NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

LOS ANGELES DIVISION

In re: L. SCOTT APPAREL, INC., Debtor.	Case No. 2:13-bk-26021-RK Chapter 11 Adv. No. 2:15-ap-01122-RK **FINDINGS OF FACT AND CONCLUSIONS OF LAW ON (1) TRUSTEE'S ADVERSARY COMPLAINT AGAINST DEFENDANTS LOWELL SHARRON AND BEYOND BASICS, LLC AND (2) CONSOLIDATED OBJECTION TO SHARRON'S PROOF OF CLAIM AND ADMINISTRATIVE EXPENSE CLAIM** Trial Dates August 18, 19, and 25, 2016, and December 15, 2016
HOWARD GROBSTEIN as Liquidating Trustee of L. Scott Apparel Inc., Plaintiff, vs. LOWELL S. SHARRON, an individual; BEYOND BASICS, LLC dba DAILY THREADS, a California limited liability company; and DOES 1-10, inclusive, Defendants.	

The above-captioned bankruptcy case and adversary proceeding came on for trial before the undersigned United States Bankruptcy Judge on August 18, 19, and 25, 2016 and December 15, 2016, on: (1) the First Amended Complaint of Plaintiff Howard Grobstein as Liquidating Trustee of L. Scott Apparel, Inc. ("Trustee" or "Plaintiff") for Fraudulent Transfer; Recharacterization of Debt; Breach of Fiduciary Duty; Goods Sold and Delivered; Alter Ego; Corporate Waste; Objection to Claim; Preference; Account Stated; Open Book

Account; and Accounting, against Defendants Lowell S. Sharron ("Sharron") and Beyond Basics, LLC ("Beyond Basics") (collectively, the "Defendants"), Electronic Case File Number ("ECF") 64, filed in the adversary proceeding on May 11, 2016, and (2) the contested matters of Trustee's Consolidated Objection to Sharron's Proof of Claim, and Sharron's Motion for Order Compelling Debtor to Pay (i) Administrative Expense and Prepetition Unsecured Wage Claims; and (ii) Equity Interest, Main Bankruptcy Case ECF 298, filed in the main bankruptcy case on March 3, 2015. Brian L. Davidoff and Courtney E. Norton of the law firm of Greenberg Glusker Fields Claman & Machtinger, LLP appeared for Plaintiff, and Lloyd S. Mann of the law firm of Mann & Zarpas, LLP, appeared for Defendants.

On October 19, 2016, Plaintiff lodged his proposed findings of fact and conclusions of law for these matters, ECF 139, and on November 18, 2016, Defendants lodged their proposed findings of fact and conclusions of law, ECF 149. On December 8, 2016, Plaintiff filed his objections to Defendants' proposed findings of facts and conclusions of law, ECF 151, to which Defendants responded, ECF 152. On December 13, 2016, Plaintiff filed his objections to Defendants' proposed findings of fact and conclusions of law. ECF 153. On December 15, 2016, the court heard the closing arguments of the parties after the submission of the proposed findings of fact and conclusions of law. After this hearing, Defendants and Plaintiff filed post-argument supplemental briefs on January 6, 2017 and January 17, 2017, respectively, and the court took the matter under submission.

Having considered the evidence admitted at trial, the oral and written arguments of the parties, and other admissible and relevant pleadings filed in this matter filed by Plaintiff and Defendants, the court makes the following findings of fact and conclusions of law pursuant to Rule 52 of the Federal Rules of Civil Procedure, made applicable here by Rule 7052 of the Federal Rules of Bankruptcy Procedure.

I. PROCEDURAL HISTORY

On June 19, 2013, Kody Branch of California Inc. ("Kody"), one of Debtor's outside vendors, and two other creditors commenced this bankruptcy case by filing an involuntary petition for relief under Chapter 7 of the Bankruptcy Code, 11 U.S.C., against Debtor.

Involuntary Petition, Main Bankruptcy Case ECF 1; *Stipulated Facts (82) and (84), Joint Pretrial Stipulation*, ECF 97, filed on August 2, 2016, at 10. On August 7, 2013, Debtor filed a motion to convert the case to one under Chapter 11 of the Bankruptcy Code. *Stipulated Fact (85), Joint Pretrial Stipulation*, ECF 97 at 10. On August 12, 2013, Debtor and the petitioning creditors filed a stipulation with respect to the conversion motion, and on August 13, 2013, the court entered an order approving the conversion stipulation, which has been treated as the order converting the involuntary Chapter 7 case to a case under Chapter 11. *Stipulated Facts (86) and (87), Joint Pretrial Stipulation*, ECF 97 at 10.

Pursuant to an order entered on April 3, 2014, as amended on April 7, 2014, the court confirmed the amended plan of reorganization proposed by Debtor, and the plan became effective on April 18, 2014. *Stipulated Facts (89) and (90), Joint Pretrial Stipulation*, ECF 97 at 10. The plan provided among other things that a liquidating trust be created for the benefit of holders of allowed claims, who were its beneficiaries, and to the extent that all allowed claims are paid in full with interest, the holders of allowed interests in Debtor. *Stipulated Fact (91), Joint Pretrial Stipulation*, ECF 97 at 10. On April 3, 2014, Plaintiff Howard Grobstein was appointed as the liquidating trustee of this liquidating trust, and pursuant to the plan, as liquidating trustee, he is authorized to initiate, prosecute, compromise, and/or resolve all claims in the name of the liquidating trust, including all causes of action and/or avoidance rights under the Bankruptcy Code. *Stipulated Facts (92) and (93), Joint Pretrial Stipulation*, ECF 97 at 10.

On September 23, 2013, Sharron filed his proof of claim, Claim Number 18 (the "Sharron Proof of Claim"), in the bankruptcy case, which claimed a total amount of $766,783.74 for "Money loaned to Debtor, and unpaid compensation." *Sharron Proof of Claim*, Defendants' Exhibit 557. Sharron claimed $350,000 as a secured debt perfected by virtue of his alleged right to setoff. *Id*. On May 5, 2014, Sharron filed his Motion for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; and (2) Equity Interest (the "Sharron Motion"). Main Bankruptcy Case ECF 198. On March 3, 2015, Trustee filed his consolidated objection to the Sharron Proof of Claim

and the Sharron Motion (the "Consolidated Objection"). *Consolidated Objection to Sharron Claim*, Plaintiff's Exhibit 147.

Concurrently with the filing of the Consolidated Objection, Trustee commenced the adversary proceeding by filing the complaint against Sharron and Beyond Basics. ECF 1. On March 30, 2015, Trustee, Sharron, and Beyond Basics entered into a stipulation consolidating the litigation of the adversary proceeding and the contested matter of Trustee's Consolidated Objection to Sharron's Claim and Administrative Expense Request with the adversary proceeding, and the court approved the stipulation by order filed and entered on April 1, 2015. ECF 4 and 6.

In the adversary proceeding, with leave of court, Trustee filed his First Amended Complaint against Defendants adding three causes of action for account stated, open book account, and an accounting. *First Amended Complaint*, ECF 64. Based on the new causes of action, on April 19, 2016, Trustee filed applications for prejudgment writs of attachment against Defendants. ECF 26 and 28. By orders filed and entered on August 8, 2016, the court approved Trustee's writ applications and issued a writ of attachment against Beyond Basics in the amount of $502,008 and a writ of attachment against Sharron in the amount of $112,194, with prejudgment interest on both writs at the rate of 10% per annum from June 19, 2013.[1] ECF 103 and 104.

II. FINDINGS OF FACT

A. Formation and Corporate History of Debtor L. Scott Apparel, Inc.

1. Debtor L. Scott Apparel, Inc. ("Debtor") was incorporated as a California corporation on May 15, 2001. *Articles of Incorporation*, Plaintiff's Trial Exhibit 1; *Stipulated Fact (4), Joint Pretrial Stipulation*, ECF 97, filed on August 2, 2016, at 2.

2. As shown on Debtor's Statement of Information filed with the California Secretary of State, as of May 13, 2013, Sharron was the President, Secretary, Chief

[1] As discussed below, the court determines that the date from which prejudgment interest should run is not June 19, 2013, the date on which the involuntary bankruptcy petition was filed against Debtor, and not October 16, 2012, the date of alleged insolvency argued by Trustee at trial, but March 3, 2015, the date Trustee filed his complaint, which commenced this adversary proceeding.

Financial Officer, and the only Director of Debtor. *Statement of Information*, Plaintiff's Trial Exhibit 1A; *Stipulated Facts (6) and (7), Joint Pretrial Stipulation*, ECF 97 at 2.

3. As shown on Debtor's Statement of Information filed with the California Secretary of State, as of May 13, 2013, the principal executive office for Debtor was Sharron's then personal residence at 702 Georgina Ave., Santa Monica, California 90402, and its principal business office was listed as 1517 S. Mateo, Los Angeles, California 90021. *Statement of Information*, Plaintiff's Trial Exhibit 1A; *Stipulated Fact (8), Joint Pretrial Stipulation*, ECF 97 at 3.

4. At the time of the filing of the involuntary bankruptcy petition in this bankruptcy case on June 19, 2013, Debtor's stock was owned 95% by Sharron, 2.5% by the Sharron Family Trust, and 2.5% by the Sharron/Bialson Revocable Living Trust. *Stipulated Fact (9), Joint Pretrial Stipulation*, ECF 97 at 3. Sharron owned 97.5% of Debtor individually and through his family trust. *Id.; Sharron Trial Declaration*, ECF 100, filed on August 4, 2016, at 17, ¶ 54.

5. Debtor was a garment manufacturer that was in business for approximately twelve years and sold finished garments to retailers, including major retail stores such as Macy's and J.C. Penney. *Sharron Trial Declaration*, ECF 100 at 5, ¶ 12; *Stipulated Fact (1), Joint Pretrial Stipulation*, ECF 97 at 2. Debtor did business under the name of "6 Degrees." *Stipulated Fact (2), Joint Pretrial Stipulation*, ECF 97 at 2. Debtor principally used outside vendors and suppliers to manufacture the garments it sold in accordance with customers' specifications. *Stipulated Fact (3), Joint Pretrial Stipulation*, ECF 97 at 2. Debtor sold garments to retailers primarily in the junior segment, though it had at least one order in the children's segment with Wal-Mart and another with Dillard's. *Stipulated Fact (10), Joint Pretrial Stipulation*, ECF 97 at 3; *Sharron Trial Declaration*, ECF 100 at 5, ¶ 12. In 2008, Debtor had an approximately $4 million order from Wal-Mart for children's clothing. *Stipulated Fact (11), Joint Pretrial Stipulation*, ECF 97 at 3. Both before and after the Wal-Mart children's order in 2008, Debtor attempted to sell children's clothing to other retailers. *Stipulated Fact (12), Joint Pretrial Stipulation*, ECF 97 at 3. Debtor's management had prior

experience in children's clothing. *Stipulated Fact (13), Joint Pretrial Stipulation*, ECF 97 at 3.

B. Debtor's Capitalization

6. Debtor was capitalized and financed its operations through a factoring agreement with CIT Group/Commercial Services, Inc. ("CIT"), and through advances by its shareholder, Sharron. *Sharron Trial Declaration*, ECF 100 at 5, ¶ 14.

7. Debtor entered into its factoring arrangement with CIT on November 20, 2002 ("CIT Factoring Agreement"). *Stipulated Fact (14), Joint Pretrial Stipulation*, ECF 97 at 3; *CIT Factoring Agreement*, Plaintiff's Exhibit 2, Defendants' Exhibit 539; *Amendment to Factoring Agreement*, Plaintiff's Exhibit 3. CIT remained Debtor's factor until the termination of Debtor's operations. *Stipulated Fact (15), Joint Pretrial Stipulation*, ECF 97 at 3.

8. Pursuant to its CIT Factoring Agreement, Debtor sold certain of its accounts receivable arising from the sales of its inventory or rendition of services, and CIT advanced up to 85% of the amount of the sold accounts, plus up to $200,000 in the aggregate based on certain other calculations. *Sharron Trial Declaration*, ECF 100 at 5, ¶ 14; *CIT Factoring Agreement*, Plaintiff's Exhibit 2, Defendants' Exhibit 539; *Amendment to Factoring Agreement*, Plaintiff's Exhibit 3. Under the CIT Factoring Agreement, if there was any non-payment by Debtor's customers, Debtor bore the risk of that non-payment, and since Sharron had personally guaranteed the CIT Factoring Agreement, he was at personal risk for repayment of the advances made by CIT under the agreement. *Sharron Trial Declaration*, ECF 100 at 5, ¶ 15; *CIT Factoring Agreement*, Plaintiff's Exhibit 2, Defendants' Exhibit 539; *Amendment to Factoring Agreement*, Plaintiff's Exhibit 3.

9. As part of the CIT Factoring Agreement, CIT had access to all of Debtor's financial records, CIT had auditing rights, CIT demanded and received regular reports and projections from Debtor, and CIT had the right to terminate the factoring relationship and agreement if it concluded that Debtor was in breach of the factoring agreement or its financial condition was compromised. *Sharron Trial Declaration*, ECF 100 at 5-6, ¶ 16; *CIT*

Factoring Agreement, Plaintiff's Exhibit 2, Defendants' Exhibit 539; *Amendment to Factoring Agreement*, Plaintiff's Exhibit 3.

10. Debtor's financial statements were provided to CIT. *Stipulated Fact (75), Joint Pretrial Stipulation*, ECF 97 at 9. CIT continued to honor the factoring agreement with Debtor up to and about the time that the involuntary bankruptcy petition against Debtor was filed in this bankruptcy case in June 2013.[2] *Sharron Trial Declaration*, ECF 100 at 5-6, ¶ 16; *Stipulated Fact (15), Joint Pretrial Stipulation*, ECF 97 at 3.

11. On or about September 2002, Sharron advanced to Debtor personal funds of $250,000, of which $50,000 was treated by him as a capital contribution or equity investment, and of which $200,000 was recorded as a loan from shareholder on Debtor's compiled financial statements for the year ended December 31, 2002 as "subordinated debt-stockholder." *Sharron Trial Declaration*, ECF 100 at 6, ¶ 18; *Stipulated Fact (16), Joint Pretrial Stipulation*, ECF 97 at 3.

12. The amount of $200,000 recorded in Debtor's books as "subordinated debt-stockholder" is referred to by the parties in the Joint Pretrial Stipulation as the "Subordinated Debt," *see Stipulated Fact (16), Joint Pretrial Stipulation*, ECF 97 at 3, but the issue as to whether this "debt" is properly characterized as debt owed to Sharron or as his equity interest is disputed by the parties, *see Legal Issues (3)(ii) and (iii), Joint Pretrial Stipulation*, ECF 97 at 34. The Subordinated Debt was subordinated pursuant to subordination agreements with CIT and with Solo Credit International Corp. *Stipulated Fact (20), Joint Pretrial Stipulation*, ECF 97 at 4; *Subordination Agreement*, Plaintiff's Exhibit 4; *Promissory Note $200,000*, Plaintiff's Exhibit 5; *Subordination Agreement*, Plaintiff's Exhibit 7; *Subordination Agreement*, Plaintiff's Exhibit 8.

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[2] In February 2013, a field examiner with CIT sent an email dated Feburary 5, 2013 to Lita Trinidad with Debtor inquiring about accounts payable over 60 days past due, including "Kody Branch - $90K, Donshen Textile - $221K, ShaoXing County Boran Textiles - $20K, Ningbo YinZhou - $15K" and requesting an explanation why these accounts were past due and if they will be paid. *Email string from L. Trinidad to L. Sharron, February 8, 2013,* Plaintiff's Exhibit 116. Ms. Trinidad forwarded the email to Sharron on February 8, 2013 for his information. *Id.* Although this inquiry was made by CIT, as discussed herein, CIT continued to provide factoring financing to Debtor through June 2013.

13. Debtor issued multiple promissory notes that periodically modified the principal and maturity dates on the Subordinated Debt:

a. Debtor issued a promissory note dated September 1, 2002 in the amount of $200,000 to Sharron for the Subordinated Debt, which had a maturity date of January 1, 2005, and accrued interest at the rate of 6% per annum. *Stipulated Fact (18), Joint Pretrial Stipulation*, ECF 97 at 4; *Promissory Note $200,000*, Plaintiff's Exhibit 5.

b. Debtor issued a new promissory note dated April 30, 2003 in the amount of $350,000 to Sharron, which reflected an increase in the Subordinated Debt in that amount and a new maturity date of July 1, 2005, at 6% interest per annum. *Stipulated Fact (19), Joint Pretrial Stipulation*, ECF 97 at 4; *Promissory Note $350,000*, Plaintiff's Exhibit 6.

c. Debtor issued a new promissory note dated July 1, 2004 in the amount of $350,000 to Sharron for the Subordinated Debt with a new maturity date of June 30, 2007, at 6% interest per annum. *Promissory Note $350,000 attached to Subordination Agreement*, Plaintiff's Exhibit 8.

d. Debtor and Sharron extended the maturity date of the Subordinated Debt to June 30, 2009. *Stipulated Fact (21), Joint Pretrial Stipulation*, ECF 97 at 4.

e. Debtor issued a new promissory note dated December 31, 2008 in the amount of $350,000 to Sharron for the Subordinated Debt with a new maturity date of January 1, 2010, at 6% interest per annum. *Stipulated Fact (22), Joint Pretrial Stipulation*, ECF 97 at 4; *Promissory Note $350,000 attached to Subordination Agreement*, Plaintiff's Exhibit 10.

f. Debtor issued a new promissory note dated December 31, 2009 in the amount of $350,000 to Sharron for the Subordinated Debt with a new maturity date of January 1, 2012, at 6% interest per annum. *Stipulated Fact (23), Joint Pretrial Stipulation*, ECF 97 at 4; *Promissory Note $350,000 attached to Email From Kabani*, Plaintiff's Exhibit 11. In an interoffice memorandum, Debtor's accountant, Zulfiqar

Kabani ("Kabani"), advised Sharron the prior note had expired, and this note was being issued to replace it. *Id.*

g. Debtor issued another promissory note dated December 31, 2009 in the amount of $350,000 to Sharron for the Subordinated Debt with a new maturity date of January 1, 2014, at 6% interest per annum. *Promissory Note $350,000*, Plaintiff's Exhibit 12.

h. Debtor issued a second promissory note dated December 31, 2009 in the amount of $350,000 to Sharron for the Subordinated Debt with a new and different maturity date of January 1, 2015, at 6% interest per annum. *Promissory Note $350,000*, Plaintiff's Exhibit 13; *see also Stipulated Fact (24), Joint Pretrial Stipulation*, ECF 97 at 4.

14. As reflected in these various promissory notes, Debtor and Sharron extended the term of the Subordinated Debt from two years to twelve years, and the final maturity date for the Subordinated Debt came on January 1, 2015, after the order for relief was entered in this bankruptcy case in August 2013. Promissory Notes, Plaintiff's Exhibits 5, 6, 8, 10, 11, 12, and 13; *see also Grobstein Trial Declaration*, ECF 86 at 6-7, ¶¶ 16-24.

15. Interest on the Subordinated Debt was credited by Debtor to the account designated in Debtor's QuickBooks as "1210 – Due from Officer" (the "Due from Officer Account"). *Stipulated Fact (25), Joint Pretrial Stipulation*, ECF 97 at 4; *see Stipulated Fact (33), Joint Pretrial Stipulation*, ECF 97 at 5; *Due from Officer Account*, Plaintiff's Exhibit 58; *Oversize Due from Officer Statement*, Plaintiff's Exhibit 59; *Grobstein Trial Declaration*, ECF 86 at 9-10, ¶ 41.

16. Debtor's December 31, 2012 credit to Sharron on the Due from Officer Account in the amount of $10,500 was on account of interest on the Subordinated Debt. *Stipulated Fact (26), Joint Pretrial Stipulation*, ECF 97 at 4.

17. The Subordinated Debt is reflected in Debtor's QuickBooks as account "2130 – Long Term Loan." *Stipulated Fact (27), Joint Pretrial Stipulation*, ECF 97 at 4; *Grobstein Trial Declaration*, ECF 86 at 7, ¶ 25. No other activity appears in Debtor's QuickBooks

account "2130 – Long Term Loan" besides entries in 2002 and 2003 reflecting Sharron's aggregate $350,000 advance. *Grobstein Trial Declaration*, ECF 86 at 7-8, ¶ 26; *see also Stipulated Facts (14)-(27), Joint Pretrial Stipulation*, ECF 97 at 3-4.

18. Debtor did not make any payments of principal on the Subordinated Debt. *Sharron Trial Declaration*, ECF 100 at 7, ¶ 26 ("At no time, however, was any portion of the $350,000 paid to me."). Based on Trustee's analysis of Debtor's books and records, not only did Debtor not make any payments of principal on the Subordinated Debt, Debtor did not make any reserve for payment of the Subordinated Debt on its books and records. *Grobstein Trial Declaration*, ECF 86 at 8, ¶ 28. Based on Trustee's analysis of Debtor's books and records, these books and records do not contain any record of a demand for payment of the Subordinated Debt, nor do they reflect that any cash payments of interest were ever paid by Debtor to Sharron. *Id.*, ¶¶ 28-29; *see also Sharron Trial Declaration*, ECF 100 at 7, ¶ 25 ("Over the years, I always received interest on the loans. Usually, and perhaps always, the interest was documented by way of credits I received on the 'Due from Officer' account."). There was no testimony in Sharron's trial declaration about Sharron having ever demanded payment of the Subordinated Debt, apparently because he felt that he "would have an eventual $350,000 offset to use against the 'Due from Officers' account." *Sharron Trial Declaration*, ECF 100 at 6-7, ¶¶ 22-26.

19. Kabani, Debtor's accountant, testified that the funds from the Subordinated Debt were needed and used as working capital for Debtor. *Kabani Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 122 ("Q. So the [$]200,000 you're saying actually was needed for financing [of Debtor] because there was no other financing other than what CIT provided by their loan, by their factoring arrangement? A. Yes, it was needed at that time."); *id.* at 125 ("Q. So are you saying that the [$]350,000 that shows a note payable to stockholders was needed was working capital? A. Correct.").

20. Sharron never attempted to offset the Subordinated Debt against the Due from Officer Account, except that after the filing of the involuntary bankruptcy petition against Debtor, Debtor claimed to offset the Sharron Subordinated Note from the Due from Officer

account on Debtor's 2013 tax return. *Defendants' Proposed Findings of Fact and Conclusions of Law*, ¶ 11 (citing *Sharron Trial Declaration*, ECF 100 at 7, ¶ 25); *see also Kabani Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 124-127; *2013 L. Scott Apparel Tax Return*, Plaintiff's Exhibit 14.

21. Sharron testified that the Subordinated Debt did not have a fixed due date and that he was willing to allow the Subordinated Debt to remain outstanding for so long as there were amounts due from him under the Due from Officer Account. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 162:4-25; *see also Sharron Trial Declaration*, ECF 100 at 7, ¶ 25 ("I always expected to be paid back the principal at some point . . .").

22. Kabani and Sharron gave slightly different testimony at trial regarding the process for the extensions of the maturity date for the Subordinated Debt: Sharron stated that he relied on Kabani regarding the extensions, while Kabani stated there were discussions with Sharron regarding whether to extend or offset the maturity date and that the decision was made to extend the date. *Compare Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 157-158, *with Kabani Testimony*, *Trial Transcript of August 25, 2016*, ECF 136 at 126-127. The court finds that this testimony is consistent and that Sharron left it to Kabani to remind him about the maturity dates as they occurred and to recommend extensions, Kabani regularly reminded Sharron about the maturity dates, Sharron regularly decided to extend the maturity dates at Kabani's recommendation, and Kabani regularly recommended extensions and prepared the paperwork to extend the loan maturity because Debtor needed working capital to operate.

C. <u>Beyond Basics</u>

23. Beyond Basics, LLC ("Beyond Basics") was formed on August 8, 2011 as a California limited liability company entity to sell children's clothing. *Beyond Basics, LLC Limited Liability Company Articles of Organization,* Defendants' Exhibit 517; *Stipulated Facts (51) and (53), Joint Pretrial Stipulation*, ECF 97 at 7. Beyond Basics did business under the trade name of "Daily Threads." *Stipulated Fact (52), Joint Pretrial Stipulation*,

ECF 97 at 7. Beyond Basics's formation occurred before Debtor's disputes with two of its major suppliers, Kody and Donshen. *See Beyond Basics, LLC Limited Liability Company Articles of Organization*, Defendants' Exhibit 517; *Beyond Basics Operating Agreement*, Defendants' Exhibit 518; *Donshen Adequate Assurance Demand*, Plaintiff's Exhibit 125; *Kody Branch Adequate Assurance Demand*, Plaintiff's Exhibit 127A.

24. The principals of Beyond Basics, Sharron, Maren "Jamara" Ghalayini, and Riad Ghalayini executed a Limited Liability Company Operating Agreement dated August 8, 2011 (the "Beyond Basics Operating Agreement"). *Stipulated Fact (53), Joint Pretrial Stipulation*, ECF 97 at 7; *see* Defendants' Exhibit 518. According to the Beyond Basics Operating Agreement, the members of Beyond Basics were: Lowell S. Sharron Revocable Trust (61.25%), Maren "Jamara" Ghalayini (33.75%) and Riad Ghalayini (5%). *Stipulated Fact (54), Joint Pretrial Stipulation*, ECF 97 at 7.

25. The Beyond Basics Operating Agreement stated that the initial capitalization of Beyond Basics was as follows: Lowell S. Sharron Revocable Trust (inventory and materials valued at $72,500), and Maren "Jamara" Ghalayini (assets of separate dissolved entity Daily Threads LLC valued at $6,000). *Stipulated Fact (68), Joint Pretrial Stipulation*, ECF 97 at 8. According to the Beyond Basics Operating Agreement, Sharron contributed inventory and related materials having a value of $72,500, and Maren "Jamara" Ghalayini contributed assets of Daily Thread, LLC, having a value of $6,000. *Stipulated Fact (55), Joint Pretrial Stipulation*, ECF 97 at 7. Sharron did not personally own any inventory and acknowledged in testimony that any such inventory would have come from Debtor. *Sharron Testimony*, *Trial Transcript of August 18, 2016*, ECF 134 at 211:7-10 ("I definitely did not have any inventory that I can remember"); *Stipulated Fact (56)*, *Joint Pretrial Stipulation*, ECF 97 at 7; *see also Sharron Deposition, March 28, 2016* at 264, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016 (Q: "So those were the – the inventory and related materials that L. Scott purchased that had been debited to your Due From account, correct? A: Yes.:) (unmarked testimony).

26. Sharron began discussions with Maren "Jamara" Ghalayini about developing the business that became Beyond Basics in early 2011. *Grobstein Trial Declaration*, ECF 86 at 16, ¶ 53; *see also Email string from Jamara Ghalayini to Lowell Sharron re Thoughts on facilitating a buy out*, Plaintiff's Exhibit 69. According to Sharron, he was motivated to start Beyond Basics as a new business because: "We were in the middle of some very difficult and changing times in the apparel industry. It was my desire to capitalize on a new line of business for children. The products would all be made in America which was a trend that many of the largest retailers were contemplating at that time." *Sharron Trial Declaration*, ECF 100 at 17, ¶ 55. According to Sharron, Debtor and Beyond Basics were offering "very, very different products," that is, Beyond Basics with its Daily Threads line of products was at "high price point, things made in America, better quality, all that" and Debtor with its Six Degrees line of products was at "a very low price point" in "the children's mass market." *Sharron Deposition, March 28, 2016* at 339, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016.

27. As shown by emails between Sharron and Ghalayini that pertain to the structure of the formation, capitalization, funding and operations of Beyond Basics:

a. Sharron wanted to retain financial control of Beyond Basics; *see Email string from Jamara Ghalayini to Lowell Sharron re Thoughts on facilitating a buy out*, Plaintiff's Exhibit 69; *Email string from Jamara Ghalayini to Lowell Sharron re Partnership agreement Comments*, Plaintiff's Exhibit 72; *Trial Transcript of August 18, 2016*, ECF 134 at 199:18-200:1 ("Operational control, yes, that would have been important to me.") and 202:25-203:7 ("[S]he wanted some kind of a process so that even though I had control, she would be able to kind of more formally express her opinion on things.");

b. Sharron was concerned that Beyond Basics could compete with Debtor; *Stipulated Fact (57), Joint Pretrial Stipulation*, ECF 97 at 7;

c. Since Debtor had sold children's clothing and the business of Beyond Basics was children's clothing, and Sharron and Ghalayini did not want Debtor and Beyond Basics to be directly competing against each other, Sharron required Ghalayini to sign a non-compete agreement; *Email string from Jamara Ghalayini to Lowell Sharron re Term Sheet*, Plaintiff's Exhibit 65; *Email string from Jamara Ghalayini to Lowell Sharron re Partnership agreement Comments*, Plaintiff's Exhibit 72; and

d. Sharron recognized that there was a "huge risk" in funding Beyond Basics as a new venture as "in any new venture there's risk." *Email string from Jamara Ghalayini to Lowell Sharron re Daily Threads Artwork Changes—additional changes*, Plaintiff's Exhibit 71; *Email string from Jamara Ghalayini to Lowell Sharron re Partnership agreement Comments*, Plaintiff's Exhibit 72 at 3; *Sharron Deposition, March 28, 2016* at 360, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016.

See also Grobstein Trial Declaration, ECF 86 at 16, ¶¶ 53 and 54.

28. On December 2, 2011, Sharron and Ghalayini discussed potential products and ideas for Beyond Basics, and Sharron wrote, "Let's get a business plan together so that we are ready to roll on the next idea after we prove the first line is a success." *Email string from Jamara Ghalayini to Lowell Sharron re We really need to focus*, Plaintiff's Exhibit 87.

29. The initial capital contributions for Beyond Basics came from the value of $6,000 attributed to the assets contributed by Ghalayini and Sharron's contribution of $50,000. *Stipulated Facts (68) and (69), Joint Pretrial Stipulation*, ECF 97 at 8; *Wall Expert Report*, Plaintiff's Exhibit 148 at 22-23. According to Debtor's Due from Officer Account and Due from Beyond Basics Account, Sharron's initial capital contribution of $50,000 to Beyond Basics was advanced by Debtor and reflected on the Due from Officer Account. *Wall Expert Report*, Plaintiff's Exhibit 148 at 23*; Due from Officer Account*, Plaintiff's Exhibit 58; *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106; *Grobstein Trial Declaration*, ECF 86 at 17, ¶ 58.

30. In December 2011, Debtor provided an additional $22,500 in capital to Beyond Basics on behalf of Sharron. *Grobstein Trial Declaration*, ECF 86 at 17, ¶ 59, *Wall Supplemental Report*, Plaintiff's Exhibit 150 at 3. Sharron's Beyond Basics capital account was increased by this $22,500 in December 2011 when Debtor advanced that amount which was reflected in the Due from Officer Account. *Stipulated Fact (70), Joint Pretrial Stipulation*, ECF 97 at 8.

31. Beyond Basics and Debtor are separate legal entities. *Stipulated Facts (4) and (51), Joint Pretrial Stipulation*, ECF 97 at 2 and 7.

32. Debtor owned no interest in Beyond Basics. *Stipulated Fact (72), Joint Pretrial Stipulation*, ECF 97 at 8.

33. Beyond Basics and Debtor were in different business segments, and Beyond Basics served a more upscale market than Debtor. *Sharron Testimony*, *Trial Transcript of August 18, 2016*, ECF 134 at 198; *Sharron Deposition, March 28, 2016* at 339, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016.

34. "AIMS" was a production software used by Beyond Basics and Debtor. *Sharron Trial Declaration* at 2, ¶ 4; *Declaration of Kailey Wright in Support of Plaintiff's Trial Brief*, ECF 88 at 3, ¶ 6. AIMS stands for "Apparel Management Software," and according to Kabani, Debtor's accountant, many of his apparel business clients use it to track important information regarding orders and sales, and other matters related to managing their apparel businesses. *Kabani Trial Declaration,* ECF 99 at 8, ¶ 25. According to Sharron, "[t]he AIMS software was an important way of documenting the orders received by L. Scott [Debtor] and Beyond Basics." *Sharron Trial Declaration,* ECF 100 at 2, ¶ 4. Each entity maintained separate AIMS programs. *Id.* at 21, ¶ 68.

35. The charges reflected in the Due from Beyond Basics Account of Debtor were from labor charges from work performed by Debtor's employees in Beyond Basics's operations and some transfers of funds, such as expenses paid on behalf of Beyond Basics. *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit

106; *Sharron Trial Declaration,* ECF 100, ¶¶ 49-62; *Grobstein Trial Declaration*, ECF 86 at 16-17, ¶ 56. Most of the charges on the Due from Beyond Basics Account came from labor charges for work performed by Debtor's employees for Beyond Basics. *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106*; Sharron Trial Declaration,* ECF 100, ¶¶ 52-60.

36. On or about August 8, 2011, Beyond Basics and Debtor entered into a Shared Services Agreement ("Shared Services Agreement"). *Stipulated Fact (62), Joint Pretrial Stipulation*, ECF 97 at 8; *Shared Services Agreement*, Plaintiff's Exhibit 73; *Grobstein Trial Declaration*, ECF 86 at 17-18, ¶ 61. The Shared Services Agreement provided for Debtor's payment of Direct Expenses (which included manufacturing, cost of sales, payroll, and general administrative expenses) at an interest rate of 9% per annum. *Stipulated Facts (63) and (64), Joint Pretrial Stipulation*, ECF 97 at 8; *Shared Services Agreement*, Plaintiff's Exhibit 73. In consideration of Debtor's payment of Indirect Expenses, Beyond Basics was to add a commission of $1.33 to what it owed Debtor for each garment shipped. *Stipulated Fact (65), Joint Pretrial Stipulation*, ECF 97 at 8; *Shared Services Agreement*, Plaintiff's Exhibit 73. Direct Expenses and Indirect Expenses were accounted for by adding debits to the Due from Beyond Basics Account. *Stipulated Fact (66), Joint Pretrial Stipulation*, ECF 97 at 8; *Shared Services Agreement*, Plaintiff's Exhibit 73; *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106. Sharron testified that the services to Beyond Basics were provided by Debtor's workforce which had time to perform these services since they did not have enough work for Debtor, *Sharron Trial Declaration*, ECF 100, ¶¶ 51-58, and the labor was tracked, documented, and charged to Beyond Basics. *Sharron Trial Declaration*, ECF 100 at 18, ¶ 58; *see DT Hours/Payroll*, Defendants' Exhibit 515.

37. Debtor's contributions to Beyond Basics were charged to Beyond Basics and reflected on the account designated in Debtor's QuickBooks as account "1222 – Due from Beyond Basics" (the "Due from Beyond Basics Account"). *See Grobstein Trial Declaration*, ECF 86 at 16-17, ¶ 56; *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond*

Basics, Plaintiff's Exhibit 106. *Due from Beyond Basics Account*; *Sharron Trial Declaration*, ECF 100, ¶¶ 49-53. Sharron does not dispute that Beyond Basics owes Debtor the amount listed in the Due from Beyond Basics Account. *Sharron Trial Declaration*, ECF 100 at 15, ¶ 49.

38. As of July 24, 2013, the amount owing by Beyond Basics to Debtor, (i) exclusive of interest, and (ii) inclusive of all cash and non-cash credits, pursuant to the Due from Beyond Basics Account was $502,008.46. *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106; *Grobstein Trial Declaration*, ECF 86 at 19, ¶ 71.

39. There is no record of any demand by Debtor on Beyond Basics for payment of the Due from Beyond Basics Account, and Debtor's QuickBooks files show that Debtor received only a single payment on the Due from Beyond Basics Account on July 24, 2013, after the involuntary petition was filed against Debtor. *Grobstein Trial Declaration*, ECF 86 at 19, ¶ 70.

40. While Sharron expected Beyond Basics to repay Debtor only if Beyond Basics became profitable, he testified that he "truly believed" Beyond Basics would become profitable and ultimately pay off its debt to Debtor. *Sharron Trial Declaration*, ECF 100 at 18-19, ¶ 60.

41. The partnership tax return of Beyond Basics for the year ending December 31, 2011 reflected net sales of $29,341, gross profit of $14,670 after deducting cost of goods sold of $14,671, and ordinary business loss of $161,939. *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2011*, Plaintiff's Exhibit 110-A.

42. The partnership tax return of Beyond Basics for the year ending December 31, 2012 reflected net sales of $325,546, gross profit of $72,889 after deducting cost of goods sold of $252,657, and ordinary business loss of $138,685. *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2012*, Plaintiff's Exhibit 110-B.

43. The partnership tax return of Beyond Basics for the year ending December 31, 2013 reflected net sales of $310,935, gross profit of $89,724 after deducting cost of

goods sold of $221,211, and ordinary business loss of $126,127. *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2012*, Plaintiff's Exhibit 110-C.

44. As shown on its partnership tax returns, Beyond Basics sustained business losses of $426,751 for the calendar years 2011, 2012, and 2013. *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2011*, Plaintiff's Exhibit 110-A; *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2012*, Plaintiff's Exhibit 110-B; *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2013*, Plaintiff's Exhibit 110-C.

45. Beyond Basics was never profitable. *Stipulated Fact (67), Joint Pretrial Stipulation*, ECF 97 at 8.

46. The partnership tax returns of Beyond Basics showed the following losses "passed through" to Sharron as a member of the LLC: (i) $99,188 of the 2011 Beyond Basics aggregate loss of $161,939, *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2011*, Plaintiff's Exhibit 110-A; (ii) all of the 2012 Beyond Basics loss of $138,685, *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2012*, Plaintiff's Exhibit 110-B; (iii) all of the 2013 Beyond Basics loss of $126,127, *Beyond Basics, LLC, U.S. Return of Partnership Income, Form 1065, for 2013*, Plaintiff's Exhibit 110-C; and (iv) all of the 2014 Beyond Basics loss of $111,560, *2014 Partnership Return – Beyond Basics*, Plaintiff's Exhibit 110-D.

47. On February 6, 2012, Kabani, Debtor's accountant, notified Sharron that he moved $40,000 of debt from the Due from Beyond Basics Account to the Due from Officer Account, and according to Kabani, the purpose of this was to allow Sharron to use the pass-through tax losses from Beyond Basics on his income tax return for 2012. *Email string from Z. Kabani to Lowell Sharron re Beyond Basics Draft Financial Statements*, Plaintiff's Exhibit 91; *Grobstein Trial Declaration*, ECF 86 at 18, ¶ 64; *Kabani Testimony*, *Trial Transcript of August 25, 2016*, ECF 136 at 156:23-157:18.

48. Sharron used 100% of the tax losses generated by Beyond Basics as a pass-through tax entity in 2013 after he requested that Ghalayini allow him to take 100% of the

tax losses passed through to its members by Beyond Basics since he said to Ghalayini that he was "funding" Beyond Basics as opposed to some of the losses being passed through to her. *See Email string from Lowell Sharron to Jamara Ghalayini re 2012 BB taxes*, Plaintiff's Exhibit 98; *Email from Jamara Ghalayini to Z. Kabani, Lowell Sharron re 2013 taxes*, Plaintiff's Exhibit 101; *Grobstein Trial Declaration*, ECF 86 at 18, ¶ 64.

49. In May and June 2013, Sharron instructed that separate payroll and accounting records be created for Beyond Basics because Sharron intended to try to keep Beyond Basics operating after Debtor was winding down its operations at that time. *Email from Lowell Sharron to Lita Trinidad re*, *May 23, 2013*, Plaintiff's Exhibit 102; *Email from Lowell Sharron to Henry Cherner re AIMS 3 or 5 User Mfg System, GL, Weblink/Remotel link and Scan & Pack*, Plaintiff's Exhibit 105; *see Sharron Testimony*, *Trial Transcript of August 25, 2016*, ECF 136 at 12 and 15:16-18:6.

50. According to Plaintiff's expert witness, Wall, Debtor "transferred" the net amount of $191,323 "on a fair value basis" toward the operations of Beyond Basics from October 16, 2012 to June 19, 2013. *Wall Expert Report*, Plaintiff's Exhibit 148 at 4 and 23 and Exhibit 18 thereto. It appears that most of these charges were attributable to the cost of labor performed by Debtor's employees on behalf of Beyond Basics, i.e., payment of wages and related expenses by Debtor which were charged to the Due from Beyond Basics account. *Id.; L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106; *Sharron Trial Declaration,* ECF 100, ¶¶ 49-62; *Grobstein Trial Declaration*, ECF 86 at 17, ¶ 56.

51. Between June 1, 2013 and June 19, 2013, the date on which the involuntary bankruptcy petition against Debtor was filed, Debtor made the following payments of business expenses of Beyond Basics as reflected on the Due from Beyond Basics account: (1) $29.21 to Vonage America on June 4, 2013; (2) $38.14 to Vonage America on June 4, 2013; (3) $11.11 to Vonage America on June 14, 2013; (4) $46.29 to Vonage America on June 4, 2013; and (5) $8,006.34 to Fullytex Industries Limited on June 14, 2013. *L. Scott Apparel, Inc. Account QuickReport – Due from Beyond Basics*, Plaintiff's Exhibit 106; *Email*

string from Lita Trinidad to Lowell Sharron re Daily Threads – Fullytex Industries, June 4, 2013, Plaintiff's Exhibit 104.

52. From June 2013 to March 2016, Sharron and his wife operated Beyond Basics from their personal residence, had sales of approximately $75,000, and retained Beyond Basics inventory with a value of approximately $50,000. *Sharron Deposition,* ECF 116 at 419-421 and 424; *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 21-22; *Sharron Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 56-60. After June 2013, Beyond Basics had nominal overhead and did not purchase new inventory. *Sharron Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 64-66. Even though Sharron continued to sell inventory from Beyond Basics, he did not pay any portion of the Due from Beyond Basics Account to Debtor. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 21-25.

D. Debtor's Disputes with Vendors

i. Dispute with Donshen

53. During the period of approximately 2007 through the end of 2012, Donshen Textile (Holdings) Ltd. ("Donshen"), a trading company with its principal place of business located in Hong Kong, China, manufactured apparel goods for the Debtor. *Stipulated Fact (76), Joint Pretrial Stipulation*, ECF 97 at 9. Donshen was a significant supplier to Debtor. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 51:4-6. For several years between 2007 and the end of 2012, Donshen manufactured apparel goods for Debtor whereby Debtor provided Donshen with apparel designs and Donshen would arrange for manufacture of samples and apparel goods ultimately ordered by Debtor. *Stein Trial Declaration,* ECF 89, ¶ 4. According to Andrew Stein, the principal of a California firm which acts as manufacturer's representative for Donshen and who acted as Donshen's representative for Debtor's account, Debtor either paid Donshen timely or was able to catch up on payments if it fell behind, but over time payments to Donshen became less frequent with invoices paid 60 to 90 days past their due date. *Stein Trial Declaration*, ECF 89, ¶ 5. Based on this payment record, on or about October 6, 2011, Donshen made a formal

request for adequate assurance of due performance on Debtor. *Donshen Adequate Assurance Demand*, Plaintiff's Exhibit 125; *Stein Trial Declaration*, ECF 89, ¶ 5.

54. Between May and December 2012, Debtor entered into written contracts with Donshen for the purchase of apparel goods pursuant to 34 separate purchase orders, and pursuant to these purchase orders, Donshen shipped apparel goods to Debtor, all of which were received and accepted by Debtor. *Stein Trial Declaration*, ECF 89, ¶ 6. Donshen invoiced Debtor for all of the goods delivered to and accepted by Debtor, but despite several demands for payment, Debtor did not pay the amounts due under the invoices. *Id.* During this time period, in August 2012, Debtor and Donshen entered into a payment plan and began negotiating a formal settlement agreement. *Id.*, ¶ 7. According to Sharron, Debtor was disputing invoices from Donshen because "there [were] charge-backs that we had to put in because of quality issues, late delivery, mark-downs that we got from our customers as a result of their late delivery" which could have resulted in cancelled orders by customers. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136, at 54:7-12.

55. According to Stein, around this time, in an effort to avoid payments to Donshen, Debtor alleged it was entitled to certain offsets due to Donshen purportedly committing acts of unfair competition in connection with apparel goods ordered by Debtor from Donshen relating to intellectual property (the "IP Dispute"). *Stein Trial Declaration*, ECF 89, ¶ 7. Sharron testified that Debtor's failure to pay Donshen was justified because of the IP Dispute. *Sharron Trial Declaration*, ECF 100, ¶ 90.

56. On or about December 13, 2012, Donshen and Debtor entered into a written contract entitled "Settlement Agreement and General Release" to resolve the disputes between them regarding the payment of outstanding invoices, the claims of offsets, and the IP Dispute. *Stipulated Fact (77), Joint Pretrial Stipulation*, ECF 97 at 9; *Settlement Agreement*, Defendant's Exhibit 553 and *Exhibit C to Donshen Arbitration Demand*, Plaintiff's Exhibit 127; *Stein Trial Declaration*, ECF 89, ¶¶ 6 and 10. As part of the Settlement Agreement, Debtor confirmed the amount owing to Donshen under the Invoices reduced based on credits given to Debtor for certain payments made or other credits in the

amount of $271,892.74, agreeing that this amount was due. *Stipulated Fact (78), Joint Pretrial Stipulation*, ECF 97 at 9; *Stein Trial Declaration*, ECF 89, ¶ 9. The parties also agreed in paragraphs 2 and 2.1 of the Settlement Agreement that Debtor could hold back $300,000 for offsets in connection with the IP Dispute, on the condition that within 35 days of the full execution of the Settlement Agreement on December 4, 2012, Debtor would provide Donshen with all findings and evidence regarding the IP Dispute, and that Donshen would have 30 days to conduct its own investigation and to resolve the IP dispute. *Stipulated Fact (79), Joint Pretrial Stipulation*, ECF 97 at 9; *Settlement Agreement*, Defendant's Exhibit 553 and *Exhibit C to Donshen Arbitration Demand*, Plaintiff's Exhibit 127; *Stein Trial Declaration*, ECF 89, ¶ 9. The parties further agreed in paragraph 2.2 of the Settlement Agreement that if they were unable to resolve the dispute within this 30-day period, they would agree to submit the IP dispute and the payment of the outstanding accounts receivable and future shipment amounts to binding arbitration. *Settlement Agreement*, Defendant's Exhibit 553 and *Exhibit C to Donshen Arbitration Demand*, Plaintiff's Exhibit 127.

57. On January 8, 2013, Lloyd S. Mann, counsel for Debtor, sent an email message to Grant Hallstrom, counsel for Donshen, requesting Donshen's consent to an extension of the 35-day submission period by three weeks to January 29, 2013. *Email re Investigation (re Donshen)*, Defendants' Exhibit 554. In this email, counsel for Debtor stated that pursuant to the Settlement Agreement, Debtor had investigated the IP Dispute, and based on the investigation, tentatively determined that unlawful conduct occurred, and that Debtor was damaged as a result. *Id.* Counsel for Debtor further stated that although Debtor had demanded an accounting and response to the allegations of wrongful conduct from the target of the investigation, Almost Famous, it had not received a response, and therefore, requested Donshen to agree to a three-week extension for further investigation. *Id.* Regarding Debtor's investigation, counsel for Debtor stated to counsel for Donshen: "Our investigation, up to this point, includes a finding that L. Scott's proprietary information was transferred to Almost Famous by Donshen in connection with multiple styles, one of

which was L. Scott's label DE10304-JIS. L. Scott became aware of this information based upon reports it received from a senior member of Deb Shop's management team who discovered that Almost Famous was offered for sale a number of L. Scott's styles, including, but not limited to, the above-referenced DE10304-JIS. Again, the investigation does not yet include a response from Almost Famous. As part of its continuing investigation, L. Scott will need to review information and documentation related to all orders produced by Donshen for Almost Famous. L. Scott is prepared to wait a short period of time for a response, but, in the absence of such a response and/or an adequate explanation from Almost Famous, L. Scott intends to proceed forward with a claim [for arbitration] pursuant to the Agreement." *Id.*

58. On January 9, 2013, Betty J. Levine, counsel for Donshen, sent an email message to Mr. Mann, Debtor's counsel, stating that Donshen agreed to Debtor's request for a three-week extension of the submission period, but no further extensions would be granted. *Extension Email re Donshen,* Defendants' Exhibit 555.

59. On January 29, 2013, Mr. Mann, counsel for Debtor, sent an email message to Ms. Levine, counsel for Donshen, inquiring whether Donshen was pursuing a claim against Debtor and stating that Debtor intended to pursue a claim against Donshen. In this email message, Mr. Mann suggested that counsel for the parties have a conference call within a week to discuss the best way to submit the matter to arbitration as called for under the Settlement Agreement. *Email re Conclusion*, Defendants' Exhibit 556.

60. As Debtor did not timely provide Donshen with all of its findings and evidence regarding the IP Dispute within the 35-day period after the execution of the Settlement Agreement as extended, on March 5, 2013, Donshen made a formal demand on Debtor for immediate payment of the invoiced amount or for arbitration pursuant to the Settlement Agreement. *Stipulated Fact (80), Joint Pretrial Stipulation*, ECF 97 at 9; *Stein Trial Declaration*, ECF 89, ¶ 10; *Donshen Payment Demand*, Plaintiff's Exhibit 126; *Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 61-63. On April 18, 2013, Donshen made its demand for arbitration, and on May 3, 2013, Debtor made its demand for

arbitration. *Donshen Arbitration Demand*, Plaintiff's Exhibit 127; *L. Scott Demand for Arbitration,* Plaintiff's Exhibit 549.

61. According to Sharron, Debtor had a legitimate good faith dispute with Donshen based on "strong" evidence that there had been an infringement of its intellectual property by Donshen. *Sharron Trial Declaration,* ECF 100, ¶ 90. Sharron testified that Debtor had evidence of an infringement by Donshen reported by the vice president of one of its customers, Deb Shops, that she was in a showroom of one of Debtor's competitors whose salesman showed her a sample of Debtor's apparel goods being manufactured by Donshen taken from Donshen's factory, telling her that the competitor could beat Debtor's price in handling her company's order, and she was disturbed that someone was manufacturing her company's designed goods, even before they were being shipped to her company in the U.S. *Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 56-59. In support of this testimony, Sharron offered into evidence a copy of the email message from Deb Shops to Debtor dated June 26, 2012 about this infringement. *Evidence of Infringement Email,* Defendants' Exhibit 550. The email message from Karen Pinney at Deb Shops to Chrissy Kenis at Debtor, dated June 26, 2012 stated: "Chrissy….I wanted to give you a heads up. About a month ago I received an email while in Europe from the owner of Almost famous. He was in china wanting to know why he didn't have more of my sequin business because he was seeing a lot of my goods at one of his factories in China[.] Here is where you come in. Last week sara walked into his showroom…. And he had some of your product on his line and even commented he should thank 6 degrees [Debtor's tradename] and debshops for his next set of business. The style that sticks out is your style 33340 that you shipped me. On your care label it is de10304jis[.] I thought you would want to know what the factory is sharing. These goods would have been on the water as it was the week before memorial day. Thanks[,] karen." *Id.*

62. On December 28, 2012, Mr. Mann, Debtor's counsel, sent a letter to Almost Famous Clothing Showroom, notifying it that Debtor suspected it of infringement and demanding an accounting of the alleged infringing products. *Corry [i.e., Correspondence] to*

Almost Famous, Defendants' Exhibit 551. Although Debtor first received the email from Deb Shops reporting infringement by Almost Famous, one of Donshen's factories, Debtor did not immediately contact Donshen to discuss it. *Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 59-60.

63. The arbitration of Donshen's claim against Debtor and Debtor's claim against Donshen did not go forward due to the automatic stay arising upon the filing of the involuntary bankruptcy petition against Debtor on June 19, 2015. *Sharron Trial Declaration,* ECF 100, ¶¶ 90 and 91; *see also* 11 U.S.C. §§ 303 and 362(a).

64. According to Stein, "[d]espite demand from Donshen, and despite granting L. Scott an extension of time to conduct its investigation of the IP Dispute, L. Scott failed to and refused to provide Donshen with any 'findings and evidence' regarding the IP Dispute, thereby prohibiting Donshen from conducting any investigation of its own," and "[i]nstead, there were only the allegations made by L. Scott regarding the IP Dispute with no evidence to substantiate the allegations." *Stein Trial Declaration,* ECF 89, ¶ 10. However, there does not appear anything in the Settlement Agreement that "prohibited" Donshen from conducting its own investigation based on the information provided by Mr. Mann in his email message of January 8, 2013 to Donshen's counsel. *Settlement Agreement*, Defendant's Exhibit 553 and *Exhibit C to Donshen Arbitration Demand*, Plaintiff's Exhibit 127; *Email re Investigation (re Donshen)*, Defendants' Exhibit 554. That is, Donshen could have inquired of its contractor, Almost Famous, or Debtor's customer, Deb Shops, regarding the alleged infringement after receiving Debtor's information in this email message. Moreover, both Donshen and Debtor had the rights to discovery during the arbitration subject to the discretion of the arbitrator, but there was no limit to any investigation that either party could conduct in the meantime. *Settlement Agreement*, Defendant's Exhibit 553 and *Exhibit C to Donshen Arbitration Demand*, Plaintiff's Exhibit 127.

65. On September 5, 2013, Donshen filed a proof of claim for $271,892.74 in the bankruptcy case which has not been objected to, and as reflected on the proof of claim filed by Donshen, the entire claim of $271,892.74 was still outstanding on the date the

involuntary petition was filed. *Stipulated Fact (81), Joint Pretrial Stipulation*, ECF 97 at 9; *Donshen Proof of Claim*, Plaintiff's Exhibit 127B; *Stein Trial Declaration*, ECF 89, ¶ 11.

66. Based on this evidence, the court finds that Debtor was within its rights under the Settlement Agreement to demand arbitration and have the dispute with Donshen resolved through arbitration before making payment on the disputed invoices and that there was sufficient evidence to demonstrate that Debtor's IP Dispute was in good faith, even though it cannot be known at this time what would have been the resolution of the IP Dispute due to the stay of arbitration proceedings due to the pendency of this bankruptcy case. Although the evidence in support of Debtor's side of the IP Dispute is not compelling on this record, it is enough to show that Debtor had a bona fide dispute with Donshen to allow it to hold back payment of the disputed claim in accordance with their agreement, and the court so finds.

ii. The Kody Dispute

67. Kody Branch of California ("Kody") was one of Debtor's outside vendors and is an apparel company that sells garment products to wholesale customers based upon the customers' manufacturing specifications, and in turn, Kody's customers, such as Debtor when it was operating, resold the garments to retailers, such as J.C. Penney's and Macy's. *Stipulated Fact (82), Joint Pretrial Stipulation*, ECF 97 at 10; *Trinh Trial Declaration*, ECF 90 at 2, ¶ 3. Debtor was previously one of Kody's wholesale customers, and Kody was a significant and later became the largest supplier of Debtor. *Trinh Trial Declaration*, ECF 90 at 2, ¶ 3*; Sharron Trial Declaration,* ECF 100 at 24; *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 50.

68. From in or about May 2010 through the first half of May 2013, Kody and Debtor entered into agreements evidenced by written purchase orders and invoices, whereby Kody agreed to sell to Debtor and Debtor agreed to purchase from Kody certain finished garments. *Trinh Trial Declaration*, ECF 90 at 2, ¶ 5. Kody and Debtor also agreed that Kody would ship the garments directly to Debtor. *Id.*

69. Over the course of Debtor's relationship with Kody, disputes arose between Debtor and Kody as to certain chargebacks, Kody's alleged failure to timely ship merchandise of adequate quality, and Debtor's outstanding amounts owed to Kody. *Stipulated Fact (83), Joint Pretrial Stipulation*, ECF 97 at 10.

70. According to Cathy Trinh of Kody, prior to 2012, Debtor always paid Kody's invoices, although payments were sometimes late. *Trinh Trial Declaration*, ECF 90 at 3, ¶ 8. Trinh oversaw sales and production for Kody relating to Debtor's account, and although she travelled often for work, she regularly visited Debtor's premises to talk about "orders, fabrics, deliveries and the like." *Trinh Trial Declaration,* ECF 90 at 2, ¶¶ 1, 4. As indicated in the purchase orders from Debtor to Kody attached to Kody's proof of claim, Debtor placed orders on a Net 30, 45, or 60 basis, or full payment in 30, 45, or 60 days. *Kody's Proof of Claim No. 6-1*, filed on September 25, 2013. Sharron admitted in his trial declaration that "throughout the years, we would often pay late," but stated that "[t]his was always accepted by Kody, and it became our regular and customary practice with Kody." *Sharron Trial Declaration,* ECF 100 at 24, ¶ 78.

71. In his trial testimony, Sharron explained the business necessity justifying why Debtor had often paid its suppliers late. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 51. In response to a question asked by Trustee's counsel about Debtor falling behind in payments to Donshen, Sharron responded: "It's a very general question. Yes, there were many payments that were not paid by the due date and we had – that was – that happened every week. I mean, that was unfortunately the nature of the business. There were discrepancies on purchase orders and it'd get stuck in a pile. You have to go through it, figure out why they're charging you X when your purchase order is Y. And yes, if you can't get the parties together in time, you don't resolve the problem in time, it becomes late and you pay it – and you pay it when you resolve it." *Id.*

72. Sharron elaborated on Debtor's business practice in discussing the course of conduct between it and Kody. When asked by his counsel what Kody would do when invoices were paid late, Sharron responded: "There was no – they wouldn't do anything. I

mean, as I said, it was – the apparel business was obviously very transactional. There were a lot of complexities with each every – and every order and there was a lot of documentation to go through when the invoice was compared to the purchase orders and that were – that were given. And we would – when we went to pay the bills we would have to work through all of that information and refer back to the production period, call it eight to twelve weeks, to determine what happened because in many incidences [K]ody and in fairness many suppliers shipped late or inferior quality. And we had to then give them notice, put the charge-back for them with all the information and email it to them as to why they were being charged back. And then there would usually be a time where they would come back and argue kind of their case and say, here's why we don't think we were at fault. It happened – it was just – it was every day. It was just part of – you're talking about thousands and thousands of orders and it was a big part of the job. It was managing the quality and on-time delivery because it meant everything to L Scott at the end of the day because the customers that we had, would not give us that opportunity. They would just slap a charge-back on us, Walmart or Penney's, they're not going to call up and say, you know, let's talk about this. So we had to be . . . very well documented." *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 66-67. The court finds Sharron's testimony about Debtor's business practices to vet quality control of products received from its suppliers before shipping to its customers which often resulted in some delay in payment to be credible in light of the volume of orders that Debtor was handling during the relevant time period of 2012 to 2013 involving millions of dollars of merchandise and the risk to it of nonpayment by its customers if the goods shipped by the suppliers were deficient as after all, Debtor needed to ship goods acceptable to its customers to be paid, so it could pay its bills, including to its suppliers.

73. Prior to June 2012, according to Trinh, Kody did not consider the late payments by Debtor to Kody to be "serious situations," *Trinh Testimony, Trial Transcript of August 19, 2016,* ECF 135 at 110:7-10, and she described the problem of Debtor's slower payments at that time to be "very minor." *Id.* at 112:1-4. According to Trinh, that Debtor

had some late payments did not concern her or Kody at that time because "Mr. Sharron always show[s] me that he will pay and I believe it," and she agreed that "things were always worked out." *Id.* at 110:20-111:1. Prior to 2012, Kody never refused to ship or threatened not to ship to Debtor because payments were not made. *Id.* at 111:2-8.

74. According to Trinh, beginning in or about June 2012, Debtor "started to default on its payments to Kody more frequently and payments became slower and slower." *Trinh Trial Declaration,* ECF 90 at 3, ¶ 8. By the word "default," Trinh meant late payment by Debtor to Kody. *Trinh Testimony, Trial Transcript of August 19, 2016,* ECF 135 at 111:15-23. According to Sharron, "[t]his is not true as we were paying on the Kody account in the same way that we had always done." *Sharron Trial Declaration,* ECF 100 at 25, ¶ 82. In her trial declaration, Trinh stated that after Sharron returned to the office after being out ill sometime in late 2012, she "started to grow nervous" about Debtor's ability to pay Kody and wondered if Debtor was facing financial issues. *Trinh Trial Declaration,* ECF 90 at 3, ¶ 10. According to Sharron, there was "[n]othing unusual, as far as our payments, . . . going on during this time period," and Ms. Trinh's statement that she was "growing nervous" as of late 2012 was not plausible because Kody was accepting new purchase orders from Debtor in the millions of dollars up through April 2013. *Sharron Trial Declaration,* ECF 100 at 26, ¶ 82.

75. In Trinh's trial testimony, she clarified that she "started to grow nervous" about Debtor probably in March 2013 and confirmed in further testimony that she was "never nervous" about Debtor's financial condition until March 2013. *Trinh Testimony, Trial Transcript of August 19, 2016,* ECF 135 at 113:14-114:11. Even though Trinh felt nervous about Debtor's financial condition in March 2013, Kody was still taking orders from Debtor based on Sharron's assurances. *Id.* at 114:12-23 ("Q: So after you became, as you say, nervous about L Scott Apparel's financial condition, [K]ody continued to take orders from L Scott. Is that correct? A: Yes. Mr. Sharron reassure me that it should be okay. I continued to take orders, yes."). In explaining Kody's position on this in March 2013, Trinh explained "I believe that [K]ody should continue shipping to Mr. Sharron so Mr. Sharron continue to have

business . . . [so] that he makes money so he could pay us little by little" and "to continue the business relationship so we could collect money, yes." *Id.* at 115:12-22.

76. Based on the analysis of Debtor's accounts payable to Kody by Wall, Plaintiff's expert witness, the amount owed by Debtor to Kody grew from $478,636 as of June 30, 2012 to $841,637 as of March 31, 2013. *Wall Supplemental Report*, Plaintiff's Exhibit 151 at 6. The amount in excess of 90 days past due as of June 30, 2012 was $36,258.15 (or 7.6% of the total payables then owed to Kody),[3] and the amount in excess of 90 days past due as of March 31, 2013 was $91,898.92 (or 10.9% of the total payables to Kody).[4] *Id.* Wall's analysis also showed the amount owed by Debtor to Kody was $810,486.64 as of December 31, 2012, of which $91,402.84 was in excess of 90 days past due (or 11.3% of the total payables to Kody). *Id.*

77. In light of these numbers, it appears that the testimony of Trinh and Sharron is not inconsistent. In June 2012, the accounts payable that were seriously past due payable (over 90 days) comprised 7.6% of Debtor's total accounts payable, which was a relatively small ratio, and this ratio slightly increased to 11.2% in December 2012, which does not seem to bear out the observation that "defaults" were becoming more frequent in a significant way. However, the gross amounts of the accounts payable to Kody increased quite a bit by December 2012—the total payables increased 69.3% from the June 2012 amount, and the seriously past due amount (i.e., over 90 days past due) increased 252% from the June 2012 amount—which apparently prompted Ms. Trinh's concern, which figures

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[3] According to Wall, Debtor's payables to Kody as of June 30, 2012 were: (1) Current: $256,471.81 (53.6% of a total of $478,636); (2) 1-30 days past due: $186,991.71 (39.1%); (3) 31-60 days past due: -$670.90 (overpaid); (4) 61-90 days past due: -$414.44 (overpaid); and (5) over 90 days past due: $36,258.15 (7.5%). *Wall Supplemental Report*, Plaintiff's Exhibit 151 at 6. According to these figures, almost all of the payables, 92.7%, were either current or only slightly past due (i.e., 1-30 days). *Id.*

According to Wall, Debtor's payables to Kody as of December 31, 2012 were: (1) Current: $291,705.13 (36.0% of a total of $810,487); (2) 1-30 days past due: $427,378.67 (52.7%); (3) 31-60 days past due: $0.00 (0.0%); (4) 61-90 days past due: $0.00 (0.0%); and (5) over 90 days past due, $91,402.84 (11.3%). *Wall Supplemental Report*, Plaintiff's Exhibit 151 at 6. According to these figures, almost all of the payables, 88.7%, were either current or only slightly past due (i.e., 1-30 days). *Id.*

[4] According to Wall, Debtor's payables to Kody as of March 31, 2013 were: (1) Current: $310,276.32 (36.9% of a total of $841.637); (2) 1-30 days past due: $336,578.85 (40.0%); (3) 31-60 days past due: $82,653.69 (9.8%); (4) 61-90 days past due: $20,229.63 (2.4%); and (5) over 90 days past due: $91,898.92 (11.8%). *Wall Supplemental Report*, Plaintiff's Exhibit 151 at 6. According to these figures, most of the payables, 76.9%, were either current or only slightly past due (i.e., 1-30 days). *Id.*

only slightly worsened from December 2012 to March 2013 with the gross payables increasing by 3.8% and seriously past due amount increasing by 0.5% (about $400). According to Trinh in her testimony at trial, she only started to grow nervous about Debtor's late payments by March 2013 because previously, Debtor and Kody worked things out. *Trinh Testimony, Trial Transcript of August 19, 2016* at 112-113. This appears to be sort of "a glass half full, a glass half empty" situation in which the gross amount of payables increased dramatically between June 2012 and December 2012, but amount of the seriously past due amounts remained proportionately the same with the vast majority of the payables being current or slightly past due, i.e., 30 days or less, and the payable situation stabilizing between December 2012 and March 2013, i.e., the amounts remaining relatively the same.

78. Email traffic between December 2012 and May 2013 reflect Kody's requests for payment of past due invoices and Debtor's responses, including partial payment and raising of disputed issues relating to late shipment and chargebacks. *Email string from L. Trinidad to L. Sharron-12/27/2012*, Plaintiff's Exhibit 113; *Email string from L. Trinidad to L. Sharron-2/27/2013*, Plaintiff's Exhibit 117; *Email string from L. Trinidad to L. Sharron-3/1/2013*, Plaintiff's Exhibit 118, and *Email string from L. Sharron to Gabi Sharron*, Plaintiff's Exhibit 122; *Grobstein Trial Declaration*, ECF 86, ¶ 72; *Email Chain between Lowell Sharron, Cathy, Tai Nguyen, Lita, and Edwina*, Defendants' Exhibit 527; *Email Chain Cathy@kodybrand, Lowell Sharron and cc: Kevin SevenBros*, Defendants' Exhibit 534; *Trinh Trial Declaration*, ECF 90, ¶ 22; *Sharron Trial Declaration*, ECF 100, ¶¶ 77-78, 82. These email messages from Kody reflect its requests to Debtor for past due amounts, and in response, Debtor sent some payments, but disagreed that all of the amounts requested were past due, and as discussed below, Kody continued to take Debtor's orders without prepayment and to ship them through May 2013. *Id.* For example, in March 2013, in response to Kody's request for past due amounts of $684,000, Debtor's staff reported that the past due amounts were only about 300,000, most of which was only slightly past due (i.e., 1-30 days). *Email string from L. Trinidad to L. Sharron-3/1/2013*, Plaintiff's Exhibit 118

(reporting current payables to Kody of $487,848.85, past due payables of 1-30 days of $241,874.03, past due payables of 31-60 days of $12,045.65, past due payables of 61-90 days of $9,335.52 and past due payables of over 90 days of $75,025.00). In several of the email messages from Kody to Debtor, Kody indicated that it was requesting payment of the past due invoices because it was having problems in not being able to pay its suppliers for Debtor's orders. *E.g., Email string from L. Sharron to Gabi Sharron, April 11, 2013*, Plaintiff's Exhibit 122

79. There is conflicting evidence in the record regarding the payment dispute between Kody and Debtor, that is, in particular whether there was a bona fide dispute justifying Debtor's non-payment of a significant portion of Kody's past due invoices. According to Sharron, Debtor withheld payments because of a bona fide dispute with Kody, while according to Trinh, Kody's position is that there was no bona fide dispute. *See Sharron Trial Declaration*, ECF 100, ¶¶ 76-88; *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135, at 119 (Trinh testimony stating that disputes were "minor"), at 122:15-17 (Trinh testimony stating, "We have a very large receivable in dollars amount with Mr. Sharron compared to $58,000 or so. It's all very minor and in the past we always worked things out.").

80. According to Sharron, "we had genuine and good faith objections to the amount that Kody was insisting upon to ship" as set forth on the Kody Dilution Report, Defendant's Exhibit 522, which showed the deductions that Debtor claimed it was entitled to due to Kody's mistakes, such as not being able to match color, Kody charging the incorrect amounts for fabric or for air costs for which Debtor was not obligated to pay, and adding seams to product without authorization, which affected $300,000 in disputed invoices. *Sharron Trial Declaration,* ECF 100 at 24-25. According to Sharron, Debtor and Kody had agreements in place which allowed Debtor to withhold payments to dispute invoices: "We had terms of conditions that were signed by [K]ody and we had the purchase order that also had specific instruction on it. We had all of our charge-back amounts for different violations and those were the terms that governed each purchase order and gave us the right to

withhold payment if they were disputed." *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 69. According to Trinh, the disputes described by Sharron were minor, and the parties always worked them out, but Kody did what it could to ship the orders placed by Debtor, even if it meant incurring additional air costs, which she said were incurred because Kody attempted to contact Sharron, but he was unavailable or unresponsive to its attempts to obtain his approval for additional shipment cost. *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 119-122.

81. The payment disputes between Debtor and Kody came to a head in May 2013 when Kody stopped shipping goods ordered by Debtor later that month. *Sharron Trial Declaration,* ECF 100 at 24-27; *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 124-134; *Trinh Trial Declaration,* ECF 90, ¶¶ 13-22. According to Sharron, email traffic between him and Trinh at this time in May 2013 demonstrate "enormous difficulties" that Debtor had with Kody and that it was Kody's failure to ship despite large payments that Debtor had made to Kody, and Kody's failure to ship Debtor's orders caused Debtor's demise. *Sharron Trial Declaration,* ECF 100 at 25; *Email Chain between Lowell Sharron, Cathy, Tai Nguyen, Lita and Edwina, May 7, 2013, Defendants' Exhibit 527; Email between Lowell and Cathy at Kody, May 13, 2013, Defendants' Exhibit 528, 0:52-5:25 p.m. Text messages between Lowell and Cathy, Defendants' Exhibit 529; Email chain between Lowell Sharron and "CathyYahoo," May 21, 2013, Defendants; Exhibit 531; Email Chain Cathy@kodybrand, Lowell Sharron and cc: Kevin SevenBros, May 16, 2013, Defendants' Exhibit 533; Email Chain Cathy@kodybrand, Lowell Sharron and cc: Kevin SevenBros, May 16, 2013, Defendants' Exhibit 534; Statement from Lowell Sharron, Defendants' Exhibit 535.* According to an email from Trinh to Sharron dated May 7, 2013, the past due amount owed by Debtor to Kody was $668,000 with another amount due the day before on May 6, 2013 based on payment terms of 30 days after shipment for a total of $978,000 past due, and another order of $547,744.99 already received by Debtor due on May 15, 2013 and a new shipment of $600,000 for J.C. Penney "at airports." *Email Chain between Lowell Sharron, Cathy, Tai Nguyen, Lita and Edwina, May 7, 2013, Defendants' Exhibit 527.* In an email

message in response, Sharron stated that "your numbers are wrong" and that only $238,000 was due now with another $700,000 due the following week. *Id.*

82. In response to Kody's requests for past due payments, on May 7, 2013, Debtor paid Kody $200,000 by wire transfer, and on May 13, 2013, Debtor paid Kody $312,000 by wire transfer. *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 132-133 and 137; *Email between Lowell and Cathy at Kody, May 13, 2013, Defendants' Exhibit 528; Sharron Trial Declaration* at 25, ¶ 80. According to Trinh, these amounts were to pay some of the past due invoices from Kody to Debtor. *Id.*

83. According to Trinh, in May 2013, she and Sharron had a meeting in which she says that she expressed frustration about his not disclosing his company's financial problems, and she said that he promised to pay Kody $700,000 on May 16, 2013 for past due invoices along with new shipments but failed to make the promised payment on that date. *Trinh Trial Declaration,* ECF 90 at 4, ¶ 13. Sharron does not dispute that he and Trinh had that meeting but denied, as she stated in her trial declaration, that he admitted to her that he was struggling to keep Debtor's business open. *Sharron Trial Declaration,* ECF 100 at 26, ¶ 83.

84. On or about May 17, 2013, Debtor delivered a cashier's check in the amount of $300,000 to the law firm Buchalter Nemer, Kody's counsel, as payment for a shipment of approximately $521,000 of goods by Kody to Debtor for the J.C. Penney order, but the funds were to be held in escrow by counsel pending authorization of release by Debtor. *Trinh Trial Declaration,* ECF 90, ¶ 14; *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 125-133 and 138-143. Although there is conflicting evidence on what conditions needed to be met for release of the $300,000 in escrow to Kody, it is clear Sharron represented to Kody that he would make a further payment of $200,000, and Sharron sent Trinh from Kody a text message showing what appeared to be a wire transfer as a ruse to show whatever Debtor paid, Kody would ask for more before shipping any orders, but despite this representation, Sharron sent no wire transfer. *Sharron Trial*

Declaration, ECF 100, ¶ 80; *Email between Lowell and Cathy at Kody*, Defendants' Exhibit 528; *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 103-107.

85. Based on Sharron's representations of payment to Kody, on or about May 21, 2013, Kody delivered to Debtor approximately $521,000 of goods and demanded release of the funds of $300,000 in escrow held by Kody's counsel, but Debtor did not authorize release of the funds. *Trinh Trial Declaration,* ECF 90 at 4, ¶ 15.

86. Because Kody was not paid the $300,000 in funds in escrow held pending delivery of the J.C. Penney order to Debtor, nor was it paid the $200,000 wire transfer, Kody stopped shipping goods on orders placed by Debtor. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 11. According to Sharron, Trinh told him that Kody was not going to ship any more goods to Debtor unless Debtor paid "the disputed 14-month-old invoices." *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 107. Kody had at no time prior to May 2013 threatened to stop shipments because of late payments. *Id.* at 68. Debtor had continued to place orders with Kody to the beginning of May 2013 but stopped placing orders at the end of May 2013 after Kody stopped shipping to Debtor for lack of payment. *Id.*

87. In an email dated May 20, 2013, Sharron requested an emergency meeting with his counsel inquiring how to proceed with Debtor's operations, including whether he should "temporarily suspend all operations." *See Email from Lowell Sharron to Lloyd Mann, Z. Kabani re Emergency Meeting,* Plaintiff's Exhibit 128. In this email message, Sharron admitted that he was "at a total loss" as to how to proceed with the business of Debtor in light of Kody not shipping the goods ordered by Debtor. *Id.; Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 49. Debtor inquired of Debtor's counsel whether there was "some kind of emergency court proceeding that could force her [i.e., Cathy Trinh of Kody] to ship the goods in her warehouse and get back the 300k wire I made." *Email from Lowell Sharron to Lloyd Mann, Z. Kabani re Emergency Meeting,* Plaintiff's Exhibit 128. Regarding Debtor's financial condition, Sharron commented in this email message: "I also have many more bills coming due this week that I am freezing payments on. Do I need to

send a letter of explanation to the suppliers? I need to conserve cash since I am not shipping anything significant unless Kody ships us. . . . I am running out of time and the payroll continues to eat up cash." *Id*.

88. According to Cathy Trinh of Kody, Sharron disclosed the prospect of an "ABC" (i.e., Assignment for the Benefit of Creditors) to Kody at a meeting on May 29, 2013, saying that Debtor had serious financial issues and that he did not know how much longer Debtor could survive.[5] *Trinh Trial Declaration*, ECF 90 at 4-5, ¶ 16. Also, according to Trinh, shortly after that meeting Sharron asked Trinh if Kody would be willing to buy Debtor and again threatened to file an Assignment for the Benefit of Creditors. *Id*. Sharron does not dispute asking Trinh about buying Debtor, but this came at a time when Kody had 80 to 90% of Debtor's backlogged orders, and without Kody shipping those orders unless Debtor prepaid, Debtor was going to be out of business. *Sharron Trial Declaration,* ECF 100 at 26, ¶ 85. According to Sharron, Debtor had $4,100,000.00 in customer orders which were cancelled due to Kody's not shipping the ordered goods to Debtor. *Id.* at 14, ¶ 42. According to Sharron, Kody was requiring prepayment of the orders to ship which had not been the agreement between Debtor and Kody. *Id*. Sharron said that Ms. Trinh told him that her sister was making all the decisions for Kody, deciding that there could be no shipments without total and complete pre-payment for each shipment, which was never the agreement between Kody and Debtor as shown by the terms and conditions clearly stated on each and every purchase order issued, the email confirmations, and the master purchasing agreement signed by Kody. *Id.* at 27, ¶ 86; *see also Kody's Proof of Claim No. 6-1,* filed on September 25, 2013, and Exhibits 1, 2 and 3 attached thereto (purchase orders issued by Debtor generally indicating terms of net 30, 45, or 60 days, or payment 30, 45, or 60 days after shipment). As a result of this meeting on May 29, 2013, the negotiations between Debtor and Kody to resolve the dispute was at an absolute impasse, and Sharron

[5] An Assignment for the Benefit of Creditors "is a recognized but less than comprehensive statutory procedure that is an alternative to liquidation in bankruptcy." *Berg & Berg Enterprises, LLC v. Boyle,* 178 Cal.App.4th 1020, 1024 (2009) (citing, *inter alia*, California Code of Civil Procedure §§ 493.010 and 1802).

was definitively told by Trinh that Kody would not ship the orders placed by Debtor without payment in advance. *Sharron Trial Declaration,* ECF 100 at 26-27, ¶¶ 85-86.

89. Shortly thereafter, on June 12, 2013, Debtor's retained counsel recommended preparations to commence an assignment for the benefit of creditors. *Email from David Levene to Peter Kravitz re L. Scott Apparel, Inc.*, Plaintiff's Exhibit 130; *Grobstein Trial Declaration*, ECF 86, ¶ 75. Based on Debtor's payment record of failure to pay past due invoices, on or about June 17, 2013, Kody made a formal request for adequate assurance of due performance on Debtor. *Kody Adequate Assurance Demand*, Plaintiff's Exhibit 127A; *Trinh Trial Declaration*, ECF 90, ¶ 19.

90. After Kody stopped shipments of orders to Debtor, Debtor had to terminate its 30 to 40 employees, except for a skeleton crew, and thus, Debtor was then not operating as a business. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 11-12. As argued by Sharron in his trial declaration, Debtor "could have stayed in business had it not been for the Kody dispute and Kody's conduct. Although it is true that I had retained bankruptcy counsel during this time frame, and that one of the options was an Assignment for the Benefit of Credit[or]s, this was only because Kody, basically our only supplier at the time, had stopped shipments despite agreements it had made with us to continue the shipment in exchange for payments we agreed to make, and did make." *Sharron Trial Declaration,* ECF 100 at 3, ¶ 5. According to Sharron, Kody essentially put Debtor out of business: "So when a company has a huge percentage of their outstanding orders with one supplier, call it 70 to 80 percent, that one supplier can crater a company by stopping shipment. So the dispute that we had was timed in such a way that there was this very very large shipment and she [Trinh] used that opportunity . . . [and] used that large shipment and held that large shipment as a way to get me to pay additional money that was not yet due." *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 100:3-101:8. Sharron acknowledged during his deposition in this case that once Kody stopped shipping goods to Debtor in May 2013 that Debtor's options were limited, two of which were shutting down the operations of the company and an assignment for the benefit of creditors. *Sharron*

Deposition, March 28, 2016 at 268:4-18, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016.

91. On September 25, 2013, Kody filed a proof of claim in this case for $2,944,362.49. *Kody's Proof of Claim No. 6-1*, Plaintiff's Exhibit 142; *Trinh Trial Declaration*, ECF 90, ¶ 24. According to Kody's proof of claim, $1.4 million was claimed for goods ordered by Debtor, but not delivered by Kody because Kody suspended delivery after Debtor's lack of response to its June 17, 2013 request for adequate assurance of payment, $1.2 million was claimed for goods ordered by and delivered to Debtor, and $236,065.29 was claimed for goods ordered and delivered to Debtor in dispute due to Debtor's chargebacks. *Id.; see also Sharron Trial Declaration,* ECF 100 at 27, ¶ 87. According to Sharron, the claim amount of $2,944,362.49 was "invalid and incorrect" because the claim included charges for purchase orders that were never shipped. *Sharron Trial Declaration,* ECF 100 at 27, ¶ 87. The Trustee objected to Kody's proof of claim, and after settlement discussions the claim was allowed in the form of payment to Kody of $250,000 of the $300,000 escrow, and an unsecured claim of $1,000,000. *Grobstein Trial Declaration*, ECF 86, ¶ 81.

E. <u>Debtor's Financial Condition 2008 - 2013</u>

92. Debtor's financial statements for the year ending December 31, 2008 reflected net sales of $19,809,323, gross profit of $6,856,154 after deducting cost of goods sold of $12,953,169, and net income of $1,147,301. *L. Scott Apparel, Inc. Financial Statements-12/31/2008*, Plaintiff's Exhibit 22; *see also L. Scott Apparel, Inc. Balance Sheet-9/10/2002*, Plaintiff's Exhibit 18; *L. Scott Apparel, Inc. Financial Statements-4/30/2003*, Plaintiff's Exhibit 19; *L. Scott Apparel, Inc. Financial Statements-12/31/2006*; Plaintiff's Exhibit 20; *L. Scott Apparel, Inc. Financial Statements-12/31/2007*, Plaintiff's Exhibit 21.

93. Debtor's financial statements for the year ending December 31, 2009 reflected net sales of $15,596,805, gross profit of $5,518,457 after deducting cost of goods sold of $10,078,348, and net income of $211,395. *L. Scott Apparel, Inc. Financial*

Statements-12/31/2009, Plaintiff's Exhibit 23; *Email from AI to L Sharron and Kabani with draft financial statements*, Plaintiff's Exhibit 24;

94. Debtor's financial statements for the year ending December 31, 2010 reflected net sales of $15,131,422, gross profit of $4,910,905 after deducting cost of goods sold of $10,220,517, and net income of $19,413. *L. Scott Apparel, Inc. Financial Statements-12/31/2010*, Plaintiff's Exhibit 25.

95. Debtor's financial statements for the year ending December 31, 2011 reflected net sales of $17,791,867, gross profit of $5,128,423 after deducting cost of goods sold of $12,663,444, and net income of $129,106. (Beginning in 2011, Debtor's financial statements included its affiliate, Beyond Basics.) *L. Scott Apparel, Inc. and Affiliate Combined Financial Statements*, Plaintiff's Exhibit 26.

96. Kabani, the accountant for Debtor and Beyond Basics, prepared combined financial statements that included both the accounts of Debtor and a "variable interest entity, Beyond Basics, LLC." *Kabani Trial Declaration*, ECF 99 at ¶ 23; *see L. Scott Apparel, Inc. and Affiliate Combined Financial Statements*, Plaintiff's Exhibit 26.

97. Beyond Basics was treated on Debtor's financial statements as a Variable Interest Entity because (a) its equity investment at risk was not sufficient to finance its activities without financial support from Debtor, and (b) all operating function and decisions relating to Beyond Basics were performed by Debtor. *L. Scott Apparel, Inc. and Affiliate Combined Financial Statements*, Plaintiff's Exhibit 26 at 10; *see Kabani Testimony*, *Trial Transcript of August 25, 2016*, ECF 136 at 144:22-145:15.

98. In 2012, as Sharron testified, Debtor was going through a "rebuilding" phase, having a "tighter overhead structure," cutting staff, and "pinching pennies." *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 35:11-36:9. In July 2012, Kabani sent Sharron a report indicating that actual earnings for the first six months of 2012 were approximately $100,000 negative and fell short of the projections by almost $300,000. *Email from Kabani to Lowell Sharron with projections*, Plaintiff's Exhibit 29; *see also Grobstein Trial Declaration*, ECF 86, ¶ 35; *Wall Rebuttal Report*, Plaintiff's Exhibit 151 at 10.

According to the combined 2012 financial statements for Debtor and Beyond Basics, Debtor incurred its first loss as of December 31, 2012. *L. Scott Apparel, Inc. Combined Financial Statements*, Plaintiff's Exhibit 30; *see also Grobstein Trial Declaration*, ECF 86, ¶¶ 34 and 36; *Email from Kabani to Lowell Sharron with projections*, Plaintiff's Exhibit 29; *Grobstein Trial Declaration*, ECF 86, ¶ 35. Debtor's financial statements for the year ending December 31, 2012 reflected net sales of $15,891,866, gross profit of $5,032,791 after deducting cost of goods sold of $10,857,075, and net loss of $10,732. *Id.* According to Wall, Plaintiff's expert witness, in 2012, Debtor was marginally profitable and had a combined loss (with Beyond Basics). *Wall Expert Report*, Plaintiff's Exhibit 148 at 19 and Exhibit 11 attached thereto.

99. A projected statement of operations prepared in January 2013 by Debtor's accountant, Kabani, for calendar year 2013 shows a projected operating loss of $816,000. *Projected Statement of Operations, January 2013 to December 2013 Showing ($816,000)*, Plaintiff's Exhibit 31; *Grobstein Trial Declaration*, ECF 86, ¶ 37; *Stipulated Fact (31)*, *Joint Pretrial Stipulation*, ECF 97 at 5. However, in March 2013, a projected statement of operations for Debtor for the same period showed projected net income of $814,650. *Email from L. Sharron to L. Sharron re CIT Projection 2013 with projection for $814,650*, Plaintiff's Exhibit 32; *Grobstein Trial Declaration*, ECF 86, ¶¶ 38 and 39; *Stipulated Fact (30)*, *Joint Pretrial Stipulation*, ECF 97 at 5. In April 2013, Kabani prepared another projected statement of operations for the same period now showing a projected operating loss of $121,125. *Projected Statement of operations, January 2013 to December 2013 Showing ($121,125)*, Plaintiff's Exhibit 33; *Grobstein Trial Declaration*, ECF 86, ¶ 39. (A profit and loss statement for Debtor for the period of January 2013 through March 2013 dated April 25, 2016 shows a loss of $864,264. *L. Scott Apparel, Inc. Profit & Loss January-March 2013*, Plaintiff's Exhibit 34; *Grobstein Trial Declaration*, ECF 86, ¶¶ 11 and 40; *see also Wall Rebuttal Report*, Plaintiff's Exhibit 151 at 9-11; *Stipulated Facts (28)-(32), Joint Pretrial Stipulation*, ECF 97 at 4-5. The origin of this document is unclear, and although Trustee

attested in his declaration that it is a true and accurate copy of the document, Trustee's cited references do not indicate who prepared this document and how it was prepared.)

100. As of October 1, 2012, Debtor had total payables of $1,423,219.48, of which $456,880.05 (approximately 32% of the accounts payable) were current payables. *A/P Aging Summary as of 10/1/12*, Plaintiff's Exhibit 28; *Grobstein Trial Declaration*, ECF 86, ¶¶ 10, 33; *see also Stipulated Fact (97), Joint Pretrial Stipulation*, ECF 97 at 13. According to this accounts payable aging summary, Debtor's payables as of October 1, 2012 were: (1) Current: $456,880.05 (32.1% of a total of $1,423,219.48); (2) 1-30 days past due: $452,219.24 (31.8%); (3) 31-60 days past due: $240,077.51 (16.9%); (4) 61-90 days past due: $70,402.29 (4.9%); and (5) over 90 days past due: $203,940.39 (14.3%). *A/P Aging Summary as of 10/1/12*, Plaintiff's Exhibit 28. According to these figures, most of the payables, 63.9%, were either current or only slightly past due (i.e., 1-30 days). *Id.* As to the seriously past due payables (i.e., over 90 days past due) totaling $203,940.39, the amount of $172,158.55, or 84.5%, was attributable to Donshen, which was being actively disputed by Debtor at the time as discussed above, and most of the moderately serious past due payables (i.e., 61-90 days past due) totaling $70,402.29, the amount of $63,694.89, or 90.4%, was also attributable to Donshen. *Id.* Taking out the seriously past due payables of $203,940.39 (over 90 days) and moderately serious past due payables of $172,158.55 (61-90 days) owed to Donshen, which were in dispute, leaves a total remaining payables of $1,047,120.60, of which the current payables of $456,880.05 would represent 43.6% of the remaining total payables and 1-30 day past due payables of $452,219.24 would represent 43.2% of the remaining total payables, or a combined total of 86.8% of Debtor’s remaining total payables not attributable to the Donshen’s seriously past due payables, which were in dispute. *Id.*

101. This payables aging summary also indicates that Donshen and Kody were at the time Debtor’s major suppliers based on the amounts of the payables attributable to them, $532,317.76 (37.4% of total payables of $1,423,219.48) and $643,290.00 (45.2%), for a combined percentage total of 82.6%. *Id.* At that time, October 2012, most of Debtor’s

payables to Kody were either current, $180,415.46 (28.0% of a total of $643,290.00) or slightly past due (i.e., 1-30 days), $388,939.33 (60.5%), for a combined total of 88.5%, and only a small percentage of the payables (11.5%) at that time were older. *Id.*

102. During December 2012 to May 2013, four of Debtor's vendors emailed Debtor about past due invoices, including Kody; Total Logistics and Finishing, Inc.; Design Collection; and Apparel Projects. *Email string from L. Trinidad to L. Sharron-12/27/2012*, Plaintiff's Exhibit 113; *Email string from L. Sharron to L. Trinidad-1/5/2013*, Plaintiff's Exhibit 114; *Email string from L. Trinidad to L. Sharron-2/8/2013*, Plaintiff's Exhibit 116; *Email string from L. Trinidad to L. Sharron-2/27/2013*, Plaintiff's Exhibit 117; *Email string from L. Trinidad to L. Sharron-3/1/2013*, Plaintiff's Exhibit 118; *Email string from L. Sharron to Gabi Sharron-3/22/2013*, Plaintiff's Exhibit 119*; Email string from Edwina to L. Sharron-3/21/2013*, Plaintiff's Exhibit 120; *Email from L. Trinidad to L. Sharron-3/25/2013*, Plaintiff's Exhibit 121; *Email string from L. Sharron to Gabi Sharron-4/11/2013*, Plaintiff's Exhibit 122; *Email string from L. Trinidad to L. Sharron-5/29/2013*, Plaintiff's Exhibit 124; *Grobstein Trial Declaration*, ECF 86, ¶ 72.

103. According to Sharron, the past due accounts payable were the product of bona fide disputes with Debtor's suppliers, such as Kody, Donshen and Zeller. *Sharron Trial Declaration*, ECF 100, ¶¶ 78-80; *Sharron Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 71-74 (trial testimony of Sharron acknowledging Debtor's pattern of late payments to vendors but contending that payments were only late for a specific reason). Sharron also testified that the late payments were not related to cash flow issues. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 45 ("things were tight on a cash flow basis" because of very large orders that Debtor had placed at the time in March 2013, but Debtor was not stretching its vendors).

104. The allowed claims against Debtor in this bankruptcy case total $3,144,716.70, and the holders of allowed claims exceeding $50,000.00 include: (1) Donshen Textile (Holdings) Ltd., $271,892.74; (2) East Mode Inc., $56,262.00; (3) Kody Branch of California Inc., $1,000,000.00; (4) Meyou One Co. Ltd., $52,582.00; (5) New

England Garment Limited, $56,224.00; (6) PTC Fashion Inc., $139,668.95; and (7) Zeller Textile Co. Ltd., $1,342,621.00. *Stipulated Fact (96), Joint Pretrial Stipulation*, ECF 97 at 11-13. The remaining 27 holders of allowed claims had claims less than $50,000.00. *Id.*

105. Debtor's reports from its AIMS production software (AIMS standing for "Apparel Management Software") indicated that Debtor had existing orders for the period of January 1 through January 31, 2013 in excess of $9,400,000.00. *Kabani Trial Declaration,* ECF 99 at 8-9, ¶ 25; *Sharron Trial Declaration,* ECF 100 at 14, ¶¶ 41-43; *AIMS Reports Copies by Trustee,* Defendants' Exhibit 511. The specific amount of orders taken by Debtor as reflected in the AIMS reports for this time period was $9,451,533.00. *Id.* Of this amount, approximately $5,300,000.00 in orders was shipped by Debtor and collected, resulting in a total payoff of Debtor's obligations to CIT, and the other $4,100,000.00 in orders was cancelled due to Kody's not shipping the ordered goods to Debtor. *Sharron Trial Declaration,* ECF 100 at 14, ¶ 42. Debtor's profit margin reported in the AIMS reports was 50.82%. *Sharron Trial Declaration,* ECF 100 at 14, ¶¶ 41-43; *AIMS Reports Copies by Trustee,* Defendants' Exhibit 511. According to Sharron, in May 2013, Debtor had the largest backlog of orders ever. *Sharron Trial Declaration,* ECF 100 at 15, ¶ 46; *AIMS Reports Copies by Trustee,* Defendants' Exhibit 511. (The figure of $4,100,000 in cancelled orders is corroborated by the email message of Debtor's production manager, Edwina von Bjorn to Sharron and Kabani, dated June 12, 2013, reporting that an AIMS open order report showed that Debtor then had $4,368,108 in open orders. *Sharron Trial Declaration,* ECF 100 at 14-15, ¶ 45; *Email from Edwina Von Bjorn, June 12, 2013,* Defendants' Exhibit 545; *see also Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136, at 83-84.)

106. Based on a profit margin of 50.82%, the cancelled orders would have represented approximately $2,100,000.00 in gross profit. *Sharron Trial Declaration,* ECF 100 at 14, ¶¶ 41-43; *AIMS Reports Copies by Trustee,* Defendants' Exhibit 511. The court finds Debtor's evidence credible that if Debtor was able to ship the cancelled orders, it could have realized gross profit of $2.1 million based on its profit margin.

107. In his trial declaration, Sharron stated that "at the time when the dispute between L. Scott and Kody was reaching a peak, in May, 2013, L. Scott had the largest backlog of orders ever. We were finally seeing some difficult times coming to an end. (When I say 'difficult times' that never meant 'pending financial threats' or insolvency. Neither Kabani, myself, or CIT had those concerns. . . .[)]" *Sharron Trial Declaration,* ECF 100 at 15, ¶ 46. According to Sharron, insolvency or "pending financial threats" was not an issue or concern for him, CIT, or Kabani because Debtor had the largest backlog of orders it ever had as shown by the AIMS reports, and Debtor was "was never at a point where our creditors were in jeopardy of not being paid, never to a point that our factor for 13 years (CIT) ever told us that [it] had to terminate or cancel our funding, never to a point where we had to add debt to our balance sheet to survive. In fact, with the exception of one year where we had a $20,000 loss, we never had suffered a loss for any fiscal year until 2013 when Kody began the dispute that ended with the involuntary bankruptcy." *Id.* (The court quotes the Sharron Trial Declaration at length here as a statement of Sharron's position as argument, and not as substantive evidence, since the court has sustained Trustee's objection to some of this testimony as evidence.). Looking at the math, there is some merit to Sharron's argument, given (i) Sharron's estimate of $2.1 million of gross profit from the cancelled orders from Kody, and (ii) the $1.5 million in net collected receivables after payoff of the debt to CIT, it would have been theoretically possible for Debtor to have paid off the allowed claims in this case of $3.1 million, but for Kody's decision not to ship the goods ordered by Debtor. However, such a possibility is strictly hypothetical because Kody decided not to ship the so-called cancelled orders due to Debtor's non-payment of its past due invoices from Kody, so that Debtor was unable to collect on its backlogged open orders which were cancelled. Whether Kody was reasonably justified in declining to ship the open orders to Debtor is not for this court to opine, but the court has to consider the fact that Kody made the decision not to ship the open orders in May 2013, which was a change of its policy and practice of handling Debtor's orders from prior policy and practice. Apparently wanting adequate assurance of payment due to large amounts of unpaid past due invoices,

in May 2013, Kody unilaterally decided not to ship on Debtor's open orders without payment in advance, even though Kody took the orders without requiring payment in advance, but only made its demand for adequate assurance in June 2013. *See* California Commercial Code § 2609. Kody's change of policy and practice meant that Debtor could not rely on the prior policy and practice of being able to pay Kody late, or not having to pay until shipment and receipt. Since this change in policy and practice took place in May 2013, this meant that as of at least by June 1, 2013, Debtor was unable to fulfill its orders to customers resulting in cancellation of $4.1 million of customer orders, which deprived Debtor of revenue from which it could to operate and generally pay its debts, and thus, the court finds that Debtor was insolvent on June 1, 2013 based on the evidence showing that it could not pay its debts generally as they became due.

F. <u>The Involuntary Bankruptcy Case against Debtor</u>

108. On June 19, 2013, Kody and two other petitioning creditors filed an involuntary bankruptcy petition under Chapter 7 of the Bankruptcy Code, 11 U.S.C., against Debtor. Cathy Trinh of Kody testified that Kody filed the involuntary petition to prevent Debtor from filing an assignment for the benefit of creditors. *Trinh Trial Declaration*, ECF 90 at 4-6, ¶¶ 16-21; *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 149-150; *see also Grobstein Trial Declaration*, ECF 86, ¶¶ 73-77.

109. On July 2, 2013, CIT filed a motion for relief from the automatic stay to allow it to continue collection of Debtor's accounts receivable on which it had a senior lien from the Factoring Agreement and related security agreements, and subsequently, on July 19, 2013, CIT and Debtor entered into a stipulation granting CIT stay relief *nunc pro tunc* to the petition date to collect all of Debtor's accounts receivable, to receive payments from the account debtors associated with the accounts, and to apply the proceeds of such accounts to reduce the amounts owed by Debtor under the Factoring Agreement, which stipulation was approved by the court by order entered on July 22, 2013. *See CIT's Notice of Motion and Motion for Relief from the Automatic Stay under 11 U.S.C. § 362,* Main Bankruptcy Case ECF 7, filed on July 2, 2013; *Stipulation by and Between L. Scott Apparel, Inc. and*

CIT Group/Commercial Services, Inc. Granting Relief from the Automatic Stay to Enable Application of Proceeds of Accounts, Main Bankruptcy Case ECF 14 at 4, filed on July 19, 2013 (Debtor and CIT stipulated to modification of the automatic stay *nunc pro tunc* to the petition date "to enable CIT to continue to collect all Accounts, to receive payments from the account debtors associated with the Accounts, and to apply the proceeds of such Accounts to reduce and satisfy the amounts owing to CIT under the Agreements."); *Order Granting Motion for Relief from the Automatic Stay under 11 U.S.C. § 362 (Personal Property),* Main Bankruptcy Case ECF 20, filed on July 22, 2013; *see also Further Stipulation by and Between L. Scott Apparel, Inc. and CIT Group/Commercial Services, Inc. Authorizing Releases and Turnover of Balances,* Main Bankruptcy Case ECF 64, filed on September 18, 2013. These stipulations between Debtor and CIT indicated that CIT was collecting all accounts receivable from the petition date, receiving the payments from the account debtors, applying the account proceeds to pay down Debtor's debt to CIT, and remitting any balance of payments to Debtor. *Id.*

110. In its stay relief motion filed on July 2, 2013, CIT asserted that under the Factoring Agreement, it had agreed to purchase all of Debtor's accounts receivable, and that Debtor had granted to CIT a continuing security interest in all of Debtor's existing and future accounts receivable, that as of the date of the involuntary petition on June 19, 2013, Debtor owed CIT $2,813,585.88, exclusive of interest and attorneys' fees, collateralized by CIT's first priority liens in the accounts receivable, that as of the petition date, Debtor had a balance of approximately $5,061,869.03 in accounts receivable, that after the petition date but before CIT received notice of the filing of the involuntary bankruptcy petition against Debtor, CIT had collected approximately $748,673.71 of Debtor's accounts receivable, for which it was holding in a segregated account pending the disposition of the stay relief motion, and that the amount of CIT's secured debt would be $2,164,625.63 after being allowed to apply the postpetition collected accounts receivable with an outstanding balance of accounts receivable of $4,333,364.27. *CIT's Notice of Motion and Motion for Relief from the Automatic Stay under 11 U.S.C. § 362,* Main Bankruptcy Case ECF 7, Supporting

Declaration at 6-8 and Memorandum of Points and Authorities at 1-3 and n. 6, filed on July 2, 2013.

111. In their stipulation resolving CIT's stay relief motion, CIT and Debtor represented to the court that Debtor was indebted to CIT in the amount of $2,813,585.88, exclusive of interest and attorneys' fees, as of the petition date, which amount was collateralized by CIT's first priority liens on, and security interests in, the accounts receivable, and that the amount of Debtor's outstanding accounts receivable was approximately $5,061,869.03 as of the petition date. *Stipulation by and Between L. Scott Apparel, Inc. and CIT Group/Commercial Services, Inc. Granting Relief from the Automatic Stay to Enable Application of Proceeds of Accounts,* Main Bankruptcy Case ECF 14 at 3. In the stipulation, CIT and Debtor agreed to modification of the automatic stay *nunc pro tunc* to the petition date "to enable CIT to continue to collect all Accounts, to receive payments from the account debtors associated with the Accounts, and to apply the proceeds of such Accounts to reduce and satisfy the amounts owing to CIT under the Agreements" and then once the applied amounts are sufficient to satisfy Debtor's debt to CIT, CIT agreed to remit the balance of the payments from the account debtors associated with the accounts receivable to Debtor upon receipt of all releases and indemnity agreements under the Factoring Agreement. *Id.* at 4-5.

112. On September 18, 2013, CIT and Debtor filed a further stipulation to authorize releases and turnover of the balance of the collected accounts receivable in the approximate amount of $1.5 million, which was approved by an order of the court entered on September 20, 2013. *Further Stipulation by and Between L. Scott Apparel, Inc. and CIT Group/Commercial Services, Inc., Authorizing Releases and Turnover of Balances,* Main Bankruptcy Case ECF 64, filed on September 18, 2013; *Order on Further Stipulation by and between L. Scott Apparel, Inc. and the CIT Group/Commercial Services, Inc., Authorizing Releases and Turnover of Balances,* filed and entered on September 20, 2013. As reported on Debtor's monthly operating report for October 2013, Debtor received a wire transfer from CIT in the amount of $1,516,613.53 on October 11, 2013. *Debtor's Chapter 11 Debtor*

Monthly Operating Report for month ending October 31, 2013, ECF 106, filed on November 15, 2013.

113. Thus, CIT and Debtor collected approximately $4.3 million of Debtor's accounts receivable from the petition date in June 2013 through September 2013, resulting in the payoff of the secured debt of $2.8 million owed to CIT and a surplus balance of $1.5 million paid over to Debtor in October 2013.

114. According to Sharron, the collection of Debtor's accounts receivable postpetition were due to his efforts: "Due to my efforts and the court's decision to deny the motion to grant an interim trustee at that time, I was able to successfully collect enough of the receivables (approx. $5 million dollars and 97% of the outstanding balances) to pay off the largest secured creditor, CIT, and still have approximately $1.7 million left for creditors. During the gap period, I did not take a salary, and only took action that brought money to the company. Nobody expected me to recover the receivables which I did." *Sharron Trial Declaration,* ECF 100 at 3 ,¶ 6.

115. Trustee primarily disputes Sharron's claim of credit for collecting Debtor's accounts receivable postpetition to oppose Sharron's bonus compensation claim, asserting based on Kody's emergency motion to appoint a Chapter 11 trustee, "Kody a petitioning creditor has asserted that CIT was the party responsible for collecting the receivables, and as part of operating the business, collecting the receivables is something that would have been part of Sharron's normal job responsibilities in any event." *Plaintiff's Trial Brief*, ECF 111 at 17-19 (citing *Kody's Emergency Motion for Appointment of a Trustee,* Main Bankruptcy Case ECF 27, ¶¶ 8-9).

116. The court finds that the preponderance of the evidence indicates that CIT collected Debtor's accounts receivable postpetition with Sharron's assistance as an officer and employee of Debtor, which assistance was material and instrumental in collecting a substantial portion of Debtor's outstanding accounts receivable and that the collection of Debtor's accounts receivable postpetition was not solely due to Sharron's efforts.

G. The Due from Officer Account and Other Amounts Owing by Sharron

117. From 2002 to the date the involuntary petition was filed on June 19, 2013, Debtor advanced funds and incurred expenses to or for the benefit of Sharron and his family for personal expenses that are reflected in the Due from Officer Account. *Stipulated Facts (33) and (42), Joint Pretrial Stipulation*, ECF 97 at 5-6; *Due from Officer Account*, Plaintiff's Exhibit 58; *Oversize Due from Officer Statement*, Plaintiff's Exhibit 59; *Grobstein Trial Declaration*, ECF 86, ¶ 41.

118. The Due from Officer Account entries were made in the regular course of business of Debtor by an employee of Debtor whose function it was to enter data into the accounting records. *Stipulated Fact (34), Joint Pretrial Stipulation*, ECF 97 at 5. No fixed repayment schedule exists for the Due from Officer Account. *Stipulated Fact (36), Joint Pretrial Stipulation*, ECF 97 at 5; *Sharron Trial Declaration*, ECF 100, ¶ 30. No interest was accrued on amounts owing by Sharron to Debtor on the Due from Officer Account. *Stipulated Fact (37), Joint Pretrial Stipulation*, ECF 97 at 5; *Due from Officer Account*, Plaintiff's Exhibit 58; *Oversize Due from Officer Statement*, Plaintiff's Exhibit 59**.**

119. Sharron testified at trial that at no time did he ever intend not to pay off the Due from Officer account and that he had the personal funds to pay off the Due from Officer Account. *Sharron Trial Declaration*, ECF 100, ¶¶ 31, 32. Thus, Sharron does not dispute his obligation to repay the Due from Officer account. *See also Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136, at 87 (Q: Have you ever denied owing whatever the due-from-officers account shows? A: Never.").

120. As of June 28, 2013, the amount owing by Sharron to Debtor, (i) exclusive of interest, (ii) without regard to any setoff of the Sharron Subordinated Note, and (iii) inclusive of all cash and non-cash credits pursuant to the Due from Officer Account was $462,194.53. *Stipulated Fact (35), Joint Pretrial Stipulation*, ECF 97 at 5.

121. Although several credits to the Due from Officer Account are in the form of non-cash transactions that reduced the amount Sharron owed to Debtor, Trustee objects only to the non-cash credits to the Due from Officer Account made on account of interest

charges on Subordinated Debt totaling $105,000. *Grobstein Trial Declaration*, ECF 86, ¶ 50. The court agrees with Trustee's objection to the claimed $105,000 interest credit on account of the Subordinated Debt and finds that the total amount of the Due from Officer Account, exclusive of interest, is $567,194.13 as of the date of filing of the involuntary petition. *Id.*, ¶ 51.

H. Other Amounts Due to Debtor

122. Debtor's books and records reflect other charges made for the benefit of Sharron that were not recorded in the Due from Officer Account. *Stipulated Facts (43) – (50), Joint Pretrial Stipulation*, ECF 97 at 6-7; *Wall Expert Report,* Plaintiff's Exhibit 148 at 10 and Exhibits 9 and 10 attached thereto; *Wall Expert Report,* Plaintiff's Exhibit 148 at 16-19 and Exhibit 10 attached thereto. However, as discussed below, since the court finds that Sharron owed no duty to creditors of the estate prior to the date of insolvency on or about June 1, 2013, those amounts incurred before June 1, 2013 are not recoverable by Trustee. *See Proposed Finding of Fact WW, Plaintiff's Proposed Findings of Fact and Conclusions of Law,* ECF 139 at 13 (asserting that only those amounts incurred after the date of insolvency alleged by Trustee to be in October 2012 are recoverable by the estate, which include (i) $9,900 in payroll checks issued by Debtor for Mirna Limon Gutierrez, the nanny taking care of Sharron's daughter, for the period January 1, 2013 to June 7, 2013, and (ii) $15,259 in payments by Debtor on June 12, 2013 prepaying car payments for Sharron and his wife for June 2013 through December 2013); *Wall Expert Report,* Plaintiff's Exhibit 148 at 16-18 and Exhibits 9 and 10 attached thereto; *Stipulated Facts (43) – (50), Joint Pretrial Stipulation*, ECF 97 at 6-7. In his Proposed Finding of Fact WW, Trustee did not argue for recovery of the other payments by Debtor on Sharron's behalf to a cabinetmaker for cabinets installed at Sharon's homes, a handyman who did work for Sharron at his home, or the Brentwood School, Sharron's daughter's school, because they predated October 2012, the date of insolvency alleged by Trustee. *See Proposed Finding of Fact WW, Plaintiff's Proposed Findings of Fact and Conclusions of Law,* ECF 139 at 13*; see also Wall Expert*

Report, Plaintiff's Exhibit 148 at 18 (the handyman expense occurred on April 8, 2013 which is before the date of insolvency of Debtor found by the court on June 1, 2013).

123. Ms. Gutierrez was employed by Sharron as his daughter's nanny from 2004 to 2013, and she was on Debtor's payroll from January 2013 to June 2013. *Stipulated Facts (43) and (44), Joint Pretrial Stipulation*, ECF 97 at 6; *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 180-181. According to Sharron, Ms. Gutierrez was on Debtor's payroll for a six-month period in 2013 when her paycheck was split between Debtor and Sharron personally, one half each, because she worked as a nanny for his daughter and did work helping the company on minor tasks, such as gathering garment receipts for bookkeeping, tagging garments, driving to return garment samples to vendors, and receiving credit for Debtor. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 181-183. Prior to 2013, only Sharron paid Ms. Gutierrez personally for her services, and not Debtor. *Id.* at 180-181. According to Sharron, because his daughter was older and did need Ms. Gutierrez as a nanny as often, he gave her other work responsibilities, doing minor tasks for Debtor, in addition to her nanny responsibilities and split her compensation with Debtor. *Id.* at 181-183; *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136, at 92-93. However, when Ms. Gutierrez was working for Debtor, it did not maintain timesheets to corroborate Ms. Gutierrez's time working for it. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134, at 183. The court finds that Sharron's testimony is credible and based on such testimony, the court finds that the payments made by Debtor to Ms. Gutierrez was for her work performing minor tasks in the business of Debtor, and not for nanny services, which were still compensated by Sharron personally, despite the absence of timesheets being kept by Debtor for Ms. Gutierrez.

124. On June 12, 2013, Sharron caused Debtor to telephonically pre-pay Sharron and his wife's vehicle payments for June 2013 through December 2013 in the amount of $15,259.02, which was not booked to the Due from Officer Account. *Stipulated Fact (50), Joint Pretrial Stipulation*, ECF 97 at 7; *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 181-183. Debtor was paying $950.00 per month to Audi for the 2013

Audi S7 automobile driven by Sharron and $1,229 to GMAC for the Cadillac Escalade automobile driven by Sharron's wife. *L. Scott Apparel, Inc., Transaction Detail by Account, June 20, 2011 through June 19, 2013 (Auto Leasing),* Plaintiff's Exhibit 56; *Grobstein Trial Declaration*, ECF 86 at 11, ¶ 42(l); *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 189-193; *Sharron Deposition, March 16, 2016* at 120, *Exhibit B to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016; *Sharron Deposition, March 28, 2016* at 264, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116, filed on August 17, 2016; *Wall Expert Report,* Plaintiff's Exhibit 148 at 17 and Exhibit 9 attached thereto. Debtor made 100 % of his automobile loan payments, although as Sharron acknowledges, a certain portion of the automobile use was for Sharron's personal use. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 189-190. On Debtor's tax returns, 70% of the vehicle expense was allocated to business purposes and 30% to Sharron, thus indicating at least some personal use by Sharron. *Stipulated Fact (49), Joint Pretrial Stipulation*, ECF 97 at 6. While Sharron testified at trial that "most of the car-related expenses were for business" and "[t]here was a portion that was personal, but it was a small portion compared to the business part," he never explained in his trial testimony what were the business purposes of Debtor for the use of the automobiles driven by him and his wife. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 191. Specifically, Sharron in his trial declaration discussed the specific payments complained of by Trustee, but not the prepaid automobile payments. *Sharron Trial Declaration,* ECF 100 at 10-12. There is no evidence regarding the business purposes of Debtor for the luxury automobiles driven by Sharron and his wife, an Audi and a Cadillac, which were paid for by Debtor. *See Trinh Trial Declaration,* ECF 90 at 3, ¶ 9 ("At one visit to L. Scott I saw a beautiful new car parked inside on the L. Scott cutting floor. During conversations with L. Scott employees during that visit (which conversations largely related to Kody orders), I learned that the car on the cutting floor belonged to Mr. Sharron and that the employees thought the company paid for the car."). Although Sharron did not explain the business purposes of Debtor for his

and his wife's automobiles in his trial testimony, he did explain why he caused Debtor to pre-pay the automobile loan payments in June 2013, that is, because he "was winding down the company during those months." *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 192. At his deposition taken in this case, Sharron also explained that he caused Debtor to make the prepayment of his car payments on June 12, 2013 because "this [was] when everything was going on. We were having a hard time with CIT getting money, et cetera, so when we had the money we wanted to make sure that the payments were made so we prepaid whatever that was, for four months or six months, whatever it was." *Sharron Deposition, March 28, 2016* at 265, *Exhibit C to Notice of Lodging of Marked Deposition Transcripts of Lowell Sharron for Trial*, ECF 116. This testimony shows that Sharron knew by that time that Debtor was having problems paying its bills and wanted to pay the ones that benefitted him personally while Debtor had some available funds. Based on these circumstances, the court finds that the automobiles driven by Sharron and his wife and paid for by Debtor were for their personal purposes and not for the business purposes of Debtor and that the prepayment of the automobile loan payments by Debtor caused by Sharron on June 12, 2013 indicated Sharron's knowledge of the financial straits of Debtor at that time, using company funds to pay for his personal use vehicles outside the ordinary course of the loans in order by prepaying the loan payments before they were due in order to use the funds before they would be unavailable for such use.

125. In summary, the total amount Trustee seeks to recover from Sharron is as follows:

Amount	**Source**
$462,194.13	Due from Officer Amount
$105,000.00	Interest Credited to Due from Officer Account
$25,159.02	Transfers not booked to Due from Officer Account
Total: $592,353.15	

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I. Facts Relating to Date of Insolvency

i. Expert Witness Reports

126. The parties offered expert witness opinion testimony in support of their contentions regarding whether and when Debtor became insolvent. Plaintiff called as an expert witness at trial David Wall, who submitted an expert witness report dated March 30, 2015. *Wall Expert Report*, Plaintiff's Exhibit 148. Defendants called as an expert witness at trial Coral Michelle Hansen, who submitted an expert witness report dated March 30, 2015. *Hansen Expert Report*, Defendants' Exhibit 540 ("Hansen Expert Report"). The court denied Plaintiff's Motion in Limine Number 1 to Exclude Portion of Expert Report and Testimony by Coral Hansen, *Hansen Expert Report*, Defendants' Exhibit 540, but ruled that Plaintiff could move to strike portions of the report as adduced by the evidence. *Trial Transcript of August 18, 2016*, ECF 134 at 10-12.

127. David Wall is a forensic accountant and an attorney. *Wall Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 186. Wall estimated that he had "worked on, [he] believe[d], between two and five" insolvency reports in bankruptcy court matters. *Id.* at 209-210. However, Wall testified that this was the first insolvency report he had written himself in a bankruptcy matter. *Id.* at 210. Wall does not hold an accreditation for business valuation, even though it is his understanding that most experts who render insolvency opinions have such an accreditation. *Id.* at 215.

128. Wall testified at trial that Debtor was not on its deathbed until sometime between April and June 2013. *Wall Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 214 ("I don't think that this company went on its deathbed until sometime in 2013."); *see also id*. at 214-215 ("[Wall:] My best estimate would be sometime between April and June. The court: April and June. All right. Between April and June. So it was not a going concern – it was a going concern up until that date, right? [Wall:] Yes, sir."). Sharron's expert, Hansen, provided a similar assessment in her expert witness report, writing that "Debtor was a going concern and the assets and liabilities should be reflected at their fair value . . . ." *Hansen Expert Report*, Defendants' Exhibit 540 at 9; *see also Hansen*

Testimony, Trial Transcript of August 18, 2016, ECF 134 at 100 (Trustee's counsel: "Well, the company ceased operations at the time – almost at the time of the voluntary [sic] filing. Are you aware of that? [Hansen:] Yes. [Trustee's counsel:] And that was around about June 19th, to be precise, 2013? [Hansen:] Yes.").

129. In his expert witness report, Wall stated that he made three findings on solvency in his expert witness report as to whether Debtor and Beyond Basics were insolvent, which were as follows: (1) "Beyond Basics was never solvent"; (2) "By or about January 1, 2011, Sharron should have been on notice that [Debtor] was operating with unreasonably small capital"; (3) "By October 2012, [Debtor] was insolvent [at] a fair value basis and never regained solvency." *Wall Expert Report*, Plaintiff's Exhibit 148 at 4.

130. Wall made additional findings as to the insolvency of Debtor: Wall concluded that "[h]ad Sharron not caused [Debtor] to fund his personal lifestyle and pay for the operations of Beyond Basics, then [Debtor] would have had additional cash" of $45,835 on January 1, 2011, $477,566 on January 1, 2012, $866,319 on January 1, 2013, and $998,274 as of the involuntary petition date of June 19, 2013. *Id*. at 19-20. Wall concluded that these facts establish that Debtor was operating with unreasonably small capital. In conducting his financial statement or "book solvency," Wall explained that he "exported from [Debtor's] QuickBooks accounting records, the total assets and total liabilities, and then subtracted the liabilities from the assets." *Id*. at 20.

131. Wall in his expert witness report described only four adjustments that he made when conducting his financial statement analysis: (1) "The amount owing from Beyond Basics was adjusted to zero for the entirety of the period," (2) "The 'Due from Officer' Account owing from Sharron is adjusted to 50% of its face value," (3) "[A] 50% adjustment is made to the 'Security Deposits' account, to reflect the lack of marketability . . . ," and (4) The Sharron Subordinated Note was "re-characterized as an equity investment." *Id*. at 20-21.

132. Wall acknowledged that "[i]tems maintained in the accounting records sometimes do not reflect their fair values." *Id.* at 20. At trial, Wall testified that Debtor's assets were not valued at a fair market approach. *Wall Testimony, Trial Transcript of*

August 19, 2016, ECF 135 at 219:13-17 ("[The court:] Did you do the market approach and the discounted cash flow in your analysis? I didn't see that. [Wall:] It was impossible for me to do that."). Moreover, Wall failed to explain why a fair market valuation of Debtor's assets could not have been conducted. *Wall Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 220:4-10 ("[The court:] –it's not in the report, so that's what I was – I just wanted to know if it was in the report or not. [Wall:] I could have done a better job at spelling out the particular challenges that interfered with my ability to do that.").

133. Wall's analysis for his opinion that by or about January 1, 2011, Sharron should have been on notice that Debtor was operating with unreasonably small capital Debtor is set forth at pages 19 and 20 of his report. *Wall Expert Report*, Plaintiff's Exhibit 148 at 19-20. Wall concluded that Debtor (i) "had suffered dwindling profits compared to prior years," referring to his chart analyzing Debtor's profitability, (ii) "experienced a marked increase in its accounts payable, and the aging of those payables," referring to his chart analyzing Debtor's accounts payable, and (iii) had increasing balances on the Due from Officer account from withdrawals from Debtor by Sharron, referring to his charts overlaying Due from Officer account balances against Debtor's profits and asset values. *Id.* at 19-20 and Exhibits 11, 12, 13, 14, and 15 attached thereto. However, Wall's analysis for his unreasonably small capital does not provide for, or consider, the amounts of Debtor's available working capital from Sharron's capital contributions of $50,000 of admitted equity and of the $350,000 from the Subordinated Debt recharacterized as equity, and most notably, from the factor financing from CIT. *Id.*

134. Defendants' expert witness Coral Hansen had never before prepared an insolvency report. *Hansen Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 17-18. Like Wall's expert witness report, Hansen in her expert witness report similarly did not value Debtor's assets at a fair market valuation. *Hansen Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 39 ("[Trustee's counsel:] And it's correct to say that you didn't apply – you did not conduct a fair value analysis, correct? [Hansen:] That's correct."). As Hansen stated in her trial testimony, "after further discussion with counsel and we

determined that we did not likely have the time or perhaps all of the information necessary to perform a formal solvency opinion, so rather, we changed our approach to provide testimony as to why the solvency opinion that was outlined in the original complaint and then prepared by Mr. Wall did not meet the standards to prove insolvency." *Id.,* ECF 134 at 19. Thus, Hansen's report and testimony were offered by Defendants to rebut any evidentiary showing by Plaintiff through Wall's report and testimony.

J. Additional Facts Related to the Consolidated Objection

i. The Sharron Proof of Claim

135. Sharron filed his proof of claim on December 23, 2013, setting forth his prepetition claim in the total amount of $766,783.74 for "Money Loaned to Debtor, and unpaid compensation." *Sharron Proof of Claim*, Defendants' Exhibit 557; *Stipulated Fact (98), Joint Pretrial Stipulation*, ECF 97 at 13. This amount consists of: (1) a $350,000 claim based on the Sharron Subordinated Note, allegedly secured by the right of setoff; and (2) a $375,283.74 priority unsecured claim which, according to the Sharron Proof of Claim, consists of (i) unpaid salary of $131,500, (ii) a bonus of $260,000 based upon the collection of receivables, and (iii) expense reimbursement owing in the amount of $25,283.74. *Sharron Proof of Claim*, Defendants' Exhibit 557. No documentation regarding the $131,500 in unpaid salary or the $260,000 bonus was attached to the Sharron Proof of Claim, though there is, however, what appears to be a summary of credit card charges attached to the Sharron Proof of Claim. *Id.*

ii. Insider Compensation Claim of Sharron

136. Sharron filed Form USTLA-12, a Notice of Setting/Increasing Insider Compensation (the "Insider Compensation Notice") for himself. *Stipulated Fact (104), Joint Pretrial Stipulation*, ECF 97 at 13. On or about September 27, 2013, Debtor served on Trustee and the Official Committee of Unsecured Creditors (the "Committee") the Insider Compensation Notice. *Committee's Objection to Debtor's Notice Setting/Increasing Insider Compensation*, Main Bankruptcy Case ECF 83 at Exhibit A; *Consolidated Objection to Sharron Claim*, Plaintiff's Exhibit 147 at Exhibit 2; *Grobstein Trial Declaration*, ECF 86, ¶ 83.

137. The Committee filed its Objection to Debtor's Notice Setting/Increasing Insider Compensation on October 8, 2013 (the "Insider Compensation Objection"). *Stipulated Fact (104), Joint Pretrial Stipulation*, ECF 97 at 13; Main Bankruptcy Case ECF 83. The Committee requested a hearing on the Insider Compensation Notice in accordance with LBR 2014-1(a). Main Bankruptcy Case ECF 83.

138. As indicated on the case docket for the main bankruptcy case, Debtor never noticed a hearing on the Insider Compensation Notice as required by Local Bankruptcy Rule 2014-1(a) in response to the Insider Compensation Objection, which was never withdrawn by the Committee, and as such, a hearing on the Insider Compensation Notice was never held by the court, nor was it ever ruled upon by the court. *See Stipulated Facts (98)-(105), Joint Pretrial Stipulation*, ECF 97 at 13.

139. Sharron did not obtain Court approval for any compensation payable to him after the entry of the order for relief in Debtor's bankruptcy case. *Stipulated Fact (99), Joint Pretrial Stipulation*, ECF 97 at 13.

iii. <u>The Sharron Motion</u>

140. The Sharron Motion was filed on May 5, 2014. *Motion of Lowell Sharron for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest*, Plaintiff's Exhibit 146 and Main Bankruptcy Case ECF 198. However, the Sharron Motion is not a motion for allowance of an administrative claim. Rather, it is a motion "for an order compelling [Debtor] to pay (1) [Sharron's] administrative expense for prepetition unsecured wage claims, and (2) post-petition unpaid amounts in connection with his wage claims . . . in addition to any potential equity interest funds." *See id.* at 1. The Sharron Motion sought immediate payment of both prepetition claims and postpetition claims. The only evidentiary support attached to the Sharron Motion were a declaration of Sharron (the "Sharron Motion Declaration") and a copy of the Sharron Proof of Claim.

141. The following describes the claims that Sharron asserts in the Sharron Motion: (i) a pre-petition claim for the Subordinated Debt in the amount of $350,000; (ii) a post-

petition claim for wages incurred during the gap period of June 19, 2013 until August 13, 2013 (the "Gap Period") in the amount of $38,233.12 (the "Gap Period Claim"); (iii) a post-petition claim for post-petition wages in the amount of $107,222 (the "Administrative Wage Claim"); (iv) a post-petition claims for expenses of $31,722.00; (v) the post-petition Bonus Claim in the amount of $260,000; and (vi) post-petition claims based on the California Labor Code (the "Labor Code Claims").

iv. The Gap Period Claim

142. The Sharron Motion asserts that Sharron is owed wages of $38,233.12 for the Gap Period Claim. *Motion of Lowell Sharron for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest*, Plaintiff's Exhibit 146 at 5, 12, 13; *Sharron Trial Declaration,* ¶ 99 ("The amount of salary that I earned, but did not take, during the gap period . . . was $38,233.12."). Sharron attested in his declaration in support of the Sharron Motion that he was the chief executive officer of Debtor and one of the last remaining employees of the company, and he ran the company during its time as a debtor in bankruptcy, including collecting its accounts receivable and seeing that Debtor complied with all bankruptcy court and United States Trustee requirements. *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 11-17, ¶¶ 1-25. Plaintiff did not object to this claim. *See Consolidated Objection to Sharron Claim*, Plaintiff's Exhibit 147 at 14 ("The only claim that should survive is the Gap Period Claim of $38,233.12 which would not be subject to LBR 2014-1."); *see also Plaintiff's Trial Brief*, ECF 111 at 34.

v. The Administrative Wage Claim

143. The Sharron Motion also includes the Administrative Wage Claim for $75,500 in wages allegedly accrued and owing for the postconversion, preconfirmation time period of August 13, 2013 through and including April 3, 2014.[6] *Motion of Lowell Sharron for Order*

[6] The amounts of Sharron's compensation claimed in the Sharron Motion and in the Sharron Proof of Claim do not exactly match up. First, page 5 of the Sharron Motion notes that the Sharron Proof of Claim lists Sharron's unpaid compensation as unpaid wages and salaries of $375,283.74, and further notes that the unpaid

(Continued...)

Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest, Plaintiff's Exhibit 146 at 5, 12, 13. Plaintiff objected to this claim. *Consolidated Objection to Sharron Claim*, Plaintiff's Exhibit 147 at 14 ("THE ADMINISTRATIVE WAGE CLAIM, THE BONUS CLAIM AND THE EXPENSE REIMBURSEMENT CLAIMS SHOULD ALL BE DISALLOWED IN THEIR ENTIRETY BASED ON PROCEDURAL INFIRMITIES."); *Plaintiff's Trial Brief* at 34. The only reason that Trustee gives for disallowance of Sharron's administrative wage claim is the lack of compliance with the Insider Compensation Procedures under the court's local rules. *Id.* Trustee does not argue that Sharron performed the work for Debtor during the postconversion, preconfirmation time period, which was necessary to preserve the estate. *Id.*

144. The Creditors' Committee objected to the Insider Compensation Notice for Sharron's postpetition wage compensation, and Debtor never set the matter for hearing. *Stipulated Facts (98)-(105), Joint Pretrial Stipulation*, ECF 97 at 13.

vi. <u>The Expense Claim</u>

145. The Sharron Motion and the Sharron Proof of Claim both list an expense claim of $31,722.00. *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 13-14, ¶ 13 and Proof of Claim, Exhibit A attached thereto. The breakdown of Sharron's expense claim is: (a) general unreimbursed expenses of $11,479.00; (b) health insurance expenses of $11,088.00 for the period from August 2013 to April 2014; (c) Sharron's automobile installment loan payments of $950.00 per month for a total of $8,075.00 for the period from August 2013 to April 2014; and (d) automobile insurance for Sharron's automobile of $120.00 per month for a total of $1,080.00 for the period from August 2013 to April 2014. *Id.* According to Sharron, Debtor always covered his expenses for his health insurance, his

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compensation was explained in the Sharron Proof of Claim as unpaid salary of $131,500 and the Bonus Claim of $260,000, but the total of the $131,500 unpaid salary and the $260,000 Bonus Claim is $391,500, which is $16,216.26 greater than the amount stated on the face of the Sharron Proof of Claim. The Sharron Motion itself gives no explanation for this discrepancy. The Sharron Motion then states that the unpaid wages consist of the $38,233.12 Gap Period Claim, the $107,222 Administrative Wage Claim, and the $260,000 Bonus Claim, which amounts total $405,455.12. The explanation appears to be an error in addition, and the court will simply address the discrete components of these claims one by one.

automobile installment loan payments and his automobile insurance before the involuntary bankruptcy case was filed. *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 13-14, ¶ 13.

146. As indicated in Debtor's books and records, Debtor was paying $950.00 per month to Audi Financial Services for a 2013 Audi automobile driven by Sharron. *L. Scott Apparel, Inc., Transaction Detail by Account, June 20, 2011 through June 19, 2013 (Auto Leasing),* Plaintiff's Exhibit 56; *Grobstein Trial Declaration*, ECF 86 at 11, ¶ 42(l); *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 189-192. Debtor made 100 percent of the automobile payments, although as Sharron acknowledges, a certain portion of the automobile use was for Sharron's personal use. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 189-190. Moreover, Debtor reported on its tax returns that 70 percent of the expense for Sharron's automobile was for business purposes and 30 percent was for Sharron personally, which further indicates his personal use of the car. *Stipulated Fact (49), Joint Pretrial Stipulation*, ECF 97 at 6. Based on these circumstances, the court finds that the Audi was for Sharron's personal use as there is insufficient evidence to show its use for Debtor's business purposes. As indicated in Debtor's books and records, Debtor pre-paid the monthly installment payments on the 2013 Audi automobile for the months of June through December 2013 in the total amount of $6,653.00. *See L. Scott Apparel, Inc., Transaction Detail by Account, June 20, 2011 through June 19, 2013 (Auto Leasing),* Plaintiff's Exhibit 56; *Stipulated Fact (50), Joint Pretrial Stipulation*, ECF 97 at 7. Thus, it appears that Sharron is claiming reimbursement for payments on the Audi for August through December 2013 already paid by Debtor, which the court finds is impermissible because there is no benefit to the estate for such expense.

147. In support of Sharron's claim of $11,479.00 for general unreimbursed expenses, he attached to his proof of claim a summary of simple billing entries with credit card account numbers, dates, and amounts, with brief descriptions of the expense items mostly limited to one to four word descriptions like "chevron," "google," "shell," "verizon," "la pallet," "Intl Fashion," "truck rental for moving," "Steam Iron fix," "Internet Fee," "USPS," and

"Credit Card Fee." *See the Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 12, ¶ 6 and Proof of Claim, Exhibit A attached thereto. The summary of billing entries indicates that the expenses were incurred during the Gap Period between the time that the involuntary petition was filed in June 2013 and the date of conversion in August 2013 and during the post-conversion period beginning in August 2013 through plan confirmation in April 2014. *Id.* However, Sharron did not provide an explanation of these expenses in his declaration in support of this claim in the Sharron Motion or in his trial declaration. *Id.; Sharron Trial Declaration,* ECF 100.

148. Sharron did not obtain Court approval for any expense reimbursement arrangement after the entry of the order for relief in Debtor's bankruptcy case in August 2013. *Stipulated Facts (100), Joint Pretrial Stipulation*, ECF 97 at 13.

vii. <u>The Bonus Claim</u>

149. The Sharron Motion also requests payment of the $260,000 Bonus Claim. The only evidence that Sharron submits in support of his claim is the Sharron Motion Declaration. Sharron provided no other evidence. In the Sharron Motion Declaration, Sharron states that "[he knows] of no reason why [his] claim for payment as described herein would or should be disputed" and that he cannot "imagine anyone opposing [his] receipt of a bonus for the collection of almost $2,000,000 in receivables." *See the Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 13-14, ¶¶ 12 and 14. Sharron bases his entitlement to the Bonus sought on the "highly impressive result [achieved] during very difficult times." *Id*. at 16, ¶ 25.

150. Part of Sharron's duties prior to the order for relief against the Debtor included the collection of receivables or supervising other personnel at the Debtor to collect receivables. *See Stipulated Fact (103), Joint Pretrial Stipulation*, ECF 97 at 13.

151. Debtor retained Peter Kravitz of Sltn Trust, LLC dba Solution Trust as its CEO in connection with a potential assignment for the benefit of creditors of Debtor's assets in June 2013, shortly before the filing of the involuntary bankruptcy case. *See Letter from Solution Trust to L. Sharron*, Plaintiff's Exhibit 131; *Consolidated Objection to Sharron*

Claim, Plaintiff's Exhibit 147 at Exhibit 4, *Board Resolution Appointing Mr. Kravitz as CEO*. Mr. Kravitz resigned from his engagement as CEO on or about July 18, 2013. There are emails from Mr. Kravitz that show that while there were negotiations about a proposed compensation plan for Sharron among Mr. Kravitz, Debtor's bankruptcy counsel, and counsel for Kody that would have included a bonus, no agreement was reached regarding the propriety of this incentive plan. *See Email from Lowell Sharron to Peter Kravitz re Lets Talk, Plaintiff's Exhibit 132; Email from Lowell Sharron to Amanda Demby, Peter Kravitz, David Levene, Lloyd Mann re rough draft of 13 wk projections*, Plaintiff's Exhibit 133; *Email string from Amanda Demby to Kurt Ramlo cc: Peter Kravitz, Lowell Sharron, David Levene re b 811 – L. Scott Apparel, Inc.*, Plaintiff's Exhibit 134; *Email string from Amanda Demby to Kurt Ramlo cc: Peter Kravitz, Lowell Sharron, David Levene re b 811 – L. Scott Apparel, Inc.*, Plaintiff's Exhibit 135; *Email string from David Levene to Amanda Demby, Kurt Ramlo, Lowell Sharron, Peter Kravitz, Lloyd Mann re b 811 – L. Scott Apparel, Inc.*, Plaintiff's Exhibit 136; *Email string from Amanda Demby to David Levene cc: Kurt Ramlo, Peter Kravitz re IN re L. Scott Apparel, Inc.*, Plaintiff's Exhibit 137; *Email string from Amanda Demby to David Levene, Kurt Ramlo, Lowell Scott cc: Peter Kravitz Peter Kravitz re L. Scott – Meeting with EBG*, Plaintiff's Exhibit 138; *Email string from Steven Gubner to Kurt Ramlo re L. Scott Apparel*, Plaintiff's Exhibit 139; *Email string from Steven Gubner to Kurt Ramlo re L. Scott Stipulation*, Plaintiff's Exhibit 140.

152. Sharron did not obtain court approval of his bonus arrangement after the entry of the order for relief in Debtor's bankruptcy case. *Stipulated Facts (101), Joint Pretrial Stipulation*, ECF 97 at 13.

153. Sharron did not get approval of the Creditors' Committee for his bonus arrangement. *Stipulated Facts (102), Joint Pretrial Stipulation*, ECF 97 at 13.

154. Sharron's Form USTLA-12 (Notice of Setting/Increasing Insider Compensation) did not disclose his claim for a bonus payment. *Stipulated Facts (105), Joint Pretrial Stipulation*, ECF 97 at 13.

155. Trustee argues that Sharron's Bonus Claim should be denied because "it suffers from incurable procedural and legal infirmities." *Plaintiff's Trial Brief*, ECF 111 at 15. Specifically, the Insider Compensation Notice filed for Sharron did not disclose any bonus arrangement; Sharron's original insider compensation arrangement was never approved by the court; the bonus compensation claim does not meet the legal standards of 11 U.S.C. § 503(c)(1) and (c)(3) as an insider retention plan or other transfer to an insider outside the ordinary course of business justified by the facts and circumstances of the case; CIT, rather than Sharron, was the party primarily responsible for collecting Debtor's accounts receivable postpetition; and while Sharron assisted CIT's efforts, his collecting Debtor's accounts receivable was part of his normal job requirements as an officer of Debtor not justifying bonus compensation, especially since Debtor was not operating at the time. *Plaintiff's Trial Brief*, ECF 111 at 15-19.

viii. <u>The Labor Code Claims</u>

156. Sharron contends that because Debtor did not pay Sharron's postpetition wage claims for the Gap Period and the postconversion, preconfirmation period after he stopped working for Debtor when he was terminated from Debtor after plan confirmation, Debtor's refusal is willful under California Labor Code § 203, and thus, as a penalty for his having to wait for payment of his wages, "the wages of the employee shall continue to accrue until paid for up to thirty days." *Motion of Lowell Sharron for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest*, Plaintiff's Exhibit 146 at 8-9.

157. Trustee opposes Sharron's waiting time penalties under the California Labor Code as "baseless" because such penalties should not be imposed under the good faith dispute exception under California Labor Code § 203 since there was a good faith dispute as to (i) whether Debtor was authorized to pay Sharron his final wages, and (ii) what those wages should be because no insider compensation was ever approved or set by the court. *Plaintiff's Trial Brief* at 19-21. However, Trustee never opposed Sharron's postpetition Gap

Period wage claim of $38,233.12, and Trustee acknowledges that such claim is not subject to the insider compensation requirements of Local Bankruptcy Rule 2014-1. *Id.* at 14.

III. CONCLUSIONS OF LAW

A. Insolvency

i. Bankruptcy Code Insolvency

1. "The Bankruptcy Code defines insolvency, for a corporation, as a 'financial condition such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation . . . .' 11 U.S.C. § 101(32)." *Wolkowitz v. American Research Corp. (In re DAK Industries, Inc.)*, 170 F.3d 1197, 1199 (9th Cir. 1999). "[C]ourts have generally engaged in a two-step process of analysis" when determining insolvency. *Id*. "First, the court must determine whether a debtor was a 'going concern' or was 'on its deathbed.' Second, the court must value the debtor's assets, depending on the status determined in the first part of the inquiry, and apply a simple balance sheet test to determine whether the debtor was solvent." *Id*. "If the debtor was a going concern, the court will determine the fair market price of the debtor's assets as if they had been sold as a unit, in a prudent manner, and within a reasonable time. If the company was on its deathbed, i.e., only nominally extant, then the court will determine the liquidation value of the assets, such as a price expected at a foreclosure sale." *Id*. at n. 3 (citation omitted).

2. The court finds that Debtor was operating as a going concern until the time that the involuntary bankruptcy petition was filed on June 19, 2013. First, Debtor was still operating near the time the involuntary petition was filed on June 19, 2013. *Sharron Trial Declaration*, ECF 100, ¶¶ 42-48 (Debtor had a large backlog of orders over $4 million in June 2013); *Trinh Trial Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 114 ("[Defendants' counsel:] In or about March 2013, were you still taking orders from L Scott Apparel? [Trinh:] Yes, sir."); *Trial Transcript of August 19, 2016*, ECF 135 at 146 ("[Defendants' counsel:] So it was . . . in June 2013 that you believed that L Scott could continue to operate? [Trinh:] Yes. Yes, I believe so, yes."). Sharron also stated that Debtor and Beyond Basics were operating until Debtor's creditors filed the involuntary petition on

June 19, 2013. *Sharron Trial Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 240-241. Second, the expert witnesses for both Plaintiff and Defendants agreed that Debtor should be valued as a going concern. Although Plaintiff's expert witness, Wall, did not address in his report whether Debtor should be valued as a going concern, he testified at trial that Debtor was not on its deathbed until sometime between April and June 2013. *Wall Trial Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 214 ("I don't think that this company went on its deathbed until sometime in 2013."); see also *id*. at 214-215 ("[Wall:] My best estimate would be sometime between April and June. The court: April and June. All right. Between April and June. So it was not a going concern – it was a going concern up until that date, right? [Wall:] Yes, sir."). Sharron's expert witness, Hansen, provided a similar assessment in her expert report, writing that "Debtor was a going concern and the assets and liabilities should be reflected at their fair value . . ." *Hansen Expert Report*, Defendants' Exhibit 540 at 9; *see also Hansen Trial Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 100 (Trustee's counsel: "Well, the company ceased operations at the time – almost at the time of the voluntary [sic] filing. Are you aware of that? Hansen: Yes. Trustee's counsel: And that was around about June 19th, to be precise, 2013? Hansen: Yes."). Third, Debtor also appeared to have sufficient capital financed by its factor, CIT, to continue operating around the time the involuntary petition was filed. *Wall Trial Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 198 ("[Defendants' counsel:] Did you see anything in the record to indicate that in May or June 2013 CIT had advised L Scott Apparel, Inc. that it intended to terminate the factoring agreement? [Wall:] No."); *see also Transcript of December 15, 2016*, ECF 166 at 110-111. For these reasons, the court finds that Debtor was operating as a going concern at least through the date that the involuntary bankruptcy petition was filed on June 19, 2013.

3. Because Debtor will be valued as a going concern, Debtor's assets must be valued at a fair market valuation when determining whether Debtor's liabilities exceed the value of its assets. *In re DAK Industries, Inc.*, 170 F.3d at 1199. The Wall Expert Report is deficient in this regard. In his report, Wall details only four fair value adjustments. *Hansen*

Rebuttal Report, Defendants' Exhibit 541 at 9 ("Wall made fair value adjustments for only four balance sheet accounts . . ."). Wall adjusted the Due from Beyond Basics account to a fair market value of $0, adjusted the Due from Officer Account to 50% of its face value, made a 50% adjustment to Debtor's Security Deposits account, and re-characterized the purported $350,000 loan from Sharron to Debtor as equity. *Wall Expert Report*, Plaintiff's Exhibit 148 at 20-21. In explaining these adjustments, Wall simply discounted the amount owed by Beyond Basics as worthless in light of its lack of payment performance history, lack of profitability and its own insolvency, but without conducting any analysis of its insolvency, discounted the amount owed by Sharron on the Due from Officer account by 50% on account of lack of due date, terms of repayment, written agreement, collateral or interest charges, without any analysis of Sharron's net worth or collectability, and discounted the Security Deposits account by 50% due to "lack of marketability," without any analysis of collectability. *Id.* In the court's view, these adjustments by Wall to fair value of Debtor are conclusory and arbitrary, lacking a scientifically valid method of valuation, and therefore, not credible. Aside from these arbitrary adjustments, Wall otherwise failed to conduct a fair market valuation on Debtor's remaining assets, instead appearing to rely on the book value of Debtor's assets. However, relying on the book values of assets for a fair market valuation is not the proper valuation method here. *Bay Plastics, Inc. v. BT Commercial Corp. (In re Bay Plastics, Inc.)*, 187 B.R. 315, 330 (Bankr. C.D. Cal. 1995) ("The valuation of assets for insolvency purposes is based on 'a fair valuation.' This differs from a balance sheet, where most assets . . . are carried at historic cost, rather than current market value."). Further, Wall himself acknowledged that "[i]tems maintained in the accounting records sometimes do not reflect their fair values." *Wall Expert Report*, Plaintiff's Exhibit 148 at 20. Wall's testimony precludes the possibility that Wall only made these fair market value adjustments because the remaining assets were already valued at fair market value in Debtor's books. At trial, Wall testified that Debtor's assets were not valued at a fair market approach. *Wall Trial Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 219 ("[The court:] Did you do the market approach and the discounted cash flow in your analysis? I didn't see that.

[Wall:] It was impossible for me to do that."). Moreover, Wall failed to explain why a fair market valuation of Debtor's assets could not have been conducted. *Wall Trial Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 220 ("[The court:] –it's not in the report, so that's what I was – I just wanted to know if it was in the report or not. [Wall:] I could have done a better job at spelling out the particular challenges that interfered with my ability to do that."). *Cf. Plaintiff's Trial Brief,* ECF 111 at 15 ("The balance sheet test is an essential step in the determination of an entity's solvency. The test is calculated using the fair value (which Hansen admittedly did not determine) of the assets of the entity minus its liabilities."). Thus, because Wall failed to value all of Debtor's assets at fair market value, the court finds that the Wall Expert Report does not provide sufficient evidence that Debtor was insolvent before the involuntary petition was filed on June 19, 2013 (or as discussed below, before the date of insolvency of June 1, 2013 determined by the court based on Debtor's inability to pay debts as they generally became due based on Debtor's inability to generate revenue from Kody's refusal to ship goods ordered by Debtor).

4. The court also finds that the Hansen Expert Report provides insufficient evidence of insolvency, as Hansen similarly neglected to value Debtor's assets at a fair market valuation. *Hansen Trial Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 39 ("[Trustee's counsel:] And it's correct to say that you didn't apply – you did not conduct a fair value analysis, correct? [Hansen:] That's correct."). However, it is Trustee who must prove insolvency to sustain his claims, and Defendants do not have to disprove insolvency here.

5. Accordingly, based on this record, the court is unable to find under the Bankruptcy Code insolvency test that Debtor was insolvent prior to the involuntary petition filing on June 19, 2013, and the court finds that Trustee has not established insolvency by a preponderance of the evidence prior to June 19, 2013 under this standard.

ii. <u>California Law Insolvency</u>

6. Under the California Uniform Fraudulent Transfer Act ("CUFTA"), insolvency is defined under California Civil Code § 3439.02(a) "under two different tests, the 'balance

sheet test' and the 'equity' or 'cash flow test.'" *GSM Wireless, Inc. v. Honarkar (In re GSM Wireless, Inc.)*, 2013 WL 4017123, slip op. at *18 (Bankr. C.D. Cal. 2013). "Under the 'balance sheet' method, 'a debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets . . . . Under the alternative 'equity' or 'cash flow test,' California Civil Code § 3439.02(c) provides for a presumption of insolvency for 'a debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.'" *Id*. (citation omitted).

7. "A debtor that is generally not paying its debts as they become due other than as a result of a bona fide dispute is presumed to be insolvent." 1 Ahart, *Rutter Group California Practice Guide: Enforcing Judgments and Debts,* ¶ 3:328 (2018) (citing California Civil Code § 3439.02(b) and Comment (3) thereto). "To overcome this presumption, the transferee has the burden of proving that the nonexistence of insolvency is more probable than its existence." *Id.*

8. According to the Legislative Committee Comment 3 to California Civil Code § 3439.02, this alternate theory of insolvency is necessary because of the "difficulties typically imposed on a creditor in proving insolvency in the bankruptcy sense." California Civil Code § 3439.02 Comment n. 3. Accordingly, the analysis of a debtor's general inability to pay debts under § 3439.02 relies on the case law interpreting Bankruptcy Code § 303(h)(1) (11 U.S.C.), which enumerates the general inability to pay debts as they become due as a ground for the filing of an involuntary bankruptcy petition. *See id.* ("The case law that has developed under Section 303(h)(1) of the Bankruptcy Code has not required a showing that a debtor has failed or refused to pay a majority in number and amount of his or her debts in order to prove general nonpayment of debts as they become due.").

9. The Ninth Circuit has "adopted a 'totality of the circumstances' test for determining whether a debtor is generally not paying its debts under 11 U.S.C. § 303(h)." *In re Vortex Fishing Systems, Inc.*, 277 F.3d 1057, 1072 (9th Cir. 2002). "A finding that a debtor is generally not paying its debts 'requires a more general showing of the debtor's

financial condition and debt structure than merely establishing the existence of a few unpaid debts.'" *Id.* (quoting *In re Dill,* 731 F.2d 629, 632 (9th Cir.1984)). In making this determination, "courts compare the number of debts unpaid each month to those paid, the amount of the delinquency, the materiality of the non-payment, and the nature of the debtor's conduct of its financial affairs." *Id.* (quoting *General Trading Inc. v. Yale Materials Handling Corp.,* 119 F.3d 1485, 1504 n. 41 (11th Cir.1997).

10. The California Legislature's description is consistent with the bankruptcy interpretation of a debtor's general inability to pay debts as they become due:

> In determining whether a debtor is paying its debts generally as they become due, the court should look at more than the amount and due dates of the indebtedness. The court should also take into account such factors as the number of the debtor's debts, the proportion of those debts not being paid, the duration of the nonpayment, and the existence of bona fide disputes or other special circumstances alleged to constitute an explanation for the stoppage of payments. The court's determination may be affected by a consideration of the debtor's payment practices prior to the period of alleged nonpayment and the payment practices of the trade or industry in which the debtor is engaged. A presumption of insolvency does not arise from nonpayment of a debt as to which there is a genuine bona fide dispute, even though the debt is a substantial part of the debtor's indebtedness [(citing 11 U.S.C. § 303(h)(1))].

California Civil Code § 3439.02 Comment n. 3.

11. Similarly, the Judicial Council of California Jury Instruction on the presumption of insolvency provides that a "debtor who is generally not paying [its] debts as they become due, other than because of a legitimate dispute, is presumed to be insolvent." Judicial Council of California Civil Jury Instruction 4206, *Presumption of Insolvency* (Sept. 2018) (citing California Civil Code § 3439.02(b)). The instruction further provides that in determining whether a debtor was generally not paying its debts as they became due, juries may consider all the following factors:

(a) The number of [*name of debtor*]'s debts;

(b) The percentage of debts that were not being paid;

(c) How long those debts remained unpaid;

(d) Whether special circumstances explain any failure to pay the debts; and

> (e) [*Name of debtor*]'s payment practices before the period of alleged nonpayment [and the payment practices of [*name of debtor*]'s [trade/industry]].

Id. (brackets in original).

12. As discussed below, the court finds that Trustee has not proven by a preponderance of evidence that Debtor was insolvent under either (i) the balance sheet test or (ii) the equity or cash flow test. Moreover, Trustee has not proven by a preponderance of evidence that as early as October 2012, Debtor was no longer paying its debts as they came due. However, the court finds that Debtor was no longer paying its debts as they came due, and was therefore insolvent, as of June 1, 2013.

13. The balance sheet test to determine insolvency under California law mirrors the test for insolvency under the Bankruptcy Code. *See In re GSM Wireless, Inc.*, 2013 WL 4017123, at *18; *In re DAK Industries, Inc.*, 170 F.3d at 1199. Thus, the court incorporates its findings discussed above and finds that Trustee has not established insolvency by a preponderance of the evidence under the California law balance sheet test. Accordingly, the court will only address whether Trustee has proven that Debtor was insolvent under the "equity" or "cash flow" test under California law prior to the filing of the involuntary petition on June 19, 2013.

14. Trustee argues that "[t]here is clear evidence in the record by October 2012, the Debtor was not paying its debts as they came due and thus was insolvent under the cash flow test." *Plaintiff's Proposed Findings of Fact and Conclusions of Law,* ECF 139 at 24. Trustee asserts that there are seven facts that support his argument:

> (1) On October 6, 2011, Donshen made a formal request for adequate assurance of due performance on the Debtor after payments became more infrequent. Notwithstanding the later dispute and settlement agreement, the amounts due Donshen under the settlement agreement were never paid by the Debtor, and as of the filing of the involuntary bankruptcy petition, Donshen held a claim against the estate in the amount of $271,892.74. *See Proposed Findings of Fact DD-HH,*

Plaintiff's Findings of Fact and Conclusions of Law (citing *Stein Trial Declaration,* ¶ 5, 7, 9, 10 and 11; Plaintiff's Exhibit 125, Plaintiff's Exhibit 126, Plaintiff's Exhibit 127, Plaintiff's Exhibit 127B).

(2) By June 2012, the Debtor also began defaulting on payments to Kody more frequently. Kody also made an adequate assurance demand on June 17, 2013. After negotiations with the Debtor that spanned almost a year, Kody and the other petitioning creditors filed the involuntary petition. Kody now holds a $1 million unsecured claim against the estate. *See Proposed Findings of Fact II-MM, Plaintiff's Findings of Fact and Conclusions of Law* (citing *Trinh Trial Declaration,* ¶ 24; *Trinh Testimony, Trial Transcript, August 25, 2016* at 119, 122; Plaintiff's Exhibit 113, Plaintiff's Exhibit 117, Plaintiff's Exhibit 118, Plaintiff's Exhibit 22).

(3) By early 2012 the internal projections reflected losses ranging from $121,000 to $800,000 for year ended December 31, 2012. *See Proposed Finding of Fact Y, Plaintiff's Findings of Fact and Conclusions of Law* (citing *Grobstein Trial Declaration,* ECF 139, ¶¶ 37-40; Plaintiff's Exhibit 31, Plaintiff's Exhibit 326, Plaintiff's Exhibit 33, Plaintiff's Exhibit 34).

(4) The Debtor's records reflect emails from several vendors beginning late 2012 demanding payment of amounts they asserted were past due. *See Proposed Finding of Fact BB, Plaintiff's Findings of Fact and Conclusions of Law* (citing Plaintiff's Exhibit 114, Plaintiff's Exhibit 115, Plaintiff's Exhibit 116, Plaintiff's Exhibit 119, 121, 123).

(5) As of June 2012, the Debtor had fallen well short of its projections, and ultimately incurred a loss on a combined basis for 2012. *See Proposed Finding of Fact X, Plaintiff's Findings of Fact and Conclusions of Law* (citing *Grobstein Trial Declaration,* ECF 139, ¶¶ 34-36; Sharron *Testimony, Trial Transcript, August 26, 2016* at 36; *Wall Rebuttal Report,* Plaintiff's Exhibit 151 at 10; Plaintiff's Exhibit 29; Plaintiff's Exhibit 30).

(6) Sharron acknowledges that payment to vendors was often late but states that such deal was due to legitimate disputes. *See Proposed Finding of Fact AA, Plaintiff's Findings of Fact and Conclusions of Law* (citing *Sharron Trial Declaration,* ECF 139, ¶¶ 78-80; Sharron *Trial Testimony, Trial Transcript, August 25, 2016* at 72-74; *Sharron Trial Testimony, Trial Transcript, August 26, 2016* at 45).

(7) As of October 1, 2012, the Debtor's accounts payable totaled $1,423,219.48. Less than one-third of this amount ($456,880.05) was current. *See Proposed Finding of Fact Z, Plaintiff's Findings of Fact and Conclusions of Law* (citing *Grobstein Trial Declaration,* ECF 139, ¶ 33; Plaintiff's Exhibit 28).

Proposed Conclusion of Law, ¶ 10, Plaintiff's Proposed Findings of Fact and Conclusions of Law, ECF 139 at 24-25.

15. The court finds that the evidence is inconclusive and that Trustee has not proven by a preponderance of the evidence that, as of October 2012, Debtor was insolvent under the "equity" or "cash flow" test under California Civil Code § 3439.02. Trustee's assertions in his proposed Conclusion of Law, ¶ 10, were more anecdotal than analytical. As to the dispute with Donshen, Trustee uncritically accepted the assertions of Donshen's agent, Stein; and did not discuss the underlying transactional documents which permitted Debtor to withhold payment of the disputed payables pending the outcome of the mutually agreed to binding arbitration and the evidence of intellectual property infringement by Donshen's contractor in support of Debtor's arbitration request. *See Findings of Fact, ¶¶ 53-66, supra.* As to the dispute with Kody, Trustee merely adopted the conclusory assertion of Kody's agent, Trinh, that Debtor "began defaulting on payments to Kody more frequently" by June 2012. But in analyzing the payable amounts themselves, most of the payables owed by Debtor to Kody were current and slightly past due through March 2013, the course of conduct between Debtor and Kody indicates that Kody willingly accepted Debtor's orders without prepayment despite some late payments through May 2013, and if Kody had shipped as promised in May and June 2013, based on Sharron's projections based on

Debtor's AIMS reports, Debtor most likely would have been able to paid off the outstanding payables to Kody. *See Findings of Fact, ¶¶ 67-91, 100, 103-106, supra.* As to the large projected losses of up to $800,000 for the year ending December 31, 2012, and Debtor falling "well short of its projections" for 2012, Trustee did not acknowledge that Debtor only had a small loss of approximately $10,000 for that year, even on combined basis with Beyond Basics. *See Finding of Fact, ¶ 98, supra.*

16. As to Trustee's assertion that Debtor's records reflecting emails from several vendors beginning in late 2012 demanding payment of amounts they asserted were past due, the email messages cited in support of this assertion seem to be isolated examples and do not show a comprehensive pattern. *See* Trustee's Proposed Finding of Fact, ¶ BB (citing Plaintiff's Exhibits 114, 115, 116, 119, 121 and 123). The specifics relating to the amounts and aging of the payables in these email messages were not generally provided, so it was difficult for the court assess the magnitude and significance of these payables in terms of Debtor's overall payables. Plaintiff's Exhibit 114 was an email string from January 2013 relating to a payable to Total Logistics and Finishing, Inc. It did not indicate the amount or aging of the subject payable, but it did indicate that payment was delayed two weeks because Sharron (who signed Debtor's checks) was out of town on vacation and when he returned he directed Debtor's staff to make a wire transfer payment. Plaintiff's Exhibit 115 was an email string from January 2013 that contained a comment by Sharron that "biz sucks." However, the context of the email is not provided, i.e., whether Sharron was just expressing normal everyday frustrations or addressing a specific financial concern cannot be ascertained from this email string. Plaintiff's Exhibit 116 was an email string regarding an inquiry from CIT about Debtor's past due invoices in February 2013, but as discussed herein, CIT continued to provide factor financing through June 2013, and thus, apparently, Debtor had adequately responded to the inquiry, and Trustee provided no other evidence regarding this inquiry to show otherwise. Plaintiff's Exhibit 119 is an email string relating to a payable owing to Design Collection, but no information is provided regarding the amount or aging of the subject payable. Debtor's responses in the email string to the

request for payment indicates that Debtor had objections to late shipment and additional air freight costs by this vendor, which had not been resolved. Plaintiff's Exhibit 121 is an email string from March 2013 between Sharron and Debtor's controller stating, "Don't send any checks out unless absolutely necessary. The next three to four weeks will be extremely tight on cash. So we will have to pay some bills late that aren't urgent." However, Trustee did not provide the context for this email to show the financial condition of Debtor at the time, such as the overall payables and cash flow. Plaintiff's Exhibit 123 consists of an email string from May 2013 relating to payables to Apparel Projects Express, but the amounts totaling less than $13,000 are relatively small in comparison to the amount of business that Debtor was doing at the time, especially considering the amounts of the Kody orders, for example.

17. As to Debtor's payables as of October 1, 2012, Trustee asserts that less than one-third of the amount of payables of $1.4 million was current. However, as discussed in the court's analysis of the payables in Finding of Fact, ¶ 100, a majority of the payables, 63.9%, was either current or only slightly past due, 30 days or less, and most of the seriously past due payables (over 90 days) and moderately serious past due payables (61-90 days) was owed to Donshen, which was in bona fide dispute as discussed herein, and considering those payables in bona fide dispute, 86.8% of Debtor's total remaining payables were either current or slightly past due (i.e., 1-30 days). *See Finding of Fact 100.* Trustee's characterization of Debtor's payables as of October 1, 2012 does not give a complete picture of the state of Debtor's payables.

18. Regarding Trustee's reliance on evidence of Debtor's disputes with its major suppliers, Donshen and Kody, the court finds that Debtor was involved in two bona fide disputes, these disputes were with major suppliers, thereby impacting Debtor's ability to stay current on its debts, and Debtor generally made late payments on its debts in its ordinary course of business.

19. First, regarding Debtor's dispute with Donshen, on October 6, 2011, Donshen made a request for adequate assurance with respect to outstanding invoices. *Donshen*

Request for Adequate Assurance, Plaintiff's Exhibit 125. Debtor and Donshen eventually entered into a Settlement Agreement in early December 2012 after Debtor alleged that Donshen infringed on Debtor's intellectual property, which allegations are referred to herein as the IP Dispute. In the Settlement Agreement regarding the various disputes between Donshen and Debtor, Donshen and Debtor agreed to allow Debtor to withhold $300,000 in money owed to Donshen until Debtor had sufficient time to investigate the IP Dispute and to enter into binding arbitration to resolve the disputes if the parties were unable to resolve the IP Dispute through investigation. The parties went to arbitration as the Settlement Agreement provided because Debtor's investigation did not resolve the IP Dispute, but the arbitration was stayed by the filing of Debtor's bankruptcy case.

20. Debtor was also involved in several disputes with Kody, alleging in part that the merchandise Kody shipped to Debtor was of inferior quality. *Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 66-67; *Copy of Kody Dilution Report*, Defendants' Exhibit 522, (noting that "Kody cannot match color" for certain products). The court notes that Cathy Trinh, principal of Kody Branch, testified that there were no disputes over the quality of merchandise. *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 118. The court does not accord much weight to this testimony. Although Trinh testified that the disputes were not related to quality, Trinh later testified that she did not "remember the details" of the disputes between Debtor and Kody. *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 119. The court rejects Plaintiff's argument that the disputes with Donshen and Kody were manufactured by Debtor to avoid paying its past due invoices. If the disputes with Donshen had as little merit as Plaintiff suggests, Donshen would not have agreed to allow Debtor's holdback of the funds to pay the disputed invoices and to enter into binding arbitration resolve the disputes with Debtor. Although Trustee argues based on the trial testimony of Donshen's representative, Stein, that the IP Dispute was manufactured by Debtor to avoid paying Donshen's invoices for shipped goods, the evidence of the alleged infringement by Donshen's contractor, Almost Famous (i.e., the email message from Debtor's customer, Deb Shops, reporting the alleged infringement),

offered in this case is suggestive and warranted Debtor's investigation. The court finds that this evidence along with the other circumstances of the Donshen dispute, i.e., the parties' Settlement Agreement providing for the holdback and binding arbitration, indicates there was a good faith dispute regarding the Donshen invoices.

21. Similarly, Debtor's and Sharron's conduct related to Debtor's dispute with Kody based on the Kody Dilution Report involving $300,000 in disputed orders suggest that Debtor had a good faith dispute with Kody regarding product quality. In May 2013, Debtor made wire transfers totaling $512,000 to Kody and placed an additional $300,000 in an escrow account with the law firm Buchalter Nemer for Kody. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 103-104; *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 132-133 and 137; *Email between Lowell and Cathy at Kody, May 13, 2013, Defendants' Exhibit 528; Sharron Trial Declaration* at 25, ¶ 80. Debtor's payments to Kody in May 2013 suggest that Debtor was attempting to resolve its dispute with Kody in order to continue to operate. If Debtor did fabricate the dispute with Kody to avoid paying past due invoices, then Debtor's decision to wire $300,000 to Kody runs contrary to this purported motivation. The court finds that Sharron's decision to send fabricated proof of an additional $200,000 wire transfer to Kody is insufficient evidence that Debtor's dispute regarding product quality with Kody was manufactured. While this behavior of Sharron's regarding the fake wire transfer in isolation is bizarre and could plausibly support Plaintiff's theory, the theory is inconsistent with Debtor's wire transfer payments totaling $512,000 and its decision to transfer $300,000 to an escrow account that could be used to pay Kody. Moreover, Debtor's behavior also shows that neither Debtor nor Kody entirely trusted the other party, which would indicate the dispute was bona fide. Sharron testified at trial that he sent fake evidence of a wire transfer to Kody because of his distrust. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 106-107. Accordingly, the court finds that Debtor's dispute with Kody regarding product quality was in good faith. However, Debtor's product quality dispute with Kody may partially justify Debtor's nonpayment of past due invoices because the disputed invoices only total

$300,000 out of $1.2 million in past due invoices for goods purchased by, and delivered to, Debtor as reflected on the Kody Proof of Claim.

22. Second, Debtor's disputes with Kody impacted its ability to stay current on its accounts payables because Kody was its major supplier in 2013. That Kody was Debtor's largest supplier is not disputed. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 50-51. Because Kody was the largest supplier of Debtor, the disputes significantly affected Debtor's opportunity to operate. Without receiving merchandise from either supplier, Debtor was unable to fulfill its own orders and receive payment. *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 99:13-102:19 ("[Sharron:] [W]hen the largest supplier stops shipping, it immediately stops everything at the company from moving forward . . ."). Additionally, Hansen in her expert witness report states, "One of the main reasons that Debtor became insolvent is that Kody, one of Debtor's largest vendors, refused to ship its merchandise to Debtor to fulfill its backlog of customer orders in the beginning of 2013." *Hansen Rebuttal Report*, Defendants' Exhibit 541 at 8; *see also id*. at 11 ("Our opinion is Debtor was paying its debts as they became due unless those debts were the subject of a bona fide dispute as to liability or amount . . ."). The court finds Hansen's report credible on this fact. Accordingly, the court finds that Debtor's disputes with Kody contributed to Debtor's inability to pay its debts on time after Kody stopped shipping goods ordered by Debtor in late May 2013.

23. Third, the court notes that Debtor's failure to pay all its debts on time in part stems from Debtor's business model and how it conducted its business. At trial, Sharron testified that payments to Debtor's suppliers were often late because Debtor's employees would have to verify orders and check for other outstanding issues, and if the issues could not be resolved in time, then payments to the supplier would be late. *Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 51 ([Sharron:] "Yes, there were many payments that were not paid by the due date and we had – that was – that happened every week. I mean, that was unfortunately the nature of the business. There were discrepancies on purchase orders . . . [a]nd yes, if . . . you don't resolve the problem in time,

it becomes late . . . and you pay it when you resolve it."); *see also Sharron Trial Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 71. While Trinh testified that Debtor's business practice of making late invoice payments was not standard in the industry, Debtor regularly made late payments to Kody in its ordinary course of business as recognized by Trinh who testified that she did not consider the late payments to be "serious situations." *Trinh Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 110-111; *see also id.* at 109:7-13 ("[Defendants' counsel:] [U]p to say 2000—through the end of 2012 . . . was there anything unusual about . . . [K]ody's relationship with L Scott Apparel? [Ms. Trinh:] No, sir."). Accordingly, the court finds that Debtor's pattern of making late payments was in its ordinary course of business with Kody, its major supplier in 2012 and 2013, and that Kody was accustomed to receiving late payments until May 2013 when Kody changed its policy and practice as to Debtor and stopped shipping on Debtor's orders without payment in advance due to Debtor's failure to pay past due invoices. Thus, Debtor could no longer rely upon the lenient payment terms that Kody had previously allowed as its customary payment practice with Kody, or in general, because Kody at that time supplied 80 to 90% of Debtor's products. That is, in considering whether debtor is paying its debts generally as they become due, the court must consider the history of debtor's payment practices, such as its prior payment practices with Kody, and the change in practices. *See* California Civil Code § 3439.02 Comment n. 3.

24. It appears that when at the end of May 2013, Kody had stopped shipping the pending purchase orders, which it allowed Debtor to place without requiring prepayment, Kody was in technical breach of the contracts arising from Debtor's purchase orders that Kody had previously accepted. Kody decided not to ship on Debtor’s purchase orders due to Debtor’s past due invoices, which also indicates technical breaches of the purchase orders for payment 30, 45 or 60 days after shipment, which Kody had previously acquiesced in by accepting and shipping orders despite the past due invoices. Kody did not avail itself of its right to request adequate assurance until June 2013, after it decided not to ship to Debtor on the existing purchase orders. However, it is not for this court to determine which

party was more "at fault" in this dispute because the court, in recognizing the fact of Kody's not shipping Debtor's orders, determines that Debtor could no longer rely upon its past practice of relying upon Kody's acquiescence in shipping its orders based on delayed payment and could no longer count on the revenue in shipping orders fulfilled by Kody to its customers to generate the funds needed to pay its bills as they generally became due. Nevertheless, as discussed herein in Findings of Facts, ¶¶ 104-107, *supra*, based on the collection of Debtor's accounts receivable by CIT and Sharron and the gross profit projections based on Debtor's pending orders based on the AIMS reports, Debtor could have paid off the amounts owed to its creditors based on the allowed proof of claim amounts.

25. Finally, aside from the invoice disputes with Donshen and Kody, Debtor appears to have been current on its other obligations. Sharron testified that Debtor did not owe any money to employees, was not behind on insurance or rent payments, and was current on its payroll taxes at the time the involuntary bankruptcy petition was filed against Debtor. At least some evidence seems to support Sharron's testimony. See *Sharron Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 70-71; *see also Email Dated March 26, 2012*, Plaintiff's Exhibit 93 (email between Sharron and employee discussing the amount of money to be wired to meet payroll).

26. Based on the foregoing, the court finds Trustee has not established by a preponderance of the evidence that Debtor was insolvent under California law as of October 12, 2012, but that the preponderance of the evidence shows that debtor was not insolvent under California law until June 1, 2013 based on its inability to pay its debts generally as they became due.

B. <u>Plaintiff's Fraudulent Transfer Claims</u>

27. Trustee asserts claims against all defendants for avoidance and recovery of transfers: (1) made with actual fraudulent intent under 11 U.S.C. §§ 548(a)(1) and 550; (2) made with actual fraudulent intent under 11 U.S.C. § 544 and California Civil Code § 3439.04(a)(1); and (3) that were constructively fraudulent transfers under 11 U.S.C. § 544,

California Civil Code § 3439.04(a)(2), and California Civil Code § 3439.05. For the reasons explained below, the court finds that Trustee has not generally met his burden of proving that Defendants made transfers with actual fraudulent intent. However, Trustee has proven that Defendants engaged in certain transfers that were constructively fraudulent transfers because they came after the date of insolvency of June 1, 2013.

i. 11 U.S.C. §§ 548(a)(1) and 550 (Actual Fraud)

28. Under 11 U.S.C. § 548(a)(1)(A), the "trustee may avoid any transfer . . . of an interest of the debtor in property . . . that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which debtor was or became, on or after the date that such transfer was made or such obligation was incurred [or] indebted[.]" 11 U.S.C. § 548(a)(1)(A).

29. "It is often impracticable, on direct evidence, to demonstrate an actual intent to hinder, delay or defraud creditors. Therefore, . . . courts . . . frequently infer fraudulent intent from the circumstances surrounding the transfer, taking particular note of certain recognized indicia or badges of fraud." *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 805-806 (9th Cir. 1994). "Among the more common circumstantial indicia of fraudulent intent at the time of the transfer are: (1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and, after the transfer, (5) retention by the debtor of the property involved in the putative transfer." *Id*. at 806.

30. "The presence of a single badge of fraud may spur mere suspicion; the confluence of several can constitute conclusive evidence of actual intent to defraud, absent 'significantly clear' evidence of a legitimate supervening purpose." *Id*. (citations omitted).

31. The circumstances here indicate that Sharron did not cause Debtor to fraudulently transfer Debtor's funds with actual intent to hinder, delay, or defraud creditors. The court notes that at least one factor is present here. As a principal of Debtor, Sharron

caused the transfers from Debtor to himself and to Beyond Basics. His position as a director and officer of Debtor provided Sharron the ability to effectuate these transfers. Thus, a special relationship between Debtor and Sharron exists. However, Trustee has not established the existence of other indicia circumstantial of fraudulent transfers. There were disputes with Debtor's major suppliers, Donshen and Kody, but these disputes were occurring in December 2012, and the transfers to Sharron and Beyond Basics occurred both before and after December 2012. Because the transfers occurred before, during, and after the disputes, the disputes do not appear to have been an impetus for the transfers. Further, because the transfers occurred over an extended period, it does not appear that the transfers were made in response to the disputes. The court acknowledges that while the transfers from Debtor to others on behalf of Sharron and Beyond Basics represent significant sums, it is unclear whether these transfers constitute all or substantially all of Debtor's property. Trustee also did not establish Debtor's insolvency before June 1, 2013, shortly before the date of the filing of the involuntary bankruptcy petition against Debtor on June 19, 2013. Because the transfers Trustee seeks to avoid occurred before June 1, 2013, the insolvency factor is not circumstantial evidence of actual intent to defraud. As to the final factor, Debtor did not retain possession of the funds that were transferred. The funds were transferred to Sharron and Beyond Basics, not to a subsidiary or other Debtor-controlled entity, and are generally indicated as debt on the Due from Officer and Due from Beyond Basics Accounts. Further, the funds transferred appear to have been spent. Thus, Debtor did not retain possession. The court finds Debtor's documentation of the transfers in the Due from Officer Account and Due from Beyond Basics Account most indicative that Debtor did not act with actual intent to hinder, delay, or defraud creditors. If Debtor intended to so act, Debtor would have likely not documented where the funds were transferred, to whom the funds were transferred, when the funds were transferred, and the amounts of each transfer. Such transparency works against a finding of fraudulent intent. Detailed documentation of these transfers provides creditors a blueprint for recovery and makes it easier to track where the funds are located. For these reasons, as to the transfers made

before June 1, 2013, the court finds that Debtor did not engage in actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A) because Debtor did not act with actual intent.

32. However, the court determines that there may be two exceptions here as to payments by Debtor after the date of insolvency on June 1, 2013 for: (a) prepayment of the automobile installment loans on the automobiles driven by Sharron and his wife, which was for the personal benefit of Sharron; and (b) payment of business expenses of Beyond Basics.

a. As to the prepaid automobile loan payments of $15,259.02 in prepaid automobile loan payments made by Debtor on behalf of Sharron, the payment was made on June 12, 2013, after the date of insolvency, and Debtor did not receive reasonably equivalent value because the prepayment of the automobile loans was for the benefit of Sharron and not for the benefit of Debtor since there was no business purpose for use of the automobiles. However, Trustee has not demonstrated that Debtor made these transfers with actual fraudulent intent. Although Sharron had a sense of Debtor's financial peril at the time he prepaid the car payments, and this was perhaps the impetus for prepaying the loan, the court is not convinced on the record before it that these transfers were made with actual intent to hinder, delay, or defraud Debtor's creditors. The payments were of relatively small value and did not constitute a substantial portion of Debtor's assets. Moreover, it appears Debtor had regularly been making the payments for both Sharron's car and his wife's car, the only difference here was that Debtor prepaid for the last half of 2013.

b. As to the payment of business expenses of Beyond Basics in the amount of $8,131.09 by Debtor after the insolvency date of June 1, 2013, (i) the payment of the business expenses of Beyond Basics was for the benefit of Beyond Basics, and (ii) Debtor did not receive reasonably equivalent value for the transfer which was in effect a loan by Debtor to Beyond Basics reflected on the Due from Beyond Basics account by an entity, Beyond Basics, which had doubtful ability to

repay the loan. However, again, the evidence suggests a lack of fraudulent intent regarding the alleged fraudulent transfers because the transfers were made right after the date of insolvency, that is, days afterwards, and such transfers had been regularly made by Debtor before insolvency.

33. For these reasons, the court finds that Trustee failed to meet his burden in proving that certain transfers were made with actual fraudulent intent under 11 U.S.C. §§ 548(a)(1) and 550.

ii. 11 U.S.C. § 544 and California Civil Code § 3439.04(a)(1) (Actual Fraud)

34. Under California Civil Code § 3439.04(a)(1), "[a] transfer made or obligation incurred by a debtor is voidable as to a creditor . . . if the debtor made the transfer or incurred the obligation . . . [w]ith actual intent to hinder, delay, or defraud any creditor of the debtor."

35. "Bankruptcy courts examining transfers under [California Civil Code § 3439.04(a)(1)] must focus on the debtor's state of mind." *Ezra v. Seror (In re Ezra)*, 537 B.R. 924, 930 (9th Cir. BAP 2015). "As long as the debtor had the requisite intent, a transfer will qualify as actually fraudulent even if reasonably equivalent value was provided." *Id.* (citing *Wolkowitz v. Beverly (In re Beverly)*, 374 B.R. 221, 235 (9th Cir. BAP 2007)).

36. "Because direct evidence regarding the debtor's fraudulent or obstructive intent rarely is available, courts typically infer the debtor's intent from the surrounding circumstances." *In re Ezra*, 537 B.R. at 930. Courts often consider the following "badges of fraud" when deciding whether the requisite intent existed:

(1) Whether the transfer or obligation was to an insider.

(2) Whether the debtor retained possession or control of the property transferred after the transfer.

(3) Whether the transfer or obligation was disclosed or concealed.

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

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

(6) Whether the debtor absconded.

(7) Whether the debtor removed or concealed assets.

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

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

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

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

Id. "No single factor necessarily is determinative, and no minimum or maximum number of factors dictates a particular outcome. . . . [T]he list should not be applied formulaically. Instead, the trier of fact should consider all of the relevant circumstances surrounding the transfer." *Id*. (citations omitted).

37. For the reasons set forth above, the court similarly finds that Debtor did not engage in fraudulent transfers with actual intent to hinder, delay, or defraud creditors under California Civil Code § 3439.04(a)(1). First, turning to the payments by Debtor after the date of insolvency on June 1, 2013 for: (a) prepayment of the automobile installment loans on the automobiles driven by Sharron and his wife, which was for the personal benefit of Sharron; and (b) payment of business expenses of Beyond Basics, the court incorporates its findings above and again concludes that Debtor did not make the prepaid car loan payments or pay the Beyond Basics expenses with actual fraudulent intent. As for the remaining transfers identified by the Trustee that were made before the date of insolvency, Debtor did not abscond with assets, Debtor was not insolvent, Debtor did not conceal assets, threatened litigation does not appear to have influenced Debtor in making the transfers, and the transfers were not made shortly before or shortly after a substantial debt was incurred. It also does not appear that Debtor's essential assets were transferred. But as noted above, some indicia are present. Transfers were made on behalf of an insider and an entity that the insider controlled. In addition, assets—though not concealed—were removed from Debtor. However, the court again notes that Debtor's behavior does not indicate that Debtor was acting with actual intent to hinder, delay, or defraud when engaging in the transfers.

Debtor's documentation of the transfers in its Due from Officer Account and Due from Beyond Basics Account indicates that Debtor was not intending to hinder, delay, or defraud creditors. If Debtor intended to hinder, delay, or defraud its creditors, Debtor would not have remained transparent about the transfers, nor would Debtor have maintained careful documentation of each transfer. The court thus finds that Debtor did not act with actual intent to hinder, delay, or defraud creditors under California Civil Code § 3439.04(a)(1).

iii. California Civil Code § 3439.04(a)(2) (Constructive Fraud)

38. Under California law, a "transfer made or obligation incurred by a debtor is voidable as to a creditor . . . if the debtor made the transfer or incurred the obligation . . . [w]ithout receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) [w]as engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction[; or] (B) [i]ntended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due." California Civil Code § 3439.04(a)(2). "At its core, 'a constructive fraudulent transfer has two elements: reasonable equivalent value and insolvency.'" *Hoffman v. Adelman (In re SCI Real Estate Investments, LLC)*, 2013 WL 1829648, at *6 (Bankr. C.D. Cal. May 1, 2013) (quoting *Allstate Insurance Co. v. Countrywide Financial Corp.*, 842 F.Supp.2d 1216, 1224 (C.D. Cal. 2012)).

39. 11 U.S.C. § 544(b) "allows a bankruptcy trustee to avoid any transfer of a debtor's property that would be avoidable by an unsecured creditor under applicable state law." *In re AFI Holding, Inc.*, 525 F.3d 700, 703 (9th Cir. 2008). To invoke § 544(b) there need be only one creditor with any claim amount. *Id.*

40. The court finds that Trustee failed to establish that transfers made by Debtor before the insolvency date of June 1, 2013 were constructively fraudulent. The transfers to Sharron and Beyond Basics that Trustee seeks to avoid occurred beginning in January 1, 2011. As discussed earlier, Trustee has not established insolvency under the Bankruptcy Code before June 1, 2013, because Trustee's expert witness, Wall, did not value Debtor's

assets at fair market value. Thus, because Trustee's expert witness, Wall, did not properly value Debtor's assets, the court cannot ascertain based on his testimony whether, after the transfers, Debtor's remaining assets were unreasonably small in comparison to any business or transaction Debtor may have engaged in. The court further finds that Trustee has not established that Debtor intended to incur or reasonably should have known that any incurred debts would be beyond Debtor's ability to pay. The court recognizes that Debtor was making late payments to its largest suppliers, Donshen and Kody, but these late payments were not because Debtor was struggling to make payments, as explained above, the late payments were in the ordinary course of business for Debtor until May 2013. Debtor would often hold payments back while it inspected shipped merchandise and negotiated with vendors. Some late payments were also related to disputes between Debtor and Donshen and Kody. At one point, Debtor had entered into a settlement agreement resolving these disputes. Because these vendors were major suppliers of Debtor, it was not unreasonable for Debtor to believe it would be able to continue making payments once the disputes were resolved. Thus, Trustee has not established that Debtor intended to incur or reasonably should have known that any incurred debts would be beyond Debtor's ability to pay before June 1, 2013. Accordingly, Trustee did not meet his burden of establishing those transfers as constructively fraudulent under California Civil Code § 3439.04(a)(2).

41. However, as previously discussed, there may be two exceptions here as to payments by Debtor after the date of insolvency on June 1, 2013 for: (a) prepayment of the automobile installment loans on the automobiles driven by Sharron and his wife, which was for the personal benefit of Sharron; and (b) payment of business expenses of Beyond Basics.

a. As to the $15,259.02 in prepaid automobile loan payments made by Debtor on behalf of Sharron, the payment was made on June 12, 2013, after the date of insolvency, and Debtor did not receive reasonably equivalent value because the prepayment of the automobile loans was for the benefit of Sharron and not for the

benefit of Debtor since there was no business purpose for use of the automobiles. Accordingly, such transfers were constructively fraudulent because both elements are present: lack of reasonably equivalent value and insolvency.

b. Similarly, the payment by Debtor of $8,131.09 in business expenses of Beyond Basics after the insolvency date of June 1, 2013, (i) was for the benefit of Beyond Basics, and (ii) Debtor did not receive reasonably equivalent value for the transfer which was in effect a loan by Debtor to Beyond Basics reflected on the Due from Beyond Basics account by an entity, Beyond Basics, which had doubtful ability to repay the loan.

42. The court may order that a transfer avoided under 11 U.S.C. § 544 may be recovered from "the initial transferee of such transfer or the entity for whose benefit such transfer was made . . . ." 11 U.S.C. § 550(a)(1). The court finds that (i) the car loan prepayment transfers are recoverable from Sharron because those transfers were made for his personal benefit; and (ii) the payment of business expenses of Beyond Basics after June 1, 2013 are recoverable from Beyond Basics because Beyond Basics was the initial transferee.

iv. California Civil Code § 3439.05 (Constructive Fraud)

43. Under California Civil Code § 3439.05, "[a] transfer made or obligation incurred by a debtor is voidable as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation." The creditor bears the burden of proving these elements by a preponderance of the evidence. California Civil Code § 3439.05.

44. As set forth above, Trustee has not established that Debtor was insolvent under the Bankruptcy Code or that Debtor was insolvent under California's alternative equity or cash flow test for insolvency until June 1, 2013. Accordingly, none of the transfers that

predate Debtor's insolvency of June 1, 2013 are recoverable as constructively fraudulent transfers.

45. However, as discussed above, Trustee has established that the transfers for prepayment of the automobile installment loans and payment of business expenses of Beyond Basics were made after the insolvency date of June 1, 2013, and Debtor did not receive reasonably equivalent value. Accordingly, these transfers are also recoverable as constructively fraudulent under California Civil Code § 3439.05.

C. Plaintiff's Preference Claim

46. In his First Amended Complaint, Trustee alleges that "[O]n or about December 31, 2012, Debtor credited Sharron with the sum of $10,500 . . . for accrued interest on the Sharron Transfer." *First Amended Complaint*, ECF 64, ¶ 87. Trustee seeks that this transfer be avoided and recovered under 11 U.S.C. § 547. Neither Trustee nor Defendant addressed this claim in their respective Proposed Findings of Fact and Conclusions of Law. ECF 139 and ECF 149. Nonetheless, the court will briefly address this claim on its merits.

47. "Section 547(b) of the Bankruptcy Code allows a trustee to avoid transfers of the debtor's property made before the bankruptcy petition was filed." *Akers v. Koubourlis (In re Koubourlis)*, 869 F.2d 1319, 1321 (9th Cir. 1989). "For a trustee to avoid a transfer, five conditions must be met: (1) the transfer was made for the benefit of a creditor; (2) the transfer was for or on account of a debt owed before the debtor made the transfer; (3) the debtor was insolvent when the transfer was made; (4) the transfer was made during the ninety days immediately preceding the filing of the bankruptcy petition; and (5) the transfer enabled the creditor to receive more than he would otherwise have received from the bankruptcy estate." *Id*. (citations omitted). The preference period for an "insider" is extended to one year before the petition date. 11 U.S.C. § 547(b)(4)(B). The debtor is presumed to have been insolvent for the 90-day prepetition period, but this presumption period is not extended when the alleged preferential transfer was to an insider. *See* 11 U.S.C. § 547(f).

48. Here, the undisputed evidence indicates that the transfer, by virtue of a credit to Sharron on the Due from Officer Account, in the amount of $10,500 was on account of interest on the Subordinated Debt allegedly owed to Sharron. *Stipulated Fact (26), Joint Pretrial Stipulation,* ECF 97 at 4. As discussed in detail below, the court has determined that Trustee has proven his claim that the Subordinated Debt should be recharacterized as equity. Thus, the transfer at issue here was not on account of an antecedent debt for the benefit of a creditor because it was a distribution to equity, that is, a dividend or other distribution to Sharron as a shareholder. Therefore, the transfer was not a preferential transfer within the meaning of 11 U.S.C. § 547. Accordingly, the court finds that Trustee is not entitled to recover on his claim under 11 U.S.C. § 547(b).

D. Claim for Breach of Fiduciary Duty

49. "Claims involving 'internal affairs' of corporations, such as the breach of fiduciary duties, are subject to the laws of the state of incorporation." *Davis & Cox v. Summa Corp*., 751 F.2d 1507, 1527 (9th Cir. 1985), *superseded on other grounds by* 28 U.S.C. § 1961. California law governs here because Debtor is incorporated in California. *Stipulated Fact (4), Joint Pretrial Stipulation*, ECF 97 at 2 ("Articles of incorporation for Debtor were filed with the California Secretary of State on May 15, 2001, per corporate file no. C2343950"); *Letter from Crystal Zarpas to L. Sharron with attachments*, Plaintiff's Exhibit 1.

50. "California courts have recognized that 'all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of its creditors.'" *Nahman v. Jacks (In re Jacks)*, 266 B.R. 728, 736 (9th Cir. BAP 2001) (quoting *Saracco Tank & Welding Co., Ltd. v. Platz,* 65 Cal.App.2d 306, 315 (1944)). "[R]ecovery for breaching the fiduciary duties imposed under the trust-fund doctrine in California generally pertains to cases where the directors or officers of an insolvent corporation have diverted assets of the corporation for the benefit of insiders or preferred creditors." *Berg & Berg Enterprises, LLC v. Boyle*, 178 Cal.App.4th 1020, 1040-1041 (2009) (citation and internal quotation marks omitted). "[T]he doctrine is not applied to create a duty owed by directors

to creditors solely due to a state of corporate insolvency." *Id*. at 1041. Rather, "[a]pplication of the doctrine requires . . . that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims." *Id*.

51. Trustee contends that once Debtor became insolvent, Sharron, as an officer of Debtor, had a fiduciary duty to not divert Debtor's assets to the detriment of Debtor's creditors. Trustee asserts that the transfers between Sharron and Debtor, and the transfers Sharron effected from Debtor to Beyond Basics, were "clearly unfair to the Debtor" and "in violation of [Sharron's] fiduciary duties." *Plaintiff's Trial Brief*, ECF 111 at 20. Trustee's contention that an officer of an insolvent corporation has a fiduciary duty to creditors to not divert assets is correct. *Berg & Berg Enterprises, LLC v. Boyle*, 178 Cal.App.4th at 1040-1041 (observing that in case of corporate insolvency, consistent with *Pepper v. Litton,* 308 U.S. 295, 306-307 (1939), the California courts "apply the 'trust fund doctrine' where 'all of the assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of all creditors' in order to satisfy their claims").

52. In *Berg & Berg Enterprises, LLC v. Boyle,* the court stated that based on "trust fund doctrine" long established in California, "under the current state of California law, there is no broad, paramount duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency . . . . We accordingly hold that the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, *to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claim.* This would include acts that involve self-dealing or preferential treatment of creditors." 178 Cal.App.4th at 1041 (emphasis in original). The court further observed that "because all the California cases applying the trust-fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold that there is no fiduciary

duty prescribed under California law that is owed to creditors solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency." *Id*.

53. In order for the court to find that Sharron breached his fiduciary duty to Debtor's creditors, Trustee must establish that Debtor was insolvent at the time of the transfers. The transfers at issue occurred up until the involuntary petition date of June 19, 2013, and none of the alleged transfers occurred after the filing of the involuntary petition. As discussed earlier, Trustee did not establish Debtor's insolvency before June 1, 2013 because (i) his expert witness failed to value Debtor's assets at fair market valuation, and (ii) Trustee otherwise did not prove that Debtor was not paying its debts as they came due before June 1, 2013. Thus, because Trustee failed to establish Debtor's insolvency before June 1, 2013, the court finds that Sharron owed no fiduciary duty to Debtor's creditors under the trust fund doctrine until that date. There can be no breach of fiduciary duty if no such duty existed. Accordingly, the court finds that Sharron did not breach a fiduciary duty to Debtor's creditors and is not liable for the amount of the transfers under this this theory, except for the transfers after the date of insolvency of Debtor determined to be by the court on June 1, 2013.

54. The post-June 1, 2013 transfers by Debtor that Sharron caused include: (1) payment to prepay automobile loan obligations due monthly for the Audi and Cadillac automobiles driven by Sharron and his wife of $15,259.02 on June 12, 2013; and (2) payments of Beyond Basics expenses on June 4 and 14, 2013 totaling $8,131.09 for a supplier invoice and online telephone service charges. As stated above, the prepaid automobile loan payments were for automobiles driven by Sharron and his wife for their personal use and not for a business purpose of Debtor, and thus, not for the benefit of Debtor. Accordingly, the court finds that such payments by Debtor caused by Sharron after Debtor became insolvent on June 1, 2013 were a diversion or dissipation of corporate assets which could have been used to pay creditors' claims in violation of Sharron's fiduciary duty to creditors of Debtor under the "trust fund doctrine." Moreover, the payments by Debtor of business expenses of Beyond Basics, a separate business entity

primarily owned by Sharron, was not for the benefit of Debtor. Thus, the court finds that such payments by Debtor caused by Sharron after Debtor became insolvent on June 1, 2013 were a diversion or dissipation of corporate assets which could have been used to pay creditors' claims in violation of Sharron's fiduciary duty to creditors of Debtor under the "trust fund doctrine."

55. California Corporations Code § 309(a) codifies the "Business Judgment Rule," which "refers to a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions." *Gaillard v. Natomas Co.*, 208 Cal.App.3d 1250, 1263-1264 (1989). "[T]he common law rule 'has two components—one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest . . . Only the first component is embodied in Corporations Code section 309.'" *Berg & Berg Enterprises, LLC v. Boyle*, 178 Cal.App.4th at 1045 (quoting *Lee v. Interinsurance Exchange*, 50 Cal.App.4th 694, 714 (1996)). The court in *Berg & Berg Enterprises, LLC* further explained as follows:

> The broader rule is a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions. It is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes. The rule establishes a presumption that directors' decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest.
>
> An exception to the presumption afforded by the business judgment rule accordingly exists in circumstances which inherently raise an inference of conflict of interest and the rule does not shield actions taken without reasonable inquiry, with improper motives, or as a result of a conflict of interest. But a plaintiff must allege sufficient facts to establish these exceptions. To do so, more is needed than conclusory allegations of improper motives and conflict of interest. Neither is it sufficient to generally allege the failure to conduct an active investigation, in the absence of (1) allegations of facts which would reasonably call for such an investigation, or (2) allegations of facts which would have been discovered by a reasonable investigation and would have been material to the questioned exercise of business judgment. In most cases, the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts, which, if proven, would establish fraud, bad

> faith, overreaching or an unreasonable failure to investigate material facts. Interference with the discretion of directors is not warranted in doubtful cases.

Berg & Berg Enterprises, LLC v. Boyle, 178 Cal.App.4th at 1045-1046 (internal citations and quotations omitted).

56. The court finds that the business judgment rule does not protect Sharron for transfers made after the date of insolvency. Once Debtor became insolvent on June 1, 2013, Sharron as a corporate director also had to consider the interests of creditors under the business judgment rule. While the business judgment rule protects him while Debtor was solvent (as to payment of the loans for the purchase by Debtor of the automobiles driven by him and his wife for their personal use and payments of the debts of Beyond Basics, his other business, with which Debtor was doing business), these transfers do not reflect sound business judgment of a corporate director when there is no benefit for Debtor as the corporation. Accordingly, Sharron is liable on the claim for breach of fiduciary duty for the post-insolvency transfers after June 1, 2013.

E. <u>Claim for Corporate Waste</u>

57. "Claims of corporate waste in California are based upon Delaware state law." *AWTR Liquidation Trust v. 2100 Grand LLC (In re AWTR Liquidation)*, 548 B.R. 300, 340 (Bankr. C.D. Cal. 2016) (citing *Swingless Golf Club Corp. v. Taylor*, 679 F.Supp.2d 1060, 1070 (N.D. Cal. 2008)). The elements of a claim of corporate waste are as follows:

> To recover on a claim of corporate waste, [a claimant] must shoulder the burden of proving that the exchange was so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. *See In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006) (A claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets. This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose.).

Id. at 340-341 (quoting *Swingless Golf Club Corp. v. Taylor*, 679 F.Supp.2d at 1070).

58. However, because Sharron effectively owned all of Debtor's shares, Sharron's transfers between himself and Debtor, and between Debtor and Beyond Basics, do not give rise to a cause of action for corporate waste. *See Miller & Lux, Inc. v. Anderson*, 318 F.2d 831, 838 (9th Cir. 1963) ("That a corporation is hurt, or destroyed, by the intended conduct

of the owners of its shares, gives rise to no legal claims, either in the shareholders, or in the corporation as a legal entity."); *see also Stipulated Fact (9), Joint Pretrial Stipulation*, ECF 97 at 3 ("At the time of the filing of the involuntary bankruptcy petition on June 19, 2013, Debtor's stock was owned 95% by Sharron, 2.5% by the Sharron Family Trust, and 2.5% by the Sharron/Bialson Revocable Living Trust.").

59. Moreover, even if Sharron was not the owner of Debtor's shares, his conduct does not rise to the level necessary for a finding of corporate waste. This was not like the "rare, unconscionable case where directors irrationally squander or give away corporate assets." *See In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 74 (Del. 2006) (citation omitted). Although transfers were made from Debtor to Sharron and Beyond Basics, these transfers were not gifts. Debtor maintained two separate accounts, the Due from Officer Account and Due from Beyond Basics Account. These accounts not only documented Debtor's transfers, but also represented Debtor's expectation that the funds reflected in these accounts would eventually be returned to Debtor. If Debtor did not have an expectation that these funds would be repaid, Debtor would not have maintained accounts documenting these transfers. Sharron's history of paying back sums to Debtor on the amounts reflected in the Due from Officer Account confirms this understanding. Regarding Beyond Basics, Sharron testified that he "truly believed" Beyond Basics would become profitable and ultimately pay off its debt to Debtor. *Sharron Trial Declaration*, ECF 100, ¶ 60. For this reason, it does not appear that Debtor was "irrationally squander[ing] or giv[ing] away corporate assets." *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 73 (Del. 2006). Nonetheless, for the reasons explained above, the court finds that there is no corporate waste because Sharron effectively owned all of Debtor's shares.

F. Equitable Subordination

60. "The subordination of claims based on equitable considerations generally requires three findings: '(1) that the claimant engaged in some type of inequitable conduct, (2) that the misconduct injured creditors or conferred unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the Bankruptcy Code.'" *Henry v.*

Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.), 471 F.3d 977, 1006 (9th Cir. 2006) (citing *Feder v. Lazar (In re Lazar)*, 83 F.3d 306, 309 (9th Cir. 1996)). "In order to justify equitable subordination, the court is required to make specific findings and conclusions with respect to each of the requirements." *In re Lazar*, 83 F.3d at 309.

61. Trustee argues that when a claim for equitable subordination is asserted against an insider, "the burden shifts to the insider to prove the transaction's fairness once the plaintiff presents material evidence of inequitable conduct." *Plaintiff's Trial Brief*, ECF 111 at 27. Thus, because Sharron is an insider and because Trustee has presented evidence of inequitable conduct, Sharron carries the burden of proving the fairness of the transfers to himself and Beyond Basics. Trustee relies on *Stoumbos v. Kilimnik*, 988 F.2d 949, 958 (9th Cir. 1993) for the assertion that an insider bears the burden of proving the fairness of the transaction. The court notes that the Ninth Circuit does not appear to expressly state that the burden shifts when the conduct of an insider is at issue, instead stating, "[w]hen the trustee seeks to subordinate the claim of a creditor the trustee must present evidence of the creditor's unfair conduct. If the trustee meets this burden, 'the claimant then must prove the fairness of his transactions with the debtor or his claim will be subordinated.'" *Id*. Nonetheless, at least some courts in this circuit and a secondary source share Trustee's interpretation. *See, e.g., Gladstone v. McHaffie (In re UC Lofts on 4th, LLC)*, 2014 WL 1285415, at *20 (Bankr. S.D. Cal. 2014) (citing *Stoumbos v. Kilimnik*, 988 F.2d at 958); 3 March, Ahart, & Shapiro, *Rutter Group California Practice Guide: Bankruptcy*, ¶ 17:1602 at 17-221 (2018) ("If the party seeking subordination of an insider's claim presents material evidence of unfair conduct, the burden shifts to the insider to prove the fairness of the transactions with the debtor . . . . [W]here claimant is an insider or fiduciary, trustee bears burden of presenting material evidence of unfair conduct; once trustee meets its burden, claimant must prove fairness of his or her transactions with debtor or claim will be subordinated"). Accordingly, if Trustee presents material evidence of unfair conduct, Sharron must prove that the transfers to himself and Beyond Basics were fair. Trustee is correct that Sharron's conduct faces higher scrutiny because he is an insider.

Stoumbos v. Kilimnik, 988 F.2d at 959 ("Where the trustee seeks to subordinate 'a claim arising from the dealings between a debtor and an insider,' the court will give the insider's actions rigorous scrutiny."). But Trustee has not presented *material* evidence of unfair conduct. As discussed earlier, subject to the narrow exception described above, Trustee did not provide sufficient evidence that Sharron's transfers were fraudulent transfers, that Sharron committed corporate waste, or that Sharron breached a fiduciary duty. Because Trustee did not provide material evidence, the burden does not shift to Sharron, and Sharron need not prove the fairness of the transactions.

62. As to the first element, the court finds that Trustee has failed to meet his burden of proving by a preponderance of the evidence that Sharron has engaged in any inequitable conduct. As previously discussed, because Trustee has failed to prove Debtor's insolvency before June 1, 2013, Trustee has also failed to prove that Sharron engaged in fraudulent transfers before that date. Moreover, the constructively fraudulent transfers described above represent a relatively small amount of money, and the court has found that Sharron effected these transfers without actual fraudulent intent. In addition, because Sharron effectively owned all of Debtor's shares, Sharron's transfers of Debtor's assets to Beyond Basics give no rise to a cause of action for corporate waste. *See Miller & Lux v. Anderson*, 318 F.2d at 838. Finally, because Trustee did not prove Debtor's insolvency until June 1, 2013, late in the period at issue in this case, Sharron owed no fiduciary duty to Debtor's creditors until that late date. In other words, Sharron did not and could not breach his fiduciary duty to Debtor's creditors because no such duty arose under the trust fund doctrine until June 1, 2013. Trustee argues that "three major categories of inequitable conduct are: '(1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant's use of the debtor as a mere instrumentality or alter ego.'" *Plaintiff's Trial Brief*, ECF 111 at 35 (citing *Blasbalg v. Tarro (In re Hyperion Enterprises)*, 158 B.R. 555, 560 (D. R.I. 1993)). Although Trustee cites to no binding authority from the Ninth Circuit for this proposition, the court will address his argument. As discussed above, Trustee failed to prove Sharron's breach of fiduciary duty to Debtor until the late date of June 1, 2013,

involving relatively small amounts totaling approximately $25,000. Trustee also did not allege that Sharron engaged in any illegal conduct or fraud. Thus, Trustee did not prove the first category of inequitable conduct for equitable subordination. Similarly, there is insufficient evidence that Beyond Basics was undercapitalized, and the analysis by Plaintiff's expert witness, Wall, of Beyond Basics's operating losses does not change this conclusion. *See Wall Expert Report*, Plaintiff's Exhibit 148 at 22-23; *Wall Rebuttal Report*, Plaintiff's Exhibit 151 at 2. But even if Beyond Basics was undercapitalized, undercapitalization alone cannot establish inequitable conduct. *See Wood v. Richmond (In re Branding Iron Steak House)*, 536 F.2d 299, 302 (9th Cir. 1976) ("subordination requires some showing of suspicious, inequitable conduct beyond mere initial undercapitalization of the enterprise"). Finally, as set forth in detail below, Trustee failed to prove that Sharron used Debtor as a mere instrumentality or alter ego. In short, Sharron's conduct does not rise to the level necessary for equitable subordination. "The burden of establishing equitable subordination is very heavy. For example, even aiding and abetting fraud does not necessarily establish grounds for equitable subordination." *In re AWTR Liquidation, Inc.*, 584 B.R. at 342 (citation omitted). Although the court determines that Trustee is entitled to relief against Sharron for constructive fraudulent transfers and breach of fiduciary duty, the conduct involved relatively small amounts totaling $25,000 late in the time period at issue, the disputed transfers resulting in partial liability occurred less than two weeks after the date that the court now determines that Debtor became insolvent on June 1, 2013, and the transfers were part of Debtor's routine course of conduct that occurred in its business before Debtor's insolvency. Thus, the court determines that such minor conduct involving relatively small amounts do not give rise to an equitable subordination against Sharron. For these reasons, the court finds that Trustee did not prove the first element required for equitable subordination.

63. As to the second element, while arguably Sharron's conduct causing Debtor's transfers may have resulted in injury to Debtor's creditors, Trustee failed to establish that Debtor's transfers were actually fraudulent transfers or that Sharron committed corporate

waste. Even though the court has found that the transfers after June 1, 2013 were constructively fraudulent and a breach a fiduciary duty to creditors under the trust fund doctrine, those two exceptions represented a relatively small amount (approximately $25,000). Injury alone is insufficient for equitable subordination—all three elements must be established. *In re First Alliance Mortgage Co.*, 471 F.3d at 1006. Because the court finds that Trustee did not satisfy the first element of equitable subordination, the court finds that Trustee cannot establish the second element, as Trustee must prove that Sharron's misconduct caused the injury. Accordingly, the court finds that Trustee does not satisfy the second element.

64. The third element for equitable subordination requires that the subordination not be inconsistent with the Bankruptcy Code. *Id*. For the reasons discussed earlier, the court finds that because Trustee has not met the other elements required for equitable subordination, he cannot meet the test for equitable subordination regardless of whether he can establish the third element.

65. Based on the foregoing, the court finds that Trustee has not established the required elements for equitable subordination and declines to equitably subordinate Sharron's claim.

G. Plaintiff's Alter Ego Claims

66. Trustee alleges that Beyond Basics is the alter ego of Sharron, and as a result, the corporate identity of Beyond Basics should be disregarded such that Sharron is personally liable for the amounts owing on the Due from Beyond Basics Account.[7] *Legal Issues (10)(iii), (11)(iii), Joint Pretrial Stipulation*, ECF 97 at 37-38; *Plaintiff's Proposed Findings of Fact and Conclusions of Law*, ECF 139, ¶¶ 26-32.

[7] Trustee originally also alleged that Debtor was the alter ego of Sharron and of Beyond Basics. *See Legal Issues (5), (10)(iii), (11)(iii), Joint Pretrial Stipulation*, ECF 97 at 35, 37, 38. However, Trustee later abandoned these claims and limited the alter ego allegations to the question of whether the corporate identity of Beyond Basics should be disregarded to hold Sharron personally liable for the amounts owing on the Due from Beyond Basics Account. *See Plaintiff's Trial Brief*, ECF 111 at 22-24; *Plaintiff's Proposed Findings of Fact and Conclusions of Law*, ECF 139, ¶¶ 26-32; *Transcript of December 15, 2016*, ECF 166 at 149-150.

67. "Ordinarily, a corporation is regarded as a legal entity, separate and distinct from its stockholders, officers and directors, with separate and distinct liabilities and obligations." *Sonora Diamond Corp. v. Superior Court*, 83 Cal.App.4th 523, 538 (2000). "The same is true of a limited liability company (LLC) and its members and managers." *Curci Investments, LLC v. Baldwin*, 14 Cal.App.5th 214, 220 (2017). "That legal separation may be disregarded by the courts 'when [a corporation or LLC] is used [by one or more individuals] to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose." *Id.* (quoting *Sonora Diamond Corp v. Superior Court.*, 83 Cal.App.4th at 538) (alterations in original). "In those situations, the corporation's or LLC's actions will be deemed to be those of the persons or organizations actually controlling the corporation, in most instances the equitable owners. . . . The alter ego doctrine prevents individuals or other corporations from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds." *Id.* (internal citations and quotations omitted).

68. "The basic rule stated by [the] Supreme Court [of California] as a guide in the application of [the alter ego] doctrine is as follows: The requirements are (1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow." *Associated Vendors, Inc. v. Oakland Meat Co*., 210 Cal.App.2d 825, 837 (1962) (citing *Automotriz Del Golfo de California S.A. de C.V. v. Resnick*, 47 Cal.2d 792, 796 (1957)). "Before a corporation's acts and obligations can be legally recognized as those of a particular person, and vice versa, it must be made to appear that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of such person and corporation has ceased, and that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice." *Id*.

69. "The first requirement for disregarding the corporate entity under the alter ego doctrine—whether there is sufficient unity of interest and ownership that the separate personalities of the individual and the corporation no longer exist—encompasses a series of factors." *Misik v. D'Arco*, 197 Cal.App.4th 1065, 1073 (2011). Factors suggesting an absence of separate personalities of the individual and the corporation include:

> (i) commingling of funds and other assets and failure to segregate funds of the separate entities;
>
> (ii) the treatment by an individual of the assets of the corporation as his own;
>
> (iii) the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; and
>
> (iv) the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets between entities so as to concentrate the assets in one and the liabilities in another.

In re Schwarzkopf, 626 F.3d 1032, 1038 (9th Cir. 2010) (quoting *Associated Vendors, Inc. v. Oakland Meat Co*., 210 Cal.App.2d at 838-840 (setting forth a list of non-exhaustive factors courts have used)) (internal quotations and alterations omitted).[8] "No one characteristic governs, but the courts must look at all the circumstances to determine whether the doctrine should be applied." *Sonora Diamond Corp. v. Superior Court*, 83 Cal.App.4th at 539.

70. Here, the narrow issue before the court is whether there is a sufficient unity of interest and ownership *between Beyond Basics and Sharron* such that the separate personalities of Beyond Basics and Sharron no longer exist. If so, the court must determine whether an inequitable result would follow if the acts of Beyond Basics are treated as those of Beyond Basics alone. If the answer to both questions is yes, then the corporate identity of Beyond Basics must be disregarded and Sharron held personally liable for the amounts owing on the Due from Beyond Basics Account. As discussed below, the court finds that there is not a sufficient unity of interest and ownership between Beyond Basics and

[8] *Associated Vendors* sets forth an extensive list of non-exhaustive factors, many of which are not relevant here. *See Associated Vendors, Inc. v. Oakland Meat Co*., 210 Cal.App.2d at 838-840.

Sharron, and even if there were, preserving Beyond Basics's corporate veil would not lead to an inequitable result.

71. Trustee asserts that the following facts and allegations prove a unity of interest between Sharron and Beyond Basics:

a. Sharron is the majority owner of Beyond Basics and it is undisputed that he controlled all financial decisions in Beyond Basics.

b. Sharron used his position as the sole director and officer and majority shareholder of Debtor to cause Debtor to advance funds and contribute its own employees' labor with a value of in excess of $500,000 toward Beyond Basics' operations.

c. Sharron caused Debtor to fund his $50,000 initial capital contribution and his additional $22,500 capital contribution to Beyond Basics.

d. Even though Debtor funded the capital contributions, Sharron (not Debtor) was the member of Beyond Basics.

e. Debtor's books were manipulated so that even though Debtor advanced Sharron's capital contribution, it saw no benefit from that.

f. Beyond Basics' books were manipulated to Sharron's benefit by shifting $40,000 from the Due from Beyond Basics Account to the Due from Officer Account, so that Sharron could increase his tax loss.

g. Beyond Basics was treated by Debtor's accountant as a "variable interest entity" under GAAP, i.e., an entity that was totally reliant on Debtor for its survival, and that survival in turn rested on Sharron's willingness to continue to "feed the beast."

h. Sharron leaned on his partner at Beyond Basics for her to give up her share of the tax losses so that Sharron could take them all.

i. Beyond Basics was woefully undercapitalized and without any assets of its own.

j. Beyond Basics was never profitable.

k. Sharron did not expect to be repaid by Beyond Basics until it became profitable, even though he knew at the outset Beyond Basics was a "risky venture."

l. Sharron controlled the resources given to Beyond Basics by Debtor and whether Beyond Basics would repay the amounts owing to Debtor.

See Plaintiff's Trial Brief, ECF 111 at 23-24.

72. The court has considered the facts and circumstances of this case and the relevant factors and finds that any unity of interest and ownership between Sharron and Beyond Basics does not undermine their separate personalities. There is no evidence that Sharron diverted Beyond Basics's funds for non-corporate use. The court acknowledges

that Sharron "used" the tax attributes of Beyond Basics because he claimed its tax losses as his own, but this is not probative because income and losses of a pass-through tax entity like Beyond Basics, a limited liability company, "pass through" to its members, i.e., Sharron, and are not really "assets" of the entity. *Sharron Testimony, Trial Transcript of August 19, 2016*, ECF 135 at 42-47; *id*. at 50; *Email String from Lowell Sharron to Jamara Ghalayini regarding 2012 Beyond Basic taxes*, Plaintiff's Exhibit 98; *Email String from Z. Kabani to Lowell Sharron re Beyond Basics Draft Financial Statements*, Plaintiff's Exhibit 91, *Beyond Basics Partnership Returns*, Plaintiff's Exhibits 110A, 110B, 110C, and 110D; *see also* Fotenos and Rybka, *Rutter Group California Practice Guide: Pass-Through Entities,* ¶ 8:401 *et seq.* (online ed. April 2018 update) ("One of the benefits of operating a business through a pass-through entity [i.e., partnership and limited liability companies] is the potential of using such losses to offset the members' or partners' income from *other* sources, a benefit not available to C corporation shareholders.") (emphasis in original). But aside from these instances, Trustee presented no further evidence that Sharron commingled Beyond Basics's assets with his own. There is also no evidence that Sharron and Beyond Basics used the same bank accounts or that Beyond Basics's proceeds funded any of Sharron's personal expenses. Sharron also "did not personally own any inventory" of Beyond Basics. *Stipulated Fact (56), Joint Pretrial Stipulation*, ECF 97 at 7. Trustee does not allege, nor is there evidence, that Sharron represented he was personally liable for any debts Beyond Basics incurred. There is also no evidence that Sharron was using Beyond Basics to shield himself from personal liability, that Beyond Basics was being used to conduct illegal activity, or that Beyond Basics was formed so that Sharron or Debtor could transfer liability to it. Sharron did not have sole ownership of Beyond Basics and did not conceal his ownership interest in Beyond Basics or the business activity of Beyond Basics. Beyond Basics observed corporate formalities. Beyond Basics had its own attorneys, it obtained a seller's permit, Defendants' Exhibit 516, it had its own articles of organization, Defendants' Exhibit 517, an operating agreement, Defendants' Exhibit 518, and a non-competition agreement, Defendants' Exhibit 519, and it conducted business under its own fictitious business name,

"Daily Threads." *Sharron Trial Declaration*, ECF 100, ¶¶ 64-68; Defendants' Exhibits 516-518; *Stipulated Facts (52) and (53), Joint Pretrial Stipulation*, ECF 97 at 7. Trustee did not show that Beyond Basics was undercapitalized—in fact, Beyond Basics received funding from Debtor on Sharron's behalf, which was reflected on the Due from Officer Account and on which Sharron admits he is liable. *Kabani Testimony, Trial Transcript of August 25, 2016*, ECF 136 at 147-148. Finally, Beyond Basics was not being used as a conduit to continue to conduct Sharron's and Debtor's businesses. For these reasons, the court finds that there is an insufficient unity of interest between Sharron and Beyond Basics to support an alter ego finding.

73. Because Sharron is the controlling shareholder of Debtor and owns Debtor's shares, Trustee argues in part that the unity of interest between Debtor and Beyond Basics is evidence of a unity of interest between Sharron and Beyond Basics. *Plaintiff's Trial Brief*, ECF 111 at 23-24 ("Sharron used his position as the sole director and officer and majority shareholder of Debtor to cause Debtor to advance funds and contribute its own employees' labor . . . toward Beyond Basics' operations . . . Even though Debtor funded the capital contributions, Sharron was the member of Beyond Basics . . . Debtor's books were manipulated so that even though Debtor advanced Sharron's capital contribution, it saw no benefit from that . . . Beyond Basics was treated by Debtor's accountant as a 'variable interest entity' under GAAP i.e. an entity that was totally reliant on Debtor for its survival . . ."). The court rejects Trustee's contention. The evidence suggests that Beyond Basics and Debtor were intended to remain separate.

74. To Trustee's point, although Sharron's ownership interests in both Debtor and Beyond Basics are not identical, Sharron effectively wielded control over both entities because he was a majority shareholder of Debtor and a majority member of Beyond Basics. *See Stipulated Facts (9) and (54), Joint Pretrial Stipulation*, ECF 97; *Limited Liability Company Operating Agreement—Beyond Basics* at Exhibit A, Plaintiff's Exhibit 75. It appears that Beyond Basics was reliant on Sharron directing Debtor to fund its operations. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 240-241; *Email string*

from Jamara Ghalayini to Lowell Sharron re Capital Call Notice, Plaintiff's Exhibit 86. Debtor was still receiving funding from its factor, CIT, under the factoring agreement, and appears to have provided some of this financing to Beyond Basics, such that Beyond Basics was not a mere shell and did not lack corporate assets. *Hansen Rebuttal Report*, Defendants' Exhibit 541 at 9 ("Debtor had availability in its credit line and was in great standing with its CIT factoring agreement. CIT never contended that Debtor was insolvent in 2012. [Debtor] could have made advances from its credit line to increase working capital if needed.").

75. On the other hand, Debtor and Beyond Basics were clearly separate entities. As discussed above, Beyond Basics observed corporate formalities. Additionally, Beyond Basics and Debtor had different attorneys. *Sharron Trial Declaration*, ECF 100, ¶¶ 64, 67. Debtor's board of directors consisted of Sharron and his parents, while Beyond Basics' membership was Sharron, Maren Ghalayini, and Riad Ghalayini. *Sharron Trial Declaration*, ECF 100, ¶¶ 64, 68. Although Beyond Basics conducted business in the juniors clothing segment like Debtor, Beyond Basics' products were intended to serve a more upscale market. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 198. Sharron testified that he wanted to avoid any potential claims that Debtor was infringing on Beyond Basics's intellectual property. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 198-199. Beyond Basics and Debtor each maintained different AIMS programs, the production software they used. *Joint Pretrial Stipulation*, ECF 97 at 7; *Sharron Trial Declaration*, ECF 100, ¶ 68. To support his position, Trustee identifies the Shared Services Agreement between Debtor and Beyond Basics, under which Debtor agreed to allow its employees to perform work for Beyond Basics. *Shared Services Agreement*, Plaintiff's Exhibit 73. However, the Shared Services Agreement did provide value to Debtor because it contemplated providing Debtor a commission of $1.33 on every sale in exchange for Beyond Basics's use of Debtor's infrastructure. *Shared Services Agreement*, Plaintiff's Exhibit 73 at 2; *Sharron Trial Declaration*, ECF 100, ¶ 57. Further, Sharron testified that the services to Beyond Basics were provided by Debtor's underutilized workforce, *Sharron Trial*

Declaration, ECF 100, ¶¶ 57-58, and the labor was tracked, documented, and charged to Beyond Basics. *Sharron Trial Declaration*, ECF 100, ¶ 58; *see DT Hours/Payroll*, Defendants' Exhibit 515. If there was a unity of interest between Beyond Basics and Debtor, it is unclear why Beyond Basics would have agreed to pay a commission to Debtor and documented the services performed under the Shared Services Agreement. Accordingly, even if a unity of interest between Debtor and Beyond Basics could prove a unity of interest between Sharron and Beyond Basics, Trustee has not met his burden in establishing such a unity of interest.

76. Additionally, the court finds that even if Trustee had shown a unity of interest and ownership between Sharron and Beyond Basics, preserving the corporate identity of Beyond Basics will not lead to an inequitable result. "Alter ego is an extreme remedy, sparingly used." *Sonora Diamond Corp. v. Superior Court*, 83 Cal.App.4th at 539. It should be "invoked only where recognition of the corporate form would work an *injustice* to a third person." *Tomaselli v. Transamerica Insurance Co.*, 25 Cal.App.4th 1269, 1285 (1994) (citing 9 Witkin, Summary of California Law (9th ed. 1989), Corporations, §§ 12-23, pp. 524-537) (emphasis in original). There must be a "showing of such critical facts as inadequate capitalization, commingling of assets, disregard of corporate formalities, [or] . . . other facts which demonstrate the critical element: that an inequitable result would have followed if the corporate separateness had been respected." *Id.* "[W]hile the [alter ego] doctrine does not depend on the presence of actual fraud, it is designed to prevent what would be fraud or injustice, if accomplished. Accordingly, bad faith in one form or another is an underlying consideration and *will be found in some form or another* in those cases wherein the trial court was justified in disregarding the corporate entity." *Associated Vendors, Inc. v. Oakland Meat Co.*, 210 Cal.App.2d at 837 (emphasis added). "The alter ego doctrine does not guard every unsatisfied creditor of a corporation but instead affords protection where some conduct amounting to bad faith makes it inequitable for the corporate owner to hide behind the corporate form. *Difficulty in enforcing a judgment or collecting a debt does not*

satisfy this standard." *Sonora Diamond Corp. v. Superior Court*, 83 Cal.App.4th at 539 (emphasis added).

77. Here, while Sharron may have engaged in less than optimal business strategies vis-à-vis Beyond Basics, preserving Beyond Basics' corporate form would not "work an injustice" to Debtor or its creditors because this conduct did not perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose. This is not a case where a corporate entity is being used to hide funds or otherwise obfuscate. While Sharron expected Beyond Basics to repay Debtor only if Beyond Basics became profitable, he testified that he "truly believed" Beyond Basics would become profitable and ultimately pay off its debt to Debtor. *Sharron Trial Declaration*, ECF 100, ¶ 60. Sharron testified that it was the filing of the involuntary petition that ended Debtor's and Beyond Basics's respective operations. *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 240-241. The court finds Sharron to be credible on this point. Further, the funds transferred from Debtor to Beyond Basics were all documented in the Due from Beyond Basics Account. Such transparency cuts against the notion that Sharron used Beyond Basics to further a bad faith scheme against Debtor's creditors. There was no attempt by Sharron to hide any transfers to Beyond Basics. Moreover, Sharron intended that Beyond Basics operate as a legitimate company. Beyond Basics was not formed as a mere shell to shield Debtor or Sharron from liability. Sharron's emails to the other Beyond Basics managers support this understanding. In an email sent on December 1, 2011 to Sharron, Jamara Ghalayini discussed potential products and ideas for Beyond Basics. *Email string from Jamara Ghalayini to Lowell Sharron re We really need to focus*, Plaintiff's Exhibit 87. Sharron wrote in response, "Let's get a business plan together so that we are ready to roll on the next idea after we prove the first line is a success." *Id*. Sharron and Ghalayini's emails indicate they intended that Beyond Basics operate as a legitimate business. Sharron's email also discussed the possibility of seeking additional capital for Beyond Basics from potential investors. *Email string from Jamara Ghalayini to Lowell Sharron re We really need to focus*, Plaintiff's Exhibit 87. In short, Sharron and Ghalayini's emails demonstrate that Sharron

was engaged in good faith efforts to operate Beyond Basics, and that both Sharron and Ghalayini desired that Beyond Basics operate as a legitimate and successful business. Both the documentation of the transfers in the Due from Beyond Basics Account and the emails seriously undermine any claim that Sharron acted in bad faith. The court finds that the Beyond Basics corporate form was not used in bad faith, to perpetrate a fraud, to circumvent a statute, or for some other wrongful or inequitable purpose. Accordingly, the court finds that no inequitable result will follow if the acts of Beyond Basics are treated as those of Beyond Basics alone.

78. The court finds that Trustee failed to establish by a preponderance of the evidence a unity of interest between Sharron and Beyond Basics and that no inequitable result would follow if the court does not pierce the corporate veil. Accordingly, because Trustee has failed to establish both elements, Sharron cannot be held liable under the doctrine of alter ego liability.

H. Plaintiff's Claim for Recharacterization of Loans

79. "The recharacterization of debt to equity is a legal concept rooted primarily in tax law . . . No provision of the Bankruptcy Code expressly authorizes the recharacterization of debt to equity. Every Circuit Court of Appeal that has addressed this issue, however, has held that a bankruptcy court may properly order the recharacterization of debt to equity under the broad authority afforded by 11 U.S.C. § 105(a)." *Daewoo Motor America, Inc. v. Daewoo Motor Co., Ltd.* (*In re Daewoo Motor America, Inc.)*, 471 B.R. 721, 729 (C.D. Cal. 2012) (citations omitted). "[A] court may recharacterize an obligation that does not constitute 'debt' under state law[.]" *Fitness Holdings International, Inc. v. Hancock Park Capital II, L.P. (In re Fitness Holdings, Inc.)*, 714 F.3d 1141, 1147 (9th Cir. 2013).

80. It does not appear that California state law has definitively addressed the question of when debt should be recharacterized as equity. "When the California Supreme Court has not decided a state law issue, the federal courts must predict how it would decide the issue by looking to other sources, such as 'intermediate appellate court decisions, decisions from other jurisdictions, statutes, treatises, and restatements.'" *In re AWTR*

Liquidation, 548 B.R. at 311. "California courts often look to decisions from Delaware and other States." *Id*. (citing *Swingless Golf Club Corp. v. Taylor*, 679 F.Supp.2d at 1070). As discussed earlier, "[c]laims of corporate waste in California are based upon Delaware state law." *Id*. at 340 (citation omitted). Because California looks to Delaware state law for claims of corporate waste, the court finds that the California Supreme Court would likely apply Delaware law when determining whether to recharacterize debt into equity. Accordingly, this court will apply Delaware law. In Delaware:

> Whether a security constitutes equity or debt depends on the interpretation of the contract between the corporation and the security holders. In interpreting the contract, courts consider numerous factors, including: (1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular corporate contributors; and (7) certainty of payment in the event of the corporation's insolvency or liquidation.

Official Committee of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Investment Partnership, L.P. (In re Color Tile, Inc.), 2000 WL 152129, at *4 (D. Del. 2000) (citations omitted). For the reasons explained below, the court finds that the factors weigh in favor of recharacterizing the sum of $350,000 from debt to equity.

81. The first factor, the name given to the instrument, weighs in favor of treating the $350,000 as debt. The Subordination Agreement dated November 20, 2002 referred to the funds Sharron advanced to Debtor as "Subordinated Debt." *Subordination Agreement*, Plaintiff's Exhibit 4. The Subordination Agreements dated April 30, 2003 and July 1, 2004 also use the terms "Creditor," "Debtor," and "Indebtedness." *Subordination Agreements*, Plaintiff's Exhibit 7 and Exhibit 8. In addition, the amount was also labeled "2130 – Long Term Loan" in Debtor's QuickBooks. *Grobstein Trial Declaration*, ECF 86, ¶ 25. Because the name of the instruments, along with the verbiage in these instruments, refers to a debt, the court finds that the first factor weighs against recharacterization.

82. The second factor, the intent of the parties, weighs in favor of recharacterization. Sharron was the Chief Executive Officer, Chief Financial Officer, Secretary, and Director of Debtor. *Articles of Incorporation*, Plaintiff's Exhibit 1; *Statement*

of Information, California Secretary of State, Plaintiff's Exhibit 1A. As an insider, Sharron had the ability to enforce payments on his "loan." Although Sharron received "interest payments," he did not receive any payments on the principal. Lenders typically demand payments on the loaned principal over the course of the loan. Because Sharron had direct control over Debtor, Sharron could have easily requested that payments on the principal be made. But Sharron never made payment requests. If this sum was indeed a loan, Sharron's behavior is even more curious considering the high amounts owed by him reflected in the Due from Officer Account, as Sharron made no attempt to offset this amount with this purported "loan." Sharron further testified that "it wasn't important that it get paid back at some specific date." *Sharron Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 162. Because Sharron could have easily demanded principal payments, it seems unlikely that $350,000 was actually intended to be a loan to Debtor. Accordingly, this factor weighs in favor of recharacterization.

83. The third factor, the presence or absence of a fixed maturity date, weighs in favor of recharacterizing the $350,000 as equity. The maturity date was extended multiple times with little explanation. The initial maturity date of January 1, 2005 was first extended to July 1, 2005. The maturity date was later extended to January 1, 2010, January 1, 2012, January 1, 2014, and finally to January 1, 2015. *Promissory Notes*, Plaintiff's Exhibits 5, 6, 10, 11, 12, 13. Ultimately, the maturity date was extended ten years past its initial two-year term. Had Sharron truly treated the sum as a loan, he would have likely objected to the multiple extensions of the maturity date. Thus, the absence of a fixed maturity date suggests the amounts were treated as equity.

84. The fourth factor, the right to enforce payment of principal and interest, favors a finding of recharacterization of the $350,000 into equity. As mentioned above, Debtor's records contain no record of a demand for payment of the amounts owed. *Grobstein Trial Declaration*, ECF 86, ¶ 28. Neither principal nor interest payments were made, nor was any reserve created for payment on the note. *Id.* In short, there is no evidence that a right to enforce payment of the principal and interest existed. Rather than attempt to enforce

payment, Sharron instead extended the maturity date for a total of ten years. *Promissory Notes*, Plaintiff's Exhibits 5, 6, 10, 11, 12, 13. Sharron also apparently left it up to his accountant, Kabani, to decide to extend the dates. This factor suggests there was no right to enforce payment and that the amounts were treated as equity.

85. The fifth factor, the presence or absence of voting rights, is neutral. There is no apparent evidence that any voting rights were conferred. Sharron was already the Chief Executive Officer, Chief Financial Officer, Secretary, and Director of Debtor and thus likely already had voting rights. *Articles of Incorporation*, Plaintiff's Exhibit 1; *Statement of Information, California Secretary of State*, Plaintiff's Exhibit 1A. Further, Debtor did not have a practice of holding board meetings or shareholder meetings on an annual basis. *Grobstein Trial Declaration*, ECF 86, ¶ 13-14. This factor is neutral.

86. The sixth factor, the status of the contribution in relation to regular corporate contributors, is also neutral. There is no evidence of other corporate contributors to Debtor. Thus, no comparison of Sharron's "loan" to other corporate contributors can be made. Accordingly, this factor is neutral.

87. The seventh factor, the certainty of payment in the event of the corporation's insolvency or liquidation, weighs in favor of an equity finding. No reserve was available to repay Sharron for the amounts owing. *Grobstein Trial Declaration*, ECF 86, ¶ 28. Therefore, there was no certainty of payment.

88. Of the seven factors, the preponderance of the evidence indicates that four weigh in favor of recharacterization, two are neutral, and one weighs against recharacterization. The court finds the factors weighing in favor of recharacterization more dispositive here. Although Sharron's "loan" was a loan in a name and form, Sharron treated the loan as an equity contribution. Sharron requested no principal payments, and the note maturity date was extended multiple times without objection. Treating the "loan" as an actual loan would require the court to ignore Sharron's behavior—behavior that deviates from that typical of a noteholder and which more closely aligns with that of a capital contributor. For these reasons, the court determines that based on a preponderance of the

evidence, the sum of $350,000 should be recharacterized as equity. Accordingly, because the court recharacterizes the sum of $350,000 as equity, this sum cannot be used to offset the figure set forth in the Due from Officer Account.

I. Consolidated Objection to Sharron Proof of Claim and Sharron Motion

89. The Sharron Proof of Claim asserts a total claim amount of $766,783.24. Of this amount, $350,000 relates to Sharron's "loan" to Debtor, that is, the Subordinated Debt. The remaining amount of the claim of $416,783.74 relates to Sharron's claim for unpaid wage compensation, $375,283.74 of which Sharron asserts is entitled to priority status. Sharron's claim for unpaid wage compensation can be further broken down as follows: salary of $131,500, a bonus of $260,000, and expenses of $25,283.74.

i. Debt Recharacterized as Equity

90. As discussed above, the court has found that the amount of the $350,000 Subordinated Debt is to be recharacterized as equity. Because this amount is to be treated as equity and not a debt from a loan, the court disallows Sharron's claim in the amount of $350,000.

ii. The Gap Period Claim

91. Sharron asserts that he is owed wages accruing during the Gap Period (as previously defined, the period from the date of the filing of the involuntary petition, June 19, 2013, to the date of conversion of the case to Chapter 11 on August 13, 2013). The amount of the Gap Period Claim is $38,233.12, which is asserted in the Sharron Motion, filed on May 5, 2014. *Motion of Lowell Sharron for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest*, Plaintiff's Exhibit 146 at 5, 12, 13. A Gap Period Claim in an involuntary bankruptcy case is allowed as a third priority claim under 11 U.S.C. § 507(a)(3) if it is "a claim arising in the ordinary course of the debtor's business" in an involuntary bankruptcy case after the commencement of the case but before the earlier of the appointment of a trustee or an order for relief; such a claim is allowed or disallowed in the same manner as a prepetition claim. 11 U.S.C. § 502(f); *see* 3 March, Ahart and Shapiro, *Rutter Group California Practice*

Guide: Bankruptcy, ¶ 17:740 at 17-95 – 17-96 (2018) (citing *In re Manufacturer's Supply Co.,* 132 B.R. 127, 129 (Bankr. N.D. Ohio 1991) and *In re Hasson Industries, Inc.,* 90 B.R. 405, 412-417 (Bankr. D. Minn. 1988)). The Sharron Motion filed on May 5, 2014 seeking payment of this claim was filed after the claims bar date of December 23, 2013. *Sharron's Proof of Claim,* Defendant's Exhibit 557; *see also Motion of Lowell Sharron for Order Compelling Debtor to Pay (1) Administrative Expense and Prepetition Unsecured Wage Claims; (2) Equity Interest*, Plaintiff's Exhibit 146 and Defendant's Exhibit 558 at 5, 12, 13 (explaining the "proofs of claim"). It appears that Sharron's claim for Gap Period wages was and is subsumed in his timely Proof of Claim filed on December 23, 2013 wherein he requests payment of a claim for salary of $131,500, and the court so finds that Sharron's Gap Period claim is timely. Sharron's timely executed and filed proof of claim for Gap Period wages is prima facie evidence of the validity and amount of the claim under Federal Rule of Bankruptcy Procedure 3001(f), and the claim is undisputed. Trustee did not object to this claim. *See Consolidated Objection to Sharron Claim*, Plaintiff's Exhibit 147 at 14 ("The only claim that should survive is the Gap Period Claim of $38,233.12, which would not be subject to LBR 2014-1."); *see also Plaintiff's Trial Brief*, ECF 111 at 34. Aside from the prima facie validity of Sharron's filed proof of claim for the Gap Period Claim, he has shown by a preponderance of the evidence that his Gap Period Wage Claim is a proper claim under 11 U.S.C. § 507(a)(3) as the claim is for compensation of his services in the ordinary course of debtor's business during the gap period (as attested to in his declaration in support of the Sharron Motion that he was the chief executive officer of Debtor and one of the last remaining employees of the company, and he ran the company during its time as a debtor in bankruptcy, including collecting its accounts receivable and ensuring that Debtor complied with all bankruptcy court and United States Trustee requirements). *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 11-17, ¶¶ 1-25. Based on the foregoing, the court allows Sharron's Gap Period Wage Claim in the amount of $38,223.12.

iii. The Administrative Wage Claim

92. Sharron seeks $75,500 for wages owing for his work from the date of conversion on August 13, 2013 to the date that the plan confirmation order was entered on April 3, 2014. Trustee argues that the remainder of Sharron's claim should be disallowed because Sharron failed to comply with Local Bankruptcy Rule 2014-1. The court rejects this argument. While the court recognizes that Sharron should have followed the court's local rules regarding insider compensation, the court will not deny Sharron's administrative claim solely on procedural grounds, and instead elects to address Sharron's claim on its merits to determine whether it is an allowable administrative expense claim for services which were necessary and beneficial to the estate under 11 U.S.C. § 503(b).

93. "In classifying the order of payment for creditors' claims, the Bankruptcy Code affords the highest level of priority to 'administrative expenses.'" *In re BCE West, L.P*, 319 F.3d 1166, 1172 (9th Cir. 2003) (citing 11 U.S.C. § 507(a)(1) and *Abercrombie v. Hayden Corp. (In re Abercrombie)*, 139 F.3d 755, 756 (9th Cir.1998)). "Section 503(b)(1)(A) of the Code defines administrative expenses and provides a nonexclusive list of allowable expenses including 'the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.'" *Id.* (citing *Kadjevich v. Kadjevich (In re Kadjevich),* 220 F.3d 1016, 1019 (9th Cir.2000)). "The availability of the priority encourages third parties to deal with a business that has filed in bankruptcy, because these parties will be paid ahead of other creditors." *Id.* (quoting *In re Abercrombie*, 139 F.3d at 757).

94. "The burden of proving an administrative expense claim is on the claimant. In order to limit abuses of the administrative-expense priority, we require a claimant to show that the debt: (1) arose from a transaction with the debtor-in-possession and (2) directly and substantially benefitted the estate." *Id.* (quoting *In re DAK Industries, Inc.*, 170 F.3d at 1199 and *In re Abercrombie*, 139 F.3d at 757) (internal citations omitted). "Critically . . . only post-petition debts can be treated as administrative expenses; pre-petition debts may not be granted administrative-expense priority." *Id.* (quoting *In re Kadjevich*, 220 F.3d at 1019).

Sharron's services primarily consisted of collecting Debtor's accounts receivable, securing insurance, terminating employees and determining if money was owed to them, as well as miscellaneous work like maintaining files and managing payroll. *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 11-17, ¶¶ 1-25. Sharron performed these services on behalf of the Debtor in possession. During the bankruptcy case, Sharron helped manage Debtor and assisted with collecting receivables to pay off Debtor's debts. According to Sharron, through his efforts Debtor was able to collect an estimated 96% of receivables, which resulted in the debt owed to CIT, Debtor's primary secured creditor, being satisfied. *Id.*, ¶¶ 3-16. Thus, the court finds that Sharron's services in managing the Debtor and facilitating the collection of accounts receivable during the bankruptcy case were necessary and directly and substantially benefitted the estate. The court also observes and finds that Sharron is entitled to compensation under 11 U.S.C. § 363, as Sharron was performing work in the ordinary course of business on behalf of the estate during the pendency of the bankruptcy case before and after conversion through plan confirmation. Finally, the court finds that Sharron's compensation requested for this period is reasonable for two reasons. First, Sharron's salary for the first month of the postconversion, preconfirmation period was the same as his monthly salary during the Gap Period to which Trustee has raised no objection. Second, Sharron actually requests a decrease in salary for the remaining months explaining it was "fair for [his] salary to be reduced as more and more of the receivables were collected, and less of [his] time and experience had to be used in the collection process." *Id.*, ¶ 11. Sharron claimed salary of $18,500 per month during the Gap Period and for August and September 2013, $15,000 per month for October 2013, $10,000 per month for November 2013, and $8,000 per month for December 2013 through March 2013, ending right before the plan confirmation date of April 4, 2014. *Id.* Thus, because Sharron's salary claim for this period is based on his salary for the immediately preceding Gap Period to which Trustee had no objection, but is also reduced over time, the court finds Sharron's request of unpaid wages of $75,500 is shown by a preponderance of the evidence to be reasonable because he performed actual and necessary services benefitting the estate

collecting Debtor's receivables. For these reasons, the court allows Sharron's administrative expense claim for unpaid wages of $75,500 for the period between the date of conversion of the case to Chapter 11 and the date of the plan confirmation.

iv. The Bonus Claim

95. The court disallows the bonus portion of Sharron's administrative expense wage claim of $260,000 because the court finds that Sharron has not met his burden of proving by a preponderance of the evidence that the bonus compensation for his services rendered postpetition constitutes "actual, necessary costs and expenses of preserving the estate, including . . . wages, salaries, and commissions for services rendered after the commencement of the case . . . ." pursuant to 11 U.S.C. § 503(b)(1)(A)(i) . As stated above, while the court allows Sharron's claim of regular salary of $75,500 for his work during the postconversion, preconfirmation period as actual, necessary costs and expenses of preserving the estate, Sharron has not shown that a substantial bonus of $260,000 in addition to his regular salary during this period constitutes "actual, necessary costs and expenses of preserving the estate".

96. First, as Trustee argues, Sharron's request for bonus compensation is procedurally defective because he did not comply with the mandatory insider compensation procedures of Local Bankruptcy Rule 2014-1, which provide that no compensation or other remuneration may be paid from the assets of the estate to a debtor's owners, officers, directors or shareholders, such as Sharron, other than through the procedures in the rule. *Proposed Conclusion of Law 68, Plaintiff's Proposed Finding of Fact and Conclusions of Law,* ECF 139. The Creditors' Committee filed a timely objection to Sharron's Insider Compensation Notice, and pursuant to Local Bankruptcy Rule 2014-1, Debtor was required to set the notice for hearing, which it never did, the Committee's objection was never withdrawn, and because the notice of hearing was not filed, the matter never came before the court. *Id.* Moreover, Sharron's Insider Compensation Notice did not identify his claim for bonus compensation.

97. Second, Sharron has not demonstrated that the substantial bonus he claims is an actual, necessary cost or expense of preserving the estate under 11 U.S.C. § 503(b)(1)(A)(i). Sharron himself testified that the filing of the involuntary bankruptcy petition ended Debtor's operations. *Sharron Trial Testimony, Trial Transcript of August 18, 2016*, ECF 134 at 240-241 ("So once [Debtor] closed, everything stopped. Both companies. I lost both companies the same day, basically."). Based on Sharron's testimony, Debtor was winding down its operations after the filing of the involuntary bankruptcy petition. At this point, Sharron was not operating Debtor's business with any meaningful prospect for reorganization. Also, as noted above, Sharron reduced his salary for the remaining months of work explaining it was "fair for [his] salary to be reduced as more and more of the receivables were collected, and less of [his] time and experience had to be used in the collection process." *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 13, ¶ 11. Thus, Sharron explicitly recognized that while he was entitled to regular pay for his postpetition services, in fairness, the amount of regular pay should be reduced because less of his time and experience were needed, which recognition is somewhat inconsistent with his claim for bonus compensation.

98. Awarding Sharron a bonus equal to three times his regular salary for his work of collecting on Debtor's accounts receivable is not justifiable as an actual, necessary expense of preserving the estate. As stated earlier, Sharron is being compensated with his regular salary for his postpetition services to collect Debtor's accounts receivables, which was in the ordinary course of business for Debtor. Moreover, it is doubtful that it was an actual and necessary expense of preserving the estate to award a bonus to Sharron for collecting Debtor's accounts receivable because Sharron was not the only party collecting the accounts receivable. CIT (acknowledged by Sharron as "perhaps the most substantial factoring institution in the country today," *Sharron Trial Declaration* at 23, ¶ 72), was actively collecting the accounts from the account debtors as recognized by the stipulations between Debtor and CIT granting CIT stay relief to collect all of Debtor's accounts receivable, to receive payments from the account debtors associated with the accounts, and to apply the

proceeds of such accounts to reduce the amounts owed by Debtor under the Factoring Agreement. *See CIT's Notice of Motion and Motion for Relief from the Automatic Stay under 11 U.S.C. § 362,* Main Bankruptcy Case ECF 7, filed on July 2, 2013; *Stipulation by and Between L. Scott Apparel, Inc. and CIT Group/Commercial Services, Inc. Granting Relief from the Automatic Stay to Enable Application of Proceeds of Accounts,* Main Bankruptcy Case ECF 14 at 4, filed on July 19, 2013 (Debtor and CIT stipulated to modification of the automatic stay *nunc pro tunc* to the petition date "to enable CIT to continue to collect all Accounts, to receive payments from the account debtors associated with the Accounts, and to apply the proceeds of such Accounts to reduce and satisfy the amounts owing to CIT under the Agreements . . . ."); *Order Granting Motion for Relief from the Automatic Stay under 11 U.S.C. § 362 (Personal Property),* Main Bankruptcy Case ECF 20, filed on July 22, 2013; *Further Stipulation by and Between L. Scott Apparel, Inc. and CIT Group/Commercial Services, Inc. Granting Relief from the Automatic Stay to Enable Application of Proceeds of Accounts,* Main Bankruptcy Case ECF 64, filed on September 18, 2013. These stipulations between Debtor and CIT indicated that CIT was collecting all accounts receivable from the petition date, receiving the payments from the account debtors, applying the account proceeds to pay down Debtor's debt to CIT and remit any balance of payments to Debtor. *Id.* Thus, as stipulated to by Debtor, since CIT was collecting all the accounts receivable, receiving the payments, and applying them to Debtor's obligations to it, it appears that CIT was already doing the work of collecting Debtor's accounts receivable and that most of Sharron's work regarding Debtor's accounts receivable was supporting CIT in collecting the accounts receivable on which CIT had a senior lien. Sharron stated in his declaration in support of his motion that "I have spoken with CIT, the factor, on a monthly basis to get reports, and/or discuss issues as it relates to receivables." *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 16, ¶ 22. This statement from Sharron indicates that he was getting reports from CIT on a monthly basis on its efforts to collect the receivables and they were discussing issues relating to receivables, which suggests that CIT was primarily responsible for collecting the

receivables, receiving the proceeds of the accounts, applying them to Debtor's debt to CIT, and holding on any surplus proceeds to be distributed to Debtor once CIT had fully collected on its debt, and Sharron was assisting in CIT's collection efforts which helped to pay down Debtor's debt to it.

99. Sharron stated in his declaration in support of his motion as follows: ". . . my contributions to the Debtor (especially during the post-confirmation period) were enormous. During this period, the main business of the Debtor, the collection of receivables, was accomplished primarily as a result of my efforts. Indeed, I was uniquely qualified to collect the receivables since pre-bankruptcy negotiations took place that I was able to recall and leverage into a successful collection program. I estimate[ ] that 96% of the receivables were collected. No one else believed that such a collection result was possible. Everyone assumed that since we were in bankruptcy, numerous parties would take advantage of the situations. However, I had been negotiating and speaking with these parties all along, the fact that I remained with the company during the pendency of the bankruptcy proceedings results in such a high collection rate. This collection rate has obviously benefitted all concerned. My written backup of these pre-bankruptcy negotiations and ability to communicate the Debtor's position to key customers and the largest creditors was the sole and absolute reason the efforts were as successful as they were. I cannot imagine anyone disputing this. . . .Collecting the receivables was not just making a few phone calls. Many of these invoices I collected upon were disputed, and I had to research the charge backs and make a determination as to the cost benefit of going after each charge and whether time was well spent." *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 11, ¶¶ 15, 16 and at 16, ¶¶ 20, 22. The court finds Sharron's statements to be generally credible in that his efforts greatly assisted in the collecting of Debtor's accounts receivable, but does not find his testimony to be completely credible as to his contentions that the collection of the accounts receivable was solely and exclusively due to his efforts to warrant the substantial bonus compensation that he is requesting. As discussed earlier, it also appears that CIT was substantially involved in collecting the accounts receivable on which it had the senior

lien and for which it had obtained stay relief through stipulations with Debtor to collect the receivables, and these statements of Sharron are not inconsistent with CIT's role in collecting the receivables as Sharron is assisting in facilitating CIT's efforts to collect the receivables though his research of the accounts and contacts with the account debtors. According to Sharron, he collected $5,000,000 in accounts receivable as CEO of Debtor during the applicable period, and the bonus of $260,000 reflects a 5.2% commission. *Sharron Trial Declaration* at 30, ¶ 97. In this regard, the court agrees with Trustee's arguments that Sharron's bonus compensation claim does not meet the legal standards set forth in the Bankruptcy Code for payments of postpetition retention and incentive payments to insiders either under 11 U.S.C. § 503(c)(1) or (c)(3) in that he had a legitimate job offer at an equal or higher rate of compensation or that his services were necessary for the survival of the business or that as a payment outside the ordinary course of business is justified by the facts and circumstances of this case. *Proposed Conclusions of Law 71-75, Plaintiff's Proposed Findings of Fact and Conclusions of Law,* ECF 139; *see also* 4 Levin and Sommer, *Collier on Bankruptcy,* ¶ 503.17[2] at 503-113 (16th ed. 2018) (citing 11 U.S.C. § 503(c)(1)(A) and (B); *In re Fieldstone Mortgage Corp.,* 427 B.R. 357 (Bankr. D. Md. 2010); and *In re Dana Corp.,* 358 B.R. 567, 584 (Bankr. S.D,N.Y. 2006)); 4 Levin and Sommer, *Collier on Bankruptcy,* ¶ 503.17[4] at 503-118 - 503-121 (citing 11 U.S.C. § 503(c)(3)). Thus, the court cannot find that Sharron's efforts warrant the requested bonus compensation as an actual and necessary cost or expense of preserving the estate, nor that the amount is reasonable, especially considering that Sharron did not give notice of such claim before he rendered such services in compliance with the insider compensation procedures of the local court rules. *See* Local Bankruptcy Rule 2014-1(a). For these reasons, the court disallows Sharron's bonus claim of $260,000.

v. <u>The Expense Claim</u>

100. The court allows in part and disallows in part Sharron's administrative expense claim for unreimbursed expenses of $31,722.00 because he has met his burden of proving by a preponderance of the evidence that the expenses were reasonable and necessary

expenses benefitting the estate pursuant to 11 U.S.C. § 503(b) only as to a part of these expenses, but he has not met this burden of proof as to most of these expenses either as post-conversion administrative expenses under 11 U.S.C. § 503(b) or as ordinary course business expenses during the Gap Period under 11 U.S.C. §§ 502(f) and 507(a)(3).

101. In support of Sharron's claim of $11,479.00 for general unreimbursed expenses, he attached to his proof of claim a summary of simple billing entries with credit card account numbers, dates, and amounts, with brief descriptions of the expense items mostly limited to one to four word descriptions like "chevron," "google," "shell," "verizon," "la pallet," "Intl Fashion," "truck rental for moving," "Steam Iron fix," "Internet Fee," "USPS," and "Credit Card Fee," but he did not provide any explanation of these expenses in his declaration in support of this claim in the Sharron Motion or in his trial Declaration. *The Sharron Motion Declaration*, Plaintiff's Exhibit 146 at 13-14, ¶ 13 and Proof of Claim, Exhibit A attached thereto. Although these entries are briefly descriptive of possible business purposes, they do not sufficiently explain the necessity and benefit of the general unreimbursed expenses to warrant allowance, and thus, the court is unable to evaluate whether these expenses were either ordinary course business expenses during the Gap Period or reasonably and necessary administrative expenses benefitting the estate, and thus, the court finds that Sharron has not met his burden of proving these claims as third party priority Gap Period expenses or second priority post-conversion administrative expenses under 11 U.S.C. §§ 502(f), 503(b), 507(a)(2) and (3).

102. As to Sharron's administrative expense claims for unreimbursed expenses for the post-conversion period from August 2013 to April 2014, namely, his health insurance expenses of $11,088.00, his automobile installment loan payments of $950.00 per month for a total of $8,075.00 and automobile insurance for his automobile of $120.00 per month for a total of $1,080.00, the court finds that Sharron has met his burden of proving by a preponderance of the evidence that his unreimbursed health insurance expenses are proper administrative expense claims as reasonable, necessary expenses benefitting the estate as part of his reasonable compensation as an officer and employee of Debtor working on

behalf of Debtor and the estate during the post-conversion period from August 2013 to April 2014. [9] The court also finds, however, that Sharron has not met his burden of proving by a preponderance of the evidence that his claimed unreimbursed expenses for his automobile installment loan payments and the related automobile insurance are proper administrative expense claims as reasonable, necessary expenses benefitting the estate since the automobile appears to have been Sharron's personal vehicle and there was no business purpose shown by the evidence for use of the automobile in the Debtor's business. Arguably, these expenses could be considered part of Sharron's insider compensation during the pendency of the bankruptcy case because Debtor had paid these expenses before the involuntary bankruptcy case was filed, but the court finds that Sharron has not met his burden of proving that these expenses were reasonably and necessarily incurred to benefit the estate, or in other words, he has not shown that payment of his automobile and related insurance expenses would be reasonable insider compensation, aside from the fact that Sharron never obtained approval of the court for such expenses under the local rules governing insider compensation as Trustee argues. 11 U.S.C. § 503(b); Local Bankruptcy Rule 2014-1(a). Moreover, the evidence from Debtor's books and records showing that Debtor pre-paid Sharron's automobile loan installment payments on the 2013 Audi automobile for June through December 2013 shows that he is not entitled to reimbursement for such payments as claimed if Debtor already paid such expenses. *L. Scott Apparel, Inc., Transaction Detail by Account, June 20, 2011 through June 19, 2013 (Auto Leasing),* Plaintiff's Exhibit 56; *Grobstein Trial Declaration*, ECF 86 at 11, ¶ 42(l); *Stipulated Fact (50), Joint Pretrial Stipulation*, ECF 97 at 7. Sharron has not offered any evidence that he, rather than Debtor, made the car payments for June through December 2013.

[9] The court has considered the reasonableness of the amount of the unreimbursed health insurance expenses of $11,088.00 for the nine-month period between August 2013 and April 2014, which is approximately $1,232.00 per month, which seems a little high, but not unreasonable, considering that Sharron had serious health issues, including a severe heart condition. Trustee does not dispute the reasonableness of the amount of Sharron's unreimbursed health insurance expenses; rather, Trustee's opposition to Sharron's expense claim is based on the argument that Sharron failed to provide a proper accounting for his expenses "organized in a manner that that corresponds to the requirements of the Bankruptcy Code" and that "the Court never approved Sharron's compensation arrangement, or expense reimbursement." *Plaintiff's Proposed Findings of Fact and Conclusions of Law*, Conclusions of Law, ¶ 70. Thus, the court allows Sharron's unreimbursed health insurance expenses.

103. Accordingly, the court allows Sharron's administrative expense claim for unreimbursed expenses in the amount of $11,088.00 and disallows the remaining portion of the $31,722.00 expense claim.

vi. The Labor Code Claims

104. Section 201 of the California Labor Code provides in pertinent part that "the wages earned and unpaid at the time of discharge are due and payable immediately." California Labor Code § 201. Sharron's employment with Debtor was terminated when the liquidating trustee took over the estate pursuant to the confirmed plan of reorganization after the entry of the plan confirmation order on April 3, 2014, and Debtor was required to pay all "wages earned and unpaid" once Sharron's employment terminated. Sharron argues that because Debtor did not pay Sharron's claims after he stopped working for Debtor, Debtor's refusal is willful under California Labor Code § 203, and thus, "the wages of the employee shall continue to accrue until paid for up to thirty days." *Sharron's Motion for Order Compelling Debtor to Administrative Expense and Prepetition Unsecured Wage Claims*, Plaintiff's Exhibit 146, Main Bankruptcy Case ECF 198 at 8-9. Trustee disagrees on grounds that he had a good faith dispute with Sharron's claims for waiting time penalties under California Labor Code § 203. California Code of Regulations, Title 8, § 13520 provides that "[a] willful failure to pay wages within the meaning of Labor Code Section 203 occurs when an employer intentionally fails to pay wages to an employee when those wages are due, but that a good faith dispute that any wages are due will preclude imposition of waiting time penalties under Section 203." California Code of Regulations § 13520. A good faith dispute "occurs when an employer presents a defense, based in law or fact which, if successful, would preclude any recover[y] on the part of the employee. The fact that a defense is ultimately unsuccessful will not preclude a finding that a good faith dispute did exist." California Code of Regulations § 13520(a). *See also Alonzo v. Maximus, Inc.,* 832 F.Supp.2d 1122, 1133-1134 (C.D. Cal. 2011).

105. Trustee has good faith disputes with Sharron's wage claims, such as the claims for postconversion, preconfirmation wages and for bonus compensation, even if not

all of Trustee's arguments prevailed. As discussed earlier, the court has disallowed Sharron's bonus compensation claim based on Trustee's objection, and this indicates a good faith dispute on Trustee's part. While the court has allowed Sharron's claim of $75,500 for postconversion, preconfirmation wages, the court finds that Trustee had a good faith dispute for not immediately paying such claim because, as Trustee argues, Sharron did not comply with the procedural requirements of Local Bankruptcy Rule 2014-1(a), and his notice of insider compensation was never set for hearing. Thus, in some respect, Trustee's claims are not meritless and can be classified as a good faith dispute precluding waiting time penalties under California Labor Code § 203.

106. However, it is undisputed that Sharron was entitled to his wage claim of $38,233.12 for the Gap Period, which was not immediately paid on termination, and there is no good faith dispute about the obligation to pay such claim. Trustee did not object to such claim, apparently having no reason to object, and such claim should have been immediately paid, thus incurring liability under California Labor Code § 203. Arguably, Trustee did not have notice of the Gap Period Wage Claim when Sharron filed his proof of claim on December 23, 2013 because Sharron was claiming his postpetition salary of $131,500 without a breakdown between the Gap Period and the postconversion, preconfirmation period, and Trustee had a good faith dispute as to the postpetition salary claim. However, after his employment was terminated, Sharron filed his motion to compel payment of his salary claim on May 5, 2014, which gave a detailed breakdown of his salary claim between the Gap Period and the postconversion, preconfirmation period, at which point Trustee could have immediately paid the undisputed Gap Period portion since it had been separately itemized. Still, Trustee did not pay the Gap Period wages. Thus, the court finds that Trustee chose not to immediately pay Sharron's uncontested wage claim after his termination and Trustee's failure to pay the claim was willful for purposes of California Labor Code § 203. For these reasons, the court finds that Sharron has shown by a preponderance of the evidence that he is entitled to waiting time penalties under California

Labor Code § 203 consisting of an additional 30 days of pay, which would be $8,000 based on his last rate of pay in March 2013 at $8,000 per month.

107. Sharron has also shown by a preponderance of the evidence that he is entitled to reasonable attorneys' fees on his waiting time penalty claims under California Labor Code § 203. Section 218.5 of the California Labor Code provides that any action brought for the nonpayment of wages, fringe benefits, or health and welfare or pension fund contributions, the court shall award reasonable attorneys' fees and costs to the prevailing party if any part of the action requests attorneys' fees and costs upon the initiation of the action. Sharron meets this qualification since the action was initiated by his motion. *Sharron's Motion for Order Compelling Debtor to Administrative Expense and Prepetition Unsecured Wage Claims*, Plaintiff's Exhibit 146, Main Bankruptcy Case ECF 198 at 9. Sharron requested an award of $20,000 as reasonable attorneys' fees. *Id.* However, Sharron provided no justification for this amount, and the court declines to award such amount of lack of showing of reasonableness. *Id.* The court in reviewing the legal work for Sharron's motion in support of his waiting time penalty claims under the California Labor Code awards reasonable attorneys' fees of $5,000, representing 10 hours of attorney time at an hourly billing rate of $500 per hour for the work performed by Sharron's counsel regarding these claims in preparing and filing the motion and litigating the claims at trial.

J. <u>Account Stated, Open Book Account, Due from Officers, and Due from Beyond Basics Accounts</u>

108. An account is stated where prior transactions between the parties are stated, the items of that account are true, and the balance struck is due and owing from one party to the other. *Gleason v. Klamer*, 103 Cal.App.3d 782, 786-787 (1980). The agreement to repay the amount due and owing need not be express and is "frequently implied from the circumstances." *Maggio Inc. v. Neal*, 196 Cal.App.3d 745, 752-753 (1987). "In the usual situation, [an account stated] comes about by the creditor rendering a statement of the account to the debtor. If the debtor fails to object to the statement within a reasonable time,

the law implies his agreement that the account is correct as rendered." *Zinn v. Fred R. Bright Co.*, 271 Cal.App.2d 597, 600-601 (1969).

109. An open book account exists where a detailed statement is kept in the books of a nature of debits and credits arising out of a contract or some fiduciary relationship. *Joslin v. Gertz*, 155 Cal.App.2d 62, 65-66 (1957). The court finds that the Due from Officer Account and Due from Beyond Basics Account are open accounts.

110. California Code of Civil Procedure § 337a provides as follows:

> The term "book account" means a detailed statement which constitutes the principal record of one or more transactions between a debtor and a creditor arising out of a contract or some fiduciary relation, and shows the debits and credits in connection therewith, and against whom and in favor of whom entries were made, is entered in the regular course of business of as conducted by such creditor or fiduciary, and is kept in a reasonable permanent form and manner and is (1) in a bound book...or is kept in any other reasonable permanent form or manner.

California Code of Civil Procedure § 337a.

111. Book accounts include computerized records. *Interstate Group Administrators, Inc. v. Cravens, Dargan & Co.*, 174 Cal.App.3d 700, 708 (1985). A book account is deemed "open" so long as there exists the possibility of future transactions between the parties and there is one indivisible liability arising from the series of related and reciprocal transactions. *R.N.C., Inc. v. Tsegeletos*, 231 Cal.App.3d 967, 972; *see also Gross v. Racabaren*, 206 Cal.App.3d 771, 778 (1988).

112. Sharron does not dispute the accuracy of the amount computed as owing on Due from Officer Account. The outstanding balance on the Due from Officer Account is $462,194.13. However, this computed amount includes credits of $105,000 claimed by him for interest on the alleged "loan" of $350,000 from Sharron to Debtor. Because the court has recharacterized this "loan" debt as his equity in Debtor, the court finds that there should be no deductions for crediting Sharron with interest on the alleged loan from the amount owed by him from the Due from Officer Account. Accordingly, the court finds that Trustee has proven his claims for account stated and open book account against Sharron by a

preponderance of the evidence and that the outstanding balance on the Due from Officer Account owed by Sharron to Debtor and its estate is $567,194.13.

113. As of July 24, 2013, the amount owing on the Due from Beyond Basics Account is $502,008.46. Beyond Basics does not contest this amount. Accordingly, the court finds that Trustee has proven his claims for account stated and open book account against Beyond Basics by a preponderance of the evidence and that the outstanding balance on the Due from Beyond Basics Account owed by Beyond Basics to Debtor and its estate is $502,008.46.

114. The court also finds that Trustee has shown by a preponderance of the evidence that Sharron and Beyond Basics are also liable to Debtor and its estate for prejudgment interest on the account stated and open book account claims under California law at the California statutory rate of interest of 10% per annum from the date of the filing of the adversary complaint on March 3, 2015 through the date of entry of judgment. California Civil Code §§ 3287 and 3289; *Oak Harbor Freight Lines, Inc. v. Sears, Roebuck & Co.,* 513 F.3d 949, 961-962 (9th Cir. 2008); *Pacific Mutual Life Insurance Co. v. Fisher,* 106 Cal. 224 (1895); *Grangers' Union v. Ashe,* 12 Cal.App. 757, 759 (1910); *see also* 3 Jones, Rosen, Wegner and Jones, *Rutter Group Practice Guide: Federal Civil Trials and Evidence,* ¶ 19:513 at 19-161 thru 19-162 (2018) (prejudgment interest on state law claims in diversity jurisdiction cases governed by state law) (citing, *inter alia, Northrup Corp. v. Triad International Marketing, S.A.,* 842 F.2d 1154, 1155 (9th Cir. 1988)).

115. "On contract claims, any legal rate specified in the contract applies until the contract is superseded by the verdict or other new obligation . . . [o]therwise, the prejudgment interest rate is *10% per annum from the date of the breach." See* 1 Ahart, *Rutter Group California Practice Guide: Enforcing Judgments and Debts,* ¶ 3:307.6 at 3-113 (2018) (citing, *inter alia,* California Civil Code § 3289(a) and (b)) (emphasis in original). Trustee argues that he is entitled to prejudgment interest from Sharron from the date of the alleged insolvency of Debtor on October 16, 2012 on the amount of $39,329, which is the amount of increase in the Due from Officer Account, disregarding the Subordinated Debt

interest credits, and on the amount of the Due from Beyond Basics Account as the alter ego of Beyond Basics and from Beyond Basics on the amount of the Due from Beyond Basics Account. *Plaintiff's Proposed Findings of Fact and Conclusions of Law*, ¶¶ 53-55. Trustee asserts that the date that prejudgment interest accrues is the date of the alleged insolvency of Debtor on October 16, 2012, but he cites no authority as to why that is the applicable date. *Id.,* ¶¶ 50-55. Defendants do not address prejudgment interest in *Defendants' Proposed Findings of Fact and Conclusions of Law*, ECF 149 The relevant California case authority is the California Supreme Court's decision in *Pacific Mutual Life Insurance Co. v. Fisher,* 106 Cal. at 234, and the appellate court decision in *Grangers' Union v. Ashe,* 12 Cal.App. at 759, following it, which decisions hold that the time that prejudgment interest accrues on an account stated claim is the date that the suit to collect is filed. Such holding makes sense because there are no definite dates of breach where the accounts are open accounts and there are no fixed dates of repayments. Thus, if Defendants are liable on Trustee's account stated or open book account claims, prejudgment interest runs from the date that Trustee filed his adversary complaint asserting such claims on March 3, 2015, rather than the date of October 16, 2012 (as argued by Trustee), two and one-half years earlier.

116. While postjudgment interest is not addressed by the parties, it is only allowable in this matter pursuant to 28 U.S.C. § 1961 at the federal postjudgment interest rate. *See* 3 Jones, Rosen, Wegner and Jones, *Rutter Group Practice Guide: Federal Civil Trials and Evidence,* ¶ 19:518 at 19-163 (postjudgment interest on state law claims in diversity jurisdiction cases governed by 28 U.S.C. § 1961, not state law) (citing, *inter alia, Northrup Corp. v. Triad International Marketing, S.A.,* 842 F.2d at 1155).

117. With respect to Trustee's Eleventh and Twelfth Claims for Relief for account stated and open book account, Defendants raised as additional issues for trial in the Joint Pretrial Stipulation the following: "Whether Sharron is entitled to an offset in the event it is determined that he owes any funds based on the 'Due from Officers' account." *Legal Issues (10) and (11), Joint Pretrial Stipulation,* ECF 97 at 38. In his proof of claim, Sharron

asserted a right to setoff with respect to his alleged secured claim for the Subordinated Debt in the amount of $350,000. *Sharron Proof of Claim*, Defendants' Exhibit 557. As discussed above, the court determines that (i) Trustee is entitled to relief on the Eleventh and Twelfth Claims for Relief for account stated and open book account against Sharron on the Due from Officer account, which is a prepetition debt, and (ii) Sharron is entitled to relief on the Sharron Motion as to his claims for Gap Period wages, Post-Conversion wages and unreimbursed Post-Conversion expenses, which are postpetition debts. In order for a right of setoff to be recognized and preserved under 11 U.S.C. § 553, three conditions must be met: "(1) the debtor owes the creditor a prepetition debt; (2) the creditor owes the debtor a prepetition debt; and (3) the debts are mutual." *In re Wade Cook Financial Corp.,* 375 B.R. 580, 594 (9th Cir. BAP 2007) (citations omitted). "In essence, a creditor must establish two elements before a setoff may be asserted: timing and mutuality." *Id.* (citation omitted). "With regard to the timing element, 'each debt or claim sought to be offset must have arisen *prior* to the filing of the bankruptcy petition." *Id.* (citation omitted; emphasis in original). "With respect to the mutuality element, the debts and claims must be 'in the same right and between the same parties, standing in the same capacity.'" *Id.* (citations omitted). Here, because Debtor's debts owed on Trustee's claims are prepetition debts, such debts cannot be set off against the postpetition debts owed by Trustee on behalf of the bankruptcy estate to Debtor because the timing element under 11 U.S.C. § 553 is not met. Accordingly, the court denies Sharron's setoff claim.

K. <u>Other Amounts Trustee Alleges as Due to Debtor</u>

118. Trustee alleges that certain transfers totaling $25,159.02 were not recorded in the Due from Officer Account. These transfers include $9,900.00 in payroll checks to Mirna Limon Gutierrez for the period of January 1, 2013 through June 7, 2013, and $15,259.02 that Sharron caused Debtor to pre-pay on June 12, 2013 for Sharron and his wife's vehicle lease payments for June 2013 through December 2013. As discussed above, the court finds that the amounts attributable to Ms. Gutierrez were compensation to her for her work in the business of Debtor, so such amounts are not recoverable by Trustee. Alternatively,

such amounts were not booked in the Due from Officer Account, and while they appear instead to be shareholder distributions to Sharron, all but one of these payments occurred before the date of insolvency found by the court on June 1, 2013 and hence before Trustee has established insolvency. Thus, such amounts are not recoverable as fraudulent transfers. Accordingly, the court finds that Trustee has not shown by a preponderance of the evidence that Sharron owes this sum of $9,900 to Debtor and its estate as to payments to Ms. Gutierrez.

119. However, as to the prepaid payments by Debtor for the automobiles driven by Sharron and his wife in the amount of $15,259.02 on June 12, 2013, because these transfers occurred after the date of June 1, 2013 that the court finds that Trustee has shown by a preponderance of the evidence that as the date of insolvency of Debtor, these amounts are recoverable as follows: (i) under the breach of fiduciary theory because such transfers were a diversion or dissipation of corporate assets which could have been used to pay creditors' claims in in violation of Sharron's fiduciary duty to creditors of Debtor under the "trust fund doctrine," and (ii) as constructively fraudulent transfers because they were made while Debtor was insolvent and without reasonably equivalent consideration since these payments were made to pay Sharron's automobile loan debts for his and his wife's automobiles used for their personal purposes. Accordingly, the court finds that Sharron owes the sum of $15,259.02 to Trustee on behalf of Debtor and its estate.

L. Abandonment of Trustee's Thirteenth Claim for Relief - Accounting

120. Before trial, Trustee abandoned his Thirteenth Claim for Relief against Sharron for an Accounting, and accordingly, no relief on that claim will be granted. *See* Contested Fact (11), Joint Pretrial Stipulation, ECF 97 at 31, and Legal Issue (12), Joint Pretrial Stipulation, ECF 97 at 38.

M. Defendants' Affirmative Defenses

121. In the answer to Trustee's first amended complaint, Defendants asserted fifteen affirmative defenses. ECF 69, filed on May 31, 2016, at 10-13.

122. Before trial, Defendants admitted that there are no facts of which they are aware that support their second affirmative defense (statute of limitations), fourth affirmative defense (laches, waiver, estoppel) and tenth affirmative defense (unclean hands). *Stipulated Facts (106) through (111)*, Joint Pretrial Stipulation, ECF 97 at 13-14. Based on these admissions, the court denies these affirmative defenses for lack of factual support.

123. In the Joint Pretrial Stipulation, Defendants did not identify any issues of fact or any issues of law to be litigated relating to their affirmative defenses, and thus, did not ask the court to determine any issues relating to these defenses. *Contested Facts*, Joint Pretrial Stipulation, ECF 97 at 14-39.

124. In Defendants' (Proposed) Findings of Fact and Conclusions of Law on Trustee's Adversary Complaint against Defendants Lowell Sharron and Beyond Basic, LLC, ECF 149, Defendants did not propose any findings of fact or conclusions of law relating to their affirmative defenses, and thus, did not argue that the evidence at trial supports any factual finding or conclusion of law in favor of these defenses.

125. Because Defendants did not identify any issues of fact or law relating to their asserted affirmative defenses in the Joint Pretrial Stipulation and they did not propose any findings of fact or conclusions of law relating to these defenses, the court determines that Defendants have abandoned their affirmative defenses, and therefore, the court denies these defenses as abandoned.

IV. CONCLUSION

Based on the foregoing, the court will enter judgment as follows:

(1) For the Defendants on the First Claim for Relief for avoidance and recovery of actual fraudulent transfer pursuant to 11 U.S.C. §§ 548(a)(1)(A) and 550.

(2) For the Defendants on the Second Claim for Relief for avoidance and recovery of actual fraudulent transfer pursuant to 11 U.S.C. § 544 and California Civil Code § 3439.04(a)(1).

(3) For the Defendants on the Third Claim for Relief for avoidance and recovery of fraudulent transfer pursuant to 11 U.S.C. § 544 and California Civil Code §§ 3439.04(a)(2)

and 3439.05, except for Plaintiff and against Sharron in the amount of $15,259.02 in prepaid automobile loan payments made by Debtor on behalf of Sharron and for Plaintiff and against Beyond Basics in the amount of $8,131.09 in expenses of Beyond Basics paid on behalf of Beyond Basics after Debtor became insolvent on June 1, 2013.

(4) For Plaintiff on the Fourth Claim for Relief for recharacterization of Sharron's claim of debt as equity.

(5) For Defendant Sharron on the Fifth Claim for Relief for breach of fiduciary duty, except for Plaintiff and against Sharron in the amount of $15,259.02 in prepaid automobile loan payments made by Debtor on behalf of Sharron and in the amount of $8,131.09 in expenses of Beyond Basics paid on behalf of Beyond Basics after Debtor became insolvent on June 1, 2013. [10]

(6) For the Defendants on the Sixth Claim for Relief for goods sold and delivered.

(7) For the Defendants on the Seventh Claim for Relief for corporate waste.

(8) For Defendant Sharron on the Eighth Claim for Relief for equitable subordination.

(9) On the Ninth Claim for Relief and claims objection, as follows:

a. Sharron's claim of $350,000 for the Subordinated Debt is disallowed because the court has recharacterized this amount claimed as debt as equity.

b. Sharron's unsecured priority claim of $38,233.12 for unpaid wages during the Gap Period wages is allowed pursuant to 11 U.S.C. §§ 502(f) and 507(a)(3), and in allowing such claim, Trustee must account for, withhold, and/or pay applicable federal and state employment and unemployment taxes related to such wages before crediting or paying Sharron the net amount of the claim based on this judgment.

[10] Although the court determines that Plaintiff is entitled to partial recovery against Defendants on his Third and Fifth Claims for Relief, Plaintiff is not entitled to multiple recoveries of the amounts awarded since the amounts awarded are the same amounts under different theories of recovery.

c. Sharron's administrative expense claim of $75,500.00 for unpaid wages covering the period between case conversion and plan confirmation is allowed pursuant to 11 U.S.C. § 503(b), and in allowing such claim, Trustee must account for, withhold, and/or pay applicable federal and state employment and unemployment taxes related to such wages before crediting or paying Sharron the net amount of the claim based on this judgment.

d. Sharron's administrative expense claim of $260,000.00 claimed as bonus compensation for work in the period between case conversion and plan confirmation is disallowed.

e. Sharron's administrative expense claim for unreimbursed expenses is partially allowed in the amount of $11,088.00.

f. Sharron's administrative expense claim for damages based on alleged violations of California Labor Code § 203 is allowed in the amount of $8,000.00 representing 30 days of wages based at his final pay rate of $8,000.00 per month, and in allowing such claim, Trustee must account for, withhold, and/or pay applicable federal and state employment and unemployment taxes related to such wages before crediting or paying Sharron the net amount of the claim based on this judgment. Sharron is also entitled to an award of reasonable attorneys' fees of $5,000.00 as part of his allowed administrative expense claim for damages based on alleged violations of California Labor Code § 203.

(10) For the Defendants on the Tenth Claim for Relief for avoidance and recovery of preferential transfer pursuant to 11 U.S.C. §§ 547 and 550.

(11) For the Plaintiff on the Eleventh Claim for Relief for account stated. The outstanding balance on the Due from Officer Account is $567,194.13. The outstanding balance on the Due from Officer Account is $567,194.13, and Defendant Sharron owes this amount to Plaintiff, plus prejudgment interest at 10% per annum from the date of the filing of

the adversary complaint on March 3, 2015 to the date of entry of judgment in this adversary proceeding. The outstanding balance on the Due from Beyond Basics Account is $502,008.46, and Defendant Beyond Basics owes this amount, plus prejudgment interest at 10% per annum from the date of the filing of the adversary complaint on March 3, 2015 to the date of entry of judgment in this adversary proceeding. Post-judgment interest is allowed pursuant to 28 U.S.C. § 1961. Sharron may not set off the postpetition debts owed by the bankruptcy estate to him against the prepetition debts owed by him to the estate.

(12) For the Plaintiff on the Twelfth Claim for Relief for open book account. The outstanding balance on the Due from Officer Account is $567,194.13, and Defendant Sharron owes this amount to Plaintiff, plus prejudgment interest at 10% per annum from the date of the filing of the adversary complaint on March 3, 2015 to the date of entry of judgment in this adversary proceeding. The outstanding balance on the Due from Beyond Basics Account is $502,008.46, and Defendant Beyond Basics owes this amount, plus prejudgment interest at 10% per annum from the date of the filing of the adversary complaint on March 3, 2015 to the date of entry of judgment in this adversary proceeding. Post-judgment interest is allowed pursuant to 28 U.S.C. § 1961. In this regard, the court notes that Plaintiff is entitled to a single recovery against each defendant on the Eleventh and Twelfth Claims for Relief. Post-judgment interest is allowed pursuant to 28 U.S.C. § 1961. Sharron may not set off the postpetition debts owed by the bankruptcy estate to him against the prepetition debts owed by him to the estate.

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(13) No relief will be granted on the Thirteenth Claim for Relief for an accounting because Trustee abandoned that Claim before trial. *See* Contested Fact (11), Joint Pretrial Stipulation, ECF 97 at 31, and Legal Issue (12), Joint Pretrial Stipulation, ECF 97 at 38.

A separate judgment consistent with these findings of fact and conclusions of law is being filed and entered concurrently herewith.

IT IS SO ORDERED.

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Date: January 29, 2019

Robert Kwan
United States Bankruptcy Judge