UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

In Re:	)	Case No.: 02-35135
	)	
American Digital Technologies Corp.,	)	Chapter 11
	)	
Debtor.	)	
	)	JUDGE MARY ANN WHIPPLE

MEMORANDUM OF DECISION REGARDING MOTIONS TO DISMISS AND TO CONVERT

American Digital Technologies Corp. ("Debtor") is before the court on the Debtor's Motion for Voluntary Dismissal of Chapter 11 Case that it filed on January 14, 2005 ("Debtor's Motion"), and the Ohio Attorney General on behalf of the Ohio Bureau of Workers Compensation (the "Bureau") is before the court on the Objection to Debtor's Motion to Dismiss, Motion to Convert, and Motion for Substantive Consolidation of the Debtor and American Digital Technologies II, Inc., that it filed on February 16, 2005 (the "Bureau's Motion").[1] After reviewing the motions and hearing the arguments of counsel, the court will deny Debtor's Motion and grant the Bureau's Motion in part and deny it in part.

FACTUAL AND PROCEDURAL BACKGROUND

On August 7, 2002, Debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. The bankruptcy schedules (as amended) list assets totaling $214,079.55, secured claims totaling $1,140,790.23, unsecured priority claims totaling $3,804,962.00, and unsecured nonpriority claims totaling $149,441.47. Debtor's Schedule G disclosed that it had leased all of its tangible assets to American Digital Technologies II, Inc. ("ADT-II").

On April 29, 2003, Debtor filed an Plan of Reorganization and a Debtor's Disclosure Statement. The plan valued Debtor's assets at $2,163,371 and stated that the Internal Revenue Service (the "IRS") holds unsecured priority claims aggregating $5,280,642.

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[1] On January 24, 2005, the court received a letter from Christopher S. Plymire, d/b/a Plymire Communications ("Plymire"), opposing Debtor's Motion. But that letter does not set forth a legally sufficient defense and so the objection set forth in it will be overruled.

On October 6, 2003, Debtor filed an Amended Disclosure Statement of American Digital Technologies Corp. The amended disclosure statement explained that, on January 31, 2002, ADT-II was formed and, "[o]n February 19, 2002, Debtor and ADT II entered into a certain Common Paymaster agreement. Pursuant to the Common Paymaster agreement, ADT II agreed to lease certain facilities and equipment from ADT. . . . Debtor has not continued its operations since the Petition Date. ADT II, however, continues to operate in the telecommunications construction industry." A proposed Amended Plan of Reorganization of American Digital Technologies Corp. was attached as an exhibit to the amended disclosure statement.

On October 28, 2003, Debtor filed a Second Amended Disclosure Statement of American Digital Technologies Corp., which reiterated the language quoted above and stated that the priority portion of the IRS's claim(s) is $5,280,641.68, a portion of the Bureau's $113,062.73 claim may be entitled to priority, and the Ohio Department of Taxation has asserted a priority claim of $1,223.01. A proposed Second Amended Plan of Reorganization of American Digital Technologies Corp. was attached as an exhibit to the second amended disclosure statement.

On November 7, 2003, Debtor filed a Third Amended Disclosure Statement of American Digital Technologies Corp., which reiterated the language quoted above and the above information regarding priority claims, except that Debtor stated its intention to object to the IRS's claim and omitted reference to the Bureau holding a priority claim. A proposed Third Amended Plan of Reorganization of American Digital Technologies Corp. was attached as an exhibit to the third amended disclosure statement. Article X.D. of the third amended plan provided:

> The Debtor hereby preserves and retains, subsequent to the Effective Date, any and all claims, demands, and causes of action of the kind the Debtor may have including those claims specified in Sections 542, 543, 544, 545, 547, 548, 549, 550, 551, and 553 of the Bankruptcy Code.
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> The Debtor hereby preserves and retains, subsequent to the Effective Date, any and all claims, demands, and causes of action the Debtor may have against Tony Tate. Tony Tate was the former CEO of the Debtor from 1994 until January 15, 2002. During this time, the Debtor failed to comply with local, state, and federal tax laws. In addition, Debtor

continues to investigate causes of action against Mr. Tate for conversion of Debtor's assets, fraud, breach of fiduciary duty and other related claims.

Neither the plan nor the disclosure statement included an analysis of preferences or other avoidance claims, or a valuation of the claims against Mr. Tate. The third amended disclosure statement was approved on November 7, 2003.

On March 11, 2004, Debtor filed objections to the IRS's claims, and the IRS filed a response on April 12, 2004. On July 28, 2004, Debtor withdrew the objections.

As mentioned above Debtor's Motion was filed on January 14, 2005. The motion states:

> The Debtor cannot obtain confirmation of its Plan of Reorganization at the hearing set for January 24, 2005 because of the amount of the claim of the Internal Revenue Service and the feasibility issues in the case. Further, the vast majority of the assets are encumber[ed] or subject to priority claims such that conversion to Chapter 7 would serve no useful purpose. As a result, reorganization is no longer feasible for the Debtor.

The Bureau's Motion opposes dismissal of the case and seeks the conversion of the case to Chapter 7 and the consolidation of Debtors assets with those of ADT-II. The court conducted a hearing on the motions on February 23, 2005. Neither party presented any evidence in support of its position beyond the existing docket and filings in the case. Debtor has filed regular operating reports in this case but, since Debtor does not have possession of its assets and is not operating its business, the reports do not set forth any business operations; nor do they contain any information regarding ADT-II's business operations.

LAW AND ANALYSIS

A. Conversion or Dismissal

The involuntary conversion or dismissal of a Chapter 11 case is governed by § 1112(b) of the Bankruptcy Code, which provides, in pertinent part:

> Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee or bankruptcy administrator, 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 . . . inability to effectuate a plan.

11 U.S.C. § 1112(b)(2). "Proof of any one factor is sufficient to justify conversion [or dismissal]." *Fishell v. U.S. Trustee*, 19 F.3d 18 (Table), 1994 WL 64718, at **1 (6th Cir. 1994). Section 1112(c) is inapplicable and Debtor has admitted its inability to effectuate a plan, so the bankruptcy court has broad discretion to dismiss or convert the case. *AMC Mortgage Co. v. Tenn. Dep't of Revenue (In re AMC Mortgage Co.)*, 213 F.3d 917, 920 (6th Cir. 2000).

"After the court has made the threshold determination that cause exists, the court must decide whether conversion or dismissal 'is in the best interest of creditors and the estate.'" *In re NuGelt, Inc.*, 142 B.R. 661, 669 (Bankr. D. Del. 1992) (quoting 11 U.S.C. § 1112(b)). "Once 'cause' has been established, whether conversion or dismissal is more appropriate is a question Congress left to the sound discretion of the bankruptcy court." *In re Northeast Family Eyecare, P.C.*, No. 01-13983DWS, 2002 WL 1836307, at *6 (Bankr. E.D. Pa. July 22, 2002) (citing H.R. Rep. 989, 95th Cong., 1st Sess. 405 (1977), *reprinted in* 1978 U.S. Cong. Code & Ad. News 5785) (additional citations omitted); *accord*, *NuGelt, Inc.*, 142 B.R. at 669 ("The decision is discretionary, based on the facts of each case."). The court finds that conversion, rather than dismissal, would be in the best interest of creditors and the estate in this case, for several reasons.

First, a trustee should be appointed to investigate whether the alleged claims against Tony Tate have sufficient merit, size, and collectibility that they should be asserted and, if so, to assert such claims for the benefit of all creditors. Second, a trustee could best investigate the prepetition transfer, s*ee* 11 U.S.C. § 101(54) (definition of transfer), of substantially all of Debtor's assets to ADT-II and, if appropriate, seek the recovery of those assets and the profits from ADT-II's use of the assets and determine the best way of doing so (such as by rejection of the contract between Debtor and ADT-II, *see* 11 U.S.C. § 348(c) (time for assumption or rejection of executory contracts under § 365(d) runs from order of conversion), a fraudulent conveyance action, or substantive consolidation or piercing the corporate veil). *See, e.g.*, *Simon v. New Ctr. Hosp. (In re New Ctr. Hosp.)*, 187 B.R. 560, 566 (E.D. Mich. 1995) ("Only the trustee, on behalf of the estate, may assert an alter ego theory without an order of the Court."). Third, although Debtor has apparently not made an analysis of preference and other avoidance claims, the approved disclosure

statement does suggest that such claims exist, and such claims, to the extent that they arise from the Bankruptcy Code, would be lost to creditors if this case were to be dismissed.[2] Fourth, while there do not appear to be any unencumbered tangible

assets, a trustee would be in the best position to analyze the validity, extent, enforceability, and priority of security interests, and to distribute assets to secured and/or unsecured creditors according to the priority scheme established by the Bankruptcy Code. The court must consider the interests of secured and priority creditors, as well as general unsecured creditors. *In re Shockley*, 197 B.R. 677, 680 (Bankr. D. Mont. 1996) (court must consider interests of all creditors) (citing *In re Gilbert Broad. Corp.*, 54 B.R. 2, 5 (Bankr. D.N.J. 1984)); *In re S. Int'l Co.*, 126 B.R. 223, 226-27 (Bankr. E.D. Va. 1991) (rejecting debtor's contention that case should not be converted because conversion would not result in distribution to unsecured creditors).

Conversion was ordered under similar circumstances in *In re Hamlin Terrace Health Care Center*, 211 B.R. 997 (Bankr. M.D. Fla. 1996). In that case, the court first noted the existence of outstanding causes of action, and concluded that "[t]he proper person to pursue these claims is a Chapter 7 Trustee." *Id.* at 1001. The court continued:

> Conversion also serves the general purposes and policies underlying the Bankruptcy Code. This Chapter 11 case was initiated on October 20, 1994 (Doc. No. 1). The Debtor has enjoyed the protections and benefits of the Bankruptcy Code for over two years. Now, the Debtor seeks to dismiss this case and avoid the appointment of a Chapter 7 Trustee to review the Debtor's claims, assets and liabilities. Sufficient questions have arisen during the course of this case to make the Court question the integrity of certain of the Debtor's actions. Debtors should not be able to enjoy the benefits of bankruptcy protection but escape the scrutiny of its review.

Id. The same may be said here, as this case has been pending more than 2½ years and the prepetition formation of ADT-II and the transfers to it raise "[s]ufficient questions . . . to make the Court question the integrity of certain of the Debtor's actions." ADT-II has been using Debtor's assets, employees, and

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[2] The Bureau's Motion represents: "On the eve of the Debtor[']s proposed Chapter 11 Confirmation the movant was advised that a substantial asset of the American Digital Technologies, II, Inc. was transferred to the Internal Revenue Service." Debtor vehemently denies that such a transfer occurred. This is the sort of allegation that a trustee should examine.

business opportunities for three years, to the apparent detriment of its creditors. Debtor's plan of reorganization involved ADT-II technically buying the same assets it has been using without compensation since the beginning of this case, with the sale consideration the means for implementation of Debtor's plan to try and repay its creditors. Debtor's creditors were more likely to withhold scrutiny of the original transaction when the assets were ultimately going to be used to their benefit in any event. With the collapse of that plan, that is no longer clearly the case. Debtor insists that there

is now no value in the assets for the benefit of unsecured creditors, as liens exceed the value even if they had not been transferred to ADT- II. Therefore, Debtor argues, conversion will serve no purpose. At this point, a trustee will be in a better position than the Debtor to objectively evaluate this assertion, in relatively short order, from the standpoint of the interests of priority and general unsecured creditors. As in *Hamlin*, Debtor in this case "should not be able to enjoy the benefits of bankruptcy protection but escape the scrutiny of its review." "The conversion of this case will ensure that any income from the operation of [Debtor's assets] is accounted for and any improper disbursements are disclosed.." *State St. Mortgage Co. v. Palmer (In re Palmer)*, 134 B.R. 472, 477 (Bankr. D. Conn. 1991).

B. Consolidation of Assets

Rule 1015(a) of the Federal Rules of Bankruptcy Procedure authorizes the consolidation of cases with the same debtor in the same district, and Subdivision (b) of the rule authorizes the joint administration of the separate cases of related debtors pending in the same court. "This rule does not deal with the consolidation of cases involving two or more separate debtors," Fed. R. Bankr. P. 1015(a) advisory committee's note, much less the consolidation of the assets of a debtor with those of a nondebtor. Nevertheless, "[c]ourts have permitted the consolidation of non-debtor and debtor entities in furtherance of the equitable goals of substantive consolidation." *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765 (9th Cir. 2000) (citations omitted).

"No uniform guideline for determining when to order substantive consolidation has emerged. Rather, '[o]nly through a searching review of the record, on a case-by-case basis, can a court ensure that substantive consolidation effects its sole aim: fairness to all creditors.'" *Id.* (quoting *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 61 (2d Cir. 1992)) (citing *Drabkin v. Midland-Ross Corp. (In re Auto-Train*

Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987)). The Sixth Circuit approach comports with that of the Ninth Circuit that, "in ordering substantive consolidation, courts must (1) consider whether there is a disregard of corporate formalities and commingling of assets by various entities; and

(2) balance the benefits that substantive consolidation would bring against the harms that it would case." *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765 (9th Cir. 2000).[3] In other words, there are two prerequisites to substantive consolidation, the first being in the nature of an "alter ego" finding and the second being a balancing of the benefits against the harms of consolidation. In the Sixth Circuit's words, "an order of consolidation is itself a statement that the two debtors are 'hopelessly intertwined' and that their respective assets and liabilities should be pooled." *Baker & Getty Fin. Servs., Inc.*, 974 F.2d at 720. *Baker & Getty* adopted the reasoning of this court in the *Evans Temple Church of God* case:

> Substantive consolidation is employed in cases where the interrelationships of the debtors are hopelessly obscured and the time and expense necessary to attempt to unscramble them is so substantial as to threaten the realization of any net assets for all of the creditors. In any consolidated case, there is implicit in the Court's decision to consolidate the conclusion that the practical necessity of consolidation to protect the possible realization of any recovery for the majority of the unsecured creditors far outweighs the prospective harm to any particular creditor.

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[3] The Second and Ninth Circuits appear to recognize a third ground for consolidation, namely that the "creditors have dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit." *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 61 (2d Cir. 1992); *In re Bonham*, 229 F.3d at 766; *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/ Restivo Baking Co.)*, 860 F.2d 515, 518-19 (2d Cir. 1988). The Sixth Circuit finds it appropriate to consider "whether creditors consider the two debtors to be one," *First Nat'l Bank v. Rafoth (In re Baker & Getty Fin. Servs., Inc.)*, 974 F.2d 712, 720 (6th Cir. 2992), but that is simply one factor to consider in determining whether the entities are "hopelessly intertwined" or in balancing the benefit and detriment of consolidation; it is not an independent ground for consolidation.

> Thus, when a case is substantively consolidated, the Order for consolidation is, in effect, a determination by the Court that consolidation is warranted by the circumstances of the cases and that it is in the best interest of unsecured creditors to join the assets and liabilities of two debtors. It is, in effect, a statement by the Court that the assets and liabilities of one debtor are substantially the same assets and liabilities of the second debtor.

Evans Temple Church of God in Christ & Cmty. Ctr., Inc. v. Carnegie Body Co. (In re Evans Temple Church of God in Christ & Cmty. Ctr., Inc.), 55 B.R. 976, 981-82 (Bankr. N.D. Ohio 1986) (citations omitted).

More recently, the Sixth Circuit stated the following in an unreported opinion:

> In exercising its equitable discretion, a bankruptcy court may consolidate cases involving related debtors. "Substantive consolidation is employed in cases where the interrelationships of the debtors are hopelessly obscured and the time and expense necessary to attempt to unscramble them is so substantial as to threaten the realization of any net assets for all of the creditors."
>
> Implicit in a bankruptcy court's decision to order consolidation is the conclusion that the benefit – protection of the possible realization of any recovery for the majority of unsecured creditors – outweighs the potential harm to any particular creditor. Thus, when substantive consolidation is ordered, there is, in effect, a determination that the circumstances of the cases warrant consolidation and that the best interests of the unsecured creditors are served by joining the assets and liabilities of two or more debtors.

Fishell v. U.S. Trustee (In re Fishell), 111 F.3d 131 (Table), 1997 WL 188458, at **2-**3 (6th Cir. 1997) (quoting *Baker & Getty Fin. Servs., Inc.*, 974 F.2d at 720 (quoting *Evans Temple Church of God in Christ & Cmty. Ctr., Inc.*, 55 B.R. at 981) (other citations omitted)); *accord, e.g., Reider v. FDIC (In re Reider)*, 31 F.3d 1102, 1107-08 (11th Cir. 1994); *Woburn Assocs. v. Kahn (In re Hemingway Transp., Inc.)*, 954 F.2d 1, 11 n.15, 11-12 (1st Cir. 1992); *Eastgroup Props. v. S. Motel Assoc., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991); *Auto-Train Corp.*, 810 F.2d at 276; *see First Nat'l Bank v. Giller (In re Giller)*, 962 F.2d 796 (8th Cir. 1992) (treating interrelationship, benefits, and harm as factors to be considered).

The threshold inquiry is thus whether there is a substantial identity between the entities proposed to be consolidated. *See Baker & Getty*, 974 F.2d at 721 ("The order of consolidation rests on the foundation

that the assets of all of the consolidated parties are substantially the same."). In determining whether this "interrelationship" test is satisfied, some of the factors considered are (1) whether there are consolidated financial statements, (2) whether there is an identity of ownership, (3) whether there are intercorporate guaranties, (4) how hard it would be to segregate the assets and liabilities of the separate debtors, (5) the extent of intercompany transfers without the observance of corporate formalities, (6) commingling of assets and business functions, and (7) the profitability of consolidation at a single physical location. *E.g.*, *In re Baker & Getty Fin. Servs., Inc.*, 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987) (citing *In re Vecco Constr. Indus.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980)); *White v. Creditors Serv. Corp. (In re Creditors Serv. Corp.)*, 195 B.R. 680, 689 (Bankr. S.D. Ohio 1996) (citing *Vecco Constr. Indus.*, 4 B.R. at 410). In other words, this branch of the analysis involves the consideration of the same kinds of facts relevant to a request to pierce the corporate veil. *See Simon v. New Ctr. Hosp. (In re New Ctr. Hosp.)*, 187 B.R. 560, 568 (E.D. Mich. 1995).

The Bureau – even if it has standing to seek substantive consolidation, *contra*, *New Ctr. Hosp.*, 187 B.R. at 566 – has not introduced (or even proffered) any evidence regarding any of these considerations. The court has no information with respect to financial statements, ADT-II's ownership, the existence of intercorporate guaranties, or the commingling of assets and liabilities and, at least according to Debtor, corporate formalities were observed with respect to the transfers to ADT-II. The court cannot find, on the basis of the record and information now before it, that the interrelationships between Debtor and ADT-II are "hopelessly obscured." *Evans Temple Church of God in Christ & Cmty. Ctr., Inc.*, 55 B.R. at 981. Nor can the court conclude that "the practical necessity of consolidation to protect the possible realization of any recovery for the majority of the unsecured creditors far outweighs the prospective harm to any particular creditor." *Id.* at 982. If the Chapter 7 trustee's investigation results in the conclusion that substantive consolidation is warranted (and is the best way to recover Debtor's assets for the benefit of its creditors), he or she may file a motion seeking such relief. There has not, however, been a sufficient showing that consolidation is warranted at the present time.

The court will enter a separate order in accordance with this memorandum of decision.

Mary Ann Whipple
United States Bankruptcy Judge