UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

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In re

ODD'S-N-END'S, INC. Case No. 94-11394 K

Debtor

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ODD'S-N-END'S, INC.,
Plaintiff

v. AP 95-1156 K

SID BIRZON, INC.,
Defendant

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**DECISION AFTER TRIAL**

This matter came before the Court as a post-confirmation adversary proceeding to recover a preferential transfer. At trial, Defendant, Sid Birzon, Inc. made a motion for a directed

verdict based on Plaintiff's failure to prove insolvency at the time of transfer, one of the five elements of an avoidable preference. 11 U.S.C. § 547(b)(3). The Court took that motion under submission, and continued the trial to allow Defendant to present its "ordinary course" defense under § 547(c)(2). This decision grants the motion for a directed verdict and focuses on the question of insolvency.

## BACKGROUND

Odd's-n-End's is a chain of retail stores that specializes in odd lot, closeout and surplus merchandise. Sid Birzon, Inc. is a wholesaler specializing in jewelry, costume jewelry, diamonds and watches. Approximately 20% to 50% of its business is in closeout merchandise. (Test. of Jerry Birzon, V.P. of Sid Birzon, Inc.).

At trial, Odd's-n-End's presented the testimony of a certified public accountant, Henry Koziel, who performed the liquidation analysis, for purposes of proving that Defendant received more from the alleged preferential transfer than it would have received in a Chapter 7. During Mr. Koziel's testimony, Plaintiff stipulated to the admission into evidence of Defendant's Exhibit A, a consolidated balance sheet of Odd's-n-End's prepared by Mr. Koziel's firm for use in a Form 10K annual report. (Odd's-n-End's, Inc.'s stock is publicly traded). That consolidated balance sheet showed, for the fiscal year ending approximately one month before the transfer in question took place, a net total shareholders' equity of $4,341,683. Defendant's

motion for a directed verdict relies on that balance sheet's showing of solvency, and certain testimony concerning that annual report.

Plaintiff argues, however, that a certain footnote contained in the audited financial statement demonstrates that Odd's-n-End's was, in fact, insolvent at the time of the transfer. "Note 6 - Lease Obligations" states that, "If approved by the Board, management intends to reduce the number of its present store locations by 20 units. The aggregate amount of the payments due under the terms of those operating leases amounts to approximately $12.5 million." (Def.'s Ex.A at F-15). Odd's-n-End's argues that subtracting this $12.5 million from the approximately $4.3 million surplus leaves it insolvent at the time of the transfer. (*See* Pl.'s Ex. #8; Trial Test. of Robert E. Weld, C.P.A., C.I.R.A.).

Initially, the Court must consider each party's burden with respect to proving the element of insolvency. Section 547(f) states that, "For purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. § 547(f). On the other hand, subsection (g) states that, "For the purposes of this section, the [debtor-in-possession] has the burden of proving the avoidability of a transfer under subsection (b) of this section." *Id.* § 547(g). The interaction of these two subsections is somewhat tricky, and can be broken down into two questions: (1) What does a creditor need to do to overcome the presumption of insolvency? and (2) Once the creditor has overcome the presumption of insolvency, who has the burden of proving or disproving insolvency?

The case law seems quite settled that if a defendant can raise substantial doubt in the mind of the trier of fact, then the "bubble" of the presumption of insolvency has been burst. *See Sandoz v. Fred Wilson Drilling Co.* (*In re Emerald Oil)*, 695 F.2d 833 (5th Cir. 1983); *Sanyo Elec., Inc. v. Taxel ( In re World Financial)*, 78 B.R. 239 (9th Cir. BAP 1987), *aff'd*, 860 F.2d 1089 (9th Cir. 1988); *see also* Fed. R. Evid. 301. The case law is equally clear that once the bubble has been burst, the party who originally enjoyed the presumption of insolvency is now left with the burden of proof prescribed by § 547(g), and so must prove insolvency without the assistance of any evidentiary device such as a presumption. *See Sierra Steel, Inc. v. Totten Tubes, Inc. (In re Sierra Steel*, *Inc.),* 96 B.R. 275 (9th Cir. BAP 1989) and authorities cited therein.

In this case substantial doubt has been raised as to whether or not Odd's-n-End's was insolvent at the time of the transfer. As part of its case in chief, Debtor elicited the testimony of one Robert Weld, a certified insolvency accountant, who had been retained by the Official Committee of Unsecured Creditors during the course of the Chapter 11 case to advise the committee and to conduct a "preference analysis." Mr. Weld's preference analysis resulted, in part, in an opinion letter (Pl.'s. Ex. #8) declaring Odd's-n-End's insolvent. Weld's testimony regarding the opinion letter was that he used the 10K balance sheet as a starting point, and made various adjustments to it.[1] The most significant adjustment was the addition of approximately

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[1]The present case, contrary to Plaintiff's arguments, is not at all like *United States Lines v. United States (In re McLean Indus.),* 132 B.R. 247 (Bankr. S.D.N.Y. 1991), *aff'd,* 162 B.R. 410 (S.D.N.Y. 1993) or *DeRosa v. Buildex, Inc. (In re F&S Cent. Mfg.),* 53 B.R. 842 (Bankr. E.D.N.Y. 1985). In those cases, balance sheets that did not relate asset values to "fair market values" were offered by the Defendant to rebut the presumption, and were offered without anything more. Moreover, the debtor in *F&S* was a manufacturer and in *McLain* was a ship

$12.5 million in leasehold liability referenced earlier.

Defendant's cross-examination of Weld, however, raised many doubts about the accuracy and propriety of that $12.5 million figure. Weld admitted that he focused mainly on the liability side of the balance sheet, and used the asset values as stated. Additionally, Weld admitted that the $12.5 million lease liability figure that he used came solely from Note 6 of the 10K balance sheet, and not from any independent analysis of the leases. As stated in his opinion letter, "footnote #6 of the January 31, 1994 financial statements disclosed that future *minimum* annual lease payments under operating leases that have *non-cancelable* lease terms at January 31, 1994 aggregate approximately $26.5 Million and the 20 units anticipated to be closed approximate $12.5 Million of that amount." (Pl.'s Ex. #8 at 2). At trial, Weld testified that he did not consider such mitigating factors as the marketability of the Debtor's leasehold interests, the ability to negotiate a lower liability with the landlords, or liquidated damage clauses.

The Court has further doubt about the Debtor's insolvency based on the asset side

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owner. In the present case, the Debtor is a retailer, whose inventory not only is usually sold at a significant mark-up over cost, but in fact was so sold, except for a portion sold when closing certain stores. Since Generally Accepted Accounting Principles ("GAAP") requires that assets be shown at the lesser of cost or actual market value, it is simply untrue that the statement in question would, *ipso facto*, overvalue the inventory. Moreover, the Defendant did not offer the statement "without more." It elicited from the Plaintiff's own witnesses the fact that inventory was typically sold at 90% mark-up and it elicited from the Plaintiff's insolvency accountant the fact that he based his preference analysis on the very same statement, without any adjustments at all.

As was the case in *T.M. Sweeney & Sons v. Crawford (In re T.M. Sweeney & Sons)*, 120 B.R. 101 (Bankr. N.D. Ill. 1990), the otherwise questionable validity of asset values used in the balance sheet was supplemented here by testimony of Mr. Koziel demonstrating that the balance sheet may have understated, not overstated, the value of inventory.

of the 10K balance sheet. For example, the 10K balance sheet was prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), which uses the lower of cost or fair market value as the value of inventory. The balance sheet shows inventory on hand in the amount of $5,769,986. At trial, Henry Koziel, an accountant at the firm that prepared the 10K balance sheet testified that Odd's-n-End's' retail mark-up, on average, was approximately 90%. That being so, the lower of cost or fair market value for Odd's-n-End's' inventory would be cost. The fair market value of that inventory could be as much as 90% higher than that. Although the Court is not ruling that the appropriate value to use for insolvency purposes is the highest retail price that a debtor can charge, it is possible that the value of the inventory could have been as high as $10,962,973 (cost + 90%). Raising the value of the inventory by a significant amount allows the corporation to be solvent even with a higher amount of lease liability. Thus, for example, in light of $4.3 million in shareholders' equity, lease liabilities of even $6 million would still not show insolvency, if the value of assets was in fact $7.4 million rather than $5.7 million -- likewise as to a $7 million debt for lease terminations if asset values were $8.4 million, and so forth.

Also significant is the Court's suspicion that a showing of insolvency cannot be premised upon a going concern's decision to improve its performance by downsizing. Unless it is a decision to liquidate, it seems evident that management sees some economic "up"-side to a decision to close some stores. The notion that such a decision changes a balance sheet from black to red at the moment it is made seems problematic.

The Balance Sheet alone might not have burst the bubble, but that coupled with the Defendant's use of the Plaintiff's own witnesses did. With the presumption having been burst, a fair preponderance of the evidence here does not support a finding of balance sheet insolvency as of 3/1/94. This is without prejudice, of course, to a contrary finding on a fuller showing by the Plaintiff in a different case.

The Motion for Directed Verdict is granted. Judgment will enter for Birzon, dismissing the Complaint on the merits. Birzon is entitled to costs.

SO ORDERED.

Dated: Buffalo, New York
August , 1996

/s/Michael J. Kaplan

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U.S.B.J.