

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF  
IOWA

IN RE: )

) Chapter 11

FORT KNOX MINI )

WAREHOUSE, INC. ) Bankruptcy No. 01-03493

)

Debtor. )

**ORDER RE U.S. TRUSTEE'S MOTION TO DISMISS OR CONVERT AND JOINDERS THERETO BY  
GUARANTY BANK AND  
IOWA DEPARTMENT OF REVENUE**

On July 16, 2002, the above-captioned matter came on for hearing pursuant to assignment on the U.S. Trustee's Motion to Dismiss or Convert pursuant to 11 U.S.C. § 1112(b). Debtor appeared by Attorney John Titler. Assistant U.S. Trustee Janet Reasoner appeared. Attorney James Holmes appeared for Guaranty Bank & Trust. Evidence was presented after which the Court took the matter under advisement. This is a core proceeding under 28 U.S.C. § 157(b) (2) (A).

**STATEMENT OF FACTS**

Fort Knox Mini Warehouse, Inc., the Debtor corporation in this Chapter 11 proceeding, operates a self storage business at 5300 J Street S.W., Cedar Rapids, Iowa. Donald Nemec is the sole shareholder of Debtor. He and his wife, JoAnn Nemec, are both actively involved in the operation of the business.

Debtor provides both short and long term storage space to individuals and businesses in units of varying sizes and costs. Debtor also operates a temperature controlled self storage facility at 301 F Avenue N.W. and a residential property at 622 3rd Street N.W. The F Avenue and 3rd street properties are not owned by Debtor, but have been operated by it under an operating agreement with the owners Donald Nemec and JoAnn Nemec. This agreement provides that Debtor collects the rental income and pays the associated expenses attributable to those properties.

Debtor's Chapter 11 Petition was precipitated by foreclosure of mortgages held by Guaranty Bank. These mortgages encumbered the real estate owned by Debtor and certain real estate owned by Donald and JoAnn Nemec. Mr. and Mrs. Nemec have personally guaranteed much of the secured debt of Debtor to Guaranty Bank. A judgment was entered in favor of Guaranty Bank on August 21, 2001 in the Iowa District Court for Linn County. The total judgment was \$1,097,104.05 plus interests and costs. Of that amount, \$916,455.55 was specifically a judgment against Debtor. Debtor filed for Chapter 11 protection on October 12, 2001.

The U.S. Trustee filed the pending Motion to Dismiss or Convert on May 24, 2002. It is asserted that the profit and loss statements filed in this case reflect that Debtor has shown a loss in most months since the filing of the petition. Debtor is delinquent on property taxes for the past three bi-annual tax periods. Additionally, current property taxes are accruing at a rate of approximately \$2,100 per month. Debtor has not paid the IRS or the Iowa Workforce Development for taxes arising out of a determination that an individual paid as an independent contractor was in fact an employee. The priority amount claimed by the IRS is \$1,935.74. Iowa Workforce claims \$364.62. Further, the Iowa Department of Revenue claims \$4,000 for pre-petition sales taxes.

Donald Nemec testified that the gross revenue for the company is trending upward. In addition, he is willing to contribute the proceeds from a promissory

note owed to Donald Nemec, personally, by Walnut Creek Storage Partners, Ltd., a limited partnership, in the amount of \$150,000. Mr. Nemec's son is the principal participant in Walnut Creek. Walnut Creek is the developer of a real estate project in Mansfield, Texas. Although, the note is scheduled to mature on March 9, 2003, Donald Nemec testified that Walnut Creek should be able to satisfy that obligation by October of 2002.

The U.S. Trustee notes this case has been on file in excess of nine months. It is asserted that Debtor continues to experience losses and has accumulated taxes since the filing of the petition which Debtor is and will be unable to pay. Guaranty Bank joins in the U.S. Trustee's motion for the same reasons and further states it is speculative that the \$150,000 will be collected. Moreover, Guaranty Bank states that even if the \$150,000 is collected it will not be enough to reduce the secured debt to a point where Debtor's monthly interest payments amortize secured debt. Finally, Guaranty Bank asserts that Debtor's income statement shows a net loss through April 2002. For these reasons, the U.S. Trustee and Guaranty Bank seek dismissal or conversion of this case.

#### **CONCLUSIONS OF LAW**

The U.S. Trustee's Motion to Dismiss or Convert is based on 11 U.S.C. § 1112 (2002). This Code section states in relevant part that:

(b) (T)he 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 interests 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; ...

11 U.S.C. § 1112(b) (1).

A bankruptcy court has broad discretion under 11 U.S.C. § 1112(b) to either dismiss a case or convert a case from a Chapter 11 reorganization to a Chapter 7 liquidation. In re Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d 647, 648 (8th Cir. 1992). Dismissal or conversion is appropriate if "cause" exists and it is in the "best interests of creditors and the estate." See In re Windsor on the River Assocs., Ltd., 7 F.3d 127, 133 (8th Cir. 1993). It is therefore incumbent upon the court to determine, as a threshold matter, whether "cause" exists.

Section 1112(b) sets forth specifically enumerated examples of "cause" including the "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation." 11 U.S.C. § 1112(b)(1). It should, however, be noted that the statutory list of causes is not exhaustive and that a court may consider other factors and equitable considerations in order to reach an appropriate result in the individual case. In re Kerr, 908 F.2d 400, 404 (8th Cir. 1990);

In re Wentworth, 83 B.R. 705, 707 (Bankr. D. N.D. 1988) (noting that the court may consider all of the circumstances of a debtor's situation when making a § 1112(b) determination). The burden of proof in a motion for conversion or dismissal rests squarely upon the moving party. In re Economy Cab & Tool Co., 44 B.R. 721, 724 (Bankr. D. Minn. Oct. 31, 1984).

#### **CONTINUING LOSS TO THE ESTATE**

The first aspect of § 1112(b)(1) requires a showing of a "continuing loss to or diminution of the estate." In re Schriock Const., 167 B.R. 569, 575 (Bankr. D.N.D. May 20, 1994).

This element can be satisfied by demonstrating that the debtor incurred continuing losses or maintained a negative cash flow position after the entry of the order for relief. Id.

Movants have established a continued diminution of the estate. The main asset in the Debtor's estate is the property consisting of land and buildings located at 5300 J. Street S.W., Cedar Rapids, Iowa. As indicated on Debtor's monthly reports, this property had a value of approximately \$1,300,000 on October 12, 2001, the date the Chapter 11 petition was filed. As of May 2002, this property has depreciated in value to roughly \$900,000. Guaranty Bank is the holder of a foreclosure judgment in the original amount of \$1,097,104 with interest accruing at \$258.77 per day from August 1, 2001. This obligation continues to accumulate despite Debtor's adequate protection payments to the Bank in the amount of \$7,000 per month. In addition, there are unpaid and delinquent property taxes. Not only is Debtor behind \$42,000 for the three previous bi-annual tax periods, but the current property taxes which are accruing at rate of approximately \$2,100 per month, also have not been addressed..

Debtor's monthly profit and loss statements indicate that Debtor has realized a profit in only three of the last nine months, as follows:

October	2001	(\$4428)
November	2001	\$476
December	2001	(\$2774)
January	2002	(\$2111)
February	2002	\$204
March	2002	(\$210)
April	2002	\$35
May	2002	(\$1246)
June	2002	(\$1077)

These figures, even though not positive, do not represent Debtor's true level of financial distress. The financial statements are incomplete. The Profit and Loss Statement does not make provision for depreciation expenses for the year 2002 or any property taxes. The record indicates that a post-petition profit would have been non-existent had Debtor included these expenses in the monthly reports. It is apparent that Debtor's estate continues to incur losses. This Court concludes that the first element of § 1112(b)(1) has been satisfied.

#### **ABSENCE OF REASONABLE LIKELIHOOD OF REHABILITATION**

The second aspect of § 1112(b)(1) requires a showing of an "absence of a reasonable likelihood of rehabilitation". This test is satisfied if the state of the debtor's financial affairs is such that it is unable to re-establish itself on a firm or sound base. Schriock Const., 167 B.R. at 576. The concept of rehabilitation necessarily hinges upon establishing a cash flow from which current obligations can be satisfied. Id.

The Court must evaluate whether Debtor can emerge as an economically viable enterprise capable of servicing its obligations under a plan. Id. This finding in turn requires an assessment of the feasibility of the debtor's proposal for rehabilitation, as contained in the Debtor's plan of reorganization together with the disclosure statement, under a cramdown scenario. Id. This Court will give Debtor the benefit of the doubt and apply the foregoing analysis to the most recent Plan submitted by the Debtor.

#### **FEASIBILITY OF THE PLAN**

Feasibility contemplates the probability of actual performance of plan provisions or whether the things to be done under a plan of reorganization can be done as a practical matter under the facts. In re Clarkson, 767 F.2d 417, 420 (8th Cir. 1985). To be feasible, a Chapter 11 plan must offer a reasonable prospect of success and be workable. In re Holiday Assocs. Ltd. Partnership, 139 B.R. 711, 716 (Bankr. S.D. Iowa Mar. 30, 1992). "Sincerity, honesty and willingness are not sufficient to make the plan feasible and neither are visionary promises."

Clarkson, 767 F.2d at 420.

When construing feasibility requirements under § 1112(b)(1), Chapter 11 debtors should be given the benefit of the doubt and a court should reasonably resolve conflicts in the evidence in favor of the debtor. In re Monnier, 755 F.2d 1336, 1341 (8th Cir. 1985). The court considers whether the debtor's projections, using reasonable inputs in light of the current economic climate, indicate that the causes of the debtor's continuing losses can be corrected and that it is reasonably probable that the debtor will be able to make the plan payments. Id.

#### ABSENCE OF FINANCIAL DATA

Debtor's monthly reports do not contain information sufficient to enable a hypothetical, reasonable investor, as defined in 11 U.S.C. § 1125(a)(2), to make an informed judgment about the Plan of Reorganization as required by 11 U.S.C. § 1125(a)(1). The monthly reports combine the income from Debtor's operations with that from the F Avenue and 3rd street properties.

The F Avenue and 3rd street properties are not owned by Debtor, but have been operated by it under agreement with the owners Donald Nemeč and JoAnn Nemeč. Under this operating agreement, Debtor is obligated to collect the rental income and pay the associated expenses. The Disclosure Statement further states that this arrangement is beneficial to Debtor because the rental income exceeds the expenses. It must be noted that Donald Nemeč's testimony is the only evidence as to the existence of this agreement.

Based upon the evidence presented, it is impossible to discern whether the income from these properties can be classified as property of the estate. As they stand, the monthly reports may seriously misrepresent Debtor's financial condition by inflating its gross revenue. It is the opinion of this Court, however, that even if the cash flow projections are based on the inflated monthly reports, Debtor does not have sufficient cash flows to produce a feasible Plan.

#### CASH FLOW ANALYSIS

Cash flow projections must be based upon objective facts. Clarkson, 767 F.2d at 420. The Court will give Debtor the benefit of the doubt when evaluating projections. The projections, however, must be based on more than wishful thinking. Historical data is one source of objective evidence upon which projections may be premised. In re Konzak, 78 B.R. 990, 994 (Bankr. D.N.D. 1987).

Debtor projects an average positive monthly cash flow of approximately \$1,575. The cash flow projection assumes that gross revenue will reach \$13,000 per month. Debtor testified that gross revenue has trended upward over the past nine months and such a trend would justify a projection of \$13,000 per month. It is the conclusion of this Court, however, that an upward trend in operating income is not supported by the record. Moreover, the historical data shows that Debtor has only recognized gross revenue in excess of \$13,000 in two of the last nine months, as follows:

October	2001	\$11,071
November	2001	\$14,268
December	2001	\$11,415
January	2002	\$10,121
February	2002	\$12,316
March	2002	\$13,214
April	2002	\$10,992
May	2002	\$11,659

June 2002 \$11,518

Debtor has not offered additional facts which would convince this Court that its projections are not the result of wishful thinking.

To determine whether Debtor will have sufficient cash flows to fund this plan, it would be appropriate to base projections on Debtor's average gross revenue for the past nine months.

Debtor has averaged \$11,840 in gross revenue over that period of time. Assuming Debtor's projected expenses are complete and realistic, Debtor would have a revised positive monthly cash flow of \$415.

INCOME \$11,840

EXPENSES

Projected

Payroll and Taxes (\$300)  
 Office Expenses (\$200)  
 Security (\$150)  
 Insurance (\$300)  
 Repairs and Maintenance (\$350)  
 Utilities (\$500)  
 Telephone (\$175)  
 Sales Tax (\$700)  
 Property Tax (\$2,100)

PLAN DEBT SERVICE - (Fixed payments)

\$7,065

Guaranty Bank and Trust	(\$6,500)
Property Taxes	(\$150)

NET MONTHLY CASH FLOW \$415

It is apparent from the record, however, that Debtor has both ignored and underestimated certain operating expenses that have been prevalent throughout the previous nine months. First, Debtor has omitted vehicle expenses, supplies, advertising, and administrative expenditures from the cash flow projections. Over the past nine months the average expenditures associated

with these categories are as follows: vehicle expense (\$338), supplies (\$555), and advertising (\$310). Debtor has failed to explain its failure to account for these historically substantial expense items. Moreover, Debtor has omitted administrative fees from the cash flow projections. Such fees total several thousand dollars. In regard to advertising expenditures, it appears that Debtor is under the impression that there is an inverse relationship between advertising expenditures and gross revenue. This Court doubts that such a relationship exists in an industry where product differentiation is nearly nonexistent.

In addition, not only is depreciation unaccounted for, but the projected repairs and maintenance expenses are nearly fifty percent below their historical level. This Court will concede that depreciation should not be included in cash flow projections since it is a non-cash expense. It is important to note, however, that unless these assets have an infinite useful life, they will be depleted as some point in the future. It is the opinion of this Court that depreciation may be ignored altogether only if Debtor has set aside sufficient funds to replace the assets at the end of their useful life. Although Debtor's testimony reveals that the premises are in good working order, the provisions made for repairs and maintenance will not be sufficient to replace these assets upon retirement. The net effect of Debtor's actions will be to eventually turn this corporation into a shell at the creditors expense.

It is apparent from the record that if the aforementioned expense items were properly forecasted Debtor would not have a sufficient cash flow to fund the Plan. Debtor's failure to either account for these substantial expenditures ultimately sounds its death knell. This Court must conclude that Debtor has failed to show that the plan is feasible on this basis, for purposes of a § 1112(b) analysis.

#### **THE PROMISSORY NOTE**

Projections of the income necessary to finance a plan of reorganization must be based on concrete evidence of financial progress and must not be speculative, conjectural or unrealistic. In re Snider Farms, 83 B.R. 1003, 1012 (Bankr. N.D. Ind. Feb 17, 1988). In In re Hoffman, 52 B.R. 212, 215 (Bankr. D.N.D. 1985), the debtor's reorganization plan called for the sale of certain real estate within two years after the plan's confirmation. The Bankruptcy Court found no evidence that the parcels would be sold as contemplated by the plan. Id. The court concluded that the plan was not feasible on this basis. Id.

Similarly, Debtor's Plan states that it is in the process of obtaining sufficient outside funding to pay the outstanding property taxes. It is Debtor's opinion that its current dilemmas will be resolved by this new infusion of capital. The record reveals that Debtor has no unencumbered assets and has not identified this new source of capital. This Court remains skeptical about the sources of such financing, and also doubts Debtor's ability to make effective use of new funding.

In addition, this Court is not satisfied that Donald Nemec will be able to collect on the \$150,000 note due from Walnut Creek Storage Partners, Ltd. Although Debtor testified that Walnut Creek will have sufficient funds to meet this obligation in October of 2002, the record provides no basis for determining that there is anything other than a speculative chance of recovery. Even if Donald Nemec were to collect the note in its entirety, he is under no obligation to personally fund Debtor's operations. Based on the foregoing, this Court concludes that the prospects of outside funding or the collection of the \$150,000 are not sufficiently concrete to make this Plan feasible.

#### **CONCLUSION**

The Court has evaluated the entire record presented herein. It is apparent from the record that the J Street storage facility is the primary asset from which Debtor's income has been derived. It is axiomatic that a business is susceptible to great risk when the future of the company is dependent upon the income derived from a single asset. In multiple asset cases, a debtor has diversified its risk by spreading it across several assets. A poor performance by one asset may be offset by the performance of the others. In this case, Debtor is attempting to create the illusion that this is a multiple asset case. While this Court has analyzed this case based on Debtor's terms, it is apparent that this business will not sustain itself even under the terms presented by Debtor.

The record proves that Debtor has done poorly since the filing of the Chapter 11 petition. It continues to lose money and has new accruing obligations which cannot be paid. The success of Debtor's Plan depends largely on its ability to cut expenses, obtain outside funding, and collect on a \$150,000 note that matures in March of 2003. Not only are Debtor's income and expense projections fanciful, but it is speculative to

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assume that Debtor will obtain outside financing or collect on the note. As such, this Court must conclude that the U.S. Trustee has established grounds to dismiss or convert this case. It is the opinion of this Court that converting this case would cause unnecessary administrative expenses to be incurred.

Accordingly, for the reasons stated, the Chapter 11 case should be dismissed.

**WHEREFORE**, for all of the reasons set forth herein, the U.S. Trustee's Motion to Dismiss under 11 U.S.C. § 1112(b)(1) is **GRANTED** and this case is **DISMISSED**.

**FURTHER**, it is ordered that Debtor pay to the United States Trustee the appropriate sum required pursuant to 28 U.S.C. § 1930(a)(6) within ten days of the entry of this order and simultaneously provide to the U.S. Trustee an appropriate affidavit indicating the cash disbursement for the relevant period.

**SO ORDERED** this 31st day of July, 2002.

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PAUL J. KILBURG  
CHIEF BANKRUPTCY JUDGE