

WILLIAM L. LARKINS, JR., (OSB #812882)  
wlarkins@larkinsvacura.com  
JULIE R. VACURA, (OSB #843692)  
jvacura@larkinsvacura.com  
LARKINS VACURA LLP  
621 SW Morrison St., Suite 1450  
Portland, Oregon 97205  
Telephone: (503) 222-4424  
Facsimile: (503) 827-7600

DAVID L. OSIAS (CSB NO. 091287) (PRO HAC VICE)  
E-Mail: dosias@allenmatkins.com  
DAVID R. ZARO (CSB NO. 124334) (PRO HAC VICE)  
E-Mail: dzaro@allenmatkins.com  
STEPHEN A. WALTERS (OSB No. 80120)  
E-Mail: swalters@allenmatkins.com  
A. KENNETH HENNESAY, JR. (CSB NO. 187531) (PRO HAC VICE)  
E-Mail: khennesay@allenmatkins.com  
ALLEN MATKINS LECK GAMBLE  
MALLORY & NATSIS LLP  
515 South Figueroa Street, Ninth Floor  
Los Angeles, California 90071-3309  
Telephone: (213) 622-5555  
Facsimile: (213) 620-8816  
Attorneys for Receiver  
Michael Grassmueck

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

FIRST INTERIM REPORT OF  
RECEIVER MICHAEL GRASSMUECK  
AS OF APRIL 23, 2009

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

Relief Defendants.

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## **I. INTRODUCTION**

Pursuant to the Order Granting Preliminary Injunction and Appointing Receiver entered by this Court on March 10, 2009 (the "Receiver Order"), Michael Grassmueck, Receiver, submits this First Interim Report ("First Report") and recommendations to the Court. This First Report is to provide the Court and all interested parties with the status of the Receiver's activities, investigations, analysis, opinions and recommendations to date. Even as this First Report is filed, there are hearings, schedules, mediations, strategy sessions and meetings taking place that will affect the findings and recommendations of the Receiver contained in this Report. The Receiver has attempted to make the First Report current as of mid-day April 23, 2009.

The Receiver and his retained professionals have met with many people and reviewed countless documents and records over the past four weeks. The volume of material and information acquired, the shortness of time, the complexity of matters analyzed and the need for additional information, verification and analysis require that this First Report be considered preliminary; the Receiver may need to materially modify its contents after further consideration. Furthermore, the Court has not yet determined the probative value of information contained in the First Report, nor determined the admissibility of such information in any future proceedings.

Pursuant to the law governing federal equity receiverships, a receiver is typically charged with assuming control over Receivership Entities and their assets; performing an accounting of the assets and financial condition of the Receivership Entities; investigating, locating and recovering receivership assets; preparing reports for the Court; and preparing a claims allowance and creditor/investor distribution plan. In this case, the Receiver Order limits some of these functions.

The Receiver's duties, responsibilities and activities fall into six 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 and the impact of the commingling on the claims of investors and creditors;

(ii) pursuing and resolving claims against third parties so that the proceeds may be distributed to investors and creditors harmed by collusive or other actions of third parties;

(iii) advising the Management Committee and Chief Restructuring Officer, Clyde Hamstreet (the "CRO"), on matters concerning the preliminary injunction, bankruptcies, secured creditors, disposition of assets and restructuring and interim distribution;

(iv) developing a claims allowance process and a plan for distribution of assets to creditors and investors;

(v) presenting the proposed claim process and distribution plan to the Court for approval; and

(vi) Implementing the distribution plan as allowed by the Court.

In addition, the Receiver is also charged with enforcing the terms of the Order. This First Report touches upon each of these categories in varying detail and degree in relation to the focus of the Receiver during the first four weeks of the case.

This Report contains a five-page Executive Summary (pp. 3 to 8), and for those who seek more detail, a further discussion on pages 8 to 30.

## **II. EXECUTIVE SUMMARY**

### **A. Operations**

Sunwest Management LLC ("Sunwest" or the "Company") manages approximately 183 assisted living facilities, 85 non-assisted living facilities and other investments (collectively, the "Facilities"). The Receivership Entities consist of the entities listed on Exhibit A to the Receiver Order and additional entities that are owned or controlled by the Defendants.

The Sunwest enterprise consists primarily of the management of individual Facilities by Sunwest (or, in a few cases, third-party management companies); the management of other real and personal property interests and entities which are encompassed by the Receiver Order; the

Facilities; and the equity and membership interests in the Receivership Entities (collectively, hereinafter the "Sunwest Enterprise").

Pursuant to the Receiver Order, the Receiver is not responsible for operations of the Facilities. Consistent with his duties as a fiduciary, however, the Receiver considered whether there were overt or systemic issues that adversely affected the elderly population who live at the assisted living Facilities. To this end, the Receiver promptly notified regulators in each state where Sunwest operates of his appointment and requested regulators advise the Receiver as to any problems at the Facilities. In addition, the Receiver has interviewed the individuals at Sunwest responsible for operations and maintenance of the Facilities and has followed-up on claims of secured creditors and third parties who raised issues with regard to the Facilities. While there are certainly issues concerning the operations of the Facilities (many likely attributed to the tight cash flow), the Receiver has preliminarily noted that, under these circumstances, most facilities appear to be stable. No one has brought to the attention of the Receiver any serious or life threatening issues.

As detailed below, Sunwest and many of the Facilities face critical cash flow problems arising from the overleveraging of properties, lower than industry standard occupancy, and disruption in the capital markets. This has caused Sunwest to be in turmoil for the past year and, while the Receiver has only performed a preliminary review, so far it appears that the alleged wrongful conduct described by the Securities and Exchange Commission (the "Commission") has played a significant role in the losses suffered by the Sunwest.

During this period, the Receiver has also focused on the two major issues facing Sunwest which directly impact the ultimate return to the investors and creditors: disposition of properties and restructuring.

1. **Sales/Disposition**

At the outset of the receivership, there was a great deal of uncertainty and a lack of clarity as to the disposition of assets and the protection of assets by the preliminary injunction. Asset

disposition decision difficulties were exacerbated by competing interests of the parties and their counsel participating in every step of the process. This was far more than having a "voice" or being given an opportunity to be heard. It was more like having too many cooks in the kitchen who were supposed to jointly cook the same thing, but each had a different preferred recipe. Based on meetings with the CRO, and the Management Committee, and their counsel over the last several weeks, the Receiver believes that he and they have reached an understanding with regard to the disposition process which will streamline decision making, reduce the cost and eliminate the duplication of work among professionals. As such, it is anticipated that asset disposition will commence shortly with greater effect at less cost. Similar steps with regard to injunction enforcement and injunction relief have also been instituted.

There has also been a recognition that the interest of secured creditors in the Facilities should be addressed. As for adequate protection, the Receiver recommends, with concurrence of the CRO and the Management Committee, the following:

- Operating profits from Facilities will be siloed for accounting purposes;
- If a Facility generates sufficient income to pay current principal and non-default interest to the lender, the CRO should do so;
- If the Facility only generates sufficient net income to pay current non-default interest, the CRO should do so;
- If the Facility does not generate sufficient net income to pay current non-default interest, the CRO should pay such Facility expenses as are necessary to protect the inhabitants and maintain the property value; and
- There should be no distribution to tenant in common owners ("TICs") or equity interests or non-ordinary course creditors at this time. However, the CRO will continue to account for such liabilities and accumulated income.



## 2. **Restructuring**

The restructuring of the Sunwest Enterprise is a work in progress. Restructuring the business and the distribution plan must fit together like hand and glove. Thus, the Receiver and the CRO have been cooperatively working together on possible plans. The Receiver has not made any decision as to the form of any plan or the treatment of any claimant's interest. Neither has the CRO. This is important to note because certain parties and counsel have made misleading statements to investors, creditors and TICs, such as: "the ultimate reorganization plan of . . . Michael Grassmueck (Receiver) . . . is to pool all the remaining properties." This and other such statements are false and misleading, create confusion and cause investors and TICs to be needlessly concerned. The law may permit such pooling, but this outcome is dependent on the facts of the case. A decision on the plan for distribution must wait the conclusion of the Receiver's accounting and the Commission's lawsuit against Mr. Harder and others. False statements about Receiver or CRO decisions impede the Receiver's ability to fulfill his duties, add unnecessary expense and delay to the process, and serve no legitimate purpose.

The Receiver has been involved in numerous discussions and meetings with the CRO and others related to restructuring. Most recently, the CRO held a two-day meeting with most of the principal parties to address some of the major restructure issues and to solicit views toward the development of a consensual plan. While progress has been made, the Receiver and others agree that predicates to a comprehensive plan include an overall feasibility analysis plus resolution, through judgment or settlement, of the Commission's lawsuit against Mr. Harder. In the interim, the parties are focused on development of alternative approaches which can accommodate multiple outcomes.

In addition, the Receiver has focused, along with others, on the interest of TICs involved in 1031 exchange transactions and their unique risks of loss. The Receiver has worked on the possibility of some tax relief for those whose interests are foreclosed upon as well as those who

will be more directly involved in the restructure. Again, this work is only preliminary and is being conducted in cooperation with the CRO and Management Committee.

**B. Accounting / Commingling**

The Receiver has commenced work related to the accounting called for in the Receiver Order. Initially, the Receiver addressed controls in place at Sunwest and a general overview of operations. This was accomplished through the review of selected financial reports and interviews with Sunwest employees, consultants and professionals, as well as interviews with individual defendants, Management Committee members and third parties.

Based on the investigation completed to date, the Receiver believes the controls and accounting for the assisted living Facilities to be sufficient. The CRO is involved with the cash management and operations. Additionally, Sunwest maintains a detail-oriented accounting department for all of the assisted living Facilities under management.

The Receiver's preliminary investigation has revealed that the commingling of funds among Facilities was rampant. Sunwest management employed a variety of transactions and accounting entries to carry out the cash transfers between 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.

The opportunistic flow of funds appears to be consistent with the alleged "all in" cash policy that has been implemented over the past few years. In short, Sunwest management would draw cash from any available source to satisfy cash shortfalls for certain Facilities. While some thought was given to the source of funds, the ultimate decision was based on mere availability. The Receiver intends to further investigate the source, use and impact of fund transfers among Facilities and entities to obtain a comprehensive understanding of the commingling.

The Receiver anticipates that the accounting will be completed in three months and a report will be available in four months. This time estimate is driven in part by the need to not disrupt the continuing business operations that also rely on Sunwest accounting staff.

### **III. SIGNIFICANT RECENT EVENTS**

#### **A. Pre-Receivership Events**

One of the goals of the receivership is to maximize the recovery of what the Commission estimates to be a \$300-\$400 million loss potentially suffered by investors and creditors. The Receiver has assisted in efforts to resolve structural issues in connection with the Sunwest Enterprise, the approach to restructuring and existing operations that might otherwise jeopardize the ability to maximize recovery for investors and creditors in this case. To understand some of the structural issues, a brief description of the events which occurred in the 12 months immediately prior to the appointment of the Receiver, is important.

- In or around the spring of 2008, Sunwest was allegedly in default on loans and/or pools of loan with certain of its primary lenders (General Electric and Merrill Lynch). In response to this situation, General Electric required that Sunwest engage a restructuring expert, apparently in order to provide the lender with comfort that the loan default and other issues were being addressed in a professional fashion. The Alvarez & Marsal firm was engaged by Sunwest for this purpose.
- During the spring and summer of 2008, Alvarez & Marsal analyzed the operations and identified what it believed were possible remedies for certain problems and made proposals to management to sell specific assets in order to generate cash for operations and possible restructuring. Mr. Harder and possibly others at Sunwest rejected these proposals. The failure to promptly address what appeared to be severe cash flow and debt issues ran straight into the disruption of the credit markets in the fall of 2008.

- From accounting records and interviews, it is evident that by the fall of 2008, finances of the Sunwest Enterprise were in turmoil and rapidly deteriorating. Among other things, loans were maturing or in default as Sunwest scrambled to generate sufficient cash to both operate and forestall foreclosure actions by the lenders.
- In the midst of this turmoil and in a further effort to stave off and satisfy secured and unsecured lenders and TICs, in October 2008, Hamstreet and Associates was engaged and Clyde Hamstreet was installed as the CRO.
- Thereafter, in an apparent effort to avoid claims of personal liability, Mr. Harder filed a petition for bankruptcy.
- Concurrently with these events, in an effort to avoid catastrophic foreclosures and generate much needed cash for operations, Sunwest pursued what became known as the Lone Star Transaction. The Lone Star Transaction involved the sale of 45 Facilities for the sum of \$364.2 million, most of which went to pay off a loan with General Electric. This sale closed in January 2009. As detailed below, \$82.7 million of net revenue was generated after payment of the secured debt. The Receiver is in the process of investigating the disposition of those proceeds and the underlying details of this transaction, but it appears that as of the date of the receivership, approximately \$11.5 million remained from the \$82.7 million.
- As of December 2008 and January 2009, Sunwest faced numerous foreclosure actions which were impacting valuable assets. 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 Facilities. In the face of this and recognizing that filing individual bankruptcies for each of the 200 plus Facilities would involve prohibitive administrative burdens and costs, Harder attempted to expand the scope of Harder's personal bankruptcy to encompass and protect all Facilities in

which Mr. Harder had an interest, directly or indirectly, and to try to use the Harder bankruptcy case to "reorganize" the Sunwest Enterprise. This strategy proved unsuccessful and after a costly three-day evidentiary hearing, the Bankruptcy Court denied the Harder motion.

- Following the hearing, the Tenant In Common/Equity Committee ("TIC Committee") agreed with Harder to attend a mediation to attempt to bring order to the Harder case and, in theory, create a structure to operate and restructure assets.
- On March 2, 2009, the Commission filed its action, including an application for a Temporary Restraining Order and appointment of Receiver. The TRO and application for a Receiver were denied.
- On March 10, 2009, the Court granted the SEC's request for preliminary injunction and entered the Order Granting Preliminary Injunction and Appointing Receiver. This Order has been appealed by certain secured lenders, but has not been stayed pending appeal.

**B. Post-Receivership Activities**

Immediately upon his appointment, the Receiver commenced his work in accordance with the terms of the Receiver Order and federal receivership law. The Receiver, with the assistance of his retained professionals, has undertaken a preliminary analysis of Sunwest and related assets. Given the complex nature of the operations at Sunwest and the related Facilities, the Receiver's work at this stage is only preliminary.

It should be noted that, as evidenced by both the Receiver's observations and recommendations below, the Receiver jumped upon what can only be described as a train which had already left the station and, as such, many of the activities and structures in place were not in the Receiver's control. As indicated in the balance of the Report, the Receiver believes that progress has been made with the CRO and Management Committee in addressing many of the structural issues that were adversely affecting the value of the receivership assets.

1. **Initial Investigation and Analysis**

The Receiver is not in control of the operations, however, consistent with the terms of the Receiver Order, the Receiver commenced an investigation and evaluation of the operations of Sunwest and the Facilities by the appointed Management Committee and the CRO. The Receiver has not taken physical control over the assets, which assets remain in the control of the CRO and the Management Committee. The Receiver has met with and talked to (in certain instances, frequently and extensively) the following:

- Clyde Hamstreet and his counsel;
- Representatives of Hamstreet & Associates;
- Representatives of Alvarez and Marsal;
- Members of the Management Committee;
- John Harder and his bankruptcy and litigation counsel
- Mr. Fischer and his counsel;
- Mr. Gutzler and his counsel;
- Counsel for the Committee;
- Counsel for the United States Trustee;
- Counsel for the TIC Committee;
- Counsel for the Official Unsecured Creditors Committee;
- Numerous secured creditors;
- Numerous employees of Sunwest (as well as former Canyon Creek Development, Inc. and Canyon Creek Financial, LLC employees);
- Counsel for investor groups who have filed or intend to file third-party claims and who have provided input on restructuring and distribution issues; and
- Representatives from the Oregon Department of Justice and other regulatory and licensing agencies related to the Facilities.

The Receiver has also been contacted by numerous investors and equity holders, as well as counsel with regard to third-party litigation. The Receiver has filed notices of appearance in Mr. Harder's bankruptcy, the 26 Facility bankruptcies, and numerous state and federal actions.

In general, Sunwest employees have been cooperative with one exception, Mr. Curtis Brody, who had been the CFO of Sunwest Management Inc. since the 1990s. As with other employees, the Receiver attempted to conduct an informational interview of Mr. Brody but, through his counsel, Mr. Brody declined to participate.

The Receiver has also filed notices of the Receiver Order in 61 jurisdictions pursuant to 28 U.S.C. § 754. In addition, the Receiver is in the process of recording the Receiver Order in over 100 counties in which the real property assets are located.

## 2. **Imaging of Documents**

The Receiver has engaged Discover E for the purpose of complying with the provisions of the Receiver Order that call for the Receiver take control of documents of Sunwest and the Receivership Entities and image electronic storage devices. The Receiver has completed the task of imaging the Sunwest electronic records.

Unfortunately, because of the assertion of alleged privilege, the Receiver has not been able to commence a review of the imaged hard drives. Mr. Harder's counsel has raised a variety of issues as to why the Receiver must await review, including that Mr. Harder, an employee of Sunwest, might have privileged communications in emails on company computers. The Receiver expects to resolve this problem soon.

It is important to note that since the Receiver is not in control of the Sunwest operations, the Receiver is not in a position to take physical custody of the personal property assets, records and other files in possession of Sunwest. In other words, while the Receiver has taken steps to image all electronic documents, it is not possible for the Receiver to secure or preserve the physical records under the current terms of the Receiver Order.

3. **Accounting Systems and Controls**

The Receiver has engaged Financial Forensics to assist in an initial preliminary evaluation of the accounting systems and controls in place at Sunwest and to commence the accounting called for under the Receiver Order. The Receiver and CRO also intend to engage Moss Adams for the purpose of conducting other accounting functions associated with the restructuring, sale of assets, day-to-day accounting functions for the Sunwest Enterprise and tax returns. The Receiver and CRO will establish a detailed description of tasks to be performed by the two accountants to insure that there is no overlap in duties.

Details concerning the preliminary findings of the Receiver with regard to the accounting are set forth later in this report.

4. **Evaluation of Management Structure of Sunwest Enterprise**

Under the current terms of the Receiver Order, the operation of the Sunwest Enterprise rests with the Management Committee and the CRO. Decisions are made by the CRO with the approval of the Management Committee. The Management Committee and CRO have authority over disposition of assets, day-to-day operations of Sunwest and restructuring.

Pursuant to the Receiver Order, the Management Committee and CRO are required to consult with and keep the Receiver informed as to their activities and the Receiver is to advise the Management Committee and CRO with regard to his views on such matters.

At the outset of the case, the Receiver immediately recognized a number of issues with regard to the management structure and the interaction of professionals and the Sunwest Enterprise. The Receiver has been working with the CRO and others to ameliorate the problems faced in the case with the goal of creating a more cost-effective approach to the case and to preserving the value of the Sunwest Enterprise pending the formulation of a distribution plan.

As has been noted elsewhere, the Receiver has worked diligently during this period with all constituents in an effort to develop information exchanges and protocols that would effectively streamline the decision-making process and allow Sunwest to, among other things,



sell and dispose of assets in a thoughtful, orderly and expeditious fashion, reduce the extraordinary burden of professional fees, and commence an analysis of the appropriate form of restructuring or liquidation. For example, the Receiver, CRO and Management Committee have agreed upon a protocol for the sale or disposition of assets and a form of order which the Receiver believes may provide assistance to individuals whose interests will be foreclosed and may face phantom income or recapture issues arising out of their 1031 exchanges.

The Receiver has made recommendations, supported by the Management Committee and the CRO, to address some of these issues which will help eliminate conflicts and duplication of work.

However, despite significant progress, real problems remain as individuals and groups with conflicting agendas spar for their constituents. For example, as expressed by Mr. Harder in his Response to April 9, 2009 Order to Show Cause re: Abatement of Proceedings, Mr. Harder appears to have an agenda which is at odds with the others in the case; one which involves retaining a seemingly unrealistic number of overencumbered facilities in light of present cash flow and limited refinancing opportunities. Moreover, he appears to be vying to propose a plan in his bankruptcy case or otherwise which is competing and interfering with the work of the CRO. Setting aside what appears to be his unrealistic optimism about the value of the assets, Mr. Harder is using two sets of attorneys who act in parallel with and duplicating the work of the CRO, Management Committee and Receiver. Harder justifies this involvement by claiming the largest stake in the case outcome. In fact, the priority of Mr. Harder's right to distribution is equitably behind all other claimants and he is currently "out of the money." His efforts, therefore, put at risk the distribution to others, a gamble he may be willing to take to try to get back into the money. But, this outcome is at direct odds with all senior claimants and unfairly reduces the prospects for their distribution.

To address this problem, the Receiver recommends that the role of Harder bankruptcy professionals be limited solely to work on bankruptcy matters in which Mr. Harder has a direct

pecuniary interest, not an indirect interest as the junior most equity holder. In other words, Mr. Harder's bankruptcy is an individual bankruptcy case that does not directly involve any of the Facilities or the Sunwest Enterprise or their restructuring. In most cases, Mr. Harder merely owns a membership interest in an ownership entity. As such, Mr. Harder is no more than a claimholder like other investors or creditors in the Receivership entities, albeit likely to be junior in priority on equitable grounds. There is no basis for Mr. Harder or Mr. Harder's counsel to directly participate in Management Committee, CRO or Sunwest decision making with regard to the disposition of assets. He may express his views, and may object to the Court, just as any other claimant in the case, but he should have no other role, especially not one funded by the assets available to other claimants.

### **C. Secured Creditors**

One of the purposes of the Receiver Order was to maintain the status quo with regard to the Sunwest Enterprise in order to minimize losses and maximize possible returns to investors and creditors pending the outcome of the Commission's litigation against Jon Harder and other defendants. One of the fundamental challenges faced by Sunwest and the Receivership Estate concerns the need to avoid foreclosures by secured creditors on assets which are believed to be of value to the Receivership Estate while allowing assets lacking value to the Receivership Estate to be taken by secured creditors. This analysis is made more complicated because certain TIC investors were involved with 1031 exchanges and these individuals face a substantial risk of an adverse tax consequences in the event that assets are foreclosed upon.

Accordingly, the Receiver has spent a substantial amount of time during the first 30 days of this case working to enforce the injunction against the actions by secured creditors where appropriate. The Receiver has worked diligently to explain the receivership process to secured creditors and to keep secured creditors informed as to the status of events. As the Court is aware, many of the Facilities involved in the Sunwest Enterprise are not performing at a level that is sustainable. To that end, the Receiver has cooperatively worked with the CRO and Management

Committee (as discussed above) to develop a protocol for the disposition of assets and modification of the injunction.

As in all bankruptcy and receivership matters, the secured creditors and their counsel are strong advocates for immediate enforcement of their rights under their loan agreements. The desire of the secured creditors to promptly realize on their collateral (and to perhaps profit in doing so) often conflicts with the efforts of the Receiver and CRO to maximize the possible return to investors and creditors in this case under a distribution plan through the use of legally recognizable restructuring techniques. As this Court and others recognize, a reasonable balance must be reached between the economic interests of the secured creditors (who took the risk of bankruptcy and other such occurrences in exchange for lucrative loan terms with payment of fees and interest), and the interests of equity holders (who in this case are alleged by the Commission to have been defrauded).

At a minimum, the balancing of these two interests requires that the Court allow some breathing room to the Receiver, the Management Committee and CRO to evaluate each asset, and if possible preserve equity for the benefit of the investors and creditors of the Receivership Estate. The Receiver believes that if the recommended disposition protocol is implemented, the number of challenges brought to the Court by lenders should be significantly reduced, the ability of the Court to make fair decisions will be enhanced, and administrative costs limited to a more reasonable scope.

As detailed below, while much has been accomplished, the Receiver has identified that these accomplishments have come at significant administrative costs, which in some instances are burdensome and unnecessary. Some of these costs are akin to "start-up" expenses attributable to the evolution of these cases in receivership and will decline naturally over time. Others are the results of competing interests trying to control decisions before they reach the Court. As detailed below, the Receiver has specific recommendations to address this issue in order to make progress in a more reasonable fashion.

#### **D. Investor Communications**

The Receiver has taken steps to communicate the status of this matter with TICs, other equity interests and creditors. The Receiver has a website where both pleadings and other materials can be found [www.grassmueckgroup.com](http://www.grassmueckgroup.com). The Receiver also addressed TICs and other investors and creditors with the CRO at three investor meetings (in Los Angeles and Portland).

One significant challenge to the Receiver, CRO and the Court has been addressing the many misstatements of fact made by attorneys seeking support for their own clients' point of view or to encourage investors to seek counsel. Examples of false statements and accusations are as follows:

- *"If there is any opportunity for recovery on . . . [third party claims], they will have to be pursued by individual lawyers on behalf of their own clients."*

This is a false and misleading statement. While investors may engage counsel, it is not necessary in every case and retention of counsel may or may not be beneficial. The Receiver will pursue all appropriate claims held by Receivership Entities. Plus, in some cases, the Receiver may adequately represent the interests of unrepresented investors in third-party cases. Individuals do not require counsel to make a claim or receive a distribution from the Receivership Estate.

- *"The SEC and Receiver . . . ignore [the] deeded purchases of real estate. . . ."*

This is patently false and misleading. The Receiver has not ignored the interest of the TIC owners and has not taken any such position. The Receiver is investigating facts that will substantially affect any eventual recommendation and has merely identified a number of possible distribution plan alternatives that arise as by-products of the Commission's lawsuit.

- *"The Receiver intends to treat each and every Sunwest property as a fungible commodity and roll them up into a pooled REIT-like arrangement. . . ."*

Again, this is a false and misleading statement. The Receiver has never stated that he intends to take this position. The restructuring of Sunwest is a work in progress and the Receiver has not proposed a distribution plan. The Receiver has noted that there are a number of alternative means to restructure and distribute proceeds and these may be impacted by the result of the Commission's lawsuit.

- *"Creditors and TICs can and should expect to be repaid in full if a plan along the lines endorsed by the Debtor is implemented."*

This prediction is not reflective of the substantial losses currently existing and the deep insolvency of many of the Receivership Entities caused by pre-CRO events and management. To get even close to the goal of a 100% distribution, substantial recoveries from third parties will be needed to compensate for the losses resulting from third party assistance to the Harder-run Sunwest Enterprise. Moreover, almost no complex reorganization or receivership case produces a 100% dividend. It is a very rare occurrence and misleading for anyone to be told to expect that outcome.

- *"From the Debtor's perspective, the paralysis on asset disposition stems from the Receiver's desire to link asset disposition with his plan of distribution."*

This is false. The Receiver has assisted, not obstructed the asset distribution process.

Unfortunately, these misstatements generate calls, emails and letters from concerned investors. Aside from the monetary cost of responding to creditors, investors and others who receive or see such communications, the Receiver is very concerned that investors are being misled and may suffer emotionally and financially from such communications.

The Receiver and CRO are exploring additional ways to effectively communicate with investors and to respond to such matters.

#### **IV. ANALYSIS OF COMPANY CASH FLOW – BURN RATE**

Historically, it appears that Sunwest extensively commingled funds among the Facilities and their related affiliates. The Sunwest Enterprise regularly acquired distressed facilities and utilized cash from other sources to pay operating expenses, mortgages and lease payments. Sunwest management employed a variety of transactions and accounting entries to move funds between the entities and facilities. At some point in time, it became Sunwest's practice to merely review all account balances in the morning for overdraft positions, and then find ways to transfer monies from other accounts to cover those cash shortfalls before the banks deem the account to be in overdraft.

Sunwest continues to act as manager of approximately 183 assisted living facilities across the country. At the time of appointment of the CRO, many of the facilities did not have sufficient cash flow to cover operating expenses and/or mortgage payments. As such, the CRO continued the practice of inter-facility "borrowing" or transfers until the closing of the Lone Star transaction. That practice has not continued post receivership.

##### **A. Lone Star Transaction**

The Lone Star sale closed in January 2009 pre-receivership and involved the disposition of 45 properties. The net proceeds available after payment of secured debt was approximately \$82,000,000, of which \$55,000,000 was allegedly attributable to the equity interests of Jon Harder and Daryl Fisher.

The following chart indicates the primary uses of the Lone Star proceeds to date. Of the \$82,000,000 raised through the Lone Star sale, only \$11,500,000 of cash is currently remaining.

Total Available for Members	\$ 82,701,354
Pledges	(16,372,957)
Corinthians/Waterfield payoff	(7,337,373)
Attorney Costs	(288,699)
Working capital to CRO per Bankruptcy Court	(6,309,900)
For Professional Fees (J G W)	(3,741,000)
Member payments	(11,913,438)
Settlements	(7,141,094)
Assumption Fee	(1,993,148)
 Sub-Total	 27,603,745
 Net Uncollected/Unpaid	 (16,063,021)
 Cash Currently Available	 <u>\$ 11,540,724</u>

The primary purpose of the Lone Star sale was to raise sufficient working capital for the Sunwest Facilities and entities so they could continue operations throughout the restructuring process. Unfortunately, it appears that over \$18,000,000 of Harder and Fisher's equity interests was allegedly encumbered as security for third party loans or as settlement of litigation claims. The Receiver and Mr. Harder's bankruptcy counsel are investigating these encumbrances to determine if any of these funds may be recoverable to the Receivership Estate or the Harder bankruptcy estate.

The CRO has made two equity distributions to other investor-members of the Lone Star entities totaling \$11,913,438. Lone Star proceeds have also been set aside to cover the legal and professional fees of Harder, Fisher and others. To date, the Bankruptcy Court has authorized the CRO to use \$6,300,000 of Harder and Fisher's equity proceeds for the working capital needs of Sunwest and Facilities.

The net of the uncollected receivables and unpaid payables is \$16,000,000. This amount has been subtracted because it is not currently collectible. For example, \$7,300,000 is due from the Corinthians and Waterfield facilities. However this money will not be collectible until the properties are sold and even at that time the proceeds may not be sufficient to repay 100% of the outstanding loans.

There are also eight properties from which Harder and/or Fisher appear to have taken disproportionate distributions. For these properties, Harder and/or Fisher appear to have received distributions in excess of their proportionate share of the equity. There is an outstanding issue as to whether Harder and/or Fisher will repay these amounts to equalize the distributions amongst the respective facility members.

**B. Current Cash Position**

As stated above, the Bankruptcy Court approved the use of \$6,300,000 from the Lone Star transaction to be used in the operations of Sunwest and Facilities. The money was allocated from Harder and Fisher's respective equity proceeds.

From February 20, 2009 to April 2, 2009 the CRO utilized \$5,122,933 of the Lone Star proceeds to cover cash shortfalls for Sunwest and Facilities. There is \$1,159,786 currently remaining of the aforementioned authorized amount.

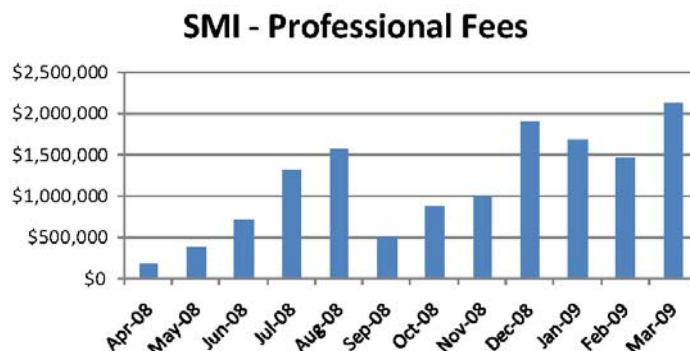
The current burn rate for operations of the assisted living Facilities is estimated at \$1,700,000 per month. This is based on the assumption that operating expenses and non-default mortgage payments will be paid. It is the Receiver's understanding that no additional funds are being allocated to the non-assisted living Facilities. Sunwest will also require an additional cash infusion of approximately \$250,000 per month to support management for operations. At this current burn rate, it would appear that Sunwest and the Facilities will utilize the remaining \$1,159,786 within a month and the remaining Lone Star proceeds, assuming authorization to use these funds for operations is obtained, within four to six months. If the payment of professional fees continues at the pace discussed below, the timing until exhaustion of Lone Star funds will be sooner.

**C. Professional Fees**

From April 2008 through March 2009, Sunwest paid over \$13,500,000 for professional fees. These payments include payments to legal counsel, restructuring consultants and other professionals. Over the past four months, professional fees paid have averaged almost



\$1,800,000 per month. The chart below indicates the increasing velocity of funds paid for professional fees over the past year.



## V. RECEIVER'S REVIEW OF ACCOUNTING

The Receiver has commenced work related to the accounting called for under the Receiver Order. Initially, the Receiver addressed controls in place at Sunwest and a general overview of operations. This was accomplished through review of selected financial reports and interviews with Sunwest employees, consultants and professionals, as well as interviews with individual defendants, Management Committee members and third parties.

### A. Assisted Living Facilities

Sunwest Management maintains a sizeable accounting department devoted to the recording of accounting transactions and producing financial reports for the assisted living Facilities. The accounting department is divided into two separate groups. One department handles the accounts receivable, collections, accounts payable and payroll for the entities. The other department is primarily responsible for preparing the monthly financial statements for each Facility and reconciling key account balances.

The Receiver's preliminary opinion is that sufficient procedures and controls are in place to insure the proper recording of transactions at the Facility level. While the Receiver may not agree with the underlying premise of each transaction, it does appear that the transactions are all being recorded and reconciled. The Receiver intends to perform additional tasks to validate

these preliminary opinions and assess the veracity of the financial records for these assisted living Facilities.

**B. Non-Assisted Living Facilities**

The accounting for non-assisted living Facilities is handled by other accounting personnel which are separate and distinct from the assisted living accounting department described above. Most of this accounting was handled by Canyon Creek Development. Additionally, Sunwest has a corporate accounting department that handles the accounting for Sunwest and some of the other affiliated entities. Finally, there are a handful of entities for which the accounting is handled by a third party.

The accounting for these entities is not current and for most entities only covers periods ending September 2008. The task of updating these accountings is underway, but it is difficult to determine when it may be completed given the reduced levels of staffing at Sunwest. The Receiver is currently assessing what steps should be taken to insure the accounting for these entities is completed and reviewed for accuracy.

**C. Treasury Department**

Sunwest also maintains a treasury department which is responsible for the cash management of all entities. Prior to the appointment of the CRO, the treasury department was mainly concerned with insuring that all bank accounts had a positive cash balance. The treasury department initiated all transfers amongst the entities as well as transfers between entity accounts and Jon Harder's and Kristin Harder's personal accounts.

The treasury department has evolved over the past few months and now performs some actual cash management tasks. While the treasury department is still responsible for monitoring cash positions, they are also preparing budgets and cash forecast to be utilized by the CRO in the restructuring process.

The treasury department is currently under the direct control of Hamstreet and Associates. Additionally, Hamstreet personnel are the only authorized signers on all key

accounts. As such, the Receiver believes that the CRO is closely monitoring the cash activity for all entities under control of the CRO.

## **VI. RECEIVER'S REVIEW OF THIRD-PARTY CLAIMS**

A significant portion of the Receiver's work during the past 30 days has been to commence a review and analysis of third-party claims. As the Court is aware, prior to the appointment of the Receiver, there were already existing third-party lawsuits filed in various state courts by individuals and groups of investors alleging wrongdoing by certain professionals utilized by the Receivership Entities. In addition, these actions included claims against certain individual defendants as well. As the Court is also aware, the Receiver is in a unique position to join such third-party litigation, commence new litigation and foster significantly greater returns than may be possible by individual investors.

### **A. Initial Tasks**

The Receiver has taken the following steps toward the investigation and prosecution of third-party claims:

- Meetings have been held with counsel representing primary groups of plaintiffs who have either commenced third-party actions or have been formed for the purpose of doing so;
- The Receiver has analyzed the claims in the principal actions that have been commenced against third parties by investors.
- The Receiver has begun obtaining relevant documents from third parties in an effort to establish a complete database which can be reviewed for the purpose of evaluating potential claims. To date, documents have been cooperatively obtained from Lane Powell, former counsel for the Sunwest Enterprise and who produced documents to the Commission, and documents have been obtained from the Commission. Two former law firms for the Sunwest Enterprise, K&L Gates and Thompson & Knight, have agreed to promptly provide their client files to the

Receiver. A third law firm, Davis Wright Tremaine, has sought confirmation from the Court that the Receiver is entitled to its client's files and has taken the position that the Receiver must pay to obtain copies of its client files; Davis Wright Tremaine has estimated the cost of copying all of the files as exceeding \$250,000. Davis Wright and Tremaine has also been dilatory and creative in erecting hurdles to the Receiver's access to client files. The Receiver is continuing to pursue those documents.

- The Receiver has requested bankruptcy counsel for Mr. Harder to provide access to their electronic database of documents related to Sunwest-managed facilities, but was initially asked to sign an inappropriate confidentiality agreement as a condition of access. The Receiver is continuing to discuss obtaining access to those documents, as well, and anticipates a prompt consensual resolution.
- The Receiver has proposed tolling agreements with Davis Wright Tremaine, K&L Gates, Thompson & Knight and others in an effort to protect claims from statutes of limitations risks while settlement discussions occur in advance of filing lawsuits. To date, Davis Wright Tremaine, K&L Gates, and Thompson & Knight have agreed in principle to such agreements, and they are being drafted;
- The Receiver has requested copies of insurance policies from potential third-party targets to assist in analyzing the prospects for recovery;
- Forensic accountants have commenced their analysis of the Sunwest's books and records and financial activities, including but not limited to the Sunwest's relationship and the activities of third-party brokers, lenders, broker dealers and others.

Ultimately, the Receiver will report to this Court regarding his intended actions in connection with third-party claims and provide budgets to the Court for prosecuting such matters.

**B. Investors' Interests in Third-Party Claims**

During the past month, the Receiver evaluated the varied interests of parties in third-party claims. The Receiver has met with attorneys representing investors and TICs who have either filed lawsuits or are contemplating filing lawsuits against Defendants, insiders and third-parties.

The Receiver has not fully identified the nature of all claims that may be brought to recover assets, however, the Receiver is initially focused on third-party claims for negligence, malpractice, and securities violations by professionals representing the Receivership Entities. The Receiver holds and controls all third-party claims that any Receivership Entity has, but without any in pari delecto defenses being applicable. While the Receiver does not presently hold claims assertable solely by individual investors, TICs or other creditors, in appropriate circumstances, the Receiver can seek authority from the Court to represent investors and creditors who wish the Receiver to proceed on their behalf in order to maximize the return to all investors in litigation and assure third-party defendants that a comprehensive settlement has no opt-outs. The Receiver has not decided whether to seek such authority from the Court, however, it is likely the Receiver will make a decision on this issues in the next 45-60 days, depending on the outcome of discussions with investors, TICs, counsel and third-party defendants on a variety of issues.

The funds recovered by the Receiver in connection with third-party litigation will be distributed to all investors and creditors in accordance with a court approved distribution plan. That plan may or may not take into account individual recoveries by investors. No agreement has been reached with attorneys who are already representing investors and TICs in lawsuits as to how they will be paid in cases where the Receiver is a recovering plaintiff. This issue will need to be addressed as the parties coordinate their work.

The Receiver cannot predict whether those who hire independent counsel to pursue their claims will recover more or less after payment of their own attorneys' fees than those investors or creditors who do not hire independent counsel and rely upon the Receiver's efforts. What can be

said is that the Receiver will work toward a distribution plan that is fair and equitable. As such, the Receiver may propose a distribution plan that if approved, would level the field such that, all things being equal, the amount of one's distribution from recoveries on third-party claims will not be adversely impacted if one does not hire independent counsel.

Note that individuals may have claims that are independent of this receivership case that may only be pursued by individuals. For example, an individual may have retained a broker or an investment advisor who may be liable under some circumstances. The Receiver cannot advise investors how to maximize their personal recoveries.

## **VII. RECOMMENDATIONS**

### **A. Operations/Decision Making**

In an ordinary receivership, the receiver would have been appointed and provided with control over the entire Sunwest Enterprise. He might have hired a chief operations officer and would have engaged professionals to handle specific duties, but the ultimate decision making would rest with him. This straightforward approach is not present in the instant case. Accordingly, as previously described, delays from collective decision making have plagued this case during the first 30 days. The Receiver makes the following recommendations, some of which have already been accepted and implemented by the CRO and Management Committee, in an effort to facilitate a more effective receivership and hopefully one which will maximize the return to investors.

The Receiver recommendations are as follows in connection with operations:

(a) Withdraw the reference of all the bankruptcy cases. Mr. Harder's personal bankruptcy case has already been withdrawn and the Receiver has filed motions to withdraw the balance of the remaining bankruptcy cases;

(b) Evaluate each of the bankruptcy cases and suspend activities in all such bankruptcy cases for a temporary period while an evaluation is conducted as to what, if any, real benefits can be achieved through the Bankruptcy Court that could not otherwise be achieved

through this federal receivership (the parties have recently reached tentative agreements as to this matter);

(c) Certain Sunwest related assets of Fisher and Gutzler are protected by the injunction from creditors. The assets of Kristin Harder, Carol Fisher and non-Sunwest related assets of Darryl Fisher and Wally Gutzler are not protected from third-party actions or from dissipation by them. As such, the Receiver proposes that an asset freeze be ordered as to the assets of Daryl Fisher, Carol Fisher, J. Wallace Gutzler and Kristin Harder, with allowed carveouts for suitable living and legal expenses. This will achieve the dual benefit of avoiding potential losses to the Receivership Estate due to improper activities by defendants and protecting potential receivership assets from garnishment, attachment or liens by third-party claimants who may file actions in state and federal court. Discussions are under way with these parties on this topic;

(d) Eliminate any appearance of impropriety that may exist as between the defendants and Sunwest Enterprise, the Management Committee and the CRO by, among other things, restricting Harder's and his counsel's direct involvement in decision making for the Sunwest Enterprise, leaving such to the Management Committee, CRO and Receiver, as applicable;

(e) As has been pointed out to the CRO and others, the CRO Agreement has not been assumed and is subject to rejection by the Receiver. The Receiver believes that the CRO Agreement or its substance must be modified to reflect the current circumstances. Under discussion are changes to the CRO Agreement to provide for a more appropriate fee structure and obligation of the Receivership Entities for the personal attorneys for Harder, Fisher and Gutzler. Other fees and commissions will be reviewed with the CRO to assure appropriate levels of compensation.

(f) The Receiver should be granted control over all cash and the preliminary injunction order should be clarified to reflect the reality that the Receiver's role in developing a

claim allowance and distribution plan must necessarily involve and take into account the sales, disposition and restructuring work of the CRO and Management Committee.

**B. Sale and Disposition of Assets**

The Receiver has proposed a protocol for the sale and disposition of assets and transmitted a memorandum to the CRO and Greg Yates, attorney for Sunwest, for this purpose. It is understood that the CRO and Management Committee have approved this protocol and that it will be implemented as part of their sales and disposition process.

This process calls for the CRO to present the case for the disposition of properties by sale or foreclosure to the Management Committee for approval. Upon approval, counsel for Sunwest will prepare pleadings and declarations in accordance with guidelines recommended by the Receiver. This will include declarations and evidentiary support for the dispositions. This information will then be shared with counsel for Harder and with the Receiver prior to filing of motions with the Court.

**C. Forensic Analysis of Investor Cash Flows**

In accordance with the Court's Order and to facilitate the ultimate fair and equitable treatment of the investors and creditors, the Receiver proposes to pursue the accounting in order to address the these fundamental questions:

- How much money was invested or lent to the Sunwest Enterprise and where did the money go?
- How much money was exported from a Facility or entity, when, and to whom?
- How much money was imported to a Facility or entity, when and from whom?
- How does the import and export of money affect the potential distribution to creditors if money is distributed on a specific Facility/ownership basis?

**D. Claims Process**

The Receiver recommends the early establishment of a claims bar date in order to determine the amount and nature of claims and interests. The information gathered by this



process, once completed, will be useful in formulating the distribution plan, the Receiver's accounting as well as establishing potential damage claims in litigation.

**E. Reporting**

The Receiver proposes to file a Second Interim Report in 90 days.

DATED: April 24, 2009

Respectfully submitted,

/s/ Michael A. Grassmueck  
MICHAEL A. GRASSMUECK

ALLEN MATKINS LECK GAMBLE MALLORY  
& NATSIS LLP

By /s/ A. Kenneth Hennesay, Jr.  
A. KENNETH HENNESAY, JR. (Pro Hac Vice)  
California SB #187531  
Attorneys for Michael A. Grassmueck,  
Court Appointed Receiver

**CERTIFICATE OF SERVICE**

I certify that I served the foregoing First Interim Report Of Receiver Michael Grassmueck As Of April 23, 2009 on April 24, 2009, by causing to be electronically mailed via ECF to:

**SEE ATTACHED ELECTRONIC MAIL NOTICE LIST**

I certify that I served the following parties by placing a true copy of the foregoing described document in a sealed envelope addressed as follows:

Marc Fagel, Esq.  
Securities and Exchange Commission  
44 Montgomery Street, Suite 1100  
San Francisco, CA 94104

Gina Anne Johnnie  
Sherman Sherman Johnnie & Hoyt LLP  
693 Chemeketa Street NE  
PO Box 2247  
Salem, OR 97308

I am readily familiar with this firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal Service on that same day in the ordinary course of business. I am aware that on motion of party served, service is presumed invalid if postal cancellation date or postage meter date is more than 1 day after date of deposit for mailing in affidavit.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on April 24, 2009, at Irvine, California.

/S/ A. Kenneth Hennesay, Jr.

A. KENNETH HENNESAY, JR.  
Attorneys for Receiver  
Michael Grassmueck

ALLEN MATKINS LECK GAMBLE  
MALLORY & NATSIS LLP  
1900 Main Street, 5th Floor  
Irvine, California 92614-7321  
Phone: (949) 553-1313

Case 6:09-cv-06056-HO

**ELECTRONIC MAIL NOTICE LIST**

- John D. Albert  
jalbert@albertandtweet.com
- Richard T. Anderson , Jr  
rick@andersonmonson.com,jaime@andersonmonson.com
- Joseph C. Arellano  
arellano@kwar.com
- James M. Barrett  
jmb@aterwynne.com,pdb@aterwynne.com
- Peter D. Bilowz  
pbilowz@goulstonstorrs.com
- Steven K. Blackhurst  
skb@aterwynne.com,sra@aterwynne.com
- David A. Bledsoe  
Dbledsoe@perkinscoie.com,acollins@perkinscoie.com,docketpor@perkinscoie.com
- Hannah L. Blumenstiel  
hblumenstiel@winston.com
- Kathleen Carroll Bricken  
kbricken@gsblaw.com,rriley@gsblaw.com
- Melissa Seifer Briggs  
melissa@shermlaw.com
- Robert R. Calo  
calor@lanepowell.com,rammr@lanepowell.com,docketing-pdx@lanepowell.com
- Barry P. Caplan  
barry@sussmanshank.com,ctolle@sussmanshank.com
- Diana K Carey  
dcarey@karrtuttle.com
- Christopher T. Carson  
ccarson@kilmerlaw.com,vschmitz@kilmerlaw.com
- Paul R. J. Connolly  
paul@connollypc.com,angela@connollypc.com
- David W. Criswell  
dcriswell@bjllp.com,swylen@balljanik.com

- Douglas P. Cushing  
doug.cushing@jordanschrader.com,litparalegal@jordanschrader.com,debra.braddock@jordanschrader.com,deborah.soloway@jordanschrader.com
- David J. Elkanich  
delkanich@hinshawlaw.com,tkohn@hinshawlaw.com,jdavis@hinshawlaw.com,astienessen@hinshawlaw.com
- Ford Elsaesser  
ford@ejame.com
- Julie Engbloom  
engbloomj@lanepowell.com,pettingerk@lanepowell.com,docketing-pdx@lanepowell.com
- Stephen F. English  
steve.english@bullivant.com,janet.carswell@bullivant.com,dbrandt@schnader.com,kvasquez@schnader.com,mwhitaker@schnader.com,carol.mclemore@bullivant.com,portlanddocketing@bullivant.com
- Michael J. Esler  
bh@eslerstephens.com,esler@eslerstephens.com,hardiman@eslerstephens.com
- Michael M. Feinberg  
mfeinberg@karrtuttle.com
- Mark P Fickes  
fickesm@sec.gov,fagelm@sec.gov
- David A. Foraker  
david.foraker@greenemarkley.com
- Gary I. Grenley  
ggrenley@grebb.com,jbecker@grebb.com,ptrincher@grebb.com,lehrenshaft@grebb.com
- Andrew D. Hart  
ahart@sidley.com
- Stephanie K. Hines  
shines@perkinscoie.com,skroberts@perkinscoie.com,docketpor@perkinscoie.com,JRaymond@perkinscoie.com
- Mark C. Hoyt  
mark@shermlaw.com,brenda@shermlaw.com
- John G. Hutchinson  
jhutchinson@sidley.com
- Kevin J. Jacoby  
kevin@connollypc.com,angela@connollypc.com

- Gary K. Kahn  
gkahn@rke-law.com
- Jared B. Kahn  
jaredk@rke-law.com
- Albert N. Kennedy  
al.kennedy@tonkon.com,leslie.hurd@tonkon.com
- Daniel L. Keppler  
keppler@kwar.com
- Jay L. Krystinik  
jay.krystinik@bryancave.com
- Susan F. LaMarca  
lamarcas@sec.gov,alcairoe@sec.gov,johnstonj@sec.gov
- William L. Larkins , Jr  
wlarkins@larkinsvacura.com,lsabatini@larkinsvacura.com
- Michael E. Liftik  
liftikm@sec.gov
- Merrilee A MacLean  
mmaclean@karrtuttle.com
- Kevin S. Mapes  
kmapes@bjllp.com,mstacey@bjllp.com,ismith@bjllp.com
- Robert B. Miller  
bob.miller@bullivant.com,leanne.l'hommedieu@bullivant.com,portlanddocketing@bullivant.com
- David R. Mylrea  
dmylrea@hinshawlaw.com
- Sheila E. O'Callaghan  
ocallaghans@sec.gov
- Teresa H. Pearson  
teresa.pearson@millernash.com,lisa.conrad@millernash.com,teri.cochran@millernash.com
- Milo Petranovich  
petranovichm@lanepowell.com,pettingerk@lanepowell.com,docketing-pdx@lanepowell.com
- Russell W. Pike  
russ@shermlaw.com,docketing@gordon-polscer.com

- John Richard Potter  
jrp@hpl-law.com
- Daniel H. Rosenhouse  
dan.rosenhouse@doj.state.or.us,toni.c.kemple@doj.state.or.us
- Douglas B. Rosner  
drosner@goulstonstorrs.com
- Salem Investors, a California General Partnership  
epierce@waldmanmgmt.com
- Tara J. Schleicher  
dfallon@fwwlaw.com,sormsby@fwwlaw.com,tschleicher@fwwlaw.com
- Kashya K. Shei  
sheik@sec.gov
- Brad T. Summers  
tsummers@bjllp.com
- Brent Gordon Summers  
brent.summers@tnslaw.net
- Laura Caldera Taylor  
laura.taylor@bullivant.com,portlanddocketing@bullivant.com,marcie.carter@bullivant.com
- Robert L. Taylor  
rtaylor@bjllp.com,jchavis@bjllp.com
- Jeanette L. Thomas  
jthomas@perkinscoie.com,etherrien@perkinscoie.com,docketpor@perkinscoie.com
- Stephen T. Tweet  
stweet@albertandtweet.com
- Julie R. Vacura  
jvacura@larkinsvacura.com,lniknabard@larkinsvacura.com
- David D. VanSpeybroeck  
David.Vanspeybroeck@bullivant.com,christine.hicks@bullivant.com,portlanddocketing@bullivant.com
- Robert J Vanden Bos  
vbcservice@yahoo.com,bob@vbcattorneys.com
- Laura J. Walker  
lwalker@cablehouston.com,kharris@cablehouston.com
- B. Scott Whipple  
swhipple@whippeduyck.com

- Greg R. Yates  
gyates@steptoe.com