

1 **MEMORANDUM DECISION AND ORDER GRANTING JUDGMENT AGAINST**
2 **DEFENDANT HALIFAX INVESTMENTS, LLC AND GRANTING JUDGMENT IN FAVOR**
3 **OF DEFENDANTS SHEILA LEMIRE, FRANK SCHAEFER, FRANK SCHAEFER**
4 **CONSTRUCTION, INC., FRANK SCHAEFER CONSTRUCTION, INC. PENSION PLAN**
5 **AND JOHN SCAFANI**

6 The court held a trial on Plaintiff Chapter 7 Trustee Leslie T. Gladstone’s Complaint against
7 Defendants Frank Schaefer, Frank Schaefer Construction, Inc., Frank Schaefer Construction, Inc.
8 Pension Plan (together the “Schaefer Entities”), John Scafani, Halifax Investments, LLC (“Halifax”) and Sheila Lemire. Plaintiff’s Complaint seeks to avoid several transfers arising out of a series of loan
9 transactions to finance the acquisition and initial development of real property held by Debtors UC
10 Lofts on 4th, LLC and UC Lofts on 5th, LLC (collectively “Debtors” or “UC Lofts”). Plaintiff has
11 failed to meet her burden to hold the Schaefer Entities, Sheila Lemire or John Scafani liable. The
12 court therefore awards judgment in their favor. But the Trustee has established that the prepetition
13 settlement payment from Debtors to Halifax is avoidable as a fraudulent transfer. The court therefore
14 awards judgment against Halifax in the amount of \$1,100,000 plus interest.

15
16 **I. JURISDICTION AND VENUE**

17 The court has jurisdiction to hear this matter pursuant to 28 U.S.C. §§ 157(b)(2)(F), (H), (O),
18 (c)(1); 1334(b). Venue is proper under 28 U.S.C. §1409(a). All parties have expressly consented to
19 this court’s authority to hear and determine the claims asserted in the Trustee’s Complaint and
20 remaining in the pretrial order.¹

21
22 **II. PROCEDURAL HISTORY**

23 The Trustee has asserted claims against the Schaefer Entities for: (1) avoidance and recovery of
24 fraudulent transfers; (2) avoidance and recovery of a preferential transfers; (3) aiding and abetting
25 breach of a fiduciary duty; (4) declaratory relief that Frank Schaefer was a partner of UC Lofts; (5)
26 equitable subordination of Frank Schaefer Construction, Inc.’s claims; (6) breach of fiduciary duty to

27
28 ¹ ECF Nos. 434, 435. This memorandum decision may likewise constitute the court’s findings of fact and conclusions of law under Federal Rule of Bankruptcy Procedure 7052(a)(1).

1 UC Lofts; and (7) conversion. Plaintiff also seeks to avoid allegedly fraudulent transfers to, or for the
2 benefit of, Defendants Lemire, Scafani and Halifax.

3 The court bifurcated the issues for trial into: (1) insolvency; and (2) all others. The court held a
4 trial in February 2012 on insolvency and issued a memorandum decision finding that the Trustee had
5 failed to prove Debtors were insolvent on February 12, 2004. The Schaefer Entities then moved for
6 summary judgment, which the court granted as to two of the Plaintiff's usury claims and denied in all
7 other respects.

8 The court conducted an eight-day bench trial on the remaining issues in this adversary
9 proceeding. On the seventh day of trial, Plaintiff orally moved to conform the pretrial order to proof
10 by adding a claim for fraudulent transfer against the Schaefer Entities and Lemire. Finding that
11 relevant and material evidence had come in without objection, and that Defendants faced no substantial
12 prejudice, the court granted the motion.

13 14 **III. FACTUAL BACKGROUND AND FINDINGS**

15 **A. The Debtors' Structure and Real Property**

16 At all relevant times, Urban Coast, LLC ("Urban Coast") was the sole owner and managing
17 member of UC Lofts on 4th, LLC and UC Lofts on 5th, LLC.² Urban Coast's only assets were its
18 membership interests in the Debtors. Before February 12, 2004 and until December 2006, UC Lofts
19 on 4th, LLC owned two parcels of real property on Fourth Avenue in San Diego, California. UC Lofts
20 on 5th, LLC owned a single parcel of real property located on Fifth Avenue, San Diego, California,
21 which is contiguous with the two parcels owned by UC Lofts on 4th, LLC (the three parcels are
22 collectively referred to as the "UC Lofts Real Property"). UC Lofts' stated purpose was to develop a
23 mixed-use facility on the UC Lofts Real Property known as the Atmosphere Project.

24 **B. Charles McHaffie's Acquisition of the Urban Coast, LLC Membership Interests**

25 Before February 12, 2004, Defendant Halifax held a forty-nine percent stake in Urban Coast.
26 Defendant John Scafani wholly owned and managed Halifax. A consortium made up of 6th and
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28 ² Pretrial Order, ECF No. 435, pp. 7-10. The court incorporates the stipulated facts contained in the
pretrial order and only mentions those necessary to support this decision.

1 Broadway Corporation, Broadsmore Capital, LLC, Peter Kostopoulos and Matthew Gordon (the
2 “Broadsmore Group”) owned the majority 51 percent interest.³ In February 2004, Charles McHaffie
3 purchased 100 percent of the membership interests in Urban Coast in two contemporaneous sale
4 agreements with Halifax and the Broadsmore Group. McHaffie paid \$2,452,803 for the Broadsmore
5 Group’s interests: \$1,899,625 in cash and \$552,803 in a promissory note secured by a deed of trust on
6 real property held by La Bella Vida, L.P.⁴

7 As consideration for Halifax’s membership interest, Urban Coast executed and delivered to
8 Halifax a \$1,600,000 promissory note (“Halifax Sale Agreement”).⁵ The Halifax Sale Agreement lists
9 McHaffie as the “Buyer,” John Scafani as the “Broker,” Urban Coast as the “Company” and Halifax as
10 the “Seller.”⁶ The Halifax Sale Agreement required McHaffie and Urban Coast to pay the purchase
11 price, which the parties intended to be secured by the UC Lofts Real Property.⁷ The agreement granted
12 Scafani: (1) exclusive rights to broker sales of condominium units, parking and commercial space in
13 the Atmosphere Project; (2) commissions; and (3) options to purchase units in the Atmosphere
14 Project.⁸ Halifax and Scafani promised to refrain from recording the security instrument until Urban
15 Coast obtained construction financing.⁹ But the agreement stated that Halifax’s note should enjoy the
16 same priority as the eventual construction loan.¹⁰

17 Both the Halifax Sale Agreement and accompanying note expressly provided that the
18 obligations run to Urban Coast and McHaffie personally.¹¹ Although McHaffie pledged the UC Lofts
19 Real Property as collateral for the note, the UC Lofts were not parties to the Halifax Sale Agreement.
20 Consequently, the court finds that the Halifax Sale Agreement and accompanying note did not impose
21 obligations on the Debtors.

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24 ³ Pl.’s Ex. 4.

25 ⁴ Pl.’s Ex. 4.

26 ⁵ Pl.’s Ex. 4, 5.

27 ⁶ Pl.’s Ex. 4.

28 ⁷ Pl.’s Ex. 4.

⁸ Pl.’s Ex. 4.

⁹ Pl.’s Ex. 4.

¹⁰ Pl.’s Ex. 4.

¹¹ Pl.’s Ex. 4, 5.

1 **C. The Loan Transactions and Transfers**

2 **1. The First Loan Transaction in February 2004**

3 McHaffie borrowed acquisition capital to finance his purchase of Urban Coast and leveraged
4 the UC Lofts Real Property to secure these loans. The First Loan transaction occurred in February
5 2004, and was comprised of: (1) \$4,000,000 from the Barth Family to UC Lofts (the “Barth Note”);
6 and (2) \$1,750,000 from Frank Schaefer Construction Inc. Pension Plan to UC Lofts. A first position
7 deed of trust secured the Barth Note, and a second position deed of trust secured the Schaefer Entities’
8 note.

9 At that time, two separate deeds of trust securing a purported \$3,400,000 obligation in favor of
10 Urban Coast (the “UC DOT”) and a \$100,000 obligation in favor of SD Lofts, LLC (the “SD Lofts
11 DOT”) encumbered the UC Lofts Real Property. But Defendant Scafani testified credibly that no
12 accompanying note existed to support the UC DOT. Nor did Plaintiff provide any evidence of a signed
13 note. Further, McHaffie signed for SD Lofts, LLC in all relevant transactions. Ultimately, both the
14 SD Lofts DOT and the UC DOT were reconveyed. Neither SD Lofts, LLC nor Urban Coast ever
15 demanded payment on these purported obligations during the relevant period between February 13,
16 2004 and November 24, 2004. The court therefore finds that the UC DOT and SD Lofts DOT were
17 not liabilities owed by Debtors. Nevertheless, to facilitate the First Loan transaction, Urban Coast and
18 SD Lofts, LLC agreed to subordinate their respective trust deeds.

19 McHaffie applied \$4,527,600 from the First Loan proceeds to purchase his interests in Urban
20 Coast and deposited the remaining \$1,222,400 into a fund control account (the “First Fund Control”) to
21 hold advanced loan proceeds until Schaefer approved disbursements. At roughly the same time, the
22 parties entered into an agreement to govern disbursements out of the fund control account (the “Fund
23 Control Agreement”).¹² The parties based the \$1,222,400 figure on a proposed budget for the
24 project.¹³ Specifically, the budget accounted for:

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26 _____
27 ¹² Defs.’ Ex. A-X. Only McHaffie executed this particular document. But the parties stipulated to its
28 admissibility. The subsequent loan transaction documents presumably refer back to this Fund Control
Agreement.

¹³ Pl.’s Ex. 98, 102; Trial Tr. vol. 5, 36-37, Dec. 13, 2013, ECF No. 450.

- 1 • Fund Control Fee: \$1,000
- 2 • Management & Supervision: \$200,000
- 3 • Shoring / Concrete: \$350,000
- 4 • Architect / Engineering: \$78,000
- 5 • Excavate / Haul / Recycle: \$250,000
- 6 • Model: \$21,000
- 7 • Legal: \$25,000
- 8 • Barricades: \$34,000
- 9 • Equipment Rental: \$61,300
- 10 • Contingency: \$202,100.¹⁴

11

12 Between February 12, 2004 and April 2, 2004, the Debtors made the following transfers with

13 the First Loan proceeds from the First Fund Control, which the Trustee alleges did not benefit Debtors

14 or were unrelated to the Atmosphere Project:

- 15 • \$20,000 on February 23, 2004 to Frank Schaefer Construction, Inc. Pension Plan for
- 16 “Reimbursement-Management;”
- 17 • \$5,000 on March 5, 2004 to James Warner, Esq. for “Legal;”
- 18 • \$20,000 on March 5, 2004 to Charlemagne McHaffie for “Funds to Borrower;”
- 19 • \$50,000 on March 8, 2004 to Ron Bedell for “Commission;” and
- 20 • \$20,000 on April 1, 2004 to Charlemagne McHaffie with no stated purpose.¹⁵

21 **2. The April 2, 2004 Loan Transaction**

22 On April 2, 2004, Frank Schaefer Construction Inc. extended UC Lofts another \$1,200,000

23 loan (the “April 2, 2004 Loan”). This loan was secured by a third position deed of trust on the UC

24 Lofts Real Property. And Urban Coast and SD Lofts, LLC again agreed to subordinate their deeds of

25 trust to the April 2, 2004 Loan.

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28 ¹⁴ Pl.’s Ex. 102.

¹⁵ Pl.’s Trial Br., ECF No. 429, p. 8; Pl.’s Ex. 14.

1 Although the \$1,200,000 never entered a bank account for the Debtors, Schaefer testified that
2 he sent the funds through escrow.¹⁶ Plaintiff offered no contradictory evidence to rebut this assertion.
3 The court therefore accepts that the funds entered escrow before Debtors first took possession of them.

4 McHaffie used the April 2, 2004 Loan proceeds to exercise an option to purchase a Nevada
5 limited liability company, Tropicana Partners, LLC. Tropicana Partners, LLC's primary asset was
6 commercial real property in Las Vegas, Nevada. McHaffie testified that he set up yet another LLC –
7 Urban Coast, LLC Nevada – to exercise the option and hold the membership interests.¹⁷ The
8 Tropicana Partners, LLC membership interests and the Las Vegas real property (together “Tropicana”)
9 never graced Debtors’ balance sheet.

10 McHaffie planned to resell Tropicana at a substantial profit. He would then redirect the funds
11 to finance the Atmosphere Project. But that did not happen. Instead, McHaffie failed to make any
12 significant progress toward selling the Las Vegas property. When Schaefer threatened to foreclose, the
13 parties negotiated a compromise. McHaffie would assign Tropicana to Frank Schaefer in full
14 satisfaction of the April 2, 2004 Loan, which had an unpaid balance of \$1,500,000. The parties
15 finalized the settlement in December 2004, but only after Schaefer had recorded a notice of sale on the
16 UC Lofts Real Property.

17 Schaefer estimated the Las Vegas property to be worth \$5,000,000 to \$6,000,000 around the
18 time of the transfer. But it had an existing \$2,000,000 to \$2,600,000 first mortgage on it, which he
19 assumed. The property also had many vacancies and required substantial repairs. Lemire paid
20 Schaefer \$70,000 for an option to buy the property for the \$1,500,000 he “had in it plus some carrying
21 costs,” which increased daily.¹⁸ She also borrowed against the property to fund improvements.
22 Schaefer attested that Lemire successfully filled vacancies through her efforts. About a year later,
23 Lemire sold the property for \$5,750,000 and paid off the \$2,100,000 owed to Schaefer.¹⁹ She testified

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25 ¹⁶ Trial Tr. vol. 5, 44, ECF No. 450.

26 ¹⁷ Trial Tr. vol. 2, 165:9-12, Dec. 5, 2013, ECF No. 442. Minutes later, McHaffie recanted, stating, “It
27 might have been Urban Coast California.” Trial Tr. vol. 2, 178:22, ECF No. 442. Regardless, he made
28 clear it was not UC Lofts on 4th, LLC or UC Lofts on 5th, LLC.

¹⁸ Trial Tr. vol. 6, 15:13-21, Dec. 18, 2013, ECF No. 462; Trial Tr. vol. 8, 12:24-25, Dec. 19, 2013,
ECF No. 473.

¹⁹ Trial Tr. vol. 8, 54:22-55:15, ECF No. 473.

1 that she realized between \$200,000 and \$400,000 net from the sale.²⁰ But she was not certain if she
2 actually received any of the proceeds because she had to pay off a loan at closing. Plaintiff presented
3 no direct evidence on this point other than Lemire's own testimony.

4 Meanwhile, the Debtors had transferred several hundred thousand dollars from the First Fund
5 Control in relation to the acquisition of Tropicana, which the Trustee also alleges benefitted the
6 Schaefer Entities. In addition to the April 2, 2004 Loan proceeds, the Debtors made the following
7 payments to acquire Tropicana:

- 8 • \$100,000 on May 20, 2004 to Santoro, Driggs for legal fees related to the Las Vegas
9 property;
- 10 • \$1,000 on May 24, 2004 to Lawyer's Title for title fees related to the Las Vegas
11 property;
- 12 • \$50,000 on May 26, 2004 to Fred Young for "Deposit, per borrower" related to the Las
13 Vegas property;
- 14 • \$5,010 on June 17, 2004 to Santoro, Driggs for legal fees related to the Las Vegas
15 property;
- 16 • \$10,000 on July 21, 2004 to Santoro, Driggs for legal fees related to the Las Vegas
17 property;
- 18 • \$300,000 on July 21, 2004 to Joy Turner for "Deposit, per borrower" related to the Las
19 Vegas property; and
- 20 • \$60,000 on July 21, 2004 to Santoro, Driggs for legal fees related to the Las Vegas
21 property.²¹

22 During this time period, the Debtors also made the following transfers from the First Fund
23 Control that were unrelated to the Tropicana acquisition or the Atmosphere Project:

- 24 • \$10,000 on May 14, 2004 to James Warner for legal fees;
- 25 • \$46,666.67 on July 8, 2004 to Pacific Horizon Financial for "Interest payment, 1st TD;"
- 26 • \$20,416.67 on July 8, 2004 to Action Loan Servicing for "Interest payment; 2nd TD."²²

28 ²⁰ Trial Tr. vol. 8, 80-81, ECF No. 473.

²¹ Pl.'s Trial Br., ECF No. 429, p. 9; Pl.'s Ex. 14.

1 The Trustee established that the last two transfers went to pay down interest on McHaffie's
2 personal residence. On August 17, 2004, the Debtors also made a \$36,000 interest payment toward the
3 April 2, 2004 Loan.²³

4 3. The Second Loan Transaction in September 2004

5 By the end of September 2004, less than \$100,000 remained in the First Fund Control.²⁴
6 Schaefer testified that the Debtors had insufficient money to pay the architects, Hawkins & Hawkins,
7 and needed a quick capital infusion to pay this invoice. Thus, on September 24, 2004, the Schaefer
8 Entities lent the Debtors another \$2,500,000 (the "Second Loan"), which was purportedly secured by
9 an assignment of a deed of trust.²⁵

10 The Schaefer Entities initially funded the loan with \$500,000 and charged \$35,312 as a loan
11 origination fee.²⁶ The Debtors directed \$100,000 of the Second Loan proceeds to pay Hawkins &
12 Hawkins and deposited the remaining \$365,688 into a second fund control account (the "Second Fund
13 Control").²⁷

14 After receiving the Second Loan Proceeds, the Debtors promptly depleted the First Fund
15 Control with the following transfers:

- 16 • \$37,000 on October 8, 2004 to Charlemagne Ed. Trust for "Funds to Borrower;"
- 17 • \$35,000 on October 8, 2004 to WS-TH²⁸ for "Funds to Borrower;" and
- 18 • \$10,000 on October 8, 2004 to Charlemagne McHaffie Trust for "Funds to Borrower."
- 19 • \$4,097.83 on October 15, 2004 to the City of San Diego to fund a bond.²⁹

20
21 After these transfers, the First Fund Control was overdrawn by \$2,179.50.³⁰

23 ²² Pl.'s Ex. 14.

24 ²³ Pl.'s Ex. 14.

25 ²⁴ Pl.'s Ex. 14.

26 ²⁵ On direct, McHaffie indicated that this was in fact the phantom \$3,400,000 UC DOT.

27 ²⁶ Pl.'s Ex. 34.

28 ²⁷ Pl.'s Ex. 34, 44.

²⁸ WS-TH apparently was a construction project on real property in Murrieta, California in which McHaffie and Warner were involved.

²⁹ Pl.'s Ex. 14.

³⁰ Pl.'s Ex. 14.

1 **4. The Third Loan Transaction and Halifax Settlement in November 2004**

2 By mid-November 2004, the First Fund Control displayed a negative balance, the Schaefer
3 Entities' notice of default remained on the UC Lofts Real Property, and the Debtors had no other
4 sources of capital. At the time Schaefer and McHaffie were negotiating the Tropicana transfer to
5 satisfy the April 2, 2004 Loan, they also discussed a possible new loan. The two transactions were
6 separate but related – Schaefer continued the foreclosure process to pressure McHaffie to negotiate. In
7 fact, the contemplated Tropicana transfer appears as a line item on a term sheet for the new loan in
8 November 2004.³¹

9 Meanwhile, Scafani and Halifax had filed a lawsuit in June 2004 against McHaffie and Urban
10 Coast for breach of the Halifax Sale Agreement and recorded a *lis pendens* on the UC Lofts Real
11 Property. Scafani testified that both McHaffie and Schaefer negotiated with him in November 2004,
12 although the only settlement offer came from Schaefer. Initially, Schaefer took the position that he
13 could simply foreclose on his senior lien to extinguish the *lis pendens*. Further, James Warner, Esq.,
14 who simultaneously represented McHaffie, Urban Coast and the Debtors at that time, observed that he
15 believed Scafani had probably recorded the *lis pendens* improperly.³² He opined that an improperly
16 recorded *lis pendens* could typically be expunged by ex parte or noticed motion for less than \$10,000.³³

17 Nevertheless, by early November 2004 Scafani, McHaffie and Schaefer had reached an
18 agreement to resolve the dispute without litigation or foreclosure. The settlement called for a
19 \$1,100,000 payment to Halifax as consideration for Halifax's releasing its \$1,600,000 note and *lis*
20 *pendens*, and for Scafani's releasing his exclusive brokerage rights and purchase options (the "Halifax
21 Settlement"). Although the underlying Halifax Sale Agreement only lists Urban Coast, McHaffie,
22 Scafani and Halifax as signatories, the exact Halifax Settlement language provides: "SHAFFER [sic]
23 to pay to HALIFAX."³⁴ The Trustee contends that this provision shifts the obligations owed by Urban
24 Coast and McHaffie under the Halifax Sale Agreement onto Schaefer. The court disagrees. None of
25 the Schaefer Entities was a party to either the Halifax Sale Agreement or the lawsuit filed by Scafani

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27 ³¹ Defs.' Ex. C-H

³² Trial Tr. vol. 2, 122:11-22, ECF No. 442.

28 ³³ Trial Tr. vol. 2, 108:7-11, 122:11-22, ECF No. 442.

³⁴ Defs.' Ex. F-1.

1 and Halifax. Rather than imposing a legal obligation on the Schaefer Entities, the court interprets this
2 provision – which, like the rest of the document, was quite loosely drafted³⁵ – as merely recognizing
3 the source of payment.

4 These events converged to precipitate an immediate need for capital. On November 19, 2004,
5 the Schaefer Entities lent Debtors an additional \$4,000,000 (the “Third Loan”), which was secured by
6 the UC Lofts Real Property. The Schaefer Entities initially advanced \$1,165,000 under the Third
7 Loan. The escrow instructions routed \$1,100,000 of the Third Loan proceeds directly to Halifax,
8 charged a \$210,500 loan origination fee and charged \$52,500 as an extension fee for the First Loan.³⁶

9 The Third Loan also extinguished the hastily made Second Loan. The Debtors transferred
10 \$206,552.65 from the Second Fund Control and \$299,447.35 from the Third Loan proceeds to pay off
11 the \$500,000 funded under the Second Loan. This transfer left the Second Fund Control with a zero
12 balance. Schaefer had to advance another \$111,600 under the Third Loan on November 22, 2004 to
13 replenish the deficiency. This left a \$6,413.69 balance in the Second Fund Control.³⁷

14 **5. The Global Settlement in April 2005 and Subsequent Foreclosure**

15 After the Third Loan, the Schaefer Entities made no new loans to the Debtors.³⁸ But in April
16 2005, the Schaefer Entities and the Debtors negotiated a Global Workout Agreement that provided
17 \$1,130,000 in additional funding under the \$4,000,000 Third Loan.³⁹ It reinstated and extended the
18 First Loans⁴⁰, extended the Third Loan’s maturity date and paid delinquent real property taxes.
19 Further, it required Debtors to reconvey all deeds of trust junior to the Third Loan, which included the
20 UC DOT, SD Lofts DOT and the April 2, 2004 Loan trust deed that Schaefer had assigned to Lemire.⁴¹

21
22 ³⁵ For instance, it erroneously refers to the Debtors as “Lofts on 4th, LLC” and “Lofts on 5th, LLC,”
23 and incorrectly spells Defendants Schaefer and Lemire’s names.

24 ³⁶ Pl.’s Ex. 40, 41.

25 ³⁷ Pl.’s Ex. 44.

26 ³⁸ The Debtors did not obtain additional financing thereafter from any party. McHaffie, however,
27 persuaded Mark Whillock, his wife and his company into lending over \$1,000,000 to fund projects
28 only tangentially related to the Atmosphere Project but secured by the UC Lofts Real Property
nonetheless.

³⁹ Defs.’ Ex. B-E.

⁴⁰ Schaefer had purchased the Barth Note by then to reduce his carrying costs. He thereafter assigned
it to First National Bank.

⁴¹ Trial Tr. vol. 7, 64:24-66:9, Dec. 19, 2013, ECF No. 468.

1 Schaefer represented that these loan fees and extension fees deducted from the funding disbursements
2 were never collected.⁴² Instead, Schaefer added these amounts to the Third Loan's balance. The only
3 advances the Schaefer Entities made after April 15, 2004 under the Third Loan went to pay off the
4 initial \$1,750,000 Schaefer loan.

5 As of January 11, 2006, the Third Loan had an outstanding balance of \$5,678,351.50. During
6 the Debtors' bankruptcy cases, the Schaefer Entities paid upward of \$20,000 per month as a holding
7 cost to keep the Barth Note current. The Schaefer Entities foreclosed on the Third Loan trust deed and
8 credit bid \$1,500,000 at a foreclosure sale in September 2006.

9 The Schaefer Entities then sold the UC Lofts Real Property through an LLC to Alpha and
10 Omega Development, LLC for \$6,000,000, and paid \$5,312,330.37 out of escrow to First National
11 Bank, the successor beneficiary to the Barth Note. Frank Schaefer Construction Pension Plan also
12 made an additional \$1,250,000 hard money loan to Alpha and Omega Development, LLC behind a
13 first deed of trust purchase money loan to Dunham & Associates of \$3,700,000. Ultimately, the holder
14 of this new first trust deed foreclosed out the Schaefer Entities' interest.

15 **D. Schaefer's Interactions with Debtors and Their Creditors**

16 Much of the Trustee's case depends upon a finding that the Schaefer Entities were insiders of
17 the Debtors. The court makes the following factual findings with respect to the Schaefer Entities'
18 interactions with the Debtors and their creditors.

19 Schaefer had to authorize all disbursements from the fund controls before Debtors had access to
20 the funds. The Schaefer Entities and Urban Coast entered into an agreement to govern disbursements
21 out of the fund control accounts (the "Fund Control Agreement").⁴³ The Fund Control Agreement only
22 permitted "payment of items relating to the job which are then due and payable."⁴⁴ The agreement also
23 allowed:

24 Control [Schaefer] shall conclusively presume that any written order of an authorized
25 person is (1)-given for the purposes stated in the order; and (2) authorized by the Owner
and Contractor.⁴⁵

26 _____
27 ⁴² Trial Tr. vol. 9, 66:15-21, Dec. 20, 2013, ECF No. 469.

28 ⁴³ Defs.' Ex. A-X.

⁴⁴ Defs.' Ex. A-X.

⁴⁵ Defs.' Ex. A-X.

1 The Schaefer Entities issued disbursements through checks listing the drawer alternatively as:
2 FRANK SCHAEFER CONSTRUCTION INC.
3 FBO UC LOFTS ON 4TH, LLC
4 FBO UC LOFTS ON 5TH, LLC; and
5 UC LOFTS.⁴⁶

6 In some instances, the checks did not identify the drawer.⁴⁷ Frank Schaefer signed many of the checks
7 and addressed them to the intended payee per McHaffie's request. He also engaged Burton Harris of
8 Real Estate Services, Inc. to handle disbursements from the fund controls.⁴⁸ But Mr. Harris lacked
9 independent authority to authorize disbursements.⁴⁹ Schaefer credibly testified that he never rejected a
10 funding request from Mchaffie.

11 Whillock testified that McHaffie introduced Schaefer "as the money partner that was paying for
12 the project" while all three were together at the UC Lofts Real Property.⁵⁰ He asserted that Schaefer
13 did not deny this characterization. Moreover, the Debtors paid Whillock's invoices through the
14 Schaefer Entities. In fact, Schaefer's office sent a letter to Whillock Contracting requesting that
15 Whillock direct its invoices to Frank Schaefer Construction.⁵¹

16 According to Schaefer, McHaffie "liked to call people his partner."⁵² To Schaefer's
17 recollection, McHaffie only did so in his presence on one occasion, which he promptly corrected.⁵³
18 Schaefer stated that McHaffie repeatedly attempted to persuade him to convert his loans to equity.⁵⁴
19 He was not interested, however. Further, Warner testified that McHaffie did not tell him Schaefer was
20 a partner in the Atmosphere Project. But McHaffie did inform Warner that he had a partnership
21 agreement with Whillock.

22 Schaefer did express interest in forming an LLC with McHaffie to obtain construction
23 financing to complete the Atmosphere Project. He and McHaffie eventually met with John

24 ⁴⁶ Pl.s' Ex. 14, 44.

25 ⁴⁷ Pl.s' Ex. 14, 44.

26 ⁴⁸ Trial Tr. vol. 5, 39:11-40:1, ECF No. 450.

27 ⁴⁹ Trial Tr. vol. 5, 39:11-40:1, ECF No. 450.

28 ⁵⁰ Trial Tr. vol. 6, 52:24-25, ECF No. 462.

⁵¹ Pl.'s Ex. 47.

⁵² Trial Tr. vol. 6, 30:24, ECF No. 462.

⁵³ Trial Tr. vol. 6, 30:21-31:13, ECF No. 462.

⁵⁴ Trial Tr. vol. 5, 94, ECF No. 450.

1 Terwilliger of IndyMac Bank’s Homebuilder Division to discuss construction financing for an “LLC
2 to be determined.”⁵⁵ Schaefer provided a financial statement to IndyMac. This meeting resulted in an
3 application letter dated September 9, 2004 with certain preliminary terms and conditions.⁵⁶ Schaefer
4 stated that by the time he received the September 9, 2004 letter he no longer had any interest in
5 pursuing the LLC formation with McHaffie.⁵⁷

6 McHaffie continued to engage IndyMac without Schaefer, however, as is evident by the email
7 sent from Mr. Terwilliger to McHaffie on February 1, 2005.⁵⁸ By this stage, the bank required
8 McHaffie to gather sufficient “cash to pay off Frank, put \$5,000,000 in the bank and to get the project
9 built.”⁵⁹

10 Additionally, Plaintiff introduced an unexecuted agreement that would have effectively
11 established a joint venture between the Schaefer Entities and McHaffie, among others.⁶⁰ It called for
12 the creation of an LLC – Lofts LLC – presumably to build the Atmosphere Project. Schaefer denied
13 having seen this document before this litigation with the Chapter 7 Trustee, and it was never executed.
14 Moreover, Warner testified that this document came through his office, as he was accepting facsimile
15 transmissions for McHaffie at the time. He believed it originated from a Texas transactional attorney,
16 Robert Graham, and was simply a proposal as part of the “back and forth” between the parties.

17 **E. The Value of the UC Lofts Property**

18 The parties offer conflicting expert opinions on the UC Lofts Real Property’s fair market
19 value⁶¹ between February 13, 2004 and November 24, 2004 (the “Relevant Period”). It is therefore
20 necessary to reconcile these contrasting figures for the court to determine if the Debtors were insolvent
21 or had unreasonably small assets during the Relevant Period.⁶²

22 _____
23 ⁵⁵ Pl.’s Ex. 33.

24 ⁵⁶ Pl.’s Ex. 33.

25 ⁵⁷ Trial Tr. vol. 5, 86:14-19, ECF No. 450.

26 ⁵⁸ Pl.’s Ex. 23.

27 ⁵⁹ Pl.’s Ex. 23.

28 ⁶⁰ Pl.’s Ex. 35.

⁶¹ “The fair market value is the price which a willing seller under no compulsion to sell and a willing
buyer under no compulsion to buy would agree upon after the property has been exposed to the market
for a reasonable time.” *Taffi v. United States (In re Taffi)*, 96 F.3d 1190, 1192 (9th Cir. 1996).

⁶² “When two appraisal reports conflict, a court ‘must determine the value based on the credibility of
the appraisers, the logic of their analys[es], and the persuasiveness of their subjective reasoning.’” *In*

1 **1. The Parties' Divergent Appraisals**

2 It is undisputed that by November 24, 2004, the Centre City Development Corporation
3 (“CCDC”) and the city of San Diego had issued building permits for construction of the Atmosphere
4 Project on the UC Lofts Property. Defendants’ expert, Thomas Heath, used the cost approach to opine
5 that the Subject Property had a \$13,287,500 value. By contrast, Plaintiff’s expert, Matthew Shake,
6 employed the comparable sales approach. He testified that the Subject Property’s value was at most
7 \$7,650,000 between April 2004 and November 24, 2004.

8 The differing assumptions made by the two experts explains the primary differences between
9 their valuations. Mr. Heath utilized a cost approach to derive a site value, a component of which
10 involved a sales comparison analysis.⁶³ He assigned a “raw land” value of \$5,287,500 to the Subject
11 Property that did not include adjustments for permitting.⁶⁴ He did so by analyzing comparable sales of
12 properties without any level of building permits.⁶⁵

13 Mr. Heath adjusted his “raw land” value upward by \$8,000,000 to account for permitting, site
14 improvements and entrepreneurial profit. He asserted that the original developer of the UC Lofts Real
15 Property provided this figure in 2003, which estimated the cost to entitle the land and develop it into a
16 “finished mixed-use site.”⁶⁶ His definition of a “finished mixed-use site” “assumes the subject lots
17 have a final recorded track map, appropriate site development fees paid except school fees and
18 building permits, land permits, and finished land improvements, including paved streets, utility
19 extensions, street and curb improvements, streetlights, and other traffic improvements.”⁶⁷

20 It is clear, however, that the UC Lofts Real Property never became a “finished mixed-use site”
21 under Mr. Heath’s definition at any time during the Relevant Period. In fact, the parties disagree on
22 whether excavation had even started by November 24, 2004. Further, Mr. Heath’s report does not
23

24 *re Atlanta S. Bus. Park, Ltd.*, 173 B.R. 444, 450 (Bankr. N.D. Ga. 1994) (citing *In re Park Ave.*
25 *Partners*, 95 B.R. 605, 610 (Bankr. E.D. Wis. 1988).

25 ⁶³ Defs.’ Ex C-T, at 37-43.

26 ⁶⁴ Defs.’ Ex. C-T, at 43.

26 ⁶⁵ Although Mr. Heath looked to comparable sales to ascertain a “raw land” value, he explained that
27 this constituted a component within the cost approach. Trial Tr. vol. 4, 186:14, Dec. 12, 2013, ECF
28 No. 449.

28 ⁶⁶ Trial Tr. vol. 4, 119:10, ECF No. 449.

⁶⁷ Trial Tr. vol. 4, 123:8-13, ECF No. 449.

1 distill the \$8,000,000 cost to reach a “finished mixed-use site” down into its individual components.
2 On the stand, he indicated that it included the cost to obtain permits, asphalt removal, excavation,
3 caisson construction, shoring and entrepreneurial profit.⁶⁸ And he resisted breaking this figure into
4 separate values for entrepreneurial profit and site improvements. Moreover, it is grossly
5 disproportionate to the \$1,222,400 originally budgeted under the Fund Control Agreement for virtually
6 the same improvements.⁶⁹ Ultimately, Mr. Heath’s only defense of the \$8,000,000 figure was that it
7 seemed “logical” once he compared it to his sales comparison value for the finished Atmosphere
8 Project.⁷⁰ Thus, his opinion of value as of November 24, 2014 was actually \$13,287,500 “minus
9 demolition, excavation, caissons, and shoring.”⁷¹

10 By contrast, Mr. Shake looked to comparable properties with CCDC, but not city, permits to
11 arrive at a \$6,525,000 value for the land. Because he used a comparable sales analysis, he did not
12 separately classify a “raw” or “vacant” land value line item. Mr. Shake’s report assumed 20 percent
13 annual appreciation for 2004, and he adjusted his comparable sales figures accordingly.⁷²

14 Mr. Shake properly recognized that fully entitling the UC Lofts Real Property beyond the
15 CCDC permits added significant contributory value, as well as reflected the existing state of the
16 property during the Relevant Period. He spoke with the developers of two of his comparable parcels to
17 calculate the cost to obtain city building permits. Based on these conversations, Mr. Shake estimated
18 that the cost to fully permit the UC Lofts Property was \$50 per square foot, which equates to
19 \$1,125,000 for the entire project.⁷³ He then added this cost to the \$6,525,000 figure to reach a total
20 value of \$7,650,000.

21 **2. The Court Adopts Mr. Shake’s Appraisal but Finds that Adjustments Are**
22 **Necessary**

23 The greatest variation in the parties’ valuations results from their disagreement over whether
24 the court should include entrepreneurial profit in the “as is” value. The court accepts Mr. Shake’s

25 _____
26 ⁶⁸ Trial Tr. vol. 4, 201:13-202:15, ECF No. 449.

27 ⁶⁹ See Pl.’s Ex. 98, 102.

28 ⁷⁰ Trial Tr. vol. 4, 136:3, 202:13, ECF No. 449.

⁷¹ Trial Tr. vol. 4, 155:17-18, ECF No. 449.

⁷² Pl.’s Ex. 106, at 56.

⁷³ Pl.’s Ex. 106, at 58.

1 assessment that a developer would not realize any appreciable entrepreneurial profit from a sale at such
2 an early stage in the project. And the court does not find Mr. Heath's value opinions to be reliable,
3 particularly because he employed unrealistic assumptions and failed to articulate any principled basis
4 for calculating entrepreneurial benefit. The court thus substantially adopts Mr. Shake's appraisal as the
5 UC Lofts Property's value during the Relevant Period.

6 Even so, certain upward adjustments to Mr. Shake's valuation are necessary to account for site
7 improvements performed during the Relevant Period and the actual cost to permit the UC Lofts Real
8 Property. For instance, Mr. Shake acknowledged that the cost of site improvements in the early stages
9 of a project would likely add dollar for dollar value to the property. But he did not build any site
10 improvement costs into his valuation because he had not been presented with evidence that any had
11 been incurred during the Relevant Period.

12 The evidence submitted, however, shows that Whillock Construction began asphalt removal
13 and excavation on October 8, 2004 and that the estimated total cost would be \$221,000.⁷⁴ Further,
14 Debtor made disbursements of \$21,000 to Whillock on November 9, 2004⁷⁵ and \$99,000 to Western
15 Foundation and Shoring on November 19, 2004 and \$89,000 on January 25, 2005 for excavation and
16 shoring work, presumably performed during the Relevant Period.⁷⁶ The court adds this \$209,000 in
17 contributory value to Mr. Shake's overall estimate.

18 Additionally, the evidence established that the Debtors incurred higher costs to maintain their
19 CCDC and city building permits than the \$1,125,000 Mr. Shake estimated. At the time McHaffie
20 purchased the membership interests in Urban Coast, LLC, the UC Lofts Real Property already had
21 CCDC and city permits for construction of the Atmosphere Project.⁷⁷ But they were in danger of
22 expiring because of an impending change to the city of San Diego's building permitting process that
23

24 ⁷⁴ Trial Tr. vol. 8, 70, ECF No. 469; Defs.' Ex. C-R.

25 ⁷⁵ Whillock testified that he performed less than \$100,000 worth of work during Relevant Period. Trial
26 Tr. vol. 6, 59:22-23, ECF No. 462. His invoices, which he credibly asserted were accurate almost to
27 the day, show that he billed \$73,000 between October 8, 2004 and December 15, 2004. Trial Tr. vol.
28 6, 57, ECF No. 462; Pl.'s Ex. 77. It is unclear, however, exactly how much work his firm completed
through November 24, 2004. For this reason, the court adopts the figure actually paid to Whillock as
the contributory value amount.

⁷⁶ Trial Tr. vol. 8, 70, ECF No. 469; Pl.'s Ex. 44.

⁷⁷ Defs.' Ex. A-A.

1 would have caused the Atmosphere Project to fall out of compliance. Thus, the project architects had
2 to quickly redraw the building plans, particularly for the subterranean structures, before “a drop-dead
3 date from the city.”⁷⁸

4 Debtors engaged Hawkins & Hawkins Architects, Inc. to maintain the necessary building
5 permits from the CCDC and city. Hawkins & Hawkins acknowledged receiving \$1,858,968 in
6 compensation to shepherd the Debtors through this process on an expedited basis.⁷⁹ Plaintiff offered
7 no testimony to rebut this figure’s reasonableness. But the court notes that the exigency to change the
8 building plans likely generated inefficiencies that a hypothetical buyer would not be willing to pay for.
9 The court therefore reduces this number by half the difference between Mr. Shake’s estimate and the
10 Debtors’ actual expenditures, or \$366,984. Thus, the total adjustment for permitting the UC Lofts Real
11 Property should be \$1,491,984. Accordingly, the court finds that the UC Lofts Real Property was
12 worth \$7,366,306 as of April 2004, and \$8,225,954 as of November 24, 2004.⁸⁰

14 IV. THE SCHAEFER ENTITIES WERE NOT INSIDERS OF THE DEBTORS

15 Among the Trustee’s claims against the Schaefer Entities is the allegation that they were
16 insiders of the Debtors. Under the Code, an “insider” includes:

18 (B) if the debtor is a corporation--

19 (i) director of the debtor;

20 (ii) officer of the debtor;

21 (iii) person in control of the debtor;

22 (iv) partnership in which the debtor is a general partner;

23 (v) general partner of the debtor; or

24 (vi) relative of a general partner, director, officer, or person in control of
25 the debtor;

26 _____
27 ⁷⁸ Trial Tr. vol. 1, 92:16, Dec. 4, 2013, ECF No. 456.

27 ⁷⁹ Defs.’ Ex. A-V.

28 ⁸⁰ The difference results from adjusting for annual market appreciation using Mr. Shake’s 20 percent figure.

1

2 (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

3 (F) managing agent of the debtor.

4 11 U.S.C. § 101(31). Specifically, the Trustee alleges that the Schaefer Entities were partners in the
5 Atmosphere project, had control over Debtors or that they allowed McHaffie to act as their agent to
6 third parties.

7 In California, a “partnership is defined by statute, as it was at common law, as an association of
8 two or more persons to carry on as co-owners a business for profit (Corp. Code, § 16202, subd. (a)).”
9 *Persson v. Smart Inventions, Inc.*, 125 Cal. App. 4th 1141, 1157 (2005). “[P]artnership is evidenced
10 by the right of the respective parties to participate in the profits and losses of the business, the
11 contribution by the partners of either money, property or services and some degree of participation by
12 the partners in the management and control of the business.” *In re Lona*, 393 B.R. 1, 14 (Bankr. N.D.
13 Cal. 2008). Further, the fact that “that profits and losses are not shared equally does not necessarily
14 compel a conclusion that no partnership existed.” *Id.* Moreover, the Corporations Code provides that
15 a partnership may form “*whether or not the persons intend to form a partnership.*” Cal. Corp. Code
16 § 16202(a) (emphasis added). The party alleging a partnership bears the burden to prove its existence
17 by a preponderance of the evidence. *See In re Lona*, 393 B.R. at 11; *Weiner v. Fleischman*, 54 Cal. 3d
18 476, 490 (1991); *Mercado v. Hoefler*, 11 Cal. Rptr. 787, 790 (1961).

19 Additionally, a partnership by estoppel may arise:

20 If a person, by words or conduct, purports to be a partner, or consents to being
21 represented by another as a partner, in a partnership or with one or more persons not
22 partners, the purported partner is liable to a person to whom the representation is made,
23 if that person, relying on the representation, enters into a transaction with the actual or
24 purported partnership. If the representation, either by the purported partner or by a
25 person with the purported partner's consent, is made in a public manner, the purported
26 partner is liable to a person who relies upon the purported partnership even if the
27 purported partner is not aware of being held out as a partner to the claimant. If
28 partnership liability results, the purported partner is liable with respect to that liability as
if the purported partner were a partner. If no partnership liability results, the purported
partner is liable with respect to that liability jointly and severally with any other person
consenting to the representation.

1 Cal. Corp. Code § 16308(a). But the Trustee has not cited any authority for the proposition that
2 partnership by estoppel – primarily utilized to hold a party liable to a particular creditor – has any
3 application in the insider analysis under the Bankruptcy Code. *See, e.g., Williams v. Cal. 1st Bank,*
4 859 F.2d 664 (9th Cir. 1988) (recognizing a general prohibition on the trustee asserting claims
5 belonging only to specific creditors).

6 The court accepts Schaefer’s testimony as credible in all respects and finds that neither he nor
7 Frank Schaefer Construction, Inc. nor Frank Schaefer Construction, Inc. Pension Plan was an insider of
8 the Debtors. The Schaefer Entities exerted considerable control over Debtors and McHaffie. But this
9 control never extended beyond that of a secured lender-to-borrower relationship.

10 Significantly, the court notes that Schaefer faithfully acted according to the terms of the various
11 promissory notes and deeds of trust. He also never refused a disbursement request from McHaffie.
12 And with the exception of the Halifax payment, Schaefer did not advocate that the Debtors pay certain
13 creditors or forego payments to others. Ultimately, the evidence did not establish that Schaefer was
14 ever able to pressure Debtors in such a way as to substitute his own decision making power for
15 McHaffie’s.

16
17 **V. FRAUDULENT TRANSFERS**

18 The Trustee moves under § 544(b) through her standing as a present and future unsecured
19 creditor under California’s adaptation of the Uniform Fraudulent Transfer Act (“UFTA”), Cal. Civ.
20 Code sections 3439 *et seq.*, to avoid certain transfers of interests in the Debtors to or for the
21 Defendants’ benefit. The UFTA authorizes a creditor to avoid a transfer “[i]f the debtor made the
22 transfer or incurred the obligation . . . [w]ith actual intent to hinder, delay, or defraud any creditor of
23 the debtor.” Cal. Civ. Code § 3439.04(a)(1). The court may consider:

- 24 (1) Whether the transfer or obligation was to an insider.
25 (2) Whether the debtor retained possession or control of the property transferred after
26 the transfer.
27 (3) Whether the transfer or obligation was disclosed or concealed.
28

1 (4) Whether before the transfer was made or obligation was incurred, the debtor had
2 been sued or threatened with suit.

3 (5) Whether the transfer was of substantially all the debtor's assets.

4 (6) Whether the debtor absconded.

5 (7) Whether the debtor removed or concealed assets.

6 (8) Whether the value of the consideration received by the debtor was reasonably
7 equivalent to the value of the asset transferred or the amount of the obligation incurred.

8 (9) Whether the debtor was insolvent or became insolvent shortly after the transfer was
9 made or the obligation was incurred.

10 (10) Whether the transfer occurred shortly before or shortly after a substantial debt was
11 incurred.

12 (11) Whether the debtor transferred the essential assets of the business to a lienholder
13 who transferred the assets to an insider of the debtor.

14 Cal. Civ. Code. § 3439.04(b). The Trustee must prove fraudulent intent by a preponderance of the
15 evidence. *See Annod Corp. v. Hamilton & Samuels*, 123 Cal. Rptr. 2d 924, 928-29 (2002); *see also*
16 *Wolkowitz v. Beverly (In re Beverly)*, 374 B.R. 221, 235 (B.A.P. 9th Cir. 2007). But “[r]epayments of
17 fully secured obligations – where a transfer results in a dollar for dollar reduction in the debtor's
18 liability – do not hinder, delay, or defraud creditors because the transfers do not put assets otherwise
19 available in a bankruptcy distribution out of their reach.” *Henry v. Lehman Commercial Paper, Inc.*
(*In re First Alliance Mortg. Co.*), 471 F.3d 977, 1008 (9th Cir. 2006) (citation omitted).

20 Alternatively, a creditor may avoid a constructively fraudulent transfer of the debtor's property.

21 Cal. Civ. Code §§ 3439.04(a)(2)-3439.05. A present or future creditor may do so by proving that the
22 debtor did not receive:

23 [R]easonably equivalent value in exchange for the transfer or obligation, and the debtor
24 either:

25 (A) Was engaged or was about to engage in a business or a transaction for which
26 the remaining assets of the debtor were unreasonably small in relation to the
27 business or transaction.

28 (B) Intended to incur, or believed or reasonably should have believed that he or
she would incur, debts beyond his or her ability to pay as they became due.

1 Cal. Civ. Code § 3439.04(a)(2). A *present* creditor of a debtor may avoid a transfer, “if the debtor
2 made the transfer or incurred the obligation without receiving a reasonably equivalent value in
3 exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became
4 insolvent as a result of the transfer or obligation.” Cal. Civ. Code § 3439.05.

5 Reasonably equivalent value is a question of fact “determined from the perspective of the
6 creditors of the estate.” *Pajaro Dunes Rental Agency, Inc. v. Spitters (In re Pajaro Dunes Rental*
7 *Agency, Inc.)*, 174 B.R. 557, 578 (Bankr. N.D. Cal. 1994). Specifically, the analysis focuses on the
8 “net effect of the transaction on the debtor's estate and the funds available to the unsecured creditors.”
9 *Frontier Bank v. Brown (In re N. Merch., Inc.)*, 371 F.3d 1056, 1059 (9th Cir. 2004). For this reason,
10 the estate receives reasonably equivalent value for repayment of money actually received as well as for
11 granting a security interest to secure the debt. *See Official Comm. of Unsecured Creditors v. Hancock*
12 *Park Capital II, L.P. (In re Fitness Holdings Int’l, Inc.)*, 714 F.3d 1141, 1149 n.9 (9th Cir. 2013); *In re*
13 *N. Merch., Inc.*, 371 F.3d at 1059; *see also In re First Alliance Mortg. Co.*, 471 F.3d at 1008. The
14 court must therefore compare “what the *debtor* surrendered and what the *debtor* received.” *In re*
15 *Pajaro Dunes Rental Agency, Inc.*, 174 B.R. at 578.

16 Further, although a subsidiary may benefit by satisfying a parent’s obligation, the general rule
17 presumes that such transfers provide “nominal value to that subsidiary in the absence of specific proof
18 to the contrary.” *Id.* at 579; *see also In re N. Merch., Inc.*, 371 F.3d at 1058-59. To constitute
19 reasonably equivalent value, the debtor-subsidary must receive some “clear and tangible benefit.” *In*
20 *re Pajaro Dunes Rental Agency, Inc.*, 174 B.R. at 579.

21 Finally, if the Trustee establishes that a transfer is avoidable, liability under the UFTA extends
22 to:

23 (1) The first transferee of the asset or the person for whose benefit the transfer was
24 made.

25 (2) Any subsequent transferee other than a good faith transferee who took for value or
26 from any subsequent transferee.

27 Cal. Civ. Code § 3439.08(b).
28

1 **A. The Subject Transfers of Interests in the Debtor Qualify as Transfers Under the**
2 **UFTA**

3 The UFTA defines “transfer” broadly as “every mode, direct or indirect, absolute or
4 conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset,
5 and includes payment of money, release, lease, and creation of a lien or other encumbrance.” Cal. Civ.
6 Code § 3439.01(i). The Trustee asserts that the Debtors improperly transferred interests in the UC
7 Lofts Property as well as payments directly to and on behalf of Defendants. Thus, the interests
8 conferred and the payments received qualify as “transfers” under the UFTA.

9 **B. Debtors’ Financial Condition from February 13, 2004 to November 24, 2004**

10 **1. Balance Sheet and Equitable Insolvency**

11 Insolvency under the UFTA has two varieties: equitable and balance sheet. Cal. Civ. Code
12 §§ 3439.02(a), (c). A debtor is presumed to be equitably insolvent if it “is generally not paying [its]
13 debts as they become due.” Cal. Civ. Code § 3439.02(c). A debtor is balance sheet insolvent “if, at
14 fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.” Cal. Civ. Code
15 § 3439.02(a).⁸¹ Notably, the UFTA definition of “asset” excludes encumbered property to the extent it
16 is leveraged. Cal. Civ. Code § 3439.01(a). It also omits the corresponding liability as a debt in the
17 insolvency calculation. Cal. Civ. Code § 3439.02(e).

18 The court has three relevant metrics for the Debtors’ financial condition during the Relevant
19 Period. The first is the court’s order following its bifurcated trial on insolvency setting the value of the
20 Debtors’ property in the range of \$8,000,000 and \$9,500,000 as of February 12, 2004.⁸² Debtors’
21 liabilities on that date numbered \$6,154,531.⁸³ Thus, the Debtors had assets of \$1,845,469 to
22 \$3,345,469 within the meaning of the UFTA.

23 _____
24 ⁸¹ The Bankruptcy Code’s definition of insolvency is strikingly similar to the UFTA’s: “financial
25 condition such that the sum of such entity’s debts is greater than all of such entity's property, at a fair
valuation . . .” 11 U.S.C. § 101(32)(A).

26 ⁸² The Honorable James W. Meyers presiding. [ECF No. 303].

27 ⁸³ This figure, advocated by Plaintiff in closing arguments, included the following liabilities: (1)
28 \$4,000,000 note to the Barth Family; (2) \$1,750,000 note to the Schaefer Entities; (3) \$250,000 owed
to Charlemagne McHaffie; and (4) \$154,531 representing invoices for services performed before
February 12, 2004. Trial Tr. vol. 2, 12, Feb. 27, 2012, ECF No. 300. It notably omitted the disputed
\$3,400,000 note in favor of Urban Coast, LLC and the \$100,000 note held by SD Lofts, LLC. The

1 Next, the court has found that the UC Lofts Real Property was worth \$7,366,306 in April 2004.
2 The court adds the \$958,000 in the First Fund Control to reach an \$8,324,306 valuation for the
3 Debtors' property. In April 2004, after the April 2, 2004 loan transaction, the Debtors' liabilities were
4 comprised of:

- 5 • Barth Note: \$4,000,000
- 6 • First Schaefer Loan: \$1,750,000
- 7 • Hawkins & Hawkins: \$154,531.52
- 8 • Christian Wheeler Engineering: \$13,854
- 9 • April 2, 2004 Loan: \$1,200,000
- 10 • Total: \$7,118,385.52

11 Thus, the Debtors still held assets exceeding their debts by \$1,205,920.48.

12 The Third Loan and the \$1,100,000 payment to Halifax ultimately rendered Debtors insolvent,
13 however. The UC Lofts Real Property had significantly appreciated in value from February 2004 to
14 \$8,225,954 as of November 24, 2004. To this, the court adds the \$4,234.19 remaining in the fund
15 controls to reach a total value of \$8,230,188.19. But their liabilities increased at a much more rapid
16 pace – and many for costs unrelated to the Atmosphere Project. The Debtors had the following debts
17 as of November 22, 2004:

- 18 • Barth Note: \$4,000,000
- 19 • First Schaefer Loan: \$1,750,000
- 20 • Hawkins & Hawkins: \$154,531.52
- 21 • Christian Wheeler Engineering: \$13,854
- 22 • April 2, 2004 Loan: \$1,500,000
- 23 • Third Loan Initial Funding: \$1,665,000
- 24 • Additional Fund Control Disbursement: \$111,600
- 25 • Total: \$9,194,985.52

26
27 court finds that neither of these purported debts was a current obligation owed by the Debtors during
28 the Relevant Period. The court also did not hear testimony regarding the alleged debt owed to
Charlemagne McHaffie, McHaffie's son. It therefore excludes them from the insolvency calculation.

1 Thus, they were balance sheet insolvent by at least \$964,797.33.⁸⁴

2 **2. Unreasonably Small Assets**

3 A transfer is constructively fraudulent as to a present or future creditor if the debtor “[w]as
4 engaged or was about to engage in a business or a transaction for which the remaining assets of the
5 debtor were unreasonably small in relation to the business or transaction.” Cal. Civ. Code
6 § 3439.04(a)(2)(A). The UFTA does not define unreasonably small assets (“USA”). *Intervest Mortg.*
7 *Inv. Co. v. Skidmore*, 655 F. Supp. 2d 1100, 1105 (E.D. Cal. 2009). Consequently, courts employ
8 varying tests to determine if a transfer leaves a debtor with USA.

9 One test equates balance sheet insolvency with USA *per se*. *In re Pajaro Dunes Rental*
10 *Agency, Inc.*, 174 B.R. at 591. The second variation utilizes a “case-by-case approach,” which requires
11 the court to “weigh the raw financial data of the balance sheet against the nature of the entity and its
12 need for capital over time.” *Id.* at 591. Courts applying this second approach have heavily criticized
13 adoption of a *per se* rule for USA. *See, e.g., id.; see also Skidmore*, 655 F. Supp. 2d at 1106. These
14 courts reason that:

15 [A] transfer leaves a debtor with assets that are “unreasonably small in relation to [the
16 debtor's] business or transaction” if the assets are not reasonably likely to meet the
17 debtors’ present and future needs. This inquiry is obviously related to whether the
18 assets exceed the total of the debtor's existing and potential liabilities. However, a
debtor's assets may be reasonable in light a debtor’s business even when they leave the
debtor insolvent.

19 *Skidmore*, 655 F. Supp. 2d at 1106. This is because “the unreasonably small assets test roughly
20 measures assets against debts as the debts become due.” *Id.* at 1105. But “the insolvency test
21 measures assets against the combined total of debts that are due and not yet due.” *Id.* The court adopts
22 the more nuanced approach espoused by the *Pajaro Dunes* and *Skidmore* courts.

23 ⁸⁴ The court is cognizant that Defendants’ valuation evidence suggests the Debtors were comfortably
24 solvent on November 24, 2004. As explained above, the major discrepancy between the experts’
25 valuations comes from their adjustments for entrepreneurial value. But even if the court were to accept
26 some measure of entrepreneurial profit, it would not exceed \$964,797.33. Mr. Shake expressly
27 rejected the notion that the Debtors would realize any entrepreneurial profit from a sale on November
28 24, 2004. And Mr. Heath failed to offer any meaningful guidance for the court to assess his estimate
of entrepreneurial profit. It is also noteworthy that Mr. Heath’s cost models in his opinion allot
\$5,000,000 for developer’s profit to complete the Atmosphere Project. It is difficult to imagine that a
sale of the land with permits and minimal excavation alone could net profit that is roughly one-sixth of
that expected from the finished project.

1 The court must therefore reconstruct the Debtors' financial condition during the Relevant
2 Period to assess "whether the remaining assets left [them] reasonably able to pay obligations that they
3 should have expected to arise out of their business." *Skidmore*, 655 F. Supp. 2d at 1107; *In re Pajaro*
4 *Dunes Rental Agency, Inc.*, 174 B.R. at 591. It is appropriate for the court to consider availability of
5 credit in the analysis. *See Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1072 (3d Cir. 1992)
6 (citing *Credit Managers Ass'n of So. Cal. v. Fed. Co.*, 629 F. Supp. 175 (C.D. Cal. 1985)).

7 The starting point for the USA analysis is the Debtors' business, which was real estate
8 development. McHaffie indicated that his goal for the UC Lofts Real Property was to develop the
9 Atmosphere Project or, if he could not attract construction financing, then to sell the property in a
10 construction-ready condition. McHaffie took pains on the stand to avoid admitting he actually
11 intended to build the Atmosphere Project rather than to sell it in a construction-ready state. But the
12 court finds his testimony on this point to be wholly lacking credibility and contradicted by the
13 construction budget estimates, invoices and testimony in the record. (The court nevertheless
14 recognizes that selling the UC Lofts Real Property to a developer constituted an attractive exit strategy
15 for McHaffie and the Schaefer Entities as the Debtors plunged deeper into debt.)

16 McHaffie testified that conventional lenders would not consider financing the Atmosphere
17 Project at the time he acquired the membership interests in Urban Coast, LLC. This drove the Debtors
18 toward hard money lenders, such as the Schaefer Entities, as a source of capital. He acknowledged
19 that these funds were "overpriced" and therefore necessitated a relatively quick turnaround on the
20 project.⁸⁵ Schaefer explained that hard money lenders do not typically scrutinize a debtor's
21 creditworthiness. Rather, their focus rests entirely on the available equity in the collateral. Schaefer
22 required a seventy percent loan to value ratio for this particular project.⁸⁶ Thus, the Debtors' ability to
23 make progress on the Atmosphere Project depended on preserving the UC Lofts Real Property's value
24 by maintaining its entitlements, continued rapid market appreciation and restricting expenditures to
25 improvements calculated to increase the property's value. Moreover, the Debtors' only interaction

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28 ⁸⁵ Trial Tr. vol. 1, 88:5-8, ECF No. 456.

⁸⁶ Trial Tr. vol. 5, 46:6-15, ECF No. 450.

1 with a traditional lender, IndyMac Bank, resulted in a tentative term sheet requiring payoff of the
2 acquisition loans and 20 percent equity in the property.⁸⁷

3 Next, the focus shifts to the Debtors' balance sheet. As noted above, the Debtors had
4 significant assets above their liabilities in February 2004 and were able to attract more financing from
5 the Schaefer entities. In fact, they maintained at least a thirteen to fifteen percent equity cushion from
6 February 2004 to April 2004. And the parties agree that the properties were appreciating in value at 20
7 percent per year during this period. Further, as of April 2004, the Debtors had \$958,000 in liquid
8 funds contained in the fund control account to finance their operations. The court concludes that the
9 April 2, 2004 loan and accompanying transfers did not leave Debtors with USA.

10 The court finds, however, that the Third Loan and the Halifax payment did leave the Debtors
11 with USA. By November 24, 2004, the Debtors had slid into balance sheet insolvency. Moreover, one
12 of the fund control accounts showed a negative balance, and the other only had \$6,413.69 – leaving
13 \$4,234.19 total. The only asset the Debtors ever possessed was the equity in the property above the
14 liens. Without any equity, there could be no more financing to fund operations. The transfers
15 therefore left the Debtors with USA.

16 3. Reasonable Ability to Pay Debts as They Come Due

17 Even if a transfer does not leave the debtor with USA, a creditor may still avoid it if the debtor
18 “[i]ntended to incur, or believed or reasonably should have believed that he or she would incur, debts
19 beyond his or her ability to pay as they became due.” Cal. Civ. Code § 3439.04(a)(2)(B). “This test
20 measures whether the debtor, as a going concern, would reasonably have been seen as able to pay its
21 debts after making the questionable transfer.” *In re Pajaro Dunes Rental Agency, Inc.*, 174 B.R. at
22 593. This analysis requires the court to scrutinize “cash flow projections and other forward-looking
23 sources of evidence available to the debtor and its creditors at the time of the transfer.” *Id.*

24 Courts generally understand this measure of constructive fraud to only apply to going concerns.
25 *Id.* As such, this test does not readily apply to the Debtors in this case. At no point in the relevant
26 period did the Debtors' operations generate positive income. Although the Defendants' introduced
27 testimony that substantial presales had occurred, there is no indication that the Debtors had ready

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⁸⁷ Pl.'s Ex. 23, 33.

1 access to these funds as a source of operational capital. The Debtors and apparently all creditors
2 understood that the Debtors would not realize any income unless and until the Debtors either sold the
3 property in a construction-ready posture, or completed the Atmosphere Project and sold the units.

4 **C. The Schaefer Entities' Liability for Fraudulent Transfers**

5 The Trustee's claims for fraudulent transfers under the UFTA against the Schaefer Entities
6 relate to two primary transactions: (1) the Tropicana Plaza Partners, LLC and April 2, 2004 Loan
7 transaction, including the accompanying trust deed; and (2) the Third Loan executed in November
8 2004 to make the \$1,100,000 payment to Halifax. At the outset, the court reiterates that the Schaefer
9 Entities were not insiders or partners of the Debtors. Thus, the transfers out of the fund controls and
10 directly from the escrowed loan proceeds to any party other than the Schaefer Entities did not benefit
11 them within the meaning of the UFTA.

12 **1. Transfers Related to the Tropicana Plaza Partners, LLC and April 2, 2004**
13 **Loan Transaction**

14 The Trustee seeks to avoid the deed of trust securing the April 2, 2004 Loan and the subsequent
15 transfers of Tropicana to Schaefer and Lemire.⁸⁸ With the benefit of hindsight, it is apparent that
16 transfers related to the Tropicana transaction set in motion the events that ultimately led to the Debtors'
17 demise. But the court has found that the Debtors were balance sheet solvent on and after the April 2,
18 2004 Loan and were not left with USA as a result. The Trustee has thus failed to prove an essential
19 element of her claim against the Schaefer Entities relating to the initial April 2, 2004 Loan trust deed
20 and transfers from fund controls to acquire Tropicana.

21 Notably, the Tropicana LLC interests and real property never belonged to the Debtors.
22 Moreover, the court finds that the Schaefer Entities provided reasonably equivalent value in exchange
23 for their receipt of Tropicana in December 2004. Thus, it is not apparent that this transaction involved
24 property of the Debtors such that it could be constructively fraudulent as to their creditors.

25 Further, the April 2, 2004 Loan's balance had risen to \$1,500,000 by December 2004.
26 McHaffie and Schaefer arranged for the transfer of Tropicana Partners, LLC as an accord and

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28 ⁸⁸ The Trustee moved orally at trial to amend the pretrial order to include this claim at trial. The court granted the motion.

1 satisfaction of the April 2, 2004 Loan obligation. As mentioned above, the Tropicana LLC interests
2 came with a first position mortgage on the property, and the property needed significant repairs. The
3 Schaefer Entities ultimately realized \$2,100,000 from the transaction, once Lemire sold the property.
4 But this figure represented the accrued interest on the April 2, 2004 Loan balance and Schaefer's
5 carrying costs to hold the property for a year. Thus, it is not clear that the Schaefer Entities received a
6 windfall from the transaction, and the Debtors were relieved of a large liability.

7 Finally, the Trustee did not adduce any evidence suggesting that the Debtors made the transfers
8 with actual intent to defraud their creditors. The court therefore finds that they were not fraudulent and
9 that judgment should be entered in the Schaefer Defendants' favor on the Trustee's second and third
10 causes of action for fraudulent transfers concerning the Tropicana Partners, LLC transaction.

11 **2. Transfers Related to the Second and Third Loans and the Halifax Payment**

12 The Schaefer Entities made the Third Loan for \$4,000,000 and initially funded it with
13 \$1,665,000. In return, they received a third position deed of trust on the UC Lofts Real Property. The
14 Debtors used the Third Loan proceeds to retire the Second Loan, pay Defendant Halifax Investments,
15 LLC \$1,100,000 to release its *lis pendens* and to settle the pending lawsuit. The court has found that
16 the Halifax payment rendered the Debtors insolvent and left them with USA. But the Schaefer Entities
17 contributed reasonably equivalent value – indeed, dollar for dollar – in exchange for taking a security
18 interest. The \$1,665,000 advanced went through an escrow, and the Debtors' manager authorized
19 payment of the funds to Halifax.

20 The Trustee has therefore failed to prove essential elements of her fraudulent transfer claims
21 against the Schaefer Entities related to the Halifax payment. First, the transfers to third parties before
22 the Halifax payment did not benefit the Schaefer Entities and were not made while the Debtors were
23 insolvent or had USA. And second, the Schaefer Entities contributed reasonably equivalent value in
24 exchange for the deed of trust on the Third Loan that provided the funding necessary for the Halifax
25 payment. The court thus finds that the Schaefer Defendants are entitled to judgment on all of the
26 Trustee's claims against them for fraudulent transfers related to the Third Loan and Halifax payment.

1 **D. Defendant Lemire’s Liability for Fraudulent Transfers**

2 The Trustee’s remaining fraudulent transfer claim against Lemire derives from her claim
3 against the Schaefer Entities arising out of the Tropicana transaction. Specifically, the Trustee seeks to
4 recover whatever profit Lemire gained from her sale of the Tropicana property.

5 As noted above, the Tropicana LLC interests or the underlying real property never belonged to
6 the Debtors. Further, Lemire contributed value for the property. She paid \$70,000 for an option to
7 purchase it from Schaefer. She then borrowed funds to improve the property and reduced the vacancy
8 rate through her own labors. Lemire sold the Tropicana real property for \$5,750,000. But she could
9 not state with certainty the amount she received from the transaction after accounting for payments to
10 Schaefer and the liens against property. And the Trustee did not offer any evidence on the amount
11 Lemire may have personally profited from the sale.

12 The court therefore finds that the Trustee has failed to meet her burden of showing that Lemire
13 was a subsequent transferee of property of the Debtors or that she did not provide reasonably
14 equivalent value. The court will enter judgment in Lemire’s favor.

15 **E. Defendants Scafani and Halifax’s Liability for Fraudulent Transfers**

16 The court finds that the payment to Halifax were constructively fraudulent and should be
17 avoided. The Halifax payment left the Debtors with USA and rendered them insolvent. Moreover,
18 neither Halifax nor Scafani provided reasonably equivalent value for this transfer.

19 As noted above, the general rule presumes that a subsidiary’s payment of a parent’s obligation
20 provides “nominal value to that subsidiary in the absence of specific proof to the contrary.” *In re*
21 *Pajaro Dunes Rental Agency, Inc.*, 174 B.R. at 579. In such an indirect benefit scenario, the debtor-
22 subsidiary must receive some “clear and tangible benefit” to qualify as reasonably equivalent value.
23 *Id.*; see also *In re N. Merch., Inc.*, 371 F.3d at 1058-59. For instance, a debtor-corporation receives
24 reasonably equivalent value for granting a security interest to secure its shareholders’ loan obligation if
25 the debtor enjoyed the benefit and unfettered use of the loan proceeds. *In re N. Merch., Inc.*, 371 F.3d
26 at 1059. In *Northern Merchandise*, the bank lent directly to a debtor-corporation’s shareholders – but
27 not to the debtor – who then caused the debtor to grant a security interest in its “inventory, chattel
28 paper, accounts, equipment, and general intangibles.” *Id.* at 1058. The shareholders intended to use

1 the proceeds to fund the debtor's operations, and they deposited them directly into the debtor's
2 account. *Id.* at 1057. Thus, the debtor received equivalent value for the security interest. *Id.* at 1059.

3 By contrast, the *Pajaro Dunes* court addressed a scenario in which a parent corporation and its
4 subsidiary jointly made a note for \$1,000,000 to build an office building. 174 B.R. at 562. As
5 consideration for the note, the subsidiary was to receive title to the building for a term of years and
6 rights to use it during that time. *Id.* at 585. Unbeknownst to the lender, after the parent accepted the
7 loan proceeds, it directed the funds to the subsidiary and immediately siphoned them back to support
8 its own unrelated operations. *Id.* at 579. Somehow the borrowers completed the building, but the
9 court found the subsidiary's interest in it to be worth only \$541,895.55 – roughly half of the obligation
10 it owed jointly with the parent. *Id.* at 589. Despite having actually funded the full \$1,000,000 to the
11 parent, the court found that the \$541,895.55 transferred to the subsidiary did not constitute reasonably
12 equivalent value. *Id.* at 590. Nor did the upstream benefit to the parent sufficiently compensate the
13 subsidiary. *Id.* at 579. The court therefore avoided the note as a fraudulent transfer. *Id.* at 597.

14 In this case, McHaffie, Urban Coast, Halifax and Scafani executed the Halifax Sale Agreement.
15 One component of this agreement required *Urban Coast* or *McHaffie* to pay \$1,600,000 to Halifax.
16 This secured *McHaffie's* acquisition of *Urban Coast* and through it, the UC Lofts Real Property.
17 *McHaffie* and *Urban Coast* also owed brokerage rights and purchase options to John Scafani. The
18 Debtors were not signatories to the Halifax Sale Agreement. That the UC Lofts Real Property secured
19 those obligations did not transform them into the Debtors' liabilities. Nor is it apparent that the change
20 in leadership from Scafani to McHaffie provided any value to the Debtors to support granting a
21 security interest in their property. Thus, under the indirect benefit rule stated in *Northern Merchandise*
22 and *Pajaro Dunes*, Defendants must demonstrate that Debtor's received a direct, tangible benefit from
23 paying *Urban Coast* and *McHaffie's* obligation.

24 Defendants offered substantial testimony emphasizing that Scafani agreed to relinquish his
25 purchase options and brokerage rights and that Halifax agreed to a \$500,000 reduction on its note. But
26 the testimony from Warner and Schaefer established that they believed the *lis pendens* was improperly
27 recorded and could have been expunged for a fraction of the settlement price. The court accepts this
28 characterization. Thus, the Debtors can hardly be said to have received reasonably equivalent value by

1 paying \$1,100,000 for its removal. Moreover, the upstream benefit Urban Coast and McHaffie
2 received by being relieved from obligations under the Halifax Sale Agreement did not provide a
3 sufficiently tangible benefit to the Debtors to allow the court to conclude they received reasonably
4 equivalent value.

5 Lastly, Defendants unpersuasively argue that they should not face liability because they
6 engaged in good faith negotiations regarding their claim. But a transferee can only take advantage of
7 the good faith defense if he lacks actual knowledge of the facts and circumstances suggesting to a
8 reasonable person that the transfer is fraudulent. *See Plotkin v. Pomona Valley Imps., Inc. (In re*
9 *Cohen)*, 199 B.R. 709, 719 (B.A.P. 9th Cir. 1996). Here, Scafani and Halifax attempted to illustrate
10 the fiction of separation between Urban Coast, UC Lofts and McHaffie. But they stopped short of
11 fully advocating alter ego liability between these entities, and such a claim did not appear in the
12 pretrial order. Moreover, Scafani owned the Debtors at one point in time. And the facts suggest that
13 their structure did not change once McHaffie took the helm. Scafani therefore knew or should have
14 known that Urban Coast – and not UC Lofts – owed the \$1,600,000 debt.

15 The court finds that Scafani and Halifax improperly recorded the *lis pendens* against the UC
16 Lofts Real Property and that Halifax’s agreement to take \$1,100,000 did not provide reasonably
17 equivalent value for its release. The evidence established that the payment went to Halifax – not to
18 Defendant Scafani. The Trustee presented no evidence to trace the funds to Scafani or otherwise
19 demonstrate that he was a subsequent transferee or beneficiary of this payment. The court therefore
20 concludes that Defendant Scafani is not liable for this transfer. The court awards judgment against
21 Halifax in the amount of \$1,100,000, plus interest.

22 23 VI. PREFERENTIAL TRANSFERS

24 The Trustee asserts that the two payments totaling \$506,000 to the Schaefer Entities on the
25 unsecured Second Loan from the Second Fund Control and Third Loan proceeds are avoidable as
26 preferential transfers. Section 547(b) allows the trustee to avoid any transfer of an interest of the
27 debtor in property:
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- 1 (1) to or for the benefit of a creditor;
2 (2) for or on account of an antecedent debt owed by the debtor before such transfer was
3 made;
4 (3) made while the debtor was insolvent;
5 (4) made--
6
7 (B) between ninety days and one year before the date of the filing of the petition, if such
8 creditor at the time of such transfer was an insider; and
9 (5) that enables such creditor to receive more than such creditor would receive if--
10
11 (B) the transfer had not been made; and
12 (C) such creditor received payment of such debt to the extent provided by the
13 provisions of this title.

14 11 U.S.C. § 547(b).

15 Because the court finds that the Schaefer Entities were not insiders, the extended preference
16 period does not apply. The disputed transfers occurred on November 19, 2004. The Debtors
17 involuntary petition was filed on October 24, 2005. Since these two transfers took place more than
18 ninety days before the petition date, they are not recoverable as preferences.

19 VII. EQUITABLE SUBORDINATION

20 The court may equitably subordinate a claim under § 510(c) if it finds: “(1) that the claimant
21 engaged in some type of inequitable conduct, (2) that the misconduct injured creditors or conferred
22 unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the
23 Bankruptcy Code.” *In re First Alliance Mortg. Co.*, 471 F.3d at 1006 (quoting *Feder v. Lazar (In re*
24 *Lazar)*, 83 F.3d 306, 309 (9th Cir. 1996)). The three major categories of inequitable conduct are: “(1)
25 fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant's use of the
26 debtor as a mere instrumentality or alter ego.” *Blasbalg v. Tarro (In re Hyperion Enters.)*, 158 B.R.
27 555, 560 (D.R.I. 1993) (quoting *In re Fabricators, Inc.*, 926 F.2d 1458, 1467 (5th Cir. 1991)).

28 A heightened standard applies to equitable subordination claims against non-insiders. *See*
29 *Firstmark Capital Corp. v. Hempel Fin. Corp.*, 859 F.2d 92, 93-94 (9th Cir. 1988). Ordinarily, “gross
30 and egregious conduct will be required before a court will equitably subordinate a claim.” *In re First*
31 *Alliance Mortg. Co.*, 471 F.3d at 1006. In a claim for equitable subordination against an insider,
32 however, the burden shifts to the insider to prove the transaction’s fairness once the plaintiff presents

1 material evidence of inequitable conduct. *See Stoumbos v. Kilimnik*, 988 F.2d 949, 958 (9th Cir.
2 1993); *Olympia and York Fla. Equity Corp. v. Bank of N.Y. (In re Holywell Corp.)*, 913 F.2d 873, 880-
3 81 (11th Cir. 1990). But the occurrence of an insider transaction alone is insufficient to invoke
4 equitable subordination absent inequitable conduct. *See In re Hyperion Enters.*, 158 B.R. at 560;
5 *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990).

6 On a proper showing of misconduct and prejudice to creditors, a court may equitably
7 subordinate a secured claim. *See* 11 U.S.C. § 510(c)(2); *Reiner v. Washington Plate Glass Co.*,
8 27 B.R. 550, 552 (D.D.C. 1982). A secured creditor generally does not act inequitably for purposes of
9 equitable subordination by exercising its bargained-for remedies. *See Smith v. Assocs. Comm. Corp.*
10 (*In re Clark Pipe & Supply Co., Inc.*), 893 F.2d 693, 701 (5th Cir. 1990). A secured lender “will
11 usually possess ‘control’ in the sense that it can foreclose or drastically reduce the debtor's financing.”
12 *Id.* But “[t]he crucial distinction between what is inequitable and what a lender can reasonably and
13 legitimately do to protect its interests is the distinction between the existence of ‘control’ and the
14 exercise of that ‘control’ to direct the activities of the debtor.” *Id.* The latter manifests itself in the
15 “exercise of such total control over the debtor as to have essentially replaced its decision-making
16 capacity with that of the lender.” *Id.*

17 In *Clark Pipe*, the debtor and lender entered into a loan agreement for revolving credit
18 advances secured by the debtor’s inventory and accounts receivable. *Id.* at 695. The lender required
19 debtor to deposit all receivables into an account so it could to determine how much to lend. *Id.* Under
20 the contract’s terms, the lender could reduce the credit extended at its discretion. *Id.* When the
21 debtor’s business suffered, the lender reduced the credit advances thereby hampering the debtor’s
22 ability to meet all but its most essential operating expenses. *Id.* As the debtor defaulted on its trade
23 vendor liabilities, litigation ensued, and the debtor filed for bankruptcy. *Id.* at 695-96.

24 The court ultimately found that the lender’s aggressive stance and disregard for the debtor’s
25 vendors did not rise to the level of inequitable conduct necessary to subordinate its claim. *Id.* at 701-2.
26 It noted that the lender had simply exercised remedies negotiated at arm’s length while the debtor was
27 solvent. *Id.* at 700. Further, the lender never instructed the debtor not to pay vendors or to pay certain
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1 vendors over others. *Id.* at 702. And significantly, the lender adhered to its procedures set forth in the
2 original lending arrangement. *Id.*

3 Courts draw a distinction between inequitable conduct in the acquisition of a secured claim and
4 in its enforcement. *See In re First Alliance Mortg. Co.*, 471 F.3d at 989; *In re Clark Pipe and Supply*
5 *Co., Inc.*, 893 F.2d at 702. To subordinate a claim, the creditor's inequitable conduct must cause the
6 injury to creditors – not the creditor's status. *See Stoumbos*, 988 F.2d at 960 n.5. Thus, a junior
7 lienholder or unsecured creditor suffers no harm from a senior lienholder's foreclosing its interest if it
8 originally acquired a valid security interest. *Id.* Rather, the creditor's lesser priority or unsecured
9 status creates the risk of nonpayment, not the senior lender's subsequent misconduct, if any. *Id.*

10 The Trustee has not met her burden to equitably subordinate the Schaefer Entities' claims.
11 Notably, the court has found that none of the Schaefer Defendants was an insider or partner of the
12 Debtors. Thus, the burden remains with the Trustee to prove circumstances justifying subordination.

13 Nor does the evidence establish that the Schaefer Entities engaged in inequitable conduct. The
14 gravamen of the Trustee's claim is that the Schaefer Entities improperly participated in McHaffie's
15 scheme to encumber the Debtors' only asset for purposes unrelated to the Atmosphere project and
16 charged usurious interest rates and exorbitant fees all along. She also alleges that, despite advances on
17 the loans for fees and interest payments, the Schaefer Entities never reduced Debtors' corresponding
18 liability in kind. This, she contends, was aimed at padding the Schaefer Entities' claim to enhance
19 their posture in a seemingly inevitable foreclosure.

20 The court is not persuaded. At the outset, Schaefer understood that his involvement in the
21 Atmosphere Project would not extend beyond the First Loan for McHaffie to acquire Urban Coast.
22 Presumably because of the permitting concerns, McHaffie could not find viable financing other than
23 hard money lenders for the initial acquisition and development. Schaefer testified that he, as such a
24 lender, generally only looks to the equity in the collateral rather than the borrower's creditworthiness.
25 This reality, coupled with the parties' intention for Schaefer to provide short-term swing financing, in
26 all likelihood produced the high interest rates. This was a function of market forces demanding a
27 higher price for capital – not inequitable bilking of the Debtors. In fact, had the Schaefer Entities not
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1 expressed a willingness to lend, it appears, based on McHaffie's testimony, that no lender stood behind
2 them to offer financing.

3 As McHaffie's mishandling of the Debtors progressed into 2004, he approached Schaefer for
4 more financing. Schaefer admitted that the Tropicana transaction seemed ill advised. Even so, he
5 believed sufficient equity remained in the UC Lofts Real Property to make the April 2, 2004 Loan.
6 The latter transaction set off a reaction culminating in Scafani's recording the *lis pendens* on the UC
7 Lofts Real Property. This threatened to derail the Atmosphere Project. The parties reasonably
8 believed the *lis pendens* at that stage in development directly imperiled the UC Lofts Real Property's
9 permit status.

10 Schaefer expressed that both the Halifax note and the Scafani lawsuit took him by surprise.
11 Indeed, he testified that he probably called McHaffie "screaming" once he became aware of the *lis*
12 *pendens*. Schaefer then took the lead in negotiations with Scafani to protect his interest in the UC
13 Lofts Real Property. At the same time, he was exerting pressure on McHaffie to make payments on
14 the April 2, 2004 Loan or to transfer Tropicana over to him. Thus, the Schaefer Entities possessed a
15 significant degree of control over the Debtors.

16 But the control Schaefer exercised, although sharp-elbowed, was not inequitable. The term
17 sheet for the Third Loan required McHaffie to transfer Tropicana to Schaefer as an accord and
18 satisfaction. The Schaefer Entities acted within their rights to pursue foreclosure of the April 2, 2004
19 Loan trust deed once the note came due. Accepting Tropicana rather than foreclosing on the UC Lofts
20 Real Property actually *preserved* value for creditors.

21 From the Debtors' and Schaefer Entities' perspective, inducing Scafani to voluntarily
22 relinquish his *lis pendens* presented the path of least resistance toward continuing the Atmosphere
23 Project. Moreover, the Third Loan with its \$4,000,000 credit line allowed the Debtors to maintain the
24 UC Lofts Real Property with its permits in place for another fifteen months. Absent the Third Loan,
25 the Atmosphere Project would likely have been pulled into litigation much earlier. Lastly, the court
26 notes that the record contains no evidence that the Schaefer Entities coerced the Debtors into accepting
27 the Third Loan and granting a security interest in the UC Lofts Real Property.

28

1 The Schaefer Entities' negotiating position left the Debtors with a difficult choice. But the
2 court finds that this situation effectively arose from McHaffie's deception of Schaefer and through the
3 Schaefer Entities' legitimate exercise of their remedies. For these reasons, the Trustee has failed to
4 carry her burden on her claim to subordinate the Schaefer Entities' claims.

5
6 **VIII. RECHARACTERIZING THE SCHAEFER ENTITIES' DEBT AS EQUITY**

7 The pretrial order includes a claim to reclassify the Schaefer Entities' claims as equity interests,
8 although the Defendants disputed its inclusion. The Ninth Circuit recently explained that allowing a
9 bankruptcy court to recharacterize debt into equity comports generally with the *Butner* principle. See
10 *In re Fitness Holdings Int'l, Inc.*, 714 F.3d at 1146-47. As distinct from equitable subordination,
11 which analyzes the creditor's behavior, debt recharacterization focuses on the substance of the
12 transaction. See *Daewoo Motor Am., Inc. v. Daewoo Motor Co., Ltd. (In re Daewoo Motor Am., Inc.)*,
13 471 B.R. 721, 735 (C.D. Cal. 2012) (citing *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys.*
14 *Corp.)*, 432 F.3d 448, 454 (3d Cir. 2006)).

15 State law provides the applicable framework for distinguishing between debt and equity. *In re*
16 *Fitness Holdings Int'l, Inc.*, 714 F.3d at 1148. In California, when "determining whether the
17 transaction is a loan or a forbearance, courts look to substance rather than form." *Sw. Concrete Prods.*
18 *v. Gosh Construction Corp.*, 51 Cal. 3d 701, 710 (1990). Specifically, the court will look to the
19 parties' intent to determine their status as equity interest holder or creditor. See *Hoppe v. Rittenhouse*,
20 279 F.2d 3, 8 (9th Cir. 1960) (citing *Hughes Mfg. & Lumber Co. v. Wilcox*, 13 Cal. App. 22 (1910)).

21 The Trustee presented only scant argument on this claim. The court finds no basis in the record
22 to convert the Schaefer Entities' claims to equity for many of the same reasons it denies the Trustee's
23 request to equitably subordinate these claims. The court considers the relationship between Debtors
24 and the Schaefer Entities to have been strictly limited to that of a borrower and a lender – and that they
25 intended it to be so. The Trustee's reclassification claim is therefore denied.

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IX. BREACH OF FIDUCIARY DUTY

The Trustee contends that the Schaefer Entities breached fiduciary duties owed to the Debtors by: (1) charging usurious interest rates on the loans; and (2) participating in McHaffie’s breaches of his fiduciary duty. The elements of a claim for breach of fiduciary duty under California law are: “(1) existence of a fiduciary duty; (2) breach of the fiduciary duty; and (3) damage proximately caused by the breach.” *Stanley v. Richmond*, 35 Cal. App. 4th 1070, 1086 (1995). General partners owe fiduciary duties to one another. *See Pellegrini v. Weiss*, 165 Cal. App. 4th 515, 524 (2008). Generally, lenders do not owe fiduciary duties to their borrowers or other creditors. *See Software Design & Application Ltd. v. Hoelter & Arnett, Inc.*, 56 Cal. Rptr. 2d 756, 760 (1996).

The crux of the Trustee’s claim for breach of fiduciary duties is that the Schaefer Entities were partners in the Atmosphere Project. But the Trustee’s claim must fail because the court has concluded that none of the Schaefer Entities was an insider or partner of the Debtors. Judgment for the Schaefer Entities on this claim is therefore appropriate.

X. AIDING AND ABETTING BREACH OF FIDUCIARY DUTY

Under California law, “[I]iability may . . . be imposed on one who aids and abets the commission of an intentional tort if the person . . . knows the other’s conduct constitutes a breach of a duty and gives substantial assistance or encouragement to the other to so act.” *In re First Alliance Mortg. Co.*, 471 F.3d at 993 (quoting *Casey v. U.S. Bank Nat’l Assn.*, 127 Cal. App. 4th 1138, 1144 (2005)); *see also Fiol v. Doellstedt*, 50 Cal. App. 4th 1318, 1325-26 (1996). “[A]iding and abetting liability . . . requires a finding of actual knowledge, not specific intent.” *In re First Alliance Mortg. Co.*, 471 F.3d at 993.

In *First Alliance Mortgage*, a jury found Lehman Brothers, Inc. and its subsidiary (“Lehman”) liable for aiding and abetting the debtor’s fraudulent lending practices. *Id.* at 983. The finding relied on Lehman’s eventual relationship as the debtor’s only lender, its intimate knowledge of the debtor’s lending practices and its substantial assistance in furthering the scheme by continuing to lend. *Id.* at 986-87, 994-95. In fact, Lehman warned the debtor that if it did “not change its business practices, it [would] not survive scrutiny.” *Id.* at 994.

1 Here, the Schaefer Entities, like Lehman, at some point became the Debtors' only source of
2 financing such that they provided substantial assistance. Further, it is apparent that Schaefer at least
3 had the opportunity to scrutinize each disbursement from the fund controls. But distinct from the
4 situation in *First Alliance*, Schaefer credibly testified that his primary, if not sole, focus was the equity
5 in the property – not the Debtors' progress on the Atmosphere Project. Moreover, the Fund Control
6 Agreement gave him the contractual right to presume that each disbursement request was actually what
7 the borrower requested and related to the project. Finally, the proposed budget negotiated between the
8 Schaefer Entities and McHaffie contemplated management and contingency line items, for which they
9 allotted over \$400,000.

10 Thus, the court cannot conclude that the Schaefer Entities had actual knowledge of McHaffie's
11 defalcations as they occurred. The Trustee has therefore failed to meet her burden on this claim, and
12 judgment for the Schaefer Entities is appropriate.

14 XI. CONVERSION

15 The Trustee's final claim alleges that the Schaefer Entities converted UC Lofts' personal
16 property. "In California, conversion has three elements: ownership or right to possession of property,
17 wrongful disposition of the property right and damages." *G.S. Rasmussen & Assocs., Inc. v. Kalitta*
18 *Flying Serv., Inc.*, 958 F.2d 896, 906 (9th Cir. 1992).

19 There was no evidence presented at trial that the Schaefer Entities converted UC Lofts assets.
20 First, the UC Lofts Real Property constituted the Debtors' only asset during the Relevant Period. And
21 the Schaefer Entities never received payments on their loans except out of their own loan proceeds and
22 advances. Finally, the Schaefer Entities enforced a valid lien to foreclose on the UC Lofts Real
23 Property, in which they realized substantially less than their debt's face value. The court therefore
24 awards judgment for the Schaefer Entities.

26 XII. DAMAGES AND INTEREST

27 "[State] law regarding prejudgment interest is applicable via 11 U.S.C. § 544(b)." *Hayes v.*
28 *Palm Seedlings Partners (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528, 541 (9th Cir.

1 1990). In “every case of oppression, fraud, or malice,” an award of prejudgment interest rests in the
2 trial court’s sound discretion. See Cal. Civ. Code § 3288⁸⁹; *Johnson v. Neilson (In re Slatkin)*, 525
3 F.3d 805, 820 (9th Cir. 2008). The purpose of prejudgment interest is to compensate the plaintiff for a
4 defendant’s wrongful conduct and therefore forms an element of damages. *Wisper Corp. v. Cal.*
5 *Comm. Bank*, 57 Cal. Rptr. 2d 141, 154 (1996); *Big Bear Prop. v. Gherman*, 157 Cal. Rptr. 443, 446-
6 47 (1979).

7 In California, the prejudgment interest rate for a fraud claim is seven percent. CAL. CONST.
8 ART. XV, § 1; *Michelson v. Hamada*, 36 Cal. Rptr. 2d 343, 352-53 (1994). Courts generally do not
9 award compound interest unless the parties stipulate or a statute provides otherwise. See *State v. Day*,
10 173 P.2d 399, 409 (Cal. Ct. App. 1946); see also *Michelson*, 36 Cal. Rptr. 2d at 353.

11 Constructive fraud forms the basis for Defendant Halifax’s liability. The court thus has
12 discretion under California Civil Code § 3288 to award prejudgment interest. See *Pepitone*, 134 Cal.
13 Rptr. at 712. Plaintiff waited three years after the fraudulent transfer to file her Complaint. The
14 Trustee also conducted minimal discovery and took six years to bring this adversary proceeding finally
15 to trial. The estate should not obtain a windfall from such delay in the form of an inflated prejudgment
16 interest award.

17 But some measure of prejudgment interest is appropriate to compensate the estate for the lost
18 time value of these funds. The court therefore awards prejudgment interest at the California legal rate
19 of seven percent from April 2, 2007, the date the Trustee filed the Complaint. The court will compute
20 prejudgment interest on a simple basis. Defendant Halifax is thus liable in the principal amount of
21 \$1,100,000, plus \$537,734.25 in prejudgment interest. Interest accrues postjudgment at the federal
22 rate.

23
24
25 ⁸⁹ The court notes that § 3287(a) makes prejudgment interest mandatory for “[a] person who is entitled
26 to recover damages certain, or capable of being made certain by calculation, and the right to recover
27 which is vested in the person upon a particular day . . .” Cal. Civ. Code § 3287(a). But § 3287
28 “applies only in cases where the recovery is predicated on breach of contract.” *Pepitone v. Russo*, 134
Cal. Rptr. 709, 712 (1976). In cases predicated on constructive fraud, however, § 3288 governs an
award of prejudgment interest. *Id.*; see also *Redke v. Silvertrust*, 6 Cal. 3d 94, 106 (1971).

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XIII. CONCLUSION

For the foregoing reasons, the court finds that the Trustee has failed to meet her burden to hold Defendants John Scafani, Sheila Lemire, Frank Schaefer, Frank Schaefer Construction, Inc. or Frank Schaefer Construction, Inc. Pension Plan liable on any of her claims. The court finds, however, that Defendant Halifax received a fraudulent transfer, and so awards judgment against it in the amount of \$1,100,000 plus \$537,734.25 in prejudgment interest. Postjudgment interest accrues at the federal rate. A separate judgment shall issue.

IT IS SO ORDERED.

Dated: March 27, 2014



CHRISTOPHER B. LATHAM, JUDGE
United States Bankruptcy Court

In re UC Lofts on 4th LLC, UC Lofts on 5th LLC, Bk. Nos. 05-15409-CL7, 05-15410-CL7
Leslie T. Gladstone, Chapter 7 Trustee v. Charles McHaffie, et al., Adv. No. 07-90139-CL

CERTIFICATE OF MAILING

The undersigned, a regularly appointed and qualified clerk in the office of the United States Bankruptcy Court for the Southern District of California, at San Diego, hereby certifies that a true copy of the attached document, to wit:

**MEMORANDUM DECISION AND ORDER
GRANTING JUDGMENT AGAINST DEFENDANT HALIFAX INVESTMENTS, LLC AND
GRANTING JUDGMENT IN FAVOR OF DEFENDANTS SHEILA LEMIRE,
FRANK SCHAEFER, FRANK SCHAEFER CONSTRUCTION, INC.,
FRANK SCHAEFER CONSTRUCTION, INC. PENSION PLAN AND JOHN SCAFANI**

was enclosed in a sealed envelope bearing the lawful frank of the bankruptcy judges and mailed via first class mail to the parties at their respective addresses listed below:

Jeffry A. Davis, Esq.
Mintz Levin Cohn Ferris Glovsky & Popeo
3580 Carmel Mountain Road, Suite 300
San Diego CA 92130
(Attorney for Plaintiff/Chapter 7 Trustee)

James Jay Stoffel, Esq.
Beberman, Stoffel & Beberman
7676 Hazard Center Dr., Suite 500
San Diego CA 92108
(Attorney for Schaefer Defendants)

Gregg A. Johnson, Esq.
12526 High Bluff Drive, Ste 300
San Diego CA 92130
(Attorney for Defendant Halifax Investments, LLC)

Leslie T. Gladstone, Chapter 7 Trustee
401 Via Del Norte
La Jolla CA 92037
(Plaintiff)

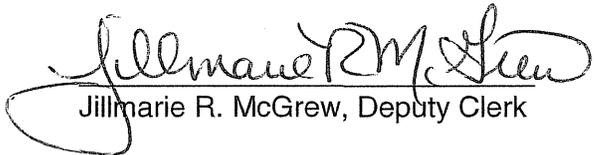
Sheila Lemire
PO Box 675548
Rancho Santa Fe CA 92067
(Defendant in Pro Per)

Sheila Lemire
1820 Avenida Del Mundo, Unit 128
Coronado CA 92118
(Defendant in Pro Per)

Frank Schaefer
Frank Schaefer Construction, Inc.
Frank Schaefer Construction, Inc. Pension Plan
1028 Berwicks Court
Carlsbad CA 92011
(Defendants)

John Scafani and Halifax Investments, LLC
5155 Waring Road
San Diego CA 92120
(Defendants)

Said envelope(s) containing such document was deposited by me in the City of San Diego, in said District on March 27, 2014.


Jillmarie R. McGrew, Deputy Clerk