

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
Western Division

In re:)	Bankr. No. 97-50297
)	Chapter 7
LEE'S TRAVELERS LODGE, INC.)	
Tax I.D. No. 46-0321285)	MEMORANDUM OF DECISION RE:
)	OBJECTION TO TRUSTEE'S REPORT
Debtor.)	

The matter before the Court is Trustee Dennis C. Whetzal's Final Report and Proposed Distribution, the objection thereto filed by Robert J. Jackson, and responses to the objection filed by Trustee Whetzal and Darrel and Emma Nelson. This is a core proceeding under 28 U.S.C. § 157(b)(2). This Memorandum of Decision and accompanying Order shall constitute the Court's findings and conclusions under F.R.Bankr.P. 7052. As set forth below, the Court concludes that the Trustee's report cannot be approved until it is determined whether the Nelsons' claim is valid.

I.

Lee's Travelers Lodge, Inc., is in the business of providing a home for veterans, the elderly, and others who cannot live alone. It commenced business in 1939 and has been operated by Darrel and Emma Nelson together since 1972. It was incorporated in 1973¹. Darrel and Emma Nelson are the sole shareholders. Since sometime in the 1980s, it has been the Nelsons only employment, although Emma Nelson also receives Social Security benefits.

The only checking account maintained was for the corporation.

¹ The Nelsons' response said Lee's Travelers Lodge was incorporated in 1974. The corporation's tax returns say 1973.

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Through it were ran most corporate income and most expenses for the family and corporation. The Nelsons had some personal savings accounts and certificates of deposit but no personal checking accounts.

The Nelsons lived in corporate housing until 1995, ate their meals "on the job," and paid most of their personal expenses, ranging from clothing to dog grooming services, through the corporation. Emma Nelson did not receive a wage. Darrel Nelson received no more salary each year than would disqualify him from receiving an earned income tax credit from the Internal Revenue Service. Other funds the family received over the years included some large inheritances from family members and former boarders and insurance money from a lost diamond ring.

The Nelsons acknowledge that corporate and personal funds were co-mingled. Funds deposited into the corporate account even included government benefits that Emma Nelson's daughter received.

Beginning in 1974, the Nelsons claim they loaned substantial sums to the corporation to keep it going, including funds from their daughter's benefits checks. Based on these "loans" from 1974 to 1996; repayments by the corporation, which were sometimes in the form of payments of the Nelsons' personal expenses; and a large credit in 1996 reflecting health insurance that the corporation had paid for the Nelsons, they claimed that by the end of 1996 the corporation still owed them \$68,200.04. The amount was determined from records based on funds going in and out of the corporate checking account and ledgers that Darrel Nelson kept. It did not

reflect the housing and food that the corporation provided the Nelsons. The loan debt calculated by the Nelsons did not coincide each year with the loans from stockholders reported by the corporation on its income tax returns; some years the difference was very substantial.

On May 2, 1996, Lee Traveler's Lodge, through Darrel Nelson as President, gave Darrel and Emma Nelson a promissory note for \$55,390.00 at 8% interest. Payments were to be made monthly beginning June 1, 1996. On May 2, 1996, Lee Traveler's Lodge also gave the Nelsons a mortgage on three pieces of realty that the corporation owned. The mortgage was recorded the same day. There were no corporate minutes authorizing the loans from the Nelsons from 1974 to 1996 but there were minutes authorizing the note and mortgage in 1996.

A worker's compensation claim was pending against Lee Traveler's Lodge around the time this note and mortgage were given. The suit, commenced by Robert Jackson, had been tried in Minnehaha County. The court awarded judgment to Robert Jackson on March 20, 1996 for \$185,315.45 (costs of \$585.51 were added a month later). The judgment was transcribed to Pennington County, where Lee's Travelers Lodge's real property was located, on May 8, 1996.

From 1990 through 1996, the Nelson's income, as reported on their federal income tax returns, never exceeded \$9,400.00. Of that sum, about \$9,000.00 of it was paid to Darrel as a corporate officer. Lee's Travelers Lodge reported net income only in 1991, 1992, and 1994. On its federal income tax returns, Lee's Travelers

Lodge reported that beginning in 1990 it owed stockholders \$39,539.00 for loans. At the end of 1996, it reported that it owed stockholders \$74,371.00 for loans.

Lee's Travelers Lodge filed a Chapter 7 petition in bankruptcy on June 25, 1997. It included on its list of secured creditors Darrel and Emma Nelson for \$60,000.00 and Robert Jackson as an unsecured creditor for \$175,000.00. It had only two other unsecured creditors whose claims totaled \$2,500.00 and it had only one priority creditor, the Internal Revenue Service, for \$400.00. All the creditors holding secured claims were essentially fully secured by Debtor's realty.

The Trustee sold the bankruptcy estate's four pieces of real property and paid the first mortgages on it. He requested and received some documentation from the Nelsons' attorney regarding their 1996 mortgage on three of the pieces of realty he had sold. Satisfied that the mortgage was valid and it had been properly recorded, the Trustee proposed to pay the Nelsons the remaining sale proceeds of \$11,709.61 on the three pieces of mortgaged realty and he prorated their remaining balance with the other unsecured creditors. Trustee Whetzal proposed to pay Robert Jackson all the proceeds of \$7,531.81 from the otherwise unencumbered realty and a prorated share of the unsecured bankruptcy funds.

Robert Jackson objected to the Trustee's proposed distribution on the grounds that the Nelsons' mortgage was without consideration and because the mortgage was recorded only ten days before his judgment against Debtor was transcribed in Pennington County.

At an evidentiary hearing on February 1, 1999, Darrel Nelson testified how he had calculated the funds that his family loaned to Debtor, the sums that had been repaid, and the balance he claimed they were yet owed. He acknowledged that his accounting did not reflect Debtor's payment of their food and housing over the years.

In closings, Robert Jackson's counsel urged the Court to look at the inconsistencies between the Nelsons' claim and Debtor's and the Nelsons' tax returns to find that no consideration was given for the note and mortgage. The Nelsons' attorney argued that no preferential transfer had occurred that the Trustee could avoid under 11 U.S.C. § 547.

II.

The Bankruptcy Code gives a Chapter 7 trustee several means of challenging or avoiding a secured creditor's claim. The trustee can object to the amount of the claim under 11 U.S.C. § 502(a) and (b). The trustee can contest the validity, priority, or extent of a creditor's lien or mortgage through an adversary proceeding under 11 U.S.C. § 502 and F.R.Bankr.P. 7001(a)(2). The trustee can also use his avoiding powers under 11 U.S.C. § 544(a) by stepping into the shoes of certain hypothetical creditors that have a superior claim, under § 544(b) by stepping into the shoes of an actual unsecured creditor with state law avoiding powers, under § 547 if a preferential transfer has occurred, or under § 548 if a fraudulent conveyance took place. Claims can be challenged under § 502 or F.R.Bankr.P. 7001(2) at any time before a distribution is allowed. The deadline for a trustee to use his avoiding powers

given by the Bankruptcy Code is generally limited to two years from the order for relief. 11 U.S.C. § 546(a)(1).

A trustee's avoiding powers under §§ 547 or 548 have another time constraint. They apply only to transfers within one year before the debtor's petition is filed.² 11 U.S.C. § 547(b)(4) and § 548(a)(1). Longer reach back periods may apply under § 544(b), though, where the Trustee steps into the shoes of an actual unsecured creditor to assert rights that the unsecured creditor has under state law. State law will then determine any reach back period. See generally *Dietz v. St. Edward's Catholic Church (In re Bargfrede)*, 117 F.3d 1078, 1080 (8th Cir. 1997) (when trustee seeks avoidance of transfer under § 544(b), the reach back period, if any, under state law will apply); and *Wintz Properties, Inc. (In re Wintz Co.)*, ___ B.R. ___, 1999 WL 149660 (8th Cir. B.A.P. 1999) (trustee must step into shoes of an actual unsecured creditor to use § 544(b)).

South Dakota has adopted the Uniform Fraudulent Transfers Act. See S.D.C.L. ch. 54-8A. In any complaint brought under it, the trustee bears the burden of proof to establish the fraudulent (actual or constructive) transfer; the standard is by a preponderance of evidence. *Prairie Lakes Health Care System, Inc. v. Wookey*, 583 N.W.2d 405, 411-14 (S.D. 1998). The debtor bears

² This presumes the creditors are insiders under § 547(b)(4), which the Nelsons have admitted they are in this case.

the burden on any defense. *Id.* at 414. Whether a conveyance was fraudulent is a question of fact, not law. *Piner v. Jensen*, 519 N.W.2d 337, 339 (S.D. 1994). It may be established by circumstantial evidence. *Andrews v. Reynolds*, 409 N.W.2d 128, 130 (S.D. 1987) (citing *Kary v. Kary* 318 N.W.2d 334, 338 (S.D. 1982)). A close relationship between the parties of a conveyance justifies heightened scrutiny of the transfer for indicia of fraud. *Andrews*, 409 N.W.2d at 130 (cites therein).

III.

The testimony and exhibits offered by Robert Jackson and the fact that this appears to be a one creditor case both indicate that the Nelsons' mortgage claim warrants further investigation and a possible objection to the amount or a complaint to determine if it was obtained fraudulently under state law. Therefore, the Trustee's present report will not be accepted until that investigation is made and any appropriate legal action is taken.

Based on the present record, the amount of the Nelsons' claim appears too high because it does not account for any debt repayment in the form of the food, housing, and possible personal use of vehicles that Debtor furnished them over the years. Since neither Debtor nor the Nelsons recognized as income on their federal tax returns, the food, housing, and vehicle use that Debtor provided the Nelsons,³ Debtor's payment of these expenses for the Nelsons

³ The Court takes no position on the legality of Debtor's and the Nelsons' decision not to recognize the food and housing Debtor

I hereby certify that a copy of this document was mailed, hand delivered, or faxed this date to the parties on the attached service list.

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Charles L. Nail, Jr., Clerk
U.S. Bankruptcy Court, District of South Dakota
By: _____ *LN*

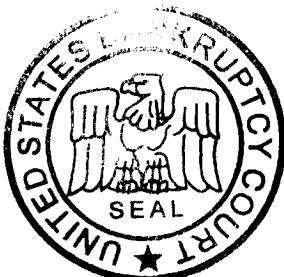
must be attributed to debt repayment.

The Trustee will also need to insure that the mortgage and note Debtor gave the Nelsons were not fraudulent or preferential transfers under state law. While the note and mortgage were given outside the one-year reach back periods set forth in 11 U.S.C. §§ 547 and 548, the note and mortgage may still be subject to challenge under 11 U.S.C. § 544(b) and S.D.C.L. ch. 54-8A. The whole transaction is troublesome because of the discrepancies between the Nelsons' accounting and the amount of loans reported on Debtor's tax returns and because the note and mortgage were not given by Debtor until a large judgment by another creditor was forthcoming.

An order sustaining Robert Jackson's objection to the Trustee's Final Report and Proposed Distribution will be entered.

Dated this 5th day of April, 1999.

BY THE COURT:



Irvin N. Hoyt
Irvin N. Hoyt
Bankruptcy Judge

NOTICE OF ENTRY
Under F.R.Bankr.P. 9022(a)
Entered

ATTEST:
Charles L. Nail, Jr., Clerk

By: *Alia O'Hara*
Deputy Clerk

APR 01 1999

Charles L. Nail, Jr., Clerk
U.S. Bankruptcy Court
District of South Dakota

provided the Nelson family over the years as part of the compensation Debtor paid them. That issue is not before this Court.

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Total notices mailed: 9

Debtor Lee's Travelers Lodge, Inc., 803 Joy Avenue, Rapid City, SD 57701
Aty Mairose, John H. 2640 Jackson Blvd. #3, Rapid City, SD 57702
Trustee Whetzal, Dennis C. PO Box 8285, Rapid City, SD 57709
Aty Driscoll, Frank J. PO Box 1820, Rapid City, SD 57709-1820
Aty Gering, Bruce J. Office of the U.S. Trustee, #502, 230 South Phillips Avenue, Sioux Falls, SD 57104-6321
Aty Martin, Thomas F. PO Box 555, Brookings, SD 57706
Aty Nash, Robert M. PO Box 1552, Rapid City, SD 57709
Aty Ridgway, Michael E. PO Box 5073, Sioux Falls, SD 57117-5073
Aty Welter, Mark J. PO Box 5027, Sioux Falls, SD 57117