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**STATE OF WASHINGTON
KING COUNTY SUPERIOR COURT**

STATE OF WASHINGTON,
DEPARTMENT OF FINANCIAL
INSTITUTIONS,

Plaintiff,

v.

CHESTERFIELD MORTGAGE
INVESTORS, INC., CHARLES M.
CHESTERFIELD AND KEY BANK,

Defendants.

NO. 10-2-32403-8 SEA

COMPLAINT FOR TEMPORARY
RESTRAINING ORDER,
PRELIMINARY INJUNCTION,
PERMANENT INJUNCTION AND
APPOINTMENT OF RECEIVER

I. NATURE OF ACTION

1. The State of Washington, Department of Financial Institutions, Securities Division (Department), commences this action against Defendants Chesterfield Mortgage Investors, Inc. and Charles M. Chesterfield. The Department seeks a temporary restraining order, preliminary injunction, and permanent injunction against all Defendants, as well as the appointment of a receiver, to prohibit Defendants Chesterfield Mortgage Investors, Inc. and Charles M. Chesterfield from improperly disposing of assets that belong to investors and to prevent further violations of the Securities Act of Washington, chapter 21.20 RCW.

1 originated by two mortgage paper securities broker-dealers that are out of business: Pacific
2 Coast Investment Company, Inc., a company in which Mr. Chesterfield was a one-third owner,
3 and Preferred Funding, Inc., an unrelated company.

4 8. From December 1999 until present, CMI has been registered with the
5 Department under RCW 21.20.210 and WAC chapter 460-33A to sell participation interest
6 investments in promissory notes secured by deeds of trust. These investments constitute
7 mortgage paper securities, as defined in WAC 460-33A-015(4). In addition, under RCW
8 21.20.040, CMI is registered as a mortgage paper securities broker-dealer, and Mr. Chesterfield
9 is registered as a mortgage paper securities salesperson.

10 9. Through a scheduled examination and its ongoing investigation of CMI, the
11 Department is informed and believes, and on that basis alleges, that CMI and Mr. Chesterfield
12 have each violated the Securities Act of Washington, chapter 21.20 RCW, by making
13 fraudulent representations and omissions to investors in violation of RCW 21.20.010(2), by
14 engaging in an act, practice, or course of business which operates as a fraud or deceit in
15 violation of RCW 21.20.010(3), by engaging in dishonest and unethical business practices in
16 violation of RCW 21.20.110, and by failing to meet the recordkeeping and reporting
17 obligations of a registered mortgage paper securities broker-dealer under RCW 21.20.110.

18 10. The Department is informed and believes, and on that basis alleges, that CMI
19 has commingled investor funds with the assets of CMI, in violation of WAC 460-33A-065.

20 11. The Department is informed and believes, and on that basis alleges, that CMI
21 has failed to keep records itemizing separately all proceeds of sales involving real property
22 securing a loan funded by sales of mortgage paper, in violation of WAC 460-33A-115.

23 A. CMI's Insolvency and Accounting Irregularities

24 12. The Department is informed and believes, and on that basis alleges, that CMI is
25 likely insolvent. Examiner McBride performed an analysis of the equity in CMI starting with
26 the December 31, 2009 independently audited balance sheet and ending with CMI's May 31,

1 2010 Trial Balance. According to this analysis, CMI had an adjusted Negative Equity of
2 \$325,717.10. Additionally, CMI reported a net loss of \$253,550 during 2009, and CMI's
3 internally generated Profit & Loss statement for January through May 2010 shows a net loss of
4 \$12,467.30.

5 13. During the Department's examination, the examiners gathered information
6 suggesting that CMI's financial condition was deteriorating, including a change in CMI's
7 lending relationship with Key Bank. Prior to July 31, 2010, CMI used its line of credit to
8 originate loans to borrowers. On July 31, 2010, CMI's line of credit with Key Bank was
9 changed into a commercial loan, administered by Key Bank's Bellevue Asset Recovery Group,
10 rendering the line of credit unavailable for funding loans as no further draws or advances were
11 allowed. As of July 31, 2010, the principal amount of the commercial loan was \$964,984.00.
12 The commercial loan agreement requires payments of \$50,000 per month until December 31,
13 2010, when the loan comes due in full.

14 14. The Department is informed and believes, and on that basis alleges, that CMI
15 also recorded a liability for the removal of investor funds in CMI's General Ledger. During
16 the Department's examination, Examiner McBride identified a general ledger entry for
17 December 31, 2009 crediting \$1,345,911.08 to Investor Loans Payable. The entry explanation
18 indicated that CMI's financial statements were being adjusted to account for the \$1,345,911.08
19 that should have been paid to investors, but was removed by CMI. Examiner McBride
20 identified similar notations during the examination review of CMI's records.

21 15. The Department is informed and believes, and on that basis alleges, that during
22 the Department examination, CMI declined to contact their external auditors to obtain detail
23 for the composition of the amounts owed to investors when asked to do so by Examiner
24 McBride. When the Department contacted the outside auditor directly to obtain this
25 information, the auditor's attorney responded with an email message on July 22, 2010,
26 indicating the auditor had withdrawn their opinion on CMI's audited financial statements. The

1 email further stated that CMI had provided the auditors with written assurance that on July 23,
2 2010 CMI had notified the Department about the withdrawal. This failure to notify the
3 Department of the withdrawn opinion on CMI's audited financial statements while continuing
4 to offer or sell securities violates RCW 21.21.110.

5 B. Misuse of Investor Funds and Unfunded Loan Liabilities

6 16. The Department is informed and believes, and on that basis alleges, that CMI's
7 books and records document misuse of investor funds. CMI's General Account is for the
8 company's business operations. CMI's Collection Trust Account is the bank account where
9 funds from borrowers are deposited before being repaid to investors. CMI improperly used
10 funds belonging to investors to finance its business operations. CMI provided the Examiners a
11 Schedule of withdrawals and reimbursements for amounts owed to the Collection Trust
12 Account from the General Account. The Schedule shows that a net total of \$2,604,836.80 was
13 transferred from the Collection Trust Account to the General Account between January 5, 2009
14 and April 8, 2010. Twenty-one improper transfers were confirmed by Examiner McBride
15 during that time period.

16 17. The Department is informed and believes, and on that basis alleges, that as of
17 December 31, 2009, CMI owed the Collection Trust Account \$2,376,057 in unfunded loan
18 liabilities. The unfunded loan liabilities represent amounts belonging to investors that CMI
19 must restore to its Collection Trust Account. By failing to deposit borrower funds in the
20 Collection Trust Account to establish loan reserves for the benefit of investors and
21 withdrawing funds from the Collection Trust Account that came from early loan payoffs, CMI
22 converted investor funds for its own use.

23 18. Prior to the examination, Lead Examiner Bernadette McBride reviewed CMI's
24 2009 audited financial statements and contacted Edward M. Hunter (Mr. Hunter), Vice
25 President of CMI, regarding the approximately \$2.3 million owed to the Collection Trust
26 Account. Mr. Hunter confirmed that CMI owed the Collection Trust Account \$2.3 million.

1 Mr. Chesterfield also admitted to the Financial Examiners that funds from early loan payoffs
2 intended to repay investors were improperly used by CMI to fund loans to other CMI
3 borrowers; to make payments for the benefit of investors in other loans; and to pay legal and
4 property expenses associated with foreclosed property or Real Estate Owned (REO) property.¹

5 19. The Department is informed and believes, and on that basis alleges, that CMI's
6 March 31, 2010 financial statement filed with the Department on May 4, 2010 shows CMI had
7 Unfunded Loan Liabilities of \$3,132,091. The Department subsequently received two letters
8 from Mr. Hunter regarding possible misstatements in the financial statements for the quarters
9 ending in December 31, 2009 and March 31, 2010. The letters promised that CMI would
10 forward any revised versions of the financial statements to the Department. To date, the
11 Department has never received any revisions

12 20. The Department is informed and believes, and on that basis alleges, that rather
13 than repaying all of the investors who had purchased participation interest investments in the
14 loans, CMI is making only partial repayments to selected investors and misappropriating the
15 remaining loan proceeds. Rosa Collins (Ms. Collins), Vice President of CMI, gave the
16 Examiners a set of Loan Funding Worksheets for seven different loans showing the status of
17 investments in those loans. The worksheets showed a total of \$1,267,081.12 of "On Account"
18 investments. Mr. Hunter explained that "On Account" means the investor has not been repaid.
19 The worksheets also listed "Reinvestments" that totaled approximately \$400,000. Except for
20 two investments, CMI did not identify the new loans that replaced the paid off loans.

21 21. The Department is informed and believes, and on that basis alleges, that
22 Mr. Chesterfield used company funds to pay for his own personal expenses. During the
23 examination, the Financial Examiners questioned Mr. Hunter about CMI's 2009 audited

24 ¹ Real Estate Owned (REO) property is real property that has already been foreclosed, but is being held
25 for resale. Title to the REO property is supposed to be held by CMI in a fiduciary capacity, as the agent for the
26 investors who purchased participation interests in the original loan transaction that created the real property
security interest.

1 financial statements, specifically Note 15, which describes a related party transaction. Based
2 upon the information in Note 15, CMI has advanced more than \$300,000 worth of interest
3 payments and property carrying costs for Mr. Chesterfield's personal benefit.

4 22. The Department is informed and believes, and on that basis alleges, that from
5 January 1, 2009 through March 31, 2010, CMI offered and sold more than \$18,000,000 worth
6 of mortgage paper securities under its permit to sell mortgage paper securities. When offering
7 and selling those investments, CMI should have disclosed, but failed to disclose, to the
8 investors that CMI was misusing investor funds.

9 C. Loans Held for Sale in Default

10 23. The Department is informed and believes, and on that basis alleges, that loans
11 held for sale are in default. CMI's 2009 audited financial statements, Note 2, stated that
12 "interest was not accruing on fifteen loans that were more than 90 days past due. The
13 investment in those fifteen loans was \$3,380,090, net of unearned loaned fees." The December
14 31, 2009 Balance Sheet showed that total Loans Held for Sale were \$4,269,055 or, in other
15 words, that 79% of CMI's Loans Held for Sale as 90 days or more past due as of December 31,
16 2009.

17 24. The Department is informed and believes, and on that basis alleges, that CMI
18 has so many loans in default, it likely needs to establish a Reserve for Uncollectable Loans.
19 Information gathered during the Department's examination shows that as of June 30, 2010, 30
20 CMI loans totaling \$14,841,500 were in default. These loans were originated by or serviced by
21 CMI. In addition, as of June 30, 2010, seven properties secured loans totaling \$5,342,500 were
22 REO.

23 D. Unauthorized Reconveyance of Real Property Security Interests

24 25. The Department is informed and believes, and on that basis alleges, that CMI
25 reconveyed the real property securing investments without authorization from the investors.
26 At least four loans totaling more than \$1 million were paid off early and investor payoff funds

1 were misappropriated by CMI.² Following the early pay-off, CMI reconveyed the real
2 property that had secured those investments. The reconveyances left the investors without any
3 real property security for their investments. The investments were originally offered and sold
4 as real estate secured loans with a first lien position deed of trust. Janet So, Enforcement
5 Attorney for the Department, reviewed four loans and found that when the loans were paid off,
6 the deed of trust originally securing the investments in the loans was reconveyed. It appears
7 that investors who were not repaid became general unsecured creditors of CMI.

8 E. False and Misleading Investor Account Statements

9 26. The Department is informed and believes, and on that basis alleges, that CMI
10 issued false and misleading monthly investor account statements. CMI provided the
11 Examiners with the June 10, 2010 CMI investor account statements. The statements falsely
12 show that some paid off loans are still outstanding. The investor statements further show that
13 interest payments are still being made on the loans without identifying the source of the
14 payments. The statements also list a projected loan maturity date that is no longer valid
15 because the underlying loan has already been repaid.

16 F. Uncollectable Notes Receivable

17 27. The Department is informed and believes, and on that basis alleges, that two of
18 the Notes Receivable listed on CMI's March 31, 2010 balance sheet and its December 31,
19 2009 balance sheets may be uncollectable. First, during the Department examination, Mr.
20 Chesterfield admitted to Examiner McBride that a \$152,000 Note Receivable, evidenced by an
21 unsigned and unsecured promissory note was given to CMI to cover a borrower payoff
22 deficiency, was likely uncollectable. Second, Mr. Chesterfield borrowed \$646,000 from CMI
23 and in exchange he gave the company the \$646,000 Note Receivable. The Note from
24 Stockholder, Mr. Chesterfield, requires interest only payments at 5%, with principal maturing

25 _____
26 ² The four investments were Loan No.7036, Loan No.7049, Loan No.7057, and Loan No.7075.

1 on January 1, 2014. Mr. Hunter informed Examiner McBride that Mr. Chesterfield has not
2 been making interest payments on the note. The May 31, 2010 Trial Balance for CMI's
3 General Ledger shows Account No.1317, Accrued Interest on Note Receivable, as \$43,645.83.
4 This amount appears to represent approximately 16 months of unpaid interest for the \$646,000
5 unsecured note from Mr. Chesterfield to CMI. It is unclear whether Mr. Chesterfield has the
6 ability to repay the \$646,000 note to the company.

7 28. For the reasons set forth in paragraphs 7 through 29 above, the Department
8 believes CMI is insolvent and poses significant risk to the investing public as demonstrated by
9 the violations of the Securities Act of Washington alleged herein.

10 **V. TEMPORARY RESTRAINING ORDER**

11 29. The Department hereby realleges paragraphs 1 through 28 as if fully set forth
12 herein.

13 30. Pursuant to RCW 21.20.390(2), upon proper showing, the court may grant the
14 Department a temporary or permanent injunction, or restraining order, to preserve a
15 defendant's assets.

16 31. The continued acts of Defendants CMI and Mr. Chesterfield complained of
17 herein, as well as the disposal of any investment proceeds or monies received from investors,
18 will result in irreparable injury and loss to investors. The Department has a clear legal and
19 equitable right under the Securities Act to prevent Defendants from causing harm to investors
20 and from further violating the Securities Act of Washington.

21 32. The Department has a substantial likelihood of prevailing on the merits.

22 33. The Department is entitled to a temporary restraining order prohibiting all
23 named Defendants from disposing of, in any manner, funds held in bank accounts owned, or in
24 the name of, Defendants CMI and Mr. Chesterfield. The Department is informed and believes
25 that said accounts contain investor proceeds, investor monies, and/or ill-gotten gains relating to
26 sales of securities to investors.

1 **VI. PRELIMINARY INJUNCTION**

2 34. The Department hereby realleges paragraphs 1 through 33 as if fully set forth
3 herein.

4 35. The Department has a clear legal and equitable right under the Securities Act to
5 prevent the Defendants from disposal of any investor proceeds, investor monies, or ill-gotten
6 gains received from investors and has a well-grounded fear of immediate invasion of that right
7 during the pendency of this action.

8 36. The Department is entitled to a preliminary injunction prohibiting Defendants
9 from disposing of, in any manner, funds held in bank accounts owned, or in the name of
10 Chesterfield Mortgage Investors, Inc. and Mr. Chesterfield. The Department is informed and
11 believes that said accounts contain investor proceeds, investor monies, and/or ill-gotten gains
12 from the sale of securities to investors.

13 **VII. PERMANENT INJUNCTION**

14 37. The Department hereby realleges paragraphs 1 through 38 as if fully set forth
15 herein.

16 38. The Department has a clear legal and equitable right under the Securities Act to
17 prevent the Defendants from disposal of any investor proceeds, investor monies, or ill-gotten
18 gains received from investors.

19 39. The Department is entitled to a permanent injunction against Defendants
20 prohibiting Defendants from disposing of, in any manner, funds held in bank accounts owned,
21 or in the name of Chesterfield Mortgage Investors, Inc. and Mr. Chesterfield. The Department
22 is informed and believes that said accounts contain investor proceeds, investor monies, and/or
23 ill-gotten gains from the sale of securities to investors.

24 **VIII. APPOINTMENT OF A RECEIVER**

25 40. The Department hereby realleges paragraphs 1 through 39 as if fully set forth
26 herein.

1 1. That the Court temporarily, preliminarily, and upon Final Judgment,
2 permanently prohibit Defendants Chesterfield Mortgage Investors, Inc. and Mr. Chesterfield,
3 and the agents, employees and officers of Chesterfield Mortgage Investors, Inc. from
4 withdrawing, transferring, assigning, selling, pledging, hypothecating, changing, wasting,
5 dissipating, converting, concealing, encumbering, or otherwise disposing of any assets held by
6 Chesterfield Mortgage Investors, Inc., whether obtained from investors or borrowers, including
7 but not limited to investor funds or borrower payments received by them, held in an account in
8 the name of them, or under the control of Chesterfield Mortgage Investors, Inc. and Mr.
9 Chesterfield, until such time that a receiver can be appointed to take control of such assets of
10 Chesterfield Mortgage Investors, Inc. and properly disburse the same;

11 2. That the Court temporarily, preliminarily, and upon Final Judgment
12 permanently, restrain Key Bank from permitting or in any way assisting with the withdrawal,
13 transferring, changing, wasting, dissipating, converting, concealing, encumbering, or otherwise
14 disposing of any funds received by, held in an account in the name of, or under the control of
15 Chesterfield Mortgage Investors, Inc. and Mr. Chesterfield until such time that a receiver can
16 be appointed to take control of such assets and properly disburse the same;

17 3. That the Court appoint a receiver for Chesterfield Mortgage Investors, Inc. to
18 (1) preserve the status quo, (2) ascertain the financial condition of Chesterfield Mortgage
19 Investors, Inc., (3) take control of investor proceeds held by Chesterfield Mortgage Investors,
20 Inc. and Mr. Chesterfield, (4) prevent further dissipation of the property and assets of
21 Chesterfield Mortgage Investors, Inc. and assets held in an account in the name of, or under the
22 control of Chesterfield Mortgage Investors, Inc. and Mr. Chesterfield for the benefit of
23 investors of Chesterfield Mortgage Investors, Inc. to prevent loss, damage, and injury to
24 investors, (5) be available to respond to investor inquiries, and (6) ascertain legitimate creditors
25 and disburse assets;

