United States Bankruptcy Court
District of New Mexico

Document Verification

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:
CYNTHIA M. STEARNS,
Debtor. No. 7-02-16222 SS

NATIONAL PRINTING AND PACKAGING,
Plaintiff,
v. Adv. No. 02-1293 S

CYNTHIA M. STEARNS,
Defendant.

FINDINGS OF FACT AND CONCLUSIONS OF LAW FROM TRIAL ON THE MERITS

This matter came before the Court for trial on the merits of Plaintiff's Amended Complaint to Revoke Discharge (Doc. 14, exhibit 1). Plaintiffs appeared through its attorney Allen & Velone, P.C. (Matthew M. Wolf). Defendant was self-represented. This is a core proceeding. 28 U.S.C. § 157(b)(2)(J).

FACTS

1. Defendant ("Debtor") filed a voluntary petition under Chapter 7 of the Bankruptcy Code on September 4, 2002. The petition lists her name and "other names used by the debtor" of d/b/a "Performance de Santa Fe Performance Publications, Inc., Santa Fe Trends, Cynthia Grimes." (Doc. 1, in Case 7-02-16222.)
2. The Court fixed the first meeting of creditors under § 341 for October 10, 2002, and the last day for filing

complaints objecting to dischargeability or discharge for December 9, 2002. (Doc. 2, in Case 7-02-16222.)

3. Debtor's Schedule B, item 12, lists an interest in "Santa Fe Trend, LLC" ("LLC") and places a value of $1. (Doc. 5, in Case 7-02-16222.)

4. Debtor's Schedule C lists LLC as exempt. (Id.)

5. Debtor's Schedule I lists current income of $1600 per month from Santa Fe Trend Magazine. (Id.)

6. The Statement of Financial Affairs, item 18, lists, among others, two businesses in which Debtor has had an interest:

Name	Nature	Dates
d/b/a Santa Fe Trend	Magazine Publication	6/2000 - 5/2002
Santa Fe Trend, LLC	Magazine Publication	5/2002 - Present

7. The Trustee's Report from the § 341 meeting (Doc. 7, in Case 7-02-16222) notes that Chris Grimmer appeared on behalf Plaintiff. In closing argument, Mr. Wolf stated that, while he had not personally attended the first meeting of creditors, he understood that a lot of creditors asked questions regarding the LLC's valuation of $1 on Schedule B. He also stated that "we" presumed

the Debtor was out of business and unaware that she would continue publishing. He also stated that "we" had several conversations with the Chapter 7 Trustee, but that the Trustee refused to pursue the matter (presumably an investigation into LLC's value).

8. The listings in the schedules and statement of financial affairs should have triggered Plaintiff to investigate possible fraud. They disclose the existence of LLC, its valuation at $1, the seamless transfer of business operations from d/b/a Santa Fe Trend to Santa Fe Trend, LLC, and an ongoing income from the magazine. Plaintiff's representative appeared at the first meeting of creditors, and could have asked if Debtor was out of business (despite contrary evidence in Schedule I and the Statement of Financial Affairs item 18) or whether she intended to continue publishing.

9. Plaintiff filed its "Complaint Objecting to Discharge and Dischargeability" (doc. 1) on December 6, 2002. The initial paragraph cites Bankruptcy Rules 4004(d)[1] and

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[1] Bankruptcy Rule 4004(d) provides:
Grant or Denial of Discharge
...
(d) **Applicability of Rules in Part VII**. A proceeding commenced by a complaint objecting to discharge is governed by Part VII of these rules.

7001(4)[2] and 11 U.S.C. § 523 and objects to "Debtor's discharge and to the dischargeability of debts owing to it." The complaint does not cite 11 U.S.C. § 727. Paragraph 5 states "This matter arises pursuant to 11 U.S.C. §§ 523(a)(2)(A) and (B)." The general allegations (¶¶ 7-11) contain no allegations on which to base denial of discharge. Paragraph 11 refers to a fraudulent credit application. The First Claim for Relief (¶¶ 12-15) refers only to the false financial statement.

10. The Court entered Debtor's discharge and a Final Decree on December 16, 2002 and closed the case. (Docs. 11 and 12, in Case 7-02-16222.)

11. Plaintiff filed an "Amended Complaint Objecting to Dischargeability of Debt Pursuant to Section 523" on January 29, 2003 (doc. 7). The only difference from the original complaint is the caption, which removed any reference to an objection to discharge.

12. Plaintiff filed a "Motion for Leave to Amend Complaint" on May 2, 2003 (doc. 14). The second Amended Complaint

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[2] Bankrutpcy Rule 7001(4) provides:

Scope of Rules of Part VII

An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings:

...

(4) a proceeding to object to or revoke a discharge[.]

is attached to the motion as Exhibit 1. Paragraph 15 of the Amended Complaint states:

> As determined during debtor's deposition conducted pursuant to Bankruptcy Rule 2004 on April 8, 2003, Santa Fe Trend LLC owns significant assets, including without limitation, capital assets, intellectual property, account receivables [sic], trade secrets and goodwill. The debtor, however, failed to conduct any type of appraisal of her equity interest in Santa Fe Trend LLC or any analysis of the value of its significant assets. In fact, she did not even consult documentation in rendering the valuation. Rather, debtor simply reported that the market value of her 100% equity interest in the limited liability company was $1.00 in an effort to exploit the bankruptcy proceeding for her self-serving purposes. The false nature of this valuation is further evidenced by debtor's statement during the course of her deposition that the proposition of selling Santa Fe Trend LLC for a dollar is "an insult."

The First Claim for Relief seeks revocation of discharge pursuant to 11 U.S.C. § 727(d)(1) and the Second Claim for Relief seeks revocation of discharge pursuant to 11 U.S.C. § 727(d)(2)[3].

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[3] Section 727(d) provides:
On request of the trustee, a creditor, or the United States trustee, and after notice and a hearing, the court shall revoke a discharge granted under subsection (a) of this section if -

> (1) such discharge was obtained through the fraud of the debtor, and the requesting party did not know of such fraud until after the granting of such discharge; [or]

13. The Court granted the Motion for Leave to Amend Complaint (doc 14) in the Order Resulting from Pretrial Conference, filed August 12, 2003 (doc. 20).

14. Debtor is an experienced publisher and salesperson. She operated the magazine "Santa Fe Trends" since August, 2000 as a d/b/a. She incurred business debts to plaintiff (and others) and was unable to pay. Plaintiff filed suit in state court in Colorado and obtained a default judgment. In May, 2002, Debtor organized the sole proprietorship into LLC, which was operating through the date she filed bankruptcy.

15. Debtor testified that she valued her interest in LLC at $1 because of its large debt. She added up the assets (including the bank account, accounts receivable, goodwill, web site, etc.) and subtracted its liabilities. She stated that the LLC had no worth, and listed it as $1 because her bankruptcy attorney's software program would not allow the input of a negative value for it. She

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> (2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee.

testified that because she lived with this company every day, she just knew it was worth nothing. The Court does not find this behavior reckless.

16. Plaintiff produced no evidence of what assets LLC owned, and no values for any individual LLC assets as of September 4, 2002. Plaintiff produced no evidence of the debts LLC owed as of September 4, 2002. Debtor attempted to introduce LLC's balance sheet as of September 4, 2002 (proposed Exhibit T), to which Plaintiff objected because it had not been timely produced during discovery. The Court sustained the objection to Exhibit T and, therefore, has not considered it in this opinion.

17. Exhibit 14 is LLC's profit/loss statement for 2001. It shows $85,000 in gross revenues, cost of goods sold of $71,000, and expenses of $7,800, leaving a net income of $6,800.

18. Exhibit 15 is LLC's profit/loss statement for 2002. It shows $161,000 in gross revenues, cost of goods sold of $127,000, and expenses of $20,600, leaving a net income of $13,400.

19. Exhibit 16 is LLC's profit/loss statement for the first six months of 2003. It shows $70,000 in gross revenues,

cost of goods sold of $42,500, and expenses of $18,000, leaving a net income of $9,800.

20. Plaintiff suggested that the three profit/loss statements above were misleading because they were on a cash basis, and therefore did not include accounts receivable. However, if they are cash basis, they also do not include accounts payable. The Court can draw no conclusion about what the statements would show if they had been done on an accrual basis.

21. Exhibit 20 is Debtor's 2002 federal income tax form 1040. The Schedule C attached showed gross receipts of $161,000[4], cost of goods sold of $127,000, and expenses of $31,000, for a net income of $3000.

22. Plaintiff suggested at trial that Debtor was failing to or improperly reporting income to the taxing authorities. The 2002 form 1040 agrees with LLC's profit/loss statement. Although Plaintiff's representative Richard Stein testified that from his review he determined that Debtor was paying personal expenses out of the business account, Debtor testified that this was accounted for in a way to not impact on the profit or loss. Plaintiff

[4] Specifically, $148,000 of receipts and $13,000 of "other income."

attempted to impeach Debtor's testimony on this point with the deposition testimony of Eloise Garcia, but the quoted passage clearly stated that Debtor's personal expenses do not show up on the profit/loss statement because they were not business expenses.

23. Richard Stein testified that he had no belief Debtor's listing of LLC at $1 was fraudulent. He had no documents to review, and would have needed financial statements. He stated that he now knew the $1 was fraudulent because "she" kept publishing the magazine and never paid Plaintiff's $41,000 debt. In his opinion, if Debtor had factored her accounts receivable, she could have avoided bankruptcy. He testified that he used Debtor's "Rate Card" (Exhibit 27), which sets out LLC's charges for advertising, to determine that LLC should have had $205,000 in gross revenues for all of 2003. In his opinion, the only relevant factor to the value of a magazine is its income stream.

24. Plaintiff also produced Terry Vitale as a witness. She owns a magazine and has been in the business for 48 years. The Court accepted her as an expert witness without objection of Debtor. In her opinion, there is an industry standard multiplier that determines a magazine's

value, which is 1 to 1.5 times its revenues. In her opinion, LLC would have been worth $160,000 to $240,000 in 2002. She testified that subtracting liabilities from assets would not be an appropriate valuation method for a magazine, because early costs are an investment made to go after higher revenues later. She commented that most magazines do not earn money for the first five years. Ms. Vitale analogized a magazine to a professional sports franchise, saying that even money-losing teams are sold for substantial sums. The Court asked this witness if a magazine's debt was relevant to its overall value; for example, what if the magazine had unpaid debts of $1 million. Ms. Vitale did not answer this with a simple yes or no. Rather, she stated that she did not know LLC's debt, but that if it were her business she would look to see if she could run it better, in order to see if it could cash flow to pay the debt. The Court infers from this that, if the LLC could not be run better to pay the debt, she would not be interested in purchasing it for the stated value. The Court finds, therefore, that the amount of debt is a factor affecting value. Furthermore, Ms. Vitale did not testify what specific aspects of the LLC might be run better; for example, she

did not suggest that the cost of goods sold was too high (83.5% in 2001, 78.8% in 2002, 60.7% for the first six months of 2003) or might be able to be reduced. From the Court's review of the profit/loss statements, it appears that the magazine was barely covering costs of sales and expenses and leaving little or no excess income to service debt. Nor did the witness explain how a magazine could survive for the five year start-up period if it were sustaining losses and unable to meet its debt obligations. Ms. Vitale's testimony was credible but, perhaps because she had not been provided the specific facts about LLC's finances or because she was not asked to address more fully the question about why the Debtor's approach to valuation would have been obviously inappropriate, her testimony did not attack directly, much less refute, Debtor's testimony about how she valued LLC.

25. Plaintiff elicited no testimony from Debtor that she was familiar with the industry standard multiplier approach to valuing a magazine business.

26. Plaintiff produced no evidence that Debtor acquired property, or became entitled to acquire property that would be property of the estate.

27. The Court finds Debtor was a credible witness, and, having considered her testimony and demeanor during the trial, finds that she did not intentionally undervalue her interest in LLC, and did not fraudulently attempt to obtain her bankruptcy discharge.

CONCLUSIONS OF LAW

1. Plaintiff's original complaint (doc 1) did not state a claim for relief under 11 U.S.C. § 727. It did not allege any of the ten grounds listed in § 727(a). The factual allegations relate to dischargeability of a single debt, and do not put the Debtor on notice that her entire discharge was being challenged. The specific code references are to section 523. That Plaintiff intended only to seek relief under section 523 is evidenced by its (first) amended complaint (doc 7), which is identical to the original except for the caption which states that only dischargeability of debt is at issue.[5] It is true

[5] Whether Plaintiff would have succeeded in proving up a fraud or false financial statement cause of action is of course no longer before the Court. See CIT Group/Factoring Manufacturers Hanover, Inc. v. Srour (In re Srour), 138 B.R. 413, 420 (Bankr. S.D. N.Y. 1992) (plaintiff amended complaint to replace claims that might have survived summary judgment with claims that did not survive summary judgment). However, despite the filing of the Second Amended Complaint, parts of the Plaintiff's case clearly still related to the § 523 claims.

that the prayer for relief in each of the first two complaints makes three requests: to deny the Debtor's discharge, to declare the debt to Plaintiff nondischargeable, and for any other relief to which Plaintiff may be entitled. However, reading the text of each complaint and taking the two complaints together, it is clear that while Plaintiff may have had some idea of the Debtor not getting a discharge, Plaintiff had no intention of raising and litigating a § 727 cause of action.

2. Plaintiff's Second Amended Complaint seeking revocation of discharge pleads totally different facts, discovered in a Rule 2004 exam of the Debtor in connection with the original complaint. It therefore does not relate back to the date of the original complaint. CIT Group/Factoring Manufacturers Hanover, Inc. v. Srour (In re Srour), 138 B.R. at 418 (an amendment which states new claim for relief based upon a different set of facts will not relate back).

3. Plaintiff's argument that its Second Amended Complaint can be construed under § 727(a) fails. The Second Amended Complaint was not filed by December 9, 2002 and

is therefore time barred. See Bankruptcy Rule 4004(a).[6] Thus Plaintiff can only succeed if its cause of action is for revocation of discharge under § 727(d).[7]

4. Under § 727(d)(1), Plaintiff must establish 1) that Debtor "must have committed a fraud in fact which would have barred the discharge had the fraud been known", and 2) "[s]uch fraud must be discovered after discharge." Lawrence Nat'l Bank v. Edmonds, (In re Edmonds), 924 F.2d 176, 180 (10th Cir. 1991) (citations and some text and internal punctuation omitted).

5. The Court concludes that Debtor did not commit a fraud in fact[8] that would have barred her discharge had the fraud

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[6] Plaintiff's invocation of § 727(d) – revocation of discharge – rather than of § 727(a) – discharge – apparently came about at least in part because by the time that the Second Amended Complaint was sought to be filed on May 2, 2003, the discharge had already been entered. Doc 11, entered December 16, 2002, in case no. 7-02-16222. Given that the Complaint (doc 1), filed shortly before the deadline, essentially pled only a § 523 cause of action, the Clerk's office would not have been on notice to flag the file to prevent the automatic docketing of the discharge, which is triggered by passage of the Rule 4004(a) deadline.

[7] Nevertheless, because of the requirement that Plaintiff prove, as an element of the § 727(d) action, that the Debtor committed a fraud that would have barred her discharge under § 727(a), this memorandum opinion in effect considers whether a § 727(a) action was proven.

[8] "The fraud which must be shown is fraud 'in fact,' such as the intentional omission of assets from the schedules, and must involve intentional wrong." Pelletier v. Donald (In re

been known. The Court found the Debtor credible, and believed her explanation that, generally, she thought that there was so much debt in LLC that it was worth nothing.[9] The Court found her approach of adding up the assets (including tangibles and goodwill) and subtracting the liabilities reasonable. The Court has no evidence that Debtor was aware that this commonly used evaluation method was inappropriate for a magazine enterprise of this sort, if indeed it were. The Court cannot find her approach to valuation to be reckless, or demonstrating a reckless indifference to the truth. Therefore, the Court cannot find any intent to deceive.

6. Furthermore, the Court cannot find on this record that LLC was in fact undervalued on Schedule B. Neither party, particularly Plaintiff, presented evidence of LLC's asset value or debts, particularly the latter. The Court has considered Ms. Vitale's testimony, but considered it incomplete. Even accepting that the proper

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Donald), 240 B.R. 141, 146 (1st Cir. BAP 1999)(citing 6 Lawrence P. King, et al, Collier on Bankruptcy ¶ 727.15[2] (15th ed. Rev. 1999).)

[9] During discovery, Debtor did characterize Plaintiff's offer (whether real or rhetorical) to purchase LLC for $1.00 as "an insult". But whether this response was based on a strictly financial analysis or on something else, such as an emotional attachment to the magazine, was not clear.

method to value a magazine of this sort is simply to apply an industry standard multiplier to annual revenues, Ms. Vitale tacitly conceded that the amount of debt could affect the sale price. The Court also considered Mr. Stein's opinion that the $1 value was fraudulent, but finds that it lacked foundation and is not entitled to much weight. In sum, the Court was simply provided insufficient evidence to make an informed finding on what the value of LLC was on September 4, 2002, precluding the Court from making any finding that Debtor fraudulently under-reported its value. Therefore, the cases cited by Plaintiff in its post-trial brief (doc. 50) regarding badges of fraud, pattern of conduct, and substantial undervaluation (pages 7-11) do not apply to this situation.

7. The Court also believes that Plaintiff cannot establish that it did not know of the fraud before the granting of the discharge. A leading case on a creditor's knowledge of fraud is Mid-Tech Consulting, Inc. v. Swendra, 938 F.2d 885 (8th Cir. 1991). In this case, the Court reasoned:

> We agree with the [Debtors] and the majority of the courts that have addressed this issue, and hold that dismissal of a § 727(d)(1) revocation action is proper where, before discharge, the

> creditor knows facts such that he or she is put on notice of a possible fraud. See West Suburban Bank v. Arianoutsos (In re Arianoutsos), 116 B.R. 116, 119 (Bankr. N.D. Ill. 1990). Thus, the burden is on the creditor to investigate diligently any possibly fraudulent conduct before discharge. See [Bear Stearns & Co. v. Stein (In re Stein), 102 B.R. 363, 368 (Bankr. S.D. N.Y. 1989); Chambers v. Benak (In re Benak), 91 B.R. 1008, 1009-10 (Bankr. S.D. Fla. 1988)].

Id. at 888. See also 6 Collier on Bankruptcy, ¶ 727.15[3] at 727-75 (15th ed. Rev.)(citing Swendra, 938 F.2d 885).

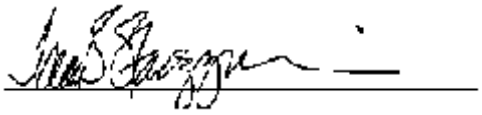
In this case, Debtor's statements and schedules disclosed the change of business from Santa Fe Trends to LLC, listed LLC's value at $1, and disclosed continuing income from the magazine. She appeared at the first meeting of creditors and testified under oath. Plaintiff appeared at the first meeting. Other creditors questioned Debtor on LLC. Plaintiff pursued the Trustee to investigate. The Court cannot find or conclude as a matter of law that Plaintiff acted diligently. All facts that Plaintiff now raises were known or available early on in the case, certainly within the sixty-day window for filing complaints objecting to discharge.

8. Under § 727(d)(2) Plaintiff must establish that Debtor acquired estate property, or became entitled to acquire

estate property, then knowingly and fraudulently failed to report, deliver, or surrender such property to the Trustee. There was no evidence presented that Debtor acquired estate property or became entitled to acquire estate property.

CONCLUSION

For the reasons set forth above, the Court finds that Plaintiff did not meet its burden of proof with respect to either 11 U.S.C. § 727(d)(1) or (2) and that Judgment should be entered for Debtor.



Honorable James S. Starzynski
United States Bankruptcy Judge

I hereby certify that on October 6, 2004, a true and correct copy of the foregoing was electronically transmitted, faxed, delivered, or mailed to the listed counsel and/or parties.

Christopher M Grimmer
PO Drawer 9570
Santa Fe, NM 87504-9570

Cynthia M. Stearns
PO Box 1951
Santa Fe, NM 87501

Matthew M Wolf
1600 Stout St Ste 1100
Denver, CO 80202-3160

Office of the United States Trustee
PO Box 608
Albuquerque, NM 87103-0608