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How Sunwest Management returned from the ashes

By **Jeff Manning**, **The Oregonian**

May 15, 2010, 7:00AM

Sunwest Management, a Salem company that 14 months ago seemed on a one way-street to foreclosure, liquidation and infamy, has pulled off a stunning turnaround.

The company's future suddenly looks so rosy, in fact, that one of the largest, most sophisticated private equity firms in the world is expected to buy it for \$1.25 billion in a federal auction Monday.

Behind the remarkable about-face is Michael Hogan, a feisty federal judge who has led the marathon restructuring of the company. The restructuring has been messy, controversial, expensive and shockingly successful.

Absent Hogan's activist intervention last March, the company would have been picked apart by lenders, which had launched mass foreclosures on the company's assisted-living centers. Investors could have lost all of the \$500 million they had poured into the company.

"You don't know if another judge could have pulled off what Hogan did using another style," said Portland attorney Steve Blackhurst. "I tend to think not. It's the most unusual case

Another investor gripe: fees

While Sunwest investors saw their interest payments nixed and wondered whether they would ever see any of their money, many of the top lawyers in Portland rushed to get a piece of the bankruptcy and mediation.

Beginning in March 2009, legal and professional fees have consistently run from \$2 million to \$4 million a month.

Former CEO Jon Harder alone hired four different firms, which racked up more than \$4 million in fees between March 2009 and March 2010, a tab picked up by Sunwest.

The new CEO, turnaround specialist Clyde Hamstreet, had his firm bill more than \$5.7

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I've ever been around."

A doomed outlook

Fifteen months ago, Sunwest appeared to be doomed.

Lenders were circling the company like sharks, and the U.S. Securities and Exchange Commission was investigating.

In February 2009, a bankruptcy court judge ruled against a restructuring proposal, which seemed to open the path for lenders to launch foreclosures against individual assisted-living centers en masse.

The grim outlook was a stark contrast to the heady growth Sunwest enjoyed through much of the decade.

Chief Executive Jon Harder and his leadership team had built Sunwest into the fourth-largest operator of assisted-living centers in the country, and the biggest in Oregon, with nearly 300 facilities nationally.

But rapid growth left the company badly overleveraged. When the economy slowed and bank credit tightened in 2008, Sunwest crashed into disarray.

Many of the individual limited liability companies that were the legal owners of the assisted-living centers defaulted on their mortgages. Individual investors, some of whom had bet their life's savings on Sunwest, were blindsided when the monthly interest checks stopped arriving that summer.

At that point, three pivotal players in the Sunwest drama stepped into the breach. Harder hired high-profile Portland lawyer Steve English. Sunwest hired Al Kennedy, an equally prominent bankruptcy attorney. And Clyde Hamstreet, a Portland-based business turnaround consultant, agreed to take the company's helm.

All three agreed that restructuring the company through a private, court-overseen mediation offered the best shot at salvaging the operation. They turned to Hogan, an iconoclastic Eugene judge who has developed a

million in the same period. His company also hired seven professional firms to help negotiate the thicket of issues - and they, in turn, billed Sunwest for \$6.9 million from March to March.

Lyle Velure, the retired judge brought in to handle day-to-day management of the complicated mediation process, billed more than \$325,000 to Sunwest over the same period.

Hamstreet estimates that by the end of 2010, the Sunwest legal bills will reach about \$75 million.

By the standards of major bankruptcy cases, he says, that's actually a bargain. He points to an American Bankruptcy Institute study finding that even in a complex corporate bankruptcy, legal fees should not exceed 4 percent of the sum of a company's assets and liabilities.

Using that formula, \$157 million in legal fees would be acceptable - far more than the reality in the Sunwest case.

But one leading authority on bankruptcy and legal fees said the Sunwest expenses seem high. UCLA law professor Lynn LoPucki questioned why the various stakeholders needed to hire 36 professional firms among them, more than were hired in the bankruptcies of United Airlines, Delta and Kmart.

U.S. District Judge Michael Hogan has repeatedly urged lawyers to hold the line on costs. He could ultimately choose to approve only a fraction of their billings. "There's an Armageddon coming on fees," he warned at a March hearing.

-Jeff Manning

reputation for handling many of the most difficult cases to come along.

After being briefed on the case by Hamstreet in December, Hogan agreed to mediate. He brought in his longtime ally, retired Judge Lyle Velure, to handle the day-to-day details of the mediation.

Harder, the architect of the Sunwest debacle, resigned and filed for personal bankruptcy Dec. 31, 2008.

But the company nearly failed before the mediation could get under way.

The dozens of banks that had lent money to Sunwest affiliates wanted to foreclose and take possession of the individual assisted-living centers, which had, after all, been offered up as collateral. It was their right after the borrower defaulted on the mortgage, they said.

Hamstreet, Kennedy and English went to U.S. Bankruptcy Judge Trish Brown, who was hearing Harder's personal bankruptcy, urging her to stop the foreclosures.

After three days of argument in February of last year, Brown sided with the banks. In pointed language, she said the law didn't allow her to extend protection to all of Sunwest's myriad operating companies under the guise of Harder's personal bankruptcy.

Sunwest seemed dead in the water - individual properties would face foreclosure and investors would probably get nothing.

Bill Bryan, a former Hollywood producer and writer and an investor in Sunwest, attended the hearing and retreated afterward with a covey of lawyers who seemed thunderstruck by Brown's ruling.

"I had been warned that the only winners in bankruptcy are attorneys and consultants, and so when even the 'suits' went pale, I assumed all our money was gone," Bryan said. "I called my wife and told her to start packing, because we had to move."

Then came a series of events that changed completely the complexion of the case.

Hogan steps in

On March 2, 2009, the SEC sued Sunwest and Harder, accusing both of defrauding investors and running a Ponzi-like scheme. Because Sunwest is based in Salem, the SEC filed the complaint in U.S. District Court in Eugene, where it landed on Hogan's desk.

Hogan, of course, was perfectly familiar with the case. He'd been overseeing the mediation since the prior December.

As he'd done in countless other complex cases, Hogan immediately asserted himself.

He unilaterally changed the structure of the company, consolidating all of the hundreds of assisted-living companies into a single entity. Most controversially, Hogan barred the banks

Complex structure

Each Sunwest assisted-living center was owned by a separate limited liability company with its own mortgage and its own set of investors.

Sunwest turned to mom-and-pop investors to help fund its rapid expansion drive. The company offered attractive terms: regular interest payments at a guaranteed 8 to 12 percent on top of significant tax advantages.

Sunwest structured many of its deals as "tenancy-in-common" (TIC) investments, which allowed investors to defer certain capital gains taxes owed for prior real estate

from foreclosing, the step that Brown said the law would not allow her to take. He made it clear that he shared the views of Hamstreet, Kennedy and English that Sunwest's investors and its thousands of elderly residents were better served by the global restructuring plan.

The banks were apoplectic. They immediately appealed Hogan's order and demanded he recuse himself on grounds that he was not impartial.

Federal statutes require judges to recuse themselves if there is even the appearance of impartiality. And the banks claimed that Hogan had shown in the mediation that he was biased against the banks in favoring the restructuring proposed by Hamstreet and Kennedy.

The banks produced a Jan. 26 e-mail from Hogan that they interpreted as clear evidence of his anti-bank stance. "Let's work hard to find solutions that leave everyone in the best possible position at the end of this, and avoid the death of a thousand paper cuts," Hogan wrote.

The SEC favored the preliminary injunction against foreclosures out of concern for the investors and didn't think much of the bank's outrage. The recusal demand "was much ado about nothing," said SEC attorney Mark Fickes. "It was all manufactured by the banks."

The jurists who heard the banks' appeals shared the SEC's views. A federal magistrate, another district court judge and the 9th Circuit Court of Appeals all backed Hogan on the recusal issue. The 9th Circuit also rejected the banks' appeal of Hogan's order barring foreclosures.

None of the banks' lawyers contacted for this story would comment on the record.

500 lawsuits loomed

Sunwest now had the breathing room it needed. But finding a path through the scorched earth was not easy.

Angry lenders and creditors had flocked to court seeking to get their bills paid. Thousands of red-hot investors had lawyered up and were seeking redress.

Altogether, Sunwest and its affiliates faced more than 500 lawsuits.

"There were boxes of lawsuits against Sunwest sitting in a room that hadn't even been opened," Kennedy said. "Some creditors had gotten judgments against Sunwest and had garnisheed its assets. At the worst, there was real doubts that the company would make payroll or be able to pay for food" for the residents in its homes.

But the judicial force field imposed by Hogan kept the antagonists at bay. Sunwest's dire cash-flow crisis also faded, in part because it never has resumed interest payments to the investors. Slowly, it grew stronger.

gains.

"They found this wonderful cash machine based on TICs and LLCs," said Clyde Hamstreet, the Portland turnaround consultant who took Sunwest's helm in December 2008, after the company's fall from grace. "They started doing deals and they got intoxicated."

Previous Sunwest coverage

Read **earlier stories** on the rise and fall of the Salem company.

Just how much stronger became evident Aug. 28 of last year, when financiers from private equity giant The Blackstone Group flew to Eugene. They delivered to Hogan an offer to buy Sunwest for about \$1.25 billion.

Hamstreet already had become convinced that Sunwest could survive as an independent entity. He and his experts had worked much of the summer on the restructuring plan.

But the Blackstone deal, which would provide up to \$300 million in cash and more than \$900 million in assumed debt, was stunning.

That didn't mean everyone was happy. Far from it.

Many investors, still seething at the thought they'd been bilked by Sunwest, felt the entire restructuring came at their expense.

The court's treatment of Harder, the crew-cut, personable entrepreneur who built Sunwest and the mastermind of the alleged fraud, earned more investor ire.

Sunwest has paid Harder \$25,000 a month since he resigned in late 2008. It also continued to pay a salary to Harder's wife until this spring.

For investors thrown into dire straits by the Sunwest default, Harder's \$300,000 salary for not working is hard to take.

"Tell the woman who now lives in her car that Harder is getting \$25,000 a month," said Kevin Murray, a Sunwest investor from Reno. "They say, 'Hey, Jon's got a mortgage, he's got this, he's got that.' Well you know what, I could care less."

Harder's monthly retainer pales in comparison with the payout he stands to get under the Blackstone deal. Harder and his fellow Sunwest executives, Darrell Fisher and Wallace Gutzler, could between them get as much as \$50 million under the Blackstone buyout.

The payment is not a sure thing, and probably wouldn't happen for a couple of years. The three executives will get their cut if and when Sunwest, going forward, generates \$500 million in dividends for investors.

Some people familiar with the case suspect Harder's favorable treatment stems in part from the central role that his attorney, English, has played in the case. Critics of the process question English's role, saying it's inappropriate for the judges to depend so heavily on the attorney for the man accused of defrauding investors.

English makes no apology for vigorously advocating for his client. He and others say Harder made the entire restructuring possible. Harder, along with two other Sunwest executives, in early 2009 voluntarily contributed their ownership share of the hundreds of assisted-living centers to the company. If he hadn't cooperated, the Sunwest restructuring would be a nonstarter, many lawyers in the case agree.

English admits that he pushed Harder to contribute his interest in the company, which during better times was worth hundreds of millions of dollars, for reasons both altruistic and more calculated.

Helping increase the odds of a significant recovery by investors was the right thing to do, English said. But it also may score Harder points with the SEC and other agencies that continue to investigate the case.

Investors could get 36 cents on the dollar

If all goes as expected, Blackstone will enter its bid Monday to buy Sunwest in federal court in Eugene.

Stakeholders initially hoped that competitors would surface to bid up the price. Bryan led an effort to draw a competing bid from AEW Capital Management, a Boston investment bank.

AEW's interest did persuade Blackstone to sweeten its offer by about \$50 million. But it appears AEW won't enter a bid.

Still, the \$1.25 billion price tag caps a turnaround that was wholly unseen in the bleak days of early 2009.

Investors who choose to cash out will get about 36 cents on the dollar. Many say they will keep their money in the company, which could conceivably allow them to recover all of their investment and maintain the tax deferral that attracted them in the first place.

Even then, the saga is not over.

For all of Harder's careful triangulation, he remains exposed. The SEC still could seek some penalty or disgorgement from Harder. The Oregon Division of Finance and Corporate Securities hopes to collect the \$4.2 million fine it levied against him.

The FBI and federal prosecutors also could open a whole new front if they choose to file criminal charges.

As for Hogan's role, most of the players involved credit him for making a gutsy move at a difficult time.

"There are people who are arguing for a bigger piece of the pie," Hamstreet said. "I understand their anger. But the fact is, we have got a pie to argue about. And that's because of Hogan."

--**Jeff Manning**

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Posted by [newsrocket](#)
May 15, 2010, 10:35AM

Nice story clearly constructed. So clear you can see that there is a ton of profit in these "not quite" nursing homes. It's even worse for nursing homes. Housing and medical care need to be thoroughly socialized so we're not having to throw investors into a financial clothes dryer while we argue over what should be proper sources of profit and which are baseline "utilities" for life.

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