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UNITED STATES DISTRICT COURT  
DISTRICT OF OREGON

SECURITIES AND EXCHANGE  
COMMISSION,

Plaintiff,

vs.

SUNWEST MANAGEMENT, INC.,  
CANYON CREEK DEVELOPMENT, INC.,  
CANYON CREEK FINANCIAL, LLC, and  
JON M. HARDER,

Defendants,

Case No. 09-CV-6056-HO

MEMORANDUM OF POINTS AND  
AUTHORITIES IN SUPPORT OF PROPOSED  
DISTRIBUTION PLAN

DARRYL E. FISHER, J. WALLACE  
GUTZLER, KRISTIN HARDER, ENCORE  
INDEMNITY MANAGEMENT, LLC,  
SENETET LEASING COMPANY, FUSE  
ADVERTISING, INC. KDA  
CONSTRUCTION, INC., CLYDE  
HAMSTREET, and CLYDE A . HAMSTREET  
& ASSOCIATES, LLC,

Relief Defendants.

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## **I. PRELIMINARY STATEMENT**

At its peak, the Sunwest Enterprise operated hundreds of senior living facilities around the country.<sup>1</sup> The Sunwest Enterprise also managed other investments, including real property both related and unrelated to operating the senior living facilities. Over the past several years, hundreds of millions of dollars in new investments in the Sunwest Enterprise were solicited, primarily offered as tenant in common ("TIC") real property investments.

This case involves the near financial meltdown of the Sunwest Enterprise. Jon Harder, the founder of the Sunwest Enterprise, and dozens of Receivership Entities have filed voluntary chapter 11 proceedings. The Sunwest Enterprise had critical cash flow problems arising from the overleveraging of properties, lower than industry standard occupancy, and disruption in the capital markets. This caused the Sunwest Enterprise to be in financial distress and led to potentially hundreds of millions of dollars in investment losses, primarily to individual Investors intending to invest in particular Sunwest facilities. But for the intervention of the preliminary injunction issued in the SEC Enforcement Action, the Sunwest Enterprise would have sunk.

The Sunwest Enterprise was managed as a unitary enterprise that generally did not respect the separateness of the Receivership Entities nor the restricted purposes of invested funds that were supposed to be limited to use for specific facilities. Now, without a successful Distribution Plan, the Investors face the potential that there is little hope they will achieve the expected, or perhaps any, return on their investments. Many Investors face the prospect of no recovery on their investment at all. There is neither an easy nor a perfect solution to the problems caused by the operations of the Sunwest Enterprise.

Receiver Michael Grassmueck and CRO Clyde Hamstreet, Court-approved fiduciaries for the Receivership Estate, have jointly proposed a Distribution Plan for all Investors in and creditors of the Sunwest Enterprise. Through the Distribution Plan, the Receiver and CRO

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<sup>1</sup> Capitalized terms not defined herein shall have the meaning set forth in the accompanying Proposed Distribution Plan.

attempt to ameliorate the harm to the innocent persons and entities who were unknowingly caught up in these events.

The Distribution Plan and the follow-on Reorganization Plan are the ultimate products of the restructuring efforts of the CRO over the past year (in coordination with the Receiver, since his appointment); the Receiver's investigation of the operations and financial condition of the Sunwest Enterprise, the use of invested funds, and the extent of commingling among nominally separate Sunwest Enterprise entities; the Receiver's investigation of potential Third Party Claims; consideration of various alternatives for an equitable distribution to Investors and creditors; and Court-supervised Mediation among the Receiver, the CRO, and numerous Parties in Interest.

As a result of the foregoing activities, the Receiver and the CRO recommend the Distribution Plan as representing the best alternative to maximize the value of the Sunwest Enterprise for all stakeholders and the most equitable means of distributing the value of the Receivership Estate to Claimants. The Distribution Plan is supported by the Case Fiduciaries. The Receiver and CRO respectfully request that the Court approve the Distribution Plan.

## **II. BACKGROUND**

### **A. Background of the Sunwest Enterprise**

Sunwest Management, Inc. ("SMI") is a management company providing housing, care, and services to approximately 11,000 elderly residents at 165 communities across the United States. SMI is part of a group of related companies involved in the acquisition, development, design, construction, financing, insuring, and operation of senior living and other properties nationwide, along with miscellaneous other assets and operations (the "Sunwest Enterprise"). Sunwest facilities include senior independent living facilities, assisted living facilities, and facilities that specialize in Alzheimer's care. Hamstreet Decl., ¶ 3.

The principal owners of SMI and related entities were founder and CEO Jon Harder, COO Darryl Fisher, and General Counsel Wallace Gutzler ("HFG"). Together or severally, HFG owned controlling interests in SMI and related entities: Senenet (an employee leasing company), Encore Indemnity (an offshore captive insurance company), Canyon Creek Development (a real

estate acquisition and development company), KDA (a construction company), Canyon Creek Financial (a broker-dealer), and several hundred LLCs that held varying degrees of ownership interests in hundreds of senior living, commercial, and other real properties affiliated with Sunwest. Hamstreet Decl., ¶ 5.

The remaining ownership interests in Sunwest-affiliated properties were held by different classes of private Investors who purchased investments offered by Canyon Creek Financial or outside broker-dealers. This group included some 1,200 tenant-in-common investors (“TIC”) and several hundred preferred and LLC members. In addition to institutional borrowing from over 100 lenders and the sale of thousands of investments, Sunwest and HFG also raised funds through non-institutional loans from various sources, which were generally guaranteed by Harder and often Fisher. Most of these loans were unsecured, but some were secured. Harder also sometimes made pledges of his equity interests in return for loans. Hamstreet Decl., ¶ 6.

Each Sunwest-affiliated property had separate ownership, often involving multiple Investors in addition to HFG. The senior living facilities and certain other properties generally employed one of two ownership structures: 1) A single special purpose LLC owned HFG’s interest in the underlying real property and the operations; or 2) One special purpose LLC owned HFG’s interest in the real property, which was leased to the operator, and a second LLC operated the facility. Either way, the Sunwest-affiliated LLC may have been a co-tenant with independent TIC affiliated LLCs, or it may have been a member of another LLC that also included outside Investors. Hamstreet Decl., ¶ 7.

Although HFG owned the Sunwest properties through separate LLCs, and those LLCs in turn shared ownership with a variety of other parties, under HFG’s leadership the Sunwest Enterprise generally conducted its business as if it were a single business entity, with centralized management, personnel administration, marketing services, and cash management. SMI managed nearly all of the affiliated senior living facilities, and Senenet was the employer of nearly all of the personnel who worked at the affiliated entities. The Sunwest Enterprise routinely aggregated and commingled funds in centralized SMI and Senenet accounts. Funds

were typically taken from wherever they could be found within the Sunwest Enterprise and used wherever they were needed. Hamstreet Decl., ¶ 8.

Essentially, Sunwest management would draw cash from any available source to satisfy its cash needs for the facilities. Grassmueck Decl., ¶¶ 22-24; Gadawski Decl., ¶¶ 10-11. A centralized account was utilized for such purposes. Gadawski Decl., ¶ 13. Indeed, the Sunwest Enterprise absolutely relied upon such commingled use of funds. Hamstreet Decl., ¶ 19; Grassmueck Decl., ¶¶ 23-25.

In addition to senior mortgage debt, Sunwest financed the acquisition and development of senior living properties by selling fractional undivided minority interests in real estate and preferred membership investments. TIC investors in particular were the lifeblood of the extremely rapid growth from 162 senior living facilities at the end of 2005 to a peak of 291 in mid-2008. Between 2005 and mid-2008, the Company raised \$440 million in cash through 1,800 TIC investments, \$45 million through 280 preferred LLC memberships, and \$85 million from 250 non-institutional loans. Sunwest typically "guaranteed" TIC and preferred LLC investors a 10% annual return plus a 2% per annum buyout premium in the event of sale or refinance. Hamstreet Decl., ¶ 9.

#### **B. The Sunwest Enterprise in Financial Distress**

Early in 2008, the Sunwest Enterprise began facing critical cash flow problems arising from the overleveraging of properties, lower than industry standard occupancy, and disruption in the capital markets. Grassmueck Decl., ¶ 12. Many of Sunwest's facilities could not generate revenues to cover operating expenses, service on secured debt, and lease payments owed to TIC Investors. Around the same time, the credit markets began to seize up, making it difficult to borrow money or refinance properties as had been done in the past. Falling real estate values also impaired financing and re-financing efforts and left many facilities with no or negative equity. By the summer of 2008, the Sunwest Enterprise could no longer meet its obligations and ceased funding all Investor payments. Hamstreet Decl., ¶ 10.

Many Investors depended on payments from the Sunwest Enterprise to fund their living expenses. Attracted by a guaranteed 10% rate, some Investors had mortgaged their homes or used cash from their retirement savings to invest in the Sunwest Enterprise. Most of the TIC Investors had exchanged into their properties under section 1031 of the tax code, which granted a special tax-deferred status. Foreclosures of property threatened not only their investments, but also their tax status. Hamstreet Decl., ¶ 21.

On December 31, 2008, Sunwest's founder Harder filed an individual, voluntary petition for bankruptcy relief commencing Case No. 08-37225-tmb11 (the "Harder Bankruptcy"). Several of the Receivership Entities also commenced bankruptcy proceedings.<sup>2</sup>

As of January 2009, there were at least 45 foreclosure actions pending in which rents and profits receivers had been appointed to take control of the relevant facilities. Grassmueck Decl., ¶ 19.

### **C. The SEC Enforcement Action**

On March 2, 2009, the United States Securities and Exchange Commission ("SEC") commenced an action against Sunwest and the other Defendants and Relief Defendants for alleged violations of federal securities laws, commencing the underlying action (the "SEC Enforcement Action").

The SEC's complaint contends that the Defendants, who controlled the Sunwest Enterprise, engaged in a massive fraud that led to losses of hundreds of millions of dollars to investors who acquired TIC interests in the real properties of the Sunwest Enterprise and to other investors and creditors as well. The SEC further contends that TIC investors and other investors were told that they were purchasing ownership interests for a specific real property that would generate enough profit to pay a fixed promised annual return, and that the Sunwest Enterprise had a history of never missing a payment. These representations, according to the SEC, were

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<sup>2</sup> This Court has withdrawn the reference of the Harder Bankruptcy and the bankruptcy cases of the Receivership Entities pending in the Bankruptcy Court.

false and concealed the true nature of the investments and the risk to investors from the Sunwest Enterprise's precarious financial position.

The SEC further contends that, contrary to representations by Defendants that investors were obtaining an interest in a specific real property which would generate a steady income stream, Defendants ran Sunwest as an integrated unitary enterprise, commingling investor and creditor funds and operational revenue into essentially a single fund, often channeled through the personal bank account of Harder, from which operating expenses and investor returns were paid. Furthermore, the SEC contends that, contrary to Defendants' representations, including written representations and marketing pitches, the Sunwest Enterprise paid some investors and some creditors steady returns on their investments and claims, not from successful management of a particular real property asset, but from cash generated in the operations of other real property assets and from funds obtained by refinancings, from loans from Defendant Harder and certain Harder creditors, and from funds raised through offerings to new investors. The SEC contends that these facts were not disclosed to, or known by, investors and constituted securities fraud.

According to the SEC, by June 2008, the Defendants operated Sunwest virtually as a Ponzi scheme: money raised in the final offerings (represented to be for new real property assets) was used to pay old investors and creditors their promised return and payments and otherwise fund existing operations and other real property assets. The SEC accuses Defendants or Harder of reporting income to investors and creditors that was partially or wholly fictitious. The SEC also contends that, despite the Sunwest Enterprise's dire financial situation, Defendant Harder misappropriated tens of millions of dollars, and the Relief Defendants were the recipients of substantial ill gotten gains. The SEC contends that as a result of this conduct, as of January 2009, over 100 real properties operated by Sunwest were in jeopardy of foreclosure, and in or headed into Rents and Profits Receiverships or bankruptcy cases.

#### **D. Appointment of the Receiver**

Also on March 2, 2009, the SEC filed its application for a preliminary injunction and appointment of a receiver. On March 3, 2009, the Court entered a temporary restraining order.

On March 10, the Court entered an order that provides for, among other things, the preliminary injunction and appointment of the Receiver. Since that time, the Court has entered additional Receiver Orders extending the injunction and receiver appointment with respect to additional Receivership Entities. The Receivership Entities consist of the entities listed on Exhibit A, Exhibit A 2 and proposed Exhibit A 3 to the Receiver Orders and additional entities that are owned or controlled by the Defendants.

Pursuant to the Receiver Orders, Michael A. Grassmueck is the Receiver appointed by the Court with respect to the Receivership Estate. The Receiver Orders provide the Receiver with various rights, powers, and duties with respect to the Receivership Estate. Receiver Order, Dkt. No. 64, Art. III and IV. The Receiver's duties, responsibilities and activities generally fall into four categories:

- (i) investigation of the financial condition of the Receivership Entities, the disposition of Investor funds and determining the extent of commingling of funds among the Defendants, Relief Defendants and Receivership Entities;
- (ii) pursuing and resolving claims against third parties so that the proceeds will be available to satisfy Investors' and creditors' Claims;
- (iii) advising the Management Committee and CRO as to issues concerning the Bankruptcy Cases, Secured Creditors, disposition of assets and restructuring and distribution; and
- (iv) developing a plan for distribution of proceeds to creditors and Investors.

#### **E. The Receiver's Investigation**

The Receiver conducted a preliminary investigation of the Receivership Entities and the Sunwest Enterprise that culminated in the filing of the Receiver's First Interim Report.<sup>3</sup>

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<sup>3</sup> See, First Interim Report of Receiver Michael Grassmueck as of April 22, 2009, Docket No. 241 (the "First Interim Report").

At the time of the SEC Enforcement Action, SMI was managing approximately 183 assisted living facilities, 85 non-assisted living facilities and other investments. Grassmueck Decl., ¶ 11.

As set forth in the First Interim Report, the Receiver's preliminary investigation revealed that the commingling of funds within the Sunwest Enterprise was rampant. Sunwest management employed a variety of transactions and accounting entries to carry out the cash transfers among Sunwest Enterprise facilities. Furthermore, it does not appear that it was merely profitable facilities propping up those with negative cash flow. The Receiver has received information and reviewed evidence that loans and other funds transfers were also made from distressed facilities to those that are now profitable facilities. Grassmueck Decl., ¶ 22-24.

Based on the Receiver's investigation, it appears that the alleged wrongful conduct described by the SEC has played a significant role in the financial distress of the Sunwest Enterprise and the losses suffered by Investors of the Sunwest Enterprise. Grassmueck Decl., ¶ 11.

#### **F. Formulation of the Distribution Plan**

Since his appointment, the Receiver has also focused on the major issues that directly impact the ultimate return to the Investors and creditors: disposition of properties, restructuring and, ultimately, a distribution plan. Grassmueck Decl., ¶¶ 9-10. The Receiver has engaged in many days of Mediation conducted by the Mediator with respect to these issues. *Id.* To a large extent, the proposed Distribution Plan is a product of these Mediation sessions.

### **III. SUMMARY OF THE DISTRIBUTION PLAN**

The Distribution Plan establishes how claims against the Receivership Estate are calculated for purposes of establishing Allowed Claims; how Allowed Claims are treated with regard to priority and source of Plan Distributions; and what the source of Plan Distributions will be and how they will be created.<sup>4</sup> An illustration of the Distribution Plan components is attached hereto as Exhibit 1.

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<sup>4</sup> In the event of any conflict or inconsistency between the terms of the Distribution Plan as described in any of

The Distribution Plan contemplates a Claims Process that will involve solicitation, review and resolution of Proofs of Claim filed by Claimants.

The Distribution Plan is focused on two core elements: (1) maximizing the value of the Sunwest Enterprise for the benefit of all stakeholders; and (2) providing for an equitable distribution of that value among all Claimants.

**A. Maximizing Sunwest Enterprise Value**

The CRO and the Receiver have established three basic categories of real property assets of the Sunwest Enterprise: Holdco, Trustco, and Divestco. Currently, Holdco consists of 152 core senior living facilities, three apartment buildings, and nine commercial properties, around which the new Sunwest will reorganize. Trustco consists of 34 land parcels to be held for sale when markets recover, unless investors exercise an option to buy out the estate's interest prior to that time. Divestco consists of 60 senior living facilities and 26 other properties that will be released to lenders as soon as possible. Hamstreet Decl., ¶ 35.

Through the Distribution Plan and the follow-on Reorganization Plan, a unitary enterprise will be recognized and reorganized to become REITCO, with an affiliated Master Limited Partnership to be known as SWP Property Holdings, L.P. ("SWP"), for which REITCO will serve as the general partner. Assets of the Receivership Entities and any co-owners in Holdco Properties will be conveyed to REITCO or SWP in exchange for securities as determined by the Receiver. REITCO (and possibly SWP) will be a public reporting company and, to maximize the value and the marketability of REITCO shares, and the Receiver and CRO hope that it will eventually take steps to have an initial public offering and its shares trade on an exchange, or REITCO will merge or be sold to a third party. The Receiver and CRO have a seven-year horizon for these events to occur.

The Receiver has initiated certain Third Party Claims and is continuing to investigate additional claims that may be brought on behalf of the Receivership Estate. To the extent not

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the supporting documents and the terms set out in the Distribution Plan, the Distribution Plan controls.

earlier resolved, all Third Party Claims will be administered by the Receiver, as sole trustee of the Litigation Trust to be formed upon approval of this Distribution Plan.

#### **B. Equitable Distributions of Value**

Cash and securities will be distributed to Claimants holding Allowed Claims. The cash will be generated from the operations of properties affiliated with REITCO and SWP, the sale of certain Trustco and Divestco Properties, and the recoveries/settlements on Third Party Claims. Securities will be issued as REITCO shares, SWP units and interests in limited liability companies formed for the purpose of owning one or more Holdco Properties ("DownREIT"). Plan Distributions to Investors and Unsecured Creditors will be made on a *pari passu* basis, using a modified Money-in/Money-out formula to determine the *pro rata* share for Investors and Unsecured Creditors.

The Distribution Plan establishes a framework for the fair and equitable treatment of Secured Creditors through the Reorganization Plan. Secured Creditor interests will remain as liens on applicable Holdco, Trustco and Divestco Properties. With respect to Holdco and Trustco Properties, the treatment of Secured Creditor Claims will be on terms authorized by the Reorganization Plan. Divestco Properties will be released from the injunction in the Federal Receivership Case.

#### **IV. FEDERAL EQUITY RECEIVERSHIP LAW SUPPORTS THE RECEIVER'S PROPOSED DISTRIBUTION PLAN**

Pursuant to the Receiver Orders, the Receiver is responsible for formulating a proposed distribution plan. Moreover, it is customary for federal equity receivers to propose plans of distribution in SEC receivership cases.<sup>5</sup> The CRO is a Case Fiduciary, charged by the Court with certain responsibilities, including decisions relating to operations and asset dispositions, pursuant

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<sup>5</sup> See, e.g., SEC v Capital Consultants, LLC, 397 F.3d 733 (9<sup>th</sup> Cir. 2005) (affirming approval of plan of distribution proposed by receiver); SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 88-90 (2d Cir. 2002) (same); SEC v. Forex Asset Management LLC, 242 F.3d 325, 328 (5th Cir. 2001) ("Prior to approving the Receiver's distribution plan, the district court sought objections to the plan . . .").

to the Receiver Orders and that certain Order Approving Rights and Powers of CRO and Management Committee entered by the Court on June 12, 2009, as docket no. 352. Accordingly, it is appropriate for the Court to consider the jointly proposed Distribution Plan of the Receiver and CRO.

As set forth in detail below, two overriding principles guide judicial decision making in federal equity receiverships. First, the district court supervising an equity receivership has extremely broad equitable power to determine an appropriate course of action to achieve an equitable and efficient administration of the estate for the benefit of creditors. Second, similarly situated victims should receive roughly equal treatment. Utilizing these broad principles, district courts have often approved the pooling of assets and *pro rata* distributions under circumstances similar to those found in the Federal Receivership Case.

**A. The Court Has the Power, in its Broad Discretion, to Approve an Equitable Distribution Plan**

The Ninth Circuit and the other courts of appeal universally hold that a district court administering an equity receivership has the power to fashion any distribution plan that is fair and equitable. Capital Consultants, 397 F.3d at 738; SEC v. Hardy, 803 F.2d 1034, 1037 (9th Cir. 1986) (“It is a recognized principle of law that the district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership.”) (quotation omitted); SEC v. Lincoln Thrift Ass'n, 577 F.2d 600, 606 (9<sup>th</sup> Cir. 1978); CFTC v. Topworth Int'l, 205 F.3d 1107 (9<sup>th</sup> Cir. 1999); SEC v. Wang, 944 F.2d 80, 84-85 (2d Cir. 1991) (stating that the district court is vested with “broad discretionary power . . . to craft an equitable decree”); Forex Asset Mgmt., 242 F.3d at 331 (5th Cir. 2001) (“[i]n shaping equity decrees the trial court is vested with broad discretionary power . . . .”) (quotation omitted); SEC v. Elliott, 953 F.2d 1560, 1566 (11th Cir. 1992) (“The district court has broad powers and wide discretion to determine relief in an equity receivership.”); SEC v. Infinity Group Co., 226 Fed. Appx. 217, 218 (3d Cir. 2007) (“District Courts have wide equitable discretion in fashioning distribution plans in

receivership proceedings . . . .”); SEC v. Basic Energy & Affiliated Res., Inc., 273 F.3d 657, 670-71 (6<sup>th</sup> Cir. 2001).

Specifically, when a receiver is appointed under remedial statutes enacted to protect the public interest, such as the Securities Act or the Commodities Act, a district court is afforded broad discretion to fashion the appropriate equitable relief. SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (“The crafting of a remedy for violations of the [Securities Exchange Act of 1934] lies within the district court’s broad equitable discretion.”); SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1474 (2d Cir. 1996) (stating that the district court has “broad equitable power to fashion appropriate remedies” in securities fraud cases); CFTC v. Muller, 570 F.2d 1296, 1300 (5th Cir. 1978).

**B. As a Matter of Equity, Similarly Situated Parties Should Receive Similar Treatment, Which May Require Pooling of Assets and Ratable Distributions based on Net Investments**

In approving a plan of distribution in an SEC receivership case, the court’s exercise of discretion in adopting a plan of distribution is guided by equitable principles. See United States v. Durham, 86 F.3d 70, 73 (5th Cir. 1996) (“Sitting in equity, the district court is a ‘court of conscience.’”) (citing Wilson v. Wall, 73 U.S. 83, 90 (1867)). In the quest for equity in SEC enforcement actions, three common features of receiver distribution plans are pooling of assets, pro rata distributions, and calculation of distributions based on each investor's net investment. See, e.g., Capital Consultants, 397 F.3d at 738; Topworth, 205 F.3d at 1115; United States v. 13328 and 13324 State Highway 75 North, 89 F.3d 551, 553-54 (9th Cir. 1996); In re Equity Funding Corp. of America Securities Litigation, 603 F.2d 1353 (9<sup>th</sup> Cir. 1979); In re Tedlock Cattle Co., 552 F.2d 1351 (1977).

**V. RECOGNITION OF A UNITARY ENTERPRISE AND RATABLE DISTRIBUTIONS BASED ON NET INVESTMENTS IS THE MOST EQUITABLE APPROACH IN THIS CASE**

**A. Recognition of a Unitary Enterprise Promotes Equity and Is Justified in this Case**

Although organized as discrete legal entities, the Receivership Entities were historically operated, and utilized cash investments and/or cash from operations in a significantly commingled manner without regard to the proper legal rights of purportedly separate entities to such funds. As a result, payments to certain Investors or to benefit certain facilities were made from funds that should have been limited to benefit other Investors or facilities. The Distribution Plan acknowledges that the Sunwest Enterprise failed to observe proper and customary legal distinctions among the various Receivership Entities, which effectively eliminated nominal legal boundaries among the various Receivership Entities such that they were operated as a unitary enterprise.

As set forth above, the Sunwest Enterprise has been operated as a unitary enterprise such that assets and funds that were intended to be kept and managed separately were instead commingled and, in certain circumstances, utilized for unauthorized purposes. A *pro rata* distribution to Claimants recognizes this reality and avoids the injustice that would result from favoring the lucky few Investors whose investments were not yet used up or lost in the faltering operations of the Sunwest Enterprise. The Receiver and the CRO submit that the most reasonable and equitable method of distributing funds on hand, proceeds of Third Party Claims, asset dispositions, and the value of the Sunwest Enterprise is by *pro rata* distribution among Investors and unsecured creditors, based on a modified Money-in / Money-out formula for calculating Allowed Claims.

In similar cases involving extensive commingling and a lack of adequate adherence to corporate formalities, pooling of assets and a *pro rata* distribution is favored and justified within the exercise of the district court's broad equitable discretion to implement a plan of distribution.

See, e.g., Credit Bancorp, 290 F.3d at 88-89; 13328 and 13324 State Highway, 89 F.3d at 553 (upholding *pro rata* distribution to victims and stating that “[i]nstead of engaging in a tracing fiction, the equities demand that all [victims] share equally in the fund of pooled assets”).

Recognition of a unitary enterprise and pooling of assets for purposes of making Plan Distributions is justified in this case because of the extensive commingling of Investor funds; the fact that the Investors are similarly situated with respect to their relationship to the Sunwest Enterprise; and the disregard for the formal entity structure within the Sunwest Enterprise. Credit Bancorp, 290 F.3d at 88-89.

### 1. Commingling of Investor Funds

The Receiver, with assistance from Financial Forensics, has determined that the extent of commingling of funds by and among the Receivership Entities and Defendants and Relief Defendants was rampant. The commingling was so extensive that it would not be feasible to attempt to trace the commingled funds to individual Investors because the cost of doing such an analysis would be prohibitive and the results, under the law and practice relating to equitable tracing, would be of no value in determining a fair and reasonable plan of distribution. Grassmueck Decl., ¶ 15; Gadawski Decl., ¶¶ 12-13; Hamstreet Decl., ¶ 43.

### 2. Similarly Situated Investors

The Sunwest Enterprise involved approximately 1,200 TIC Investors, several hundred LLC members (including preferred members), and non-institutional note holders with various unsecured and secured notes issued by certain entities within the Sunwest Enterprise. These were nominally different types of Investors, who intended to invest in particular real property or facility investments. For purposes of the appropriate treatment under a federal equity receiver's distribution plan, however, they are considered similarly situated because their investment was made within the context of an investment scheme whose unraveling entitled all of them to equal, equitable consideration from the court. 13328 and 13324 State Highway 75 North, 89 F.3d at 553-54. The investors were intending to make investments for specific purposes, but the

invested funds generally were used in a commingled fashion such that all of their funds went to support the greater Sunwest Enterprise.

### 3. Disregard of Corporate Separateness

Courts have also relied on disregard of corporate or entity separateness to justify pooling of assets and *pro rata* distributions. See Topworth International Ltd., 205 F.3d at 1110; Securities and Exchange Commission v. Elliot, 953 F.2d 1560 (11th Cir. 1992) rev'd. in part on other grounds, 998 F. 2d 922 (11<sup>th</sup> Cir. 1993);<sup>6</sup> SEC v. AmeriFirst Funding, Inc., No. 3:07-1188-D, 2008 WL 919546 (N.D. Tex. Mar. 13, 2008).

In this case, the Sunwest Enterprise failed to respect entity separateness. The Sunwest Enterprise regularly disregarded limits and restrictions on use of funds by Receivership Entities. The use of the common accounts to pool the entities' funds to facilitate improper inter-company "loans" among the Receivership Entities – that were not necessarily repaid by the receiving entity – evidences an intent by the control parties to treat the Sunwest Enterprise as a single economic unit. The fact that all of the Receivership Entities were managed collectively by the same group of individuals in the same locations, typically including HFG, supports treating the Sunwest Enterprise as a unitary enterprise. Hamstreet Decl., ¶¶ 8, 19, 36.1.3, and 43; Grassmueck Decl., ¶¶ 22-25; Gadawski ¶¶ 10-13.

In Elliott, an equity receiver was appointed for the principal defendant (Elliott) and three of his affiliated companies. The Eleventh Circuit affirmed the district court's decision to "treat[] the various companies as one entity for the purpose of the receivership proceedings," because "Elliott had commingled funds between the various companies and had failed to maintain a strict separation of the companies . . . ." Elliott, at 1565 n.1. Thus, at the conclusion of the proceedings, the court approved a *pro rata* distribution across the multiple entities.

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<sup>6</sup> Elliott has been cited with approval by the Ninth Circuit in 13328 and 13324 State Highway 75 North, 89 F.3d 551, 553-54 (9th Cir. 1996).

Similarly, in AmeriFirst Funding, the district court specifically rejected the argument that the existence of multiple, legally formed corporate entities precludes pooling their assets and distributing pro rata in the context of an SEC receivership. AmeriFirst Funding, at \*4.

The Sunwest Enterprise's former control parties failed to adhere to corporate formalities such that the entire group of companies functioned as a single economic unit, wherein the individual LLCs had no meaningfully separate financial existence. Therefore, in addition to the equitable factors, evidence of commingling, and similarities between the defrauded investors described above, the disregard of corporate separateness among the Receivership Entities provides additional support for adopting a *pro rata* plan of distribution in this case.

4. Pooling of Assets to Accomplish Ratable Distribution Is Also Appropriate and Equitable, Even if Tracing is Possible

In cases involving investment schemes in enterprises comprised of numerous entities, courts have approved the pooling of assets for distribution to ensure equitable treatment of investors. Commingling of investor funds typically occurs through transfers of funds among various accounts or entities. Under these circumstances, in order to accomplish an equitable, ratable distribution among similarly situated investors, federal equity receivership courts may order the pooling of assets of receivership entities. Topworth Int'l, 205 F.3d at 1110 (affirming approval of receiver's plan that proposed combining multiple receivership entities into one fund). see also, Securities and Exchange Commission v. Elliot, 953 F.2d 1560 (11th Cir. 1992) rev'd. in part on other grounds, 998 F. 2d 922 (11<sup>th</sup> Cir. 1993).<sup>7</sup>

Elliot offered several different vehicles for his victims to "invest" in his companies, all giving the false impression the investments were secured. One of the investment vehicles involved investors "loaning" their securities in exchange for receiving interest payments in excess of the dividends they would otherwise earn. In some instances, Elliot sold the "loaned"

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<sup>7</sup> Elliot has been cited with approval by the Ninth Circuit in 13328 and 13324 State Highway 75 North, 89 F.3d 551, 553-54 (9th Cir. 1996).

securities, but in other cases the securities were still held in the name of the investor at the time the receivership was initiated.

The district court found that the investors had unwittingly transferred legal title to the securities to Elliot when they physically delivered the securities. The court also held that although some investors could trace the securities they had transferred because they were still held in the investors' names, those investors had no greater claim to the securities than the investors whose securities were sold. The court reasoned that to allow certain investors to reclaim specific assets based upon equitable theories would be wrong where "all former securities owners occupied the same legal position" and it was merely a "fortuity" that some securities had been sold and some had not. Id. at 1570.

In the Ninth Circuit, pooling has been allowed in receivership cases even though an investor could arguably trace its investment to a particular asset. Where widespread fraud is committed and insufficient assets exist to make investors whole, pooling is an appropriate remedial distribution tool. When the struggle over receivership assets is between equally innocent parties and the assets were obtained by fraudulent conduct, "tracing should not and will not apply." 13328 and 13324 State Highway 75 North, 89 F. 3d 551, 553 (9th Cir. 1996).

In 13328 and 13324 State Highway 75 North, a redevelopment agency could trace its investment through several of the defendants' accounts directly to a real property forfeited by the defendants and subsequently sold by the SEC. The Ninth Circuit refused to permit tracing. The court held the tracing fiction should not be utilized where it would promote unequal treatment of similarly situated fraud victims. Id. at 553. See also Durham, 86 F.3d at 73 (although particular claimant would be permitted to trace funds and impose a constructive trust under state law, district court refused to permit tracing because fraud victims were in equal positions and should be treated as such); Credit Bancorp, 290 F. 3d at 88 (investor's ability to trace investment and successfully assert a constructive trust claim under state law did not defeat the equitable authority of the district court to treat all the fraud victims alike and order a pro rata distribution).

Pooling has also been permitted in the absence of actual fraud even though certain investors could trace their funds. If the ability to trace is simply a function of timing or luck and there is no other basis for distinguishing between the various defrauded investors, pooling is still appropriate. Torres v. Eastlick (In re North American Coin & Currency, Ltd.), 767 F.2d 1573 (9th Cir. 1985). North American, involved a precious metal dealer that operated a legitimate business but began experiencing financial difficulty. The principals of North American recognized the severity of the problem but postponed ceasing operations until after a scheduled shareholders' meeting in the hope that new equity would be invested. The principals did, however, segregate funds received for new orders in a separate trust account during the one week period in the event additional equity was not obtained and North American was unable to fill the orders of those customers.

After the chapter 11 filing, those customers whose investment funds had been segregated demanded that those funds be returned. The Court denied the request. Other customers of the debtor had placed orders and remitted funds before the debtor began segregating funds and were left to seeking redress from the assets in the bankruptcy estate. After concluding that there was no fraud on which to base a theory of constructive trust, the court concluded "We fail to discern the equitable principle that requires us to protect the plaintiffs' investments fully, at the expense of these other creditors. Id. at 1579.

In this case, the Receiver proposes the recognition of the Sunwest Enterprise as a unitary enterprise for purposes of the Distribution Plan and follow-on Reorganization Plan. Recognition of the unitary enterprise is appropriate, given the operations and widespread commingling of funds among the entities within the Sunwest Enterprise. Recognizing the unitary enterprise also is equitable, because it will allow all Claimants the opportunity to share in equitable, ratable distributions.

**B. The Proposed REIT Structure Furthers Both Maximization of Enterprise Value and Equitable Distribution**

In consultation and through Mediation with various parties in this case, the Receiver and the CRO have worked to identify the restructuring of the Sunwest Enterprise that will maximize its value for the benefit of all stakeholders and determine the most equitable method of distributing that value to Claimants holding Allowed Claims. From this process, the Receiver and the CRO have determined that recognition and reorganization of the Sunwest Enterprise as a unitary enterprise to be reorganized into the REITCO structure will be the greatest opportunity to maximize value of the enterprise and allow for ratable distributions to Investors and Unsecured Creditors, and the most equitable means of distribution.

**1. General Description of a REIT and Reasons for Use of REIT Structure**

The Distribution Plan proposes establishing a real estate investment trust (“REIT”) with a subsidiary operating partnership (“UPREIT”). This structure maximizes the value of the Sunwest Enterprise to Claimants because it results in an enterprise that avoids the double taxation normally associated with owning shares in a corporation because REITS are generally not subject to corporate level taxation. It also provides tax deferral and liquidity to Claimants who are contributing property with a low tax basis because they can contribute their property tax-free to the UPREIT under I.R.C. § 721 and gain liquidity benefits through the option to exchange their UPREIT Units for REIT Shares, which the Receiver anticipates will be tradeable even before the possible opportunity to be accepted on a national securities exchange at some point in the future.

A REIT is a business entity organized as a trust, a corporation, or other entity, that primarily invests in real estate. (I.R.C. § 856.) If a REIT complies with certain restrictions applicable to its operations and ownership, the REIT will not be subject to corporate level income tax to the extent that it distributes its taxable income to its shareholders. (I.R.C. § 857.) Most REITs form an UPREIT, of which the REIT is the general partner. The UPREIT issues units (the “UPREIT Units”) that mirror the REIT shares. Investors who have appreciated property and

want to exchange such property for an interest in a REIT on a tax-deferred basis typically contribute their property to the UPREIT in exchange for UPREIT Units pursuant to I.R.C. Section 721. The UPREIT Units can then be exchanged for REIT shares pursuant to provisions of the UPREIT's partnership agreement. If a REIT has an UPREIT, the REIT will contribute all of its property to the UPREIT in exchange for UPREIT Units, such that all of the property owned by the REIT and the UPREIT is held by the UPREIT. Most REITs will also form a taxable REIT subsidiary ("TRS") as a subsidiary of the UPREIT, through which the REIT can engage in certain business activities in which it would otherwise not be able to engage, provided that the TRS is a taxable entity that pays a corporate level tax and that the REIT and the TRS make a joint election for TRS status with the IRS. (I.R.C. § 856(l)(1).)

## 2. Ownership and Operational Requirements of a REIT

REITs must operate under the following general ownership and operational requirements:

- The REIT must have at least 100 shareholders. (I.R.C. § 856(a)(5).)
- Five or fewer persons may not own 50% or more of the REIT (except during the first taxable year in which the corporation elects to be taxed as a REIT). (I.R.C. §§ 856(a)(6) and 856(h).)
- The REIT must distribute at least 90% of its taxable income annually. (I.R.C. § 857.)
- At least 75% of the REIT's assets must be in cash, government securities or real estate assets, and the REIT's remaining assets must meet the following requirements:
  - (a) not more than 25% of the REIT's assets may be represented by securities of one or more TRS;
  - (b) not more than 5% of the REIT's asset may be represented by securities of a single issuer (TRS excepted);
  - (c) the REIT may not hold more than 10% of the voting rights in any specific issuer (TRS excepted); and
  - (d) the REIT cannot own more than 10% of the value of the outstanding securities of a single issuer (TRS excepted). (I.R.C. §§ 856(c)(4)(A) and 856(c)(4)(B).)
- At least 75% of the REIT's gross income, excluding gross income from prohibited transactions, must be derived from rents from real property, interest on obligations

secured by mortgages on real property, gain from the sale or other disposition of real property, dividends or other distributions from shares of other qualified REITs and qualified temporary investment income. (I.R.C. § 856(c)(3).)

- At least 95% of the REIT's gross income must be derived from one or more of the following sources: (a) sources which satisfy the 75% test listed in paragraph 5, above; (b) dividends; (c) interest; and (d) gain from the sale or other disposition of stocks or securities. (I.R.C. § 856(c)(2).)

### **3. Contribution of Property to the REITCO Structure**

Property of the Receivership Estate and Investors may be contributed either to the REIT or the UPREIT, depending on the characteristics of the property and the circumstances regarding its contribution.

#### **(a) REITCO Contributed Property**

Contribution of the property to REITCO ("REITCO Contributed Property") will be a taxable transaction to the contributors based on the ownership assumptions described below. (I.R.C. § 351(e); Treas. Reg. § 1.351-1(c)(1).) The distribution of REIT Shares (as opposed to UPREIT Units) in satisfaction of Claims will be a taxable exchange to the transferors and the transferees.

#### **(b) UPREIT Contributions**

The TIC Investors and PM and LLC Investors that choose to contribute their property to the UPREIT in exchange for UPREIT Units should not recognize a taxable gain or loss in connection with the contribution pursuant to I.R.C. Section 721(a), which states that no gain or loss shall be recognized in the case of a contribution of property to the partnership in exchange for an interest in the partnership. Claimants who contribute their property to the UPREIT for UPREIT Units will need to maintain a sufficient amount of debt allocation. (I.R.C. § 752.)

#### 4. Limitation on Transfers of UPREIT Units to Avoid Taxation as a Corporation

The UPREIT will comply with the publicly traded partnership safe harbors so that it is not treated as a publicly traded partnership or a corporation for tax purposes pursuant to I.R.C. Section 7704. Thus, the UPREIT will limit the number of transfers of UPREIT Units after the initial distribution to 2% of the UPREIT Units per year, not including certain allowable private transfers such as transfers as a result of death or incapacity, transfers among family members, transfers pursuant to a redemption plan and certain other limited transfers. (See Treas. Reg. § 1.7704-1(e).) The exchange of UPREIT Units for REIT Shares will not be subject to the 2% limitation; however, the exchange of UPREIT Units for REIT Shares generally will be limited to 10% of the UPREIT Units per year in order for the UPREIT to avoid being treated as a publicly traded partnership or a corporation. (See Treas. Reg. § 1.7704-1(f).) The REIT's board of directors will have the ability to allow exchanges of UPREIT Units for REIT Shares in excess of 10% if they determine that doing so will not cause the UPREIT to be treated as a corporation.

#### 5. Leasing and Operation of Qualified Health Care Properties

A REIT cannot operate a qualified health care property directly; instead, it must lease the entire facility to a TRS or a third-party. (I.R.C. § 856(d)(8).) Qualified health care property is defined as a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility or other licensed facility that extends medical or nursing or ancillary services to patients and was operated by a provider that was eligible for participation in Medicare with respect to such facility. (I.R.C. § 856(e)(6)(D).) If qualified health care property is leased to a TRS, the property must be operated, on behalf of the TRS, by an independent contractor that is actively engaged in the trade or business of operating qualified health care properties for any person not related to the REIT or the TRS at the time such contractor enters into the management agreement. (I.R.C. § 856(d)(9)(A).)

An independent contractor is defined as any person that (i) does not own, directly or indirectly (which includes by attribution the holdings of any 10% or greater shareholder of the

independent contractor), more than 35% of the shares or interests in the REIT and (ii) not more than 35% of the combined voting power of the stock of the contractor (if a corporation) or not more than 35% of the capital or profits of the contractor (if not a corporation) is owned by one or more persons owning 35% or more of the shares or interests of the REIT. (I.R.C. § 856(d)(3).) For purposes of operating the REIT's qualified health care facilities, a corporation will be formed (the "Management Company") with up to 35% of its ownership held by the REIT shareholders and UPREIT Unit holders, in aggregate, and the remaining ownership interests held by nonaffiliates. The qualified health care properties held by the UPREIT will be master leased to a TRS, which will enter into one or more operating agreements with the Management Company.

#### **6. Operation of Non-Qualified Health Care Properties**

If a facility, such as an independent living facility, does not fit the definition of a qualified health care property, the REIT can, in most cases, operate the facility directly. However, the REIT (as opposed to an independent contractor) may generally only provide customary services. A REIT may provide a limited amount of non-customary services so long as the amount of compensation received attributable to the non-customary services does not exceed from each property 1% of all amounts received by the REIT from such property. (I.R.C. §§ 856(d)(7) and 856(d)(2)(C).) Given that non-customary services typically include meal preparation, transportation, housekeeping, and laundry service, it is likely that the compensation received by the REIT for such services would exceed 1% of the revenue for any senior living facility. Therefore, the REIT must either (i) hire an independent contractor or use a TRS to provide the non-customary services or (ii) master lease the property to a third-party master tenant.

7. The Proposed REIT Structure Is Designed to Maximize the Value of the Sunwest Enterprise and Ensure Equitable Distribution, Including Consideration of Tax Issues

The structure of a REIT with an affiliated MLP, as described above, provides liquidity and marketability while preserving the opportunity for certain tax advantages. The proposed structure is depicted on Exhibit B to the Hamstreet Declaration filed concurrently herewith. The combined structure achieves the primary goals of the CRO and the Receiver in restructuring the Sunwest Enterprise: financial and operational stability through professional management and corporate flexibility; maximization of value through formation of a unitary enterprise; and preservation of key tax advantages for Investors. Hamstreet Decl., ¶¶ 36, 49. The structure also allows for ratably distributing the value of the Sunwest Enterprise, through the issuance of new securities that recognize the unitary nature of the Sunwest Enterprise.

C. Ratable Plan Distributions Are the Most Equitable Under the Circumstances of this Case

1. Ratable Distribution Is Typically Upheld as Appropriate and Equitable in Similar Cases

In the federal equity receivership context, courts frequently approve a *pro rata* distribution to similarly situated victims, relying on the equitable maxim that “equality is equity.” See, e.g., 13328 and 13324 State Highway 75 North, 89 F.3d at 553-54 (approving like distributions to similarly situated parties); Basic Energy, 273 F.3d at 668; Credit Bancorp, 290 F.3d at 88-89. Ratable distributions have been held to be appropriate elements of federal equity receiver distribution plans where: (i) funds of investors have been commingled; and (ii) investors were similarly situated with respect to their relationship to the defendants. Credit Bancorp, 290 F.3d at 88-89.

2. Denying Distributions to Entities Liable to the Estate Promotes Judicial Economy and a Truly Ratable Distribution

To further ensure an equitable distribution in this case, the Distribution Plan also disqualifies any Claimant from receiving a Plan Distribution if that Claimant is liable to the Receivership Estate on any Third Party Claims. Consequently, parties that might have engaged in transactions which contributed to the financial distress of the Sunwest Enterprise shall not share in the value of the enterprise unless and until they make the Receivership Estate whole. See, e.g., Basic Energy, 273 F.3d at 660-61.

**D. Basing Pro Rata Distributions on Net Investments Achieves Equity**

The Receiver believes that under the circumstances of the Federal Receivership Case, limiting Claims to the sum of all money or other material tangible value invested with or paid to the Sunwest Enterprise, less all money or other material tangible value received by Investors or creditors after January 1, 2006, best serves the interests of equity. The Ninth Circuit first recognized the appropriateness of this "Money-in/Money-out" approach to claim allowance in Tedlock Cattle, 552 F.2d 1351.

Tedlock involved a Ponzi scheme promising investors large profits from the operation of cattle feedlots. After the collapse of the scheme, early investors argued that claims should be based on a benefit-of-the-bargain theory as generally provided for under state law with respect to fraud claims. The bankruptcy trustee, contended that where insufficient assets existed to pay claims in full, equitable principles must override state law and limit the claims to the net amount of funds invested. To do otherwise would permit investors who had already recovered their initial investment and "false profits" to unfairly defeat the claims of later investors who had yet to receive any return on their investment.

Numerous courts have since followed the Money-in/Money-out approach—in an effort to ensure that all investors receive a return of their initial investment before any investors receive distributions based on profit claims.<sup>8</sup> In CFTC v. Hoegh, 205 F. 3d 1107 (9th Cir. 1999), the

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<sup>8</sup> The Money-in/Money-out approach is a permissive, appropriate, preferred approach under

Ninth Circuit affirmed a pro rata distribution plan based on the claimants' net investment: ". . . [d]efined as total amount deposited by the claimant with the receivership entities less amounts returned to the claimant from the receivership entities and less any illegal trading profits reinvested by or credited to the claimant." Id. at 1110. An investor who had meticulously documented his investment objected to the distribution plan, claiming that he should be returned his account balance before the assets were pooled and distributed on a net investment basis. The Ninth Circuit noted that the plan adopted by the district court supervising the receivership was within that court's discretion.

Other cases have similarly rejected tracing in favor of applying a net investment allowance approach. For example, in Capital Consultants, the Ninth Circuit affirmed approval of a receiver's distribution plan that employed a modified net investment or MIMO approach. Capital Consultants, 397 F.3d at 738; see also Credit Bancorp, 290 F.3d at 89; In re Financial Partners Class Action Litigation, 73 B.R. 49 (N.D. Ill. 1987) (claim calculated as all payments made by the investor to the debtor reduced by all payments received by the investor whether designated as interest, principal or otherwise).

Demonstrating the broad discretion to approve equitable distribution plans, courts have also approved different variations on the Money-in / Money out formula based on the particular case circumstances. In re Taubman, 160 B.R. 963, 980 (Bankr. S.D. Ohio 1993) (court upheld dividing investor claims into "A" and "B" claims: "A" claims received priority and represented the actual pecuniary loss of a claimant, defined as the difference between what the investor gave the debtor on a combined basis, minus all amounts returned to or for the benefit of that claimant at any time; "B" claims represented all promised profit, interest or other amounts in excess of the actual pecuniary loss).

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similar circumstances and is a determination committed to the discretion of the supervising court where necessary to achieve equity. Hoegh at 1116.

## **VI. ALTERNATIVE DISTRIBUTION APPROACHES CONSIDERED FOR PAYMENT OF INVESTOR CREDITORS**

The Receiver and CRO considered several alternative distribution approaches and plan terms. The Receiver and CRO consulted with Parties in Interest and engaged in several Mediation sessions before recommending the proposed Distribution Plan. Hamstreet Decl., ¶¶ 37, 38; Grassmueck Decl., ¶ 17, 53. The following is a summary of the general distribution approaches considered by the Receiver and CRO and the reasoning for the decision to move forward with the proposed Distribution Plan.

### **A. The Orderly Liquidation Alternative**

The CRO and Receiver realized early on that liquidation of the Sunwest Enterprise likely would provide very little recovery to Investors and Unsecured Creditors. Hamstreet Decl., ¶ 40; Grassmueck Decl., ¶ 19. The CRO estimates that dividends to Investors upon an orderly liquidation would be between 3% and 13%.<sup>9</sup> Hamstreet Decl., ¶ 40; Marcos Decl., ¶ 5.4; Rundell Decl., ¶ 22. Additionally, distributions upon a liquidation would not be evenly distributed among Investors. Only 27% of TIC Investors would receive any recovery; 73% would receive nothing. Of the 27% receiving something, only two in ten would receive more than 25 cents on the dollar of their investments. Hamstreet Decl., ¶ 36.3.

The Receiver and CRO did not believe that this paltry and uneven recovery was representative of the potential value of the Sunwest Enterprise or the most fair and equitable treatment possible for Investors. Consequently, focus turned to developing a structure for preserving the going concern value of the Sunwest Enterprise.

### **B. The Status Quo Alternative**

One going concern alternative considered was the "status quo" option, which would involve continuing with the asset disposition process to shed properties that were burdensome to the Sunwest Enterprise, and moving forward with the profitable facilities and assets in which the Sunwest Enterprise enjoyed some equity. Grassmueck Decl., ¶ 20; Hamstreet Decl., ¶ 45.

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<sup>9</sup> In fact, liquidation without the benefit of the injunction would have been disorderly.

Under this alternative, however, Investors and Unsecured Creditors related to unprofitable facilities and properties likely would receive little or no distributions (perhaps only distributions funded by Third Party Claim recoveries), while investors and creditors related to profitable facilities and properties would receive large distributions or possibly payment in full plus profit. Within the context of the unitary operations of the Sunwest Enterprise, such unbalanced distributions to Investors and Unsecured Creditors would not be equitable. Grassmueck Decl., ¶ 20; Hamstreet Decl., ¶ 45.

**C. Asset-based Distributions Are Effectively Tracing Alternatives, which Courts Disfavor under the Circumstances of this Case**

The liquidation or partial liquidation of the Sunwest Enterprise would leave Investors to trace their investments to particular assets. Due to the extensive commingling of funds among the Receivership Entities and the HFG Parties, if all Investors' funds are administered separately, a significant number of Investors who have invested in certain Receivership Entities or related properties or facilities would receive no return on their investment, while others who were fortunate enough to have invested in certain in certain Receivership Entities or related properties or facilities may receive all of their invested capital plus interest. This result would be inequitable because it would allow greater recovery by certain Investors on the arbitrary basis of the actions of the Sunwest Enterprise control parties. Durham, 86 F.3d at 72.

Moreover, favoring certain Investors through tracing of invested funds is not justified solely because such investments were "legitimate" transactions that otherwise would be recognized and enforced according to their terms by the courts. Because the Sunwest Enterprise relied on commingling of funds to support its operations, all of its transactions lost this presumption of legitimacy. It may seem only fair that an Investor who can trace and recover his invested funds should be able to do so. That would be true as between the Investor and the HFG Parties or the Sunwest Enterprise. But it is not true as among that Investor and either the Unsecured Creditors of or other Investors in the Sunwest Enterprise. As a matter of equity, one Investor should not be permitted to benefit from a fraud at the expense of other Investors merely

because he was not himself to blame for the fraud. Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. 1995).

Typically, tracing of invested funds does not yield the most equitable result, because the ability to trace funds is the result of the merely fortuitous fact that certain investor funds were spent before funds of others, where the funds of investors have been shown to be substantially commingled. See, e.g., 13328 and 13324 State Highway 75 North, 89 F.3d at 553 (upholding *pro rata* distribution to victims, stating “[t]his Court believes that where, as here, the struggle over the res derived from fraudulent conduct is between innocent parties, tracing should not and will not apply.”); Liberte Capital Group, LLC v. Capwill, 148 Fed. App’x 426, 436 (6th Cir. 2005) (affirming *pro rata* disbursement plan and noting that in two previous cases “the courts rejected a tracing method, even though tracing was clearly possible”); Forex Asset Mgmt, 242 F.3d at 328, 332 (affirming *pro rata* distribution even though some investor funds were not commingled); United States v. Vanguard Investment Co., 6 F.3d 222, 227 (4th Cir. 1993) (approving *pro rata* distribution although some investors could trace their funds as all investors shared same equitable position); Durham, 86 F. 3d at 73 (affirming *pro rata* distribution even though money could be traced to particular claimants); Elliott, 953 F.2d at 1570 (affirming district court’s decision to disallow tracing in Ponzi scheme, holding that all former securities owners “occupied the same legal position” and thus some should not be preferred over others).

#### **D. The Corporate Unification Option**

Another option to realize the Sunwest Enterprise's going concern value would be to substantively consolidate the Sunwest Enterprise as a single corporate entity, with securities issued to Claimants so that they could participate in realization of the going concern value. The advantage to this option would be that it is consistent with the actual operation of the Sunwest Enterprise, would allow for *pro rata* distribution among Investors and Unsecured Creditors, and would be the most simple business approach. Grassmueck Decl., ¶ 21; Hamstreet Decl., ¶ 44. The main disadvantage to this approach would be that the TIC Investors, who comprise the majority of the Investors victimized in this case, would likely suffer adverse tax consequences as

a result of such a consolidation. Many of the TIC Investors made their investments through 1031 exchanges. To the extent that consolidation would be construed as a transfer of their property interest for income tax purposes, consolidation would impair their § 1031 status. *Id.* Moreover, Secured Creditors would object to the Distribution Plan because of the violence it would do to their single purpose borrower structure.

**E. The Recommended Approach – Restructuring the Sunwest Enterprise and Pro Rata Plan Distributions**

To resolve these competing concerns, the proposed Distribution Plan is based on an equitable consolidation of the Sunwest Enterprise, a chapter 11 reorganization, and the creation of a REIT/MLP structure and issuance of securities. This structure has the advantages of realizing the future going concern value of the Sunwest Enterprise for the benefit of all Investors and Unsecured Creditors, the ability to make pro rata distributions of that value through the issuance of securities, offers the potential for certain tax benefits for the TIC Investors, and will preserve the borrower –Secured Creditor structure except as modified through a consensual or cramdown loan modification under the bankruptcy laws. The relative disadvantages are the administrative burden of the additional chapter 11 process and the complexity of the structure. It is important, however, that the Sunwest Enterprise have the opportunity to restructure certain secured loans and to issue new securities under the provisions of the Bankruptcy Code. For all of these reasons, the CRO and the Receiver support and jointly propose the Distribution Plan as the most fair, equitable, and feasible means to distribute the highest value to Investors and Unsecured Creditors of the Sunwest Enterprise. Grassmueck Decl., ¶¶ 22-23; Hamstreet Decl., ¶¶ 49-50.

**1. Maximizing Value**

The CRO estimates that the restructuring provided for under the Distribution Plan could create \$500 million in value. Based on current MIMO Allowed Claim estimates and the going concern value estimates of the CRO, the recovery projected for Investors on MIMO Allowed Claims could range as high as 70%. Hamstreet Decl., ¶ 41; Marcos Decl., ¶ 5.5.

## 2. Equitable, Pro Rata Distributions

The Sunwest Enterprise's long-term practice of operating on a unitary basis effectively meant that Investors—whether they knew it or not—were investors in the Sunwest Enterprise as a whole, not the particular entity in which they initially purchased their interest. For this reason, it would be equitable for Investors to share on a *pro rata* basis in the Sunwest Enterprise's value. Hamstreet Decl., ¶ 36.3. Grassmueck Decl., ¶ 21, 52.

## **VII. EXCEPTIONS TO RECOMMENDED DISTRIBUTION PLAN**

As discussed above, much of the rationale for adopting a pro rata distribution plan derives from the fact of the commingling of funds among facilities and Receivership Entities. As a result, the repayment of Investors was largely a product of chance. To the extent that an exception to this general rule exists, the Receiver acknowledges that it may be appropriate to use a different approach to distribution. Thus, if it can be shown that a certain property or facility was separately selected, separately managed, and completely insulated from the commingling of funds with Harder or any other Sunwest Enterprise purpose, the non-Receivership owners of that asset can elect to retain such property, subject to the terms of the Distribution Plan. Because the Retaining Owners under this scenario will have received the benefit of their bargain, however, any such Investors should not be permitted to share in any Plan Distributions of any kind.

The Distribution Plan also provides for a "Bare Land Election" for Investors with an interest in the Sunwest Enterprise's Bare Land assets. The Bare Land Election allows such Investors to retain their interests in the particular property under certain terms and conditions that are fair and equitable and should not allow Bare Land Investors a disproportionate distribution.

## **VIII. APPROVAL OF SUMMARY PROCEDURES FOR CERTAIN DISTRIBUTION PLAN PURPOSES**

The Distribution Plan specifically references the use of Summary Procedures for resolution of various matters in connection with implementation of the Distribution Plan, including:

- the Non-Mingled Property Election;

- the Receiver's pursuit of Disgorgement of Ill-Gotten Gains, Avoidance Actions and Third Party Claims suitable for resolution by the Court; and
- allowance of Claims.

In implementing a plan of distribution, the district court's use of summary proceedings to allow, disallow, and subordinate the claims of interested parties has been approved as an appropriate and efficient adjudication mechanism, so long as potential claimants are afforded an opportunity to be heard and present claims. Hardy, 803 F.2d at 1038 ("A district judge supervising an equity receivership faces a myriad of complicated problems in dealing with the various parties and issues involved in administering the receivership. Reasonable administrative procedures, crafted to deal with the complex circumstances of each case, will be upheld. A district judge simply cannot effectively and successfully supervise a receivership and protect the interests of its beneficiaries absent broad discretionary power."); SEC v. Universal Fin., 760 F.2d 1034, 1037 (9th Cir. 1985) (challenge to exercise of summary jurisdiction defeated when investors could not distinguish summary proceedings from plenary suit process); SEC v. Wenke, 783 F.2d 829, 834-39 (9<sup>th</sup> Cir. 1986); U.S. v. Arizona Fuels Corp., 739 F.2d 455, 458-60 (9<sup>th</sup> Cir. 1984); U.S. v. Fairway Capital Corp., 433 F.Supp.2d 226, 241 (D.R.I. 2006); Basic Energy, 273 F.3d 657; Elliott, 953 F.2d 1560.

This power is derived from the broad powers granted the district court in the administration of the receivership proceedings. It is well-settled that district courts supervising federal equity receiverships have broad discretion to adopt appropriate procedures to administer the assets of, and claims asserted against the receivership estate. Capital Consultants, 397 F.3d at 738; Hardy, 803 F.2d 1034; Universal Fin., 760 F.2d at 1037. The Ninth Circuit explained with respect to a distribution plan proposed by the receiver in Capital Consultants:

A district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad. The district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership. The basis for this broad deference to the district court's supervisory role in equity receiverships arises out of the fact that most receiverships involve multiple parties and complex transactions. A district court's decision concerning the supervision of an equitable receivership is reviewed for abuse of discretion.

Capital Consultants, 397 F.3d at 738 (citations omitted); see also Topworth Int'l 205 F.3d at 1115 (9th Cir. 1999) ("This court affords 'broad deference' to the court's supervisory role, and 'we generally uphold reasonable procedures instituted by the district court that serve th[e] purpose' of orderly and efficient administration of the receivership for the benefit of creditors.")

District courts have noted that the use of summary proceedings is customary in federal equity receivership cases, which require efficient administration in order to fulfill their very purpose of preserving the assets of the receivership estate:

. . . One common thread keeps emerging out of the cases involving equity receivership – that is, a district court has extremely broad discretion in supervising an equity receivership and in determining the appropriate procedures to be used in its administration.

In keeping with this broad discretion, "the use of summary proceedings in equity receiverships as opposed to plenary proceedings under the Federal Rules, is within the jurisdictional authority of a district court." Such procedures "avoid formalities that would slow down the resolution of disputes. This promotes judicial efficiency and reduces the litigation costs to the Receivership," thereby preserving receivership assets for the benefit of creditors.

FDIC v. Bernstein, 786 F. Supp. 170, 177-78 (E.D.N.Y. 1992) (citations omitted).

Specifically, the receivership court has the power to use summary procedures in allowing, disallowing, and subordinating claims of creditors. McFarland v. Winnebago South, Inc., 863 F. Supp. 1025, 1034 (W.D. Mo. 1994). A federal equity receivership court also has broad equitable discretion to employ summary proceedings in order to fairly adjudicate claims of the receivership. "Receivership courts can employ summary procedures in allowing, disallowing and subordinating claims of creditors . . . . Summary proceedings should afford creditors fair notice and an opportunity to be heard . . . . They should also allow parties to present evidence when the facts are in dispute and to make arguments regarding those facts." Fairway Capital, 433 F. Supp. 2d at 241 (quoting Hardy, 803 F.2d at 1037, 1040); see also Wencke, 783 F.2d at 837 n.9; Elliott, 953 F.2d at 1566.

In employing such procedures, courts have instructed that "the rights of creditors of a receivership must be balanced against the need for expeditious administration of the receivership." Hardy, 803 F.2d at 1039. Accordingly, during the Claims Process, the Receiver

and/or the Court may properly deny Investor or creditor Claims that are not adequately substantiated by the claimant. Fairway Capital Corp., 433 F. Supp. 2d at 246-47.

In light of these principles, the Receiver respectfully requests that the Court exercise its broad equitable discretion (1) to adopt the Receiver's proposed Distribution Plan and (2) employ Summary Procedures to adjudicate issues as referenced in the Distribution Plan.

## **IX. CONCLUSION**

The Distribution Plan jointly proposed by the Receiver and CRO is the product of an extraordinary level of input from representatives of the various constituencies in this case, including through many days of Court-ordered and supervised Mediation. As in any case of this complexity and with so many competing interests, complete satisfaction of all parties is not a likely or even realistic outcome. The Receiver and CRO, as proponents, and the Court are not charged with achieving such a result.

Instead, the goal here is to make the best of a situation that has been so unfortunate for so many. The Distribution Plan represents the best efforts of Case Fiduciaries to maximize the value of the Sunwest Enterprise for the benefit of all. It follows well-established principles of equitable distribution applied in federal equity receivership cases, as affirmed in the Ninth Circuit and other courts of appeal. Accordingly, the Receiver and CRO believe that the Distribution Plan provides for the most equitable means of distribution of the value of the Sunwest Enterprise.

For all of the foregoing reasons, the Receiver and the CRO respectfully request that the Court approve the proposed Distribution Plan. Based on the Declarations filed in support of the Distribution Plan and the points and authorities set forth herein, the CRO and Receiver also respectfully request that the Court adopt the Findings of Fact and Conclusions of Law attached hereto as Exhibit 2.

Dated: August 25, 2009

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