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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In Re:	
RODDY MAC STEWART, **DEBORAH B. STEWART,**	**CASE NO. 98-41315-7** **CHAPTER 7**
DEBTORS.	
THE CADLE COMPANY,	
PLAINTIFF,	
v.	**ADV. NO. 98-7100**
RODDY MAC STEWART, **DEBORAH B. STEWART,**	
DEFENDANTS.	

MEMORANDUM OF DECISION

This proceeding is before the Court for decision following a bench trial. Plaintiff The Cadle Company ("Cadle") appeared by counsel Thomas J. Fritzlen, Jr., of Martin, Leigh & Laws, P. C., Kansas City, Missouri. The debtor-defendants appeared by counsel William S. Woolley of Redmond and Nazar, L.L.P., Wichita, Kansas. The Court has heard the evidence and the arguments of counsel, reviewed the exhibits and relevant pleadings, and is now ready to rule.

ISSUES

Cadle contends the debtors should be denied a discharge under any of four subsections of 11 U.S.C.A. §727(a). The issues raised are:

1. Whether the debtors transferred property within one year before filing for bankruptcy in order to hinder, delay, or defraud Cadle, in violation of §727(a)(2);
2. Whether the debtors failed to maintain records from which their financial condition or business transactions might be adequately ascertained, in violation of §727(a)(3);
3. Whether the debtors knowingly and fraudulently made a false oath in or in connection with their bankruptcy case, in violation of §727(a)(4)(A); and
4. Whether the debtors failed to satisfactorily any loss or deficiency of assets to meet their liabilities, in violation of §727(a)(5).

BACKGROUND

At all times relevant to this proceeding, debtor Roddy Mac Stewart worked as a realtor for a corporation he owned, and also engaged in the business of selling, managing, and leasing real property through various entities, including a partnership, a joint venture, and a corporation. Debtor Deborah B. Stewart worked as a paralegal and also helped her husband with business bookkeeping. Cadle became a creditor of the debtors in 1997 when a deficiency judgment of about $450,000 against the debtors was assigned to it.

Debtor Roddy Mac Stewart is the sole shareholder of Rod M. Stewart Realtor, Inc. (“Realtor”), a company through which he works as a realtor. The debtors each have a financial interest in a partnership called “Stewart Properties” (“Properties”) and an interest in a partnership or joint venture called “Kenrod Properties” (“Kenrod”). These two businesses owned buildings that they leased to third parties.

The parties have raised no issues concerning the law that applies to their disputes. Instead, all the questions before the Court involve determining the facts and then determining the significance of those facts under the relevant provisions of §727(a). The Court will therefore discuss its factual findings and legal determinations under each provision.

FINDINGS AND CONCLUSIONS

1. §727(a)(2)(A)

Under §727(a)(2), the Court is to deny a discharge if "the debtor, with intent to hinder, delay or defraud a creditor . . . , has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—(A) property of the debtor, within one year before the date of the filing of the petition." Cadle contends that the debtors made numerous prepetition transfers which separately or cumulatively violate this section. The debtors admit they made the specified transfers, but deny they made them with the necessary intent.

One of the transfers Cadle attacks involved Mr. Stewart's transfer of his interest in a pending lawsuit in which he was one of several plaintiffs suing several defendants who had participated in the construction of a low-income housing development that had run into financial difficulties and not yet been completed. Several individual defendants were dismissed from the suit, and the plaintiffs obtained a judgment against the remaining entity-defendants that had no assets other than the over-encumbered development. The plaintiffs appealed the dismissal of the individual defendants, and the entity-defendants appealed the judgment against them. Mr. Stewart then recognized that he could not afford to pay his share of the legal fees and other expenses of the suit, and wanted to avoid them since recovery in the suit did not appear promising. He orally assigned his interest in the suit to the other plaintiffs in exchange for their promise to pay all the fees and expenses of the suit. At that time, he reasonably believed that the judgment, even if upheld on appeal, could not be collected from the entity-defendants, and had no assurance that the dismissal of the individual defendants would be reversed and a judgment would later be obtained against any of them. Some months later, a third party began negotiating a possible settlement with the remaining plaintiffs to clear his way to take over the housing development. The plaintiffs then drafted a document to memorialize their agreement with Mr. Stewart so that disputes over the oral assignment could be avoided and not interfere with any settlement with the third party. Mr. Stewart signed this document without being informed of the third party's overtures. A settlement was reached under which the third party paid the remaining plaintiffs $150,000. The Court concludes this transfer did not violate §727(a)(2)(A) because: (1) Mr. Stewart received reasonably equivalent value for his interest in the lawsuit by receiving the other plaintiffs' promise to pay his share of the legal fees and expenses; and (2) he did not have an intent to hinder, delay or defraud his creditors when he made the transfer.

Another transfer Cadle attacks concerns a check written from Realtor's bank account to pay a second mortgage held by Intrust Bank on the debtors' residence. The debtors explained that Mrs. Stewart withdrew from her retirement account the money to pay Intrust and gave it to her husband. Mr. Stewart deposited the money in the Realtor account and then wrote the corporate check. Cadle claims that this transaction constitutes the use of corporate funds for personal purposes. However, the money came from personal funds and was placed in a corporate account to be paid out for apparently personal purposes. The debtors said they did this because the second mortgage had secured a loan borrowed for corporate purposes, so they wanted the corporation to transfer the money to Intrust. While the intermediate transfer to the corporation was unnecessary, the Court is not convinced that this transaction was arranged with any intent to hinder, delay, or defraud creditors. The transaction did not violate §727(a)(2)(A).

Cadle complains that a $15,500 payment to Gary Snyder, a former business associate of Mr. Stewart, is suspicious. Mr. Stewart stated that the payment was a result of a business deal in which Mr. Snyder earned a finder's fee that Mr. Stewart paid out of the money he realized in the transaction. Mr. Snyder did not testify at trial, and Cadle presented no other evidence indicating that Mr. Stewart did not actually owe Mr. Snyder this money. Cadle similarly complains about numerous other transfers of money to entities or individuals who were creditors of the debtors, for example, Collegiate High School and Dandurand Pharmacy. No evidence was presented that would support a reasonable inference that the debtors did not actually owe the money they paid to these creditors. The debtors simply preferred these creditors over others, like Cadle, that they did not pay. At most, some of these payments might constitute preferences that could be avoided under §547(b), but the Court does not believe that preferring some legitimate creditors amounts to hindering, delaying, or defrauding others under §727(a)(2)(A).

Cadle complains a $3,000 payment that Mr. Stewart made from Realtor's corporate account to settle a lawsuit was improper. In the suit, a creditor had sued Mr. Stewart personally over a business transaction. Mr. Stewart claims that he was working for his corporation during the transaction, and therefore paid the claim from corporate funds. The Court is certain an independent corporation could pay its employee's potential liability in this situation, and sees no reason why a one-person corporation cannot do the same for its sole shareholder. Once again, the Court is not convinced that this transfer was made in violation of §727(a)(2)(A).

Finally, Cadle essentially complains about the debtors' habits in transferring money between various bank accounts. Besides the Realtor account mentioned previously, each of the debtors had a separate personal account, and Mr. Stewart controlled, or at least had access to, money in an account owned by Properties and another owned by Kenrod. Generally, these transfers began with Mr. Stewart's transfer of funds from the Realtor corporate account to his personal account and then to third parties, or to his wife's account, from which she then paid third parties. From the debtors' records, the transfers can be traced from one account to another and ultimately to third-party creditors. Cadle contends these transfers amount to some sort of fraud, although its fraud allegations are rather vague. The debtors testified that their normal procedure for paying personal bills went like this: (1) Mrs. Stewart would create a list of bills to be paid and present it to Mr. Stewart; (2) Mr. Stewart would write a check on the Realtor account for the total amount of the bills and deposit it in his personal account; (3) he would then write a personal check to Mrs. Stewart for the same amount; and (4) she would deposit that check in her personal account and pay the bills from that account. An example of a list of invoices Mrs. Stewart would use to create such a list was admitted as Defendants' Exhibit X. On one occasion that Cadle complains about, Mrs. Stewart's list included a debt to the Kansas Department of Revenue. After Mr. Stewart gave her the money to pay the listed bills, she reconsidered and decided that because he had dealt with the Department of Revenue, he should pay that bill. She then returned that amount to him and he paid the bill. While the debtors' manner of handling their money seems overly complicated and perhaps a bit suspicious in retrospect, they gave plausible innocent explanations for their actions that eliminated any suspicions of fraud that the Court might otherwise have had. Their actions in this regard did not violate §727(a)(2)(A).

In sum, the Court is convinced that all the transfers Cadle finds objectionable were made for legitimate (or at least understandable) business or personal purposes, and not with the intent to hinder, delay, or defraud the debtors' creditors. At most, a few of the transfers involved technically improper transfers of money from the corporation to pay personal debts, but since Mr. Stewart is the sole shareholder of the corporation, he could have avoided these technical errors and achieved the same result simply by writing himself a corporate check and then paying the bills from his personal account. The Court believes these transfers demonstrate at most poor business practice, not any fraudulent or evil intent. Even considering the transfers cumulatively rather than separately, the Court is not convinced that the debtors acted with the intent required to violate §727(a)(2)(A).

2. §727(a)(3)

Under §727(a)(3), the Court is to deny a discharge if "the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case." Cadle claims that the debtors violated this section by failing to maintain adequate records for Properties and Kenrod, stating that the debtors have provided virtually no information concerning these enterprises. The debtors contend they have provided "plenty."

Properties is a partnership formed by the debtors. Its sole asset was a building of about 7,000 square feet. In mid-1997, Properties lost its tenant of eleven years, and was unable to find a new one. The building was in an economically deteriorating area. When the debtors filed for bankruptcy, Properties was in default on the mortgage payments. The mortgage holder obtained stay relief and foreclosed its mortgage. The chapter 7 trustee abandoned the estate's interest in the building. The debtors kept financial records for the building until the tenant was lost. Since then, Properties has derived no income from the building, and paid only taxes and insurance with money remaining from rent the former tenant had paid. Given the nature of the enterprise and the circumstances, the Court is convinced that the records the debtors kept were sufficient.

Kenrod is a joint venture between Mr. Stewart and Ken Steffens that owns and leases out a single commercial building. Mr. Stewart produced records for this entity through March 1998, when he turned the active management of the entity over to Mr. Steffens. Mr. Stewart testified that he has asked Mr. Steffens for later records but has received none. At a deposition, Cadle asked Mr. Stewart to supply records beyond March 1998, and his attorney agreed to supply them. However, neither Mr. Stewart nor his attorney ever obtained any records from Mr. Steffens. Neither party sought any formal discovery from Mr. Steffens. Mr. Stewart testified that he is familiar with the venture's sole asset. As substantiated by the older records he did produce, the property had not generated sufficient income to meet its expenses for seven years before he turned the active management over to Mr. Steffens. He further stated that to his knowledge nothing had changed since March 1998 that would materially improve the building's cash flow. The chapter 7 trustee has also abandoned the estate's interest in the joint venture. Although Mr. Stewart has a right to require Mr. Steffens to disclose the joint venture's records to him, under the circumstances, his failure to have or to obtain those records was justified because: (1) the venture had been unprofitable over a long period of time; (2) the trustee has abandoned the property; (3) Mr. Stewart is aware of no change that would have improved the venture's financial situation; and (4) Mr. Steffens did not voluntarily supply the venture's records, and Cadle did not attempt to force him to do so.

Other than Mr. Stewart's limited but justified failure to produce the most recent records for Kenrod, the debtors' records for these businesses were sufficient to disclose the financial condition of both Properties and Kenrod. Consequently, the debtors did not violate §727(a)(3).

Without offering any explanatory argument, Cadle has also complained that the debtors violated §727(a)(3) by failing to itemize their jewelry on their bankruptcy schedules and understating the jewelry's value. The Court does not believe these complaints indicate a possible violation of that provision, but only §727(a)(4), which is discussed below.

3. §727(a)(4)

Under §727(a)(4), the Court is to deny a discharge if "the debtor knowingly and fraudulently, in or in connection with the case—(A) made a false oath or account." Cadle claims the debtors' schedules contain false oaths because they: (1) understated the value of their jewelry and household goods; (2) failed to list a number of active real estate listings as assets; and (3) listed corporate obligations as debts. The debtors dispute that any of these matters constituted a false oath.

On their schedules, the debtors indicated that they jointly owned jewelry with a market value of $500. They claimed the jewelry was exempt under K.S.A. 60-2304(b). That Kansas statute provides “[e]very person residing in” Kansas with an exemption for jewelry “having a value of not to exceed $1,000.” At trial, the parties stipulated to the admission of a three-page appraisal covering nine items of the debtors’ jewelry by a company “in the jewelry business.” The appraisal is made up of three copies of a form labeled “Appraisal” with the different items of jewelry described in handwritten notes and assigned a dollar value. Each page contains the statement: “We estimate the value as listed for insurance or other purposes at the current PVB value, excluding Federal and other taxes.” The printed forms had contained the word “retail” between “current” and “value,” but that word is stricken on each page and letters that appear to be “PVB” are handwritten above it. Although the Court often sees appraisals and hears appraisal testimony, it is not familiar with a kind of appraisal value that might be abbreviated “PVB.” In any event, the values given for the items add up to $1,056.15. Some question was raised at trial about the value of some costume jewelry that was not included in the appraisal, but no evidence of its value was actually presented. Under the Kansas statute, the debtors could each have exempted up to $1,000 worth of jewelry, for a total exemption of $2,000. While the appraisal value of the jewelry was twice that given by the debtors, assuming the same method of valuation was being used, the Court does not generally expect debtors to know the value a professional appraiser would give for jewelry, unless it is shown that they are involved in the jewelry business or have recently obtained such an appraisal, and the difference between $500 and $1,000 as the total value of nine items does not seem to the Court to indicate a deliberately false statement of value. The jewelry value listed in the debtors’ schedules has not been shown to constitute a knowing and fraudulent false oath.

Cadle also contends the debtors’ statement in their schedules that their household goods and furnishings had a “current value” of $25,900 was a false oath because they had insured those goods for

$87,500. K.S.A. 60-2304(a) provides every resident an exemption for "furnishings, equipment and supplies . . . for the person which . . . is reasonably necessary at the principal residence of the person for a period of one year." The debtors claimed their household goods and furnishings as exempt under this provision, and had no incentive to underestimate their value since the exemption has no value limit. The debtors explained that the scheduled value was their estimate of the current market value of their used goods and furnishings, while they purchased insurance that would enable them to replace the items with new ones if they were stolen or destroyed. No evidence presented at trial indicated that the actual market value of the debtors' present goods and furnishings was greater than the value they stated in their schedules. Neither Cadle nor the debtors offered any appraisal of the goods and furnishings, so the debtors' valuations are the only evidence before the Court. The Court finds it unremarkable that the cost of replacing household goods and furnishings would be substantially more than the used items would bring at a sale. Cadle has failed to prove that the value the debtors gave in their schedules for their goods and furnishings was incorrect, much less that it amounted to a knowing and fraudulent false oath.

Cadle complains that the debtors failed to include in their schedules as assets certain real estate listings. It suggests that Mr. Stewart ignored Realtor's separate existence before filing for bankruptcy, and so should have ignored its corporate form in the schedules and listed its assets as his own. In effect, Cadle seems to claim that Mr. Stewart should have "pierced the corporate veil" of his own corporation on his own initiative. The Court is not familiar with such a practice and does not believe debtors must follow it in preparing their bankruptcy schedules. In response to Cadle's claim, the debtors rely on the fact that the listings were owned by Realtor, not by Mr. Stewart personally, and that they properly disclosed in their schedules Mr. Stewart's ownership of that corporation. They also suggest that real estate listings by themselves have little or no value. The evidence supported the debtors' claim that the listings were owned by Realtor, and Cadle did not really contest that fact. The Court is convinced that the debtors adequately disclosed the listings by disclosing their ownership of Realtor. Not including the listings in the schedules did not amount to a knowing and fraudulent false oath.

Cadle briefly suggested at trial that the debtors should have included corporate assets on their schedules since they included some corporate debts. However, as competent debtor's counsel would probably advise, debtors may want to list the debts of corporations they own so that those creditors will have notice of the personal bankruptcies and be unable, after the debtors receive a discharge, to pursue claims that the debtors are personally liable for the corporate debts as guarantors or on some other legal theory such as piercing the corporate veil. The debtors testified that they had no intent to defraud by being cautious and listing the corporate debts. The Court concludes that listing those debts did not constitute a knowing and fraudulent false oath.

4. §727(a)(5)

Under §727(a)(5), the Court is to deny a discharge if "the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities." Cadle's complaints here concern the debtors' 1997 income. First, Cadle claims the debtors' 1997 income tax return shows that they had gross income of $227,365 that year, while their Statement of Financial Affairs reports that their income was about $180,000. Having reviewed Plaintiff's Exhibit 2, which is a copy of the Statement of Financial Affairs, the Court concludes that Cadle overlooked the entry for "income other than from employment or operation of business" in making this argument. It is true that the 1997 "income from employment or operation of business" that the debtors reported totals about $180,000, but the 1997 "income other than from employment or operation of business" that they reported adds about $47,500 to their total income for the year, almost identical to the gross income reported on their 1997 tax return. Cadle's claim on this point fails.

At the end of the trial, the Court directed the parties to submit additional materials concerning the debtors' accounting for their 1997 income. After reviewing the debtors' attempted reconciliation of their records from their various bank accounts, Cadle contends the debtors have failed to account for over $22,000 of their 1997 income, and so have failed to account for a loss of assets. The debtors claim they have accounted for all the income. The parties relied largely on the same materials to reach their differing conclusions, although Cadle ignored one of the accounts—the Realtor account—that the debtors included in their calculations. The Court has reviewed the parties' calculations and found errors made by each side. After correcting for these errors, the Court finds that the materials submitted show that the debtors' deposits to the bank accounts were essentially equal to the payments from the accounts plus the balances remaining in them, so the 1997 income has been accounted for.

To avoid double-counting any money, Cadle correctly decided to eliminate deposits that merely moved money from one to another of the four accounts it reviewed. However, according to the Court's calculations, Cadle failed to follow this rule for a significant number of deposits. In addition, when it added the total independent deposits made to the four accounts, Cadle used a number for the

Deborah Stewart account different from the one that it calculated in its month-by-month review of that account. Correcting these errors, the Court finds that the independent deposits to the accounts total about $206,500, not around $227,000 as Cadle calculated. Apparently, Cadle felt that the 1997 deposits to the debtors' accounts had to be about the same as the income reported on their 1997 tax return. Of course, this is not true. The debtors could, for example, have sold an asset for an amount equal to or less than its tax basis, thus incurring no income tax, and deposited the proceeds into one of these accounts. Furthermore, since Mr. Stewart did not always strictly follow proper business practices in connection with the corporate Realtor account, the Court believes some money that went directly from that account to creditors probably was included in the debtors' income for tax purposes. In fact, by adding in the Realtor account, the debtors' accounting shows that they deposited a total of $319,000 into their five accounts, significantly more than their taxable income for 1997.

Cadle calculated that the debtors made about $204,600 in payments to creditors from the four accounts it reviewed. This leaves a difference of about $1,900 between the corrected total of the deposits to and payments made from these accounts. However, Cadle also made no adjustment for the beginning and ending balances of the accounts. On January 1, 1997, some pre-1997 money remained in the accounts, and on December 31, 1997, some 1997 money remained in them, even when checks that were written in 1997 but cleared later are deducted. By the Court's calculation, about $2,200 of 1997 money remained in the accounts after all the 1997 payments were deducted. This amount must be added to the payments to creditors in order to account for all the debtors' 1997 deposits to the accounts. The Court believes the remaining $300 difference between the deposits and the sum of the payments and ending balances is explained by more minor errors Cadle made, including clerical errors such as repeating a deposit made one month in the list of the next month's deposits, thus double-counting that deposit, and mathematical errors. In short, when Cadle's review of the debtors' accounts is corrected, the $22,000 difference that Cadle thought it found disappears.

The Court has also reviewed the debtors' reconciliation of their bank accounts, and has located only one significant error in their calculations. Rather than adjusting the balances remaining in the accounts by deducting pre-1997 deposits and calculating the amount of 1997 deposits remaining in the accounts at the end of the year but after all checks written in 1997 had cleared, the debtors simply pointed out that the accounts contained more than the $11,000 difference between their 1997 deposits and 1997 payments on dates at or shortly after the end of the year. By the Court's calculation, a total of about $9,800 in 1997 deposits remained in the accounts after all checks written in 1997 cleared. The Court is convinced that this $1,200 difference is attributable to mathematical or other computational errors in the reconciliation, and not to any unexplained loss of assets. In any event, such a difference in a $319,000 accounting would be too small to warrant the extreme sanction of a denial of discharge.

Based on its review of the records submitted by the debtors and the parties' attempted reconciliations, the Court concludes that the debtors have satisfactorily explained what they did with their substantial 1997 income, and Cadle has failed to establish any unexplained loss of assets or deficiency of assets to meet the debtors' liabilities. Cadle's claims under §727(a)(5) all fail.

SUMMARY

For the reasons stated above, the Court concludes that Cadle has failed to prove that the debtors should be denied a discharge under §727(a)(2)(A), (3), (4)(A), or (5).

The foregoing constitutes Findings of Fact and Conclusions of Law under Rule 7052 of the Federal Rules of Bankruptcy Procedure and Rule 52(a) of the Federal Rules of Civil Procedure. A judgment based on this ruling will be entered on a separate document as required by FRBP 9021 and FRCP 58.

Dated at Topeka, Kansas, this ____ day of September, 2000.

____
JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In Re: **RODDY MAC STEWART,** **DEBORAH B. STEWART,** **DEBTORS.**	**CASE NO. 98-41315-7** **CHAPTER 7**
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JUDGMENT ON DECISION

This proceeding was before the Court for decision following a bench trial. Plaintiff The Cadle Company ("Cadle") appeared by counsel Thomas J. Fritzlen, Jr., of Martin, Leigh & Laws, P. C., Kansas City, Missouri. The debtor-defendants appeared by counsel William S. Woolley of Redmond and Nazar, L.L.P., Wichita, Kansas. The Court heard the evidence and the arguments of counsel, reviewed the exhibits and relevant pleadings, and has now issued its Memorandum of Decision resolving this dispute.

For the reasons stated in that Memorandum, judgment is hereby entered denying Cadle's claims that the debtors should be denied a discharge under 11 U.S.C.A. §727(a)(2)(A), (3), (4)(A), or (5).

IT IS SO ORDERED.

Dated at Topeka, Kansas, this _____ day of September, 2000.

JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE