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8 UNITED STATES BANKRUPTCY COURT
9 NORTHERN DISTRICT OF CALIFORNIA
10 SAN FRANCISCO DIVISION

12 In re:
13 CMR Mortgage Fund, LLC,
14 CMR Mortgage Fund II, LLC,
15 CMR Mortgage Fund III, LLC,
16 Debtors,

17 Affects **ALL FUNDS**

Case Nos: 08-32220 TEC
09-30788 TEC
09-30802 TEC

Chapter Number: 11

**MEMORANDUM OF POINTS AND
AUTHORITIES IN SUPPORT OF INDIAN
HARBOR INSURANCE COMPANY'S
MOTION FOR RELIEF FROM THE
AUTOMATIC STAY TO ALLOW
ADVANCEMENT OF DEFENSE
EXPENSES UNDER LIABILITY
INSURANCE POLICY**

[Filed concurrently with Notice of Motion and
Motion; Declaration of Leslie S. Ahari]

Date: September 13, 2010
Time: 1:00 p.m.
Courtroom: 23
235 Pine Street
San Francisco, CA
Judge: Hon. Thomas E. Carlson

1047502v2

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF
MOTION FOR RELIEF FROM THE AUTOMATIC STAY

1 Indian Harbor Insurance Company (“Indian Harbor”), by and through its undersigned
2 counsel, enters a limited appearance solely for the purpose of moving this Court, pursuant to Rule
3 4001(a) of the Federal Rules of Bankruptcy Procedure and 11 U.S.C. §362(d), for relief from the
4 automatic stay to pay from the proceeds of a Financial Services Liability Policy issued to a non-
5 debtor, California Mortgage and Realty, Inc. Indian Harbor does not consent to jurisdiction for
6 any other purpose. Indian Harbor respectfully submits this Memorandum of Points and
7 Authorities in support of its Motion For Relief From the Automatic Stay to Allow Advancement
8 of Defense Expenses Under Liability Insurance Policy (the “Motion”).

9 **I. INTRODUCTION AND STATEMENT OF REQUESTED RELIEF**

10 In 2007, and before the filing of the above-captioned bankruptcy cases, Indian Harbor
11 issued a liability insurance policy to non-debtor California Mortgage and Realty, Inc. (“CMRI”).
12 CMRI managed investment funds, including CMR Mortgage Fund, LLC (“Fund I”), CMR
13 Mortgage Fund II, LLC (“Fund II”), and CMR Mortgage Fund III, LLC (“Fund III”), the debtors
14 in these bankruptcy cases (collectively, the “Debtor Funds”).

15 Beginning in 2009, several investors in the Debtor Funds have filed lawsuits against
16 CMRI and others (including, in some cases, the Debtor Funds). CMRI tendered these lawsuits to
17 Indian Harbor for coverage under a professional liability insurance policy it issued to CMRI.

18 Based on information known to date, Indian Harbor has acknowledged potential coverage
19 for the lawsuits under the policy. The non-debtor **Insureds** have sought coverage for their legal
20 fees incurred in the defense of the lawsuits.¹ Although Indian Harbor has reserved its right to
21 deny or limit coverage under the policy, it has agreed to advance **Defense Expenses** on behalf of
22 the non-debtor **Insureds** subject to its continuing reservation of rights, including the right to seek
23 repayment of all amounts determined not to be covered by the policy or for which it has no duty
24 or obligation to pay. However, because the Debtor Funds qualify as **Insureds** under at least one
25 of the policy’s coverage parts, the Debtor Funds may share an interest in the policy’s proceeds
26 with the other non-debtor **Insureds**. As a result, Indian Harbor’s proposed advancement of
27

28 ¹ Other than in headings, words appearing in bold are defined terms under the Policy.
1047502v2 - 1 -

1 **Defense Expenses** on behalf of the non-debtor **Insureds** named as defendants in these lawsuits
2 arguably is prohibited by the automatic stay, 11 U.S.C §362.

3 Although the automatic stay currently may prohibit it, there is good cause for the Court to
4 modify the stay to permit Indian Harbor to advance **Defense Expenses** on behalf of the non-
5 debtor **Insureds**. The **Insureds** have incurred, and are incurring, attorneys' fees and costs to
6 defend themselves in the lawsuits, yet these **Insureds** have represented to Indian Harbor that they
7 lack the funds to pay defense counsel. If the automatic stay is not modified to allow Indian
8 Harbor to advance **Defense Expenses** on their behalf, the non-debtor **Insureds'** defense of the
9 lawsuits will be substantially prejudiced and their interest in the policy will be significantly
10 infringed. To permit the automatic stay to prevent advancement of **Defense Expenses**, in effect,
11 would grant the Debtor Funds greater rights to the policy proceeds than they would have outside
12 of the bankruptcy context while risking substantial irreparable harm to the non-debtor **Insureds**.
13 Additionally, the non-debtor **Insureds'** defense of the lawsuits may benefit the Debtor Funds by
14 establishing defenses to the various plaintiffs' claims against the Debtor Funds. Accordingly,
15 modification of the stay is appropriate here.

16 **II. JURISDICTION**

17 This Court has jurisdiction to consider the Motion pursuant to 28 U.S.C. §§ 157 and 1334.
18 This matter is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before this
19 Court pursuant to 28 U.S.C. §§ 1408 and 1409. The Motion is a motion pursuant to Section
20 362(d) of the Bankruptcy Code entitled to resolution in accordance with Section 362(e) of the
21 Bankruptcy Code.

22 **III. BACKGROUND**

23 **A. The Debtor Funds and the Bankruptcy Cases**

24 The Debtor Funds are California limited liability companies. Each of the Debtor Funds
25 was and is managed by a non-member and non-debtor management company, CMRI. The
26 president and principal of CMRI is David Choo.

27 On November 19, 2008, Fund I filed its voluntary Chapter 11 bankruptcy case. Fund II
28 and Fund III both filed their voluntary Chapter 11 cases on March 31, 2009.

1047502v2

- 2 -

MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF
MOTION FOR RELIEF FROM THE AUTOMATIC STAY

1 On March 31, 2010, this Court conditionally approved substantive consolidation of the
2 Debtor Funds' Chapter 11 cases, subject to confirmation of the Debtor Funds' and Official
3 Committee of Equity Security Holders' ("Equity Committee") Joint Plan of Reorganization.

4 **B. CMR, Choo and Other Insureds Are Named as Defendants in Various**
5 **Lawsuits**

6 There currently are pending five lawsuits filed by investors in the Debtor Funds against
7 CMRI and other **Insureds**:²

- 8 • *Zadik v. California Mortgage and Realty, Inc., et al.*, San Francisco County
9 Superior Court, No. CGC-09-486094 (the "*Zadik* Action"). The *Zadik* Action
10 names CMRI, Mr. Choo and debtor Fund II as defendants.
- 11 • *Strouzas v. Choo, et al.*, San Francisco Superior Court Case No. CGC 09-491988
12 (the "*Strouzas* Action"). The *Strouzas* Action names CMRI, Mr. Choo and the
13 three Debtor Funds as defendants.
- 14 • *McCarthy v. Choo, et al.*, San Francisco Superior Court Case No. CGC 09-492051
15 (the "*McCarthy* Action"). The *McCarthy* Action names CMRI, Mr. Choo and the
16 three Debtor Funds as defendants.³
- 17 • *Stevens v. California Mortgage and Realty, Inc., et al.*, San Francisco Superior
18 Court Case No. CGC 10-497123 (the "*Stevens* Action"). The *Stevens* Action is
19 against, among others, CMRI, Mr. Choo and certain non-debtor investment funds.
- 20 • *Bergman, et al. v. California Mortgage and Realty, Inc., et al.*, Adv. Proc. No. 10-
21 03107 (Bankr. N.D. Cal.) (the "*Bergman* Action"). The *Bergman* Action names
22 CMRI and Mr. Choo as defendants.

23 The *Zadik* Action, *Strouzas* Action, *McCarthy* Action, *Stevens* Action and *Bergman*
24 Action are collectively referred to herein as the "CMRI Lawsuits."

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26 ² Another action, *Foreman v. California Mortgage Realty, Inc., et al.*, San Francisco Superior
27 Court Case No. CGC-09-486152, was voluntarily dismissed without prejudice on February 26,
28 2010.

³ It appears that debtor Fund I (CMR Mortgage Fund, LLC) was erroneously sued as "CMR
Mortgage Fund I, LLC" in the *McCarthy* Action.

1 **C. The Indian Harbor Policy and Potential for Coverage for the CMR Lawsuits**

2 Indian Harbor issued Financial Services Liability Policy No. ELU 100039-07 (the
3 “Policy”) to CMRI for the claims-made policy period September 1, 2007 to September 1, 2009.
4 A true and correct copy of the Policy is attached as Exhibit A to the Declaration of Leslie S.
5 Ahari (“Ahari Decl.”), filed concurrently herewith. The Policy provides a \$5 million maximum
6 aggregate limit of liability, inclusive of **Defense Expenses**. Indian Harbor’s payment of **Defense**
7 **Expenses** therefore reduces, and may exhaust, the limit of liability.

8 The Policy contains five coverage parts: (1) the Investment Advisers Management
9 Liability (“IAML”) Coverage Part; (2) the Investment Advisers Professional Liability (“IAPL”)
10 Coverage Part; (3) the Investment Fund Management and Professional Liability (“IFMPL”)
11 Coverage Part; (4) the Employment Practices Liability Coverage Part; and (5) the Pension and
12 Welfare Benefit Plan Fiduciary Liability Coverage Part. Each Coverage Part provides a \$5
13 million maximum aggregate limit of liability for all **Claims** under such Coverage Part. However,
14 the limits of liability provided by the various Coverage Parts are part of, and not in addition to,
15 the \$5 million maximum aggregate limit of liability for all **Claims**. See Policy Declarations Item
16 3; General Terms and Conditions Section II(A)(1), (2), (3).

17 Based on the limited information presently available to it, Indian Harbor has
18 acknowledged potential coverage under the IAPL and IFMPL Coverage Parts of the Policy for
19 the CMRI Lawsuits subject to a reservation of rights. The IAML, Employment Practices
20 Liability or Pension and Welfare Benefit Plan Fiduciary Liability Coverage Parts are not
21 implicated by the CMRI Lawsuits.

22 Subject to all of the Policy’s terms and conditions, the Insuring Agreement of the IAPL
23 Coverage Part provides that Indian Harbor shall pay on behalf of the **Insureds Loss** resulting
24 from **Claims** first made against them during the **Policy Period** for **Wrongful Acts**.⁴ See Policy

25 _____
26 ⁴ **Wrongful Acts** under the IAPL Coverage Part include, in pertinent part, any actual or alleged act, error, omission,
27 misstatement, misleading statement or breach of fiduciary duty or other duty committed by an **Insured** in the
28 performance of or failure to perform **Professional Services**. See *id.* at Section II(E). **Professional Services** means,
in pertinent part, financial economic or investment advice given or investment management services performed for
others for a fee or commission by the **Adviser** or on behalf of the **Adviser** by any person or entity. See *id.* at Section
II(D).

1 IAPL Coverage Part Section I. **Insured** means the **Insured Persons** and the **Adviser**. *See id.* at
2 Section II(B). **Adviser** means the **Named Insured** – here, CMRI – and its **Subsidiaries**. *See id.*
3 at Section II(A). **Insured Person** includes directors and officers of the **Adviser**. *See id.* at
4 Section II(C). Accordingly, CMRI and Mr. Choo are **Insureds** under the IAPL Coverage Part;
5 but the Debtor Funds are not.

6 Subject to all of the Policy’s terms and conditions, the Insuring Agreement of the IFMPL
7 Coverage Part provides that Indian Harbor shall pay on behalf of the **Insureds Loss** resulting
8 from **Claims** first made against them during the **Policy Period** for **Wrongful Acts**.⁵ *See* Policy
9 IFMPL Coverage Part Section I. **Insured** under the IFMPL Coverage Part includes the **Named**
10 **Insured**, the **Insured Persons**, and each **Investment Fund**. *See id.* at Section II(A). CMRI is
11 the **Named Insured**. **Investment Fund** includes those funds identified in Endorsement No. 3,
12 which lists each of the Debtor Funds. *See id.* at Section II(D), Endorsement No. 3. Accordingly,
13 the Debtor Funds are **Insureds** under the IFMPL Coverage Part. **Insured Persons** include
14 directors and officers of the **Investment Funds**, the general partner or managing general partner
15 of **Investment Funds** organized as limited partnerships, and the managing member of
16 **Investment Funds** organized as limited liability companies. *See id.* at Section II(C). Mr. Choo
17 therefore is an **Insured Person** under the IFMPL Coverage Part.

18 **D. Indian Harbor is Willing to Advance Defense Expenses, Subject to its Full**
19 **Reservation of Rights, If the Court Grants Relief From the Automatic Stay**

20 As the Debtor Funds are **Insureds** under the Policy’s IFMPL Coverage Part, the Debtor
21 Funds share an interest in the Policy’s proceeds with the other non-debtor **Insureds**, including
22

23 ⁵ **Wrongful Act** includes, for purposes of the IFMPL Coverage Part: (1) any actual or alleged act, error, omission,
24 misstatement, misleading statement or breach of fiduciary duty or other duty committed by an **Insured** in the
25 performance of or failure to perform **Professional Services**; (3) any actual or alleged act, error, omission,
26 misstatement, misleading statement or breach of fiduciary duty or other duty committed by an **Insured Person** in his
27 or her capacity as a director, officer, or member of the Board of Managers, general partner or managing general
28 partner of an **Investment Fund**; and (4) any matter asserted against an **Insured Person** solely by reason of his or her
status as a director, officer, member of the Board of Managers, general partner, or managing general partner of an
Investment Fund. *See id.* at Section II(J). **Professional Services** means, among other things, advisory or other
services performed by an **Investment Fund** or on behalf of an **Investment Fund** by any person or entity, provided
such services are performed in connection with the management or operation of such **Investment Fund**. *See id.* at
Section II(I).

1 CMRI, Mr. Choo and others. Therefore, advancing **Defense Expenses** under the Policy on behalf
2 of the non-debtor **Insureds** arguably is prohibited by the automatic stay. However, the non-
3 debtor **Insureds** currently are incurring legal expenses in defending against the CMRI Lawsuits
4 and are in need of the Policy’s proceeds to pay defense counsel. Indian Harbor is willing to
5 advance **Defense Expenses** on behalf of the non-debtor **Insureds** subject to a full reservation of
6 rights, including the right to seek repayment of amounts determined not to be covered by the
7 Policy.

8 **IV. GOOD CAUSES EXISTS TO GRANT THE REQUESTED RELIEF FROM THE**
9 **AUTOMATIC STAY**

10 Bankruptcy Code section 362(a) imposes an automatic stay, as of the petition date, on
11 (among other things) “any act to obtain possession of property of the estate or of property from
12 the estate or to exercise control over property of the estate....” 11 U.S.C. § 362(a)(3). “The
13 Bankruptcy Code also recognizes that certain circumstances require the court to respond to other
14 interests and permits a flexible approach to the stay as the circumstances may require.” *Groshong*
15 *v. Sapp*, 423 B.R. 537, 542 (B.A.P. 9th Cir. 2010). “Section 362(d)(1) authorizes the bankruptcy
16 court broad discretion to grant relief from the automatic stay imposed under section 362(a) for
17 ‘cause.’” *Id.* “Such relief may include ‘terminating, annulling, modifying, or conditioning such
18 stay.’” *Id.* See also 11 U.S.C. § 362(d).

19 The Ninth Circuit Court of Appeals has held that “[b]ecause there is no clear definition of
20 what constitutes ‘cause,’ discretionary relief from the stay must be determined on a case by case
21 basis.” *In re MacDonald*, 755 F.2d 715, 717 (9th Cir. 1985). See also *In re Delaney-Morin*, 304
22 B.R. 365, 369 (9th Cir. B.A.P. 2003) (quoting *In re MacDonald*). The proper analysis under
23 section 362(d)(1) involves “weighing the parties’ respective harms....” See *Groshong*, 423 B.R.
24 at 545 (declining to determine whether D&O liability insurance policy proceeds were property of
25 the estate, but finding that, regardless, the bankruptcy court did not abuse its discretion in
26 granting relief from stay to allow insurer to pay defense costs to the non-debtor director of a
27 debtor corporation).

1 Good cause exists for this Court to grant the requested relief from the automatic stay.
2 First, unless relief is granted so to permit the payment of their **Defense Expenses**, the interests of
3 the non-debtors **Insureds** in the Policy proceeds impermissibly would be subordinated to the
4 interests of the Debtor Funds. Despite the broad reach of Section 541, courts have held that only
5 the *debtor's* interest in property held jointly by the debtor and a non-debtor party is property of
6 the bankruptcy estate. *See, e.g., In re Carousel Int'l Corp.*, 89 F.3d 359, 362 (7th Cir. 1996).
7 Thus, while the debtor's interest in insurance proceeds may become property of the debtor's
8 estate, courts have held that a non-debtor, co-insured's interest in insurance policy proceeds does
9 *not* become property of the debtor's estate. In other words, courts recognize that the non-debtor,
10 co-insured retains its interest in proceeds of an insurance policy held with a debtor, co-insured.
11 *See In re Spaulding Composites Co.*, 207 B.R. 899, 906-07 n.1 (B.A.P. 9th Cir. 1997). The
12 recognition of distinct property rights of the debtor and non-debtor co-insureds is supported by
13 the doctrine that the "owner of an insurance policy cannot obtain greater rights to the proceeds of
14 that policy ... by merely filing a bankruptcy petition." *In re Denario*, 267 B.R. 496, 499 (Bankr.
15 N.D.N.Y. 2001).

16 Moreover, the proceeds of an insurance policy ordinarily may be made available to a non-
17 debtor insured despite the existence of other claims which may need to be paid in the future. *See*
18 *Scharnitzki v. Bienenfeld*, 534 A.2d 825, 827 (Pa. Super. Ct. 1987). This result should not be
19 altered by the filing of the debtor's bankruptcy petition. *Butner v. United States*, 440 U.S. 48, 55
20 (1979) ("Unless some federal interest requires a different result, there is no reason why [property]
21 interests should be analyzed differently simply because an interested party is involved in a
22 bankruptcy proceeding").

23 It is clear from the case law outlined above that the non-debtor **Insureds** have their own
24 interest in the Policy proceeds. Although the Debtor Funds also share an interest in the proceeds,
25 they do not have greater rights than the non-debtor **Insureds**, and their filing for bankruptcy
26 protection should not be permitted to undermine the non-debtor **Insureds'** interest. The
27 automatic stay therefore should be modified so as not to infringe on the non-debtor **Insureds'**
28 interest in the proceeds.

1 Second, good cause exists to grant relief from the automatic stay to prevent substantial
2 and irreparable harm to the non-debtor **Insureds**. As noted above, **Insureds** have represented to
3 Indian Harbor that they have incurred, and continue to incur, legal expenses to defend themselves
4 in the CMRI Lawsuits, but lack the funds to pay defense counsel and are in immediate need of the
5 Policy's proceeds to fund their defense. See Ahari Decl. ¶ 5. The automatic stay should be lifted
6 in order to ensure that the non-debtor **Insureds** are not substantially and irreparably harmed by
7 not being able to defend themselves in the litigation.

8 In recognition of the non-debtor insureds' interests and the harm they would suffer by
9 being deprived of policy proceeds to fund a defense, a number of courts have lifted the automatic
10 stay in order to allow for the payment of defense costs to non-debtor insureds even though the
11 insurance policies also provided direct coverage to the co-insured debtor. See, e.g., *In re*
12 *CyberMedica, Inc.*, 280 B.R. 12, 18 (Bankr. D. Mass. 2002) ("This Court further finds that there
13 is cause to lift the automatic stay because [non-debtor insureds] may suffer substantial and
14 irreparable harm if prevented from exercising their rights to defense payments."); *In re Enron*
15 *Corp.*, 2002 Bankr. LEXIS 544 (Bankr. S.D.N.Y. May 17, 2002); *In re Boston Regional Med.*
16 *Center Inc.*, 285 B.R. 87, 96 (Bankr. D. Mass. 2002) (recognizing that the non-debtor, co-insureds
17 had an immediate need for payment of proceeds from the relevant policy and that "[i]f the costs
18 of defense [were] not disbursed in time to provide the defense, a significant part of their value and
19 of their function [would] have been lost").

20 Finally, any harm to the Debtor Funds is outweighed by the harm to the non-debtor
21 **Insureds** in the event relief from the stay is not granted. The non-debtor **Insureds** have an
22 immediate need for payment of their **Defense Expenses** in the CMRI Lawsuits. By contrast, the
23 Debtor Funds are not named as defendants in the *Bergman* Action. Moreover, Indian Harbor
24 understands that the other investor lawsuits filed in state court, some of which do name the
25 Debtor Funds as defendants, might not be permitted to proceed if this Court determines to allow
26 the *Bergman* Action to proceed as a mandatory class action without opt-out rights. In that event,
27 the Debtor Funds would not have a need for their **Defense Expenses** to be paid. Any harm to the
28 Debtor Funds resulting from Indian Harbor's advancement of **Defense Expenses** to the non-

1047502v2

1 debtor Insureds therefore would be speculative and remote.

2 **V. CONCLUSION**

3 For the foregoing reasons, Indian Harbor respectfully requests that the Court modify the
4 automatic stay to allow Indian Harbor to advance **Defense Expenses** on behalf of non-debtor
5 **Insureds** in connection with the CMRI Lawsuits, and any other subsequently filed lawsuits
6 potentially covered by the Policy, subject to Indian Harbor's full reservation of rights, including
7 the right to seek repayment of all amounts that are determined not to be covered by the Policy.

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9 Dated: August 25, 2010

TROUTMAN SANDERS LLP

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By: /s/ Meghan Canty Sherrill

Thomas H. Prouty
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Indian Harbor Insurance Company