WRITTEN DECISION – NOT FOR PUBLICATION

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SOUTHERN DISTRICT OF CALIFORNIA
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UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re: EPIC CYCLE INTERACTIVE, INC., Debtor, ______________________________ RONALD E. STADTMUELLER, CHAPTER 7 TRUSTEE, Plaintiff, v. JAMES AND SUSAN FITZGERALD, Defendants. ______________________________	Bankruptcy Case No. 08-03289-CL7 Adversary Proceeding No. 11-90111-CL Chapter 7 MEMORANDUM DECISION AND ORDER GRANTING JUDGMENT FOR DEFENDANT Judge: Christopher B. Latham

MEMORANDUM DECISION AND ORDER GRANTING JUDGMENT FOR DEFENDANT

Plaintiff, Chapter 7 Trustee Ronald E. Stadtmueller, brings this action to avoid and recover alleged preferential transfers from Debtor Epic Cycle Interactive, Inc. ("Epic") to Defendants Susan and James Fitzgerald.[1] Defendant made the subject loan on December 13, 2007 to Debtor in the principal amount of $100,000 with interest at ten percent. Seventy-one days later on February 22, 2008, Debtor repaid the note and all accrued interest in the total amount of $101,972.22. This note contained a *pari passu* provision to ensure equal treatment with other outstanding notes – most significantly those owed to Newlight Associates, L.P. ("Newlight"), Dolphin Communications Parallel Fund II ("Dolphin") and their affiliates (collectively, the "VC Firms"). Ultimately, Debtor only repaid the note owed to Defendant while the other notes of equal priority went unpaid.

The court held a six-day trial on Trustee Stadtmueller's adversary complaint. The court finds that the Trustee has failed to carry his burden to show that the Debtor was insolvent on the transfer date. It therefore grants judgment in Defendant's favor and against the Trustee.

I. Jurisdiction

The court has jurisdiction to hear and determine this matter under 28 U.S.C. §§ 157(b)(2)(F) and 1334(b).

II. Procedural History

Epic filed a voluntary Chapter 11 petition on April 22, 2008. The court converted the case to Chapter 7 on March 5, 2010. Plaintiff initiated this adversary proceeding against Defendant on March 3, 2011.

Defendant moved for summary judgment claiming that the ordinary course defense in § 547(c) insulated the subject transfer from avoidance. The court denied that motion. On the eve of trial, the

[1] Defendant James Fitzgerald, Sr. passed away this past year. His wife, Susan, remains as the only named Defendant in this case. Any mention of James or Jim Fitzgerald refers to Defendant James Fitzgerald, Sr.'s son. Hereafter, the term "Defendant" refers to Susan Fitzgerald.

court issued a tentative ruling on the applicable insolvency analysis and finding that the Debtor should be valued as a going concern on the transfer date.

III. FACTUAL BACKGROUND

A. Debtor's Business and Financing Practices

Epic embodied every sense of the term "start up." James Fitzgerald, the deceased Defendant's son, ("Fitzgerald") created the Debtor around 1998 to develop and market website design software. Epic's innovation, according to its founder, was its business model arranged around licensing its software to firms and centralizing the support costs.

Epic's lean cost structure still required significant capital to support its start up and operating expenses. Fitzgerald solicited equity investment through a series of private stock offerings. The first round raised funds from Fitzgerald's circle of close family and friends. To supplement its stock offerings, Epic issued convertible notes to raise additional capital. Fitzgerald attracted this type of investment from Epic's staff and his parents, as well as from venture capital firms.

Early in the business's history, virtually all of the note holders elected to convert their debt into equity. Defendant lent to Epic on at least three occasions between 1998 and 2000, in amounts ranging from $10,000 to $50,000. They exercised their conversion option in satisfaction of each note. During this same period, Dawn Diskin,[2] who worked for Epic at the time, also purportedly lent money to Epic that it repaid according to an amortization schedule. Although Ms. Diskin recalled making an equity investment, she disclaimed any personal knowledge of this specific transaction.

Epic then approached EmTek, a fund organized by the City of San Diego to encourage development of indigenous technology companies, for $250,000 in financing. The EmTek lending terms precluded Epic from incurring additional debt. Epic and EmTek executed a release in full satisfaction of EmTek's loan in 2005.

Meanwhile, Epic became involved with the VC Firms, Newlight and Dolphin. Newlight provided a bridge loan in 2005 in exchange for a convertible note. Then in April 2006, Epic and the

[2] Ms. Diskin went by her maiden name, Whirry, at the time of the transaction. She is also currently employed by the estate to perform accounting services.

VC Firms entered into a preferred stock transaction in which they acquired a minority interest in Epic and seats on its board of directors. Newlight also exercised the conversion option for its 2005 bridge loan during this transaction. This began a period of aggressive expansion for Epic, which culminated in its acquisition of SpotsAdMarketplace and an attempt at another private preferred stock offering.

By 2007, Debtor had secured large contracts with CBS and newspapers within the Tribune group that were slated to begin performance in 2008. A major customer had recently defaulted in October 2007 and had historically paid late. To Fitzgerald, this highlighted Epic's need to maintain substantial working capital to ensure its ability to perform these new contracts. But the new equity investment round was not progressing quickly enough to keep pace with Epic's rapid growth. Fitzgerald estimated that Epic needed to raise an additional $500,000 in working capital in late 2007.

The VC Firms provided $400,000 in bridge financing between October 31 and November 27, 2007. In exchange, Epic gave them senior convertible promissory notes (the "Bridge Notes"). Epic used a standardized form for these notes, which indicated that they would bear interest at ten percent per annum, were payable upon demand on or after a specific date and prohibited prepayment. The notes also featured a conversion option that would automatically take effect if a qualified financing transaction ("QFT") occurred, defined as the first issuance of equity securities in Epic aggregating $1,000,000, inclusive of the Bridge Notes' collective principal and interest. If a QFT triggered the conversion option, the Bridge Notes would cease bearing interest and be converted to equity shares in Epic. Defendant admits that the relationship between Epic's management and the VC Firms was openly hostile at this point.

To raise the additional $100,000, Fitzgerald turned to the Defendant. She made the loan on December 13, 2007. The note accrued interest at ten percent per annum and had a sixty-day maturity date, after which she could either demand repayment or convert the note to equity. The note also provided that it ranked in *pari passu* with the Bridge Notes. Rather than exercise the conversion option, as Defendant had every time in the past, she demanded repayment in writing within the performance period. On February 22, 2008, Fitzgerald caused Epic to wire the funds to Defendant at the note's full face value plus interest. The entire transaction occurred over the course of 71 days, and was consummated less than 90 days before the petition date.

Mrs. Fitzgerald testified that her husband had elected repayment over equity conversion because the couple had planned were planning to invest in Arizona real estate – during the first quarter of 2008. According to Mrs. Fitzgerald, her and her husband's bail bond business was winding down, and they were looking to supplement their income. This assertion lacks credibility, however, given that the Arizona real estate market was trending down sharply in this period.

Between October 2007 and February 2008, Epic's relationship with the VC Firms deteriorated. In January 2008, the VC Firms filed suit against Fitzgerald and Epic alleging, among other things, breach of contract and fiduciary duty. It appears that the complaint may not have been served until March 2008. In addition, Plaintiff produced a letter from the VC Firms demanding repayment dated December 21, 2007.[3] But Fitzgerald testified that he did not receive this demand until March 2008.

Meanwhile, Fitzgerald and Epic's management actively negotiated with the VC Firms and offered to pay off the outstanding Bridge Notes. But the VC Firms resisted Fitzgerald's settlement overtures. On February 28, they formally demanded repayment of outstanding Bridge Note. And on April 22, the VC Firms obtained a writ of attachment on Epic's assets. Epic's Chapter 11 petition followed that same day, without the VC Firms having received payment on their outstanding notes.

B. Debtor's Balance Sheet

1. Plaintiff's Expert, Alan Myers, CPA

The Trustee offered the testimony of Alan Myers, Certified Public Accountant, to show that Debtor was insolvent on the transfer date. Mr. Myers's practice has focused primarily on bankruptcy matters since 1989. He trained his analysis on Epic's internal balance sheets, tax returns and information related to the transfer at issue. Mr. Myers believed that two dates, February 21, 2008 and February 29, 2008, provided the most accurate time bracket available for him to perform his analysis and opine on Epic's financial condition as of February 22, 2008.

Mr. Myers opted against using Epic's December 31, 2007 tax return figures in his analysis because he believed the February 21, 2008 and February 29, 2008 balance sheet entries were more

[3] The court did not receive this letter in evidence for the truth of its contents. The court did, however, take judicial notice of a complaint for equitable subordination filed by Epic against the VC Firms to which it was attached. But Epic did not file that complaint until 2009. Thus, the fact that Epic itself relied on this letter in subsequent litigation is not directly probative of when Epic received it.

directly relevant. He assumed that the accuracy of Epic's accounting records for the December 31, 2007 the tax return and the internal figures supplied for February 21, 2008 and February 29, 2008 remained constant.

Specifically, Mr. Myers reviewed Epic's federal corporate income tax returns for 2007, 2008 and 2009. He then compared them to Epic's balance sheets for January 31, 2008, February 21, 2008, February 29, 2008, April 22, 2008 and June 30, 2008. These statements, generated from Debtor's internal accounting system, matched the figures Epic reported to the IRS in 2008 within one dollar. He also analyzed the Debtor's bank statements for January, February and March of 2008.

Mr. Myers stated that he valued Epic as a going concern for his solvency analysis. He moved asset by asset to determine the fair market price for each asset category. In essence, he used the book value of each asset, as it was listed on the balance sheets, and made a series of adjustments to arrive at the fair market price. He clarified that his definition of the latter assumed that the assets "had been sold as a unit in a prudent manner and within a reasonable time."[4]

He made the following relevant adjustments to Epic's balance sheet asset valuations:

(1) Discounting Epic's accounts receivable by eighteen percent;
(2) Converting the "Payroll Payment" listed as a negative asset to a liability;
(3) Valuing the landlord's security deposit at zero, because Epic consumed its value by the petition date;
(4) Discounting the workers' compensation deposit by fifty percent, since he assumed it would only be partially refundable;
(5) Valuing at zero a $161,200 letter of credit on deposit with Comerica Bank intended to secure Epic's performance under a licensing agreement with OK Bridge;[5]
(6) Discounting to zero $33,603 in prepaid utility deposits on the basis that he did not believe Epic could realize any value from this asset;
(7) Discounting the Debtor's book value for its fixed assets by applying a formula that: (1) divided the balance sheet valuation by the total net liquidation value for all Debtor's assets: and (2) multiplied that dividend by the net liquidation value for the fixed assets;[6]
(8) Reducing Debtor's goodwill book value to zero based on the theory that it could not be sold; and

[4] Trial Tr. vol. 1, 91:2-16, Jan. 30, 2014, ECF No. 77.

[5] Alternatively, he applied a factor rate of one, two and three percent to value the asset at $100,000, $45,000 and zero, respectively. But ultimately, he assigned a zero value because he asserted the Trustee could not sell this asset or otherwise realize any benefit for the estate.

[6] Mr. Myers used a net liquidation valuation performed by Debtor as of December 31, 2008 to supply the data inputs. His calculations produced a $101,306 valuation as of February 21 and $98,575 as of February 29. The court appreciates the novelty of this formula and recognizes Mr. Myers's admission that he had only the thinnest rationale for applying it to this context – or any other. Further, the Trustee's counsel conceded its unprecedented nature in closing. The court therefore affords it no weight in this decision.

(9) Discounting the book value attributed to SportsAdMarketplace to zero.

Mr. Myers also reduced Debtor's current liabilities from their face value to account for income that would eventually be reported. This adjustment amounted to $31,700 on February 21 and $35,850 on February 29.

Using this analysis, he opined that Epic's assets on February 21 totaled $1,350,638, and its liabilities $1,827,937. Mr. Myers asserted that Epic was therefore insolvent by $477,299. For February 29, he valued Epic's assets at $808,880, and its liabilities at $1,410,438. Thus, in the course of one week, Epic had slipped further into insolvency to the point that its liabilities exceeded its assets by $601,558. Based on these data points, Mr. Myers concluded that Epic had been insolvent on February 22 when it repaid Defendant.

2. Defendant's Expert, Michael Corson, CPA

The Defense's expert, Mr. Corson, is a CPA with forty years of experience, ten of which included corporate controller and chief financial officer roles. Mr. Corson chose a time bracket broader than Mr. Myers's, using January 1, 2008 and April 22, 2008 as his start and end dates. He opined that Epic was solvent on January 1, 2008, and April 22, 2008. Mr. Corson interviewed Fitzgerald and reviewed the Debtor's disclosure statements, tax returns and operating reports.

Mr. Corson relied heavily on Epic's December 31, 2007 balance sheet included on its 2008 tax return. He believed this source was most reliable because it was filed under penalty of perjury and was prepared by a CPA. As a general proposition, Mr. Corson allowed that internally generated small business financials can often be unreliable, although he had no reason to question Epic's reliability specifically. And he acknowledged that the internal accounting accorded closely with the figures Epic submitted on its tax returns. Mr. Corson criticized Mr. Myers's report as paying mere lip service to the going concern valuation. Instead, he asserted that Mr. Myers ultimately performed a liquidation analysis.

The 2008 tax return showed an asset balance as of January 1, 2008 of $2,511,202 and total liabilities of $1,864,348. As a result, Mr. Corson concluded that Epic's assets exceeded its liabilities by $646,854 on January 1, 2008. He made no significant adjustments to the figures as of this date.

For April 22, 2008, Mr. Corson began his analysis with the bankruptcy schedules. He used these figures, instead of the Debtor's internally generated balance sheet information, because they were filed under penalty of perjury. He applied a fifteen percent discount rate to the Debtor's accounts receivable based on Epic's past history of cash collections. Mr. Corson did not discount any of Debtor's other assets. But he did augment Epic's assets by: (1) $37,500 for the unused portion of a $50,000 retainer paid to its bankruptcy counsel;[7] (2) $64,200 to account for leased assets as Epic had capitalized the lease obligation; and (3) $100,000 to reflect Epic's goodwill. Thus, Mr. Corson valued Epic's assets at $1,168,489 as of April 22.

As for liabilities, Mr. Corson discounted the Dolphin and Newlight convertible notes by $250,000. He based this upon his mistaken understanding that Epic had reached a settlement with the VC Firms. On cross-examination, Mr. Corson conceded that this knowledge undoubtedly would have affected his valuation of the liabilities. Nevertheless, he posited that his discount remained appropriate given the notes' conversion contingency.

Plaintiff objected to this testimony based on relevance and that it constituted an impermissible previously undisclosed expert opinion. The court reserved ruling on Plaintiff's objection. The court now sustains the Trustee's objection. Mr. Corson lacks sufficient personal knowledge to opine on the subject. And to the extent he provided an expert opinion, it was inappropriately omitted from Defendant's pretrial expert disclosures. Nor did it result from a properly posed hypothetical. Regardless, the court perceives no prejudice to Defendant by excluding this testimony. Fitzgerald testified extensively on the likelihood that the Bridge Notes would convert to equity.

Ultimately, Mr. Corson valued Epic's liabilities on April 22 at $889,972. He therefore determined that its assets exceeded its liabilities on this date by $278,517. Because he had found Epic solvent on January 1 and April 22, respectively, he concluded that Epic had necessarily also been solvent on February 22.

[7] His original report allowed a $50,000 upward adjustment. But Fitzgerald's trial testimony clarified that Epic had depleted $12,500 of the retainer by the petition date.

3. James K. McCormack, Auctioneer

James K. McCormack, a certified auctioneer, member of the Auctioneers Institute, testified for the defense. He assigned a $74,000 liquidation value to Debtor's fixed assets. Mr. McCormack acknowledged that the $74,000 figure comprised a "piecemeal auction valuation" of the Epic assets as of December 9, 2008. But had the system been sold as an operational data center, he opined that it would have likely realized $148,000. He testified that 2008 was a buyer's market because of the many sales of older computer equipment. His analysis also included a valuation of other leased assets of the Debtor.

IV. Preference Liability Under § 547

To avoid a transfer under 11 U.S.C. § 547(b),

> the trustee must prove by a preponderance that the transfer was (1) made to or for the benefit of a creditor, (2) on account of an antecedent debt, (3) made while the debtor was insolvent, and (4) made within one year of the petition, and (5) enabled the creditor to receive more than it would have had the transfer not been made and the case liquidated pursuant to the provisions of chapter 7 of the bankruptcy code.

Arrow Elec., Inc. v. Justus (*In re Kaypro*), 218 F.3d 1070, 1073 (9th Cir. 2000) (citation omitted).

Epic's solvency on the transfer date is the only materially disputed element, although Defendant contends that Epic's subordination efforts against the VC Firms and numerous contested debts call the greater recovery element into dispute. The Code defines "insolvent" to mean:

> (A) [W]ith reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of--
>
>> (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
>> (ii) property that may be exempted from property of the estate under section 522 of this title[.]

11 U.S.C. § 101(32). Section 547(f) establishes a rebuttable presumption of insolvency during the 90 days before the petition date. But this presumption does not modify the Trustee's ultimate burden of persuasion – i.e., it "vanishes" once a defendant produces credible evidence of the Debtor's solvency

on the transfer date. *Sierra Steel, Inc. v. Totten Tubes, Inc.* (*In re Sierra Steel, Inc.*), 96 B.R. 275, 277 (B.A.P. 9th Cir. 1989).

> The Ninth Circuit has described the insolvency analysis as a two-step inquiry: First, the court must determine whether a debtor was a "going concern" or was "on its deathbed." Second, the court must value the debtor's assets, depending on the status determined in the first part of the inquiry, and apply a simple balance sheet test to determine whether the debtor was solvent.

Wolkowitz v. Am. Research Corp. (*In re DAK Indus., Inc.*), 170 F.3d 1197, 1199 (9th Cir. 1999); *see also Travellers Int'l AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines, Inc.*), 134 F.3d 188, 193 (3d Cir. 1998). If the debtor was a going concern, the proper measure to value its assets is "as if they had been sold as a unit, in a prudent manner, and within a reasonable time." *In re DAK Indus., Inc.*, 170 F.3d at 1199 n.3; *see also In re Trans World Airlines, Inc.*, 134 F.3d at 194. If it was not, then a liquidation valuation is more appropriate, "such as a price expected at a foreclosure sale." *In re DAK Indus., Inc.*, 170 F.3d at 1200 n.3.

In the liability column, the court must credit the subject debt's "face value" because of the potential "anomalous results" if the value of liabilities is viewed from a creditor's standpoint of collectability rather than the debtor's perspective. *See In re Trans World Airlines, Inc.*, 134 F.3d at 197 n.7; *Covey v. Commercial Nat'l Bank*, 960 F.2d 657, 660 (7th Cir. 1992). The court must also include contingent liabilities in the calculation discounted "by the probability that the contingency will occur and the liability will become real." *In re Sierra Steel, Inc.*, 96 B.R. at 279.

Finally, the court need not estimate additional costs affecting an asset's value simply because the evidence establishes that such a cost exists. *See Batlan v. TransAmerica Commercial Fin. Corp.* (*In re Smith's Home Furnishings, Inc.*), 265 F.3d 959, 968 (9th Cir. 2001) (liquidation costs). If the evidence presented at trial falls short of "precise projections," the court does not err by declining to estimate such costs. *See id.*

As the court already found in its in limine tentative ruling [ECF Nos. 69 & 70], Epic must be valued as a going concern. Notably, Epic: (1) had secured several lucrative contracts by late 2007 that were not in default; (2) was generating substantial gross revenues; and (3) continued to operate as a debtor in possession for over a year after the petition date.

The most expeditious method to assess Epic's solvency as of February 22, 2008 under the *In re DAK* standard is to proceed asset by asset. First, the court finds that Mr. Myers's bracketing methodology more precisely captures the data necessary to determine the Debtor's solvency on the transfer date. The court appreciates the greater detail included in the balance sheets as well as their close correlation to the tax return figures. Additionally, the narrower bracket's closer proximity to the transfer date enhances the analysis's accuracy.

The court found each party's expert witness testimony to be generally credible. But on balance, the court found Mr. Corson's analytical approach to valuation more reliable and persuasive for ascertaining a going concern's worth. The major exceptions, discussed below, relate to Defendant's valuation of Epic's fixed assets and contingent liabilities. Mr. Myers, by contrast, tended to blur the line between going concern and liquidation value such that the court cannot fully credit his testimony without contravening applicable case authority. Thus, the court will determine the Debtor's solvency on February 22, 2008 by consulting its balance sheets and applying both experts' logic where appropriate.

A. Epic's Assets on February 22, 2008

1. Cash and Cash Equivalents

Mr. Myers valued the Debtor's cash and cash equivalents at their balance sheet numbers. Mr. Corson agreed that no adjustment to this asset was necessary. The court will therefore value Epic's cash accounts at their book value.

2. Accounts Receivable

Mr. Myers reduced this amount by eighteen percent to allow for doubtful accounts. He did not look to Epic's actual performance on collecting its receivables. Mr. Myers simply believed the information was not available because he could not locate an allowance for doubtful accounts book entry. By contrast, Mr. Corson based his analysis on the Debtor's past history of cash collections. He discounted Epic's accounts receivable by fifteen percent accordingly.

The court accepts Debtor's past performance as a better indicator of the Debtor's current performance on collecting its receivables. The court therefore adopts Mr. Corson's fifteen percent discount rate on the accounts receivable.

3. Payroll Deposit

Mr. Myers made no adjustments to a negative asset account called Payroll Deposit, although he noted that Epic should have classified it as a liability. Nor did Mr. Corson disagree. The court thus values this negative asset at its full book value.

4. Security Deposit

Epic had a $72,800 cash security deposit in an account to secure its obligations to its landlord. Mr. Myers valued the security deposit at zero, discounting it fully from its book value of $72,800 on both February 21 and 29, 2008. Mr. Myers based his decision in large part on the fact that this account shrank from $72,800 to $800 by April 22, 2008. He thus opined that it would be unlikely that Epic would have been able to convert this asset to cash on February 21 or 29, 2008.

Defendant took issue with Mr. Myers's inference that the $72,800 had been consumed. Her counsel posed a hypothetical to assess how Mr. Myers would have valued the account had the money been returned to the Debtor in March 2008. Mr. Myers stated that he would not have reduced the value to zero in that event.

The court does not find Mr. Myers's *ex post* analysis persuasive. Although Debtor may have depleted this account by a later date, the court must view the circumstances using information available on the transfer date. The Trustee bears the burden of persuasion and has not provided the court with a principled way to discount this asset, other than at zero or full book value. The court therefore values the security deposit at $72,800 on both February 21 and 29, 2008.

5. Workers' Compensation Deposit

Epic also had a $1,852 workers' compensation deposit on record with the state of California. The court finds that Mr. Myer's acceptance of the Debtor's scheduled numbers, assuming 50 percent collectability, is reasonable. Moreover, Defendant did not meaningfully challenge this valuation. The court therefore concludes that this asset was worth $926 on both February 21 and 29, 2008.

6. OK Bridge Letter of Credit on Deposit with Comerica Bank

The Debtor's balance sheet included a $161,200 asset listed as "letter of credit." Both parties' understanding of this asset is the same, though their competing valuations differ significantly.

Mr. Myers understood this asset to be a deposit held at Comerica Bank guaranteeing the Debtor's performance on a contract, which would complete sometime in February of 2011. A third party, OK Bridge, was the beneficiary to the deposit in the event that Debtor failed to perform. Mr. Myers acknowledged that $150,000 of the letter of credit deposit was eventually returned to Epic between June of 2009 and April of 2010. Using his knowledge of this ultimate recovery, he adjusted his valuation to $125,000 as of February 2008. Restricting his analysis to information available at the time of the transfer, however, Mr. Myers discounted the letter of credit down to zero. He believed the Debtor would have been unable to convert it to cash on February 21 or 29, 2008.

Alternatively, on the stand, Mr. Myers valued the letter of credit as a type of account receivable, applying factor rates at one, two, and three percent. These resulted in values of $100,000, $45,000 and a negative number, respectively. Mr. Myers opined that the account as of February 22 and 29, 2008 was zero based on the information that would have been available February 22 and 29, 2008. Additionally, Mr. Myers believed it highly unlikely that any buyer would purchase the note because the entity performing on it was not financially sound. He specifically emphasized the note's three-year performance window.

Mr. Corson did not make any downward adjustments to this asset. Affording it the book value, he contended, was more consistent with valuing Epic as a going concern.

Fitzgerald, Debtor's CEO at the time, described the asset as follows: Epic licensed rights to a computer game called OK Bridge for which it paid royalties to the licensor. If Epic missed a payment, the licensor had the right to draw on the deposit account. But if Epic performed on the contract, it was entitled to the funds in full. Thus, Epic's claim to the letter of credit rested on its ability to perform.

In a hypothetical sale of Debtor's rights to this asset on the transfer date, any potential buyer would need to assess the likelihood that Epic would successfully perform on the contract. Of course, Epic was not guaranteed to perform on the contract, but neither was its failure a certainty. The Trustee bears the burden of proof and has not provided a persuasive method to discount the value of this account. Absent evidence to the contrary, the court finds that this asset was worth $161,200 on both February 21 and 29, 2008.

7. Prepaid Expenses

Epic's assets also included prepaid utility deposits. Mr. Myers reduced the Debtor's prepaid expenses from $33,603 to zero. He opined that, because this asset represented spent money, it was not possible to convert it to cash. But this overlooks the possibility that Epic might have assigned its lease interest and so have preserved some value in these accounts. The court does not find Mr. Myers's zero dollar determination to be reliable or persuasive. And the Trustee has not provided the court with any principled way to appropriately discount this asset. The court therefore accepts the book values for these assets as of February 21 and 29, 2008.

8. Fixed Assets

The parties also disagree on the valuation of Epic's fixed assets, which consisted primarily of computer equipment. Mr. Myers discounted Epic's book value of $418,467 for the fixed assets as of February 21, 2008 to $101,306, using the formula described in section III.B.1. above. Mr. Corson opined that valuing Epic as a going concern required him to use its net book value for the fixed assets. The court finds that the auctioneer's report and trial testimony best represent the value of Epic's fixed assets. While Mr. Myers's formula is decidedly creative, the logic underlying it is far from persuasive. Similarly, the court concludes that the book value of the Debtor's assets does not accurately capture the actual value of its computers.

The court finds that the Debtor's fixed assets were worth $248,940 on both February 21 and 29, 2008. This figure equals the sum of the $74,100 and $64,200 liquidation figures from Mr. McCormack's report, multiplied by two to represent the computers' "fully operational" value, and subtracting a ten percent sales commission. Although Mr. McCormack's liquidation valuation relates to December 2008, the court finds that his report ascertains the actual value of these assets more reliably than does Mr. Corson's.

9. SportsAdMarketplace

SportsAdMarketplace was an advertising distribution network where national advertisers could break up their advertising expenditures into smaller, targeted regional markets. Fitzgerald testified that Epic acquired it through an asset purchase agreement. Though Epic reported SportsAdMarketplace's revenue separately on its income statements, it was not a separate legal entity.

Mr. Myers discounted this asset from its $50,000 book value to zero. He looked to the net liquidation value to support his valuation. He found it significant that Epic did not sell this asset even though it was experiencing losses. He also noted that Epic listed it as an investment on the tax return balance sheet. Thus, he reasoned that the Debtor would have sold the SportsAdMarketplace if it had any value and a market existed for it.

This does not adequately capture SportsAdMarketplace's actual value, however. Fitzgerald credibly testified that SportsAdMarketplace generated significant gross revenues. Further, he stated that Epic had received multiple offers to purchase SportsAdMarketplace for roughly $1,000,000. Fitzgerald suggested that the VC Firms prevented a sale by using their positions on Epic's board of directors. Mr. Myers indicated that the information regarding SportsAdMarketplace's gross revenues and third party offers to purchase it would have caused him to inquire further about the investment. But he did not specify what effect, if any, it would have had on his ultimate conclusion.

Mr. Corson did not make an upward adjustment to the SportsAdMarketplace asset value. But he stated that he would have attempted to determine whether the third party purchase offers were bona fide arm's length ones. He would have also have researched whether the potential buyers were able to perform. If so, he would have valued the SportsAdMarketplace asset at the offer amount. But even without further analysis of the offers, Mr. Corson was comfortable valuing this asset at its book value of $50,000.

The court accepts Mr. Corson's conservative analysis as the more reliable one, and so credits the SportsAdMarketplace with its book value.

10. Epic's Goodwill and Intangible Assets

The parties disagree on whether Epic held any intangible value or goodwill that could be realized to satisfy creditors' claims. Businesses often record the "excess purchase price paid over the value of the assets" on their balance sheets as goodwill. *Collins v. Kohlberg & Co.* (*In re Southwest Supermarkets, LLC*), 325 B.R. 417, 423 n.12 (Bankr. D. Ariz. 2005). Goodwill is also understood to represent the "value of intangible factors that are expected to translate into greater than normal earning power." *Bay Plastics, Inc. v. BT Commercial Corp.* (*In re Bay Plastics, Inc.*), 187 B.R. 315, 330 n.24 (Bankr. C.D. Cal. 1995). Generally Accepted Accounting Principles ("GAAP") in certain circumstances allow for a business to carry goodwill on its balance sheets, particularly after purchasing an asset above market value. *See In re Southwest Supermarkets, LLC*, 325 B.R. at 423 n.12; *In re Bay Plastics, Inc.*, 187 B.R. at 330 n.24; *Kendall v. Sorani* (*In re Richmond Produce Co., Inc.*), 151 B.R. 1012, 1019 (Bankr. N.D. Cal. 1993). But although relevant, GAAP conventions do not control the court's determination of insolvency in an avoidance action. *In re Sierra Steel, Inc.*, 96 B.R. at 278.

In an insolvency analysis, the court must determine a fair valuation of an entity's property. *See In re Southwest Supermarkets, LLC*, 325 B.R. at 423 n.12; *In re Richmond Produce Co., Inc.*, 151 B.R. at 1019. "This differs from a balance sheet, where most assets apart from publicly traded stocks and bonds are carried at historic cost, rather than current market value." *In re Bay Plastics, Inc.*, 187 B.R. at 330. Thus, "[i]ntangible balance sheet assets, such as goodwill, which may have no market value (either on a liquidation or going concern basis) generally should be excluded from the calculation." *GSM Wireless, Inc. v. Honarkar* (*In re GSM Wireless, Inc.*), No. 2:12–ap–01350 RK, 2013 WL 4017123, at *18 (Bankr. C.D. Cal. Apr. 5, 2013); *see also In re Bay Plastics, Inc.*, 187 B.R. at 330-31. Since by itself, "[g]oodwill cannot be sold to satisfy a creditor's claim," the court should not generally include it in its valuation. *In re Bay Plastics, Inc.*, 187 B.R. at 330-31 (analyzing a liquidating Chapter 11).

Epic's balance sheets list amortized goodwill of $110,550 on February 21, 2008 and $109,563 on February 29, 2008. Mr. Myers discounted Epic's goodwill from its book value to zero. He opined that the Debtor would not have been able to sell this asset, and therefore, was unable to convert it to cash. Mr. Myers relied on the Debtor's significant retained earnings deficit of $4.8 million by 2007, although it does not appear he analyzed whether Epic's intangible value might have an effect on its accumulated losses. He concluded that Epic's assets would not command a premium above their fair market value. He therefore declined to provide an upward adjustment for any intangible asset or goodwill value.

Mr. Corson took a different approach. He relied on a liquidation report prepared by an accounting and auditing firm, "CBIZ", to arrive at a $100,000 asset value for Debtor's intangibles. Mr. Corson did not specifically reference Epic's balance sheet entry for goodwill. In his opinion, the third party offers to buy the SportsAdMarketplace at a significant premium above its book value indicated that the Debtor's goodwill was likely realizable. The presence of long-term revenue contracts also made him "comfortable" with valuing goodwill at $100,000.

The court finds that Epic's goodwill book value should be excluded from its valuation. The appearance of goodwill on Epic's balance sheet more than likely represented a specific asset purchase, rather than the intangible value attributable to Epic as an enterprise.[8] It is unlikely that Epic could realize any value to satisfy creditors' claims from this historic cost. The court thus accepts Mr. Myers's testimony as the more reliable in this regard.

But the court does not accept Mr. Myers's opinion that it should not recognize any intangible value in Epic. Mr. Corson justified his $100,000 intangible asset value based on Epic's long-term revenue contracts and interest in purchasing SportsAdMarketplace. Neither expert condoned including the long-term revenue contracts on Debtor's balance sheet or otherwise assigned a specific value to them. Thus, they could not appear on Epic's balance sheet under conventional financial accounting principles. But Mr. Corson offered persuasive testimony that a prospective buyer of Epic as a going concern would consider the contracts and Epic's ability to perform as an intangible asset that had economic value. Further, even if Fitzgerald was unlikely ever to persuade the Dolphin and Newlight representatives on Epic's board to consent to sell SportsAdMarketPlace, it generated substantial gross revenues and interest from potential purchasers.

For the foregoing reasons, the court excludes Epic's goodwill balance sheet entry of $110,550 on February 21, 2008 and $109,563 on February 29, 2008. But the buyer interest in SportsAdMarketplace and Epic's related long-term contracts undoubtedly added some intangible value not reflected on Epic's balance sheet or schedules. The court therefore accepts Mr. Corson's opinion that Epic had at least $100,000 in intangible value it could realize to satisfy creditors' claims. Consequently, the court finds that Epic held assets worth $1,927,234 on February 21, 2008 and $1,399,248 on February 29, 2008.

[8] Businesses do not ordinarily carry goodwill on their own balance sheets, although "[g]oodwill frequently appears on a balance sheet after the sale of a business, where it represents the excess of the purchase price over the net value of the other assets purchased." *In re Bay Plastics, Inc.*, 187 B.R. at 330 n.24.

B. Epic's Liabilities on February 22, 2008

The only significant disagreement between the parties regarding Epic's liabilities concerns the VC Firms' convertible Bridge Notes. Specifically, the parties dispute whether the court should discount for the possibility that they would convert to equity and what an appropriate discount rate would be. Notably, neither expert performed a contingency analysis on the outstanding Bridge Notes to guide the court. Mr. Myers credited them at face value. And as explained above, Mr. Corson mistakenly believed the parties had entered into a settlement to write down the loan balance by $250,000.

Thus, the only admissible testimony regarding the probability that the VC Firms would convert came from Fitzgerald and William M. Rathbone, Esq., Epic's bankruptcy counsel. Fitzgerald testified at trial that he first became became aware of Dolphin's and Newlight's repayment demand on March 3, 2008. But Trustee's counsel produced the December 21, 2007 demand letter to refute this. Mr. Rathbone testified that he received the December 21, 2007 letter from Fitzgerald while preparing Epic's equitable subordination suit against the VC Firms.

The combined effect of the pending VC Firms' litigation, the delay in completing the stock offering and the failure to consummate a QFT by the transfer date lead to a strong inference that the Bridge Notes' contingency was unlikely ever to obtain. Further, it is undisputed that Dolphin and Newlight had demanded repayment by the petition date. The court finds that Fitzgerald, and therefore, Epic, had reason to believe as of the transfer date that conversion was a virtual uncertainty. And so the court concludes that all liabilities on Epic's February 21 and 29, 2008 balance sheets should be valued at face value.

Thus, Epic's liabilities as of February 21 and 29, 2008 were $1,827,937 and $1,410,438, respectively.

C. Epic Was Solvent on the February 22, 2008 Transfer Date

On February 21, 2008, Epic's assets exceeded its liabilities by $99,297. By February 29, 2008, Epic had slipped into insolvency, and its liabilities then exceeded its assets by $11,190. Epic's net loss for 2008, as of February 21, 2008, was $341,459. As of February 29, 2008, the loss was $450,538. Epic experienced a $109,079 deficit in those eight days. Because the court cannot more accurately determine the daily rate of losses, it finds that Epic was losing $13,635 a day. Applying this logic to Epic's balance sheet on February 22, 2008, Epic's assets exceeded its liabilities by $99,297, less $13,635, for a total value of $85,662. Epic was thus solvent on the transfer date.

V. Greater Recovery

Beyond challenging Epic's insolvency on the transfer date, Defendant contends that the transfer did not enable her to recover more than she would have in a hypothetical Chapter 7 liquidation. To avoid a transfer under § 547, the "the trustee must show that the creditor received a greater amount than it would have if the transfer had not been made and there had been a hypothetical chapter 7 liquidation as of the petition date." *In re Smith's Home Furnishings, Inc.*, 265 F.3d at 963. The analysis includes select administrative expenses incurred during the bankruptcy case. *See Neuger v. United States* (*In re Tenna Corp.*), 801 F.2d 819, 823 (6th Cir. 1986). Generally, a trustee can satisfy this element simply by proving that the distribution to unsecured claim holders would total less than 100 percent. *See Elliott v. Frontier Props.* (*In re Lewis W. Shurtleff, Inc.*), 778 F.2d 1416, 1421 (9th Cir. 1985).

The Trustee testified that the unsecured creditors, including Ms. Fitzgerald, would receive less than one hundred percent in a hypothetical Chapter 7 liquidation. On cross-examination, the Trustee acknowledged that he had not factored any of the executory contracts on Schedule G into his analysis. Debtor's counsel contended that these contracts represented guaranteed revenue streams, and thus, had value. Additionally, the Trustee did not account for any claim objections or subordination actions for the purposes of his analysis. Nor did he take into account the SportsAdMarketplace investment.

The Trustee has carried his burden to show that the transfer enabled Defendant to recover more than she would have in a hypothetical Chapter 7 liquidation. Notably, the Debtor incurred substantial administrative fees. Further, crediting Epic's efforts to subordinate the VC Firms' debt at or near the petition date would require speculation by the court. Finally, Epic was hemorrhaging cash and indeed was convincingly insolvent by February 29, 2008. These facts, taken together, establish the greater recovery element.

VI. ORDINARY COURSE

Defendant contends that the transfer is not avoidable as a preference because Epic paid her in the ordinary course. It is an affirmative defense to an action under § 547(b): "(1) that the transfer was 'in payment of a debt incurred by the debtor in the ordinary course of business' and (2) that the payment was either 'made in the ordinary course of business' or 'made according to ordinary business terms.'" *Sigma Micro Corp. v. Healthcentral.com* (*In re Healthcentral.com*), 504 F.3d 775, 789 n.5 (9th Cir. 2007) (quoting 11 U.S.C. § 547(c)(2)). Defendant need only prove one of the two alternatives under § 547(c)(2). 11 U.S.C. § 547(c)(2). Whether a transaction qualifies as ordinary involves a detailed factual analysis. *Ganis Credit Corp. v. Anderson* (*In re Jan Weilert RV, Inc.*), 315 F.3d 1192, 1196 (9th Cir. 2003). The defendant bears the burden of proof to establish the ordinary course defense by a preponderance of the evidence. *See G.H. Leidenheimer Baking Co. v. Sharp* (*In re SGSM Acquisition Co.*), 439 F.3d 233, 239 (5th Cir. 2006).

The first prong requires the court to consider:

> 1) the length of time the parties were engaged in the transactions at issue; 2) whether the amount or form of tender differed from past practices; 3) whether the debtor or creditor engaged in any unusual collection or payment activity; and, 4) whether the creditor took advantage of the debtor's deteriorating financial condition.

Wood v. Stratos Prod. Dev., LLC (*In re Ahaza Sys., Inc.*), 482 F.3d 1118, 1129 (9th Cir. 2007) (quoting *Sulmeyer v. Pacific Suzuki* (*In re Grand Chevrolet, Inc.*), 25 F.3d 728, 732 (9th Cir. 1994)).

A first time transfer between the parties may still qualify as ordinary course. *Id.* at 1126. But "a first-time debt must be ordinary in relation to this debtor's and this creditor's past practices when dealing with other, similarly situated parties." *Id.* Even if the parties have previously transacted, "[n]ew events arise within a business relationship. Such events are not excluded from the ordinary course of business exception simply because they have not arisen before. In a situation when such an event occurs, a fact intensive evaluation of the event must occur." *Compton v. Plains Marketing, LP* (*In re Tri-Union Development Corp.*), 349 B.R. 145, 151 (Bankr. S.D. Tex. 2006).

The ordinary course defense is designed to protect trade creditors and other transactions in the ordinary course of the debtor and creditor's business affairs. *See Pioneer Tech., Inc. v. Eastwood* (*In re Pioneer Tech., Inc.*), 107 B.R. 698, 702 (B.A.P. 9th Cir. 1988). It is not intended to shield stockholders from preference liability for short-term loans to the debtor "to maintain operations despite capitalization problems." *Id.*; *see also Shubert v. Mull* (*In re Frey Mech. Grp., Inc.*), 446 B.R. 208, 216 (Bankr. E.D. Pa. 2011).

Defendant's primary argument is that she and Epic followed the note's terms to the letter. But this alone is insufficient to trigger the defense. Notably, Fitzgerald testified that he believed Epic needed to raise additional capital to hedge against potential interruptions to its operational capacity during this period of unprecedented expansion. Thus from the start, this loan resembled a capital infusion rather than an ordinary trade creditor transaction. That the note was convertible to equity only strengthens this characterization.

Moreover, the transaction was hardly typical for this Defendant. She and her husband were not ordinarily engaged as bridge financing lenders. Rather, they operated a bail bond business and occasionally invested Epic when Fitzgerald, Defendant's stepson, requested financing. Although they had transacted with Debtor in the past, they had exercised their conversion option each time. And seven years had passed since the last loan. Further, the court has found that Defendant's proffered justification for demanding repayment is not persuasive. For all of these reasons, the ordinary course defense does not apply to this transaction.

VII. Conclusion

The court finds that Epic was not insolvent on February 22, 2008. The Trustee has therefore failed to prove an essential element under § 547(b) to avoid the transfer. The court accordingly grants judgment in Defendant's favor.

IT IS SO ORDERED.

Dated: June 6, 2014

Christopher B. Latham

CHRISTOPHER B. LATHAM, JUDGE
United States Bankruptcy Court

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA
325 West "F" Street, San Diego, California 92101-6991

In re Epic Cycle Interactive, Inc., Bk. No. 08-03289-CL7
Ronald E. Stadtmueller, Chapter 7 Trustee v. James & Susan Fitzgerald, Adv. No. 11-90111-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 FOR DEFENDANT

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:

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Said envelope(s) containing such document was deposited by me in the City of San Diego, in said District on June 6, 2014.

Jillmarie R. McGrew

Jillmarie R. McGrew, Deputy Clerk