

1 **DESCRIPTION OF CLAIMS AND CAUSES OF ACTION**

2 **Factual Background**

3 Mathon Fund I, L.L.C. ("**Mathon I**") was formed on February 25, 2002, as an Arizona limited
4 liability company. Its sole member manager was Mathon Management Company, L.L.C. ("**Mathon
5 Management**"), an Arizona limited liability company formed on the same date.¹ Mathon
6 Management's sole member was Slade Williams and Associates, Ltd. ("**SW&A**"), an Arizona limited
7 liability company formed in 1999 by its sole members, Duane Slade and Guy Williams (the
8 "**Principals**").

9 Shortly after formation, Mathon I began soliciting subscriptions for investments in real estate
10 loans. Investors were told that their investment would be secured by real estate, which would have a
11 value at least two to three times the amount of the loan, and that they would receive an annualized
12 rate of return of at least 36%. In some instances, prospective investors were also told that the
13 Mathon entities had little or no problem-loan history and had achieved a 75% rate of return for
14 investors during 2002.

15 Upon subscribing, an investor received a "Non-Recourse & Unsecured Promissory Note"²
16 from Mathon I in the amount of their principal investment.³ While, in most instances, Mathon I
17 received a deed of trust or other lien from the borrower, investors did not receive any assignment or
18 security interest in the borrower's note or the real estate.

19 According to the Amended Complaint filed by the ACC in the Conservatorship Action, Mathon
20 I offered and sold investment opportunities to at least 114 investors who invested over \$68 million
21 between April 2002 and November 2003. Mathon Fund offered and sold investment opportunities to
22 at least 104 investors who invested over \$82 million between November 2003 and April 2005. Funds
23 received from investors were commingled in a number of bank accounts maintained in the name of
24 Mathon I and other entities affiliated with the Principals. A portion of the funds were in fact loaned to
25 borrowers. In general, the loan agreement between Mathon I and a borrower provided for an initial
26 10% loan fee with monthly interest rates of 3% to 6%.

The Amended Complaint alleges that Mathon I and Mathon made various material
misrepresentations in these offerings, including representations that the investments were secured,
that investors would receive any payments made by the third party borrowers, that there were no or
very limited amount of problem loans included in the portfolio. The Amended Complaint also alleges
that Mathon I and Mathon failed to disclose material facts, including the fact that the main source of
payments to investors were funds from new investors, that a substantial portion of the investor's
funds would be used to pay prior investors, that non-performing loans made by Mathon I would be
rolled into Mathon, that all funds of all investments were commingled, and that a large portion of the
third party loans were non-performing.

1 Mathon Management was reorganized as a Delaware limited liability company on November 23,
2003.

2 This oxymoronic phrase was apparently intended to reflect that Mathon I was not itself liable for
payment of the note, which would be paid solely from, and to the extent of, payments from the
borrower.

3 In some instances, an investor received notes with a principal amount greater than the amount
invested, apparently to reflect a guaranteed minimum rate of return.

25 **DISCLOSURE STATEMENT**

The Conservator's Interim Reports indicate the primary source of payments to early investors was not loan payments by the third-party borrowers but new investors' funds. The reports also detail that the Principals received over \$4 million each from Mathon and Mathon I in 2003 and that Mathon Management received over \$5 million from the funds in 2004 and 2005.

The schedules filed in these bankruptcy proceedings indicate that, in 2003 and 2004, Debtor received approximately \$3.4 million in "management fees" from Mathon-related entities, and approximately \$570,000 in sharing point revenues. These schedules also indicate that, between November 2004 and February 2005, the Principals received distributions aggregating over \$793,000 from Debtor.

Conflicting Claims and Counterclaims.

Based upon this factual background, the Mathon companies are at the center of a number of potential claims and counterclaims among the companies, third-party borrowers, management, equity holders, salesmen and other company agents, the ACC, professionals and advisers of the companies, financial advisers of investors, and investors themselves. An analysis of these claims strongly suggests that the claims are duplicative and conflicting and could likely consume years in litigation with limited and uncertain recoveries. A brief summary of the potential claims would include the following:

Investor Contractual Claims. Investors in Mathon I who have not received their promised recovery of principal and interest could pursue claims against Mathon I based on their individual contracts, primarily the "non-recourse, unsecured" promissory notes. Mathon I could defend these claims based upon the "non-recourse" language of the notes, and contend that investors were only entitled to receive distributions from the actual (and very limited) collection of third-party loans. Investors in Mathon may have similar contractual claims, although it is uncertain whether such investors were actually promised anything other than a participating in the profits, if any of that entity.

Investor Securities Law Claims. Recoveries on investor contractual claims would be limited to the assets of the respective Mathon investment entity, which are clearly insufficient to pay all contractual claims. Accordingly, investors would likely seek to recover on other theories and from other parties, including claims against Mathon and Mathon I and others persons liable under federal and state securities laws. Securities laws provide for civil liability for the issuers of securities (in this case, Mathon or Mathon I) and also persons who participated in or induced the sale of securities in violation of Arizona law or persons who offered for sale securities in violation of federal securities laws, which would likely include the Principals, Mathon Management, and salesmen or dealers who helped sell the interests. Investors would contend that these parties made misrepresentations or material omissions by, *inter alia*, failing to disclose that returns received by prior investors had actually been funded from new investor funds rather than recoveries on the assets of the funds. See, e.g., *SEC v. Whitworth Energy Resources, Ltd.*, Fed. Sec. L. Rep. ¶91,280 (9th Cir. December 1, 2000)(publication restricted)(failure to disclose that new investor funds was source of payment to existing investors was materially misleading). Defendants would likely contend that investors' interests in the Mathon entities were not "securities" and/or were securities that did not require registration under applicable laws. In general, investor claims based on securities law would be limited to recovery of the amount invested less any amounts received on account of the security.

Investor Common Law Fraud Claims. Investors may also seek recovery from the Mathon entities and persons associated with them based upon common law fraud theories, contending that such persons defrauded investors by making misrepresentations and material omissions regarding the interests being offered, the financial condition of the Mathon entities, and the sources for payments to prior investors. In general, investor claims based on common law fraud would be limited

to the recovery of the investor's net loss, rather than the promised returns.

Investor Constructive Trust Theories. The causes of action described above are limited to claims against Mathon I and Mathon Fund and certain persons directly responsible for misrepresentations or material omissions. Because investors are not likely to recover all of their losses from these parties, investors would likely seek additional recoveries from other parties based on principles of "constructive trust" and "tracing." Under common law, a person injured by fraud involving misapplication of funds may seek the imposition of a constructive trust. *See generally* 5 SCOTT ON TRUSTS §462 (2001)("A constructive trust arises where a person who holds title to property is subject to an equitable duty to convey it to another on the ground that he would be unjustly enriched if he were permitted to retain it"). Applying this equitable principle, an investor may seek, in addition to damages from those who defrauded the investor, the imposition of a constructive trust on assets acquired by those persons with the investor's funds.

The constructive trust approach would likely lead investors to seek recovery from a number of the Other Conservatorship Entities, which received funds from Mathon I and Mathon Fund, either as "management fees" or simply as transfers among affiliated entities. Investors would also likely seek recovery from other investors who received distributions from the Mathon entities that were funded primarily or exclusively with the funds of new investors.

Once the right to a constructive trust arises, a court in equity would be required to determine to which assets the trust should apply. The general rules are as follows: (1) If the responsible person still holds the funds, equity will impose a duty on the fiduciary to return them and will impose a constructive trust on those specific funds. (2) If the responsible person has improperly wasted the funds, equity will impose a duty to replace the funds and impose a trust on the responsible party's own funds, applying an equitable fiction that the responsible party is presumed to be innocent and therefore to have used its own funds, rather than trust funds, for the unauthorized purpose. (3) If the responsible party has used the funds to acquire property of value, equity will impose a constructive trust on the property acquired by the responsible party.

If the responsible parties had breached their duties to only one investor, applying these general rules might result in the identification of specific assets upon which a constructive trust would arise in favor of that investor. These general rules become impossibly complex when we consider that the responsible parties would have breached the same duties to every investor and that each investor could seek to apply these rules. A few specifics will illustrate:

The Mathon funds were engaged, on a daily basis, in receiving funds -- from investors and from third party borrowers -- and similarly and constantly engaged in disbursing those funds - to investors, new third party borrowers, Affiliates, vendors and employees. Each disbursement can be seen as an additional violation of the duties of the responsible party and justify tracing the funds into the hands of the recipient. With respect to each breach, the investor is entitled to elect which remedy should be applied. In other words, for each transfer of funds, the affected investor could choose to follow funds in the responsible party's next investment or remain attached to the responsible party's deposit

account. An investor also could, as to each breach, simply waive the breach and accept the use of funds.

If an investor elected to trace funds from his investment to valid accounts, this tracing would likely eventually lead to persons rightfully receiving the funds without knowledge of Debtor's misconduct. At this point, the investor's constructive title to traced accounts would be inferior to the interests of the innocent recipient of the funds because courts imposing constructive trusts universally agree that the tracing of trust fund assets ceases when the assets are transferred to a *bona fide* purchaser without notice of the trust.

When a trust exists or is imposed on funds in a commingled account, the account is considered as an undivided mass. In determining whether withdrawals from that account were made from "trust funds" or non-trust funds, courts ignore the actual intent of the fiduciary who made the withdrawals, whether that intent is reflected in bookkeeping entries, statements of intent by the fiduciary, or any coincidental matching of the amount of deposits with the amount of withdrawals. Virtually all courts apply a conclusive presumption that non-trust funds are expended first for non-trust purposes. If non-trust funds are both deposited to and withdrawn from the commingled account, this presumption results in the "lowest daily balance" rule under which the amount of identifiable funds in the account subject to a constructive claim is limited to the lowest daily balance experienced during the period in which the constructive trust is imposed.

Different rules apply when a commingled account contains funds held in trust for separate trusts, constructive or express. Several courts have adopted the "first-in-first-out" rule, concluding that the first victim's funds were spent first. Other courts have adopted a proportionate rule, presuming that each victim's funds were misused in proportion to their balance in the account as of the date of the misuse. Again, all courts ignore bookkeeping entries or other evidence of actual intent of the fiduciary. Many courts have concluded that applying these various tracing rules for the benefit of one victim but at the loss of another victim is, simply, not equitable, and, accordingly, treat all victims simply as general unsecured creditors of the constructive trustee.

Avoidance Claims. As the above discussion indicates, applying non-bankruptcy law to the claims of all injured investors results in a never-ending loop of claims against the same potentially liable parties, and against investors who received distributions funded, in substantial part, from the funds of new investors. In bankruptcy proceedings, however, simpler approaches are available.

Under §§ 544 through 551 of the Bankruptcy Code, Debtors' Estates are empowered to bring actions to recover certain transfers made by Debtors from the immediate and subsequent transferees. Under § 547, Debtors' Estates may recover certain non-ordinary course transfers of funds or other properties made by Debtors during the ninety days (in the case of non-insiders) or one year (in the case of insiders) if made on account of antecedent debts while Debtors were insolvent. Under §§ 544 and 548, Debtors' estates may recover transfers made by Debtors during the four years prior to bankruptcy if such transfers were actually or constructively fraudulent. A transfer is actually fraudulent if made by Debtors with the intent to hinder, delay or defraud any creditor. A transfer is constructively fraudulent if, at the time of the transfer, Debtors were insolvent or otherwise financially impaired and Debtors received less than reasonably equivalent value for the transfer.

These basic bankruptcy principles have been widely applied in the context of Debtors that operated schemes under which existing investors were paid with funds from new investors. These schemes are generally named "Ponzi schemes" based upon the Supreme Court case of *Cunningham v. Brown*, 265 U.S. 1 (1924). In *Cunningham*, Charles Ponzi operated an investment opportunity alleged based on international postage coupons. In fact, Ponzi never acquired any postage and funded substantial returns to existing investors solely from the funds of new investors. Ponzi's scheme reached enormous proportions but rapidly deflated when newspapers reported the absence of any real assets in the scheme. After years of litigation through the bankruptcy courts, the Supreme Court held that the trustee of Ponzi's bankruptcy estate could recover payments made to certain investors by Ponzi shortly before the news became widespread.

Other federal courts have substantially expanded on this same theme. Most courts have found that (i) a Ponzi scheme operation is inherently insolvent from its beginning, *In re Independent Clearing House, Co.*, 41 B.R. 985 (Bankr. D. Utah 1984); (ii) transfers made to investors by a Ponzi scheme are, by their nature, always made with intent to hinder, delay and defraud creditors, *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528 (9th Cir. 1990); and (iii) all transfers by a Ponzi operation are made outside the ordinary course, *Grauly v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)*, 819 F.2d 214, 217 (9th Cir. 1987). Accordingly, a determination that a Debtor has operated as a "Ponzi scheme" is tantamount to a determination that all payments to investors made by that Debtor meet the substantive standards of a fraudulent transfer recoverable by the Bankruptcy estate.

While courts have used a number of different descriptions or definitions of "Ponzi schemes," the Ninth Circuit has established a very broad approach. *In re Bullion Reserve of N. Am.*, 836 F.2d 1214, n. 8 (9th Cir. 1988) (A "Ponzi" scheme is any sort of fraudulent arrangement that uses later acquired funds or products to pay off previous investors."). Clearly, bankruptcy courts will conclude that the debtor has operated a Ponzi scheme even if the Debtor conducted some legitimate operations or received funds from the represented business purpose. *Jobin v. McKay (In re M & L Bus. Mach. Co.)*, 84 F.3d 1330 (10th Cir. 1996).

Once a court determines that a debtor has operated a Ponzi scheme and that an investor has received distributions from the debtor, the court must then determine how much, if any, of the transfer can be recovered from the investor. The Ninth Circuit has taken two approaches: In *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528 (9th Cir. 1990), the Court upheld the recovery by the Debtor's estate of all payments made to the defendant investor. In *In re United Energy Corp.*, 102 B.R. 727 (9th Cir. BAP 1989), *aff'd*, 944 F.2d 589 (9th Cir. 1991), the court concluded that the debtor's estate could recover only the difference between the amount of the transfers received by the investor and the amount of principal invested.