

IT IS ORDERED as set forth below:

Date: July 8, 2013



A handwritten signature in black ink, reading "James R. Sacca".

James R. Sacca
U.S. Bankruptcy Court Judge

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION**

IN RE:	}	
	}	CASE NO. 09-86091-JRS
ATLANTA RUG GALLERY, INC.,	}	
	}	CHAPTER 7
Debtor.	}	

PAUL H. ANDERSON, JR., as Trustee,	}	
	}	ADVERSARY PROCEEDING
Plaintiff,	}	
	}	NO. 12-05081-JRS
v.	}	
	}	
MOHAMAD GAVAH, I,	}	
	}	
Defendant.	}	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter came on for trial on May 7, 2013 on the Complaint filed by the Chapter 7 Trustee seeking to avoid—under 11 U.S.C. §§ 544, 548 and 550—the transfer of \$3,450,000 worth of Persian rugs at cost by the Debtor to its principal, Mohamad Gavahi. After considering all of the

evidence, including testimony and documents, and all other matters of record, the Court makes the following findings of fact and conclusions of law.

Background

The Debtor was a retail seller of premium quality Persian rugs, antique carpets, and other rugs and related accessories at a store it owned, located at 752 Miami Circle, Atlanta, Georgia. Mohamad Gavahi was the Debtor's sole officer, director, shareholder and person in control at all times relevant to this matter, making him an "insider" of the Debtor as defined by 11 U.S.C. §101(31)(B). Gavahi also controlled several related entities which operated similar stores in Charlotte, North Carolina (the "Charlotte Store") and Palm Beach, Florida (the "Palm Beach Store").

After the collapse of the real estate market and a drop in demand for the Debtor's products, the Debtor filed a voluntary petition commencing this case under Chapter 11 of the Bankruptcy Code on October 4, 2009 (Case No. 09-86091-JRS). This case was converted to one under Chapter 7 on November 19, 2010, and Plaintiff Paul H. Anderson, Jr. was appointed as the Chapter 7 Trustee (the "Trustee"). The Trustee filed a Complaint seeking to avoid and recover a transfer of rugs having a cost value of \$3,450,750.00 from the Debtor to Gavahi on July 15, 2008 (the "Rug Distribution"). The Debtor's General Ledger characterized this transfer as a "Return of rugs on 7/15/08 originally contributed by Mohamad Gavahi back to him."¹

The evidence indicated that Gavahi did in fact make certain contributions of rugs to the Debtor before the Rug Distribution. Evidence admitted at trial indicated that Gavahi contributed rugs with a cost value of \$1,514,952.87 in the fiscal year ending in 2000,² and he contributed rugs

¹ Following this transfer, Gavahi transferred these rugs to the Palm Beach Store.

² The Debtor's fiscal year ended April 30 of each year.

with a cost value of \$1,750,418.31 in the fiscal year ending in 2002, for a total of about \$3,266,000 of rugs at cost. According to the evidence presented at trial, he made no further contributions of rugs after 2002.³

Allegedly Fraudulent Transfer Under § 548

The Trustee seeks to avoid and recover the value of the Rug Distribution from Gavahi, arguing that it is a recoverable fraudulent transfer under 11 U.S.C. §§ 544, 548 and 550. The Court will first address the Trustee's argument under § 548. The Trustee primarily argued that the Rug Distribution was an avoidable fraudulent transfer under § 548(a)(1)(B) because it was a transfer "of an interest of the debtor in property" made "within 2 years before the filing date of the petition," for which the Debtor "received less than a reasonably equivalent value in exchange," and the Debtor "was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer." 11 U.S.C. § 548(a)(1)(B). The Rug Distribution (made on July 15, 2008) was made within two years of the petition date (October 4, 2009). Also, the Court finds that the Debtor received no value whatsoever in exchange for the Rug Distribution, so the Debtor certainly did not receive reasonably equivalent value for the rugs. Thus two issues remain: (1) whether the Rug Distribution was a transfer of the Debtor's property, and (2) whether the Debtor was insolvent either at the time of the Rug Distribution or on account of the Rug Distribution.

Was the Rug Distribution a Transfer of the Debtor's Property?

In order for the Rug Distribution to be avoidable under § 548(a), the rugs transferred from the Debtor to Gavahi must have been the Debtor's property at the time of the transfer. Gavahi argued that he contributed these rugs; that the rugs were his property and not the

³ The evidence reflected that Gavahi did in fact contribute cash in excess of distributions in the approximate total amount of \$1,600,000 in fiscal years 2003, 2004, and 2007. In fiscal years 2000 and 2001, he also contributed net cash of about \$1,330,000.

Debtor's; and that he was simply taking back rugs that belonged to him all along. However, his testimony at trial and other evidence revealed this position to be untenable.

Gavahi repeatedly testified that he "contributed" these rugs, not that he lent them to the Debtor or had them on consignment. In fact, these rugs were included in the Debtor's inventory and listed on the Debtor's balance sheet as assets with no corresponding liability indicating that the Debtor owed Gavahi for these rugs. Further, Gavahi testified that the Debtor sold rugs which he had contributed and kept all of the proceeds, using this money to fund operations. Had these rugs been Gavahi's property on consignment, one would expect him to have received a portion of any sales proceeds, but there was no evidence that the Debtor paid him any portion of those proceeds.

Moreover, the Court does not find credible Gavahi's testimony that the rugs the Debtor distributed to him in 2008 were the same rugs that he had contributed no later than 2002. For that to be true, those rugs would have to have just sat there for at least 6 years, which is hard to believe, considering the Debtor's sales during those years. In fact, the grand total of the value of the rugs Gavahi contributed was \$3,266,000 at cost, and even if one were to assume that not a single one of those rugs were sold, this amount is still less than the \$3,450,000 worth of rugs at cost the Debtor distributed to him in the Rug Distribution. In sum, the Court finds that these rugs were property of the Debtor at the time of the Rug Distribution and that this transfer was nothing more than a distribution to a shareholder.

Was the Debtor Insolvent at the Time of the Rug Distribution?

The next element under § 548(a)(1)(B) concerns Debtor's financial condition at the time of the Rug Distribution. Under § 548(a)(1)(B)(ii), this element is met if, at the time of the Rug Distribution: (1) the Debtor was insolvent or the transfer rendered the Debtor insolvent, or (2) the

transfer left Debtor with unreasonably small capital, or (3) the Debtor believed or knew it was incurring debts it would be unable to repay, or (4) the Debtor made the transfer to an insider under an employment contract and not in the ordinary course of business. 11 U.S.C. § 548(a)(1)(B)(ii). Proving any of these elements will satisfy § 548(a)(1)(B)(ii). The Trustee has argued that the Debtor was insolvent at the time of the Rug Distribution or that this transfer at least rendered the Debtor insolvent.

Determining whether a business is insolvent under § 548(a)(1)(B)(ii) a question of fact. *Join-In Int'l (U.S.A.) Ltd. v. Wholesale Distribs. Corp. (In re Join-In Int'l (U.S.A.) Ltd.)*, 56 B.R. 555, 560 (Bankr. S.D.N.Y. 1986) (citation omitted). A business is insolvent if “the sum of [its] debts is greater than all of [its] property, at a fair valuation.” 11 U.S.C. § 101(32)(A)(I). This determination has been called the “balance sheet test,” and involves tallying a debtor’s assets and liabilities. *Mellon Bank, N.A. v. Metro Commc’ns, Inc. (In re Metro Commc’ns, Inc.)*, 945 F.2d 635, 648 (3rd Cir. 1991). The balance sheet test is applied at the time of the transfer. *Mellon Bank, N.A. v. Official Committee of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 154 (3d Cir. 1996) (citation omitted).

Although on first glance the Debtor’s balance sheet appeared to indicate that it was solvent at the time of the Rug Distribution, a more searching analysis has revealed that the Debtor was insolvent at the time of the Rug Distribution; and even if the Debtor was solvent at that time, this transfer clearly rendered the Debtor insolvent.

At trial, the Trustee presented the report and testimony of his forensic accountant, Paul A. Jones, CPA, CFF, who was qualified as an expert witness. In preparation for trial, Jones examined the books and records of the Debtor, the financial representations made by the Debtor to this Court in the filings in the main bankruptcy case, and the proofs of claim filed by creditors in the main

bankruptcy case.⁴ Rather than accept the Debtor's balance sheet on its face as a fair representation of the value of its assets and amount of its liabilities, Jones made adjustments and prepared a report reflecting what he thought was a more accurate representation of the fair value of Debtor's actual assets and liabilities at the time of the Rug Distribution.

Debtor's balance sheet showed it was solvent on April 30, 2008, just a few months before the Rug Distribution.⁵ The 2008 balance sheet showed assets of \$16,491,400 and liabilities of \$9,111,350, for a net worth of almost \$7,400,000.⁶ But according to Jones' expert report, the Debtor's assets actually were worth no more than \$10,048,252 at a fair valuation, and its liabilities were at least \$12,636,850, so the Debtor's net worth was actually *negative* (\$2,588,598). Jones concluded that the Debtor became insolvent no later than April 30, 2008, and it remained insolvent continuously thereafter through the filing of its bankruptcy petition.

The Court finds Jones' report and testimony persuasive because most of the adjustments Jones made were reasonable. For example, he adjusted Accounts Receivable downward from \$581,231 to \$406,862. In reality, this downward adjustment should have been much greater, since nearly this entire balance was eventually written off as uncollectible. Also, Jones'

⁴ The Court took judicial notice of the proofs of claim and pleadings filed in the bankruptcy case, some of which were also admitted into evidence without objection at trial.

⁵ Debtor's fiscal year ended on April 30 of each year, and Debtor apparently did not keep its books on a monthly basis, but rather only generated sufficient accounting information to have tax returns prepared. In addition to the fact that Debtor did not keep monthly business records, Jones did not find the Debtor's books to be reliable in at least other several areas: (1) the balance sheet showed almost \$12,300,000 of Debtor's \$13,400,000 of inventory, or about 90%, was consigned outside of the state of Georgia, but there were no records to show where that inventory was, (2) the proofs of claims filed by creditors were not the same amounts as in the Debtor's records, and (3) Debtor did not maintain vendor invoices, only lump sum amounts due to vendors.

⁶ Despite its balance sheet showing it had a net worth of almost \$7,400,00 and supposedly being solvent at this time, about 18 months later, the Debtor was in bankruptcy and the only return unsecured creditors will get will be from recoveries on avoidance actions and even the secured creditors did not realize a full recovery from their collateral. In this Court's experience, it is not uncommon for a Debtor's balance sheet to show solvency or at least substantial value for unsecured creditors at the time a bankruptcy petition is filed, but like this Debtor, the fair value of the assets is lower and the amount of liabilities is higher, such that there is little or no value or return to the unsecured creditors from the assets.

downward adjustment to Depreciable Assets from \$1,930,740 to \$1,214,520 was reasonable because this category consisted primarily of the Debtor's land and building, and real estate values had fallen. In addition, Jones' adjustments removing loans receivable in the amounts of \$8,363 and \$140,000 from the asset total were reasonable because no evidence seems to exist indicating these were anything more than valueless loans.

Jones' largest asset adjustment—reducing Consigned Inventory Outside Georgia from \$12,286,879 to \$6,608,796—was also reasonable. Jones adjusted this account for three reasons: (1) a physical inventory in February 2010 revealed that the Debtor's inventory was about \$400,000 lower at cost than what its books reflected at that time; (2) the Debtor reported a loss of \$3,654,667 after its inventory was eventually sold on foreclosure, and Jones estimated that at least half this amount —\$1,827,334—was missing, obsolete, or overvalued at the time of the Rug Distribution; and (3) the Rug Distribution reduced the Debtor's inventory by \$3,450,750.

As for the first two components of this adjustment, the Court does not find either to be unreasonable. Although the cost valuation of inventory may be probative of its actual value, it is not necessarily conclusive of what the fair market value of that inventory would be at a later point in time, particularly when the inventory has been unsold for many years. Many factors can influence fair market value downward, some of which were present in this case. For example, basic economic law dictates that if demand for a product goes down while supply remains steady, its fair market value will go down. In other words, a product is only worth what people are willing to pay for it. If fewer people are willing to buy Persian rugs, sellers necessarily must reduce the price of those rugs in order to find more willing buyers. The rugs in the Debtor's inventory were likely overvalued at the time of the Rug Distribution because willing buyers were increasingly scarce at that time. Demand for Persian rugs, like other high-dollar home

furnishings, typically falls during a recession and tracks closely with home sales because many people buy those types of items in connection with moving into a home. In 2007, the American “housing bubble” popped, triggering a recession which began in December 2007 and which continued into 2008 and which led to a massive slowdown in new home purchases. This slowdown no doubt led to a corollary drop in demand for Persian rugs, which suggests that the actual value of the Debtor’s inventory had declined. In addition, it was clear from Gavahi’s testimony that some of this inventory was many years old, which means the demand for it was not there, which would further indicate a lower actual value.

As for the third component of Jones’s downward inventory adjustment—for the amount of the Rug Distribution—the Court does not entirely agree with Jones’ analysis. Jones asserted that he made this adjustment because these rugs were improperly included as inventory and paid-in capital when initially contributed. But in order to accept this assertion, one must accept Gavahi’s position that the rugs should not have been included in inventory because they belonged to him all along. As explained above, this position is untenable, and these rugs were property of the Debtor at the time of the Rug Distribution. Therefore, it is inappropriate to reduce the Debtor’s inventory by \$3,450,750 to account for the Rug Distribution prior to the time that distribution was made. However, after the Rug Distribution, the Debtor’s inventory was obviously that much lower as a result. Therefore, although it was inappropriate to suggest that this amount should never have been included in inventory, it is appropriate to reduce the Debtor’s inventory by this amount at the moment the Rug Distribution occurred.

In addition to these downward asset adjustments, Jones made several upward adjustments to the Debtor’s liabilities which the Court finds were appropriate. Jones identified numerous loans in the Debtor’s name that were not on its books. Jones adjusted the Debtor’s liabilities

upwards to reflect additional loans payable to John LaBarbera, Sherkat Nafis, LLC, Alidad Gavahi, and Gita Gavahi totaling \$3,525,500. Jones also identified other liabilities which should have been carried on the Debtor's books, such as (1) a \$4,734,234 discrepancy between the amount shown on David Belke's proof of claim (and the promissory note attached thereto) and the amount owed to him according to the Debtor's books, and (2) a \$433,991 discrepancy between J. Thompson's proof of claim and the amount owed to him according to the Debtor's books.

In sum, the Court concludes that the Debtor was insolvent before the Rug Distribution, and even if it was not insolvent then, the Rug Distribution clearly rendered it insolvent. Other than generally arguing that Jones' conclusions were unreasonable, Gavahi offered no evidence to counter those conclusions. Therefore, the Trustee satisfied his burden in proving this element. And because the Trustee has proven all of the elements of 11 U.S.C. § 548(a)(1)(B), he is entitled to avoid the Rug Distribution and recover it under 11 U.S.C. § 550.

Gavahi's Liability Under § 544

Alternatively, the Court will consider Gavahi's liability under 11 U.S.C. § 544 and O.C.G.A. §§ 18-2-74(a)(2)(B) and 18-2-75. Section 544(b)(1) of the Bankruptcy Code provides that "the trustee may avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an [allowable] unsecured claim." 11 U.S.C. § 544(b)(1). In other words, the Trustee may "'step into the shoes' of an unsecured creditor and void a transfer of an interest in the debtor's property that the unsecured creditor would have the power to void under federal or state law."⁷ *Westgate Vacation Villas, Ltd. V. Tabas (In re Int'l Pharmacy & Disc. II,*

⁷ The Trustee could step into shoes of any of several unsecured creditors because, at the time of the Rug Distribution, there were several creditors holding allowable unsecured claims. See main bankruptcy case: Case. No. 09-86091-JRS, Claim Nos. 2-1, 3-7, 6-1, 7-1, 9-1, 10-1, and 11-2.

Inc.), 443 F.3d 767, 770 (11th Cir. 2005) (citation omitted). Georgia law provides bases for such an avoidance in O.C.G.A. §§ 18-2-74(a)(2)(B) and 18-2-75.

O.C.G.A. § 18-2-74(a)(2)(B) provides that a transfer of a debtor's property is fraudulent if the debtor did not receive reasonably equivalent value for the transfer and "believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due." O.C.G.A. § 18-2-74(a)(2)(B). As discussed above, the Court has found that the Rug Distribution was a transfer of the Debtor's property for less than reasonably equivalent value. Also, the Trustee presented the testimony of its forensic accountant (Jones), who testified that Debtor was unable to pay its debts as they came due at the time of this transfer. Jones testified that at the time of the Rug Distribution, the Debtor was unable to pay certain debts, including, among other things, withholding, sales and real estate taxes that were consistently not paid in 2007 and 2008, and the Debtor had consented to a judgment in the amount of \$1,600,000 in March 2008. Although Gavahi disputed whether the Debtor was paying its debts as they came due, the Court finds that, generally, it was not. Accordingly, the Trustee may avoid the Rug Distribution pursuant to 11 U.S.C. § 544 and O.C.G.A. § 18-2-74(a)(2)(B).

Similarly, the Trustee may avoid the Rug Distribution pursuant to 11 U.S.C. § 544 and O.C.G.A. § 18-2-75. This Georgia code section provides that a transfer is fraudulent "if the debtor made the transfer . . . without receiving a reasonably equivalent value in exchange for the transfer . . . and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer." O.C.G.A. § 18-2-75. As explained above, the Debtor did not receive reasonably equivalent value in exchange for the Rug Distribution, and it was either insolvent at that time and was rendered insolvent by this transfer. Accordingly, Gavahi would be liable under this code section as well.

Conclusion

For the reasons stated above, the Trustee may avoid the Rug Distribution pursuant to 11 U.S.C. §§ 544 and 548 and recover the value of the Rug Distribution pursuant to 11 U.S.C. § 550. Because Jones made adjustments downward to the cost value of the inventory of about 22%, exclusive of the inventory excluded in the Rug Distribution, the Court finds it is appropriate to reduce the value of the Rug Distribution by the same percentage, so the value of the property transferred that is being avoided is \$2,690,000. Accordingly, it is hereby

ORDERED that judgment shall be entered in favor of the Trustee and against Gavahi for \$2,690,000, plus pre-judgment interest from the date of the filing of the Complaint to the date of judgment, plus post-judgment interest as provided by law.⁸

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⁸ The Court has statutory and constitutional authority to enter a final order in this core adversary proceeding. *See* 28 U.S.C. § 157(b)(2)(H) (designating “proceedings to determine, avoid, or recover fraudulent conveyances” as core proceedings); *see also Tyler v. Banks (In re Tyler)*, --- B.R. ---, 2013 WL 2477274 at *4–14 (N.D. Ga. June 6, 2013) (holding that bankruptcy court had constitutional authority to enter final order in fraudulent transfer action). The Court also has authority to enter a final order in this proceeding pursuant to 28 U.S.C. § 157(c)(2) because the parties have consented to the Court doing so. (*See* Compl. [Doc. 1] ¶2, Answer [Doc. 5] ¶2 and Consolidated Pre-Trial Order [Doc. 13] (admitting that this proceeding is core)). In the event that an appellate court were to conclude that this Court does not have the constitutional authority to enter a final judgment in this matter, the Court’s findings of fact and conclusions of law should be treated as a Report and Recommendation to the District Court pursuant to Fed. R. Bankr. P. 9033.