UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

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

BRIEF IN SUPPORT OF DEBTORS AND DEBTORS IN POSSESSION MOTION FOR 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), 364(D) AND 364(E), (II)) GRANTING ADEQUATE PROTECTION PURSUANT TO SECTIONS 361, 363 AND 364 OF THE BANKRUPTCY CODE, AND (III) MODIFYING THE AUTOMATIC STAY

Schwab Industries, Inc ("SII"), Medina Cartage Co. ("MCO"), Medina Supply Company ("MSC"), Quality Block & Supply, Inc. ("QBS"), O.I.S. Tire, Inc. ("OIS"), Twin Cities Concrete Company ("TCC"), Schwab Ready-Mix, Inc. ("SRM"), Schwab Materials, Inc. ("SMI") and Eastern Cement Corp. ("ECC"), and together with SII, MCO, MSC, QBS, OIS, TCC, SRM and SMI, the "Debtors"), the debtors and debtors in possession in the above-captioned Chapter 11 cases (the "Cases"), submit this brief in support of the Motion of Debtors for an 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), 364(d), and 364(e), (ii) Granting Adequate Protection Pursuant to Sections 361, 363, and 364 of the Bankruptcy Code, and (iii) Modifying the Automatic Stay (the "Motion").[2]

[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] Capitalized terms not otherwise defined herein have the meanings given to them in the Motion.

I. Introduction

The Debtors are leaders in the production, supply and distribution of ready-mix concrete, concrete block, cement and related supplies to commercial, municipal and residential contractors throughout Northeast Ohio and Southwest Florida.

On February 28, 2010 (the "Petition Date") the Debtors filed a voluntary petition for relief under chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code"). Since the Petition Date, the Debtors have been operating their business as a debtors-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code.

As of the Petition Date, Debtors owed their Prepetition Lenders[3] pursuant to the prepetition Secured Loans as set forth in the Motion. Upon information and belief, as of the Petition Date, the Prepetition Lenders had a first priority security interest in substantially all the personal property assets of Debtors and a first priority mortgage interest in substantially all the real property (collectively, the "Prepetition Collateral") of the Debtors to secure repayment of the prepetition Secured Loans.

Immediately upon the commencement of the case, the Debtors filed the Motion seeking interim authority to obtain postpetition secured financing pursuant to section 364(d) of the Bankruptcy Code from EFO Financial Group, LLC (the "DIP Lender").

The Prepetition Lenders filed an objection to the Motion (the "Objection"). In the Objection, the Prepetition Lenders objected to the Debtors' request to grant superpriority claims and priming liens to the DIP Lender. Furthermore, the Prepetition Lenders disputed whether their interests were adequately protected.

[3] The "Prepetition Lenders" are KeyBank, National Association, Bank of America, N.A. and The Huntington National Bank.

This Court held an emergency interim hearing on March 2, 2010 (the "Interim Hearing"). On March 3, 2010, this Court entered an interim order granting the Debtors' request to obtain postpetition secured financing from the DIP Lender in the maximum interim amount of $3,500,000 (the "Emergency Advance"). The Debtors were further authorized to grant the DIP Lender superpriority claims and priming liens on all of the Debtors assets to secure the amount of the Emergency Advance.

The Debtors are now seeking a final order from this Court authorizing the Debtors (a) to obtain postpetition financing from the DIP Lender in the maximum amount of $18,308,655 (the "DIP Loan") and (b) to grant superpriority claims and first priority priming liens on substantially all of the Debtors' assets. The Debtors anticipate the Prepetition Lenders continuing their objections to the Debtors' request to grant the DIP Lender superpriority claims and priming liens. However, the Debtors submit that they have a viable, sustainable and realistic business plan that supports a reasonable prospect of reorganization. Furthermore, the Debtors submit that the Prepetition Lenders are fully secured as of the Petition Date and that their secured claim is adequately protected by, *inter alia*, the Debtors' equity in the Prepetition Collateral over and above the amount of the prepetition Secured Loans and the DIP Loan.

II. Argument

Section 364(d) of the Bankruptcy Code states as follows:

> (d)(1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if--
>
> (A) the trustee is unable to obtain such credit otherwise; and
>
> (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

> (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

11 U.S.C. 364(d).

A debtor may borrow money under section 364(d) of the Bankruptcy Code if the debtor meets its burden of establishing that it was unable to obtain alternative financing and that the holder of the lien to be subordinated is adequately protected. *In re Futures Equity L.L.C.*, 2001 Bankr. LEXIS 2229 *14 (Bankr. N.D. Tex. April 11, 2001) (J. Houser). The transaction "should provide the prepetition secured creditor with the same level of protection it would have had if there had not been postpetition superpriority financing." *Id*. at *15 (internal citations omitted).

The Debtors have determined that financing is available only under sections 364(c) and (d) of the Bankruptcy Code. Substantially all of Debtors' assets are encumbered and, despite the diligent efforts of Debtors, Debtors have been unable to procure the necessary funding absent the proposed superpriority claims and priming liens. Furthermore, Debtors have negotiated the best terms available to obtain the funding they need to maintain sufficient liquidity to preserve their assets over the course of their chapter 11 cases. Debtors submit that the circumstances of these cases require Debtors to obtain financing from the DIP Lender under section 364(d) of the Bankruptcy Code.

Further, without access to the proposed DIP Loan, Debtors' liquidity will evaporate and Debtors will be forced to cease operations, in a non-orderly manner. In contrast, the value of the Prepetition Lenders' interest in their collateral is preserved by the DIP Loan because it ensures the uninterrupted continuance of Debtors' operations. Moreover, the Debtors' equity in the Prepetition Collateral is significant. Accordingly, the Debtors submit that the Prepetition Lenders' interests are sufficiently protected by the equity cushion calculated by using the going concern value of the Debtors' assets coupled with the Replacement Liens and Prepetition Lender

Superpriority Claims, as set forth in the Motion. Accordingly, the adequate protection proposed by the Debtors is fair and reasonable and sufficient to satisfy the requirements of Bankruptcy Code sections 364(d).

A. The Debtors can show by a Preponderance of the Evidence that the DIP Loan is Necessary and that the Interests of the Prepetition Lenders are Adequately Protected

Section 364(d)(2) states that the debtor has the burden of proof to establish that the creditor's interests are adequately protected. 11 U.S.C. 364(d)(2). It is generally accepted that a debtor must satisfy its burden of proof by a preponderance of the evidence. *See e.g.*, *In re Thurston Highland Associates, LLC*, 2010 WL 148683 at *4 (Bankr. W.D. WA 2010) (concluding that a preponderance of the evidence supports that a sufficient equity cushion exists); *see also In re Carbonne Companies, Inc.*, 395 B.R. 631, 636 (Bankr. N.D. Ohio 2008) (holding that a debtor must show that a creditor is adequately protected for purposes of section 363 of the Bankruptcy Code by a preponderance of the evidence).

The Debtors demonstrated at the Interim Hearing, which was undisputed, that they are unable to obtain alternative financing. At the final hearing, the Debtors will further demonstrate by a preponderance of the evidence that the Prepetition Lenders' interests in the Prepetition Collateral are adequately protected.

B. The Debtors are Unable to Obtain Alternative Financing

Pursuant to Section 364(d) of the Bankruptcy Code a court may authorize a debtor to obtain postpetition financing if the debtor demonstrates its inability to obtain alternative financing. 11 U.S.C. 364(d)(1)(A). However, section 364(d) does not require that a debtor seek alternative financing from every possible lender; rather, the debtor must demonstrate that sufficient efforts were made to obtain financing on other terms. *Bray v. Shenandoah Fed. Savs.*

& Loan Assoc. (In re Snowshoe Co., Inc.), 789 F.2d 1085, 1088 (4th Cir. 1986) (finding that the trustee's unsuccessful efforts in seeking financing from lenders in the immediate geographical area sufficiently demonstrated that trustee was unable to obtain alternative financing); *In re 495 Central Park Ave. Corp.*, 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992) (holding that the debtor's testimony that its numerous failed attempts to procure financing from various sources sufficiently demonstrated its unsuccessful efforts to obtain financing on other terms).

The Debtors presented uncontroverted testimony at the Interim Hearing, that despite their efforts, Debtors have been unable to (a) procure sufficient financing (i) in the form of unsecured credit allowable under section 503(b)(1), (ii) as an administrative expense under section 364(a) or (b), (iii) in exchange for the grant of a super-priority administrative expense claim pursuant to section 364(c)(1), without granting limited priming liens pursuant to section 364(d); or (b) obtain postpetition financing or other financial accommodations from any alternative prospective lender or group of lenders on more favorable terms and conditions than those for which approval is sought. The Debtors, therefore, submit that they have met their burden of proof on this issue.

C. The Secured Lender's Interests are Adequately Protected

Section 364(d)(1) further requires that a debtor show that the interests of the prepetition secured lenders are adequately protected. 11 U.S.C. 364(d)(1)(B). Additionally, Section 363(e) of the Bankruptcy Code provides that, "on request of an entity that has an interest in property used . . . or proposed to be used by a debtor in possession, the court . . . shall prohibit or condition such use . . . as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e). Section 361 of the Bankruptcy Code delineates the forms of adequate protection, which include periodic cash payments, additional liens, replacement liens and other

forms of relief. 11 U.S.C. § 361. What constitutes adequate protection must be decided on a case-by-case basis. *See MNBank Dallas, NA v. O'Connor (In re O'Connor*), 808 F.2d 1393, 1396 (10th Cir. 1987). The focus of the requirement is to protect a secured creditor from diminution in the value of its interest in the particular collateral during the period of use. *See In re 495 Central Park Avenue Corp.*, 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992) ("The goal of adequate protection is to safeguard the secured creditor from diminution in the value of its interest during the Chapter 11 reorganization.") (internal citations omitted).

Furthermore, under section 361 of the Bankruptcy Code an equity cushion "is the classic form of protection for secured debt…" *In re Mellor*, 734 F.2d 1396, 1400 (9th Cir. 1984). The Debtors submit the Prepetition Lenders' interests are sufficiently protected by a significant equity cushion in the Prepetition Collateral. As support, the Debtors submit that they have a viable business plan supporting a reasonable prospect of reorganization, and therefore, the equity cushion in the Debtors' assets is appropriately calculated by a going concern or fair market value. Accordingly, under the circumstances, an equity cushion is the appropriate form protection of the Prepetition Lenders' interests.

a. The Debtors' Business Plan Demonstrates a Reasonable Prospect of Reorganization

Courts may consider whether a debtor has a reasonable prospect of reorganization when determining the appropriate valuation method to use in valuing a debtor's assets for adequate protection purposes. *See, e.g.*, *In re Timber Products, Inc.*, 125 B.R. 433 (Bankr. W.D. PA 1990)(denying postpetition secured financing when the debtors' business plan did not evidence a reasonable prospect of reorganization); *In re Beker Industries Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986)(authorizing postpetition financing when the debtors' had a viable business plan and showed a reasonable prospect of reorganization).

In *Timber*, the debtors sought financing pursuant to section 364(d) of the Bankruptcy Code to fund a plan of reorganization, although the debtors were not operating for the six months since they filed their petitions. *Id.* Denying the request, the court determined that the debtors did not have realistic assumptions and projections in their analysis when compared with industry standards, did not take into account contingencies or risks, and were not able to secure enough capital to start up their business and survive after confirmation of a plan. *Id.* at 437. Although finding that the debtors were unlikely to successfully reorganize with insufficient start up capital and speculative projections, the court stated that "given sufficient operating capital, the plant could be profitable and the Debtors could be expected to reorganize." *Id.* at 440. The court further stated that if the debtors' projections and assumptions were more reasonable, the court would be amenable to finding that the equity cushion, based on a fair market value analysis, adequately protected the secured lenders' interests. *Id.*

Unlike *Timber*, the court in *Beker* determined that the debtors provided a realistic business plan with conservative cash flow projections, particularly when compared to the industry standards. *Id.* at 730-31. In *Beker*, the debtors sought to obtain financing to fund the continued operations of their phosphate mining and plants until confirmation of a plan of reorganization. *Beker*, 58 B.R. at 737. The court recognized that the business plan provided by the debtors was "done honestly and forthrightly with considerable prudence and with care to recognize the factors that can contribute to material variations" and that it was a "valuable tool" in determining the debtors' ability to remain a going concern. *Id.* The court further determined that it is always impossible to tell the future when "peering through the mist that shrouds the present from the future." *Id.* at 730. Even so, the court determined that it was reasonable to rely on the debtors' projections. *Id.* Based on the credible evidence presented by the debtors with

respect to a steady improvement of their cash projections, the court determined that the debtors were likely to "remain a going concern with time to reorganize as the Code contemplates." *Id.* at 738. Accordingly, the court concluded that the secured creditors' interests were adequately protected. *Id.* at 740.

In this case, the credit provided under the DIP Loan will enable the Debtors to continue to operate their businesses in an orderly and reasonable manner to preserve and enhance the value of their estates for the benefit of all parties in interest. Further, like the debtors in *Beker*, the Debtors in this case will submit evidence and testimony showing a viable, sustainable and realistic business plan that supports a reasonable prospect of reorganization. Because the Debtors will be able to demonstrate a sustainable business plan, a going concern method of valuation of their businesses is the appropriate method to determine the value of their assets.

b. The Applicable Standard for Valuation of the Debtors' Assets is the Fair Market or Going Concern Value

Although, generally, when ascertaining whether a secured creditor is adequately protected, courts determine how to measure the value of the debtor's assets on a case by case basis, during the early stages of a chapter 11 reorganization, or when a debtor can show a reasonable prospect of reorganization, the proper measure of valuation of the debtor's assets is at a going concern or fair market value. *Beker*, 58 B.R. at 737; *see also Bray v. Shenandoah Fed. Savs. & Loan Assoc. (In re Snowshoe Co., Inc.)*, 789 F.2d 1085, 1086-87 (4th Cir. 1986) (affirming bankruptcy court's decision that secured creditor was adequately protected for purposes of section 364(d) priming loan based on the fair market value of the debtor's ski resort); *Bank Rhode Island v. Pawtuxet Valley Prescription & Surgical Center, Inc. (In re Pawtuxet Valley Prescription & Surgical Center, Inc.)*, 386 B.R. 1 (DC D. RI 2008) (affirming the bankruptcy courts use of the fair market value of the assets and stating that "courts should value

the collateral in light of the debtor's proposal to retain it and ascribe to it its going-concern or fair market value.").

In *Snowshoe*, the debtor filed under chapter 7 of the Bankruptcy Code, but desired to sell its ski resort at its going concern value. *Snowshoe* 789 F.2d at 1086. The trustee sought to obtain 364(d) financing to keep the ski resort operating, arguing that the prepetition secured lender would be adequately protected based upon the going concern value of the ski resort. *Id.* at 1089. The Fourth Circuit affirmed the bankruptcy court's decision that the use of the going concern or fair market value of the ski resort was appropriate under the circumstances as the debtors intended to sell the ski resort as a going concern. *Id.* The court further determined that the going concern value of the resort adequately protected what was owed to the prepetition lender. *Id.*

Moreover, in *Beker* because the debtors intended to continue business operations, the court determined that a going concern value for adequate protection purposes was appropriate. *Beker*, 58 B.R. at 736-38. The court further determined that the debtors' plants were more valuable to all parties in interest if the plants were in operation as opposed to being shut down. *Id.* at 731.

Other courts have also applied going concern valuations in the context of debtor in possession financing. For example, *In re Stanley Hotel, Inc.*, 15 B.R. 660 (D. Colo. 1991), the District Court affirmed a finding of adequate protection for purposes of section 364(d) based upon the market value of a hotel, even though the hotel was the subject of a foreclosure proceeding just prior to the debtor's chapter 11 filing. *Id.* at 664; *see also In re Utah 7000, LLC*, 2008 WL 2654919, at *3 (Bankr. D.Utah 2008) (finding that the use of a going concern or fair market value is appropriate particularly when the debtors can show reasonable prospect of reorganization).

In this case, the Debtors will demonstrate at the hearing that the Debtors have a viable business plan that supports a reasonable prospect of Debtors' reorganization. The Debtors will show that they can continue operations of their business, enhancing the value of the estate for all creditors. Further, in a potential sale of certain of the Debtors' assets, the Debtors intend to market certain of their property on a going concern basis. Since the Debtors intend to continue their business operations and potentially sell certain of their assets as a going concern, the Debtors submit that the going concern or fair market value of the assets is appropriate. The Debtors submit that when using a going concern or fair market value of the Debtors' assets, the Debtors have substantial equity in the Prepetition Collateral and the Prepetition Lenders' interests are, therefore, adequately protected.

c. The Prepetition Lenders are Adequately Protected by a Significant Equity Cushion and Other Forms of Adequate Protection

Pursuant to section 361 of the Bankruptcy Code, forms of adequate protection include periodic cash payments, additional liens, replacement liens and other forms of relief. 11 U.S.C. § 361. Accordingly, courts determine that adequate protection provided in the form of an equity cushion, calculated by the fair market or going concern value of the assets, is sufficient on its own to adequately protect a secured lender's interests. *See Bank Rhode Island v. Pawtuxet Valley Prescription & Surgical Center, Inc. (In re Pawtuxet Valley Prescription & Surgical Center, Inc.)*, 386 B.R. 1, 5 (DC D. RI 2008). In fact, courts generally find that an equity cushion of 20% or more adequately protects a secured lender's interests. *Id.* Certain courts have even determined that a secured lender is adequately protected when the equity cushion is less than 20%. *See e.g., In re Rogers Development Corp.*, 2 B.R. 679, 685 (Bankr. E.D. VA 1980) (holding that an equity cushion of at least 15% adequately protected the secured creditor).

In *Pawtuxet*, the debtors sought authority to prime the secured lender's liens only on certain drug inventory by granting a trade creditor a first lien on such inventory obtained on credit. *Id.* at 1. The District Court of Rhode Island, using a going concern valuation method, held that a 4% equity cushion with no other form of adequate protection was not sufficient to adequately protect the secured lender. *Id.* at 5. However, the court remanded the case to the Bankruptcy Court for a determination of the value of additional collateral not considered in its first analysis recognizing that an equity cushion over 10% may be sufficient for adequate protection purposes. *Id.*

At the final hearing, the Debtors will present evidence demonstrating a significant equity cushion in the Debtors' real property, machinery and equipment, and working capital assets. The debtors submit that the equity cushion on its own will adequately protect the Prepetition Lenders' interests. However, the Debtors are providing the Prepetition Lenders additional adequate protection in the form of Replacement Liens and Pre-Petition Lenders' Superpriority Claims (as defined in the Motion). These forms of adequate protection will, taken together, provide more than enough protection of Prepetition Lenders' interests in Prepetition Collateral.

Accordingly, the adequate protection proposed to the Prepetition Lenders is fair and reasonable and sufficient to satisfy the requirements of section 364(d) of the Bankruptcy Code.

III. Conclusion

WHEREFORE, Debtors respectfully request entry of an order authorizing postpetition secured superpriority financing (ii) granting adequate protection to the Prepetition Lenders, and (iii) modifying the automatic stay.

Dated: March 15, 2010

/s/ Marc. B. Merklin

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