

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION



In re:) Case No. 13-16287
)
JACK WORKS LLC,) Chapter 11
)
Debtor.) Chief Judge Pat E. Morgenstern-Clarren
)
) **MEMORANDUM OF OPINION AND**
) **ORDER**¹

The court held an evidentiary hearing on these motions:

1. First-Citizens Bank & Trust Company's Amended Motion for Relief from Stay, as opposed by the debtor (Docket 47, 58, 77); and
2. (A) Debtor's motion to require state court receiver to turn over assets, as opposed by First-Citizens and the receiver (Docket 9, 24, 27, 34); and the related (B) Motion of First-Citizens to excuse the receiver from complying with Bankruptcy Code § 543 (Docket 25), as opposed by the debtor.²

For the reasons stated below, the motion for relief from stay and the motion to excuse compliance with Bankruptcy Code § 543 are granted and the motion to require turnover is denied.

I. JURISDICTION

This court has jurisdiction under 28 U.S.C. 1334 and General Order No. 2012-7 entered by the United States District Court for the Northern District of Ohio on April 4, 2012. This is a

¹ This opinion is not intended for publication, either electronic or print.

² The court also heard the debtor's motion to address utility issues under Bankruptcy Code § 366, as opposed by the City of Cleveland and the receiver. (Docket 44, 62, 66). That has been addressed in a separate order.

core proceeding under 28 U.S.C. § 157(b)(2)(A), (E) and (G), and it is within the court's constitutional authority as analyzed by the United States Supreme Court in *Stern v. Marshall*, 131 S.Ct. 2594 (2011).

II. THE EVIDENTIARY HEARING

At the evidentiary hearing, First-Citizens Bank & Trust Company presented its case through stipulated facts, the testimony of Timothy Fenwick (state court receiver), the testimony as if on cross-examination of Mitchell Kelly (sole member of the debtor LLC), cross-examination of Patricia Missal (the debtor's CPA), and exhibits. The debtor presented its case through stipulated facts, the testimony of Mr. Kelly and Ms. Missal, cross-examination of Mr. Fenwick, and exhibits.

The findings of fact made below are based on that evidence and reflect the court's weighing of the evidence presented, including determining the credibility of the witnesses. "In doing so, the Court considered the witness's demeanor, the substance of the testimony, and the context in which the statements were made, recognizing that a transcript does not convey tone, attitude, body language or nuance of expression." *In re The V Companies*, 274 B.R. 721, 726 (Bankr. N.D. Ohio 2002). *See* FED. R. BANKR. P. 9014(c) (incorporating FED. R. BANKR. P. 7052).

III. FACTS

A. The Debtor's Business³

The debtor began its automatic car wash business with one location in Fairview Park, Ohio, followed by a second location in Lakewood, Ohio. The debtor obtained loans to open and

³ The information in this section quotes heavily from the court's opinion in *In re Jack Works LLC*, Case no. 12-16778 (Bankr. N.D. Ohio filed Nov. 27, 2012). (Docket 44).

operate the business; those loans are memorialized in notes secured by mortgages on both properties, as well as by a mortgage on the debtor's personal property. First-Citizens owns and holds those notes and mortgages. Historically, Mitchell Kelly, the debtor's sole member, has also been the debtor's sole employee.

The customers paid either with cash or a credit card. The credit card proceeds went directly into one of the debtor's accounts at Charter One. Mr. Kelly periodically removed the cash from the car wash bays and the vacuum machines. He did not keep a record of the amount of cash removed or what he did with it. Sometimes he deposited it into a debtor account; sometimes he spent it for business expenses; sometimes he put it into his personal family account at Huntington National Bank; and sometimes he spent it on personal items.

Mr. Kelly did not take a monthly salary or a management fee from the business. Instead, when there was cash available, he used it for his personal expenses.⁴

The debtor's financial problems began with the decision to expand to Lakewood. The troubles grew worse in 2011 when business dropped off at both locations due to an unusually warm winter.

B. First-Citizens' State Court Lawsuit

When the debtor defaulted on the notes, Kelly and First-Citizens worked together for quite some time to see if the debtor could regain its financial footing. Ultimately, First-Citizens filed a state court lawsuit to obtain judgment on the notes, foreclose on the mortgages, and have a receiver appointed.

⁴ Stip. 43.

C. The First Chapter 11 filed by the Debtor

The debtor filed its first chapter 11 on September 17, 2012 to head off a state court hearing on First-Citizens' motion to appoint a receiver. On November 27, 2012, this court granted First-Citizens' motion for relief from stay for the reasons set out in detail in the opinion issued that date.⁵ As part of that decision, the court found that the debtor (through Mr. Kelly) had: (1) failed to comply with a cash collateral order; (2) compounded the problem by failing to provide First-Citizens with timely and complete reports detailing cash and credit card income and expenses incurred and paid; and (3) used cash collateral improperly to pay Mr. Kelly's personal debt. The debtor later chose to dismiss the case, as reflected in a January 7, 2013 order.⁶

D. Back to State Court

The parties returned to state court and again attempted to work out a solution. By this time, Mr. Kelly was also having personal financial problems. The debtor made a settlement offer through Mr. Kelly, which resulted in First-Citizens delaying a hearing set on the appointment of a receiver. In connection with those discussions, Mr. Kelly provided a personal finance statement to First-Citizens. That statement failed to reflect a 2012 loan in the amount of \$75,000.00 from Mark Reichart and a January 2013 loan from Denise Abood in the amount of \$60,000.00.⁷ When the debtor failed to make certain agreed-upon payments, First-Citizens renewed its state court motion to appoint a receiver.

On August 29, 2013, that court appointed Timothy Fenwick to serve as receiver. The receiver contacted Mr. Kelly to arrange a meeting that day so that the receiver could obtain

⁵ Case no. 12-16778, Docket 44

⁶ Case no. 12-16778, Docket 48.

⁷ Stip. 39, 40, 58 and Exh. 48.

possession of the properties and the keys. When Mr. Kelly said that he could not meet until August 31, 2013, the receiver agreed to postpone the meeting.

At the time the state court appointed the receiver, the debtor had two bank accounts at Charter One and one at US Bank.⁸ Mr. Kelly did not tell the receiver about the US Bank account. Mr. Kelly went to the Fairview property some time after his phone contact with the receiver and withdrew at least \$300.00 in quarters from a vacuum machine for the specific purpose of using the funds to pay part of the filing fee for this Chapter 11 case.⁹ The court finds that he did this knowing that he did not have the right to do so.

After the receiver took possession, he found that the debtor had not paid the water, sewer or electric bills on time. From January 1, 2013 through September 4, 2013, the debtor made only one payment of \$5,000.00 to the City of Lakewood for water and sewer services provided to the Lakewood location. The debtor did not make any payments during that time to the City of Cleveland for water and sewer services provided to Fairview. As of September 3, 2013, the debtor owed Cleveland \$40,325.31.¹⁰ Additionally, because the debtor owed \$1,200.60 to the Illuminating Company for the Fairview location and \$1,290.41 for the Lakewood location, the debtor had received a notice that service would be disconnected unless a substantial payment was made by September 17, 2013.¹¹

As the receiver became familiar with the debtor's financial operations, he concluded that Mr. Kelly had opened the car wash vault at some point between August 26 and August 30, 2013

⁸ Stip. 21.

⁹ Stip. 73.

¹⁰ Stip.48.

¹¹ Stip. 49.

and removed cash that he did not account for to the receiver. The court finds that the evidence on this point was inconclusive. The receiver also began to think that Mr. Kelly had not correctly reported the total number of car washes sold at the two locations, which would mean that the total income was also incorrectly reported. The Lakewood location, only, has a portal system through which its operations are managed. The receiver used that to generate reports as to gross cash receipts at Lakewood for the years 2009, 2010, and 2011. He then compared them to the gross sales for that location reported on Schedule C of Mr. Kelly's federal income tax returns for the same years. The portal system showed greater sales than those reported on Schedule C for each of those years in these amounts: 2009 (\$57,146.00); 2010 (\$86,205.00); and 2011 (\$41,869.00), for a total difference of \$185,220.00 over the three year period.

The receiver initially hired Joe Galluci from Parma Laser Wash¹² to do routine maintenance at the car washes. Mr. Kelly was not helpful to the receiver while Mr. Galluci was doing this work. Soon, the receiver hired Mr. Kelly to do the maintenance, and he was helpful to the receiver from that point forward.

E. The Second Chapter 11 Filing

The debtor filed this second chapter 11 case on September 4, 2013, about a week after the state court appointed the receiver. The chapter 11 filing stated that the debtor regularly paid Mr. Kelly a monthly draw of \$4,900.00; this was not true. On a different financial matter, an issue arose soon after the filing with respect to the Charter One account. One of the debtor's Merchant

¹² The debtor makes much of the fact that the receiver has no prior experience in operating automatic car washes and that Mr. Galluci has a criminal record. Stip. 67, 83 and 84. While the receiver does not have car wash experience, he has considerable experience stepping in to a number of different businesses to serve as receiver. That experience is sufficient to make him competent to serve in this case. As to Mr. Galluci, there was no evidence that his criminal conviction had a negative impact on his ability to maintain the equipment and grounds.

Service Providers (MSP) regularly deposited funds owed to the debtor into that account. On September 10, 2013, this MSP deposited \$4,581.73 into the US Bank account.¹³ That same day, Mr. Kelly withdrew \$4,500.00 from the account without telling the receiver¹⁴ or the Bankruptcy Court. On September 12, 2013, the receiver learned from the MSP that Mr. Kelly had moved the direct deposit account from Charter One to US Bank.¹⁵ On September 13, 2013, again without telling the receiver¹⁶ or the Bankruptcy Court, Mr. Kelly withdrew another \$420.00 from the US Bank account. The receiver contacted the debtor's initial counsel to ask where Mr. Kelly was having the MSP deposits made. Shortly after that, Mr. Kelly deposited \$4,889.00 into the Charter One account, at least \$669.00 of which came from a check drawn on Mr. Kelly and his wife's personal account at Huntington. Again, the court finds that Mr. Kelly withdrew the debtor's funds knowing that he did not have the right to do so.

F. The Debtor's Plan for Running the Business

By all accounts, Mr. Kelly lacks management skills. Before the bankruptcy filing, he did not keep adequate books and records to show the amount of cash generated, the amount attributable to each of the two locations, or the amount that he withdrew for his own personal use. He used the debtor's bank account for the debtor's expenses, but also for some of his own personal expenses without accounting. He does not know the methodology he used to allocate the number of car washes between the two locations. He did not show any familiarity with the projections prepared by Patricia Missal, a CPA hired by the debtor.

¹³ Stip. 74.

¹⁴ Stip. 75.

¹⁵ Stip. 76.

¹⁶ Stip. 75.

Ms. Missal has significant experience in reviewing troubled businesses, assessing their viability, and rehabilitating them. She did a comprehensive review of the 2012 information available from the debtor and prepared revenue and expense projections.¹⁷ She projected expenses to rise and revenue to be relatively flat, a conservative approach. Using that methodology, she projects that the debtor will be able to generate cash in the amount of \$158,110.00 while operating in chapter 11 from September 2013 through April of 2014 when a confirmed plan is anticipated. She projects this amount will be available after paying expenses, including \$2,000.00 a month in adequate protection to First-Citizens; current utility, water, sewer, and real estate tax payments; and a monthly line item for legal and professional fees.

On the expense side, she assumes that the debtor will employ Mr. Kelly at a monthly gross salary of \$6,000.00 until plan confirmation, when the line item for his salary increases to \$8,000.00. This is considerably more than the \$4,900.00 that the debtor earlier represented was Mr. Kelly's draw, but Ms. Missal did not have an explanation for the increase.

Under this proposed plan, Mr. Kelly's responsibilities will be limited to equipment maintenance, landscaping, phone calls with customers and the like. Ms. Missal's company will be responsible for all chapter 11 reporting, cash collections, bank accounts, vault operations, and bookkeeping. She proposes to hire Victoria Simpkins, one of her subcontractors, to collect the cash and take it to the bank at a rate of about \$125.00 an hour. Ms. Missal's time would be at a rate of \$250.00 an hour. Mr. Kelly will be able to view bank statements online, but will not be a signatory to the account. When he needs to buy supplies, he will have to come to Ms. Missal for the funds. In sum, he will have no direct access to cash and no input into financial operations

¹⁷ The court in this section refers to a "plan", but notes that the debtor has not filed a formal plan, nor has its time for doing so expired.

whatsoever. Ms. Missal's explanation for this proposed set-up is that Mr. Kelly realizes his strength is operations, not bookkeeping. This did not, however, explain why he would not have access to the cash or to the vault. Nor does it explain why \$6,000.00 a month rising to \$8,000.00 a month is reasonable compensation for the services that Mr. Kelly will provide.

G. The Debtor's Projections

As of the chapter 11 filing date, the debtor owes First-Citizens \$1,018,285.79 on the Fairview loan. The property securing the debt is valued at \$860,000.00.¹⁸ The delinquent real estate taxes owed to the Cuyahoga County Treasurer (\$8,931.23) are a first lien on the property. If the taxes are not paid by December 1, 2013, additional interest of 8% will be added to the balance.¹⁹

The debtor also owes First Citizens \$1,477,396.39 on the Lakewood loan. The property securing that debt is valued at \$750,000.00.²⁰ Delinquent real estate taxes, water assessments, and sewer assessments totaling \$20,948.36 on the Lakewood property are a first lien on that property.²¹ If the amount owed is not paid by December 1, 2013, additional interest of 8% will be added to the balance.

The parties disagree as to whether First-Citizens has an interest in cash collateral, but First-Citizens acknowledges that the amount of cash the debtor had at the start of the case was negligible.²²

¹⁸ Stip. 2, 7.

¹⁹ Stip. 8.

²⁰ Stip. 9, 18.

²¹ Stip. 19.

²² See First-Citizens' brief at 5, docket 80.

Ms. Missal projects that the debtor can afford to pay its debt service and operating expenses throughout the year despite the seasonality of its income. For the 12 month period following confirmation (May 2014-April 2015), she projects that the debtor will generate \$214,057.00 for plan payments. She believes that this amount is sufficient to pay all of the debtor's past-due real estate taxes and water and sewer charges in full at confirmation. It is also sufficient to accommodate a plan providing for monthly payments to First-Citizens over 20 years on its secured claim of \$1,610,000.00 at 4% interest, full payment to unsecured creditors other than First-Citizens over 5 years at 4% interest, and payment of First-Citizens' unsecured claim over 20 years.

IV. THE POSITIONS OF THE PARTIES

First-Citizens argues that the stay should be lifted for cause because of the debtor's bad acts and gross mismanagement. Additionally, it contends that the debtor does not have any equity in the property and cannot confirm a plan of reorganization because First-Citizens will not agree to one based on Mr. Kelly's history.

The debtor contends that First-Citizens did not meet its burden of proving cause or that a plan cannot be confirmed. More specifically, while the debtor admits that Mr. Kelly removed money from the vacuum machine and re-directed the MSP deposits, it denies that those acts are sufficient to show cause. As to the other allegations of bad acts, the debtor denies that Mr. Kelly skimmed money from the debtor's accounts, took an improperly large amount of money for his personal use, or removed money from the vault. The debtor also argues that it is too early in the chapter 11 case to say that the debtor cannot confirm a plan.

Each party relies on similar arguments on the issue of whether the receiver should be permitted to remain as the custodian of the estate assets.

V. DISCUSSION

A. Relief From Stay

First-Citizens asks for leave to return to state court and prosecute its pending foreclosure action. In support, it relies on Bankruptcy Code § 362(d):

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this of section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization[.]

11 U.S.C. § 362(d)(1) and (2). First-Citizens has the burden of proving that the debtor does not have equity in the properties. 11 U.S.C. § 362(g). The debtor has the burden of proof on all other issues. *Id.*

1. 11 U.S.C. § 362(d)(1)

Relief from stay may be granted for cause under § 362(d)(1), which term includes a lack of adequate protection of an interest in property. As cause is not otherwise defined, it is determined on a “case-by-case basis.” *Laguna Assocs. Ltd. Partnership v. Aetna Cas. & Sur. Co.* (*In re Laguna Assocs. Ltd. Partnership*), 30 F.3d 734, 737 (6th Cir. 1994). Cause is a broad and flexible concept, which permits a bankruptcy court to respond to inherently fact-sensitive situations. *In re Indian River Estates, Inc.*, 293 B.R. 429, 433 (Bankr. N.D. Ohio 2003).

A debtor's lack of good faith can constitute cause for lifting the stay. *See In re Laguna Assocs. Ltd. Partnership*, 30 F.3d at 737-38 (concluding that a debtor's lack of good faith in filing Chapter 11 petition was cause for lifting the automatic stay). Because debtors are required to both file and prosecute bankruptcy cases in good faith, a lack of good faith in either circumstance supports relief from stay. *In re Mantachie Apartment Homes, LLC*, 488 B.R. 325, 331 (Bankr. N.D. Miss. 2013) (citing *Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (In re Little Creek Dev. Co.)*, 779 F.2d 1068, 1071 (5th Cir. 1986)). However, a showing of bad faith is not required; failure to deal fairly with creditors even in the absence of bad faith may constitute cause. *In re Balco Equities Ltd., Inc.*, 312 B.R. 734, 748-49 (Bankr. S.D.N.Y. 2004). And debtor misconduct can also amount to cause. *See, for example, In re Madison Hotel Corp.*, 175 B.R. 94, 96 (Bankr. N.D. Ala. 1994) (citing debtor misconduct including unauthorized post-petition loans as cause); *In re Holly's Inc.*, 140 B.R. 643, 687-88 (Bankr. W.D. Mich. 1992) (noting that mismanagement can constitute cause under § 362(d)(1)); *Farmers & Merch. Bank & Trust of Watertown v. Trail West, Inc.*, 28 B.R. 389, 394 (D. S.D. 1983) (debtor's failure to comply with Bankruptcy Code requirements constituted misconduct warranting relief from stay).

The court concludes that cause exists to grant First-Citizens relief from stay based on the debtor's actions through Mr. Kelly. Those actions have shown a lack of good faith with respect to the debtor's duty to operate within the parameters of the Bankruptcy Code. Additional cause is shown by the debtor's mismanagement, misconduct and failure to deal fairly with First-Citizens.

Lack of good faith is evidenced by Mr. Kelly's failure to disclose the US Bank account in the debtor's current chapter 11 filing or to the receiver, his redirecting the MSP deposits to that account after the chapter 11 case was filed, and his withdrawal of funds from the account.

Failure to deal fairly with First-Citizens is evidenced by Mr. Kelly's withdrawal of money from the vacuum machine after he was notified of the receiver's appointment knowing that it was improper to do so.

Additionally, cause exists based on Mr. Kelly's failure to exhibit the management skills and attention to the detail required to operate the business as shown by: (1) his failure to keep books and records showing the amount of cash each location generated; (2) his total lack of familiarity with Ms. Missal's projections for the business; and (3) his withdrawal of substantial funds from the business for a family vacation at a time when the debtor was not paying its utilities. Also, as Mr. Kelly's finances are so intertwined with the debtor's, his lack of attention to detail as to his personal finances negatively affects the debtor, which was demonstrated when he provided First-Citizens an inaccurate personal finance statement in connection with their settlement discussions.

While Mr. Kelly's improper actions to date in this case do not involve a significant amount of money, they are particularly telling because they reflect the same type of behavior on Mr. Kelly's part that resulted in relief from stay in the previous case. The debtor's professionals acknowledge this issue and propose to rectify it by placing Ms. Missal and her staff in charge of the debtor's money. However, that is a short-term and incomplete fix that can only work with Mr. Kelly's consent and cooperation. And based on Mr. Kelly's actions to date, the court is not convinced that Mr. Kelly will maintain the required cooperation. Additionally, the decision to separate Mr. Kelly from access to the money means that the debtor will have to pay an additional salary for someone to carry out those basic responsibilities. Based on the totality of the circumstances, the court finds First-Citizens will be granted relief from stay for cause under § 362(d)(1).

That determination makes it unnecessary to resolve First-Citizens' request for relief under § 362(d)(2). The court, however, notes that the debtor's proposal to separately clarify First-Citizens' unsecured claim from other unsecured claims and to then pay it over 20 years is problematic.

B. Turnover of Property by the Receiver

The next issue is whether the receiver as a custodian should be required to turn over the debtor's property and provide an accounting under § 543 of the Bankruptcy Code.²³ 11 U.S.C. § 543. The court may excuse the receiver from complying with these requirements "if the interests of creditors . . . would be better served" by permitting the receiver "to continue in possession, custody, or control of such property[.]" 11 U.S.C. § 543(d)(1). "Turnover is the general rule, however, and excuse from compliance is the exception. Therefore, a party opposing turnover must demonstrate affirmatively how creditors will be better served if the receiver is retained." *In re California Gardens Apartments, Ltd.*, 130 B.R. 509, 515-16 (Bankr. S.D. Ohio 1991). These factors are often considered in determining whether to excuse turnover: (1) the debtor's likelihood of reorganization; (2) the probability that the funds required for reorganization will be available; and (3) whether the evidence shows mismanagement of the property by the debtor. *In re Bryant Manor, LLC*, 422 B.R. 278, 289 (Bankr. D. Kan. 2010); *In re California Gardens Apartments, Ltd.*, 130 B.R. at 516; *In re Poplar Springs Apartments of Atlanta, Ltd.*, 103 B.R. 146, 150 (Bankr. S.D. Ohio 1989).

The decision to grant First-Citizens relief from stay in conjunction with the court's consideration of the relevant factors on the turnover issue leads to the inescapable conclusion that

²³ The receiver, who was appointed to take charge of the debtor's property for the purpose of enforcing liens against the property, is a custodian within the meaning of 11 U.S.C. § 543. See 11 U.S.C. § 101(11)(C).

creditors would be better served if the receiver is excused from the requirements of § 543.

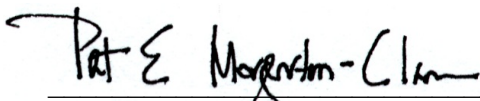
Requiring the receiver to turn over the debtor's property makes little sense in light of the decision to lift the stay and allow the state court proceeding to go forward. Additionally, based on the problems previously cited in this opinion there is ample evidence of mismanagement which makes it unlikely that the debtor will be able to reorganize.

VI. CONCLUSION

For the reasons stated, First-Citizens' motion for relief from stay and its motion to excuse the receiver from complying with § 543 are granted and the debtor's motion to require turnover is denied.

The decision to lift the stay and permit the receiver to retain possession of the debtor's property raises the issue of whether the case should continue in the bankruptcy court. The court will issue a separate order addressing that issue.

IT IS SO ORDERED.



Pat E. Morgenstern-Clarren
Chief Bankruptcy Judge