

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF )  
 )  
ROBERT AND SANDRA SMITH, ) CASE NO. BK93-80682  
 )  
DEBTOR ) CH. 12

MEMORANDUM

Hearing was held on August 17, 1994, on Motion to Convert to Chapter 7 filed by Leland Porter and on Motion to Dismiss filed by debtors. Appearing on behalf of debtors was Albert Burnes of Omaha, Nebraska. Appearing on behalf of Leland Porter was Susan Williams of Murphy, Pederson, Waite & Williams, North Platte, Nebraska. Appearing on behalf of the Chapter 12 Trustee was Patricia Napier of Omaha, Nebraska. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(A), (I) and (O).

Background

The debtors, Robert D. and Sandra E. Smith, filed a petition for Chapter 12 bankruptcy protection on April 23, 1993. The debtors have moved to have their Chapter 12 case dismissed pursuant to 11 U.S.C. § 1208(b). An unsecured creditor of the debtors, Leland Porter (Porter), opposes having this case dismissed, and instead, requests that the Court convert the case to one under Chapter 7 pursuant to 11 U.S.C. § 1208(d).

Robert Smith is a farmer who currently farms property located in Colorado, and Sandra Smith operates a beauty salon in Chappell, Nebraska. The debtors purchased a farm from Porter on contract on February 22, 1982. The farmland was located in Deuel County, Nebraska. The debtors defaulted on the contract with Porter in 1986, and Porter filed a foreclosure action in the District Court of Deuel County, Nebraska on May 22, 1986. The property was sold at a sheriff's sale on September 14, 1987. The sale proceeds did not fully compensate Porter and he filed an action to collect the deficiency on October 14, 1987. The District Court of Deuel County ruled in favor of the debtors and found that Porter was not entitled to a deficiency judgment on April 21, 1989. The Supreme Court of Nebraska reversed the state district court's decision on June 26, 1992 and ordered the state district court to enter an order for a deficiency judgment. The District Court of Deuel County entered a deficiency judgment on December 15, 1992 in the amount of \$491,457.52.

Porter alleges that over the course of the litigation, the debtors fraudulently placed their assets into trusts purportedly created by Robert Smith's mother, Joyce E. Smith, sold other assets to prevent Porter from collecting the deficiency judgment, and fraudulently misrepresented facts on their bankruptcy schedules.

The debtors do not deny that any of the transactions that Porter has alleged to be fraudulent took place, but the debtors do deny that these transactions occurred to avoid having Porter execute on their assets to collect the deficiency judgment. The debtors take the position that Joyce E. Smith created the trusts as an investment for herself, that all asset sales were for a reasonable price and that any omissions in the bankruptcy schedules are the result of oversight by the debtors, not fraud.

#### Decision

This case is converted to Chapter 7 pursuant to 11 U.S.C. § 1208(d) for fraud in connection with the case.

#### Discussion

##### A. Statutory Authority

The debtor has moved to have this case dismissed pursuant to Section 1208(b) of the bankruptcy code, which provides:

On request of the debtor at any time, if the case has not been converted under section 706 or 1112 of this title, the court shall dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

11 U.S.C. 1208(b).

Porter takes the position that the case should not be dismissed but should be converted to a case under Chapter 7 of the Bankruptcy Code pursuant to Section 1208(d), which provides:

On request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter or convert a case under this chapter to a case under chapter 7 of this title upon a showing that the debtor has committed fraud in connection with this case.

11 U.S.C. § 1208(d).

Despite the mandatory language of Section 1208(b), a Chapter 12 debtor is not entitled to have a Chapter 12 case automatically dismissed on request if a showing of fraud has been made under subsection (d). Graven v. Fink (In re Graven), 936 F.2d 378, 385 (8th Cir. 1991); Reinbold v. Dewey County Bank, 942 F.2d 1304, 1306 (8th Cir. 1991). The existence of fraud is a factual matter for the trier of fact. Graven, 936 F.2d at 382; Reinbold, 942 F.2d at 1306. Fraud, for purposes of Section 1208(d), may include prepetition acts and post-petition acts. Reinbold, 942 F.2d at 1306.

#### B. Findings of Fact

The transactions that Porter alleges to be fraudulent are set forth below.

##### 1. Deuel County/Greeley County Property

The debtors purchased farmland in Deuel County, Nebraska from Porter in 1982 (Deuel County Property). The purchase contract provided that the debtors would make annual payments to Porter, amortized over fifteen (15) years. The purchase price for the property was \$586,000.

The debtors defaulted on the land contract in 1986. At the time of the default, the value of the property had decreased, and the property was worth substantially less than the price agreed to in the purchase agreement. The debtors were forcibly evicted by foreclosure. The entire parcel of property was sold at the foreclosure sale.

On November 8, 1982, approximately eight months after the debtors entered into the Deuel County land contract, the debtors transferred a quarter section of the Deuel County Property to Joyce E. Smith by exchange contract. Exhibit 29. Joyce E. Smith executed a warranty deed to the debtors for property in Greeley County, Kansas (Greeley County Property) in exchange for one quarter of the Deuel County Property. The Exchange Contract provided that the value of the quarter section of the Deuel County farmland was \$129,600.00, and the consideration required to be paid by Joyce E. Smith in the exchange was \$60,000 in addition to the Greeley County, Kansas property. Joyce Smith did not pay the debtors the \$60,000 which was due and owing to them under the Exchange Contract.

The land exchange took place without the knowledge or consent of Porter, in violation of the land contract between Porter and the debtors. The contract between Porter and the debtors prohibited the debtors from selling the Deuel County farmland. Robert Smith testified at the 2004 Examination that Porter had knowledge of and consented to the land exchange.

Porter's affidavit testimony that he did not have any knowledge that the land exchange took place until the 2004 examination is supported by other evidence. Porter did not sign any documents which pertain to the land exchange transfer. In addition, the debtors resided on the Deuel County farm, and Robert Smith apparently continued to farm the entire parcel of Deuel County Property. At the sheriff's sale, the debtors surrendered the entire parcel of property, including Joyce Smith's interest. Joyce Smith did not attempt to assert any ownership interest in the property, nor did she formally file an action to recover the Greeley County Property. The debtors state that the purpose of the land exchange was to exchange ownership on paper so that Joyce Smith could avoid paying taxes on the gain from the sale of the Greeley County property to a third party. Since the purpose of the Exchange Contract was to mislead the Internal Revenue Service as to the actual beneficiary of the Greeley County property, it is unlikely that the debtors disclosed and that Porter consented to the transaction.

Immediately after the land exchange, on November 8, 1982, the debtors sold the Greeley County property to a third party for \$69,600.00 on a land contract. Pursuant to the agreement that the debtors were owners "on paper" only, all proceeds from the sale were passed through the debtors and handed over to Joyce Smith. The debtors maintain that even though titles were exchanged on the properties for tax purposes, the Deuel County property continued to be farmed as property of the debtors, and the Greeley County property continued to be the property of Joyce Smith.

Joyce Smith first testified that she entered the land exchange so Robert Smith could farm the Greeley County Property and she would not have to hire custom farmers to work on the property. However, because the debtors immediately sold the property after the land exchange and turned the proceeds from the sale over to her, this Court concludes that her true intent under the land exchange was to hide the sale of the Greeley County Property from the Internal Revenue Service. Later in her deposition testimony, she conceded that the purpose of the land exchange was for a tax benefit.

The third party purchaser made payments under the land contract to the debtors, which were passed on by the debtors to Joyce Smith.<sup>1</sup> Prior to April 1, 1992, however, the third party defaulted on the land contract, and the debtors filed a foreclosure action. The third party turned over the deed to the debtors, and

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<sup>1</sup> After the property was sold to the original third party purchaser, the property was apparently sold at least two other times. Since the succession of ownership is not relevant to this Memorandum, the third party purchasers are treated as one entity to simplify the transaction.

the debtors did not seek a deficiency judgment. The debtors subsequently sold the Greeley County property on April 1, 1992 for \$ 54,000, but turned the proceeds over to Joyce Smith. The debtors listed the sale of the property on their 1992 tax returns and paid a tax on the \$5,803 capital gain allegedly realized on the property, even though they did not receive any of the proceeds of the property. Exhibit 2, Schedule D. The debtors did not file bankruptcy until over one year after this sale, and thus, have hindered the estate from recovering the proceeds of the sale which were passed on to Joyce Smith.

The land exchange of the Deuel County Property for the Greeley County Property is not fraudulent as to Porter. Porter recovered all of the Deuel County Property in the foreclosure sale, and therefore, did not suffer any damages as a result of the exchange. The transfer was fraudulent to the Internal Revenue Service because the debtors misrepresented on their tax returns that they were the owners of the property, and thus, permitted the true owner, Joyce Smith, to avoid paying taxes on the gain from the sale of the property.

## 2. The Joyce E. Smith Trust

On November 26, 1986, the Joyce E. Smith Trust was created (the Trust) by and on behalf of Joyce E. Smith. The Trust was created by the same attorney who represented the debtors in the deficiency judgment litigation with Porter. Joyce E. Smith, who is the mother of Robert Smith, is a resident of Denver, Colorado and has owned various rental units in Denver and Englewood, Colorado over the years. While managing the rental units, she actively participated in real estate deals and is not unsophisticated in real estate matters.

The Trust is irrevocable and provides that Joyce E. Smith and Sandra Smith are the trustees of the Trust. It also states that Robert and Sandra Smith are the beneficiaries under the Trust. The corpus of the Trust originally consisted of two pieces of property located in Sedgwick County, Colorado (Sedgwick County Properties). The Sedgwick County Properties were purchased by Joyce Smith on March 25, 1986, Exhibit 33, and conveyed to the Trust on December 23, 1988. Exhibit 34. Joyce Smith acquired the Sedgwick County Properties at the same time that the debtors were defaulting on the Deuel County Property contract with Porter. Joyce Smith testified that the intent of the Trust was to provide her with an investment and to provide her son with property that he could farm.

Joyce E. Smith has a right to receive \$100.00 of income per month under the Trust, but she has so far declined to receive the monthly payment. The Trust document states that the trustees shall pay over to the beneficiaries "so much of the income and so much of the principal of this Trust as the Trustees deem necessary or advisable to provide for the care, comfort and support of ROBERT D.

SMITH and SANDRA E. SMITH." Exhibit 14, § 18, ¶ 2. The trustees are also authorized to pay for the funeral, burial, and probate expenses of the debtors in the event of their deaths. Finally, the trustees may terminate the Trust at any time and assign all interests in the Trust to the debtors.

Even though it is not in the written Trust document, the debtors are permitted, pursuant to an oral lease agreement, to farm all of the Trust property and keep all of the income from the farming operation. In addition to operating the farm, the debtors also maintain a residence on the Sedgwick County Properties.<sup>2</sup>

There is substantial evidence that the Trust was created at the direction of Robert and not Joyce Smith. The debtors' Nebraska attorney (not their bankruptcy attorney) created the Trust for Joyce Smith. She lives in Colorado and Colorado is the location of the trust corpus. Joyce Smith stated that she was advised to create the trust on the advice of the debtors' attorney, who also advised Joyce to make Sandra a trustee in the Trust instead of Robert. The Trust was created a few months after the foreclosure action was filed by Porter, and the Sedgwick County property was conveyed to the Trust while the deficiency action was pending in state court. The Trust document erroneously states: "Trustor declare [sic] that she has one son, ROBERT E. SMITH [E. is marked out and initialed by all three parties that the correct initial is D.] on the date of the execution of this Trust." Exhibit 14, § 21, p. 12. In fact, Joyce Smith has two other sons besides Robert. This statement is an oversight by the drafter and not due to any intent to defraud on the part of the debtors or Joyce Smith, but the statement illustrates, especially when considered in the context of Joyce Smith's deposition where she showed that she has little working knowledge about the business of the Trust and its creation, that Joyce Smith does not control the Trust or the management thereof.

The most compelling evidence that Robert orchestrated the creation of the Trust to permit the debtors to acquire assets without accounting to Porter, is the original Contract to purchase the Trust property entered into on March 26, 1986 between Joyce Smith and the seller. Exhibit 42. On the last page of the contract, the debtors personally guaranteed all of the payments under the purchase contract.

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<sup>2</sup> Before the bankruptcy case was filed, the debtors began to rent an apartment in Chappell, Nebraska, where Sandra Smith works in her beauty shop. The debtors also maintain their residence in Sedgwick County, Colorado, which is approximately twenty-five (25) miles from Chappell. Originally, Porter filed a motion to change venue in this case, but then withdrew the motion. For this reason, the Court has not evaluated the testimony which relates to where the debtors' principle residence is located.

On December 30, 1988, shortly after the Sedgwick County Property was conveyed into the Trust, the Trust executed a Note and Deed of Trust with First Federal Savings and Loan for \$41,000. Exhibit 35. Pursuant to what the debtors term an oral lease with Joyce Smith for the right to farm the property, the debtors made all payments due and owing under the Note and Deed of Trust. Robert Smith testified that the note has been paid in full.

In addition to guaranteeing the payments under the contract, Robert Smith farmed the property and received all government payments attributable to the property. Robert has always acted like the true owner of the property, and the Trust received no benefit from its alleged ownership interest. Joyce Smith has no recollection that an accounting has ever been done of the Trust property. The trustees have not ever attempted to collect rents or profits from the land.

Sandra Smith testified that she does not manage or administer any of the Trust property, nor does she recall signing any paperwork dealing with these trusts. Sandra Smith has, in fact, signed several documents as trustee, but her lack of recollection demonstrates that she signed these documents with little knowledge as to the contents of what she was signing. According to Joyce Smith and Sandra Smith, Robert Smith makes all of the decisions regarding the Trust properties and the proceeds from the Trust properties. Robert Smith testified at the 2004 exam that he did not make any decisions regarding the Trust properties, but this statement simply lacks credence. Not only do the trustees, who are his mother and his wife, contradict his testimony, but also, his mother's and wife's consistent lack of knowledge of the business of the Trust and the lack of records regarding the Trust's operations supports their testimony that Robert has constructive ownership of the property in the Trust, and the trustees do not actively make decisions regarding the Trust property.

On February 5, 1992, the Trust purchased another portion of property in Sedgwick County, Colorado (Second Sedgwick County Purchase), which happened to be adjacent to the Sedgwick County Properties already in the Trust. Exhibit 30. Robert Smith testified that the Second Sedgwick County Purchase was made with the proceeds from the sale of the Greeley County Property. He claims that the proceeds of the Greeley County property sale were passed through to Joyce Smith, who purchased this property.

However, the Trust borrowed \$68,000 from the Farm Credit Bank of Wichita for the purchase of the Second Sedgwick County Purchase. The loan is secured by the Second Sedgwick County Purchase and the Sedgwick County Properties which are already in the Trust. This secured loan amount is close to the amount that Robert Smith stated was the purchase price of the Second Sedgwick Purchase, \$70,000. Joyce Smith also testified that the Greeley County Property proceeds were applied to this purchase.

Sandra Smith and Joyce Smith signed the Deed of Trust in their capacities as trustees, and the Deed of Trust is signed by the debtors. Exhibit 45. However, Joyce Smith did not sign in her capacity as trustee on the Note and Loan Agreement with Farm Credit Bank. Only Sandra Smith signed as trustee and the debtors signed individually for the \$68,000 note. Joyce Smith also states that she did not participate in the discussions concerning the financing agreement and that the debtors arranged all of the financing and the mortgaging of the Second Sedgwick Property.

Like the other property in the Trust, Robert Smith farms this property and fully exercises control of the property. This property was acquired shortly prior to the reversal of the deficiency judgment by the Nebraska Supreme Court. It appears that Robert Smith is the constructive owner of the property because he makes all decisions regarding this property and has made all payments towards the purchase of the property.

At about the same time the Second Sedgwick Property was purchased, another adjacent quarter to the Sedgwick Property was sold to Clifford L. Johnson's (Johnson) corporation, C.L.J. Farms, Inc. (Third Sedgwick Property). Johnson is a friend and neighbor of the debtors. The Third Sedgwick Property is farmed by the debtors, who leased the property from C.L.J. Farms, Inc. in 1992 and began planting crops there in 1993.

The creation and continuation of the Trust appears to be fraudulent. There is no evidence that Joyce Smith tendered any consideration for the purchase of any of the properties in the Trust. The evidence also overwhelmingly shows that Robert Smith acts as the true owner of the Trust properties. The debtors use the income from the farming operations to pay all expenses related to the purchase price of the property, taxes and upkeep of the Trust properties. Joyce Smith and Sandra Smith do not exercise any of the trustee powers that they are authorized to use under the Trust, and neither of the trustees appears to even have a working knowledge of the Trust. In addition, Joyce Smith has not received any beneficial interest from owning the Trust, which she claimed was supposed to be an investment. Robert Smith and Joyce Smith appeared to have entered into this arrangement so Robert Smith could operate a profitable farming operation and rid himself of the Deuel County Property and of his debts to Porter.

### 3. The Joyce E. Smith Living Trust

The Joyce E. Smith Living Trust (the Living Trust) was created on October 3, 1987. Exhibit 13. The Living Trust was created less than one month after the September 13, 1987 sheriff's sale of the Deuel County Property. Like the Trust, the Living Trust was created by debtors' Nebraska attorney, the same lawyer who served as the debtors' attorney during the litigation with Porter. The Living Trust was created three days after the sheriff's sale of the

Deuel County Property. Joyce Smith and Sandra Smith are named as the trustees of the Living Trust, subject to the identical duties as in the Trust, and the debtors are named as the beneficiaries of the Living Trust. Unlike the Trust, the Living Trust is revocable.

Joyce Smith is entitled to \$1,000.00 per month in income from the Living Trust, but she has not yet elected to receive this income. In fact, she has not yet earned any income from either the Trust or the Living Trust. The trustees are obligated to pay over to the debtors as beneficiaries as much income and principal from the Living Trust as the trustees, in their sole discretion, deem necessary or advisable for the support of the debtors. In addition, the Living Trust is authorized to pay for the debtors' funeral, burial and probate expenses, and the Living Trust may be terminated at any time by the trustees who will then assign all income and corpus to the debtors.

Other than being revocable, the Living Trust is essentially the same arrangement as was discussed above in the Trust. As in the Trust, the Living Trust incorrectly states that Joyce Smith only has one son. Exhibit 13, § 13, p. 12. Statements like this in the Living Trust and Joyce Smith's testimony about the Living Trust demonstrate that she possesses little knowledge about the Living Trust and that she has failed to keep adequate records regarding the Living Trust. She also does not know if an accounting has ever been performed of the Living Trust. Sandra Smith, the other trustee, testified that Joyce Smith did all of the bookwork, but clearly, Joyce Smith is not involved in the operations of the trusts. In fact, Joyce Smith testified that Robert Smith keeps all of the bookwork. The Trust documents do not state and the trustees testified that they do not know what state's laws, Nebraska's or Colorado's, govern the Living Trust and the Trust.

On the same date that the Living Trust was created, October 3, 1987, the debtors sold farmland that they had owned for over ten (10) years in Washington County, Colorado to Joyce Smith (the Washington County Property). The Washington County Property was immediately transferred by Joyce Smith to the Living Trust. Joyce Smith allegedly paid \$166,400.00 for the property. Exhibit 15. However, she has no recollection or records which show that this dollar amount was the actual consideration or that she paid any money to the debtors.

Robert Smith claims that the Living Trust was created by Joyce Smith because the debtors owed her money and the sale of the Washington County Property was to account for that previous debt. He also claims that all of the proceeds from the sale of the Washington County Property were used by the debtors to pay bills and living expenses. If the debtors did in fact receive proceeds from the sale of the Washington County Property, their 1987 tax returns do not reflect the receipt of these funds. Exhibit 11, Exhibit 12.

On October 3, 1987, Joyce Smith individually entered into a mortgage agreement with Johnson whereby the Washington County Property was used to secure a promissory note for \$80,000. Exhibit 43, Exhibit 44. This real estate transaction was apparently arranged by debtors' Nebraska attorney in the litigation with Porter. Joyce Smith testified that she borrowed the money from Johnson to finance the purchase of the Washington County Property from the debtors. Joyce Smith testified that she has never made any payments under this note, and in fact, Robert has made all such payments to Johnson. Joyce Smith also testified that the first mortgage on the Washington County Property to another creditor, which was executed before Joyce Smith purchased the property, continued to be paid by Robert Smith.

Johnson testified that he did not know that Joyce Smith purchased the property from the debtors on the same date that she granted the mortgage to Johnson. This testimony directly conflicts with Joyce Smith's story, which is that Johnson gave her the loan so she could buy the Washington County Property from the debtors.

Robert Smith supports Johnson's testimony, and contradicts Joyce Smith's testimony.

Johnson also testified that Joyce Smith always paid the mortgage on the Washington County Property, but this testimony is obviously incorrect. Robert Smith testified that he made these payments as part of the oral lease agreement that he had with the Trust. The debtors' 1991 tax returns, which account for the expenses made by the debtors on behalf of the trusts, show that Robert Smith paid the mortgage payments to Johnson from 1987 to 1991 and that Robert Smith paid all of the real estate taxes from 1987 to 1991. Exhibit 3. Johnson also admitted that various checks signed by Robert Smith and payable to Johnson and various interest payments recorded by the debtors to the Internal Revenue Service show that Robert Smith paid the mortgage and interest payments on the Washington County Property. Exhibits 55-58. However, Johnson insists that Joyce Smith did pay the 1993 mortgage payment.

On October 2, 1987, Joyce Smith also purchased a parcel of land in Sedgwick County, Colorado (Living Trust Sedgwick County Property), which was located near the Sedgwick County Properties described previously. Exhibit 16. The purchase price was \$105,000. Johnson testified that the Living Trust approached him about purchasing the property at an auction, and then, asked him to sell the property to the Living Trust, which he did for the same price that he bid at the auction. The time period between the auction and deeding it to Joyce Smith was short. Joyce Smith immediately transferred the property to the Living Trust on October 3, 1987. Exhibit 17. Apparently, the mortgage on the Washington County Property, which was discussed above, financed this purchase, and the debtors paid the mortgage debt to Johnson and the real

estate taxes on the property with the income from the farm. Johnson testified that the debtors' Nebraska lawyer prepared the real estate sale documents for Johnson.

Robert Smith claims that he is not involved in the operation of the Living Trust and leaves those activities to the trustees, who are, according to him, both active in carrying out their trustee duties. Joyce Smith testified that Robert Smith farms all of the Living Trust property subject to an oral agreement with the Living Trust. In addition to farming the land, he is to maintain the property, make all payments for the purchase of the property and pay all taxes as they come due out of the income that he earns farming. The legal addresses for both Trusts are located at the debtors' residence, and all correspondence regarding the trusts goes to the debtors' address, not to Joyce Smith. Joyce Smith stated that the Living Trust does not receive any cash rent or proceeds from crops off of the property because Robert Smith keeps all such proceeds. The debtors' 1991 tax returns support Joyce Smith's testimony that Robert Smith makes all payments on the property and that he fully controls all of the Living Trust Property.

All proceeds from the farming operation that are received by the trusts are placed in one trust checking account located in Sterling, Colorado. Both Joyce Smith and Sandra Smith are authorized to use the account, but Joyce Smith has given Robert Smith a power of attorney for her interest, so he may access the checking account as well. Joyce Smith is also not aware as to whether the debtors use this account to pay taxes or the mortgages on both of the trusts' properties. Therefore, it appears that even if some of the trusts' income is turned over to the trusts by the debtors, the income goes straight into an account that the debtors may use for farm expenses, including paying all mortgages and taxes of the trusts' properties.

Any determination of net profits and thus, income are determined by Robert Smith, who does all of the accounting. Joyce Smith testified that she does not know whether the debtors have profited or had losses in the farm operations. Because she is not familiar with how the trusts have performed, she does not know how much income, if any, has ever been paid into the trusts' account.

The debtors are permitted to use their own money to improve both trust properties in any manner that they desire. Joyce Smith testified that all improvements become property of the trusts. Improvements made so far on the trust properties include \$50,000 spent to remodel the debtors' residence, the purchase of a bin for the debtors' farming operation, landscaping, and general upkeep of the properties. The debtors have been taking the depreciation expense on their tax returns for the house and have deducted expenses for the remodeling of the debtors' Colorado home on their personal tax returns. Exhibit 2, Exhibit 3, Exhibit 5, Exhibit 9,

Exhibit 11. [The question of the legitimacy of such deductions on personal tax returns is not before the Court and no opinion is expressed thereon.]

Joyce Smith also testified that she opened an account at A.G. Edwards in the debtors' name for their own personal use on the farm. She initially placed \$25,000 into the account, but she does not recall when.

Joyce Smith created a new trust agreement entitled "The Joyce E. Smith Trust" on January 19, 1993. Exhibit 41. The new trust was created by an attorney in Denver, Colorado. Joyce Smith originally testified that the new trust was created to replace the Living Trust, but later she testified that the new trust did not include property already in the Living Trust and the Trust. Since the Trust is irrevocable and the Living Trust has not been terminated by the trustees, the Living Trust and the Trust have retained title to the property conveyed to the trusts and, therefore, none of the property of the trusts has been transferred to the new trust.

The Living Trust was fraudulently created to provide the debtors with the ownership, possession and use of farm properties, without having to take title to the properties. The evidence shows that the debtors are the constructive owners of the property. Joyce Smith has not paid any consideration for the assets conveyed to the Living Trust, and Robert Smith has paid the mortgages and real estate taxes on the Living Trust properties with the money that he earns from farming the Living Trust properties. The Living Trust was created shortly after the sheriff's sale of the Deuel County Property.

#### 4. Equipment and Beauty Shop Asset Sales

On August 7, 1992, the debtors conveyed to Johnson the real property on which Sandra Smith's beauty shop is located for \$7,500.00. Exhibit 18, Exhibit 51. The sale was at a loss of over \$17,206.00 to the debtors because the cost basis in the property was listed at \$25,715 by the debtors in their 1992 tax returns. Exhibit 2, Schedule 4797. The debtors claim that the selling price was at the appraised value, but no appraisals were submitted to the Court to verify this claim.

The debtors' 1992 tax returns state that the real property where the beauty shop was located was acquired June 1, 1991. Exhibit 2, Form 4797. If so, the purchase would have been during the period of time that the deficiency litigation was on appeal and after the debtors won at the state district court level. It is not lost on this Court that the debtors conveyed the beauty shop real estate to Johnson approximately one and one half months after the Supreme Court of Nebraska reversed the Deuel County District Court on the deficiency action.

On the same date that the real property was sold, August 7, 1992, the debtors also sold to Johnson all of the business assets and personal property of the beauty shop for \$1,400.00. Exhibit 19, Exhibit 51. The debtors and Johnson claim that the selling price was for the appraised value of the business assets, but the debtors did not submit any appraisals to verify this claim. The debtors list the cost basis in the property at \$2,196.00 in their 1992 tax returns. Exhibit 2, Schedule 4797. The business assets were also acquired on June 1, 1991, during the period of time that the deficiency litigation was on appeal, and the assets were sold approximately one and one half months after the Supreme Court reversed the state district court.

On September 23, 1992, the debtors sold all of the debtors' farming equipment to Johnson for \$32,500. Exhibit 20, Exhibit 51. This sale took place only about three months after the Nebraska Supreme Court reversed the state district court and found that Porter was entitled to a deficiency judgment.

Johnson states that the appraised value of this property was \$54,000.

The debtors' testimony is that the property had to be sold because Joyce Smith was pressuring the debtors to pay back various loans that she had extended to them over the years and which now totaled \$60,000. The alleged basis for the debt to Joyce Smith was for various operating loans extended to the debtors over prior years for their farming operations. No signed promissory notes or other documentation exists to verify that these loans were in fact extended to the debtors and that, if they were, that they totaled \$60,000.

The loans were a "family deal." Joyce Smith believed that the loans began in 1982, but she does not recall what the loans were for, nor did she keep an accounting of the loans. She states that the loans were more analogous to an open account where the debtors took a loan, paid some of the loan back, took another loan, and so on. Joyce Smith claims that she kept a running tab of the loans on a tablet, which she did not keep after the loan was repaid in 1992.

After paying the proceeds from the sales of these assets to Joyce Smith, the debtors immediately leased all of the property back from Johnson. The debtors are leasing the beauty shop from Johnson for a rental rate of \$450.00 every six months. Exhibit 21. The debtors are leasing the farm machinery from Johnson for \$3,800.00 per year. Exhibit 22. The debtors never lost possession of the farm equipment or the beauty shop during the period of the sale and leaseback.

With regard to the farm machinery, two pieces of equipment were sold by Johnson, a rodweeder and a swather, and he purchased

a new swather for \$10,300. Exhibit 51. The new swather was included in the lease to the debtors.

Joyce Smith believes that she was paid in full in 1992 with various checks, but she does not recall when in 1992 or whether she received the entire \$60,000. Since the debtors could not have paid the proceeds over to Joyce Smith until after the property was sold, Joyce Smith began receiving the proceeds no earlier than August of 1992.

At the time that Joyce Smith demanded the money back, Joyce Smith was aware that Porter had won in the Nebraska Supreme Court in June of 1992, and she admits that Porter's victory compelled her to pressure the debtors for payment. It did not seem irregular to her that by her demands for payment, she caused the debtors to sell the farm equipment assets which the debtors used to operate her trust properties.

The sales of the assets and the application of the loan proceeds on the debt with Joyce Smith occurred within one year of the filing of the bankruptcy petition. Even though debtors may favor one creditor over another outside of the bankruptcy, it appears here that a transaction was created to enable debtors to pay back Joyce Smith, and transfer title to real and personal property before Porter could execute on such property. The lease arrangement permits the debtors to keep their assets, but lose title to the assets so they may not be levied upon. In addition, making lease payments keeps the debtors' net income from the farm property near zero so they can avoid paying Porter anything over the life of the Chapter 12 plan.

#### 5. Bankruptcy Schedules

The debtors' bankruptcy schedules were filed on June 1, 1993. Filing no. 20. The schedules assert that debtors do not have any real property. Virtually all of their personal property is claimed as exempt. Listing no secured creditors, other creditors include the Internal Revenue Service, who has a \$4,282.00 unsecured priority claim; a law firm that has a \$4,865.50 general unsecured claim; and Porter, who is listed as holding an approximate \$500,000 unsecured claim.

The debtors omit from their schedules the fact that they are co-signers with the Trust on the note with the Farm Credit Bank of Wichita for the purchase of the Second Sedgwick County Purchase. The debtors take the position at the time of filling out their schedules that they did not recall that they had individually signed on this note. The debtors propose to amend their Schedules to reflect this debt.

The debtors also failed to disclose that they have co-debtors. The debtors have proposed to amend their Schedule H to reflect this

omission. The debtors claim that they did not know that they had co-debtors on any debt at the time the petition was filed.

The debtors stated in their schedules that they have no executory contracts or unexpired leases. This statement is false, if any of the testimony of debtors is to be believed. According to such testimony, all of the trusts' properties are leased to the debtors. In addition, the debtors have leases with Johnson for the beauty shop assets and farm equipment.

The debtors did list rent payments for their Chappell, Nebraska apartment under Schedule J for yearly expenses. The debtors also list "Rents and Leases" under their cash flow projections for their farming operations, but do not list the lease payments for the beauty shop. Clearly, these disclosures are insufficient. The debtors should have disclosed the various lease agreements and the amount of the lease payments. It appears from the schedules that the debtor is attempting to hide from this Court the fact that the lease payments are in fact payments on the mortgages and the real estate tax obligations of the trusts.

The debtors have misrepresented the amount of income that they receive from the Trust and the Living Trust. Schedule I states that each debtor will receive approximately \$1,010.00 in income from the trusts. In Schedule B, the debtors list the value of their interest in the trusts to be only \$3,500.00. In their Statement of Financial Affairs, the debtors state that they receive no additional income on top of the income earned from the farming operations and the beauty shop.

The debtors' tax returns show that the income that has historically been received from the trusts is significantly greater than the income that the debtors reported in the bankruptcy schedules. The debtors reported the following income from the trusts in their tax returns:

<u>Year</u>	<u>Income from trusts</u>
1987	\$13,786
1988	\$17,909
1989	\$10,898
1990	\$10,830
1991	\$11,313

Exhibits 2-12. The income from the trusts and the value placed on their beneficial interest were reported in the schedules at a value lower than what historically has been the case.

The debtors have also failed to disclose that they hold and control all of the property which belongs to the Living Trust and the Trust. The debtors, or at least Robert Smith, testified that he did not control and hold all of the trust properties, but as discussed above, his testimony is not credible.

When listing their assets, the debtors did not disclose that they had crops on hand. The debtors state that the crop, winter wheat, was not mature, and therefore, the debtors believed that the winter wheat did not possess any value. However, the bankruptcy schedules clearly asked for "Crops-growing or harvested. Give particulars." The winter wheat crops should have been disclosed by the debtors.

The debtors did not disclose that the A.G. Edwards account, which was established by Joyce Smith, but in the debtors' names, existed and contained funds. The debtors claim that they thought that the account had been closed and that they did not think that they had any interest in the account.

The debtors have misrepresented a significant number of items in their bankruptcy petitions. The debtors have attempted to hide from this Court the true nature of the Trust and the Living Trust, and Robert Smith's constructive ownership of those trusts. The debtors excuse is that all of the omissions were oversights, and they will amend their schedules to reflect the omitted items. However, their testimony is not credible. The Court finds that the debtors misrepresented items in their bankruptcy petition to mislead the Court and creditors so they could obtain confirmation of a Chapter 12 plan that would have not paid Porter his deficiency judgment. See Chapter 12 Plan of Reorganization, Filing No. 29.

### C. Conclusions of Law

The original contract for the purchase of the Deuel County Property between the debtors and Porter was, without a doubt, at a price that was beneficial for Porter, but detrimental to the debtors. The Court is familiar with, and not unsympathetic to, the plight of farmers who saw the value of their farm property drop during the first half of the 1980's. Many honest farmers turned to this Court to reorganize their farming operations after farm property prices fell and faced foreclosure. The debtors in this case are no exception to this crisis as the amount of the deficiency judgment owed to Porter illustrates. However, Chapter 12 bankruptcy relief is for honest debtors, and not farmers who are attempting to totally circumvent the rights of creditors. In this case, the debtors do not come to this Court in good faith, and therefore, are not entitled to the protection offered by Chapter 12.

Under a motion to convert a Chapter 12 case to one under Chapter 7 pursuant to Section 1208(d), a showing of fraud must be made. Several courts have examined what standard of fraud should be applied. See Graven v. Fink (In re Graven), 936 F.2d 378 (8th Cir. 1991) (finding that bankruptcy court applied the correct standard for fraud under Section 1208(d) when it used the "clear pattern of deliberate fraud perpetrated with the intent to hinder, delay and defraud creditors of the debtors" standard located at 11

U.S.C. § 548(a) and used the state law fraudulent conveyance standard as authorized by 11 U.S.C. § 544(b). The Court also noted that under applicable state law intent was inferable from the circumstances of the transactions); Reinbold v. Dewey County Bank, 942 F.2d 1303 (8th Cir. 1991) (finding that conversion of Chapter 12 case to Chapter 7 pursuant to Section 1208(d) was proper when the bankruptcy court found that the debtor fraudulently transferred property and fraudulently failed to adhere to the Chapter 12 plan); Agribank, FCB v. Kingsley (In re Kingsley), 162 B.R. 249 (Bankr. W.D. Mo. 1994) (holding that finding of actual fraud and of misrepresentations in schedules and at meeting of creditors pursuant to Section 1208(d) conversion action precluded relitigation of fraud element necessary to deny discharge under 11 U.S.C. 727(a)(4)(A), but did not collaterally estop debtors from defending nondischargeability claims based upon transfers of property with intent to hinder, delay, or defraud creditors and failure of debtors to satisfactorily explain any loss or deficiency of assets pursuant to 11 U.S.C. § 727(a)(2) & (a)(5)); (In re Caldwell, 101 B.R. 728 (Bankr. D. Utah 1989) (holding that Section 1208(d) action was analogous to an 11 U.S.C. § 727(a)(4) action, which did not require a showing of reliance or damages by the creditor); In re Zurface, 95 B.R. 527 (Bankr. S.D. Ohio 1989) (holding that a Section 1208(d) conversion was proper when debtor fraudulently conveyed property pursuant to state law). This Court believes that in addition to the statutory provisions and standards used by courts in previous Section 1208(d) actions, Section 523(a)(2)(A) would also provide an acceptable standard. 11 U.S.C. § 523(a)(2)(A).

Whether certain prepetition activities amount to fraud is a state law question. Nebraska law will be examined to determine whether the debtors' actions amount to prepetition fraud. Before 1990, the relevant statutory authority was the Uniform Fraudulent Conveyance Act. NEB. REV. STAT. § 36-601 et. al (Reissue 1988). (Now repealed). The applicable standard is located at Section 36-607, which provides:

Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.

NEB. REV. STAT. § 36-607 (Reissue 1988). This language is similar to the language used in Section 548(a) of the Bankruptcy Code, which relates to fraudulent conveyances within one year of the bankruptcy petition.

To show intent in a fraudulent conveyance action, the circumstance surrounding the transfers may be considered:

Because intent to hinder, delay, or defraud . . . , as any other subjective state or mental element, is frequently difficult to establish by direct proof, circumstances surrounding a transaction provide evidence to determine whether fraudulent intent existed at the time of the transaction.

Gifford-Hill & Co., Inc. v. Stoller, 221 Neb. 757, 763, 380 N.W.2d 625 (Neb. 1986) (citations omitted). The Nebraska Supreme Court has recognized that the existence of certain circumstances, called "badges of fraud" produce a probability of fraudulent intent in a transfer. Id. "Badges of fraud" are not per se fraud, but they are facts which tend to show the existence of fraud in a transaction. Schall v. Anderson's Implement, Inc., 240 Neb. 658, 664, 484 N.W.2d 86 (Neb. 1992) (citing Gifford-Hill, 221 Neb. at 763).

The recognized "badges of fraud" recognized under the Fraudulent Conveyance Act in Nebraska are:

the lack of consideration for the conveyance, the transfer of the debtor's entire estate, relationship between transferor and the transferee, the pendency or threat of litigation, secrecy or hurried transaction, insolvency or indebtedness of the transferor, departure from the usual method of business, the retention by the debtor of possession of the property, and the reservation of the benefit to the transferor.

Schall, 240 Neb. at 665; Gifford-Hill, 221 Neb. at 764 (citing 37 AM JUR. 2D Fraudulent Conveyances § 10 at 701). The burden of proof to show fraudulent intent is by clear and convincing evidence. Id.

Based on the findings of fact recited above, the Court concludes that before 1990 the debtors did intend to fraudulently convey property into the trusts and did fraudulently purchase property under the alter ego of the trusts to delay, hinder and defraud Porter. The evidence establishes that all of the "badges of fraud" are present in this case, and the evidence is clear and convincing that the debtors did intend to delay, hinder and defraud Porter from collecting his deficiency judgment.

For the transactions occurring after 1990, the relevant statute is Section 36-705 of the Fraudulent Transfers Act. NEB. REV. STAT. § 36-705(a)(1) (Reissue 1993). Section 36-705(a)(1) is identical to the prior fraudulent conveyance Section 36-607, but at Section 36-705(b), the Nebraska legislature has codified the "badges of fraud" as indicia of actual intent. NEB. REV. STAT. § 36-705(b) (Reissue 1993). Therefore, the same standard may be applied to those transactions which occurred after 1990.

The transactions that occurred after 1990 would be the acquisition by the Trust of the Second Sedgwick County Property and the sale of the debtors' farming equipment and business assets. The Court finds that both of these transactions clearly and convincingly constitute fraudulent transfers under Nebraska law because the reasons cited in the findings of fact show that the debtors had a fraudulent intent with respect to these conveyances.

Likewise the sale of assets would also fall under Section 548(a)(1) of the Bankruptcy Code, and a trustee after conversion may be able to recover the proceeds from the sale of the assets from Joyce Smith in her individual or trustee capacity for the benefit of the estate. 11 U.S.C. § 548(a)(1).

It is not material that the trusts were created, instead of Joyce Smith holding the property fraudulently conveyed to her at the direction of the debtors. Trusts which are shams may either be set aside as fraudulent conveyances or treated as alter egos of the debtors and levied upon by creditors. F.P.P. Enter. v. United States, 830 F.2d 114 (8th Cir. 1987) .

In addition to the prepetition conduct relating to the trusts, Robert Smith's testimony, post bankruptcy, at the 2004 Exam, and his failure to disclose the facts about his assets, his transfers, his leases and his income on the bankruptcy schedules would be sufficient to deny his discharge, if this case had been filed under Chapter 7 and could permit Porter to have his debt declared non-dischargeable. 11 U.S.C. § 523(a)(2)(A). Furthermore, the erroneous tax returns filed prepetition and post petition can be and are considered as fraud in connection with the case.

Once fraud is shown, it is permissible for the Court to convert this case to one under Chapter 7.

This case is converted to Chapter 7 pursuant to 11 U.S.C.

Separate journal entry shall be entered.

DATED: December 22, 1994

BY THE COURT:

/s/ Timothy J. Mahoney  
Timothy J. Mahoney  
Chief Judge

Copies faxed by the Court to:

SUSAN WILLIAMS            8-308-532-2741

Copies mailed by the Court to:

Albert P. Burnes, Attorney, 319 South 17th Street, Suite 428,  
Omaha, NE 68102

Richard Lydick, Trustee

Movant (\*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
ROBERT AND SANDRA SMITH,	)	CASE NO. BK93-80682
	)	A
<u>DEBTOR(S)</u>	)	
	)	CH. 12
	)	Filing No.
Plaintiff(s)	)	
vs.	)	<u>JOURNAL ENTRY</u>
	)	
	)	
	)	DATE: December 22, 1994
<u>Defendant(s)</u>	)	HEARING DATE: August 17,
	)	1994

Before a United States Bankruptcy Judge for the District of Nebraska regarding Motion to Convert to Chapter 7 filed by Leland Porter and Motion to Dismiss filed by the debtors.

APPEARANCES

Albert Burnes, Attorney for debtors  
Susan Williams, Attorney for Leland Porter  
Patricia Napier, Attorney for Chapter 12 Trustee

IT IS ORDERED:

This case is converted to Chapter 7 pursuant to 11 U.S.C. § 1208(d). See memorandum entered this date.

BY THE COURT:

/s/ Timothy J. Mahoney  
Timothy J. Mahoney  
Chief Judge

Copies faxed by the Court to:  
SUSAN WILLIAMS 8-308-532-2741

Copies mailed by the Court to:  
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Omaha, NE 68102  
Richard Lydick, Trustee

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