U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS

ENTERED

TAWANA C. MARSHALL, CLERK
THE DATE OF ENTRY IS
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The following constitutes the order of the Court.

Signed December 3, 2004.

United States Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

IN RE:	§	
	§	
PC SERVICE SOURCE, INC.,	§	CASE NO. 00-35427-SAF-7
DEBTOR.	§	
	§	
JEFFREY H. MIMS, TRUSTEE,	§	
PLAINTIFF,	§	
	§	
VS.	§	ADVERSARY NO. 03-3277
	§	
COMPAQ COMPUTER CORPORATION,	§	
DEFENDANT.	§	

MEMORANDUM OPINION AND ORDER

In this adversary proceeding, Jeffrey H. Mims, the Chapter 7 trustee of the bankruptcy estate of PC Service Source, Inc. ("PCSS"), the debtor, seeks, under 11 U.S.C. §§ 547(b) and 550, to avoid and recover transfers of $928,624.23 made by the debtor to Compaq Computer Corporation, now Hewlett-Packard Company, as successor in interest. Hewlett-Packard ("HP") contends that the trustee cannot establish the preferential avoidance elements of § 547(b), that the transfers had been made in the ordinary course of business, and that Compaq provided new value, precluding recovery under § 547(c)(2) and (c)(4). The court conducted a trial on September 21, 22, and 23, 2004.

This adversary proceeding raises a core matter over which this court has jurisdiction to enter a final judgment. 28 U.S.C. §§ 157(b)(2)(F) and 1334. This memorandum opinion contains the court's findings of fact and conclusions of law. Bankruptcy Rule 7052.

Section 547(b)

Section 547(b) of the Bankruptcy Code provides that:

> [t]he trustee may avoid any transfer of an interest of the debtor in property–
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made– (A) on or within 90 days before the date of the filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if– (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C § 547(b).

PCSS had been a publicly traded company in the business of buying and selling personal computer parts. PCSS owned Cyclix Engineering Corp., a personal computer and printer repair business, performing warranty repair work for manufacturers. PCSS bought computer parts from original equipment manufacturers, including Compaq.

PCSS filed a petition for relief under Chapter 11 of the Bankruptcy Code on August 29, 2000. The court converted the case to a case under Chapter 7 on March 22, 2002. Mims was appointed the Chapter 7 trustee. Cyclix also filed a petition for relief under Chapter 11 on August 29, 2000.

PCSS made six payments to Compaq by checks drawn on PNC Bank Account No. 1008438458, the debtor's general operating account. The payments by checks drawn from the PCSS general operating account constitute transfers of an interest of the debtor in property. Southmark Corp. v. Grosz (Matter of Southmark Corp.), 49 F.3d 1111, 1116-17 (5th Cir. 1995).

Check #15478, dated June 2, 2000, in the amount of $118,894, cleared the bank on June 6, 2000. Check #15482, dated June 2, 2000, in the amount of $132,171, cleared the bank on June 6, 2000. Check #15707, dated June 9, 2000, in the amount of $238,335, cleared the bank on June 13, 2000. Check #15806, dated June 16, 2000, in the amount of $125,991, cleared the bank on June 21, 2000. Check #15807, dated June 16, 2000, in the amount of $124,007, cleared the bank on June 21, 2000. Check #16683, dated June 28, 2000, in the amount of $189,226.23, cleared the bank on July 3, 2000.

The six checks were made payable to Compaq. Compaq has filed a proof of claim in the PCSS bankruptcy case. Compaq had sent invoices to the debtor. The transfers were therefore to a creditor. 11 U.S.C. § 547(b)(1).

Compaq applied the payments to outstanding PCSS balances, reducing Compaq's claim. Mims compiled an exhibit documenting the Compaq invoices paid by each check. For each check, the invoice total matches or virtually matches the check amount, except for two. Check #15707 appears to overpay the invoice total by about $34,000. Check #16683 was handled differently. Compaq credited $120,000 of the payment to the PCSS debt, even though Compaq could not determine or locate an applicable invoice. Nevertheless, Compaq applied that payment to the outstanding debt. While the invoice totals do not match the check amounts exactly, the trustee has established by a preponderance of the evidence that the six payments were made for or on account of an antecedent owed by the debtor before the transfers were made. 11 U.S.C. § 547(b)(2).

The six transfers had been made within ninety days of the filing of the PCSS bankruptcy petition. 11 U.S.C. § 547(b)(4)(A).

In order for Mims to avoid and recover the transfers, he must prove that the transfers enabled Compaq to receive more than Compaq "would have received if (A) the case were a case under chapter 7 . . .; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title." 11 U.S.C. § 547(b)(5). See also 11 U.S.C. § 547(g) (placing the burden of proving the avoid-ability of a transfer under subsection (b) on the trustee). Section 547(b)(5) is commonly referred to as the "greater percentage test." See e.g., In re El Paso Refinery, L.P., 171 F.3d 253-54 (5th Cir. 1999).

PNC Bank held a secured claim of approximately $14 million that has been paid. In addition, Mims testified that the estate had about $1 million of additional secured claims. Tax claims have been paid, although Mims testified that some priority tax claims may remain. Unsecured proofs of claim totaling about $18 million have been filed. Mims has not yet commenced the claims allowance process. As a result, he testified that the allowed claims may be less than the filed claims. Mims holds $300,000 for payment of administrative expenses and distributions to the creditors. Even if Mims substantially reduces the allowed claims, the bankruptcy estate cannot pay any dividend approaching the full payment of the Compaq debt covered by the six transfers.

There is no evidence that the estate would have been materially different if the bankruptcy case had been filed on the date of any of the six transfers.

Accordingly, Mims has established the greater percentage test. 11 U.S.C. § 547(b)(5).

The case therefore turns on whether PCSS had been insolvent on the date of each of the transfers. 11 U.S.C. § 547(b)(3). The Bankruptcy Code presumes that PCSS had been insolvent within ninety days of the filing of the bankruptcy petition. 11 U.S.C. § 547(f). HP may rebut that presumption. See GasMark Ltd. Liquidating Trust v. Louis Dreyfus Natural Gas Corp., 158 F.3d 312, 315 (5th Cir. 1998).

In June 2000, PCSS had been a publicly traded company, with market value. Bob McLean, the CFO at the time of the filing of the bankruptcy case, testified that no assertion of fraud regarding trading disclosures has been made. The PCSS annual report, Form 10-K for the year ending December 31, 1999, reported total assets of $70.4 million with liabilities of $50.7 million. The PCSS quarterly report, Form 10-Q for the period ending March 31, 2000, reported total assets of $72.9 million, with liabilities of $53.6 million.

The PCSS summary of schedules filed in the Chapter 11 case on October 2, 2000, reported assets of $37.4 million, with liabilities of $33.9 million. The instructions for the official bankruptcy form direct the debtor to use market values.

Karen G. Nicolaou, a certified public accountant, testified as an expert for HP. She explained that her objective had been to rebut the presumption of insolvency. Based on a comparison to other market comparables that she identified, Nicolaou opined that as of December 31, 1999, PCSS had an estimated market value of $14.1 million as a going concern; and that as of March 31, 2000, PCSS had an estimated market value of $17.3 million as a going concern. Utilizing an adjusted consolidated balance sheet incorporating circumstances that were known but not quantified as of the date of PCSS's public financial reports, she estimated, using market values, PCSS' assets exceeded its liabilities by $12.5 million as of March 31, 2000. Utilizing information that occurred post-bankruptcy petition, Nicolaou opined that PCSS' assets exceeded liabilities by $2.1 million as of December 31, 1999, and $1.7 million as of March 31, 2000. Based on corrected and adjusted bankruptcy schedules, Nicolaou opined that the estimated market value of PCSS' assets exceeded liabilities by $269,725, on the petition date, August 29, 2000.

The totality of this evidence rebuts the presumption of insolvency. As a result, Mims must establish, by a preponderance of the evidence, that PCSS had been insolvent on the dates of the transfers.

The Bankruptcy Code defines insolvency as a "financial condition such that the sum of [the] entity's debts is greater than all of [its] property, at a fair valuation . . ." 11 U.S.C. § 101(32). Courts refer to this test as a balance sheet test, and engage in the “fair valuation” of the debts and property shown on the debtor’s balance sheet. However, a fair valuation may not be equivalent to the book values assigned on a balance sheet. Sherman v. FSC Realty LLC (In re Brentwood Lexford Partners, LLC, 292 B.R. 255, 268 (Bankr. N.D. Tex. 2003).

To perform this test, the court makes a two-step analysis. The court must first determine whether the debtor was a “going concern” or was on “its deathbed.” The court must then value the debtor’s assets, depending on the status determined in the first inquiry, and apply the balance sheet test to determine whether the debtor was solvent. Id. For a debtor that was a going concern, the court would 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 on its deathbed, the court would determine a fair value using the auspices of a forced sale. Id.

The transfers were made between June 2, 2000, and July 3, 2000. J. James Jenkins, a certified public accountant and long time Chapter 7 trustee, testified on behalf of Mims. Jenkins opined that during the time the transfers were made, PCSS was on its deathbed. Consequently, he used a forced sale, liquidation analysis to determine the fair value of the debtor’s assets. Nicolaou testified that as of March 31, 2000, PCSS was a going concern and remained a going concern until the eve of its bankruptcy filing. By August 2000, however, Nicolaou opined that PCSS' assets should be valued based on a forced sale basis, except that Cyclix should be valued as a going concern.

As the court's sole inquiry focuses on June 2, 2000, to July 3, 2000, the court accords greater weight to Jenkins' testimony. The court, therefore, employs the forced sale valuation of the assets.

Throughout the year 2000, in the months leading to the bankruptcy filing on August 29, 2000, PCSS had been increasingly losing money. While Cyclix had value, PCSS' continuing losses exceeded Cyclix's profits. PNC Bank, PCSS' secured lender, had been lowering its loan advance rates. PCSS' inventory had been growing, implicating a cash flow problem. Its liabilities had been growing faster than its assets. In May, management issued an employment letter, encouraging employees to stick with the company.

McLean had been PCSS' chief financial officer from May 31, 2000. He testified that he would not sign the 1999 tax returns. By the summer of 2000, he testified that PCSS risked lacking funds to operate. Its secured lender, PNC Bank, had to approve checks before issued by PCSS. PCSS slowed payments to vendors, paying small vendors and vendors willing to work with PCSS' cash flow problem. PCSS had violated several bank loan covenants. McLean explained that the PCSS business model collapsed because of changes in the computer industry, including dropping prices for new computers and printers. PCSS' auditors expressed concern about PCSS' solvency in their work papers. While McLean intended to reorganize the PCSS business, especially around Cyclix as a going concern, he had to abandon that attempt after the filing of the bankruptcy cases.

Concerned with the prospect of having its loan repaid, the bank hired two workout specialists for PCSS. By late June, the debtor was seeking a strategic partner, and would agree to sell its business.

By August, PCSS discontinued selling certain parts. PCSS obtained an extension to file its SEC report. McLean explained that the debtor issued comfort letters to its employees. It attempted to sell parts using a web site marketing strategy. Payroll checks began bouncing.

The experts' opinions must be considered against these events in the summer of 2000. Indeed, Nicolaou's values, as adjusted and summarized above, reflect a downward spiral for PCSS. As she added information, her assessment of values declined. She concluded that while PCSS should be considered a going concern on March 31, 2000, it was not a going concern in August, except for its subsidiary, Cyclix. She then assumed that in August 2000, PCSS would liquidate its parts business but maintain Cyclix.

As of the date of the transfers, PCSS could not operate for another six months. Both experts would define a going concern as an entity that would continue to operate. PCSS was on its deathbed in June 2000.

Jenkins' valuation therefore is entitled to the greater weight. But Nicolaou testified that she found PCSS solvent because she placed an $18 million value on Cyclix. Cyclix was a going concern. But Cyclix too filed a bankruptcy petition. Cyclix had been sold in Chapter 11 in September 2000. Cyclix was not sold as a going concern, but rather was sold in parts. The testimony of the total sales price was unclear, but there was testimony that the sale brought $3.8 million. Cyclix had liability on the PNC Bank debt. The sale of Cyclix's assets would be used to reduce the bank debt, and that would, in turn, reduce PCSS' liabilities. Beyond that, Cyclix assets did not yield sufficient value to pay the Cyclix creditors. Consequently, during the bankruptcy case, Cyclix equity had no value. The court would infer a greater sales price had Cyclix been sold in June rather than post-petition in September. But the court cannot find that greater sales price would have yielded a dividend to equity, let alone the $18 million attributed by Nicolaou. By one analysis, Nicolaou conceded that if her valuation of Cyclix had been off by $1 million, considering her adjusted figures, PCSS would have been insolvent. Her valuation of Cyclix was off by considerably more. Beyond the debt reduction to the bank on the liability side of the PCSS balance sheet, the court cannot accord value to Cyclix on the asset side. PCSS was insolvent.

HP criticizes Jenkins approach to derive the value of the assets. Jenkins worked retrospectively, by taking information from monthly operating reports prepared by McLean post-petition, and then revising the pre-petition balance sheets. Jenkins did not value the assets of PCSS by testing the forced sale markets for computer parts and other assets in June 2000. Nicolaou criticized Jenkins' conclusions because she disagreed with his opinion that PCSS was on its deathbed. She did not, however, contest his conclusion that if not a going concern, PCSS was insolvent in June 2000.

The court therefore finds that Mims has established by a preponderance of the evidence that the transfers were made while the debtor was insolvent. 11 U.S.C. § 547(b)(3).

Mims has established that the transfers were avoidable under § 547(b). As a result, the court turns to HP's affirmative defenses.

Section 547(c)(2); Ordinary Course of Business Defense

Preferential transfers made in the ordinary course of business may not be avoided. HP contends that the transfers had been made in the ordinary course of business under 11 U.S.C.

§ 547(c)(2). HP has the burden of proving the ordinary course of business defense. 11 U.S.C. § 547(g).

Section 547(c)(2) provides:

> [t]he trustee may not avoid under this section a transfer (2) to the extent that such transfer was- (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2).

Under the first prong of the ordinary course test, § 547(c)(2)(A), HP must establish that the debtor incurred the debt in the ordinary course of PCSS' and Compaq's business or financial affairs. McLean and Ken Higman, testifying on behalf of HP, confirmed that Compaq sold parts to PCSS, with invoices for due amounts, in the ordinary course of their respective businesses.

Under the second prong of the ordinary course test, § 547(c)(2)(B), HP must establish that the payments were made in the ordinary course of its and PCSS' business or financial affairs. The Bankruptcy Code does not impose a precise legal test for whether payments have been made in the ordinary course of business. GasMark, 158 F.3d at 317-18. Accordingly, courts focus on the time within which the debtor ordinarily paid the creditor and whether the timing of payments during the preference period demonstrated some consistency with that practice. Id.

The court must also compare prior dealings between the debtor and the creditor with their dealings during the preference period to determine whether the challenged dealings were ordinary. Mossay v. Hallwood Petroleum, Inc., No. Civ. A: 3:96-CV-2898, 1997 WL 222921, at *4 (N.D. Tex. Apr. 28, 1997). The court considers the timing of the payments, the amount and manner in which the transaction was paid and the circumstances under which the transfer was made. Id.

HP did not establish this prong by a preponderance of the evidence. Higman, who was responsible for locating Compaq documents, could not find all invoices, could not find Compaq's copy of the parties' spare parts agreement, and could not locate Compaq's documentation. He testified that Compaq's records may have been purged when Compaq merged with HP.

Under the third prong of the ordinary course test, § 547(c)(2)(C), HP must establish that the transfers had been made according to ordinary business terms. To meet that burden, HP must establish the customary terms and conditions used by other enterprises in the same industry facing the same or similar problems. The court must analyze whether the transfers were made according to ordinary business terms using an objective standard. Gulf City Seafoods, Inc., v. Ludwig Shrimp Co., Inc. (In re Gulf City Seafoods, Inc.), 296 F.3d 363, 369-70 (5th Cir. 2002). "[T]he question must be resolved by consideration of the practices in the industry – not by the parties' dealings with each other." Id. at 369. HP did not produce evidence addressing this prong.

As HP has not established two of the three prongs to the ordinary course test, HP may not invoke that affirmative defense.

Section 547(c)(4); New Value

Providing new value after a transfer may shield the transfer from recovery as a preference. HP contends that some of the amount of the transfers may not be avoided under 11 U.S.C. § 547(c)(4). That section provides:

> [t]he trustee may not avoid under this section a transfer (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor- (A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547(c)(4).

Based on Compaq's proof of claim, Compaq continued to ship parts after the receipt of each of the six checks. HP asks the court to calculate an amount of subsequent new value of $11,381. HP did not walk the court through that evidence at trial, but that amount does not appear to be in contention. HP does not claim a greater amount under § 547(c)(4). Accordingly, the court will credit $11,381 against the preference judgment.

Release

On September 19, 2000, the court entered an order approving a compromise and settlement between PCSS and HP. Compaq was then a separate legal entity and was not a party to that settlement. Nevertheless, HP contends that the preferential transfers from PCSS to Compaq should be covered by the release granted to HP in the settlement. The order approving the settlement provides:

> [Hewlett-Packard], its subsidiaries, affiliates, attorneys, agents, predecessors, successors and assigns and all past, present and future officers, directors, agents and employees of each and their respective successors, assigns, heirs, executors, and administrators are hereby released, remised and forever discharged from any and all claims, actions, causes of action, sums of money and demands relating to the prepetition obligations owed Debtors, including but not limited to Chapter V causes of action, or any transactions or actions with regard to purchase of the Inventory, except as provided hereunder.

Order at 5.

On May 3, 2002, Compaq completed its merger with HP. HP maintains that, as a result of the merger, HP may invoke the release. Higman testified, however, that he was not claiming that the HP settlement covered transactions between PCSS and Compaq. HP has produced no evidence that suggests that the bankruptcy court or bankruptcy estate had any knowledge in 2000 that Compaq would merge into HP in 2002. HP has presented no authority that would allow the 2000 settlement to apply to a then separate legal entity with no affiliated relationship to HP.

HP has presented no evidence to suggest that it provided consideration to the bankruptcy estate to permit the release of Chapter 5 causes of action of totally separate legal entities.

That HP chose to assume the obligations of Compaq two years after the settlement is completely outside the settlement. The release does not apply to the obligations of Compaq.

Conclusion and Order

Mims has established that transfers totaling $928,624.23 should be avoided under § 547(b). HP has established that it should receive a credit of $11,381.00 against the avoided transfers under § 547(c)(4). Mims, as trustee, shall therefore have a judgment of $917,243.23 under 11 U.S.C. § 550.

Based on the foregoing,

IT IS ORDERED that Jeffrey H. Mims, the Chapter 7 trustee for the bankruptcy estate of PC Services Source, Inc., shall recover a judgment of $917,243.23 against Hewlett-Packard Company, as successor to Compaq Computer Corp., together with pre-judgment interest of 1.32% from March 23, 2003, the date of the filing of the complaint, to the date of entry of judgment, and post-judgment interest at the applicable rate from the date of entry of judgment.

Counsel for Mims shall prepare a final judgment consistent with this order.

###END OF ORDER###