UNITED STATES BANKRUPTCY COURT
DISTRICT OF CONNECTICUT

IN RE:	)	
	)	
STONECRAFTERS, LTD.,	)	CASE NO. 96-30422 (ASD)
	)	
DEBTOR.	)	CHAPTER 7
MICHAEL J. DALY,	)	
CHAPTER 7 TRUSTEE FOR	)	
STONECRAFTERS, LTD.,	)	
	)	
PLAINTIFF,	)	
	)	
vs.	)	ADV. PRO. NO. 96-3202
	)	
AMERICAN STONECRAFTERS, INC.	)	
	)	
DEFENDANT.	)	

APPEARANCES:

Douglas S. Skalka, Esq. — Attorney for Plaintiff
Neubert, Pepe & Monteith, P.C.
195 Church Street (13th Floor)
New Haven, Connecticut 06510

F. Woodward Lewis, Esq. — Attorney for Defendants
439 Main Street
Yalesville, Connecticut 06492

MEMORANDUM OF DECISION ON TRUSTEE'S COMPLAINT TO AVOID FRAUDULENT TRANSFER AND FOR PAYMENT ON A NOTE

DABROWSKI, ALBERT S., United States Bankruptcy Judge

I. INTRODUCTION

In this adversary proceeding the Plaintiff-Trustee attempts to track, and recover for the benefit of the estate, the business assets of the Debtor which have been strategically moved between the Debtor and the Defendant in an attempt to shield those assets from execution by creditors, as well as the Trustee's pursuit. As detailed herein, the Trustee will be accorded a monetary judgment on his Amended Complaint.

II. JURISDICTION

The United States District Court for the District of Connecticut has jurisdiction over the instant adversary proceeding by virtue of 28 U.S.C. § 1334(b); and this Court derives its authority to hear and determine this matter on reference from the District Court pursuant to 28 U.S.C. § 157(a). This is a "core proceeding" pursuant to 28 U.S.C. § 157(b)(2)(A), (H) and (O).

III. FACTUAL AND PROCEDURAL BACKGROUND

The following enumerated Findings of Fact, while principally derived from the record at trial of this adversary proceeding, also originate from the files and records of the instant bankruptcy case and adversary proceeding, and from conceded and undisputed facts drawn from the parties' briefs and responsive pleadings.

1. At all relevant times prior to May 1, 1995, the Debtor was a Connecticut corporation engaged in "stone cutting", *i.e.* the fabrication of marble, granite, etc. Prior to May 1, 1995, the Debtor's principal place of business was 488 Washington Street, Wallingford, Connecticut (hereafter, the "Washington Street Property").

2. At all relevant times 100% of the Debtor's corporate stock was owned by Constance Kronberg (hereafter, "Constance"),[1] the Debtor's Secretary/Treasurer. Constance, along with her husband, John W. Kronberg (hereafter, "John") - the Debtor's President - controlled all aspects of the Debtor's operations (Constance and John are hereafter jointly referred to as the "Kronbergs").

3. The Defendant (hereafter, "American") is a Connecticut corporation with a principal place of business at 378 North Cherry Street, Ext., Wallingford, Connecticut. At all relevant times following May 1, 1995, American was engaged in "stone cutting", *i.e.* the fabrication of marble, granite, etc.

4. At all relevant times, 80% of American's corporate stock was owned by Constance - American's Secretary/Treasurer. She and John - American's President - control all aspects of American's operations. The Kronbergs' son and nephew, both American's Vice Presidents, hold in equal proportion – 10% each – the balance of American's corporate stock.[2]

5. American is an "insider" of the Debtor as that term is defined in Section 101(31)(B), (E) and (F) of the Bankruptcy Code.

6. In 1990, two employees embezzled approximately $300,000.00 from the Debtor (hereafter, the "Embezzlement").

7. In part, to make up for the Embezzlement, the Debtor failed to remit certain federal taxes to the Internal Revenue Service (hereafter, "IRS") when due.

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[1]Following her 1989 purchase of 50% of the Debtor's stock then held by other investors.

[2]The Kronbergs' son and nephew received their stock interest in consideration of their contributions of "time" and "effort".

8. The Debtor was assessed by the IRS for unpaid withholding tax liabilities and related interest and penalties totaling $211,271.68 for eleven quarterly periods from September 30, 1990, through December 31, 1995. The IRS filed Notices of Federal Tax Liens totaling $125,138.03 with the State of Connecticut Secretary of State for seven of the above-referenced quarterly periods.

9. In early 1995, John Kronberg, acting through "Mr. Scotty" - an "advisor" - commissioned an appraisal (hereafter, the "Champion Appraisal") by the George Champion Appraisal Company (hereafter, "Champion") for the purpose of obtaining financing secured by the Debtor's machinery, equipment and inventory (hereafter, the "Physical Assets"). Tr. 6/1 at 74-75.

10. To facilitate the preparation of the Champion Appraisal, John provided Champion with a list of the Physical Assets along with corresponding cost figures (hereafter, the "List"). John knew that those figures did not represent the current value of the Physical Assets, terming them instead as "overvalued", "overpriced" and "out of whack". Tr. 6/1 at 69, 73, 75.

11. The List also included items with significant value - as much as $41,650.00 - that were *not* property of the Debtor[3] (hereafter, the "Padded Property"), see, e.g., Exhibits

[3] *See Statement of Material Facts*, Doc. I. D. No. 48, (asserting, *inter alia*, "the value of . . . machinery and equipment owned by others" to be $41,650")submitted in connection with the *Defendant's Motion for Summary Judgment*, Doc. I.D. No. 46, accompanied by an affidavit executed by Constance Kronberg, attesting, *inter alia*, "I have reviewed all the *facts* and figures included in the Statement of Material Facts, and believe them to be true and accurate to the best of my knowledge . . . ." Affidavit at ¶ 3. *See also*, *Memorandum and Order Denying Motion for Sanctions* entered simultaneously herewith.

At trial Constance Kronberg initially testified that "I'm not sure [what] the total was. I just knew at the time there were things that didn't belong there." Tr. 6/2 at 110. Subsequently, she testified that shortly after receiving the Champion Appraisal she prepared a highlighted list to "show" her husband that, in her opinion, the Champion Assets included property belonging to others totaling $41,300.00 Tr. 6/11 at 133-134.

Following trial American maintained the value of the Padded Property was actually $42,075.00 in accordance with Constance's testimony. *Defendant's Proposed Findings of Fact*, Doc. I.D. No. 131, Proposed

2(a), 2(b), 2(c)) (the Physical Assets *plus* the Padded Property are collectively hereafter, the "Appraised Assets").

12. Champion prepared the Champion Appraisal with obvious reliance on the List,[4] and opined therein that the Appraised Assets had a fair market value of $225,520.00.

13. Despite the Champion Appraisal, the Debtor could not obtain financing as it desired.[5]

14. On or about May 1, 1995, following the Debtor's failure to obtain financing, the Debtor faced the following economic adversities, *inter alia:*

a. an inability to pay its tax debt to the IRS;

b. an inability to fully pay its suppliers, most of whom were then demanding COD;[6]

c. had its bank account "swept" by at least one creditor; and

d. faced eviction from the Washington Street Property.

15. At that same time the Kronbergs' desired that two family members – their son and nephew – join them in the Debtor's business. The Kronbergs' son and nephew also desired to "come into the business", Tr.6/1 at 38, but only on condition that "they start fresh with clean books", Tr. 6/1/at 38 , "not . . . incur personal liability on any of the [D]ebtor's

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Finding No. 8. While the Court views Constance Kronberg's trial testimony as to this value to be uncertain and overstated it has charitably assigned $41,650.00 as the value of the Padded Property for purposes of this Memorandum of Decision.

[4]While by its terms the Champion Appraisal does "not warrant the accuracy of the information contained in the inventory list which has been prepared by [the Debtor]", Champion adopted that information as the foundation of its valuation. *See* Exhibit A.

[5]The evidentiary record was not developed to show whether the Champion Appraisal was actually used in connection with loan applications. The sole reference in the record to such use was John's testimony that he was "not sure, but I [didn't] think it was actually used to try to get a loan." Tr. 6/1 at 77.

[6]"Cash on Delivery", *i.e.*, trade creditors would not extend credit to the Debtor.

[IRS] debt", and that any new business they joined operate out of a new physical facility. Tr. 6/2 at 23.

16. To address their economic adversities, and to accommodate the conditions articulated by their son and nephew, the Kronbergs created American as a new entity to carry on the business of the Debtor.

17. Toward that end, on May 1, 1995, the Debtor "sold" to American *all of its assets* (hereafter, the "Transferred Property"). This transfer (hereafter, the "Transfer") was evidenced by a Bill of Sale dated May 1, 1995, identifying the Transferred Property as, *inter alia*, "all items contained in the attached [Champion Appraisal] dated April 13, 1995", *i.e.* the Appraised Assets. In addition, the Transferred Property included all of the Debtor's other, intangible assets, *e.g.*, accounts receivable, good will, work-in-progress and customer lists (hereafter, collectively, the "Intangible Assets").[7]

18. The Intangible Assets plainly had value, although a precise valuation cannot be determined from the record of this proceeding.[8]

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[7]While the Transfer of the Property was evidenced by a Bill of Sale and a Security Agreement referencing the Appraised Champion Assets, the undisputed evidence at trial was clear and unequivocal - American purchased all of the Debtor's assets. (The Debtor "sold to American the complete business of the debtor including its inventory, machinery, work in progress, viable accounts receivable, customer list and good will for $150,000.00 . . . ." *Defendant's Proposed Findings of Fact*, No. 9, Doc. I. D. No. 131. American purchased all the Debtor's assets, including its machinery, equipment, inventory, accounts receivable, and good will such that "after the sale [the Debtor] no longer had any assets".). Testimony of Constance, Tr. 6/11 at 11.

[8]Following the Transfer American exercised control over all the Debtors assets. During the period between August - December, 1995, American *may have* collected as much as $121,200.00 on accounts receivable purchased from the Debtor. Constance testified that a value for receivables was not directly implicated in the sales price because "work-in-progress" cost more to complete than the related receivables as "money had already been paid to [the Debtor] through the customers' deposits". Tr. 6/23 at 137. John also testified that the value of the Debtor's receivables was not included in the sale price but contradicted his spouse by testifying "that $121,000 is not accounts receivable". Tr. 6/23 at 146. In the final analysis, it appears to the Court that the Other Assets included in the Transfer had significant value, in exchange for which the Debtor received no consideration (and, therefore, less than a reasonably equivalent value). However, the Trustee's focused reliance on the Champion Appraisal as the means for calculating the fair

19. At the time of the Transfer the fair market value of the Transferred Property was *at least* $183,870.00.[9] In view of, *inter alia*, the inflated prices related to the Physical Assets, the Padded Property component of the Appraised Assets, and on the evidentiary record presented, the Trustee did not establish the extent to which the fair market value of the Transferred Property at the time of the Transfer exceeded $183,870.00.

20. In consideration and exchange for the Transfer, American executed and delivered to the Debtor a promissory note dated May 1, 1995, in the amount of $150,000.00 (heretofore and hereafter, the "Note").[10] Under the terms of the Note, monthly payments in the amount of $997.97 were to commence on or before January 1, 1996, with interest to accrue at seven percent (7%) per annum.

21. In order to secure its obligations under the Note, American granted to the

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market value of the Other Assets, and the poor state of the evidentiary record as a whole, precludes the Court from quantifying, individually or collectively, the value of the Intangible Assets.

[9]The Trustee argued the Appraised Champion Assets valuation figure ($225,520.00) as evidence of the floor for the fair market value of the Property. Therefore, according to the Trustee, the fair market value of the Property would be $225,520.00 *plus* the value of the Intangible Assets.

American originally asserted $41,650.00 as the value of the Padded Property and argued "[t]herefore, the **total** fair market value of the inventory, machinery and equipment of the 'Debtor/Ltd.' sold to the'Defendant/American' was actually $183,870.00 in accord with the 'Champion Appraisal.'"($225,520.00 - 41,650.00 = $183,870.00).

The Court reached the $183,870.00 Property valuation figure by subtracting $41,650.00 from the $225,520.00. Although the Other Assets had value, no such value was included in this calculus in view of the Trustee's exclusive reliance on the Champion Appraisal figure. No adjustment was made for the inflated valuation component of the Physical Assets due to (i) the Kronbergs' *intended* use of those false values in connection with financing applications, (ii) their actual use in connection with the *Defendant's Motion for Summary Judgment*, and (iii) the absence of an evidentiary record upon which the Court could quantify such value.

Accordingly, by using the Debtor's high $41,650.00 Padded Property figure, by not estimating and adding a value for the Intangible Assets, by declining to adopt the Defendant's Proposed Finding No. 8, and by embracing the Defendant's fair market value figure for *only* the Physical Assets asserted in its Statement of Material Facts, the resultant Transferred Property valuation of $183,870.00, is charitable, if not merciful, to the Debtor.

[10]The facial amount of the Note - $150,000.00 - was established by the Kronbergs in an arbitrary manner - the Kronbergs, in the presence of their son and nephew, and perhaps others, sat around a table and casually determined the sales price.

Debtor a security interest in certain of the assets transferred, as evidenced by a purchase money security agreement dated May 1, 1995 (hereafter, the "Security Agreement"). The collateral given as security for the Note was identified in the Security Agreement as "all items contained in the [Champion Appraisal] . . .1995", *i.e* the Appraised Assets.

22. Following the Transfer, American engaged in “stone cutting and related manufacturing work”, using and depleting the Physical Assets, thereby, *inter alia*, adversely impacting the IRS enforcement activity and its liens on that property.

23. Following the Transfer, American used the Debtor as a conduit for salary payments totaling $93,900.00 “to avoid red tape”, thereby, *inter alia*, inhibiting IRS knowledge of the Transfer.[11]

24. In making the Transfer, the Debtor, through the Kronbergs, intended to hinder and delay certain creditors of the Debtor in their efforts to collect debts due from the Debtor. The IRS, in particular, was substantially and adversely impacted by the Transfer and American’s significant post-Transfer depletion of the Physical Assets.

25. After the Transfer, American paid many, but not all of the Debtor’s creditors. The precise amount of such payments cannot be determined from the testimonial or documentary record.[12] These payments (hereafter, the “Creditor Payments”) were

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[11]Exhibit 3A reflects American paid $93,900.00 for payroll and payroll tax purposes to the Debtor during the period August 1, 1995, and December 29, 1995.

[12]The Kronbergs testified that post-Transfer American *voluntarily* paid some of the Debtor’s creditors by direct payments or payments through the Debtor totaling between $250,000.00 and 300,000.00 (“we [American] decided we would pay some of the bills of [the Debtor]. – and we probably paid $250,000, maybe $300,000.” John, Tr. 6/2 at 15). The testimony of John relative to these payments was confusing, unsupported, and speculative at best. The testimony of Constance, while more particularized, *see* Tr. 6/23/ at 6 *et seq.,* was the result of a calculus admittedly flawed, in her words, because “there was so much paper shuffling going on; things get lost.” Tr.6/23 at 104. The documentary exhibits end no real clarity to the amount of such payments. Nevertheless, while the Kronbergs’ testimony and documentary evidence do not present an adequate basis to *quantify* such payments, it is clear that significant *voluntary* payments were made.

voluntary, and selective,[13] and made for the specific purpose of reestablishing credit terms with certain vendors on behalf of American.

26. American defaulted under the terms of the Note and the Security Agreement by virtue of its failure to commence making payments of principal and interest when due on January 1,1996.

27. On February 14, 1996, the Debtor commenced the instant bankruptcy case through the filing of a voluntary petition under Chapter 7 of the Bankruptcy Code.

28. On December 13, 1996, the Trustee filed the original Complaint.

29. After the commencement of the Debtor's bankruptcy case, the Trustee made demand upon American to make the periodic payments due under the Note. American complied for a time, making a total of $11,229.70 in payments. See Exhibit 5a.[14]

30. On February 4, 1997, the Debtor exercised its right to convert from Chapter 7 to Chapter 11, by filing a Motion to Convert to Chapter 11. The case was in fact converted to Chapter 11 by Order entered February 6, 1997.

31. On February 5, 1997, without notice or approval of this Court, American, by and through Constance, and the Debtor, by and through John, executed an Agreement for Reconveyance of Personal Property Back to Transferor, (hereafter, the "Reconveyance Agreement"), Exhibit 11a, which, *inter alia*, purported to transfer American's rights in the

[13]John testified that American "volunteered to pay the some of [the Debtor's] creditors . . . [o]n a case by case basis . . . " even though "it wasn't obligated to do so." Tr. 6/1/ at 59.

[14] The Trustee's post-trial briefs assert ten payments on the Note totaling $9,979.70 – a discrepancy of $1,250.00. It appears this discrepancy is explained by two payments, s*ee* Exhibit 5a, Check Nos. 1411($500.00) and 1413 ($750.00), not included in the Trustee's calculus.

Appraised Assets[15] "back to [the Debtor]", and "agree[d]", *inter alia*, that (i) the Transfer is "reversed" with all relevant documents "voided and of no further force and effect", and (ii) certain "payments already made . . . are equivalent to the value of any inventory reduction so there is no balance due [the Debtor] from American that is not included as part of the consideration for American's consent to this agreement."[16]

32. On March 11, 1997, on Motion of the United States Trustee, the Court entered an Order reconverting the bankruptcy case to Chapter 7. Thereafter, the Trustee was reappointed by the United States Trustee.

33. On June 3, 1997, the Trustee filed a . . . Request for Leave to Amend Complaint, (hereafter, the "Request for Leave to Amend"), Doc. I. D. No. 25, which was granted on June 25, 1997, Doc. I. D. No. 31. In the Amended Complaint the Trustee (i) abandoned claims for the return of the Property itself (as an alternative to the recovery of its value) in Counts One through Four of the original Complaint, and (ii) added an additional Count seeking a monetary judgment pursuant to Section 542(b) for an alleged indebtedness under the Note (Count Five).

34. Incident to post-petition "discussions" concerning ownership, custody and other issues related to the Reconveyed Property, John apparently offered the Trustee $31,229.70 for the Reconveyed Property. That offer, however, was withdrawn on May 12,

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[15]The Reconveyance Agreement states, *inter alia*, "American in accord with the bill of sale attached hereto Quit Claims whatever rights, title, and interest it might have in said personal property, machinery and inventory, back to [the Debtor]." The attached Bill of Sale references "All items contained in the [Champion Appraisal]".

[16] The Reconveyance Agreement also states, *inter alia*, "the parties . . . believe the trustee has made a mistake and are confident that the [Champion Assets] are worth less than what American is now paying for them . . . so that had the [Transfer] been allowed to stand the creditors would not have been defrauded in any way . . . ."

1997. See Exhibit D, to Motion to Compel, Doc. I. D. No. 23. Certain ownership, custody and other issues related to the Reconveyed Property were ultimately resolved by agreement of the parties and Orders of this Court.

35. On September 17, 1997, the IRS (i) agreed to assume an obligation for storage payments,[17] see Order dated September 17, 1997, Doc. I. D. No. 75 (Case No. 96-30422), and (ii) was granted relief from the automatic stay of Section 362(a) to "seize [the Reconveyed Property Component] by administrative levy, administratively sell the property, and apply the proceeds received thereby against the outstanding tax liabilities of the [D]ebtor." See Order dated September 17, 1997, Doc. I. D. No. 76 (Case No. 96-30422). The record does not reflect the dollar amount of proceeds received by the IRS in connection with any such sale.

IV. DISCUSSION

A. Fraudulent Transfers.

In the present proceeding, the Trustee seeks, *inter alia*, to avoid and recover the Transfer as "fraudulent" pursuant to Code Sections 548(a), 544(b) and 550. The Trustee's claims in this regard possess a solid footing within the letter and spirit of the Bankruptcy Code. With the policy goal of maximizing the assets that constitute property of the bankruptcy estate, and thereby allowing greater distributions to creditors, the Bankruptcy Code has granted trustees the power to avoid certain prepetition transfers under Sections 544(b) and Section 548(a), *inter alia*. These tools serve to mitigate prejudice to creditors from the undue depletion of the debtor's property as a result of illicit transfers. See, e.g.,

[17] *See*, Order, Doc. I. D. No. 34, dated July 11, 1997, mandating, *inter alia*, the Trustee's payment to American of monthly Section 503(b) administrative expense payments "commencing May 12, 1997 [to the extent] the said estate property remains on American's property.").

Le Café Creme, Ltd. v. Le Roux (In re Café Creme, Ltd.), 244 B.R. 221, 238 (Bankr. S.D.N.Y. 2000). Within the constraints of these statutes, the Trustee may avoid, under federal and/or state law, transfers which are actually or constructively fraudulent.

1. Actual Intent to Hinder, Delay or Defraud - Code Section 548(a)(1).

a. Avoidance.

Code Section 548 provides for the avoidance of actually fraudulent transfers as follows:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
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> > (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

11 U.S.C. § 548(a)(1) (1992).

Because the Transfer plainly occurred within one year before the Petition Date,[18] the dispositive question is whether the Trustee has shown by a preponderance of the evidence that the Debtor transferred property with "actual intent to hinder, delay, or defraud [creditors]." Belford v. Cantavero (In re Bassett), 221 B.R. 49 (Bankr. D. Conn. 1998).[19] The Trustee has easily met his burden in this regard. The testimony of the Kronbergs effectively admitted that the Transfer was structured to hinder and delay the IRS and other

[18] The Transfer occurred no earlier than its stated date of May 1, 1995, and this case was commenced on February 14, 1996.

[19] There is some dispute regarding whether that burden is fulfilled by a preponderance of the evidence or clear and convincing evidence. *See In re Colonial Realty Co.*, 226 B.R. 513, 521 (Bankr. D. Conn. 1998) (recognizing the dispute). In this proceeding, however, the Trustee has met his burden under either standard.

creditors. Yet even without this direct evidence of fraudulent intent, the record contains a sufficient circumstantial basis of fraud.

Because actual fraudulent intent is rarely susceptible to direct proof, courts may infer the requisite intent from circumstantial evidence, or from the presence of "badges of fraud" as recognized by the United States Court of Appeals for the Second Circuit, to wit:

> (1) the lack or inadequacy of consideration;
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> (2) the family, friendship or close associate relationship between the parties to the transfer;[20]
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> (3) the retention of possession, benefit or use of the property in question;
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> (4) the financial condition of the party sought to be charged both before and after the transaction in question;
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> (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct, after incurring the debt, onset of financial difficulties, or pendency or threat of suits by creditors; and
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> (6) the general chronology of the events and transactions under inquiry.

Salomon v. Kaiser (In Re Kaiser), 722 F.2d 1574, 1582-83 (2d Cir. 1983). In short, a "finding of the requisite intent may be predicated upon the concurrence of facts which, while not direct evidence of actual intent, lead to the irresistible conclusion that the [debtor's] conduct was motivated by such intent." 5 Lawrence P. King, ed., Collier on Bankruptcy ¶ 548.04[2][a] at 548-25 (15th ed. rev. 1998).

With respect to the Transfer in the case at bar, it is not difficult to conclude that such transfer was made with the actual intent to hinder, delay and/or defraud. As a starting point the Court observes that the Kronbergs' are individuals willing to engage in fraud to obtain

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[20] The court recognizes that fraudulent intent is not inferred *solely* because property is transferred to a family member. *See, e.g., Hoffman v. Boyd (In re Boyd)*, 264 B.R. 62, 66 (Bankr. D. Conn. 2001) (citing *Citizens Bank of Clearwater v. Hunt*, 927 F.2d 707, 711 (2d Cir. 1991)).

money from lenders through the use of the Champion Appraisal, *inter alia*. Such conduct is indicative of a predisposition to engage in fraudulent and obstructive conduct as a means of addressing the financial peril which led to the Transfer. Wholly independent of this predisposition, the "badges of fraud" compel the same conclusion. With regard to these "badges" the Court makes the following observations and specific findings:

Inadequacy of Consideration

There was inadequate consideration received by the Debtor for the Transfer to American. The $150,000.00 "purchase price" evidenced by the Note was arbitrarily determined between family members, and effected a transfer of property worth at least $183,870.00.

Relationship Between the Parties

Notwithstanding the 20% equity interest of the Kronbergs' son and nephew in the transferee, American, that entity is effectively the Debtor in camouflage. From this Court's perspective, the Kronbergs simply changed the Debtor's name to American, moved to a new address, shed selective debt, insulated the Physical Assets from creditor access, and continued with the family business as usual. See, e.g., Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941) (The shifting of assets by a debtor to a corporation wholly controlled by him/her is a badge of fraud).

Financial Condition Before and After the Transaction

Prior to the Transfer, the Debtor was insolvent but owned valuable assets. Post-Transfer the Debtor's sole asset was the Note - a deferred payment obligation between insiders.

Course of Conduct Including the Retention/Use of Property, Financial Difficulties,

Pendency or Threat of Suits and General Chronology of Events

Following, and as a result of the Embezzlement, the IRS liens and related enforcement activity, and the loss of credit status with creditors, the Debtor was in extreme financial peril, and the target of foreclosure activity with respect to its physical facility. By May 1, 1995, it was clear to the Debtor that the combination of a successful foreclosure, IRS lien enforcement, and an inability to operate on a C.O.D. basis, would result in the loss of its assets and an inability to continue in the family business. By 1995, the Kronbergs were fully cognizant that under no legitimate scenario was it possible to continue the family business. Consequently, and driven by the obvious apprehension of the doomed nature of their business, the Kronbergs, after considering defrauding a new lender, then engaged the Transfer as an attempted means of escape. The deceptive pre-petition activities of the Debtor's principals are compounded by their transparent attempt to escape liability on the original Complaint through the post-petition reconveyance (and purported releases) related to what they alleged was the Transferred Property. In short, the Transfer was a sham concocted by the Debtor's principals to insulate valuable assets from IRS and creditor access while simultaneously positioning themselves to continue in their family business without old debt.

In view of the overwhelming evidence demonstrating the Kronbergs' fraudulent and/or obstructive intent in connection with the orchestration of the transfer of the Debtor's property to American, the Court shall avoid that Transfer pursuant to Code Section 548(a)(1).

b. Recovery.

Having concluded that the Transfer is avoidable, this Court must turn to a

consideration of what recovery, if any, can be had from American as a result of such avoidance. Avoidance action recoveries under the Bankruptcy Code are governed by Section 550. That Section provides in relevant part as follows:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section. . . 548. . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> (1) the initial transferee of such transfer . . . .
>
> * * * *

11 U.S.C. § 550 (1992).

Because American was the "initial transferee" within the meaning of Section 550(a)(1), under the terms of Section 550(a), the Transferred Property, or its monetary value, is recoverable from American. The focus of Section 550 is on what the bankruptcy estate lost as a result of the subject transfer.

> Section 550(a) is intended to restore the [bankruptcy] estate to the financial condition it would have enjoyed if the transfer had not occurred . . . . [T]he object of any remedy should be, to the extent practicable, to 'undo' the transfer and to restore the parties to their pretransfer positions . . . . [T]he proper focus in [Section 550(a)] actions is not on what the transferee gained by the transaction, but rather on what the bankruptcy estate lost as a result of the transfer.

In Re Colonial Realty Company., 226 B.R. 513, 525 (D. Conn. 1998) (citations omitted).

In this proceeding little, if any, of the Transferred Property is presently recoverable from American[21] due to (i) its significant depletion of the Physical Assets while in its control, (ii) its voluntary return of the Reconveyed Property Component, and (iii) the potential spoliation of the Intangible Assets. Accordingly, the Court concludes that it is appropriate

[21]As previously noted, the Trustee, in the Amended Complaint, *inter alia*, abandoned a claim for the return of the Property itself.

in this proceeding for the Trustee to recover the monetary value of the Transferred Property for the benefit of the bankruptcy estate pursuant to Section 550(a).

American argues that it is entitled to certain credits or set-offs against any gross valuation of the Transferred Property. First, American contends it established at trial, *inter alia*, that it paid at least $286,795.20 to the Debtor and/or the Debtor's creditors. Of this amount, $93,900.00 purportedly represented American's payments to the Debtor for salaries of *American* shop employees carried on the *Debtor's* books to "avoid a lot of government red tape." Tr. 6/1 at 57. The remaining $192,895.20[22] (heretofore and hereafter, the "Creditor Payments") consisted of payments American purportedly made directly[23] and indirectly[24] to trade creditors of the Debtor. The Creditor Payments, American argues, constitute a claim against the Debtor, which pursuant to Section 553, more than offsets any monetary judgment entered against it under Section 550.

American's reliance on Section 553(a) is misplaced. That Section provides as follows:

> (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—

Section 553(a) (1996) (emphasis added).

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[22]American, in its brief, asserts this amount to be $195,895.20 ($185,581.45 + $7,313.75 = $192,895.20.

[23]American argues it paid, *inter alia*, $7,313.75 directly to the Debtor's creditors with reference to Exhibit 4A – marked for identification but not admitted in full. *See Defendant's Proposed Findings of Fact*, ¶ 13(a)(1), Doc. I. D. No. 131.

[24]American purportedly paid $185,581.45 to the Debtor which amount was in turn purportedly used by the Debtor to pay its creditors.

Plainly Section 553 permits the offsetting of only mutual *pre-petition* debts. While an avoidance action judgment under Sections 548 and 550 clearly gives rise to a debt owing from American to the Trustee as the Debtor's estate fiduciary, such debt is not a *pre-petition* obligation owing to the *Debtor* as such. By its very nature, such a debt could not arise until after the commencement of a bankruptcy case. Simply put, Bankruptcy Code avoidance recoveries cannot be offset pursuant to Section 553(a).

Nor is it appropriate for this Court to consider American's argument for set-off under equitable - *i.e.* non-Section 553 - principles. A bankruptcy court should not bring equitable principles - under Section 105 or otherwise - to bear if they conflict directly with an otherwise controlling Code provision. Because Section 553(a) is clear on its face to provide relief limited to mutual pre-petition debts, equity can not broaden that relief.

More compelling, however, is American's argument that it should be credited with the value of that portion of the Transferred Property which it reconveyed to the Debtor's estate. In essence, American has satisfied, in part, any transfer avoidance judgment by relinquishing the Reconveyed Property. Yet, because the record of this proceeding is insufficient to determine the value of the Reconveyed Property, the Court shall reopen the evidentiary record to determine such value, and thereafter enter a judgment providing for recovery in an appropriate and specific monetary amount.

2. Constructive Fraud - Code Section 548(a)(2).

Given the nature of the Court's disposition of the Trustee's avoidance claims under Sections 548(a)(1) and 550, it is unnecessary to consider the propriety of duplicative relief under Sections 548(a)(2) and 550.

3. State Law-Based Transfer Avoidance - Code Section 544(b).

Given the nature of the Court's disposition of the Trustee's avoidance claims under Sections 548(a)(1) and 550, it is unnecessary to consider the propriety of alternative relief under Sections 544(b) and 550.

B. Collection on the Note - Code Section 542(b).

In addition to seeking recovery of the value of the Transferred Property pursuant to Sections 544(b), 548(a) and 550, the Trustee seeks to collect the balance of the Note under the authority of Bankruptcy Code Section 542(b).

Section 542(b) provides in pertinent part as follows:

> (b) . . . [A]n entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

11 U.S.C. § 542(b) (1996).

In this proceeding the Trustee has easily met his burden of proof. It is undisputed, or it cannot be disputed, that:

> (a) American owes a debt on the Note which is property of the bankruptcy estate pursuant to Section 541;
>
> (b) American defaulted under the terms of the Note by virtue of its failure to make monthly payments when due; and
>
> (c) that the Note became payable on demand and order of the Trustee.

Accordingly, subject to any valid offset under Section 553, the Trustee is presumptively entitled to collect from American the balance on the Note plus interest.

American contends that any balance due on the Note is wholly offset pursuant to Section 553 by the Creditor Payments totaling $195,895.20. However, as noted, supra, Section 553(a) provides for the set-off of only mutual pre-petition debts. The fundamental

flaw in American's argument is the absence of any support in the record for the proposition that the Creditor Payments were intended to create an obligation on the part of the Debtor. Rather, the record reveals that in making the Creditor Payments, the Kronbergs made selective, "case-by-case" determinations to pay only certain creditors of the Debtor, i.e. those with whom American desired to do business on a credit basis. On the record before the Court, the fact that the Creditor Payments were made in the self-interest of American without an expectation of repayment from the Debtor, precludes any finding that those payments created a debt from the Debtor to American. Accordingly, since there is no *American* debt, there can be no *mutual* debts within the meaning of Section 553.

American's argument for set-off on equitable grounds also fails. A party which seeks equity must have clean hands. American's hands are soiled by the machinations of its principals. As already noted, in early 1995, in an attempt to resuscitate the Debtor and continue their family business, the Kronbergs' arranged and commissioned the Champion Appraisal – containing inflated valuations and Padded Property – with the intention of using it in obtaining new financing. American was created, and the Transfer employed to, *inter alia*, evade the reach of the IRS, and avoid payment of selected debts. American, *inter alia*, (i) continued in the Debtor's business, using and significantly depleting the Physical Assets, with adverse consequences to any IRS enforcement of its liens.

Assuming, arguendo, the existence of a statutory or equity-based foundation for set-off, the confusing, disorganized and ill-prepared testimony of the Kronbergs[25] provided an insufficient basis for this Court to quantify the extent of any qualifying setoff. The

[25]The difficulty presented by Constance Kronberg's ill-prepared trial testimony was compounded by her failure to recollect facts as the apparent consequence of an intervening stroke.

Kronbergs' testimony in this regard was replete with inconsistencies, resplendent with conjecture[26], and is reflective of the overall careless preparatory effort of the Kronbergs by counsel for American in connection with the trial of this adversary proceeding.[27] In summary, the absence of mutual debts and clean hands, as well as a failure of proof, is fatal to the set-off of any amount in this proceeding.

Nonetheless, the Court determines it appropriate that the recovery on the Note be adjusted by the value of the Reconveyed Property. In essence the value of the Reconveyed Property shall be treated as a payment on the Note. Yet, because the record of this proceeding is insufficient to determine the value of the Reconveyed Property, the Court shall reopen the evidentiary record to determine such value, and thereafter enter a judgment providing for recovery in an appropriate and specific monetary amount.

C. <u>Reconciling the Avoidance and Note Recoveries</u>.

The Court must now consider whether the Trustee shall be entitled to recover on the Note and on the Transfer avoidance, or whether judgment should be limited to one or the other. By its terms, the relief provided by Section 550(d) - "[t]he trustee is entitled to only

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[26]Causing the Court to observe on the second day of the testimony of Constance Kronberg:

> "You said, well, I think we did, I suppose we did . . . . But I want to know what you did and why you believe you did it, not what you suppose, not what you think, not what may have happened, not what could have happened. I want to know to the best of your recollection exactly what happened and why you believe that is the case.
> Supposing is of no value to me . . . .

Tr. 6/11/98 at 7.

[27]*See* this Court's "state of evidence" remarks near the conclusion of the second day of testimony:

> The Court: "I am frank to say I could have taken and presented your case within an hour or two, at least insofar as what you've accomplished.
> * * *
> The state of these exhibits is not what one would ordinarily expect in federal court. I'm assuming that they will be what one would expect when we return here and complete this case . . . . "

Tr. 6/11/98 at 219.

a single satisfaction" - applies only to avoidance action recoveries.[28] Nonetheless, the spirit of Section 550(d) guides this Court to limit the Trustee's ultimate judgment in this proceeding to a single recovery for an individual transaction notwithstanding multiple statutory provisions allowing such recovery. See In re Bell & Beckwith, 64 B.R. 620, 631 (Bankr. N.D. Ohio 1986). Simply stated, the Note and the Transfer were two independent elements of an individual transaction. This equitable reason dictates that the amount of the Trustee's Transfer avoidance and recovery in this proceeding pursuant to Sections 548(a) and 550 shall be concurrent with his recovery on the Note pursuant to Section 542(b).[29]

V. CONCLUSION

For the foregoing reasons, the Trustee is entitled to a Judgment against American on his Complaint in this adversary proceeding on (i) Count Two (avoiding the Transfer, and ordering recovery from American of the value of the Transferred Property, that is, $183,870.00 – adjusted by the value of the Reconveyed Property Component – pursuant to Sections 548(a)(1) and 550(a)(1)), and (ii) Count Five (ordering, pursuant to Section 542(b), a monetary award in the amount of the outstanding balance of the Note plus interest as adjusted by the value of the Reconveyed Property Component). The Judgments on Counts One and Five shall be concurrent in that the Trustee shall collect no

[28]American argues that the Trustee is now estopped from recovering on the Note pursuant to Section 542(b) because he is "bound by his election to bring a fraudulent conveyance suit, *and by statute [Section 550(d)]*, he cannot recover [on the Note]." Defendant's Post-Trial Brief at page 4, Doc. I.D. No. 130 (emphasis added).

[29]The Trustee concedes that "[a] judgment for the return to the estate of the value of the property under 11 U.S.C. § 550 would, therefore, be for the difference between the value of the fraudulently transferred goods and any judgment on the Note." *Plaintiff's Sur-Reply Brief* at 2-3.

more than the larger of the monetary judgment on Counts One or Five. Given the disposition herein, the relief requested in Counts Two (pursuant to Sections 548(a)(2)) , Three (pursuant to Section 544(b) (incorporating Conn. Gen. Stat. §§ 52-552(e) and (h)) and Four (pursuant to Section 544(b) (incorporating Conn. Gen. Stat. §§ 52-552(e) and (f)), shall be denied as moot.

The Court retains jurisdiction over this proceeding and reopens the evidentiary record to determine the monetary value of the Reconveyed Property.[30] By copy of this Memorandum of Decision, the Office of the United States Attorney for the District of Connecticut, as counsel for the IRS, is requested to advise the Court, by letter transmitted on or before Tuesday, February 4, 2003, simultaneously noticed to the parties herein, of such monetary amount of the gross proceeds realized by it from its sale of the Reconveyed Property (hereafter, the "Supplemental Letter Exhibit"). To facilitate this process, upon its receipt by the Court, the Supplemental Letter Exhibit shall be marked as a Court Exhibit *for identification* in this proceeding. A separate Order shall enter simultaneously herewith (i) requiring that the parties to this proceeding file on or before Tuesday, February 18, 2003 any objection(s) to the reopening of the evidentiary record and/or the full admission of the Supplemental Letter Exhibit, (ii) establishing a hearing on any timely-filed objection(s) to be held before this Court at the Connecticut Financial Center, 157 Church Street (18th Floor), New Haven, Connecticut on Wednesday, February 26, 2003 at 10:00 A.M., and (iii) ordering that absent timely objection(s), the Supplemental Letter Exhibit shall be admitted in full and considered as evidence of the value of the Reconveyed Property. Entry of the

[30] *See* Fed. R. Evid. 614(a) ("The court may, on its own motion or at the suggestion of a party, call witnesses, and all parties are entitled to cross-examine witnesses thus called.").

Judgment in this matter shall be deferred pending completion of any hearing on any objection(s) to the full admission of the Supplemental Letter Exhibit.

This Memorandum of Decision shall constitute the Court's Findings of Fact and Conclusions of Law as required by Fed. R. Bank. P. 7052.

BY THE COURT

Dated: January 21, 2003

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Albert S. Dabrowski
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
DISTRICT OF CONNECTICUT

IN RE:	)	
	)	
STONECRAFTERS, LTD.,	)	CASE NO. 96-30422 (ASD)
	)	
DEBTOR.	)	CHAPTER 7
MICHAEL J. DALY,	)	
CHAPTER 7 TRUSTEE for	)	
STONECRAFTERS, LTD.,	)	
	)	
PLAINTIFF,	)	
vs.	)	ADV. PRO. NO. 96-3202
	)	

AMERICAN STONECRAFTERS, INC.)
)
DEFENDANT.)

ORDER ON MEMORANDUM OF DECISION ON TRUSTEE'S COMPLAINT TO AVOID FRAUDULENT TRANSFER AND FOR PAYMENT ON A NOTE

In accordance with the Court's Memorandum of Decision on Trustee's Complaint to Avoid Fraudulent Transfer and for Payment on a Note entered this same date**:**

IT IS HEREBY ORDERED that upon its receipt by the Court, the Supplemental Letter Exhibit shall be marked as a Court Exhibit for Identification in this proceeding, and

IT IS FURTHER ORDERED that the parties to this proceeding (i) shall file and serve on or before Tuesday, February 18, 2003 any objection to the reopening of the evidentiary record in this proceeding and/or to the full admission of the Supplemental Letter Exhibit (hereafter, the "Objection(s)"), and

IT IS FURTHER ORDERED that a hearing on any timely filed Objection(s) will be held before this Court at the Connecticut Financial Center, 157 Church Street (18th Floor), New Haven, Connecticut on Wednesday, February 26, 2003 at 10:00 A.M., and

IT IS FURTHER ORDERED that absent timely filed Objection(s) the Supplemental Letter Exhibit shall be admitted in full and considered as evidence of the dollar amount realized by the IRS from the sale of the Reconveyed Property Component.

BY THE COURT

Dated: January 21, 2003

_____
Albert S. Dabrowski
United States Bankruptcy Judge