UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In Re:

Flexseal Packaging Corp., **BK. NO. 93-22374**

Debtor.

Flexseal Packaging Corp.,

Plaintiff,

vs. **A.P. NO. 94-2010**

Leonard Krulewich, as Assignee for Benefit of Creditors of Flexible Packaging Limited Partnership, d/b/a Max Pak,

Defendant.

BACKGROUND

On October 27, 1993, the Debtor, Flexseal Packaging Corp. ("Flexseal"), filed a petition initiating a Chapter 11 case.[1]

On January 18, 1994, Flexseal commenced an adversary proceeding (the "Krulewich Adversary Proceeding") against Leonard Krulewich ("Krulewich"), as Assignee for the Benefit of Creditors of Flexible Packaging Limited Partnership, d/b/a Max Pak ("Max Pak"). In the Adversary Proceeding, Flexseal requested that the Court determine the validity, extent and priority of any lien which Max Pak had on equipment located in Somerville, Massachusetts (the "Somerville Equipment") which it was alleged Flexseal had purchased from Max Pak on or about April 29, 1993 for the sum of $325,000.00. Flexseal contended in its Complaint that: (1) Max Pak did not retain

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[1] On September 22, 1994, the Court issued a Decision and Order on a motion by the Official Creditors Committee to convert Flexseal's Chapter 11 case to a Chapter 7 case which provides an overview of the Flexseal Chapter 11 case.

a security interest in the Somerville Equipment; (2) if Max Pak did retain a security interest in the Equipment, the security interest was not properly perfected by filing as required by the Massachusetts Uniform Commercial Code (the "UCC"); or (3) any perfected security interest Max Pak might have was avoidable as a preference pursuant to Section 547 of the Bankruptcy Code. In his responses and motions, Krulewich contended that: (1) the agreed upon sale of the Somerville Equipment was never completed because of a failure of a condition precedent; (2) when Flexseal filed a $50,000.00 claim for the return of its deposit in the pending assignment for the benefit of creditors proceeding, it acknowledged that the sale was never completed; and, in the alternative, (3) Max Pak retained a security interest in and possession of the Somerville Equipment; and (4) perfection of its security interest was accomplished by such possession and no filing was required.

At an October 4, 1994 trial, Kenneth Bersani, Esq. ("Attorney Bersani"), the attorney who represented Flexseal in the purchase and sale transaction, and Gerald Kramer ("Kramer"), the President of Flexseal, testified on behalf of Flexseal. Max Greenbaum ("Greenbaum"), a limited partner of Max Pak and the President of Max Pak Industries, Inc., its general partner, and James B. Zuckernik, Esq. ("Attorney Zuckernik"), the attorney who represented Max Pak in the purchase and sale transaction, testified on behalf of Krulewich.

By letter agreement (Plaintiff's Exhibit 1 at trial) dated April 28, 1993 (the "Purchase and Sale Agreement"), Flexseal and Max Pak agreed to the purchase by Flexseal of the Somerville Equipment. The Purchase and Sale Agreement provided for a $50,000.00 downpayment and the balance to be paid pursuant to the terms of a promissory note. The Agreement further provided that: (1) "Flexseal will not pledge, sell, assign, transfer or relocate the Equipment until the Note is paid in full, without the consent of Max Pak, which shall not be unreasonably withheld"; and (2) "Flexseal's obligation to Max Pak shall be contingent upon Clyde Street Service Corporation entering into a service agreement with Flexseal pursuant to which Clyde Street Service Corporation shall

provide services necessary to operate the Equipment for its intended purposes, on terms and conditions reasonably acceptable to Flexseal".

On or about April 29, 1993, Max Pak executed a Bill of Sale (Plaintiff's Exhibit 4 at trial) covering the Somerville Equipment (the "Bill of Sale") which provided that, "This sale is being made as is, where is." By an April 29, 1993 letter of Attorney Zuckernik (Plaintiff's Exhibit 5 at trial) the Bill of Sale and an original signed counterpart of the Purchase and Sale Agreement were delivered to Attorney Bersani.

Flexseal paid the agreed upon $50,000 deposit and executed a promissory note (Plaintiff's Exhibit 3 at trial) in the principal amount of $275,000.00 (the "Flexseal Note") in favor of Max Pak which was delivered and accepted by Max Pak, and which provided that:

> "the Lender hereby agrees that until all indebtedness of the Borrower to M&T and CNB, in an amount not to exceed $2,350,000.00, whether or not represented by negotiable instruments or other writings, has been fully paid with interest, then the Lender shall not demand or receive from the Borrower any part of the monies owing by the Borrower to the Lender, or any security therefor, and the Borrower shall not make payment or give security to the Lender except in conformity with the terms of this Note until such time as the Borrower has cured such default and paid off the present loan from CNB and M&T, after which Lender's rights shall include, but not be limited to those referenced below."

The Flexseal Note further provided that:

> "In the event of default, acceleration or demand of the M&T or CNB obligations, Lender shall, notwithstanding the foregoing, be free to pursue its remedies against the equipment sold under a certain Bill of Sale of even date herewith."

On July 1, 1993, after the filing in June, 1994 of the assignment for the benefit of creditors proceeding, Krulewich executed and delivered a Subordination Agreement (the "Subordination Agreement"), in favor of M&T Bank and Shawmut Bank (Plaintiff's Exhibit 7 at trial). The Subordination Agreement, to which Flexseal was not a signatory, in setting forth certain rights of

the banks, provided that:

> "(iv) to direct the order or manner of the disposition of any and all other collateral and the enforcement of any and all endorsements or guaranties relating to the Protected Indebtedness or any part thereof as the Bank, in its sole discretion, may determine, *to the extent that said disposition does not effect creditor's secured status."* (The portion in italics was written by Krulewich by hand.)

DISCUSSION

This Court has jurisdiction over this proceeding under 28 U.S.C. §1334(b) as a matter arising under §547(b) and §506(a) of the Bankruptcy Code. This matter is a core proceeding under 28 U.S.C. §157(b)(2)(F) and (K) as proceedings to determine, avoid or recover preferences and determinations of the validity, extent and priority of liens. It is before this Court pursuant to standing order of the United States District Court for the Western District of New York referring all proceedings arising under Title 11 of the United States Code to the Bankruptcy Court.

The business and other goals and objectives which the parties and related entities may have been hoping to achieve by entering into the purchase and sale of the Somerville Equipment was not the focus of the Krulewich Adversary Proceeding or the trial. However, the Court has learned from the trial that for the Debtor these goals and objectives included showing increased sales in connection with a proposed public offering, and for Max Pak and related entities they included selling the Somerville Equipment at the insistence of its secured creditors through a transaction that would benefit its creditors but also continue to benefit related entities going forward. Given the financial conditions of Flexseal and Max Pak at the time, the numerous and varied goals and objectives which the parties and related entities were attempting to achieve and the business practices and experience of the principals involved, the purchase and sale of the Somerville Equipment could hardly be characterized as a simple, straightforward business transaction.

Unfortunately, the Court's decision in this Adversary Proceeding will negatively affect the

distribution to be received by either the innocent creditors of Flexseal or the innocent creditors of Max Pak.

I. Max Pak Security Interest

A. Retention of Security Interest

Apart from any equitable arguments he has made, including a counterclaim for unjust enrichment, Krulewich has relied upon the Massachusetts version of Section 9-113 of the Uniform Commercial Code ("Section 9-113").[2] Krulewich has contended that the facts and circumstances of this case warrant the Court finding that within the meaning and intent of Section 9-113, Max Pak had retained a security interest in and possession of the Somerville Equipment and, therefore, at all times had a perfected security interest in the Equipment which could not be avoided by Flexseal as a debtor-in-possession pursuant to the provisions of Sections 544 or 547.[3] Section 9-113

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[2] Although various bases for a security interest were addressed by the parties in their pleadings during the pretrial stages of the Adversary Proceeding, by the time of trial the only basis asserted relied on Section 9-113.

Section 9-113 provides:

> A security interest arising solely under the Article on Sales (Article 2) is subject to the provisions of this Article except that to the extent that and so long as the debtor does not have or does not lawfully obtain possession of the goods
>
> > (a) no security agreement is necessary to make the security interest enforceable; and
> >
> > (b) no filing is required to perfect the security interests; and
> >
> > (c) the rights of the secured party on default by the debtor are governed by the Article on Sales (Article 2).

Mass. Gen. L. ch. 106, §9-113 (1994).

[3] The issue of preference was not addressed at trial since if it was determined that Krulewich or Max Pak had a security interest under Section 9-113, it would not be avoidable as a

speaks to a security interest which the seller may have reserved or retained in connection with the Uniform Commercial Code Article on Sales ("Article 2"), and provides in subparagraph (a) that no security agreement is necessary to make the security interest enforceable in those circumstances.

At trial both Attorney Bersani and Kramer emphatically testified that in their negotiations for the purchase and sale of the Somerville Equipment, all of the participating representatives of Max Pak and Attorney Zuckernik were specifically advised that Max Pak could not have a security interest in the Somerville Equipment because of actual restrictions placed on Flexseal by M&T and Shawmut and because Flexseal felt that the existence of such a security interest would negatively affect its ongoing negotiations with those financial institutions. Consistent with that testimony, which was not denied or controverted by Attorney Zuckernik or Greenbaum, the contractual and closing documents, including the Purchase and Sale Agreement, Bill of Sale and related correspondence, do not mention or provide for a security interest or lien to be granted to Max Pak or for such an interest to be retained or reserved by it. Furthermore, the Flexseal Note specifically provides that Max Pak shall not "demand or receive" any security in the Somerville Equipment, unless and until M&T and Shawmut were repaid certain obligations. This repayment clearly had not occurred at the time of the purchase and sale transaction in April of 1993 when the provisions of Article 2 might otherwise have been applicable. Although the Flexseal Note is not signed or otherwise acknowledged in writing by Max Pak, no objection to the language contained in the Note was ever raised by Max Pak or its representatives, including Krulewich, prior to the commencement of the Krulewich Adversary Proceeding.

This Court does not believe that Max Pak, as a seller of goods, can rely on any security

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preferential transfer. This is because due to the requirements of Section 9-113 any security interest would have been at all times perfected and thus, would have been a contemporaneous exchange for new value.

interest which might otherwise arise by operation of law pursuant to Section 9-113 and Article 2 when Flexseal, as the buyer, in its negotiations for the purchase and sale of the goods in question specifically advised Max Pak that a security interest in the goods would not be available and could not be retained by the seller or granted by the buyer. In view of the clear intention of the parties at the time of the purchase and sale that no security interest or lien on the Equipment would exist, Max Pak cannot legally or equitably claim the applicability of Section 9-113.

Therefore, the Court finds that Krulewich and Max Pak do not have a security interest in the Somerville Equipment by reason of Section 9-113.

B. Max Pak Possession

From the evidence and testimony presented at trial, the Court does not find that Krulewich has met his burden to prove that Max Pak or he, as an assignee, at all times retained continuous possession of the Somerville Equipment within the meaning and intent of Section 9-113. In fact, the evidence presented is to the contrary, as follows: (1) there is nothing in the Purchase and Sale Agreement which specifically provides for the retention of possession of the Somerville Equipment by Max Pak or an agent of Max Pak; (2) there is a negative covenant in the Purchase and Sale Agreement that Flexseal would not relocate the Equipment, but that provision is just that, a negative covenant and not a provision for the retention of possession by Max Pak or its agent; (3) the Bill of Sale provided that "THIS SALE IS BEING MADE AS IS, WHERE IS"; (4) Max Pak's attorney's letter of April 29, 1993 acknowledged that Flexseal had taken possession;[4] and (5) although the

[4] Although he testified that the statement was an error, Attorney Zuckernik's correspondence to Attorney Bersani unequivocally stated, "I am advised that your client has taken possession of the property." (Plaintiff's Exhibit 5 at trial). Furthermore, Attorney Zuckernik did not correct this alleged error in his subsequent correspondence of May 14, 1993. (Plaintiff's Exhibit 6A at trial). *See* Plaintiff's Memorandum of Law filed October 14, 1994, at 2.

Somerville Equipment remained at the premises formally leased by Max Pak and was operated by Clyde Street Service Corp. ("Clyde Street"), there has not been sufficient evidence presented to conclude that Max Pak or Krulewich was in actual possession of the Equipment or that Clyde Street, if it was in possession, was in possession as the agent for Max Pak and not Flexseal. The Court finds that under the facts and circumstances of this case, for purposes of Section 9-113, possession of the Somerville Equipment was obtained by Flexseal.

II. Completion of the Sale

Krulewich has contended that the sale between Max Pak and Flexseal as provided for in the Purchase and Sale Agreement never was finalized because of the failure by Flexseal to enter into an operating agreement with Clyde Street to provide services necessary to operate the Equipment. The evidence at trial indicated that an arrangement was entered into between Flexseal and Clyde Street which resulted in the operation of the Somerville Equipment by Clyde Street for the benefit of itself and Flexseal. Although the arrangement was not reduced to a writing, there was no requirement in the Purchase and Sale Agreement that the service agreement between Flexseal and Clyde Street be in writing. The evidence is clear and uncontroverted that Clyde Street operated the Equipment for the benefit of both Flexseal and Clyde Street and that significant monies (approximately $61,000) were paid to Flexseal as the owner of the Equipment pursuant to that operating agreement. Greenbaum testified that Clyde Street continued to negotiate with Flexseal for a modification or alteration of the terms of the operating agreement, thus clearly indicating that there was such an operating agreement in place. Furthermore, the provision in the Purchase and Sale Agreement did not require that the operating agreement be acceptable to Clyde Street or Max Pak, only that it be acceptable to Flexseal, which this operating agreement was. Therefore, the Court finds that the condition precedent was fulfilled and the purchase and sale of the Somerville Equipment pursuant

to the terms of the Purchase and Sale Agreement were completed and finalized.[5]

III. Unjust Enrichment

Krulewich has contended that Flexseal would be unjustly enriched if it were allowed to retain the Somerville Equipment free and clear of an interest in the nature of a security interest or a lien in his favor. The doctrine of unjust enrichment is equitable in nature and requires a determination that it is against equity and good conscience to permit a party to retain benefits sought to be recovered.[6]

The Court does not find that Flexseal would be unjustly enriched by the Court's decision in finding that Krulewich does not have a perfected security interest in the Somerville Equipment. Krulewich has a claim as a creditor in the Flexseal case. In the Court's view the evidence is clear that Max Pak entered into the Purchase and Sale Agreement and completed the purchase and the sale provided for therein fully understanding the risk that it was taking by not being able to have a perfected security interest in the Somerville Equipment for the balance of the purchase price. It was made clear that a security interest would not be available because of the actual or perceived

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[5] At trial Kramer testified that the claim filed by Flexseal in the Max Pak assignment for the benefit of creditors case was for open invoices, not for the return of the $50,000 deposit.

[6] New York's broad principle of unjust enrichment was set forth in a Court of Appeals opinion by Judge Breitel:

> The essential inquiry in any action for unjust enrichment or restitution is whether it is against equity and good conscience to permit the defendant to retain what is sought to be recovered. Such a claim is undoubtedly equitable and depends upon broad considerations of equity and justice. Generally, courts will look to see if a benefit has been conferred on the defendant under mistake of fact or law, if the benefit still remains with the defendant, if there has been otherwise a change of position by the defendant, and whether the defendant's conduct was tortious or fraudulent.

Paramount Film Distr. Corp. v. State of New York, 30 N.Y.2d 415, 421 (1972), *remittitur amended*, 31 N.Y.2d 678 (1972) (citations omitted).

constraints placed on Flexseal by its lending institutions. Although Max Pak and Greenbaum may have believed that they had retained a certain degree of practical and economic control over the Equipment, this Court believes Max Pak knowingly bargained away the ability to retain a perfected security interest and it accepted the attendant risks.

At trial Krulewich placed into question the good faith of Flexseal in the transaction. To assert that Max Pak somehow unilaterally found a way to retain and perfect a security interest in the Somerville Equipment after agreeing that one would not be available, would seem, if it was intentional on the part of Max Pak, to be a fraud on Flexseal or at least on its lending institutions.

CONCLUSION

The Court finds that neither Krulewich nor Max Pak had a valid perfected security interest in the Somerville Equipment at the time of filing. Flexseal is determined to be the owner of the Somerville Equipment free and clear of any lien or security interest which Krulewich or Max Pak may assert in such Equipment. The claim of Krulewich for the unpaid amounts due on the Flexseal Note is determined to be an unsecured claim. The counterclaim of Krulewich against Flexseal for unjust enrichment is in all respects denied.

IT IS SO ORDERED.

/s/
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY COURT JUDGE

Dated: November 22, 1994