

§ 727(a)(3)
Financial condition
Inadequate records
Justification

UST v. Knowling, Adversary No. 10-03298-rld
Joel Robert Knowling, Case No. 09-40551-rld7

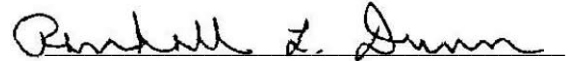
10/20/2011 RLD

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Following trial, the court found that the debtor did not prepare and maintain adequate financial records from which his prepetition financial condition could be determined. The burden then shifted to the debtor to justify the lack of financial records. The court rejected debtor's defense based on lack of education. The court concluded that debtor's conscious choice not to retain the services required for preparation of financial reports for his business that generated millions of dollars of gross income in the three year's preceding the debtor's bankruptcy filing was not justified where the debtor took annual compensation from the business in the hundreds of thousands of dollars but failed to file tax returns accounting for his income or that of the business. The debtor's discharge was denied pursuant to § 727(a)(3).

P11-15(17)

Below is an Opinion of the Court.



RANDALL L. DUNN
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

11	In Re:)	
12	JOEL ROBERT KNOWLING,)	Bankruptcy Case
13)	No. 09-40551-rld7
14	Debtor.)	
15	_____)	
16	UNITED STATES TRUSTEE,)	Adv. Proc. No. 10-03298-rld
17)	
18	Plaintiff,)	
19)	
20	v.)	MEMORANDUM OPINION
21	JOEL ROBERT KNOWLING,)	
22)	
23	Defendant.)	
24	_____)	

On August 9-10, 2011, I received evidence and heard testimony and argument at the trial ("Trial") of the United States Trustee's ("UST") Complaint for Denial of Discharge ("Complaint") to the debtor Joel Robert Knowling ("Mr. Knowling"). The parties previously had filed a Joint Pretrial Order ("Pretrial Order") that was entered on August 8, 2011. See Adversary Proceeding Docket No. 30. At the conclusion of the Trial, I took the matter under advisement.

1 In deciding this case, I have considered carefully the
2 testimony presented and the exhibits admitted at the Trial, as well as
3 arguments presented, both in legal memoranda and orally. I further have
4 taken judicial notice of the docket and documents filed in this adversary
5 proceeding ("Adversary Proceeding") and in Mr. Knowling's main chapter 7¹
6 case, Case No. 09-40551-rld7 ("Main Case"), for purposes of confirming
7 and ascertaining facts not reasonably in dispute. Federal Rule of
8 Evidence 201; In re Butts, 350 B.R. 12, 14 n.1 (Bankr. E.D. Pa. 2006).
9 In addition, I have reviewed relevant legal authorities, both as cited to
10 me by the parties and as located through my own research.

11 In light of that consideration and review, this Memorandum
12 Opinion sets forth the court's findings of fact and conclusions of law
13 under Civil Rule 52(a), applicable in this Adversary Proceeding under
14 Rule 7052.

15 16 Factual Background

17 Mr. Knowling has about twenty years' experience in repairs,
18 purchases and sales of heavy equipment in the construction industry. He
19 graduated from high school in 1986 and did not attend college, but he
20 attended mechanic school. He got his first job in the equipment business
21 in approximately 1988. After working for a succession of employers,
22 including Ivy Equipment, Sky Reach, Viking Equipment Rentals and Power
23 Rents, Mr. Knowling started his own proprietorship business to buy and
24

25 ¹ Unless otherwise indicated, all chapter and section references are
26 to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and all "Rule" references
are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037. The
Federal Rules of Civil Procedure are referred to as "Civil Rules."

1 sell heavy lift equipment in the spring of 2000, operating under the name
2 "Columbia River Lift Equipment" ("CRLE"). CRLE was registered as a
3 business name in the business registry of the Oregon State Corporation
4 Division on June 11, 2007.

5 From approximately March 2000 through December 15, 2009, Mr.
6 Knowling, dba CRLE, bought and sold used heavy equipment for the
7 wholesale market. He operated his business from a leased office, shop
8 and equipment yard property located on 92nd Avenue in Portland, Oregon
9 ("Commercial Property").

10 Mr. Knowling operated his business as follows: He would locate
11 and purchase items of heavy lift equipment, sometimes for cash and
12 sometimes on terms, and would resell equipment inventory items at a mark-
13 up he determined to be appropriate as soon as possible, sometimes before
14 his own purchase invoice for the subject equipment became due. He
15 started with a few thousand dollars, but as his business grew, he relied
16 more and more for working capital on loans from private lenders at high
17 rates of interest.

18 Mr. Knowling maintained records for his business on two
19 computers and in organized folders containing copies of leases,
20 promissory notes, tax records, bank statements, carbon copies of checks,
21 stubs from cashier's checks, invoices to and from CRLE, and miscellaneous
22 documents. At the time of his bankruptcy filing, Mr. Knowling's records
23 were retained on the two computers and in twelve banker's boxes
24 containing his document folders. Mr. Knowling maintained a single
25 business checking account at U.S. Bank ("Account 9982") into which he
26 deposited business checks, wire transfers and some cash. He drew from

1 Account 9982 payments for both his business and personal expenses. Mr.
2 Knowling never employed a bookkeeper or accountant to organize and manage
3 the finances of his business, and he did not maintain a business ledger.
4 He never prepared any financial statements for his business: No balance
5 sheets, no profit and loss statements, no accounts receivable aging
6 reports. While he frequently checked on the status of Account 9982, he
7 operated day to day based on figures he juggled "in his head." Based on
8 the record of the Trial, it is apparent that Mr. Knowling's business
9 focus was on cash flow.

10 Mr. Knowling's approach to taxes was unique in my experience.
11 He clearly recognized that he was obligated to file tax returns and to
12 pay taxes. However, he did not file any income tax returns for 2000 or
13 2001 forward, although he did request repeated extensions to file, and he
14 paid income taxes only when he would receive a statement from the
15 Internal Revenue Service ("IRS"). He testified that he never employed a
16 tax accountant because he thought it would be "cost prohibitive."

17 Ms. Kristin Emminger testified as the IRS agent who was
18 assigned postpetition the task of analyzing and determining Mr.
19 Knowling's income tax obligations for the years 2006 through 2009. In
20 her amended report on Form 4549-A, Income Tax Discrepancy Adjustments,
21 and Explanation of Changes ("Amended Report"), Ms. Emminger stated after
22 reviewing Mr. Knowling's bank statements and expense invoices that, "The
23 records are voluminous and are organized in such a way that
24 reconstructing income or expenses will be burdensome for the government."
25 See Exhibit P, at p. 43. Based on her review, Ms. Emminger ultimately
26 concluded that Mr. Knowling's gross income for 2006 through 2009 was as

1 follows:

2	2006	\$5,012,184
	2007	\$3,505,603
3	2008	\$1,493,987
4	2009	\$ 544,795

5 Exhibit P, at p. 42. In an earlier version of the 4549-A report, Ms.
6 Emminger had estimated Mr. Knowling's gross income for 2006 through 2009
7 as follows:

8	2006	\$5,483.684
	2007	\$3,882,603
9	2008	\$2,248,987
10	2009	\$ 799,795

11 Exhibit A, at p. 82. On or about July 21, 2011, Ms. Emminger prepared a
12 second amended report, reflecting further changes to gross receipts and
13 business expenses.

14 Although Mr. Knowling included the gross income figures for
15 2007 through 2009 from the Amended Report in the latest amended version
16 of his Statement of Financial Affairs (see Exhibit E, at p. 1), he
17 disputes the IRS computations of his gross income and expenses for 2009,
18 the year of his bankruptcy filing, and has appealed the IRS
19 determinations.²

20 The accounting firm of Henderson Bennington Moshofsky, P.C. was
21 employed by the chapter 7 trustee for accounting work and preparation of
22

23
24 ² In the Amended Report, the IRS concluded that Mr. Knowling's
25 business expenses exceeded his gross income by \$233,628 in 2008 and
26 \$429,200 in 2007, resulting in \$0 net income for each of those years.
Mr. Knowling apparently has not appealed those conclusions and reported
them in his amended Statement of Financial Affairs. See Exhibit E, at p.
1.

1 tax returns. See Main Case Docket No. 58. Accountant Roger Henderson
 2 testified that he reviewed bank statements, checks and computer records
 3 to try to account for what happened in Mr. Knowling's business from 2006
 4 to 2009. He testified that he prepared the report included in Exhibit 10
 5 as a "first stab" at estimating Mr. Knowling's cash flow for 2007 through
 6 2009. He further testified that it took him approximately 42 hours to
 7 put the Exhibit 10 report together, but another 40-60 hours might be
 8 needed to reconcile inventory and other accounting issues. In Exhibit
 9 10, Mr. Henderson estimated Mr. Knowling's total gross income for 2007
 10 through 2009 as follows:

11	2007	\$3,915,070.75
12	2008	\$2,357,382.01
	2009	\$ 867,504.96

13 See Exhibit 10, at pp. 1, 5 and 10.

14 Ms. Tammy Combs, the UST's bankruptcy analyst, further analyzed
 15 Mr. Knowling's financial records and information. She noted generally
 16 that a debtor's statements that income for relevant years is "unknown"
 17 hamper her ability to analyze the financial condition of the debtor. She
 18 reviewed and analyzed Mr. Knowling's financial records, including bank
 19 statements, checks, invoices and receipts, and Ms. Emminger's reports,
 20 but admitted that she could not determine Mr. Knowling's financial
 21 condition with any accuracy. Her analysis of deposits into the CRLE
 22 business account v. CRLE sales invoices for 2007 through December 18,
 23 2009 is as follows:

24		<u>Total Deposits</u>	<u>Total Sales Invoices</u>
25	2007	\$4,366,070.75	\$2,032,726.24
	2008	\$2,401,192.76	\$1,429,619.19
26	2009	\$ 881,497.81	\$ 288,535.00

1 Exhibit 33, at p. 1.

2 Mr. Knowling filed his chapter 7 bankruptcy petition on
3 December 18, 2009. His was a "short" filing, that is, Mr. Knowling did
4 not file his schedules and Statement of Financial Affairs with his
5 bankruptcy petition. See Main Case Docket No. 1. On December 21, 2009,
6 the court entered an order directing Mr. Knowling to file his schedules
7 and Statement of Financial Affairs within 14 days. See Main Case Docket
8 No. 5. On December 22, 2009, Mr. Knowling filed a motion to extend time
9 to file the subject documents through January 15, 2010, which motion was
10 granted by order entered on December 29, 2010. See Main Case Docket Nos.
11 6 and 9. Mr. Knowling filed his schedules and his Statement of Financial
12 Affairs on January 15, 2010. See Main Case Docket No. 16.

13 Mr. Knowling signed and filed his Statement of Financial
14 Affairs under the following declaration: "I declare under penalty of
15 perjury that I have read the answers contained in the foregoing statement
16 of financial affairs and any attachments thereto and that they are true
17 and correct." In response to question one of his Statement of Financial
18 Affairs, Mr. Knowling reported gross income from his employment, trade or
19 profession, or from the operation of his business for 2007, 2008 and 2009
20 through December 18, 2009, as follows: "Unknown. [CRLE] took out various
21 loans from private parties and sold construction equipment. Debtor's
22 books and records are incomplete."

23 Mr. Knowling filed his amended Statement of Financial Affairs
24 on July 20, 2011, less than 60 days prior to the start of the Trial. See
25 Main Case Docket No. 133.

26 ///

1 element of its § 727 claim by a preponderance of the evidence. Grogan v.
2 Garner, 498 U.S. at 289; Retz v. Samson (In re Retz), 606 F.3d 1189, 1196
3 (9th Cir. 2010).

4 II. 727 Claims at Issue

5 In the Complaint the UST stated claims for relief under
6 §§ 727(a)(2), (a)(3), (a)(4)(A) and (a)(5). In the Pretrial Order, the
7 UST continued to assert claims under all the same four subsections of
8 § 727, but the § 727(a)(4)(A) claim was limited to claims that Mr.
9 Knowling had knowingly and fraudulently made false statements in his
10 Statement of Financial Affairs when he stated that his gross income for
11 2007, 2008 and 2009 was "unknown," and that he did not correct those
12 statements. Accordingly, I conclude that the UST has abandoned its
13 § 727(a)(4)(A) claims that Mr. Knowling lied at his § 341(a) meeting when
14 he stated that all monies received for business purposes were deposited
15 in Account 9982, and that he failed to disclose his access to and use of
16 a bank account at the Heritage Bank of Nevada. I treat the Pretrial
17 Order as limiting the scope of claims to be determined at the Trial. See
18 Civil Rule 16(d), applicable in this Adversary Proceeding under Rule
19 7016.

20 III. Judgment on Partial Findings

21 Following the presentation of the UST's case, I granted Mr.
22 Knowling's oral motion to dismiss the UST's claims under §§ 727(a)(2) and
23 (a)(4)(A). The UST's § 727(a)(2) claim was that Mr. Knowling concealed
24 property with intent to hinder, delay or defraud creditors and/or the
25 chapter 7 trustee within one year prior to his bankruptcy filing. No
26 evidence was presented of such concealment. As noted above, the UST's

1 § 727(a)(4)(A) claims essentially were that Mr. Knowling had "knowingly
2 and fraudulently" made false statements in his Statement of Financial
3 Affairs when he stated that his gross income for 2007, 2008 and 2009 was
4 unknown. After hearing the testimony of Ms. Emminger, Mr. Henderson and
5 Ms. Combs to the effect that after all of their best efforts to examine
6 and analyze Mr. Knowling's financial records, they could come up with no
7 more than estimates of Mr. Knowling's gross income for those years in
8 amounts that varied widely among the three of them, I conclude that Mr.
9 Knowling's statements in his Statement of Financial Affairs that his
10 gross income for 2007, 2008 and 2009 was unknown were fundamentally
11 accurate. Accordingly, I find that the UST did not meet its burden of
12 proof to prevail on its §§ 727(a)(2) and (a)(4)(A) claims, and Mr.
13 Knowling is entitled to a judgment of dismissal on those claims under
14 Civil Rule 52(c), applicable under Rule 7052.

15 IV. 727(a)(3)

16 Under § 727(a)(3), a debtor may be denied a discharge if, "the
17 debtor has concealed, destroyed, mutilated, falsified, or failed to keep
18 or preserve any recorded information, including books, documents,
19 records, and papers, from which the debtor's financial condition or
20 business transactions might be ascertained, unless such act or failure to
21 act was justified under all of the circumstances of the case." The
22 purpose of § 727(a)(3) "is to make discharge dependent on the debtor's
23 true presentation of his financial affairs." Caneva v. Sun Communities
24 Operating Limited Partnership (In re Caneva), 550 F.3d 755, 761 (9th Cir.
25 2008). See Meridian Bank v. Alten, 958 F.2d 1226, 1230 (3d Cir. 1992)
26 ("The statute . . . ensures that the trustee and creditors are supplied

1 with dependable information on which they can rely in tracing a debtor's
2 financial history.").

3 The plaintiff in a § 727(a)(3) case bears the burden of proving
4 by a preponderance of the evidence that (1) the debtor failed to maintain
5 and preserve adequate records, and (2) such failure makes it impossible
6 to determine the debtor's financial condition and material business
7 transactions. Landsdowne v. Cox (In re Cox) ("Cox II"), 41 F.3d 1294,
8 1296 (9th Cir. 1994). As opposed to many of the other provisions for
9 denial of discharge under § 727(a), the plaintiff with respect to a
10 § 727(a)(3) claim is not required to establish that the debtor's failure
11 to maintain adequate books and records was "knowing" or "fraudulent."
12 However, Section 727(a)(3) does not require debtors to maintain
13 immaculate books of account either. Rhoades v. Wikle, 453 F.2d 51, 53
14 (9th Cir. 1971).

15 Rather, the debtor must "present sufficient written
16 evidence which will enable his creditors reasonably to
17 ascertain his present financial condition and to
follow his business transactions for a reasonable
period in the past."

18 In re Caneva, 550 F.3d at 761 (quoting Rhoades v. Wikle, 453 F.2d at 53).
19 Evidence that the debtor did not maintain journals, ledgers or other
20 books of account is relevant. Burchett v. Myers, 202 F.2d 920, 923 (9th
21 Cir. 1953).

22 Once the plaintiff in a § 727(a)(3) adversary proceeding has
23 made a prima facie case, the evidentiary burden shifts to the debtor
24 defendant to establish that the absence of adequate financial records is
25 justified. Cox II, 41 F.3d at 1296.

26 Section 727(a)(3) cases are necessarily fact dependent. "What

1 constitutes adequate books, documents, and records must be decided on a
2 case-by-case basis, depending on the Debtors' business operations and
3 sophistication." See First Security Bank of Helena v. Hirengen (In re
4 Hirengen), 112 B.R. 382, 385 (Bankr. D. Mont. 1989), and cases cited
5 therein. Most debtors in bankruptcy are not great financial record
6 keepers. In fact, many debtors are in bankruptcy because they don't have
7 an adequate grasp or records of their financial transactions.
8 Accordingly, § 727(a)(3) is not appropriately used to deny a discharge to
9 inexperienced business operators who through inadvertence, lack of
10 competence, or both, maintain less than pristine financial records.
11 However, the Bankruptcy Code does not condone a default in maintaining
12 and preserving records from which basic information regarding a debtor's
13 financial condition during the years immediately preceding the debtor's
14 bankruptcy filing can be determined. See, e.g., Stanley v. Hoblitzell
15 (In re Hoblitzell), 223 B.R. 211, 216 (Bankr. E.D. Cal. 1998):

16 Given the complexity of the defendant's business
17 dealings, his lack of records is astounding. When
18 challenged regarding this on cross-examination, he
19 stated that he was not a "detail" person.

19 In light of the foregoing principles and reality-based
20 assessments, my approach to § 727(a)(3) cases generally is to give the
21 benefit of the doubt to financial records challenged debtors. However,
22 there is a limited subset of cases where the debtor's financial records
23 are so inadequate, incomplete and/or unenlightening that denial of
24 discharge under § 727(a)(3) is appropriate, and I ultimately conclude
25 that this is one of those rare cases for the following reasons.

26 The bankruptcy system is dependent on voluntary disclosures to

1 function. In this district alone, 12,424 bankruptcy cases were filed in
2 2008, and the figure for 2009 was 18,059. That is why the statements
3 made by a debtor in the Statement of Financial Affairs are made under
4 penalty of perjury (see Rule 1008), and that is why § 727(a)(3) was
5 written without a requirement that a debtor's failure to maintain
6 adequate financial records be "knowing" or "fraudulent."

7 In this Adversary Proceeding, I have evidence that the IRS, the
8 accountant for the chapter 7 trustee and the UST's financial analyst all
9 have spent many hours sorting through Mr. Knowling's bank records,
10 invoices and other financial records in efforts to determine Mr.
11 Knowling's income and expenses for the years preceding his bankruptcy
12 filing, and none of them has arrived at results that they can be
13 confident are accurate. Certainly, Mr. Knowling does not agree with any
14 of them.

15 The problems with determining with any accuracy Mr. Knowling's
16 financial condition during the periods leading up to his bankruptcy
17 filing, highlighted in this Adversary Proceeding, result in large part
18 from Mr. Knowling's failure to create and maintain any general ledgers or
19 financial statements providing periodic accounts of his income and
20 expenses. However, I recognize that the creation and maintenance of such
21 records is not a requirement for obtaining a discharge in bankruptcy, and
22 their absence does not automatically support a denial of discharge under
23 § 727(a)(3).

24 The UST argues that Mr. Knowling "deliberately kept his income
25 'unknown' to avoid paying taxes and to minimize his liability." See
26 UST's Trial Memorandum, Adversary Proceeding Docket No. 23, at p. 1.

1 That argument has the ring of truth. Mr. Knowling knew that he was
2 required to file federal income tax returns each year; yet, during the
3 entire period that he operated his CRLE proprietorship business, he filed
4 no federal income tax returns, instead repeatedly requesting extensions,
5 and only paid the IRS when presented with a bill.

6 Based on the evidence presented at the Trial, Mr. Knowling's
7 business model was fundamentally flawed. The Trial record reflects that
8 CRLE's business grew to encompass transactions in the millions of dollars
9 annually, but Mr. Knowling relied on private investor loans at very high
10 interest rates for working capital. Exhibit H, submitted by Mr.
11 Knowling, is illustrative. Pages 1 and 2 of Exhibit H is a promissory
12 note ("Promissory Note") from Mr. Knowling to Machinery Connection/Steve
13 Schimmel, dated June 3, 2009. The Promissory Note reflects that Mr.
14 Knowling accepted a wire transfer of \$55,000 from Mr. Schimmel on June 3,
15 2009, to be repaid in full with an additional \$10,000 return on or before
16 July 15, 2009. In other words, for a loan of \$55,000 for a maximum term
17 of 42 days, by my calculations, Mr. Schimmel was entitled to an annual
18 rate of return of approximately 158% on his loan to Mr. Knowling under
19 the Promissory Note. A business dependent for working capital on such
20 loan transactions could not be sustained long-term. When construction
21 activity contracted in 2008 and 2009, the CRLE business failed, and Mr.
22 Knowling sought protection in bankruptcy.

23 However, while the CRLE business lasted, Mr. Knowling
24 apparently had a good ride. Based upon his preliminary review of bank
25 and computer records from Mr. Knowling's business, Mr. Henderson
26 concluded that Mr. Knowling took draws of at least \$304,000 in 2007,

1 \$216,400 in 2008, and \$60,566 in 2009 (while the bottom was falling out
2 of the CRLE business) from Account 9982, but it is unclear exactly what
3 additional financial benefits Mr. Knowling took from the CRLE business.
4 See Exhibit 10, particularly at pp. 1, 5 and 10.

5 In any event, based on the Trial record, I find that Mr.
6 Knowling did not prepare and maintain adequate financial records from
7 which his financial condition during the three years preceding his
8 bankruptcy filing can be determined, and the UST has met its burden of
9 proof to establish a prima facie case under § 727(a)(3).

10 The burden then shifts to Mr. Knowling to justify his lack of
11 such financial records. "Justification for [a] bankrupt's failure to
12 keep or preserve books or records will depend on . . . whether others in
13 like circumstances would ordinarily keep them." In re Caneva, 550 F.3d
14 at 763 (quoting Cox II, 41 F.3d at 1299). Relevant, nonexclusive factors
15 to consider in determining justification include: 1) the debtor's
16 intelligence and educational background; 2) the debtor's experience in
17 business; 3) the extent of the debtor's involvement in the business under
18 consideration; 4) the debtor's reliance on others to prepare and maintain
19 financial records; and 5) any record keeping duties required by law. See
20 Cox v. Lansdowne (In re Cox) ("Cox I"), 904 F.2d 1399, 1403 n.5 (9th Cir.
21 1990).

22 Mr. Knowling's primary justification for his failure to
23 maintain financial records adequate for the chapter 7 trustee and the UST
24 to determine his financial condition prepetition is his limited
25 education. As a high school graduate with some training as a mechanic, I
26 recognize that Mr. Knowling was not trained as an accountant, and he

1 personally could not prepare financial statements and accounting records
2 like the CFO of a Fortune 500 company. However, he impressed me during
3 the course of his testimony as reasonably intelligent. He had
4 approximately 20 years' experience in the construction equipment business
5 prior to his bankruptcy filing. He recognized that he had an obligation
6 to file income tax returns during the period that he operated the CRLE
7 proprietorship business, and he chose not to file them. Indeed, while he
8 did maintain a large volume of business records, it is questionable
9 whether he ever maintained business records that would allow him or
10 anyone else to prepare his tax returns accurately.

11 Mr. Knowling took compensation annually in the hundreds of
12 thousands of dollars from the CRLE business, at least prior to 2009; yet,
13 he made the choice not to hire any bookkeeping or accounting staff. He
14 ran the CRLE business entirely on his own. He likewise chose not to
15 retain the services of a tax accountant because such services would be
16 "cost prohibitive." He made conscious choices not to retain the services
17 that were required for the preparation of periodic financial reports that
18 would have allowed the chapter 7 trustee and the UST to make
19 determinations readily as to his financial condition in the years
20 preceding his bankruptcy filing. Those decisions have consequences.

21 Based on the foregoing analysis of the Trial record, I conclude
22 that Mr. Knowling's failure to maintain adequate financial records was
23 not justified in the circumstances of this Adversary proceeding.
24 Accordingly, I conclude that Mr. Knowling must be denied a discharge
25 under § 727(a)(3).

26 V. 727(a)(5)

