

EXHIBIT 1

First Interim Report of Examiner

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	§	Chapter 11
	§	
	§	Case No. 08-12687 (PJW)
DBSI, INC., <u>et al.</u> ,	§	
	§	Jointly Administered
Debtors.	§	

First Interim Report of Examiner

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Joshua R. Hochberg, the duly authorized and appointed Examiner in *In re DBSI Inc., et al.*, Case No. 08-12687 (the “Cases” or “Bankruptcy Proceedings”), herewith files his Interim Report in the Cases as follows:

I. INTRODUCTION AND PROCEDURAL BACKGROUND

On November 10, 2008 (the “Petition Date”), the majority of the Debtors herein filed Voluntary Petitions for relief under Chapter 11 of the Bankruptcy Code. The Debtors have continued in possession of their respective properties and have continued to operate their businesses as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

On March 25, 2009, the Bankruptcy Court entered its Order directing the United States Trustee to appoint an examiner herein (the “Examiner Order”)¹ and on April 3, 2009, the United States Trustee filed her Notice of Appointment of Examiner (“Notice of Appointment”) wherein she appointed Joshua R. Hochberg as the Examiner.² On April 14, 2009, the Bankruptcy Court approved the Examiner’s appointment.³

In accordance with the Examiner Order, the Examiner consulted with the Debtors, the Committee and other parties in interest regarding the proposed Investigation and prepared and submitted a proposed Work Plan and Budget on April 21, 2009 (the “Examiner’s Work Plan

¹ Docket No. 2974.

² Docket No. 3207.

³ Docket No. 3308.

Motion”).⁴ On April 29, 2009, the Bankruptcy Court conducted a hearing with respect to the Work Plan Motion and granted the Work Plan Motion from the bench, made oral comments with respect to the Examiner’s Work Plan and Budget, and authorized the Examiner to begin the investigation (the “Investigation” or “Examination”) immediately. On June 9, 2009, the Examiner provided an oral status report as ordered by the Court.

Prior to filing his Work Plan Motion, the Examiner selected the law firm of McKenna Long & Aldridge LLP (“MLA”), to serve as his counsel in these Cases and the law firm of Cole, Schotz, Meisel, Forman & Leonard, P.A. to serve as his Delaware counsel. In addition, the Examiner determined that the services of an investigator and financial advisors would be necessary. The Examiner selected Don B. Southerland, Jr., CPA (“Southerland”), a former FBI Special Agent, to serve as his principal investigator in the Examination, and Hays Financial Consulting, LLC (“HFC”) to serve as his Financial Advisor. Applications to employ the Examiners’ professionals were filed on April 17, 2009 and granted by the Court on April 29, 2009.⁵

II. WHY AN INTERIM REPORT IS BEING FILED

The Examiner is filing this Interim Report for two reasons. First, the Official Committee of Unsecured Creditors in these Cases (the “Committee”) requested that the Examiner file an interim report to address certain issues related to the pending plan confirmation process. In particular, the Committee requested that the Examiner report, to the extent possible, on the status of his investigation with respect to the corporate and financial relationships existing by and

⁴ Docket No. 3356.

⁵ As used herein, “the Examiner” means the Examiner and / or his retained professionals, including attorneys from MLA, Southerland, and HFC.

between the Debtors in the Cases and certain non-Debtor affiliates and related entities. This Interim Report summarizes aspects of the interrelated ownership and control of Debtors and non-Debtor entities as requested by the Committee.

Second, the Examiner has uncovered and is reporting on information relevant to the Bankruptcy Proceedings that brings into question issues concerning the Debtors' books and records and uses of cash. The Examiner believes it is important for the Court, creditors and parties-in-interest to be advised of these findings at this time. Specifically, this Interim Report details the uses of cash from the DBSI 2008 Notes Corporation ("2008 Notes Corp.") and examines how the uses were booked in the records of the Debtors. This cash (the "2008 Notes Proceeds") was raised from investors through a February 2008 offering (the "2008 Notes Offering").

This Interim Report documents that the Debtors had common ownership of, exercised control over, and engaged in complex financial transactions with non-Debtor related companies. Based on an analysis of the uses of 2008 Notes Proceeds, the Examiner concludes that the Debtors' general ledger accounting entries provide both confusing and misleading impressions of what occurred. The initial journal entries used to document the transfer of funds from investors are often misleading as to how those funds raised from investors were actually used. Indeed, the process of tracing the actual money flows is complicated because of the misleading journal entries. The difficulty in tracing sources and uses of funds is also compounded by intercompany transfers and the Debtors' practice of transferring and re-transferring funds among numerous Debtor and non-Debtor related company accounts, often on the same day. In addition, the Debtors' paper records are disorganized. Hundreds of boxes of documents containing records of both the Debtors and their non-Debtor affiliates are located throughout the Debtors' offices.

Although the Debtors are now making efforts to organize and catalog their records, this has been a slow process. It can take several days to find requested accounting records.

Based on an analysis of the Debtors' financial records, the Debtors had serious cash flow problems and operating losses before and at the time of the 2008 Notes Offering, and needed to use the 2008 Notes Proceeds in order to continue their operations. Based upon an analysis of the uses of the funds obtained from the 2008 Notes Offering, it appears that the Debtors booked journal entries explaining the uses of the 2008 Notes Proceeds in a way that concealed that large sums of money from those Notes were used to fund day to day operations and pre-existing obligations. Determining the Debtors' actual use of funds requires extensive analysis and the tracing of funds through numerous Debtor and non-Debtor accounts.

III. INVESTIGATION OVERVIEW

Upon approval of the Work Plan Motion on April 29, 2009, Southerland and a professional employed by HFC traveled to the Debtors' corporate offices in Boise, Idaho to begin the Investigation. They were joined one week later by a second professional from HFC. These three professionals have been working out of the Debtors' office almost continuously since May 1, 2009.

In addition, the Examiner assigned personnel from MLA to head up certain portions of the Examination. In particular, attorneys were assigned to lead the investigations and report generally concerning intercompany transfers; accountable reserves; business ownership and control; the financial and other dealings involving Stellar Technologies LLC ("Stellar") and the other non-Debtors including Western Electronics LLC, iTerra, UltraDesign, BioReaction, GigOptix and Wavetronix (each defined further below and collectively referred to in this Report

as the “Tech Companies”); and reviews of particular transactions identified by the Examiner as problematic that relate to how the Debtors generally conducted their business operations.

A. Description of Investigative Steps Undertaken to Date

Upon his arrival in Boise, Southerland began meeting with employees and attorneys of the Debtors to identify possible witnesses, locate and identify documents and set up witness interviews. The two HFC professionals began working with the Debtors’ accounting and technology staff to obtain access to the Debtors’ accounting and financial records and to gain an understanding of the Debtors’ financial and accounting practices.

As noted in the Work Plan Motion, the Examiner planned to utilize the work product prepared by the Committee’s Financial Advisors, FTI Consulting, to the fullest extent possible. On May 8, 2009, the Examiner executed a Stipulation and Consent Protective Order with the Committee, which was approved by the Court on May 14, 2009.⁶ Pursuant to this Stipulation, the Committee and FTI have provided the Examiner with full and complete access to FTI’s work product, which has been utilized by the Examiner in the Investigation. FTI has also suggested areas requiring further scrutiny by the Examiner.

In order to be able to procure testimony and documents through subpoenas, the Examiner also filed his “Motion Directing the Production of Documents and Authorizing the Examinations of the Debtors, the Debtors’ Current and Former Officers, Directors and Employees and other Persons and Entities” (the “2004 Motion”) on May 12, 2009. The 2004 Motion proposed

⁶ Docket No. 3533.

expedited procedures that the Examiner could use to procure the production of documents and information and deposition testimony. This Motion was granted by the Court on May 22, 2009.⁷

To date, the Examiner has reviewed voluminous electronic data and hard copy documents, conducted a detailed review of the Debtors' accounting systems, investigated numerous transactions, and conducted forty-nine witness interviews. He has reviewed the organizational documents and company minutes for over thirty DBSI related entities. The Examiner has obtained or had access to a large volume of documents through the Debtors and/or their counsel and from third parties. He has also had access to electronic records contained in an electronic database maintained by Debtors' counsel, Young Conaway Stargatt & Taylor, LLP ("YCST"). Although a large number of documents are posted on the YCST database, much of the documentation needed to complete the Examination is not. In addition, the HFC forensic accountants assisting the Examiner have had access to the Debtors' computerized accounting systems such as YARDI, Solomon, and QuickBooks. The Examiner has had access to CSC Global, a web-based program used by the Debtors to store organizational documents such as operating agreements and state filings. The Examiner has also retrieved and reviewed numerous paper records maintained by the Debtors. Finally, the Examiner has copied, preserved and reviewed electronic data from both the Debtors' main computer servers and from individual computers used by current and former employees of the Debtors.

The interviews conducted to date have included all of the Debtors' principal management personnel with the exception of Mr. Mark Ellison, General Counsel to certain of the Debtors ("Ellison"), and Mr. Douglas L. Swenson, Debtors' co-founder and most senior executive

⁷ Docket No. 3622.

("Douglas Swenson"). The Examiner conducted interviews of key witnesses taking into consideration factors including time, resources, and the avoidance of duplicative interviews. The Examiner's professionals have also had frequent contact with the Debtors' management and employees during the course of the Examination. The Debtors, the Debtors' Idaho counsel, and the interviewees have been generally cooperative in the scheduling and conduct of the interviews.

The interviews have not been conducted under oath. Detailed notes have been taken by the Examiner's professionals during the interviews. One interview has been transcribed.

The Examiner anticipates interviewing Mr. Ellison in the near future. It should be noted that Mr. Ellison has made himself available to the Examiner's professionals to answer specific questions or to provide documents requested by the Examiner during the course of the Examination.

The Examiner had been negotiating for approximately six weeks with Douglas Swenson's attorneys to set an interview date for Douglas Swenson, and in mid-June had agreed that the interview would occur on July 14 and 15, 2009. After preparing for this interview and traveling to Boise with some of his retained professionals to conduct it, the Examiner was informed on July 13, 2009 that Douglas Swenson was canceling the interview. Numerous witnesses have indicated that they never engaged in transactions of any significance without first consulting Douglas Swenson. Further, the Debtors had previously filed with the Court the "Declaration of Douglas L. Swenson in Support of Chapter 11 Petitions and First Day Motions" in which Mr. Swenson declared, under penalty of perjury, that he had "detailed knowledge of

and experience with the business and financial affairs” of the Debtors.⁸ The Examiner served a subpoena to compel Douglas Swenson’s deposition after he refused to appear for his scheduled interview. Douglas Swenson has objected to this subpoena, and this matter is pending before the Court.⁹

In addition to obtaining information from the Debtors, the Examiner has also obtained information from third parties. Several third parties have voluntarily provided information and documents. Others have either requested a subpoena or the Examiner has determined that a subpoena would be required. Approximately ten subpoenas have been issued and served to date.

B. Challenges Encountered to Date in Connection With the Examination

Although the Debtors have been generally cooperative, the Examination has faced several procedural and logistical difficulties.

First, upon arrival at Debtors’ offices, the Examiner discovered that the Debtors’ business records were largely unorganized and were not readily accessible. The Debtors’ paper records are now located in the Debtors’ office on West Explorer Drive in Boise, Idaho. These paper records represent the accumulation of many years’ files both from the Explorer Drive location and from other former offices of the Debtor that have been consolidated post-Petition with the Explorer Drive office. Although the Examiner has been able independently to review boxes containing records, the Examiner normally has to make requests for specific records directly through employees of the Debtors because of the volume of records at issue. This has been a time consuming and cumbersome process, which has been complicated by the limited amount of

⁸ Docket No. 3.

⁹ Docket Nos. 4073, 4085, and 4122.

staff available to assist on site. In addition to being short-staffed as a result of the bankruptcy, the Debtors' current employees are often not the ones with personal knowledge concerning the location of required records.

Second, it took several weeks for employees of HFC to obtain complete access to all of the Debtors' electronic databases. Although the Examiner was initially provided with access to databases maintained by the Debtors' attorneys, the Examiner quickly learned that the Debtors maintained several additional electronic databases. The Examiner now believes that he has access to all of the Debtors' electronic records and financial databases.

Third, the Debtors' accounting systems are extremely complex and require significant training time. Multiple separate accounting systems are in use by different Debtors, and in many cases, more than one system must be consulted to review all material information regarding transactions. The systems used by the Debtors often contain numerous entries relating to individual financial transactions, and the Debtors did not use consistent language or methodology in describing transactions entered into their ledger systems, which makes searching for information cumbersome. Moreover, as set forth in more detail below, the Examiner has now determined that the ledger entries themselves can be misleading, which makes it necessary but difficult and time consuming to trace ledger transactions to bank and other direct records.¹⁰

Fourth, the Debtors' books and records, both paper and electronic, are completely under the control of the Debtors' senior management. Although the Examiner was initially advised

¹⁰ The Debtors' uses of company names adds another layer of complexity. When a Debtor entity ceased or changed operation, consolidated, and/or was created, the old entity would from time to time assume the name of one of the former entity groups, and the new entity would assume the name of another previous entity. The computer accounting systems made all name changes retroactive, thereby making the names inconsistent with bank statements and documents.

that the Debtors' Chief Restructuring Officer, Timothy Boates of RAS Management, would be the primary liaison between the Examiner and the Debtors, Mr. Boates has had no involvement in the Examination to date and, to the Examiner's knowledge, has not been present at the Debtors' offices since the Examination began. Thus, in order to obtain information and access to the Debtors records, the Examiner must generally make requests upon employees who are directly controlled and supervised by senior management as opposed to an independent, court-approved professional.

Fifth, and related to the previous point, the Examiner cannot state with certainty the degree to which the Debtors' records have been fully and completely preserved and cannot state whether there has (or has not) been alteration or destruction of records material to the Examination either before the Examination began or thereafter. Indeed, the Examiner learned through interviews that, for a period of time following the Petition Date, Debtors' former employees were permitted to take home company computers as a form of severance compensation, but Debtors required the computers to be "wiped" of data first. This practice apparently stopped after a litigation hold was enforced.

Sixth, the Examiner is investigating the sources and uses of funds transferred to certain Tech Companies. According to the Debtors' general ledgers and information provided by the Debtors, approximately \$200 Million was loaned to or secured by the assets of these entities or by Debtor and non-Debtor holding companies' interests in these Tech Companies. Four of the Tech Companies are still operating. Upon authorization of the Examination, the Examiner intended to contact the Tech Companies directly to obtain documents and information. However, both the Debtors and the Committee requested that the Examiner work through Paul Judge ("Judge"), the CEO of Stellar Technologies LLC, a non-Debtor, to obtain information and

documents related to most of these companies. The Debtors, the Committee and Judge each asserted that Judge could provide the information required by the Examiner. Further, the Debtors, the Committee and Judge claimed that issuing subpoenas or contacting these companies directly could result in disruptions of the businesses of these companies. Ultimately, Judge was unable to deliver certain critical information requested by the Examiner and the Examiner has now sought this information directly from the Tech Companies. To the Examiner's knowledge, information and belief, there has been no disruption in the business activities of the operating Tech Companies and they have been generally cooperative with the Examiner. However, not going directly to the Tech Companies in the early stages of the Examination has caused some delay and additional expense.

Seventh, the Debtors have asserted attorney-client privilege and/or work product protection for certain records, including records specifically requested by the Examiner. The Examiner does not know whether these documents would have shed further light on the issues investigated to date or whether they would have aided the Investigation. Due to time constraints, the Examiner has not challenged these assertions of privilege and/or work product protection.

IV. DEFINITIONS

For purposes of this Report, the following terms shall have the meaning ascribed to them below:

“BioReaction” shall mean BioReaction Industries LLC, a Idaho limited liability company.

“Control Group” shall mean, collectively, Douglas Swenson, Charlie Hassard (“Hassard”), John Mayeron (“Mayeron”), Walt Mott (“Mott”), Ferrell Bennett (“Bennett”), John Foster (“Foster”), Thomas Var Reeve (“Reeve”) and Gary Bringhurst (“Bringhurst”).

“2008 Notes Corp.” shall mean DBSI 2008 Notes Corporation, an Idaho corporation.

“GCC” shall mean DBSI Guaranteed Capital Corporation, an Idaho corporation.

“DBSI Inc.” shall mean DBSI Inc., an Idaho corporation, which entity was known as DBSI Housing Inc. until April 1, 2008.¹¹

“DBSI Properties” shall mean DBSI Properties Inc., an Idaho corporation, which entity was known as Spectrus Group LLC until April 1, 2008.

“DBSI Realty” shall mean DBSI Realty Inc., an Idaho corporation, which entity was known as DBSI Realty Corporation until March 25, 2008.

“DBSI Related Companies” shall mean, collectively, those entities that are not owned by DBSI Inc. but are owned by members of the Control Group, including DBSI Securities Corporation, an Idaho corporation, DCJ Inc., an Idaho corporation, and DBSI/Western Technologies LLC, an Idaho limited liability company.

“DCJ Inc.” shall mean, DCJ Inc., an Idaho corporation, which entity was formerly known as DBSI Inc. until March 25, 2008.¹²

¹¹ Where in this Report “DBSI Inc” is used in connection with events prior to April 1, 2008, this should be read to refer to the predecessor entity, DBSI Housing, Inc. Note that the Debtors themselves used these titles somewhat interchangeably after April 1, 2008 -- for example, DBSI Inc. continued to use bank accounts that were in the name of DBSI Housing Inc.

“DDRS” shall mean, DBSI-Discovery Real Estate Services LLC, an Idaho limited liability company.

“Debtor Entities” shall mean, collectively, DBSI Inc., the Operating Entities, the Debtor Project Subsidiaries and the DBSI Related Companies.

“Debtor Project Subsidiaries” shall mean those certain Project Subsidiaries that have been included as parties to the Bankruptcy Proceedings.

“DRR” shall mean DBSI Redemption Reserve, an Idaho general partnership.

“FOR 1031” shall mean FOR 1031 LLC, an Idaho limited liability company.

“Former Related Companies” shall mean, collectively, those entities that are now wholly owned by DBSI Inc. but which have not always been wholly owned by DBSI Inc., including, DDRS, FOR 1031 and DBSI Properties Inc.

“GigOptix” shall mean GigOptix, Inc., a Delaware corporation.

“Investments” shall mean DBSI Investments Limited Partnership, an Idaho limited partnership.

“iTerra” shall mean iTerra Communications LLC, an Idaho limited liability company.

“Master Leaseco” shall mean DBSI Master Leaseco, Inc., an Idaho corporation.

¹² Other than in this sentence to note the former name of DCJ Inc., unless expressly otherwise noted, “DBSI Inc.” as used in this report refers only to the entity currently known as DBSI Inc. and formerly known as DBSI Housing Inc.

“Non-Debtor DBSI Entities” shall mean, collectively, Kastera LLC, Investments, Stellar and the Non-Debtor Project Subsidiaries.

“Non-Debtor Project Subsidiaries” shall mean those certain Project Subsidiaries that have not been included as parties to the Bankruptcy Proceedings.

“Operating Entities” shall mean DBSI Realty, DDRS, DBSI Development Services LLC, DBSI Land Development LLC, Spectrus Real Estate Inc., FOR 1031, Master Leaseco and DBSI Properties Inc.

“Project Subsidiaries” shall mean the DBSI related entities created in connection with the acquisition, ownership, management, leasing or sale of particular real estate projects or used in connection with a bond or note investment projects.

“Stellar” shall mean Stellar Technologies LLC, an Idaho limited liability company.

“Subsidiaries” shall mean, collectively, DBSI Realty Inc., DBSI Development Services LLC, DBSI Land Development LLC, Spectrus Real Estate Inc. and Master Leaseco.

“Technology Holding Companies” shall mean, collectively, Stellar and DBSI/Western Technologies LLC.

“UltraDesign” shall mean UltraDesign LLC, an Idaho limited liability company.

“Wavetronix” shall mean Wavetronix LLC, an Idaho limited liability company.

V. SUMMARY OF PRELIMINARY CONCLUSIONS AND RECOMMENDATIONS

A. Preliminary Conclusions

Based on review and analysis of corporate records, the actual uses of 2008 Notes Proceeds described herein, interviews conducted to date, and the overall investigation to date, the Examiner has reached the following specific preliminary conclusions:

1. DBSI Inc., Douglas Swenson, and the Control Group owned and/or controlled both the Debtor companies and all significant non-Debtor companies. Specifically, DBSI Inc, Douglas Swenson, and the Control Group were able to control the flow of funds and direct that loans be made to or “secured” by non-Debtor company assets including DRR, Stellar, DBSI Investments Limited Partnership, and Kastera.
2. DBSI and Douglas Swenson-controlled companies, whether Debtors or non-Debtors, were run as a unified business. The sources and uses of funds were evaluated by considering all companies controlled by DBSI Inc., Douglas Swenson and/or the Control Group. DBSI Inc. and its controlled entities typically commingled and accumulated their available funds, which were disbursed for the most pressing obligations as they came due. Intercompany transfers were typically treated as loans.
3. Many of the general ledger entries accounting for fund transfers do not fully, fairly and accurately reflect the transactions they purport to describe. It is the Examiner’s understanding that these ledger entries are the primary sources of financial information provided by the Debtors to the Court and to creditors and parties-in-interest.

4. A company known as DRR, which is a non-Debtor, was used as an intermediary for most intercompany cash transfers. DRR is purportedly a general partnership; however, no partnership agreement exists for this entity. The use of DRR helped obfuscate the true source and use of funds that were transferred between entities. Large loans receivable from DRR on the books of Debtor entities represent nothing more than an accumulation of fund transfers which were documented by accounting entries. The money that flowed through DRR was always obtained from other sources and DRR had no significant assets (other than the loans receivable) or business operations. Determining the true source of the funds received by DRR is complex. DBSI Inc's balance sheet dated December 31, 2008 reflects that DRR owes DBSI Inc. \$196 million.

5. In large part, the loans made by 2008 Notes Corp. were used for the benefit of DBSI Inc. to meet existing obligations and operating expenses, rather than for the investment purposes described in the Private Placement Memorandum for the 2008 Notes Offering. DBSI Inc. and its controlled entities had severe cash flow problems and operating losses. DBSI Inc. used 2008 Notes Proceeds to fund current operating expenses of a failing enterprise. Ultimately, none of the business entities controlled by Douglas Swenson and the DBSI Control Group had any reasonable likelihood of generating revenues sufficient to ever repay DBSI's obligations to the 2008 Notes Corp. (or to the investors who contributed the cash to it).

6. Highly questionable internal valuations and appraisals were used to support loans from the bond and note programs sponsored by DBSI Inc.

B. Recommendations

Due to the findings set forth herein, the Examiner believes that the current Work Plan should be reconsidered and amended. Because funds were commingled and transferred among numerous entities, tracing commingled funds from bond and note offerings or TIC investments would be time consuming and expensive without corresponding benefit to the Debtors and their Estates. Further, these funds often lost their identity as they moved among various Debtor and non-Debtor entities. It appears from the Investigation conducted to date that the commingled funds used by the Debtors to meet pre-existing obligations and operating expenses were used without regard to their source and without regard to whether such obligations and expenses were TIC-related or non-TIC-related.

Accordingly, because of the substantial work already done, expertise already developed, and issues identified that would be of benefit to the Debtors and their Estates, the Examiner recommends that he be permitted to complete and report on his investigation of the following issues:

1. Detail the amounts and timing of distributions to insiders from Debtors and non-Debtors, including, in particular, distributions from DBSI Investments Limited Partnership. This project would also entail reporting on significant credits against distributions claimed by Douglas Swenson. This project was included in the Work Plan and is near completion.

2. Determine the amounts booked, transferred or loaned to Tech Companies and the uses of these funds. With respect to the funds transferred to the Tech Companies, the report would also include a description of the terms and conditions under which such funds were transferred to the Tech Companies (e.g. loan, equity stakes, and any conversions of loans to

equity stakes). This project was also in the original Work Plan. The Examiner has made substantial progress in this area, including resolving issues related to confidentiality of records, conducting preliminary interviews, and obtaining and analyzing some financial information. This project will require additional work to complete.

3. Report on the legal and financial issues related to Accountable Reserves. The Examiner has been investigating issues related to the Accountable Reserves maintained by the Debtors, however, the investigation of these issues is not complete. To date, the Examiner has not identified any bank or other accounts containing segregated Accountable Reserves. It appears to the Examiner that funds designated as Accountable Reserves were relied upon and used by the Debtors for their day to day business operations. This project was also included in the original Work Plan and an overview could be completed without substantial additional work.

4. Conduct the depositions of Douglas Swenson and, as necessary, interview or depose additional persons. This is a limited project.

5. Complete the investigation of four to six specific property transactions that appear problematic to the Examiner. These transactions illustrate significant problems and issues with respect to how DBSI Inc. and the individuals who controlled it conducted its business operations over a period of years. Substantial progress has been made on this project, but it has not yet been completed.

6. Investigate and report on potential claims and causes of action against third parties. Several possible claims have been identified, but will require further investigation.

7. Report on and summarize all other results to date, including the results of interviews and a description of significant documents. This investigative work is mostly done. Additional time will be required to compile the information and prepare a report.

C. Disclaimer

This is an Interim Report. The Examiner has not yet completed his Examination in this matter. Upon completion of his Examination, the Examiner will file a written report containing his final findings and conclusions. Although the findings and conclusions set forth herein have been carefully considered and investigated, they are interim findings and conclusions. Additional information may be discovered in the course of this Examination that may alter or amplify them.

VI. INVESTIGATION OF RELATIONSHIPS BETWEEN DEBTORS AND NON-DEBTORS.

A. Introduction

1. Scope of Review

In this section, the Examiner reports his findings concerning the ownership, control, management and inter-relationships among numerous DBSI related companies, some of which are currently Debtors and some of which are not. This section analyzes the relationships between the Debtors and those companies that are not currently debtors in the Bankruptcy Proceedings. In addition, the relationships between the individual owners of the Debtors and those companies that are not currently Debtors are analyzed.

In connection with the Examination, the Examiner’s professionals reviewed the company record books for the various DBSI-related entities detailed below. Reviewed were any and all documents included in the record books, including formation documents, meeting minutes, consents of the board of directors (or managers), ownership ledgers and certificates and related organizational agreements. The record books for DBSI Inc., the DBSI Related Companies, Former Related Companies, the Operating Entities, Kastera LLC, and Investments have been maintained by Ellison, as general counsel for DBSI Inc., and were provided by him for review at the DBSI Inc. headquarters. The record books for the Technology Holding Companies, Western Electronics LLC,¹³ UltraDesign and iTerra have been maintained by Judge and were provided by him for review at the DBSI Inc. headquarters. BioReaction, Wavetronix, and GigOptix each maintain their corporate record books at their respective headquarters, and all of these entities produced copies of their corporate records to the Examiner. The factual statements set forth in the section below are based on the materials set forth in the company record books unless otherwise specifically stated.

2. Overview of Relationships Between the Companies.

DBSI Inc. is the parent entity that owns, directly or indirectly, 100% of the Operating Entities and the Debtor Project Subsidiaries. DBSI Inc. is owned almost entirely by Douglas Swenson (91.38%). Douglas Swenson and other members of the Control Group also own the DBSI Related Companies. DBSI Inc., the Operating Entities, the Debtor Project Subsidiaries and the DBSI Related Companies are currently all party to the Bankruptcy Proceeding (collectively, the “Debtor Entities”).

¹³ Western Electronics LLC also produced copies of its corporate record books directly to the Examiner.

As described in further detail below, for the last fifteen years each of these Debtor Entities has been exclusively owned, controlled, operated and managed by all or some portion of the Control Group. Some of the individuals who compose this Control Group have changed over time, but each, during their period of ownership of the Debtor Entities, has been actively engaged in and involved with directing the operations of the Debtor Entities, serving on the various boards of directors and serving as senior executive officers of the Debtor Entities.

The Control Group also owns, directly and/or indirectly through its interest in DBSI Inc. and Investments, all or substantially all of the interests in the Non-Debtor DBSI Entities, including Kastera and Stellar. These entities are not currently Debtors. The Non-Debtor DBSI Entities have been owned by various members of the Control Group for almost the entirety of their existence. The respective company minutes reflect that Douglas Swenson and the individuals who compose the Control Group have each, during their individual periods of ownership of the Non-Debtor DBSI Entities, been actively engaged in and involved with directing the operations of these Non-Debtor DBSI Entities, serving on the various boards of directors and as senior executive officers of these entities.

DRR is an entity apparently used and managed by the Control Group that is currently not party to the Bankruptcy Proceedings. DRR was used as a bank clearing house for both the Debtor Entities and the Non-Debtor DBSI Entities. In many instances, the money flowing through DRR was booked as loans payable to and loans receivable from the other entities. The actual ownership of DRR remains in question, but it was routinely used in the day to day operations of the Debtor Entities.

According to the books and records of the Debtor Entities, the Non-Debtor DBSI Entities have derived significant financial benefits from the Debtor Entities consistently throughout their existence. The Non-Debtor DBSI Entities and the Debtor Entities have shared overhead expenses, office space and employees and have maintained common accounting and payroll services and systems. Douglas Swenson and the rest of the Control Group (through their control of the Debtor Entities) have caused the Debtor Entities to provide Non-Debtor DBSI Entities with on-going financial support via loans and capital infusions, and to guaranty the third party financial obligations of the Non-Debtor DBSI Entities. In addition, the Control Group caused loans to be made that were used for Debtor Entity operating expenses and capital requirements, secured by Stellar and DBSI/Western Technologies LLC assets.¹⁴

Finally, the Control Group owns an indirect interest (via its interests in the Technology Holding Companies) in the Tech Companies. These Tech Companies are not currently Debtors. In most cases, these Tech Companies are majority owned by the Control Group and, with the exception of GigOptix, are controlled by DBSI Inc. and Douglas Swenson. Further, the Control Group has historically exercised a significant amount of control over most of these Tech Companies, holding a majority of the positions on the various boards of directors. Douglas Swenson has, with very little exception, always served on the board of directors of each of these Tech Companies. For the past several years, other members of the Control Group have been increasingly less involved in the management and operations of these Tech Companies and, in fact, these Tech Companies have become increasingly managed by individuals who are completely unrelated to DBSI Inc. and its related entities. On the face of the Debtor Entities'

¹⁴ See analysis of 2008 Notes Proceeds contained herein.

financial records, these Tech Companies have derived significant financial benefit from DBSI Inc. and the Debtor Entities, being provided the benefit of loans received by the Technology Holding Companies from DBSI controlled entities.

Douglas Swenson is by far the single greatest constant in both the ownership and the control of all of the Debtor Entities, the Non-Debtor DBSI Entities and the Tech Companies. He has owned nearly all of the ownership interests, either directly or indirectly, of each of the Debtor Entities throughout their existence. Further, he has, throughout the entire existence of each of these entities, held a position on each of the boards of directors of the Debtor Entities (in many cases as the sole director) and has routinely acted as the most senior executive officer of each of these entities. Additionally, he owns a controlling interest, indirectly, in all of the Non-Debtor DBSI Entities and all of the Tech Companies other than GigOptix. The board minutes indicate that he has been an actively engaged member of the board of directors of each of the Non-Debtor DBSI Entities and all of the Tech Companies throughout almost the entire existence of each of these entities. He exercised great influence on the direction and operation of these entities and, particularly, on the financial relationship between the Debtor Entities, the Non-Debtor DBSI Entities and the Tech Companies.

3. Description of Charts Depicting Ownership, Control and Management

Appended hereto as Appendices 2A-N are charts depicting the ownership, control and management of the DBSI related companies by the Control Group. More specifically, (i) Appendix 2-A details the significant entities owned by the Control Group and shows whether each is currently a Debtor or a non-Debtor; (ii) Chart 2-B details non-Debtor entities directly and indirectly owned by the Control Group and shows the percentages of ownership of the Control

Group in the non-Debtor entities; (iii) Chart 2-C details the ownership interests of DBSI Inc. in each of the non-Debtor entities and shows which non-Debtor entities are controlled by DBSI Inc.; (iv) Chart 2-D details non-Debtor entities directly and indirectly owned by Douglas Swenson and shows his percentages of ownership in the non-Debtor entities; (v) Chart 2-E shows which non-Debtor entities are controlled by Douglas Swenson; (vi) Chart 2-F shows the non-Debtor entities in connection with which Douglas Swenson serves on the board of directors (or managers); (vii) Chart 2-G details non-Debtor entities directly and indirectly owned by Reeve and shows his percentages of ownership in the non-Debtor entities; (viii) Chart 2-H shows the non-Debtor entities in connection with which Reeve serves on the board of directors (or managers); (ix) Chart 2-I details non-Debtor entities directly and indirectly owned by Hassard and shows his percentages of ownership in the non-Debtor entities; (x) Chart 2-J shows the non-Debtor entities in connection with which Hassard serves on the board of directors (or managers); (xi) Chart 2-K details non-Debtor entities directly and indirectly owned by Mayeron and shows his percentages of ownership in the non-Debtor entities; (xii) Chart 2-L shows the non-Debtor entities in connection with which Mayeron serves on the board of directors (or managers); (xiii) Chart 2-M details non-Debtor entities directly and indirectly owned by Bringhurst and shows his percentages of ownership in the non-Debtor entities; and (xiv) Chart 2-N shows the non-Debtor entities in connection with which Bringhurst serves on the board of directors (or managers).

B. Debtor Entities

As detailed below, some portion of the Control Group has owned, directly or indirectly, 100% of the interests of the various Debtor Entities throughout the existence of these Debtor Entities. Further, some portion on this Control Group has, with very little exception, controlled, managed and operated the Debtor Entities throughout the existence of these Debtor Entities.

1. DBSI Inc.

a. Ownership.

Douglas Swenson currently owns 91.38% of DBSI Inc. Other current owners include Hassard (4.06%), Mayeron (4.06%) and Bringhurst (0.5%). Douglas Swenson has been an owner of DBSI Inc. since its formation in 1980 and has owned no less than 75% of the shares of DBSI Inc. since March 1, 1992. Hassard and Mayeron have been owners of DBSI Inc. consistently since March 1, 1992. Bringhurst acquired his interest in DBSI on May 25, 2008.¹⁵ Former owners of DBSI Inc. include Mott (1992-2006), Bennett (1992-2000) and Foster (1992-2002), each of whom owned less than 5% of DBSI Inc. during their period of ownership.¹⁶ In addition, Reeve owned less than 2% of DBSI Inc. for a very short period of time, from May 25, 2008 through December 31, 2008.¹⁷

b. Management.

The current board of directors of DBSI Inc. consists of Douglas Swenson, Hassard, Mayeron and Reeve. The current executive officers of DBSI Inc. are Douglas Swenson (Chief Executive Officer and President), Hassard (Chief Financial Officer), Mayeron (Executive Vice President), David Swenson (Assistant Secretary) and Jeremy Swenson (Assistant Secretary).

¹⁵ All of this ownership information is based the stock ledger included in the minute books for this entity provided by company counsel and, in part, from review of the corporate minutes. The stock certificates for these interests are not included the company records.

¹⁶ Note also that Ellison and David Palfreyman owned interests of DBSI Inc. from 1980-1992, however this period of ownership is not significant to the current analysis.

¹⁷ Reeve pledged his interest in DBSI Inc. to Douglas Swenson in connection with a \$2,000,000 loan to Reeve from Swenson. Reeve assigned his interests in DBSI Inc. to Swenson in exchange for forgiveness of the debt on December 31, 2008. The loan was provided to Reeve in order so that Reeve could make a capital contribution to Kastera LLC in exchange for ownership interests in Kastera LLC.

The current board of directors and executive officers generally reflect the persons who have controlled and managed DBSI Inc. throughout its history, with the exception of Bringhurst who resigned from his position on the board of directors and as Chief Operating Officer in February 2009. Although there have been some changes in the management of DBSI Inc. throughout the years, the involvement and influence of Douglas Swenson and, to a somewhat lesser extent, Hassard and Mayeron, has been consistent and extensive. Douglas Swenson has served on the board of directors and acted as President of DBSI Inc. consistently since its formation in 1980. In addition, he has acted as the Chief Executive Officer of DBSI Inc. since the establishment of such position in 2004. In the vast majority of circumstances, he has acted as the attorney in fact on behalf of DBSI Inc. and has been the individual authorized to take actions, sign documents and negotiate business authorized by the board of directors. Since 1992, Mayeron and Hassard have also consistently served on the board of directors and acted as senior officers of DBSI Inc. The corporate minutes of DBSI Inc. show that both Mayeron and Hassard were active and engaged in the operations and management of DBSI Inc. consistently since 1992.

Reeve did not join the board of directors of DBSI Inc. until 2005. Similarly, Bringhurst only served on the board of directors of DBSI Inc. for a short period during 2008 and 2009 (during which time he also held very senior management positions in the entity). However, these individuals have both served on the board of directors and acted as the senior management of FOR 1031 since its inception in 2003, which entity had an ongoing relationship with DBSI Inc.

David Swenson and Jeremy Swenson have never served on the board of directors of DBSI Inc. However, each of these individuals have held middle to senior level management positions within the DBSI related companies since approximately 2004 and, ultimately, each

served as a senior executive officer of DBSI Inc. Jeremy Swenson began acting as Assistant Secretary of DBSI Inc. on April 13, 2005 and since then has been authorized to and has executed many acquisition, financing and other related documents on behalf of DBSI Inc. and its related subsidiaries. Similarly, David Swenson began acting as an Assistant Secretary of DBSI Inc. in January 2008. Each of these individuals continues to serve as an Assistant Secretary for DBSI Inc. and many of its related entities, including but not limited to, DBSI Realty Inc., DBSI Development Services LLC, Spectrus Real Estate Inc., DBSI Properties Inc. and Master Leaseco.

Other members of the board of directors have included Mott (1992-2006), Foster (1992-2002), Bennett (1992- approximately 2002) and Ellison (2005-2008). These individuals were each heavily involved in the management and operations of DBSI Inc. during the periods in which they served but their period of involvement is confined.

2. Operating Entities

The business, operations and management of the DBSI businesses was directed through the Operating Entities. Each of the Operating Entities described below served a particular function in facilitating the underlying business of the DBSI Inc., being the acquisition, ownership, management, leasing or sale of commercial real estate projects and the creation, sale and management of various investment vehicles. Each of these Operating Entities is wholly owned, directly or indirectly, by DBSI Inc. and is a Debtor Entity.

a. Subsidiaries

The Subsidiaries have been wholly owned, directly or indirectly, by DBSI Inc. since their formation or have otherwise been owned by the same individuals (in the same percentages of ownership) as DBSI Inc. Given the history of ownership of the Subsidiaries, it is not surprising that the control and management of these entities has tracked, fairly consistently, the control and management of DBSI Inc. described above.

In the case of each of these Subsidiaries, Douglas Swenson has served without interruption on the board of directors (or in the case of any limited liability company, on the board of managers) since the formation of the of such companies and has, with a few inconsequential exceptions, also served as the most senior officer of each of the Subsidiaries. In addition, at one time or another, he has served as the sole director (or manager) of each of these Subsidiaries. With some limited exception described below, both Mayeron and Hassard have also been consistently involved with the management and operations of these Subsidiaries.

(1) DBSI Development Services LLC

DBSI Development Services LLC was created in March 2005 for the purpose of acting as the operating entity in connection with the acquisition, ownership, management, development and sale of unimproved real estate. This entity has been owned by DBSI Inc. for the entirety of its existence.¹⁸ Douglas Swenson has served as Chairman of the board of managers for this entity from its inception and throughout its existence. Mayeron also served on the board of

¹⁸ This is based on the company's operating agreement included in the minute books for this entity provided by company counsel. The minute books did not contain either an ownership ledger or ownership certificates for this entity.

managers of DBSI Development Services LLC beginning in March 2005, as did Jeremy Swenson who joined the board of managers in September 2005. Both of these individuals resigned from their positions on the board of managers in November 2006, leaving Douglas Swenson as the sole manager. Other members of the board of managers of this entity include former DBSI Inc. owners, Foster and Mott, who served on the board of managers from March 2005 until August 2006.

Douglas Swenson has served as the President of such entity since August 11, 2006. Jeremy Swenson has been the acting Assistant Secretary since September 1, 2006, and David Swenson began acting as an Assistant Secretary on June 1, 2008. With the exception of Mott (who served as the President and Chief Executive Officer from March 2, 2005 until August 11, 2006) and Foster (who served as Executive Vice President of Operations from December, 2005 until August 8, 2006), the company records show no individuals have held executive offices other than Douglas Swenson, Jeremy Swenson and David Swenson.

DBSI Development Services LLC maintained very few corporate formalities. Virtually the only formal, documented actions by the board of directors were with respect to appointment and resignation of officers and directors. There are only a couple of meetings of the board of directors in which it appears that business matters were discussed, and the corporate records reflect only one instance in which consent was obtained in connection with a specific business related action item by this entity (i.e., authorizing acceptance of a line of credit). Other than that, there are no documented consents or authorizations by the board of directors regarding the acquisition, sale or ownership of assets by this entity or the financing activities of this entity, nor do their board meeting minutes reflect board discussion and analysis of such business activities. Given the lack of corporate formalities, it is difficult to ascertain who directed and carried out the

operations of this entity prior to 2006 but, as stated above, Douglas Swenson has been the President and the sole manager of this entity since 2006.

(2) DBSI Realty Inc.

DBSI Realty Inc. was created in 1982 for the purpose of providing overhead and support to DBSI Inc. and its related companies. It appears based on the records of this entity that it has also been involved in the funding and use of certain of the DBSI related investment vehicles. Although this entity did not become owned by DBSI Inc. until January 2007, its ownership has always tracked that of DBSI Inc. (i.e., it has always been owned by the same owners in substantially the same percentages of ownership as DBSI Inc.).

Douglas Swenson has served on the board of directors of this entity and, except for the period from 1987-1992, has served as the most senior executive officer of this corporation from its inception. Mayeron and Hassard served on the board of directors of DBSI Realty Inc. from 1992 until they stepped down from their positions on the board of directors in early 2008, leaving Douglas Swenson as the sole director of this entity. The corporate minutes of DBSI Realty Inc. reflect that both Mayeron and Hassard were actively engaged in the operations and management of this entity starting in November 1992, at which time they began serving on the board of directors and serving as senior executive officers. Mayeron stopped serving as an executive officer in February 2007, and Hassard stopped serving as an executive officer in March 2008. Jeremy Swenson began acting as an executive officer, specifically as the Assistant Secretary, in November 2005, and David Swenson joined him in such position in February 2008. Both David Swenson and Jeremy Swenson continue to hold the positions of Assistant Secretary. Douglas Swenson continues to act as President and Secretary.

It appears that DBSI Realty Inc. maintained some corporate formalities. Prior to 2006, the records reflect that the board of directors of this entity met and took formal action to consent to the material business matters undertaken by this entity. After 2005, it appears that there were annual meetings of the shareholders and board of directors. Records regarding the elections and resignations of officers and directors were maintained, but records reflect little other formal action was taken in connection with the business operations after 2005.

(3) Master Leaseco

Master Leaseco was created in 2004 to serve as the master tenant in connection with the master leases placed on improved real estate purchased and sold through DBSI related companies. Master Leaseco has been owned by DBSI Inc. and, as such, its management has closely tracked the management of DBSI Inc. since its inception.

Douglas Swenson has served on the board of directors of this entity and has served as the most senior executive officer of this corporation throughout its existence. Mayeron and Hassard consistently served on the board of directors of this entity since its inception in 2004 until February 2009, at which time Douglas Swenson became the sole director of this entity. Hassard also served as senior executive officer of this entity until February 2009. Jeremy Swenson began acting as the Assistant Secretary of this entity in October 2005 and David Swenson joined him in such position in January 2008. Both David Swenson and Jeremy Swenson continue to act as Assistant Secretaries. Douglas Swenson continues to act as President and Secretary.

The company records for Master Leaseco are minimal. It appears that the board of directors did not conduct meetings regarding business management and operations nor did they consent to or authorize the majority of the actions of such entity with any formality. The records

reflect that the board of directors conducted annual meetings of the shareholders and board of directors and maintained records regarding the elections and resignations of officers and directors, but it appears that no consent was granted in connection with the business operations of this entity. Specifically, the company records do not reflect consent or authorization by the management board to make specific loans to or receive of any loans from the various DBSI-related entities.¹⁹ Further, the records do not reflect any discussion and analysis by the management board of such specific undertakings. Similarly, the company records do not reflect consent or authorization by the management board to any of the master lease obligations undertaken by this entity.

(4) DBSI Land Development LLC

DBSI Land Development LLC was created in 2006 for the purpose of managing DBSI 2006 Land Opportunity Fund LLC. This entity has been wholly owned by DBSI Development Services LLC (which is wholly owned by DBSI Inc.) since its inception.²⁰ Douglas Swenson and Jeremy Swenson have been managers of this entity consistently throughout its existence. Based on the company records, it appears that there have been no documented meetings of the managers during its existence. Further, there are only two documented consents for action by this company, both of which deal with the appointment of managers.

¹⁹ The records do contain one general authorization for the making of intercompany loans.

²⁰ This is based on the company's operating agreement included in the minute books for this entity provided by company counsel. The minute books did not contain either an ownership ledger or ownership certificates for this entity.

(5) Spectrus Real Estate Inc.

Spectrus Real Estate Inc. was created in March 2008 for the purpose of sponsoring whole property, single buyer real estate transactions. This entity has been wholly owned by DBSI Inc. since its formation and throughout its existence. During this company's very short existence from March 2008 to the present, Douglas Swenson has been its sole director. Bringhurst acted as President and Secretary of this entity from its inception until February 3, 2009, at which time Douglas Swenson assumed that position. Jeremy Swenson and David Swenson have been acting as the Assistant Secretaries of this entity since its inception and continue to serve in that position.

There are very few company records for Spectrus Real Estate Inc. since it was only created in March 2008. Further, the few consents for actions that were formalized were consented to solely by Douglas Swenson as the sole director of the entity. It appears that officers and directors were formally elected. But, consents to or authorizations regarding the business operations of the entity were not documented with any formality during the period of its existence. There are no documented consents or authorizations by the board of directors regarding the acquisition, sale or ownership of assets by this entity or the financing activities of this entity, nor do the board meeting minutes reflect board discussion and analysis of such business activities.

b. Former Related Companies

The Former Related Companies are currently wholly owned, directly or indirectly, by DBSI Inc. but these entities have not been owned by DBSI Inc. throughout their existence. Despite that, there has been much overlap in the ownership and management of DBSI Inc. and these Former Related Companies since their formation. Douglas Swenson was a majority owner

of these Former Related Companies and has been actively involved in the management of each of these entities without interruption since their formation and throughout their existence. Further, even prior to these entities being owned by DBSI Inc., the records indicate that these entities received substantial benefits from DBSI Inc. and were materially inter-connected with and dependant on DBSI Inc. and the subsidiaries.

(1) FOR 1031

FOR1031 was formed in August 2003 by Reeve and Douglas Swenson for the purpose of acquiring and selling improved real estate to tenants in common through the real estate channel. Although the entity was owned for a short time entirely by Reeve, the organizational documents provide that Douglas Swenson was always a manager of the company. Further, the organizational documents provide that Douglas Swenson would arrange for financing and working capital for the entity in return for stock purchase options. Effective January 1, 2004, Douglas Swenson exercised the stock options and became the majority shareholder (90%) of FOR 1031. This stock was paid for by Swenson's execution of a \$90,000 demand note in favor of FOR 1031.²¹ From January 1, 2004 until March 15, 2006, FOR 1031 was owned by Swenson (90%) and Reeve (10%). On March 15, 2006, Swenson and Reeve contributed their interests in FOR 1031 to DBSI Properties Inc. in exchange for ownership interests in DBSI Properties Inc. For the period of March 15, 2006 through April 1, 2008, DBSI Properties Inc. (which owned 100% of FOR 1031) was owned by Douglas Swenson (86.6%), Reeve (9.6%) and Bringhurst (3.8%). In 2008, Swenson, Reeve and Bringhurst exchanged their indirect ownership interests in

²¹ The Examiner has searched the company ledger and cannot confirm that Douglas Swenson repaid this note.

FOR 1031 for additional interests in DBSI Inc. and all shares of FOR 1031 came to be owned by Spectrus Real Estate Inc., which is wholly owned by DBSI Inc.²²

Since its formation and throughout its existence, FOR 1031 has been managed and controlled by Douglas Swenson, Reeve and Bringhurst as described below. Reeve and Douglas Swenson have acted as the managers of the entity from its formation in August 2003 without interruption throughout its existence. Bringhurst joined such board of managers for the period of September 1, 2005 through February 16, 2009. Reeve acted as the most senior executive officer from its formation until September 1, 2005. Bringhurst served as a senior executive officer for the vast majority of its existence in one capacity or another, replacing Reeve as the President and Chief Financial Officer for the period beginning September 1, 2005 and ending February 16, 2009. Douglas Swenson and Reeve continue to be the managers of this entity. There are no longer any executive officers of this entity, however, Douglas Swenson continues to act as the “Authorized Representative” on behalf of the entity.

Even prior to being owned by DBSI Inc., FOR 1031 received substantial benefit from DBSI Inc. and its subsidiaries. The corporate minutes of DBSI Inc. show that DBSI Inc. often acted as the guarantor with regard to loans from third parties to FOR 1031. Further, DBSI Inc. established, funded and owned subsidiaries that acted as the master tenants in connection with each of the master leases placed on the various real estate projects sponsored by FOR 1031. These master lease obligations were integral to FOR 1031’s ability to sell these real estate

²² All ownership information in connection with this entity was obtained from the company’s operating agreement and unit ledger included in the minute books for this entity provided by company counsel. The ownership certificates for these interests are not included the company records.

projects to investors and were often a drain on the financial resources of DBSI Inc.²³ Further, Master Leaseco (a wholly owned subsidiary of DBSI Inc. and a Debtor Entity) made numerous loans to wholly owned subsidiaries of FOR 1031.²⁴ Similarly, it appears based on an analysis of the flow of funds of these entities, that FOR 1031 also made certain capital transfers to Master Leaseco.²⁵ Even prior to DBSI Inc.'s ownership of FOR 1031, the Control Group treated these entities as if FOR 1031 were a subsidiary of DBSI Inc. and did very little to maintain the separateness of these entities.

The company records for FOR 1031 are minimal and reflect only one meeting of the board of managers during the existence of this entity. There are some written consents authorizing action by the entity with respect to appointment and resignation of officers and directors and, a couple of actions related to the sale of assets. There are no documented consents or authorizations by the board of directors regarding the acquisition or ownership of assets by this entity or the financing activities of this entity, nor do board meeting minutes reflect board discussion and analysis of such business activities. It appears based on the lack of company records that the operations of this entity and any business decisions and undertakings were taken without any formal member or management consent.

²³ This information was ascertained during interviews with former and current employees of DBSI Inc., including Paris Cole, Michael Attiani, Matthew McKinlay, Matthew Ray and Deborah Miller.

²⁴ These loans from Master Leaseco have not been verified from an accounting standpoint but this information is based on promissory notes from FOR 1031 subsidiaries to Master Leaseco which are included in the company books of Master Leaseco.

²⁵ The Examiner has found at least one transfer from FOR 1031 on December 30, 2004 that went through various DBSI related entities to ultimately be contributed to Master Leaseco in the amount of \$7,900,063.04. This capital transfer was booked as a loan on the company books but was not shown as an amount owing by Master Leaseco in the audit report prepared by Eide Bailly dated January 7, 2005.

(2) DBSI Properties

DBSI Properties Inc. was formed in August 2005 by Bringhurst as Spectrus Group LLC. The entity was formed to act as the sponsor in connection with real estate transactions being sold through the real estate channel (rather than the securities channel). In April 2008, this entity was converted into a corporation and renamed DBSI Properties Inc. Thereafter, this entity acted as the sponsor for real estate transactions being sold through the securities channel.

Although the entity was owned for a short time entirely by Bringhurst, Douglas Swenson acted as co-manager of the entity even during such period. Effective January 1, 2006, Douglas Swenson became the majority shareholder (86.54%) of DBSI Properties Inc., along with Reeve (9.62%) and Bringhurst (3.84%). Douglas Swenson and Reeve acquired their interests in exchange for their ownership interests in FOR 1031. In 2008, all shares of DBSI Properties Inc. were transferred to DBSI Inc. via assignment by the owners in exchange for interests in DBSI Inc.²⁶

Until April 1, 2008, DBSI Properties Inc. was managed and controlled fairly consistently by a board of managers consisting of Douglas Swenson and Bringhurst. Reeve, Pete Johnson and Lee Broome joined the board of managers in March 2006. Bringhurst acted as the most senior executive officer of the entity from its formation in 2005 until April 1, 2008. After April 1, 2008, Douglas Swenson became the sole director and the most senior executive officer of DBSI Properties Inc. Jeremy Swenson and David Swenson did not serve on the board of managers for this entity, but David Swenson began acting as the Assistant Secretary in May 2006

²⁶ This is based on the ownership ledger included in the minute books for this entity provided by company counsel. The stock certificates for these interests are not included the company records.

and Jeremy Swenson assumed a similar role in January 2008. Both David Swenson and Jeremy Swenson continue to serve as Assistant Secretaries, with Douglas Swenson acting as President and Secretary.

The company records for DBSI Properties Inc. are minimal. There were a few meetings of the managers in which business matters were discussed (without any specificity being noted in the records). Formal records were maintained with regard to the election and resignation of officers and managers and certain organizational related actions (such as change of names, grant of stock options, increase in size of management board). There are no written consents to action or authorizations for any of the business operations of the entity, nor do their board meeting minutes reflect board discussion and analysis of business activities. It appears based on the lack of company records that the operations of this entity and any business decisions and undertakings were taken without any formal member or management consent.

(3) DDRS

DDRS was effectively owned by DBSI Inc. and FOR 1031 in equal shares from its formation in 2005 until April 1, 2008, at which time it became owned indirectly (through DBSI Realty Inc.) entirely by DBSI Inc. This entity was formed with the purpose of serving as the common paymaster and provider of overhead services for numerous DBSI related companies and FOR 1031 (prior to FOR1031 being owned by DBSI Inc.).

Throughout its existence, the board of managers of DDRS has been effectively the same as the management of DBSI Inc. and FOR 1031. Such board of managers has included Douglas Swenson, Mayeron, Bringhurst and Reeve, with the senior executive officers being Bringhurst, Jeremy Swenson and David Swenson. Bringhurst acted as the President and Chief Executive

Officer of the entity for the majority of the existence of this company from the period beginning in 2005 through his resignation from such position in February 2009. Jeremy Swenson and David Swenson became the Assistant Secretaries of such entity in 2005 and continue to serve in such role. The board of managers now includes Douglas Swenson, Mayeron and Reeve.

DDRS has maintained almost no corporate formalities since its formation. The board of managers has had only one meeting and issued only four consents for action during the company's existence. There are no documented consents or authorizations by the board of directors regarding the business operations of this entity or the financing activities of this entity, nor do the records reflect board discussion and analysis of such business activities. It appears based on the lack of company records that the operations of this entity and any business decisions and undertakings were taken without any formal member or management consent.

3. Project Level Subsidiaries

DBSI Inc. owns, directly or indirectly, 100% of the Project Level Subsidiaries which have been used in connection with the acquisition, ownership, management, leasing and sale of each particular real estate project or have been used in connection with a bond or note investment vehicles. Many of the subsidiary entities are Debtor Entities, but many remain Non-Debtor DBSI Entities. Not surprisingly, given the ownership of such entities, the management of such entities tracks closely the management of DBSI Inc. These entities have maintained little or no corporate formalities since their formation.

4. DBSI Related Companies

a. DCJ Inc. and DBSI Securities Corporation

DBSI Inc. shares substantially the same ownership and management with the DBSI Related Companies. DCJ Inc. is an entity that has existed since 1979 for the purpose of investing in various real estate projects. DBSI Securities Corporation was created in 1979 as well, serving as the broker dealer for all securities offerings by the DBSI group of companies.

These two DBSI Related Companies have been owned by the same owners as DBSI Inc. in substantially the same percentages for almost the entirety of their existence. Douglas Swenson owns the vast majority of interests (88.23%), along with minority shareholders, Hassard (5.8%) and Mayeron (5.8%). Douglas Swenson has been an owner of these companies since their inception, and Hassard and Mayeron have been owners of these DBSI Related Companies consistently since March 1, 1992. Further, former owners²⁷ of DBSI Inc., including Mott (1992-2006), Bennett (1992-2000) and Foster (1992-2002), each owned a minority interest (less than 5% in each case) in these entities during the same periods in which they owned interests in DBSI Inc.²⁸

Similarly, these DBSI Related Companies have been operated and managed by these same owners since 1992. Douglas Swenson has served on the board of directors of these entities since their formation. Hassard and Mayeron have served on the board of directors consistently

²⁷ Note also that Ellison and David Palfreyman owned interests of DBSI Inc. from 1980-1992, however this period of ownership is not significant to the current analysis.

²⁸ All of this ownership information is based the stock ledger included in the minute books for this entity provided by company counsel and, in part, from review of the corporate minutes. The stock certificates for these interests are not included the company records.

since they obtained ownership in the entities in 1992. Each of these owners have, during some period of time, held various senior executive management positions in these entities. Douglas Swenson has held the most senior executive management office of DCJ Inc. throughout the company's existence. He also held the most senior executive management office of DBSI Securities Corporation until May 2005. Mayeron served as the Chief Executive Officer of this entity from May 2005 until February 2009 (at which time Douglas Swenson returned to his position as President and Chief Executive Officer). Hassard has served as the Secretary of these entities consistently since 1992, and also served as either the Chief Financial Officer or the Executive Vice President of Finance of DCJ Inc. throughout such period. Reeve and Ellison also served on the board of directors of DCJ Inc. for the period of 2005-2009.

b. DBSI/Western Technologies LLC

The Control Group, directly or indirectly, owns all of DBSI/Western Technologies LLC. This is a non-operational holding company that owns a majority of the interests in Western Electronics LLC.

DBSI/Western Technologies LLC is not owned directly by DBSI Inc. However, the control and management of this entity substantially and closely tracks the management of DBSI Inc. DBSI/Western Technologies LLC is managed and operated by a board of managers consisting of DBSI Inc. owners, Douglas Swenson, Hassard and Mayeron, and former DBSI Inc. owners, Foster and Mott. Further, according to the corporate books and records, substantial funding for DBSI/Western Technologies LLC has been provided via loans from DBSI related Project Level Subsidiaries, specifically from the DBSI bond and notes entities.

(1) Ownership.

DBSI/Western Technologies LLC was created in 2000 and is the owner of a majority of the ownership interests of Western Electronics LLC. DBSI/Western Technologies LLC is owned solely by the Control Group (directly or indirectly through certain individuals ownership of Investments). Based on the corporate minutes, it appears that the Control Group influenced the management and operation. Specifically, this entity is owned by Investments (80%), Reeve (10%) and Bringhurst (10%). DBSI Inc. does not own a direct ownership interest in DBSI/Western Technologies LLC and owns, indirectly through its ownership stake in Investments, less than a majority of the total interests of such entity (43.44%). It appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. to provide this entity with material financial benefits.

(2) Control

DBSI Inc. controls DBSI/Western Technologies LLC indirectly. Investments controls DBSI/Western Technologies LLC as the owner of 80% of DBSI/Western Technologies LLC's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

The board of managers of this entity reflects its ownership and includes Douglas Swenson, Foster, Hassard, Mott and Mayeron.

This entity did not maintain entity formalities. In fact, based on the company records, it appears that the board of managers only consented to three actions on behalf of this entity throughout the entirety of its existence. Further, there is no record of any meetings of the board of managers or the members of this entity during its nine years of existence. Specifically, the company records do not reflect consent or authorization by the management board to the making of loans to Western Electronics LLC or receiving of any loans from the various DBSI related entities. The records do not reflect any discussion and analysis by the management board of such specific undertakings. Per the corporate records, the operations of this entity and any business decision and undertakings were taken without any formal member or management consent.

(4) Commingling of Funds and Assets

Further, it appears that this failure to maintain the entity separate and apart from its majority shareholder (DBSI Investments Limited Partnership) extends to the ownership of assets. More specifically, the entity formation documents of DBSI/Western Technologies LLC reflect that Investments, its sole member at that time, would make an initial capital contribution to the entity upon its formation on October 1, 2000 of all of its shares in Western Electronics LLC and Strategic Finishing LLC. However, neither the records of Investments nor the records of DBSI/Western Technologies LLC show that Investments actually transferred its interests in Western Electronics LLC and Strategic Finishing LLC to DBSI/Western Technologies LLC in 2000.²⁹ The records in fact show that Investments did not transfer its interests in Western

²⁹ It should be further noted that neither the records of Strategic Finishing LLC nor the records of Investments indicate that Investments ever owned interests in Strategic Finishing LLC. The records indicate that DBSI Inc.

(footnote continued on next page)

Electronics LLC until April 21, 2005. The records do not show that the interests of Strategic Finishing LLC were ever transferred to DBSI/Western Technologies LLC. The fact that DBSI/Western Technologies LLC did not own an interest in these entities for the period from and after October 1, 2000 and until April 21, 2005 means that any loans from DBSI related bond and note funds which were made to DBSI/Western Technologies LLC during such period based on its value as the supposed owner of the interests of Western Electronics LLC and Strategic Finishing LLC were based on a false valuation. Further DBSI/Western Technologies LLC's pledge of assets in connection with these loans was valueless and the note holders did not have an actual security interests in these assets.

Despite not being majority owned by DBSI Inc., DBSI/Western Technologies LLC has received substantial benefit from DBSI Inc. throughout its existence. It appears that DBSI Inc. has provided this entity with administrative support services, including accounting services.

Further, DBSI/Western Technologies LLC has reportedly received funding for its operations and investments via loans from DBSI related entities, including specifically from DRR, GCC and 2008 Notes Corp. For example, DBSI/Western Technologies LLC reportedly received \$5,775,500 in loan funds from GCC.³⁰ Based on DBSI/Western Technologies LLC's general ledger as of December 31, 2008, it appears that DBSI/Western Technologies LLC owed \$18,958,390 to various DBSI related entities.³¹ In connection with each of these financings,

owned a majority of the interests in such entity but there is nothing to indicate that such interests were ever transferred to Investments.

³⁰ Amended and Restated Promissory Note and Pledge from DBSI/Western Technologies LLC to DBSI Guaranteed Capital Corporation dated July 1, 2002.

³¹ Company ledger shows \$8,706,499.89 owing to 2008 Notes Corp., \$6,806,814.72 owing to DRR and \$3,445,075 owing to GCC.

DBSI/Western Technologies LLC pledged its interest in the Western Electronics LLC to the applicable DBSI related bond and notes funds. In addition, despite DBSI Inc. not owning a majority interest in this entity, the Control Group caused DBSI Inc. to act as the guarantor with regard to the financial obligations of this entity on several occasions, including its obligations to the DBSI bond and note entities. For example, DBSI Inc. guaranteed payment of all amounts owed by DBSI/Western Technologies LLC to GCC.³²

C. Non-Debtor Companies

All or a portion of the Control Group has, as detailed below, owned, directly or indirectly, 100% of the interests of the various Non-Debtor Related Entities throughout the existence of these Non-Debtor Related Entities. Further, individual members of the Control Group have controlled, managed and operated the Non-Debtor Related Entities throughout the existence of these Non-Debtor Related Entities.

Indeed, during sworn testimony provided in mid-2005 to the Securities and Exchange Commission (“SEC”), Douglas Swenson stated that he considered any entity that he had “a controlling interest in as being part of the DBSI Group”³³ and acknowledged that all of the assets of the DBSI Group had been pledged to repay DBSI Housing, Inc.’s bond guarantee obligation.³⁴ Douglas Swenson further acknowledged that cash flows were commingled

³² Guaranty executed by DBSI Housing Inc. in favor of DBSI Guaranteed Capital Corporation dated July 1, 2002 executed by Douglas Swenson on behalf of DBSI Housing Inc.

³³ Douglas Swenson’s June 28, 2005 SEC Testimony at 110:25-111:7.

³⁴ *Id.* at 46:4-48:24.

throughout the entire Group such that “it’s really hard to trace where all the funds go to or where all the funds come from.”³⁵

1. Kastera LLC

a. Ownership

Kastera LLC was created in 2005 and is the parent entity that owns, directly or indirectly, 100% of the interests of the Kastera related entities, including Kastera Homes LLC, Kastera Development LLC and a number of subsidiary project level entities, which are in the business of acquiring, owning, developing and selling unimproved residential real estate. Kastera LLC is owned by DBSI Inc. (66.67%) and Reeve (33.3%). The interests of Kastera LLC that are now owned by DBSI Inc. were originally owned by Douglas Swenson personally but were transferred by Swenson to DBSI Inc. on March 1, 2007.³⁶

b. Control

Douglas Swenson indirectly controls Kastera LLC. DBSI Inc. is the controlling shareholder of Kastera LLC with 66.6% of the total shares. Douglas Swenson is the controlling shareholder of DBSI Inc. with 91.38% of the total shares.

³⁵ *Id.* at 24:3-22.

³⁶ All of this ownership information is based the unit ledger included in the minute books for this entity provided by company counsel. There are no certificates of ownership in the company records.

c. Management

Kastera LLC was managed from the time of its formation until March 1, 2007 by Reeve and Douglas Swenson. On March 1, 2007, Douglas Swenson became the sole manager of Kastera LLC. On June 1, 2009, Todd Twedt replaced Douglas Swenson as the sole manager. For the period of August 1, 2005 through August 29, 2007, Reeve acted as the President of this entity, with Joe Swenson acting as Vice President. On March 31, 2007 (after Douglas Swenson became the sole manager of Kastera LLC) the entity was reorganized and all of its assets and liabilities were split between Kastera Homes LLC and Kastera Development LLC. Thereafter, Kastera LLC became simply a non-operating parent holding company for the Kastera related companies. Reeve was removed from his position as President of Kastera LLC and became the President of Kastera Development LLC, and Joe Swenson was removed from his position as Vice President of Kastera LLC and became the President of Kastera Homes LLC. There are currently no executive officers for Kastera LLC.

Kastera LLC maintained few corporate formalities according to the corporate minute books maintained by this entity. The records show no meetings of the managers and such managers consented to only eight actions during the entity's existence. The majority of these consents were in connection with either the appointment or removal of managers and officers, and one half of these were consented to solely by Douglas Swenson. There are no documented consents or authorizations by the board of managers regarding the acquisition, sale or ownership of assets by this entity or the financing activities of this entity, nor management discussion and analysis of such business activities. It appears based on the lack of company records that the operations of this entity and any business decisions and undertakings were taken without any formal member or management consent. Given the lack of corporate formalities, it is difficult to

ascertain who directed and carried out the operations of this entity but, as stated above, Douglas Swenson acted as the sole manager of this entity from 2007 until June 1, 2009.

d. Commingling of Funds and Assets

The operational overhead of Kastera LLC and its related subsidiaries is commingled with that of DBSI Inc. Kastera LLC has adopted DBSI Inc.'s 401(k) retirement plan, DBSI provides accounting and payroll services for the Kastera related entities and DBSI has provided internal auditing services for the entities.

The source of the initial capital contribution for Kastera LLC was a \$6,000,000 distribution to Douglas Swenson from FOR 1031. Douglas Swenson in turn loaned \$2,000,000 of this distribution to Reeve to be attributed to Kastera LLC as his capital contribution. Additional funding for Kastera LLC was provided by DBSI Inc. and its related entities (including FOR 1031 and Spectrus Group LLC) pursuant to multiple loans from such entities, including but not limited to a \$10,000,000 Revolving Line of Credit dated May 3, 2005 from FOR 1031.³⁷ In addition, Kastera LLC and its subsidiaries received funding for the purchase of assets via loans from DBSI related Project Level Subsidiaries, specifically from the DBSI bond and notes entities. For example, it appears that the Kastera related entities received loans from the DBSI 2008 Notes Corporation in connection with the purchase of assets.

³⁷ The company records indicate that as of the Petition Date, \$7,790,158.63 remains outstanding in connection with this loan.

2. DBSI Investments Limited Partnership

a. Ownership

Investments is a Non-Debtor entity that is a holding company for other DBSI Non-Debtor Entities. Investments owns interests in Stellar and DBSI/Western Technologies LLC. In addition, Investments owns an interest in a number of limited partnerships that own real estate projects, and acts as a general partner for certain other limited partnerships that own real estate projects. Investments received substantial funding from other DBSI entities over many years. According to spreadsheets maintained by the Debtors' accountants to track intercompany loans and receivables, Investments owed \$101,144,847 to DRR as of December 31, 2008.³⁸ Further, Investments was used to make numerous distributions, which are still being analyzed, to members of the Control Group.

Investments was created in 1994. Currently, the majority of the interests of this entity are owned by DBSI Inc. (54.3%), with all remaining interests owned by the current owners of DBSI Inc., Douglas Swenson (26.2%), Mayeron (6.5%) and Hassard (6.5%), and by one former owner of DBSI Inc., Mott (6.5%).³⁹ Foster and Bennett are former owners.⁴⁰

³⁸ The Examiner was provided with these spreadsheets by Hassard, the Chief Financial Officer of DBSI Inc.

³⁹ Note that the profit distribution percentages for DBSI Investments Limited Partnership vary slightly from the capital contribution percentages provided above. The profit distribution percentages are as follows: DBSI Inc. (58.05%), Douglas Swenson (28.03%), Mayeron (6.96%), Hassard (6.96%) and Mott (0.0%).

⁴⁰ All of this ownership information is based the partnership agreement included in the minute books for this entity provided by company counsel.

b. Control

DBSI Inc. controls Investments as the owner of 54.3% of its interests. Ultimately, however, Douglas Swenson controls Investments by virtue of his control of DBSI Inc. In fact, Douglas Swenson controls over 80.5% of the total interests of Investments. He owns 26.2% of Investments directly. He also controls the 54.3% of the interest of Investments that are owned by DBSI Inc., as he is the controlling shareholder of DBSI Inc. with 91.38% of its total shares.

c. Management

Prior to January 1, 2005, Investments was managed and controlled by its general partners, including Douglas Swenson, personally and on behalf of DBSI Inc., Mayeron, Hassard, Mott and, for a period of time, Foster and Bennett (being the same individuals who were managing and controlling DBSI Inc. during the same periods). On January 1, 2005, the general partners agreed that Investments would be managed and operated in almost every aspect solely by DBSI Inc.

According to the corporate minute books maintained by Investments, the entity maintained some limited entity formalities prior to July 1, 2006. It appears that during the period of 1995-2001, the general partners (being the same individuals who were managing and operating DBSI Inc. during that same period) met annually in connection with the business and operations of this entity, but few other entity formalities were maintained. There are no records of consents for action by the entity during such period. For the period of 2001-2006, the company records show a few documented consents to entity actions, although they are sporadic. Further, those consents to action that were executed were, in almost every case, executed solely by Douglas Swenson as managing general partner of Investments or by Douglas Swenson on

behalf of DBSI Inc. No corporate formalities whatsoever have been maintained since July 1, 2006. From that date on, the corporate minute books do not show that any meetings of the partners have transpired, nor that the managing general partner during that period (DBSI Inc.) has consented to any actions on behalf of the entity.

d. Commingling of Funds and Assets

Investments enjoyed substantial financial advantages from its relationship with DBSI Inc. The operational overhead of Investments was commingled with that of DBSI Inc. DBSI Inc. provides all accounting services for Investments.

Based on the corporate minute books of DBSI Inc., it appears that the funds and ownership assets of DBSI Inc. and Investments have been commingled. The Examiner has found several instances where it appears that DBSI Inc. has assigned its ownership interests in DBSI related entities to Investments. The Examiner has reviewed the financial records of both DBSI Inc. and Investments in connection with these assignments and cannot find that consideration was paid to DBSI Inc. in connection with any of these transactions. For example, the corporate records show that on March 1, 2000, the board of directors of DBSI Inc. authorized assignment of 100% of DBSI Inc.'s interests in Stellar to Investments. The Examiner has neither been able to determine the terms and conditions of this assignment nor identify any consideration paid for these assets after a review of the company records. Similarly, (i) on July 1, 2003, the board of directors of DBSI Inc. authorized assignment of 100% of its interests in DBSI Fresno Forms LLC; (ii) on July 29, 2003, the board of directors of DBSI Inc. authorized assignment of 100% of its interests in DBSI Salem Offices LLC; (iii) on September 9, 2003, the board of directors of DBSI Inc. authorized assignment of 100% of its interests in DBSI Genesis LLC; (iv)

and on September 16, 2003, the board of directors of DBSI Inc. authorized assignment of 100% of its interests in DBSI Advantage LLC. Again, the Examiner has not been able to determine the terms and conditions of this assignment, nor has he been able to identify any consideration paid for these assets after a review of the company records.

Further, the records purport that DBSI Inc.'s business purposes were advanced by the use of the assets of Investments. For example, it appears pursuant to the company minutes dated February 28, 2005, that Investments pledged its indirect ownership interests in DBSI related technology companies to GCC and DBSI Real Estate Funding Corporation in connection with the guarantees to these entities made by DBSI Inc.⁴¹

3. DRR

According to spreadsheets maintained by the Debtors' accountants to track intercompany loans and receivables, DRR owed \$196,693,698 to DBSI Inc. as of December 31, 2008. The spreadsheets further indicate that DRR has the following large receivables due from Non-Debtor Entities as of December 31, 2008: \$101,144,847 from Investments and \$127,869,385 from Stellar. Ledger entries regarding these loans and receivables date back to 1999.

As with all of the Debtor entities, the Examiner requested a corporate minute book or similar records from the Debtors regarding the ownership and control of DRR. The Examiner was advised that no such records existed for DRR. This is the only entity for which such records were not readily available.

⁴¹ The actual pledge agreements in connection with these pledges have not been located.

Accordingly, the Examiner requested copies of any documents that would evidence the ownership and control of DRR and also reviewed publicly available records. The Examiner determined that the only publicly available record concerning DRR was a Statement of Partnership Authority filed with the Idaho Secretary of State on June 21, 2007 and signed by Douglas Swenson. The Examiner therefore also requested copies of any partnership or similar agreements related to DRR together with copies of any loan or other agreements relating to the loans and receivables identified above. In response, the Debtors produced copies of federal tax returns filed by DRR and produced ledger entries relating to financial activities of DRR. The Debtors have been unable to provide the Examiner with a partnership agreement or other governing document for DRR.

The Examiner was able to locate certain promissory notes from DBSI related entities in favor of DRR relating to loans made by DRR during and prior to 2005.⁴² The Examiner has not found any formal loan documentation for loans made by DRR after 2005. He has not found any formal loan documentation evidencing loans to DRR from DBSI Inc. The Examiner was advised that the Debtors had considered preparing a “Master Note” in connection with the DRR transactions and may have at least drafted the form of such a document concerning indebtedness owed to DRR by DBSI related entities.

The Examiner also questioned several current and former company employees regarding DRR. All but a few of the numerous witnesses interviewed by the Examiner disclaimed any knowledge of DRR. Hassard, the Chief Financial Officer of DBSI Inc., provided the most detailed explanation of DRR. He indicated that DRR was established in 1994 to allow investors

⁴² See, e.g., Promissory Note from Stellar in favor of DRR dated December 31, 2004 in the amount of \$41,627,720.

in Limited Partnerships (the “LPs”) “who had sales proceeds or cash available to invest and for other DBSI affiliated entities to borrow these funds and provide a return to the investing entities.”⁴³ He further explained that DRR “was intended to break even, but consistently has some variable income or loss which is thus allocated to its principal PLP [i.e., Preferred Limited Partnership] creditors.”⁴⁴ Hassard further noted that, for the “convenience and ease of accounting, DBSI Inc. has also made loans to its affiliates through DRR.”⁴⁵ As to this latter function, Hassard and other witnesses such as former DBSI accountants, Matt Duckett (“Duckett”) and Paris Cole (“Cole”), described DRR as a mechanism through which intercompany transactions were made.

DRR’s most recent federal tax return for the year ended 2007 indicates that it is a partnership with 17 members, all of which are LPs and none of which is a DBSI entity. This is consistent with what Cole told the Examiner during his interview: DBSI did not have an ownership interest in DRR; instead, the LPs were the partners and DBSI simply managed DRR.

In order to confirm that his understanding of DRR was complete, the Examiner sent a June 24, 2009 letter to counsel for the Debtors that identified the information available to the Examiner regarding DRR and requested a partnership agreement or other documentation evidencing ownership and control of DRR. In response, the Examiner received a June 26, 2009 letter from counsel for the Debtors indicating that the Examiner had been provided with detailed spreadsheets of DRR transactions, copies of its partnership tax returns for the years 2001-2007,

⁴³ This statement is taken from a one page history of DRR provided by Hassard and attached hereto as Exhibit 1.

⁴⁴ *Id.*

⁴⁵ *Id.*

and Hassard's testimony at an interview that DRR was formed under Idaho's Uniform Partnership Act. The letter, however, did not confirm or deny that a written partnership agreement for DRR existed.

After continuing to investigate this matter, counsel for the Examiner had further conversations and correspondence with Thomas Banducci, ordinary-course counsel for the Debtors. On July 24, 2009, counsel for the Examiner, had a conversation with Banducci wherein he confirmed that no executed partnership or similar agreement existed with respect to DRR.

In sworn testimony provided to the SEC on June 28, 2005, Douglas Swenson described DRR as "essentially an internal partnership that serves to keep track of money that has been borrowed and lent between the various DBSI controlled entities."⁴⁶ He further testified that DRR borrowed money from or lent money to entities that were not part of DBSI Inc. but were entities in which he personally held a controlling interest.⁴⁷

The Examiner is continuing his examination of DRR to analyze its function and role. His current belief, based upon the lack of documentation provided to date and the interviews of DBSI accounting personnel such as Hassard, Cole, Duckett, and Miller, is that little or no formalities have been followed with respect to the establishment of DRR and that, at most, it can be described as an oral or implied partnership. Further, it appears that the loans receivable from DRR and the loans payable to DRR represent an accumulation of accounting entries and, other than the old promissory notes from DBSI related companies in favor of DRR identified above, have not been documented by formal loan documents. Examples of the use of DRR as an entity

⁴⁶ Douglas Swenson's June 28, 2005 SEC testimony at 109:18-21.

⁴⁷ *Id.* at 110.

used to distribute money between various companies are included in the analyses provided later in this Interim Report for the uses of the 2008 Notes Proceeds.

4. Stellar

The Control Group directly or indirectly owns most of Stellar. Individuals unrelated to DBSI Inc. own 16.98% of the interests in Stellar but all other interests are owned by the Control Group. Stellar is a non-operational holding company that own interests in a variety of companies that manufacture and sell technology related products.

Stellar is not owned directly by DBSI Inc. However, the control and management substantially and closely tracks the management of DBSI Inc. Stellar is managed and operated by a board of managers consisting of Douglas Swenson, Hassard, Mayeron, Reeve and Paul Judge. In fact, the only member of the board of managers that is unrelated to DBSI is John Wasden. Further, according to the corporate books and records, substantial funding for Stellar has been provided via loans from DBSI related entities, specifically from DRR and the DBSI bond and notes entities.

a. Ownership

Stellar is owned by Investments (62.26%), Reeve (10.38%), Bringhurst (10.38%) and various other individuals that are not associated with DBSI related companies (16.98%). DBSI Inc. does not own a direct ownership interest in Stellar and owns, indirectly, less than a majority of the total interests of such entity (33.81%) but it appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. to provide this entity with material financial benefits.

Stellar was created March 1, 2000 and is the holding company that owns interests in iTerra (in which Stellar owns 80.10% of the total shares), UltraDesign (in which Stellar owns approximately 64.1% of the total shares), BioReaction (in which Stellar owns approximately 98.17% of the total shares), GigOptix (in which Stellar owns approximately 18.60% and iTerra owns 14.20% of the total shares) and Wavetronix (in which Stellar owns approximately 62.18% of the total shares).

b. Control

DBSI Inc. controls Stellar indirectly. Investments controls Stellar as the owner of 62.26% of Stellar's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

c. Management

Management for this entity is provided by a board of managers that consists almost exclusively of members of the Control Group, including specifically, Douglas Swenson, Reeve, Hassard and Mayeron. Other members of the board of managers include Judge, a former executive of FOR 1031⁴⁸, and Wasden, an individual otherwise unaffiliated with DBSI Inc. This entity has maintained fairly consistent and regular company formalities, having regular meetings of the board of managers and obtaining member and/or board of managers consent and authorization to act on behalf of the company on what appears to be a fairly regular basis.

⁴⁸ As a result of an interview with Judge, the Examiner understands that he was a consultant to the Tech Companies until he began working for FOR 1031 at its inception in 2003. He then left FOR 1031 to act as the senior executive officer of Stellar in August 2005.

According to the entity minute books, until August 2005, Douglas Swenson was almost always the individual authorized to carry out actions and execute documents and agreements authorized by the board of managers on behalf of Stellar. On August 15, 2005, Judge became the President and Chief Executive Officer of this entity, reporting to the board of managers. Judge was also added to the board of managers at that time. Nevertheless, in his review of the documents relating to the 2008 Notes Proceeds, the Examiner found that the Promissory Note dated May 22, 2008 from Stellar in favor of the 2008 Notes Corp. is executed by Douglas Swenson as the Chairman of the Board of Directors of Stellar.⁴⁹ Further, Douglas Swenson also signed the Pledge Agreement dated May 22, 2008 from Stellar in favor of the 2008 Notes Corp. as the Chairman of the Board of Directors of Stellar.⁵⁰

d. Commingling of Funds and Assets

Despite not being majority owned by DBSI Inc., Stellar has reportedly received substantial benefit from DBSI Inc. DBSI Inc. provides this entity with administrative support services and office space. In addition, DBSI Inc. provides Stellar with accounting services and payroll services.

Further, since 2002, Stellar has reportedly received funding via loans from DBSI related entities, specifically from the DBSI bond and notes entities and DRR. For example, Stellar reportedly received \$27,127,658 in loan funds from GCC.⁵¹ As of December 31, 2008, Stellar

⁴⁹ Promissory Note dated May 22, 2008 from Stellar in favor of 2008 Notes Corp.

⁵⁰ Pledge Agreement dated May 22, 2008 from Stellar in favor of 2008 Notes Corp. Note, it does not appear that any collateral was actually pledged pursuant to the Pledge Agreement dated May 22, 2008 from Stellar in favor of 2008 Notes Corp.

⁵¹ Amended and Restated Promissory Note from Stellar to DBSI Guaranteed Capital Corporation dated July 1, 2002.

reportedly owed \$127,869,385 to DRR attributable at least in part to monies borrowed from DBSI related bond and note funds.⁵² In connection with each of these financings, Stellar pledged its interest in the Tech Companies to the applicable DBSI related bond and notes funds.

5. Tech Companies

The Technology Holding Companies (which, as stated above, are owned almost exclusively by the Control Group, directly or indirectly) own a substantial interest in the Tech Companies, including Western Electronics LLC (in which DBSI/Western Technologies LLC owns 80.28% of the total shares), iTerra (in which Stellar owns 80.10% of the total shares), UltraDesign (in which Stellar owns approximately 64.1% of the total shares), BioReaction (in which Stellar owns approximately 98.17% of the total shares), GigOptix (in which Stellar owns approximately 18.60% and iTerra owns 14.20% of the total shares) and Wavetronix (in which Stellar owns approximately 62.18% of the total shares).⁵³

DBSI Inc. owns an indirect interest in these Tech Companies in the following percentages: (i) DBSI Inc. indirectly owns 34.75% of Western Electronics LLC⁵⁴; (ii) DBSI Inc. indirectly owns 27.08% of iTerra⁵⁵; (iii) DBSI Inc. indirectly owns 21.67% of UltraDesign⁵⁶; (iv)

⁵² The Examiner was provided with these spreadsheets by Hassard, the Chief Financial Officer of DBSI Inc.

⁵³ These ownership percentages are based on the most current reports provided by Judge. The stock certificates and ledgers contained in the company records and minute books vary slightly from the reported percentages of ownership.

⁵⁴ 80.28% of Western Electronics LLC is owned by DBSI/Western Technologies, LLC. 80% of DBSI/Western Technologies, LLC is owned by Investments (i.e., Investments owns 64% of Western Electronics LLC indirectly). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 34.75% of Western Electronics LLC indirectly).

⁵⁵ 80.10% of iTerra is owned by Stellar. 62.26% of Stellar is owned by Investments (i.e., Investments owns 49.87% of iTerra indirectly). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 27.08% of iTerra indirectly).

DBSI Inc. indirectly owns 33.19% of BioReaction⁵⁷; (v) DBSI Inc. indirectly owns 8.65% of GigOptix⁵⁸; and (vi) DBSI Inc. indirectly owns 21.02% of Wavetronix⁵⁹.

The Control Group owns an indirect interest in these Tech Companies in the following percentages: (i) 80.28% of Western Electronics LLC⁶⁰; (ii) 66.50% of iTerra⁶¹; (iii) 64.10% of UltraDesign⁶²; (iv) 81.5% of BioReaction⁶³; (v) 21.25% of GigOptix⁶⁴; and (vi) 41.35% of Wavetronix⁶⁵.

⁵⁶ 64.10% of UltraDesign is owned by Stellar. 62.26% of Stellar is owned by Investments (i.e., Investments owns 39.91% of UltraDesign indirectly). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 21.67% of UltraDesign indirectly).

⁵⁷ 98.17% of BioReaction is owned by Stellar. 62.26% of Stellar is owned by Investments (i.e., Investments owns 61.12% of BioReaction indirectly). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 33.19% of BioReaction indirectly).

⁵⁸ 14.2% of GigOptix is owned by iTerra. 80.10% of iTerra is owned by Stellar (i.e., Stellar owns 11.4% of GigOptix through iTerra's interest). 18.6% of GigOptix is owned by Stellar directly, so Stellar owns 25.6% of GigOptix total. 62.26% of Stellar is owned by Investments (i.e., Investments owns 15.94% of GigOptix). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 8.65% of GigOptix indirectly).

⁵⁹ 62.18% of Wavetronix is owned by Stellar. 62.26% of Stellar is owned by Investments (i.e., Investments owns 38.71% of Wavetronix indirectly). 54.3% of Investments is owned by DBSI Inc. (i.e., DBSI Inc. owns 21.02% of Wavetronix indirectly).

⁶⁰ 80.28% of Western Electronics LLC is owned by DBSI/Western Technologies, LLC. 100% of DBSI/Western Technologies, LLC is owned by the Control Group (i.e., the Control Group owns 80.28% of Western Electronics indirectly).

⁶¹ 80.10% of iTerra is owned by Stellar. 83.02% of Stellar is owned by the Control Group (i.e., the Control Group owns 66.50% of iTerra indirectly).

⁶² 64.10% of UltraDesign is owned by Stellar. 83.02% of Stellar is owned by the Control Group (i.e., the Control Group owns 53.22% of UltraDesign indirectly).

⁶³ 98.17% of BioReaction is owned by Stellar. 83.02% of Stellar is owned by the Control Group (i.e., the Control Group owns 81.5% of BioReaction indirectly).

⁶⁴ 25.6% of GigOptix is owned by Stellar (directly and through Stellar's interest in iTerra). 83.02% of Stellar is owned by the Control Group (i.e., the Control Group owns 21.25% of GigOptix indirectly).

⁶⁵ 62.18% of Wavetronix is owned by Stellar. 83.02% of Stellar is owned by the Control Group (i.e., the Control Group owns 41.35% of Wavetronix indirectly).

Douglas Swenson currently controls all of the Tech Companies other than GigOptix. The management of these Tech Companies overlaps with the management and operational authority of DBSI Inc. and, more specifically, in each case, Douglas Swenson serves on the board of managers (or directors) of each of the Tech Companies and has done so for substantially the entire existence of these entities. Furthermore, the minute books of these companies show that Douglas Swenson has been actively involved with and engaged in the management, operations and direction of these companies.

DBSI related companies loaned large sums of money to the Technology Holding Companies, who then reportedly loaned those sums to the Tech Companies. In exchange for these loans from the DBSI related companies, the Technology Holding Companies pledged their ownership interests in the Tech Companies as collateral. These loans, which required an 85% loan to value ratio, were made and approved based on DBSI Inc.'s valuation of the Tech Companies.

Moreover, Douglas Swenson acknowledged in his 2005 SEC testimony that he calculated the estimated values and cash flows of DBSI/Western Technologies LLC, Bio-Reaction, iTerra LLC, EmergeCore Networks LLC and Wavetronix that were included in the Real Estate Funding Offering Statement used in connection with the sale of the GCC bonds.⁶⁶ Furthermore, he considered the interests in these companies to have been pledged in support of DBSI Inc.'s bond obligation.⁶⁷

⁶⁶ Douglas Swenson's June 28, 2005 SEC Testimony at 22:17-23:5.

⁶⁷ *Id.* at 46:4-48:24.

Finally, although DBSI management did not run the day to day operations of the Tech Companies, it did provide oversight, accounting, assessment of business strategies, and assistance with marketing issues.⁶⁸ More specifically, during Douglas Swenson's 2005 SEC testimony, the following discussion occurred:

Q: I do understand that there are some accounting functions that are provided for the company, so that might be separate or that might be what you are referring to but, yeah, if you could just generally talk about that oversight, and then I specifically wanted to get into the accounting functions?

A: One of the, what I call my partners, he's actually a minority interest holder, John Foster, spends probably 70 to 80 percent of his time overseeing the non-real estate [i.e., Tech Company] aspects of the business. And I probably spend, I don't know, maybe a third of my time. And then there are I guess three other people, at least three other people, that basically spend full time on non-real estate aspects of the business, of the overall group. So this is all involved in oversight and accounting, and assessing business strategies, trying to assist these companies in marketing issues and those sorts of things, but not in running the day to day operations.

Q. And how long has that been the case that you've had those people in place at DBSI who provide this oversight function for these companies.

A. Well, I was just trying to recall. I think John Foster began that role two and a half to three years ago. I think it would have been before the last real estate funding offering there. Before that, besides the group was smaller and I was much more involved personally, I was basically doing what he's doing now so, I basically added another layer between myself and the companies directly, so I could spend more time on other matters.⁶⁹

⁶⁸ *Id.* at 77:16-78:8.

⁶⁹ *Id.* at 67:4-22 & 77:16-78:19.

a. Western Electronics LLC⁷⁰

(1) Ownership

80.28% of the total shares of Western Electronics LLC are owned by DBSI/Western Technologies LLC (which is owned entirely by the Control Group, including, Reeve (10%), Bringhurst (10%) and Investments (80%)). DBSI Inc. does not hold a direct ownership interest in Western Electronics, but indirectly owns less than a majority of the total interests of such entity (34.75%); however, the Control Group owns 80.28% of Western Electronics indirectly and based on the corporate minutes, it appears that the Control Group influenced the management and operation. In fact, prior to 2003, the Control Group had nearly exclusive management of this entity. Further, Douglas Swenson controls the voting interests of this entity and it appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. and other Debtor Entities to provide this entity with material financial benefits as further described below.

⁷⁰ This description reflects the ownership, management and control of Western Electronics LLC as of the date of the filing of these Bankruptcy Proceedings and the ownership, management and control structure under which the members of Western Electronics LLC currently operate; however, the operating agreement of Western Electronics LLC provides that a member ceases to be a member of the company upon certain events, including a bankruptcy. This appears to be an automatic cessation that does not require action by the other members. Therefore, under the terms of the operating agreement of Western Electronics LLC, DBSI/Western Technologies LLC ceased to be a member of Western Electronics LLC as of the date that DBSI/Western Technologies LLC became a Debtor. The operating agreement of Western Electronics LLC further provides that upon such an occurrence, the remaining members can elect to either (i) purchase the dissociated member's membership interests at fair market value or (ii) allow the dissociated member to hold its membership interest as an assignee. As an assignee, the dissociated member has no right to participate in management and is only entitled to distributions and return of capital, and to be allocated profits and losses. To the Examiner's knowledge, DBSI/Western Technologies LLC's interests have not been purchased per option (i). The Examiner therefore assumes that by default DBSI/Western Technologies LLC is currently holding its interests as a dissociated member with the rights of an assignee. Neither DBSI/Western Technologies LLC nor the other members of Western Electronics LLC have enforced the terms of these provisions to date, and DBSI/Western Technologies LLC is still involved in the management of Western Electronics LLC. At any time, however, the remaining members of Western Electronics LLC could chose to enforce these provisions and remove DBSI/Western Technologies LLC (or its estate) from the control/management of Western Electronics LLC or to purchase their interests.

(2) Control

DBSI Inc. controls Western Electronics LLC indirectly. DBSI/Western Technologies LLC controls Western Electronics LLC as the owner of 80.28% of Western Electronics LLC's interests. Investments controls DBSI/Western Technologies LLC as the owner of 80% of DBSI/Western Technologies LLC's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

The current board of managers of Western Electronics LLC consists of Douglas Swenson, Judge and four individuals unrelated to DBSI related companies. Despite the current involvement from individuals outside of the Control Group, Western Electronics LLC was managed almost exclusively by a board of managers that consisted of individuals from the Control Group, including, Douglas Swenson, Hassard, Foster, Mott, Reeve and Bringhurst for the period of November 1999 until December 2003. In December 2003, however, it was determined that the board of managers of this entity should largely consist of individuals outside of the Control Group and the DBSI group of companies. As such, from and after December 2003, the board of managers of this entity purposely became a more balanced mixture of DBSI insiders and owners, and individuals unrelated to the DBSI related companies; however, (i) Douglas Swenson has remained a member of the board of managers of this entity throughout its existence save for the period of November 2003 through August 2005, (ii) Judge has remained a

member of the board of managers of this entity since August 2005 and (iii) Reeve and Bringhurst continued as members of the board of managers of this entity until January 2007.

Although some corporate formalities have been maintained by this entity, it appears that many material actions by this entity were undertaken without any formalities. For example, there is no record of or information about the issuance or forgiveness of loans from DBSI related entities in the company record books for this entity.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in Western Electronics LLC, it appears that Western Electronics LLC enjoyed material financial benefits from its relation with DBSI Inc. Western Electronics LLC reportedly received the benefit of loans from DBSI related entities (which passed through DBSI/Western Technologies LLC), specifically from DRR and the DBSI bond and notes entities.⁷¹ However, based on DBSI/Western Technologies LLC's ledger as of December 31, 2008, it appears that Western Electronics LLC no longer owed any amount to DBSI/Western Technologies LLC in connection with these financings. The Examiner understands based on conversations with Judge that any and all amounts owed to DBSI/Western Technologies LLC were converted to equity in Western Electronics LLC. DBSI/Western Technologies LLC's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporations in connection with these

⁷¹ The Examiner has not yet verified receipt of loan money by this entity.

financings. Further, it appears that DBSI Inc. itself may have made loans to Western Electronics LLC in 2002, 2003 and 2004, all of which appear to have been forgiven by DBSI Inc.⁷²

b. iTerra

(1) Ownership

80.10% of the total shares of iTerra are owned by Stellar (which is owned by Reeve (10.38%), Bringhurst (10.38%), various other individuals that are not associated with the DBSI related companies (16.98%) and Investments (62.26%)). DBSI Inc. does not hold a direct ownership interest in iTerra, but indirectly owns less than a majority of the total interests of such entity (27.08%); however, the Control Group owns 66.50% of iTerra indirectly and based on the corporate minutes, it appears that the Control Group influenced the management and operation. Further, Douglas Swenson controls the voting interests of this entity and it appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. and other Debtor Entities to provide this entity with material financial benefits as further described below.

(2) Control

DBSI Inc. controls iTerra indirectly. Stellar controls iTerra as the owner of 80.10% of the interests. Investments controls Stellar as the owner of 62.26% of Stellar's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

⁷² Although not fully confirmed at this time, records indicate that a total of \$6,552,747 of debt from DBSI Inc. to Western Electronics LLC was forgiven from 2002-2004. The trial balance of DBSI/Western Technologies LLC, however, still shows that DBSI/Western Technologies LLC owes money to DRR in approximately this same amount. It is possible that DBSI/Western Technologies LLC actually made these loans to Western Electronics LLC and later forgave the Western Electronics LLC's indebtedness. Nonetheless, it appears that the underlying loan from DRR (or DBSI Inc.) to DBSI/Western Technologies LLC still remains outstanding despite DBSI/Western Technologies LLC's apparent forgiveness of Western Electronics LLC's debt. The Examiner has been unable to get further insight and clarification on these loans from DBSI employees.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

Since November 26, 2007, the board of managers of iTerra has consisted of Douglas Swenson, Judge and Hassard. Prior to that time, however, the board of managers of this entity, as well as the executive officers, included individuals outside of the DBSI group of companies. According to the company minutes, Douglas Swenson, however, has always been an active and engaged member of the board of managers (except for a period of 10 months in 2007), acting on behalf of the company as authorized agent in many instances and serving as the Chairman of the board of managers from August 2005 until January 2007. Although iTerra continues to exist, it is the Examiner's understanding that the company is no longer an operating entity.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in iTerra, it appears that iTerra has enjoyed material financial benefits from DBSI Inc. iTerra has reportedly received the benefit of loans from DBSI related entities (which loan funds passed through Stellar), specifically from DRR, GCC and 2008 Notes Corp.⁷³ Based on Stellar's ledger as of December 31, 2008, it appears that iTerra owed \$51,873,328 (including, principal and interest) to Stellar in connection with these financings. Stellar's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporations in connection with these financings.

⁷³ The Examiner has not yet verified receipt of loan money by this entity. This information was obtained from the general ledger of Stellar as of December 31, 2008.

Further, the minutes of DBSI Inc. indicate that the Control Group caused DBSI Inc. to guaranty certain of such entity's third party financial obligations and lease obligations.⁷⁴

In July 2007, iTerra formed GigOptix LLC, a wholly owned subsidiary of iTerra. All of iTerra's assets and liabilities, as well as operations and intellectual property, were transferred to GigOptix LLC except for \$45,800,000 worth of debt that iTerra owed to Stellar. According to the general ledger of Stellar as of December 31, 2008, it appears that approximately \$51,873,328 (including, principal and interest) remained outstanding in connection with this indebtedness. Additional amounts were then loaned by Stellar to GigOptix LLC directly. GigOptix LLC then merged with Lumera Corporation to form GigOptix. In June 2007, amounts outstanding by GigOptix to Stellar were reclassified as paid in capital to GigOptix.⁷⁵

c. UltraDesign

(1) Ownership

64.1% of the total shares of UltraDesign are owned by Stellar (which is owned by Reeve (10.38%), Bringhurst (10.38%), various other individuals that are not associated with the DBSI related companies (16.98%) and Investments (62.26%)). DBSI Inc. does not hold a direct ownership interest in UltraDesign, but indirectly owns less than a majority of the total interests of such entity (21.67%); however, the Control Group owns 64.10% of UltraDesign indirectly and based on the corporate minutes, it appears that the Control Group influenced the management and operation. Further, Douglas Swenson controls the voting interests of this entity and it

⁷⁴ DBSI Inc. corporate minute book, in particular, minutes of March 7, 2002.

⁷⁵ GigOptix 10Q report dated 4/5/2009.

appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. and other Debtor Entities to provide this entity with material financial benefits as further described below.

(2) Control

DBSI Inc. controls UltraDesign indirectly. Stellar controls UltraDesign as the owner of 64.10% of the interests. Investments controls Stellar as the owner of 62.26% of Stellar's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

Douglas Swenson was the only DBSI Insider to serve on the board of managers of UltraDesign. According to the company minutes, Douglas Swenson has been an active and engaged member of such board of managers, acting on behalf of the company as authorized agent in several instances. Although UltraDesign continues to exist and may have some residual value, the Examiner understands that the company is no longer actively operating. Based on the company records, it appears that the board of managers has not consented to any action since March 2005.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in UltraDesign, this entity appears to have enjoyed material financial benefits from DBSI Inc. UltraDesign is reported to have received the benefit of loans from DBSI related entities (which loans passed

through Stellar), specifically from DRR and the DBSI bond and notes entities.⁷⁶ Based on Stellar's ledger as of December 31, 2008, UltraDesign no longer owed any amounts to Stellar in connection with these financings.⁷⁷ Stellar's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporations in connection with these financings.

d. BioReaction

(1) Ownership

98.17% of the total shares of BioReaction are owned by Stellar (which is owned by Reeve (10.38%), Bringhurst (10.38%), various other individuals that are not associated with DBSI related companies (16.98%) and Investments (62.26%)). DBSI Inc. does not hold a direct ownership interest in BioReaction, but indirectly owns less than a majority of the total interests of such entity (33.19%); however, the Control Group owns 81.5% of BioReaction indirectly and based on the corporate minutes, it appears that the Control Group influenced the management and operation. Further, Douglas Swenson controls the voting interests of this entity and it appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. and other Debtor Entities to provide this entity with material financial benefits as further described below.

⁷⁶ The Examiner has not yet verified receipt of loan money by this entity. This information was obtained from the general ledger of Stellar as of December 31, 2008.

⁷⁷ The Examiner has not yet been able to determine whether previous amounts owing were repaid to Stellar or converted to equity or otherwise forgiven.

(2) Control

DBSI Inc. controls BioReaction indirectly. Stellar controls BioReaction as the owner of 98.17% of the interests. Investments controls Stellar as the owner of 62.26% of Stellar's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

The board of managers of BioReaction has always consisted of members of the Control Group, as well as individuals outside of the DBSI group of companies in almost equal proportions. According to the company minutes, Douglas Swenson, however, has always been an active and engaged member of the board of managers, has been the chairman of the board of managers since August 2005, and has acted on behalf of the company as authorized agent in many instances.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in BioReaction, this entity appears to have enjoyed material financial benefits from DBSI Inc. BioReaction reportedly received the benefit of loans from DBSI related entities (which passed through Stellar), specifically from DRR and the DBSI bond and notes entities. Based on Stellar's ledger as of December 31, 2008, it appears that BioReaction no longer owed any amount to Stellar in connection with these financings. The Examiner understands from conversations with Judge that any and all amounts previously owing to Stellar in connection with these financings have been

converted to equity. Stellar's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporations in connection with these financings. Further, the minutes of DBSI Inc. indicate that the Control Group caused DBSI Inc. to guaranty certain of such entity's third party financial obligations.⁷⁸

e. GigOptix

(1) Ownership

18.60% of the total shares of GigOptix are owned by Stellar (which is owned by Reeve (10.38%), Bringhurst (10.38%), various other individuals that are not associated with DBSI related companies (16.98%) and Investments (62.26%)) and 14.20% are owned by iTerra (80.10% of which, as stated above, is owned by Stellar). DBSI Inc. does not hold a direct ownership interest in GigOptix but owns indirectly less than a majority of the total interests of such entity.

(2) Control

Stellar directly and indirectly owns 29.43% of GigOptix⁷⁹ and, therefore, neither Stellar nor any member of the Control Group controls this entity.

⁷⁸ DBSI Inc. corporate minute book, in particular, the minutes from June 2003.

⁷⁹ 18.6% of GigOptix is owned directly by Stellar. 11.37% of GigOptix is owned indirectly by Stellar (via the interests of iTerra (14.2%)).

(3) Management

The Examiner has not yet reviewed the corporate records for this entity. He has, however, confirmed that Douglas Swenson serves on the board of directors of this entity along with other individuals who are not associated with DBSI Inc.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in GigOptix, this entity has enjoyed material financial benefits from DBSI Inc. GigOptix has received the benefit of loans from DBSI related entities (which loans passed through Stellar), specifically from DRR and the DBSI bond and notes entities. Based on Stellar's ledger as of December 31, 2008, it appears that GigOptix no longer owed any amount to Stellar in connection with these financings. The Examiner understands from conversations with Judge as well as GigOptix's public filings with the SEC that any and all amounts previously owing to Stellar in connection with these financings have been converted to equity. Stellar's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporations in connection with these financings.

f. Wavetronix

(1) Ownership

62.18% of the total shares of Wavetronix are owned by Stellar (which is owned by Reeve (10.38%), Bringhurst (10.38%), various other individuals that are not associated with DBSI related companies (16.98%) and Investments (62.26%)). DBSI Inc. does not hold a direct ownership interest in Wavetronix, but indirectly owns less than a majority of the total interests of

such entity (21.02%); however, the Control Group owns 41.35% of Wavetronix indirectly and based on the corporate minutes, it appears that the Control Group influenced the management and operation. Further, Douglas Swenson controls the voting interests of this entity and it appears that the Control Group (via their control of DBSI Inc.) caused DBSI Inc. and other Debtor Entities to provide this entity with material financial benefits as further described below.

(2) Control

DBSI Inc. controls Wavetronix indirectly. Stellar controls Wavetronix as the owner of 62.18% of the interests. Investments controls Stellar as the owner of 62.26% of Stellar's interests. DBSI Inc. controls Investments as the owner of 54.3% of Investments' interests.

Currently, Douglas Swenson controls DBSI Inc. as the owner of 91.38% of the total shares of DBSI Inc.

(3) Management

The board of managers of BioReaction has always consisted of members of the Control Group, as well as individuals outside of the DBSI group of companies in almost equal proportions. According to the company minutes, Douglas Swenson has always been an active and engaged member of the board of managers, frequently being authorized to act on behalf of the company. Douglas Swenson, Hassard and Judge continue to serve on the board of managers, along with individuals outside of the DBSI group of companies.

(4) Commingling of Funds and Assets

Despite the fact that DBSI Inc. has never owned a direct interest in Wavetronix, this entity appears to have enjoyed material financial benefits from DBSI Inc. Wavetronix has reportedly received the benefit of loans from DBSI related entities (which loan funds passed through Stellar), specifically from DRR, GCC and 2008 Notes Corp.⁸⁰ Based on Stellar's ledger as of December 31, 2008, it appears that Wavetronix owed approximately \$30,990,231 (including, principal and interest) to Stellar in connection with these financings. Stellar's interests in this entity were reportedly pledged to the applicable DBSI related bonds and notes corporation in connection with these financings.

VII. USES OF 2008 NOTES PROCEEDS

A. Introduction

The Examiner analyzed the use of funds raised from DBSI's 2008 Notes Offering. DBSI raised approximately \$90 million from investors from the 2008 Notes Offering. The Examiner decided to report on the 2008 Notes at this time because the analysis of the actual use of funds raised in the offering impacts issues of importance to the Bankruptcy Proceedings and is indicative of how the Debtors and the Control Group ran their business operations. The analysis illustrates the use of intercompany transfers by and among Debtors and non-Debtors in the day-to-day operations of DBSI Inc.

⁸⁰ The Examiner has not yet verified receipt of loan money by this entity. This information was obtained from the general ledger of Stellar as of December 31, 2008.

The Examiner selected the 2008 Notes for an in-depth analysis to try to answer the following questions:

- Can DBSI's books and records be relied on accurately to reflect the flow and use of money?
- Were 2008 Notes Proceeds commingled with other sources of cash to meet current cash flow needs including ongoing expenses and obligations of DBSI Inc.?
- Was adequate security obtained for loans made with 2008 Notes Proceeds?
- Did entities providing security for loans from 2008 Notes Corp. actually receive any benefit?
- Were non-Debtor entities used as conduits for disbursing 2008 Notes Proceeds and, if so, what is the effect of this?

Based on analysis of the uses of the 2008 Notes Proceeds, the Examiner concludes that the Debtors' ledger entries explaining the use of those proceeds cannot be relied upon to fairly explain the essence of the transactions. A significant portion of the 2008 Notes Proceeds were not actually used for the purposes described in the ledgers. These proceeds were also not used for a purpose detailed in the Private Placement Memorandum offering the sale of investor interests in the Notes. Much of the 2008 Notes Proceeds were neither used to acquire real estate nor to finance or refinance loans. In fact, the proceeds were used to prop up a failing enterprise by making cash available to support current operations and obligations. The mechanism used by DBSI Inc. to make this cash available included purporting to loan 2008 Notes Proceeds based on

collateral the value of which was overstated. Much of the 2008 Notes Proceeds was not truly “invested.” Rather, these proceeds were actually used to meet then-current cash needs. As a result, investments were not made that could one day be used to repay the 2008 Notes.

B. The 2008 Notes Offering

On February 6, 2008, 2008 Notes Corp. issued a Confidential Private Placement Memorandum (the “PPM”) wherein it offered \$50,000,000 in investment interests, with the ability to increase to \$90,000,000, the aggregate principal amount of 9.5% Notes due on December 31, 2015 (the “2008 Notes”). A copy of the PPM is attached as Exhibit 2. According to the PPM, the proceeds of the Offering were to be used:

- (i) to acquire, rehabilitate, entitle, develop and/or finance real estate assets prior to their sale, resale, third-party financing or syndication; and
- (ii) to finance or refinance non-real estate Entities.

With respect to loans to be made using 2008 Notes Proceeds, the PPM stated “To receive a Loan in accordance with the Loan requirements, an Entity must meet certain Loan requirements, including a maximum overall 85% Loan to Value Ratio.”⁸¹ The PPM disclosed that for real estate, the value used for this calculation might not reflect fair market value, might not be based on valuations obtained from third parties,⁸² and could be based on a “reasonable estimate” by the guarantor, DBSI Housing Inc.⁸³ Some or all of the loans would be unsecured.⁸⁴

⁸¹ PPM at 10.

⁸² *Id.* at 17.

⁸³ *Id.* at 1, *id.* at 26.

An undefined “percentage” of the PPM proceeds could be used to retire an “entity’s existing debt obligations.”⁸⁵ The PPM also stated that “proceeds from the sale of the Notes will be held in a separate account (the “Loans to Entities Account”), which will be used only to pay offering costs and to fund loans, and will not be commingled with the Guarantor’s financial or business accounts or with the accounts of any Affiliates.”⁸⁶

Exhibit B to the PPM is DBSI Housing Inc.’s (now DBSI Inc.) financial statements dated June 30, 2007. These financial statements are significant because DBSI Housing Inc. agreed to unconditionally guarantee repayment of the Notes.⁸⁷ The balance sheet for DBSI Housing Inc. reflected retained earnings of more than \$99 million which, if accurate, made the guarantee DBSI agreed to supply appear substantial. However, the financial statements were not prepared according to GAAP and were not audited. The financial statements did not disclose which DBSI-owned and/or controlled entities were consolidated for reporting purposes. The notes to the Balance Sheet and Statement of Operations stated that DBSI Housing Inc. was a principal in numerous entities, and referred only in general terms to affiliated entities that composed the “DBSI Group of Companies.” DBSI Securities Corporation, DBSI Inc., (currently, DCJ Inc.), DBSI Realty Corporation, numerous bond finance subsidiaries, and DBSI Properties L.P. (currently DBSI Investments Limited Partnership) were listed as “other affiliated entities.” The notes to the financial statements stated that the Company entered into numerous transactions

⁸⁴ *Id.* at 15.

⁸⁵ *Id.* at 15. Entities were defined to include current and future wholly or partially owned subsidiaries of DBSI Housing Inc. within the meaning of Section 270.3a of the Investment Company Act of 1940. *Id.* at 35.

⁸⁶ *Id.* at 27.

⁸⁷ *Id.* at 1.

with “affiliated entities included in the DBSI Group of Companies” without further defining exactly which companies were included in the group.

Most significantly, DBSI Housing Inc.’s. balance sheet netted payables and receivables from affiliates in a single entry as “net payable to affiliates” of \$2,985,091. According to the financial statements, all receivables were treated as collectible except for a minimal amount disclosed as “doubtful accounts.” The fact that there was more than \$140,000,000 in loans receivable from DRR on the June 30, 2007 date of the Financial Statements is not disclosed.⁸⁸ It also appears that DRR was being treated as an “affiliate” although it is not a Debtor in the Bankruptcy Proceedings. This netting of loans payable and receivable effectively concealed the size of the loans receivable. Also concealed was the fact that DBSI Housing Inc.’s loans receivable were from DRR, an entity that was used as a conduit for money transfers, and which had no liquid assets that could be used to repay the loan.

DBSI Housing Inc.’s financial statements also included as an asset \$89,897,937 described as “Land Investments.” The Notes to the Financial Statements disclosed only that the investments consisted of “controlling interests in various entities. . .” which were valued at their “original cost.” The Examiner is still analyzing whether the company in fact had land investments worth \$89 million for financial reporting purposes.

⁸⁸ Trial Balance for DBSI Housing dated June 30, 2007 retrieved from DBSI Yardi system.

C. Uses of the 2008 Notes Proceeds

The 2008 Notes Offering raised a net of \$89.3 million from investors.⁸⁹ The 2008 Notes Corp., a wholly owned subsidiary of DBSI Inc., accumulated and distributed the funds raised by the 2008 Notes Offering. The funds were accumulated in a newly created account set up for the 2008 Notes Corp. In addition to the 2008 Notes Proceeds, other 2008 Notes Corp. funds flowed through that account as property loan repayments and interest income.

The Examiner analyzed and traced the use of a significant portion of the funds raised through the 2008 Notes Offering. This task was complicated because funds flowed in and out of the 2008 Notes account, often on a daily basis. In addition, the same money was transferred between various DBSI entities (both Debtors and non-Debtors), also often on a daily basis. The numerous movements of the funds were documented by journal entries that did not always describe the basis for the transfer. Because of these numerous vague, confusing, and misleading journal entries, determining the use of the 2008 Notes Proceeds required the devotion of extensive and unanticipated resources.

In large part, the uses of the funds raised through the 2008 Notes Offering were documented by reference notes and general ledger entries in DBSI's accounting systems. At times these journal entries were entered days or weeks after the money was transferred and/or were subject to modifications and adjustments. Exhibit 3 details the sources and uses of all the 2008 Notes Proceeds as reflected in the original journal entries.

⁸⁹ The Debtor's investor schedule reflects a total of \$89,604,000. According to the Examiner's analysis, the total is actually \$89,388,733. This difference has not been reconciled, but it does not affect the Examiner's analysis.

Detailed below are the Examiner's findings concerning some of the significant uses of the 2008 Notes Proceeds.

1. \$27,293,500 from 2008 Notes Booked as Loans to Stellar
 - a. Stellar Loan Approvals

The DBSI accounting entries for the disbursement of the 2008 Notes Proceeds reflect that \$27,293,500 was loaned to Stellar.⁹⁰

The Examiner located a DBSI Loan Record Index on the website of the Debtors' counsel, YCST, in support of the \$27,293,500 amount that was loaned to Stellar on June 16, 2008.⁹¹ This loan accumulated and superseded prior loans for smaller amounts that were made from the 2008 Notes as those funds were received.

For the June 16, 2008 loan, Hassard, as Secretary for 2008 Notes Corp., certified on August 20, 2008 that the amount loaned did not exceed a loan to value ("LTV") ratio of 85% of the fair market value of the security for the loan. The DBSI loan approval documents reflect that this 85% LTV was based on a \$32,110,000 valuation of Stellar's interests in Wavetronix and Bio-Reaction, but the loan package lacks a valuation of Wavetronix as back-up.⁹² Douglas

⁹⁰ Judge, the President and CEO of Stellar Technologies, LLC, provided the Examiner with "draft" flow charts labeled "for discussion purposes only" detailing the flow of funds from the 2008 Notes for the benefit of Stellar which agrees with this figure. These charts also reflect that Stellar owed far in excess of \$100 million in total to DRR and to a lesser degree to 2008 Notes and GCC as of December 31, 2008.

⁹¹ Stellar Technologies LLC Loan Record Index for June 16, 2008 Loan.

⁹² Earlier, loan documents had been prepared to justify a loan made on May 22, 2008 to Stellar by the 2008 Notes. This loan was subsumed by the June 16, 2008 loan. The Examiner located the DBSI loan packet for the May 22, 2008 loan. (DBSI Request For Funds From Loan Committee submitted May 21, 2008 and related documents.) The package was sent to Jeremy Swenson, Mark Griffin, Shane Warner, and Cole for approval of the proposed loan for Stellar Technologies and included loan documents. Jeremy Swenson approved the loan on behalf of the loan

(footnote continued on next page)

Swenson supplied paperwork in support of this loan. He consented to the pledge of Stellar assets as President of GCC. He also consented to the loan on behalf of “DBSI Investments Limited Partnership, as the Majority Member of Stellar Technologies LLC” and signed the document as the “Majority Member: DBSI Investments Limited Partnership by DBSI Inc. its General Partner, Douglas L. Swenson President.” Judge authorized the loan on behalf of Stellar. (Previously, Douglas Swenson had signed a May promissory note on behalf of Stellar.) Stellar pledged its membership interests, which were valued at \$32 million, in Wavetronix and Bio-Reaction in support of the loan. Although DBSI Inc. was listed as a guarantor on the loan approval sheets, the Examiner has not located any such guarantee. No evaluation was done of collectability issues. The loan was “secured” only by Stellar’s ownership interest in Wavetronix and Bio-Reaction and no stock was actually pledged.

b. Uses of 2008 Notes Proceeds Loaned to Stellar

The Examiner analyzed the general ledger cash account entries supporting the disbursements of the \$27,293,500 for Stellar and the Tech Companies. There were a total of ten journal entries booked for transfers between March and July 2008 to support these

committee. Douglas Swenson signed the promissory note on behalf of Stellar, the borrower, and the pledge agreement as “Owner: Stellar Technologies LLC By: Douglas L Swenson, Chairman of the Board.”

The May 22, 2008 loan package also included details explaining how DBSI attempted to justify the 85% LTV requirements imposed as a lending requirement by 2008 Notes PPM. For example, according to an Executive Summary of the Wavetronix LLC-secured loan request dated May 21, 2008, DBSI’s Loan Committee requested \$18 million on May 22, 2008 to be loaned against Stellar’s ownership interest in Wavetronix. An internal evaluation was performed by DBSI to determine the net amount that could be loaned by 2008 Notes Corp. to Stellar for the May loan. The executive summary makes clear that the calculations of LTV were based on claimed appraised values for Wavetronix without any subtraction for intercompany debt. If intercompany debt is considered then Wavetronix actually had negative value according to an internal “restricted use appraisal report” dated December 31, 2007, which was included in the package. In addition, Stellar/DBSI was treated as owning 100% of Wavetronix for calculating the LTV, according to the executive summary. The summary also stated that the loan will be used to pay down GCC loans.

disbursements. All of the disbursements were booked as loans receivable by the 2008 Notes Corp. from Stellar. After extensive tracing of these ten transactions beyond the initial journal entries, the Examiner concludes that \$18,341,536 “loaned” to Stellar was promptly transferred to DBSI Inc.’s checking and operating accounts.⁹³ The \$18 million was then used almost immediately by DBSI Inc., in large part for general operating expenses. At the time of the transfers, DBSI Inc. was suffering from a severe cash shortage crisis that required it to obtain significant cash infusions to sustain its operations.⁹⁴

The transfer of the \$18,341,536 to DBSI Inc. was obscured by a series of misleading journal entries. The cash transfers were often accomplished by using DRR as an intermediary. Once the \$18,341,536 was received by DBSI Inc., it was used to pay, among other expenses, payroll and personal state income taxes owed by owners. The Examiner concludes that only \$8,951,964 of the \$27,293,500 booked as loans to Stellar may have actually been retained by GCC in repayment of Stellar’s debt to GCC, which was the stated explanation for several of the loan entries.⁹⁵

The ten journal entries summarizing the \$27,293,500 in disbursements to Stellar are summarized in the following chart.

⁹³ In its books and records, DBSI Inc. is still often treated as DBSI Housing but the Examiner will refer to DBSI Inc. unless an entry is directly quoted.

⁹⁴ DBSI Inc. prepared weekly cash flow statements analyzing all disbursements that were scheduled and all anticipated sources of cash for all DBSI-related entities. These statements have not been fully analyzed but they reflect that the company understood for a lengthy period of time that it was losing money in its ongoing operations and that the only way to meet its cash flow needs was to bring in additional investment money.

⁹⁵ The Examiner is in the process of analyzing how this debt had been actually incurred and whether it was because of cash investments that went to the Tech Companies.

Entry #	Property Name	GL Account Name	Date	Description	Control	Amount
1	DBSI 2008 Notes Corporation	Receivable - Loans	13-Mar-08	Funds to Stellar	J-367514	7,000,000.00
2	DBSI 2008 Notes Corporation	Receivable - Loans	20-Mar-08	Funds to Stellar fr NC2008	J-369894	1,058,000.00
3	DBSI 2008 Notes Corporation	Receivable - Loans	28-Apr-08	gcc redemption	J-384964	750,000.00
4	DBSI 2008 Notes Corporation	Receivable - Loans	05-May-08	ach to stellar	J-386572	88,470.10
5	DBSI 2008 Notes Corporation	Receivable - Loans	13-May-08	paydown stellar debt to gcc	J-390305	620,000.00
6	DBSI 2008 Notes Corporation	Receivable - Loans	15-May-08	pay stellar debt owed to gcc	J-391294	318,000.00
7	DBSI 2008 Notes Corporation	Receivable - Loans	05-Jun-08	funds to paydown stellar debt to	J-399667	10,895,494.00
8	DBSI 2008 Notes Corporation	Receivable - Loans	17-Jun-08	loan to Stellar	J-403572	3,000,000.00
9	DBSI 2008 Notes Corporation	Receivable - Loans	19-Jun-08	loan to Stellar	J-404433	810,000.00
10	DBSI 2008 Notes Corporation	Receivable - Loans	03-Jul-08	funds to stellar	J-409847	2,753,536.00
Total Loans Booked to Stellar from 2008 Notes Corporation						27,293,500.10

The journal entries numbered 1, 2, 4, and 10 reflect \$10,900,006 in funds transferred to Stellar with almost no further information. Entries 3, 5, 6, and 7 (\$750,000, \$620,000, \$318,000, and \$10,895,494) reflect that a total of \$12,583,494 in funds was used to pay down GCC debt owed by Stellar. Entries 8 and 9 were booked as loans to Stellar. The Examiner has identified significant issues with respect to each of these ten “loans” to Stellar. Two charts detailing his analysis of the initial actual cash flow of the \$27,293,500 are appended as Exhibits 4A and 4B. The two charts organize the same information in different ways. A more detailed analysis of each of the journal entries reproduced above, including information about how the \$27,293,500 was used once it was transferred to DBSI Inc., follows:

Entry #1

Reported: On March 12, 2008, \$7 million was wired to Stellar and booked as “Funds to Stellar.”

Analyzed Use: The \$7 million was transferred to DBSI Inc. to meet then-current cash needs.

On March 13, 2008, \$7 million was withdrawn from the 2008 Notes Corp. bank account and transferred to DRR. This money was then deposited in Stellar’s bank account via an electronic transfer from DRR on the same day. On March 14, 2008, the \$7 million was withdrawn from Stellar’s bank account and electronically transferred back to DRR. According to DBSI Inc’s check register for its KeyBank account, this amount was then transferred from DRR to the general operating account for DBSI Inc. The DBSI Inc. account reflects the transfer of the \$7 million into the account, bearing the notation “Funds to Hsg fr DRR” on March 14, 2008. Without this money, the account would have had a negative balance on that day in excess of \$1.5 million. Funds were then disbursed from DBSI Inc. over the next three days, resulting in a negative balance in the account by March 17, 2008.

Among the significant uses of the funds disbursed from the DBSI Inc. account are transactions recorded as payments to GigOptix (\$350,000) and to the 2006 Secured Notes Corporation to pay off a loan owed by Kastera on a property, transfers to an account described as “TIC OP,” payments for more than \$55,000 of Douglas Swenson’s state tax liabilities, and a transfer recorded by the Debtors as “Funds to Hsg. LR fr Hsg OP” account.

Entry #2

Reported: On March 20, 2008, \$1,058,000 was wired to Stellar and booked as “Funds to Stellar fr NC 2008.”

Analyzed Use: The \$1,058,000 was transferred to DBSI Inc. to meet then-current cash needs.

On March 20, 2008, the \$1,058,000 was withdrawn from the 2008 Notes Corp. bank account and transferred to DRR. This money was then deposited to Stellar’s bank account via an electronic transfer from DRR on the same day. After this transfer, and still on the same day, \$1,058,000 was withdrawn from the Stellar bank account and electronically transferred back to DRR. According to DBSI Inc’s check register for its KeyBank account, DRR transferred the exact same amount, \$1,058,000, to DBSI Inc. At the time of this transfer, the DBSI Inc. account had reflected a negative balance since March 17, 2008. On March 24, 2008, \$1,750,000 was sent to “TIC MMA” placing the account again in a negative balance. The Chart below details the uses of funds after the \$1,058,000 was deposited into DBSI Inc.’s account.

Date	Description	Amount	Totals
3/20/2008	Funds Transfer		1,058,000.00
	Uses:		
3/20/2008	Beginning balance in the DBSI Inc., 11000 operating account at 03/20/08	(239,938.49)	
3/20/2008	Accountable Reserves transfers to 17 properties ranging between \$750 and \$1,650 per property.	(31,400.00)	
3/20/2008	TIC Deposit for Regents	(34,050.00)	
3/20/2008	Transfer to pay a loan at Bank of Cascades #740006962	(11,489.11)	
3/20/2008	Payment to Knipe, Janoush Knipe, LLC for appraisal	(3,950.00)	
3/21/2008	Funds to DBSI Realty for operational expenses	(100,500.00)	
3/21/2008	Funds sent to Plantation property	(1,000.00)	
3/21/2008	Funds sent to the TIC deposit accounts	(160,000.00)	
3/21/2008	Funds sent to Kastera	(66,000.00)	
3/24/2008	Funds transferred to the TIC money market account for TIC expenses	<u>(1,750,000.00)</u>	<u>(2,398,327.60)</u>
	Net Uses of Cash		<u>(1,340,327.60)</u>

Entries #3, 5, 6, and 7

Reported: Four transfers made between April 28, 2008 and June 5, 2008, totaling \$12,583,494 were booked as Stellar pay-downs of GCC debt.

Analyzed Use: \$3,720,000 out of the \$12,583,494 was transferred back to DBSI Inc. and used for then-current cash needs.

The funds detailed in the four entries were withdrawn directly from the 2008 Notes Corp. bank account and deposited in the GCC bank account. After the final deposit on June 5, 2008, GCC made three transfers into DBSI Inc.'s M&I Bank operating account. These transfers

occurred on June 13, 2008, June 16, 2008, and June 19, 2008 and totaled \$3,720,000, which was described in the check register as follows:

- On June 13, 2008, \$2,000,000 was transferred and described as “Gcc to issue \$2M distribution to Housing, Inc.”
- On June 16, 2008, \$1,300,000 was transferred and described as “funds to gcc on behalf of stellar. Gcc had temporary funds (idle) so it re-loaned it to Stellar, so Stellar paid back Drr and drr paid back Inc.”
- On June 19, 2008, \$420,000 was transferred and described as a “loan to stellar to paydown DRR.” DBSI Inc’s check register for its M&I Bank account reflected that this money was deposited into that account, and it was booked as coming from DRR.

The chart below describes the use of the \$3,720,000 after it was transferred to the DBSI Inc. operating account.

Date	Description	Amount	Totals
6/13/2008	Transferred from the GCC account to DBSI Inc's operation account described as "Gcc to issue \$2M distribution to Housing, Inc."	2,000,000.00	
6/16/2008	Transferred from the GCC account to the DBSI Inc operating account described as "funds to gcc on behalf of stellar. Gcc had temporary funds (idle) so it reloaned it to Stellar, so Stellar paid back Drr and drr paid back Inc."	1,300,000.00	
6/19/2008	Transferred from the GCC account to the DBSI Inc operating account described as a "loan to Stellar to paydown DRR."	<u>420,000.00</u>	3,720,000.00
	<u>Uses:</u>		
6/13/2008	Pay-down to 2006 Notes for Kastera Properties	(1,169,015.00)	
6/13/2008	Pay-down Purdy 64 Peacock loan from Real Estate Funding Corp	(450,000.00)	
6/13/2008	Funds from Inc to 06 Note to pay-down South Hill Loan	(380,395.00)	
6/16/2008	Wire to GigOptix	(350,000.00)	
6/16/2008	Title Insurance for Colony West	(24,058.32)	
6/16/2008	Accountable Reserves transfers to 11 Land Bank TIC properties ranging between \$1,500 and \$1,836 per property.	(17,408.00)	
6/16/2008	Funds transferred to DBSI Properties Liquid Reserve account to cover an ongoing negative balance in account	(100,000.00)	
6/16/2008	Funds transferred to DBSI Properties Liquid Reserve account to cover an ongoing negative balance in account	(30,000.00)	
6/16/2008	Wire to DBSI TIC Securities account for overdraft balance of (749,940.75) created from transfers to other DBSI entities covering their over-drafted accounts	(750,000.00)	
6/17/2008	Funds transferred to DBSI Properties Liquid Reserve account to cover an ongoing negative balance in account	(20,000.00)	
6/19/2008	Partially covers payroll funding request	<u>(429,123.68)</u>	<u>(3,720,000.00)</u>
	Remainder		<u>0.00</u>

Entry #4

Reported: On May 5, 2008, \$88,470.10 was transferred to Stellar and booked as “ach to stellar.”

Analyzed Use: This money appears to have been used in connection with the GCC notes.

On May 5, 2008, \$88,470.10 was withdrawn from the 2008 Notes Corp. bank account and transferred to DBSI Inc. On the same day, this money was electronically transferred to Stellar’s bank account. On the next day, May 6, 2008, the \$88,470.10 was withdrawn from the Stellar bank account and electronically transferred back to DBSI Inc.

The transfer back from Stellar was not reflected on DBSI Inc’s bank account statement, but it was recorded as coming into GCC’s account that day. There are conflicting notations concerning this flow of funds: a notation on Stellar’s bank statement reflects that the money transferred through DBSI Inc., while GCC’s register and bank statement reflect that the money went directly to its savings account. The Examiner cannot determine which is correct. In any event, the \$88,470.10 was distributed as \$50,000 in a roll-over of GCC investor principal to Villago North and \$38,470.10 in GCC bond payments.

Entry #8

Reported: On June 17, 2008, \$3,000,000 was booked as a “loan to Stellar” from the 2008 Notes.

Analyzed Use: The \$3,000,000 was transferred to DBSI Inc. to meet then-current cash needs.

The Examiner found no evidence in Stellar's bank statements that these funds were actually sent to Stellar. According to DBSI Inc.'s check register for its M&I Bank checking account, these funds were received by DBSI Inc. directly from DRR, which obtained the money directly from the 2008 Notes Corp. bank account. The entry notes describe these funds as "coming from DRR to INC - actually coming from 08 notes to Stellar - Stellar to DRR - DRR to Inc." According to the check register, the funds received by DBSI Inc. covered payments to Legacy Hills and interest payments for other properties, and \$2,206,671 was used to cover overdrafts on the same day. In addition, money from the account (coupled with money received from Entry #7 above and Entry #9 described below) was used to meet payroll expenses within days of the transfer.

Entry #9

Reported: On June 19, 2008, \$810,000 was booked as a "loan to Stellar" from the 2008 Notes.

Analyzed Use: The \$810,000 was transferred to DBSI Inc. to meet then-current cash needs except for \$7,400, which was transferred back to Stellar.

The Examiner found no evidence in the Stellar bank statements that these funds were actually sent to Stellar. However, as indicated below, Stellar did actually receive \$7,400 of this amount in its checking account on July 2, 2008, which it used to cover a debit for payroll taxes. The \$810,000 moved as follows:

- On June 19, 2008, \$810,000 was withdrawn from the 2008 Notes Corp. bank account and transferred directly to DRR.

- On the same day, June 19, 2008, DBSI Inc.'s check register for its M&I Bank checking account, reflects a deposit of \$802,600 (\$810,000 less the \$7,400 kept by DRR and later transferred to Stellar), which was booked as "funds to paydown Inc."
- This money was combined with the money described in Entry #7 to fund the DBSI Realty payroll expenses paid on June 19, 2008.
- On July 2, 2008, DRR transferred to Stellar the \$7,400 not sent to DBSI Inc's account.

Entry #10

Reported: On July 3, 2008, \$2,753,536 was booked as "funds to Stellar" from the 2008 Notes.

Analyzed Use: The \$2,753,536 was transferred to DBSI Inc. to meet then-current cash needs.

Analysis of the 2008 Notes Corp. bank statement and the Debtor's cash ledgers indicate a commingling of the "funds to Stellar" with funds for a property called "Florissant." The funds flowed as follows:

- On July 3, 2008, \$3,613,536 was withdrawn from the 2008 Notes Corp. bank account, booked as "funds to Prop for Florissant and to Stellar."
- On the same day, July 3, 2008, \$2,753,536 was credited and subsequently withdrawn from the Stellar bank account, noted only as a "Cash Mgmt TRSFR."

- On the same day, July 3, 2008, the same \$2,753,536 was booked as moving through DRR to DBSI Inc.'s check register in its M&I Bank account. The journal entry for the transfer stated: "fund trans only- no backup available as it's a routine transfer."
- The remaining \$860,000 was attributed to the Florissant property on the Debtor's general ledger.

Subsequently, the \$2,753,536 was combined with other funds, including TIC money, and accumulated in the M&I account into total funds of \$5,490,000. This amount was subsequently transferred on the same day to KeyBank with a journal entry reading "funds to key bank account – no back up. Just a normal transfer." On the same day, the \$5,490,000 was again moved from the operating account to the DBSI Realty Reserve account, where it was consumed by operations, flowing into the daily bank sweeps and covering positive pay transactions in numerous DBSI-controlled bank accounts.⁹⁶ Twenty-seven pages of transfers with approximately twenty-five entries per page document the full use of these funds.

2. \$9,600,827 from 2008 Notes Booked as Loans to DBSI Western Technologies LLC

a. Western Technologies Loan Approvals

The DBSI accounting entries for the disbursement of the 2008 Notes reflect that \$9,600,827 was loaned to DBSI/Western Technologies LLC ("Western Technologies") based

⁹⁶ In a positive-pay or "zero-balance" cash management system, a bank may use funds as needed to cover various payments from accounts that draw from those funds.

upon a Minority Interest Valuation of Western Electronics, LLC. The actual loan approval to Western Technologies is dated September 2, 2008.⁹⁷ The Examiner has been unable to locate a promissory note or a pledge agreement of assets in connection with this loan. The loan approval documents show that \$8,706,500 was internally approved as loans to Western Technologies. There is no support for \$9,600,827 being the amount of the loan.

b. Uses of 2008 Note Proceeds Loaned to Western Technologies

Between September 4, 2008 and October 29, 2008 a total of \$9,600,827 was loaned to Western Technologies from the 2008 Notes, as evidenced by a series of six journal entries. The Examiner analyzed some of the actual uses of the \$9,600,827 as follows:

(1) Loan of \$2,400,827

Between September 4, 2008 and September 19, 2008, \$2,400,827 was loaned to Western Technologies. \$1,646,189.50 of this money was described as funds transferred through “Western Tech to gcc.” The remaining funds were described as funds transferred/loaned to Western Technologies from the 2008 Notes. The funds passed through Western Technologies’ account. A chart detailing the cash flow of the \$2,400,827 is appended as Exhibit 5. Below is a description of some of uses of this money.

Of the \$2,400,827, a total of \$875,000 was transferred from Western Technologies to DRR on September 5, 2008. On the same day, money was transferred through various DBSI Inc. accounts and \$875,000 was deposited in the DBSI Inc. Operating Account.

⁹⁷ Western Technologies LLC Loan Approval Committee packet dated August 28, 2008 and approved September 2, 2008.

The remaining \$1,525,827 was transferred to GCC. Of that amount, \$941,982 paid GCC investors. \$350,000 was transferred through DRR to GigOptix. Other funds were reinvested by GCC investors in the 2008 Notes.

(2) Loan of \$7,200,000

On October 29, 2008, \$7,200,000 was transferred from the 2008 Notes to DBSI Inc. The entry for that transfer stated: “fnds from 08 notes to pydwn drr” and the notes to the entry state “fnds from 08 notes to Inc”.⁹⁸ A chart detailing the cash flow of the \$7,200,000 loaned to Western Technologies is appended as Exhibit 6. Below is a description of some of uses of this money.

Based on the Examiner’s analysis of the actual uses of the \$7,200,000, the money never went to Western Technologies. Rather, on October 29, 2008, it was transferred to the DBSI Inc. operating account. On the same and the following day, \$2,385,241 was swept into the TIC Operating Expenses account. From the \$7,200,000, an additional \$4,808,262.79 was transferred to the DBSI Inc. M&I Bank Operating account.

From the funds placed into the M&I account, a variety of legal fees were paid. Additional sums were transferred to GigOptix and Kastera. \$3,714,660.57 of the funds were transferred back to 2008 Notes and then redistributed. \$2,105,672 of that redistribution from 2008 Notes Corp. was transferred back to DBSI Inc. to pay additional legal fees and salaries on November 7, 2008, mere days before the Petition Date.

⁹⁸ The description for the transaction stated: “(fnds from 08 ntes to inc) fnds frm 08 ntes to Inc thru d westec n drr-though 08 notes gives fund to Inc, its going thru dwestec fr drr, as 08 notes gvng to dwestec to pydwn dwestec-drr payable, then drr pys dwn pyble to Inc.”

3. \$4,460,939 from 2008 Notes Corp. Booked as a Loan to FOR 1031

a. \$4,460,939 Loan Approval Documents

Among the intercompany transfers from the 2008 Notes was \$4,460,939, which was booked as a loan to FOR 1031.

The Loan Committee records document the approval of a loan to FOR 1031 on April 18, 2008. The records include a Promissory Note and a Pledge Agreement containing a schedule purporting to show that, on April 18, 2008, FOR 1031 borrowed the \$4,460,939 from the 2008 Notes using as collateral its 1% interest in 109 TIC properties. The loan committee records also reflect that this loan amount had an 85% LTV ratio by calculating 85% of the original TIC Sales Price (net of Accountable Reserves and debt).

The 1% interest in TIC properties that was used as collateral for the \$4,460, 939 loan was the retained ownership interest in real estate projects that were sold to TIC investors between 2003 and 2006. The Loan Committee records reflect no evaluation of the current worth of the 109 properties. There was also no evaluation as to whether the individual properties were performing and whether the residual 1% interest held by FOR 1031 had any value. Douglas Swenson signed the promissory note and pledge agreement on behalf of FOR 1031 LLC as its manager. He also signed the pledge agreement on behalf of the LLC that owned the 1% interest in the individual TIC properties. Further, he signed the pledge agreement for the secured party, DBSI 2008 Notes Corp., as its President.

b. Uses of \$4,460,939 of 2008 Notes Proceeds Loaned to FOR 1031

The Examiner analyzed the use of the \$4,460,929 in 2008 Notes Proceeds and determined that the money never went to FOR 1031. Rather, it was transferred to an account in the name of DBSI Properties, Inc. As summarized in the chart attached as Exhibit 7, the money then was transferred from the DBSI Properties Inc. account to “TIC Securities,” for use as “DBSI Closing and Broker Expenses,” and to the “TIC MM” and “DBSI Housing Inc. Operations” account. Some of the funds were used for commission and payroll expense.

4. \$18,700,002 in 2008 Notes Proceeds Loaned in Connection with the
“Riverview” Project

In September 2008, \$18,700,002 from the 2008 Notes was loaned in connection with the purchase of three contiguous parcels of unimproved land called the “Riverview” property. The \$18,700,002 was disbursed by 2008 Notes in three separate loans to three DBSI subsidiary LLCs (DBSI Villages of Riverview LLC, DBSI Villages of Riverview II LLC, and DBSI Villages of Riverview III LLC) for the purpose of acquiring the property.⁹⁹ Although the actual purchase price of the property was approximately 2/3 of the total loan amount, the loan was justified as conforming to the 85% LTV ratio required by the 2008 Notes Corp. PPM. This LTV ratio was based on an appraisal of the property obtained by DBSI.

The full amount of the three loans, \$18,700,002, was disbursed into a DBSI Inc. “Properties Operating” bank account at M&I Bank, and promissory notes secured by mortgages for the full amount of the loan were executed by the three LLCs and recorded. However, the full

⁹⁹ The amounts of the three separate loans were \$6,348,246, \$6,229,142, and \$6,122,612.

purchase price for the property was \$12,000,000, and only that amount was used to acquire the property. The remaining funds, totaling \$6,700,002, remained in the “Properties Operating” account, which is an unsegregated cash account.

- a. \$6,700,002 of the Riverview Loan Proceeds Used for DBSI Inc.
Operations

On September 10, 2008, two days after the purchase of the Riverview properties, \$6,122,612 – an amount precisely equaling one of the three loans to the subsidiary LLCs – was transferred to a “TIC Liquid Reserve” bank account held by DBSI Inc. Both the DBSI Inc. “Properties Operating” and “TIC Liquid Reserve” bank accounts are tied to the Debtor’s general ledger account #14000, which is also called a “liquid reserve” account.¹⁰⁰ This account had a zero balance when the remaining 2008 Notes Proceeds were deposited. Over the course of September 2008, the balance of that account again dwindled to zero as cash was disbursed to fund a variety of business expenses, including funding other property acquisitions, repaying investors in prior years’ Notes corporations, and funding business expenses that the Examiner is still in the process of identifying. The description of these transfers in company accounting records was not always complete or accurate, which significantly complicated the Examiner’s analysis. A spreadsheet detailing the use of these funds as currently known to the Examiner is attached as Exhibit 8. Below is further analysis of the subsequent uses of 2008 Notes Proceeds borrowed in connection with the Riverview property after the funds were transferred to the “Properties Operating” and “TIC Liquid Reserve” bank accounts:

¹⁰⁰ Because the two bank accounts are tied to the single GL account, there is no ledger entry accompanying this transfer of funds.

(1) Use of \$1,231,527.50 to Repay Prior Investors

On September 15, 2008, \$1,231,527.50 of the \$6,122,612 was transferred into the DBSI Inc. Operating Account, GL #11500. At the same time, Debtor's TIC Liquid Reserve bank account was credited in the same amount.

Reported: The records state that the transfer was "to cover outgoing interest payments."

Analyzed Use: Prior to this transfer, the DBSI Inc. GL account #11500 reflected a negative cash balance. The initial transfer of funds covered this negative balance. The remaining money was used by DBSI Inc. to repay the 2005, 2006, and 2008 Notes Corps, which in turn appear to have used the funds to make investor interest payments. For instance:

- 2005 Notes
 - \$265,660.03 was described as "pay-down pristine int to 05 notes"
- 2006 Notes
 - \$321,256.24 was described as "pay-down kastera inv int on 06 notes"
- 2008 Notes
 - \$150,000 was described as "Oakridge int pay-down by inc thru prop"
 - \$100,000 was described as "Spectrus Inv int pay-down by inc thru prop"
 - \$207,224.50 was described as "Stellar int pay-down by inc thru drr"

In each case, the general ledgers of the respective Notes Corporations reflect these sums being received, and then disbursed in smaller amounts described as “bond payments” to various persons and entities. The recipients of these payments were identified in the ledger entries and appear to be investors in the respective Notes Corporations.

(2) Transfer of \$2,952,000 to “Liquid Reserves”

On September 16 and 17, 2008, \$2,952,000 of the \$6,122,612 was transferred from DBSI Properties’ GL Operating Account to DBSI Inc.’s #11500 GL Operating Account.

Reported: \$2,402,000 was described as “funds transfer,” and \$550,000 was described as “transfer to cover outgoing wire.”

Analyzed Use: After being transferred to DBSI, Inc’s operating account, the funds were transferred on the same day to DBSI, Inc’s liquid reserve account, #14000. From there, the funds were transferred to DBSI, Inc’s cash clearing account, GL #14500, where the funds were commingled with funds from both Debtor and non-Debtor cash accounts.

Once in the cash clearing account and commingled with other funds, these 2008 loan proceeds were used to pay DBSI operating expenses. DBSI maintained over 700 cash accounts that were operated on a zero-balance or positive-pay cash management system, described *supra* at note 96. In DBSI’s case, these accounts included TIC entity, corporate, and bond-holder note accounts, among many others.

(3) Transfer of \$1,671,826.19 to a General Operating Account

On September 18, 19, and 23, 2008, the \$6,122,612 further funded three transfers totaling \$1,671,826,19 from the DBSI Properties GL operating account to the DBSI Inc. operating account.

Reported Use: Each of the three transfers was described as a “funds transfer.”

Analyzed Use: Following these three transfers, there were seventeen separate disbursements from the DBSI Inc. operating account for expenses, which were generally indicated in the journal entry description. These fund uses are fully identified in Exhibit 8, but some examples of the more significant amounts are as follows:

- \$383,890 was used by DBSI Inc. to pay insurance premiums;
- \$360,000 was used as earnest money in connection with other property acquisitions;
- \$350,000 was transferred to the DBSI Inc. cash clearing account; and
- \$125,000 was transferred to DBSI Realty’s GL #11500 “Operating Account” and was described as “to cover an overdraft.”

The remaining \$577,390 was never transferred out of the DBSI Inc. “Properties Operating” bank account into which the loan proceeds were initially deposited. Instead, these funds were consumed by operating expenses of DBSI Properties, Inc.

An e-mail (Exhibit 9) dated September 5, 2008, which was near the time of the Riverview acquisition and shortly before the Petition Date, sheds some light on the inner workings and cash flow difficulties of the company, and reflects the extent to which the Company relied on Note proceeds to fund the ongoing operations of the Company. This e-mail, which was written by Duckett, DDRS's Vice President of Finance and Accounting, to Jeremy Swenson, David Swenson, Bringham, Cole, and Douglas Swenson, reflects various anticipated uses of money from the 2008 Notes in September, including "GCC redemptions" and "to payoff GCC." It also notes that the "Villages at Ridgeview" (believed to be a reference to the Villages of Riverview) was moved to a September closing date. In connection with demands on the 2008 Notes funds, Duckett projected the 2008 Notes to have a negative balance by the end of September, which he proposed remedying by "[moving] collateral between different notes." However, he anticipated a "challenge" in late October when he predicted the company's working capital needs would outstrip by a significant margin the availability of Notes money.¹⁰¹

VIII. AVAILABILITY AND ALLOCATION OF FUNDING FOR THE EXAMINATION

As of the filing of this Interim Report, and although several fee requests have been filed with the Court, neither the Examiner nor any of his retained professionals have been paid for the substantial services rendered and costs incurred to date or reimbursed for the significant travel and other expenses they have incurred. As of the filing of this Interim Report, the Examiner and his retained professionals have requested total compensation and reimbursement of expenses in

¹⁰¹ Duckett wrote, "The challenge comes in late October when there is projected to be only around 6 million of total note availability with 7 million of collateral and approximately 10 million of working capital needed." (See Exh. 9)

the approximate amount of \$950,000. The Examiner and his retained professionals will shortly be filing their July compensation and expense requests.

For the first two months of the Examination, the Examiner and his retained professionals have requested approximately \$890,000 in fees and approximately \$60,000 in expenses. In his work plan and budget, the Examiner projected that the fees and expenses incurred during the first two months of the Examination would be \$1,072,000 and \$125,000, respectively. Accordingly, the Examiner was approximately \$180,000 under his fee estimate and \$65,000 under his expense budget for the first two months. Please note that these figures do not include April fees and expenses for the Examiner and HFC, which were incurred in preparing the work plan and budget and were not included in the Investigation budget.

Although final numbers are not yet available for July, fees and expenses will exceed what was budgeted. There are several reasons why. The Examiner and his retained professionals spent significant time and incurred expenses to prepare and write this Interim Report, which was not contemplated in the original work plan and budget. Furthermore, the analysis of the Debtors' complex accounting entries proved difficult and required peeling away layers of accounting transactions. In addition, the Examiner and his professionals spent significant time and incurred expenses preparing for and traveling to Boise, Idaho for the cancelled interview of Douglas Swenson and the motions practice associated with this.

There are two primary reasons why the Examiner has not been paid to date. First, the Committee has filed its Omnibus Limited Objection and Reservation of Rights to Applications for Compensation and Reimbursement of Expenses of the Examiner's Professionals (the "Committee Objection"). The Committee Objection asserts that no fees or reimbursement of

expenses should be paid to the Examiner and his professionals unless and until the Examiner recommends a procedure by which the costs of the Examination may be allocated among the respective Debtors.

Second, the Committee has advised the Examiner that it has demanded that the Debtors cease all payments to non-Ordinary course professionals pending a further overall agreement regarding the allocation of the administrative expenses of these cases. The Committee made this demand after learning of certain post-petition transfers of funds from certain Debtors largely to fund administrative expenses, but without attempting to determine the overall status of payments to professionals. This demand by the Committee has had the perverse effect of causing wide disparities in the compensation paid to professionals to date, with the Debtors' professionals having been paid, by far, the highest percentages of compensation requested.

Based upon the information learned by the Examiner to date, the pattern and practice of the Debtors prior to bankruptcy was to use money from any available source to fund their operations and obligations and to create after-the-fact ledger entries to justify their uses of funds in this manner. Funds were commingled and used without regard to their sources or intended purposes. Therefore, it will be difficult, and likely cost-prohibitive, to allocate and separately account for uses of funds by and among Tenant-in-Common Investors and Bond and Note Investors.

IX. CONCLUSION

The Examiner believes that the findings set forth herein are material, and that they may affect the future course of these Chapter 11 proceedings and the Court's judgment with respect to the continued role of the Examiner. Moreover, given certain of the findings herein, the Examiner

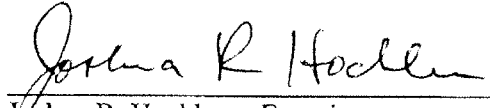
recommends refocusing his Examination on areas of greatest value to the Debtors and their Estates. Accordingly, the Examiner recommends that the Court and parties-in-interest consider the Examiner's proposal herein for work to be completed and undertaken.

The Examiner is concerned that significant time, expense and effort will go to waste if he does not complete the Investigation as set forth in Section V(B) above. The Examiner believes that he should continue his Investigation as set forth therein because the proposed areas of examination are important, will add value to the Estates, and will optimize the value of the work already done. The Examiner has consulted and will continue to consult with parties-in-interest. For now, the Examiner is continuing his efforts, but awaits further developments and the Court's instructions.

[SIGNATURES ON NEXT PAGE]

Respectfully Submitted,

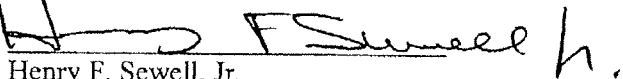
Dated: August 3, 2009
Wilmington, Delaware



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