IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
BEAUMONT DIVISION

IN RE:	§	
	§	
RUSSELL J. FAIRCHILD	§	Case No. 02-10536
	§	
Debtor	§	Chapter 7

JOHN E. STOCKTON	§	
	§	
Plaintiff	§	
	§	
vs.	§	Adv. Proc. No. 03-1037
	§	
RUSSELL J. FAIRCHILD	§	
	§	
Defendant	§	

MEMORANDUM OF DECISION[1]

John E. Stockton ("Stockton") filed the complaint in this consolidated adversary proceeding to oppose the discharge of Russell J. Fairchild (the "Debtor") under 11 U.S.C. §727(a)(2), (3), (4), and (5), and to oppose the dischargeability of particular debts owed to him pursuant to 11 U.S.C. §523(a)(2). Upon the trial of the consolidated complaint and the submission of written closing arguments and responses thereto by the parties as allowed by the Court at the conclusion of trial, the Court took this matter under advisement. The following memorandum of decision disposes of all issues before the

[1]This Memorandum of Decision is not designated for publication and shall not considered as precedent, except under the respective doctrines of claim preclusion, issue preclusion, the law of the case or as to other applicable evidentiary doctrines.

Court.[2]

Background

The facts underlying the present dispute arise out of an unsuccessful cattle partnership venture between Stockton and the Debtor, and the resulting disintegration of that business relationship which culminated in the filing of a lawsuit by Stockton against the Debtor litigated as cause no. 60,720 before the 75th Judicial District Court of Liberty County, Texas. Upon the conclusion of the trial in that lawsuit in early November, 2001, a jury verdict was rendered which awarded Stockton a net recovery of approximately $645,025.57.[3] Two months later, on the day that the state court was to enter a final judgment, the Debtor filed a petition for relief under Chapter 11 of the Bankruptcy Code. This Court subsequently lifted the automatic stay solely to allow the entry of the judgment in the interrupted state court litigation, and the 75th Judicial District Court thereafter entered a final judgment based upon the jury findings.

The current adversary proceeding was not the first opportunity for the Court to delve into the contentious history between the Debtor and Stockton. A hearing was previously held during the Chapter 11 phase of this case to adjudicate the claims asserted

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[2] This Court has jurisdiction to consider the Motion pursuant to 28 U.S.C. §1334 and 28 U.S.C. §157(a). The Court has authority to enter a final order in this contested matter since it constitutes a core proceeding as contemplated by 28 U.S.C. §157(b)(2)(A), (I), and (J).

[3] The state district court found that Stockton had made $426,750.18 in capital contributions, while the Debtor had contributed only $12,243.13. Stockton was also awarded $23,018.52 in interest on his advances, along with $200,000 in attorney's fees and actual damages of $7,500. This gives Stockton a net award of $645,025.57.

by Stockton against the Debtor's estate and the Debtor's objections thereto. That hearing resulted in the allowance of a secured claim of $56,500.00 in favor of Stockton, together with the allowance of an unsecured claim of $757,357.42.

Ultimately, the Debtor converted his case to a voluntary liquidation under Chapter 7. In seeking to preclude the Debtor's discharge through the current adversary proceeding, Stockton has pled numerous causes of action and has levied at the Debtor a myriad of allegations ranging from unexplained conduct to actual fraud. Amidst all of the various allegations, the Court will focus upon those facts relevant to the consideration of Stockton's complaint under 11 U.S.C. §727(a)(3).

At the time of his bankruptcy filing, the Debtor owned all the stock in a sub-chapter S corporation called Fairchild Farms, Inc. ("FFI"). That entity did not seek bankruptcy relief, and though the Debtor claims that he dissolved FFI during the pendency of his personal bankruptcy case, no formal actions to dissolve the corporate entity have been documented to the Court. FFI was formerly in both the cattle business and in the production of Christmas trees, but most of its operations during the period immediately prior to the bankruptcy case focused on the construction and distribution of pallets. The Debtor testified at trial that the actual fabrication of pallets had terminated prior to his bankruptcy filing, but that FFI continued to purchase, repair, paint and sell used pallets during the pendency of the Chapter 11 case.[4] The Debtor testified that he

[4] This testimony directly conflicts with earlier sworn testimony of the Debtor at his Rule 2004 examination in August, 2002, when the Debtor testified that FFI was purchasing lumber to fabricate

earned $200 per day for each day devoted to FFI's operations. Additionally, the Debtor received payments from FFI for its rental of real property owned individually by the Debtor and upon which FFI conducted its business operations.[5]

Between the time of the initial Chapter 11 filing and the conversion to Chapter 7, the Debtor maintained a debtor-in-possession bank account (the "DIP account"). A number of transactions involving the funds in this account are noteworthy, especially in light of the relationship between FFI and the Debtor. The deposits into the DIP account through the first eight months of the chapter 11 proceeding were in multiples of $200, likely reflecting FFI paying the Debtor $200/day for his labor.[6] While this seems proper, many of the withdrawals from the account were not satisfactorily explained by the Debtor. The Debtor was fairly consistent in his use of the "memorandum" space provided on the checks he drafted from the DIP account. More than 168 checks, totaling at least

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pallets. *See* Exhibit P-37, p. 18.

[5] In previous filings with the Court, the Debtor claimed that "Fairchild Farms, Inc. was closed out at or about the time of Debtor's filing for reorganization. Thereafter Fairchild's source of income was from Russell J. Fairchild buying, selling, and building wooden pallets." *See* Exhibit P-6, p. 7. If this were accurate, there would be no reason for FFI to pay the Debtor a $200/day salary. As subsequently explained herein, the Debtor offered no explanation as to the discrepancies arising by and among his trial testimony, his abbreviated financial records, and his previous filings, but the Court must conclude that such discrepancies evidence the fact that the Debtor's records were inadequate to allow even himself, much less a creditor or trustee, to distinguish between FFI and the Debtor, or to ascertain the financial conditions or business transactions of each.

[6] The Debtor, at least in some instances, references the conclusion of the first eight months of the chapter 11 proceeding as the time after which FFI was dissolved. However, as noted in note 5 *supra*, such was not always his position.

$131,000, were ostensibly written for the purchase of used pallets.[7] However, the veracity of these purported purchases is impossible to verify. Many of those checks were, in fact, written to an individual identified only as "Cotton," whom the Debtor identified as the local barber in Hardin, Texas who was willing to cash the checks necessary for the Debtor to pay cash to those parties selling pallets but who were unwilling to take checks. Other checks were simply made to the order of "Petty Cash," with a simple notation referencing used pallets. However, no documentation of any kind was offered by the Debtor in corroboration of these transactions. Additionally, it is noteworthy that at least three checks out of the account were payable to Russell J. Fairchild, but mysteriously contained no notation indicating a purpose. It is uncontested as well that at least $1000 left the DIP account with no indication of its destination other than "cash."

Discussion

Among the various causes of action, Stockton alleges that the Debtor should be denied a discharge because he has failed to keep financial records adequate to allow proper scrutiny of the Debtor's financial condition or business transactions. While it is true that denial of discharge is always a harsh result, and one wholly inconsistent with the fresh start contemplated by the Bankruptcy Code, it should be noted in this context that those individuals who desire the privilege of a discharge are required to provide their creditors "with enough information to ascertain the debtor's financial condition and track

[7] *See* Exhibit P-12.

his financial dealings with substantial accuracy for a reasonable period past to present." *In re Juzwiak*, 89 F.3d 424, 427 (7th Cir. 1996); *see also Broad Nat'l Bank v. Kadison*, 26 B.R. 1015, 1018 (D.N.J. 1983) ["The privilege of a discharge is hinged on disclosure."] and *WTHW Inv. Builders v. Dias (In re Dias)*, 95 B.R. 419, 422 (Bankr. N.D. Tex. 1988) ["Section 727(a)(3) is intended to allow creditors and/or the trustee to examine the debtor's financial condition and determine what has passed through a debtor's hands."].

Specifically, 11 U.S.C. §727(a)(3) provides:

> The court shall grant the debtor a discharge, unless the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case[.]

The initial burden of proof under this statute falls on the party objecting to the discharge to present evidence of the inadequacy of the debtor's records. *Robertson v. Dennis (In re Dennis)*, 330 F.3d 696, 703 (5th Cir. 2003). Once that burden is met, the burden of proof shifts to the debtor to prove that the inadequacy of the records is "justified under all of the circumstances." *Id.* "Unless the debtor justifies his failure to keep such records, a discharge need not be granted." *Pher Partners v. Womble (In re Womble)*, 289 B.R. 836, 856 (Bankr. N.D. Tex. 2003), *aff'd* in unpublished opinion, no. 03-11135, 2004 WL 2185744 (5th Cir. Sept. 29, 2004). "The debtor's records need not be perfect, but must be

kept in an 'intelligent fashion.'" *Id.* Thus, "[t]he level of the debtor's sophistication and extent of his business activities will bear on the adequacy of his record keeping." *Goff v. Russell Co. (In re Goff)*, 495 F.2d 199, 201-02 (5th Cir. 1974).

Stockton has successfully identified several areas in which the Debtor's record-keeping was inadequate. The claim that cash sums in excess of $131,000 were expended from the DIP account allegedly for the purchase of used pallets remains dubious. None of the explanations proffered by the Debtor in regard to those transactions are credible. If, during the first eight months of the bankruptcy proceeding, FFI was buying pallets and paying Fairchild $200/day for his work painting, repairing and distributing these pallets, one would expect such activity to be recorded in the corporate books and records of FFI and for FFI to recognize its cost of goods sold in resulting tax returns. Yet no corporate records have been produced by the Debtor and the tax returns for the corresponding time period reflect no cost of goods sold other than pre-bankruptcy inventory on hand.[8] If FFI was purchasing lumber and fabricating pallets during that time, as the Debtor testified at his Rule 2004 examination,[9] one would still expect a corresponding entry on FFI's tax returns. The premise that the Debtor implicitly asks the court to adopt is that in September, 2002, when FFI was purportedly dissolved, the Debtor personally took over that operation and began purchasing used pallets with individual funds, expending more

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[8] The same tax returns report no inventory on hand at year end. *See* Exhibit P-38.

[9] *See* Exhibit P-37, p. 18.

than $131,000 over the next 8 months. If this were true, one would expect a sufficient quantum of records from independent sources reflecting those facts. Even if a modicum of credibility could be assigned to the Debtor's contention that the corporate entity had been dissolved and that he, as a debtor-in-possession, was personally engaging in the pallet business, the Debtor had a statutory duty to maintain more precise business records capable of establishing how many used pallets were purchased, and the price for which those pallets were later sold.[10] Simply noting "used pallets" on the memorandum line of a check is clearly insufficient to allow a creditor to fully review the transactions of the Debtor in hopes of ascertaining his true financial condition. Any endorsement of such frivolous accounting practices simply creates an incentive for the misuse of debtor-in-possession funds.

Stockton also points to the deficiencies of the Debtor's monthly operating reports submitted during the pendency of the chapter 11 case to demonstrate inadequate record keeping. Such reports are designed to provide transparency with respect to a debtor's income and cash disbursements and they constitute an integral component of every Chapter 11 debtor's attempt to fulfill its duty of complete financial disclosure. However, the Debtor never made any attempt to categorize or account for his numerous cash disbursements by transaction, instead lumping everything into a "personal expenses"

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[10] *See* 11 U.S.C. §1107(a), incorporating both §§1107(a)(1) and 704, and Fed. R. Bankr. P. 2015(a).

catch-all category.[11] Such amalgamations cannot fulfill the requirements of adequate record keeping.

Additionally, Stockton demonstrates that the Debtor expended $2,850 from the DIP account for tax services. Yet the limited records provided by the Debtor do not identify whether the work was performed for the corporation or for the Debtor individually. If the services were rendered for the Debtor's estate, motions to employ and applications for compensation should have been filed. They were not. If the services were for the benefit of FFI, the funds should not have been expended from the DIP account for such services.

Finally, it is inconceivable that a business with revenues in excess of $145,000 for each of the previous four years[12] could be properly terminated and its affairs wound up without a single shred of documentary evidence evidencing such an event. Yet that is precisely the premise that this Debtor urges the Court to accept. Actually, the premise which the evidence supports is that the Debtor, during the pendency of his Chapter 11 case, utilized and enjoyed the benefits of a wholly owned corporation at his whim and discretion without any concern for the maintenance of proper business records from which this Court or any creditor could ascertain the distinction between the corporate entity and the individual.

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[11] *See* Exhibit P-1.

[12] *See* Exhibit P-38.

Sister courts have taken a similar stand on the requisite record-keeping of a debtor and his closely held entities. *See Womble*, 289 B.R. 836 (Bankr. N.D. Tex. 2003). In *Womble*, Judge Jones noted that record keeping is inadequate "when the debtor pays personal expenses out of business accounts, or when the debtor pays business expenses out of a personal account.... When such a debtor's actions lead to 'confusion of assets' between the debtor and his entities... the debtor has failed to maintain adequate records as mandated by section 727(a)(3)." *Id.* at 858.

The Debtor's lack of adequate record keeping was not limited to financial records. It also extended to records of cattle, some of which likely belonged to the Stockton-Fairchild partnership and some of which clearly encompassed property of this bankruptcy estate. The Debtor was by all accounts a very successful cattleman, well-known throughout the state among breeders of Longhorn cattle and, in fact, recognized within a year of his bankruptcy filing by the Texas Longhorn Journal as one of "The 25 Most Influential Texas Longhorn Producers, 1976-2001."[13] The success of breeding pure-bred livestock, as would be evidenced by the accolades afforded to the Debtor within the Longhorn cattle industry, depends upon meticulous record-keeping. The testimony of both the Debtor and Stockton established that purebred Longhorn cattle, without registration papers,[14] were not worth any more than steers headed for the slaughterhouse.

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[13] *See* Exhibit D-31.

[14] There are two entities which maintain registration records for Longhorn cattle: the I.T.L.A. and the T.L.B.A.A. The Court notes that the Debtor renewed his membership with the T.L.B.A.A. in

Thus, it is preposterous to think that the Debtor achieved such a lofty status among cattle breeders without an ability to maintain precise and verifiable records for his prized Longhorns. Yet when the Debtor was forced earlier in this case to relinquish possession of some of those cattle to Stockton,[15] the Debtor was suddenly incapable, unable or unwilling to provide *any* corresponding registration records which were absolutely essential in preserving the value of the animals tendered. Such records were also absolutely crucial to any effort by the Chapter 7 trustee to review, to verify, or to preserve the value of any remaining animals for the benefit of the estate. The Debtor's testimony that any prior registration records had been misplaced or accidentally destroyed and that he currently could produce no registration papers on any of the Longhorn cattle is simply not credible.[16] Combined with the Debtor's failure to maintain sufficient written evidence regarding FFI and the ongoing pallet operations, Stockton's burden to demonstrate that the Debtor failed to keep and preserve his financial records and that such failure prevents him from ascertaining the Debtor's true financial condition has been more than satisfied.

August, 2002.

[15] *See* Memorandum Order Granting Motion of John Stockton for Relief From Automatic Stay Against Cattle Collateral, docket entry 106 in the above-referenced bankruptcy case, entered Feb. 28, 2003.

[16] Stockton explained the lack of registration records by surmising that the valuable Longhorn cattle had been swapped by the Debtor for ordinary unregistered cattle. While no evidence was actually proffered in support of that theory, the Court does not find it improbable, given the totality of the circumstances. Yet Stockton is not under an ultimate burden to explain the disappearance of the cattle or to supply any of the missing financial information. That burden rests upon the Debtor.

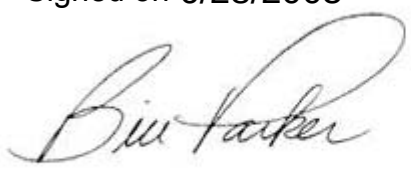
Having found that the Debtor failed to keep adequate business records, the burden shifts to the Debtor to provide an explanation for such an inadequacy and why his inability to produce sufficient documentation regarding his financial condition is justified under these circumstances. The Debtor offered no plausible justification at all for those failures. He offered contradicting explanations as to what "might" have happened to underlying documentation as he proceeded to conduct his business affairs. Most of his "explanations" were sketchy at best, with no justification or corroboration offered in support of them. He could not satisfactorily explain several specific financial transactions, particularly as to the business connection between himself and FFI, which occurred during the pendency of the case, and many of the comments and/or observations which he did offer in regard to his business operations can be dismissed as nothing more than unsupported allegations or mere speculation.

Such a result stands in direct contradiction to the Debtor's background. This Debtor is not an unsophisticated neophyte in business affairs. Quite to the contrary, he is an experienced and recognized cattleman and businessman. He has engaged in extensive and complicated financial transactions involving millions of dollars. He is even familiar with the requirements of the bankruptcy process, having crossed that bridge once before in the last 15 years. Such credentials render his vague recollections and the utter lack of relevant documentation regarding his business activities unbelievable and highly suspicious.

The Court concludes that the evidence offered by the Debtor falls far short of that necessary to examine his business transactions and to determine what occurred financially during his tenure as a debtor-in-possession. His cursory and superficial explanations regarding his business affairs during the pendency of this case offered little insight. Indeed it would be a fair inference from the evidence that a proper examination, or the discovery of information, sufficient to reconstruct his business activities was exactly what the Debtor intended to preclude. That goal may have been accomplished — but it comes at a high price. The Court concludes that the Debtor's failure to maintain business records from which his financial condition and business affairs could be determined is not justified and that such an unjustified failure warrants the denial of his discharge under §727(a)(3).[17]

This memorandum of decision constitutes the Court's findings of fact and conclusions of law[18] pursuant to FED. R. CIV. P. 52, as incorporated into adversary proceedings in bankruptcy cases by FED. R. BANKR. P. 7052. An appropriate judgment will be entered consistent with this opinion.

Signed on 6/28/2005



THE HONORABLE BILL PARKER
CHIEF UNITED STATES BANKRUPTCY JUDGE

[17] Accordingly, the Court need not reach the facts and arguments presented with respect to Stockton's complaint under other causes of action.

[18] To the extent that any finding of fact is construed to be a conclusion of law, it is hereby adopted as such. To the extent any conclusion of law is construed to be a finding of fact, it is hereby adopted as such. The Court reserves the right to make additional findings and conclusions as necessary or as may be requested by any party.