

UNITED STATES BANKRUPTCY COURT  
MIDDLE DISTRICT OF FLORIDA  
JACKSONVILLE DIVISION

In re:

LYDIA CLADEK, INC.,

Case No. 3:10-bk-02805-PMG

Debtor.

(Consolidated by Prior Court Order with Case  
No. 10-bk-02800-PMG)

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**CHAPTER 11 TRUSTEE'S RESPONSE TO THE OBJECTIONS OF THE OFFICIAL  
COMMITTEE OF UNSECURED CREDITORS OF LYDIA CLADEK, INC. TO THE  
MOTIONS OF THE CHAPTER 11 TRUSTEE TO SELL SUBSTANTIALLY ALL OF  
THE DEBTOR'S PERFORMING AND NON-PERFORMING ASSETS**

Michael Phelan, as the Chapter 11 Trustee of the consolidated Chapter 11 cases of Lydia Cladek, Inc. (the "Chapter 11 Trustee"), files this response to the Objections of the Official Committee of Unsecured Creditors (the "Committee") of Lydia Cladek, Inc. (the "Debtor" or "LCI") to the Chapter 11 Trustee's Motions to Sell Substantially all of the Debtor's Performing and Non-Performing Assets, and in support thereof states as follows:

1. On April 2, 2010, several petitioning creditors filed an involuntary Chapter 11 petition against Lydia Cladek, Inc., case styled as *In re Lydia Cladek, Inc.*, Case No. 10-bk-02800-PMG, in the United States Bankruptcy Court, Middle District of Florida, Jacksonville Division (the "Involuntary Case").

2. Subsequently, on April 5, 2010, Lydia Cladek, Inc. ("LCI" or the "Debtor") filed the instant voluntary Chapter 11 petition, case styled as *In re Lydia Cladek, Inc.*, Case No. 10-bk-02805-PMG, in the United States Bankruptcy Court, Middle District of Florida, Jacksonville Division (the "Voluntary Case").

3. On April 7, 2010, several creditors filed an Emergency Motion to Consolidate the Involuntary and Voluntary Chapter 11 cases of Lydia Cladek, Inc. [Docket No. 13], and an Emergency Motion to Appoint a Chapter 11 Trustee [Docket No. 11].

4. On April 12, 2010, the Court entered its Order Granting Motion to Consolidate, consolidating the Voluntary and Involuntary Chapter 11 cases of the Debtor, and providing that the Voluntary Case, Case No. 10-02805, shall be the lead case [Docket No. 32].

5. On April 12, 2010, the Court entered its Order Granting Motion to Appoint Chapter 11 Trustee. [Docket No. 31], and on April 13, 2010, the United States Trustee filed its Appointment of Chapter 11 Trustee and Setting Bond, and its Application for Approval to Appoint Michael Phelan as Chapter 11 Trustee [Docket Nos. 44 and 46].

6. On June 1, 2010, the Court entered a Notice of Appointment of an Unsecured Creditors' Committee of Lydia Cladek, Inc. [Docket No. 111].

7. On July 2, 2010, the Chapter 11 Trustee filed a Motion to Approve the Sale of Substantially All of the Debtor's Performing Assets, consisting of those automobile loans less than 180 days past due (the "Sale of the Performing Assets") [Docket No. 152], and on July 6, 2010, the Chapter 11 Trustee filed a Motion to Approve the Sale of Substantially All of the Debtor's Non-Performing Assets, consisting of those automobile loans greater than 180 days past due (the "Sale of the Non-Performing Assets") [Docket No. 158] (the Sale of the Performing Assets and the Sale of the Non-Performing Assets shall be referred to herein as the "Sale").

8. On July 27, 2010, the Court entered its Orders (a) Authorizing the Chapter 11 Trustee to Conduct an Auction, (b) Approving the Bidding Procedures for the Auction, including Payment of Break-Up Fee, (c) Scheduling Dates for the Auction, Sale Hearing, and Objection

Deadline and (d) Approving the Form and Manner of Notices for both the Performing Assets and Non-Performing Assets [Docket Nos. 192 and 193].

9. On August 9, 2010, the Committee filed Objections to the Sale of the Performing Assets (the "Objection to Sale of the Performing Assets") [Docket No. 214] and the Non-Performing Assets (the "Objection to the Sale of the Non-Performing Assets", and collectively referred to herein as the "Objections") [Docket No. 215].

10. The Committee's Objections are based upon the assertion that (i) a reorganization of the Debtor's business is in the best interest of the creditors of the estate, and (ii) if the Court were to approve the Sale, the Committee would be prevented from exercising its right to submit a plan of reorganization and thus would be deprived of its due process rights under the Bankruptcy Code.

11. In response, the Chapter 11 Trustee believes that (i) the Sale is supported by a sound business reason and is in the best interest of the estate, (ii) the Committee's proposed reorganization is not feasible and is not in the best interest of the creditors of the estate, and (iii) approval of the Sale does not foreclose the Committee's opportunity to reorganize the Debtor's affairs.

**I. The Sale is Supported by a Sound Business Reason and is in the Best Interest of the Creditors of the Estate**

12. The applicable standard to determine whether the Sale should be approved is whether the Sale is supported by a sound business reason, i.e., the business judgment standard. *See Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983); *see also In re Chateaugay Corp.*, 973 F.2d 141, 143 (2d Cir. 1993); *In re Gulf State Steel, Inc. of Alabama*, 285 B.R. 497, 514 (Bankr. N.D. Ala. 2002).

13. Under the business judgment standard, in reviewing whether a proposed sale should be approved, courts should give substantial deference to the business judgment of the debtor-in-possession or chapter 11 trustee. *See e.g., Esposito v. Title Inc. Co. of Pa. (In re Fernwood Mkts)*, 73 B.R. 616, 621 n.2 (Bankr. E.D. Pa. 1987).

14. The Chapter 11 Trustee submits, based on the exercise of his business judgment, that the terms of the Sale are fair, reasonable, and in the best interests of this estate. Further, the Sale will return a greater benefit to the Debtor's estate and its creditors than any of the alternatives, including (i) a sale at a later date, (ii) servicing the automobile loan portfolios until confirmation of a plan, (iii) a piecemeal liquidation of the automobile loans, or (iv) the continued operation and reorganization of the Debtor as a going concern.

15. Approval of the Sale provides the Chapter 11 Trustee the ability to maximize the value of the assets of the estate through a fair and open auction process and minimize the Debtor's need to incur further administrative expenses. Accordingly, the Chapter 11 Trustee believes that the Sale is the best way, at this time, to maximize the value of the assets of the estate for the benefit of all creditors in this chapter 11 case.

16. The Chapter 11 Trustee has analyzed and discussed with several creditors, investors, and third parties the possibility of the continued operation and reorganization of the Debtor as a going concern. After a thorough investigation, the Chapter 11 Trustee determined that it would not be economically feasible for or beneficial to the estate to continue the Debtor's operations as a going concern.

17. Based on the foregoing, the Chapter 11 Trustee submits that the Sale is in the best interest of the Debtor, its estate, and its creditors, and is based upon sound, reasoned and

informed business judgment warranting this Court's approval. *See In re Lionel Corp.*, 722 F.2d at 1071; *In re Gulf State*, 285 B.R. at 514.

**II. The Committee's Proposed Reorganization is Not in the Best Interest of the Estate**

18. Before addressing the merits of the Committee's proposed reorganization, the Chapter 11 Trustee notes that the Committee in its Objection to the Performing Assets stated that the Chapter 11 Trustee has not produced all of the information requested by the Committee. This statement is wholly disingenuous. The Chapter 11 Trustee has worked diligently to accommodate and provide the Committee any and all documents and information the Committee has requested. Moreover, the Chapter 11 Trustee has provided the Committee access to all of the Debtor's records and computers, participated on numerous conference calls with the Committee, prepared an analysis of certain issues related to the Committee's projections, and has responded to every request by the Committee to the best that the Chapter 11 Trustee and his counsel are able.

19. With respect to the Objections, the Committee argues that a reorganization of the Debtor's affairs through the administration and growth of the loan portfolio is in the best interest of the creditors of the estate. The Committee's belief in this regard is based upon certain financial projections attached to the Committee's Objections.

20. The Committee's proposed reorganization, and the projections upon which it is based, are flawed in several respects and not feasible, and the monetary return to creditors under the Committee's projections is significantly overstated.

**A. The Committee's Proposed Reorganization is Not Feasible**

21. The Committee's projections are purportedly based upon an economic model used in the sub-prime automobile finance industry.

22. These projections fail to recognize that, *inter alia*, the sub-prime automobile finance industry is competitive, has inherent risk, and is subject to legislative changes that could negatively impact the industry. Additionally, the Committee has not determined, with any reasonable degree of accuracy or reliability, the true cost to the estate for a reorganization of this nature, and therefore reliance on the Committee's projections as a viable alternative to the Sale is misguided. Quite simply, there is no certainty that the Committee's proposed reorganization is feasible.

23. Presently, the creditors of the estate have virtually no reassurance that these projections will, in fact, be reached. Given the absence of any reasonable reassurance that the Debtor is capable of reorganizing in the way the Committee projects, denying the Sale on the basis of the mere hope or the opportunity to reorganize, irrespective of the projected monetary return to creditors under such reorganization, is not in the best interest of the creditors of this estate.

24. Furthermore, Thomas Imler, the individual with whom the Committee is working in developing its proposed plan of reorganization, is the relative of Lydia Cladek, the individual who perpetrated a massive fraud on creditors. Accordingly, Mr. Imler is an insider under 11 U.S.C. § 101(31)(B)(v).

25. On June 11, 2010, Lydia Cladek sent an email to members of the Committee, advocating a reorganization of the Debtor's affairs which included financial projections. Column three of Ms. Cladek's projections are substantially similar to the financial projections the Committee attaches to its Objections. A copy of Ms. Cladek's June 11, 2010 e-mail to Committee members is attached hereto and incorporated herein as **Exhibit A**.

26. Accordingly, any proposed plan with which Lydia Cladek has any involvement, no matter how attenuated, is inherently in bad faith under 11 U.S.C. § 1129(a)(3) and is therefore not confirmable.

**B. The Committee's Projections, and the Forecasted Monetary Return There Under, are Significantly Flawed and Overstated**

27. The Committee's projections significantly overstate the amount of return to creditors under the Debtor's proposed reorganization, and are materially flawed in several respects, including, *inter alia*, (i) the projections utilize net operating losses of the Debtor which will be eliminated and unavailable upon a discharge and confirmation of a plan, (ii) the projections are inherently skewed by double-counting certain income, which results in material misrepresentations and embellishments regarding the amount of revenue generated, (iii) the projected amount of administrative costs during the pendency of the Chapter 11 case are significantly undervalued, and (iv) the Committee substantially underestimates the detriment to the estate if the Sale is not approved.

28. Perhaps the most significant flaw in the Committee's projections is that the projections utilize the net operating losses ("NOLs") of the Debtor to offset and reduce the tax liability on future income of the reorganized Debtor. However, by operation of 26 U.S.C. § 108, the NOLs will not be available to any reorganized entity.<sup>1</sup>

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<sup>1</sup> Section 108(a) of the Internal Revenue Code of 1986, as amended, provides that

(a)(1) Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if--

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness; or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013.

(2) Coordination of exclusions.--

29. As a general matter, a taxpayer has taxable income equal to a discharge of indebtedness. *See* 26 U.S.C. § 61(a)(12). However, section 108 of the IRC contains various exceptions to income recognition from the discharge of indebtedness, including, but not limited to, a discharge which occurs in a case under Title 11. *See* 26 U.S.C. §§ 108(a)(1)(A) and 108(d)(2). However, the income exclusion carries with it the burden that the amount excluded from gross income under section 108(a)(1)(A) shall reduce certain tax attributes of the taxpayer, and under section 108(b)(1), the NOLs of the taxpayer are required to be reduced first on a dollar-for-dollar basis to the extent of the discharge of indebtedness. *See* 26 U.S.C. § 108(b)(1)-(3); *see also Lewis v. C.I.R.*, 928 F.2d 404 (6<sup>th</sup> Cir. 1991) (stating that "when a discharge occurs in a bankruptcy case, the amount of the discharge need not be included in gross income. 26 U.S.C. § 108(a)(1)(B). In exchange for this tax benefit, 26 U.S.C. § 108(b) requires the reduction of some of the taxpayer's other tax attributes to the extent of the amount excluded from gross income. These tax attributes are net operating losses in the year of discharge, research and general business credits, capital loss carryovers, the basis of the taxpayer's property, and foreign tax

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(A) Title 11 exclusion takes precedence.-- Subparagraphs (B), (C), (D) and (E) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion takes precedence over qualified farm exclusion.-- Subparagraph (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(C) Principal residence exclusion takes precedence over insolvency exclusion unless elected otherwise.— Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).

(3) Insolvency exclusion limited to amount of insolvency.-- In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes.--

(1) In general.-- The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction.-- Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL.-- Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

credits carryovers"); *Firsdon v. U.S.*, 1994 WL 773397 (N.D. Ohio 1994) (stating that section 108(b) provides that the amount excluded from income under § 108(a)(1) must be applied to reduce certain tax attributes of the taxpayer, including net operating losses).

30. The ability of the post-reorganization company to utilize the NOLs of the Debtor is reduced on a dollar-for-dollar basis to the extent that the Debtor receives a discharge of indebtedness under 11 U.S.C. § 1141. According to the Debtor's schedules, there is \$105,635,472.67 of unsecured claims, and therefore upon confirmation of a plan and discharge of indebtedness, the availability of the alleged \$65 million of NOLs of the Debtor will be eliminated, given that the return to creditors under any plan of reorganization is expected to be a small-fraction of the amount of claims even under the Committee's projections.

31. The inability to utilize the NOLs of the Debtor has a significant impact on the Committee's projections, as the projections do not account for any annual income tax of the company's revenue or pass-through tax obligations. Failing to account for taxation could mean the Committee's projections are potentially overstated by 35% (the current maximum individual tax rate) or more if tax rates change just for failing to account for the tax liabilities.

32. The income tax ramifications on the Committee's projections may also manifest by potentially obligating creditors of the estate to pay income tax in years that there is no distribution, a result some creditors are certain to find objectionable.

33. In summary, the Committee's projections fail to take into consideration significant tax issues, many of which will have a significant impact and reduction upon the overall amount of return to creditors.

34. Additionally, setting aside the gaping hole in the Committee's projections regarding the failure to factor income tax, the Committee's projections, in two different places,

include income which is included and used elsewhere. In other words, the Committee's projections account for the same income twice, which consequently falsely inflates the amount of revenue generated under the projections.

35. Further, the Committee's projections assume a \$50,000 cost per month for the administrative expenses of this Chapter 11 case going forward. The administrative costs to date have been approximately \$150,000 per month, without the administrative expense of counsel for the Committee and related professionals.

36. Finally, not only are the Committee's projections flawed with respect to their proposed reorganization, the Committee's unsupported opinion regarding the detriment to the estate if the Sale is not timely approved is mistaken as well. The Committee argues that there is no real detriment to the estate if the Sale is not approved because the Chapter 11 Trustee is able to continue to collect the Debtor's receivables, the aggregate amount of which would allegedly be close to the amount of the Sale. However, the Committee fails to factor the present value of money in its analysis, which upon proper consideration, reveals that the Sale will yield approximately twice the amount collected by the continued administration and collection of the receivables.

**III. Approval of the Sale Does Not Foreclose the Committee's Opportunity to Reorganize**

37. The primary concern of the Chapter 11 Trustee and the Committee are one and the same: maximizing the value of the estate.

38. The Committee argues that approval of the Sale will deprive the Committee of its rights to pursue a plan of reorganization. This is simply not true.

39. Upon approval of the Sale, the net proceeds can be used to fund a plan of reorganization which provides creditors the option of participating in the Committee's proposed

reorganization, or alternatively, the opportunity to elect immediate payment from the proceeds of the Sale. The Chapter 11 Trustee believes that a plan of this nature may provide a more equitable result for creditors which have not yet had an opportunity to vote on the proposed course of action of this case. The Chapter 11 Trustee has already proposed this plan concept to the Committee.

40. If the Sale is not approved, the current stalking horse bidder of the Performing Assets has indicated an intent not to purchase the Performing Assets, and as of the time of this Response, the next closest bid is believed to be approximately \$350,000 lower than the Sale amount, and there is no certainty that the lower bid will go forward.

41. As a consequence, the Chapter 11 Trustee believes that the failure to approve the Sale at this time may result in a significant detriment to the estate, for the Sale may not ultimately be consummated.

42. In summary, the Chapter 11 Trustee believes that the Sale is clearly in the best interest of the estate.

WHEREFORE, the Chapter 11 Trustee respectfully requests entry of an order granting the Sale and overruling the Objections of the Committee, and granting such other and further relief that is just and proper.

Dated: August 11, 2010.

AKERMAN SENTERFITT

By: /s/ Jacob A. Brown

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**CERTIFICATE OF SERVICE**

I HEREBY CERTIFY that a true and correct copy of the foregoing was furnished either by electronic notification or U.S. mail, this 11th day of August, 2010 to all parties on the attached Amended Official Service list.

*/s/ Jacob A. Brown* \_\_\_\_\_

Attorney

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**(amended as of August 11, 2010)**

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# **Exhibit A**

**From:** Noel Yell [mailto:noelyell1@hotmail.com]  
**Sent:** Monday, June 14, 2010 8:24 PM  
**To:** David Rees; Don Radbill; Gary Alligood; Michael Egelman; Robert Helfferich; Rudolph Danowski  
**Subject:** FW: Draft for discussion purposes only

Hello Members, I would like to share with you that Lydia has contacted me. To give you a brief on her demeanor at the time of the call I want the members to know that I have a pretty good read on people. I think she called me as a past friend and a member of the creditors committee. In my opinion she is very frail, distraught and sorry for all that has happened to the creditors. She was grateful that I would talk with her as she has a business plan to help the investors. She is very distraught that people have lost their money. I waited until today to notify you as she said she was sending me further info on her business plan. As of now, I have not received any additional info from her so I decided to update you on what I have. keep in mind she is not doing this to get control or to benefit her self. She is beside herself trying to figure out what can help the investors. As you can imagine, a lot is on her mind. The attachment shows different plans and the outcome of each. As you may recognize, this is similar to what several creditors wanted to do when the trustee was initially appointed. He showed no interest in this. Now that we have a creditors committee and a legal voice for all creditors, we need to look at all possibilities. I have also signed a legal form from Nina Lafluer to enable her to submit to the court to act as the creditors attorney. Time is of the essence as the trustee has in mind to sell the current auto accounts so I would suggest having a teleconference soon which Gary Alligood can set up. Tuesday is not good for me but I suggest making this meeting a priority. If any of you have any questions, give me a call or e-mail me. Thanks Noel

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To: noelyell1@hotmail.com  
Subject: Draft for discussion purposes only  
Date: Fri, 11 Jun 2010 14:05:59 -0400  
From: lydiacadek@usa.com

Dear Noel and Bennett,

6/15/2010

Message

Page 2 of 2

Thank you again for taking my call. You and Bennett are extraordinary people, and I want with all my heart to see as much recovered for you and others as possible.

Attached please find a table showing four options for the accounts, and the potential funds available for investors with each option.

There are detailed spreadsheets to support the data, which I will send.

This summary page is a draft. The supporting data, and this summary, will be further refined over the weekend.

Since timing is so urgent, I am sending this on to you today so that you can see the potential when funds are collected or reinvested.

Please please email me or call with thoughts or questions.

There will be further material on Monday.

Sincerely,

Lydia

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Hotmail is redefining busy with tools for the New Busy. Get more from your inbox. [See how.](#)

6/15/2010

## DRAFT 1

## Projected Funds Available for LCI Investors\*

	Option 0	Option 1	Option 2	Option 3
	Liquidate	Collect current accounts	Collect current accounts; reinvest payments in new notes for a two year period	Collect current accounts and reinvest payments in new notes for a three year period
Begin with this in current active notes on the books	\$4.0M	\$4.0M	\$4.0M	\$4.0M
Reinvestment of funds to purchase contracts	No	No	Yes	Yes
Term for purchasing contracts			24 months	36 months
Approx dates for purchasing			July 2010 - Jun 2012	July 2010 - Jun 2013
Term for collecting contracts			Jly 2012 - Jun 2014	Jly 2013 - Jun 2015
Projected date of completion from Jly 10	18-30 months	18-24 months	48 months	60 months
Potential funds for investors at projected date of completion	\$2.0m; Sale of assets at 50%; (not adjusted for fees and expenses)	\$4.0m	\$14M Approx \$10M collected Jly 2012-Jun 2013; Approx \$4m collected Jly 2013 - Jun 2014	\$20 -23M Approx \$16M collected Jly 2013-Jun 2014; Approx \$5.5m collected Jly 2014 - Jun 2015

\*The data is compiled from spreadsheets, which project revenue and expenses for Options 1 through Option 3.