UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
Southern Division

In re:	)	Bankr. No. 02-40922
	)	
THE CREDIT STORE, INC.	)	Chapter 7
Tax I.D. No. 87-0296990	)	
Debtor.	)	
	)	
John S. Lovald, Trustee,	)	Adv. No. 03-4017
Plaintiff,	)	
	)	
-vs-	)	DECISION RE:
	)	CROSS MOTIONS
Thornton Capital Advisors, Inc.,	)	FOR SUMMARY JUDGMENT
and Recovery Partners II, L.L.C.,	)	
Defendants.	)	

The matter before the Court is the Motion for Summary Judgment filed by Plaintiff-Trustee John S. Lovald and the response and the cross-motion for summary judgment filed by Defendants Thorton Capital Advisors, Inc., and Recovery Partners II, L.L.C. This is a core proceeding under 28 U.S.C. § 157(b)(2). This Decision and accompanying order shall constitute the Court's findings and conclusions under Fed.R.Bankr.P. 7052. As set forth below, Plaintiff-Trustee's Motion will be granted in part, Defendants' motion will be denied, and a trial will be set to receive evidence under § 548(a)(1)(B)(i) regarding whether Defendants gave Debtor The Credit Store, Inc., reasonably equivalent value for a second lien Defendants received pre-petition on the Credit Store's assets and to receive evidence on all elements of § 548(a)(1)(A) regarding whether the subject Repurchase Agreement was an actual fraudulent transfer.

I.

On December 31, 2001, The Credit Store, Inc., ("Credit Store") and Thorton Capital Advisors, Inc., and Recovery Partners II, L.L.C., (collectively "Thorton Capital") entered into a Repurchase Agreement. Under the Agreement, the Credit Store bought back a pool of credit card receivables from Plains Commerce Bank, under a separate, earlier repurchase agreement, and then transferred those receivables to Thorton Capital for $8,000,000. The Credit Store agreed to continue servicing these accounts. The Repurchase Agreement also contained provisions for the Credit Store to repurchase the receivables from Thorton Capital for $8,000,000. Further, the Repurchase Agreement defined the parties' positions should the transfer be deemed not a "true sale," and it gave Thorton Capital a first lien position in the receivables under that contingency. In addition, the Repurchase Agreement gave Thorton Capital a second lien position on all of the Credit Store's other assets. According to Article 4 of the Agreement, this collateral was given to "secure the obligations of [the Credit Store] to [Thorton Capital] hereunder, including its obligations to service the [pool of credit card receivables] and to pay [Thorton Capital] the Repurchase Price together with interest....[.]" Thorton Capital filed separate UCC-1 financing statements in Delaware regarding the pool of credit card receivables and the Credit Store's other assets.

On July 12, 2002, Thorton Capital exercised its option to require the Credit Store to repurchase the pool of credit card receivables. The Credit Store did not do so.

On August 15, 2002, which was within one year of the Repurchase Agreement with Thorton Capital, the Credit Store filed a Chapter 11 petition in bankruptcy. The Chapter 11 case was converted to a Chapter 7 case on February 4, 2003. John S. Lovald was appointed the Chapter 7 trustee. Thorton Capital is liquidating the pool of credit card receivables and expects to recover between $4,000,000 and $8,000,000. It will look to its second lien on the Credit Store's other assets to satisfy, at least in part, any deficiency.

On April 4, 2003, Trustee Lovald commenced this adversary proceeding against Thorton Capital. He alleged that the Credit Store's transfer of a second lien position on all its other assets to Thorton Capital is avoidable either as an actually fraudulent transfer under 11 U.S.C. § 548(a)(1)(A) or a constructively fraudulent transfer under 11 U.S.C. § 548(a)(1)(B). Trustee Lovald also asked that Thorton Capital's claim be disallowed under 11 U.S.C. § 502(d) until Thorton Capital returned the subject collateral to the bankruptcy estate.

Thorton Capital moved to dismiss Trustee Lovald's amended complaint. Trustee Lovald consented to dismissal of Count III regarding Thorton Capital's proof of claim. The Court ordered

Trustee Lovald to amend Count I under § 548(a)(1)(A) to more specifically set forth its allegations of fraud. The Court allowed Count II to stand as pled.

In Count I of its second amended complaint, Trustee Lovald alleged several misdeeds by Debtor or its principals and argued that the transfer to Thorton Capital of the second lien position in the Credit Store's other assets was made with an actual fraudulent intent at a time when the Credit Store was not solvent.

Thorton Capital answered. It noted that the Repurchase Agreement had been amended twice during 2002. It essentially argued, regarding the actual fraud count under § 548(a)(1)(A), that the security interest it received in Debtor's other assets was partial consideration for the $8,000,000 it gave Debtor under the Repurchase Agreement and that the transfer was not made with any fraudulent intent. As to the constructive fraud count, Thorton Capital denied that the Credit Store became insolvent because of the transfer of the second lien position in the Credit Store's other assets.

At the initial pre-trial conference, the parties requested time to attempt a settlement. Eventually, Trustee Lovald moved for summary judgment on the constructive fraud count. In his motion, Trustee Lovald noted that Thorton Capital has always claimed, and continues to claim, that the pool of credit card receivables was transferred to Thorton Capital as an actual sale. Therefore, he

argued, that left the second lien position in the Credit Store's other assets to secure the other obligations that the Credit Store made under the Repurchase Agreement, which were servicing the credit card accounts and paying the repurchase price. Trustee Lovald said two elements of § 548(a)(1)(B) were not factually in dispute: that the lien on the Credit Store's other assets was a transfer of an interest in the Credit Store's property and that the lien was given within one year of the Credit Store's Chapter 11 petition date. Due to a lack of consideration and the effect of the lien on the Credit Store's financial status, however, Trustee Lovald characterized this lien on the Credit Store's other assets as avoidable under § 548(a)(1)(B).

To demonstrate under § 548(a)(1)(B)(ii)(I) that the Credit Store was insolvent at the time it transferred the second lien position to Thorton Capital, Trustee Lovald relied upon two documents. The first, was the Credit Store's quarterly report (form 10-Q) to the Securities and Exchange Commission for the quarter ending March 31, 2002. The report included consolidated financial information with one of the Credit Store's three active subsidiaries, Credit Store Financial, Inc. The report indicated the consolidated entities had a combined net worth of $2.8 million dollars, but the report also indicated that they had a net loss of $3,361,180 for the nine months that ended March 31, 2002. The report further detailed many of the Credit Store's recent, complex

financial transactions with its several creditors and investors and some of its present financial problems. It also summarized on pages 25 and 26 the Repurchase Agreement that the Credit Store made with Thorton Capital:

> On December 31, 2001, we entered into a repurchase agreement with Thornton Capital Advisors & Recovery Partners II ("Thornton/Recovery"). In accordance with the repurchase agreement on January 4, 2002, Thornton/Recovery purchased $10.5 million principal face value of receivables for $8.0 million. We used the proceeds of this sale to exercise the Plains Commerce Bank repurchase option described above. We may repurchase the receivables at any time and are required to repurchase the receivables upon an insolvent event. As of May 1, 2002, on 60 days notice, Thornton/Recovery can require us to repurchase the portfolio for the remaining repurchase price. If we were required to repurchase the portfolio and were unable to do so within the required period, Thornton/Recovery could sell the receivables and would have recourse to us for any amounts due, subject to the restrictions in the intercreditor and subordination agreement with Coast. Our obligations under this agreement are secured by a second lien on substantially all our assets, subordinated to Coast's lien. Under the Repurchase Agreement, Thornton/Recovery receives a required return of the amounts collected on the receivables. The percentage was 12% at closing, and increased to 37.5% as of March 5, 2002. After Thornton/Recovery has been paid its percentage, collections are applied to the repurchase price of the portfolio. We are required to maintain receivables coverage of 125% of the repurchase price. As of March 31, 2002, the repurchase price was $7.4 million and the principal face value of the receivables was $9.3 million. We are actively seeking the sale or refinancing of these receivables. However, we cannot assure you that we will be able to effect the sale or refinancing of these portfolios or do so on favorable terms.

In the report, the Credit Store also stated, on pages 28-30:

WE MAY NOT ACHIEVE POSITIVE CASH FLOW FROM OPERATIONS OR PROFITABILITY. We have incurred significant expenditures to build the infrastructure necessary to acquire charged-off portfolios, market and create new credit card accounts from these portfolios, and service the resulting base of credit card accounts. As a result, we have historically experienced negative cash flow from operations before our investing activities. Cash flow from our investing activities includes our cash flow from credit cards and collections. Our negative cash flow from operations was $9.8 million for the nine months ended March 31, 2002, and $8.0 million for the nine months ended March 31, 2001. We may continue to generate negative cash flow from operations. Until we generate sufficient cash flows from operations, we will need to use our available capital, including any proceeds from the sale or securitization of receivables and any future issuances of debt or equity securities to fund our cash flow requirements.

IF WE CANNOT REPLACE OUR SENIOR CREDIT FACILITY AND OBTAIN ADDITIONAL WORKING CAPITAL AS NEEDED TO FINANCE OUR OPERATIONS AND GROW OUR BUSINESS, WE MAY BE REQUIRED TO SELL PORTFOLIOS OF RECEIVABLES ON TERMS LESS FAVORABLE TO US THAN THOSE OF PAST SALES, LIMIT OUR OPERATIONS AND RESTRICT OUR GROWTH. ANY OF THESE ACTIONS COULD HURT OUR ABILITY TO GENERATE CASH FLOW FROM OUR INVESTMENT IN RECEIVABLE PORTFOLIOS AND COULD HAVE A MATERIAL AND ADVERSE IMPACT ON OUR BUSINESS OPERATIONS. We have a substantial ongoing need for capital to finance our operations. This need is expected to increase along with the growth of our business. We fund our cash requirements through a combination of:

- cash flow from operations;
- asset sales and securitizations; and
- loans and other financing transactions.

Our senior credit facility currently has an expiration date of, and the outstanding balance matures on, July 31, 2002. In addition, Thornton/Recovery can require us to purchase the portfolios of receivables subject to the repurchase agreement on sixty days notice.

If we cannot refinance the senior credit facility and the repurchase option, obtain additional working capital when needed and additional receivable sales and securitizations are not completed, our ability to operate and grow our business will be limited. In addition, we may be required to complete receivable sales or securitizations on less favorable terms than in the past in order to raise the working capital needed to repay maturing obligations and operate our business. We cannot assure you we will be successful in obtaining additional financing when needed to meet our working capital requirements.

BECAUSE WE HAVE PLEDGED ALL OF OUR ASSETS, WE MAY HAVE DIFFICULTY SECURING FUTURE FINANCING. Our principal lender, Coast Business Credit, has a security interest in all of our assets, including all receivables, inventory and equipment, to secure our payment and performance under our senior secured facility. Thornton Capital Advisors and Recovery Partners II have a subordinated lien on our assets to secure payment of notes held by them. Our controlling stockholder, Jay L. Botchman, also has a subordinated lien on our assets to secure payment of notes held by him. While both our senior secured lender and our controlling stockholder have in the past voluntarily released their liens on assets we wanted to sell or securitize, the terms of our loan agreements do not require them or Thornton Capital and Recovery Partners II to release their liens. We cannot assure you they will be willing to do so in the future. As a result, we may find it more difficult to sell certain of our assets or to secure additional financing in the future.

BECAUSE WE ARE LEVERAGED OUR ABILITY TO SUCCESSFULLY OPERATE OUR BUSINESS MAY BE LIMITED. As of March 31, 2002, we had approximately $52.9 million of debt outstanding and we may incur substantial additional debt in the future. Our level of debt could have important consequences to you, including:

- a substantial portion of our cash flow from operations will b dedicated to paying principal and interest on our debt, reducing funds available for expansion or other purposes;
- our significant amount of debt could make us more vulnerable to changes in general economic conditions or increases in prevailing interest rates;
- our failure to comply with the restrictions contained in any of our financing arrangements could lead to a default which could result in our being required to repay all of our outstanding debt; and
- we may be more leveraged than some of our competitors, which may result in a competitive disadvantage.

Trustee Lovald also relied on the Credit Store's Chapter 11 schedules, which were filed September 16, 2002. The schedules indicated that the Credit Store's liabilities exceeded its assets by just over $16,000,000.

To demonstrate under § 548(a)(1)(B)(ii)(III) that the Credit Store was unable to meet its obligations after it gave Thorton Capital a second lien on its other assets, Trustee Lovald relied on the Credit Store's July 10, 2002, 8-K statement to the Securities and Exchange Commission. Attached to the 8-K was a July 9, 2002, press release from the Credit Store that stated, in pertinent part:

The Company is currently engaged in discussions with its various institutional creditors and possible new sources of funding looking toward extensions of maturity dates or refinancing of its existing indebtedness. It is also in the process of negotiating receivable sales. If these discussions and negotiations are not successful, the Company will be unable to meet its existing obligations maturing during July and would likely be unable to continue to fund its operations by the end of the month. There can be no assurance that these discussions will be successful. Accordingly, the Company is reviewing the alternatives available to it to preserve its liquidity if its funding discussions are not successfully resolved this month, including filing a petition for reorganization under Chapter 11 of the federal bankruptcy act.

The Company has also settled the Renaissance Trust I litigation previously described in the Company's filings with the Securities and Exchange Commission. Pursuant to the settlement, the Company has agreed to pay Renaissance $4.0 million plus interest over a four-year period. The recording of this settlement agreement will likely result in the Company reporting negative net worth. Further, the Company will likely be required to accrue additional funds as a reserve in connection with a similar dispute with the O. Pappalimberis Trust.

To demonstrate that the lien was not given for a reasonable value as required by § 548(a)(1)(B)(i), Trustee Lovald relied upon the language of Article II of the Repurchase Agreement. Trustee Lovald first pointed out that the Repurchase Agreement said the asset lien was being given to secure Debtor's obligations to service the pool of credit card receivables and to pay Thorton Capital the repurchase price. However, Trustee Lovald noted, under Article 3 of the Repurchase Agreement, the Credit Store received only limited compensation from Thorton Capital to service the pool of credit card receivables because the Credit Store was, in part, providing this service in consideration for "the other covenants and provisions" of the Repurchase Agreement. Further, the Credit Store was to pay Thorton Capital interest if it did not perform timely on the repurchase portion, Article 2, of the Repurchase Agreement. Since this other consideration had already been given

and since the interest provision was conditional, Trustee Lovald argued that the Credit Store had not received any compensation for the asset lien it gave Thorton Capital, which is categorized as a separate transfer governed by Article 4 of the Repurchase Agreement.

Thorton Capital objected to Trustee Lovald's summary judgment motion and it cross-motioned for summary judgment on all counts. It argued that the Repurchase Agreement should be read as a whole and that the second lien on the Credit Store's other assets was an integral part of the transaction to insure that Thorton Capital received back its full investment plus interest should the pool of credit card receivables be worth less than $8,000,000. It argued that since the second lien on other assets could do no more than make it whole, *i.e.*, insure that Thorton Capital received back its $8,000,000 investment plus interest, the second lien could not be characterized as a transfer that conferred additional, uncompensated value on Thorton Capital.

Thorton Capital also challenged the competency of Trustee Lovald's evidence under § 548(a)(1)(B)(ii)(I) regarding whether the Credit Store was insolvent when it gave Thorton Capital the second lien on its other assets. Thorton Capital argued that the Credit Store's March 31, 2002, Form 10-Q was not dispositive of the Credit Store's financial picture three months earlier and it argued that Trustee Lovald had failed to supply any sworn testimony or other

evidence that the 10-Q or the Credit Store's bankruptcy schedules were accurate. In the end, Thorton Capital argued that the March 31, 2002, 10-Q ultimately showed that the Credit Store was solvent since the consolidated report indicated assets exceeded liabilities. Thorton Capital did not acknowledge that the report included the Credit Store's financial position over the prior nine months, which incorporated the date the Repurchase Agreement was signed, and Thorton Capital did not respond to the specific statements made by the Credit Store within the 10-Q wherein the Credit Store acknowledged that it was fully leveraged and that its present level of debt might lead to default.

Thorton Capital also argued that Trustee Lovald had not met his burden under § 548(a)(1)(B)(ii)(III) of showing that the transfer was made at a time when the Credit Store was unable to meet its obligations as they matured. Thorton Capital stated that the Credit Store's July 10, 2002, 8-K statement to the SEC was too distant in time to December 31, 2001. Though it did not cite the rule of evidence on which it relied, Thortan Capital stated the press release attached to the 8-K was not competent evidence because it was not made under oath. It also argued that Trustee Lovald had failed to make a showing regarding the "intent" portion of § 548(a)(1)(B)(ii)(III), that is, Trustee Lovald had not shown that the Credit Store knew or believed that it was incurring debt it could not pay at maturity.

In support of its position, Thorton Capital filed an affidavit from Steven R. Cook, the Vice President of Strategica, a company that Cook says advised Thorton Capital regarding its dealings with the Credit Store. Cook essentially affied that the Repurchase Agreement was drafted in light of Thorton Capital's ultimate intention of acquiring a controlling interest in the Credit Store and in light of Thorton Capital's lack of due diligence, due to time constraints, regarding an accurate value of the pool of credit card receivables it was purchasing. He said the second lien on the Credit Store's other assets was necessary to protect Thorton Capital should its attempt to acquire a controlling interest in the Credit Store fail and should the Credit Store then be unable to repurchase the pool of credit card receivables from Thorton Capital. He also stated that each article in the Repurchase Agreement was intended to be read as a whole and that each article was not intended to stand alone.

Trustee Lovald moved to strike portions of Steven Cook's affidavit. It argued that Cook's competency to testify on the pending issues had not been shown, that many of his statements were inadmissable hearsay, and that many statements violated the parole evidence rule.

In response to the Trustee's motion to strike, Thorton Capital filed another affidavit by Steven Cook to address the Trustee's challenges, and one by Mark Bernier, President of Thorton Capital

Advisors, Inc.[1] In his affidavit Bernier acknowledged Cook's role with Thorton Capital and his involvement with the Repurchase Agreement with the Credit Store. He also stated that the second lien on the Credit Store's other assets was an integral part of the whole Repurchase Agreement. In essence, Thorton Capital argued that the Repurchase Agreement was not clear enough to be interpreted solely on its face and that Cook's affidavit was relevant and necessary to decipher the parties' intent and to provide background or contextual evidence regarding the purpose of the Repurchase Agreement.

Trustee Lovald also moved to strike Cook's supplemental affidavit and Bernier's affidavit. He argued that they were untimely and should have been submitted when Thorton Capital filed its cross motion for summary judgment. In the alternative, he asked the Court to consider his surreply. Thorton Capital again responded saying parole evidence from Cook and Bernier was necessary since Trustee Lovald was advocating that the Repurchase Agreement should be interpreted article by article rather than as a whole.

II.
Motions to Strike.

The Court will deny both motions to strike by Trustee Lovald.

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[1] Bernier's affidavit was docketed as part of Thorton Capital's reply to the Trustee's response regarding the cross-motions for summary judgment.

The Court has considered Trustee Lovald's concerns regarding the foundation and relevancy of the affidavits by Cook and Bernier and, in fact, shares some of those concerns regarding hearsay statements and relevancy. If necessary, those issues can be addressed at trial. As the better alternative under this summary judgment proceeding, the Court will instead consider Trustee Lovald's surreply and weigh the relevancy and materiality of the affidavits in light of the issues presented.

Contrary to Thorton Capital's assertions, the Court at this juncture finds limited value in receiving evidence on the "background, intent, purpose, and context" for the Repurchase Agreement, which was the reason that Thorton Capital said it submitted Cook's affidavit. The record does not show that there is any meaningful dispute regarding what the Credit Store agreed to do under the Agreement and what Thorton Capital agreed to do under the Agreement. *Farm Credit Services v. Heine Feedlot Co. (In re Heine Feedlot Co.)*, 107 F.3d 622, 624-25 (8th Cir. 1997)(cite therein)(a writing is ambiguous when it is reasonably capable of being understood in more than one sense). Instead, for purposes of § 548(a)(1)(B), the focus should be on the impact, if any, that the Repurchase Agreement had thereafter on the Credit Store's financial well-being. That is an issue separate from what the terms of the Repurchase Agreement provided.

Parole evidence may, of course, be appropriate when the actual fraud provisions of § 548(a)(1)(A) are at issue. *Mueller v. Hubbard Milling Co.*, 573 F2d 1029, 1035-36 (8th Cir. 1978)(quoting therein *Baker v. Jewell*, 96 N.W.2d 299, 301-02 (S.D. 1959)); *In re Estate of Rosenbaum*, 624 N.W. 2d 821, 824-25 (S.D. 2001). Cook's affidavit, however, offered little on that issue except to argue that the Repurchase Agreement should be interpreted as a whole.

III.
Applicable law.

SUMMARY JUDGMENT. Summary judgment is appropriate when "there is no genuine issue [of] material fact and . . . the moving party is entitled to a judgment as a matter of law." Fed.R.Bankr.P. 7056 and Fed.R.Civ.P. 56(c). An issue of material fact is *genuine* if it has a real basis in the record. *Hartnagel v. Norman*, 953 F.2d 394, 395 (8th Cir. 1992)(quotes therein). A genuine issue of fact is *material* if it might affect the outcome of the case. *Id.* (quotes therein).

The matter must be viewed in the light most favorable to the party opposing the motion. *F.D.I.C. v. Bell*, 106 F.3d 258, 263 (8th Cir. 1997); *Amerinet, Inc. v. Xerox Corp.*, 972 F.2d 1483, 1490 (8th Cir. 1992)(quoting therein *Matsushita Elec. Industrial Co. v. Zenith Radio*, 475 U.S. 574, 587-88 (1986)(cites therein)). The nonmoving party is entitled to all reasonable inferences that can

be drawn from the evidence without resorting to speculation. *P.H. v. School District of Kansas City, Missouri*, 265 F.3d 653, 658 (8th Cir. 2001)(quoting therein *Sprenger v. Fed. Home Loan Bank of Des Moines*, 253 F.3d 1106, 1110 (8th Cir. 2001)(internal quotation omitted)). Only disputes over facts that might affect the outcome of the suit under the applicable law properly preclude the entry of summary judgment. *P.H. v. School District*, 265 F.3d at 658.

The movant meets his burden if he shows that the record does not contain a genuine issue of material fact and he identifies that part of the record that bears out his assertion. *Handeen v. LeMaire*, 112 F.3d 1339, 1346 (8th Cir. 1997)(quoting therein *City of Mt. Pleasant v. Associated Electric Coop*, 838 F.2d 268, 273 (8th Cir. 1988)). No defense to an insufficient showing is required. *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 156 (1970)(cite therein); *Handeen*, 112 F.3d at 1346. If the movant meets his burden, however, the nonmovant, to defeat the motion, "must advance *specific facts* to create a genuine issue of material fact for trial." *Bell*, 106 F.3d at 263 (emphasis added)(quoting *Rolscreen Co. v. Pella Products of St. Louis, Inc.*, 64 F.3d 1202, 1211 (8th Cir. 1995)). The nonmovant must do more than show there is some metaphysical doubt; he must show he will be able to put on admissible evidence at trial proving his allegations. *Bell*, 106 F.3d at 263 (citing *Kiemele v. Soo Line R.R. Co.*, 93 F.3d 472, 474

(8th Cir. 1996), and *JRT, Inc. v. TCBY System, Inc.*, 52 F.3d 734, 737 (8th Cir. 1995)).

FRAUDULENT TRANSFERS UNDER § 548(a). Section 548(a) of the Bankruptcy Code allows a trustee to avoid transfers infected by either actual fraud or constructive fraud. *BFP v. Resolution Trust Corp.*, 114 S.Ct. 1757, 1760 (1994). The trustee must show each element of an avoidable transfer by a preponderance of the evidence. *Sherman v. Third National Bank*, 67 F.3d 1348, 1353 (8th Cir. 1995). If the trustee makes a *prima facie* case of fraud, the burden of going forward with evidence may shift to the debtor or creditor involved in the transfer to prove some "legitimate supervening purpose" for the transfer at issue. *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 806 (9th Cir. 1994); *First National Bank in Anoka v. Minnesota Utility Contracting, Inc. (In re Minnesota Utility Contracting, Inc.)*, 110 B.R. 414, 418-20 (D. Minn. 1990); *see Kelly v. Armstrong*, 141 F.3d 799, 802-03 (8th Cir. 1998).

Actual fraud. Under § 548(a)(1)(A), a trustee may avoid a transfer if the debtor transferred property within one year of his petition and if the debtor made the transfer with the actual intent to hinder, delay, or defraud present or future creditors. Because fraud can rarely be established by direct evidence, fraudulent intent may be inferred from the circumstances surrounding the

transfer. *Sherman*, 67 F.3d at 1353. To determine whether circumstantial evidence establishes a fraudulent intent, courts consider whether any "badges of fraud" are present. *Id.*

> The presence of a single badge of fraud is not sufficient to establish actual fraudulent intent; however, "the confluence of several can constitute conclusive evidence of actual intent to defraud, absent 'significantly clear' evidence of a legitimate supervening purpose."

Id. at 1354 (quoting *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254-55 (1st Cir. 1991)(quote therein omitted)). The badges of fraud to consider include whether:

(1) the transfer or obligation was to an insider;

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

(3) the transfer or obligation was disclosed or concealed;

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

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

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) 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) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the

> business to a lienor who transferred the assets to an insider of the debtor.

Id. (citing Mo.Rev.Stat. § 428.024(2)); S.D.C.L. § 54-8A-4(b). These badges of fraud, which originated in the common law, are set forth in the Uniform Fraudulent Transfer Act, which is recognized in South Dakota. S.D.C.L. Ch. 54-8A.

Constructive fraud. Under 548(a)(1)(B), a trustee may avoid a transfer if the debtor transferred property within one year of his petition, the transfer was for less than reasonably equivalent value, and the debtor was insolvent at the time of the transfer or the debtor intended or believed he would incur debts beyond his ability to pay. *Meeks v. Don Howard Charitable Remainder Trust (In re Southern Health Care of Arkansas, Inc.)*, 309 B.R. 314, 318 (B.A.P. 8th Cir. 2004). The trustee must establish that (1) the debtor had an interest in property; (2) the debtor transferred that interest in property within one year of the date the debtor filed his petition; (3) the debtor was insolvent at the time of the transfer or became insolvent because of the transfer, the debtor was undercapitalized, or the debtor intended to incur or believed he would incur debts beyond his ability to pay; and (4) the debtor received less that a reasonably equivalent value for the transfer. *See BFP v. Resolution Trust*, 114 S.Ct. at 1760; *Peltz v. Hatten*, 279 B.R. 710, 742-48 (D. Del. 2002). Value is defined as "property, or satisfaction or securing of a present or antecedent

debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A).

Whether the debtor received "reasonably equivalent value" for the transfer is a question of fact. *Southern Health Care*, 309 B.R. at 319. It is answered by determining whether the debtor received "value that is substantially comparable to the worth of the transferred property[.]" *BFP*, 114 S.Ct. at 1767. The analysis to be made is whether:

> (1) value was given; (2) it was given in exchange for the transfers; and (3) what was transferred was reasonably equivalent to what was received.

Pummill v. Greensfelder, Hemker & Gale (In re Richards & Conover Steel, Co.), 267 B.R. 602, 612 (B.A.P. 8th Cir. 2001)(quoted in *Southern Health Care*, 309 B.R. at 319)). Further,

> When evaluating a transfer for reasonable equivalency of value as compared to a money payment, a court must examine the whole transaction and measure all the benefits--whether they be direct or indirect. *Christians v. Crystal Evangelical Free Church (In re Young)*, 82 F.3d 1407, 1415 (8th Cir. 1996)(holding that the trustee could not recover tithes to a church under 11 U.S.C. § 548), *vacated*, 521 U.S. 1114, 117 S.Ct. 2502, 138 L.Ed.2d 1007 (1997)(vacating for further consideration on the legitimacy of the Religious Freedom Restoration Act), *reinstated*, 141 F.3d 854 (8th Cir.1998), *cert. denied*, 525 U.S. 811, 119 S.Ct. 43, 142 L.Ed.2d 34 (1998). If the measure for reasonable equivalency is the value of an indirect benefit then that benefit must be tangible. *Richards & Conover Steel, Co.*, 267 B.R. at 612-13. Transfers made by a debtor for the benefit of a third party, by themselves, do not provide any reasonable equivalent benefit for the debtor. *Dietz v. St. Edward's*

> *Catholic Church (In re Bargfrede)*, 117 F.3d 1078, 1080 (8th Cir. 1997)(holding that the receipt of an indirect, non-economic, intangible, psychological benefit was not sufficient to constitute reasonable equivalent value).

Southern Health Care, 309 B.R. at 319-20. In other words, chimerical benefits will not prevent a transfer from being avoided under § 548(a)(1)(B). *Id.* at 320. A tangible, direct, and economic benefit to the debtor must be demonstrated on the record. *Id.*

IV.

Actual fraud under § 548(a)(1)(A). Thorton Capital has asked this Court to grant summary judgment in its favor regarding Trustee Lovald's amended complaint under § 548(a)(1)(A). In its arguments, Thorton Capital said,

> Given the eventual likelihood that a repurchase would occur, T/RP [Thorton Capital] wanted the assurance that the debtor would be able to pay the Repurchase Price of $8 million plus the Required Return in the event the repurchase option was exercised. At the time of the transaction, however, T/RP did not have the opportunity to do a detailed collateral review of the receivables it would purchase. As a result, T/RP did not have the assurance that those receivables in of themselves provided sufficient value to assure the debtor would have the wherewithal to pay the Repurchase Price and fulfill its other obligations. T/RP therefore insisted on obtaining a junior lien in all of the debtor's assets to assure the repayment of the repurchase price and the debtor's other obligations, and the debtor agreed to provide that collateral to secure its obligations in order to receive the $8 million from T/RP.

Thorton Capital's OPPOSITION TO TRUSTEE'S MOTION FOR SUMMARY JUDGMENT AND CROSS-MOTION FOR SUMMARY JUDGMENT, p. 5, filed March 27, 2004 (citations

to Cook's affidavit therein omitted). Rather than satisfying the Court that the Repurchase Agreement was a legitimate business deal and that Thorton Capital appropriately required other collateral from the Credit Store to secure the Credit Store's possible repurchase of the pool of credit card receivables, Thorton Capital's argument instead raises several red flags. First, if the pool of credit card receivables was not worth $8,000,000, why was Debtor repurchasing it from Plains Commerce Bank for $8,000,000, then selling it to Thorton Capital for $8,000,000 and then agreeing to repurchase it from Thorton Capital for $8,000,000 plus interest? And why would Thorton Capital fund the Credit Store's repurchase from Plains Commerce Bank if the pool was not worth what the Credit Store paid for it? Why were Debtor and Thorton Capital both willing to enter a "rush" agreement when apparently neither had time to obtain a current appraisal of the pool of credit card receivables? Why was Debtor willing to pay Thorton Capital such high interest rates, especially where the repurchase was, as described by Thorton Capital, an "eventual likelihood"? What were all the benefits that Plains Commerce Bank or other third parties received because of the Credit Store and Thorton Capital's Repurchase Agreement? What was the value of the "other obligations" that the Credit Store assumed under the Repurchase Agreement compared to the value of the lien it gave Thorton Capital

in its other assets? Only when the Court is provided answers to these questions, coupled with a reliable valuation of the pool of credit receivables on December 31, 2001,[2] can the Repurchase Agreement between the Credit Store and Thorton Capital be appropriately reviewed under § 548(a)(1))A).

On page 8 of its March 27, 2004, pleading, Thorton Capital summarized the parties' deal as follows:

> I will give you the $8 million you need and buy these receivables you need to repurchase from the Bank, but if we decide to abandon the acquisition, I want the ability to get my $8 million back and return the receivables to you. And to be sure that you will be able to pay the $8 million at that time - especially because I am not sure that the receivables are worth the $8 million - I will need a junior lien in your assets.

In doing so, Thorton Capital itself identified the apparent inconsistency in this transaction: If the pool was not worth $8,000,000, then why was Debtor repurchasing it from Plains Commerce Bank for $8,000,000 and also agreeing to repurchase the pool at a later time from Thorton Capital for $8,000,000 plus interest at a high rate?

Thorton Capital also seems to think the Repurchase Agreement makes good sense if it is read as a whole, rather than article by

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[2] The only value of the pool of credit card receivables that the Court has found in the record is in the Credit Store's March 31, 2002, 10-Q form. Therein, the Credit Store said the pool had a "principal face value" of $10,500,000 on January 4, 2002. That value raises its own red flag. Why was Thorton Capital getting more than it paid for?

article as Trustee Lovald has recommended, and if it is read in light of Cook's affidavit, which discusses Thorton Capital's tentative plan to acquire a controlling interest in the Credit Store. Even when read as a whole and even when read in light of Cook's affidavit, however, the several troublesome questions raised above remain unanswered.

In another part of its March 27, 2004, pleading, Thorton Capital states:

> [T]he junior lien served only to assure T/RP that the Purchased Receivables were in fact worth the $8 million which it had paid, should it exercise its option to have the debtor repurchase them. [Thorton Capital] could never receive back more than its $8 million and the Required Return. It is absurd to imagine that that provisions which merely enable a party to get back what it paid may be set aside as a fraudulent conveyance.

That statement is inconsistent with the terms of the Repurchase Agreement. The Agreement stated the second lien on the Credit Store's other assets was being given to "secure the obligations" that the Credit Store made under the Agreement, "including [but apparently not limited to] its obligations to service the Credit Card Accounts and to pay [Thorton Capital] the Repurchase Price together with interest[.]" Thus, Thorton Capital's argument that a fraudulent transfer could not have occurred because it could never get back more than the $8,000,000 plus interest that it gave to Debtor is inaccurate. The exchange of value under the Repurchase Agreement was not that clear; the Credit Store obligated

itself to do more for Thorton Capital under the agreement, such as servicing the pool of receivables, and the value of those additional obligations is unknown. These values are needed to assess whether the Credit Store received appropriate value for the second lien on other assets.

Thorton Capital made one summary statement in its March 27, 2004, pleading that was on target: "Fraudulent conveyance laws measure the equivalence of the promises and performance on each side." Thorton Capital's OPPOSITION TO TRUSTEE'S MOTION FOR SUMMARY JUDGMENT AND CROSS-MOTION FOR SUMMARY JUDGMENT, p. 16. The present record does not allow the Court to conclude that the promises and performance on each side of the Repurchase Agreement were equivalent. Accordingly, summary judgment is not warranted and a trial is needed. Trustee Lovald bears the burden of proof to establish a *prima facie* case. If he meets that burden, Thorton Capital must go forward to show the transfer was legitimate. *Kelly*, 141 F.3d at 802-03.

Constructive fraud under § 548(a)(1)(B). The parties have agreed that the Credit Store gave Thorton Capital a lien on the Credit Store's other assets and that this transfer was within one year of the Credit Store's bankruptcy petition. Two elements of constructive fraud remain at issue: whether the Credit Store received less than a reasonably equivalent value for this transfer,

§ 548(a)(1)(B)(i), and whether the transfer rendered the Credit Store insolvent, undercapitalized, or unable to meet its maturing obligations, § 548(a)(1)(B)(ii).

As discussed above, the present record does not allow the Court to reach a conclusion on whether the Credit Store received a reasonably equivalent value for the second lien on its other assets that it gave Thorton Capital. The total values on each side of the equation are unknown. Hence, summary judgment cannot be awarded to either party under § 548(a)(1)(B)(i). A trial on that issue is needed.[3] Trustee Lovald will bear the burden of proof by a preponderance of evidence.

Under subsection (a)(1)(B)(ii) of § 548, Trustee Lovald has met his burden, as required by *Handeen*, 112 F.3d at 1346, of showing that the record does not contain a genuine issue of material fact regarding the Credit Store's dire financial circumstances on December 31, 2001. The March 31, 2002, Form 10-Q bears out his assertions under both §§ 548(1)(1)(B)(ii)(I) and (II). The 10-Q that the Credit Store gave the SEC, while it may

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[3] If Thorton Capital agrees that its lien on the Credit Store's other assets is limited to any deficiency on the $8,000,000 repurchase price, plus agreed interest, Trustee Lovald's constructive fraud theory likely fails. At times, Thorton described its secured claim in that fashion. At other times, it has recognized that the Repurchase Agreement provided that the lien on other assets secured both the repurchase price and the Credit Store's "other obligations" under the Agreement.

have shown a positive net worth in numbers, painted a very bleak financial picture. Therein, the Credit Store acknowledged it was fully leveraged, that it did not have a positive cash flow and might not be able to achieve one, and that it had a "substantial ongoing need for capital to finance [its] operations." Therein, the Credit Store even warned of imminent default. The Credit Store's July 10, 2002, 8-K statement bears out Trustee Lovald's assertions under § 548(a)(1)(B)(ii)(III) since therein the Credit Store acknowledged that absent refinancing it would not be able to meet its current obligations. Since Trustee Lovald met his burden, Thorton Capital was obligated, to defeat the motion, to "advance *specific facts* to create a genuine issue of material fact for trial." *Bell*, 106 F.3d at 263. That it did not do. Though Thorton Capital challenged the competency of the financial documents that Trustee Lovald presented with his summary judgment motion, Thorton capital did little more than raise "some metaphysical doubt" about the Credit Store's solvency. Thorton Capital did not identify or show that it had admissible evidence that the Credit Store actually was solvent, was not undercapitalized, and was currently meeting all its obligations on December 31, 2001. *Bell*, 106 F.3d at 263.

Though Thorton Capital would like the Court to rely on the March 31, 2002, 10-Q to conclude that the Credit Store *was* solvent

on December 31, 2001, the Court cannot. To do so would require the Court to ignore the rest of the report, which better detailed the Credit Store's actual financial straits. Accordingly, summary judgment regarding § 548(a)(1)(B)(ii) will be granted to Trustee Lovald.

An order will be entered granting denying Trustee Lovald's motions to strike and granting him partial summary judgment. Thorton Capital's cross-motion for summary judgment will be fully denied. A trial will be held to receive evidence under § 548(a)(1)(A) and § 548(a)(1)(B)(i).

Dated this 23rd day of June, 2004.

BY THE COURT:

Irvin N. Hoyt
Bankruptcy Judge

ATTEST:
Charles L. Nail, Jr., Clerk
By Deputy Clerk
(SEAL)

NOTICE OF ENTRY
Under F.R.Bankr.P. 9022(a)
Entered
JUN 23 2004
Charles L. Nail, Jr., Clerk
U.S. Bankruptcy Court
District of South Dakota

I hereby certify that a copy of this document was electronically transmitted, mailed, hand delivered or faxed this date to the parties on the attached service list.

JUN 23 2004

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