UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

ENDICOTT JOHNSON CORPORATION — CASE NO. 99-66539
HM FATHER AND SON SHOE, INC. — Chapter 11
FATHER & SON SHOE STORES CO. — Jointly Administered

Debtors

THE OFFICIAL COMMITTEE OF UNSECURED
CREDITORS OF
ENDICOTT JOHNSON CORPORATION
HM FATHER AND SON SHOE, INC.
FATHER & SON SHOE STORES, CO.

Plaintiff

vs. — ADV. PRO. NO. 00-80252A

GEORGE NEWMAN, and
GEORGE NEWMAN & COMPANY a/k/a
GEORGE NEWMAN COMPANY, and
NEWMAN PROPERTIES, LTD.

Defendants

APPEARANCES:

KRONISH LIEB WEINER & HELLMAN, LLP Attorneys for Plaintiff 1114 Avenue of the Americas New York, New York 10036	RONALD R. SUSSMAN, ESQ. Of Counsel GREGORY G. PLOTKO, ESQ. Of Counsel
MARTIN, MARTIN & WOODARD, LLP Attorneys for Defendants One Lincoln Center Syracuse, New York 13202	DAVID M. CAPRIOTTI, ESQ. Of Counsel WENDY A. KINSELLA, ESQ. Of Counsel

Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,

CONCLUSIONS OF LAW AND ORDER

Before this Court is an adversary proceeding commenced on December 26, 2000, by the Official Committee of Unsecured Creditors ("Committee" or "Plaintiff") of Endicott Johnson Corporation ("EJC"), HM Father And Sons Shoes, Inc. and Father & Son Shoe Stores Co.[1] (collectively, the "Debtors"). Plaintiff seeks a determination that $2,972,309.81 transferred by EJC between March 1997 and August 1999 to George Newman & Company, a/k/a George Newman Company ("GNC"), actually constituted a series of loans from EJC to GNC, and that GNC, as well as George Newman ("Newman"), individually, and Newman Properties, Ltd. ("NPL") (collectively, the "Defendants") are liable on this indebtedness and should be required to turnover said monies to the Debtors' estates pursuant to § 542 of the U.S. Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"). Plaintiff also seeks to avoid approximately $4,523,234.09[2] in alleged preferential and fraudulent transfers Newman, pursuant to Code §§ 541, 544(b), 547 and 548(a), made to or on behalf of GNC and Newman. Plaintiff also alleges a breach of fiduciary duty by Newman.[3]

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[1] EJC is a New York corporation. HM Father and Son Shoes, Inc. is a Delaware corporation and a wholly owned subsidiary of EJC. Father & Son Shoe Stores Co. is a Delaware corporation and a wholly owned subsidiary of HM Father and Son Shoes, Inc.

[2] The $2,972,309.81 in alleged loans is included in the $4,523,234.09.

[3] Prior to the commencement of this adversary proceeding, the Plaintiff filed a motion seeking approval of an agreement between itself and Paragon Capital, LLC ("Paragon"), a secured creditor of the Debtors, whereby Paragon would fund the Plaintiff's investigation, review and analysis of potential claims against the Defendants. On August 18, 2000, the Court granted that motion. (*See* Order Granting Motion for Approval of Agreement, In re Endicott Johnson Corp. et al., Aug. 24, 2000 (No. 99-66539).) The Defendants appealed, alleging that the agreement amounted to champerty, which is prohibited by New York Judiciary Law § 489. On August 7, 2002, Judge Lawrence Kahn, U.S. District Court, N.D.N.Y., affirmed this Court's decision. (*See* Memorandum – Decision and Order, Aug. 7, 2002 (Civ. Act. 00-CV-1463 (LEK).) Judge Kahn ruled that the prohibition was meant to keep parties from purchasing a claim at a level below its potential value and then suing on the claim in the hopes of obtaining a windfall

Defendants filed a motion on February 27, 2001, seeking to dismiss the complaint ("Complaint"), alleging lack of jurisdiction, failure to join a necessary party and *forum non conveniens*. The Court denied the motion by Order dated April 20, 2001. In the interim, issue was joined by the filing of an Answer by the Defendants on April 13, 2001. Defendants filed an Amended Answer on April 26, 2001. On July 9, 2002, Defendants filed a Second Amended Answer after having been granted leave of this Court by Order, dated June 27, 2002.

A trial of the adversary proceeding was conducted in Utica, New York, on September 11 and 12 and November 14, 2002.[4] In lieu of closing arguments, the Court provided the parties with an opportunity to file post-trial memoranda of law. The matter was submitted for decision on January 21, 2003.

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b), 157(a), 157(b)(1), (b)(2)(E), (F) and (H).

FACTS

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recovery, and that Paragon was merely facilitating the investigation and prosecution of a claim in which it *already* had a direct financial interest, so that the prohibition against champerty was inapplicable.

[4] Plaintiff originally made a demand for a jury trial. By letter dated July 31, 2002, Plaintiff withdrew its demand.

The Debtors filed voluntary petitions pursuant to Chapter 11 of the Code on December 13, 1999. On December 16, 1999, the Court signed an Order approving joint administration of the Debtors' three cases. At the time of filing, the Debtors owned and operated a number of retail shoe stores in twelve states.

Newman testified at trial that he was a graduate of the University of Cincinnati Law School with a *juris doctor* degree in 1964. In 1967 he founded George Newman & Company. The company bought and sold leather products manufactured by DuPont. (Tr. 11/14/02 at 4-5). He sold the company in 1994 and formed GNC, a Delaware corporation, which was involved in "looking for investments, companies to buy, turn around, and sell and also occasionally will be approached by a firm to provide management services to them." *Id.* at 6. Newman is the sole shareholder and director of GNC. *Id.*

In August 1996 Newman formed NPL to acquire the stock of EJC from HH Holdings, Inc. and Hanson America, Inc.[5] ("Hanson"). *Id.* at 7. Newman is the sole member and manager of NPL, a limited liability company formed under the laws of the State of Ohio. *See* Plaintiff's Exhibit 33. According to the Operating Agreement of NPL, Newman contributed $9,500 in his individual capacity and $500 as Trustee. *Id.*

Pursuant to a Stock Purchase Agreement, dated August 1, 1996 (*see* Plaintiff's Exhibit

[5] The name of Hanson America, Inc. was changed to Millennium America, Inc. *See* Plaintiff's Exhibit 31.

30), and later amended on October 7, 1996 (*see* Plaintiff's Exhibit 31), NPL[6] [7] agreed to acquire the shares of EJC for the purchase price of $1.00, "subject to post-closing adjustment pursuant to Section 2.2." *See* Stock Purchase Agreement at Section 2.1. According to Newman, the original target date for the acquisition was June 1996. *Id.* at 15. The acquisition was not actually consummated until October 1996. *See* Plaintiff's Exhibit 36 ("Joint Stipulation of Uncontested Facts") at ¶ 21. Newman asserts that the parties agreed that the adjusted price would be based upon the net worth of EJC on the date of acquisition, tied in large part to the amount of inventory on hand. As a result of a significant drop in inventory levels between the projected closing date and the actual closing date, as well as the closing of certain stores, Hanson, as seller, actually ended up paying approximately $3.5 million for the stock transfer (Joint Stipulation of Uncontested Facts at ¶ 22) because ultimately EJC's final net worth was less than the target net worth of $12,379,000. *See* Stock Purchase Agreement at Section 2.2.

Newman testified that under the terms of the Stock Purchase Agreement the sale proceeds were to go to NPL and that he had authorized that NPL then transfer the monies to EJC for working capital.[8] (Tr. 11/14/02 at 106 and 153). Newman testified that it was not until the fall of 2001 that he became aware that the $3.5 million had been paid directly to EJC and not to NPL, the "Buyer" as provided in the Stock Purchase Agreement. (*Id.* at 23). He was unable to

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[6] NPL is the sole shareholder of EJC.

[7] Under the terms of the Stock Purchase Agreement, dated August 1, 1996, NPL was identified as "Newman Properties, LLC." On October 7, 1996, the Stock Purchase Agreement was amended to change the "Buyer" to "Newman Properties Ltd," an Ohio limited liability company.

[8] According to Newman, working capital was needed by EJC to buy shoes for the Christmas season. (*See* Tr. 11/14/02 at 140).

explain why the monies had been paid directly to EJC. (*Id.* at 107).

Newman served as chairman of the board of EJC from October 1996 through December 1999. In December 1998 he also assumed the role of president of EJC following the resignation of Burt Strecker, its chief executive officer and president (*See* Joint Stipulation of Uncontested Facts at ¶ 31).

EJC and GNC entered into a management agreement ("Management Agreement"), made effective October 14, 1996. *See* Plaintiff's Exhibit 34. The Management Agreement was signed by Scott Davis ("Davis")[9] on behalf of EJC and by Newman on behalf of GNC. Under the terms of the Management Agreement, GNC was to provide management services to EJC, including "long-range planning, financing, mergers and acquisitions, the sale of assets, and budgeting." *See id.* at ¶ 2. In fact, Newman testified that some time after the purchase of EJC, he, acting on behalf of GNC, and Davis, on behalf of EJC, were involved in efforts to sell EJC.[10] (Tr. 11/14/02 at 25-26).

In consideration of its services, GNC was to be paid a monthly fee of $18,750. EJC also agreed to provide Newman with family health insurance coverage, as well as "a late model automobile for use of [*sic*] him or his family." Management Agreement at ¶ 8(c). During the

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[9] Davis served as vice president, director and treasurer of EJC from the fall of 1996 through early 2000 (Tr. 9/12/02 at 111-112). *See* Joint Stipulation of Uncontested Facts at ¶ 33. Davis also served as vice president and chief financial officer of GNC prior to the fall of 1996.

[10] Under the terms of the Stock Purchase Agreement, Newman, as "Principal Shareholder" or "Principal Member" of NPL, agreed for a period of three years from the closing to provide the Debtors "with sufficient cash as he, in his sole reasonable discretion, believes shall be required by the [Debtors] in order to maintain a reasonably sufficient amount of capital to fund all the ongoing business operations of the [Debtors] after the Closing Date . . ." subject to being released from this obligation in the event that NPL were to transfer, convey or sell the business prior to the three years in an arm's-length transaction to a person/persons not related to NPL or Newman. *See* Exhibit 30 at ¶¶ 6.6(a) and 10.11.

year prior to the petition date of December 13, 1999, EJC made a number of transfers totaling $520,000 to GNC at Newman's request. In addition, during the same year, under the terms of the Management Agreement, GNC received the following amounts from EJC:

Management fees	$225,000.00
Health insurance premiums	16,760.54
Automobile payments to Firstar/Star Bank	7,621.71
Parking fees to Central Parking	3,000.00
Total (including $520,000 referenced above)	$772,382.25

See Plaintiff's Exhibit 11 and Joint Stipulation of Uncontested Facts at ¶35.

Over the period between October 1996 and December 1999, transfers from EJC to GNC and/or related parties amounted to:

Management fees	$ 725,000.00
Health insurance premiums	45,571.06
Automobile payments to Firstar/Star Bank	8,360.85
Parking fees to Central Parking	9,423.50
Acquisition fees	725,000.00
Reimbursement of acquisition/other expenses	37,568.87
Unclassified transfers to GNC and/or related parties (3/97 - 8/99)[11]	$2,972,309.81
Total	$4,523,234.09[12]

See Plaintiff's Exhibits 10, 12-16

The last check written to GNC covering management fees was December 3, 1999 (*see* Plaintiff's Exhibit 12). A payment covering health insurance premiums was made on November

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[11] *See* Joint Stipulation of Uncontested Facts at ¶ 25. The Court notes after reviewing the checks that constituted the so-called "unclassified transfers" that all but one were written to GNC. The one exception was a check written to Newman, presumably the "related party," on October 16, 1999, in the amount of $17,309.81 with a memo notation indicating that it was for the "purchase of 1996 Aurora." *See* Plaintiff's Exhibit 10.

[12] This figure includes the $772,382.25 in transfers made during the year immediately prior to the filing of the petition.

29, 1999 (*see* Plaintiff's Exhibit 13). On November 8, 1999, approximately one month prepetition, a car payment of $1,864.88 was made on Account # 32716623 at Firstar/Star Bank, whereas all prior car payments had been made on Account # 32110777. *See* Plaintiff's Exhibit 14. This payment was followed by payments on November 24, 1999, and December 3, 1999, of $466.22 on Account #32716623, in addition to the regular monthly payments of $369.67 on Account #3211077. *See* Plaintiff's Exhibits 11 and 14. A payment covering parking was made on November 29, 1999 to Central Parking (*see* Plaintiff's Exhibit 15).

The payments identified as "Acquisition Fees," totaling $725,000, were made between October 22, 1996 and February 10, 1997. Payments labeled "Reimbursement for Acquisition and Other Expenses," totaling $37,568.87, were made between October 29, 1996 and October 8, 1998.

Newman testified that in his Answer of April 12, 2001, and his Amended Answer of April 24, 2001, he had admitted that the "unclassified transfers" of $2,972,309.81 constituted loans from EJC. (Tr. 11/14/02 at 76 and 77). Newman also acknowledged that he had given sworn testimony in April 2000 that the $2,972,309.81 of "unclassified transfers" represented loans from EJC to GNC. It was not until his Second Amended Answer, filed June 27, 2002, that he denied that they were loans. At the trial he testified that the monies were not loans but were actually intended to reduce amounts owed by EJC to GNC totaling $3.5 million in connection with the sale of the business to NPL in October 1996. (*Id.* at 31). Newman testified that there was never any formal consent by EJC's board of directors to make the transfers, however. (Tr. 9/11/02 at 89).

It was Newman's testimony that the "unclassified" transfers from EJC to GNC were made at his request. Davis would advise him of the level of funds in EJC and whether there was a need for them. Newman would then direct Davis to have the monies transferred to GNC. (*Id.* at 28). Newman testified that if Davis indicated to him that EJC needed the monies for operating purposes, then no transfer was made to GNC. (*Id.* at 29). Newman testified that during the six months prepetition there had been no transfers made to GNC by EJC. (*Id.*). However, the record reflects that three checks were issued in August 1999 from EJC to GNC totaling $120,000. *See* Plaintiff's Exhibit 10.

Kenneth Simon ("Simon"), a certified public accountant employed by the accounting firm of Deloitte & Touche LLP and retained by the Committee, was qualified as an expert at the trial. He testified that he reviewed the schedule of checks issued by EJC, contained in Plaintiff's Exhibit 10, as well as EJC's monthly internal financial statements for 1998 and 1999 (Plaintiff's Exhibit 24), the consolidated financial statements of NPL and EJC as of 10/4/97 and 10/12/96 (Plaintiff's Exhibit 25), the 12/5/97 audit representation letter signed by EJC (Plaintiff's Exhibit 26), the consolidated financial statements of NPL and EJC as of 10/97 and 10/98 (Plaintiff's Exhibit 27), the 1999 audit representation letter (Plaintiff's Exhibit 28), and the opening balance sheet for EJC (Plaintiff's Exhibit 29).

Simon testified that the audited consolidated financial statements of NPL and EJC reflecting the two-year period ending October 3, 1998 (Plaintiff's Exhibit 27), indicate a member receivable as of 10/4/97 of $700,000 and as of 10/3/98 of $2,050,000 (Tr. 9/11/02 at 129). Simon testified that the "member" from whom this receivable was due was Newman, who was the sole member of NPL (*Id.* at 132). Simon also testified that on the operating balance sheet for September 1999, the final one prepared prior to EJC's bankruptcy filing, the stockholder receivable showed a balance of $2,972,309.81, as a result of approximately $922,000 in further advances during the period from October 13, 1998 through the end of September, 1999. (*Id.* at

138-39*).* Simon testified, based on his review of the financial records, that the $2,972,309.81 in advances making up the stockholder receivable general ledger account represented a receivable due to EJC from Newman. (*Id.* at 146-47*).* He further asserted that EJC received no value or consideration for this receivable. (*Id.* at 152-53*).* Defendants' counsel stipulated that no money ever went back to EJC. (*Id.* at 152). According to Simon's review of the documents, no capital was ever paid in to EJC. Instead, a line of credit was obtained by pledging its assets, including inventory (*Id.* at 233). He also stated his opinion that, at the time when each of the payments that made up the stockholder receivable was made, EJC was insolvent. (*Id.* at 166-67*).* In his opinion, EJC was always undercapitalized and, therefore, when the transfers to GNC occurred, they did not cause the company to become undercapitalized.

As to what happened to these "unclassified" transfers from EJC, Simon testified that the monies were paid to GNC and, in his opinion, were recorded in the financial records of GNC as additional paid-in capital (Tr. 9/12/02 at 8-10, citing GNC's 1998 tax return,[13] Plaintiff's Exhibit 37). Simon opined that the checks from EJC to GNC were actually written on Newman's behalf as Newman was the sole shareholder of GNC and was the only one in a position to make a capital contribution to the company (Tr. 9/12/02 at 46). According to Simon, EJC is not a shareholder of GNC and, therefore, could not have contributed capital to it; the monies deemed to be capital contributions would have had to come from Newman. *Id.*

Simon also noted that the GNC financial statements showed no single liability in excess of $12,000 but did show a balance in the additional paid-in capital account of $2 million, which further supported his conclusion that the money was not transferred from EJC to GNC in

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[13] A total of $2,001,789 was listed as paid-in capital to GNC as of the end of 1998. *See* Plaintiff's Exhibit 37.

payment of the $3.5 million owed in connection with the sale of the stock of EJC to NPL. (*Id.* at 43). According to Simon, because Newman is the only stockholder of GNC, the only possible way that money from EJC found its way into the capital accounts of GNC is if the stockholder receivable on EJC's books was due from Newman, and he in turn used the money to capitalize GNC. (*Id.* at 45-46). As he explained,

> I believe the internal financial statements, the audited financial statements, the tax return all supports the concept that this was, in fact, monies that are owed to Endicott Johnson by George Newman, the individual.

Id. at 10.

As to arguments that EJC owed NPL and by paying GNC, EJC was reducing the obligation owed NPL, Simon testified that if EJC actually owed NPL $3.5 million, there would have been no receivable listed on the consolidated statements (*Id.* at 4). He noted that it should also have appeared on EJC's internal balance sheets as a payable to NPL, which it did not. *Id.*

In addition to the live testimony of Simon, the Plaintiff, as well as Defendants, presented selected portions of the deposition testimony of Davis.[14] Davis testified that he was employed by GNC between September 1995 and October 1996. He acknowledged that he received a bonus of $150,000 in connection with the acquisition of EJC, which was paid by EJC. *Id.* at 115-116. He also testified that in October 1996 he became vice president and treasurer of EJC, positions he held until February 2000. *Id.* at 116.

According to Davis, the transfers from EJC to GNC over the course of several years were all made at the request of Newman personally and were not made as the result of consensus

[14] Davis' testimony was in deposition form due to the fact that he resides in the Commonwealth of Kentucky, and is thus outside the subpoena jurisdiction of the Court. (Tr. 9/12/02 at 108).

decisions by the board of directors of EJC, either at a meeting or by written consent. (*Id.* at 78-79*).* He further testified that no one voiced any objection to the transfers, however. (*Id.* at 142*).*

With respect specifically to the approximately $2.98 million in "unclassified" transfers out of EJC, Davis testified that initially the general ledger of EJC recorded the transfers as an asset before there was a determination of what the proper accounting for it was by Arthur Andersen. According to Davis, the $2.98 million was carried on the consolidated financial statements of NPL as a debit entry in the equity portion of the balance sheet. In other words, according to Davis the books and records showed a reduction of the equity of the company (*Id.* at 121-22).

Davis also indicated in his deposition that the member receivable item did not refer to a loan between NPL and EJC because all significant intercompany transactions between NPL and EJC were eliminated for the purposes of preparing consolidated financial statements. (*Id.* at 135*).* He stated that he did not understand why Arthur Anderson had classified the debit balance of $700,000, representing transfers of funds from EJC to GNC between 10/13/96 and 10/4/97, as a stockholder receivable from NPL other than perhaps to make full disclosure that these funds had been transferred to a related company. According to Davis, it was not a receivable that was collectible on demand, and, therefore, it was shown as a reduction of equity. (*Id.* at 135-36*).* It was not reported as a dividend because that would show as a change to retained earnings. (*Id.* at 136). Davis further indicated that "this is how the advance – advance to Newman was accounted." (*Id.*).

Newman was unable to explain why the $2.98 million was listed as a stockholder receivable on EJC's internal financial statements. (Tr. 11/14/02 at 32). He pointed out that it was not listed as an asset but was in the liability and shareholder equity portion of EJC's balance sheet. (*Id.* and at 123). He noted that in October 1999 it was no longer identified as a "receivable" to make it clear that it was not an asset of EJC. (*Id.*). Newman further testified that he never considered the "receivable" on EJC's books as a payable owed by him. (*Id.* at 156-157). According to Newman, "[i]t's certainly my understanding that I did not and do not owe the money." (*Id.* at 158).

With regard to transfers made by GNC to Newman, it was Newman's testimony that there were occasions when GNC would transfer money into his personal account. (Tr. 9/11/02 at 97). He explained that "[i]f GNC happened to have a good bit of cash and I did not have it personally and a substantial bill would come in, then some of my funds that I had put into the corporation would be transferred back to my personal account." (*Id.*). Newman testified that, in July 1998, he had GNC issue him a check for his personal income taxes. (*Id.* at 64-65). In addition, at other times during 1998, Newman had GNC pay for repair and maintenance of his home office in Massachusetts (*Id.* at 65), for a computer and graphing calculator for his sons (*Id.* at 65-67) and that GNC paid for the telephone lines in his homes in Cincinnati and Massachusetts. (*Id.* at 88.) Further, GNC paid various expenses on Newman's behalf for thirteen vehicles, including a Bentley, a Rolls Royce, a Jaguar, a Cadillac, and several Land Rovers. (*Id.* at 72, 78.) Newman testified that each of his three children had their own credit card, as did his cook and his maintenance man/gardener, all of which were issued in Newman's name and paid out of GNC's account. (Tr. 11/14/02 at 100). Additional payments by GNC on Newman's behalf included legal fees in connection with estate planning and a family partnership (Tr. 9/11/02 at 74-75), payments to the telephone system at Duke University where one of his children attended college (*Id.* at 76-77), dues to the Cincinnati Athletic Club (*Id.* at 78), tuition for two of his four children at Cincinnati Country Day School (*Id.* at 78-80), and a personal loan from a bank (*Id.* at 80). In addition, on an ongoing basis, the full-time cook and gardener and part-time household help in Newman's Cincinnati home were paid out of GNC's payroll account. (*Id.* at 84).

When questioned by Plaintiff's counsel, Newman testified whenever GNC paid expenses for himself personally or his family, a reconciliation was prepared at the end of the year wherein any such expenses were either charged against GNC's capital account, consisting of money he put into the company, or else treated as additional compensation to him. (*Id.* at 72-73). However, when questioned by his own attorney on direct, he indicated that

> if there has been an expense paid by me that was a corporate expense, then an adjustment would be made, and if there was a corporate expense paid on my behalf personally, there would be another adjustment made. I would then either take that expense that the corporation paid on my behalf and treat that - - the accountants would treat that as additional income, or it could be treated as a loan repayment.

(Tr. 11/14/02 at 60).

According to the Amended Expert Report issued by Simon and dated August 30, 2002,

> [t]he Debtors were insolvent from the date of acquisition, October 12, 1996, through the date of the filing of the bankruptcy filing, December 13, 1999. The historically internally prepared financial statements indicate that the net sales of Endicott Johnson Corporation ("EJC") declined from $85.6 million in 1994 to $51.6 million in 1996 and that losses from operations approximated $12.6 million during that period.

Plaintiff's Exhibit 35 at ¶ 2.

Simon acknowledged that he could have performed three or four different calculations as to what would be the realizable value of the inventory (Tr. 9/11/02 at 162). Simon testified that in determining the extent of EJC's insolvency, he used a balance sheet analysis, assuming liquidation values of 20% based on (1) EJC's loss of $12.6 million over the three years prior to the sale in October 1996 and (2) the fact that NPL paid nothing for the shares of EJC and, in fact, as the buyer, was to be paid $3.5 million by the seller (*Id.* at 204, 221). He revised those calculations based upon the agency agreement ("Agency Agreement") with the liquidator that actually purchased the Debtors' inventory, which provided for a guaranteed purchase price of 27.5% of retail value as defined in the agency agreement. *See* Plaintiff's Exhibit 38. In his liquidation analysis he calculated deficiencies in assets and liabilities for the years 1996-1999 as follows:

October 12, 1996	($ 75,000)
October 4, 1997	($555,000)
October 3, 1998	($5 million)
October 27, 1999	($12.2 million)

See id.

On cross-examination, Simon acknowledged that EJC was operating as a going concern between 1996 and 1999 but he felt that the company could not have been marketed as a going concern (Tr. 9/12/02 at 33). He admitted that a company operating as a going concern would not have incurred certain costs which he had included in his calculations, namely $500,000 in wind-down costs and $4.46 million in expenses associated with lease rejection claims (*Id.*). He also acknowledged that a company could lose money and still be solvent (Tr. 9/11/02 at 219).

According to EJC's Statement of Financial Affairs, it generated the following income from sales:

October 5, 1997 - October 3, 1998	$33,803,780
October 4, 1998 - October 2, 1999	30,833,854
October 3, 1999 - December 12, 1999	5,578,348

DISCUSSION

<u>First Cause of Action Seeking Determination that Money Allegedly Transferred by EJC to GNC was a Loan</u>

In the First Cause of Action of its Complaint, the Plaintiff seeks a finding by this Court that approximately $2.98 million in "unclassified" transfers to GNC by the Debtor between March 1997 and August 1999 actually constituted a series of loans from the Debtor to GNC, and that the Defendants are liable on this indebtedness. The Plaintiff alleges that this amount was transferred to GNC by way of advances to Newman personally, as well as to third parties for Newman's benefit, and that as of September 30, 1999, the Debtors' accounting records reflect an account receivable from GNC in this amount. (Plaintiffs' Post-Trial Memorandum, at 7-14.)

The Defendants do not dispute that approximately $2.98 million was transferred to GNC. (Joint Stipulation, at ¶ 25.) However, the Defendants assert that Plaintiff has failed to prove that the transfers were loans, and that therefore the presumption that arises under New York law upon the delivery of a check that is deemed to be in payment of a debt rather than a loan remains undisturbed. (Defendants' Post-Trial Memorandum, at 20.)

The only case cited by the Defendants for their contention that the delivery of a check from one party to another creates a rebuttable presumption that it was in payment of a debt is *de Cordova v. Sanville*, 165 A.D. 128 (N.Y. App. Div. 1914). Aside from the fact that the case was decided almost ninety years ago, it was also reversed in a subsequent decision of the New York Court of Appeals. *See de Cordova v. Sanville*, 214 N.Y. 662 (N.Y. 1915). In its summary reversal, the Court of Appeals specifically relied upon the dissenting opinion of then Presiding Judge Ingraham of the Appellate Division, who acknowledged that such a presumption would be available, but noted that it is not created by the mere fact that a check was delivered from one party to another. As Judge Ingraham noted in his dissenting opinion, "the plaintiff should state the facts which constitute the cause of action and [the court] should not sustain a pleading which only states the evidential facts from which the trier of facts is *authorized* to infer . . . a liability." *de Cordova*, 165 A.D. at 135 (emphasis supplied). Based on the Court of Appeals' summary reversal of the Appellate Division relying on Judge Ingraham's dissent, the Court cannot accept the Defendants' contention that the delivery of a check creates a rebuttable presumption that it was in payment of a debt.

Furthermore, even if the Court were to accept the presumption that the "unclassified" transfers were in payment of a debt, that presumption was rebutted by the evidence. EJC's audited financial statements, Newman's own sign-off on those statements, as well as Newman's own sworn statements confirm that the $2.98 million in "unclassified" transfers represented a loan to be repaid to EJC. At the trial, Newman was asked,

> let me see if I understand where we are. After your review of the company's internal income statements that carry the $2.9 million as a receivable from 1996 all the way through October of 1999, and after all the answers that you've testified where you swore that the money was a loan from Endicott Johnson to GNC, and after your sworn statements in both affidavit form and in oral testimony that the $2.9 million and change was a loan from Endicott Johnson Corporation to GNC, after all of that, you now today want this Court to believe, oops, it's a mistake, it was never a loan, is that right?

(Tr. 11/14/02 at 96). To which Newman replied, "Yes." (*Id*).

"Even after amendment, an admission in an original pleading is evidence of the fact admitted." *Coraci v. Yurkin*, 12 Misc. 2d 619, 621 (N.Y. Sup. Ct. 1957) (citation omitted); *see also Standard Oil Co. of New York v. Boyle*, 231 A.D. 101, 102-03 (N.Y. App. Div. 1930) (commenting that admissions made under oath in defendant's original answer, in his bill of particulars and in his affidavit opposing a motion for summary judgment were "competent evidence" but were insufficient "to warrant a total disregard of the allegations in the amended answer"). This Court has difficulty finding the change in Newman's position credible. This is particularly true given the fact that the $3.5 million paid to EJC pursuant to the Stock Purchase Agreement, which Defendants contend was a loan to EJC, was never recorded as a liability to GNC/NPL/Newman on EJC's financial statements. There were no loan agreements or promissory notes executed to support the position now taken by Defendants. In addition, Simon testified that there was no significant account payable which appeared on the books of GNC. (*See* Tr. 9/12/03 at 8). Instead, it appeared from the balance sheet on GNC's 1998 tax returns that Newman had taken credit for the monies transferred from EJC to GNC in excess of $2 million as capital contributions made by him to GNC that year. (*See* Tr. 9/12/03 at 8-9).

In addition, there are the terms of the Stock Purchase Agreement to be considered, which required that Newman, as "Principal Member" of NPL, make capital contributions for the three years following the closing in October 1996 sufficient to fund all the ongoing business operations of EJC. Newman testified that at the time the $3.5 million was paid to EJC, the company was in need of capital to purchase Christmas inventory. According to the testimony, there were no other capital contributions made to EJC during the three years following the closing. Instead, EJC found it necessary to obtain a line of credit from Paragon sometime in 1998.

Accordingly, the Court concludes that the "unclassified" transfers made by EJC to GNC constituted loans, totaling $2,972,309.81, which must be repaid to the Debtors. The question then arises whether Newman, as well as GNC, is liable for the repayment of those monies under an alter ego theory.

The Plaintiff seeks to impose liability for these loans on Newman individually, and on

GNC, on the basis that the corporate entity GNC is in reality an alter ego of Newman. The Plaintiff thus asks this Court to pierce the corporate veil and find that Newman is personally liable on the GNC indebtedness.

"In determining whether the corporate form will be disregarded and the corporate veil pierced, the law of the state of incorporation is applied." *Official Comm. of Unsecured Creditors v. Morgan Stanley & Co., Inc. (In re Sunbeam Corp.)*, 284 B.R. 355, 365 (Bankr. S.D.N.Y. 2002), *appeal dismissed*, 287 B.R. 861 (S.D.N.Y. 2003) (citation omitted). The Court of Appeals for this Circuit has stated that under the "interest analysis" adopted by the New York courts in resolving choice of law issues, "the state of incorporation has the greater interest in determining when and if [corporate] insulation is to be stripped away." *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132-33 (2d Cir. 1993); *see also* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 (1971) ("The local law of the state of incorporation will be applied to determine the existence and extent of a shareholder's liability to the corporation . . . and to its creditors for corporate debts.").

GNC is a corporation organized in Delaware. (Joint Stipulation of Uncontested Facts at ¶ 12.) Accordingly, the determination whether to pierce the corporate veil must be made based on Delaware law.[15]

Under Delaware law:

> In order to . . . pierce the corporate veil of the [corporation], plaintiffs must . . . demonstrate the [individual's] complete domination and control of the [corporation]. The degree of

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[15] The Court notes that the Plaintiff based its analysis solely on New York law governing the piercing of the corporate veil. However, as noted above, New York has adopted a rule whereby state courts follow the law of the state of incorporation in making that determination, here Delaware.

> control required to pierce the veil is "exclusive domination and control . . . to the extent that [the corporation] no longer has legal or independent significance of its own."
>
> Piercing the corporate veil under the alter ego theory "requires that the corporate structure cause fraud or similar injustice." Effectively, the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.

Wallace ex rel. Cencom Cable Income Partners II, L.P. v. Wood, 752 A.2d 1175, 1183-84 (Del. Ch. 1999) (quoting *Outokumpu Engineering Enter., Inc. v. Kvaerner EnviroPower, Inc.*, 685 A.2d 724, 729 (Del. Sup. Ct. 1996)).

The Delaware Chancery Court in another case gave a more extensive explanation of the alter ego theory:

> [A]n alter ego analysis must start with an examination of factors which reveal how the corporation operates and the particular defendant's relationship to that corporation. These factors include whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder.

Harco Nat'l Insur. Co. v. Green Farms, Inc., 1989 WL 110537 at *10 (Del. Ch. Sept. 19, 1989) (Hartnett, V.C.).

Applying this statement of Delaware law on piercing the corporate veil, the Court finds that Newman's control over GNC and his actions in dealing with assets of GNC meet this standard. The record in this case is replete with examples of instances in which Newman used the assets of GNC for purely personal purposes that could not conceivably benefit the corporation. He testified that he used GNC's corporate funds to pay his personal income taxes; to pay for the maintenance and repairs of his home office in Massachusetts; to purchase a computer and graphing calculator for his son's use in school; to pay expenses of his children while they were attending Cincinnati Country Day School; to pay personal debts (Visa cards) of family members who had no connection with the corporation other than by virtue of their relationship to him; to pay a gardener, cook and part-time household help at his residence in Cincinnati; to pay expenses at the Cincinnati Country Club; to pay legal expenses associated with a family partnership for estate planning purposes; and to pay the expenses on his thirteen automobiles. (*See* Tr. 9/11/02, 64-78) These are transactions that provided personal benefit to Newman, but provided no conceivable benefit to GNC.

In addition, a review of the factors set forth in *Harco* supports the conclusion that Newman used GNC "as a facade for the dominant shareholder"- himself. Supporting facts include: (1) that GNC did not conduct regular board meetings (*see* Tr. 11/14/2002 at 54); (2) that it did not pay dividends; (3) by Newman's own testimony, that he used company employees to handle his own personal business (*see* Tr. 9/11/02 at 85); and (4), as noted above, Newman used corporate funds to pay his own personal expenses and those of family members not otherwise affiliated with the company. *See also HMG/Courtland Properties, Inc. v. Gray*, 729 A.2d 300, 310 n.9 (Del. Ch. 1999) (stating that "[i]n the case of a corporate veil piercing argument, the failure of the corporate entity to follow formalities is evidence that its owners are using it as a mere agent and that the corporation is not in fact a free-standing, accountable entity"). In sum, Newman treated GNC not as a separate "free-standing, accountable entity" but rather as "a mere agent" of himself, mingling corporate and personal business in a manner justifying piercing the corporate veil.

Accordingly, the Court finds in favor of the Plaintiff on this cause of action and finds that the "unclassified" transfers made by EJC to GNC/Newman were loans, for which GNC and

Newman are liable in the amount sought by the Plaintiff of $2,972,309.81.

Second Cause of Action Seeking Turnover from the Defendants of Money Transferred

Code § 542 provides, in relevant part: “an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee.” 11 U.S.C. § 542. The Defendants GNC/Newman owe a debt to the Debtors. That debt constitutes property of the estate, defined to include “all legal . . . interests of the debtor in property as of the commencement of the case.” Code § 541(a)(1). The Second Circuit has held that “[w]ithin [the] definition of a debtor’s property fall the debtor’s rights of action to collect . . . receivable[s].” *In re Crysen/Montenay Energy Co.*, 902 F.2d 1098, 1101 (2d Cir. 1990); *see also In re Ralar Distributors, Inc.*, 4 F.3d 62, 67 (1st Cir. 1993); *In re Columbia Gas Systems, Inc.*, 997 F.2d 1039, 1059 (3rd Cir. 1993); *In re Prudential Lines, Inc.*, 928 F.2d 565, 569 (2d Cir. 1991). The Court thus finds that the Defendants, GNC/Newman, received property from EJC and were legally obligated to repay same. Accordingly, EJC received in exchange a receivable, the right to collect which constitutes property of the estate, subject to turnover under Code § 542.

With respect to the $2,972,309.81 addressed in the First Cause of Action referenced above, the Court has found for the Plaintiff and has held that those transfers were loans, for which Newman and GNC are liable on the resulting receivable. As loans to Newman and GNC, they constitute a receivable on the books of EJC, an asset which represents property of the estate, recoverable pursuant to Code § 542. Accordingly, the Court finds in favor of the Plaintiff and orders that the Defendants, GNC and Newman, turn over to the Plaintiff for the benefit of the estate the $2,972,309.81 found by this Court to have been loans by EJC to the Defendants.

Third Cause of Action Seeking Recovery of Insider Preferences Under Code § 547

In the Third Cause of Action set forth in its Complaint, the Plaintiff seeks an order from this Court pursuant to Code § 547 permitting it to recover for the benefit of the Debtors' estates $772,382.25,[16] representing the value of transfers made by Debtors during the year prior to the filing of the petition, consisting of the following:

Transfers to GNC 2/1/99 – 8/23/99	$520,000.00
Management fees paid to GNC 12/13/98 – 12/12/99	225,000.00
Health Insurance paid to GNC 12/13/98 – 12/12/99	16,760.54
Automobile payments to Firstar/Star Bank 12/13/98 – 12/12/99	7,621.71
Payments to Central Parking 12/13/98 – 12/12/99	3,000.00
Total	$772,382.25

The Court has already found that the transfers of $520,000 made by EJC to GNC, which were included in the "unclassified" transfers of $2,972,309.81 discussed above, constituted loans to GNC and their payment was not based on any antecedent debt owed by EJC. Accordingly, the Court is only concerned with the balance of the above-listed transfers, totaling $252,382.25. These transfers were made under the terms of the Management Agreement.

Management fees of $18,750 were paid by EJC to GNC on a regular monthly basis. *See* Plaintiff's Exhibits 11 and 12. Payments were also made to GNC on a regular monthly basis covering Newman's health insurance premiums. These range in amounts from $1,287.80 per month for January through May 1999 and $1,494.18 per month between June and the end of

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[16] Although the Plaintiff's complaint sets forth $772,382.05 as the amount of the transfers, the total listed in the parties' Stipulation of Uncontested Facts is $772,382.25, the total arrived at above.

December 1999.[17] *See* Plaintiff's Exhibits 11 and 13

Automobile payments were made by EJC to Star/Firstar Bank on a monthly basis of $369.67, with a notation that they were made with respect to Account # 32110777. *See* Plaintiff's Exhibits 11 and 14. However, on November 8, 1999, approximately one month prepetition, a payment of $1,864.88 was made on Account # 32716623. *See id.* This payment was followed by payments of $466.22 on November 24, 1999 and December 3, 1999 on Account #32716623. *See* Plaintiff's Exhibits 11 and 14.

The payments for parking of $250 per month were made by EJC to Central Parking Systems on a regular basis on behalf of Newman under the terms of the Management Agreement. *See* Plaintiff's Exhibit 11 and 15.

In order for the Court to find that the transfers in question constitute avoidable preferences pursuant to Code § 547(b), it must find that they were: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor; (3) made while the debtor was insolvent; (4) made either within 90 days of the filing of the petition or to an insider creditor within one year of the filing of the petition; and (5) they must have allowed the transferee to receive a larger share of the estate's assets than it would have received if the transfers had not been made and the estate's assets had been liquidated under chapter 7. *See Union Bank v. Wolas*, 502 U.S. 151, 154 (1991). The Plaintiff bears the burden of proof on these five elements by a preponderance of the evidence. *See Roblin Industries*, 78 F.3d at 34. The seven exceptions, which are set out in Code § 547(c), are affirmative defenses which must be asserted and proven

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[17] The Court finds that the payments in July and August, totaling $2,850.64, represented only a minor change from the regular monthly payments beginning in June as they average $1,425.32 for each of those two months.

by the transferees. *Id.* at 39.

The Plaintiff contends that these transfers were made either directly to or on behalf of Newman, an insider of the Debtors, so that the one year reach back period provided in Code § 547(b)(4)(B) is applicable, and further that EJC was insolvent at the time these payments were made. In opposition to this cause of action, the Defendants allege that neither GNC nor Newman individually was a creditor of EJC and that, although NPL was a creditor of EJC, none of the transfers sought to be recovered were made either to or for the benefit of NPL. In addition, the Defendants allege that the payments to GNC were not for or on account of an antecedent debt since they were only made on a contemporaneous monthly basis as GNC provided management services under the Management Agreement. The Defendants further assert that EJC was not insolvent when the transfers were made; that GNC is not an insider of the EJC, so that the appropriate preference period is only 90 days; and that the Plaintiff has failed to prove that the Defendants received more than they would have in a Chapter 7 case.

The first inquiry is whether the transfers in question were to or for the benefit of a creditor. At the time the various transfers were made to or for the benefit of GNC/Newman, GNC was a creditor of EJC because EJC was obligated to compensate GNC/Newman for services rendered pursuant to the Management Agreement, which included monitoring and approving budgets for EJC, financial reporting, monitoring of sales activities and inventory and overall determination of the strategic direction of the company, including the possibility of selling EJC.

Having received full payments, both direct and indirect, on a monthly basis for these services, it is also apparent that GNC/Newman received more than they would have received as unsecured creditors in a chapter 7 liquidation because it is unlikely that unsecured creditors would receive 100% on their claims in the case.[18]

The main issues left confronting the Court with respect to Code § 547(b) concern whether GNC/Newman should be considered insiders of EJC and whether, at the time of the transfers, EJC was insolvent.

Code § 101(31)(B) states among those defined as an "insider" are (i) directors, (ii) officers and (iii) persons in control of the debtor. 11 U.S.C. § 101(31)(B). In this case, there is little doubt that Newman is an insider - he was president of EJC and Chairman of the Board of Directors of EJC during the year prepetition. In addition, GNC, pursuant to the terms of the Management Agreement, was in control of EJC. Indeed, since Newman was the sole shareholder and director of GNC and was the one actually providing the management services to EJC, it is clear that GNC/Newman were insiders of EJC at the time of the transfers. Thus, the Court must examine transfers dating back to December 13, 1998.

Before the Court engages in an analysis of EJC's insolvency for the year prior to filing,[19] the Court finds it appropriate to consider the defenses available to the Defendants, which, if valid, would render any determination on the issue of insolvency pursuant to Code § 547 moot. As noted above, Code § 547(c) provides various defenses to the avoidance of transfers found to be preferential.

As an initial matter, no evidence has been presented to the Court to support Defendants'

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[18] The Court reaches this conclusion based on Simon's liquidation analysis which showed that liabilities exceeded assets by more than $7.2 million as of October 27, 1999, exclusive of wind down costs and lease rejection claims.

[19] Code § 547(f) provides that "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). However, in this case Plaintiff seeks to avoid transfers which are alleged to have been made during the year prior to the filing.

Ninth Affirmative Defense based on Code § 547(c)(2).[20] *See* Defendant's Second Amended Answer at ¶ 31. In order to succeed on that defense, it was necessary that the Defendants present not only evidence of the course of conduct between EJC and GNC/Newman but also evidence of the normal practices in the industry. *See Roblin Industries*, 78 F.3d at 40-41. No such evidence was presented at the trial. Accordingly, the Court will focus on Code § 547(c)(1), alleged in Defendants' Eighth Affirmative Defense, which requires that the Defendants establish that the transfers constituted contemporaneous new value exchanges between EJC and GNC/Newman.

"'New value' for § 547(c) purposes includes 'money or money's worth in goods, services or new credit.'" *Jones Truck Lines, Inc. v. Cent. States (In re Jones Truck Lines, Inc.)*, 130 F.3d 323, 327 (8th Cir. 1997). In *Jones* the court discussed the value given by a debtor's employees in providing services to the debtor in exchange for payment of salary and benefits when due. *Id.* The court found such payments contemporaneous exchanges for "new value," namely the employees' continuing services. *Id.* In this case, the payments to or on behalf of GNC/Newman were made on a regular monthly basis pursuant to the terms of the Management Agreement in exchange for the services rendered by GNC/Newman. The only departure from the regular monthly payments occurred in connection with the payments to Star/Firstar Bank one month prepetition on account #32716623 totaling $2,797.32. With respect to the balance of the payments, totaling $249,584.93, the Court concludes that they were made contemporaneously in exchange for the services rendered by GNC/Newman and do not constitute preferences.

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[20] It is unnecessary for the Court to consider the defenses set forth at Code § 547(c)(3) and (5) because there is no assertion that the transfers at issue involved the creation of a security interest in property of the Debtors.

However, in the view of the Court the payments totaling $2,797.32 represent a change in the amount of the regular monthly payments made to Star/Firstar Bank during the prior eleven months, were made approximately a month prior to the petition and appear to be on a different account number. It is just such transfers that Code § 547 was intended to deter, namely "unusual action by either the debtor or [its] creditors during the debtor's slide into bankruptcy." H. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6329. As previously found, Newman was an insider of EJC and had to have known of EJC's financial difficulties in that month prepetition. Yet, he apparently chose to purchase a new vehicle shortly before EJC filed its petition.[21] Such actions are not to be countenanced by this Court. Pursuant to Code § 547(f), there is a presumption that EJC was insolvent at the time of those payments since the were all made within 90 days of the chapter 11 filing. Accordingly, the Court concludes that only $2,797.32 in transfers made on behalf of GNC/Newman were preferential and may be avoided by the Plaintiff.

Causes of Action Four through Eleven seeking to avoid alleged fraudulent transfers pursuant to Code § 548 and Code § 544(b)

The Fourth through Seventh Causes of Action seek to recover $772,385.25 in alleged fraudulent transfers made by EJC to GNC between December 13, 1998 and December 12, 1999. The Eighth through Eleventh Causes of Action seek to recover $4,523,233.09 in alleged fraudulent transfers made by EJC to GNC between October 1996 and December 12, 1999. The $4,523,233.09 is broken down as follows:

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[21] Newman testified that GNC paid various expenses associated with thirteen vehicles used by himself and members of his family including a Bentley, a Rolls Royce, a Jaguar, a Cadillac and several Land Rovers. (Tr. 9/11/02 at 72, 78).

Management fees	$ 725,000.00
Health insurance premiums	45,571.06
Automobile payments to Firstar/Star Bank	8,360.85
Parking fees to Central Parking	9,423.50
Acquisition fees	725,000.00
Reimbursement of acquisition/other expenses	37,568.87
Unclassified transfers to GNC and/or related parties (3/97 - 8/99)[22]	2,972,309.81
Total	$4,523,234.09[23]

See Plaintiff's Exhibits 10, 12-16.

The Court has already found that the "unclassified" transfers of $2,972,309.81 made by EJC to GNC constituted loans to GNC. As previously discussed with respect to Plaintiff's First and Second Causes of Action, these monies will have to be repaid by GNC/Newman and, accordingly, the Court need not get into a lengthy analysis concerning whether those transfers were fraudulent and should be avoided as Plaintiff is not entitled to a double recovery with respect to those monies. The Court will, therefore, focus its discussion on the balance of the transfers of $1,550,924.28, less the $2,797.32 determined to have been preferential transfers, or a total of $1,548,126.96. These monies are comprised of payments made pursuant to the Management Agreement, as well as certain payments identified as acquisition fees and other expenses.

The Plaintiff is proceeding under Code §§ 548(a)(1)(A) and (B), as well as §§ 273-276 of the New York Debtor & Creditor Law ("NYD&CL"), as incorporated by Code § 544(b). Code § 548(a)(1)(A) and NYD&CL § 276 each allow for avoidance of certain transfers of an interest in property of the debtor made, or obligations incurred, with actual intent to hinder, delay or

[22] *See* Joint Stipulation of Uncontested Facts at ¶ 25.

[23] This figure includes the $772,382.25 in transfers made during the year prepetition.

defraud creditors. In considering whether the transfers were made with actual intent, the courts rely on certain "badges of fraud," including

> (1) the lack of or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors, and (6) the general chronology of events and transactions under inquiry.

Solomon v. Kaiser (In re Kaiser), 722 F.2d 1574, 1582-83 (2d Cir. 1983) (citing *In re May*, 12 B.R. 618, 627 (Bankr. N.D. Fla. 1980)); *see also Elgin Sweeper Co. v. Melson, Inc.*, 884 F. Supp. 641, 649 (N.D.N.Y. 1995) (indicating that "intentional fraud"

> is normally inferred from circumstances surrounding the transfer. . . . Factors considered include close relationships among parties to a transaction, secrecy and haste in making the transfer, inadequacy of consideration, and the transferor's knowledge of creditors' claims and his own inability to pay them. . . . Only an actual intent to *hinder and delay* need be established, not an actual intent to *defraud*, and lack of fair consideration gives rise to a rebuttable presumption of fraudulent intent. (citations omitted). (emphasis supplied in original)).

With respect to the first factor enumerated in *Kaiser*, GNC/Newman provided various management services in exchange for approximately $20,864 per month, including fees, health insurance, automobile payments and parking. Based on 40 hours per week, this calculates out to 173 hours per month or approximately $120 per hour. In its Post-Trial Memorandum, Plaintiff identifies various services provided by GNC/Newman, which included developing and approving budgets, analyzing and monitoring financial reporting, monitoring sales activity and inventory levels, deciding which stores to open and close, setting staffing levels, including hiring executives and key employees, deciding executive bonus plans, approving of all bank financing transactions, analyzing and monitoring disbursements that were out of the ordinary course of business, approving significant capital expenditures, and making decisions that required a significant amount of money or monetary commitments. *See* Plaintiff's Post-Trial Memorandum at 25. Based on these services, the Court finds that the consideration paid by EJC to GNC was reasonable and adequate.

With respect to the second "badge of fraud," the evidence presented at trial makes it very clear that there was a close relationship between EJC and GNC/Newman. Newman served as Chairman of the Board of EJC from October 1996 and assumed the role of president in December 1998. Newman was the sole member of NPL, which held all of the shares of EJC. Newman was also the sole shareholder of GNC, and it was Newman who actually provided the management services to EJC.

Given the fact that it was services rather than property that GNC/Newman provided to EJC under the terms of the Management Agreement, the issue of retention of possession, benefit or use of the property is not implicated. However, because the Court has been asked to examine a series of monthly transfers between EJC and GNC/Newman, the fifth and sixth factors or "badges of fraud" have some relevance to the matter at hand. Looking at the series of transfers between October 1996 and December 1999, they were all recorded on EJC's books and they were all made with regularity on a monthly basis in the same amounts for the most part. There is nothing to suggest that any of the transfers were made in secrecy. Nor does the evidence support that they were made to hinder or delay payment to other creditors. They appear to have been made as "part of a well established, continuous, ordinary and reasonable business practice" for approximately three years. *See In re Top Sport Distrib., Inc., f/k/a Top Sports Distrib., Inc.*, 41 B.R. 235, 239 (Bankr. S.D. Fla. 1984); *see also In re Gateway Inv. Corp.,* 152 B.R. 354, 357

(Bankr. S.D. Fla. 1993) (finding that "[w]ithout the management agreement the Debtor would have to incur the expense of the . . . management services at substantially the same cost. There was no depletion of assets as a result of performance under the agreement and the creditors were not materially affected. The Debtor in fact received a reasonably equivalent value . . . ."). The Court concludes that the transfers under the terms of the Management Agreement were not actually fraudulent pursuant to Code § 548(a)(1)(A) and NYD&CL § 276 and, accordingly, will dismiss Plaintiff's Fourth and Eleventh Causes of Action.

Under Code § 548(a)(1)(B) and NYD&CL § 273, a transfer of an interest in a debtor's property is deemed constructively fraudulent without regard to actual intent if, *inter alia*, the transfer is made at a time the debtor is insolvent and adequate consideration is not received in exchange for the transfer. Code § 548(a)(1)(B) allows for avoidance of transfers and obligations incurred within one year prepetition for which "reasonably equivalent value" is not received by the debtor, while NYD&CL § 273 allows for avoidance of transfers and obligations going back six years prepetition for which "fair consideration" was not received. "The two terms have substantially the same meaning, although the definition of 'fair consideration' under the NYD&CL expressly incorporates the concept of good faith in making a transfer,[24] whereas the term 'reasonably equivalent value' does not." *In re The Bennett Funding Group, Inc.*, 220 B.R. 743, 754 n.15 (Bankr. N.D.N.Y. 1997) (citing *United States v. McCombs,* 30 F.3d 310, 326 n.1 (2d Cir. 1994)).

As Plaintiff acknowledges in its Post-Trial Memorandum, GNC/Newman provided a

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[24] Interestingly enough, Code § 548(c) shifts the burden of proof by providing defendants with an affirmative defense if they are able to establish that they received the transfer from the debtor in exchange for value <u>and in good faith</u>. *See Jobin v. McKay (In re M&L Business Machine Co.)*, 84 F.3d 1330, 1338 (10th Cir. 1996).

variety of services to EJC under the terms of the Management Agreement. The fact that Newman for all intents and purposes executed the Management Agreement on behalf of both EJC[25] and GNC does not, under the circumstances presented, form a basis for a finding that the services did not constitute reasonably equivalent value for the payments made by EJC as discussed above in connection with the allegations of actual fraudulent intent. *See Rockmore v. Schilling*, 72 F. Supp. 172, 174 (D.N.J. 1947), *aff'd* 167 F.2d 204 (3d Cir. 1948). In *Schilling* the defendant had been the founder and primary shareholder of a corporation, as well as its president and treasurer until he resigned. Subsequent to his resignation, he continued as director and as a consultant, for which he was compensated "in view of his comprehensive knowledge of the business, his familiarity with contacts to be maintained by the company, and his general experience . . . ." *Id.* at 174. The district court concluded that the payments were not fraudulent. *Id.* The Third Circuit affirmed the lower court on this particular issue. *See Schilling*, 167 F.2d at 206.

This Court concludes that the payments in connection with the Management Agreement were for reasonably equivalent value pursuant to Code § 548(a)(1)(B). Code § 548(a)(1)(B) requires that Plaintiff establish <u>both</u> less than a reasonably equivalent value and that either (1) EJC was insolvent at the time of the transfers or became insolvent as a result of the transfers, or (2) EJC was engaged in business or a transaction or about to engage in business or a transaction for which there was unreasonably small capital, or (3) EJC intended to incur debts beyond its ability to pay as such debts matured. 11 U.S.C. §§ 548(a)(1)(B). Because of the Court's finding of reasonably equivalent value, it is unnecessary that the Court address the issue of insolvency or remaining small capital or incurring debts beyond EJC's ability to pay. Accordingly, the Court

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[25] Davis was the one who actually signed the Management Agreement on behalf of EJC in October 1996, the same month he left the employ of GNC and became an employee of EJC.

will dismiss Plaintiff's Fifth, Sixth and Seventh Causes of Action.

However, it is still necessary that the Court consider Plaintiff's request pursuant to NYD&CL §§ 273-275 as asserted in its Eighth, Ninth and Tenth Causes of Action. Under NYD&CL §§ 273-275, a creditor may avoid a transaction as constructively fraudulent if it is proven (1) that a transfer was made for less than fair consideration, as defined in NYD&CL § 272, and (2) that at the time of the transaction, the transferor was either insolvent, a defendant in an action for money damages, engaged in a business with unreasonably small capital, or about to incur debts beyond the transferor's ability to repay. *See Goscienski v. LaRosa (In re Montclair Homes)*, 200 B.R. 84, 98 (Bankr. E.D.N.Y. 1996) (citing *Marine Midland Bank v. Murkoff*, 120 A.D.2d 122, 124 (N.Y. App. Div. 1986)).

NYD&CL § 273 provides that "every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to the person's actual intent if the conveyance is made . . . without fair consideration." Thus, a transfer is considered a fraudulent conveyance under NYD&CL § 273 if the requirements of lack of fair consideration and insolvency are met, regardless of the transferor's intent. *In re Lollipop, Inc.*, 205 B.R. 682, 686 (Bankr. E.D.N.Y. 1997) (citing *HBE Leasing v. Frank*, 48 F.3d 623, 633 (2d Cir. 1995)).

Generally, NYD&CL § 273 places the burden of proving both lack of fair consideration and insolvency on the party challenging the conveyance. *McCombs*, 30 F.3d at 323-324; *In re 375 Park Assocs., Inc.*, 182 B.R. 690, 695 (Bankr. S.D.N.Y. 1995); *American Inv. Bank, N.A. v. Marine Midland Bank, N.A.*, 191 A.D.2d 690, 692 (N.Y. App. Div. 1993). However, if the party establishes that the transfer was made without fair consideration, "the law presumes that the transfer rendered [the transferor] insolvent." *In re Corcoran*, 246 B.R. 152, 163 (E.D.N.Y. 2000) (citations omitted). "The burden then shifts to the transferee to overcome that presumption by demonstrating the debtor's continued solvency after the transfer." *Corcoran*, 246 B.R. at 163; *see also In re O.P.M. Leasing Serv., Inc.*, 40 B.R. 380, 393 (Bankr. S.D.N.Y. 1984), *aff'd* 44 B.R. 1023 (S.D.N.Y. 1984) (noting that "the New York Debtor and Creditor Law evinces a policy protective of creditors in placing the burden of going forward with proof of the debtor's solvency on the transferee").

NYD&CL § 272 defines "fair consideration" as follows: "Fair consideration is given for property, or obligation, (a) when in exchange for such property, or obligation, as fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied."

However, as noted by the Second Circuit,

> New York courts have carved out one exception to the rule that preferential payments of pre-existing obligations are not fraudulent conveyances: preferences to a debtor corporation's shareholders, officers, or directors are deemed not to be transfers for fair consideration.

HBE Leasing Corp., 48 F.3d at 634-35 (citations omitted); *see also Farm Stores, Inc. v. School Feeding Corp.*, 102 A.D.2d 249, 254 (N.Y. App. Div. 1984) (finding that monies paid to certain shareholders in connection with loans and services provided to the corporation although made for fair consideration were not made in good faith and should be voided). The exception rests on an initial finding of insolvency, however. As noted by the court in *Farm Stores*,

> It has been held that preferential transfers to directors, officers and shareholders <u>of insolvent corporations</u> in derogation of the rights of general creditors do not fulfill the good-faith requirement of the Debtor and Creditor Law. "Whether it be upon the theory that directors of insolvent corporations are trustees for the benefit of all creditors, or upon the theory that it would be inequitable to allow directors to use inside information and their controlling voice in corporate affairs to benefit themselves over the claims of others, the common law forbids preferences to directors <u>of</u>

> insolvent corporations as being contrary to principles of fair, honest and open dealing."

Id., (quoting *Southern Industries, Inc. v. Jeremias*, 66 A.D.2d 178, 185 (N.Y. App. Div. 1978) (emphasis supplied) and also citing *Julien J. Studley, Inc. v. Lefrak,* 66 A.D.2d 208, 215 (N.Y. App. Div. 1979), *aff'd* 48 N.Y.2d 954 (1979)).

Thus, it would appear that New York case law has created a rather circuitous approach for this Court's analysis. The Court has already found that GNC and Newman are alter egos. Therefore, the payments to GNC were for all practical purposes payments to Newman, a director and officer of EJC. Under New York law, it is presumed that such payments were without fair consideration if made at a time when EJC was insolvent. Accordingly, the Committee is left with the burden of establishing EJC's insolvency in the context of establishing a lack of "fair consideration" and cannot take advantage of the presumption of insolvency afforded under New York law with respect to conveyances made without fair consideration to officers and directors.

Therefore, in order to make a determination whether the transfers from EJC to GNC/Newman were fraudulent pursuant to NYD&CL § 273 and entitled to be avoided, it is necessary that the Court first address whether EJC was insolvent at the time of the transfers. NYD&CL § 271 provides that "a person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." Section 271 "imposes a 'balance sheet' test, namely assets versus liabilities." *In re Russo,* 1 B.R. 369, 380 (Bankr. E.D.N.Y. 1979); *see In re Tabala,* 11 B.R. 405, 408 (Bankr. S.D.N.Y. 1981). Furthermore, the book value of assets found in a balance sheet using generally accepted accounting principles, although relevant, are not determinative in insolvency determinations. *See In re Lids Corp.*, 281 B.R. 535, 543 (Bankr.

D. Del. 2002). Instead, the courts rely on

> "market value" rather than "distress value," but . . . the valuation must be analyzed "in a realistic framework" considering amounts that can be realized "in a reasonable time" assuming a "willing seller" and a "willing buyer."

In re Trans World Airlines, Inc., 134 F.3d 188, 193-94 (3d Cir. 1998). Generally, the analysis is performed in the context of a going concern. *See Lids Corp.*, 281 B.R. at 541.

A "'going concern'" is a commercial enterprise actively engaged in business with the expectation of indefinite continuance." *Id.*, citing BLACK'S LAW DICTIONARY 592 (7th ed. 1999). In this case, Simon testified that he did not value EJC as a "going concern" based, in part, on the fact that when EJC was sold to NPL in October 1996 the seller actually paid the buyer $3.5 million in order to consummate the sale. Simon indicated that he believed it more appropriate to use a liquidation analysis. *See* Plaintiff's Exhibit 38. Based on the retail value of EJC's inventory as defined in the Agency Agreement, as well as assuming wind-down costs of $500,000 and lease rejection claims of $4,464,000, he estimated the following deficiencies between EJC's assets and its liabilities for the years between October 12, 1996 and October 27, 1999 if liquidated:

October 12, 1996 - ($75,000)
October 4, 1997 - ($555,000)
October 3, 1998 - ($5,007,000[26])
October 27, 1999 - ($12,229,000[27])

Based on these calculated deficiencies, as well as a review of EJC's books and records and certain other documents made available to him, Simon concluded that EJC was insolvent between October 1996 and October 1999.

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[26] This included $2,000,000 due on a line of credit, which did not exist in 1996 or 1997.

[27] This included $4,341,000 due on the line of credit.

The Court takes issue with Simon's conclusion that EJC was insolvent for the three year period ending in October 1999. "As long as liquidation in bankruptcy is not clearly imminent on the Valuation Date, the company must be valued as a going concern." *Id.* (citing *In re Trans World Airlines, Inc.*, 134 F.3d 188, 193 (3d Cir. 1998)); *see also In re Toy King Distrib., Inc.* 256 B.R. 1, 92 (Bankr. M.D.Fla. 2000) (citing *In re Tennessee Chemical Co.*, 143 B.R. 468 (Bankr. E.D.Tenn. 1992) in which the court used a "going concern" valuation even though the debtor had failed to make a profit for three years but had been sold as a "going concern").

A review of EJC's Monthly Internal Financial Statements for 1998 and 1999, as well as the 1997/1998 and 1998/1999 Audited Financial Statements and EJC's Statement of Financial Affairs, reveals approximate net sales for October 12, 1996 through October 4, 1997 of $37,167,000; for October 5, 1997 through October 3, 1998 of $33,804,000; for October 4, 1998 through October 2, 1999 of $30,834,000 and for October 3, 1999 through December 12, 1999 of $5,578,000. *See* Plaintiff's Exhibits 24, 25 and 27. While the figures clearly indicate a downward trend in sales, nonetheless, it also indicates that EJC was engaged in business activities from which sales were being generated. In addition, it is noted that apparently in 1998 EJC was able to obtain a line of credit to allow it to continue its operations. *See* Plaintiff's Exhibit 38. Furthermore, as long as EJC was operating as a going concern, the Court finds that it would be inappropriate to include the $4,964,000 in costs and liabilities associated with liquidation for the period from October 1996 through October 1998. *See Trans World Airlines*, 134 F.3d at 197 (noting that "it is the antithesis of a 'going concern' valuation to include such costs."). Thus, Simon's calculations in his liquidation analysis show only a deficiency on October 27, 1999. *See* Plaintiff's Exhibit 38.

In contrast, where an entity "is on its 'financial deathbed' and has no hope of continuing to operate as a going concern, liquidation value may represent a fair valuation of the financial condition of the debtor. . . . This standard is especially applicable . . . where the debtor is liquidated shortly after the filing of the petition because otherwise the company's true financial condition is 'fictionalized.'" *Toy King*, 256 B.R. at 92 (citations omitted).

EJC filed its petition on December 13, 1999. According to the case docket on January 5, 2000, EJC filed a motion on shortened notice to sell certain inventory and to conduct store closings. The motion was heard on January 10, 2000, and an Order was signed that date approving the sale and closing of the stores and also authorized EJC to enter into the Agency Agreement. On February 4, 2000, EJC made a similar application to conduct a second set of store closings, which was granted at a hearing on February 11, 2000. These actions, taken shortly after EJC's bankruptcy filing, are indicative of the serious financial straits in which EJC found itself in 1999 and warrant application of a liquidation analysis at some point between October 3, 1998 and October 27, 1999 based on the belief that EJC was no longer operating as a "going concern." A review of the sales figures for 1998 and 1999 reveals a 16% drop in sales by EJC in April 1999, as compared to the same month the year before. *See* Plaintiff's Exhibit 24. From that point until the petition date, EJC's sales were consistently below that of the comparable months in 1998, ranging from a drop of 4% in May 1999 to a drop of 20% in July 1999. *Id.* Accordingly, the Court makes a finding that EJC was insolvent beginning in April 1, 1999 through December 12, 1999.

Based on the finding of solvency between October 12, 1996 and March 30, 1999, the Court concludes that the transfers of $725,000 in what have been identified as "Acquisition Fees" paid to GNC between October 22, 1996 and February 10, 1997, were not fraudulent transfers pursuant to NYD&CL § 273. The same finding applies to the transfers identified as

"Reimbursement of Acquisition and Other Expenses" totaling $37,568.87 paid to GNC between October 29, 1996 and October 8, 1998.

What remains for the Court to consider are the transfers made to GNC pursuant to the Management Agreement between April 1, 1999 and December 12, 1999. As discussed above, New York courts hold that payments to an insolvent debtor corporation's shareholders, officers, or directors are not made in good faith even if consideration was provided and should be voided. *See, e.g., Farm Stores*, 102 A.D.2d at 254. In this case, Newman was a director and president of EJC during the relevant eight month period of 1999. The Court previously determined that Newman was the alter ego of GNC. Accordingly, the Court is compelled to find that the payments made to GNC and on behalf of Newman from April 1, 1999 through December 12, 1999 were constructively fraudulent pursuant to NYD&CL § 273 and should be voided. The Court concludes that a total of $187,224.17 in transfers, exclusive of the payments totaling $2,797.32 previously determined to have been preferential transfers in the form of automobile payments, is avoidable as being constructively fraudulent pursuant to NYD&CL § 273 based on a finding that EJC was insolvent during that period and the payments were not made in good faith to GNC given GNC/Newman's close relationship with EJC and the knowledge they possessed regarding EJC's failing financial condition. The management services provided by GNC/Newman were no less vital to EJC than the goods and services provided by the trade creditors, landlords and utility companies to EJC, and GNC/Newman should not receive more than other unsecured creditors on a pro rata basis as a result of their insider status.

Plaintiff's Ninth Cause of Action is based on NYD&CL § 274, which allows a court to avoid a transfer made without fair consideration by a person engaged in business or a transaction for which the property remaining after the transfer is an unreasonably small capital. The evidence presented on the issue of unreasonably small capital is insufficient, in the view of the Court, to find in favor of the Plaintiff. Other than the initial $3.5 million transferred to EJC following the closing in October 1996, it appears that there were no infusions of capital made by NPL or Newman, despite the provision in the Stock Purchase Agreement requiring him, as "Principal Member" of NPL, to provide sufficient cash "to maintain a reasonably sufficient amount of capital to fund all the ongoing business operations" of EJC through October 1999. However, this is not sufficient evidence to allow the Court to making any finding in regard to this particular cause of action. Accordingly, the Court will dismiss Plaintiff's Ninth Cause of Action for lack of proof.

The Court also will dismiss the Plaintiff's Tenth Cause of Action made pursuant to NYD&CL § 275 for the same reason. There is no evidence indicating if and when EJC might have incurred debts beyond its ability to pay as matured. It is reasonable to believe that it occurred some time within the last few months prior to filing given that EJC listed $5,865,514.70 in unsecured debt as of December 13, 1999. A review of EJC's schedules shows much of this debt, consisting of trade debt, rent and utilities, as having been incurred some time in 1999. Having granted the relief sought by the Plaintiff in its Eighth Cause of Action brought pursuant to NYD&CL 273, arguably much of the relief sought in connection with the monies paid by EJC to GNC in 1999 has already been granted, and Plaintiff is not entitled to a double recovery.

<u>Twelfth Cause of Action alleging Breach of Fiduciary Duty by Newman</u>

Plaintiff alleges in its Twelfth Cause of Action that Newman breached his fiduciary duty to EJC's creditors as the sole owner (through NPL), chairman of the board, and president of EJC in allowing the transfers to be made to GNC. To begin this analysis, the Court notes that "fiduciary duty" is defined as

> [a] duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person . . . .

BLACK'S LAW DICTIONARY 523 (7th ed. 1999). Furthermore, "good faith" is defined as

> [a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.

Id. at 701.

The Plaintiff asserts that "[i]t is well settled that officers and directors of corporations owe a fiduciary duty to creditors when a corporation becomes insolvent or approaches the 'vicinity' or 'zone' of insolvency." *See Plaintiff's Post-Trial Memorandum*, filed January 21, 2003, at 63 (citations omitted). As this Court has found, EJC was insolvent from May 1, 1999 through December 12, 1999. Because the Court has also concluded that the transfers to GNC/Newman under the terms of the Management Agreement during that period were constructively fraudulent, it is unnecessary to address whether Newman breached his fiduciary duty to the creditors as Plaintiff, on behalf of the creditors of the estate, is not entitled to a double recovery.

Based on the foregoing, judgment will enter as follows

ORDERED that on the First Cause of Action, judgment is rendered in favor of the Plaintiff, and the Court finds that the sums transferred to Newman and GNC, totaling $2,972,309.81 were loans, for which Newman and GNC are liable;

ORDERED on the Second Cause of Action, judgment is rendered in favor of the Plaintiff pursuant to Code § 542 and Newman and GNC are ordered to turn over to the Plaintiff for the benefit of the creditors the sum of $2,972,309.81 for which they were found to be liable in the First Cause of Action;

ORDERED on the Third Cause of Action, judgment is rendered in favor of the Plaintiff in the amount of $2,797.32 pursuant to Code §§ 547 and 550;

ORDERED that the Fourth, Fifth, Sixth, Seventh Causes of Action, pursuant to Code § 548(a)(1), as well as the Eleventh Cause of Action, pursuant to Code § 544 and NYD&CL § 276, are hereby dismissed;

ORDERED that on the Eighth Cause of Action, judgment is rendered in favor of the Plaintiff in the amount of $187,224.17 pursuant to Code § 544 and NYD&CL § 273;

ORDERED that the Ninth and Tenth Causes of Action pursuant to Code § 544 and NYD&CL §§ 274 and 275 are dismissed; and it is finally

ORDERED that the Twelfth Cause of Action based on breach of fiduciary duty is dismissed.

Dated at Utica, New York

this 26th day of January 2004

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge