

In the United States Bankruptcy Court  
for the  
Southern District of Georgia  
Savannah Division

SEP 6 12 28 PM '94  
U.S. DISTRICT COURT

In the matter of: )  
)  
FRANK J. HERNANDEZ )  
d/b/a Classic Auto Painting )  
& Bodyworks, Inc. )  
)  
*Debtor* )  
)  
CLASSIC COLLISION )  
& INSURANCE REPAIRS, INC. )  
)  
*Debtor* )  
)  
CLASSIC AUTO PAINTING )  
& BODYWORKS, INC. )  
)  
*Debtor* )

Chapter 11 Case  
Number 93-40730

**MEMORANDUM AND ORDER ON MOTION TO DISMISS, TO  
CONVERT, OR TO APPOINT A CHAPTER 11 TRUSTEE**

This matter comes before the Court on First Union National Bank of Georgia's Motion to Dismiss Debtor's Chapter 11 case and the United States Trustee's Motion to Dismiss, Convert, or Appoint a Chapter 11 Trustee. A full evidentiary hearing to consider the Motions was held on August 25 and 26, 1994, after which the

Court took the matter under advisement. Based upon the evidence adduced at the hearing, the record in the file, and applicable authorities, I make the following Findings of Fact and Conclusions of Law.

### FINDINGS OF FACT

This Memorandum and Order involves three related Chapter 11 cases, Frank J. Hernandez, Chapter 11 Case Number 93-40680 (hereinafter "Hernandez"), Classic Auto Paint & Bodyworks, Inc., Chapter 11 Case Number 93-40730 (hereinafter "Classic Auto"), and Classic Collision & Insurance Repairs, Inc., Chapter 11 Case Number 93-40681 (hereinafter "Classic Collision"), all of which were administratively consolidated under the Classic Auto case by Order of this Court entered June 23, 1993. Each Debtor filed a petition for relief under Chapter 11 of the Bankruptcy Code on April 29, 1993, and remains in possession of the bankruptcy estate as debtor-in-possession under Section 1107 of the Code.

By Order entered May 4, 1993, the Court required Debtors to file a Disclosure Statement and Plan not later than October 4, 1993, subsequently extended to December 17, 1993. Debtors filed their initial Disclosure Statement and Plan on December 17, 1993, and a hearing to consider the same was conducted on February

15, 1994. As a result of the evidence taken at that time, the court denied approval of the Disclosure Statement, ordered Debtors to file all amendments to the Disclosure Statement within 30 days and assigned the matter for further hearing. Debtors filed the required amendments and the matter came on for hearing on June 9, 1994. At the hearing, a number of relatively minor deficiencies in the Disclosure Statement were revealed. As a result, the Court directed Debtors to amend their Disclosure Statement to correct these problems, and indicated its intention of approving it without further notice or hearing unless one of the parties in attendance at the June 9 hearing made a timely objection.

Debtors filed their third Amended Disclosure Statement and Plan of Reorganization on June 24, 1994, and First Union National Bank of Georgia ("First Union") thereafter filed a Motion on July 12, 1994, requesting an additional hearing to consider the Disclosure Statement based on certain allegations contained in the Motion as to evidence it had allegedly uncovered in the course of discovery. In response to that Motion, the Court directed the Clerk to issue a notice of a continued hearing to consider the amended Disclosure Statement and that notice was issued to Debtor's counsel on July 14, 1994, requiring that a copy of the Amended Disclosure Statement and Plan, and a notice of the hearing to consider same, be served on all creditors by July 22, 1994. Shortly before the scheduled date for that hearing, counsel

for the Debtors informed the Court that Debtors were unable to comply with the Order requiring service of the Disclosure Statement and Plan due to a lack of cash, explaining that the Debtors could not cover the cost of some \$1,400.00 required to timely serve the notice and the other documents. Thereupon, the Court scheduled a hearing for the Debtors to show cause why the cases should not be dismissed for failure to comply with that Order or to consider imposition of other sanctions, which hearing was held on August 17, 1994. During the course of that hearing, very serious allegations were made by counsel for First Union as to irregularities in the conduct of this case by the debtor-in-possession. The Court declined to dismiss the case based on the explanation given by Debtors' counsel as to why the notice had not been served, but took notice of the other allegations raised by First Union and informed all parties at that time that a hearing would be set on short notice to consider the issue of dismissal or conversion if any party in interest brought such a motion after having heard the nature of the allegations raised by First Union. Thereupon, on August 19, 1994, First Union and the United States Trustee filed the Motions presently before the court.

The evidence presented at the hearing in support of the Motions lasted for several hours and included voluminous exhibits. What follows is a summary of the evidence:

1) Classic Auto has failed to file its monthly operating reports with the Office of the United States Trustee since January 1994, during which time its president, Mr. Hernandez, estimates gross receipts of \$35,000.00 per month. Thus, nearly \$250,000.00 in funds, all received by Classic Auto during bankruptcy, is completely unaccounted for. Debtor's explanation for its failure to submit monthly reports is that it has provided all the raw material to its Certified Public Accountant, who for reasons not fully explained, has failed to timely file the finished reports with the United States Trustee and who now has sought to be relieved as CPA to the Debtor.

2) Hernandez has failed to file his July and August 1994 operating statements. Neither Hernandez nor Classic Auto has filed their 1992 or 1993 Federal or State income tax returns.

3) Post-petition payroll taxes for which withholdings have occurred, but for which no returns have been filed or remittances made to the Internal Revenue Service, are delinquent in an amount acknowledged to be at least \$10,000.00.

4) Post-petition administrative expenses have accrued in an amount of approximately \$100,000.00. Total post-petition claims and pre-petition priority tax

obligations total over \$400,000.00. Debtors lack funds with which to satisfy these administrative expenses.

5) At the time the case was filed Hernandez owned a luxury 50-foot yacht, which was subject to a Motion for Relief from Stay by the secured lender. Because of objections by creditors to the maintenance of such a luxury item, Debtor entered a consent order requiring that no portion of the funds for the maintenance or expenses on this vessel would be paid by the Debtor. Instead, it was contemplated that the boat, which Hernandez had used for his own pleasure, would be converted to a business asset, placed in charter service in Florida, and that all expenses, including debt service, would be paid from the proceeds of those charter operations with any shortfall being made up by Debtor's wife, who is a non-debtor. At the June 9th hearing, an objection was made to permitting the Debtor to maintain an asset of this type, but after hearing evidence on Debtor's plan for the vessel, the Court ruled that Debtor had made the necessary showing that the asset had been converted from luxury personal use to that of a business asset, that it was not anticipated to constitute any drain against the assets of the estate, and that its maintenance would assist in shielding income otherwise taxable to the Debtor due to certain tax attributes including depreciation and interest expense. Accordingly, the Court overruled the objections raised by the creditors on this point and permitted the Debtor to continue to attempt

to formulate a plan utilizing this asset.<sup>1</sup> In fact, the records reveal that, contrary to the testimony of the captain of the vessel at that hearing, the charter operations have been a dismal failure. While the maintenance of records for the charter operation have been abysmal, in that no logs of trips made or income received have been maintained on the vessel, nevertheless the testimony at this hearing was uncontradicted that all income actually received from charter boat operations has been deposited into a debtor-in-possession account and have been accounted for. From the bank records I conclude that for the period during which the boat has been placed in charter service, it earned something under \$40,000.00 in income and sustained more than \$70,000.00 in expenses. In fact, the Debtor apparently suspended any active charter service almost immediately after the hearing which led to the Court's previous order, went into default under the terms of the Consent Order and an Order granting relief from stay to the secured creditor was entered on August 19, 1994.<sup>2</sup>

6) The charter operation is relevant, however, not so much because it turned out to be poorly planned and implemented and resulted in a loss of income, but because in January 1994, the Debtor opened an account at a branch of The

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<sup>1</sup> Matter of Frank J. Hernandez, et.al., Ch. 11 No. 93-40730, Memorandum and Order (Bankr. S.D.Ga. July 26, 1994).

<sup>2</sup> See In re Frank J. Hernandez d/b/a Classic Auto Painting & Bodyworks, Inc., et. al., Ch. 11 Case No. 93-40730, Docket No. 297 (Bankr. S.D.Ga. August 18, 1994).

Barnett Bank in Florida, which it did not report to the United States Trustee, to the Court, or to any party in interest. The Debtor's financial report for January 1994, which was filed in February, is executed under oath and requires disclosure of the title and the location of all bank accounts. Despite this clear requirement, Debtors failed to reveal the Barnett Bank account for the charter boat operation. In fact, the existence of the Florida charter boat account was not revealed until Debtors filed their Monthly Income and Expense Statement for May, 1994, on June 23, 1994,. This revelation, however, came two days after First Union learned, while engaged in discovery in a related matter pending in this case, that the account existed. There is little question, then, that Debtor acted intentionally in concealing the existence of the Florida bank account until he was forced by First Union to reveal it in his May report.

7) Hernandez, and his wife own a corporation which operates a Dairy Queen franchise restaurant in Chatham County, Georgia. Debtor owns 51% of the stock and his wife owns 49%. On February 23, 1994, a contract of sale was entered into between Hernandez and Rizwan Momin for the sale of all of the assets of that Dairy Queen franchise restaurant for the sum of \$130,000.00. See Plaintiff's Exh. 33. The assets listed included the leasehold interest, all equipment, furnishings, furniture, and the Dairy Queen franchise itself. It does not appear that the contract contemplated transfer of the Debtor's stock in the corporation which owned this

business. However, Hernandez clearly was vested with title to at least a one-half interest in the Dairy Queen franchise and may, in fact, own the entire interest. In addition, Hernandez was lessee of a ground lease on which the restaurant operates and committed to an assignment of his leasehold interest in that same instrument. These constitute transfers out of the ordinary course of business of the Debtor and Hernandez never sought Court authority to enter these contracts although the pendency of these contracts had been revealed at previous hearings. What was not revealed at any time was that Hernandez received \$35,000.00 as a deposit to bind that contract for the sale of those assets including assets of his estate. \$30,000.00 of the \$35,000.00 was deposited to the Florida charter boat account and almost immediately thereafter was drawn out of that account in a transaction which was intended to permit Mrs. Hernandez to acquire title to a piece of residential real estate. \$5,000.00 of the deposit cannot be accounted for by Hernandez. He admitted that the opening of the Florida account and the attempt to purchase the real estate in his wife's name was motivated by First Union's active pursuit of its claim and his desire to insulate his assets from First Union. Because no accounting of the existence or the transactions in the Florida account was made until June 16 and only after that account was discovered by counsel for First Union, neither the United States Trustee, the Court, nor any creditor was aware that the Debtor had received a substantial deposit for the transfer of assets of the estate or that the money had been put to a use which would

benefit only his wife, a non-debtor. Upon the discovery of this transaction, the Debtor undertook to rescind the contract for the purchase of the real estate and redeposited the \$30,000.00 into the Florida account. However, it apparently was subsequently used to pay expenses either of Hernandez or a corporate Debtor. In short, none of the three Debtors in this case has any access to the money which was given to bind the contract of sale and if, for any reason, it is not consummated or not approved by the Court, Hernandez has no funds with which to refund those sums to the contracting party.

8) During the pendency of the case, Debtor, Frank Hernandez, has incurred over \$7,000.00 of debt at Friedman's Jewelers. One of the items purchased was a ring which cost \$2,000.00, which he characterized as a gift from his wife to him, but for which he is obligated.

9) During the pendency of the case, the Debtor has also utilized the yacht on at least one occasion for his own personal pleasure, taking a week-long trip with his spouse and friends to the Bimini Islands. The extent to which he made personal use of the vessel beyond this particular trip is unclear.

10) Based on the operating reports that have been filed, it appears

that the Debtors have sustained losses during the pendency of the case. The financial picture is cloudy because of Debtors' failure to timely file reports, for which no valid excuse has been provided. Because of that failure, any ambiguity in the evidence must be construed against the Debtor.

### CONCLUSIONS OF LAW

A court should analyze a motion to dismiss, convert, or appoint a trustee or examiner under a two-step analysis, the first step is to determine whether "cause" exists to dismiss, convert, or appoint a trustee or examiner, and the second is to determine which remedy is in the best interests of creditors and the estate. *See In re Superior Siding & Window, Inc.*, 14 F.3d 240, 243 (4th Cir. 1994). The above summary of Debtor's activities during the pendency of this case makes clear that there is sufficient cause to appoint an examiner or trustee under section 1104 of the Code,<sup>3</sup>

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<sup>3</sup> 11 U.S.C. § 1104, in relevant part, provides:

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee--

(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 the securities of the debtor or the amount of assets or liabilities of the debtor; or

(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

as well as to dismiss or convert the case to Chapter 7 under section 1112 of the Code.<sup>4</sup> Clearly, something must be done to protect the creditors of the estate. The problem is determining, under the second prong, what course of action is truly in the best interests of all creditors.

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the debtor or the amount of assets or liabilities of the debtor.

(b) If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management of the debtor, if--

- (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
- (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.

<sup>4</sup> 11 U.S.C. § 1112, in relevant part, provides:

(b) Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including--

- (1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;
- (2) inability to effectuate a plan;
- (3) unreasonable delay by the debtor that is prejudicial to creditors; . . .

The circumstances of this case clearly provide this court with "cause" to dismiss or convert under any of the above three provisions. Moreover, Debtor's wrongful conduct, standing alone, is, in this court's estimation, more than ample cause for dismissal or conversion.

In deciding upon the most appropriate remedy, a court should ascertain what the impact of each option will be upon on all creditors of the estate. In re Superior Siding & Window, Inc., 14 F.3d at 243. Moreover, this inquiry should be made against the backdrop of what the creditors' rights would be under state law. Id. With these principles in mind, it is clear that dismissal is not a viable option. Debtors had some 66 lawsuits pending against them when these three bankruptcy cases were filed. Dismissal will clearly result in the sort of "race to the courthouse" under state law that bankruptcy is designed to avoid. Moreover, First Union holds a deed to secure debt that is apparently valid under state law, but may not be under the trustee's strong-arm powers in bankruptcy.<sup>5</sup> Therefore, if the litigation already commenced against First Union is successful in voiding its security deed, there is likely to be a substantial amount of equity freed up for the benefit of unsecured creditors.

However, the appointment of a Chapter 11 trustee is not practical in this case. Debtor's core business of auto painting and body repair is highly specialized and for a trustee to attempt to manage it over the long term in a profitable manner is not, in this Court's opinion, very realistic. Furthermore, the businesses are not currently solvent and the cash flow to maintain current operations and carry the

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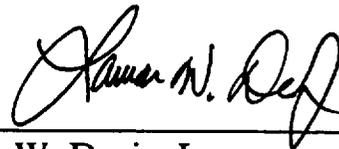
<sup>5</sup> See Matter of Classic Auto Paint & Bodyworks, Inc. (First Union National Bank v. Classic Auto Paint & Bodyworks, Inc.), Ch. 11 No. 93-40730, Memorandum and Order on Motion for Relief from Stay (Bankr. S.D.Ga. March 10, 1994).

additional expense of a trustee and its management does not exist. That leaves the Court with conversion to Chapter 7 as the only viable option.

In deciding to order conversion of the case, however, I do note the authority of a Chapter 7 trustee to operate the business under 11 U.S.C. Section 721. I specifically direct the trustee, upon appointment, to assess the feasibility of short-term operation of the business, together with the feasibility of selling the business as a going concern.

ORDER

Pursuant to the foregoing Findings of Fact and Conclusions of Law, IT IS THE ORDER OF THIS COURT that the Motion to Convert of the United States Trustee is granted. An Order for Relief under Chapter 7 shall issue in each Debtor's case.



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Lamar W. Davis, Jr.  
United States Bankruptcy Judge

Dated at Savannah, Georgia

This 6th day of September, 1994.