UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)
JAMES J. PARKS COMPANY,	) CASE NO. BK84-1357
DEBTOR	) A86-166
EUGENE CHAMBERLAIN, Trustee,	) CH. 7
Plaintiff	)
vs.	)
J.P. CONSTRUCTION, INC.,	)
Defendant	)

MEMORANDUM

Trial on this preference action was heard in two parts, beginning on October 1, 1987, and the final day of trial was April 26, 1988. Marion Pruss, David Koukol and C.G. Wallace, of Thompson, Crounse, Pieper, Wallace and Eggers, P.C., Omaha, Nebraska, appeared on behalf of the plaintiff. Robert Bothe and Geoffrey Pohl of McGrath, North, O'Malley & Kratz, P.C., Omaha, Nebraska, appeared on behalf of the defendant. This memorandum is the Court's findings of fact and conclusions of law as required by Bankruptcy Rule 7052.

Facts

The debtor, James J. Parks Company, operated an asphalt paving company in the Omaha, Nebraska, area for many years until May of 1985. On June 17, 1985, an involuntary Chapter 7 proceeding was filed against the debtor and on September 3, 1985, an order for relief was entered. Plaintiff Chamberlain was appointed trustee in the Chapter 7 case.

By its action, the trustee seeks to recover the following payments made by debtor to defendant during the one-year insider preference period of Section 547 of the Bankruptcy Code:

FILED
DISTRICT OF NEBRASKA
AT ________ M
JUL - 1 1988
Judith M. Napier
Clerk, U.S. Bankruptcy Court
By ________ Deputy

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Date	Amount
August 23, 1984	$24,979.62
September 24, 1984	$24,050.98
March 6, 1985	$26,592.89
March 6, 1985	$20,139.00
April 29, 1985	$ 1,347.50

The defendant, by its own admission, is an insider of the debtor. 11 U.S.C. § 101(30)(B).

The Bankruptcy Code at 11 U.S.C. § 547 permits a trustee to avoid a transfer of an interest of the debtor in property, or payment such as those described above, if the trustee can prove each of the following elements:

1. that the transfer or payment was to or for the benefit of a creditor;

2. for or on account of an antecedent debt owed by the debtor before such transfer was made;

3. made while the debtor was insolvent;

4. made (A) on or within ninety days before the date of the filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

5. such payment enables such creditor to receive more than such creditor would receive if the transfer had not been made and the creditor received payment to the extent provided by the Bankruptcy Code.

For the purposes of a preference action, the debtor is presumed to have been insolvent on and during the ninety days immediately preceding the date of the filing of the petition. Section 547(f). In addition, the trustee has the burden of proof on each of the elements in Section 547(b) recited above. And the defendant has the burden of proving the nonavoidability of such a transfer for any or all of the reasons listed at 11 U.S.C. § 547(c).

There is no dispute that the payments were made to a creditor on account of an antecedent debt owed by the debtor before the transfer was made, that all but the last payment were made between ninety days and one year before the date of the filing of the petition to an insider and that the last payment was made within ninety days of the date of the filing of the petition and finally, there appears to be no dispute that the creditor received more than it would have had the case been filed, the transfer not been made and the creditor received payment to the extent provided under the provisions of the Bankruptcy Code. Therefore, the only issue upon which the trustee has the burden of proof is the insolvency of the debtor at the time the transfers were made. Section 547(b)(3).

The defense, in addition to the solvency/insolvency argument, alleges that all of the payments were made in the ordinary course of business and, therefore, are not avoidable by the trustee under Section 547(c)(2). That section provides that the trustee may not avoid such a transfer to the extent that such transfer was:

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.

The Court must first determine whether or not on the dates the transfers were made the debtor was insolvent. That is, the Court must determine whether or not the financial condition of the debtor was such that the sum of the debtor's debts was greater than all of the debtor's property, at a fair valuation on the date of each transaction. 11 U.S.C. § 101(31)(A). The Court finds as a fact that on August 23, 1984, and September 24, 1984, the debtor was an operating business. It had employees, assets, contracts, ongoing contractual obligations and current receivables. The certified public accountant engaged to audit the books and records of the debtor for the calendar year ending December 31, 1984, determined after such audit that the assets of the corporation exceeded its liabilities as of December 31, 1984, assuming an ongoing business and based upon the knowledge of the CPA of the prior history of the debtor, its assets and liabilities and its historical earnings.

The certified public accountant provided an audit report to the debtor in early March of 1985 which contained such conclusions. However, in May of 1985 the debtor conveyed almost all of its business assets to a third party for several hundred thousand dollars less than the assets were carried on the books of the debtor and for an amount which was less than the liabilities shown on the audit report for December 31, 1984.

As a result of such conveyance, the certified public accountant withdrew its opinion on the financial statement for December 31, 1984, because as a result of such conveyance the debtor did not have sufficient assets to remain in operation. The certified public accountant testified that the auditing standards by which he operated assumed that the books and records of the company fairly stated the assets and liabilities of the company on the basis of an ongoing operation. Once it was discovered by the auditor that there would be no future ongoing operations, the auditor was required to notify the users of the audited financial statements that they could no longer be relied upon. The withdrawal of the opinion of the auditor did not mean that he believed the financial records of the debtor were inaccurate as of December 31, 1984.

In addition to conveying most of the operating assets of the debtor to a third party in May of 1985, at a value less than the liabilities of the debtor, the trustee urges the Court to find the debtor to be insolvent in 1984 because many of the account receivables that the trustee attempted to collect during 1985 and later were found to be uncollectible. Some of the account receivables, in large amounts, were due from insiders and others were hotly disputed. Therefore, the trustee suggests the Court should take a backward look at the transaction and attempt to determine the solvency or insolvency of the debtor in August and September of 1984 by 20/20 hindsight having the benefit of unsuccessful collection activities over a year later.

This Court does not believe that is the appropriate standard for determining insolvency. The appropriate inquiry for determining a fair valuation as required by the Code is whether the assets should be valued on a going-concern basis or on an item-by-item basis. According to one commentator:

> (t)here is overwhelming authority to the effect that normally such valuation must be made from the vantage of a going concern and that subsequent dismemberment or impossibility to dispose of plant, equipment, inventory, etc., as an entirety should not enter into the picture. But in some cases where the enterprise was already defunct at the critical date a contrary position has been taken by the courts. While undoubtedly in certain extreme cases it would be unrealistic to ascribe, under the guise of fair valuation, a going concern character to an assembly of assets belonging to an enterprise which ceased functioning, caution should be taken not to consider property as "dead" merely because hindsight teaches that the debtor was traveling on the road to financial ruin.

2 Collier on Bankruptcy ¶ 101.31 (15th Ed. 1988) (citations omitted).

As previously discussed, the debtor was an active business in August and September of 1984. It had assets which were used in an ongoing business operation. Although the evidence shows that it sustained a loss in the calendar year 1984 from its operations, the financial statements audited by a certified public accountant familiar with the operations of the business by virtue of previous auditing assignments, show that for the year 1984, on an ongoing business basis, the assets exceeded the liabilities and the operation was, therefore, solvent. This Court concludes that the appropriate method for determining the solvency or insolvency of the debtor in August and September of 1984 based upon a "fair valuation" as required by the Bankruptcy Code at Section 101(31)(A) is on an "ongoing concern" basis. Using such a valuation standard, the Court finds as a fact that in August and September of 1984 the debtor was solvent and the trustee's preference action must fail with regard to the first two payments.

However, a different analysis is required with regard to the payments on March 6, 1985, and April 29, 1985. This debtor was in the asphalt paving business. The income of the debtor resulted from contracts which could be performed during the late spring, summer and fall of the year. The cashflow of the debtor was such that all of its income was received between March or April of a particular year and the end of November of a particular year. The winter months were dry as far as income was concerned but operating expenses were still incurred, although at a much slower pace than during the actual busy season.

On March 6, 1985, the debtor and the defendant met, by their representatives, and "settled up" their accounts. In order for them to determine how much each owed the other, the services of the debtor's certified public accountant was required. The evidence presented both by the testimony of the certified public accountant and by the testimony of representatives of the debtor and the defendant is that the accountant reviewed and summarized the different contractual obligations running between the parties from various subcontracts completed in the fall of 1984. The accountant made a determination of the amount owed by debtor to defendant and the amount owed by defendant to debtor. However, based upon testimony of the representatives of the two entities, the Court finds as a fact that even after the accountant had made such determination, the amounts were disputed. Settlement was made by the exchange of checks which bear very little relationship to the computations made by the accountant.

Before reaching the defense of whether or not this transaction was in the ordinary course of business exception to the trustee avoiding powers pursuant to Section 547(c), the Court must once again analyze the solvency or insolvency position of the debtor on March 6, 1985. For this analysis, however, the Court finds that the appropriate valuation standard is not the "going concern" but instead, the Court believes the appropriate valuation standard is a determination of what the debtor could have obtained from the sale of the assets on or about the date of the transfer. Evidence of such value was presented. Within two months of the date of the March 6 payments, all of the operating assets of the debtor were sold to a third party for $995,000. That amount is less than the assets were carried on the books and is less than the total liabilities of the debtor. In addition, within a few short months thereafter, the accounts receivable which, for the most part, were owed by insiders or affiliates, were determined to be uncollectible. Therefore, working backward from the determination of uncollectibility at a date several months after March 6, 1985, this Court concludes that the obligations allegedly owed by the affiliates and insiders which were found to be uncollectible in late 1985 and early 1986 were most likely uncollectible on March 6, 1985.

As evidentiary support for such finding, the Court accepts the analysis of Mr. Hall, the certified public accountant employed by the trustee to analyze the books and records of the debtor and to participate in the collection attempts. The Court concludes from the evidence presented by Mr. Hall that the affiliated companies which were responsible for the majority of the accounts receivable listed upon the books and records of the debtor actually had no assets nor income possibilities separate from the debtor. Many of the entities, although separately incorporated, were either owned by the debtor in whole or in part or were owned by some of the same shareholders in whole or in part and were subcontractors of the debtor. Their viability as "going concerns" and their ability to pay the debts to the debtor were totally dependent upon the debtor remaining in business and operating successfully enough to pass on subcontracts to the affiliated entities.

Furthermore, one of the major account receivables consists of an amount owed by the major shareholder of the debtor. The amount is disputed even though the major shareholder was also the senior officer in charge of the operation.

This Court concludes that from at least March 6, 1985, and thereafter, the debtor was insolvent. The assets of the debtor were worth less if sold than the liabilities of the debtor.

The defendant presented evidence that the transactions on March 6, 1985, were in the ordinary course of business. However, the exception to the trustee avoiding powers under 11 U.S.C. § 547(c)(2) has three elements. First, the debt must have been incurred in the ordinary course of business of the debtor and the transferee; second, the payment must be made in the ordinary course of business of the debtor and the transferee; and finally, the payment must be made according to ordinary business terms.

It appears that the relationship between the debtor and the defendant was such that the parties did, on more than one occasion, meet, determine the amount owed by each to the other, and make payments based upon that determination. This procedure is totally different from the manner in which the debtor treated all other account payables. The ordinary course of business of the debtor was to contract for the supplies or services, obtain the supplies or services, receive an invoice for the supplies or services, and eventually, within thirty to sixty days, make payment. This defendant was the only creditor of the debtor that was paid on any type of "let's settle up" basis.

The payments made on March 6, 1985, were for debts incurred by the debtor in the ordinary course of its business and in the ordinary course of business of the defendant. However, the evidence is insufficient to convince this Court that either payment was made in the ordinary course of business of the debtor and the transferee or that such payments were made according to ordinary business terms. As mentioned above, ordinary business terms were for services and supplies to be rendered, invoices to be mailed and payments to be made within a certain amount of time. The payments made on March 6, 1985, were for services or supplies rendered in the fall of 1984 and, therefore, do not meet the ordinary business terms of this debtor.

The defendant claims that on March 6, 1985, it had a right of setoff against the debtor that it could have exercised and, therefore, it did not receive any more than it would have received in the Chapter 7 bankruptcy. However, to sustain such theory, the Court would be required to permit a "net result rule" which does not appear to be the law. The Sixth Circuit Court of Appeals in the case of Fulgham Const. Co., 8 C.B.C.2d 644 (6th Cir. 1983) prohibited such net result. In addition, even though the defendant may have had a right to setoff, such setoff was not exercised. On March 6, 1985, the parties exchanged checks and the fact that the defendant may have on March 6, 1985, had a right of setoff is not a defense to an action to recover a preference. See In re McCormick, 2 C.B.C.2d, 1145, 1149 (Bkrcy. N.D. Ohio 1980).

On April 29, 1985, the debtor paid $1,347.50 to this creditor. This payment was made within ninety days of the date of the petition when the debtor is, pursuant to the Code, presumed insolvent. Section 547(f). There is no evidence that such a payment was either in the ordinary course of business or was intended to be a contemporaneous exchange for new value given to the debtor and, in fact, was a substantially contemporaneous exchange which would prohibit the trustee from avoiding the transfer pursuant to Section 547(c)(1)(a) and (b).

The Court, therefore, concludes that the payments made by the debtor to the defendant on August 23, 1984, and September 24, 1984, are not preferences and may not be avoided by the trustee. The Court further concludes that the payments on March 6, 1985, in the amount of $26,592.89 and $20,139 and the payment made on April 29, 1985, in the amount of $1,347.50 are all preferential transfers subject to avoidance by the trustee under Section 547 of the Bankruptcy Code.

Therefore, judgment is entered in favor of the trustee and against the defendant in the amount of $48,079.39.

Separate journal entry shall be filed.

DATED: June 30, 1988.

BY THE COURT:

Timothy J. Mahoney

Chief Judge