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## **CONSERVATOR'S INITIAL REPORT**

RE: No. CV 2005 005484

### **Overview**

During the past four weeks the accounting staff of Mathon has been diligently working to construct a list of all investors, their mailing addresses, their capital investments, their distributions and their resultant net investment. Net Investment is calculated by subtracting distributions received from total capital contributed. Our verification and testing of the individual investor calculations is an ongoing process. Based on the work performed to date we have calculated the investors' net investment in Mathon to be approximately \$80,000,000. Once we have concluded the Mathon records validation process, we will send each investor a copy of our analysis for their review and confirmation. We anticipate the individual investor statements will be available for mailing to the investors in approximately two weeks.

Our analysis of the assets of Mathon indicates a value of approximately \$60,000,000. (MAT000109-113) A potential, but not probable, value above \$60,000,000 would require the investment of additional funds into assets that are more in the nature of venture capital equity positions rather than loans. In addition to the necessity to invest additional funds, any return would be highly speculative and of an unknown time limit. A return of less than net investment value would constitute a loss of principal by the investors.

The Conservator and Mathon Management continue to develop and pursue an asset optimization and collection strategy. As more information is obtained about the asset portfolio we will be able to better determine the realizable net value of the portfolio.

The Mathon Funds hold equity interests in some of the borrower entities. At this time it is not possible to establish a reasonable value for those equity interests. Additional analysis of the equity interests will be necessary before a reasonable value for those interests can be established.

Mathon's organization and operation provide no single source of tracking investor historical data. **Mathon's documentation and accounting systems appear to have been based on management directives rather than established accounting principles.** Accounting by management directive appears to have occurred despite an adequate well trained accounting department that was run by two CPA's. Brent Williams, CPA, Mathon's Chief Financial Officer and supervisor of the accounting department, is the father of Guy Williams (one of Mathon's co-founders).

**During our preliminary review we observed a number of material transactions that have been improperly recorded in the company's books and records and, as a consequence, it appears that various financial statements prepared by the company are materially misstated as a result of management directives.** The following are a few examples of questionable transactions:

1. On November 5, 2003 check number 10555 for \$700,000 was issued to Guy Williams. (MAT000035, 36, 42, 45, 47) On November 11, 2003 check number 10564 for \$500,000 was issued to Guy Williams. (MAT000035, 36, 43, 46, 48) On November 11, 2003 check number 10565 for \$100,000 was issued to Duane Slade. (MAT000035, 36, 44, 46, 47) All three of these checks were deposited into the individuals' personal accounts. (MAT000046, 48) The entire \$1,300,000 was added to the Texen Oil loan. (MAT000036) Texen Oil received none of the \$1,300,000 as confirmed in a meeting with Mike Sims (Texen Oil), Guy Williams and Duane Slade (Mathon Principals). The entire \$1,300,000 came from Mathon Fund I, LLC investors. (MAT000037-41)
2. On November 24, 2003 check number 10583 was issued to Jennifer Slade (Duane Slade's wife) for \$12,000. (MAT000050, 52) The \$12,000 check was deposited into her personal bank account. The memo on the check reads "Jerry King/Cedar Crest Payoff". Jerry King is Jennifer Slade's father. Duane Slade represented that Jerry King was an investor in Cedar Crest even though he does not show up on the investor list. At the time the \$12,000 check was issued Jerry King had been in prison for approximately 2 1/2 years. Jerry King (MAT000120) is currently serving a 9 year federal jail sentence for operating the Golden Age Planning, Inc./Wishbone Properties (MAT000121-131) Ponzi scheme in the State of Washington and is subject to a \$5,800,000 restitution order as part of his plea agreement. The \$12,000 disbursement to Jennifer Slade was written off as a "Bad Debt". (MAT000051) The source of the \$12,000 was Mathon Fund I, LLC investors. There is evidence in the records of other phantom Cedar Crest investors being paid from Mathon Fund I, LLC investor funds. (MAT000053-55)
3. It appears that a large number of disbursements were inappropriately recorded as bad debt expenses. For example a \$1,926,875 loan to Mill Creek, LLC was written off as a bad debt in 2003. (MAT000098) Mill Creek, LLC was owned by

Slade Williams and Associates, LLC. In addition, the stated value of loans appears to be materially overstated.

4. Substantial sums of investor funds were loaned to Mathon Management for operating expenses. Those loans were not in accordance with the loan objectives stated in the PPM. (MAT000005-34)

Success appears to have been Mathon's worst enemy. During its start up stage Mathon had several small successful hard money loan transactions. Buoyed by its early success. Mathon sought to greatly expand its hard money lending program. Coupled with management's desire to expand, investors' hearing of the company's early success, eagerly sought to invest. Mathon was overwhelmed with a flood of investor money and the need to "get it placed". In its eagerness to satisfy its investors' expectations of huge returns, Mathon expanded into a market where its management lacked general and specific experience. Mathon began making larger, riskier loans based on questionable collateral. Mathon's real estate asset backed lending business model metamorphosed into an intellectual property based venture capital business model.

### **Too Good to Be True**

Mathon Fund I, LLC purported that it could generate huge returns (84% per annum in the following example) for loan investors. (MAT00084) On September 5, 2003, D&R Enterprises, LLC invested \$800,000 in Mathon Fund I, LLC's loan fund. Mathon represented the \$800,000 D&R invested would be loaned to TMC Partners (Connecticut Loan) as part of a \$14,000,000 loan to them. TMC was to pay-off its loan on or before December 9, 2003. The TMC loan appears to have been a bad idea from its inception. According to a March 22, 2004 letter written to Guy Williams by D&R's attorney, "the Connecticut Loan file raised other concerns". The concerns were Mathon misrepresented the following:

1. TMC was putting \$4,000,000 of their own money into the transaction while the closing statement disclosed they received a "purchase price credit" of \$3,975,000.
2. Richard Swartz was both a seller and a buyer in the Loan transaction.
3. "That raises concerns about the legitimacy of the \$15,900,000 purchase price given that the previous owners purchased the property for only \$5,000,000 in October 1999." (MAT000082, 83)

**On May 5, 2004 in an attempt to placate D&R, Guy Williams, on behalf of Mathon Fund I, LLC, executed a partial assignment of beneficial interest for the Connecticut property to D&R. (MAT000080) The assignment was never recorded. Williams' assigned collateral, Mathon Fund I, LLC no longer held.**

**Unknown to D&R or their attorneys, Guy Williams had on January 31, 2004 transferred Mathon Fund's entire interest in the Connecticut property to the Mathon Fund. (MAT000101-4).**

By December 31, 2003 the bulk of Mathon Fund I's loan portfolio was non-performing or was anticipated to become non-performing. Mathon Management's solution was to convert Mathon Fund I lenders into equity investors of the new Mathon Fund. Management offered to add the investors' accrued but unpaid interest to their capital account balance and then roll the combined amount into an equity investment in Mathon Fund, LLC. I have reviewed Mathon Fund, LLC's Private Placement Memorandum dated February 17, 2005 (PPM). (MAT000005-34)

The PPM does not disclose management's intent to roll Mathon Fund I investors into the Mathon Fund nor does it disclose its intent to transfer all or a portion of Mathon Fund I's defaulted loan portfolio into the new fund.

Page 8 of the PPM discloses two ways to invest in the new fund, "Upon execution of the subscription agreement, a Member will be required to fund the entire amount of the investment unless the Manager in its sole discretion allows the Member to fund the investment in two or more installments in amounts and at times mutually agreed upon by the Manager and the Member." (MAT000022)

In practice there were four ways a prospective investor could invest in the Mathon Fund, LLC.

1. Cash purchase of an equity interest.
2. A cash down payment and the remainder of the subscription price on payment terms.
3. Exchange their accrued Mathon Fund I loan balance for an equity interest.
4. Purchase a Mathon Fund I investor's interest at a discount for cash and then exchange the Mathon Fund I loan interest for a Mathon Fund equity interest.

A fifth participation method was offered to a select group of prospective investors. A member of the select group could purchase "equity points" in Mathon Management Company, LLC.

An equity point investor was entitled to receive a proportionate share of the monthly management fee Mathon Management was to receive for managing the fund. The fee was 2.0833% per month (25% per year) of the total balance of all Capital Accounts. Perhaps the most egregious aspect of Mathon's investor fund raising activities was its sale of "Points". A one point holder was entitled to receive 1% of 25% of the outstanding

principal balance of the Mathon Fund per year. Points were sold by Mathon Management on varying terms and for varying amounts. \$1,000,000 was the stated price for a point.

**For Example:**

James Glauser paid \$4.0 million and received the financial benefit of 5.0 points. An entry was not made on Mathon Management's books for the additional one million in point equity. Jim Glauser received his share of the monthly operating fee as if he had purchased \$5.0 million or 5.0 points.

Larry Pew paid \$793,000 for a \$1.0 million point. When the controller inquired of Duane Slade as to the remaining balance of \$207,000 yet to be received, Duane Slade said the balance was paid to him personally and would not be coming into the LLC.

World Sport Fans was recorded on the company's books as the holders of two Points. However, they never paid for their Points. Despite not paying for the Points, they received distributions on those Points of \$546,035.44 in 2004. (MAT000132)

**In my opinion, Mathon's business plan could not achieve the promised returns to investors of 36% per annum or more. (MAT000091) In Mathon's operation, the 25% fee was sufficiently onerous to destroy the economic viability of Mathon Fund's business plan. To achieve a 36% return a borrower would have to pay interest at an annual rate in excess of 81% (typical Mathon points charged 20%, management fee 25% and return to investor 36%). If you added in sales commissions and fund operating expenses, the needed yield would be in excess of 85%. According to Duane Slade Management eventually realized the devastating effect the 2.0833% per month management fee was having on the Fund and on March 28, 2005 suspended the payments to the management company. (MAT000063-65) In actuality the adjustment was the result of the Auditors challenging the propriety of Mathon Management charging origination fees on equity investments made by the fund.**

**Investors in successful, sustainable hard-money lending enterprises typically receive 12% to 24% return. Mathon's business plan did not provide for the impact borrower defaults would have on investor returns. Lending at rates substantially above their competitors hard money rates invited an above average default rate. Management's transfer of non-performing loans from the "Old Fund" to the "New Fund" guaranteed a significant default rate and further exasperated their ability to provide investors with the promised returns.**

On April 5, 2005, Mathon sat on the brink of financial collapse. Since all of its outstanding loans were either in default or not yet due, no cash flow was being generated by its lending activities. The only source of funds was from new investors. The cash flow problems had existed since late 2003 as evidenced by the backlog of investor withdrawal requests and lack of cash reserves. (MAT000092)

Favored investors or those who were more aggressive in their request would get their investment withdrawal over other less favored or persistent investors. A binder has been maintained in the accounting department listing thirty eight investors who requested their investment monies be returned, but did not receive their requested investment withdrawal.

These thirty eight investors in Mathon Fund I and Mathon Fund requested to liquidate their investments during the period June 9, 2004 through April 4, 2005. These requests totaled more than \$22.5 million and were not fulfilled. (MAT000107)

At the commencement of the Receivership on April 5, 2005 the Receivership entities had \$310,824 in all of their bank accounts. The \$310,824 was insufficient to meet its current obligations. Mathon Management's operating expenses (excluding Principals' draws) exceed \$150,000 per month. Slade Williams & Associates' operating expenses were approximately \$180,000 and Fund related legal fees were approximately \$30,000 per month.

A flawed business plan and greed exhibited by both the investors and management, led to Mathon's precarious financial condition. Investors virtually threw money at Mathon in anticipation of reaping huge returns. Management made certain it took its fees off the top. **During 2004 Duane Slade and Guy Williams each received in excess of \$4,000,000. Between November 29, 2004 and March 31, 2005, \$11,408,750 was raised from investors, but only \$350,200 was disbursed as loans. During that same period of time only \$185,000 was received as payments on its' loan portfolio. The bulk of the cash received was paid out to old investors (\$5,270,128) and to Mathon Management (\$5,063,557) for points, operating expenses and commissions.** Since only \$185,000 was received by the company on its loan portfolio, the bulk of the money paid to old investors came from new investors. (MAT000066-69)

Ponzi schemes fall into two broad categories; no business enterprise and insufficient business enterprise. Stated another way, the Ponzi scheme is either a fraud from the beginning or a "good deal" gone bad.

**Mathon may not have started out as a "Ponzi scheme but appears to be a good deal gone bad.** Mathon exhibits two classic elements of a Ponzi scheme; earnings of the business enterprise were not sufficient nor were they the predominate source of payments to old investors. **New investor funds were the primary source of funds used to pay old investors.** (MAT000066-69)

During the marketing of Mathon Fund, L.L.C, Mathon represented to prospective investors that it would obtain an insurance policy to guarantee the safety of investors principal. **Mathon never obtained the represented insurance policy.**

Mathon represented to prospective investors and to existing investors that it had established a "Reserve Account". The Reserve Account should have contained liquid assets that could be used as a source of cash to pay investors thus mitigating the effects of loan defaults and foreclosures. At least some of the point purchasers were told their investment dollars were used to fund the Reserve Account. **The Reserve Account is fictional in that it does not contain cash or near cash items. The Reserve Account contains unsecured interests in loans made by Mathon Fund I and Mathon Fund.** To the extent the loans were in default, the Reserve Fund's assets were impaired and were illiquid. To refer to an impaired pool of loans as a "Reserve Fund" is at best, misleading.

**Misuse of Investors' Monies**

Investors' monies were used to pay Mathon Management and Slade Williams & Associates, LLC operating expenses such as payroll and to pay off Mathon Fund I investors. Monies were moved to and from various entities as needed (see attached list) from April 19, 2004 to January 28, 2005.

Between April 19, 2004 and January 28, 2005, \$2,857,986.52 was transferred from the Mathon Fund, LLC. (MAT000115-19)

**"Upsides" or Bonus Credits Given to Special Investors**

The following Mathon Fund investors received monies credited to their investment accounts totaling more than \$2.0 million in addition to actual money received by Mathon Fund for the investors.

Mathon Fund "Upside" investors:

Asay II Wadsworth, LLC	\$800,000
Collins, David	5,129
DG Development	50,000
Eagles Point, LLC	163,000
Fischbeck, Jason	11,441
Geiser Group, LLC	125,000
King Henry, Inc.	700,000
Lloyd Family Trust	93,750
Marigot Properties, LP	62,500
Mattingly, Ty	70,000
Newman Family Trust	96,600
Pacific Friends, LLC	5,000
Spyglass Ventures – (King Henry)	<u>60,411</u>
<b>Total Bonus Credits to Investors</b>	<b>\$2,242,832</b>

The additional bonuses were charged to the "Due From Mathon Management" account. Not all investors were provided these additional bonuses. Mathon Management never paid Mathon Fund the \$2,242,832.

### **Desperate needs for cash lead to desperate measures**

By late November 2004 Mathon Management was desperate for cash. On November 23, 2004 Mathon Management borrowed \$500,000 from Alan Archibald, Ltd. for 90 days bearing interest at the rate of 3% per month. (MAT000074-78)

On March 25, 2005 Sherman and Karen Kearnl wire transferred \$300,000 to MM Colonial Fund, LLC's Compass Bank account. The funds were to be held by the Fund until the Kearls' completed their investigation of the Fund and Mathon Management Company, LLC. The Kearls' never executed a Subscription Agreement for the Fund. (MAT000070) On March 29, 2005, Brent Williams initiated the transfer of the Kearls' money from Mathon Colonial Fund to Mathon Fund. (MAT000061) Approximately four minutes later **the Kearls' money was used to pay down an old investors' redemption request.** (MAT000060)

On May 7, 2005 the Conservator received a fax from Kyle Larson stating that he had wire transferred \$76,000 with intentions to invest in the Mathon Fund. He stated that his "subscription agreement was never completed or accepted" and requested the return of his money. (MAT000062)

A third investor, Phil Zorbrist, sent \$25,000 on March 24, 2005 to Mathon but had not submitted a subscription agreement. (MAT000071, 72)

A Mathon internal email dated April 5, 2005 confirms the three investors had subscriptions pending. (MAT000073)

### **Don't ask, don't tell**

On August 19, 2003 Jim Cundiff, a Mathon Fund sales representative, sent an email to [jim@ctacgroup.com](mailto:jim@ctacgroup.com) as part of an apparent much larger email distribution. (MAT00001-3) In the email Cundiff summarizes "some evolutions that have come from closed door meetings. Now, make note of this fact, THIS INFO IS NOT COMING FROM THE COMPANY, BUT IT IS COMING FROM ONE WHO SITS IN STRATEGY MEETINGS WITH MANAGEMENT AT LEAST WEEKLY, AND OFTEN MULTI-WEEKLY."

Cundiff goes on to explain Round Valley Capital's policy for sales representatives forming sub-investor groups as follows: "Regarding the LLC's, S-Corps that all of you are working; the best way to describe RVC's policy is kind of like Clinton's policy for Gays in the Military, "Don't ask, don't tell"! RVC is aware of these entities. BUT, they can not openly approve or discuss and won't get involved in mediating or arbitrating

disputes within these entities. If they do, they are liable for all of the activity therein, and they are simply not interested in being put in a position that puts their entire company at risk. So here is a summary of some of the ground rules that are evolving:

- A. All of what you are doing has to be based on warm, personal relationships. 'Recruiting' someone we don't know just because they can write a check is a recipe for disaster. IF, a loan were to go south or be slow to pay, that person will turn on you (and RVC) like a rabid dog.
- B. Participation in an entity has to be by choice, if a prospective lender were told that it was 'required' that he pay part of his interest to another lender, the regulators would have a field day and RVC would be history. If the relationship is not tight enough for a meeting of the minds, then there is not enough of a relationship to go forward together.
- C. What has emerged around the country is that the typical manager of a group is getting 10% of the profit of each of the lenders he/she personally brings into his/her entity. This is not set in concrete, and it can't be, but that is the norm. Each Lender has to have the option of standing alone if they so desire (they can still pay a 10% fee to their personal mgr). Of course, that means they have to pay the Annual Mgt Fee to RVC of \$25,000 and make a commitment of \$500,000. That is a pretty steep barrier to entry.
- D. RVC has said in no uncertain terms, and I quote, "if we find that someone has turned this into an AMWAY MLM deal and is dipping into multiple levels, we will cut them off like a 'red-haired step-child', the person who writes the check deserves almost all of the interest". Again, they can not and will not set or acknowledge policy on this, but they will not allow anyone to jeopardize this company and it's future. I am in a very difficult position here. I have committed major resources and 75 hours a week to this venture. "Don't ask, don't tell", works fine for me. BUT, if I am asked, I will not lie and I will also not risk my family's future on the future of RVC/Mathon. I have passed along the 'unofficial' policy, my job is done."

Jim Cundiff added the following post script to his email: "P.S. This has been sent to every entity on my lender list. PLEASE do not forward this to anyone else. THIS IS NOT AN OFFICIAL COMPANY DOCUMENT, IT IS MY SUMMARY OF DISCUSSIONS WITH MGT AND IS MEANT ONLY FOR THOSE WHO ARE TREATING THIS AS A SERIOUS, LONG-TERM BUSINESS."

The primary purpose for the formation of sub-groups of investors was to allow non-accredited investors, with small amounts to invest, a vehicle for investing in Mathon. Mathon practiced a "don't ask, don't tell" policy in an attempt to shield itself from exceeding the 35 non-accredited investor participation limit afforded under the Regulation D Private Placement Rules. If the sub-groups of investors were integrated

with all investors, Mathon would have been deemed, in all likelihood, an unregistered public offering. Sales would have ceased, rescission required and full registration achieved before resumption of securities sales. Other reasons for the formation of the sub-groups was to limit the \$25,000 per account management fee to provide an additional source of revenue for the organizer of the sub-group and to increase the size and rate of growth of the Mathon Fund.

One of the sub-investor groups formed for the specific purpose of investing in Mathon Fund I, LLC and later rolled into Mathon Fund, LLC was Beames Investments. In a November 27, 2004 letter sent by K. Hal Beames to Guy and Brent (Williams), Beames' states "There are several of my friends and family who have loaned money for the purpose of investing in Mathon Fund I and then rolled into the Mathon Fund. BI has Deanna and my personal money as well as other money that has been lent to BI for the purpose of investing into the Mathon Fund I loans and the Mathon Fund." (MAT000095) Beames stated "It was my understanding during Mathon Fund I program that this was acceptable to Mathon Management." He went on to state "But after the die had been cast, I have learned that this is not an acceptable arrangement." (MAT000095) In October 2004 Beames learned there were about 12 outstanding loans and 8 of them were in default. (MAT000095) Beames went on to state "I have recently been told that Mathon presently has a \$7 Million cash reserve." No such reserve existed. What Mathon called a reserve was not in cash or cash equivalents. Continuing on Beames said "Some of the other representations were that Lloyds of London and Inc Bank would insure the Mathon Fund. It was a question of which would give the better terms not if they would do it." (MAT000096)

Beames included a list of the Beames Investment Lenders. There are 21 names on the list. The smallest investment was \$2,540 and the largest \$121,820. Beames identifies only 5 of the 21 investors as being accredited. In the investor schedule Beames discloses another known sub-group, Bright Star, and its organizer, Sue Malone. (MAT000093)

There appears to be at least a dozen sub-groups. Further analysis and contact with investors will disclose the extent of the formation of sub-groups of investors. We intend to ask; investors are beginning to tell.

### **Bankruptcy**

Mathon was a multi-state lender and its investor base, encompasses several states. Mathon currently is engaged in various litigations as both a plaintiff and a defendant. The litigation involved suits brought in Arizona as well as other states.

We are in the process of evaluating whether or not Bankruptcy Court should be recommended for the Mathon entities as a preferred forum for maximizing investor recoveries.

Factors we are reviewing include:

1. The broad inherent powers that a Bankruptcy confers on a Debtor;
2. The nationwide effect of a stay in 11 USC Section 362; and
3. The scope of recoveries available under Chapter 5 of the Bankruptcy Code.

Prior to making a recommendation to this court on the Bankruptcy issue, I request additional time to confer with the Mathon Investors Committee regarding the benefits and detriments of a Bankruptcy proceeding. It is my intent to issue a supplemental report to the Court on the Bankruptcy issue as well as additional information on asset values and a definitive investor accounting. The supplemental report will be filed on or before June 6, 2005.

Sincerely,

JAMES C. SELL, Conservator

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