

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)	
)	
PAPP INTERNATIONAL, INC.,	)	CASE NO. BK91-81297
)	
DEBTOR	)	CH. 11
	)	Fil. 20 & 82

MEMORANDUM

Hearing was held on April 6-9, 1993, on the Motion to Dismiss filed by the Estate of Joseph Papp, Jr. The motion was joined in by UPC. Appearing on behalf of Trustee was David Crawford of Schmid, Mooney & Frederick, P.C., Omaha, Nebraska. Appearing on behalf of petitioning creditors and Kneifl was Patrick Betterman of Betterman & Katelman, Omaha, Nebraska. Appearing on behalf of petitioning creditors was Paul Festersen of Omaha, Nebraska. Appearing on behalf of Estate of Joseph Papp and UPC were T. Randall Wright and Kathryn Derr of Dixon & Dixon, P.C., Omaha, Nebraska. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(A).

Background

Papp International Incorporated is a Nebraska corporation which is the assignee and owner of a patent concerning certain technology related to a new fuel source for engines.

The corporation was initially capitalized with an assignment to it by Joseph Papp, Jr., (Papp or Mr. Papp) of a then pending patent application and appurtenant rights, in exchange for which he received 3,900 shares of common stock, amounting to approximately 83% of the issued and outstanding shares. In 1984, Patent No. 4,428,193 was issued to the debtor corporation. The patent is styled "Inert Gas Fuel, Fuel Preparation Apparatus System for Extracting Useful Work from the Fuel." Over the years, additional shares of stock were issued to various parties, including the petitioning creditors in this involuntary Chapter 11 case. The petitioning creditors, J. Gayle Gibson, Henry Orthman and Clarence Folkerts and their related entities are owners of approximately 3% of the issued and outstanding shares of stock in the debtor. These three individual petitioning creditors are also officers and directors of the corporation. An

additional petitioning creditor, Orthman Manufacturing, Inc., is not a shareholder in the debtor, but is an entity founded and operated by Henry Orthman and others.

Joseph Papp, Jr., invented the fuel for which the patent was issued and built or had built an engine which is operated by use of the fuel. Mr. Papp, sometimes using the corporate entity, and apparently, on other occasions, acting individually as if he owned the patent, raised hundreds of thousands, if not millions of dollars, to promote the development and commercialization of the invention. He entered into a licensing agreement and other types of agreements with various entities around the United States and he and the corporation became embroiled in litigation in various parts of the country resulting from his activities.

Sometime in the 1980's, Mr. Papp entered into an agreement with an entity which shall be referred to as UPC. Pursuant to contractual arrangements between Mr. Papp and UPC, he transferred his 3,900 shares of stock in the debtor to UPC and caused the stock records of the debtor to reflect the ownership of the shares by UPC.

Eventually, there was litigation between the debtor, Mr. Papp, UPC and others in the Federal District Court in the Northern District of Oklahoma. A settlement was reached which provided for the return of 3,900 shares of stock from UPC to Mr. Papp and provided for other considerations exchanged between the parties, including a contract for development of the technology to be entered into by Papp and an entity which shall be referred to as ACES.

The settlement document, Exhibit 28, at paragraph 3(H) provides that ACES and Mr. Papp will enter into an agreement to develop and ultimately sell the Papp Engine and that if they are successful, they will be required to pay a royalty to UPC. At paragraph 3(L) of the settlement document, the parties agreed "that this settlement agreement is contingent upon the agreement between ACES and PAPP for the development and sales of engines for electrical power generation."

Mr. Papp died in 1989, before he executed an agreement with ACES. The personal representative of Mr. Papp's estate obtained a certificate representing the 3,900 shares of the debtor, properly endorsed from UPC to the estate of Mr. Papp. However, the directors of the corporation refuse to acknowledge the interest of the personal representative and refuse to record on the books and records of the corporation the personal representative's ownership interest in the shares of stock.

The personal representative of the estate of Mr. Papp has in his possession some, if not all, of the documents, fuel apparatus and engine for which the patent was originally issued. Apparently the widow of Mr. Papp has some papers concerning the patent and the designs for a working engine. From the evidence, it appears that there are other parties who had entered into various arrangements with Mr. Papp over the years who have possession of some documents or equipment related to the development of the fuel technology and the engine. The one entity that doesn't have any of the documentation or the equipment is the debtor. It has only a patent.

Litigation and controversy did not cease upon the death of Mr. Papp. In the probate of his estate in Florida, there is litigation between the personal representative, the Internal Revenue Service, and others who claim an ownership interest in the patent or in the documents and/or equipment concerning the technology.

In Nebraska, the remaining directors were unable to come to an agreement with the personal representative with regard to the rights of the debtor versus the rights of the personal representative. Therefore, the Board of Directors decided to attempt to reorganize the debtor, obtain financing, and proceed with the development and commercialization of the patent and the technology. In order to do so, a majority of the members of the Board of Directors, Mr. Orthman, Mr. Folkerts and Dr. Gibson, held a special meeting of the Board of Directors in April of 1991 and at that meeting they passed a resolution to authorize the corporation to compensate all the directors for the expenses they had incurred over the years in traveling to various board meetings and participating in litigation and to reimburse those directors for contributions that they had made in the form of loans to the corporation to permit the continuing operation of the business. Those "loans" had been in the form of cash advances either to the corporation or to Mr. Papp to support the development of the technology.

Prior to the passage of the resolution in April of 1991, the corporation had no debt. It also had no assets, other than the patent rights, and it had no operations, no employees and no revenue. In other words, it had no money in the bank and no ability to pay anybody anything. Within two months of the adoption of the resolution by the Board of Directors, the three individual members of the Board mentioned above and Orthman Manufacturing Co., an entity that allegedly had provided some services to the debtor, signed a petition to place Papp International Incorporated in an involuntary Chapter 11 case.

According to the petitioning creditors, they and their related companies, such as Energy Executives, which allegedly had also "loaned" the debtor \$3,000.00 at some point in time, were the only creditors. Therefore, they were the only parties to receive notice of the filing of the petition. The personal representative of the estate of Mr. Papp did not receive notice of the filing of the petition because the directors would not acknowledge that the personal representative had an interest. Since only insiders received notice of the filing, no objections were received by the Court and an Order for Relief was entered in August of 1991. Shortly thereafter, the personal representative did discover the filing and brought this motion to dismiss.

Soon after the Order for Relief was entered, the petitioning creditors, all of whom are insiders, requested the appointment of a trustee and, after notice and hearing, a Chapter 11 trustee was appointed.

Motion

The personal representative of the estate of Joseph Papp and UPC have filed a motion to dismiss the case. They claim that the petitioning creditors are not actually "creditors" of the debtor. The movants also claim that the petitioning creditors will not be able to obtain confirmation of a plan because of various statutory problems.

The Court will not deal with the alleged statutory problems concerning confirmation, because those issues can be addressed at the time a plan is submitted for confirmation. The real issue in this case is whether the petitioning creditors actually hold claims which entitle them to file this petition and entitle them to present a plan of reorganization.

Findings of Fact, Conclusions of Law, Discussion

The question of whether or not the petitioning creditors are actually claimholders requires a rather straight-forward analysis. The by-laws of the corporation, Exhibit 34, at Article III, Section 9, state, in appropriate part: "By resolution of the Board of Directors, the directors may be paid their expenses, if any, of attendance at each meeting of the Board of Directors, and may be paid a fixed sum for attendance at each meeting of the Board of Directors or a stated salary as director." In Article V, Section 2, the bylaws state: "No loans shall be contracted on behalf of the corporation and no evidences of indebtedness shall be issued in its name unless authorized by a resolution of the Board of Directors. Such authority may be general or confined to specific instances."

At a special meeting of the Board of Directors held on April 27, 1991, three of the four directors were present, those three being Mr. Folkerts, Mr. Orthman and Dr. Gibson. The minutes of the meeting, Exhibit 25, reflect the following:

The question of expenses incurred by Directors of the Board since 1984 was discussed at length. Clarence Folkerts made the motion that they are to be repaid by the Corporation as are all other out-of-pocket expenditures (advances) contributed by the Directors for travel expense, loans to the Corporation, and other related expenditures since the commencement of their involvement with the corporation and/or Joseph Papp. The motion was seconded by Dr. Gayle Gibson. A vote was called for and was unanimous by all Directors.

After the bankruptcy petition was filed and an order for relief entered, the petitioning creditors, and others, filed proofs of claim. The proof of claim of Clarence Folkerts, Exhibit No. 36, is in the amount of \$1,602.94. It consists of a schedule of travel expenses incurred between January 20, 1991, and April 27, 1991, in the amount of \$428.80. It also includes \$1,000.00 representing principal of a "loan" and \$174.14 representing accrued interest on that "loan" from the date of the "loan," March 12, 1990, through June 16, 1991.

The claim of Henry Orthman, Filing No. 38, is in the amount of \$50,949.13. Schedules attached include supporting documentation for "loans" which were cash advances to the checking account of the corporation beginning in late January of 1988, the first time a checking account was opened for the corporation. The documentation also includes what Mr. Orthman has characterized as loans to the corporation for trips or expenses incurred by Joseph Papp specifically on trips to Tulsa, Oklahoma, and San Jose, California. Those amounts, which total \$3,812.00 of actual advances, did not pass through the corporate checking account. Finally, the claim includes more than \$25,000.00 in travel and lodging expenses incurred at various meetings of the Board of Directors and shareholders, meetings with outsiders concerning the development of the technology or financing of the technology and participation in conferences concerning pending litigation. Interest has been added to the actual out-of-pocket expenses reflected in the claim.

The proof of claim of Dr. Gibson, Exhibit 40, is in the amount of \$43,414.36. It includes a number of direct cash advances made to the corporate checking account in the

approximate amount of \$12,300.00. To that amount, Dr. Gibson has added interest. The claim also includes what Dr. Gibson has characterized as loans to the corporation for expenses incurred by Joseph Papp. These amounts, totaling \$6,000.00 plus accrued interest, are not reflected as deposits to the corporation or payments by the corporation. The balance of the claim consists of out-of-pocket expenses from June 14, 1984, through April 26, 1991, in the amount of \$19,516.72, plus accrued interest.

The Orthman Manufacturing, Inc., claim, Filing No. 39, is in the amount of \$8,007.30. It consists of a statement for professional fees paid by Orthman Manufacturing, Inc., to Shonsey & Associates, a CPA firm, relating to Papp International, Inc. It also includes travel expenses of Mr. W. H. Orthman in January, 1991, to attend a Board of Directors meeting of the debtor. Mr. W. H. Orthman is not a director or shareholder or officer of debtor. Finally, the claim includes labor expense of an employee of Orthman Manufacturing, Inc., for review of the history of Papp International, Inc., and other work relating to a restructuring plan for Papp International, Inc.

The Court finds as a fact that at least a portion of the claims of the individual petitioning creditors are legitimate claims. The Bankruptcy Code, at 11 U.S.C. § 101(5), defines a "claim" as: "(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." The Board of Directors had authority from the bylaws of the corporation to compensate directors for out-of-pocket expenses related to attendance at meetings of the Board of Directors. The Board did, at its April 27, 1991, meeting, authorize the directors to be compensated for their out-of-pocket expenses. Nebraska law permits directors to determine their own compensation unless prohibited by the articles of incorporation. Neb. Rev. Stat. § 21-2035 (Reissue 1987). There is no evidence that the articles of incorporation of the debtor prohibit such action. Therefore, they have a facially valid claim, in some amount, to be reimbursed for their out-of-pocket expenses related to attendance at Board meetings.

There was testimony at the trial from each of the individual petitioning creditors that at the time the expenses were incurred, they each realized they would not be compensated in the short run because the corporation had no money and because Joseph Papp would not authorize reimbursement of any expenses. Therefore, none of the petitioning creditors anticipated, at the time the expenses were incurred, that they would be reimbursed until and unless the corporation was successful. However, the fact that they did not anticipate being reimbursed until the

invention was successfully marketed does not prohibit the Board of Directors, at any time, from exercising its right under the appropriate bylaw to authorize reimbursement. The Board did so authorize and the petitioning creditors have presented uncontroverted evidence of their actual out-of-pocket expenses. Therefore, for purposes of this motion to dismiss, the petitioning creditors do have claims which entitle them to bring this bankruptcy petition and to submit a plan of reorganization.

The Court cannot now determine the actual amount of any claim by the petitioning creditors. Since some of the expenses incurred did not relate to attendance at Board meetings, those expenses were not authorized by the resolution of the Board of Directors on April 27, 1991, because there is no authority in the bylaws for such authorization.

There is a significant issue with regard to the allowability of that portion of the claims of the individual petitioning creditors which are supported by documentation concerning loans. First, some of the loans relate to payment of the expenses of Joseph Papp. The funds went directly from the individual petitioning creditors to Mr. Papp or to an entity providing services to Mr. Papp. The funds did not go through the corporation. That being the case, it is questionable whether these advances can be considered legitimate loans to the corporation, rather than loans or gifts to Mr. Papp. Although Mr. Orthman testified about these expense advances and the other loans to the effect that he did not intend to make a gift, he also testified that he did not expect to be reimbursed until the technology was successfully developed and it is clear from the testimony of Mr. Orthman and the other witnesses that the corporation was not actually run as a corporation, but was rather run as a fund for the personal benefit of Joseph Papp during the development process. Contributions by shareholders, directors or others to Mr. Papp for his travel expenses are not necessarily to be construed as loans to a corporation.

In addition to the "loans" which represent advances to Mr. Papp for his expenses, there is a serious question about the allowability of all or part of the "loans" represented by advances which did pass through the checking account of the corporation. Those cash advances to the corporation from Mr. Orthman, Mr. Folkerts and Dr. Gibson and cash advances from Energy Executives, a company in which one or more of the individual petitioning creditors have an ownership interest, have been submitted to the Court in the form of promissory notes executed by the appropriate corporate officers in favor of the claimants. However, the Court finds as a fact from the testimony presented by Mr. Orthman, Mr. Folkerts, Dr. Gibson and Mr. Kneifl

that at the time the advances were made, there was no discussion amongst the directors, shareholders and/or officers, of a date of repayment, an interest rate, or a requirement that the corporate liability be recorded by the creation of a promissory note. Instead, the promissory notes which are attached to the various proofs of claim were prepared by Mr. Kneifl after the order for relief was entered and the terms contained therein were terms that he determined were appropriate, rather than terms the Board of Directors or officers had agreed to at the time the funds were advanced. Therefore, although it is possible that the principal amount of the cash advances could be considered "loans" and could be considered as authorized by the resolution of the Board of Directors on April 27, 1991, the validity and enforceability of the promissory notes themselves is subject to further litigation in the claims process.

The proof of claim filed by Orthman Manufacturing is based on services allegedly rendered to debtor. However, there are no Board minutes requesting such services or agreeing to financial terms for such services. Therefore, the liability of the debtor, as opposed to Mr. Henry Orthman, for such expenses is questionable.

The evidence is fairly clear that the shareholders and directors of this corporation did not, during the life of Mr. Papp, religiously follow the corporate niceties, such as having shareholder meetings as required by the bylaws and having appropriate elections of directors on an annual basis. In addition, the corporation did not maintain a checking account or financial books and records. The corporation appears to have been a shell holding only a patent. Mr. Papp, from the evidence presented at this trial, appears to have operated totally separately from the corporation with regard to raising money for the development of the technology and it appears that he entered into licensing agreements with various entities as if he himself owned all of the rights to the technology, rather than the debtor owning such rights.

In the year immediately preceding his death, the corporation did set up a checking account and did funnel some cash advances from directors through the checking account. However, other than minimally recording minutes of directors' meetings, the directors and officers still did not comply with the requirements of the bylaws of the corporation with regard to holding shareholder meetings. After the death of Mr. Papp, the Board of Directors continued to act as if they were the majority shareholders, and refused to acknowledge the rights of the true majority shareholder, either UPC or the estate of Joseph Papp, and

continued to fail to comply with the bylaws by failing to hold annual shareholder meetings.

Even though the Board has not exactly followed the letter or the spirit of corporate governance, its individual members do hold claims against the debtor. They do have the right to file this petition and they have the right under the Bankruptcy Code to file a plan of reorganization. Whether they can obtain confirmation of a plan, or whether their claims will be allowed as filed, disallowed in part or subordinated to the interest of others, is a question which can be resolved in the future. Contrary to the position of the moving parties, there are other non-insider claimants. Those claimants may or may not be treated in a particular class and the class in which they are treated for purposes of confirmation, may or may not be impaired. This court has reviewed the disclosure statement which has been filed by the petitioning creditors and it does appear from such disclosure statement that the plan which is now on file treats claimants other than these petitioning creditors in a manner which could be construed as impairing their interests. This is not, as alleged by movants, simply a case of three insiders versus the estate of Joseph Papp for control of this corporate entity. Other non-insiders have filed claims which can be dealt with in a plan of reorganization.

Decision

The motion to dismiss is denied. The Clerk shall now schedule a hearing on the disclosure statement and objections.

Separate journal entry to be entered.

DATED: July 6, 1993.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)	
)	
PAPP INTERNATIONAL, INC.,	)	CASE NO. BK91-81297
	)	A
<u>DEBTOR(S)</u>)	
	)	CH. 11
	)	Filing No. 20 & 82
Plaintiff(s))	
vs.	)	<u>JOURNAL ENTRY</u>
)	
)	
	)	DATE: July 6, 1993
<u>Defendant(s)</u>	)	HEARING DATE: April 6-9, 1993

Before a United States Bankruptcy Judge for the District of
Nebraska regarding Motion to Dismiss.

APPEARANCES

David Crawford, Attorney for Trustee
Patrick Betterman, Attorney for petitioning creditors and Kneifl
Paul Festerson, Attorney for petitioning creditors
T. Randall Wright and Kathryn Derr, Attorneys for Estate of
Joseph Papp and UPC

IT IS ORDERED:

Motion to Dismiss denied. See memorandum entered this date.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge