UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

In re:	)	
	)	Chapter 11
SCHWAB INDUSTRIES, INC., *et al.*[1]	)	
	)	Case No. 10-60702-rk
Debtors.	)	(Jointly Administered)
	)	
______________________________________	)	Judge Russ Kendig

OBJECTION OF OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO DEBTORS' MOTION FOR ORDER (I) AUTHORIZING POST-PETITION SECURED FINANCING PURSUANT TO BANKRUPTCY CODE SECTIONS 105, 361, 362, 363 AND 364, (II) MODIFYING THE AUTOMATIC STAY AND (III) SCHEDULING A FINAL HEARING

The Official Committee of Unsecured Creditors (the "*Committee*") appointed in the above-captioned chapter 11 cases, by and through its counsel, hereby files this objection (the "*Objection*") to the Debtors' *Motion for Order (I) Authorizing Post-Petition Secured Financing Pursuant to Bankruptcy Code Sections 105, 361, 362, 363 and 364, (II) Modifying the Automatic Stay and (III) Scheduling a Final Hearing* (the "*Motion*"). In support of this Objection, the Committee states:

PRELIMINARY STATEMENT

1. The Debtors[2] now seek to obtain post-petition financing from their pre-petition lenders (the *"Pre-Petition Lenders*") to fund the Debtors' ongoing sale process and to cure a Termination Event under the Final Cash Collateral Order because of their inability to obtain a $3.2 million refund (the "*Refund Obligation*") from certain Schwab family life insurance policies

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[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's tax identification number are: Schwab Industries, Inc. (2467); Medina Cartage Co. (9373); Medina Supply Company (3995); Quality Block & Supply, Inc. (2186); O.I.S. Tire, Inc. (7525), Twin Cities Concrete Company (9196); Schwab Ready-Mix, Inc. (8801); Schwab Materials, Inc. (8957); and Eastern Cement Corp. (7232).

[2] All capitalized terms used in the Preliminary Statement are defined below.

(the "*Policies*"). In consideration for this short-term loan (the "*DIP Loan*"), the Debtors propose to secure the Pre-Petition Lenders with liens on substantially all of the Debtors' assets, including previously unencumbered assets, subordinated only to the priming liens of EFO Financial Group, LLC (as succeeded in interest by Naples Lending Group, L.C., "*Naples*"). As such, unsecured creditors' recoveries may be adversely affected on a dollar-for-dollar basis by the DIP Loan. Moreover, the DIP Loan attempts to dictate the terms of a future marshalling scenario whereby these unencumbered assets will be used to satisfy the secured claims of Naples, leaving the Debtors' estates and unsecured creditors with little or nothing. Such a result is unacceptable to the Committee.

2. It is obvious to the Committee that: (a) the Debtors' insiders are using the purported "emergency" transaction to render termination of the Schwab family's $7 million life insurance policies unnecessary, and (b) the Pre-Petition Lenders have consented to the transaction to cure certain significant defects in their collateral position, namely hundreds of valuable motor vehicles, a substantial tax refund and cash. Yet this carefully structured transaction comes at the direct expense of the Debtors' estates and unsecured creditors, represents an irresponsible exercise of the Debtors' business judgment given the circumstances, and should not be approved in its current form by this Court.

3. The necessity of the proposed DIP Loan was borne from the refusal of Huntington Trust, an affiliate of one of the Pre-Petition Lenders, to comply with instructions to effectuate a loan transaction whereby the Schwab family would borrow $3 million against the Policies and contribute those funds to the Debtors in satisfaction for the Refund Obligation. The Committee proposed several viable alternatives to obtain these monies from the Policies but they were rejected by the Schwab family, creating the current liquidity crisis and a Termination Event. Of

course, the Pre-Petition Lenders now propose to advance the necessary funds but only if they are permitted to cure significant defects in their collateral position at the estate's expense.

4. Perhaps even more brazen, the Pre-Petition Lenders have conditioned the DIP Loan on the entry of an order authorizing the Debtors to first satisfy their obligations to Naples with proceeds of unencumbered assets. Recognizing that the Naples DIP Loan has been used to preserve the Pre-Petition Lenders' collateral, and that in the absence of that loan, the Pre-Petition Lenders would only have received liquidation value on the Debtors' assets, the Pre-Petition Lenders – and not unsecured creditors – should bear the cost for these gains under applicable law.

5. In short, the transactions proposed by the Debtors are unjustified, unnecessary and appear to benefit only the Debtors' insiders and the Pre-Petition Lenders at the expense of unsecured creditors. For these reasons – as more fully set forth below – the Court should deny the Motion.

RELEVANT BACKGROUND

A. The Chapter 11 Cases

6. On February 28, 2010 (the "*Petition Date*"), Schwab Industries, Inc. and its affiliated debtors and debtors-in-possession (collectively, the "*Debtors*") filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "*Bankruptcy Code*") in the United States Bankruptcy Court for the Northern District of Ohio (the "*Court*").

7. The Debtors are currently operating and managing their businesses as debtors-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. The Committee was appointed on March 9, 2010.

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B. The Pre-Petition Indebtedness and the Committee's Investigation of the Pre-Petition Lenders' Liens

8. On October 18, 2007, the Debtors, as borrowers, and KeyBank National Association, as agent and lender (the "*Agent*"), Bank of America, N.A., as lender ("*B of A*") and The Huntington National Bank, as lender ("*Huntington*" and, collectively with the Agent and B of A, the "*Pre-Petition Lenders*") entered into an Amended and Restated Credit Agreement (as amended or modified, the "*Pre-Petition Credit Agreement*").

9. Pursuant to the Pre-Petition Credit Agreement, the Pre-Petition Lenders extended to the Debtors a revolving loan (the "*Revolving Loan*") in the amount of $25,000,000,[3] a term loan A (the "*Term Loan A*") in the amount of $30,000,000, and a term loan B (the "*Term Loan B*") in the amount of $50,000,000.

10. The Debtors have represented that, as of the Petition Date, the total indebtedness owed to the Pre-Petition Lenders was $59,703,781 (consisting of $8,582,950 with respect to the Revolving Loan, $19,125,245 with respect to Term Loan A and $31,995,586 with respect to Term Loan B) (the "*Pre-Petition Obligations*").

11. On April 15, 2010, this Court authorized the Debtors' continued use of cash collateral during the Bankruptcy Cases pursuant to its *Final Agreed Order Authorizing Limited Use of Cash Collateral* (Docket No. 280) (the "*Cash Collateral Order*"). The Cash Collateral Order expressly preserved the Committee's right to challenge the validity, enforceability or priority of the Pre-Petition Obligations or the Pre-Petition Lenders' liens and security interests

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[3] Pursuant to certain forbearance agreements, prior to the Petition Date, the maximum amount of the Revolving Loan was reduced to $18,000,000.

and assert claims against the Agent and/or the Pre-Petition Lenders within sixty (60) days of the appointment of the Committee.[4]

12. While the Committee's investigation is ongoing, it has determined that a substantial amount of the Pre-Petition Collateral may not be subject to the Pre-Petition Lenders' liens (collectively, the "*Unencumbered Collateral*"). These collateral defects fall within three categories of the Pre-Petition Collateral: (i) rolling stock and motor vehicles; (ii) deposit accounts; and (iii) a federal tax refund expected to be payable to the Debtors for the 2009 tax year (fiscal year ending April 30, 2010). At present, the Committee believes that the Unencumbered Collateral may equal or exceed $10 million, and accordingly, if the asserted liens on this collateral are determined to be invalid or unperfected, the estates will be entitled to receive a substantial portion of the proceeds of a sale(s) of the Debtors' assets. In these cases – where the Pre-Petition Lenders have liens over substantially all of the Debtors' assets and appear to be undersecured – such Unencumbered Assets may end up being the ***sole*** source of distributions for the Debtors' unsecured creditors.

C. The Naples DIP Loan

13. Pursuant to the *Interim Order (I) Authorizing Post-Petition Secured Superpriority Financing Pursuant to Bankruptcy Code Sections 105, 361, 362, 363(c), 363(e), 364(c)(1), 364(c)(2), 364(c)(3), and 364(d), (II) Granting Adequate Protection Pursuant to Sections 361, 363 and 364 of the Bankruptcy Code, (III) Modifying the Automatic Stay and (IV) Setting Final Hearing Pursuant to Bankruptcy Rule 4001* entered on March 3, 2010 (Docket No. 44) (the "*Interim DIP Order*"), the Debtors were authorized to obtain superpriority financing from Naples in an amount not to exceed $3,500,000 (the "*Naples DIP Loan*").

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[4] The Committee and the Pre-Petition Lenders have agreed to extend the deadline for the Committee to assert claims against the Pre-Petition Lenders to May 31, 2010.

14. The Debtors' obligations to Naples were secured by, among other things, a first priority priming lien and security interest in the Pre-Petition Collateral and all other assets of the Debtors, including the Unencumbered Collateral.

15. The Debtors obtained the Naples DIP Loan from Naples for two primary reasons: (i) to obtain working capital funds necessary to maintain the going concern value of the Debtors' businesses; and (ii) because the Pre-Petition Lenders refused to provide any debtor-in-possession funding. DIP Order, at ¶¶ F and G.

16. In the absence of the Naples DIP Loan, the Debtors would have been unable to fund ongoing business operations and would have been forced to immediately liquidate, thereby causing the depletion of the Debtors' going concern value. In a forced liquidation, the Pre-Petition Lenders would have received substantially less for the Pre-Petition Collateral. Accordingly, the proceeds of the Naples DIP Loan directly benefitted the Pre-Petition Lenders by helping preserve the going concern value of the Debtors' businesses and assets.

D. The Life Insurance Refund

17. The only reason the Debtors require additional post-petition financing is because they failed to obtain a $3 million cash infusion based on certain life insurance policies naming Schwab family members as beneficiaries.

18. Under paragraph 7(f) of the Cash Collateral Order, the Debtors' authorization to use the cash collateral of the Pre-Petition Lenders, and any and all obligations of the Pre-Petition Lenders thereunder, shall immediately cease in the event that the Debtors fail to obtain, "on or before April 28, 2010,[5] a refund in the amount not less than $3.0 million of the life insurance

[5] The Pre-Petition Lenders have a agreed to a brief extension of this deadline. The Committee believes that the Pre-Petition Lenders will not terminate the Cash Collateral Order based on a failure to obtain the Insurance Refund.

premiums advanced by Schwab Industries, Inc. for certain life insurance policies on the lives of Jerry and Donna Schwab that are held by certain Schwab family trust (the "*Insurance Refund*")." Paragraph 7(f) further provides that "Agent and Pre-Petition Lenders will provide any reasonably necessary consent and authorizations required to obtain the Insurance Refund."

19. As represented by the Debtors, the proceeds of the Insurance Refund constituted necessary funding for the operation of the Debtors' businesses and for the ongoing sale process with respect to substantially all of the Debtors' assets. The Insurance Refund was therefore a key component of: (a) the Pre-Petition Lenders' willingness to permit the Debtors to use their cash collateral pursuant to the Cash Collateral Order; and (b) the Committee's consent to the Cash Collateral Order.

i. The Schwab Trust

20. Pursuant to that certain Irrevocable Trust Agreement (the "*Trust Agreement*"), dated as of April 1, 1992, Jerry A. Schwab, as settler, established the Schwab Irrevocable Trust #1 (the "*Schwab Trust*"). Huntington Trust Company of Florida, N.A. ("*Huntington Trust*"), an affiliate of Huntington, one of the Pre-Petition Lenders, is the trustee of the Schwab Trust and, under the Trust Agreement, was bestowed significant authority with respect to the management and investment of Schwab Trust assets.

21. The Schwab Trust establishes an advisory committee (the "*Advisory Committee*"), consisting of three Schwab family members, to perform all duties with respect to the maintenance of the Policies, including the designation of the Trustee as beneficiary, the payment of premiums, the pledging of the Policies and the exercise of available options or elections. Trust Agreement, at § 5.7.2.

22. The Schwab Trust holds, among other assets, three life insurance policies (collectively, the "*Policies*") that were opened prior to the Petition Date. The Policies provide for an aggregate of $7 million in benefits, name Jerry A. Schwab and Donna L. Schwab as Insureds, and further name Huntington Trust as sole owner and beneficiary.

23. Also on April 1, 1992, Debtor Schwab Industries, Inc. ("*Schwab Industries*") and Huntington Trust entered into a certain Split Dollar Agreement (the "*Split Dollar Agreement*"). Pursuant to the Split Dollar Agreement, Schwab Industries agreed to pay to the respective insurers the annual premium under the Policies. Huntington Trust remained the sole owner and beneficiary of the Policies, subject to a collateral assignment to be executed by Huntington Trust in favor of Schwab Industries. The collateral security interest was limited to the amount of premiums contributed by Schwab Industries.

24. On or about April 16, 2009, pursuant to three separate Assignments of Life Insurance Policy as Collateral (collectively, the "*Assignments*"), the Policies were assigned to the Agent. Copies of the Assignments are attached hereto as *Exhibit A*.

25. Among the rights assigned to the Agent in the Assignments is the sole right to obtain one or more loans or advances on the Policies, either from the Insurer or, at any time, from other persons, and to pledge or assign the Policies as security for such loans or advances.

ii. The Debtors' Failure To Obtain the Insurance Refund

26. Rather than terminate the Policies and obtain the Insurance Refund as required by the Cash Collateral Order, the Debtors instead chose to attempt to satisfy the refund obligation set forth in the Cash Collateral Order by seeking authority from Huntington Trust to obtain a $3 million loan against the Policies. It is believed that the Schwab family chose to seek a loan rather than terminate the Policies in order to preserve the value of the Policies for the Schwab

Trust beneficiaries (the Schwab family members) and to avoid certain adverse tax consequences to the Schwab family.

27. To that end, on April 2, 2010, the Advisory Committee directed Huntington Trust to borrow funds from the cash value of the Policies in order to provide an advance or a loan to the beneficiaries of the Schwab Trust (the "*Life Insurance Loan*"). This advance or loan would then be tendered to the Debtors' estates to avoid a termination of the Debtors' use of cash collateral. A copy of this April 2, 2010 correspondence is attached hereto as *Exhibit B*.

28. On April 15, 2010, the Agent sent a letter to Huntington, noting that the Schwab Trust intended to borrow $3 million against the cash surrender value of the Policies and remit such proceeds to the Debtors as a partial satisfaction of the Schwab Trust's reimbursement obligations to the Debtors (and in satisfaction of the Insurance Refund requirement). The Agent acknowledged and consented to the loan. A copy of this April 15, 2010 correspondence is attached hereto as *Exhibit C*.

29. By e-mail correspondence dated April 22, 2010, Huntington Trust denied the Life Insurance Loan request, noting various deficiencies in the request by the Advisory Committee and the acknowledgment and consent by the Agent. A copy of this April 22, 2010 correspondence is attached hereto as *Exhibit D*.[6]

30. Since April 22, 2010, however, neither the Agent, Huntington Trust nor the Debtors have accomplished anything approaching a solution to the Insurance Refund dilemma. Based on the Debtors' immediate need for the Insurance Refund proceeds to prevent a Termination Event under the Cash Collateral Order, to operate the Debtors' businesses and to avoid the need to obtain the DIP Loan, the Committee inquired as to the Agent's and Debtors'

[6] The Debtors' counsel did not forward the April 22, 2010 e-mail correspondence to Committee counsel until April 27, 2010, the day prior to the deadline to obtain the Insurance Refund set forth in the Cash Collateral Order.

failure to timely propose an alternative transaction that would satisfy Huntington Trust's concerns.[7] The Advisory Committee and Agent have – without explanation – failed to seek out these alternatives.[8] Meanwhile, the Agent has allowed the Insurance Refund deadline to pass without taking any action against the Debtors.

31. It has become clear that the Schwab insiders and the Pre-Petition Lenders are now attempting to use this opportunity to benefit themselves – with the Debtors' unsecured creditors suffering the consequences. Securing the DIP Loan with the Unencumbered Collateral would cure certain defects of the Pre-Petition Lenders in heir collateral, and would encumber the sole portion of the Debtors' assets that could be used to satisfy unsecured claims. The DIP Loan proceeds are being obtained in lieu of the Insurance Refund so that the Schwab family members may retain the benefits of the Policies and prevent any adverse tax consequences of terminating the Policies to satisfy the condition in the Cash Collateral Order. This approach, however, is in direct contravention of the transactions anticipated by the Cash Collateral Order, and relied upon by the Committee, to bring in the needed funds to conduct an orderly sale process. The Committee therefore seeks an order of this Court denying the Motion and prohibiting the Pre-Petition Lenders and the Debtors from using this self-manufactured dilemma to cure the defects in the Pre-Petition Lenders' collateral position.

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[7] For example, the Advisory Committee could request that Huntington Trust terminate the Policies, which would result in a refund of approximately $3 million of the premiums to Schwab Industries. Apparently, such a cancellation would cause adverse tax consequences to the Schwab family (as well as result in the cancellation of the valuable Policies that could benefit the Schwab family members upon the death of the insureds). Alternatively, the Agent could have requested the Life Insurance Loan directly from Huntington Trust, as authorized by the Assignments.

[8] The haphazard nature of these negotiations compels the question: did the Agent, Huntington Trust, and the Schwab family even discuss the mechanics of how the Insurance Refund would be accomplished prior to agreeing to it in the Cash Collateral Order?

ARGUMENT

32. Pursuant to the Motion, the Debtors seek approval of a $2 million DIP Loan with the Pre-Petition Lenders that will: (i) allow the Pre-Petition Lenders to cure their collateral defects by granting them liens in the Unencumbered Collateral; and (ii) further protect the Pre-Petition Lenders by requiring Naples to first look to the Unencumbered Collateral for satisfaction of the Naples DIP Loan. By granting the Pre-Petition Lenders this relief, the potential sole source of the unsecured creditors' recovery may be significantly reduced – if not altogether depleted.

33. Section 364(c) of the Bankruptcy Code, which governs the obtaining by a debtor of post-petition secured credit, provides:

> If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.

11 U.S.C. § 364(c).

34. In addition to the statutory requirements of section 364(c), there is an implicit condition that courts have placed on a debtor seeking post-petition secured financing: the proposed financing facility must be the product of the debtor's reasonable business judgment. Such financing must also be fair and equitable, and in furtherance of the Debtors' fiduciary duties to the estates and creditors. Here, based on the apparent motivations of the parties to protect the Schwab family and cure significant deficiencies in the Pre-Petition Collateral, both of

which run to the detriment of unsecured creditors, the Committee believes that the proposed DIP Loan is not a reasonable exercise of the Debtors' business judgment and represents a breach of the Debtors' fiduciary duties to the bankruptcy estates. Therefore, the DIP Loan should be denied.

A. The Debtors Are Not Disinterested and Their Business Judgment in Obtaining the Proposed DIP Loan Was Not Reasonable.

35. Before approving a post-petition financing transaction pursuant to section 364(c) of the Bankruptcy Code, the Court must find that, among other things, obtaining the loan is within the Debtors' reasonable business judgment. *See, e.g.*, *In re Farmland Indus., Inc.*, 294 B.R. 855, 879 (Bankr. W.D. Mo. 2003) (for approval of financing pursuant to section 364(c) of the Bankruptcy Code, the debtors must show, among other things, "[t]hat the proposed financing is an exercise of sound and reasonable business judgment"); *In re Phase-I Molecular Toxicology Inc.*, 285 B.R. 494, 495 (Bankr. D.N.M. 2002) ("In order to secure approval of post-petition financing pursuant to 11 U.S.C. §§ 364(c) and/or (d), the debtor-in-possession bears the burden of proving . . . 'that the proposed financing is an exercise of sound and reasonable business judgment[.]'"); *see also In re Metaldyne Corp.*, 2009 Bankr. LEXIS 1533, at *16 (Bankr. S.D.N.Y. June 23, 2009) (unpublished) (noting that "the real issue is whether the Debtors in the exercise of their business judgment have demonstrated that the value of the estate will best be protected for all creditors (not just the secured creditors) by having the Court give final approval to the DIP Facility.").

36. The business judgment rule comes into play based on the fiduciary duties owed by the Debtors' officers and directors to the Debtors' creditors. In a bankruptcy case, a debtor owes fiduciary duties to the bankruptcy estate. As such, the operators of the debtor's business, "acting as a debtor in possession, must run the business as agents of the bankruptcy estate, and

not for their own personal gain. The fiduciary obligations consists of two duties: the duty of care and the duty of loyalty." *Lange v. Schropp (In re Brook Valley VII, Joint Venture)*, 496 F.3d 892, 900 (8th Cir. 2007); *see also In re Penick Pharmaceutical, Inc.*, 227 B.R. 229 (Bankr. S.D.N.Y. 1998) (holding that when a chapter 11 debtor-in-possession's fiduciary duties fall on the debtor's directors, officers and managing employees, who have an obligation to maximize the value of the estate, and who are burdened to ensure that resources that flow through the debtor's hands are used to benefit the unsecured creditors and other parties in interest). As further held by the *Brook Valley VII Joint Venture* court:

> The duty of loyalty comes into play when there appears to be a conflict between the interests of the fiduciary and the entity to which he owes loyalty. ***For a debtor in possession, this duty includes an obligation to refrain from self-dealing, to avoid conflicts of interests and the appearance of impropriety, to treat all parties to the case fairly and to maximize the value of the estate.***

In re Brook Valley VII Joint Venture, 496 F.3d at 900-01 (emphasis added); *see also In re Tenn-Fla Partners*, 226 F.3d 746, 748 (6th Cir. 2000) (affirming bankruptcy court decision to revoke confirmation order where the debtor violated its debtor-in-possession obligations and engaged in self-dealing at the expense of the bondholders, who had been induced by the debtor's misrepresentations to give up their elections pursuant to section 1111(b)(2) of the Bankruptcy Code); *In re V Cos.*, 274 B.R. 721 (Bankr. N.D. Ohio 2002) (converting a chapter 11 case based, in part, on the breached of fiduciary duties by the debtor-in-possession's management in engaging in certain questionable transactions and self-dealing).

37. The business judgment rule does not apply where the debtor's insiders are not disinterested, as is the case here, and a proposed transaction is thereby subject to heightened scrutiny. *See, e.g.*, *Marsalis v. Wilson*, 778 N.E.2d 612, 615-16 (Ohio Ct. App. 2002) ("The rule [under Ohio law] is a rebuttable presumption that directors are better equipped than the courts to

make business judgments and that the directed ***acted without self-dealing or personal interest*** and exercised reasonable diligence and acted in good faith.") (emphasis added); Robin E. Phelan, et al., *If Their Business Judgment Was So Good How Come They're In Bankruptcy and Other Perplexing Mysteries of the Business Judgment Rule: Corporate Governance Issues for the Financially Troubled Company*, 10 J. Bankr. L. & Prac. 471, 474 (Sept./Oct. 2001) ("The business judgment rule presupposes that a challenged corporate decision is made by disinterested corporate directors."). As explained by the Fourth Circuit Court of Appeals:

> Under the business judgment rule, courts defer to corporate officers' decisions on matters entrusted to their business judgment absent a showing of bad faith or gross abuse of that judgment, and this rule extends to bankruptcy proceedings. Whether a debtor's decision is so manifestly unreasonable that it could only be based on bad faith, whim, or caprice rather than sound business judgment is a question of fact, and this factual determination is subject to the clearly erroneous standard.

Quality Inns Int'l, Inc. v. L.B.H. Assocs. Ltd. P'ship, 1990 WL 116761, at *7 (4th Cir. July 26, 1990) (unpublished) (citations omitted); *see also In re W.A. Mallory Co.*, 214 B.R. 834 (Bankr. E.D. Va. 1997) (concluding that where proposed purchasers were insiders of the corporation, it suggested a lack of good faith).

38. And as held in *Farmland Industries*:

> Under the "business judgment" rule, the management of a corporation's affairs is placed in the hands of its board of directors and officers, and the Court should interfere with their decisions only if it is made clear that those decisions are, *inter alia*, clearly erroneous, made arbitrarily, are in breach of the officers' and directors' fiduciary duty to the corporation, are made on the basis of inadequate information or study, are made in bad faith, or are in violation of the Bankruptcy Code. . . . ***Only in circumstances where there are allegations of, and a real potential for, abuse by corporate insiders, should the Court scrutinize the actions of the corporation.***

In re Farmland Indus., Inc., 294 B.R. at 881 (citations and internal quotation marks omitted) (emphasis added).

39. Here, it is clear that the Debtors are not disinterested and that their business judgment in obtaining the DIP Loan should not be respected.[9] As set forth above, the Debtors are involved in substantial self-dealing by (a) seeking to obtain the Insurance Policy Loan rather than the Insurance Refund, as contemplated by the Cash Collateral Order, and (b) abandoning their obligation to obtain any type of insurance proceeds altogether and, instead, proposing to grant liens on unencumbered assets to the Pre-Petition Lenders. Rather than pursue the Insurance Refund as required by the Cash Collateral Order, which could admittedly have an adverse economic impact on the Schwab family, the Schwabs are instead willing to grant the Pre-Petition Lenders' liens in all the Unencumbered Assets – a result that preserves the Policies at the expense of unsecured creditors and that improves the Schwabs' bottom line by $3 million. It is easy to see that the Schwabs have chosen to protect their interests – at all costs – rather than do what is best for the Debtors' estates.[10]

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[9] In fact, the Committee posits that obtaining the DIP Loan in lieu of the Insurance Refund – to preserve valuable assets for the sole benefit of the Schwab insiders – constitutes a breach of the Schwab family's fiduciary duties owed to the Debtors' creditors.

[10] It is apparent that the Schwab family either does not understand its fiduciary obligations to the bankruptcy estates or is completely ignoring them. In addition to its acts adverse to the bankruptcy estates with respect to the DIP Loan, the Schwab family stands to have an ownership interest and/or employment relationship with the Debtors' proposed stalking horse for substantially all of the Debtors' assets. If the DIP Loan is approved and the stalking horse prevails as the winning bidder, the Schwab family will continue to: (a) have all of the benefits of the Policies; and (b) hold an ownership interest and employment relationship with the Debtors. At the same time, the Debtors' bankruptcy estates and unsecured creditors will likely be left with little or nothing from these chapter 11 cases. Bankruptcy courts may *sua sponte* appoint a chapter 11 trustee under appropriate circumstances with requisite procedural safeguards if cause exists or to prevent an abuse of process. *Matter of Mother Hubbard, Inc.*, 152 B.R. 189, 197 (Bankr. W.D. Mich. 1993). Certain conduct of the Schwab family in these chapter 11 cases is questionable, including, but not limited to: (a) exorbitant executive compensation at the outset of the chapter 11 cases; (b) the priming litigation; (c) the refusal to consummate the Insurance Refund requirements of the Cash Collateral Order; and (d) the naming of the stalking horse and modification to the bid procedures. Frankly, the bankruptcy estates may be better served by a disinterested third party operating the Debtors' businesses for the benefit of all creditors.

40. Moreover, it is an unreasonable exercise of the Debtors' business judgment to permit a financing arrangement that will benefit only the Pre-Petition Lenders. *See In re Berry Good, LLC*, 400 B.R. 741, 747 (Bankr. D. Ariz. 2008) ("While certain favorable financing terms may be permitted as a reasonable exercise of the debtor's business judgment, bankruptcy courts do not allow terms in financing arrangements which convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the post-petition lender."); *In re Farmland Indus., Inc.*, 294 B.R. at 884 ("The Courts should permit debtors to exercise their reasonable judgment 'so long as the financing agreement does not contain terms that leverage the bankruptcy process and powers or its purpose is not so much to benefit the estate as it is to benefit a party-in-interest.'") (citing *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 40 (Bankr. S.D.N.Y. 1990)).

B. Permitting the Pre-Petition Lenders To Provide the DIP Loan Solely in Order To Cure Their Collateral Defects Would Be Inequitable.

41. The granting of the additional liens to the Pre-Petition Lenders would be extremely inequitable here and would serve only to cure the Pre-Petition Lenders' defects in perfecting their liens in the Unencumbered Collateral at the expense of unsecured creditors. The situation giving rise to the DIP Loan was created by the Pre-Petition Lenders' themselves. Huntington Trust, which unjustifiably refused to provide the Insurance Refund, is an affiliate of one of the Pre-Petition Lenders. This refusal led to a significant cash shortfall. Now, the Pre-Petition Lenders have taken advantage of this "dilemma" in order to demand liens over the Unencumbered Assets. The Pre-Petition Lenders' use of this situation to their own advantage is clear by their failure to terminate the Cash Collateral Order based on the occurrence of a Termination Event or take any action vis-à-vis the Debtors' failure to seek alternatives to the Life Insurance Loan transaction.

42. Adding to this inequity is the fact that the Pre-Petition Lenders simply do not need liens on the Unencumbered Collateral. The loan is effectively a no-risk proposition to the Pre-Petition Lenders, since in light of the superpriority liens they will be granted, coupled with the bids received to purchase the Debtors' assets, prompt repayment of the loan is a virtual certainty. Given this reality, the Pre-Petition Lenders will not be prejudiced, or subjected to unreasonable risk, if the liens on Unencumbered Collateral are not granted.

43. Indeed, a number of alternatives are available to provide adequate protection and certainty of repayment to the Pre-Petition Lenders – none of which were apparently explored:

- grant the Pre-Petition Lenders replacement liens in the Pre-Petition Collateral, perhaps limited to a replacement lien on the Insurance Refund;
- request the advance of additional Revolving Loans (within the commitment amount) pursuant to the Pre-Petition Credit Agreement;
- ask the Agent to seek authorization for the Life Insurance Loan directly, as permitted by the Assignments; or
- terminate the Policies, which would result in a refund of the premiums paid to Schwab Industries in the approximate amount of the proposed DIP Loan (the original transaction, which was required by the Cash Collateral Order in the first place).

44. That none of these alternatives were considered further underscores the impropriety of the Pre-Petition Lenders' request, and suggests that the proposed DIP Loan may be motivated primarily by a desire to cure the defects of the Unencumbered Collateral.

C. It is Inequitable and Impermissible for the Debtors to Require Naples to Marshal Against the Unencumbered Collateral

45. The Debtors also seek an order of the Court requiring Naples to marshal against the Pre-Petition Collateral prior to collecting against the Unencumbered Assets. As further evidence that the Pre-Petition Lenders are offering a 30-day loan to the Debtors mainly as a scheme to cure their collateral defects, the Pre-Petition Lenders seek this marshalling order to

ensure that the proceeds of the Pre-Petition Collateral go only to the Pre-Petition Lenders, regardless of the consequences to all other parties-in-interest. Such a ruling would be prejudicial to the Debtors' unsecured creditors and should not be granted.

46. If the Court orders marshaling, it would result in unjust enrichment to the Pre-Petition Lenders because the DIP Loan was used to preserve their collateral. Given that the going concern value of the Debtors' assets and businesses is considerably higher than it would be in a fire sale liquidation, and in light of the fact that the Naples DIP Loan permitted the Debtors to continue operating as a going concern, it follows that the Naples DIP Loan benefitted the Pre-Petition Lenders by a significant amount – likely in excess of the amount of the Naples DIP Loan.[11] Accordingly, it would be more appropriate to require Naples to marshal against the Pre-Petition Collateral first. This would also be the most equitable solution for the Debtors' unsecured creditors, whose recovery in these cases may be entirely dependant upon the Unencumbered Assets. If the DIP Lender is required to collect, first, against the Unencumbered Assets, there could possibly be nothing left for unsecured creditors.

47. Marshalling should not be permitted when it will exact an inequitable result for the Debtors' estates and unsecured creditors. Under Ohio law, one of the requirements for marshaling "is that compelling a party to resort to one of the funds rather than the other [can] not work an injustice to any party connected with the litigation, i.e. the application of marshaling

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[11] In its March 13, 2010 Viability Scenario Analysis, MorrisAnderson & Associates (the Pre-Petition Lenders' financial advisor) determined that the liquidation value of the Debtors' assets was approximately $45,400,000, and the Court has accepted this estimate as credible. Given that the economic value of the proposed "stalking horse" bid of Cement Resources, LLC is valued at over $52,000,000, it therefore follows that the Pre-Petition Lenders will earn a net benefit of over $3 million from the going concern sale of the Debtors' assets, even if Naples is required to collect from the encumbered Pre-Petition Collateral. And when compared to the recently-received higher and better competing bids of a strategic buyer for the Debtors' operating assets and of the bidder for the Florida orange grove, the net benefit grows dramatically – **to more than $10 million**.

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[can] not work an injustice either to the common debtor or to other persons under circumstances where it would be inequitable to apply the principle." *In re Leviton Constr. Co.*, 122 B.R. 530, 532 (Bankr. S.D. Ohio 1991) (citing *Green v. Ramage*, 18 Ohio 428 (1849)); *see also Sicherman v. Page (In re Page)*, 2006 Bankr. LEXIS 4156, at *11 (Bankr. N.D. Ohio Oct. 20, 2006) (holding that marshalling "is applicable only when its operation will be equitable") (citation omitted).

48. The equities clearly balance in favor of denying the Debtors' request for marshalling in this case. First, and as noted above, unsecured creditors may very well be deprived of any chance of recovery in these cases if marshalling is permitted. Second, and perhaps more importantly, the Pre-Petition Lenders will not be harmed if marshalling is denied, because the value of the Pre-Petition Collateral preserved by the Naples DIP Loan likely far exceeded the amount of the loan itself. This reality means that even if Naples is paid from the proceeds of the encumbered Pre-Petition Collateral, the Pre-Petition Lenders will have enjoyed a substantial net benefit – *perhaps in an amount exceeding $10 million* – when compared to its recovery in a forced liquidation. At a minimum, the question of marshalling should be preserved for further discussion and, if necessary, litigation before this Court.

CONCLUSION

49. The proposed DIP Loan comes at far too high of a cost to unsecured creditors to be in the best interests of the Debtors' estates. The unjust enrichment that will inure to the Pre-Petition Lenders from the granting of liens on, and the marshalling of, the Unencumbered Collateral – particularly when several alternative transactions exist that are fair and equitable to all constituencies – demand the denial of the proposed DIP Loan. Accordingly, the Committee respectfully requests that the Court deny the Motion.

Dated: May 9, 2010

OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF SCHWAB INDUSTRIES, INC., *et al.*

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