masonek* Counsel's putative class) for a mass action against the Trustees. The purpose of this solicitation was to take Noteholders away from *Masonek* Counsel, thereby reducing the size of their putative class. For more than eight months, from November 2009 through June 2010, *Masonek* Counsel and *Abbate* Counsel battled—before this Court and in the Ninth Circuit—over whether *Abbate* Counsel was required to send out a so-called "curative notice" to the Noteholders which would correct alleged misstatements and omissions sent to

Noteholders by *Abbate* Counsel and its "litigation manager" Waverton.[11] *Masonek* Counsel accused *Abbate* Counsel of serious unethical conduct, including making false and misleading statements to the Noteholders and engaging in illegal fee splitting. *Masonek* Counsel also accused Waverton of practicing law without a license.

This bitter in-fighting has plagued almost every aspect of this litigation as *Masonek* Counsel and *Abbate* Counsel have been unable to cooperate on even routine matters such as discovery. For example, they have consistently failed to coordinate their discovery requests or even to provide each other with notice of such discovery.

The open warfare between *Masonek* Counsel and *Abbate* Counsel throughout this litigation made it extremely unlikely that they could play a constructive role in bringing together a settlement. BNYM concluded that a mediation would simply provide them with one more forum for their on-going battle. By contrast, the Receiver was focused on a single goal—to reach a reasonable and fair resolution of the claims of the MedCap SPCs.

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[11] Indeed, *Masonek* Counsel's earliest discovery was directed at Waverton—*Masonek* Counsel served a subpoena on Waverton in January 2010, more than two months before they even served document requests on the Trustees. That subpoena, in turn, commenced a lengthy court battle in the District Court of Colorado between *Masonek* Counsel and Waverton, including motions to compel, motions for reconsideration, and threats of contempt. *Masonek* Counsel filed updates to keep this Court apprised of these developments obviously for the purpose of undermining the integrity of *Abbate* Counsel.

III. CONCLUSION

For all of the foregoing reasons, BNYM respectfully requests that the Court grant the Receiver's Motion for Approval of the Settlement with BNYM and Wells Fargo.

DATED: October 1, 2012

GIBSON, DUNN & CRUTCHER LLP

By: /s Joel A. Feuer
JOEL A. FEUER

Attorneys for
THE BANK OF NEW YORK MELLON

PROOF OF SERVICE

I, Babak Lalezari, declare as follows:

I am employed in the County of Los Angeles, State of California; I am over the age of eighteen years and am not a party to this action; my business address is 333 South Grand Avenue, Los Angeles, California 90071-3197, in said County and State. On October 1, 2012, I served the following document(s):

(1) REPLY MEMORANDUM OF POINTS AND AUTHORITIS OF THE BANK OF NEW YORK MELLON IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF SETTLEMENT WITH TRUSTEES

(2) DECLARATION OF BRUCE STROMBOM, PH.D. IN SUPPORT OF THE BANK OF NEW YORK MELLON'S REPLY MEMORANDUM IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF SETTLEMENT WITH TRUSTEES

☒ **BY CM/ECF Electronic Service:** I caused such document to be served via the Court's (NEF) electronic filing system on all registered parties.

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I declare under penalty of perjury that the foregoing is true and correct. Executed on October 1, 2012.

/s/ Babak Lalezari
Babak Lalezari

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Case Number:	8:09-cv-00818-DOC-RNB
Filer:	The Bank of New York Mellon
Document Number:	872

Docket Text:

RESPONSE IN SUPPORT of MOTION for Settlement Approval of Settlement with Wells Fargo Bank and Bank of New York Mellon[730] filed by Movant The Bank of New York Mellon. (Attachments: # (1) Declaration, # (2) Exhibit, # (3) Exhibit, # (4) Exhibit, # (5) Exhibit, # (6) Exhibit, # (7) Exhibit, # (8) Exhibit)(Lalezari, Babak)

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