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Arizona Corporation Commission

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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

In the matter of:

Morgan Financial, L.L.C., an Arizona limited liability company,
 Jimmy Hartgraves, Jr. and Laurie Hartgraves, husband and wife,
 Respondents.

DOCKET No. S-20719A-09-0583

MORGAN FINANCIAL, L.L.C. AND HARTGRAVES' EXCEPTIONS TO ORDER

PROCEDURAL BACKGROUND

Respondents Morgan Financial, L.L.C., Morgan Financial Lenders, L.L.C., Jimmy Hartgraves Jr., and Laurie Hartgraves (collectively "Respondents") take no exception to the Procedural Timeline as set forth in Administrative Law Judge Marc Stern's February 28, 2012 Recommendation ("Recommendation")

PROPOSED FINDINGS OF FACT

Respondents take no exception to paragraphs 1-14 of the Recommendation.

Respondents take exception to paragraph 15, specifically the finding that Mr. Graf had little experience in investing in real estate or in making loans for hard money

1 transactions. This finding conflicts with the record, and completely ignores substantial
2 testimony and documentary evidence, including but not limited to, testimony provided by
3 Mr. Graf that his spouse, Mrs. Kathryn Sullivan Graf, is an attorney by training, licensed to
4 handle real estate transactions, and that the Grafts consulted with her father, Mr. Michael
5 Sullivan, who had experience related to loan underwriting and real estate. (Tr. 65-66: 17-
6 25) Mrs. Graf, who worked as an estate planning attorney, had the sophisticated training of
7 an attorney. (Tr. 85: 2-7).

9 Respondents take no exception to paragraphs 16 through 51.

10 With respect to paragraph 52, Respondents add that Mr. Stephen Barnes also
11 testified that prior to investing, he discussed with Mr. Hartgraves his qualifications as a
12 potential investor, he had been investing for 30 or 40 years, and had been involved in
13 several real estate limited partnerships, had prior knowledge regarding investments, and is a
14 sophisticated investor. (Tr. 95: 16-20)

15 Respondents take no exception to paragraphs 53 through 85.

16 Respondents take exception to paragraph 86. Mr. Brokaw testified that MF's
17 business activities were brought to the Division's attention when the Department of
18 Financial Institutions recommended Mr. Hartgraves upgrade to a mortgage banker, and that
19 he didn't recall the specifics of why ADFI wanted the Division to look into it. (Tr. 150: 3-
20 6) (Tr. 212-214: 18-14)

21 Respondents take no exception to paragraph 87.

22 Respondents take exception to paragraph 88 because such paragraph is incomplete
23 without including reference to Mr. Bushman's additional testimony. Mr. Bushman testified
24 at the hearing about his sophistication, particularly that he had previous experience with
25

1 Morgan Financial and had taken out loans from Morgan Financial for the construction of
2 properties. (Tr. 164: 5-10) Furthermore, Mr. Bushman testified that he previously held
3 series 6 and 67 securities licenses, and demonstrated that he is a sophisticated and suitable
4 investor. (Tr. 175: 4-25)
5

6 Respondents take no exception to paragraphs 89 through 92.

7 Respondents take exception to paragraph 93, which refers to some comments made
8 by Mr. Bushman about a pamphlet that Mr. Bushman obtained from the Securities and
9 Exchange Commission website. The best evidence of the pamphlet content is the pamphlet
10 itself, which we placed in evidence as Respondent's Exhibit R-6. Paragraph 93
11 misrepresents the full content of Exhibit R-6, part of which refers to commercial paper as
12 being exempt as determined by the Securities and Exchange Commission.
13

14 Respondents take no exception to paragraphs 94 through 100.

15 With regards to paragraph 101, Respondents clarify that there is either a
16 typographical error or Respondent Hartgraves misspoke with regards to the time period.
17 The mortgages were for 3, 6, or 9 months, not 30, 60 or 90 days.
18

19 Respondents take no exception to paragraphs 102 through 106.

20 With regard to paragraph 107, Respondents determined that 21 of the Note
21 purchasers were accredited investors. (See Notice of Supplemental Payments to Members
22 of Morgan Financial Lenders, L.L.C. Dated November 14, 2011, which is post-hearing
23 evidence in this matter). Mr. Hartgraves testified that he inquired as to the sophistication
24 and assets of all Note purchasers. Respondents determined that the other investors had such
25 experience in real estate investment and business and that they were sophisticated investors.
26 (Tr. 260-262: 5-4)
27
28

1 Respondents take no exception to paragraphs 108 through 117.

2 With regards to paragraph 118, Respondents clarify that there is either a
3 typographical error or Respondent Hartgraves misspoke. The construction pool held by
4 Merrill Lynch had a *low* loan-to-value ratio, not a *high* loan-to-value ratio as reflected in the
5 transcript.
6

7 Respondents take no exception to paragraphs 119 through 143.

8 Respondents take exception to paragraph 144, as it is incomplete. Mr. Hartgraves
9 also testified that he believed the lack of a response by the Division signaled that the
10 Exchange Memorandum satisfied or corrected outstanding issues. (Tr. 292-294: 7-11)
11

12 Respondents take no exception to paragraphs 145 through 150.

13 With regard to paragraph 151, Respondents clarify that there is either a
14 typographical error or Respondent Hartgraves misspoke. At the time of the purchase of the
15 Merrill Lynch portfolio in 2008, it was estimated that approximately \$13 million was the
16 current *equity* value of the portfolio to MF, not the total value.
17

18 Respondents take no exception to paragraphs 152 through 166.
19

20 **IGNORED EVIDENCE OF EXEMPTIONS**

21 Respondents take exception to paragraph 167, which, among other things, states that
22 “Respondents failed to present sufficient evidence to prove that either offering was
23 exempt.” That proposed finding simply ignores the record. While the Recommendation
24 contains over 150 paragraphs on 19 pages referring to transcribed testimony from the
25 Hearing, it makes few references to the documentary evidence (less than 10 out of many
26 dozens of relevant exhibits) which support Respondents’ case. The Recommendation refers
27 to eight selective exhibits.
28

1 fit the description of commercial paper, and that the discounting requirement for
2 commercial paper was dropped in 1980.

3 **EVIDENCE THAT THE INTERESTS WERE SOLD IN AN EXEMPT OFFERING**
4

5 Similarly, ample evidence was presented, without any contraverting evidence being
6 presented, that the Interests were sold in an offering exempt under A.R.S. § 44-1844(A)(1).
7 Without providing an exhaustive legal analysis, an overview published by the Division is
8 instructive (footnotes have been renumbered):
9

10 “Section 4(2) of the federal Securities Act of 1933 (the “1933 Act”) provides an exemption from the registration provisions of section 5 of the
11 1933 Act for “transactions by an issuer not involving any public offering.” Section 44-1844(A)(1) of the Arizona Securities Act provides a similar
12 exemption. These exemptions from the registration requirements of the 1933 Act and the Arizona Securities Act each are referred to as a “statutory private
13 offering exemption” The statutory private offering exemption has developed
14 over the years through interpretations by the Securities and Exchange Commission (the “SEC”) and court cases.¹
15

16 “The SEC and judicial interpretations² have developed the requirement that in order to satisfy the statutory private offering exemption,
17 sales of securities can only be made without advertising (or any other form of “general solicitation”) to a limited number of “sophisticated persons”³ with
18 “access to the information that would be included in a registration statement.”⁴ An offer of securities to even one unsophisticated person,
19 however, can result in the loss of the exemption.⁵ If an issuer intends to rely upon the statutory private placement exemption, the Division recommends
20 that the issuer obtain assistance to understand and comply with the requirements of the exemption, as expressed in case law and SEC
21 interpretations. The statutory private placement exemption is self-executing; i.e. has no filing requirement.
22
23

24 ¹ Arizona looks to federal interpretations of securities law for guidance. Vairo v. Clayden, 153 Ariz. 13, 734 P.2d 110 (Ct. App. 1987).

25 ² The Ninth Circuit Court of Appeals has adopted a four-part test to analyze the validity of an asserted private offering exemption, which focuses on the number and
26 sophistication of offerees, the size and manner of the offering, and the relationship of the offerees to the issuer. See SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).
27

28 ³ “Sophisticated” purchasers are purchasers who either alone or with their purchaser representatives have such knowledge and experience in financial and

1 business matters that they are capable of evaluating the merits and risks of the
2 prospective investment.

3 ⁴ The issuer should provide the offeree with an offering document that discloses the
4 pertinent information, unless offeree occupies a privileged position relative to the
5 issuer that affords the offeree actual access to the information.

6 ⁵ See Mark v. FSC Securities Corporation, 870 F.2d 331 (6th Cir. 1989).”

7 *Raising Capital: Overview of Registration of, and Exemptions From Registration For,*
8 *Securities Offerings August 2010, p. 5, Arizona Corporation Commission website*
9 *www.azcc.gov/Division/Securities/Good-To-Know/Raising%20Capital.pdf*

10 No evidence at all was presented that the offering of Interests was a public offering.
11 On the other hand, Respondents presented ample, unrefuted evidence that the offer and sale
12 of Interests was a private offering under the 9th Circuit test of the validity of the A.R.S.
13 § 44-1844 (A)(1) exemption. The record reflects extensive evidence, both documents and
14 testimony, demonstrating that the offer and sale of Interests did not involve a public
15 offering because it met the four-part test of SEC v. Murphy based upon:
16

- 17 (1) The number of offerees;
- 18 (2) The sophistication of offerees;
- 19 (3) The size and manner of the offering; and
- 20 (4) The relationship of the offerees to the issuer.

21
22 **1. Number of Offerees.** The record reflects that the Interests were offered only to a
23 very limited number of persons, each of whom was a holder of Notes, and not offered in a
24 “public” offering to any other person. (Tr. 245: 16-22, 366: 7-24, 294-295: 12-10 and TR
25 367: 3-13). As is demonstrated by the Notice of Supplemental Payments, the offer was
26 made to 25 family groups, and Notes were issued in 44 names comprising four groups.
27
28

1 **2. *Sophistication and Suitability.*** The record includes Exchange Agreements
2 executed by all holders of Notes who exchanged Notes for Interests (Exhibits S-9(b)
3 through S-9(mm), inclusive. Each exchanging Note holder made written representations
4 that:
5

6 “EXCHANGE INFORMATION
7

8 “1. Representations and Warranties. I represent and warrant to Morgan Financial, LLC
and Morgan Financial Lenders, LLC that:

9 “(a) I (i) have adequate means of providing for my current needs and possible
10 contingencies, and I have no need for liquidity of my investment in the Company, (ii) can bear the
11 economic risk of losing the entire amount of my investment in the Company, and (iii) have such
12 knowledge and experience in business and financial affairs that I am capable of evaluating the
relative risks and merits of an investment in the Company.

13 “(b) I have received and reviewed, and understand the Exchange Memorandum prior to
14 executing this Agreement.

15 “(c) I have had an opportunity to ask questions of and receive answers from the
16 principals of Morgan Financial, LLC about the Company, the Loan, the Loan Portfolio, the
business of Morgan Financial, and all other topics that I believe are material to this transaction.

17 “(d) I understand that no Old Notes, nor any Membership Interests to be received in
18 exchange for Old Notes, have been registered under the Securities Act, nor have they been
19 registered pursuant to the provisions of any securities laws of other jurisdictions, and are subject to
substantial restrictions on transfer.

20 “(e) The Old Notes are being held, and the Membership Interests will be held, solely for
21 my account, for investment and I have no current intent to resell or distribute Membership
Interests. The residence address set forth below is my correct address.

22 “(f) I understand that no federal or state agency, including the Securities and Exchange
23 Commission or the Securities Division of the Arizona Corporation Commission, has approved or
24 disapproved the Membership Interests, or passed upon or endorsed the merits or the accuracy or
adequacy of the Exchange Proposal.”

25 **3. *Size and Manner of Offering.*** As supported by the evidence, no money at all
26 was raised by the Exchange Offering. While \$6,234,559 in principal amount of Notes was
27 exchanged by existing Note holders (\$5,461,000 excluding the Hartgraves), no additional
28

1 capital was invested by anyone. The Offering was made through personal contacts by
2 Mr. Hartgraves with the existing Note holders. No form of general solicitation was utilized
3 in any manner, and, as acknowledged in writing and testimony, each Note holder received
4 the Exchange Memorandum dated May 7, 2010 (Exhibit 6 to Exhibit S-12; Examination
5 Under Oath of Mr. Hartgraves).
6

7
8 **4. *The Relationship of the Offerees to the Issuer.*** Each of the offeree Note
9 holders had a long-standing relationship of at least several years with MF and
10 Mr. Hartgraves, the manager of MF Lenders and its principal. The relationship between
11 Mr. Hartgraves and the Note holders is exactly that of a restricted, limited private offering.
12 On the other hand, there is no evidence that the offering of these Interests was “public” in
13 any way.
14

15 ***Other Exempt Transactions.*** In addition to the above written proof that the offer
16 and sale of Interests were transactions by an issuer not involving any public offering,
17 evidence was also presented supporting that the offer and sale of Interests was an exempt
18 transaction described in at least two other parts of A.R.S. § 44-1844:
19

20 (7) The exchange of securities by an issuer with its existing security
21 holders exclusively, where no commission or remuneration is paid or given,
22 directly or indirectly, for soliciting the exchange, if such exchange has been
23 duly authorized and has been approved by the holders of not less than a
24 majority of the outstanding securities of each class affected by the exchange
25 (as described in the Exchange Memorandum, the exchange by MF and MF
26 Lenders with existing Note holders was conducted with no commission or
27 remuneration, and was approved by \$6,134,550 out of \$6,234,550 in
28 principal amount of Notes); and

(9) The issuance and delivery of securities in exchange for other securities
of the same issuer pursuant to a right of conversion entitling the holder of
the securities surrendered in exchange to make such conversion (each Note
holder was given a right of exchange [conversion]).

1 the Interests were offered and sold in transactions not involving a public offering under
2 A.R.S. § 44-1843(A)(1). No evidence was introduced indicating that a public offering
3 occurred, nor to refute the documents and testimony provided.
4

5 Based upon the evidence, there is no support at all for proposed Conclusions of Law
6 paragraphs 9, 10, or 11 finding “grounds for an order assessing restitution,” but then
7 proposing an examination of the “action and conduct of Respondents...after completion of
8 the sales of all Merrill Lynch properties in the portfolio....” This is an attempt to avoid the
9 Commission’s responsibility, and to continue Respondents in administrative limbo,
10 essentially instructing Respondents to earn money so that Respondents can potentially pay
11 that amount to the Commission.
12

13 Further, without any authority or precedent, the Recommendation would create a
14 new function within the Division, that of a monitor of the activities of Respondents.
15

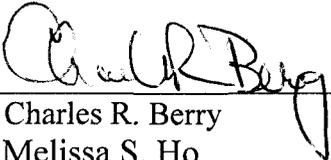
16 The Recommendation would then order further proceedings to “make a finding” to
17 determine whether additional restitution or penalties should be ordered. The
18 Recommendation does not indicate what standards would be applied to such future hearing.
19 Is it a new proceeding? Presumably, if Respondents’ efforts are successful, the
20 Commission could order higher restitution and fines. That result is unfair and untenable.
21

22 CONCLUSION

23 Because, as demonstrated above, many of the proposed Conclusions of Law in the
24 Recommendation are wholly unsupported by the record, the order proposed by the
25 Recommendation is fundamentally flawed. There is no authority for imposing an “interim”
26 restitution and “interim” administrative penalties, leaving the proceeding open for
27 additional “findings” to impose further punishment on Respondents and their investors.
28

1 The Division has now interfered with the ability of Respondents to conduct their
2 business for nearly 27 months (since it filed the initial Notice on December 30, 2009).
3 Respondents believed that the matter was finally nearing resolution when the hearing was
4 held in May. This Recommendation would have this extended for another indeterminate
5 time. That is unconscionable. Respondents are entitled to have this matter finally resolved.
6

7 **RESPECTFULLY SUBMITTED** this 19th day of March, 2012.

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17 this 19th day of March, 2012
18 with the Arizona Corporation Commission
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