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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. 8:09-CV-0818-DOC (RNBx)

WELLS FARGO BANK, N.A. 'S REPLY IN SUPPORT OF THE 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.
Ctrm: 9D

Hon. David O. Carter

Docket
10/2/12

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Wells Fargo Bank, N.A. ("Wells Fargo") respectfully submits the following reply points and authorities in support of the Receiver's motion to approve the settlement reached with Wells Fargo and Bank of New York Mellon ("BNYM"), referred to collectively as the "Banks."

I. INTRODUCTION AND SUMMARY OF REPLY ARGUMENT

Class and mass action counsel ("Noteholder Counsel") – joined by a small group of Noteholders[1] – have opposed the settlements reached by the Receiver with the Banks. Noteholder Counsel suggest that the fact of their newly-united opposition[2] is reason enough to reject the settlements, *see* Opp. at 18-19. They are wrong as a matter of law. "[C]reditors' objections to a compromise . . . are not controlling." *In re A & C Properties*, 784 F.2d 1377, 1382 (9th Cir. 1986).

On the contrary, the *Court* must consider "the paramount interest of the creditors and a proper deference to their *reasonable* views." *Id*. at 1381 (emphasis added). Here, the assertion that a settlement for $106 million in cash (plus the release of indemnity claims) falls below the range of reasonableness is demonstrably *unreasonable* in light of (i) the law, (ii) this Court's prior rulings, and (iii) the evidentiary record including, notably, the relevant contracts.

In his Reply, the Receiver described many of the ways in which the strength of the claims against the Banks has been seriously overstated by Noteholder Counsel. To his credit, the Receiver candidly acknowledged that he is

[1] Of more than 8,000 noteholders in MP II through MP VI, *see* Noteholders' Joint Objection ("Opp.") at 1:3, fewer than 250 have submitted formal or informal objections. *See* Declaration of Matthew A. Macdonald ("Macdonald Decl.") ¶ 2.

[2] Class counsel previously accused the *Abbate* litigation manager of obtaining Noteholder clients by means of a "solicitation [that] makes false and misleading statements about the pending litigation, conceals material conflicts of interest, and appears to violate numerous ethical rules relating to solicitation, fee-splitting, and the unauthorized practice of law." *Masonek* Dkt. No. 22-2, at p. 1; *see In re Medical Capital* Dkt. No. 132, at pp. 1, 5-10, 19-20; *In re Medical Capital* Dkt. No. 132-9. *Abbate* counsel previously accused Class counsel of misleading the Court due to a "demonstrated motivation to maximize the size of the class action—and thus, its own fees" at the expense of the *Abbate* plaintiffs. *Abbate* Dkt. No. 156, at p. 17; *see id*. at pp. 4-7, 16-17; *Abbate* Dkt. No. 168, at pp. 18-19, 25; *Abbate* Dkt. No. 205 at pp. 1, 5-6.

constrained by his role from attacking those claims with all available ammunition. Wells Fargo is not so constrained, and writes separately to describe how the hurdles to recovery against it are much higher than even the Receiver has described them.

First, it is an oxymoron for Noteholder Counsel to suggest that a $106 million+ settlement is inadequate by comparing it to the $1 billion in unpaid principal owed to the Noteholders. The Banks were not parties to the notes, and the NISAs expressly disclaim any obligation by the Banks to repay the notes. Noteholder Counsel have not offered, and cannot offer, any theory by which the Banks might be liable to repay the notes, for there is none. Although the comparison is irrelevant, however, it appears to permeate the thinking of the objecting individual Noteholders. Indeed, many of them describe the settlement as insufficient precisely because it represents only "ten cents on the dollar." *See, e.g.*, Furukawa Decl. Ex. 37.

Second, the settlement cannot be deemed inadequate based on the attenuated theory that the Banks breached a duty to declare an Event of Default, thereby *actually* and *proximately* causing $650-790 million in damages. The Receiver's Reply meticulously explains the fundamental legal and factual weaknesses in such a theory, which simply *assumes* (1) that the Banks had knowledge of a material breach of the NISAs by the SPCs, (2) that the Banks owed (and breached) a duty to give notice to the SPCs of a 30 day period to cure, (3) that that the SPCs would *not* have cured, thereby essentially confessing to their fraud, and (4) that all such steps would have occurred immediately after the first document default by each of the SPCs (as would be necessary to support any significant damages under the theory). And, indeed, the theory is fatally flawed for yet additional reasons:

- This Court already has held, as a matter of law, that allegations that Medical Capital submitted late documents would *not* support a claim for improper failure to declare an Event of Default. That ruling

was made in response to allegations that every single Medical Capital document was late by up to seven months. The Receiver's Reply demonstrates that – using the same measure of seven months for the earliest possible date of a declaration of an Event of Default – there are essentially *no* damages under Noteholder Counsel's "Event of Default" theory.

- As demonstrated below, Wells Fargo did *in fact* obtain the required documents (contrary to the assertions of Noteholder Counsel). Therefore, even if Wells Fargo somehow had a duty at some earlier time to send a formal notice demanding those same documents within 30 days, there is no evidence its failure to do so was negligent, willful or in bad faith as is required to find a breach of the NISAs.

- Finally, it would be impossible for the Receiver (or Noteholders) to carry the causation burden by showing that Medical Capital would not have prevented Events of Default simply by curing document deficiencies upon formal demand. There is no basis in reason to conclude that criminals simply would have allowed their scheme to fail, rather than submitting self-certifications. Indeed, the Court need not rely on reason alone in that regard: It is an historical fact that Medical Capital *did* timely cure document deficiencies when Wells Fargo sent a formal notice demanding cure within 30 days.

Third, arguments that the settlement is inadequate because of the purported strength of theories based on improper *specific* disbursements also fail to acknowledge significant legal and factual problems with such theories:

- Noteholder Counsel assert that tardy documentation – even if insufficient to trigger an Event of Default – nevertheless rendered all disbursements impermissible thereafter. The NISAs are not properly read, however, to call for cessation of all money-generating activities (on which the Noteholders relied to be paid) based on every immaterial documentation breach.

- Here again, reason dictates *and history demonstrates* that, if the Banks had refused to disburse funds until deficiencies were cured, Medical Capital would have rushed to cure and so obtained the same funds.

- With respect to disbursements that *might* be deemed impermissible, any calculation of recoverable losses would have to consider offsets for benefits received (such as returns on investments or subsequent liquidation of loan collateral) and issues of proximate causation (such as the extent to which any losses reflected investment risk for which the Banks are not liable under *Hadley v. Baxendale*).

- Noteholder Counsel assert that disbursements were improper because the Banks lacked "good faith." The Banks believe that, under existing law, only *actual knowledge of fraud* can constitute "bad faith." Document discovery having been completed years ago, *there is no evidence of such actual knowledge in this case.* Neither is there evidence to support a finding of "bad faith" under the lower standard that might apply, *i.e., deliberately* ignoring *obvious* "red flags." Noteholder Counsel may argue otherwise without pointing to any evidence, but if this Court or a jury or the Ninth Circuit disagrees, their clients will have been deprived of the benefit of a very significant settlement, forged while those issues were still open.

Fourth, the assertion that a "statistical analysis" proves the settlement is inadequate – under even the Receiver's own assumptions regarding the risks and rewards of litigation – may charitably be characterized as deeply misleading. Noteholder Counsel may have found an "expert" willing to *say* that, using the Receiver's own assumptions, he should have a net trial recovery in excess of $104 million some *96.5% of the time*, and that the expected value of his claims is 88% higher than the settlement achieved. But, as discussed in greater detail below, the assumptions used to generate these statistical "results" deviate so far from both the expert's stated understanding of the Receiver's views, and from common sense, that the entire exercise not only is meaningless, but it also raises serious questions of competency, bias, or both.

Fifth, the assertion that a release of the Banks' indemnity claims against the Receivership Estate has no value is unreasonable. At a minimum, a release of such claims avoids the risk that either this Court or the Ninth Circuit will

require the Receiver to hold back, as a reserve against such claims, a substantial sum from the assets he hopes to distribute shortly.

Sixth, Noteholder Counsel's assertion that the proposed injunction is improper is wrong as a matter of law. The Banks have agreed to pay substantial sums in exchange for complete peace. The Fifth Circuit and other courts have approved such injunctions in such circumstances. Ninth Circuit case law prohibiting injunctions *in bankruptcy cases* reflects the application of a particular provision of the bankruptcy code, which does not apply in receivership actions.

In sum, it may be understandable that individual Noteholders who believe they have a strong case for recovering *all* of their losses from the Banks would oppose the settlements. But the Court knows that the Banks did not assume the role as guarantor for Medical Capital, and Noteholders Counsel know it (or should know it) as well. It is the Court's role to decide whether the settlements are within the range of reasonableness *measured against legally viable claims, and against the evidence*, albeit without conducting a mini-trial. Given the serious issues regarding duty, breach, causation and damages raised by the Banks – issues considered by a sophisticated and informed adversary in negotiating the proposed settlements – there is no question that they fall within the range of reasonableness; that they are fair and equitable; and that they properly should be approved.

II. THE COURT SHOULD APPROVE THE SETTLEMENTS

A. There Is No Basis For Noteholder Counsel's Assertion That There Is A Viable Theory Under Which Noteholders Could Recover Their Entire Loss Of Principal From The Banks.

Noteholder Counsel assert that the Wells Fargo settlement is unreasonably low when measured against *all principal owed by the SPCs* under the notes (over $1 billion). *See* Opp. at 36:16-25; Skorheim Decl. Schedules B & E. The comparison is legally irrelevant, and one suspects they know it. The Banks were *not* parties to the notes, and did *not* undertake in the NISAs to backstop the SPCs' obligation to pay the notes. On the contrary, Section 5.06(c) of the NISAs

expressly provides that "[t]he Trustee has no duty or obligation to pay the Notes from its own funds, assets or corporate capital."

As this Court previously held, the Banks agreed to perform only the limited duties expressly identified in the NISAs. *See, e.g.*, *In re Medical Capital Secs. Litig.* Dkt. No. 143 at 6-12. And, as the authorities cited by Noteholder Counsel confirm, Wells Fargo is potentially subject to liability *only* for damages (if any) *proximately caused* by its breaches of those limited duties. *See, e.g.*, *Coughlin v. Blair*, 41 Cal. 2d 587, 600, 603 (1953). Such damages cannot possibly equal the principal due under the notes, and Noteholder Counsel fail even to offer a theory under which they would. *See, e.g.*, *Lewis Jorge Const. Management, Inc. v. Pomona Unified School Dist.*, 34 Cal. 4th 960, 968 (2004) ("The injured party's damages cannot, however, exceed what it would have received if the contract had been fully performed on both sides."). Noteholder's Counsel might just as well argue that the settlement amounts are small compared to the national debt. That might be true. But it is no more relevant than a comparison to outstanding principal and interest.

B. There Is No Viable Basis For Recovering "Massive Damages" From The Banks For Failing To Declare Events Of Default.

Noteholder Counsel next assert that the settlement amount is too low because the Banks' "failure to recognize Events of Default despite the SPCs' repeated material breaches of the NISAs resulted in massive damages to the Noteholders" of approximately $650-790 million. Opp. at 33:3-5; *see id*. at 34:24-36:15. Their theory simply assumes away the language of the NISAs, the Court's prior rulings, prevailing law and the evidence.

In his Reply, the Receiver meticulously explains the factors based on which the chances of success on such a theory are highly remote, or the damages are very small: (1) the Court's prior rulings foreclose any assertion that alleged document deficiencies on which the theory rests *immediately* constituted material

breaches that should have matured into Events of Default thirty days later; (2) if one assumes a reasonable period before there might have arisen a duty to declare an Event of Default, potential damages are reduced well below the settlement amounts, or to zero; (3) the Banks have a strong argument against liability under this theory, because they had no duty to send a notice demanding the SPCs cure the document deficiencies alleged within 30 days (a precondition to declaration of an Event of Default); and (4) the Banks have a strong argument that they have no liability under this theory because the SPCs would have cured any alleged document deficiencies, thereby avoiding declaration of an Event of Default.

In fact, the "Event of Default theory" is even weaker than even the Receiver acknowledges, for at least three reasons:

First, as demonstrated in the declarations submitted with the Receiver's Reply, the potential damages under such a theory drop to *zero* if the time between (i) the alleged first default by each SPC and (ii) the time of the duty to declare an Event of Default is extended from thirty days (the period used by Noteholder Counsel's damages expert) to seven months. And the Court already has ruled *as a matter of law* (in connection with the Motion to Dismiss the Second Amended Complaint in *Masonek*) that no such breach could possibly have arisen for at least seven months.

The Second Amended Complaint in *Masonek* expressly alleged (as Noteholders' Counsel argue here) that:

> in the ***entire history*** of the existence of both MP III and MP V, MCC failed ***on each occasion a NISA-required document was due*** to submit the document on time as required. For example, the Fourth Quarter 2007 schedule reflecting UCC financing statements for collateral for MP V was turned in on July 24, 2008, although it was due ***seven months before*** on January 15, 2007. *See* Exh. 7, attached hereto. On information and belief, the same practice existed with regards to MP II, IV, and VI. Meanwhile both Trustees continued to pay out Administrative Fees and allow MCC to make withdrawals for other purposes, even as they did not receive the documents as required under the NISAs and did not inform Noteholders of the SPCs' severe and continuing defaults.

Second Amended Consolidated Complaint (*Masonek* Dkt. No. 104) ¶ 145 (*emphasis in original*[3]); *accord id.* ¶ 90 & Exs. 7-8. Yet, in the face of these allegations of ubiquitous late documents, including the specific example of a *seven month* delay, this Court held that no plausible claim for breach of the NISAs was stated because the alleged delays were not material:

> Defendants contend, however, that even assuming Defendants' actual knowledge of such tardy filings, any breach from the late-filed documents was not "material." The Court agrees. A material breach is one that goes to the essence of the agreement, threatening the aggrieved party with the prospect of being de[p]rived of the benefit of the contract. Because tardiness in submitting documents does not go [to] the essence of the agreement, it is not a material breach. Section 6 of the NISAs allows Defendants to declare an Event of Default only in the face of a "material" breach. Therefore, asserting that Defendants should have declared Events of Default in response to late-filed documents is tantamount to asserting that Defendants should have violated the NISAs.

In re Medical Capital Secs. Litig., Dkt. No. 143 at 11:13-26 (emphasis added; citations omitted); *accord Abbate*. Dkt. No. 196 at 4. Therefore, the "Event of Default theory" would lead to no damages, even if it were otherwise viable.

Second, even if Wells Fargo were deemed to have had a duty to send notices demanding a cure of material document deficiencies, failure to perform that duty cannot form the basis for imposing liability because there is no evidence that it resulted from negligence, willful misconduct, or bad faith. *See* NISA § 5.06(j).[4] Although Noteholder Counsel may *say* that "Wells consistently failed to receive or police compliance reports required by NISAs for MP's III and V," Opp. at 8:26-27, this assertion is demonstrably untrue. On the contrary, in accordance with its standard practice, Wells Fargo in fact maintained a "tickler system" to monitor periodic compliance reports. If a compliance report became past due, the Wells

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[3] The original *form* of emphasis, underlining, is changed here for ease of reading to bolding and italics.

[4] NISA § 5.06(j) provides that "[t]he Trustee shall not be liable for any action it takes or omits to take in good faith which it believes to be authorized or within its rights or powers; provided, however, that the Trustee's conduct does not constitute willful misconduct, negligence or bad faith."

Fargo account manager would follow up informally with the SPC via email or phone. If the compliance reports nevertheless remained past due more than 120 days, the issue was elevated to a managers group within the Corporate Trust Department. And, if and when it was deemed appropriate by this group in face of continuing delay (or by an officer in the Default and Restructuring group if and when it became involved), a formal "clock tick" notice would be sent to the SPC (in the manner required by NISA § 9.03) advising that the SPC had to provide the overdue item within 30 days or Wells Fargo would deem it an Event of Default and proceed to provide notice to the Noteholders. *See* Declaration of Matthew A. Macdonald ("Macdonald Decl."), Ex. 1 at pp. 74-77, 85-87, 92, 211-12, 327-29. Indeed, the very exhibits cited by Noteholder Counsel in an effort to falsely impugn Wells Fargo merely are illustrations of this system at work. And, as a result of this system, Wells Fargo ultimately *did* "receive twenty-three periodic compliance documents each year from each SPC" (as Noteholder Counsel assert are called for under Sections 2.02(a), 3.05(g)-(i) and 5.05 of the NISAs,[5] *see* Opp. at 8:14-16), including each of the overdue compliance items referenced in the exhibits Noteholder Counsel cite.[6]

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[5] The "twenty-three periodic compliance documents" referenced by Noteholder Counsel consist of four quarterly note registers under Section 2.02(a), four quarterly collateral listings under Section 3.05(g), twelve monthly NCCR certifications under Section 3.05(h), one annual certification of value under Section 3.05(i), one annual statement of compliance from the SPC under Section 5.05, and one annual statement of compliance from the Servicer under Section 5.05.

[6] Allegations that the monthly NCCR calculation form did not comply with the requirements of the NISAs (*see* Opp. at 10-11) do not demonstrate a negligent, willful, or bad faith failure by Wells Fargo to declare an Event of Default in the face of a *known material breach*. There is no evidence that Wells Fargo knew (or should have known) that inclusion of a line item for "principal due within 30 days" was improper. *See* NISA Art. I (defining "Net Collateral Coverage Ratio" as limiting Note liabilities to "the aggregate principal amount of Notes *outstanding*," and defining "Outstanding" to *exclude* any note "which remains unpaid as to principal or interest" whenever "provision has been made for such payment pursuant to Section 2.04"). Moreover, that line item *never* "proved the tipping point that purported to show the SPC was not in default" on an NCCR calculation form received by Wells Fargo. *See* Opp. at 11:9-12 & Furukowa Decl. Ex. 17 (cited NCCR calculation form for MP III-1 shows NCCR would remain above the

1 At the risk of burdening the record, Wells Fargo is submitting with the
2 Declaration of Matthew A. Macdonald which compends *and attaches* summary
3 business records, as well as just a small subset of the actual communications with
4 Medical Capital, that Noteholder Counsel might like the Court to believe not to
5 exist. In negotiating a settlement, Wells Fargo and the Receiver did not simply
6 argue about what was or was not in Wells Fargo's files; both sides verified what the
7 documentary evidence actually would show. Whether on this motion or a summary
8 adjudication motion, the Court can and will see that Wells Fargo routinely and
9 consistently policed Medical Capital's compliance documentation, and that when it
10 demanded late documents, *it got them.* *See* Macdonald Decl. ¶¶ 4-13 & Exs. 2-30.
11 Noteholder Counsel similarly assert Wells Fargo failed to obtain asset-
12 related "required documents such as UCC statements," and had a duty to declare an
13 Event of Default 30 days later. Opp. at 15:22-23; *see id.* at 35:6-10. In fact, Wells
14 Fargo *did* obtain UCC statements,[7] and *did* have a system in place to follow-up with
15

16 required 100% even without challenged deduction from liabilities). *See* Macdonald Decl. ¶ 27.
17 Moreover, although the NCCR calculation form did not contain a signed statement
18 in words as to whether or not the Collateral Coverage Ratio requirement was satisfied (as Wells Fargo recognized in an email cited by Noteholder Counsel, *see*
19 Opp. at 11:13-20) the form did contain a line entry which showed for each month whether or not the "Collateral Ratio" was at least equal to 100% as required. *See*
20 Furukowa Ex. 19 (sample NCCR calculation form submitted to Wells Fargo). This conformed as to form because the NISAs expressly authorize the NCCR
21 certification to be "in such form as the Trustee and Debtor shall agree upon," and the NISAs do not expressly require a signature by an authorized officer of the SPC
22 on the NCCR certification. *See* NISA § 3.05(h); *compare id.* (no express requirement of officer signature on NCCR certification) *with* NISA § 5.05
23 (expressly requiring officer signatures on annual compliance certifications by SPC and by Servicer). In any event, this alleged deviation in form hardly is material,
24 particularly given that the SPCs also submitted a signed certification of the NCCR and the lack of a collateral coverage default with each administrative fee request.
25 *See infra* Part II.C.2.a below.

26 [7] The only evidence Noteholder Counsel cite regarding missing UCC statements is an email chain indicating that a file for one non-receivable loan discussed lacked
27 UCC statements. But that very email indicates that UCC statements were present for the other four non-receivable loans discussed. *See* Furukowa Decl. Ex. 36.
28 And, while not in the file discussed in the email, the SPC had in fact sent the UCC filings for that loan. *See* Macdonald Decl., Ex. 44.

1 the SPCs about tardy non-receivable asset-related documents.[8] *See* Macdonald
2 Decl., Ex. 1 at pp. 57-60.
3 *Third*, even if one assumes an actionable failure to send a formal
4 notice, the causation hurdle is not merely steep, but insurmountable. As the
5 Receiver recognizes in his Reply, any failure by Wells Fargo to send a formal
6 demand to cure a document deficiency could only have caused a failure to declare
7 an Event of Default (and damages, if any, that would flow from such a failure) if
8 the SPC would not have cured during the 30-day period, or such longer period
9 before notice of the Event of Default would have been sent to Noteholders.
10 As the Receiver recognizes, there is no basis in reason to conclude that
11 criminals would simply have ignored such a demand, as opposed to preparing and
12 sending self-certifications in order to keep their scheme alive. And indeed, it is not
13 necessary to rely on reason alone. Wells Fargo actually sent formal "clock tick"
14 notices to the SPCs, and *in each such historical instance* prior to the
15 commencement of this action by the SEC, the SPCs did cure the noticed document
16 deficiencies within the 30 day cure period. *See* Macdonald Decl. ¶¶ 14-24 & Exs.
17 14-41. In addition, the record is replete with instances where the SPCs responded
18 promptly to demands for additional or changed documentation as a precondition to
19 the release of funds for non-receivable asset purchases. *See, e.g.*, Macdonald Decl.,
20 Ex. 45. Given both reason and history, the SPCs (and the Noteholders) could not
21 possibly meet their burden to prove that an Event of Default would have been
22 declared if the Banks had formally demanded the cure of the documentation.[9]
23
24 [8] The Receiver acknowledges that Wells Fargo had no duty to obtain any asset-related documents for receivable assets in MP III, Series 2 and in MP V. These two
25 trusts account for approximately 95% of the principal amount of outstanding notes for which Wells Fargo was indenture trustee. While the Receiver contends Wells
26 Fargo had a duty to obtain copies of purchase documents for receivable assets in MP III, Series 1, Wells Fargo disagrees because there is no express requirement to do so stated in the body of the NISA.
27 [9] *Shawmut Bank, N.A. v. Kress Associates*, 33 F.3d 1477, 1496 (9th Cir. 1994), cited
28 by Noteholder Counsel (Opp. at 34:1), is not to the contrary. *Shawmut Bank* stands for the proposition that the SPCs (or Noteholders) satisfy their initial burden of

C. The Settlement Is Not Inadequate By Reference To The Strength Of Claims Based On Specific Disbursements By The Banks.

Noteholder Counsel also assert that the settlement is inadequate in light of the strength of claims based on allegedly improper specific disbursements. Again, the assertion ignores the NISAs, the Court's prior rulings, the facts and the applicable law.

1. Disbursement During Periods Of Immaterial Document Defaults

a. No Breach Of The NISAs

As an alternative to their "Event of Default theory," Noteholder Counsel argue that *all* disbursements were improper because the certificates submitted to the Banks falsely stated that the SPC is not "in default under the Agreement" when, in fact, the SPCs were tardy in delivering various compliance documents.[10] Opp. at 13:26-14:4, 14:24-15:2. Theirs is a tortured interpretation of the NISAs and the certificates and, if the Court ultimately rejects it, their clients will have been significantly prejudiced by relying on that theory to reject the settlements.

The plain language of the NISAs simply does not require immediate cessation of all money-generating activities (on which the Noteholders were relying for payment) each time there was an immaterial documentation breach that did not

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proof on causation in the context of allegedly wrongful disbursements by an indenture trustee because, but for the wrongful disbursement, the funds would remain in the trust in the first instance, subject to consideration of evidence that the debtor would have obtained the funds anyway by correcting the documentation. However, as explained in *Dell'Oca v. Bank of New York Trust Co.*, 159 Cal. App. 4th 531, 551 (2008), where the theory of causation advanced by the SPCs (or Noteholders) depends in the first instance upon what actions persons other than the indenture trustee would have taken had the indenture trustee properly performed its duties (as is the case with the "Events of Default theory"), it is the burden of the SPCs (or Noteholders) to prove with evidence how those other persons would have acted.

[10] Noteholder Counsel also asserts, without any evidentiary citation, that disbursements were made when the SPCs were in payment default. This likely reflects their continuing misunderstanding that a payment default in one SPC is not an Event of Default or otherwise a bar to the continued operation of another SPC under the NISAs.

even require issuance of a formal notice to cure, let alone declaration of an Event of Default. Absurd interpretations of contracts are properly rejected. *See, e.g.*, *Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership*, 157 Cal. App. 4th 1515, 1521 (2007) ("Interpretation of a contract must be fair and reasonable, not leading to absurd conclusions." (internal quotation marks omitted)).

Moreover, even if the NISAs were sufficiently ambiguous to permit such a jarring interpretation of the certificates, the ordinary course of conduct by Wells Fargo and the SPCs prior to any dispute constitutes a contrary practical construction of the NISAs which may properly be considered and adopted by the Court. *See, e.g.*, *Crestview Cemetery Assn. v. Dieden*, 54 Cal. 2d 744, 752-53 (1960) ("That the actions of the parties should be used as a reliable means of interpreting an ambiguous contract is, of course, well settled in our law."). That is a rule for *construing* the meaning of a contract in the first instance, *see id.*, and not for changing or modifying its meaning. Accordingly, Noteholder Counsel's discussion of the NISA provisions and contract law rules restricting *modifications* of contract are wholly beside the point.

b. No Actual Causation

Even if disbursements during periods of tardy documentation did constitute a breach of the NISAs, it caused no harm. For, once again, both reason and history demonstrate that, if the Banks had refused to disburse funds until document deficiencies were cured, the SPCs would have rushed to cure and so obtained the same funds.

c. Limits On Recoverable Damages

Finally, even if any specific improper disbursements had occurred, the *recoverable* damages would be far less than the amount of the disbursements (as the Receiver has recognized). First, the value *realized* from assets acquired with improperly released funds must be deducted when calculating recoverable damages (including both sums received from either repayment or resale of the loans, and

1 sums received upon liquidation of the underlying collateral).[11] For, it is a
2 fundamental principle of contract law that sums that were received by the plaintiff
3 in mitigation of damages are deducted when calculating damages recoverable for
4 breach. *See, e.g.*, *Utter v. Chapman*, 43 Cal. 279, 284 (1872).

5 Moreover, recoverable damages do not include losses that resulted
6 either because (1) "loans were made to risky borrowers of low or poor credit
7 quality," as stated in the Receiver's forensic accounting,[12] or (2) as a result of a
8 decline in value caused by other forces (such as the deepest recession this county
9 has experienced since the Great Depression, which coincided with the collapse of
10 Medical Capital). The rule of *Hadley v. Baxendale* applies to limit recoverable
11 damages to those that are the natural and probable consequence of the breach. *See,*
12 *e.g.*, *Hunt Bros. Co. v. San Lorenzo Water Co.*, 150 Cal. 51, 56-57 (1906). Given
13 that Wells Fargo had no role in underwriting or selecting the assets to be acquired,
14 or in losses caused by the recession, such investment losses cannot be the natural
15 and probable consequence of any alleged breaches of the NISAs.

16 Recoverable damages must be further reduced by other benefits
17 conferred on the Medical Capital SPCs as a result of the alleged breaches. For
18 example, if the Receiver somehow could establish that disbursements of
19 administrative fees were improper, recoverable damages for each SPC would be
20 reduced by the sizeable portion of those fees that either was returned to that SPC, or
21 used to pay broker fees that the Medical Capital SPCs otherwise were authorized to
22 pay from funds held in the trust accounts pursuant to the terms of the NISAs.[13]

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24 [11] *See, e.g.*, Receiver's Forensic Accounting (*SEC v. Medical Capital Holdings* Dkt.
25 No. 608) at pp. 12-13, 20, 41.

26 [12] *Id*. at p. 10.

[13] *See id*. at 36; NISA for MP V at § 5.08(a)(ii)(D) (authorizing Trustee "to pay, as
27 directed by the Debtor in writing, to the applicable Broker/Dealer or other selling
agent any related sales expenses or commission or to the Debtor for its payment of
28 such sales expenses and commissions.").

2. **Disbursement Of Administrative Fees**

While both the Receiver and Noteholder Counsel assert that their claims to recover administrative fees are strong (*see* Opp. at 10-12), it is worth briefly pausing to note that Wells Fargo has substantial defenses to those claims, as well.

a. **No Breach Of The NISAs**

Noteholder Counsel assert that the Administrator's Request For Funds forms received by Wells Fargo did not have the required certification "to the effect that the Collateral Coverage Requirement is satisfied (after giving effect to the requested disbursement) on the basis of the Net Collateral Coverage Ratio calculated and provided by the Debtor to the Trustee as of the last day of the month preceeding the month in which such request is made." NISA § 3.05(h). The statement is inaccurate. The very form cited by Noteholder Counsel states: "The Net Collateral Coverage ratio is 104.51% or 1.04:1 and there is no Collateral Coverage Default in accordance with the terms and scope of the Agreement." Thus, on its face, it provides the Net Collateral Coverage Ratio and it certifies that there is no Collateral Coverage Default within the terms of the NISAs (including, of course, Section 3.05(h)). Section 3.05(h) requires only a certification "to the effect" of the statements therein, not a verbatim statement, and the mutual course of conduct by Wells Fargo and the SPCs prior to any dispute constitutes a practical construction that the certification requirement was met.[14]

Noteholder Counsel also say the NCCR calculation form was to be received prior to the payment of administrative fees. But Section 3.05(h) does not say that the calculation form is required, just the calculated amount (and that

[14] Noteholder Counsel err when they state Wells Fargo knew as of September 2008 that the required certification was missing. *See* Opp. at 12:26-13:4. In the cited letter, the Wells Fargo account manager raised the question with MedCap of whether or not the reported NCCR on the form should change with each disbursement of administrative fees, and not whether the certification form was improper. *See* Furukawa Decl. Ex. 26.

1 appears on the certification). Indeed, there would be no purpose to requiring the
2 calculation form prior to administrative fee requests as the Trustee had no
3 obligation under the NISAs to review the numbers in that form, or to make a
4 comparison of that form with administrative fee requests.

5 Finally, Noteholder Counsel assert that administrative fees properly
6 were to be paid only once per month, and could not be directed by the administrator
7 to be paid to someone else. However, the NISAs do not say either of those things.
8 The fact that the fee is calculated on a monthly basis does not expressly require that
9 it be paid in a lump sum, or that it not be paid by order of the administrator to a
10 third party. As this Court repeatedly has held, there are no implied obligations
11 under the NISAs. Moreover, here again, the mutual course of performance by
12 Wells Fargo and the SPCs prior to any dispute provides a practical construction that
13 these payments were proper under the NISAs.

14 **b. <u>Actual Causation And Recoverable Damages Limits</u>**

15 Even if Wells Fargo had improperly disbursed administrative fees over
16 defective documentation, or in multiple payments rather than a single lump sum,
17 the actual causation defenses (and recoverable damages limitations) discussed
18 above would apply. And, here again, there is no basis on which to conclude that the
19 Receiver (or Noteholders) could meet a burden of showing that the criminals at
20 Medical Capital would have folded their Ponzi scheme rather than supplying a
21 revised self-certification.

22 **3. <u>Disbursements In Bad Faith</u>**

23 Noteholder Counsel appear to assert that most disbursements were
24 made in "bad faith." They vastly overrate the strength (and value) of that claim.

25 *First*, the Banks believe that, under existing law, only actual
26 knowledge of fraud constitutes "bad faith" under the NISAs. The Court initially
27 adopted that interpretation, holding that "bad faith" means "*actual knowledge*
28 contradicting information in [a] certificate or opinion" submitted by Medical

1 Capital (*see In re Medical Capital* Dkt. No. 53 at 7 (emphasis added) (citing Robert
2 I. Landau & John E. Krueger, CORPORATE TRUST ADMINISTRATION &
3 MANAGEMENT 67 (5th ed. 1998))). Noteholder Counsel have not suggested they
4 have evidence to meet that standard.

5 Wells Fargo recognizes that, subsequent to its having adopted an
6 "actual knowledge" standard, the Court decided to withhold decision on the
7 meaning of "bad faith" until "the factual context of Defendants' actions has . . .
8 been fully developed." *In re Medical Capital* Dkt. No. 143 at 10. Accordingly, the
9 Banks were left to negotiate with Receiver under a cloud of some uncertainty,
10 recognizing that the Court might adopt an alternative standard for bad faith, *i.e.,*
11 *"deliberately* ignor[ing] *obvious* 'red flags.'" *Id.* (emphasis added).

12 The evidence does not support a finding of bad faith pursuant to even
13 that somewhat lower standard. Noteholder Counsel assert that the documentation
14 deficiencies, plus the movement of collateral between SPCs at the time funds were
15 required, constitutes sufficient evidence to meet that standard. Opp. at 22-23. But
16 tardy compliance documents – which have now been held *not* to have been even a
17 material breach of the NISAs – hardly constitute an "obvious 'red flag'" of a Ponzi
18 scheme. Indeed, compliance self-certifications patently are *not* an anti-fraud
19 mechanism. Fraudulent actors can (and do) simply make up false certifications, as
20 both the Receiver and Noteholder Counsel acknowledge happened here. The lack
21 of a duty on the part of the Trustee even to review the contents of those self-
22 certifications, let alone audit them, means the certifications cannot possibly prevent
23 fraud.

24 Neither is the movement of collateral and funds between SPCs –
25 which is expressly disclosed as a risk factor in the Private Placement Memorandum
26 the Noteholders received from the SPCs, *see* Macdonald Decl., Ex. 43 at p. 12 –
27 sufficient by itself to constitute an "obvious red flag." The NISAs did not prohibit
28 such transfers, and liquidation of collateral when funds are needed is certainly

subject to a benign interpretation.[15] Furthermore, Noteholder Counsel offer no explanation of who at the Banks "deliberately" ignored these purported "obvious 'red flags'" or why they would do so.

Respectfully, Wells Fargo continues to believe that "actual knowledge" is the correct standard to be applied to indenture trustees, and is confident that this Court or the Ninth Circuit ultimately will agree. If so, the uncertainty under which the settlements were negotiated will disappear, and Wells Fargo will again put the value of claims based on bad faith at zero. Even the somewhat lower standard – *deliberately* ignoring *obvious* 'red flags' – is one that Wells Fargo believes cannot be met based on this record.

D. The "Probablistic Analysis" By The "Damages Expert" On Which Noteholders Counsel Rely Adds Absolutely Nothing Of Relevance To the Court's Analysis.

In an extraordinary portion of their Opposition, Noteholder Counsel state as follows:

> ***Using the Receiver's own numbers,*** Skorheim performed a probabilistic analysis of the possible outcomes of the damages. . . . Based on this analysis, Skorheim determined that the probability is 96.5% (measured by z-score) that the damages, net of litigation costs, are substantially greater than $104 million. Conversely, the probability that the damages, net of litigation costs, are less than or equal to $104 million, is only 3.5% (measured by z-score). Therefore, even assuming his calculation of losses is correct, the Receiver grossly underestimates the amount of potential damages in this case by as much as 88% of the current tendered settlement amount.

Opp. at 29:21-30:10 (*emphasis in original*; record citations omitted). Those statements are the result of either incompetence, or they are purposely misleading. *See generally* Declaration of Joao Dos Santos ("Dos Santos Decl."), Ex. 1.

First, the assertion that – using the Receiver's own numbers – he should have a recovery net of litigation costs in excess of $104 million some 96.5%

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[15] Similarly, as already explained in the Receiver's Reply, the deposit of funds into the trust accounts by the administrator likewise is permitted under the NISAs, and is subject to benign interpretation.

of the time necessarily means that the Banks have only a 3.5% chance of either prevailing outright, or limiting the damages to less than roughly $119 million (including estimated litigation costs). *See* Dos Santos Decl., Ex. 1 at 5-6. Those are obviously *not* the Receiver's assumptions. And, indeed, Wells Fargo submits that any such assumption is objectively unreasonable in light of the substantial issues already discussed in connection with duty, breach, causation and damages.[16]

Second, the assertion that, under the Receiver's assumptions, potential damages are 88% higher than the current net settlement amount reflects an intentional bias in the model design, as well as another obvious error. In particular, this figure apparently derives from a comparison of the $104 million settlement amount (net of costs incurred) with the $195.75 million "Probability Weighted Damages Outcome of Litigation" figure Skorheim calculated when designing his model (essentially, the expected value of the SPCs' claims), and/or the nearly identical $195.65 million average result of the subsequent Monte Carlo simulation he ran with his model.[17] *See* Dos Santos Decl., Ex. 1 at Ex. B; Skorheim Decl. Sch. H. This latter figure is essentially the difference between the estimated average net recovery when Receiver wins multiplied by the probability of the Receiver winning, minus the average net loss when the Receiver loses multiplied by the probability of the Receiver losing. *See* Dos Santos Decl., Ex. 1 at 4; Skorheim

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[16] Wells Fargo is hopeful that the misstatement is a result of design error by the "expert" retained by the Noteholders Counsel, as appears to be the case at least in part. For, his result (quoted in the text) is inconsistent with the assumption regarding the probability of the Banks prevailing that *Skorheim himself* programmed into his model. *See* Dos Santos Decl., Ex. 1 at 6-8. However, this error also reflects in part the assumption built into the model that when the Receiver prevails, he will *always recover between $300 million and $400 million* for his non-administrative fee claims. *See id.* at 5. It is difficult to understand how anyone could assert in good faith that such a prediction is consistent with the Receiver's own assumptions as reflected in his declaration.

[17] Because the average model result by design should closely reflect the "Probability Weighted Damages Outcome of Litigation" used as inputs to the model, *see* Dos Santos Decl., Ex. 1 at 6, any errors or bias in those inputs necessarily skewed Skorheim's assertion that the settlement understated potential damages by 88%.

1 Decl. Sch. H.

2 The intentional bias is reflected in the value Skorheim chose as the
3 average recovery on non-administrative fee claims. Under the methodology
4 Skorheim uses, the average recovery is set at the mid-point between the lowest and
5 the highest estimated recovery amount in the event the Receiver wins. Thus,
6 because Skorheim understood the Receiver to state that he estimated the range of
7 recoveries for administrative fees at $60 million to $151 million in the event he
8 prevailed, Skorheim used $105 million as the average recovery when calculating
9 the expected value of the SPCs' claims. Yet, when Skorheim chose the average
10 recovery for non-administrative fee claims, he used the mid-point between $0 and
11 $700 million (i.e., $350 million) even though he stated that he understood the
12 Receiver to say that $400 million was the maximum recovery (which under
13 Skorheim's methodology would imply an average recovery of just $200 million, the
14 mid-point between $0 and $400 million). This severely biased both the expected
15 value calculation, and the Monte Carlo simulation results, against the Receiver. *See*
16 Dos Santos Decl., Ex. 1 at 5, 8 & Ex. B; Skorheim Decl. Sch. H at lines 1-2 & nn.
17 1-2.

18 The obvious error came when Skorheim failed to include the costs of
19 litigation as part of the loss the Receiver would suffer in those cases when the
20 Banks prevail. *See* Dos Santos Decl., Ex. 1 at 5-6; Skorheim Decl. Sch. H at lines
21 1-2 & notes (1)-(2). The Receiver will have to pay his lawyers and experts
22 irrespective of whether he wins or loses as they are not on a contingency.

23 Correction of this bias and error brings the "Probability Weighted
24 Damages Outcome of Litigation," and the average result of the Monte Carlo
25 simulation to roughly $113 million, or less than 10% above the current net
26 settlement amount. *See* Dos Santos Decl., Ex. 1 at 8 & Ex. B.

27 Of course, Wells Fargo is not suggesting that Skorheim's model, even
28 as corrected, accurately reflects the Receiver's analysis or has utility for the Court.

Wells Fargo is suggesting that the Court should consider what was presented to it by Noteholder Counsel and Skorheim when deciding what weight to give the rest of their analyses.

E. There Is No Basis For Noteholder Counsel's Assertion That The Releases By The Banks Of Their Indemnity Claims Against The Receivership Estate Essentially Have No Value

Noteholder Counsel offer a litany of arguments in an effort to show that the Banks cannot realistically prevail on their indemnity claims against the Receivership Estate. These arguments reflect a misunderstanding either of the NISAs, the applicable law, or both.[18] For present purposes, however, it suffices to point out that, by obtaining a release of those indemnity claims through the settlements, the Receiver will eliminate the risk that either this Court or the Ninth Circuit will compel him to withhold a substantial portion of the current assets of the Receivership Estate as a reserve pending resolution of the Banks' claims. Given the Receiver's plans for an imminent distribution to the creditors (including the Noteholders), this alone is of substantial value.

[18] Noteholder Counsel assert that the Banks necessarily must prevail at trial in order to obtain any indemnity, citing the language of Section 5.07(a) of the NISAs. However, Section 5.07(b) of the NISAs permit the Banks to recover their litigation expenses, irrespective of liability, if they were incurred as a result of the SPCs' breaches (which by definition they were given the nature of the allegations).

Noteholder Counsel also assert that the Banks will have to satisfy standards governing expenses of administration. But at worst the Banks are entitled to equal priority, *see In re Flight Transp. Corp. Sec. Litig.*, 874 F.2d 576, 583-84 (8th Cir. 1989), and at best the Banks otherwise are entitled to priority because reimbursement of their expenses is a priority under the terms of the NISAs. *See, e.g.*, NISA § 3.06(c) ("This Agreement shall create a continuing security interest in the Collateral and shall . . . (c) inure to the benefit of the Trustee"); *id.* at § 5.08(a)(ii)(A) (authorizing Trustee, even without instructions from Debtor, *first* "[t]o pay to the Trustee, the amount of its fee due and payable for performing services under this Note Agreement . . . and expenses incurred in connection therewith").

Noteholder Counsel further contend that the Court can deny the Banks indemnity through equitable subordination. But that would require a finding of inequitable conduct, not mere negligence by the Banks in the performance of their express duties.

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F. The Proposed Injunction Is Proper

Noteholder Counsel object to the Receiver's request for an injunction against further actions against the Banks on substantive, technical and equitable grounds. But the equitable basis is clear: The Banks have agreed to make very substantial settlement payments to the Receivership Estate only in exchange for the assurance of *complete* peace. It is equitable for the Court to facilitate through the requested injunction the Receiver's ability to obtain a favorable settlement result. Nor is there any technical hurdle. The Ninth Circuit case law precluding similar injunctions in bankruptcy cases is based on its interpretation of Section 534(e) of the Bankruptcy Code, a provision that does not apply to SEC receivership actions. Courts routinely refuse to apply Bankruptcy Code restrictions on their normal equitable powers to receivership actions. *See, e.g.*, *Jones v. Wells Fargo Bank*, 666 F.3d 955, 966-68 (5th Cir. 2012) (although Bankruptcy Code § 541(a) makes *in pari delicto* defense applicable against a bankruptcy trustee, court may preclude application of that defense against a receiver when equitable to do so). Finally, the substantive issue of whether the Receiver's exclusive standing to bring the SPCs' claims precludes the Noteholders' claims is now fully briefed in connection with the Banks' pending motions for summary judgment, and the Noteholders' pending motion for partial summary judgment. Wells Fargo incorporates the Banks' briefing on those motions here by reference. If the Banks prevail on that issue (as they should), then an injunction is proper as the Fifth Circuit recognized in *SEC v. Sharp Capital, Inc.*, 315 F.3d 541 (5th Cir. 2003)

III. CONCLUSION

For all of the foregoing reasons, the Court should grant the Receiver's motion for approval of his settlements with Wells Fargo and BNYM.

1
2 DATED: October 1, 2012 MUNGER, TOLLES & OLSON LLP
3
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Filer:	Wells Fargo Bank, National Association, in its capacity as Trustee for the holders of Medical Provider Financial Corporation III Series I and Series II Notes and Medical Provider Funding Corporation V
Document Number:	873

Docket Text:
REPLY in support of MOTION for Settlement Approval of Settlement with Wells Fargo Bank and Bank of New York Mellon[730] filed by Trustee Wells Fargo Bank, National Association, in its capacity as Trustee for the holders of Medical Provider Financial Corporation III Series I and Series II Notes and Medical Provider Funding Corporation V. (Macdonald, Matthew)

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