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**E-filed November 5, 2007**

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7  
8 **UNITED STATES BANKRUPTCY COURT**  
9 **DISTRICT OF NEVADA**

10  
11 In re:

12  
13 **VESCOR DEVELOPMENT, LLC**  
07-15210 -- Lead Case

14 **ADL 1, LLC**  
15 07-15211

16 **IDL 9, LLC**  
17 07-15212

18 **JDL 10, LLC,**  
07-15213

19 Debtors.

**Jointly Administered**

Chapter 11 Cases  
Judge **Mike K. Nakagawa** Presiding

Date: November 13, 2007

Time: 9:30 a.m.

Place: Courtroom # 2

**Affecting:**

All Cases

**or Only:**

Vescor Development, LLC

ADL 1, LLC

IDL 9, LLC

JDL 10, LLC

20  
21 **THE UNITED STATES TRUSTEE'S REPLY TO DEBTOR'S OPPOSITION TO**  
22 **MOTION FOR THE APPOINTMENT OF A TRUSTEE PURSUANT TO**  
23 **11 U.S.C. § 1104(a)**

24 To the Honorable **MIKE K. NAKAGAWA**, United States Bankruptcy Judge:

25 Debtors oppose the United States Trustee's Motion for the Appointment of a Trustee  
26 Pursuant to 11 U.S.C. § 1104(a). Debtors claim that, aside from Val E. Southwick's steadfast  
27 assertion of the right to avoid self-incrimination pursuant to the Fifth Amendment to the United  
28

1 States Constitution throughout these proceedings, there is not enough independent evidence to  
2 allow the Court to draw adverse inferences from the resultant failure of proof, or to appoint a  
3 trustee under 11 U.S.C. § 1104(a). The opposition fails, because there is indeed sufficient record  
4 evidence to establish cause for the appointment of a trustee pursuant to 11 U.S.C. § 1104(a).  
5 This reply is supported by the pleadings and papers comprising the official Court files in the  
6 cases identified in the caption, and the following Memorandum of Points and Authorities.

7 **MEMORANDUM OF POINTS AND AUTHORITIES**

8 **I.**  
9 **STATEMENT OF FACTS**

10 1. Val E. Southwick testified under oath at the meeting of creditors conducted in these  
11 voluntary and jointly administered cases that he is the managing member of each of the debtors,  
12 either directly or through a related entity. See Reporter's Transcript of 341 Meeting of Creditors  
13 ("Transcript"), DE # 69<sup>1</sup>, at p. 19 l. 9 - p. 22 l. 2.

14 2. In the opposition, the debtors do not (and cannot) dispute the fact that Val E.  
15 Southwick is also the debtors' designated representative under FED. R. BANKR. P. 9001(5)  
16 pursuant to this Court's order entered September 26, 2007. See DE # 48.

17 3. In the opposition, the debtors do not (and cannot) dispute that while enjoying  
18 managerial control over the debtors, and despite having been designated as the debtors'  
19 representative by this Court, Southwick refused to answer certain questions at the initial debtor  
20 interview conducted in these cases on September 25, 2007. See Declaration of Richard M.  
21 Pachulski in Support of Application to Employ Pachulski Stang Ziehl & Jones, LLP as Co-  
22 Counsel for Debtors and Debtors in Possession *Nunc Pro Tunc* ("Pachulski Declaration"), DE  
23 # 62, at p. 9, para. 29.

24 4. In the opposition, the debtors do not (and cannot) dispute that while enjoying  
25 managerial control over the debtors, and despite having been designated as the debtors'  
26 representative pursuant to court order, when the meeting of creditors pursuant to 11 U.S.C. § 341

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<sup>1</sup>Unless otherwise indicated, all "DE # \_\_\_" cites refer to docket entries the lead case, No. 07-15210.

1 was conducted on October 3, 2007, Southwick repeatedly refused to testify regarding even the  
2 most rudimentary aspects of the debtors' financial condition and business operations. *See*  
3 *generally*, Transcript, DE # 69.

4 5. In the opposition, the debtors do not (and cannot) dispute that the Fifth Amendment  
5 right to avoid self-incrimination was the uniform predicate for Southwick's refusal to testify in  
6 response to the vast majority of questions he was asked at the meeting of creditors. *See*  
7 *generally*, Transcript, DE # 69.

8 6. In the opposition, the debtors do not (and cannot) claim that Southwick has verified  
9 the accuracy of any of the pleadings debtors have filed with the Court by signing them under  
10 penalty of perjury, or confirming their accuracy through his sworn testimony. The absence of  
11 such pleadings can be ascertained through judicial review of the official court docket pursuant to  
12 FED. R. EVID. 201. The absence of such testimony from Southwick can be ascertained by  
13 reference to the record developed at the meeting of creditors. *See* Transcript, DE # 69, at p. 10 l.  
14 1 - p. 13 l. 25.

15 7. Despite the fact that Southwick has been designated by the Court as the debtors'  
16 representative pursuant to court order, there is no suggestion in the debtors' opposition that  
17 Southwick will ever provide verified information regarding the debtors' financial condition and  
18 business operations. To the contrary, sworn statements of proposed counsel for the debtors  
19 confirm that "Mr. Southwick's counsel has instructed him not to sign amended petitions,  
20 amended schedules, amended statements of affairs, monthly operating reports, declarations or  
21 applications seeking to employ professionals with respect to the cases the Debtors [sic]." *See*  
22 Pachulski Declaration, DE # 62 at p. 9 para. 29 - p. 10 para. 31.

23 8. More than \$19 million in unsecured intercompany loans made by the debtors to  
24 related companies remained unpaid when the debtors' bankruptcy petitions were filed. The  
25 unpaid amount owed to each debtor on unsecured intercompany loans as of the petition date is  
26 summarized in the following chart:  
27  
28

Debtor	Total Unpaid Intercompany Loans	Case Number	Source Document
VesCor Development, LLC	\$16,506,587.52	07-15210	Sch. B, DE # 1, p. 13 of 18
ADL 1, LLC	\$303,566.58	07-15211	Sch. B, DE # 1, p. 12 of 26
IDL 9, LLC	\$2,523,293.05	07-15212	Sch. B, DE #1, p. 12 of 28
JDL 10, LLC	- 0 -	07-15213	Sch. B, DE #1, p. 12 of 28
<b>Total</b>	<b>\$19,333,447.15</b>		

9. During the year before the debtors’ petitions were filed, more than \$5.5 million in potentially preferential payments were made by the debtors to insiders. Those insider payments are summarized in the following chart, and left no amount still owing to the insider recipients:

Debtor	Total Insider Payments (1 Year Pre-Petition)	Case Number	Source Document
VesCor Development, LLC	\$1,918,000.00	07-15210	SOFA 3(c), DE # 26, p. 4 of 13
ADL 1, LLC	- 0 -	07-15211	SOFA 3(c), DE # 25, p. 3 of 9
IDL 9, LLC	\$3,641,252.82	07-15212	SOFA 3(c), DE # 24, p. 3 of 9
JDL 10, LLC	- 0 -	07-15213	SOFA 3(c), DE # 27, p. 3 of 9
<b>Total</b>	<b>\$5,559,252.82</b>		

10. The Statements of Financial Affairs filed by the debtors reveal that the debtors had been named as defendants in not less than 8 lawsuits pending in two states (Nevada and Utah) on the petition date. A declaration recently filed with the Court indicates that there “are at least 12 existing lawsuits related to the Secured Noteholders” alone. *See* Declaration of David Lawlor in Support of Opposition of Heritage Group and Covenant Management Group to United States Trustee’s Motion for the Appointment of a Trustee and Joinder in Debtors’ Opposition (“**Lawlor Declaration**”), DE # 85-2 at p. 9 of 11. Allegations contained in some of the lawsuits identified in the debtors’ Statements of Financial Affairs are detailed in the following chart:

Case Name	Jurisdiction / Case Number	Debtor(s) Named as Defendants	No. of Counts	Causes of Action Alleged
Heritage Capital Management, LLC et al. vs. Val Southwick, et al.	Clark Co. Nevada, 8 <sup>th</sup> Judicial District / No. A525992	VesCor Development, LLC	42	Breach of Contract, Breach of Implied Covenant of Good Faith and Fair Dealing, Promissory Estoppel, Breach of Fiduciary Duty, Engaging in Deceptive Trade Practices Pursuant to NRS 498.0903 to NRS 598.0999, Fraudulent Conveyance, NRS 112.140 to NRS 112.250
Lynn L. Monteverde, et al. v. VesCorp Capital, LLC, et al.	Clark Co. Nevada, 8 <sup>th</sup> Judicial District / No. A531146	VesCor Development, LLC	14	Breach of Contract, Breach of Implied Covenant of Good Faith and Fair Dealing, Negligence, Fraud, Negligent Misrepresentation, Intentional Misrepresentation, Conversion, Unjust Enrichment, Violation of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder, Civil Liability for Sale of Securities Under State Law Pursuant to NRS § 90.660, Breach of Fiduciary Duty, Constructive Trust, Accounting, Alter Ego
Berkovitz v. Advanced Business Development, LLC, et al.	Clark Co. Nevada, 8 <sup>th</sup> Judicial District / No. A531146	VesCor Development, LLC	10	Breach of Fiduciary Duty
Apex Commercial Center North, LLC v. Val E. Southwick, et al.	Clark Co. Nevada, 8 <sup>th</sup> Judicial District / No. A531146	VesCor Development, LLC	30	Breach of Contract, Unjust Enrichment, Promissory Estoppel, Quasi-Contract, Breach of Implied Covenant of Good Faith and Fair Dealing, Constructive Trust, Fraud
Industrial Properties Development, Inc. v. Val E. Southwick, et al.	Clark Co. Nevada, 8 <sup>th</sup> Judicial District / No. A531146	VesCor Development, LLC	6	Breach of Contract, Unjust Enrichment, Quasi Contract, Breach of Implied Covenant of Good Faith and Fair Dealing, Fraud, Constructive Trust, Attorney's Fees and Special Damages
Oak Valley Investments, L.P. v. Val E. Southwick, et al.	United States District Court / District of Utah	VesCor Development, LLC	8	Securities Fraud, Fraud in the Inducement, Negligent Misrepresentation, Breach of Fiduciary Duty, Unjust Enrichment, Accounting

1 Certified copies of the complaints in those cases, and the Affidavit of Jonathan H. Horne, M.D. ,  
2 filed in the Oak Valley Investments case, will be proffered.

3 11. While Southwick exercised management and control over the debtors and a  
4 multitude of related entities:

- 5 a. There have been “losses sustained by Investors and Creditors at all levels  
6 of the Southwick/VesCor capital Structure.” Lawlor Declaration, DE #85-  
7 2, at Exhibit A, p. 6 of 11.
- 8 b. “[V]irtually all of the Southwick/VesCor assets are likely to be foreclosed  
9 upon before [pending] litigation can be concluded.” Lawlor Declaration,  
10 DE #85-2, at Exhibit A, p. 6 of 11.
- 11 c. Secured creditors have been exposed to a “shortfall” in an amount  
12 “currently estimated to exceed \$75 million.” Lawlor Declaration, DE  
13 #85-2, at Exhibit A, p. 6 of 11.
- 14 d. Unsecured debt balances, which would be repaid in part are “estimated to  
15 be approximately \$100 million dollars[,]” an amount which “increase[s]  
16 by 75 % to 100%” when the secured creditors’ “shortfall” is included.  
17 Lawlor Declaration, DE #85-2, at Exhibit A, p. 10 of 11.
- 18 e. The direct and indirect real estate holdings of the debtors comprise “the  
19 only asset offering a potential opportunity for recovery.” Lawlor  
20 Declaration, DE # 85-2, p. 3 of 11, at para. 8.

21 12. While enjoying management control over the debtors, and during negotiations with  
22 third parties that took place after the debtors’ bankruptcy petitions were filed, Southwick agreed  
23 to the transfer of the debtors’ real estate interests to third parties, subject to the condition that  
24 “All lawsuits against Val Southwick and Vescor and other parties will have to be settled. The  
25 settlement will require that all parties agree to release any claims against any and all other parties  
26 included in the agreements.” Lawlor Declaration, DE #85-2, at p. 9 of 11. The debtors’ \$19  
27 million in intercompany receivables, and over \$5.5 million in preference claims against insider  
28 entities, would be destroyed through such a settlement and release agreement.

13. On October 22, 2007, after agreeing in principal to convey and compromise the  
debtors’ corporate assets in exchange for the dismissal of litigation and release of claims against  
him personally, Southwick signed documents purporting to memorialize that agreement.  
Lawlor Declaration, DE #85-2, pp. 9 and 11 of 11.

14. The “intensive negotiations” that lead up to the agreement referenced in paragraphs

1 12 and 13 were conducted over the two months prior to the October 29, 2007 date reflected on  
2 the Lawlor Declaration. *See* Lawlor Declaration, DE # 85-2, p. 3 of 11, at para. 10.

3 15. The meeting of creditors in these cases was conducted on October 3, 2007, while the  
4 “intensive negotiations” that led up to the agreement referenced in paragraphs 12 and 13 were in  
5 progress. *See* Transcript, DE # 69, p. 1 *and* Lawlor Declaration, DE # 85-2, p. 3 of 11, at para.  
6 10.

7 16. When asked under oath at October 3, 2007 meeting of creditors whether he was  
8 engaged in attempts to sell the debtors’ real estate assets, and to use the proceeds to settle  
9 outstanding litigation with creditors or claimants of other entities, Southwick refused to answer  
10 and asserted his right to avoid self-incrimination pursuant to the Fifth Amendment to the United  
11 States Constitution. Transcript, DE # 69, p. 55 l. 3 - p. 56 l. 19.

12 **II.**  
13 **LEGAL ARGUMENT**

14 There is a straightforward consistency in the positions taken by all parties who have  
15 weighed in so far in these jointly administered voluntary Chapter 11 cases: Val E. Southwick  
16 cannot continue to exercise management and control over the debtors.

17 In order to displace Southwick as the debtors’ manager, the United States Trustee filed its  
18 motion for appointment of a trustee. Two creditors, including the debtors’ largest secured  
19 creditor, Apex Holding Company, LLC, have filed joinders. DE # 64 and 70. The debtors  
20 themselves previously filed an unsuccessful motion seeking to retain a Chief Restructuring  
21 Officer. DE # 7 and 47. Finally, an opposition to the United States Trustee’s motion to appoint  
22 a trustee was filed by Heritage Capital, Inc. and others, which expressly proposes to “displace  
23 Southwick with a ‘Chief Restructuring Officer’ pending confirmation of a ‘Plan[.]’”<sup>2</sup> For his  
24

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25 <sup>2</sup>DE # 85. Heritage’s suggestion regarding a “Chief Restructuring Officer” is a proposal already made by  
26 the debtors, rejected by the court, and devoid of any citation to supporting authority. *See In re SunCruz Casinos,*  
27 *LLC*, 298 B.R. 821, 832 (Bankr. S.D. Fla. 2003)(“In the alternative, the Committee recommends that the Court  
28 appoint a “Responsible Person” in lieu of a trustee, in the event the Court determines that Debtors’ management  
should be replaced. [ . . . ] The Court rejects this recommendation. The Bankruptcy Code expressly provides for  
appointment of a trustee when a debtor’s management is replaced. The Code does not contemplate appointment of a  
“Responsible Person” to perform the duties of a trustee.”).

1 part, Southwick has made it abundantly clear that he will not answer substantive questions  
2 regarding the debtors' financial condition or business operations. In addition to invoking his  
3 Fifth Amendment right to avoid self-incrimination during the administration of these estates, he  
4 has been instructed by his attorneys "not to sign amended petitions, amended schedules,  
5 amended statements of affairs, monthly operating reports, declarations or applications seeking to  
6 employ professionals with respect to the cases the Debtors [sic]." See Pachulski Declaration, DE  
7 # 62 at p. 9 para. 29 - p. 10 para. 31.

8 Given the parties' uniform view that Southwick must be replaced as the debtors'  
9 management, the real issue before the Court is how that replacement should be accomplished.  
10 The Bankruptcy Code provides the answer, and "expressly provides for appointment of a trustee  
11 when a debtor's management is replaced." In re SunCruz Casinos, LLC, 298 B.R. 821, 832  
12 (Bankr. S.D. Fla. 2003).

13 **A. A Trustee Should Be Appointed Now Pursuant to 11 U.S.C. § 1104(a)(1)**

14 Debtors' opposition suggests that the United States Trustee's motion is "based on  
15 Southwick's invocation of his Fifth Amendment privilege against self-incrimination" and that  
16 "the UST has not provided any independent evidence of 'fraud, dishonesty, incompetence, or  
17 gross mismanagement'" with respect to the Debtors in the herein cases[.]" Opposition, p. 10.  
18 Debtors' argument is flawed in two respects. First, Debtors' position overemphasizes the  
19 significance of Southwick's assertion of his Fifth Amendment privilege in the legal analysis that  
20 governs contested motions for the appointment of a trustee under 11 U.S.C. § 1104. Second,  
21 Debtors' argument fails to recognize that "cause" for appointment of a trustee 11 U.S.C.  
22 § 1104(a)(1) can exist even if the non-exclusive examples of misconduct listed in that section  
23 are not borne out by the facts of a particular case.

24 **1. The United States Trustee Has A Statutory Duty to Seek Appointment**  
25 **of a Trustee Pursuant to 11 U.S.C. § 1104(e)**

26 Debtors' opposition to the United States Trustee's motion for appointment of a receiver  
27 suggests that the motion "rests on a single ground - that Southwick, the Debtors' principal and  
28 designated representative, has invoked his Fifth Amendment privilege against self-

1 incrimination.” Opposition, p. 7. Debtors’ opposition fails to recognize recent substantive  
 2 changes to the text of 11 U.S.C. § 1104, and misapprehends the position of the United States  
 3 Trustee.

4 The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of  
 5 2005 (“BAPCPA”) resulted in the addition of a new subsection (e) to 11 U.S.C. § 1104:

6 **§ 1104. Appointment of trustee or examiner**

7 . . . . .  
 8 (e) *The United States trustee shall move for the appointment of a trustee*  
 9 *under subsection (a) if there are reasonable grounds to suspect that*  
 10 *current members of the governing body of the debtor, the debtor’s chief*  
 11 *executive or chief financial officer, or members of the governing body*  
 12 *who selected the debtor’s chief executive or chief financial officer,*  
 13 *participated in actual fraud, dishonesty, or criminal conduct in the*  
 14 *management of the debtor or the debtor’s public financial reporting.*

15 *See generally*, 11 U.S.C. § 1104(e)(emphasis added).

16 In this case, Southwick testified under oath at the meeting of creditors that he is the  
 17 managing member of each of the debtors, either directly or through a related entity. *See*  
 18 *Transcript*, DE # 69 at p. 19 l. 9 - p. 22 l. 2. Southwick then declined to answer any substantive  
 19 questions regarding the debtors’ prebankruptcy business operations, current financial condition,  
 20 or postbankruptcy intentions, asserting his Fifth Amendment right to avoid self-incrimination.  
 21 *See generally*, *Transcript*, DE # 69. The information contained in the debtors’ court filings (*see*  
 22 *Statement of Facts*, *supra*, para. 1 - 10), taken together with Southwick’s assertion of the Fifth  
 23 Amendment right to avoid self-incrimination when asked specific, discrete questions regarding  
 24 his involvement in the debtors’ business operations and financial condition at the meeting of  
 25 creditors, triggered the United States Trustee’s statutory duty under 11 U.S.C. § 1104(e), and the  
 26 filing of the motion for appointment of a trustee now pending before the Court.

27 **2. “Cause” for Appointment of a Trustee is Not Limited to the List of**  
 28 **Examples Found in 11 U.S.C. § 1104(a)(1)**

Debtors’ opposition posits that there is no “cause” for appointment of a trustee under 11  
 U.S.C. § 1104(a)(1) because, aside from Southwick’s dogged assertion of his Fifth Amendment  
 right to avoid self-incrimination in these proceedings, there has been no independent proof of  
 “fraud, dishonesty, incompetence, or gross mismanagement” in connection with the debtors. *See*

1 *generally*, Opposition pp. 10 - 15. Debtors' opposition seems to suggest that "cause" exists for  
 2 appointment of a trustee under 11 U.S.C. § 1104(a)(1) only if "fraud, dishonesty, incompetence,  
 3 or gross mismanagement" have been proven.<sup>3</sup> That is not the law.

4 The presence of fraud, dishonesty, incompetence, or gross mismanagment is not a  
 5 mandatory prerequisite to a finding that "cause" for appointment of a trustee exists under that  
 6 section. "Cause" for appointment of a trustee under 11 U.S.C. § 1104(a)(1) is a much broader  
 7 concept:

8 Section 1104(a) represents a potentially important protection that courts should not  
 9 lightly disregard or encumber with overly protective attitudes towards debtors-in-  
 10 possession. Under § 1104(a)(1), the words "including" and "or similar cause" before and  
 11 after the enumerated examples of cause and 11 U.S.C. § 102(3) indicate that the grounds  
 12 for appointing a reorganization trustee are not even limited to the derelictions specifically  
 13 enumerated. The mandate of § 1104(a)(1) is explicit and should be enforced according to  
 14 its plain language. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct.  
 15 1026, 1030, 103 L. Ed. 2d 290 (1989).

16 *In re V. Savino Oil & Heating Co.*, 99 B.R. 518, 525 (Bankr. E.D.N.Y. 1989); *see also SunCruz*  
 17 *Casinos*, 298 B.R. at 828 (11 U.S.C. § 1104(a)(1) "provides a nonexhaustive list, including,  
 18 fraud, dishonesty, incompetence, or gross mismanagement, as conduct warranting appointment  
 19 of a trustee for 'cause'."); *In re Microwave Products of America, Inc.*, 102 B.R. 666, 671 (Bankr.  
 20 W.D. Tenn. 1989)(same, noting that courts may consider prepetition, as well as postpetition  
 21 conduct in determining the necessity of a trustee); 11 U.S.C. § 102(3)("In this title . . . 'includes'  
 22 and 'including' are not limiting[.]");

23 Courts have given credence to the nonexhaustive nature of the list of circumstances, and  
 24 substance to the term "cause," found in the text of 11 U.S.C. § 1104(a):

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25 <sup>3</sup>The United States Trustee maintains that the controlling burden of proof is the preponderance of the  
 26 evidence, not the clear and convincing evidence standard advanced by the debtors. As noted recently by the United  
 27 States District Court for the District of Massachusetts, "general Supreme court reasoning in the bankruptcy realm  
 28 suggests that the reflexive endorsement of a demanding 'clear and convincing' evidentiary burden regarding trustee  
 appointments under § 1104 is anomalous." *Tradex Corp. v. Morse* (*In re Tradex Corp.*), 339 B.R. 823, 830 (D.  
 Mass. 2006). Continued "reflexive" use of the clear and convincing standard in resolving trustee motions following  
 the enactment of 11 U.S.C. § 1104(e) in 2005 has also been questioned in law review commentary. *See Clifford J.*  
*White III & Walter W. Theus, Jr., Chapter 11 Trustees and Examiners After BAPCPA*, 80 AM. BANKR. L. J. 289,  
 315-16 (2006)(Because 11 U.S.C. § 1104(e) requires the United States Trustee to file a motion for appointment of a  
 trustee based only upon "reasonable grounds to suspect fraud or other dishonest conduct," the adoption of § 1104(e)  
 "calls for a reexamination of the case law that established this heightened level of proof.").

1 Determinations to appoint a trustee pursuant to Section 1104(a)(1) are fact intensive.  
2 [citation omitted]. In addition to Section 1104(a)(1)'s enumerated examples of conduct  
3 constituting cause - fraud, dishonesty, incompetence, or gross mismanagement - courts  
4 have found cause to appoint a trustee based on the following factors:

- 5 (1) Materiality of the misconduct;
- 6 (2) Evenhandedness or lack of same in dealings with insiders or affiliated  
7 entities vis-a-vis other creditors or customers;
- 8 (3) The existence of pre-petition voidable preferences or fraudulent transfers;
- 9 (4) Unwillingness or inability of management to pursue estate causes of  
10 action;
- 11 (5) Conflicts of interest on the part of management interfering with its ability  
12 to fulfill fiduciary duties to the debtor;
- 13 (6) Self-dealing by management or waste or squandering of corporate assets.

14 SunCruz Casinos, 298 B.R. at 830, *citing In re Intercat, Inc.*, 247 B.R. 911, 921 (Bankr. S.D. Ga.  
15 2000) and In re Bellevue Place Associates, 171 B.R. 615, 622 (Bankr. N.D. Ill. 1994).

16 **B. The Burden of Proving That Appointment of a Trustee for Cause is  
17 Appropriate Under 11 U.S.C. 1104(a)(1) is Met by the Record Before the  
18 Court**

19 Contrary to the argument advanced in debtors' opposition, there is sufficient evidence in  
20 the record before the Court to establish that "cause" exists for appointment of a trustee under 11  
21 U.S.C. §1104(a)(1), separate and apart from Southwick's invocation of his right to avoid self-  
22 incrimination under the Fifth Amendment. That conclusion is inevitable under both the  
23 preponderance of the evidence and clear and convincing evidence standards.

24 **1. Debtors' Filings Demonstrate a Lack of Evenhandedness in Debtor's  
25 Dealings with Insiders and Affiliated Entities Vis-a-Vis Other  
26 Creditors or Customers (Intercat Factor #2)**

27 Debtors' statements of financial affairs show that the debtors made payments to insiders  
28 totaling \$5,559,252.82 during the year prior to the filing of their bankruptcy petitions. Those  
payments left no outstanding balance due to the various insider recipients. In contrast, during  
the 90 days prior to the filing their bankruptcy petitions, there are virtually no payments to non-  
insider creditors (other than attorneys) reflected in the debtors' statements of financial affairs.

**2. Debtors' Filings Reveal Substantial Pre-Petition Payments Made to  
Insiders During the Year Prior to Filing, and That Large Insider  
Intercompany Loan Balances Exist (Intercat Factor # 3)**

1 Debtors' statements of financial affairs show that the debtors made payments to insiders  
2 totaling \$5,559,252.82 during the year prior to the filing of their bankruptcy petitions. More  
3 than \$19 million in unsecured loans were made by the debtors to related companies which  
4 remained unpaid as of the filing of the debtors' bankruptcy petitions, too. Aside from the  
5 debtors' direct and indirect real estate holdings, these claims represent the vast majority of the  
6 substantive assets in the debtors' bankruptcy estates.

7 **3. The Record Reveals That Southwick Has Been Engaged in Self-**  
8 **Dealing That Would Waste or Squander the Debtors' Corporate**  
9 **Assets (Intercat Factor # 6)**

9 While enjoying management and control of the debtors, and after the debtors' bankruptcy  
10 petitions were filed, Southwick engaged in negotiations for the transfer of the debtors' real estate  
11 assets to third parties, subject to the condition that "All lawsuits against Val Southwick and  
12 Vescor and other parties will have to be settled. The settlement will require that all parties agree  
13 to release any claims against any and all other parties included in the agreements." Lawlor  
14 Declaration, DE #85-2, at p. 9 of 11. The net result: Southwick would obtain a release of  
15 personal liability, while \$19 million in intercompany receivables, and over \$5.5 million in  
16 potentially preferential payments made by the debtors to insiders, would be lost from the  
17 debtors' estates. The record before the Court reveals with startling clarity that Southwick is  
18 actually and actively engaged in self-dealing, and a related attempt to waste or squander  
19 corporate assets.

20 **4. The Record Confirms That Southwick Suffers From a Conflict of**  
21 **Interest That is Interfering With His Ability to Fulfill Fiduciary**  
22 **Duties as Manager of the Debtors (Intercat Factor #5)**

22 Southwick is burdened by conflicts of interest that at a minimum interfere with, and at  
23 worst make it impossible for him to discharge, the fiduciary duties he owes in his capacity as  
24 manager of the debtors. As explained by the SunCruz Casinos court:

25 Fiduciary obligations [of a debtor in possession] include the duty of loyalty and good  
26 faith which forbid "directors and other business operators from using their position of  
27 trust and control over the rights of other parties to further their own private interest,  
28 either by usurping opportunities, holding undisclosed conflicts, or otherwise exploiting  
their position." *In re Microwave Products*, 102 B.R. at 672. The willingness of  
Congress to leave a debtor in possession is premised on the expectation that current  
management can be depended upon to carry out the fiduciary responsibilities of a trustee.

1 And if the debtor in possession defaults in this respect, Section 1104(a)(1) commands  
2 that the stewardship of the reorganization effort must be turned over to an independent  
3 trustee. *In re Marvel*, 140 F.3d 463, 474 (3d Cir. 1998)(quoting *V. Savino Oil*, 99 B.R.  
4 at 326).

5 SunCruz Casinos, 298 B.R. at 829-30. Any attempt by managers like Southwick to “structure  
6 deals that would benefit them privately to the detriment of other creditors would contravene the  
7 fiduciary relationship.” Microwave Products, 102 B.R. at 672.

8 Southwick’s self interests would plainly be advanced by using the debtors’ corporate  
9 assets to obtain relief from personal liability. Southwick has already contravened fiduciary  
10 duties attendant to his management of the debtors by attempting to negotiate a release from  
11 personal liabilities through the transfer of the debtors’ assets to third parties and waiver of (a)  
12 \$19 million in intercompany receivables, and (b) over \$5.5 million in potential preference  
13 claims against insider entities. Various courts have concluded that the presence of such a  
14 conflict of interest alone may constitute a sufficient basis for appointment of a trustee. *See*  
15 SunCruz Casinos, 298 B.R. at 831 (collecting cases holding that conflicts of interest alone are a  
16 sufficient basis to appoint a trustee), *citing* In re Cajun Elec. Power Cooperative, Inc., 74 F.3d  
17 599 (5<sup>th</sup> Cir. 1996), In re Fiesta Homes of Georgia, Inc., 125 B.R. 321, 325 (Bankr. S.D. Ga.  
18 1990), *and* In re Bellevue Place Associates, 171 B.R. 615, 623 (Bankr. N.D. Ill. 1994); *see also*  
19 Intercat, 247 B.R. at 922-23 (where debtor’s manager, his family and closely held corporations  
20 were targets of claims held by debtor’s estate, court found it “impossible to believe” that the  
21 manager would pursue those claims “in the manner that a disinterested person would.”)

22 **5. The Record Establishes Southwick’s Unwillingness and Inability to**  
23 **Pursue Estate Causes of Action (Intercat Factor # 4)**

24 As noted previously, when debtors’ bankruptcy petitions were filed, over \$19 million in  
25 intercompany receivables remained unpaid, and over \$5.5 million in potentially recoverable  
26 preference payments to insider entities existed. A review of the docket confirms that Southwick  
27 has taken no action to recover those sums after the debtors’ petitions were filed in August.  
28 Instead, Southwick has been working to reach an agreement through which he would obtain a  
release of personal liability in exchange for the transfer of the debtors’ real estate assets to third  
parties, and the waiver of those intercompany receivables and preference claims. Also, the

1 record before the Court certainly suggests that Southwick is unable to cause the debtors to take  
2 action directed toward recovery of their intercompany receivables and preference claims. It is  
3 unlikely that his Southwick's attorneys would authorize him to verify an adversary complaint,  
4 when they have already instructed him not to sign "amended petitions, amended schedules,  
5 amended statements of affairs, monthly operating reports, declarations or applications seeking to  
6 employ professionals with respect to the cases the Debtors [sic]." See Pachulski Declaration, DE  
7 # 62 at p. 9 para. 29 - p. 10 para. 31. This Intercat factor also militates strongly in favor of the  
8 appointment of a trustee. See In re Fiesta Homes of Georgia, Inc., 125 B.R. 321, 325-26 (Bankr.  
9 S.D. Ga. 1990), citing In re L.S. Good & Co., 8 B.R. 312 (Bankr. N.D. W. Va. 1980)(removal of  
10 present management and appointment of trustee is appropriate where there is a strong probability  
11 of conflict of interest such as to hinder management's ability to make impartial investigations  
12 and decisions in pursuing claims on behalf of the estate).

#### 13 **6. Materiality**

14 Southwick's actions (and inactions) in managing the debtors are material in every  
15 respect. The duties borne by Southwick as the debtors' manager are fiduciary duties. Over \$19  
16 million in unpaid intercompany receivables, and over \$5.5 million in potentially preferential  
17 payments made by the debtors to insider entities, are implicated. Southwick has invoked rights  
18 afforded to him under the Fifth Amendment to the United States Constitution. The integrity of  
19 the bankruptcy system itself will be impacted by the Court's resolution of the issues before it:  
20 "[I]n the appropriate case, the appointment of a trustee is a power which is critical for the Court  
21 to exercise in order to preserve the integrity of the bankruptcy process and to insure that the  
22 interests of creditors are served." SunCruz Casinos, 298 B.R. at 828, quoting Intercat, 247 B.R.  
23 at 920.

24 "Once the court finds that cause exists under § 1104(a)(1), there is no discretion; an  
25 independent trustee must be appointed." SunCruz Casinos, 298 B.R. at 828, citing In re  
26 Oklahoma Refining Co., 838 F.2d 1133, 1136 (10<sup>th</sup> Cir. 1988) and cf. Committee of Dalkon  
27 Shield Claimants v. A.H. Robins Co., 828 F.2d 239, 242 (4<sup>th</sup> Cir. 1987)(determining that the  
28 court's discretionary authority is necessary to determine if the "conduct shown rises to a

1 sufficient level to warrant the appointment of a trustee.”). The Court must therefore enter an  
2 order pursuant to 11 U.S.C. § 1104(a)(1), directing the United States Trustee to appoint a trustee  
3 in these cases.

4 C. **Appointment of a Trustee is Also Appropriate Pursuant to 11 U.S.C.**  
5 **§ 1104(a)(3).**

6 The United States Trustee reiterates the argument advanced in its motion that  
7 appointment of a trustee is also appropriate under 11 U.S.C. § 1104(a)(3). It is true that "adverse  
8 inference[s] can only be drawn when independent evidence exists of the fact to which the party  
9 refuses to answer." In re National Audit Defense. Network, 367 B.R. 207, 216-17 (Bankr. D.  
10 Nev. 2007), *quoting Doe ex rel. Rudy- Glanzer v. Glanzer*, 232 F.3d 1258, 1264 (9th Cir. 2000).  
11 It is also true that there is ample evidence of gross mismanagement of the debtors' estates in the  
12 record, separate and apart from the failure of proof occasioned by Southwick's silence. *See*  
13 *Statement of Facts, supra*. As a result, the Court may properly draw negative inferences from  
14 Southwick's invocation of the Fifth Amendment Privilege against self-incrimination; may rely  
15 on such inferences in holding that cause exists for conversion or dismissal pursuant to 11 U.S.C.  
16 § 1112(b)(4)(B); and should conclude that appointment of a trustee is also warranted under 11  
17 U.S.C. § 1104(a)(3).

18 **CONCLUSION**

19 For the reasons and pursuant to the authorities discussed above, the United States Trustee  
20 requests that the Court enter an order directing the United States Trustee to appoint a single  
21 trustee to serve in these four jointly administered Chapter 11 cases pursuant to 11 U.S.C.  
22 § 1104(a)(1) and (3), and FED. R. BANKR. P. 2009(c)(2). The United States Trustee further  
23 requests that the Court grant such other and additional relief as is just and equitable.

24 Respectfully submitted,

25 **SARA L. KISTLER**  
26 **ACTING UNITED STATES TRUSTEE**  
27 **REGION 17**

28 By: /s/ August B. Landis  
August B. Landis, Assistant United States Trustee  
United States Department of Justice