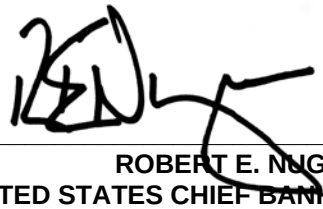
SO ORDERED.

SIGNED this 14 day of August, 2007.



ROBERT E. NUGENT
UNITED STATES CHIEF BANKRUPTCY JUDGE

NOT DESIGNATED FOR PUBLICATION

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

IN RE:	)	
	)	
GARY E. KRAUSE,	)	**Case No. 05-17429**
Debtor.	)	**Chapter 7**
	)	
UNITED STATES OF AMERICA,	)	
	)	
Plaintiff,	)	
and	)	
	)	
LINDA S. PARKS, Trustee	)	
	)	
Intervener,	)	
v.	)	**Adversary No. 05-5775**
	)	
GARY KRAUSE and RICHARD KRAUSE,	)	
	)	
Defendants	)	
and	)	
	)	
DRAKE KRAUSE and RICK KRAUSE,	)	
	)	
Interveners.	)	

ORDER DENYING INTERVENER DRAKE KRAUSE'S MOTION FOR RECONSIDERATION OF SANCTIONS ORDER

This matter comes before the Court on intervener Drake Krause's ("Drake") motion for reconsideration of the Court's order entered June 4, 2007 and partial default judgment entered June 6, 2007 against debtor-defendant Gary Krause ("Gary"), movant's father.[1] The Government and the Trustee have filed responses in opposition to the motion for reconsideration and Drake has filed a lengthy reply.[2]

Background

This adversary proceeding was commenced November 1, 2005 against debtor Gary and his brother Richard Krause, in Richard's capacity as trustee of several trusts. Gary owes a tax debt in excess of $3 million dollars. In the amended complaint the Government seeks a declaration that the following trusts and entities are Gary's nominees and subject to the Government's federal tax lien: Drake Enterprises, Inc., Financial Investment Management Corporation, Federal Gasohol Corporation, PHR, LLC, Krause Children Trusts I, II, III, IV, and V (collectively the "KCTs"), Gary E. Krause Trust, and the Krause Irrevocable Family Trust.[3] Early in this proceeding, the Court entered a preliminary injunction that froze the assets of the above-named trusts and entities.

Drake was allowed to intervene in this adversary proceeding on February 22, 2007 to protect his beneficial interest in the KCTs because his uncle, Richard Krause, the trustee of the KCTs, abdicated his duty to defend the KCTs from the claims of the Government and the Trustee when the

---

[1] Dkt. 331 and 332.

[2] Dkt. 357 (Trustee), Dkt. 359 (Government) and Dkt. 363 (Drake Reply).

[3] Dkt. 65. *See also*, Dkt. 50 (Trustee's Complaint).

Court ruled that the frozen assets could not be used to pay his attorney fees.[4] Drake graduated from high school in May of 2007 and his brother, Rick, is scheduled to graduate in May of 2008. Drake and Rick are beneficiaries of the KCTs. Gary is the named beneficiary of the Gary E. Krause Trust and the Krause Irrevocable Family Trust. Drake and Rick are at most contingent, remainder beneficiaries of the Gary E. Krause Trust and the Krause Irrevocable Family Trust.[5] All of the trusts in question were created in the late 1980's and 1990 while Gary was embroiled in tax litigation with the Government.

During the course of the proceedings in 2006, the Court ordered Gary to disclose the assets owned or controlled by the above trusts and entities and to disclose all assets "of any entity with which Gary . . . ha[s] a connection of any kind."[6] Gary's asset disclosures[7] indicate the following: (1) Drake Enterprises, Inc. owns no assets; (2) PHR, LLC owns the Oneida property where Gary and his sons presently reside; (3) FIMCO has a bank account and membership interests in two LLCs, Live Wire Media Partners and K Mountain; (4) Federal Gasohol Corporation owns several bank and brokerage accounts and security holdings; (5) the Gary E. Krause Trust owns bank accounts, a money market account, certificate of deposit, and wholly owns Federal Gasohol Corporation; (6)

---

[4] Dkt. 232.

[5] The Gary E. Krause Trust and the Krause Irrevocable Family Trust contain identical provisions for final distribution upon the death of Gary: "Upon the death of the Beneficiary, the Trustee shall distribute the principal and undistributed income then remaining in the Trust to . . . such person or persons or the estate of the said Beneficiary . . . as the Beneficiary shall appoint by a will . . . If the Beneficiary dies and fails to fully and validly exercise this general testamentary power of appointment, . . .the Trustee shall distribute the principal and undistributed income then remaining in the Trust to the issue of the Beneficiary who survive the Beneficiary . . ." No evidence has been presented to the Court in any of the hearings held in this proceeding indicating whether Gary has exercised his power of appointment and designated remainder beneficiaries.

[6] Dkt. 80.

[7] Dkt. 98. Also mentioned, Polo Executive Rentals is a non-entity and has no assets. An account in the name of Polo is owned by the KCT1.

the Krause Irrevocable Family Trust wholly owns FIMCO; (6) KCT I, II and V own percentage interests in PHR, LLC; and (7) the KCTs own liquid assets and insurance policies.

Gary, the Government and the Trustee engaged in discovery during the course of 2006; those discovery efforts focused on what assets Gary had an interest in and the web of transfers by and among Gary and the alleged nominees. It required the intervention of the Court with respect to the Government's first request for production of documents served upon Gary in mid-February 2006. Gary intermittently produced some documents responsive to the document requests but initially failed and refused to produce electronic evidence on his computers. In the fall of 2006, the Court ultimately ordered Gary to turnover his computers to the Trustee and the Government for their inspection. Upon receiving his computers, the Trustee and the Government discovered that a software wiping program had been installed and run on his computer prior to turnover, resulting in the erasure and destruction of electronic data and files. The Trustee then filed her motion for sanctions for spoliation of evidence and the Government filed its motion for contempt and for default judgment. Both motions made it clear that they were asking the Court to impose the harshest of sanctions for Gary's misconduct, including default judgment on *all* of their claims.[8] Drake filed responses to both motions. Although he did not argue Gary's liability, Drake opposed the entry of default judgment with respect to the trusts, characterizing such a sanction as the "death penalty."[9]

The Court convened a three day evidentiary hearing in March of 2007 on the motions. Drake, by his attorney, attended the evidentiary hearing but sat mute throughout the proceedings. Drake's attorney declined to make an opening and closing statement and did not examine witnesses.

---

[8] *See* Dkt. 220, pp. 37-40; Dkt. 235, pp. 27-28, 35-40.

[9] Dkt. 251 (Response to Contempt Motion) and Dkt. 252 (Response to Spoliation Motion)..

None of the arguments advanced by Drake in his motion for reconsideration were presented to the Court at trial. The Court found that Gary destroyed electronic evidence by running computer wiping software to permanently erase his computer hard drives prior to turning them over, violated orders compelling discovery, transferred or disbursed funds from FIMCO in violation of the preliminary injunction entered December 5, 2005, and failed to fully comply with the Court's asset disclosure orders of April 14, 2006.[10] As a consequence of these actions, the Court assessed several sanctions against Gary, including orders requiring him to affirmatively divulge electronic evidence and perform other acts. The Court's harsher sanctions imposed against Gary granted default judgment with respect to some, but not all, trusts and entities that the Trustee and Government asserted were his nominees, were property of the bankruptcy estate and were subject to turnover. Those trusts and entities were: the Gary E. Krause Trust, the Krause Irrevocable Family Trust, Financial Investment Management Corporation ("FIMCO"), Federal Gasohol Corporation, Drake Enterprises, Inc., and PHR, LLC. The Court declined, at least initially, to default Gary on the five Krause Children Trusts ("KCTs"). The Court also declined to except his tax debt from discharge under 11 U.S.C. §523(a)(1)(C) as sought by the Government.

Following the Court's sanctions decision, Gary filed a notice of appeal to the Bankruptcy Appellate Panel (BAP).[11] He also filed a motion to stay the imposition of sanctions pending appellate review which this Court denied on August 3, 2007.[12] Drake filed this motion for reconsideration and because the Court had not yet ruled on it, Gary's appeal was deemed premature

---

[10] Dkt. 311 and 317.

[11] Dkt. 334.

[12] Dkt. 373.

and suspended pending a determination on Drake's motion by this Court.[13] The Court has now reviewed its sanctions order and the briefs submitted by the parties concerning reconsideration and is prepared to rule.

Standards for Motion for Reconsideration

While the Federal Rules of Civil Procedure do not recognize a pleading known as a "motion for reconsideration," the courts have construed a motion for reconsideration as a motion to alter or amend judgment under Fed. R. Civ. P. 59(e).[14] Motions to alter and amend judgment serve a limited purpose. Such motions are only appropriate when a court has misapprehended the facts, a party's position, or controlling law.[15] It is not appropriate to revisit issues already addressed or advance arguments that could have been raised in prior briefing.[16] Grounds warranting a motion to reconsider include (1) an intervening change in the controlling law; (2) new evidence that was previously unavailable; and (3) the need to correct clear error or prevent manifest injustice.[17]

Drake's Motion

Drake does not challenge the Court's determination that his father committed spoliation of electronic evidence and acted in contempt of certain of the Court's orders. Drake only seeks reconsideration of the sanctions imposed by the Court for Gary's misconduct. Even then, Drake

---

[13] Dkt. 346.

[14] *Van Skiver v. United States*, 952 F.2d 1241, 1243 (10th Cir. 1991). Rule 59 is made applicable to bankruptcy proceedings by Fed. R. Bankr. P. 9023.

[15] *See Servants of Paraclete v. Does*, 204 F.3d 1005, 1012 (10th Cir. 2000).

[16] *Id.*; *Van Skiver*, 952 F.2d at 1243 ("[R]evisiting the issues already addressed 'is not the purpose of a motion to reconsider,' and 'advanc[ing] new arguments or supporting facts which were otherwise available for presentation when the original' [trial was held] is likewise inappropriate.")

[17] *See Servants*, 204 F.3d at 1012; *Brumark Corp. v. Samson Resources, Corp.*, 57 F.3d 941, 948 (10th Cir. 1995).

apparently complains only of the default judgment entered with respect to the trusts, specifically the Gary E. Krause Trust and the Krause Irrevocable Family Trust. At this time, the Court has not entered default judgment with respect to the five Krause Children Trusts.[18]

The Court questions whether Drake has asserted a proper ground for reconsideration. He raises some arguments for reconsideration that he could have, but did not, raise at the evidentiary hearing or in his written response to the sanction motions. Drake previously argued against a sanction of default in his written response to the sanction motions as being unjust; an argument that the Court considered but rejected before imposing the default sanction.

It appears that Drake advances the "manifest injustice" ground for reconsideration of the sanctions. In this connection, Drake contends that he and his brother are innocent beneficiaries of the trusts and to default "them" on the trusts for their father's misconduct is unjust. He argues that the Court did not apply the criteria enumerated by the Tenth Circuit Court of Appeals in *Ehrenhaus v. Reynolds*[19] before imposing the sanction of default and, in particular, that this Court did not warn the litigant that he could be defaulted and that the sanction was related to the claim. Drake also complains that the imposition of the default sanctions infringes upon his due process rights, because of his beneficial interests in the trusts and the determination of those trusts without a trial on the merits of the Government's and Trustee's claims.

Finally, Drake argues that the effect of the default sanction was to effectuate a "reverse-

---

[18] At this time, the Court has not entered default judgment with respect to the five Krause Children Trusts. As learned from the parties at the pretrial status conference held August 2, 2007 in this matter, Gary has complied with most of the sanction orders entered by the Court. In light of this, and coupled with the fact that trial on the remaining claims in this adversary (including the nominee theory asserted with respect to the KCTs) have been set for trial commencing November 26, 2007, the Court is not inclined to effectuate the second tier of sanctions contained in the June 4 Sanctions Order pending the trial on the merits of the remaining claims.

[19] 965 F.2d 916 (10th Cir. 1992).

piercing" of the trusts and entities defaulted, making them liable for Gary's tax debt. Drake devotes a substantial portion of his briefs to the merits or legality of this reverse-piercing theory. As Drake's counsel fully understands, the Court never reached the merits of the nominee or alter ego theory and did not enter partial judgment on that basis. Gary was defaulted on these trusts and entities *as a sanction*, and not as a result of evidence and proof at trial on the merits of the Government's and Trustee's claims. In the Court's view, this question is wholly beyond the scope of a motion for reconsideration, particularly where Drake never advanced this argument at the evidentiary hearing and did not raise this issue in his written response to the spoliation and contempt motions.

The "misapprehension of controlling law" as a basis for reconsideration applicable to these motions and the Court's sanctions order would entail a showing that the Court misapplied the common law governing spoliation of evidence or contempt or abused its discretion in assessing the sanction of default, not the substantive law on the Government's and Trustee's nominee or alter ego theory. Drake does not contend that the Court misapplied the law governing spoliation or contempt. If anything, Drake contends that the Court abused its discretion in imposing the default sanction. This, however, is the same argument Drake advanced in his written response, an argument that was rejected by the Court after trial on the motions. In short, Drake's assessment of the reverse-piercing theory is not a proper basis to reconsider the default sanctions, because it is an argument that was available to Drake but not previously raised by him and presented to the Court. Nevertheless, the Court will briefly address this argument below.[20]

Analysis

[20] It appears to the Court that this argument is a likely precursor to the dispositive motion that Drake advises he will be filing, either in an effort to "educate" the Court on the law of "reverse-piercing"or to take advantage of multiple opportunities to attack the claims asserted against Gary. This Court views such strategy with disfavor and is hesitant to address this argument, thereby giving Drake several "bites at the apple."

A. ***Ehrenhaus*** **Criteria**

Drake asserts that the Court failed to consider some of the factors in *Ehrenhaus* before imposing the sanction of default and in effect, abused its discretion in imposing such a sanction.[21] Assuming that *Ehrenhaus* even applies to the spoliation and contempt motions, a conclusion not free from doubt,[22] the Court believes it gave due consideration to those factors before concluding that a default judgment was the only recourse left to the Court that would gain Gary's cooperation and coerce compliance with his duties as a debtor in bankruptcy, his discovery obligations as a litigant, and with the Court's orders. Drake complains that the Court did not give due consideration to the fourth (advance warning) and fifth (efficacy of lesser sanctions) factors.

The Court first observes the factual setting in *Ehrenhaus.* In that case, the Tenth Circuit upheld the dismissal of plaintiff's securities fraud case as a sanction for plaintiff's failure to appear for the completion of his deposition. Plaintiff was cautioned that if he failed to appear for the scheduled deposition the court would entertain a motion to dismiss the case from the defendants. It is not apparent from the Court's reading of *Ehrenhaus* that the offending party engaged in a pattern of non-cooperation over an extended period of time, such as the case at bar. It is clear, however, that the plaintiff in *Ehrenhaus* did not engage in spoliation of evidence. This Court views spoliation misconduct very differently from a nonappearance at a deposition. Because the plaintiff

---

[21] The *Ehrenhaus* court cited the following factors: (1) the degree of actual prejudice to the other party; (2) the amount of interference with the judicial process; (3) the culpability of the litigant; (4) whether the court warned the offending party in advance that dismissal would be a likely sanction for noncompliance; and (5) the efficacy of lesser sanctions. 965 F.2d at 921.

[22] The Court based its authority to assess sanctions for Gary's contempt violations upon 11 U.S.C. § 105(a). These sanctions were not imposed as discovery sanctions as in *Ehrenhaus.* The Court relied upon § 105(a) and Fed. R. Civ. P. 37 for its sanctions attributable to Gary's spoliation of evidence. The latter more closely resembles a discovery sanction.

in the securities fraud case filed bankruptcy during the pendency of his securities lawsuit, but before he was sanctioned with dismissal of his case, the impact of the sanction was felt by the bankruptcy trustee, who succeeded to the plaintiff's-debtor's lawsuit:

> . . . the trustee took possession and control of a lawsuit encumbered by Ehrenhaus' misconduct and, as successor-in-interest, was subject to sanction for that misconduct. *Although the sanction now affects parties other than the one who engaged in the wrongful conduct, the nature of the property interest transferred cannot be altered.* Nonetheless, it would not exceed a district court's discretion to consider whom the sanction affected in determining what sanction was appropriate.[23]

With respect to the factors the court "should ordinarily consider" before choosing a dismissal sanction, the Tenth Circuit emphasized that "[t]hese factors do not constitute a rigid test; rather, they represent criteria for the district court to consider prior to imposing dismissal as a sanction."[24] Some factors will take on more importance than others.[25]

1. Prior Warning

As the Trustee correctly points out in her response to Drake's motion, the prior warning consideration noted in *Ehrenhaus* is directed at the litigant who is engaged in the offending discovery behavior.[26] This Court warned Gary early and often. When the Court announced its ruling granting the Government's application for a preliminary injunction and froze the assets of the trusts and entities then in play, it explained to Gary his obligations as a debtor in bankruptcy:

THE COURT: . . .Mr. Nazar, I'm aware that the Defendant will be placed in a very

---

[23] 965 F.2d at 920. This Court did take into account the effect of the default sanctions on Drake and his brother. *See infra,* p. 15.

[24] *Id.* at 921.

[25] *Id.* at 922.

[26] *But see F.D.I.C. v. Daily*, 973 F.2d 1525 (10th Cir. 1992) (District court's failure to warn party that default judgment is a possible sanction before entering default judgment is of no consequence.). No reference to *Ehrenhaus* was made in *Daily* because it was decided after *Daily.*

> significant financial jeopardy by virtue of the Court's order, and I've not made this order lightly. It seems to me that you are in a position to at least negotiate with the government or to ask this Court to allow the use of some funds based upon a budget, and I tell you, it will be a bare bones budget. The United States of America, Mr. Krause, and your creditors are not going to finance a lifestyle of the expanse that you currently enjoy. You said that you entered bankruptcy to put it behind you, and I want you to understand, Mr. Krause, when you're in a bankruptcy you take your financial past and you lay it on the table and a very bright light shines upon it. And you have an absolute duty to be candid with your counsel and be candid with the Court and be candid with the Trustee and to be candid with your creditors to reveal whatever it is they ask of you. . . . So you should not be surprised to learn that everything that you've been up to is going to be under significant scrutiny going forward, and that if you fail to respond to these questions or if you are evasive in answering these questions you may not only lose your discharge as to the United States' claims, you will lose your discharge period.[27]

When the Court heard evidence on the adequacy of Gary's asset disclosures ordered in its April 14, 2006 order, it again commented on this obligation:

> THE COURT: . . .I also want to continue to encourage Mr. Krause, as I did in December Mr. Krause, to fully cooperate. And fully cooperating does not include forgetting or sending 85,000 pages when 100 would do it. And it does not include sending 100,000 pages that don't have anything to do with the questions that you've been asked. I thought that I had made it clear, both in my order in December and in my written order in April that when you subject yourself to Chapter 7 relief and the protection of this Court that is not a free deal, that is a quid pro quo, and a quid pro quo is you gotta tell us everything. . . . Again, renewing my earlier admonition that you've gotta tell them, you've gotta make a full and complete disclosure of where these assets came from and where they're going and why. . . . The answer is not simply to ignore it or to answer it incompletely and then have that brought to my attention in this context. . . . And as long as we're in bankruptcy I'm going to require, as long as this case is under my jurisdiction, I'm going to require full and complete disclosure and full and complete answers to the IRS's and the Trustee's questions. . . . And I don't anticipate granting another discovery extension, unless I believe that one is warranted by the misconduct of a party. And if I perceive there is misconduct of a party . . . I will not hesitate to accompany that extension with more meaningful sanctions. Because this case is going to get done and I am not going to allow any parties [sic] obfuscation to get in the way of the schedule.[28]

---

[27] Tr. of Proceedings December 2, 2005, pp.73-74.

[28] Tr. of Proceedings, June 15, 2006, pp. 141-143.

At the September 14, 2006 hearing on the Government's motion to compel Gary's production of documents responsive to the Government's first requests (served in mid-February, 2006), the Court clearly warned Gary (who at that time was represented by counsel) of the repercussions of not making full disclosure:

> THE COURT: . . . It's apparent to me that the responses have not been timely and have not been complete. . . . I've got a pretty good idea who's fault that is, Ms. Saidian. Now, I was not born yesterday, and I've seen Mr. Krause perform on the stand now three or four times in the last nine months. And I told Mr. Krause the first time he was here that under Section 521 he had an absolute duty to lay his soul bare to Ms. Parks and to the Government, and that if he didn't do that he wasn't going to get a discharge, and that moreover some very bad things were going to happen to him in this litigation, and it may happen to him anyway. I think it is appropriate to compel Mr. Krause to respond to the remaining outstanding discovery in the first request for production .
>
> THE COURT: . . . Mr. Krause is going to produce on day X or those things that he does not produce and does not swear under oath he doesn't have and never heard of and doesn't know where they are he will be precluded from making defenses based on those documents.
>
> THE COURT: That I do not intend to exact a sanction against Mr. Krause today, but I want to make it pretty clear that he either is to produce documents within a deadline . . . or he is to produce a statement under oath that he does not have those documents and there are no such documents. And I'm telling you, if those documents surface in the trial God help him. Because aside from the perjury problem I'm not going to allow him to mount a defense based on any of those documents. In other words, just as a hypothetical, if he does not produce the documents that are requested with respect to the Children's Trust Number 1 and it turns out there are documents with respect to the Children's Trust Number 1, I will default him on Children's Trust Number 1. And I think I have the power to do that under Rule 37. I'm not pleased with his ongoing apparent refusal to cooperate and follow the rules. . . . But I will not tolerate any deviation. You know, there are no objections here on privilege, there are no objections here on overbreadth, there are no objections here on overreaching, there are no objections here on relevance. There really isn't an objection at all, except he doesn't feel like doing it, and that's not acceptable. . . .[29]

At the hearing on the motion to compel, the Court also ordered that the computer and its

---

[29] Dkt. 142, Tr. of Proceedings September 14, 2006, pp. 13-15.

contents were encompassed by the Government's first document request and ordered that they be turned over within 15 days.[30]

THE COURT: .. . and I think the order should include, as I have stated, that should Mr. Krause fail to comply with the fifteen days that I will at that time entertain sanctions, *sanctions may include default as to various of these assets.* [Emphasis added.][31]

The order granting the Government's motion to compel did indeed advise that noncompliance could result in default judgment:

> It is further ORDERED, that if Debtor does not comply with the terms of this ORDER on or before September 29, 2006, the Court shall act upon the Government's request for sanctions, and *will issue appropriate sanctions, which may include precluding debtor from introducing certain evidence or arguments during the trial of this matter or entering a default judgment against Debtor.* [Emphasis added.][32]

Drake's contention in the current motion for reconsideration that the Court did not previously warn Gary that the sanction of default could result from his noncompliance with the order compelling discovery is wholly without merit. As set forth above, the Court repeatedly cautioned Gary of his duty to make full disclosure of his assets and to cooperate with the Trustee and the Government. If anything, the Court showed restraint given the fact that the Government's document requests were served in February 2006 and the Government was still trying to obtain documents some eight months later.

Moreover, Drake can claim no surprise by the sanction of default. Both the Trustee and Government were abundantly clear in their motions that they were seeking default judgment as a

---

[30] *Id.* at pp. 18-20.

[31] *Id.* at p. 21.

[32] Dkt. 139, p. 3.

sanction for Gary's spoliation of electronic evidence and contempt violations.[33] They reiterated their request for the sanction of default at the evidentiary hearing on the motions in both opening and closing statements. Drake obviously recognized the potential impact a default judgment would have on him because he devoted his written response to the motions arguing against this sanction. Drake's counsel, though present throughout the evidentiary hearing on the motions, chose not to make an opening or closing statement or address the propriety of a default sanction – a sanction that he termed the "death penalty" in his papers.

2. Efficacy of Lesser Sanctions

Drake suggests that a sanction short of default would have just as readily secured Gary's cooperation, full disclosure and compliance with Court orders. He suggests that a sufficient sanction for Gary's misconduct would consist of "a substantial monetary fine, payment of costs, attorneys fees and expenses" incurred by the Government and the Trustee. The Court disagrees.

As noted in the previous section, the Court implored Gary early on in these proceedings to make full disclosure of his assets and to cooperate fully with the Trustee and his creditors. Those admonitions fell on deaf ears as demonstrated by Gary's subsequent conduct. The Court gave Gary the opportunity to use some of the frozen assets for living expenses and to pay his attorney, provided that he made a full disclosure of his assets.[34] That did not occur.

One of the sanctions imposed by the Court was to require Gary to return the $59,000 FIMCO investment in Live Wire Media Partners, LLC. This transfer on behalf of FIMCO was made after and in violation of the preliminary injunction entered in December of 2005, freezing the assets of

---

[33] *See* Dkt. 220, pp. 37-40; Dkt. 235, pp. 27-28, 35-40.

[34] Dkt. 66, pp. 6-7; Dkt. 80, pp. 25-26; Dkt. 123.

FIMCO. At the August 2, 2007 status conference in this matter, the Court learned that Gary has not caused the return of the funds to FIMCO or otherwise restored the $59,000 wrongfully transferred. A monetary sanction in the Court's view would be of little effect here, where Gary purports to own no assets and all potential assets are held by various trusts and entities that Gary claims cannot be reached by creditors.

Furthermore, as this Court has previously noted, even if all the assets of the alleged nominee trusts and entities were liquidated, that sum would be insufficient to pay Gary's tax debt which is now in excess of $3 million dollars. The Court sees little value, and even less realistic hope of getting paid, a monetary sanction as suggested by Drake. Drake has not offered how the imposition of monetary sanction will alleviate the severe prejudice inflicted upon the Government and Trustee by Gary's spoliation of evidence. The imposition of a monetary sanction, even if paid by Gary, will not magically make the destroyed computer evidence reappear. This Court even observed in one of its earlier opinions in this proceeding that the drastic threat of denying Gary's discharge is "somewhat hollow." [35] Because the Tenth Circuit has previously concluded in the tax court litigation that Gary evaded taxes, the Government's dischargeability complaint has considerable promise of success. It is therefore to Gary's advantage to delay reaching the merits of the Government's and Trustee's claims. To date, Gary has proven quite capable in this regard.

In any event, this Court *did* take care to consider the effect of the default sanctions on Gary's sons – what the Court perceives to be the true complaint asserted here by Drake. That is why the Court refrained from defaulting Gary in the first instance on the Krause Children Trusts. The Court focused on those trusts that Gary was the named beneficiary and the entities over which Gary has

[35] Dkt. 123, p. 10.

exercised control – particularly FIMCO and Federal Gasohol. The two Krause trusts the Court defaulted wholly own FIMCO and Federal Gasohol. Drake and his brother have no interest in FIMCO and Federal Gasohol and have no present beneficial interest in the two Krause trusts defaulted. Thus, the Court's sanctions were directed, in the first instance, at those trusts and entities that would bear the most on Gary's behavior and for which Gary stood to lose the most.

3. The Sanctions are Related to the Claim at Issue in the Order to Provide Discovery

Ehrenhaus also instructs that a district court's discretion in the choice of a sanction is limited to one that is "related to the particular 'claim' which was at issue in the order to provide discovery."[36] The Court in *Ehrenhaus* did not, however, address or elaborate on this limitation in its decision.

The Court has reviewed *Insurance Corp. of Ireland*, the Supreme Court case cited in *Ehrenhaus*. In that case, after defendants raised the defense of lack of personal jurisdiction, discovery was sought by plaintiff to establish jurisdictional facts and the exercise of personal jurisdiction over various insurance companies. Because the defendants did not produce the requested information (showing the defendants' contacts with Pennsylvania), the court deemed the jurisdictional facts established, permitting plaintiff's suit to go forward. The Federal Rules of Civil Procedure permits a court to find or assume personal jurisdiction without a further showing in these circumstances. This sanction was entered pursuant to Fed. R. Civ. P. 37(b)(2)(A) which expressly states: "An order that the matters regarding which the order was made or any other designated facts shall be taken to be established for the purpose of the action in accordance with the claim of the

[36] 965 F.2d at 920-21, citing *Insurance Corp. Of Ireland v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 707, 102 S.Ct. 2099, 72 L.Ed. 2d 492 (1982).

party obtaining the order."[37] Here, the default sanction was entered under Fed. R. Civ. P. 37(b)(2)(C) and 11 U.S.C. § 105, neither of which expressly requires this "relational" requirement.[38]

Drake suggests that because there has been no showing that the discovery order violation relates specifically to the various trusts, the Court abused its discretion in defaulting Gary on the trusts. Even if the above legal proposition in *Ehrenhaus* (and *Insurance Corp. of Ireland*) is applicable to a default sanction as entered in the case at bar for spoliation of evidence and contempt, the Court believes that Drake has construed the Government's 'claim' and the discovery sought much too narrowly.[39] The Government's first document requests were broadly framed to ascertain the extent of Gary's assets, *to discover facts relevant to proving its nominee theory*, and to determine the existence of other potential assets that might be held by alleged nominees.[40] Those first document requests clearly covered electronic evidence, evidence that Gary did not initially reveal or produce. When Gary testified in June of 2006 that he kept records on his computers pertaining to all of the trusts and entities, he then claimed, incredibly, that he was "computer illiterate" and unable to download the records for production to the Government. When the Government continued to press Gary for the computer evidence and eventually obtained the order compelling Gary to turnover his computers for inspection, Gary ran wiping software to erase the files and data

---

[37] The Court notes that in the case at bar, the default sanction was assessed pursuant to Rule 37(b)(2)(C), not Rule 37(b)(2)(A). Unlike the sanction of deeming facts established under Rule 37(b)(2)(A), Rule 37(b)(2)(C) contains no relational requirement. Likewise, 11 U.S.C. § 105(a) contains no relational requirement.

[38] *See Harris v. City of Philadelphia*, 47 F.3d 1311, 1331 (3rd Cir. 1995) (A nexus must exist between the sanction and the discovery violation unless it is a flagrant discovery violation that supports dismissal of an entire suit or imposition of default judgment).

[39] *See F.D.I.C. v. Daily, supra.*

[40] *See Compaq Computer Corp. v. Ergonome Inc.*, 387 F.3d 403 (5th Cir. 2004), *cert. denied*, 544 U.S. 962 (2005) (Discovery sanction of default was rooted in party's repeated refusal to adequately respond to interrogatories aimed at proving alter ego.).

on his hard drive. As the Court noted in its spoliation and sanctions opinion, the Trustee and the Government have no way of proving what files or data existed on Gary's computers prior to their turnover that may have supported their nominee theory or any of their other claims.[41] Gary's discovery violation, the affirmative and intentional spoliation of evidence – evidence that may support or establish an adversary's claims, is the most flagrant and prejudicial of discovery violations. For this reason, the law on spoliation permits the Court to assume that the destroyed evidence would have been relevant and favorable to the Trustee's and Government's claims.[42] Under these circumstances, the Court concludes that the Trustee and the Government established a sufficient nexus between the discovery violation (spoliation of computer evidence and turnover of the computer) and their nominee claims, thus warranting the sanction of default.[43]

Under the circumstances here, the Court gave full consideration to the *Ehrenhaus* factors in its sanctions order before defaulting Gary on the Gary E. Krause Trust, the Krause Family Irrevocable Trust, and the specified entities – PHR, LLC, Drake Enterprises, Inc., FIMCO, and Federal Gasohol Corporation. The Court rejects Drake's claim that a default on these trusts is unjust. To the contrary, the default judgment was imposed on these trusts because they have the most impact on Gary. Gary is the named beneficiary of both of these Krause trusts. Drake and Rick are no more than contingent remainder beneficiaries in these Krause trusts while Gary is alive.

---

[41] While it is true that the Trustee's spoliation evidence focused mostly on e-mails unrelated to the trusts, the limited computer evidence available at trial was what the computer experts were able to retrieve and recover from Gary's computer hard drives; everything else had been permanently deleted or erased by the wiping software run on the computers by Gary.

[42] *See* Dkt. 314, pp. 41, 45-49.

[43] The default of FIMCO and the Krause Family Irrevocable Trust (which wholly owns FIMCO) is clearly justified, as a nexus between the default sanction and the misconduct was established. The Government demonstrated Gary's contempt of the December 2005 preliminary injunction by causing FIMCO's transfer of "frozen funds" for an investment in Live Wire Media Partners, LLC.

Default judgment has not been entered with respect to the Krause Children Trusts, the trusts in which Drake and Rick have current beneficial interests.

B. Due Process

A more sensitive judge would take great offense at Drake's suggestion that he and his brother were somehow deprived of due process in the course of the spoliation hearing. They were at all times represented by counsel *who sat silent* for almost the entire three day trial. They have been represented by counsel since being permitted to intervene in this case. And, as evidenced in their pre-hearing filings in response to the spoliation motion and the contempt motion, they were fully cognizant that the Trustee and Government sought the most severe sanctions against their father for his conduct. They have had every opportunity to participate meaningfully in these proceedings since their intervention. That is all that due process requires.[44]

While the Court is not without sympathy for these children whose expectant interests in their father's property may well be thwarted by the Government's massive claims against him, their "innocence" of his actions to destroy evidence, secrete property and obfuscate the legitimate marshaling efforts of the Trustee should not divert this Court from taking appropriate measures to preserve and protect the bankruptcy estate and the dignity of its processes.

C. The Default Judgment is Legally Supportable

Drake asserts that the default judgments entered are not legally supportable because, to

---

[44] *See McCart v. Jordana (In re Jordana)*, 232 B.R. 469, 480 (10th Cir. BAP 1999); *M.E.N. Co. v. Control Fluidics, Inc.*, 834 F.2d 869 (10th Cir. 1987) (Because default judgment is a harsh sanction, due process requires that litigant's failure to obey a court order be the result of willfulness, bad faith, or fault of litigant other than an inability to comply); *Omnibank Arapahoe, N.A. v. Lowndes (In re Lowndes)*, 95 B.R. 194, 196 (D. Colo. 1989). As addressed at length in the June 4 sanctions order, Gary's noncompliance with the discovery orders had nothing to do with his inability to comply. It had everything to do with his voluntary, deliberate, intentional and willful spoliation of computer evidence by installing and running wiping software on his computers.

justify them on the merits legally, this Court would have had to "reverse-pierce" FIMCO, Federal Gasohol, Drake Enterprises, PHR, LLC, and the two trusts. In addition, they argue that their rights in the Gary E. Krause Trust and the Krause Family Irrevocable Trust have been unfairly abridged by the Court's default judgment. Neither argument holds water for the following reasons.

In the June 4, 2007 Sanctions Order, the Court entered *judgment by default* declaring that FIMCO, Federal Gasohol, PHR, Drake Enterprises, and the two Krause trusts were nominees or alter egos of Gary Krause and, accordingly, their assets were actually assets of the estate. The Court has had several prior occasions in the case to consider this issue, the most prominent one being the entry of the preliminary injunction. At that time, the Court concluded that the Government and Trustee were likely to prevail on the merits on their claims that these corporate and trust entities should be disregarded as separate and their assets treated as assets of the estate, subject to the attachment of tax liens. The Court drew this conclusion after careful consideration of extensive evidence that Gary routinely trafficked in the assets of these entities and treated them as his own. As District Judge Marten articulated in *United States v. Dawes*:

> Courts have recognized that the government may place liens on property held by a business entity as the alter ego or nominee of a taxpayer. *Towe Antique Ford Found. v. Internal Revenue Service*, 791 F. Supp. 1450, 1453 (D. Mont.1992), aff'd 999 F.2d 1387 (9th Cir.1993). To determine whether a trust serves as a taxpayer's nominee, the court examines several factors including: 1) the taxpayer's control over the nominee and its assets; 2) the use of trust funds to pay taxpayer's personal expenses; 3) the relationship between the taxpayer and the nominee; 4) the lack of internal controls and the lack of nominee oversight of taxpayer's actions; and 5) the lack of consideration for transfers of property. *Shades Ridge v. U.S.*, 888 F.2d 725, 729 (11th Cir.1989); *Loving Saviour Church v. United States*, 728 F.2d 1085, 1086 (8th Cir.1984). The Tenth Circuit has noted that even when legal title may be held by others, a taxpayer may be found to be an equitable owner. *U.S. v. Miller Bros. Construction Co.*, 505 F.2d 1031, 1036 (10th Cir.1974).[45]

[45] 344 F. Supp. 2d 715, 721-22 (D. Kan. 2004).

Gary's conduct in connection with each of these entities suggests the presence of nearly all of these factors.

Drake's rights do not appear to be abridged in any material way by this Court's judgment. Recall that the Court deferred making a nominee determination (by default) with respect to the Krause Children's Trusts pending Gary's obedience of its sanction orders. The obedience, while not complete, has commenced. Drake is not a beneficiary of the Gary E. Krause trust, Gary is. Likewise, Drake is not a beneficiary of the Krause Family Trust, but Gary is. The Court supposes that Drake and Rick may expect to inherit their father's interests in the trusts, but that interest is contingent at best. That FIMCO and Federal Gasohol paid Gary's and his sons' bills until this Court froze their assets (while Drake was still a minor) does not give Drake a substantive right in the assets of those companies. The Court has previously heard evidence that Drake Enterprises, Inc., while named after Drake, has no assets. PHR, LLC nominally owns the Oneida property (where Gary and his sons live) by virtue of a deed made by Children's Trust I to PHR *after* the Government collection action that precipitated this bankruptcy filing commenced. Nowhere is there documentary evidence of Drake having a substantive right in any of the property of any of these entities and, even if there were, his interests would be derived from Gary's interests and burdened with Gary's encumbrances. Drake's contention that the default sanctions entered by the Court are unjust is therefore without merit.

Based upon the foregoing, intervener Drake Krause's motion to reconsider this Court's Sanctions Order entered June 4, 2007 is DENIED.

# # #