

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

In Re:

**FLEXSEAL PACKAGING CORP.,
Debtor.**

BK. NO. 93-22374

DONALD A. ROBINS,

Plaintiff,

A.P. NO. 93-2223

vs.

**FLEXSEAL PACKAGING CORP.,
Defendant.**

DECISION & ORDER

BACKGROUND

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

On November 23, 1993, Donald A. Robins ("Robins"), a former shareholder, officer and director of the Debtor, commenced an adversary proceeding requesting an order: (1) enjoining the Debtor from destroying, using or handling certain customer files and records (files and records of customers which Robins alleged were his customers); (2) directing the Debtor to turn over those customer files and records to Robins; (3) enjoining the Debtor from soliciting, contacting, communicating or in any way dealing or interfering with the customers alleged to be Robins' customers; and (4) awarding damages to Robins for the Debtor's refusal to turn over the customer files and records and for its interference with the customers in question. Robins asserted his right to such relief pursuant to the provisions of: (1) a Stock Purchase Agreement (the "Stock Purchase Agreement"), dated as of January 1, 1993 but entered into on April 8, 1993 with the Debtor and Gerald S. Kramer ("Kramer"), the only other shareholder and the President of the Debtor; and (2) an Employment Agreement (the "Employment Agreement"), dated as of January 1, 1993 but entered

into on April 8, 1993 with the Debtor.

The Stock Purchase Agreement provided in part for: (1) the sale by Robins of all of his stock in the Debtor to Kramer for a purchase price of \$313,923.00, to be paid pursuant to the provisions of a term promissory note (the "Kramer Note"), executed and delivered by Kramer and calling for sixty consecutive monthly payments commencing October 1, 1993; (2) the payment by the Debtor of then-due bonus compensation in part to be paid on a deferred basis; (3) the resignation of Robins as an officer and director of the Debtor effective April 8, 1993; (4) Robins and the Debtor to enter into the Employment Agreement; and (5) the Debtor to guaranty the Kramer Note.¹

Paragraph 27(c) of the Stock Purchase Agreement provided various remedies to Robins in the event of a default under the Stock Purchase Agreement, the Employment Agreement or related documents. Included in the remedies on default was the following provision:

Further, in case any such Event of Default shall occur, the Corporation and Kramer agree that for the period set forth below from the occurrence of any Event of Default, neither the Corporation nor Kramer, will directly or indirectly, solicit or in any way deal with any person, corporations, or other entities who or which on the date of this Agreement were formerly or are currently customers of Robins or become customers of Robins under paragraph 3 of the Employment Agreement. The Corporation and Kramer shall immediately following such Event of Default provide Robins with all files and other records pertaining to such customers of Robins from the inception of Robins' relationship with the Corporation to the date the files are furnished to Robins. If the event of default occurs in the first year following consummation of the transaction contemplated by this Agreement, the period of non-competition will be six (6) years.

..

(Stock Purchase Agreement at 28.)

By the terms of the Employment Agreement, Robins agreed: (1) to render advice to the Debtor as to what were termed his "former customers and accounts;" (2) to be employed by the

¹ It would seem more logical for the bonus compensation provisions to have been in the Employment Agreement rather than the Stock Purchase Agreement.

Debtor on a commission basis for business which he obtained from either new customers or from the sale of new products to present or former customers; and (3) not to compete with the Debtor. The Employment Agreement was for a term of five (5) years, commencing January 1, 1993 and ending December 31, 1998, unless earlier terminated by a default or the exercise by either party of the right to terminate the Agreement by giving three months notice. The Employment Agreement also contained a cross-default provision with the Stock Purchase Agreement.

On November 24, 1993, Robins filed a Motion for Summary Judgment (the "Summary Judgment Motion"), made returnable on December 8, 1993, which included the November 23, 1993 Affidavit of Robins (the "Robins Affidavit"). The Summary Judgment Motion alleged that: (1) from 1981 through 1993, Robins and Kramer had operated the Debtor corporation as two entirely independent salesmen, an arrangement that could be characterized as a "joint venture," each servicing their own customers, maintaining their own books, selling separate product lines, marking customer invoices to indicate whose customer it was, and setting up individual files for their own open and closed orders; (2) the Robins "customer files were his personal property" and that he "had dominion and control over the files at all times either individually or through his customer service representatives;" and (3) by reason of the Debtor's acknowledged defaults under both the Stock Purchase and Employment Agreements and the provisions of Paragraph 27(c) of the Stock Purchase Agreement, the Agreements had been terminated the day before the Debtor filed its petition, and Robins was clearly entitled to the immediate possession of his customer files and records and an injunction prohibiting the Debtor from in any way competing against him, including by contacting, communicating or in any way dealing with those customers, and that by virtue of the termination of the Employment Agreement, Robins could not be prohibited from competing against the Debtor.

The Robins Affidavit focused primarily upon the alleged uniqueness and necessity for the customer files and records, stating that "[t]he files contain information, particularly with regard to suppliers and pricing, that are invaluable to me in my continuing business operations. Without this

information I am not able to be competitive in a competitive business." (Robins Nov. 23, 1993 Aff. at ¶5.)

In the Robins Affidavit Robins alleged that under the Stock Purchase and Employment Agreements "my customers and files remained my personal property, and upon a breach of the agreements I had an absolute right to take my customer order files free from the Debtor's and Kramer's interference, and compete against Kramer and the Corporation." (Robins Nov. 23, 1993 Aff. at ¶7.)

In support of his claim of irreparable harm in the Robins Affidavit, Robins alleged that:

The loss of my files is causing me immediate inconvenience and could result in irreparable harm to me in my business. Without the information in those files I must perform needless and time-consuming research to properly price orders. The resulting uncertainty and delay could well cause me to lose customers. The information in my files is personal to me and of little value to anybody else, even the Debtor. My business would further be damaged if the Debtor is allowed to interfere in my relationship with my customers.

(Robins Nov. 23, 1993 Aff. at ¶8).

In opposition to the Summary Judgment Motion, the Debtor interposed a December 3, 1993 affidavit by Kramer (the "Kramer Affidavit"). The Kramer Affidavit alleged that: (1) the Debtor had always been operated in accordance with all corporate formalities and could not be characterized as a joint venture; (2) the Debtor had always maintained proper corporate records, deposited all receivable collections into the corporate checking accounts and paid all expenses from corporate accounts; (3) M & T Bank had a perfected security interest in the customer files and records which Robins requested be turned over to him; (4) Robins did not obtain a security interest in the customer files and records as part of the negotiations and transactions which resulted in the execution of the Stock Purchase and Employment Agreements; (5) the customer files and records were always assets of the Debtor corporation and Robins' custody of them was as an officer and employee of the Debtor corporation, not as an individual; (6) a proposal that Robins be granted a security interest in the

customer files and records had been rejected in the negotiations surrounding the execution of the Stock Purchase and Employment Agreements; and (7) Robins' entire relationship with the Debtor must be carefully scrutinized to insure that the Debtor's creditors are not prejudiced by the terms, conditions, rights and remedies contained in the Agreements because the Stock Purchase and Employment Agreements were entered into at a time when Robins was a shareholder, officer and director of the Debtor and the Debtor was having financial difficulties, and were entered into by insiders of the Debtor.

In a Memorandum of Law in Opposition to the Summary Judgment Motion, the Debtor emphasized that: (1) the customer files and records were at all times, both pre-petition and post-petition, property of the Debtor's estate and Robins had not obtained a perfected security interest in them; (2) any claims which Robins might have against the Debtor resulting from breaches of the Stock Purchase and Employment Agreements should be subordinated, pursuant to Section 510 of the Bankruptcy Code, in whole or in part, to the claims of the Debtor's other creditors because of the facts and circumstances surrounding the execution of the Agreements; and (3) Robins had not and could not show the kind of irreparable harm required to obtain the injunctive relief which he requested, or that any harm he had or could demonstrate outweighed the potential harm which would result to the Debtor's other creditors and to its prospects for reorganization if the customer files and records were ordered to be turned over to Robins.

On December 8, 1993, the Court denied the Summary Judgment Motion after determining from the pleadings and proceedings before it that: (1) the customer files and records were never "owned" by Robins either pre-petition or post-petition, were not sold or transferred to him by the Debtor and therefore, remained property of the Debtor's estate; (2) Robins had not obtained a perfected security interest in the customer files and records as security for the obligation of the Debtor under the Stock Purchase and Employment Agreements; (3) Robins had not demonstrated a clear right to injunctive relief after the Court, in its discretion, considered the factors ((A) the

likelihood that Robins would suffer irreparable harm if the request is denied, (B) the likelihood of success on the merits, (C) relative harm as between Robins and the Debtor, and (D) public interest); and (4) there were material issues of fact to be determined regarding the issues raised by the Debtor as to equitable subordination under Section 510, possible fraudulent conveyances under Section 548 and 544 and violations of the New York Business Corporation Law. However, the Court did determine that Robins could compete with the Debtor, which the Debtor did not oppose.

On December 1, 1993, Robins filed a Motion for a Preliminary Injunction (the "Preliminary Injunction Motion") to enjoin the Debtor from disposing of or using the customer files and records and from contacting, communicating or in any way dealing with the customers alleged by Robins to be his customers. The Preliminary Injunction Motion was adjourned to December 17, 1993 to afford Robins the opportunity to file a responsive affidavit to the opposition filed on behalf of the Debtor.

On December 17, 1993, a Memorandum of Law in Support of the Motion for Preliminary Injunction (the "Robins Memorandum of Law") was filed on behalf of Robins. The Robins Memorandum of Law asserted that he was entitled to specific performance of the provisions of Paragraph 27(c) of the Stock Purchase Agreement because: (1) he had no adequate remedy at law; (2) he would be permanently handicapped in the only business that he has ever known without the information contained in the customer files and records; and (3) an award of money damages could not replace the information in the customer files and records. Robins asserted, at a minimum, the Court needed to enjoin the Debtor from competing and should direct it to provide Robins with all of the customer files and records. The Robins Memorandum of Law further asserted that: (1) the facts and circumstances surrounding the execution of the Stock Purchase Agreement and Employment Agreement do not warrant equitable subordination pursuant to Section 510, since that section of the Bankruptcy Code specifically deals with claims and security interests not equitable rights and remedies which are at issue in this case; (2) since Robins was claiming ownership of the

customer files, Robins had a beneficial interest in the customer files pursuant to Paragraph 27(c) of the Stock Purchase Agreement until that matter is finally decided by the Court; (3) the Stock Purchase Agreement and Employment Agreement taken together grant Robins ownership and a beneficial equitable interest in the information in the customer files and records; and (4) any value which the files and records have to the Debtor would be less than the claims which Robins would have against the Debtor for its failure to turn them over to Robins and its continuing use of them to compete against Robins.

On December 20, 1993, the Debtor interposed an Answer in the adversary proceeding. The Answer contained a number of affirmative defenses and counterclaims including allegations that: (1) the Stock Purchase Agreement and Employment Agreement should be read together as a unitary agreement, the central purpose of which was to effect a sale or redemption of Robins' stock in the Debtor, in connection with which Robins received significant cash payments and the transfer of valuable items of property of the Debtor, whereas the Debtor did not receive any consideration for the sale or redemption of Robins' stock, and this all occurred at a time when the Debtor was insolvent or was engaged in business for which its remaining property constituted unreasonably small capital; (2) the rights and claims of Robins should be equitably subordinated to the claims of the Debtor's other creditors pursuant to Section 510 of the Bankruptcy Code and Section 513(a) of the New York Business Corporation Law; (3) Robins did not hold a perfected security interest in any of the property of the Debtor, including the customer files and records; (4) Robins had violated his fiduciary duties to the Debtor and wasted property of the Debtor in violation of New York Business Corporation Law Section 720; and (5) if the provisions of Paragraph 27(c) of the Stock Purchase Agreement were found by the Court to be enforceable as of the date of the breach of the Agreement on or about October 1, 1993, this constituted a transfer or a right to the transfer of the customer files and records as of that date, and such transfer or right was an avoidable preference pursuant to Section 547 of the Bankruptcy Code.

On December 22, 1993, after once again determining that there was not a sufficient showing of irreparable harm and likelihood of success on the merits, and again emphasizing the unresolved issues of equitable subordination, indirect redemption of stock by a corporation and the fair value of any consideration given by Robins to the Debtor in consideration for its execution of the Stock Purchase and Employment Agreements, the Court denied the Preliminary Injunction Motion. The Court also noted that this was the very early stages of the Debtor's Chapter 11 case when it was unclear whether the Debtor had a reasonable prospect of reorganization and further, in its attempt to balance any possible harm to Robins against harm to the Debtor and its estate, the Court could not determine what the impact of the loss of the portion of the business at issue might be on the overall prospects for a reorganization of the Debtor.

Thereafter, the Court conducted a pretrial in connection with the Adversary Proceeding on January 18, 1994 at which it ordered the Debtor to provide information regarding December revenue and orders received from the alleged Robins customers by January 21, 1994 and similar information with regard to the month of November, 1993 by January 28, 1994. On January 27, 1994, the Debtor filed a motion (the "Extension Motion") for an order extending the time for it to comply with the reporting requirements set forth in the Pretrial Order of January 18, 1994. The Extension Motion indicated that the Debtor anticipated that it would have complied with the Pretrial Order by the February 9, 1994 return date of the Extension Motion.²

On February 4, 1994, Robins filed a response to the Extension Motion and a Cross-Motion

² The information supplied by the Debtor on February 4, 1994 was as follows:

	<u>Nov. '93</u>	<u>Dec. '93</u>	<u>Jan. '94</u>	<u>TOTAL</u>
Sales	\$26,229	\$43,498	\$1,016	\$70,743
Orders Rec.	24,211	9,450	-0-	33,661
Payments	58,971	20,626	33,200	122,797

As of May 13, 1994 no further information regarding sales and orders has been filed with the Court.

(the "February Cross-Motion") for an Order of Preclusion and Reconsideration of his motion for a preliminary injunction. In a February 3, 1994 Affidavit in Support of the February Cross-Motion, Robins stated that to his knowledge "Defendant has taken only one or at most a very few post-petition new orders from any of my customers since the filing." (Robins Feb. 3, 1994 Aff. at ¶4). He also stated, "I continue to suffer the time and expense of extensive back-tracking in order to process my orders and am required to incur significant legal expense to obtain what is legally and rightfully mine." (Robins Feb. 3, 1994 Aff. at ¶5). On February 18, 1994, a Supplemental Affirmation in Support of Plaintiff's Motion for Summary Judgement was filed on behalf of Robins and on February 18, 1994, an Affidavit in Support of the Debtor's Claims against Robins and in Opposition to Robins' Claims was filed on behalf of the Debtor.

DISCUSSION

I. Rights to the customer files and records as a secured creditor or owner.

From all of the pleadings and proceedings in this Adversary Proceeding, it is clear to the Court that before the execution of the Stock Purchase Agreement and the Employment Agreement the customer files and records in question were the property of the Debtor Corporation and not Robins. It is also clear that nothing in the Stock Purchase Agreement or Employment Agreement constituted an outright sale or transfer of the customer files and records to Robins. At most, by reason of the provisions of Paragraph 27(c) of the Stock Purchase Agreement, the parties agreed that as security for the performance of the obligations of the Debtor and Kramer under the Stock Purchase, Employment and related Agreements, these customer files and records would be transferred to Robins in the event of a default. However, Robins was not granted a security interest in the customer files and records as part of the Agreement, unless Paragraph 27(c) is construed as the grant of a security interest in those assets. However, if Paragraph 27(c) were interpreted to be

a grant of a security interest, Robins nevertheless has failed to perfect any such security interest by either having taken possession of the collateral or by the filing of proper financing statements with the appropriate filing offices as required by the New York Uniform Commercial Code. Therefore, Robins does not own the customer files and records and does not have a right to them as a perfected secured creditor whose rights are superior to those of the Debtor as a debtor-in-possession with the avoidance rights afforded it by Section 544.

II. Equitable right to the customer files and records and to an injunction to enforce the Debtor's contractual obligation not to compete upon a default under the Stock Purchase and Employment Agreements.

Robins contends that the Debtor's filing of a Chapter 11 case should have no effect on the enforcement of the rights granted to Robins by the Debtor under Paragraph 27(c) of the Stock Purchase Agreement to have the Debtor turn over the customer files and records and to have the Debtor not compete in any way with Robins for business from the customers in question. Robins contends that a Chapter 11 debtor should not be able to avoid its legitimate contractual obligations including what he terms the "reverse non-competition agreement" contained in Paragraph 27(c) of the Stock Purchase Agreement which by reason of default he alleges has now become enforceable simply by filing Chapter 11.³

In denying the Summary Judgment and Preliminary Injunction Motions, the Court made it clear that it was concerned about the issues of fraudulent conveyance, improper stock redemption under New York State law, equitable subordination, and avoidable preferences in connection with the execution, performance and enforcement of the Stock Purchase, Employment and related

³ In the cases provided by Robins in support of his position, the adequacy of the consideration for the non-competition agreement of the Debtor employee was not at issue as the non-compete agreement was entered into at the inception of the relationship. *See, e.g., In re Udell*, 898, 901 (Bankr. N.D.Ind. 1992), *rev'd*, 149 B.R. 908 (N.D.Ind. 1993), *rev'd*, 18 F.3d 403 (7th Cir. 1994).

Agreements, particularly in connection with the requested enforcement of the provisions of Paragraph 27(c) of the Stock Purchase Agreement.

In the Supplemental Affirmation, it was asserted,

[t]o enforce the Defendant's reverse covenant not to compete the Court need only find that the entire agreement between the parties was bargained for at arms length and for fair consideration (the Court may not reform the agreement). Only if a transfer is made for less than fair consideration is it avoidable as a fraudulent conveyance. Further, only when a contract with an insider shown not to be inherently fair to the Debtor may it be equitably subordinated.

(Supp. Aff. at ¶4.)

Further, the Supplemental Affirmation asserts that Robins' rights with respect to the customer files and records, although contained in Paragraph 27(c) of the Stock Purchase Agreement, really flow from the Employment Agreement which it asserts was for fair consideration and otherwise fair to the Debtor. In this regard, the Supplemental Affidavit points out that the Employment Agreement was negotiated over a two-year period, resulted in Robins' compensation being reduced from a previous six-year average of over \$435,000.00 per year to \$228,000 per year and the Debtor did not experience financial difficulties until after April, 1993 when the Agreements were executed and then for unrelated reasons.

Based on all of the facts and circumstances before it, the Court cannot determine that: (1) the Debtor received fair consideration for its incurring the obligations upon default to turn over the customer files and records to Robins and not to compete in any way with regard to those customers or that portion of its business;⁴ (2) the Debtor was clearly solvent in April of 1993 when it entered

⁴ Undoubtedly Robins developed, managed, expanded and was primarily responsible for customer retention for this portion of the business, and it would be difficult for the Debtor to retain all or possibly even a minor portion of this business should Robins leave the Debtor without a non-competition agreement. Such a non-competition agreement could very well make overall economic sense for the Debtor, since it could essentially be viewed as a purchase of that portion of the business, given the economic realities involved. Therefore, the Corporation certainly received consideration for Robins executing a non-competition agreement. The issue is whether it received

into the Stock Purchase and Employment Agreements and would not be rendered insolvent by the execution of those Agreements and the incurring of the obligations under Paragraph 27(c) in the event of a default or be left with insufficient capital going forward for its anticipated operations; (3) the facts and circumstances surrounding the execution and delivery of those Agreements would not warrant the Court from equitably subordinating any rights which Robins acquired to the rights and claims of the Debtor's other creditors; and (4) the grant and vesting of the Paragraph 27(c) rights upon default did not constitute an avoidable preference.

The only information the Court has as to the pre-petition financial condition of the Debtor in 1993 are the schedules filed by it in connection with its Chapter 11 case. In its summary of schedules filed with the Court, the Debtor listed its assets as having a value of \$1,717,806.00 and its liabilities to be in the amount of \$5,146,468.08. Although the Court is aware that the Debtor entered into some significant financial transactions subsequent to April, 1993, the Debtor's schedules certainly raise a question as to whether the Debtor was solvent six months prior to the filing of its petition in April, 1993.

Because the Court is unable to determine in the preliminary stages of the Adversary Proceeding the financial condition of the Debtor in April, 1993 or the financial impact upon it by reason of the transactions entered into among the Debtor, Robins and Kramer at that time, the Court can not resolve the potential fraudulent conveyance, equitable subordination, New York Business Corporation Law violation or avoidable preference issues raised by the Debtor in a manner satisfactory to warrant the Court enforcing the provisions of Paragraph 27(c) of the Stock Purchase

fair consideration for what at least this Court believes is a somewhat unusual provision upon default. As the Court sees it, enforcing the default provisions and rights of Paragraph 27(c) essentially transfers that entire portion of the Debtor's business to Robins. Therefore, conceding that Robins' non-competition agreement was of value to the Debtor, the issue which the Court simply does not have enough financial information to determine is whether the Debtor received fair consideration for the unusual default provisions which transfer an entire portion of the Debtor's business to Robins without even a credit against any obligations the Debtor may have to Robins or Kramer.

Agreement by granting a preliminary injunction.

CONCLUSION

The relief requested in the Cross-Motion is in all respects denied.

IT IS SO ORDERED.

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

Dated: May 25, 1994