

Judge A L Alton W



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HENN CO. DISTRICT
COURT ADMINISTRATOR

Receiver Report to The Honorable Ann L. Alton

In re: Bank of Scotland plc, vs. Lakeland Construction Finance, LLC

Court File No.: 27-CV-08-22657

December 19, 2008

Submitted By:

James Bartholomew, Principal
Patrick Finn, Associate
Lighthouse Management Group, Inc.
Receiver for Lakeland Construction Finance, LLC
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I. Introduction

This report by the Receiver ("Receiver," "we," "us," or "our") provides information required pursuant to the Court's Order Granting Receiver with respect to Lakeland Construction Finance, LLC ("Lakeland") entered on October 31, 2008 ("Order").

Lakeland is in the business of making loans to developers and home builders to finance the development of subdivisions and home sites and the construction of homes.

Lakeland has two remaining offices, Eagan, Minnesota and Greenville, South Carolina. The office located in Maple Grove Minnesota will be vacated at December 31, 2008, as there are no longer employees at that location.

II. Portfolio Analysis

The book balance of the portfolio at December 12, 2008 was:

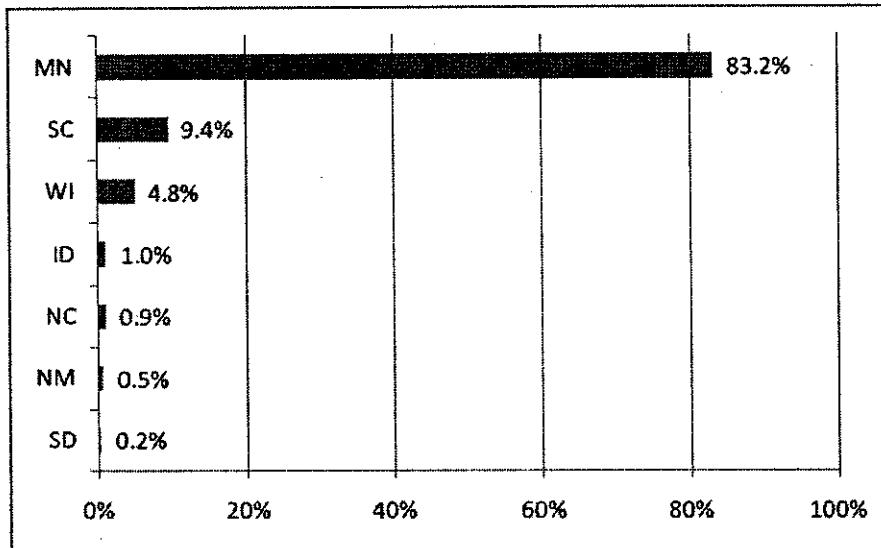
Loan principal balance	\$346,407,000
Loan accrued interest	114,299,000
REO (P&I)	<u>70,102,000</u>
Total	<u>\$530,808,000</u>

The character of the collateral underlying the loans is further broken down by loan amount:

<u>Description</u>	<u>Amount</u>	<u>%</u>
Houses with less than \$10k to complete	\$ 44,544,000	8%
Houses with more than \$10k to complete	\$ 46,306,000	9%
Finished lots in 13 County Metro Area	\$ 160,718,000	30%
Finished lots other areas	\$ 108,519,000	20%
Raw land in 13 County Metro Area	\$ 66,710,000	13%
Raw land other areas	\$ 75,322,000	14%
Non conforming	\$ 28,689,000	5%
Total	<u>\$ 530,808,000</u>	<u>100%</u>

The loans are located throughout seven states with 83% located in Minnesota, 9% in South Carolina, and 5% in Wisconsin, with the remaining 3% located in four other states.

Figure 1 Loan Portfolio by State



The loan portfolio is entirely in default, as Lakeland's borrowers are not making the loan payments. We are in the process of working with borrowers to take the collateral back through negotiated deed in lieu arrangements, voluntary foreclosures or formal foreclosure actions.

III. Plan of Liquidation

A. Bulk Sale

We have met with two parties that expressed an interest in looking at the value of the portfolio. One party declined to make an offer for the value of the portfolio. The second party has given us their preliminary indication of value which is subject to further due diligence. We will review this offer with Bank of Scotland plc as Administrative Agent for Senior Lenders ("Bank of Scotland") to determine if they would like us to pursue this expression of interest.

B. Self Wind Down Plan

We have prepared a plan of liquidation over the course of the next two years. The plan is to focus on getting ownership and possession of all the collateral, while selling properties that have already been taken back.

We will work with the Bank of Scotland to determine the timing and disposition of the property taken back. This may include deeding back property to Bank of Scotland that is subject to its security interest.

IV. Settlement with Majkrzak

On or about October 31, 2008 we received notification that Mr. Jeffrey Majkrzak ("Majkrzak"), one of Lakeland's creditors had attempted to garnish accounts held by Lakeland at Wells Fargo Bank ("Wells Fargo") and M&I Marshall and Isley Bank ("M&I").

On November 6, 2008, the Receiver filed a motion ("Motion") to stay collection efforts and prevent garnishment of Lakeland's accounts. The Court entered an order on November 6, 2008, which, among other things, stayed all collection actions and collection efforts by Lakeland's creditors and directed Wells Fargo to hold \$328,889 and M&I to hold \$520,112 until further order of the Court. The Court further directed each of Lakeland's banks to follow the Receiver's instructions for payment of remaining proceeds from any account. The Receiver conducted two depositions in connection with the Motion. Mr. Jeffrey Majkrzak ("Majkrzak"), one of Lakeland's creditors, opposed the Receiver's Motion and the Receiver replied to Majkrzak's opposition. The Court held a hearing on the Motion on December 1, 2008, allowed further briefing by the parties, and continued the hearing to January 22, 2009.

We reached a tentative settlement with Majkrzak on the garnishment he served both M&I Bank and Wells Fargo Bank. The settlement terms are:

- Majkrzak will receive 60% of the balance of funds held in the M&I bank account. M&I is holding approximately \$522,000, and Majkrzak's share would be \$313,200. (The balance of the funds would be segregated in a separate account for the benefit of unsecured creditors as discussed in Section VIII below.)
- Majkrzak would release any interest he may have in the Wells Fargo bank account and such funds would be released to the Receiver.
- The Receiver would acknowledge an unsecured claim for the unpaid balance of the Majkrzak claim, in the approximate amount of \$536,000.
- Majkrzak would participate in any recovery received from Avalon Capital Group, Inc. as discussed in Section VII B. below in an amount equal to 1.25% of the recovery or an amount equal to his normal pro rata distribution, whichever is greater, subject to the full amount of his claim. Majkrzak would not be responsible for the costs or expenses associated with such action.

V. Issues with the Bank of Montreal ("BMO")

Lakeland assigned a pool of assets to LCF Funding I in December 2005, in connection with a securitized financing from BMO in the approximate amount of \$150,000,000.

Twelve loans that were assigned to BMO were in a 2nd mortgage position on the underlying property. In each instance Lakeland had another loan secured by a 1st mortgage position on that property that Lakeland assigned to its lender (now Bank of Scotland) as security for its loan to Lakeland. It is our understanding that these incidents occurred as a result of an inadvertent error in the allocation of the loans to the various security pools.

BMO is asserting that it should have first mortgages securing all purchased loans based on the terms of its receivable finance agreement, and asserts that its junior mortgages are entitled to priority over Lakeland mortgages regardless of dollar amount or recording date. This is an issue for at least twelve

transactions in several different counties. We are attempting to work with BMO on a process to consolidate this dispute for resolution in one county.

VI. Other Claimants

A. Letters of Credit

Lakeland has 42 outstanding letters of credit with a face value of approximately \$28,000,000 issued on behalf of its borrowers to various governmental and developmental agencies. Lakeland estimates that the balance due under the letters of credit is approximately \$11,235,000. These letters of credit were issued to secure the completion of work required under the borrowers' development agreements. At least three of the cities have initiated lawsuits against Lakeland for failure to advance funds required under the letters of credit. Those actions are subject to the Court's stay, but the cities may be able to assess the property for the cost of the uncompleted work.

Lakeland is unable to pay the draws as required under the letters of credit and will have to work with each of the governmental bodies to minimize the amount that has to be completed now versus passing the amount that can be passed along to a new buyer for the property.

B. Other Actions

There are two other lawsuits pending:

1. LB Smith Construction is suing in South Carolina, for breach of contract and lender liability. The plaintiff is seeking lost profits totaling \$11,000,000.
2. Robert Machacek is suing for wrongful termination and redemption of ownership units. This action is in arbitration in Minnesota.

C. Office Leases

Attached as Exhibit 1 is a list of the long-term leases Lakeland entered into for office space. Lakeland is in the process of vacating the office space in Maple Grove and should be out of the space by December 31, 2008.

D. Unsecured Claim of Bank of Scotland

We expect that Bank of Scotland will have a deficiency claim as the value of its underlying collateral is projected to yield less than the amount of its secured debt. The deficiency will be treated as an unsecured claim and included in the distribution proposal described in Section VII below.

VII. Issues with Avalon Capital Group, Inc. ("Avalon")

A. Employee Retention Agreements

Lakeland entered into Bonus Retention Agreements with sixteen employees' prior to the receivership. Under these agreements each employee is entitled, subject to certain requirements, to a bonus unless the employee quits without cause (as defined in the agreement) prior to the expiration of the Retention Period. In each case, the Retention Period runs to December 31, 2008, unless the Company exercised its

option to extend the period to a later date, in most cases to April 30, 2010. The Bonus Retention payments were guaranteed by Avalon.

We exercised the option to extend ten of the sixteen employees' Retention Periods. The total obligation under the Bonus Retention Agreements is \$1,470,263.

We reached an agreement with Avalon and Bank of Scotland to fund two accounts to secure payment of the Bonus Retention obligation to employees. The two accounts are under the control of the Receiver, Avalon agreed to fund \$940,663 into the accounts. Lakeland funded the balance totaling \$529,600. One account is for the benefit of the extended employees and the other is for the benefit of the non extended employees. The funds held in these accounts will be used to fulfill Lakeland's obligations under the Bonus Retention Agreements, and if any funds are not due to employees, they will be returned to Avalon and Lakeland in accordance with their contributions.

B. September 28, 2007 Payment to Avalon

Lakeland paid Avalon \$32,935,659 in preferred distributions on account of its ownership of preferred units. In addition, Lakeland paid Avalon \$34,564,341 of interest and principal on account of unsecured loans made by Avalon to Lakeland. These payments were made on September 28, 2007 and came from proceeds from the issuance of \$70,000,000 of secured senior subordinated notes to Bank of Scotland.

We have not fully investigated the nature of these payments and whether they were made by Lakeland during a period when it was insolvent or rendered Lakeland insolvent after the transactions were completed. We plan to investigate these transactions further and will discuss a resolution with Avalon.

VIII. Distribution Proposal

There was approximately \$115,000 at Highland Bank in an account that was not subject to a control agreement with the Bank of Scotland. Further these funds were not proceeds from the sale of any of Bank of Scotland's collateral.

The approximately \$520,000 in the M&I Bank account that Majkrzak garnished, as discussed in Section IV above, also was not proceeds from the sale of Bank of Scotland collateral or subject to a control agreement with the Bank of Scotland.

We proposed to segregate these funds into an account for the benefit of unsecured creditors ("Unsecured Creditors Account"). The initial balance in the account will be approximately \$323,800 (\$115,000 from Highland plus \$208,800 from the M&I Bank account after settlement with Majkrzak). Proceeds from any recovery from Avalon, as discussed in Section VII B. above, if any, will also be deposited into the Unsecured Creditors Account. If we discover that any other assets of Lakeland are unencumbered they will also be deposited into this account.

We will then establish a claims process to enable unsecured creditors to file claims with the receivership. We will prepare a Final Claims List after all disputes are resolved with claimants. Once the

liquidation is substantially complete we propose to distribute the balance of funds in the Unsecured Creditors Account on a pro rata basis to creditors listed on Final Claims List.

IX. Invoice for Services of Receiver

Attached as Exhibits 2, 3 and 4 are invoice numbers 1372, 1387 and 1392 for services we have rendered to date.

Respectfully Submitted,



James A. Bartholomew

President
Lighthouse Management Group, Inc.
Its Receiver

X. List of Exhibits

Exh #	Description
1	Office Lease Schedule
2	Receiver invoice #1372
3	Receiver invoice #1387
4	Receiver invoice #1392