

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)	FILED UNDER SEAL

SEVENTH 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 April 2, 2010 through July 9, 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 USD6,400,000 in cash from Grupo Kelly, which has been deposited in an account maintained by Mayer Brown (the “Special Master’s Trust Account” or “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 the last 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 June 30, 2010 is USD \$2,301,176.10 and the balance of sale proceeds in the Special Master’s Sales Proceeds Account as of June 30, 2010 is USD \$982,661.17.

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 FTI Financial Consulting Inc. (“FTI”) to identify ways in which corporate expenses may be minimized. The Special Master and FTI have proposed certain head-count reductions, including elimination of the vacation club operation, thereby saving approximately \$500,000 annually based upon management’s annual expense budget. The termination of the vacation club operation has now been finalized.

Additionally, with regard to Grupo Kelly management, the Special Master, with the assistance of JNN and Del Valle Torres (“DVT”), has prepared and negotiated a termination package for the Chief Operating Officer, [REDACTED], which he expects to be executed within the next two weeks. The termination of [REDACTED] will cut approximately \$500,000 in annual expenses from the corporate expenses budget. Furthermore, with respect to the employment contracts for [REDACTED], the Special Master has worked with JNN and DVT to

produce revised employment contracts for these individuals that, in the case of [REDACTED], compensate him at \$85,000 less per year. 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 has made separate written submissions to the Court with respect to [REDACTED], under seal, and the proposed terms have been approved. The termination and re-hiring of [REDACTED] are necessary to change their employment conditions, pursuant to Mexican labor law.

The Special Master will continue to look for cost-savings opportunities from an ongoing operational perspective. The eventual sale of the Group's 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 FTI and 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 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.

b. Form Documentation for Asset Sales

In addition to developing a final form of Promise to Purchase instrument for real property, the Special Master, with the assistance of JNN, has developed a form of Promise to Purchase Agreement to be used in a share-sale scenario. These forms, in addition to introduction letters to inform the sale process and English and Spanish form Confidentiality Agreements, will be used for the duration of the Asset sale process in order to ensure consistency among sales processes and to foster efficiency. As the Mexican law forms have been approved, the Special Master and Arias, Fabrega & Fabrega ("ARIFA"), Panamanian counsel to the Special Master, have prepared analogous form documentation under Panamanian law and such documentation is currently being finalized.

c. Sales Process for [REDACTED]

The Special Master and FTI identified a potential purchaser for the [REDACTED] and executed purchase and sale documentation for the same. Additionally, counsel to the Special Master and JNN prepared a notice of sale for [REDACTED] that was run in a regional newspaper of general circulation (*Novedades*) to publicize the terms of the sale in accordance with the prescribed publication period and no serious counteroffers emerged as a result of the

same. With the publication complete, the Special Master is pending the finalization of a merger that it is effecting in connection with the sale of the [REDACTED] and receipt of the deposit required pursuant to the relevant purchase and sale documentation.

The proposed buyer is overdue in making the required deposit for the purchase of the [REDACTED], and has been unresponsive to multiple contact attempts. As a result, the Special Master is considering terminating such buyer's purchase agreement for the [REDACTED] and reviewing other purchase offers.

d. Sales Process for [REDACTED]

The Special Master has received and evaluated several preliminary bids for the [REDACTED]. The bidders that will advance to the diligence stage of the process have executed non-disclosure agreements and electronic due diligence has begun through an internal data site maintained by the Special Master. Meetings between [REDACTED] management and prospective bidders are expected to commence within the next month. The form sale documentation for the sale of [REDACTED] has been finalized in anticipation of the selection of a prospective purchase.

e. Rescission of [REDACTED]

[REDACTED] includes an 18 hole [REDACTED] designed golfed course. The purchase of the golf course and the related beach club within [REDACTED] was rescinded by the proposed buyer during this Reporting Period after Grupo Kelly was unable to secure the required condominium regime density within the time frame specified in the purchase agreement for the golf course. Although Grupo Kelly and the Special Master attempted to negotiate revised contractual terms with the proposed buyer, these efforts were ultimately unsuccessful and the buyer opted to rescind. In connection with such rescission, Grupo Kelly refunded a deposit payment to the buyer equal to approximately USD\$4,200,000, which amount represented the deposit initially provided to Grupo Kelly in connection with such sale. Although this was a setback in terms of loss of general cash on hand, the Special Master believes that the addition of the golf course and beach club to [REDACTED] may enhance its value.

f. Meetings in Mexico

The Special Master met with Grupo Kelly in Cancún, Mexico on July 1, 2010, to review the status of the cash flow surrounding the Grupo Kelly assets. During the meetings, the participants reviewed the status of the various hotels, the [REDACTED], construction at [REDACTED], and the performance of the various hotel assets.

g. 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 FTI 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. Specifically, since the last status report, the cash flow forecasts have enabled: (i) decisions made to focus more senior management attention on the spend rate at [REDACTED] and the profitability of the hotel operations; and (ii) an understanding of up-to-date cash availability to allow for decision-making in negotiations with the former owners of the golf course and other [REDACTED] customers.

h. 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 [REDACTED]: (a) corporate irregularities affecting the Panamanian shares and (b) a lien linked to a payable owed to the current manager of the [REDACTED] 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 must be rectified by July 23, 2010. ARIFA, JNN and counsel to the Special Master are currently engaged in the final discussions and are taking the final steps to deliver revised Panamanian corporate books to the Bank of New York Mellon, S.A. as Trustee under the Restitution Trust (the “Trustee”). Once the Trustee has possession of such corporate books, the Special Master will effectively hold legal title to such Panamanian corporations, thus facilitating an eventual sale of the [REDACTED].

With respect to the second marketability issue, the general manager of the [REDACTED] (who represents that he has run the hotel business and invested his personal funds in its infrastructure and operations as a “personal favor” to the Defendant), through a corporate entity that he controls, has a lien upon the [REDACTED] 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.

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 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 Claims Procedure Order (the "Claims Procedure Order") for approval by this Court. The Claims Procedure Order was entered on April 6, 2010 with an effective date of April 27, 2010. At the May 25, 2010 hearing, this Court asked the Special Master to revise Section II (vi) of the Claims Procedure Order to make it clear that no part of the Claims Procedure Order shall preclude victims from seeking to enforce any claims they may have against Michael E. Kelly in his personal capacity, or against any agent, servant, co-conspirator of Michael E. Kelly or any assets owned by or affiliated with Michael E. Kelly that have not been transferred to the control of the court through the Special Master. The Special Master and the USAO revised the Claims Procedure Order (the "Amended Claims Procedure Order") accordingly and submitted the Amended Claims Procedure Order to this Court on June 11, 2010. This Court approved the revised language and entered the Amended Claims Procedure Order 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 of how the Special Master and Stenger reached that value. Stenger sent 8,113 claims forms to the victims between June 24 and June 25, 2010.

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.)

As discussed between the Special Master and the USAO, it is imperative that the Special Master and Stenger receive these 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 and adverse claims).

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 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.

As of July 7, 2010, Stenger had received 1,225 executed Victim Claim Forms from the victims and 421 Victim Claim Forms were returned to sender. Of the 1,225 executed Victim Claim Forms, only 2.7% of victims disagreed with their claim as calculated by Stenger. An additional 3.4% neglected to return all pages of the Victim Claim Form. Stenger will follow up with those victims and make an effort to find the victims whose Victim Claim Forms were returned to sender. The victims must have their Victim Claim Forms postmarked to the Special Master by August 25, 2010.

While the liquidation of Kelly's Assts 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 **13th day of July 2010.**

/s/ Douglas A. Doetsch

Douglas A. Doetsch, Special Master

Exhibit A

Standardized Fund Accounting Report