UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

In Re:

FLEXSEAL MEDICAL PACKAGING CORPORATION,

BK. No. 93-22373

Debtor.

In Re:

FLEXSEAL PACKAGING CORPORATION,

BK. No. 93-22374

Debtor.

DECISION & ORDER

BACKGROUND

On October 27, 1993, the Debtor, Flexseal Packaging Corp. ("Flexseal") and Flexseal Medical Packaging Corp. ("Medical"), owned 75% by Flexseal, each filed a petition initiating a Chapter 11 case.

On October 27, 1993, after a conference with the attorneys for Flexseal and Manufacturers & Traders Trust Company ("M & T"), the Court entered an Order prohibiting Flexseal from using cash collateral in which M & T had an interest pending an expedited hearing to be conducted on November 3, 1993 on M & T's Motion (the "M & T Cash Collateral Motion") brought pursuant to Section 363(e) to Prohibit Flexseal's Use of Cash Collateral.

In an Affidavit by John C. Morsch, an officer of M & T, it was alleged that: (1) in October, 1993 Flexseal owed M & T in excess of $1,000,000 on a revolving line of credit facility secured by a first perfected security interest in inventory and accounts receivable; (2) on or about October 4, 1993, Flexseal opened an operating account in a financial institution other than M & T and by on or about October 18, 1993 had deposited in excess of $344,000.00 in that account; (3) when M & T demanded the return of the proceeds of its accounts receivable collateral, Gerald Kramer ("Kramer"), the President and sole shareholder of Flexseal, advised it that he would consider returning the collateral if M & T would commit to a $250,000 loan to a new corporation to be formed by him that would succeed to Flexseal's business opportunities; and (4) when M &

T demanded full payment on its loans and commenced a state court action, Flexseal filed its Chapter 11 petition.

In an Affidavit by Ronald C. Carson, an officer of M & T, it was alleged that Kramer had an ownership interest in Flexseal's landlord as well as at least three other affiliated entities, and that Flexseal had engaged in numerous insider transactions with entities controlled by Kramer within the prior year.

On October 28, 1993, an Order was entered granting Flexseal's request for an expedited hearing to be conducted on November 3, 1993 on its Motion (the "Flexseal Cash Collateral Motion") to be authorized to use cash collateral in which both
M & T and Shawmut Bank ("Shawmut") had an interest.

In its Response to the M & T Cash Collateral Motion, Flexseal interposed an Affidavit by Kramer which: (1) disputed that M & T's security interest was properly perfected; (2) alleged that Flexseal had done nothing wrong by opening an operating account in a financial institution other than M & T, since the operative loan documents between Flexseal and M & T did not require that Flexseal maintain all of its accounts at M & T; (3) alleged that some of the monies deposited into the account were the proceeds of government contracts in which M & T had not properly perfected its security interest; and (4) indicated that Flexseal's financial difficulties arose after its acquisition of the assets of Quality Packaging in June of 1993 when it became clear that anticipated economies of scale and other benefits were not realized. The Response also indicated that Flexseal's intermediate-term business plan was to: (a) scale back the scope of its operations in sales, expenses and staffing with a view to maintaining going concern values, concentrating on profitable areas of business and raising cash as the levels of accounts receivable decreased; and (b) maintain ongoing operations so that it could dispose of excess machinery, floor space in its plant, and non-economic lines of business. The Response further indicated that Flexseal anticipated it could raise its gross profit margin from 19% in November, 1993 to 36% in March,

1994. Exhibit B attached to the Response, an Income and Expense Projection, showed anticipated net income prior to depreciation and amortization in excess of $26,000 for January, 1994, $32,000 for February, 1994 and $36,000 for March, 1994.

After hearings on the two cash collateral motions, M & T and Flexseal came to an agreement for Flexseal's use of cash collateral in which M & T had an interest, and on November 9, 1993 an Order was entered approving the terms of the agreement. At a November 4, 1993 hearing Flexseal and Shawmut advised the Court of the terms of an agreement which they had reached for Flexseal's use of cash collateral.

On November 23, 1993, Flexseal filed a Motion for a Final Order on the Flexseal Cash Collateral Motion requesting that it be authorized to use cash collateral on the terms and conditions agreed to between Flexseal, M & T and Shawmut, and on January 6, 1994, an Order was entered approving the use of cash collateral in which Shawmut had an interest. The stipulated Order, as submitted and entered, provided that Shawmut has a valid, perfected second lien security interest in all of Flexseal's assets.[1]

On November 23, 1993, Donald A. Robins ("Robins"), a former shareholder, officer and director of Flexseal, commenced an adversary proceeding (the "Robins Injunction Proceeding") requesting a permanent injunction preventing Flexseal from using certain customer files and records (files and records of customers which Robins alleged were his customers) and for other relief, which included the turnover of those files and records and damages for Flexseal's prior failure to turn them over and for its interference with the customers in question. In the Proceeding, Robins alleged pre-

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[1] This would not preclude the avoidance or subordination of the lien if appropriate under Sections 510, 544 or 548 of the Bankruptcy Code. Shawmut's second security interest in the accounts receivable and inventory, although never explained by Flexseal in any of its cash collateral motions, appears to arise from the collateralization of Flexseal's guaranty of the obligations of Medical to Shawmut. To date Shawmut has not filed a proof of claim or a pleading in the Flexseal Chapter 11 case which sets forth the basis for a perfected security interest in the assets of Flexseal.

petition breaches by Flexseal of various April, 1993 agreements (the "Robins Agreements") between the parties, including a Stock Purchase Agreement and an Employment Agreement which included a clear and unambiguous covenant by Flexseal not to compete in the event that it breached its various agreements with Robins. In its responses, Flexseal alleged that: (1) the customer files and records were never the property of Robins, but were always the property of Flexseal; (2) Robins had never obtained a perfected security interest in the files and records and that a specific request for such a security interest had been requested and denied; (3) the rights and benefits conveyed to Robins by the Robins Agreements constituted avoidable fraudulent conveyances or preferences; and (4) any claims which Robins had against Flexseal as a result of the Robins Agreements should be equitably subordinated pursuant to Section 510(c) of the Bankruptcy Code. After the Court denied motions by Robins for summary judgment, a preliminary injunction and for reconsideration on the preliminary injunction motion, the District Court for the Western District of New York denied Robins request for leave to appeal the denial of the preliminary injunction. The Robins Injunction Proceeding continues at great expense to the parties.

An initial Section 341 meeting of creditors was conducted in the Flexseal Chapter 11 case on December 2, 1993. The minute sheet from the meeting, prepared by the Office of the United States Trustee (the "U.S. Trustee") and filed with the Court, indicated that Flexseal had been losing money since 1992 but believed it would turn around and become profitable again, and that a decision would be made by December 31, 1993 whether a plan of reorganization was feasible or there was a need to liquidate.

On November 24, 1993, Flexseal filed a motion, initially returnable on December 8, 1993, for an order approving the payment of insider compensation to Kramer in the amount of $125,000 in salary plus various benefits (the "Kramer Compensation Motion").

On December 3, 1993, Robins filed written opposition to the Kramer Compensation Motion, and on the December 8, 1993 return date, the matter was adjourned to January 19, 1994 to allow the

parties an opportunity to more fully discuss and analyze the proposed insider compensation at an adjourned Section 341 meeting scheduled for December 16, 1993.

On the January 19, 1994 adjourned date of the Kramer Compensation Motion, the U.S. Trustee, Bell Packaging ("Bell Packaging"), a member of the Official Creditors Committee (the "Committee")[2], M & T and Shawmut appeared in opposition and the matter was adjourned so that it could be set down for a hearing at the Court's February 16, 1994 Evidentiary Hearing Calendar. On February 16, 1994, the now organized Committee, appeared in opposition to the Kramer Compensation Motion and the matter was set down for an evidentiary hearing to be conducted on March 1, 1994. A major concern expressed by a number of the interested parties in opposition to the requested compensation for Kramer was a belief that Kramer was not as attentive to Flexseal's business as he should be, was not spending full time on Flexseal business and was devoting much of his time to his other business interests.

After an evidentiary hearing on March 1, 1994, the Court granted the relief requested in the Kramer Compensation Motion, finding that there was insufficient evidence presented by the opposing parties to conclude that the reasonable value of the services to be provided by Kramer were other than as represented in the Motion and the evidence presented by Flexseal at the hearing.[3]

On January 6, 1994, Flexseal filed a motion (the "Removal Motion") to remove Robins as a member of the Committee. The grounds for the Removal Motion included that: (1) any claims Robins had in the Flexseal Chapter 11 case would at best be subordinated claims to the claims of

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[2] On December 28, 1993, the U.S. Trustee appointed a Committee consisting of Robins, individually, representatives of Bell Packaging, The DuBois Press, Cadillac Products, Inc., and Pap-R Products. A First Amended Appointment, dated December 29, 1993 added a representative of Dis-Tech Systems, Inc. and a Second Amended Appointment added representatives of Franz Heldwein and Syracuse Label to the Committee.

[3] A review of the various applications made by professionals for compensation in connection with the Flexseal Chapter 11 case indicates that fees in excess of $5,490.00 has been approved or requested in connection with the payment of insider compensation to Kramer.

other unsecured creditors because they arose by reason of his redemption of stock; (2) Robins was attempting to obtain specific property from the estate, certain customer files and records; and (3) Robins was a competitor. On the January 19, 1994 return date, after hearing the U.S. Trustee, Robins and Bell Packaging in opposition to the Removal Motion, the Court denied the Motion.

On January 26, 1994, R. David Diederich ("Diederich"), a minority shareholder of 24 Seneca Avenue, Inc. ("Seneca Avenue"), the landlord of Flexseal's business premises, filed a motion (the "Diederich Motion") seeking relief from the automatic stay to allow Seneca Avenue to proceed in New York State Court to enforce its rights under its pre-petition lease with Flexseal, including the right to seek an order of eviction due to Flexseal's defaults under the lease. The Diederich Motion indicated that Kramer was a majority shareholder of Seneca Avenue, owning two-thirds of its stock, but was taking no actions on behalf of Seneca Avenue to enforce its rights as landlord. On the February 16, 1994 return date of the Motion, the Court noted that the Flexseal pre-petition lease with Seneca Avenue had already been deemed rejected pursuant to the provisions of Section 365(d)(4), since Flexseal had not assumed the lease within the time frames set forth in that subsection, and granted the relief requested in the Diederich Motion. On February 23, 1994, the Court entered an Order confirming the rejection of the pre-petition lease with Seneca Avenue which ordered that Flexseal, pursuant to Section 365(d)(4), surrender the leased premises to Seneca Avenue.

In granting the relief requested in the Kramer Compensation Motion, the Court had imposed certain conditions precedent to any payments to Kramer. These conditions included that all post-petition expenses be paid on a current basis. Since Flexseal was still operating at the Seneca Avenue premises, the Court specifically required an escrow for the payment of any administrative rent which might be found to be due to Seneca Avenue which was to be in an amount equal to the monthly rent provided for in the pre-petition lease. This amount would be required to be escrowed unless Seneca Avenue filed a waiver of any administrative claim, a modified monthly rent claim or otherwise

entered into a different lease agreement with Flexseal.

On or about March 2, 1994, Flexseal, by Kramer as its President, and Seneca Avenue, by Kramer as its President, entered into a new lease agreement for the Seneca Avenue location commencing March 1, 1994 (the "New Flexseal Lease"). The rent provision in the New Flexseal Lease provided as follows:

> 2. RENT: As rent for the demised portion of the premises, Flexseal shall be responsible, at its own cost, for the maintenance of the premises, under the direction and control of Seneca, shall pay the cost of all utilities
> consumed by it, and shall make the premises safe and secure under the direction and control of Seneca.

On March 3, 1994, Seneca Avenue, by Kramer as its President, signed a Waiver of an Administrative Claim (the "Claim Waiver") in Flexseal's Chapter 11 case which covered the period October 27, 1993 through February 28, 1994. The Claim Waiver was filed with the Court on March 14, 1994 as an exhibit to a motion by Flexseal to settle a final order on the Kramer Compensation Motion. On March 31, 1994, after a conference with the attorneys for the Committee, Shawmut, Flexseal and the U.S. Trustee to settle the Order, the Court entered an Order approving insider compensation to Kramer which provided for a $19,000 monthly escrow for any possible Seneca Avenue administrative expense claim. In response to Shawmut's allegations that because of various agreements entered into between Shawmut and Seneca Avenue, Seneca Avenue could not provide an effective waiver of an administrative expense claim, the Order also provided that: (1) Flexseal could move to have the Court determine a reduction of the reasonable use and occupancy amount for the Seneca Avenue premises; and (2) within a stated period of time any interested party could move to contest the validity of the Claim Waiver.

On April 5, 1994, the Court received a letter from the attorneys for Shawmut which indicated that Shawmut would object to

the Claim Waiver because on June 29, 1993 Seneca Avenue had executed an Assignment to Shawmut of the pre-petition lease with Flexseal as well as an Estoppel Certification and Subordination and Attornment Agreement. Later on April 5, 1994, Shawmut filed a motion (the "Shawmut Motion") requesting that Flexseal be directed to pay directly to Shawmut $19,000 per month as Section 365(d) rent and an administrative expense for monthly use and occupancy for the periods after the pre-petition lease was rejected and that the Claim Waiver be declared to be null and void and of no effect. Also on April 5, 1994, Flexseal filed a motion for the Court to determine the monthly fair rental or use and occupancy value for the Seneca Avenue premises.

On the May 4, 1994 return date of the Shawmut Motion, the Court was advised that the matter had been settled, and on May 6, 1994 the Court entered a stipulated Order which provided for the payment of a total of $70,000 by Flexseal to Shawmut, as an assignee of Seneca Avenue.[4]

On January 18, 1994, Flexseal commenced an adversary proceeding against Leonard Krulewich ("Krulewich"), as Assignee for the Benefit of Creditors of Flexible Packaging Limited Partnership, d/b/a Max Pak (the "Krulewich Adversary Proceeding"). The Krulewich Adversary Proceeding was brought to have the Court determine the validity, extent or priority of any lien on equipment located in Somerville, Massachusetts (the "Somerville Equipment") which it was alleged Flexseal had purchased from the defendant on or about April 29, 1993 for the sum of $325,000.00. Flexseal contended in the Krulewich Adversary Proceeding that Krulewich did not retain a security interest in the Somerville Equipment or, if he did retain a security interest in the Equipment, the security interest was not properly perfected by filing, or that any such security interest was an avoidable preference pursuant to Section 547 of the Bankruptcy Code. In his responses and motions in the Proceeding, Krulewich has contended that: (1) completion of the sale never took place because

[4] During the course of the matters involving Seneca Avenue, the Court was advised that there were potential environmental problems at the premises.

of the failure of a condition precedent, acknowledged by Flexseal when it filed a $50,000.00 claim for the return of its deposit in assignment for the benefit of creditors proceeding; and, in the alternative, (2) Krulewich retained a security interest in and possession of the Equipment, so that perfection of the security interest was accomplished by possession rather than by filing. The Krulewich Adversary Proceeding has been set down for trial on October 4, 1994.

On February 23, 1994, Flexseal filed a motion (the "Somerville Equipment Sale Motion") for the approval of a proposed sale of certain of the Somerville Equipment to Ocean Packaging Corp., Inc. ("Ocean Packaging") for $50,000.00. On the April 6, 1994 return date, the matter was adjourned to April 20, 1994 when the attorney for Flexseal advised the Court and interested parties that there was a prospective agreement between Flexseal and others, including Ocean Packaging and the landlord at Somerville, which would allow Flexseal to continue to own and utilize the equipment under an arrangement which Flexseal believed would be in the best interests of the estate and would result in Flexseal's withdrawal of its Motion. In papers filed by M & T, which opposed the withdrawal of the Somerville Equipment Sale Motion, M & T indicated that as the first secured creditor, it had received an unsolicited, non-contingent offer of $125,000.00 for the equipment which Flexseal had proposed to sell. On the April 20, 1994 adjourned date the Court marked the Motion to sell to Ocean Packaging as withdrawn and denied the requests by M & T, Krulewich and the Committee to require Flexseal to sell the equipment to any other proposed buyers or to auction the equipment. The Court noted that the agreement negotiated by Flexseal had the potential to provide it with a positive stream of payments for the use of the Equipment, but, most important, there was nothing in the Bankruptcy Code or Rules prohibiting a debtor from withdrawing a motion to sell.

On May 19, 1993, Flexseal commenced an action in the United States District Court for the Western District of New York against American Complex Care ("American Complex") and others to collect an account receivable alleged to be due it in connection with the alleged sale of certain goods by Flexseal to American Complex. On June 24, 1994, the District Court granted a motion to

transfer the case to the Bankruptcy Court. The defendants in the case alleged that the underlying transaction, structured as a sale of goods, actually was a usurious loan. Flexseal contended that the transaction actually was a sale of goods (the goods in question were not regularly sold by Flexseal but were purchased by it and drop shipped to American Complex) or, in the alternative, was an informal joint venture agreement or transaction intended by the parties to allow Flexseal to share in the profits earned under a government contract held by American Complex. This adversary proceeding continues in the pretrial stage.

On June 1, 1994, the Committee filed a motion (the "Conversion Motion"), pursuant to Section 1112(b) requesting that for cause the Court convert Flexseal's Chapter 11 case to a Chapter 7 case or, in the alternative, appoint a trustee. The Conversion Motion, initially returnable on June 30, 1994, alleged that: (1) within the meaning and intent of Section 1112(b)(1) there had been a continuing loss to or diminution of the Flexseal estate and there was the absence of a reasonable likelihood of rehabilitation; (2) through April, 1994 Flexseal's monthly financial reports indicated that it was experiencing an operating loss; (3) through April, 1994 sales were declining and over 90-day receivables were increasing; (4) Flexseal's attempts to procure DIP asset-based financing had not been successful; and (5) Flexseal's failure to sell some of the Somerville Equipment evidenced bad faith and the agreement for the continuing use of the Equipment was less favorable to the estate than a sale.

Filed with the Conversion Motion was a Memorandum in Support of the Motion (the "Committee Memorandum") which asserted additional grounds for conversion under Section 1112(b), that Flexseal was unable to effectuate a plan and that it was acting in bad faith in continuing to proceed in Chapter 11. In support of the assertion that Flexseal was unable to effectuate a plan, the Committee Memorandum emphasized the inability of Flexseal to obtain approval of a plan since the Committee, holding claims equal to approximately 66% of Flexseal's total outstanding unsecured non-priority debt, was in favor of conversion and would not vote for the Draft Plan

circulated by Flexseal in connection with the Conversion Motion (the "Draft Plan"). The Draft Plan proposed to pay the unsecured creditors a pro rata share of only approximately $200,000.00 over more than five years.[5] Attached to the Committee Memorandum were Affidavits in Support of the Conversion Motion by the following members of the Committee: (1) Franz Heldwein, a former consultant to Flexseal and a former 10-year employee of Quality Packaging; (2) Curt Christiansen, Corporate Credit Manager of Bell Packaging; (3) John A. Falco, Chief Financial Officer of DuBois Press; (4) Peter Rhodes, Vice President of Syracuse Label; (5) Scott Ware, President of Pap-R Products; (6) Michael Schimpf, Credit Manager of Cadillac Products, Inc.; (7) Donald A. Robins; and (8) John Amrine, Managing Partner of Phenix Controls. Each of the Affidavits indicated reasons why the deponent believed the case should be converted and also indicated that the respective Committee member had reviewed the Draft Plan and would reject it.

On June 27, 1994, the U.S. Trustee filed a letter with the Court supporting the Conversion Motion.

On June 30, 1994, the attorneys for M & T filed a letter with the Court on behalf of M & T supporting the Conversion Motion, which indicated that it believed that the Draft Plan was not capable of being confirmed.

A Response to the Conversion Motion (the "Response") filed on behalf of Flexseal contained a long dissertation on the difference between profit and loss and cash flow in relation to a debtor's ability to make payments under a reorganization plan, and claimed that within the meaning of Section 1112(b)(1) Flexseal had not in fact been experiencing a continuing loss. The Response emphasized that Flexseal had downsized, as it originally indicated it would, and that since the commencement of the case it had reduced the M & T secured claim by approximately $655,000.00,

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[5] This was estimated by the Committee to have a present value of only approximately $142,000.

thereby improving potential recovery for other classes of creditors. The Response also emphasized various efforts undertaken by Flexseal to increase sales, improve margins, liquidate surplus equipment, and asserted that the Somerville Equipment agreement was more favorable to the estate than a sale. The Response also responded in great detail to the various specific allegations made by the members of the Committee in their Affidavits in Support of the Conversion Motion in an apparent attempt to justify Kramer's actions in the pending Chapter 11 case. The Response further indicated that Flexseal believed that the Draft Plan could be confirmed on a "cram down" basis.

An Evidentiary Hearing was conducted on the Conversion Motion on July 14, 1994 and July 21, 1994 and the Court reserved decision.

During the Evidentiary Hearing, there was substantial concern expressed by the Committee regarding: (1) the status of various joint venture agreements entered into between Flexseal and two Malaysian corporations in February of 1993; and (2) the Committee's belief that the security interest of Shawmut in Flexseal's assets, which the Draft Plan proposed to pay in full, was avoidable as a fraudulent conveyance.

DISCUSSION

By this District's standards, the Flexseal Chapter 11 case is highly contested. Very often in this District the U.S. Trustee is unable to even appoint a committee of creditors, and in many cases where a committee is appointed, it never becomes active in the case. In this case the Committee has organized, expanded, been active in opposing many of Flexseal's actions and has moved to convert Flexseal's case to a Chapter 7 case.

Also by this District's standards, the Flexseal Chapter 11 case has been and continues to be very costly. For a debtor which has reported post-petition net sales for the nine months ending December 31, 1993 through August 31, 1994 of only $3,581,944 and a net operating loss of in excess of $145,000, substantial professional fees have been incurred. The Court has approved or

received applications for professional compensation in excess of $127,000.00. This amount does not include requests for compensation by the attorneys for Flexseal for periods after May 31, 1994 or for the attorneys for the Committee for periods after May 25, 1994. After the Robins, Krulewich and American Complex Adversary Proceedings continue, and it appears from the representations made during the hearings on the Conversion Motion, the interested parties have not yet even begun good faith negotiations on a possible Plan of Reorganization that might be acceptable to Flexseal's creditors.

The pleadings and proceedings in this case to date indicate that Kramer is an intelligent, experienced entrepreneur who is a tough negotiator, always willing to fight the fight, and who has learned well the importance of hiring competent and tough professionals to assist him. Flexseal's attorneys have done an excellent job in "managing the case" and overcoming opposition to many of Flexseal's proposed actions by continuously presenting Flexseal's case in its most favorable light in well-prepared and thorough presentations. However, the proceedings also indicate that Flexseal is but a part of the Kramer empire, Flexseal's creditors really consider Flexseal to be Kramer, and even though the Disclosure Statement filed with the Draft Plan appears to attempt to explain and untangle a tangled web, the reader gets the feeling that at best it discloses only the tip of the iceberg.

The Disclosure Statement is perhaps more notable for what it doesn't explain than for what it does. As a minor example, it indicates that Gerald and Suzanne Schultz are secured creditors, but that Flexseal believes there is no equity to secure their claims and, therefore, the Draft Plan proposes to treat them as general unsecured creditors. There is no other discussion of the basis for the claims held by Gerald and Suzanne Schultz and no proof of claim has been filed by them in the Flexseal Chapter 11 case. However, the monthly financials filed by Flexseal show a note payable to Schultz with a balance of $11,333.23 as of December 31, 1993 and $6,000.00 as of August 31, 1994.

The Draft Plan proposes to: (1) pay M & T in full in equal installments of $8,200.00 inclusive of principal and interest at the pre-petition contract rate; (2) pay Shawmut $1,000,000.00

in full satisfaction of its claim: $600,000.00 to be paid in equal, monthly installments of $9,351.72, which includes interest at 8%, until paid in full or in seven years, and $400,000.00 to be paid within twelve months or from the collection or liquidation of various assets, including the collection of over 90-day accounts receivable, the sale of excess equipment and the proceeds of Flexseal's claims against Robins; (3) pay administrative expenses in full, either on confirmation or as such obligations fall due under applicable non-bankruptcy law; (4) pay general unsecured creditors a pro rata share of a fund of approximately $200,000.00 to be created by the payment of twenty equal quarterly installments of $10,000.00 to commence seven months after the effective date under the Plan; (5) have the existing stock in Flexseal surrendered and cancelled and for new stock to be issued to new shareholders who will make a $50,000.00 capital contribution in consideration of the issuance of the stock: such new shareholders to be Donna Steele, a customer service representative who is to own 51% of the reissued stock, Rachel Kramer who is to own 16-1/3% of the reissued stock, Lee Kramer who is to own 16-1/3% of the reissued stock and Brian Kramer who is to own 16-1/3% of the reissued stock; and (6) have Flexseal enter into an employment contract with Kramer at a salary of $125,000.00 per year plus benefits not to exceed $5,000.00 per month, which contract is to provide for Kramer to receive an annual bonus of 50% of Flexseal's net operating income less the amount of payments made to general unsecured creditors.

The Committee in the Conversion Motion and the related hearings alleged that there was cause to convert the Flexseal Chapter 11 case to a Chapter 7 case because Flexseal was suffering a continuing loss to or diminution of its estate and there was the absence of a reasonable likelihood of its rehabilitation.

Section 1112(b)(1) provides:

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

(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.

The determination to convert a case to a Chapter 7 case pursuant to Section 1112(b) is addressed to the sound discretion of the Bankruptcy Court and, in this Court's view, requires the Court to take into consideration all of the facts and circumstances of the debtor and the case. *See Matter of Santiago Vela*, 87 B.R. 229, 231 (Bankr. (D. P.R. 1988); *Matter of Levinsky*, 23 B.R. 210, 217 (Bankr. E.D.N.Y. 1982).

In assessing whether there has been a continuing loss under Section 1112(b)(1), the monthly financial reports (the "Flexseal Financials") filed by Flexseal with the Court and the U.S. Trustee for the months ending December 31, 1993 through August 31, 1994 show a net operating loss in excess of $145,000.00 and widely fluctuating gross profit margins (from as high as 33.6% in February, 1994 to as low as 3.6% in June, 1994[6]), summarized as follows:

	OPERATING INCOME		GROSS MARGIN
December, 1993	$38,063.00	-	26.4
January, 1994	1,677.00	-	19.6
February, 1994	59,236.00	-	33.6
March, 1994	-	($6,410.00)	22.7
April, 1994	-	(35,601.00)	20.3
May, 1994	-	(54,899.00)	10.4
June, 1994	-	(139,785.00)	3.6
July, 1994	-	(41,823.00)	9.0
August, 1994	34,026.00	-	20.8
	$133,002.00	($278,518.00)	

[6] Flexseal's gross profit margin never reached the 36% it had projected in its Response to the M & T Cash Collateral Motion, nor did Flexseal achieve even net operating income equivalent to the net income it had projected for the first quarter of 1994. *See supra* pp. 3-4.

Although the Flexseal Financials do not include a separate balance sheet for Flexseal, they do include a consolidated balance sheet for Flexseal and Medical. These Financials show that current assets have declined between December 31, 1993 and August 31, 1994 in an amount in excess of $438,000.00.[7] Although the secured position of M & T has been reduced correspondingly, because there has been a substantial net operating loss and there is insufficient evidence that non-current assets have appreciated in value (there was some testimony by Kramer that fixed assets like machinery may have appreciated in value), Flexseal has less assets available to pay its pre-petition creditors and its unpaid post-petition administrative expenses, including professional fees which are already substantial and growing daily.

Although Flexseal has asserted that it has had a post-petition cash profit, it has not denied that it has had a substantial post-petition net operating loss. Furthermore, Flexseal's projections for 1995 depend on a questionable 19% increase both in sales and gross profit margins over what were indicated from December 31, 1993 to August 31, 1994 to achieve an operational profit.

In the absence of proof that other assets are appreciating in value, the combination of substantial net operating losses and substantial unfunded post-petition administrative expenses is sufficient in this Court's view to find that there exists a continuing loss within the meaning of Section 1112(b)(1).

In view of its net operating loss, fluctuating gross margins, declining current assets, increasing unfunded administrative expenses in the nature of professional fees, as well as Flexseal's own projections, the Court does not believe that there is a reasonable likelihood that Flexseal can or will rehabilitate within the meaning of Section 1112(b)(1). Rehabilitation requires more than simply the ability to execute a plan of reorganization.

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[7] In addition, over 90-day accounts receivable have increased from 44.80% in December, 1993 to 52.16% in August, 1994.

> "Rehabilitate" has been defined to mean "to put back in good condition; re-establish on a firm, sound basis." Rehabilitation, as used in section 1112(b)(1), does not mean the same thing as reorganization, as such term is used in chapter 11. Since a debtor can be liquidated in chapter 11, the ability to confirm a plan of reorganization is considerably different than reaching a firm, sound financial base.
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> . . . While a debtor should have a fair opportunity to reorganize, such opportunity must be balanced against protection of creditors' interests. When visionary schemes for reorganization entail significant risk to creditors without any reasonable probability that the debtor can successfully rehabilitate, liquidation is generally in order.

5 *Collier on Bankruptcy*, 1112-18, 1112-19, ¶1112.03[2][d][i] (15th Ed. 1994) (footnotes omitted). *See In re Wright Air Lines, Inc.,* 51 B.R. 96, 99-100 (Bankr. N.D. Ohio 1985); *Matter of E. Paul Kovacs and Co., Inc.,* 16 B.R. 203, 205-06 (Bankr. D. Conn. 1981).

In its submissions in opposition to the Conversion Motion, Flexseal has not addressed the Code's focus on rehabilitation but has focused on the ability to fund a "cram down" plan of reorganization because, at least at this time, it does not appear that the Draft Plan or any similar plan will be acceptable to its creditors. Flexseal's contention is that notwithstanding its past and possible ongoing losses, it can generate sufficient cash flow, in part by the orderly liquidation of its assets, including accounts receivable and surplus machinery and equipment, sufficient to make the payments proposed in the Draft Plan, and therefore it can reorganize.

The ability of a financially unsound debtor to fund a liquidation or quasi-liquidation plan of reorganization may in the absence of objections by creditors result in a Bankruptcy Court confirming such a plan under Section 1129. However, it is not the ability to reorganize but to rehabilitate which the Court must find under Section 1112(b)(1) for a debtor to overcome a motion to convert so overwhelmingly supported by its creditors.

Based on the evidence presented and the pleadings and proceedings in this case to date, the Court is unable to find, as asserted by the Committee, that Flexseal is unable to effectuate a plan within the meaning of Section 1112(b)(2) or, that as a separate grounds for cause under Section 1112(b), Flexseal is operating in Chapter 11 in bad faith. This is principally because it is clear from

the pleadings and proceedings in connection with the Conversion Motion that there have been no good faith negotiations between Flexseal and its creditors, including Shawmut, in an attempt to determine whether there is any plan of reorganization which Flexseal could propose in good faith which would be acceptable to its creditors and comply with the provisions of Section 1129. Although the Draft Plan on its face may be technically confirmable under Section 1129(b), this Court has serious concerns whether it would confirm the Draft Plan or a similar plan on good faith grounds given: (1) the extremely small proposed distribution to unsecured creditors; (2) the unresolved issue of the avoidability of the Shawmut lien; (3) the identity of the proposed new shareholders and the amount of their proposed capital contribution; (4) the overwhelming opposition to Flexseal's continuing in Chapter 11 by the U.S. Trustee, the Committee, which represents a broad cross-section of Flexseal's creditors, and M & T, its primary secured creditor; and (5) the terms of the proposed employment agreement to be entered into with Kramer. The Court is also concerned with the feasibility of the Draft Plan given the questionable ability of Flexseal to pay all administrative expenses, including professional fees, on confirmation and still have settlement working capital to operate and make the required plan payments thereafter, and the need for some of the plan payments to be made from the proceeds of litigation.

As this Court has stated on a number of occasions, the decision whether to exercise its discretion under Section 1112(b) to convert a debtor's Chapter 11 case to a Chapter 7 liquidation case for cause is one of the most difficult decisions which a Bankruptcy Court must make, and one which this Court never takes lightly. This is especially true when a debtor has a basic core business and a substantial number of employees.

In this case, although grounds for conversion exist[8], Flexseal appears to have indicated a

[8] Conversion rather than dismissal would clearly be in the best interests of the creditors and the estate.

serious desire to attempt to reorganize by having the opportunity to propose a plan which would either be acceptable to its creditors, or could be found by the Court to have been proposed in good faith and be capable of being confirmed pursuant to Section 1129(b).

At this time, the Court is going to continue the Conversion Motion. This will afford the interested parties a limited opportunity to: (1) clarify the potential avoidability of the Shawmut lien; (2) determine whether a plan of reorganization can be proposed by Flexseal which would be acceptable to its creditors; and (3) clarify how Flexseal will pay all outstanding administrative expenses upon the confirmation of a plan.

CONCLUSION

This matter is adjourned to the Court's Chapter 11 Conversion and Dismissal Calendar on September 29, 1994 at 9:30. At that time the Court expects to receive a status report from the parties regarding their discussions to date on: (1) the avoidability of the Shawmut lien; (2) the possibility of a plan being proposed which might be acceptable to Flexseal's creditors; and (3) Flexseal's ability to pay all outstanding administrative expenses upon the confirmation of a plan. At that time, if it is appropriate, the Court will set a time within which Flexseal must file a plan and disclosure statement.

IT IS SO ORDERED.

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

Dated: September 22, 1994