UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

In re	:	Case No. 10-60702
	:	
	:	Joint Administration Pending
SCHWAB INDUSTRIES, INC., *ET AL.*,	:	
	:	Chapter 11
Debtors.	:	
	:	Judge Russ Kendig

SUPPLEMENTAL OBJECTION OF KEYBANK NATIONAL ASSOCIATION, AS ADMINISTRATIVE AGENT FOR THE LENDERS, WITH RESPECT TO DEBTORS' MOTION SEEKING ENTRY OF 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, (III) MODIFYING THE AUTOMATIC STAY AND (IV) SETTING A FINAL HEARING PURSUANT TO BANKRUPTCY RULE 4001

KeyBank National Association, for itself as a secured lender, and as Administrative Agent (the "Agent") for secured lenders The Huntington National Bank and Bank of America, N.A. (collectively with KeyBank National Association, the "Lenders"), hereby files its supplemental objection (the "Supplemental Objection") to the *Debtors' Motion Seeking Entry of 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, (iii) Modifying the Automatic Stay and (iv) Setting a Final Hearing Pursuant to Rules (sic) 4001* [Docket No. 10] (the "Motion"), respectfully stating as follows:

BACKGROUND

1. On February 28, 2010 (the "Petition Date"), the above-captioned debtors (collectively, the "Debtors") filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code") and thereafter continued to operate and manage their businesses as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

2. As of the Petition Date, Debtors were in default of their obligations under that certain Amended and Restated Credit and Security Agreement, dated as of October 18, 2007, among Debtors, Agent and Lenders (as amended, restated, supplemented or otherwise modified from time to time, the "Pre-Petition Credit Agreement") and related Loan Documents (as defined in the Credit Agreement), and had outstanding Obligations (as defined in the Credit Agreement) in the approximate amount of $57,000,000, plus accrued interest, fees and expenses (collectively, the "Pre-Petition Debt").

3. As described in the Motion and Objection (as defined below), the Debtors' obligations under the Pre-Petition Credit Agreement and Loan Documents are secured by valid, enforceable, properly perfected liens (the "Pre-Petition Liens") on substantially all of the Debtors' real and personal property and the proceeds thereof (collectively, the "Pre-Petition Collateral"). *See* Motion at ¶ 31.

MOTION FOR SECURED SUPERPRIORITY DIP FINANCING

4. On the Petition Date, Debtors filed the Motion seeking authority to obtain post-petition secured superiority financing in the amount of $18,300,000 from EFO Financial Group, LLC (the "DIP Lender") and, on an interim basis, draw down $3,500,000 from the post-petition credit facility provided by the DIP Lender (the "DIP Facility"), which post-petition advances

would be secured by, among other things, priming liens on the Pre-Petition Collateral (collectively, the "Priming Liens").

5. On March 2, 2010, Agent filed its objection [Docket No. 36] (the "Objection") to the Motion seeking to have the Motion denied as a result of the Debtors' inability to satisfy their obligation under Section 364(d) of Bankruptcy Code that requires them to provide the Pre-Petition Lenders with adequate protection for the diminution in value of the Pre-Petition Collateral resulting from, among other things, the grant of Priming Liens in favor of the DIP Lenders.

6. At the emergency interim hearing on March 2, 2010 (the "Interim Hearing"), the Court authorized Debtors, on an interim basis, to draw down $3,500,000 on the DIP Facility, which would be secured by superpriority claims and Priming Liens, until the Court could conduct a final hearing on the Motion on March 17, 2010.

7. In the Motion and Brief in Support of the Motion filed on March 15, 2010 [Docket No. 114] (the "Brief"), Debtors contend that the Pre-Petition Lenders' interests are adequately protected through an alleged "equity cushion" in the Pre-Petition Collateral of no less than 20%. According to Debtors, a sufficient equity cushion exists in this case because the Pre-Petition Collateral should be valued under a fair market or going concern methodology, which is appropriate in situations where the debtor has a viable business plan that demonstrates a reasonable prospect of reorganization under the chapter 11 of the Bankruptcy Code.

8. As noted below, Agent maintains that (i) Debtors have the burden of proof with respect to demonstrating that the Pre-Petition Lenders' interests are adequately protected, (ii) Debtors must establish the existence of a sufficient equity cushion in order to demonstrate adequate protection, and (iii) use of the fair market value methodology is only appropriate *in*

instances where a debtor can satisfy its burden of demonstrating that it has a reasonable prospect of reorganization. However, if a debtor does not demonstrate a reasonable prospect of reorganization, the equity cushion must be calculated by using the orderly liquidation value of the collateral.

9. As the evidence at the final hearing will show, the Debtors do not have a viable business and there is no prospect of reorganization. Indeed, based upon a review of the Debtors' "Go-Forward Plan" prepared by Mr. Goddard, the Debtors' Chief Restructuring Officer (the "Chief Restructuring Officer"), the Debtors now propose that if they are unable to identify an equity investor willing to invest $35-40 million in their ready mix and cement business located in southwest Florida and central Ohio with over $67 million in secured debt and approximately $20 million in unsecured debt, the Debtors will be forced to liquidate certain significant assets in the next six months (an orderly liquidation marketing period) and use the proceeds of these sales to pay down the outstanding obligations under the DIP Facility and/or Pre-Petition Credit Agreement in the hope that the remaining business will be able to reorganize and emerge from chapter 11. Regardless of how the Debtors package their assets for sale, the Debtors' remaining operations will not be able to generate sufficient revenue to service the debt remaining after the asset dispositions, and liquidation is thus inevitable. In light of the foregoing, there is no question that the equity cushion must be calculated based upon the orderly liquidation value of the collateral.

10. An application of the orderly liquidation analysis to the Pre-Petition Collateral and post-petition collateral securing the Pre-Petition Debt and indebtedness under the DIP Facility demonstrates that the equity cushion (if any) is hopelessly insufficient. In fact, based upon the appraisals completed to date, nearly all of which were prepared by appraisers retained

by the Debtors, it is clear that the most generous orderly liquidation value of the Debtors' assets results in an insufficient equity cushion. *See* Equity Cushion Analysis, attached to the Objection as Exhibit A. According to substantially all of the Debtors' calculations, (i) the aggregate value of the Pre-Petition Collateral and post-petition collateral is $77,350,616; (ii) the amount of Pre-Petition Debt is $58,973,077; and (iii) the amount of post-petition debt projected to be incurred under the DIP Facility is $11,898,077. A simple calculation of the numbers demonstrates that the equity cushion is only 9.14%. Moreover, appraisals to be presented by the Agent at the final hearing will establish that rather than having an equity cushion, the Pre-Petition Lenders are, in fact, under-collateralized. As such, the Debtors cannot provide the Pre-Petition Lenders with adequate protection of their interests and the Motion should be denied in its entirety.

ARGUMENT

11. Under § 364(d), a debtor is not permitted to prime the lien of a senior creditor to obtain post-petition financing unless (1) the debtor is otherwise unable to obtain credit and (2) the existing senior creditor is "adequately protected." *See* 11 U.S.C. § 364(d). "The concept of adequate protection was designed to ensure that the secured creditor receives the value for which he bargained." *In re Martin*, 761 F.2d 472, 474 (8th Cir. 1985). As bankruptcy courts and Circuit Courts have noted, any proposal by a debtor of adequate protection for a prepetition secured creditor as part of a superpriority postpetition financing arrangement should provide the prepetition creditor "with the same level of protection it would have had if there had not been post-petition superpriority financing." *In re Swedeland Dev. Grp.*, Inc., 16 F.3d 552, 564 (3d Cir. 1994); *see also*, *In re Mosello*, 195 B.R. 277, 288 (Bankr. S.D.N.Y. 1996). Moreover, the Bankruptcy Code imposes upon the debtor the burden of proof with respect to establishing that the secured party's interests are adequately protected. *See* 11 U.S.C. § 364(d)(2).

12. Whether a secured party is adequately protected by through an equity cushion turns upon the valuation of the collateral as compared to the outstanding secured indebtedness. A security interest is to be valued "in light of the purpose of the valuation and of the proposed disposition or use of [the] property…" 11 U.S.C. § 506(a). Courts must determine value on a case-by-case basis, taking into account the facts of each case and the competing interests of the case. *See In Re Tenney Village Co.*, 104 B.R. 562, 567 (Bankr. N.H. 1989) (*quoting* H.R. Rep. No. 5954, 95th Cong., 1st Sess. 356 (1977)). In determining whether adequate protection exists by virtue of an equity cushion, case law has almost uniformly held that an equity cushion in excess of 20% must be proven. *In re Kost*, 102 B.R. 829 (D. Wyo. 1989) citing *In re San Clemente Estates*, 5 B.R. 605 (Bankr. S.D. Cal. 19800 (holding 65% adequate); *In re Nashua Trust Co.*, 73 B.R. 423 (Bankr. D.N.J. 1987) (holding 50% adequate); I*n re Ritz Theatres*, 68 B.R. 256 (Bankr. M.D. Fla. 1987) (holding 38% adequate).

13. To the extent the debtor is unable to present a plan of reorganization with a reasonable prospect of success, the equity cushion must be calculated based upon the liquidation value of the collateral. For example, in *In Re Tenney Village Co.*, the court adopted a liquidation value for collateral consisting of a condominium project intended to support the debtor's snow ski operations and rejected the debtor's request for a priming lien under 364(d) where the debtor proposed unfavorable loan terms and showed consistent operating losses. 104 B.R. 562, 567 (Bankr. N.H. 1989). The court found the proposed financing agreement reduced the likelihood of successful reorganization because the financing agreement (i) would require a balloon payment during the middle of the debtor's peak season, (ii) gave the priming bank numerous rights over the debtor's operations, and (iii) required the debtor to apply income to a collateral account at the bank that could be applied to the outstanding loan balance at any time. *Id.* at 567-

68. The court considered both the business's going concern value of $2,354,000 and the liquidation value of $759,000, but given the debtor's slim chance of remaining in operation to sell its business as a going concern, the court reasoned that only a liquidation value would afford the creditor adequate protection as required by section 364(d). *Id.*.

14. Similarly, the court in *In re KeyStone Camera Prod. Corp.* adopted a forced sale liquidation value in evaluating adequate protection under 364(d) where the debtor's reorganization prospects were dim given the debtor's history of operating losses over the preceding three years, the substantial post-petition obligations incurred by the debtor, and the management's patent ignorance of facts regarding company's inventory and operations. *In re KeyStone Camera Prod. Corp.*, 126 B.R. 177, 185 (Bank. D. N.J. 1991).

15. On the other hand, in cases where the court adopted a going-concern valuation of collateral to determine whether a lender was adequately protected as required by 364(d), the court was convinced that the debtor's reorganization was likely. *See, e.g., In re Beker Indus. Corp.*, 58 B.R. 725 (Bankr. S.D.N.Y. 1986) (adopting a going-concern valuation where the company was likely to succeed because of the projected lower cost of raw materials and the company's historical ability to "rise again and again from the ashes"); *see also In re Phoenix Steel Corp.*, 39 B.R. 218 (D. Del. 1984) (valuing collateral at the mean between liquidation and going concern value where court found the business would likely be sold as a going concern if the market turnaround were sustained or a buyer for the business were found in a timely manner).[1]

[1] Three of the cases primarily relied upon by the Debtors in their Brief do not address the issue raised in this case regarding whether fair market value or liquidation value is the appropriate valuation method in the context of determining adequate protection under § 364(d). For example, two cases simply affirm the bankruptcy court's finding of adequate protection, which finding was based incidentally upon a going concern valuation. *See* e.g., *Snowshoe Co., Inc. v. Shenandoah Fed. Savings and Loan Assn.,* 789 F.2d 1085 (4th Cir. 1986); *In re Stanley Hotel, Inc.*, 15 B.R. 660 (D. Colo. 1981). Similarly, in *In re Timber Products, Inc.*, there is no indication that either party

16. Only by accepting wildly optimistic and unreasonable assumptions is there any way to even remotely suggest that the Debtors' prospects for reorganization are bright. As outlined above, the Debtors' own "Go-Forward Plan" for administering this chapter 11 case underscores the Debtors' continued failure to recognize that they are no longer operating viable business enterprises. In essence, the Debtors pin their hopes of a reorganization on an equity investor magically appearing in the next 90 days and writing a check for $35-40 million to invest in a business that is hemorrhaging cash and is dependent upon a very depressed industry in severely distressed markets. Perhaps in recognition of the hopelessness associated with this expectation, the Debtors' have formulated a back-up plan pursuant to which the Debtors intend to market significant assets over a period of less than 6 months and realize proceeds of approximately $35-40 million. In accordance with the "Go-Forward Plan," the Debtors would use the proceeds to satisfy a portion of the obligations under the DIP Facility and/or Pre-Petition Debt and reduce these secured obligations by an amount sufficient to allow the remaining businesses to generate enough revenue to service the remaining debt and any additional debt that the Debtors would be forced to incur in order to obtain working capital.

17. At the final hearing, the evidence will show that under no scenario will the Debtors be able to generate revenue adequate to service all of the secured debt owed by the Debtors that will remain after any proposed asset sales. Furthermore, to the extent one considers the need to address, as part of a plan of reorganization, the approximately $14 million of unsecured trade debt owed by the Debtors, along with unfunded pension liabilities of approximately $11 million that would be incurred upon termination of the Debtors' pension plan, it is clear that there is simply no reasonable prospect for the Debtors to successfully reorganize.

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argued for a liquidation valuation. Although one appraiser opined as to the liquidation value, the testimony centered on the fair market value of the collateral. 125 B.R. 433 (Bankr. W.D. Penn. 1991). Thus, such cases should not serve as persuasive precedent for the instant valuation issue because the issue was not addressed by those courts.

18. In sum, the Debtors' reorganization prospects are bleak, and the likely disposition of the assets will be through an orderly liquidation, not as going concerns. Like in *Tenney* and *KeyStone*, the Debtors have been plagued by substantial operating losses, (Motion at ¶ 21) that will not be cured by post-petition financing or sales of assets. Despite continuing efforts from an investment banker for at least a year prior to their bankruptcy filing, the Debtors have been unable to identify an equity investor that was willing to inject sufficient capital into these businesses. An orderly liquidation of a portion of the assets designated by the Debtors under their "Go-Forward Plan" will not allow them to reduce the outstanding secured obligations by enough to be able to service their debt obligations after their chapter 11 case is concluded. The simple truth is that nothing material has changed in the industry and economic environment in which these Debtors operate – nor will there be any change in the next several months – which means that the DIP Lender's proposed financing will only prolong Debtors' continued cash burn while eroding the Pre-Petition Lenders' security interests through subordination over $18.3 million of indebtedness to the DIP Lender.

19. Notwithstanding the fact that the Debtors' own asset valuations demonstrate the non-existence of a sufficient equity cushion for purposes of providing the Pre-Petition Lenders with adequate protection of their interests, the appraisals commissioned by Agent paint an even more disheartening picture. At the final hearing, Agent will present evidence that the equity cushion, to the extent any exists, is materially less than the amount calculated by using the Debtors' unsupportable valuations.

20. For the reasons set forth herein and that will be presented at the final hearing on the Motion, the Agent submits that the Pre-Petition Lenders are not adequately protected as

required by 364(d). Accordingly, the Objection should be sustained and the Motion should be denied in its entirety.

WHEREFORE, Agent respectfully requests: (i) that the Motion be denied in its entirety; and (ii) that the Court grant to Agent and Pre-Petition Lenders such other and further relief to which they may be justly entitled.

Respectfully submitted,

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ATTORNEYS FOR KEYBANK NATIONAL ASSOCIATION, AS ADMINISTRATIVE AGENT FOR THE LENDERS

CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of March 2010, a true and correct copy of the foregoing was served via electronic mail or the Court's ECF system upon those parties registered to receive notice thereby, as indicated below.

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