

**UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION, AT CANTON**

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

**MOTION OF OHIO FARMERS INSURANCE COMPANY
FOR RELIEF FROM AUTOMATIC STAY UNDER SECTION 362 OF THE
BANKRUPTCY CODE TO TERMINATE SURETY BOND**

Ohio Farmers Insurance Company (“Ohio Farmers”), by and through its undersigned counsel, pursuant to 11 U.S.C. § 362(d)(2), Rule 4001(a) of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”) and LBR 4001-1, hereby submits this motion for relief of the automatic stay to terminate surety bond.

In support of this Motion, Ohio Farmers states as follows:

JURISDICTION

1. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper in this Court pursuant to 28 U.S.C. §§ 1408 and 1409. This matter is a core proceeding pursuant to 28 U.S.C. §§ 157(b)(2)(G).

BACKGROUND

2. On February 28, 2010 (the “Petition Date”), Medina Supply Company (“Medina Supply”) and Medina Cartage Company (“Medina Cartage,” and with Medina Supply (the

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. ((373); 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).

“Principals”) along with certain other affiliates (and with the Principals, collectively, the “Debtors”), each filed a voluntary petition for relief under title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (the “Bankruptcy Code”).

3. Ohio Farmers has had a long history with the Debtors. In the years leading up to the Petition Date, Ohio Farmers issued numerous surety bonds on behalf of the Debtors. Specifically, on or about February 15, 2010, Ohio Farmers, as surety, issued that certain contract performance bond (the “Strongsville Bond”) to the Principals on behalf of the City of Strongsville, as obligee (the “Obligee”). A copy of the Strongsville Bond is attached hereto as Exhibit A. Upon information and belief, the Strongsville Bond supports a \$750,000 supply contract between the Principals and Obligee and assures the Principals’ compliance with and performance of certain obligations referenced in the Strongsville Bond. Upon information and belief, in the absence of the Strongsville Bond, the Principals would not have been able to bid on the particular job for the Obligee.

4. Ohio Farmers issued the Strongsville Bond in accordance with that certain Agreement of Indemnity dated July 25, 2002 (the “Indemnity Agreement”), in which Principals agreed to, among other things, “exonerate, indemnify and keep indemnified [Ohio Farmers] from and against any and all liability for losses and/or expenses of whatsoever kind or nature...and from and against any and all such losses and/or expenses which [Ohio Farmers] may sustain and incur: (1) [b]y reason of having executed or procured the execution of the [Strongsville Bond], (2) [b]y reason of the failure of the [Principals] to perform or comply with the covenants and conditions of [the Indemnification] Agreement or (3) [i]n enforcing any of the covenants and conditions of [the Indemnification] Agreement.” See Indemnity Agreement, p. 1. Moreover,

pursuant to the Indemnity Agreement, Ohio Farmers has the right to decline to execute or renew any bonds. A copy of the Indemnity Agreement is attached hereto as Exhibit B.

5. In consideration for the Strongsville Bond, the Principals were required to pay a premium for the issuance. The Principals failed to pay the premium, and within two weeks of the issuance of the Strongsville Bond, filed for bankruptcy.

6. The value of the penal limit of the Strongsville Bond is not less than \$253,535. As a result, Ohio Farmers faces potential exposure of not less than that amount during the period the Strongsville Bond remains effective. As further noted below, however, the recent events in the Debtors' bankruptcy cases indicates that risk of non-performance by the Principals is likely, if not certain.

7. According to the recent filings in the chapter 11 cases, the Debtors have commenced a sale process for substantially all of their assets at auction in accordance with the terms of the Sale Motion² and Bid Procedures Motion.³ The filing of both motions were required under the First Amended Agreed Order Authorizing Limited Use of Cash Collateral, Docket No. 239 (the "Cash Collateral Order").

8. Even if the Debtors successfully consummate a going concern sale of their businesses within the required time frame under the Cash Collateral Order, none of the surety bonds issued by Ohio Farmers for which any of the Debtors are principals—including the

² The "Sale Motion" defines the Motion for an Order: (1) Authorizing the Sale of Substantially All of the Debtors' Assets, Free and Clear of Liens, Claims, Interests and Encumbrances, Subject to Higher and Better Offers, Pursuant to Bankruptcy Code Sections 363 and 365; (2) Approving the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection with Such Sale and Determining and Adjudicating Cure Amounts with Respect to Such Contracts and Leases; (3) Waiving the Fourteen-Day Stay Period Provided by Bankruptcy Rule 6004(ii); and (4) Granting Related Relief, Docket No. 241, filed on April 5, 2010.

³ The "Bid Procedures Motion" defines the Motion for an Order: (i) Approving Auction and Bidding Procedures and an Auction Date; (2) Scheduling Date and Time for Sale Hearing; (3) Approving Form and Manner of Service of Notice of the Sale Hearing and Auction Pursuant to Bankruptcy Rules 2002, 6004 and 6006; (4) Approving the Form and Manner of Service of the Notice of the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases; and (5) Granting Related Relief, Docket No. 245, filed on April 5, 2010.

Strongsville Bond—are transferable to a prospective purchaser under applicable law. Moreover, because the Strongsville Bond is a “financial accommodation” under the Bankruptcy Code, Ohio Farmers cannot be compelled to extend postpetition credit to the Debtors. In light of this and because the Principals never paid any premiums on the Strongsville Bond prior to filing bankruptcy, there is no basis to maintain the Strongsville Bond. Accordingly, Ohio Farmers should be permitted to take any steps as may be required under applicable law to cancel the Strongsville Bond.

9. While it is not clear that relief from the automatic stay is required in this instance, out of an abundance of caution, Ohio Farmers seeks relief from the automatic stay imposed by section 362 of the Bankruptcy Code. Therefore, to the extent the stay applies, good and sufficient cause exists to grant Ohio Farmers relief from the automatic stay to allow it to take the steps necessary to effectuate the termination of the Strongsville Bond in accordance with applicable law.⁴

RELIEF REQUESTED

10. By this Motion, Ohio Farmers requests that the Court grant it relief from the automatic stay imposed by section 362 of the Bankruptcy Code to allow Ohio Farmers to take the steps necessary to terminate and/or cancel the Strongsville Bond in accordance with its terms and applicable law.

LAW AND ARGUMENT

A. The Strongsville Bond Is Not Property of the Debtors’ Estates.

11. A surety bond is not an insurance policy; rather, it is a form of guarantee. The bond is issued to guarantee certain obligations of a principal to another party, namely, the

⁴ In the event that a prospective purchaser decides to acquire the supply contract with the City of Strongsville, Ohio Farmers may be willing to negotiate a new surety bond with the prospective purchaser.

obligee. A suretyship obligation is also commonly understood to be an extension of credit through an agreement to stand for the debt of another.⁵ Obligations of a surety under the bond run to the obligee, up to the penal sum of the bond and subject to the terms of the bond, indemnity agreement and/or any applicable statutory requirements. In the present case, to the extent it was validly procured, the Strongsville Bond assures the Principals' obligations to the Obligee under the supply contract with the city. The Indemnity Agreement and the Strongsville Bond govern the relationship of the parties in this arrangement.

12. Recognizing that a principal cannot claim the benefits of a surety bond, some courts have correctly concluded that surety bonds are not property of the estate. See, e.g., In the Matter of Lockard, 884 F.2d 1171, 1178 (9th Cir. 1989); In re Mansfield Tire and Rubber Co., 660 F.2d 1108, 1115 (6th Cir. 1981) (recognizing that a bond posted in favor of a state agency to guarantee payment of workers' compensation claims was not property of the estate); In re Buna Painting & Drywall Co., Inc., 503 F.2d 618, 619 (9th Cir. 1974) (denying trustee's request to compel payment of the penal sums of a bond into the estate); In re McLean Trucking Co., 74 B.R. 820, 826-28 (Bankr. W.D.N.C. 1987) (recognizing that a bond posted in favor of a state agency to guarantee payment of workers' compensation claims was not property of the estate); In re Capitol-York Construction Corp., 43 B.R. 52, 56 (Bankr. S.D.N.Y. 1984); In re Jay Forni, Inc., 33 B.R. 538, 541 (Bankr. N.D. Cal. 1983); see also In re Wegner Farms Company, 49 B.R. 440, 443 (Bankr. N.D. Iowa 1985) (citing In re Apache Construction, Inc., 34 B.R. 415, 417 (Bankr. Or. 1983)). If this is the end of the analysis, then there is no further relief for the Court to grant. Ohio Farmers would then be free to seek termination of the Strongsville Bond under applicable non-bankruptcy law.

⁵ See Restatement of Security § 82 (1941).

B. As “Financial Accommodations,” The Strongsville Bond May Be Terminated Without Relief From The Automatic Stay.

13. Even if a surety bond is considered property of the bankruptcy estates as an executory contract, the Strongsville Bond is clearly a “financial accommodation” through which surety credit has been provided to the Principals by Ohio Farmers. Section 365(c)(2) of the Bankruptcy Code provides that a debtor “may not assume or assign any executory contract or unexpired lease of the debtor...if...(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor....” See 11 U.S.C. § 365(c). Although the term “financial accommodation” is not defined in the Bankruptcy Code, courts have held that surety bonds are financial accommodations, which cannot be assumed or assigned. See, e.g., In re Sun Runner Marine, Inc., 945 F.2d 1089 (9th Cir. 1991); In re Thomas B. Hamilton Co., 969 F.2d 1013, 1020 (11th Cir. 1992); In re Edwards Mobile Home Sales, Inc., 119 B.R. 857, 859 (Bankr. N.D. Fla. 1990); In re Wegner Farms Co. Inc., 409 B.R. at 443; In re Adana Mortgage Bankers, Inc., 12 B.R. 977 (Bankr. N.D. Ga. 1980). A surety bond is a tripartite agreement executed by both the surety and its bond principal in favor of the bond obligee to whom the principal and surety are bound. See, e.g., Handex of Maryland, Inc. v. Waste Management Disp. Svcs. of Maryland, 458 F. Supp. 2d 266, 271 (D. Md. 2006). Therefore, to the extent that a surety bond is an executory contract within the meaning of section 365 of the Bankruptcy Code, it is a “financial accommodation” under section 365(c)(2) and, therefore, not subject to assumption or rejection in bankruptcy. See, e.g., Edward Mobile Home Sales, Inc. v. Ohio Cas. Ins. Co., 119 B.R. at 869. Indeed, the Bankruptcy Code cannot compel a party extending credit to a debtor prepetition to continue to extend that credit postpetition.

14. Pursuant to section 365(c)(2) of the Bankruptcy Code, as a “financial accommodation,” the Strongsville Bond may not be assumed or assigned by the Debtors (or any

subsequently appointed trustee). In this case, because the Debtors are selling substantially all of their assets, they can give no assurances that the Principals will have any ability to perform under the supply agreement with the Obligee, thus unduly shifting all of the risk of loss to Ohio Farmers. Based on the Principals' ability to perform under the supply agreement and the non-assignable nature of the Strongsville Bond, Ohio Farmers is entitled to cancel the Strongsville Bond.

15. Moreover, as "financial accommodations," under 11 U.S.C. § 365(e)(2)(b), the Strongsville Bond may be terminated by reason of the filing of the Debtors' bankruptcy petitions. Section 365(e)(2) of the Bankruptcy Code provides that the prohibition against termination of an executory contract after the filing of a bankruptcy petition "does not apply to an executory contract or unexpired lease of the debtor...if...(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor...." In the present case, the Strongsville Bond clearly constitutes a financial accommodation for the benefit of the Debtors as it is an agreement to extend credit on behalf of Debtors as security for the Principals' obligations to the Obligees. Because it is a financial accommodation, Ohio Farmers may be entitled to take action to terminate the Strongsville Bond notwithstanding the filing of the Debtors' bankruptcy petitions.

16. The Third Circuit has held that relief from the automatic stay is not required in order to terminate a non-assumable contract. See Watts v. Pennsylvania Housing Finance Co. (In re Watts), 876 F.2d 1090, 1096 (3d Cir. 1989) ("Section 365(e)(2)(B), unequivocally and without qualification provides for the termination of a contract to make a loan after the commencement of a bankruptcy case. To hold that such termination is, at the same time, stayed under Section 362 would be at worst, anomalous, and at best an imposition of a pro forma

requirement that the Creditor must ask for what the Code plainly grants him”). Thus, section 362 of the Bankruptcy Code is inapplicable to any actions Ohio Farmers may take to terminate the Strongsville Bond in accordance with its terms and/or applicable law. As noted above, however, out of an abundance of caution, Ohio Farmers seeks an order lifting the automatic stay, to the extent required, so that Ohio Farmers may exercise its right to terminate the Strongsville Bond.

17. Ohio Farmers advises the Principals that new surety obligations must be obtained by the Principals for Ohio Farmers’ postpetition performance of any bonds. In addition, the Debtors must provide adequate assurance of future performance on the supply contract with the Obligee. Since the Debtors are effectively ceasing operations in a couple months and have no ability to assume the Strongsville Bond as part of their proposed asset sale, the Strongsville Bond may be terminated pursuant to section 362(e)(2)(B) of the Bankruptcy Code.

C. Notwithstanding That Relief From The Automatic Stay May Not Be Required, Ohio Farmers Is Entitled To Relief From The Stay “For Cause.”

18. Section 362(d) of the Bankruptcy Code provides that upon request of a party in interest and after hearing, a bankruptcy court shall grant relief from the automatic stay of section 362(a) of the Bankruptcy Code “for cause.” In this case, such “cause” exists as a matter of law on several grounds: (i) where a creditor seeks relief to terminate an agreement that the debtor is prohibited from assuming or assigning⁶; (ii) the failure to pay the premiums for a bond; and (iii) the inability of the Principals to assign the underlying obligations under the bonded contract.

19. Because the Debtors are prohibited from assuming or assigning the Strongsville Bond, Ohio Farmers is entitled to relief from the stay “for cause.” Ohio Farmers should not be compelled to involuntarily finance the Debtors, especially without any of the protections set forth

⁶ See e.g., Adana Mortgage Bankers, 12 B.R. at 988.

in section 364 of the Bankruptcy Code.⁷ The stay should be lifted to permit cancellation of the Strongsville Bond under section 362(d)(2) of the Bankruptcy Code because the Debtors have no equity in the Strongsville Bond and Ohio Farmers has not elected to extend any financial obligations on behalf of the Principals postpetition.

20. In addition, as a result of the impending sale and/or liquidation of the Debtors' businesses, it is clear that the Principals have no intention of continuing any business that is supported by the Strongsville Bond. Indeed, as of the filing of this Motion, the Debtors do not have a stalking horse purchaser for any portion of their businesses. Accordingly, absent assurances that the Principals can even assign the bonded obligations to which the Strongsville Bond relates or offer adequate assurance of future performance of the supply contract, there is no basis for the Strongsville Bond to stay effective.

21. Finally, while Ohio Farmers makes no accusation or allegation as to the Principals' conduct in acquiring the Strongsville Bond, the reality is that within two weeks of filing for bankruptcy, the Principals secured the Strongsville Bond (when, according to the Debtors' own pleadings, they were in default to their secured lender no later than January 13, 2010). The Principals' failure to pay the premium in exchange for securing the Strongsville Bond and the Principals' insolvency when executing the Strongsville Bond, improperly shifted the entire risk to Ohio Farmers. Typically, only when the principal fully and finally completes its bonded obligations is the bond and the surety thereon discharged (unless the surety has some defense to liability such as a "cardinal change" in the scope of the underlying bonded

⁷ One court has stated: "Reading § 365(c)(2) and (e)(2) together, it is clear that Congress intended to protect creditors who have entered into pre-petition agreements to extend money or accommodations to a debtor from being required to extend money or accommodations to it post-petition if the contract that it entered into was totally or partially unperformed when the debtor filed bankruptcy. These sections prevent a creditor from being required to involuntarily finance a debtor-in-possession's reorganization effort based on a contract that it negotiated without knowledge that the debtor would be filing for bankruptcy." In re TS Industries, Inc. 117 B.R. 682, 686 (D. Utah 1990); see also In re Cardinal Industries, Inc., 146 B.R. 720, 731 (Bankr. S.D. Ohio 1992).

obligations, the “involuntary substitution” of the bond principal, fraud on the part of the bond obligee, or other surety defense).⁸ This situation is different: the Principals provided no consideration for the Strongsville Bond and are now going out of business. The Principals’ actions also may have bound Ohio Farmers to an agreement that the Principals never intended to perform. Therefore, cause exists to cancel and/or terminate the Strongsville Bond.

22. Based upon the foregoing, to the extent section 362 of the Bankruptcy Code applies, sufficient cause exists to grant Ohio Farmers relief from stay to cancel and/or terminate the Strongsville Bond in accordance with its terms and applicable law.

NOTICE

23. Notice of this Motion has been provided to the following parties, or counsel thereto: (a) the Debtors; (b) the Official Committee of Unsecured Creditors; (c) the Debtors’ prepetition and postpetition secured lenders; (d) the United States Trustee; and (e) all parties who have filed a request for notice in the chapter 11 cases pursuant to Bankruptcy Rule 2002. Ohio Farmers, in light of the nature of this request, submits that no other or further notice is necessary.

NO PRIOR REQUEST

24. No prior motion for the relief requested herein has been made to this or any other court.

⁸ Ohio Farmers reserves all rights relating to any defenses to liability it may have relating to the Strongsville Bond and/or Indemnity Agreement.

WHEREFORE, Ohio Farmers respectfully requests that the Court enter an order:

- (i) granting Ohio Farmers relief from the automatic stay to the extent necessary to allow it to terminate and/or cancel the Strongsville Bond in accordance with its terms or applicable law; and
- (ii) granting Ohio Farmers such other further relief as may be appropriate.

April 16, 2010

Respectfully submitted,

/s/ Michael J. Kaczka
Jerome W. Cook (0036835)
Michael J. Kaczka (0076548)
John A. Polinko (0073967)
MCDONALD HOPKINS LLC
600 Superior Avenue, East
Suite 2100
Cleveland, Ohio 44114
Telephone: (216) 348-5400
Facsimile: (216) 348-5474
E-Mail: jcook@mcdonaldhopkins.com
mkaczka@mcdonaldhopkins.com
jpolinko@mcdonaldhopkins.com

COUNSEL FOR OHIO FARMERS
INSURANCE COMPANY