

**UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF GEORGIA
GAINESVILLE DIVISION**

In re:)	Chapter 11
)	
CORNERSTONE MINISTRIES)	Case No. 08-20355-reb
INVESTMENTS, INC.)	
)	
Debtor.)	Judge Brizendine
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EXAMINER’S REPORT

The central character in the Cornerstone story is Cecil A. Brooks (“Brooks”). Through a tangled web of non-profit and for-profit corporations and limited liability companies, Brooks and fellow Cornerstone board member, John Ottinger, Jr. (“Ottinger”),¹ profited from real estate development. Beginning with churches, they expanded – in the late 1990’s - to senior housing facilities, single family housing, and multi-family housing. Through disclosed and undisclosed ownership interests in related companies, Brooks and Ottinger reaped substantial income over and above the salaries disclosed in the Cornerstone Ministries Investments, Inc.’s filings with the U.S. Securities and Exchange Commission (“SEC”). As detailed below, bondholders may have valid claims against not only Brooks, Ottinger, and the other insiders, but also against others who assisted them.

THE EXAMINER AND THE SCOPE OF HIS INVESTIGATION

The Court appointed Pat Huddleston as Chapter 11 Examiner on December 30, 2008 and described the scope of the Examiner’s investigation as follows:

¹ The Examiner will describe conduct by other officers and directors as their conduct arises in the story. He mentions Brooks and Ottinger by name because they were involved in almost all of the events described herein. The Examiner has attached as Exhibit A a document listing the people involved in the Cornerstone story. That document includes a description of all of Cornerstone’s directors.

a) Investigating the sequence of events that led to the Debtor's shift from making loans to churches and non-profit organizations to making loans to for-profit developers;

b) Investigating whether and to what extent the Debtor's shift from making loans to churches and non-profit organizations to making loans to for-profit developers was motivated or otherwise characterized by self-dealing on the part of its officers, directors and/or other insiders; and

c) Investigating whether and to what extent purchasers of Debtor's bonds may have causes of action against brokers and others related to sale of the bonds.

The Cornerstone story becomes complicated at points. But, many of the most confusing aspects of the story are not relevant to the questions that the Court asked the Examiner to investigate. For example, there are many instances of mismanagement - across many projects - that do not rise to the level of self-dealing. Many times, Cornerstone spent vast amounts of money unnecessarily. But not all of those instances are within the scope of the Examiner's investigation. For the sake of brevity in a report which must necessarily be long the Examiner has included only those facts that bear upon the questions asked. Accordingly, this Report is not a complete history of Cornerstone and all of the projects it funded. It is, however, a complete report within the scope defined by the Court.

The Investigation

The Examiner began by reviewing Cornerstone's SEC filings. That review provided leads to likely sources of information and productive lines of questioning.

So as not to duplicate investigation already done by the Creditor's Committee ("the Committee"), the Examiner met with counsel for the Committee to learn what investigation those professionals had already conducted. The Committee produced documents (not covered by protective order), including testimony transcripts. Specifically, among the documents the Examiner received from the Committee were the transcripts of depositions of John Lowery (regarding two matters - the Middlecreek matter and the Bluffton matter), Cecil Brooks, John Ottinger, Marvin Hoeflinger, and Jack Wehmiller.

Believing that direct input from Cornerstone bondholders was essential to a helpful investigation, the Examiner created a contact form on his website and mailed notice of that contact form to all known bondholders. To date, the Examiner and members of his staff have spoken to and received documents from 582 bondholders.

Learning that the Georgia Securities Commission had conducted an investigation into the sale of Cornerstone bonds, the Examiner went to the offices of Andrew Ekonomou, Esq., the investigator appointed by the Georgia Securities Commission. The Examiner identified documents, including testimony transcripts, and received copies. Through that production, the Examiner was able to read the transcripts of the testimony of Sylvia Hoeflinger, Craig Lewis, Ray Noragon, Christy-Lyn Seay, Jayme Sickert, Laura Tedball, and John Underwood.

Having identified other witnesses through the investigation detailed above, the Examiner took the sworn testimony of Barbara Byrd, Ron Cochran, Heidi Crow, Frank

Culbreath, Sylvia Hoeflinger, John Lowery, Walt McGill, Ed Moore, John Ottinger², James Quinlan, T.J. Turner, John Underwood, and Frank Vann.

The Examiner also interviewed other witnesses – Marvin Hoeflinger, Phillip Kantor, Glen Pawlowski, and Kerri Schoening.

Focusing on the brokerage firms who sold CMI securities, the Examiner reviewed the background and regulatory history of all firms and individuals identified as having sold Cornerstone Bonds. Those registered broker-dealers include American Heritage Church Finance, Inc., Cambridge Legacy Securities, Inc., Commonwealth Church Finance, Inc., G.A. Repple & Company, Huntleigh Securities Corporation, MMR, Inc., and Wellstone Securities, Inc. Bauerle Financial, Inc., a registered investment advisory firm, but not a registered broker-dealer, purchased Cornerstone bonds for its clients' account through a registered broker-dealer. The Examiner sent letters to each of these firms seeking information about its insurance coverage. Most responded, claiming that they had no errors and omissions coverage. Wellstone Securities is defunct.

The Examiner also asked for and received what he believes to be full cooperation from counsel for the Debtor. The Examiner posed questions and received prompt answers. He asked for documents and received prompt production.

Just as any two witnesses to a single event will remember different details, on occasion the testimony of the witnesses conflicted. When that happened, the Examiner investigated further to secure other sources of information on the disputed point. In most cases, he was able to find sources that settled the discrepancy.

² Ottinger and his counsel accommodated the Examiner by agreeing to an examination on the evening of Friday, March 13, 2009. Ottinger reserved the right to read and sign the transcript of the examination. The Examiner has based this report, in part, on the expedited, but unsigned, transcript to that examination.

The Examiner and his staff have worked tirelessly to file this Report on March 16, 2009 so that people entitled to vote on the pending Joint Plan of Liquidation can consider the Report before making their decision. While the Examiner could gather additional evidence with more time to do so, he is confident that this Report answers the questions posed by the Court.

Cecil A. Brooks

Brooks earned his undergraduate degree from Mercer University in Macon, Georgia in 1952. He then embarked on a career that included real estate sales and development. He owned a construction business and a roofing business. In the early 1970's he enrolled in Presbyterian Reformed Theological Seminary, graduating in 1975 with a Master's of Divinity degree.

In the early 1980's, Brooks became the Pastor at Trinity Presbyterian Church in Miami, Florida. In 1986, he moved to Atlanta, where he worked for the Presbyterian Church in America ("PCA") as Director of Development for Mission to North America ("MNA"). According to MNA, it "serves PCA churches and presbyteries as they advance God's Kingdom in North America by planting, growing and multiplying Biblically healthy churches through the development of intentional evangelism and outreach ministries."

John T. Ottinger, Jr.

Ottinger graduated from the University of Delaware in 1976. He then went to Westminster Seminary in Philadelphia. He graduated in 1979 with a Master's of Divinity degree. He worked for one year in the lodging industry and then took a job as the

assistant pastor of Trinity Presbyterian Church in Miami, where he met Brooks. He left Trinity after two and one-half years and started a new church in Hickory, North Carolina.

Cornerstone's Origins

After moving to Atlanta, Brooks led the Investors Fund for Building and Development, formed by the PCA to assist PCA churches in building and expanding their facilities. Brooks recruited Ottinger to assist with that project. The PCA divested itself of the Investors Fund for Building and Development in 1994, with Brooks in charge and Ottinger assisting. Brooks changed the name to Presbyterian Investors Fund, Inc. ("PIF"), and set out to continue making loans to PCA churches.

The Investors Fund/PIF made state registered bond offerings from 1986 to 2000, offering investors 9% interest on five-year bonds, and raising over \$30 million during that time. Brooks and Ottinger made presentations to churches to sell the bonds. Some of the investors who responded to the Examiner's request for information described buying PIF bonds after a presentation by Brooks or Ottinger. Investors Fund/PIF loaned that money to fund the construction of churches and church-related projects such as Christian schools.

Cornerstone – The Church Loan Years

Inspired to extend financing to non-PCA churches, Brooks and Ottinger created Cornerstone Ministries Investments, Inc. ("Cornerstone") in 1996 to operate a business that mirrored PIF's business, but with a broader mandate. The only two employees at the inception of Cornerstone were Brooks, who served as CEO, and Ottinger, who served as CFO. The Cornerstone board of directors was identical to the PIF board.

From Cornerstone's inception, Brooks served as chairman and chief executive officer and Ottinger served as vice-president and chief financial officer. They served in those capacities until November 1, 2006, although – as described below – they continued to profit from the company thereafter.

Every witness in a position to know Brooks agreed that he “controlled” the Cornerstone board of directors – a collection of friends of Brooks and Ottinger. The witnesses said that many of the directors are elderly, had a longstanding friendship with Brooks, were not inclined to challenge him, and never did challenge him. But, we need not rely upon their testimony to understand who controlled Cornerstone. In a newsletter to investors, Brooks described himself as follows: “I can be blunt, suffer fools poorly, have a hair-trigger temper and despise all bureaucracy”

From PIF to Cornerstone

In December 1996, Brooks and Ottinger took Cornerstone public through an offering under Regulations A of the Securities Act of 1933 (“Securities Act”). In that initial offering, Cornerstone raised \$3,747,000 from the sale of common stock and certificates of indebtedness (bonds).

Shortly after the Cornerstone initial public offering, Brooks merged Cornerstone with PIF with the surviving public company keeping the Cornerstone name. The entire PIF board of directors moved to the Cornerstone board. After the merger, PIF owned most of the shares of Cornerstone stock. In 2003, PIF was “distributed to” Church Growth Foundation, Inc., making Church Growth Foundation the largest Cornerstone shareholder.

In 2003, Cornerstone made an administrative change, contracting with a separate, but related, company called Cornerstone Capital Advisors, Inc. (“CCA), to handle all “back-office” operations, including processing loan paperwork, communicating with investors, and doing Cornerstone’s in-house accounting work.³

The Bond Offerings

Beginning with its initial public offering in 1996, Cornerstone sold bonds to raise money to lend to borrowers. The Examiner has attached as Exhibit C a chart showing the dates of the various offerings (Series A through Series G), the date each series began and the amount raised in each offering. Under federal securities laws, Cornerstone was responsible for insuring that each prospective investor received a copy of a prospectus describing the securities, the company, and the risks involved with the investment. The Examiner has reviewed those offering documents and will discuss apparent material misrepresentations and omissions from some of those filings later in this Report.

The offering documents that were supposed to precede acceptance of any investment in Cornerstone bonds were not the only communication Cornerstone sent to investors. Brooks and his successor sent periodic newsletters to Cornerstone investors. The newsletters reiterated that the money invested was going to pursue “God’s work.” In fact, a copy of PIF’s letterhead in April 2000 includes the tag line “Using God’s Money for God’s Kingdom.” In general, the monthly newsletters had the effect of reassuring investors.

A PCA Mission to North America newsletter sent out in the winter of 1999 to 2000 included a solicitation under the heading “God’s Money for God’s Kingdom,”

³ Cornerstone and CCA occupied the same office suite. Brooks kept other related companies close by, as well. Exhibit B, attached hereto, is an aerial photo of the Cornerstone office park with the offices of the companies mentioned in this Report identified.

followed by details of the interest rates and maturity dates available. The solicitation invited people to contact PIF for a prospectus.

In the monthly newsletters, Brooks emphasized that he owned Cornerstone bonds. Many newsletters told a story of a resident at one of the developments Cornerstone funded. Many of the newsletters directly addressed how Cornerstone was able to pay 9% interest while keeping investor money safe. Occasionally, some newsletters would include a brief admission that, theoretically, the company could fail, but quickly brushed that possibility aside with encouraging predictions. In 2005, Cornerstone also sent investors a DVD showing glowing testimonials from tenants of Wellstone Retirement Community facilities, complete with the love story of a couple who met and married in one of these communities.

Many investors responded to solicitations to buy bonds directly from Cornerstone. Bondholders who contacted the Examiner confirmed that they first bought Cornerstone bonds as a result of such presentations as far back as the 1980's and as recently as 2005. Of the 582 investors who responded to the Examiner's invitation to offer evidence, 31% invested directly with Cornerstone. In Cornerstone parlance, investors who bought directly from Cornerstone were called "house accounts." The other investors bought Cornerstone bonds through broker-dealers registered as such with the Securities and Exchange Commission ("SEC").

Cornerstone also had selling agreements with registered broker-dealers. Those broker-dealers included American Heritage Church Finance, Cambridge Legacy Securities, Inc., Commonwealth Church Finance, G.A. Repple & Company, Huntleigh Securities Corporation, MMR, Inc., and Wellstone Securities, Inc.

The Broker-Dealers

Early in Cornerstone's story, the company developed relationships with registered broker-dealers and motivated them to sell Cornerstone bonds by offering a 4% commission on every sale. The Examiner has attached as Exhibit D a roster of the broker-dealers who sold Cornerstone bonds.

Cornerstone selected one brokerage firm to "manage" each offering. That firm received 5% in commissions. In Cornerstone's early days, Commonwealth Church Finance, Inc., headquartered in McDonough, Georgia was the "preferred broker-dealer." Later on, Cornerstone removed Commonwealth as the preferred broker-dealer and moved that extra 1% commission closer to home.

According to Cornerstone director Jack Wehmiller ("Wehmiller"), who was a Series 7 registered representative, Cornerstone would send prospectuses to the broker-dealers who were selling Cornerstone bonds, and those broker-dealers would forward the prospectuses to prospective investors, including those who were renewing mature bonds into the next series of bonds being offered.

Registered investment advisory firm Bauerle Financial bought Cornerstone bonds in some of its clients' accounts. As an investment adviser, it had authority to buy and sell for its clients' accounts without first clearing each trade with the client. Because it is not a broker-dealer, it executed those trades through a broker-dealer.

Early on, Brooks and Ottinger decided that Cornerstone should have its own distribution network. They decided to achieve that goal by creating their own broker-dealer. They recruited Wehmiller to create that broker-dealer – to be called Wellstone Securities, Inc. ("Wellstone Securities"). Wehmiller hired a firm that specialized in

bringing broker-dealers into existence and launched into the often lengthy process of gaining the approval of the National Association of Securities Dealers, Inc. (“NASD”) (now called the Financial Industry Regulatory Authority (“FINRA”)).

According to Wehmiller, he learned just before the final interview with the NASD that securities laws prohibit companies like Cornerstone from distributing their own securities through an affiliated broker-dealer unless they are selling mutual funds, annuities, or real estate investment trusts. Learning too late that the whole purpose of the exercise had been frustrated, Wehmiller asked Brooks what he should do. Wehmiller testified that Brooks directed him to give the all-but-approved broker-dealer to a non-profit company called the African-American Church Growth Foundation, Inc. (“AACGF”). The person behind that foundation was John Underwood (“Underwood”), who had been a member of the congregation when Brooks was pastor at Trinity Presbyterian Church in Miami.

Suspicious that Cornerstone was seeking to do indirectly what it could not do directly, the NASD conducted several more interviews before satisfying itself that Wellstone Securities was independent of Cornerstone. Independent or not, Cornerstone favored Wellstone Securities by making it the preferred broker-dealer allowing it to collect a 5% commission on each sale rather than the 4% collected by other broker-dealers.

Cornerstone’s largesse to Wellstone Securities did not end there. Cornerstone director Jayme Sickert (“Sickert”) became the company’s national sales director on January 31, 2002 and moved his securities license from Consumer Concepts Investments, Inc. to Wellstone Securities. When investors with house accounts were nearing the date

on which their bonds became due, Sickert – or someone at his direction – contacted the investor and said that the company was converting all house accounts into brokerage accounts and that doing so was necessary for the company to collect information to make a “suitability” determination.⁴

Sickert had a significant incentive to convert investors from house account investors to brokerage customers of Wellstone Securities. Though a director of Cornerstone, he collected a 4% commission on each bond renewal. The additional 1% commission went to Wellstone Securities as the preferred broker-dealer. Sickert collected 90% of the 4% gross commission, reaping hundreds of thousands of dollars in commissions from conversion of the house accounts.

QUESTION ONE – THE SHIFT

The Examiner’s investigation has given him a sound basis to describe the “sequence of events that led to [Cornerstone’s] shift from making loans to churches and non-profit organizations to making loans to for-profit developers.”⁵ The shift came early in Cornerstone’s life as a public company.

A thorough understanding of Cornerstone’s shift to making loans to for-profit enterprises requires an understanding of how Cornerstone identified potential borrowers. Brooks and Ottinger created their own opportunities by finding businesses in which they wanted to invest and then striking a deal with a developer to do the construction in exchange for Cornerstone providing the financing. None of the witnesses interviewed by

⁴ Under FINRA’s “Know Your Customer Rule,” broker-dealers must have sufficient information about a customer’s risk tolerance, investment objectives, and financial circumstances so that the broker-dealer can determine whether each recommendation is “suitable” for that customer.

⁵ The Examiner has construed the scope of the inquiry into Question 1 as calling for a description of the several instances in which Cornerstone loaned to for-profit entities, as each such instance led the company further away from loans to churches and non-profit entities. Construing the question that way has led the Examiner to facts relevant to Question 2 (regarding self-dealing by officers, directors and other insiders).

the Examiner has claimed that Cornerstone's move to loans to for-profit borrowers was motivated by a dearth of churches looking for financing. Rather, Brooks and Ottinger simply decided - in the years in which they had more money to lend than they had projects to fund - that they wanted to start doing other kinds of financing.

Sage Living Centers and Senior Housing Services

In 1999, Brooks and Ottinger approached two Florida men – Glen Pawlowski (“Pawlowski”) and David Ostlie (“Ostlie”) - with experience in developing, constructing, and managing senior housing projects. The two men were working for another firm at the time. At Brooks's suggestion, they left their jobs and started their own for-profit senior housing development and management company to develop such facilities with money loaned by Cornerstone. They called their company Certus Management, LLC (“Certus”).

Cornerstone provided the land for the first senior housing development - a parcel of land in Ft. Pierce, Florida. Certus planned, built, and managed a senior housing facility - called Lake Forest Park Retirement Community - on that property with funds borrowed from Cornerstone.

Eventually, Cornerstone financed at least eight such developments, most of them renovations, rather than development from the ground up. Certus managed every aspect of the development, construction, renovation, and operation of the projects.

In its SEC filings, Cornerstone characterizes its loans for the Certus-led construction, renovations, and management of senior housing developments as loans to non-profit entities. Technically, this is correct; but only technically. Cornerstone was only able to characterize the developments that way because Brooks and Ottinger

arranged for the creation of two Florida non-profit corporations – Sage Living Centers, Inc. (“Sage”) and Senior Housing Services, Inc. (“SHS”) - to “own” the Certus-managed senior housing projects.

Neither Sage nor SHS was ever independent of Cornerstone in any meaningful sense. The titular president of Sage, Ed Moore (“Moore”), a longtime friend of Brooks and Ottinger, testified that Sage was a “subsidiary of Cornerstone.” Mike Dixon – Brooks’s son-in-law – kept the books for Sage and SHS, and has rebuffed the Examiner’s numerous attempts to secure his testimony.

The true nature of the Sage/Cornerstone relationship is best revealed by Moore’s testimony. He assumed the title of “president” at Brooks’s request. When examined under oath, Moore said, “I technically have the title of president of Sage Living Centers.” He never saw Sage’s financial records and had no idea how much debt the company had. Moore testified that Brooks and Ottinger “were managing all of the – the financial things – in Georgia.” Summing up his understanding of his role, Moore said that the title of “president” of Sage was “far greater than any kind of responsibility that went with it or anything else. I never did quite feel comfortable with titles like that. But anyway, that’s the title that they put to it.”

The current supposed president of SHS – Nick Howard - has rebuffed all attempts to secure his testimony. The testimony of other witnesses confirms that he was no more the president of SHS than Moore was the president of Sage.

Sage and SHS notwithstanding, Certus developed, constructed, renovated, and managed the senior housing facilities and collected between five and six percent of the revenues of the facilities in consideration for that work. Certus and its related companies

become very significant when the Cornerstone story turns to the second question posed by the Court. The facts described below leave no doubt that the Sage and SHS projects were for-profit in every meaningful sense of the word.

Wellstone Development Group, Inc.

At about the time they were striking their deal with Pawlowski and Ostlie, Brooks and Ottinger arranged to develop three parcels of land for single family housing. Moore's testimony illustrates another example of the Brooks/Ottinger model of development.

Moore had known Brooks and Ottinger for years, having been a competitor in the church financing business. They had become friends. So, when Brooks called Moore in the late 1990's and asked him to look for a parcel of land on which they could develop single family homes, Moore looked. He found a 40-acre tract in Dallas, Texas and reported the find to Brooks. Brooks and Ottinger thereafter struck what was quickly becoming "the usual deal;" Moore would develop the property and Cornerstone would provide the financing.

Near the same time, Brooks and Ottinger also found a parcel of land in Bluffton, South Carolina and decided to build town homes on the property. They struck a deal with Underwood to oversee the development of the property with Cornerstone financing.

Underwood created a company called Wellstone Development Group, Inc. ("Wellstone") (the first company to bear the Wellstone name) and arranged for it to be owned by another company called Wellstone Housing, Inc. As a further layer of obfuscation, Brooks and Ottinger arranged for Wellstone Housing to be owned by non-

profit Senior Housing Services, the same non-profit set up to be the ostensible owner of the Certus-developed senior housing facilities.

John Lowery and Wellstone, LLC

Cornerstone's for-profit development continued in March of 2004, when Brooks asked John Lowery ("Lowery") to move to Atlanta to review some of the projects for which Cornerstone was loaning money – specifically the single family housing projects in Mableton, Georgia, Bluffton, South Carolina, and Dallas/Ft. Worth, Texas. At the time, Lowery was working on a debit card product for a company called Revelation America Corp.

At about the same time, Underwood had left Wellstone Development Group for medical reasons. Underwood had been supervising the projects at Mableton and Bluffton (poorly, according to most of the witnesses). Lowery joined Cornerstone just in time to take over these projects.

Later, Lowery created a Delaware limited liability company called Wellstone, LLC.⁶ Brooks granted Lowery a 25% interest in the company in exchange for his finding projects in which Cornerstone could invest. Brooks and Ottinger kept the façade of non-profit lending, by having the other 75% of Wellstone, LLC owned by Church Growth Foundation, the same company that owned a majority interest in Cornerstone. Witnesses have testified that Brooks controlled Church Growth Foundation. Church Growth Foundation would eventually transfer its 75% interest in Wellstone, LLC to Brooks, Ottinger, Wehmiller, and CCA president Robert Covington ("Covington").

⁶ There were three operating divisions of Wellstone, LLC - Wellstone Construction, Wellstone Communities, and Wellstone Realty.

Lowery brought Cornerstone an opportunity to fund two up-scale for-profit single family home developments in McKinney, Texas – Wellstone at Craig Ranch and CooperLife. An email from Ottinger to Lowery, copied to Brooks, Wehmiller, and others, demonstrates Cornerstone’s understanding of what the investment in those projects meant for Cornerstone. Dated June 29, 2006, the email reads in part: “This deal we are closing today is going to put us in a very precarious position financially.”

Because the scope of the investigation does not include a thorough inquiry into why Cornerstone was not successful, except to the extent that those answers relate to self-dealing or causes of actions that bondholders may have, the Examiner will not go into detail about spending on Wellstone projects (or the other projects). There is, however, substantial evidence of extravagant spending on those projects, including first-class and private jet travel for Lowery, purchase of memberships to the nearby Tournament Players Championship Golf Club, annual \$250,000 sponsorships of a Dallas marathon, and many other examples of lavish spending.

Meridian Housing, LLC

The extravagant spending on the Wellstone, LLC projects left insufficient money to finance another category of projects. Through a mutual acquaintance, Brooks and Ottinger approached Walt McGill (“McGill”), a developer with experience building low-income housing. Brooks and Ottinger made the same offer to McGill that they had made to Moore and Certus: “We provide the financing and you provide the work.” In return, McGill owned one-third of Meridian Housing, LLC, and the ubiquitous Church Growth Foundation owned the remaining two-thirds.

McGill began development of several low-income housing projects with funds borrowed from Cornerstone. Lowery's demands on Cornerstone's money, though, did not leave enough for the timely development of the Meridian projects. Cornerstone often told McGill to "slow down" his work on projects because there was not enough money to fund both Wellstone, LLC, and Meridian. That delay, of course, increased the interest expense for each project.

The evidence gathered by the Examiner demonstrates that the "shift" took place as early as 1999. The "sequence of events" that led to the "shift" to making loans to for-profit companies first took place in the minds of Brooks and Ottinger. Ottinger testified, "Everybody at Cornerstone just decided 'today we're going to begin doing other types of gap and construction lending' and there were dollars available to make those loans." Cornerstone had money to lend and Brooks and Ottinger created companies to receive it. It is difficult to conclude that Cornerstone had **any** interest in financing churches between 1999 and 2006.

QUESTION TWO – SELF-DEALING

The Court directed the Examiner to investigate "whether and to what extent the Debtor's shift from making loans to churches and non-profit organizations to making loans to for-profit developers was motivated or otherwise characterized by self-dealing on the part of its officers, directors and/or other insiders." Determinations of intent are difficult, but the Examiner has found evidence that Cornerstone's shift to making loans to for-profits was "characterized by self-dealing," at the very least.

The Certus Companies

The senior housing centers funded by Cornerstone were owned by non-profits (Sage and SHS) only because Brooks and Ottinger created non-profits to own them. They installed “presidents” of the companies who were long-time friends of Brooks willing to stand back and exercise none of the duties of that office unless directed to do so by Brooks. They had Brooks’s son-in-law do the accounting work. The men who ran Certus - Glen Pawlowski and David Ostlie - were recruited by Brooks to create that company and develop, construct, and manage the senior housing projects.

The Examiner has discovered that Brooks and Ottinger each owned 25% of companies called Certus Holdings and Certus Development – with Pawlowski and Ostlie owning the remaining interests in those companies - which made profits from the development, construction, and management of the senior housing facilities funded by Cornerstone. Brooks, through a company called BB&D, Inc. (“BB&D”), and Ottinger, through a company called Lothlorian Group, Inc. (“Lothlorian”), received distributions from those Certus companies. Ottinger’s best recollection, without referring to his records, was that his distributions from Certus Development were “above six figures,” and that Brooks received the same amounts.

But the ownership of the Certus companies was not the only way that Brooks and Ottinger made money off of the senior housing facilities that Cornerstone funded. Through their personal S corporations, they also received “consulting fees” for the development of each of the eight facilities. While Ottinger could not remember how much his S corporation collected in consulting fees, the Examiner had found evidence of a suspicious \$250,000 transaction involving a corporation called R.E.E.D. Services, Inc.,

ostensibly run by Ottinger's son. Ottinger testified that his son was not involved with the company, and that the \$250,000 payment was for Ottinger's consulting work on a senior housing facility called "Summit View." He split the money with Brooks.

Brooks and Ottinger never disclosed in SEC documents their interest in the Certus companies or their receipt of consulting fees on each senior housing facility. Ottinger testified that Brooks assured him that he (Brooks) had informed the other Cornerstone directors.

Not knowing that Brooks and Ottinger were part-owners of Certus, accounting personnel at CCA advised Brooks and Ottinger that Certus was charging too much to manage the Sage and SHS properties and recommended that the companies shop around for a lower management fee. Brooks and Ottinger refused, for reasons that are now obvious. That Brooks and Ottinger never disclosed their interests in those companies suggests that they appreciated that their ownership interest was problematic for them and/or for Cornerstone.

Cornerstone's accounting personnel were concerned enough about Cornerstone's control of the supposedly-independent Sage and SHS that they raised the issue with Ottinger, who "assured" them that they were, indeed, independent. It was an important question according to Cornerstone's Chief Accountant, as the company would need to disclose the loans to Sage and SHS as related-party transactions if those companies were not independent.

Upon his departure from Cornerstone, from a position in which he worked exclusively on Sage and SHS issues, an accounting employee wrote a letter to Cornerstone's securities counsel, Miller & Martin, addressing the lack of independence.

According to other Cornerstone employees, Miller & Martin concluded that Sage and SHS were, indeed, independent.

Wellstone Retirement Communities I, LLC

Their ownership in the Certus companies and their receipt of “consulting fees” on each senior housing development was not the only way by which Brooks and Ottinger profited from the senior housing projects. Brooks and Ottinger, joined by Cornerstone director Wehmiller, were members of a company called Wellstone Retirement Communities I, LLC (“WRC”) which bought the senior housing projects in December 2005 with money raised in a private placement offering and money borrowed from GE Captial.

Brooks and Ottinger did not disclose in SEC filings that they were among the owners of WRC. In connection with the December 2005 transaction in which WRC bought the senior housing facilities, Cornerstone loaned \$37.9 million to WRC to help finance the purchase. Because Brooks, Ottinger, and Wehmiller were owners of WRC, Cornerstone was, in substance, loaning money to three of its directors. Cornerstone’s SB-2/A filing of April 7, 2006 discloses that “30.9% of our loan portfolio at December 31, 2005 consisted of loans to Wellstone Retirement Communities I, LLC.”

The disclosure of that deal in Cornerstone’s February 15, 2006 SB-2 filing for the Series G bonds, reads: “In December 2005 Sage Living Centers and Senior Housing Services, or entities that they control, sold eight senior housing properties to Wellstone Retirement Communities I, LLC, a newly formed limited liability company that is managed by Cornerstone Capital Advisors Inc., **which also serves as our advisor.**” (emphasis added). Cornerstone seemed to be fully transparent in reporting that WRC had

the same “advisor.” It did not report, however, that three of its directors owned interests in WRC. Of course, Cornerstone’s funding of WRC’s purchase of those facilities put the three directors in a position to receive a profit when WRC sold them to Senior Lifestyles in April 2007. Ottinger testified that he did not vote on any loans to Sage, SHS, or WRC.

In April 2007, Senior Lifestyles, Inc. bought those facilities from WRC. Brooks and Ottinger each received \$6,200,000 from the deal. The Examiner has not yet learned the amount of Wehmiller’s profit.

Wellstone, LLC

In September 2006, Cornerstone directors Brooks, Ottinger, Wehmiller, and Robert Covington became owners of Wellstone, LLC. Each of them acquired, from Church Growth Foundation, 18.75% of the company, with Lowery owning the remaining 25%. Significantly, they did not tell Cornerstone’s Chief Accountant about their ownership at the time. He may never have known if he had not seen an email - in December 2006 or January 2007 - that made him inquire. He disclosed their ownership interest in the next SEC filing. He believes that, because of the directors’ failure to tell him about their ownership of Wellstone, LLC, one of Cornerstone’s quarterly reports may have been inaccurate in that it failed to disclose that material information.

Brooks, Ottinger, Wehmiller, and Covington received a substantial benefit from their ownership interest in Wellstone, LLC. In early 2007, each of them received a \$170,894 distribution. Brooks took his money through a company he controls called Drew Development, LLC. Ottinger received his \$170,894 through Lothlorian Group (the same company through which he owned his 25% interest in the Certus companies).⁷

⁷ Ottinger testified that he was not expecting the distribution and that he donated his distribution to two charities.

Wehmiller's check was made payable to Lexus Marketing, which he controls. Covington took his money through a company he controls called SCMC Properties, LLC.⁸ Lowery was the only member to receive the distribution in his own name. He received a distribution of \$227,859. Cornerstone never disclosed those distributions. While Brooks and Ottinger "resigned" as officers and directors of Cornerstone in November 2006, before they received this distribution, the resignation does not mask the fact that the men who controlled Cornerstone received substantial funds from a project to which Cornerstone loaned money.

Those Wellstone distributions are especially troubling given that Wellstone, LLC never made any money. The K-1's evidencing the distributions to Brooks, Ottinger, Wehmiller, and Covington show the balance of their capital accounts after giving effect to the distributions. The men had paid only \$1,000 apiece (to Church Growth Foundation) to acquire their interests in Wellstone, LLC. After receiving the distributions, each man had a negative capital account balance of \$255,460. When asked how Wellstone, LLC could afford to make distributions given that it never earned a profit, Lowery testified that one of the Wellstone subsidiaries – Wellstone Construction – had earned a profit and that the distribution was intended to distribute the profits from Wellstone Construction.

In seeking to explain why they took an interest in Wellstone, LLC, Brooks and Ottinger have testified that it was done because banks did not want to lend to a company whose majority owner was a non-profit corporation. Lowery disputed that explanation,

⁸ Records from the Georgia Secretary of State show Covington as the sole member of both SCMC Properties and Drew Development, LLC. If, as witnesses have testified, Brooks controls one of those companies, his reluctance to have his name associated with it may speak to both Brooks's scienter and Covington's scienter.

saying that Brooks, Ottinger, Wehmiller, and Covington “wanted in” because they liked the business plan. Lowery said that the banks were not concerned with the ownership structure. Indeed, by the time they took the ownership interest in Wellstone, “most of the money had been borrowed already.”

This episode also speaks to how Brooks and Ottinger viewed the non-profit entities that litter any attempt to diagram the Gordian Cornerstone/Wellstone structure. Ostensibly, Church Growth Foundation owned 75% of Wellstone, LLC. Assuming for the moment that the distribution to owners of Wellstone was appropriate - despite the lack of profits – the Cornerstone insiders could have chosen to let Church Growth Foundation receive the \$683,576. Instead, those four directors received that money. Indeed, the Examiner has yet to discover evidence that any of the supposed non-profit companies received money from their supposed for-profit subsidiaries.

Cornerstone Capital Advisors, Inc.

Before 2003, Cornerstone employees received paychecks from Cornerstone. In July 2003, Brooks and Ottinger created CCA and made all employees, except for Brooks, employees of that company. There was no practical difference between what CCA did and what Cornerstone did. The directors of CCA came from the Cornerstone board. When asked who they worked for, most Cornerstone witnesses failed to recognize the distinction between the two companies.

Early on, Cornerstone reimbursed CCA dollar for dollar for its actual expenses in providing services to Cornerstone. CCA received de minimis incentive payments “for good performance,” but they were not so large as to suggest a motivation to self-dealing.

In mid-2004, however, Cornerstone chose to increase what it paid CCA. In mid-2004 the compensation system changed so that CCA received 10% of revenue and 30% of loan participation fees. Ottinger explained the change by saying that a real estate investment trust in Atlanta “does it that way.” The new formula for compensating CCA resulted in dramatically higher costs to Cornerstone. Over the years, Cornerstone paid CCA more than \$11 million. The compensation was so large that, in December 2006, CCA paid all employees, including Brooks and Ottinger (who had supposedly resigned from Cornerstone in November 2006) a bonus of \$57,000 per employee. Witnesses confirm that they neither worked longer or harder that year. Other witnesses testified that, apart from a handful of the accounting personnel, employees worked no more than 40 hours per week. Ottinger estimated that 15 people received the bonuses. In conjunction with the announcement of the \$57,000 bonuses, Brooks and Ottinger held a meeting of all CCA employees during which they said future bonuses would be even bigger depending on profits.

This episode further demonstrates Cornerstone’s approach to non-profit companies. Ostensibly, CCA was owned by a non-profit called the Foundation for Christian Community Development, Inc. Rather than transfer the 2006 profits to the non-profit “owner” of CCA for distribution according to its religious and charitable purposes, CCA paid that money in unannounced and un-negotiated bonuses, with the promise that bigger bonuses would follow.

Other Suspicious Payments to Insiders

Several witnesses testified that Underwood built his home in Jasper, Georgia by misdirecting workers and funds charged to the Wellstone Development Group project in

Mableton, Georgia. Others testified that Underwood did the same thing for his son and his daughter. When asked about those allegations under oath, Underwood denied them. When confronted with them again after several other witnesses had testified about them, Underwood “remembered” the episode, but said that Brooks had authorized him to build his house through draws on the Mableton project and forgotten that he had given permission. Witnesses testified that Brooks allowed Underwood to pay back a portion of the debt, but that Underwood never paid back the entire amount.

Other witnesses testified that, even after Lowery had displaced Underwood’s role in Cornerstone/Wellstone activities, Cornerstone continued to fund payments to Underwood of \$20,000 per month. Underwood admitted to receiving payments, but claimed they amounted to only about \$100,000 per year. The Examiner has yet to find the motivation for these payments.

Payments to Lowery

Several witnesses testified about draw requests of between \$5,000 to \$10,000 per week to a business called PKA Consulting, located in Memphis, Tennessee. The president of that company, Phillip Kantor (“Kantor”) spoke to the Examiner’s staff and said that he is an engineer who provided pro formas for Cornerstone-funded developments.

Lowery’s administrative assistant testified that, in reconciling Lowery’s check book she noticed regular monthly payments to Lowery with the notation “PK” on the deposit slips. Lowery admitted to receiving payments from Kantor during the time that Cornerstone was paying Kantor’s invoices. Lowery claims that he and Kantor are equal

partners in PKA, and that the payments were Lowery's partnership share of the money from Cornerstone.

QUESTION THREE – CAUSES OF ACTION

Finally, the Court has asked the Examiner to investigate “whether and to what extent purchasers of Debtor’s bonds may have causes of action against brokers and others related to sale of the bonds.” In light of the evidence described above, the Examiner believes that bondholders have valid causes of action against broker-dealers, Cornerstone directors, and others. The Examiner has evaluated possible causes of action under a “motion to dismiss” standard. That is, in deciding whether such a cause of action exists, the Examiner has asked whether the facts uncovered, taken in the light most favorable to the prospective plaintiff, could make out any set of provable facts that would entitle them to relief.⁹

Broker-Dealers, Registered Representatives, and Investment Advisers

Account opening documents at brokerage firms include a clause by which every customer “agrees” to submit any dispute to binding arbitration, rather than the civil justice system. The Supreme Court has upheld the validity of such pre-dispute arbitration clauses. Bondholders who first bought Cornerstone bonds after opening an account at a registered broker-dealer, therefore, will have to pursue their claims in FINRA arbitration.

An interesting question in this case is whether customers who Sickert signed up for Wellstone Securities accounts as they called in to renew their bonds must pursue their claims against Sickert in arbitration. Wellstone Securities is defunct and would default in

⁹ Time constraints prevented a more stringent, summary judgment, standard. The prospective defendants identified herein will have defenses to the claims. The Examiner has not thoroughly evaluated the strengths of likely defenses. The Examiner has researched federal and Georgia causes of action. There may be more of fewer causes of action in other states.

any arbitration action. The issue may turn on whether the customer renewed his or her bonds before opening the Wellstone Securities account.

The Examiner has attached as Exhibit E a chart reflecting a sampling of his staff's communications with bondholders. That chart reflects the percentage of the customer's assets invested in Cornerstone bonds and the representations made in convincing the investor to buy Cornerstone bonds.

The information provided paints a troubling picture of broker misconduct. More than 85% of the investors who responded were over age 60. Many investors were over age 75. More than 40% invested more than half of their life savings in Cornerstone bonds. Many bought in reliance on assurances that Cornerstone invested only in churches and non-profits.

Suitability Claims

A stockbroker must have a reasonable basis to believe that a recommendation or strategy is suitable for a customer in view of the customer's resources and sophistication. NASD Conduct Rule 2310(a). This is commonly referred to as the "Know Your Customer" rule. The information the Examiner received from bondholders convinces him that many of the registered representatives¹⁰ who sold Cornerstone bonds disregarded their obligations under that rule. Whether any particular registered representative is liable for making an unsuitable recommendation will depend on the financial circumstances and expertise of the investors and the specific representations made in connection with the sale of the bonds.

¹⁰ "Registered representative" is the correct industry term for "stockbroker."

The “Know Your Customer” rule is designed to prevent, among other things, an unwise concentration of investor assets in a single security. Those investors who had more than half of their life savings invested in Cornerstone bonds, therefore, especially have reason to complain about the unsuitability of the recommendation.

Other Claims Against Registered Representatives

Both Georgia and federal law prohibit any act, practice, or course of business that operates as a fraud or deceit. 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5; O.C.G.A. § 10-5-12. The registered representatives who sold Cornerstone bonds owed investors a fiduciary duty to exercise loyalty and the utmost good faith in handling their affairs. Minor v. E.F. Hutton Co., Inc., 200 Ga. App. 645, 409 S.E.2d 262, 264 (1991); Harrison v. Harrison, 214 Ga. 393, 105 S.E.2d 214 (1958). The Georgia Supreme Court¹¹ and Legislature have provided a number of remedies for people who find themselves injured by those who have promised to protect them. Cornerstone bondholders may, therefore, be able to recover from those registered representatives for negligence, breach of fiduciary duty, breach of contract, and general fraud (O.C.G.A. § 51-6-1). Investors can also pursue claims for misrepresentations or omissions, whether intentional, reckless, or merely negligent. Robert & Co. Assoc. v. Rhodes-Haverty Partnership, 250 Ga. 680, 300 S.E.2d 503 (1983).

If the registered representative making the sale is liable, the broker-dealer employing that registered representative will likely also be liable:

[W]here...the erring salesman completes the transactions through the employing brokerage house and the brokerage house requires a commission on the transactions, the burden of proving good faith is

¹¹ The Examiner has not researched the law of every jurisdiction in which bondholders live. The law in other states may be the same, or may be more or less favorable to the investor.

shifted to the brokerage house . . . and requires it to show at least that it has not been negligent in supervision . . . and that it has maintained and enforced a reasonable and proper system of supervision and internal control over sales personnel.

Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), cert. denied, 449 U.S. 1011 (1980).

As the entity responsible for supervising the individual registered representative, the broker-dealer with whom he is associated will be subject to liability under the common law doctrine of *respondeat superior*. In addition, the firm will likely be liable as a “controlling person,” under section 20(a) of the Securities Exchange Act of 1934 and/or the state law equivalent of that provision, which provides that the broker-dealer is jointly and severally liable for the acts of the person controlled (the registered representatives) unless the former acts in good faith and does not directly or indirectly induce the acts constituting the violation.

Apart from *respondeat superior* and control person liability, the employing firms may also be separately liable for “failure to supervise” the registered representative making the sale. Securities laws make broker-dealers responsible for supervising registered representatives who – by the nature of what they do – are subject to the temptation to ignore customers’ best interests in pursuit of commissions.

The unusual circumstances of the conversion of house accounts to Wellstone Securities accounts – detailed above - is particularly troubling. In convincing investors to renew their bonds and open brokerage accounts with Wellstone Securities, Sickert was acting as both an insider of Cornerstone and a registered representative of Wellstone Securities. There is a question as to whether that dual role put him under a duty to

disclose his conflict of interest in making that recommendation. As an insider of Cornerstone, he had a duty to the corporation to maximize the amount of money raised from each purchase. As a registered representative of Wellstone Securities, he had a personal motivation to decrease the amount collected by Cornerstone to the tune of his 5% commission.

Section 12(2) of the Securities Act of 1933

Section 12(a)(2) of the Securities Act of 1933 (“Securities Act”) (15 U.S.C. § 77l(a)(2)) provides for civil liability of “any person” who offers or sells a security with a prospectus that includes an untrue statement of material fact or a material omission. Section 12(a)(2) of the Act is a strict liability law; it does not require proof of reliance or scienter. Broker-dealers who sell securities are subject to liability under section 12(2). Pinter v. Dahl, 486 U.S. 622, 680 (1988) (holding that “the applicability of section 12 liability to brokers and others who solicit security purchases has been recognized frequently since the passage of the Securities Act.”). Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973); Securities and Exchange Commission v. Manor Nursing Centers, 458 F.2d 1082, 1098 (2nd Cir. 1972); Miller v. Thane, 519 F.3d 879, 886 (9th Cir. 2008).

To successfully bring a section 12(a)(2) claim, bondholders must show that there, (1) was an offer or sale of a security, (2) through interstate commerce, (3) using a prospectus or oral communication, and (4) that the prospectus included an untrue statement of material fact or failed to state a material fact that was necessary to make the statement not misleading. Miller, 510 F.3d at 885. Cornerstone bondholders will likely meet all four requirements, shifting the burden of proof to the broker-dealers to prove that

they “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.”¹² 15 U.S.C. § 77l(2).¹³

Officers and Directors of Cornerstone

Under O.C.G.A. §§ 14-2-830 and 14-2-842, officers and directors owe a duty of good faith and due care and are required to act “with undivided loyalty” in the best interests of the corporation. See, Super Valu Stores, Inc. v. First Nat’l. Bank of Columbus, 463 F. Supp. 1183, 1194 (N.D. Ga. 1979); In re: Corporate Jet Aviation, 45 B.R. 629, 638 (N. D. Bankr. 1985). Officers and directors of a company must only take action based “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company.” In re: Intercat, Inc., 247 B.R. 911, 923 (S.D. Ga. 2000). Corporate officers and directors violate fiduciary duties owed to the corporation when they appropriate a business opportunity rightfully owed to the corporation. See, Southeast Consultants v. McCrary Engineering Corp., 246 Ga. 503, 507-10 (1980); Mau, Inc. v. Human Technologies, 274 Ga. App. 891, 894 (2005) (*citing Southeast*).

A legal doctrine called the “business judgment rule” protects corporate officers and directors from liability for decisions they make in good faith. Officers and directors can, however, by their actions or inactions, lose that protection.

¹² Section 13 of the Securities Act provides that, “No action shall be maintained to enforce any liability created under section 11 or section 12(a)(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 12(a)(1), unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 11 or section 12(a)(1) more than three years after the security was bona fide offered to the public, or under section 12(a)(2) more than three years after the sale.” 15 U.S.C. § 77m.

¹³ Class actions cases are not arbitrable. Investors who band together to pursue classable causes of action can thereby avoid arbitration.

Courts have held that self-dealing by directors can negate application of the business judgment rule or, at least, shift the burden of proof to the defendant director. HMG/Courtland Properties, Inc. v. Gray, 749 A.2d 94 (Del. Ch. 1999). Likewise, “[d]irectors that appear on both sides of a transaction, derive personal benefit from the transaction, or fail to inform themselves of all material information available to them” will not be able to hide behind the business judgment rule. In re: Intercat, Inc., 247 B.R. 911, 923 (S.D. Ga. 2000). Some, if not all, of Cornerstone’s officers and directors – in light of the evidence outlined below – may, therefore, have lost the benefit of the business judgment rule.

Derivative Claims

Ordinarily, corporate shareholders may bring actions against corporate officers and directors only in a “derivative action” on behalf of the corporation, rather than for themselves individually. Phoenix Airlines Services, Inc. v. Metro Airlines, Inc. et al., 397 S.E. 2d 699, 701 (Ga. 1990). Actions for breach of fiduciary duty, actions to recover for misappropriation of corporate opportunity, and actions for mismanagement, must, ordinarily, be pursued as derivative actions. Where a corporation is insolvent, creditors, rather than shareholders, are the proper constituency to pursue derivative actions. Production Resources Group, L.L.C. v. NCT Group, Inc., et al., 863 A.2d 772, 794 (Del. Ch. 2004).

The facts revealed in this Report may support a successful derivative action against Cornerstone officers and directors.¹⁴ Directors Brooks and Ottinger were at least

¹⁴ While shareholders or creditors must ordinarily make demand on the corporate directors to commence the lawsuit to recover from the offending directors before pursuing a derivative action, they may avoid such a demand if they can show the futility of such a demand for reasons including control of the board by one of the offending directors. In re: Friedman, Inc., 386 F. Supp. 2d 1355, 1361 (N.D. Ga. 2005).

arguably involved in self-dealing in arranging to receive undisclosed “consulting fees” from Sage and SHS senior housing projects. The same may be true of their receipt of distributions as members of Certus Development and Certus Holdings.

Director Wehmiller joined Brooks and Ottinger as an undisclosed owner of Wellstone Retirement Communities. As owners of that company, those three directors were, for a time, indirect borrowers from Cornerstone (the February 15, 2006 SB-2 states that Cornerstone loaned WRC \$37.9 million in connection with its purchase of the senior housing facilities). Moreover, their undisclosed ownership interest in WRC – which brought Brooks and Ottinger \$6.2 million each and Wehmiller an, as yet, undisclosed profit – may constitute a misappropriation of corporate opportunity or breach of other duties.

According to Ottinger – quoting Brooks – the other Cornerstone directors were aware of all of the above. A review of board minutes, though, suggests that neither Ottinger nor Brooks ever brought them to the attention of the board in a board meeting. If the other board members knew about them, their failure to act to either stop or disclose those relationships may support an action against them. Even if they did not know, if they acted unreasonably in failing to inquire, they may be liable.

There is substantial evidence of general bad management at Cornerstone – more than could be investigated thoroughly in the time allowed - in addition to specific troubling instances highlighted above. That mismanagement may also rise above the business judgment rule hurdle. If so, it may provide a separate basis for filing a derivative action against Cornerstone directors, including those not involved in the undisclosed deals discussed herein.

Direct Actions

Section 11 of the Securities Act of 1933 (“Securities Act”) 15 U.S.C. § 77k provides for civil liability of any director of a company that sells securities pursuant to a registration statement that includes material misrepresentations or omits material information.¹⁵ Section 11 is a strict liability provision and purchasers of securities can, therefore, recover even for “innocent” misstatements or omissions in registration statements. See Krim v. BancTexas Group, 989 F.2d 1435 (5th Cir. 1993) (defining a material fact as one which a reasonable investor would consider significant in making the decision whether to invest). Every Cornerstone director, serving when the company issued a registration statement including a material misrepresentation or omission, may face liability under section 11 of the Securities Act (15 U.S.C. § 77k). See, Carlon v. NationsMart, 130 F.3d 309, 315 (8th Cir. 1997) (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983)).

To successfully bring claims under section 11 of the Securities Act, bondholders must show that the prospectus: (1) contained an untrue statement of a material fact, (2) omitted to state a material fact required to be stated therein, or (3) omitted to state a material fact necessary to make the statements therein not misleading. 15 U.S.C. § 77k. In order to survive a motion to dismiss on these claims, the bondholders must establish that the prospectus had a material misrepresentation or omission on the date it was issued. Id.

¹⁵ Other potential defendants under Section 11 include every person who signed registration statements, underwriters, and “every accountant, engineer, or appraiser or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any report of valuation which is used in connection with the registration statement, and every underwriter with respect to such security.” 15 U.S.C. § 77k.

Cornerstone's Chief Accountant testified that he was concerned that Sage and SHS were not independent of Cornerstone. He explained that confirming that information would have been important because it, at the very least, would have required a significant footnote to the financial statements attached to SEC filings, including prospectuses. He did not know about Brooks and Ottingers's ownership interest in Certus Holdings and Certus Development, nor of their receipt of consulting fees in connection with the individual senior retirement housing facilities.

Brooks and Ottinger's receipt of "consulting fees" from Sage and SHS stretches back to 1999. None of the six registration statements declared effective thereafter disclosed those relationships. Their ownership interest in Certus Development predates the effective date of the Series C through G registration statements. Their ownership interest in WRC and Certus Holdings predates the Series G registration statement, as does their receipt of six-figure distributions from Wellstone, LLC. If bondholders can establish the materiality of those omissions, they have a right to recover from the Cornerstone directors under section 11 of the Securities Act.¹⁶

Many state blue-sky laws contain provisions that mirror sections 11 and 12 of the Securities Act. While there is some deviation from state to state, and varying judicial interpretations, bondholders have viable claims under those state laws, as well.

The peculiar facts of this case may give rise to individual claims beyond the Securities Act and blue-sky laws. In the ninety days before Cornerstone's bankruptcy filing, several bonds matured. In an effort to deter those bondholders from redeeming their bonds, the Cornerstone board authorized a three-month extension of the maturity

¹⁶ Directors not involved in the self-dealing relationships will likely defend by arguing that they neither knew nor, in the exercise of reasonable care, could have known of the misrepresentation or omission. The Examiner, though, has yet to find evidence that any of them made any inquiry.

date of 9% bonds coming due in January 2008. Shortly thereafter Cornerstone sent another letter to bondholders whose bonds were coming due to “remind them” that they could choose to roll over into a new (Series G) 5-year bond at 9% interest. The board had increased the interest rate on Series G bonds, which, in the prospectus, provided for an 8.25% interest rate.

At the time it wrote the above letters to bondholders, the company was desperate for cash. Indeed, several witnesses testified that Cornerstone had been severely cash strapped since the summer of 2007. The letters announcing the interest rate increase, offering the extension on the maturity date, and offering rollovers into Series G bonds, made no mention of the company’s dire financial position. By those actions, Cornerstone deterred bondholders from redeeming their bonds while it was still possible. The affected bondholders may have a direct cause of action against the directors who authorized those actions, if they can prove that the action went beyond the conduct protected by the business judgment rule.

Auditors and Accountants

Because he was not authorized to employ his accounting professionals in connection with his investigation, the Examiner lacks detailed evidence of auditor misconduct apart from their participation in preparing the misleading registration statements. Nevertheless, more than one witness testified that Cornerstone’s auditors should have explored more thoroughly the relationship between Cornerstone, Sage, and SHS.

In December 2005, over 76% of Cornerstone’s loan portfolio consisted of loans to its two largest borrowers – 45.2% to SHS, from which Brooks and Ottinger indirectly

reaped large consulting fees and their share of the Certus Development profit, and 30.9% to WRC, in which Brooks, Ottinger, and Wehmiller owned an interest that would bring Brooks and Ottinger \$6,200,000 each. Yet, in note 19 to the audited financial statements accompanying the Series G registration statement, Cornerstone affirmatively stated that SHS was “not a related party” and that Cornerstone had “no power to direct or significantly influence the management or operating policies of SHS.”

Whether the auditors should have uncovered the above-mentioned relationships will be a matter for further discovery. The Examiner notes, though, that he learned of these previously undisclosed relationships simply by asking the right questions of the right witnesses. Neither Pawlowski nor Ottinger denied the relationships when asked about them. Presumably, they would have given their auditors the same information if asked. Moore, the figurehead president of Sage, forthrightly volunteered that Sage was a “subsidiary of Cornerstone.” Presumably, he would have told the auditors the same thing had they asked.

Section 11 of the Securities Act, discussed above, provides for strict liability in cases involving material misrepresentations or omissions in a registration statement. Among the parties expressly subject to liability is “every accountant . . . or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared any report or valuation which is used in connection with the registration statement.” 15 U.S.C. § 77k. The audited financial statements attached to each registration statement would seem to make the auditors strictly liable if the omission of the related-party transactions between Cornerstone, Brooks, Ottinger, and Wehmiller, were material.

In another peculiar twist, the first two Cornerstone auditors, both sole practitioners, died untimely deaths. Berman Hopkins – the only surviving accountant and auditor who worked on the Cornerstone registration statements – took over on November 5, 2005. Only the Series G statement went effective – on October 29, 2007 - after Berman Hopkins became auditor. Only bondholders who bought that series of bonds, therefore, likely have a cause of action against Berman Hopkins. The Examiner has insufficient evidence to opine on whether the corporation has a state law professional negligence claim against Berman Hopkins.

Attorneys

The other professionals involved in Cornerstone’s registration statements were attorneys. Two firms worked on Cornerstone’s filings – Miller & Martin of Atlanta, and Drew Fields of Monterrey, California.

Because Miller & Martin does not fit within the categories of defendants subject to strict liability under sections 11 and 12(2) of the Securities Act, any action against them arising from material misrepresentations or omissions in registration statements must arise from another source. Private plaintiffs may sue under section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 thereunder, which proscribe misrepresentations and omissions in connection with the purchase or sale of any security.

The United States Supreme Court has set a high bar for recovery from secondary parties in securities fraud cases. Since 1994, private plaintiffs have not been able to maintain actions against secondary parties for “aiding and abetting” securities fraud. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. 511 U.S. 164

(1994). Secondary actors, such as lawyers and accountants, may be liable as primary violators of section 10(b). But, the bar is high.

The Eleventh Circuit has interpreted Central Bank of Denver to mean that, to maintain an action, against an attorney for material misrepresentations or omissions in a registration document or an oral representation, a private plaintiff must prove, (1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) publicly attributable to the defendant at the time that the plaintiff's investment decision was made, (5) on which plaintiff relies, and (6) that proximately causes his injury. Ziembra v. Cascade International, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001).

Whether the bondholders would be able to clear that high hurdle is uncertain based on the information available to the Examiner thus far. The Examiner did not seek attorney/client information from either Miller & Martin or Drew Fields,¹⁷ Cornerstone's securities counsel. The Examiner has requested, and Miller & Martin has agreed to provide, copies of all conflict of interest waivers relating to Cornerstone. The Examiner will maintain those documents in his file.

The Examiner did, however, ask the witnesses he examined about Miller & Martin's representation of Cornerstone and various other entities. That examination revealed that a Cornerstone accountant raised concerns about Sage and SHS by way of letter addressed to Miller & Martin. Miller & Martin concluded that Sage and SHS were, indeed, independent. Whether Miller & Martin should have done a more thorough investigation, whether that investigation would have yielded the truth about the undisclosed related party transactions involving Brooks, Ottinger, Wehmiller, and

¹⁷ While Drew Fields is identified in some Cornerstone filings, the Examiner first learned the extent of his involvement in preparing the registration statements on March 13, 2009.

Covington, and whether – assuming a “yes” to both questions – such evidence would be sufficient to clear the high hurdle under Ziemba is uncertain. Courts interpreting Eleventh Circuit authority have held that, “the mere fact that a law firm played a significant role in drafting, creating, reviewing or editing a corporations allegedly fraudulent [documents] was an insufficient basis for holding it primarily liable under Rule 10b-5.” In re: Infocure Securities Litigation, 210 F. Supp. 2d 1331, 1353 (N.D. Ga. 2002).

The high bar set for actions against attorneys under section 10(b) of the Exchange Act leaves the Examiner unable to opine on whether the bondholders have a cause of action against Cornerstone’s attorneys. Likewise, the Examiner is without sufficient information to opine on whether the corporation has a valid claim against Cornerstone’s attorneys under a common law negligence theory.

Other Causes of Action

Some bondholders reported being introduced to Cornerstone bonds by employees of the IBM Employees’ Credit Union. Ottinger testified that Wehmiller arranged a referral relationship with the Credit Union. Whether any individual bondholder has a cause of action against that company will depend heavily on the particular facts surrounding the circumstances of the referral, the bondholder’s financial circumstances, and the amount of the investment relative to the investor’s investable assets. For example, if the nature of the relationship with the Credit Union were such that it owed the bondholder fiduciary duties, the Credit Union would have been under a duty to exercise extreme care in making the recommendation. If there was no such relationship, there is likely no viable cause of action.

Assignment of Claims

District Courts have upheld the assignability of claims under the federal securities law, as long as such assignment “does not encourage strike suits.” Farey-Jones v. Buckingham et al., 132 F. Supp. 2d 92, 102 (E.D. N.Y. 2001); AmeriFirst Bank v. Bomar, 757 F. Supp. 1365, 1372 (S.D. Fla. 1991). District Courts have also recognized the assignability of other actions arising under both federal common law and federal statute. In re Preston Trucking Co., 392 B.R. 623 (D. Md. 2008). A concurring opinion in a Third Circuit case supports the proposition that a “direct assignee” of a defrauded security purchaser may pursue claims under the federal securities laws. Lowry v. B&O Railroad, 707 F.2d 721, 729 (3rd Cir. 1983) (concurring opinion). As the assignment proposed by the pending Joint Plan of Liquidation would serve the interests of bondholders and would not encourage development of a market for assigned claims, the Examiner believes that Courts would uphold assignments of federal causes of action to the Private Actions Trust.

In Georgia and other states, tort claims for fraud or injuries arising from fraud are not assignable. See, O.C.G.A. § 44-12-24; In re Estate of Sims, 259 Ga. App. 786, 791 (2003); In re: Timothy L. Allen, 2008 Bankr. LEXIS 366, *6 (2008). The law regarding the assignability of tort claims varies widely from state to state.

CONCLUSION

The Examiner finds that the shift to making loans to for-profit borrowers occurred as early as 1999. The Examiner finds that the shift was characterized by self-dealing. Finally, the Examiner finds that bondholders have causes of action against broker-

dealers, investment advisers, all Cornerstone officers and directors, and Cornerstone's auditors.

While the Examiner believes that his Report is complete given the scope of his assignment, additional investigation would further enlighten the Court and bondholders on the details of the business arrangements revealed in this Report (and, perhaps, reveal others), and the specifics of the many instances of corporate mismanagement. Counsel hired to pursue the identified actions on behalf of bondholders or the Private Actions Trust, however, can discover those facts in the course of civil discovery without additional cost for the Examiner's time. The Examiner, therefore, considers his assignment complete, subject to being called to further service by the Court.

Respectfully submitted this 16th day of March, 2009.

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