

ORIGINAL



0000127970

1 Charles R. Berry (#003379)
2 cberry@polsinelli.com
3 Melissa S. Ho (#23269)
4 mho@polsinelli.com
5 **POLSINELLI SHUGHART PC**
6 CityScape
7 One E. Washington St., Ste. 1200
8 Phoenix, AZ 85004
9 Phone: (602) 650-2000
10 Fax: (602) 264-7033

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AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE – Chairman
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

IN THE MATTER OF:

MORGAN FINANCIAL, L.L.C., an Arizona
limited liability company,

MORGAN FINANCIAL LENDERS, L.L.C.,
an Arizona limited liability company,

and

JIMMY HARTGRAVES, JR. and LAURIE
HARTGRAVES, husband and wife,

RESPONDENTS

DOCKET NO. S-20719A-09-0583

**MEMORANDUM OF POINTS AND
AUTHORITIES IN SUPPORT OF
RESPONDENTS' POSITION**

(Assigned to the Honorable
MARC E. STERN)

I. OVERVIEW.

Respondent Jim Hartgraves is a legitimate businessman who has tried to do the right thing, conducting business in a real estate market first buoyed by irrational exuberance, and then ravaged by the largest market decline since the Great Depression. As a result of

1 Respondents' voluntary consultation with the Securities Division (the "Division") of the
2 Arizona Corporation Commission (the "Commission"), the Division initiated this action
3 claiming that offers and sales of securities were made without registration by the issuer,
4 Morgan Financial, L.L.C. ("Morgan Financial"), or by Jim Hartgraves as a
5 dealer/salesperson. An evidentiary hearing (the "Hearing") in this matter was held on
6 May 16 and 17, 2011. A transcript of the matter has been prepared and is referred to as the
7 "Transcript."
8

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10 As was demonstrated at the Hearing, no registration of any Respondent, whether as
11 an issuer, dealer or salesperson, was required. Jim Hartgraves acted through his affiliate
12 company, Morgan Financial, which had been licensed as a mortgage broker, and then as a
13 mortgage banker, by the Arizona Department of Financial Institutions ("AzDFI") since
14 1996. Relying on the advice of counsel, Morgan Financial issued unsecured demand
15 promissory notes (the "Notes") to persons, many of whom had utilized Morgan Financial as
16 a licensed mortgage broker. Notes were never sold in transactions involving a public
17 offering, but were sold by Morgan Financial in individual private transactions.
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20 When AzDFI suggested that Morgan Financial change its license from a mortgage
21 broker to a mortgage banker, Jim Hartgraves cooperated and did so. AzDFI recommended
22 that Mr. Hartgraves consult with the Division about the Notes, and he did so. As a result of
23 information disclosed by Respondents' voluntary cooperation with agencies of the State of
24 Arizona, the Division brought these proceedings, where the Division alleged violations of
25 the registration provisions of the Arizona Securities Act in connection with the offer and
26 sale of the Notes.
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1 In an attempt to cooperate fully with the Division, to provide full disclosure to
2 holders of Notes, and to restructure the business of Morgan Financial in a difficult real
3 estate market, Morgan Financial and Jim Hartgraves conducted an exempt, private exchange
4 offering, utilizing an Exchange Memorandum and other extensive disclosure documents,¹
5 whereby a newly-created entity, Morgan Financial Lenders, LLC ("Morgan Lenders"),
6 offered to exchange Notes for membership interests ("Interests") in Morgan Lenders.
7 Morgan Lenders would then consolidate all Notes exchanged into a new loan to Morgan
8 Financial with a fixed term, secured by a second lien on a specified portfolio of loans and
9 properties. All holders of Notes (with one exception) exchanged their Notes for Interests
10 and Morgan Financial issued a new secured note in the principal amount of \$6,134,559 to
11 replace all unsecured Notes exchanged. One holder of a \$100,000 Note did not exchange.
12 As established by the Hearing record, the issuance of the Interests to existing holders of
13 Notes in exchange for their Notes was clearly an exempt private offering as described in the
14 Exchange Memorandum, and did not require registration by any of the Respondents.
15 Nevertheless, the Division filed an amended Notice of Opportunity alleging additional
16 claims of non-registration.
17

18 Morgan Financial, Jim Hartgraves, and Laurie Hartgraves (collectively
19 "Respondents") were advised at the time Notes were offered and sold, and maintain, that:
20 (a) the Notes were not securities, or (b) the Notes are commercial paper and therefore
21 exempt from registration under A.R.S. § 44-1843(A)(8). In addition, both the Notes and the
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28 ¹ The Exchange Memorandum and other exchange offering documents are included in Exhibit S-12 to Mr. Hartgraves' November 30, 2010 examination under oath, and other associated exhibits.

1 Interests were sold in transactions not involving a public offering, which are exempt under
2 A.R.S. § 44-1844 (1).

3
4 At no time has the Division alleged misleading or fraudulent behavior by any
5 Respondent in connection with the offer or sale of the Notes or Interests under A.R.S. § 44-
6 1991 or otherwise. The Division acknowledges that this proceeding involves a registration-
7 only matter. (Transcript at 15). Respondents, along with Morgan Financial's then C.F.O.
8 Douglas Odom, obtained legal advice from their attorney at different times during the
9 process to ensure that the Notes did not have to be registered. (See generally Transcript
10 361-380, 389-390, and 396). When negotiating lines of credit and purchasing a significant
11 real estate loan portfolio (the "Merrill Lynch Portfolio") from Merrill Lynch, attorneys at
12 two different prominent law firms also reviewed the structure² and tacitly confirmed the
13 validity of the "exempt commercial paper" concept.
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16 II. MORGAN FINANCIAL IS A COMPANY REGISTERED WITH AzDFI

17 At all relevant times, Morgan Financial was registered with the AzDFI as a mortgage
18 broker or mortgage banker in Arizona.³ (Verified by the Division, see Transcript at 150 and
19 267-169). As a registered financial institution, Morgan Financial met all of the
20 requirements for such licensing, including, among other things: (a) relevant experience,
21 (b) adequate net worth; (c) bond; (d) audited financial statements; (e) fingerprints; (f) credit
22 report; (g) personal financial statements of control persons; and (h) other qualifications.
23 Morgan Financial sold \$6,234,559.00 in principal amount of Notes, denominated as
24 unsecured subordinated promissory notes, to approximately 35 sophisticated buyers in the
25 2006-2007 timeframe.
26

27 ² This included attorneys at Patton Boggs LLP as well as Loeb & Loeb LLP, attorneys for Merrill
Lynch. (Transcript 223-228 and 233-234)

28 ³ A summary of Morgan Financial and its different accreditations is recited in the Transcript at
210-214.

1 III. COMMERCIAL PAPER IS AN EXEMPT SECURITY UNDER ARIZONA
2 SECURITIES REGISTRATION STATUTES.

3 The registration provisions under A.R.S. § 44-1841 and § 44-1842 do not apply to
4 (a) exempt securities listed in A.R.S. § 44-1843; or (b) exempt transactions listed in
5 A.R.S. § 44-1844. Exempt securities include commercial paper under A.R.S. § 44-
6 1843(A)(8). See *State v. Tober*, 841 P.2d 206, 208 (1992) (“[t]he provisions of § § 44-1841
7 and § 44-1842 do not apply to any of the following classes of securities. Among them
8 are...commercial paper”).

9 Under Arizona law, registration requirements for securities do not apply to:

10 “Commercial paper that arises out of a current transaction or the proceeds of which
11 have been or are to be used for current transaction, that evidences an obligation to
12 pay cash within nine months of the date of issuance or sale, exclusive of days of
13 grace, or any renewal of such paper that is likewise limited, or any guarantee of such
14 paper or of any such renewal.”

15 A.R.S. § 44-1843(A)(8).

16 Arizona courts have often quoted federal definitions in their interpretation of
17 commercial paper. Arizona courts have found that “[b]ecause Arizona’s statutory definition
18 of security is ‘substantially similar to the definitions found in the Securities Act of 1933 and
19 the Securities Exchange Act of 1934[,] [f]ederal interpretations are often looked to for
20 guidance.”” *MacCollum v. Perkinson*, 913 P.2d 1097, 1104 (Ariz. Ct. App. 1996) (quoting
21 *Rose v. Dobras*, 624 P.2d 887, 889 (Ariz. Ct. App 1981)). The United States Supreme Court
22 has held that commercial paper is a security. *Securities Industry Ass’n v. Board of*
23 *Governors of Federal Reserve System*, 468 U.S. 137, 140, 149 (1984) (“we conclude that
24 commercial paper is a ‘security’....commercial paper consists of unsecured promissory
25 notes and falls within the general meaning of the term ‘notes.’”).

26 The language in A.R.S. § 44-1843(A)(8) is substantially similar to the federal
27 exemption for commercial paper in the federal statutes, 15 U.S.C. § 77c(a)(3), which reads
28 in pertinent part:

1 “(a)...the provisions of this subchapter shall not apply to any of the following classes
2 of securities: ...

3 (3) Any note, draft, bill or exchange, or banker’s acceptance which arises out of a
4 current transaction or the proceeds of which have been or are to be used for current
5 transactions, and which as a maturity at the time of issuance of not exceeding nine
6 months, exclusive of days of grace, or any renewal thereof the maturity of which is
7 likewise limited.”

8 The United States Supreme Court has stated that “[c]ommercial paper refers
9 generally to unsecured, short-term promissory notes issued by commercial entities. Such a
10 note is payable to the bearer on a stated maturity date. Maturities vary considerably, but
11 typically are less than nine months.” *Securities Industry Ass’n v. Board of Governors of
12 Federal Reserve System*, 468 U.S. 137, 140 (1984). Similarly, for a security to qualify as
13 commercial paper in Arizona, it must 1) mature within nine months, 2) must “arise out of a
14 current transaction or the proceeds of which [must] have been or are to be used for current
15 transactions.” *See* A.R.S. § 44-1843(A)(8).

16 IV. NOTES UNDER THE SECURITIES LAWS.

17 It can be credibly argued that the Notes are not securities under the family
18 resemblance test articulated by the Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56
19 (1990). Under the *Reves* family resemblance test, every promissory note is presumed to be
20 a security, as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. However,
21 the presumption that a note is a security can be rebutted if the note bears a strong family
22 resemblance to an item on the judicially crafted list of exceptions. The list of exceptions
23 includes, among others, notes evidencing loans by financial institutions for current
24 operations. *Reves*, 494 U.S. at 60.

25 The motivation of the sellers and purchasers, the plan of distribution, the reasonable
26 expectation of the public, and the adequacy of a regulatory scheme are the four factors that
27 are used to determine whether a family resemblance exists between a particular promissory
28 note and the judicially-adopted exceptions. In *Reves*, the Supreme Court explicitly left open

1 the question of whether the presumption that every note is a security applies to short-term
2 notes, i.e., notes with terms of less than nine months.

3 V. MORGAN FINANCIAL HAS ESTABLISHED THE NOTES SOLD ARE
4 COMMERCIAL PAPER, AND WERE SOLD IN EXEMPT
5 TRANSACTIONS.

6 However, for the purposes of this proceeding, Morgan Financial need not contest that
7 the Notes sold were securities. Arizona law requires issuers to register securities for sale,
8 and for securities dealers and salespersons to be registered, unless the securities sold, or the
9 transactions in which they were sold, are exempt. In this case, both the Notes and the
10 transactions in which they were sold were exempt. The Notes are commercial paper, which,
11 under A.R.S. § 44-1843(A)(8), is a security exempt from the registration requirements under
12 Arizona law. The Notes were sold in transactions not involving any public offering, which
13 is exempt under A.R.S. § 44-1844(1). Under A.R.S. § 44-2033, Respondents have the
14 burden of proving that the transactions in which the Notes and Interests were sold were
15 exempt private transactions and that the Notes were exempt securities. Respondents have
16 met that burden, as evidenced by the record in this proceeding.

17 Arizona law is guided by federal law on this issue. Both Arizona and federal law
18 define commercial paper as notes that: 1) mature within nine months; and 2) arise out of
19 current transactions or the proceeds of which have been used or are to be used for current
20 transactions. Courts have looked to the United States Securities and Exchange Commission
21 (the "SEC") for additional clarification. The SEC has explained, and Courts have adopted
22 the guidance that commercial paper be of prime quality *and* is not made available to the
23 general public. Testimony given by Jim Hartgraves under oath supports each and every one
24 of these requirements.

25 A. Nine-Month Maturity Requirement

26 The nine-month maturity date is a necessary condition of commercial paper. *See*
27 *S.E.C. v. Wallenbrock*, 313 F.3d 532, 540 (9th Cir. 2002) (holding that the exception from
28 registration requirements applies only to commercial paper that matures within nine months,

1 registration requirements applies only to commercial paper that matures within nine months,
2 and not to all notes that mature within nine months). Witness David Bushman testified
3 during the Hearing. Mr. Bushman explained his understanding of the nature of his loan,
4 what he did for due diligence, and what he learned from the SEC's website regarding the
5 characteristics of a promissory note. (Transcript 162-171). Mr. Hartgraves testified that the
6 transactions Morgan Financial dealt with were three, six, and nine-month notes. (Transcript
7 272-276).

8 B. "Arising out of a current transaction"

9 The proceeds from the sale of Notes by Morgan Financial arose out of, and were
10 utilized for, current transactions. Mr. Hartgraves testified that Morgan Financial had
11 sufficient capacity to sustain its secured lending program and that attorney Don Newman
12 represented to him that they were dealing with a current transaction as the transactions had a
13 maturity date of less than nine (9) months. (Transcript 272-276).

14 Statutory provisions defining commercial paper have been acknowledged by federal
15 courts. *In re NBW*, 813 F.Supp. at 17; *see also SEC v. American Bd. Of Trade*, 751 F.2d 529
16 (2d Cir. 1984); *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984);
17 *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. den'd*, 414 U.S. 908 (1973);
18 *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), *cert. den'd*, 409 U.S. 1009 (1972).

19 The Court has stated "In short, the SEC release states that only prime quality commercial
20 paper which is not generally available to the public qualifies for the § 3(a)(3) exemption. *In*
21 *re NBW*, 813 F.Supp at 17.
22

23
24 1. *Notes were not made available to the general public, but were*
25 *sold in private transactions*

26 There is no question that Morgan Financial did not make the Notes available to the
27 general public, and the Notes were sold in exempt transactions not involving any public
28 offering. Testimony given by Mr. Hartgraves evidenced that Morgan Financial made the

1 Notes available only to a limited number of individuals with proven experience and net
2 worth. (See Transcript 220-223). In total, there were approximately thirty-five (35) Lenders
3 involved. (Transcript at 260). Morgan Financial did not advertise or utilize any form of
4 public solicitation in connection with offering these Notes. (Transcript at 123, 221). While
5 there is no requirement that the holders of the Notes be “sophisticated investors,”
6 Mr. Hartgraves testified that those who bought the Notes had investment experience and
7 understood the inherent risks.⁴ The SEC has not limited section 3(a)(3) to institutional
8 purchasers, and the United States Supreme Court has acknowledged that “the Act admits of
9 no exception according to the particular investment expertise of the customer.” *Securities*
10 *Industry Ass’n v. Board of Governors of Federal Reserve System*, 468 U.S. 137, 159 (1984).
11
12

13
14 2. *The Notes offered were of “Prime Quality”*

15 Notes offered by Morgan Financial were regarded as prime quality at the time they
16 were offered and sold. Testimony at the hearing established that at the time Notes were
17 sold, Morgan Financial’s audited financial statements disclosed ample assets available to
18 repay the Notes. Even in 2007, current valuation showed that Noteholders would have
19 received over \$13,095,962 on a loaned amount of \$6,200,000. (Transcript at 156). Witness
20 David Bushman testified that it was his understanding the Merrill Lynch Portfolio was
21 sufficient enough to be liquidated to repay his loan as well as the other Noteholders given
22 the appraised value and market in 2008. (Transcript 177-178). Morgan Financial has made
23 the requisite showing that: 1) the Notes were not made generally available to the public or
24 other unsophisticated investors; and 2) the investments were of prime quality.
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⁴ Transcript at 260-262.

1 VI. PUBLIC POLICY CONSIDERATIONS

2 Given the unprecedented real estate downturn, enforcing a restitution order for the
3 full amount of the initial offering is both illusory, as liquid funds to make restitution do not
4 exist, and would be detrimental to all those involved. In order to meet concerns of the
5 Division, to provide full disclosure to holders of Notes, and to restructure the business in
6 order to afford all participants the best prospects for recovering profits from the Merrill
7 Lynch Portfolio, Mr. Hartgraves and Morgan Financial conducted the exchange offering
8 utilizing the Exchange Memorandum. The exchange offer was made solely to holders of
9 Notes, and during the process, the Division was kept apprised of the situation and Mr.
10 Hartgraves in good faith believed that the Exchange Memorandum would cure any
11 outstanding issues. (Transcript 244-247). All but one of the thirty-five (35) note holders
12 elected to exchange their Notes for Interests. Mr. Hartgraves offered to settle individually
13 with the only individuals to not exchange (Mr. and Mrs. Graf).

14 Any administrative order that includes a restitution order in excess of \$100,000.00
15 would trigger Merrill Lynch's ability to foreclose on the Merrill Lynch Portfolio as is set
16 forth in the Repurchase Agreement, which could result in a total loss to all Lenders. The
17 Respondents simply ask for the opportunity to continue to work with Members and Merrill
18 Lynch on the Merrill Lynch Portfolio and make pro-rata distributions to the Members.⁵ If
19 Merrill Lynch seizes the Merrill Lynch Portfolio, all Members will lose any hope of
20 recovering any amount. (The ability of Morgan Financial Lenders to foreclose on the loan
21 portfolio properties is subordinate to Merrill Lynch in the event of default. Transcript at 43-
22 45, 113, 183, 193, 249-252). For the benefit of all, the parties involved should be allowed
23 the freedom to negotiate and try to achieve positive results during this difficult economic
24 situation.

25 Securities laws were designed to protect investors and the public. An order of
26 restitution by the Commission would be detrimental to the very persons the Commission is
27

28 ⁵ In fact Mr. Hartgraves made a distribution to members as recently as May of this year. See
testimony of Stephen Barnes, Transcript at 108-109, 252-253.

1 entrusted to protect. As explained above, this administrative proceeding was brought
2 alleging solely technical registration violations. No individuals contacted the Division to
3 complain about Morgan Financial or Mr. Hartgraves. Rather, Jim Hartgraves contacted the
4 Division as requested by AzDFI. The Division initiated contact with individual holders of
5 Notes in preparation for the Hearing before the Commission. (Transcript at 152 and 157).
6 Members who testified do not want a restitution order in place, as they know this could
7 trigger a default with Merrill Lynch. (Transcript pg.127-131).
8
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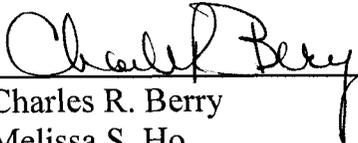
10 The United States Supreme Court has stated that “we construe the Securities Acts
11 broadly to effectuate Congress’ purpose to protect investors.” *United Housing Foundation,*
12 *Inc. v. Forman*, 421 U.S. 837, 849 (1975), and “[i]n reviewing the evidence, we must keep
13 in mind that the securities laws were designed to protect the public from speculative or
14 fraudulent schemes of promoters...form should be disregarded for substance and the
15 emphasis should be on economic reality.” *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).
16

17 Respondents firmly believe that the Notes are commercial paper that was sold in
18 exempt private transactions. Similarly, the exchange transactions were clearly exempt
19 private transactions. No registration of either issuers or salesmen was required, and no
20 administrative sanction is appropriate here. However, if the Commission believes that an
21 order is appropriate, the Transcript notes that if there is an order for full restitution, “that
22 would mean that is the end of [the Lenders’] return.” Transcript at 359. The economic
23 reality of this situation is that these Lenders and Members will be hurt by a finding that
24 registration was required, and that restitution is an appropriate remedy. If in fact the
25 Commission believes that restitution must be ordered in any amount, it is respectfully
26 suggested that Respondents be ordered to pay from their funds to Mr. Michael Graf and
27
28

1 Mrs. Kathryn Sullivan Graf an amount equal to the amount received by a Member who
2 exchanged a \$100,000 Note for an Interest in Morgan Financial Lenders. The Grafs were
3 the only Noteholders who retained their Note (See Transcript 75-78), and such a resolution
4 would be in the interests of justice.
5

6 Dated August 1, 2011.

7 POLSINELLI SHUGHART PC

8
9 By: 
10 Charles R. Berry
11 Melissa S. Ho
12 CityScape
13 One E. Washington St., Ste. 1200
14 Phoenix, AZ 85004

13 **ORIGINAL** and 13 copies filed this
14 1st day of August, 2011 with the
15 Arizona Corporation Commission
16 Docket Control Center and COPIES
17 hand-delivered this same date to:

18 Administrative Law Judge Marc E. Stern
19 Arizona Corporation Commission
20 Securities Division
21 1200 W. Washington Street
22 Phoenix, AZ 85007

23 Phong (Paul) Huynh
24 Staff Attorney
25 Arizona Corporation Commission
26 Securities Division
27 1200 W. Washington Street
28 Phoenix, AZ 85007