

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

IN RE:)

) Chapter 11 MIDWEST COMMUNICATIONS, INC.,)
) Bankruptcy No. 02-00431

Debtor.)

**ORDER RE MOTION TO CONVERT CASE TO OPERATING CHAPTER 7 AND PRELIMINARY
HEARING ON PLAN CONFIRMATION AND AMENDED CLAIMS REPORT**

This matter was heard on December 3, 2002 pursuant to assignment. The matters before the Court are a Motion to Convert Case to Operating Chapter 7 and preliminary hearings on plan confirmation and the Amended Claims Report. The following parties appeared through their respective attorneys:

Debtor Midwest Communications John Titler
U.S. Trustee John Schmillen Internet Wisconsin LLC and Clancy
Technology & Supply Jeff Courter Dubuque Bank & Trust Dan Childers
Kramer, Ceilley & Assoc. Eric Lam Qwest Communications and Alpine
Communications Mark Walz TechHead Computers Renee Hanrahan

The hearing commenced with the parties presenting their positions on confirmation of Debtor's plan and amended claims report. Debtor conceded that its Plan was not confirmable.

Debtor proposed to file an amended plan and disclosure statement with negotiations and discovery continuing as necessary on the claims report. The parties were directed to file applications to adjudicate claim disputes as such become necessary, with hearings to be set as soon as practical. The deadline for Debtor's amended plan and disclosure statement was initially set for January 3, 2003. This deadline was later extended to January 10, 2003.

Evidence was presented on the Motion to Convert filed by Internet Wisconsin and Clancy Technology (hereinafter "IWI"). After presentation of arguments, the Court took the matter under advisement. The time for filing briefs has now passed and this

matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. § 157(b) (2) (A).

STATEMENT OF THE CASE

IWI seeks to convert this case to Chapter 7 alleging that Debtor engaged in improper conduct postpetition. It asserts that Debtor paid unsecured claims, transferred ownership of domain names, sold equipment, paid off leases, discontinued subscriber services, and improperly compensated President Ed Larson. IWI argues this constitutes cause to convert and supports its claims of Debtor's lack of good faith and breach of fiduciary duty to creditors. It also asserts there is continuing loss to the bankruptcy estate with no reasonable probability that a feasible reorganization plan can be confirmed. IWI requests conversion to an operating Chapter 7 case rather than liquidation.

Debtor denies bad faith. It asserts none of its actions have diminished the estate. It claims to be operating profitably and asserts it can reorganize. Debtor argues the actions which IWI argues establish its lack of good faith are easily explained and were done in the best interests of the estate.

FINDINGS OF FACT

Debtor Midwest Communications, Inc. has been under Bankruptcy protection for approximately 28 of the past 50 months. This is Debtor's third Chapter 11 case. Debtor filed its first Chapter 11 petition on November 27, 1998. That case was

dismissed on Debtor's motion on September 9, 1999 after Debtor explained it had successfully negotiated with its creditors. Debtor filed its second Chapter 11 petition on March 9, 2001. On November 6, 2001, the Court granted the U.S. Trustee's motion to dismiss that case based on continuing loss to the estate and absence of a reasonable likelihood of rehabilitation under § 1112(b)(1). The currently pending case was initiated by an involuntary petition on February 19, 2002. Debtor converted to Chapter 11 on March 18, 2002.

At the present hearing, IWI offered testimony of Robert Lanham, a financial consultant who is a retired CPA. Mr. Lanham was previously a consultant with Cyberlink which in the past has attempted to purchase Debtor. He testified regarding Debtor's monthly reports and other financial information. According to Mr. Lanham's testimony, Debtor has experienced significant decreases in its client base during this case. The exhibits show Debtor's client number decreased from 10,200 in March 2002 to 7,393 at the end of October 2002. Exhibit 4 establishes postpetition payments on prepetition debts and other debts not listed in Debtor's schedules. Debtor also paid off equipment leases. Mr. Lanham could not trace \$70,000 of equipment. In comparing September and October balance sheets, Mr. Lanham observed discrepancies in retained and current earnings. He testified that Debtor's President, Ed Larson, received money from Debtor which exceeded the amount Debtor reported as payments to an insider.

Mr. Lanham noted that reports of Debtor's finances have changed from month to month. For example, amounts reported for each postpetition month changed between Debtor's August and September monthly reports. Similarly, the recently filed November monthly report contains changes for the month of October compared to the October monthly report. The October report concludes Debtor had positive Net Income of \$2,094.35 for the month. The November report states Debtor had negative Net Income of (\$5,098.65) in October. Debtor now reports negative Net Income of (\$958.21) for November.

Mr. Lanham noted that Debtor's total expenses have decreased in the past few months. He finds these numbers suspect because some expenses, such as postage, have completely disappeared. He agreed that Net Income plus amortization and depreciation expense amounts would show Debtor's cash flow.

Debtor's President, Ed Larson, testified. He stated the information in Debtor's monthly reports comes directly from Debtor's Quick Books computer data. The September report contains restated financials compared to the August report. The restated figures are final after changes are made, including such things as phone bill credits. Mr. Larson explained that customers were lost because of the ongoing reorganization efforts and changes made in the pricing of accounts. Discounts associated with prepaid accounts discontinued in December 2001. Some subscribers living north of Dubuque were cut off. Mr. Larson testified between 250 and 500 subscribers no longer had a port available and the area had become unprofitable for Debtor. Debtor was unable to sell these accounts to another provider.

Mr. Larson testified he sold Debtor's van postpetition for \$18,000. Only \$230 remained from the proceeds after the note was paid off. Mr. Larson testified he believed this sale was in the ordinary course of business and he did not need court

authorization. He also stated he entered into settlements of equipment leases, either returning the equipment or selling it to pay off the leases. Mr. Larson testified he negotiated in good faith but did not seek court authorization to settle the leases. He testified this was also part of Debtor's ordinary course of business. Mr. Larson believes the sales, except for the van, were nominal compared to the total value of the company. He asserts the U.S. Trustee said he did not need to seek court approval for small transactions.

In October, Debtor paid off a car loan to Chrysler Financial. The car was totaled in an accident. Part of the payoff came from insurance proceeds. No court

authorization was sought. Debtor has a substantial additional claim against the other driver's insurance.

Mr. Larson sold a router to Ed Vardon for \$1,500 cash postpetition in October 2002. He testified he did not request cash payment and Debtor's bookkeeper deposited the funds in Debtor's bank account. He did not determine whether the router constituted collateral for IWI's claim prior to the sale. He testified Debtor's bank account has sufficient funds to cover IWI's security interest in the router. Mr. Larson also advertised other equipment for sale on Debtor's website. He did not seek court approval for these actions. Mr. Larson stated he talked to his attorney and believed no court approval was needed.

Debtor was not delinquent on the leases Mr. Larson paid off. He testified he paid these off to stop the drain on Debtor's monthly cash flow. It is noteworthy that Mr. Larson personally guaranteed all the leases he paid off except one to United Capital. He testified all lease payoffs were discounted through negotiations, no leases remain and all equipment has been turned over or sold. He testified that he loaned Debtor \$12,000 without court authority to help pay off leases. The lease payoffs eliminated not only the corporate obligation but Mr. Larson's personal debt as well. Mr. Larson had personally guaranteed leases totaling at least \$200,000. When asked whether he was acting as Debtor's president or as personal guarantor of the leases when negotiating payoff, Mr. Larson stated he was not able to separate between the two.

No court approval was sought for the sale of leased equipment or pay-off of the leases. Exhibit 31 shows all the lease payoffs occurred postpetition.

Exhibit 28 includes correspondence between Mr. Larson and Jim Hollis regarding Debtor's lease with IBC, Mr. Hollis' company. In the email, Mr. Larson indicates that "the court has ordered that [Debtor] stop paying on all leases" and offers immediate payoff of the lease at a discount. When his offer was not accepted, Mr. Larson's subsequent email to IBC states "go away as agreed or I'll get my funds back by court order." Mr. Larson testified he was under the impression that he could get back previous payments to IBC with a court order. He also stated the court had not ordered Debtor to stop paying on leases but he had been so instructed by his attorney. Mr. Larson testified he was trying to get Mr. Hollis to back down on an extra payment of \$5,494 IBC was demanding.

Mr. Larson's employment contract with Debtor expired some time ago. His salary is determined by Debtor's Board of Directors, of which Mr. Larson is a member. Mr. Larson's salary is \$104,000 per year, although this is not in writing. The Board has had no meetings in some time.

Mr. Larson testified regarding payments made to him by Debtor postpetition but not reported as compensation to an insider. He explained Debtor is unable to get a company credit card so he makes charges on his personal credit card for Debtor and gets reimbursed. He characterized one amount which was defined as "computer allowance" as a "dumb bookkeeper error". He stated he does not get a computer allowance but used his credit card to buy computer equipment for Debtor. Mr. Larson testified that all payments received from Debtor postpetition that were not net payroll were expenses reimbursed by Debtor based on receipts provided by Mr. Larson. He explained that the increase in his net payroll payment in November reflects a change in the number of exemptions he claims as all his social security and income taxes have been paid for 2002.

Debtor made some changes to registration of internet domain names for IWI and TechHeads, among others. With the change, "Founders Group" became the administrative contact and the address became Mr. Larson's home address. He testified that Debtor made appropriate changes on multiple domain names and

inadvertently made these inappropriate changes to the IWI and TechHeads domain names. Apparently, the inappropriate changes have now been reversed.

Mr. Larson testified that Debtor will have approximately \$30,000 positive cash flow in the future with which to fund a successful plan of reorganization. This includes net ordinary income before depreciation and amortization expense. Expenses have reduced in the past few months. Significantly, Debtor's payment to its wholesaler reduced by \$15,000 per month. Subscriber attrition is leveling off as are expenses. Mr. Larson testified Debtor has \$49,720 cash balance in corporate accounts as of the end of November.

CONCLUSIONS OF LAW

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

(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 § 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." 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). The statutory list of causes is not exhaustive; 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. 1984).

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The first aspect of § 1112(b)(1) requires a showing of a "continuing loss to or diminution of the estate." In re Schriock Construction, Inc., 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.

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 Construction, 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.

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.

Debtor proposes to use money allocated to the non-cash expenses of amortization and depreciation to fund its plan. Courts are skeptical of approving plans which project such funding. Schriock Construction, 167 B.R. at 577 (rejecting plan which failed to make provision for depreciation, amortization, interest, income tax and materials); In re Agawam Creative Mktg. Assocs. Inc., 63 B.R. 612, 620-21 (Bankr. D. Mass. 1986) (disapproving a plan where, among other reasons, a depreciation expense item is used to obtain cash flow to service debt). This Court has stated that depreciation may be ignored altogether only if the debtor has set aside sufficient funds to replace the depreciated assets at the end of their useful life. In re Fort Knox Mini Warehouse, Inc., 2002 WL 1842452, at *5 (Bankr. N.D. Iowa Jul. 31, 2002).

Cause to convert or dismiss under § 1112(b) can be based on a debtor-in-possession's dereliction of its fiduciary duty to creditors. In re V Companies, 274 B.R. 721, 726 (Bankr. N.D.

Ohio 2002). Such breach of duty includes self-dealing by the debtor's principal, failure to abide by court orders or maintaining ongoing financial transactions with an insider. Id. Cause for conversion exists where the court has a lack of confidence in a principal's ability and inclination to comply with fiduciary duties of a debtor in possession. In re Hampton Hotel Investors, L.P., 270 B.R. 346, 358 (Bankr. S.D.N.Y. 2001).

ANALYSIS

Debtor has been provided significant opportunity to restructure its business through the protection of the Bankruptcy Code. Debtor's present Chapter 11 petition has been pending for at least 10 months with no confirmable plan on file. Discrepancies in Debtor's financial picture appear in its month-to-month reports. Recent reports show fairly consistent net losses over the period since this Chapter 11 case has been pending. Debtor's supposed positive net gain in October is now undermined by Debtor's November monthly report filed after the hearing.

The Court concludes IWI has met its burden to prove a continuing loss to or diminution of the estate under § 1112(b)(1). Debtor reports net losses each month from May through October in amounts ranging between (\$968.21) and (\$121,512.38). The number of Debtor's subscribers has reduced significantly.

Postpetition monthly reports include monthly amortization expense of \$20,387 and depreciation expense which has declined from \$16,432 to \$12,565. Debtor proposes to rely on the cash flow attributed to depreciation and amortization expenses to fund its plan payments. Even if such funding is appropriate, Debtor's historical figures fail to support a finding that its cash flow will be sufficient to fund plan payments even at a reduced rate of \$20,000 per month. Debtor's average monthly net losses would offset cash flow attributable to monthly non-cash expenses such that even a \$20,000 monthly payment is not supported by historical data.

The likelihood of reorganization is also undercut by the number of objections raised to Debtor's proposed plans. Furthermore, significant claims disputes have arisen. Debtor now reports a cash balance of approximately \$47,000. This is insufficient, however, to support

