

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

UNITED STATES OF AMERICA,)
) No. 06 CR 964
)
 v.) Judge Ronald Guzman
)
 MICHAEL E. KELLY)

EIGHTH STATUS REPORT OF THE SPECIAL MASTER

Douglas A. Doetsch, the court-appointed special master (the “Special Master”) in the case of *United States of America v. Michael E. Kelly*, hereby submits this Seventh Status Report of the Special Master, pursuant to this Court’s Order Appointing Douglas A. Doetsch As Special Master dated February 10, 2009 (the “Order”), to update the Court and interested parties on the status of the Special Master’s progress since July 10, 2010 through October 8, 2010 (the “Reporting Period”) with respect to the goals of his appointment: namely, preserving and repatriating Assets as defined in the Order potentially subject to forfeiture, administering their liquidation, and distributing restitution to the victims of the Defendant.

I. THE PLAN OF ACTION

Under the terms of the Order, the Special Master presented a plan of action within ninety days of the Order date to (a) advise the court of the Special Master’s appraisal and valuation of the assets subject to liquidation for restitution (the “Assets”); (b) determine whether additional funds will be necessary to make full restitution to the victims and pay the fees and expenses of the Special Master and his retained professionals; (c) if necessary, advise the court as to additional steps that need to be taken to investigate, evaluate, obtain and liquidate such Assets; and (d) recommend a methodology, timetable and approximate cost associated with the control, possession and liquidation of the Assets with an end goal of making restitution to the victims (the “Plan of Action”). On June 19, 2009, the Special Master filed his Plan of Action under seal with the Court. The Special Master’s Plan of Action (i) set forth the preliminary results of the diligence and valuation exercise involving the Grupo Kelly entities in Panama and Mexico; (ii) described the optimal legal structure to permit the Special Master to obtain control over the Assets and the companies owning and operating the Assets as a Mexican trust; (iii) identified certain “Exhibit B” assets that could be subjected to the Mexican trust and liquidated if necessary; (iv) addressed issues of victim restitution and sales strategy; and (v) identified potential obstacles and next steps in each of the aforementioned areas.

II. THE ASSETS

A. Cash

The Special Master has received a total of USD 6,400,000 in cash from Grupo Kelly, which has been deposited in an account maintained by Mayer Brown (the “Special Master’s Operating Account”). In addition, on December 16, 2009, the Special Master received Court approval to consummate the sale of the Aguascalientes Property (as described in a prior Status Report submitted to the Court). The proceeds related to the Aguascalientes sale were deposited into the Special Master’s Sales Proceeds Account (the “Special Master’s Sales Proceeds Account”) for the benefit of the victims. Taking into account interest accruals and disbursements to outside professionals for services rendered to the Special Master since February 10, 2009, the balance of cash and investments in the Special Master’s Operating Account as of September 30, 2010 is USD 1,133,662.59 and the balance of sale proceeds in the Special Master’s Sales Proceeds Account as of September 30, 2010 is USD 983,489.17.

B. The Assets

1. Formation of the Restitution Trust and Contribution of Exhibit B Assets

On July 17, 2009, the Special Master, with the assistance of Jáuregui, Navarrete y Nader, S.C. (“JNN”), Mexican counsel to the Special Master, and Arias, Fabrega & Fabrega (“ARIFA”), Panamanian counsel to the Special Master, completed the formation of a trust in Mexico to hold the Assets (the “Restitution Trust”). One salient feature of the final Restitution Trust is that it contemplates the post-execution joinder of assets as necessary to make full restitution to the victims. Accordingly, on October 9, 2009, several Exhibit B Assets (as defined in the Fourth Status Report of the Special Master) were contributed to the Restitution Trust. The Special Master is currently involved in discussions with the U.S. Attorney’s Office (the “USAO”) and with Grupo Kelly to consider other assets that may be suitable for contribution to the Restitution Trust, as appropriate.

2. Strategies to Minimize Corporate Expenses

To address the liquidity crisis experienced by Grupo Kelly in light of a sluggish real estate market and generally weak global economy, the Special Master has been working with Grupo Kelly and Frontera Capital Advisors (“Frontera”). The Special Master has previously eliminated the vacation club operation and terminated a senior employee in furtherance of this goal. Additionally, the Special Master is working with JNN to renegotiate employment agreements with several other senior employees. The aggregate savings resulting from these head-count reductions, the employment contract revisions, and the closing of the vacation club operation are approximately \$1,000,000 per year.

The Special Master continues to look for cost-savings opportunities from an ongoing operational perspective. The managers of the hotel operations and the Puerto Cancún project (“Puerto Cancún”) have also been instructed to implement cost-saving measures. The eventual sale of the Assets may also provide an opportunity to further downsize the corporate infrastructure supporting the operating companies.

3. The Asset Sale Process: Salient Points

a. Tax Review

The Special Master, with the assistance of Del Valle Torres (“DVT”), Mexican tax counsel to the Special Master, has invested significant time in analyzing the tax implications of a potential sale of the various Assets currently subject to the Restitution Trust. This analysis has involved reviewing the balance sheets and tax accounts of the various Grupo Kelly corporations and, in particular, focusing on the substantial intercompany accounts and how to best address such intercompany balances in order to minimize adverse tax consequences for the disposition of Assets. JNN and DVT, under the oversight of the Special Master, are presently engaged in certain corporate restructuring steps relating to specific Grupo Kelly entities (*e.g.*, mergers of certain entities) that should permit the Special Master to maximize the proceeds of particular Asset sales available to make restitution to the victims. Specifically, current tax structuring efforts are focused on Puerto Cancún given the progress made in the sales process for this Asset.

b. Sales Process for the City Discotheque

As described in the Seventh Status Report, the Special Master and FTI identified a potential purchaser for the City Discotheque (the “City”) and executed purchase and sale documentation for the same, but, unfortunately, this sale was never consummated. However, the Special Master and Frontera have identified another purchaser and they are currently working to negotiate sales documentation and execute the same. Once documentation for the sale of the City has been executed, the Special Master will coordinate with JNN to prepare a notice of sale and, once publication has been completed, the Special Master will present the terms of the sale to this Court for its approval.

c. Sales Process for Puerto Cancún

The Special Master met with FONATUR senior officials in Mexico City, Mexico on September 1, 2010, to brief them on the Puerto Cancún sale process. The Special Master received and evaluated preliminary bids and chose several bidders to advance to the diligence stage of the process for Puerto Cancún. Once the bidders executed nondisclosure agreements, they were able to commence electronic due diligence through an electronic due diligence site maintained by Mayer Brown. Throughout August and the first week of September, prospective bidders sent management teams to Cancun to meet with Puerto Cancún’s management team, Mayer Brown, and Frontera to conduct on-site diligence.

Bidders will have access to the electronic due diligence site until October 31, 2010. The Special Master anticipates that bidders will submit binding offers for the shares of Promotora de Desarrollos de Puerto Cancun, S.A. de C.V., the owner of the Puerto Cancún assets, or the Puerto Cancún assets by November 1, 2010, along with a refundable bid participation deposit. The Special Master expects to complete his evaluation of the bids for the Puerto Cancún on or before the end of 2010. Bids will be evaluated on a number of criteria in addition to the actual dollar amount of the bid to determine which offer is in the best interest of the victims, including,

but not limited to, the net amount to be received (after taxes, fees, etc.), structure of the sale, certainty of payment and speed of payment.

The Special Master likely will then select one bidder to enter into good faith negotiations for a mutually agreeable definitive agreement, for the sale of the Puerto Cancún. The Special Master will endeavor to close a sale as promptly as possible after executing the sale documentation. Once documentation for the sale of the Puerto Cancún has been executed, the Special Master will coordinate with JNN to prepare a notice of sale and, once publication has been completed, the Special Master will present the terms of the sale to this Court for its approval

d. Financial Monitoring Process

Since the beginning of October 2009, Grupo Kelly has published, on a weekly basis, a rolling 13-week company-by-company cash flow model (the "Cash Flow Model") to forecast income and expenses (the "Cash Flow Forecast"). On a weekly basis, the Special Master has hosted a conference call with Grupo Kelly management and Frontera to review these forecasts. The Cash Flow Model and Cash Flow Forecast have been effective in highlighting operational strengths and weaknesses within the Grupo Kelly companies and providing the Special Master with up-to-date information to make operational decisions related to the Assets.

e. Bella Vista

The Special Master and Frontera have been in discussions with Grupo Kelly regarding the future of the Bella Vista Towers project ("Bella Vista"). The parties are analyzing the viability of the construction of Towers Three and Four at Bella Vista. The first two Towers are basically finished, with only minor finishing still remaining to be completed. The Special Master, Frontera and Grupo Kelly are in the process of evaluating the economic implications of finishing construction on only three of the four towers versus completing the construction of all four towers as originally planned. The Special Master is also considering other strategic options to effectively minimize costs relating to the continued construction of Bella Vista.

In addition, the Special Master, together with Grupo Kelly, is in the process of analyzing the legal documentation provided by Grupo Kelly related to Bella Vista purchasers to verify and decide which units shall be delivered and whether there are any defaulting purchasers. Grupo Kelly, in turn, is reaching out to purchasers to obtain additional records. This analysis will inform the decisions as to whether to finish Tower Three and to construct Tower Four.

f. Panamanian Issues

During this Reporting Period, the Special Master has worked, with the assistance of ARIFA, Panamanian counsel to the Special Master, to address two marketability issues involving the Grupo Kelly corporate entities in Panama that must be resolved prior to the sale of the Avalon Grand Panama Hotel (the "Avalon Grand Panama"): (a) corporate irregularities affecting the Panamanian shares and (b) a lien linked to a payable owed to the current manager of the Avalon Grand Panama property.

With respect to the first marketability issue, under the terms of the Restitution Trust, the corporate irregularities affecting the shares of the Panamanian entities subject to the Restitution Trust were rectified and the shares were revised. Panamanian corporate books were delivered to the Bank of New York Mellon, S.A. as Trustee under the Restitution Trust. Consequently, the Special Master presently effectively holds legal title to such Panamanian corporations, thus facilitating an eventual sale of the Avalon Grand Panama.

With respect to the second marketability issue, the general manager of the Avalon Grand Panama, through a corporate entity that he controls, has a lien upon the Avalon Grand Panama that effectively blocks the Special Master's ability to sell the hotel. The Special Master and ARIFA are involved in negotiations with the general manager and his counsel to finalize a draft settlement agreement, and to modify the form of lien held by the general manager in order to facilitate a sale. The Special Master has recently agreed to issue a mortgage in favor of a collateral agent (holding on behalf of the general manager) in exchange for the general manager lifting his judicial lien. ARIFA is currently assisting the Special Master to document a collateral agency agreement.

Recently, the Avalon Grand Panama has seen an increase in union activity originating with a hospitality union organized at the national level. This union filed an employee complaint on September 9, 2010 demanding a variety of improvements to the employment conditions. The Avalon Grand Panama is currently involved in negotiations with the relevant Panamanian regulatory body and with the union to address these claims but, if successful, the implementation of demands may have a detrimental effect on the cash flow at the Avalon Grand Panama.

III. THE VICTIMS

A. The Universal Lease Files

The Universal Lease files have been produced by Grupo Kelly and have been scanned by the USAO. The USAO conducted an audit of the calculation of the victims' restitution claims provided by Grupo Kelly against the Universal Lease information the USAO has received directly from the victims in October - December 2009. Generally, the USAO's audit found that the information provided by Grupo Kelly was consistent with the information provided by the victims.

B. The Victim Claim Process: Salient Points

The Special Master and the Special Master's Claim Processing Agent ("Stenger"), in consultation with the USAO, drafted a proposed Amended Claims Procedure Order (the "Amended Claims Procedure Order"), which was approved by this Court on June 14, 2010. The Amended Claims Procedure Order gave the Special Master and Stenger sixty days from the date the Claims Procedure Order became effective to send each victim a Victim Claim Form with the total restitution amount that each victim is entitled to receive should the Special Master be able to make full restitution to all victims (the "Total Restitution Amount"),¹ as well as an explanation

¹ The Total Restitution Amount will be the basis for the claim; however, the amount of the actual distribution received by each victim will be reduced depending on the amount of funds available for distribution. All victims

of how the Special Master and Stenger reached that value. Stenger sent 8,113 claim forms to the victims between June 24 and June 25, 2010 and has sent an additional 953 claim forms per request.

The Amended Claims Procedure Order requires each victim to review their Claim Form and either approve the calculated Total Restitution Amount or ask for a recalculation of the Total Restitution Amount. The Victim Claim Form also asks the victims to terminate their leases and release their claims on the properties themselves to allow the properties to be sold free and clear of all liens and/or liabilities in order to receive the maximum value possible. (Any claims a victim might have against Michael E. Kelly in his personal capacity, however, will not be affected by this release.)

In an effort to clarify questions raised by victims in regard to both the waiver language included with the Victim Claim Form and the deadline for submission of the Victim Claim Form as outlined in the Amended Claims Procedure Order, the Special Master submitted a proposed Superseding Claims Procedure Order (the "Superseding Claims Procedure Order") to the Court, which was approved on July 28, 2010. The Superseding Claims Procedure Order made three clarifications. First, it made clear that the Claims Bar Date referred to in the Amended Claims Procedure Order was actually the deadline to challenge the Total Restitution Amount, rather than a bar to receiving restitution generally. Second, the Superseding Claims Procedure Order approved the sending of a Substitute Waiver/Release (the "Substitute Waiver") to make it clear that the waiver applied only to certain Assets (as defined in the Amended Claims Procedure Order) that currently are or may come under the control of the Court through the Special Master and any other assets of the Defendant are subject to legal actions and other legal rights of any victim. The Substitute Waiver also did not apply to any claims that victims may have against Michael E. Kelly or any agent, servant, or co-conspirator of Michael E. Kelly.

Finally, a Substitute Waiver form was sent to all identified victims on August 13, 2010, which included a clarifying letter that outlined these changes and highlighted the fact that victims were not required to sign a waiver in order to participate in the restitution program. However, as discussed between the Special Master and the USAO, the Substitute Waiver stressed the importance of the Special Master and Stenger receiving the waivers from the victims. Pursuant to advice received from both JNN and ARIFA, until the victims largely have released their claims on the hotel properties, the Special Master's ability to market effectively these properties will be compromised (due to potential purchasers' concerns regarding the properties being free and clear of adverse claims).

As of October 5, 2010, Stenger has received 6,309 executed Victim Claim Forms from the victims. Of the 6,309 executed Victim Claim Forms, only 14.3% of victims disagreed with their claim as calculated by Stenger. An additional 2.1% neglected to return all pages of the Victim Claim Form. Also, 5,736 Substitute Waivers were returned. Of those 5,736 Substitute Waivers, 83.7% agreed to waive their claims to the Assets, 12.3% did not agree, and 3.9%

will receive a pro rata share of the proceeds available for restitution if there are not enough proceeds from the liquidation of the Assets to make full restitution to all victims, provided they have not already received distributions greater than their pro rata share.

returned a blank form. Victims had until September 24, 2010 to contest the calculation of their Total Restitution Amount and provide supporting documentation. Although the deadline for objecting to the Total Restitution Amount has now passed, Stenger is in the process of following up with those victims who have either not submitted a Victim Claim Form, have not submitted a Substitute Waiver/Release or who failed to fully complete either document.

The most common objection to the calculation of the Total Restitution Amount is that promised interest (or in a few cases promised rental payments) on the Universal Lease should be included in the Total Restitution calculation. Other objections were that: (a) the initial lease investment or payments received were calculated incorrectly, or (b) restitution should be based on current fair market value of lease, not net investment. Once Stenger has obtained and reviewed the remaining outstanding Victim Claim Forms, the Special Master will raise these objections, and any other objections that may arise, with the Court for resolution.

While the liquidation of Kelly's Assets may take a considerable amount of time to complete, the Special Master does anticipate being able to make periodic restitution payments to victims on a rolling basis as substantial Assets are sold. The Special Master will decide at his discretion, with the guidance of the Court, when such distributions can be made. Distributions will be made equitably on a pro rata basis to the victims.

C. Victim Communication

Very few victims have contacted the Special Master at this point, and the Special Master has not had cause to contact victims himself. Any victim who has contacted the Special Master directly was referred to the resources provided by the USAO, which include:

- 1) a telephone line established by the USAO dedicated to addressing victims' questions. The telephone number associated with such phone line is: (866) 364-2621;
- 2) an email address established by the USAO dedicated to addressing victims' questions. The email address is as follows: USAILN-Victim.MK@usa.doj.gov;
- 3) for victims who have already been identified, the USAO has created a password protected website, www.notify.usdoj.gov, which victims can access with a Victim Identification Number ("VIN") and Personal Identification Number ("PIN") provided to them by the USAO. Victims should call (866) 625-1631 if they have any problems accessing such website; and
- 4) for victims who have already been identified and do not have access to the Internet, the USAO has also established a call center, (866) DOJ-4YOU (1-866-365-4968), which victims can access with the same VIN and PIN provided to them by the USAO.

IV. CONTINUING STRATEGY

The Special Master will continue his efforts to transfer control of the Assets to the Restitution Trust or otherwise take control of additional assets or the proceeds therefrom, analyze the value and sale prospects of Assets, prepare a sales strategy for the various Assets, and

facilitate the sale of such Assets. Additionally, the Special Master continues to engage in regular discussions with Grupo Kelly regarding the financial performance of the Assets.

CONCLUSION

The Special Master shall continue to perform his responsibilities and duties consistent with the Order and all other directives of this Court.

RESPECTFULLY SUBMITTED this 11th day of October 2010.

/s/ Douglas A. Doetsch

Douglas A. Doetsch, Special Master

Exhibit A

Standardized Fund Accounting Report

FUND ACCOUNTING (See Instructions):				
		Detail	Subtotal	Grand Total
Line 1	Beginning Balance (As of 07/01/2010):	\$3,285,854.95	\$3,285,854.95	\$3,285,854.95
	Increase/ Decreases in Fund Balance:			
Line 2	Business Income	-	-	-
Line 3	Cash and Securities	-	-	-
Line 4	Interest / Dividend Income/ Loss	\$1,936.90	\$1,936.90	\$1,936.90
Line 5	Business Asset Liquidation	-	-	-
Line 6	Personal Asset Liquidation	-	-	-
Line 7	Third-Party Litigation Income	-	-	-
Line 8	Miscellaneous - Other (transferred by the defendant)	-	-	-
	Total Funds Available (Lines 1 – 8):	\$3,287,791.85	\$3,287,791.85	\$3,287,791.85
	Decreases in Fund Balance:			
Line 9	Disbursements to Investors	-	-	-
	Total Disbursements for Receivership Operations	-	-	-
Line 10	Disbursements for Distribution Expenses Paid by the Fund:	-	-	-
	1. Fees:			
	Special Master (including related U.S. legal fees and expenses).....	\$374,883.15	\$374,883.15	\$374,883.15
	Independent Distribution Consultant (IDC).....	-	-	-
	Distribution Agent.....	-	-	-
	Consultants.....	\$502,543.20	\$502,543.20	\$502,543.20
	Other Legal Advisers.....	\$135,952.39	\$135,952.39	\$135,952.39
	Tax Advisers.....	\$129,353.85	\$129,353.85	\$129,353.85
	Claims Processing.....	\$27,857.50	\$27,857.50	\$27,857.50
	2. Administrative Expenses	-	-	-
	3. Miscellaneous (wire transfer fee)	\$50.00	\$50.00	\$50.00
Line 11	Disbursements to Court/Other:	-	-	-
Line 11a	Investment Expenses/Court Registry Investment System (CRIS) Fees	-	-	-
Line 11b	Federal Tax Payments	-	-	-
	Total Disbursements to Court/Other:	-	-	-
	Total Funds Disbursed (Lines 9 – 11):	\$1,170,640.09	\$1,170,640.09	\$1,170,640.09
Line 12	Ending Fund Balance (As of 09/30/2010):			\$2,117,151.76
Line 12a	Cash and Cash Equivalents			\$1,854,030.33
Line 12b	Investments			\$263,121.43
	Additional disclosure on the Ending Fund Balance:			
Line 12c	Operating Account			\$1,133,662.59
Line 12b	Sales Proceeds Account			\$983,489.17

OTHER SUPPLEMENTAL INFORMATION:		Detail	Subtotal	Grand Total
Line 14	Report of Items NOT To Be Paid by the Fund:			
	Disbursements for Plan Administration Expenses Not Paid by the Fund:			
<i>Line 14a</i>	<i>Plan Development Expenses Not Paid by the Fund:</i>			
	1. Fees:			
	Special Master (including related U.S. legal fees and expenses).....	-	-	-
	IDC.....	-	-	-
	Distribution Agent.....	-	-	-
	Consultants.....	-	-	-
	Other Legal Advisers.....	-	-	-
	Tax Advisers.....	-	-	-
	2. Administrative Expenses	-	-	-
	3. Miscellaneous	-	-	-
	<i>Total Plan Development Expenses Not Paid by the Fund</i>	-	-	-
<i>Line 14b</i>	<i>Plan Implementation Expenses Not Paid by the Fund:</i>			
	1. Fees:			
	Special Master (including related U.S. legal fees and expenses).....	-	-	-
	IDC.....	-	-	-
	Distribution Agent.....	-	-	-
	Consultants.....	-	-	-
	Other Legal Advisers.....	-	-	-
	Tax Advisers.....	-	-	-
	2. Administrative Expenses	-	-	-
	3. Investor Identification:			
	Notice/Publishing Approved Plan.....	-	-	-
	Claimant Identification.....	-	-	-
	Claims Processing.....	-	-	-
	Web Site Maintenance/Call Center.....	-	-	-
	4. Special Master (including related U.S. legal fees and expenses) Bond	-	-	-
	5. Miscellaneous	-	-	-
	6. FAIR Reporting Expenses	-	-	-
	<i>Total Plan Implementation Expenses Not Paid by the Fund</i>	-	-	-
<i>Line 14c</i>	<i>Tax Administrator Fees & Bonds Not Paid by the Fund</i>			
	Total Disbursements for Plan Administration Expenses Not Paid by the Fund:	-	-	-
Line 15	Disbursements to Court/Other Not Paid by the Fund:			
<i>Line 15a</i>	<i>Investment Expenses/CRIS Fees</i>	-	-	-
<i>Line 15b</i>	<i>Federal Tax Payments</i>	-	-	-
	Total Disbursements to Court/Other Not Paid by the Fund:	-	-	-
Line 16	DC & State Tax Payments			
Line 17	No. of Claims:			
<i>Line 17a</i>	<i># of Claims Received This Reporting Period.....</i>	0	0	0
<i>Line 17b</i>	<i># of Claims Received Since Inception of Fund.....</i>	0	0	0
Line 18	No. of Claimants/Investors:			
<i>Line 18a</i>	<i># of Claimants/Investors Paid This Reporting Period.....</i>	0	0	0
<i>Line 19b</i>	<i># of Claimants/Investors Paid Since Inception of Fund.....</i>	0	0	0

Special Master:

By: /s/ Douglas A. Doetsch
(signature)

Douglas A. Doetsch
(print)

Special Master
(title)

Date: 10/12/10