

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	Chapter 11
	:	
DBSI, Inc. et al,	:	Case No. 08-12687(PJW)
	:	
Debtors.	:	Jointly Administered
	:	
	:	Objection Deadline: 8/4/2009 at 9:30 a.m.
	:	Hearing Date: 8/4/2009 at 9:30 a.m.

**MOTION FOR ENTRY OF AN ORDER DIRECTING THE
APPOINTMENT OF A CHAPTER 11 TRUSTEE**

Roberta A. DeAngelis, the Acting United States Trustee for Region Three, by and through her counsel, hereby moves pursuant to 11 U.S.C. § 1104 for the entry of an order directing the appointment of a chapter 11 trustee (“Motion”) and in support thereof respectfully represents as follows:

BACKGROUND

1. Pursuant to 28 U.S.C. § 586, the U.S. Trustee is charged with the administrative oversight of cases commenced pursuant to Title 11 of the United States Bankruptcy Code. This duty is part of the UST’s overarching responsibility to enforce the bankruptcy laws as written by Congress and interpreted by the courts. *See United States Trustee v. Columbia Gas Sys., Inc. (In re Columbia Gas Sys., Inc.)*, 33 F.3d 294, 295-96 (3d Cir. 1994) (noting that U.S. Trustee has “public interest standing” under 11 U.S.C. § 307, which goes beyond mere pecuniary interest); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500 (6th Cir. 1990) (describing the U.S. Trustee as a “watchdog”).

2. Pursuant to 11 U.S.C. § 307, the U.S. Trustee has standing to be heard.



STATEMENT OF CASE

3. Based upon the Examiner's First Interim Report filed earlier today,¹ it appears that certain of the Debtors' officers and directors, including Douglas L. Swenson, have engaged in misconduct, fraud and mismanagement which collectively caused damage to the Debtors' investors and creditors. While the Examiner's investigation is ongoing and the full extent of the fraudulent activity is not yet known, the information disclosed in the First Interim Report makes it clear that the Debtors' current management can not be entrusted to exercise the fiduciary duties placed upon a debtor in possession.

4. As set forth in the Examiner's First Interim Report, Swenson and certain other DBSI officers and directors betrayed DBSI, its investors, and creditors through their control of both the debtor companies and significant non-debtor companies. They used funds that were raised for specified purposes, including restricted proceeds from a 2008 unsecured bond issuance, to cover operating shortfalls and to make payments on other outstanding debts. This misuse of funds enabled them to improperly present a distorted view of DBSI's financial situation to the public.

5. This fraud and misconduct on the part of DBSI's current management constitutes clear grounds for the court to direct the appointment of a chapter 11 trustee under 11 U.S.C. § 1104(a).

¹ The U.S. Trustee's impetus to file this motion so soon after the filing of the Preliminary Report is based both on the nature of the information it contains and on 11 U.S.C. § 1104(e), which mandates that the U.S. Trustee seek the appointment of a trustee:

if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

11 U.S.C. § 1104(e).

RELEVANT FACTS

6. On November 10, 2008,² each of the Debtors filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. This Court directed that the cases be jointly administered under case number 08-12687.

7. On November 21, 2008, the U. S. Trustee appointed an official committee of unsecured creditors (the “Committee”).

8. On or about March 13, 2009, the Court granted the State of Idaho’s motion for the appointment of an examiner³. On April 2, 2009, the U. S. Trustee appointed Joshua Hochberg as the examiner to, *inter alia*, investigate the circumstances surrounding: (i) any and all of the Debtors’ inter-company transactions and transfers; (ii) any and all transactions and transfers between and among the Debtors and any non-debtor affiliates; and (iii) any and all transactions and transfers between and among the Debtors and any insiders, officers, directors and principals of the Debtors.

9. The Examiner in the discharge of his duties performed an investigation of the Debtors and on August 3, 2009, filed a First Interim Report stating that, among other things, the Debtors’ books, records and general ledger entries cannot be relied upon and the several millions of dollars of investment proceeds were misappropriated (D. E. 4159).

10. Specifically, DBSI Inc., Douglas Swenson, and the DBSI control group controlled both the debtor companies and all significant non-debtor companies and were able to control the

² While the majority of the Debtors filed voluntary petitions on November 10, 2008, some of the Debtors filed voluntary petitions on November 6, 2008, December 12, 2008, January 6, 2009 or January 9, 2009.

³ The U. S. Trustee filed a Statement and Response in Support of the Motion of the State of Idaho Department of Finance for the Entry of an Order Appointing an Examiner Pursuant to 11 U.S.C. 1104(c) on March 10, 2009 (D. E. 2415).

flow of moneys and direct that loans be made to non-debtor companies or “secured” by the assets of those companies. Among those non-debtor companies were entities known as DRR, Stellar, Western Technologies, Investments, and Kastera.

11. The First Interim Report focuses on the use by DBSI of funds raised through the 2008 issuance by debtor DBSI 2008 Notes Corporation (“2008 Notes”) of up to \$90 million in unsecured notes. In large part, the loans made by 2008 Notes were used for the benefit of DBSI Inc. to meet existing obligations. DBSI Inc. and its controlled entities had severe cash flow problems in 2008 and undoubtedly earlier. It used monies obtained from the 2008 Note as a stopgap measure to fund the current operating expenses of a failing enterprise. Ultimately, none of the business entities controlled by Swenson and the DBSI group had any reasonable likelihood of generating revenues sufficient to ever pay back DBSI’s obligations on the 2008 Notes (or to the 2008 Notes investors).

12. DRR was used as an intermediary for many inter-company fund transfers. The use of DRR helped obfuscate the true sources and uses of the funds. The loans receivable from DRR on the books of debtor entities represent nothing more than an accumulation of fund transfers which were documented by accounting entries. The Examiner found no formal loan documents obligating DRR to pay DBSI Inc. The money that flowed through DRR was always obtained from other sources. Determining the true source of the funds is difficult. Many of the journal entries for DBSI-controlled companies do not fairly and accurately reflect the essence of the transactions they purport to describe. DBSI and other Douglas Swenson-controlled companies, whether debtors or non-debtors, were run as a unified business. The sources and uses of funds were evaluated by considering all companies controlled by DBSI Inc., Douglas Swenson and/or the control group. Highly questionable internal valuations and appraisals were used to support

loans. DBSI Inc. and its controlled entities commingled their available cash which was disbursed for the most pressing obligations as they came due.

APPLICABLE LAW AND ANALYSIS

“Cause” exists for the appointment of a chapter 11 trustee under 11 U.S.C. § 1104(a)(1)

13. 11 U.S.C. § 1104(a) states that the Bankruptcy Court shall order the appointment of a trustee, at any time after the commencement of the case but prior to confirmation of a plan, on request of a party in interest or the U.S. Trustee, and after notice and a hearing:⁴

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

11 U.S.C. § 1104(a).

14. Subsection (1) addresses management’s pre- and post-petition misdeeds or mismanagement, while subsection (2) provides the court with “particularly wide discretion” to

⁴ A number of courts have indicated that grounds for the appointment of a trustee must be established by “clear and convincing” evidence. *See In re G-I Holdings, Inc.*, 385 F.3d 313 (3d Cir. 2004). However, in light of Supreme Court precedent and the recent addition of § 1104(e) to the Bankruptcy Code, the better view is that the appropriate burden of proof should be the “preponderance of the evidence”. *See Tradex Corp. v. Morse*, 339 B.R. 823, 829-32 (D. Mass. 2006) (citing *Grogan v. Garner*, 498 U.S. 279, 286 (1991)). The evidence supporting the appointment of a trustee for these cases is sufficient to meet either burden of proof.

direct the appointment of a trustee even absent wrongdoing or mismanagement. *In re Bellevue Place Associates*, 171 B.R. 615, 623 (N.D. Ill. 1994). Where the court finds either that cause exists or that appointment is in the interest of the parties, an order for the appointment of a trustee is mandatory. *Official Comm. Of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (In re W.R. Grace & Co.)*, 285 B.R. 148, 158 (Bankr. D. Del. 2002).

15. The categories enumerated in 11 U.S.C. § 1104(a)(1) “cover a wide range of conduct” and, thus, are best described as illustrative, rather than exclusive. *See In re Marvel Entertainment Corp.*, 140 F.3d 463, 472 (3d Cir. 1998)(quoting *Committee of Dalkon Shield Claimants v. A.H. Robbins Co.*, 828 F.2d at 242). Fraud, dishonesty, incompetence, and gross mismanagement of a debtor’s business affairs are all grounds for appointment of a chapter 11 trustee under 11 U.S.C. § 1104(a)(1). *See, e.g., In re Sharon Steel Corp.*, 871 F.2d 1217 (3d Cir. 1989); *In re Colby Construction Corp.*, 51 B.R. 113, 116-118 (Bankr. S.D.N.Y. 1985). The determination of whether cause exists must be made on a case by case basis, taking into account all relevant factors. *Sharon Steel*, 871 F.2d at 1225. In making that determination, courts should be cognizant of the fact that “section 1104 represents a protection that the court should not lightly disregard or encumber with overly protective attitudes towards debtors-in-possession.” *In re V. Savino Oil & Heating Co., Inc.*, 99 B.R. 518, 525 (Bankr. E.D.N.Y. 1989). Pre-petition conduct alone may provide the basis for a court to order the appointment of a trustee. *See In re Rivermeadows Assocs., Ltd.*, 185 B.R. 615, 619 (Bankr. D. Wyo. 1995).

16. Once cause is found to exist to support the appointment of a Chapter 11 trustee (including for the debtor's fraud, dishonesty, incompetence, or gross mismanagement of its affairs by current management) the court has no discretion in ordering the appointment of an independent trustee. *V. Savino Oil & Heating*, 99 B.R. at 525.

17. Under 11 U.S.C. § 1107(a), a Chapter 11 debtor in possession assumes essentially all of the rights and duties of a trustee. This includes the trustee's primary fiduciary duty to act in the best interests of general creditors rather than insiders. *See, e.g., Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) ("[o]ne of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors"); *Wolf v. Weinstein*, 372 U.S. 633, 649 (1963) ("[S]o long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession."); *In re United Healthcare System, Inc.*, 200 F.3d 170, 177 n.9 (3d Cir. 1999) (debtor, "as a debtor-in-possession, is a fiduciary for its estate and for its creditors."); *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 474 (3d Cir. 2000) ("When the chapter 11 petition was filed in this case, the debtor-in-possession assumed the same fiduciary duties as would an appointed trustee. . . . [including] the duty to protect and conserve property in its possession for the benefit of creditors.") (internal quotation omitted).

18. The fiduciary duty imposed upon a Chapter 11 debtor in possession is shared by its directors, as a corporation may only act through its agents. Thus, directors of a debtor in possession individually "bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession." *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. at 355.

19. The presumption in favor of allowing debtors to manage their own operations and administer their own estates vanishes completely when management has demonstrated that it cannot be relied upon to comply with its fiduciary duties. *See Commodity Futures Trading Comm’n v. Weintraub* at 471 U.S. 355 (“[T]he willingness of courts to leave debtors in possession ‘is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.’”) (quoting *Wolf v. Weinstein*, 372 U.S. 633, 651 (1963)). When a debtor in possession, its management, or its professionals have exhibited an inability or unwillingness to comply with their fiduciary duties, there is but one remedy established by Congress that can supplant management while allowing the case to remain in Chapter 11 – the appointment of a trustee pursuant to 11 U.S.C. § 1104(a). *See In re PRS Insurance Group, Inc.*, 274 B.R. 381 (Bankr. D. Del. 2001).

20. In its decision in *In re Marvel Entertainment Group, Inc.*, the Third Circuit quoted the following passage approvingly in affirming the appointment of a Chapter 11 trustee:

The willingness of Congress to leave a debtor-in-possession is premised on an expectation that current management can be depended upon to carry out the fiduciary responsibilities of a trustee. And if the debtor-in-possession defaults in this respect, Section 1104(a)(1) *commands* that the stewardship of the reorganization effort must be turned over to an *independent trustee*.

Id. (quoting *In re V. Savino Oil & Heating Co., Inc.*, 99 B.R. 518, 526 (Bankr. E.D.N.Y. 1989)) (emphasis added). The Third Circuit further stated that appointment of a trustee is mandatory if cause is found under 11 U.S.C. § 1104(a)(1), and while it is not mandatory under subsection (a)(2), the district court’s refusal to appoint something less than a trustee was not an abuse of discretion. *See Marvel*, 140 F.3d at 174-75. Congress provided no other way to replace debtor’s

management's control of the case with an independent fiduciary other than appointment of a trustee pursuant to 11 U.S.C. § 1104(a).

21. The Examiner has uncovered unmistakable evidence that members of the Debtors' top management have engaged in serial misconduct. While the details of their financial machinations are convoluted, the net effect is easily understood. DBSI attempted to prop up its financial house of cards by using investor funds raised for one purpose for entirely different purposes. Funds that should have been used for income-producing investments were instead, either directly or indirectly, used to cover operating losses or to avoid defaults on other financial instruments.

22. Swenson, his cronies and others in current or former management engaged in inappropriate and untoward corporate behavior and engaged in misconduct and mismanagement in the Debtors' affairs. Like the *PRS Insurance* debtor, it is unrealistic and naive to assume that the Debtors, if controlled by Swenson and his cohorts, will ever be able to propose a plan based upon credible information or even act upon the information that has been uncovered by the Examiner in his investigation. *PRS Insurance*, 274 B.R. at 387. Accordingly, a trustee is required to fulfill this duty and obligation. Cause therefore exists for the appointment of a chapter 11 trustee under 11 U.S.C. § 1104(a)(1).

Section 1104(a)(2) of the Bankruptcy Code provides an additional basis for the appointment of a chapter 11 trustee which is in the best interests of the estate

23. Courts have construed § 1104(a)(2) to provide for a "flexible standard" for the appointment of a trustee. *See, e.g., In re Sharon Steel Corp.*, 871 F.2d at 1226; *see also In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1990). Section 1104(a)(2) emphasizes

the court's discretion allowing it to appoint a trustee when to do so would serve the parties' and the estates' interests." *Id.*

24. Other courts have considered the following factors in determining whether the appointment of a trustee is in the best interest of the parties under Section 1104(a)(2): (1) the trustworthiness of the debtor; (2) the debtor's past and present performance and prospects for the debtor's rehabilitation; (3) the confidence or lack thereof of the business community and of creditors in present management; and (4) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment. *See In re Cajun Electric Power Co-Op, Inc.*, 1991 B.R. 659 661-62 (M.D. La. 1995) *aff'd* 74 F.3d 599 (5th Cir.), *cert. denied*, 117 S.Ct. 51 (1996); *Accord In re Ionosphere Clubs, Inc.*, 113 B.R. at 168.

25. The appointment of a chapter 11 trustee is in the best interests of the parties and the Debtors' estates. The Debtors' management and leadership appear to have engaged in significant and wide-spread fraud, self-dealing and mismanagement. Significant concerns have been raised about the Debtors' bona fides since the very inception of these cases, and the Examiner's First Interim Report only adds to, if not confirms, those concerns. The appointment of a trustee will replace embattled current management with a dispassionate, disinterested fiduciary in whom all parties in interest can place their trust.

26. The U.S. Trustee reserves and any all rights, remedies and obligations to, *inter alia*, complement, supplement, augment, alter, substitute, replace and/or modify this Motion and to conduct any and all discovery as may be deemed necessary or as may be required and to assert such other grounds as may become apparent.

WHEREFORE, for the foregoing reasons, the United States Trustee respectfully requests that this Court enter an order directing the appointment of a Chapter 11 trustee pursuant to 11 U.S.C. § 1104(a), and granting such other and further relief that is deemed fair, just, equitable and proper.

**ROBERTA A. DEANGELIS
ACTING UNITED STATES TRUSTEE**

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Dated: August 3, 2009

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re

DBSI, Inc., et al.

Debtors.

:
: Chapter 11
:
: Case No. 08-12687 (PJW)
:
: Jointly Administered

Proposed Hearing Date: August 4, 2009 at 9:30 a.m.

Proposed Objection Deadline: August 4, 2009 at 9:30 a.m.

**NOTICE OF MOTION OF THE ACTING UNITED STATES TRUSTEE FOR ENTRY
OF AN ORDER DIRECTING THE APPOINTMENT OF A CHAPTER 11 TRUSTEE
PURSUANT TO 11 U.S.C. § 1104**

TO: Parties on the Accompanying Certificate of Service:

Roberta A. DeAngelis, the Acting United States Trustee, has filed a Motion for Entry of an Order Directing the Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104 ("Motion").

You are required to file a responsive brief and any other objections to the Motion on or before the time as set by the court. At the same time, you must also serve a copy of the response upon the movant's attorney:

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A HEARING ON THE MOTION WILL BE HELD ON **August 4, 2009 at 9:30 a.m.** or as soon thereafter counsel maybe heard before the Honorable Peter J. Walsh, U.S.B.J., U.S. Bankruptcy Court, 824 Market Street Mall, 6th Floor, Courtroom #2, Wilmington, Delaware.

IF YOU FAIL TO RESPOND IN ACCORDANCE WITH THIS NOTICE, THE COURT MAY GRANT THE RELIEF DEMANDED BY THE MOTION WITHOUT FURTHER NOTICE OR HEARING.

Dated: August 3, 2009

BY: /s/Richard L. Schepacarter
Richard L. Schepacarter, Esquire
Trial Attorney

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re

DBSI, Inc., et al.

:
: Chapter 11
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: Case No. 08-12687 (PJW)
:
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Proposed Hearing Date: August 4, 2009 at 9:30 a.m.

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CERTIFICATE OF SERVICE

I certify that on August 3, 2009, I caused to be served a copy of the Motion to Shorten Notice Period as to the Motion of the Acting United States Trustee for Entry of an Order Directing the Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104 and the accompanying Motion for Entry of an Order Directing the Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104 *via* facsimile, email and/or regular mail to the persons listed below and on the attached service list:

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re

DBSI, Inc., et al.

:
: Chapter 11
:
: Case No. 08-12687 (PJW)
:
: Jointly Administered

Related to Docket No. _____.

**ORDER GRANTING THE MOTION OF THE UNITED STATES TRUSTEE FOR
ENTRY OF AN ORDER DIRECTING THE APPOINTMENT OF A CHAPTER 11
TRUSTEE PURSUANT TO 11 U.S.C. § 1104**

_____ This matter came before this Court for hearing on August 4, 2009, on the Motion of the Acting United States Trustee for Entry of an Order Directing the Appointment of a Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104 (the “Motion”). Due and sufficient notice of the Motion was given to interested parties in accordance with the Bankruptcy Code and Rules. Based upon the record, the Court finds that grounds exist for the appointment of an trustee under 11 U.S.C. § 1104(a). The Court further finds that the appointment of a Chapter 11 trustee is in the interests of creditors, any equity security holders, and other interests of the estate.

Based on the foregoing and on the record in these cases, it is hereby

ORDERED that the Motion is GRANTED; and

IT IS FURTHER ORDERED that the United States Trustee is hereby directed to appoint one disinterested person as Chapter 11 trustee in these cases, subject to the Court’s approval pursuant to 11 U.S.C. § 1104(d).

The Honorable Peter J. Walsh
United States Bankruptcy Judge

Dated: _____