

REGINA VS. H. SCHEEL

(METRO PALLET REPAIR COMPANY)

SYNOPSIS

This case is an example of operations being continued despite the fact that the owner knew that the company would fail. Metro Pallet Repair Company commenced operations in January 1973 as a partnership to repair the pallet boxes commonly used in the agricultural industry. However, the owners decided in May of 1973 to manufacture pallet boxes. They moved from their premises in Mississauga, Ontario, to Alliston, Ontario, where premises were rented to commence the manufacture of pallet boxes for the farmers located around the Holland Marsh.

FINANCIAL REVIEW

After six months in business, the company was experiencing severe financial difficulties largely due to its under-capitalization. An un-audited financial statement was prepared by their part-time bookkeeper in the latter part of August 1973. It covered the period January 23, 1973, the date of commencement of the business, to July 31, 1973. A review of this statement showed total assets of \$39,936.03 against total liabilities of \$66,674.44. Furthermore, net sales of \$34,564.10 had produced a nominal gross profit of less than 1% of sales, amounting to \$204.51. After deducting the operating expenses of \$25,228.67, the company showed a loss from operations of \$25,024.16, which was shared equally by the partners, H. Scheel and B. Brooks.

Before the compilation of the financial statement, the bookkeeper had prepared a listing of assets and liabilities as at April 30, 1973 and May 31, 1973. This list disclosed that the company was not operating profitably and had a cash shortage.

This bleak financial position included an existing bank loan of \$35,000.00. Faced with this situation, H. Scheel requested his part-time bookkeeper to prepare a list of "Accounts Receivable in Process As Of August 27th, 1973." This list indicated to the bank manager, to whom the list was given, that \$59,420.00 would be realized from the completion of the present customer orders.

After discussion with the bank manager, Scheel assigned this list of receivables to the bank. He also signed a promissory note and a chattel mortgage on the company's machinery as collateral security for the existing \$35,000.000 bank loan

and an additional bank loan of \$3,700.00 The latter loan was used to eliminate the overdraft of \$3,665.65 in the company's current bank account. The bank agreed to allow the company to continue in business on the understanding that the funds to be paid by the customers would be applied to reduce the company's bank loan. However, by October 5, 1973, when the company became bankrupt, the bank was still looking for its money.

A search of records undertaken by the Investigating Officers produced some sales invoices which became a starting point. The Investigating Officers interviewed the customers named on the sales invoices to determine not only the representations made to them, but also what documents they had in their possession, i.e., their copy of sales invoices and cancelled cheques which had been issued to the company. They were also asked whether they knew of others who had had dealings with this company. This search for customers was assisted by bank documents, obtained through a search warrant, which included a listing of accounts receivable as at August 27, 1973.

From this information we were able to determine the validity of the listing of accounts-receivable-in-process submitted to the bank by H. Scheel through his part-time bookkeeper. Examination of this list of receivables suggested that at most only \$36,196.00 could have been realized assuming, of course, the satisfactory completion of all orders. The "will say" statements revealed that the percentage of customer orders for boxes "complete and delivered" as set out on the list was also overstated.

CUSTOMER SALES AND PRODUCTION

In order to ascertain the correctness of the listing of account-receivable-in-process, it was necessary to determine the position of the company vis-a-vis its customers. What was the value of deposits received from these customers, and how many orders had been made and filled from the time the customers, and how many orders had been made and filled from the time this company commenced the manufacture of pallet boxes?

The company apparently began manufacturing pallet boxes in May 1973. Our examination revealed that the company had accepted orders in July 1973 for 996 boxes, of which 688 were completed by October 5, 1973, the last day of business.

During August, the company accepted orders for 4,240 boxes, of which 631 were completed by October 5, 1973. These orders, valued at \$76,398.00, resulted in cash deposits of \$33,128.00.

For the month of September, the company accepted orders for 720 boxes, of which 94 were completed by October 5, 1973. These orders valued at \$12,065.00 resulted in cash deposits of \$6,520.00.

Finally, for the month of October the company received one order but rejected it because the customer would not leave a cash deposit.

Summarizing therefore for the period August 1, 1973 to October 5, 1973, the company accepted orders for 4,960 pallet boxes of which 725 (allowance given for bottoms and sides) were completed by October 5, 1973. These orders valued at

\$88,463.00 resulted in cash deposits of \$39,648. Of these deposits, \$28,396.00 representing cash advances on the customer orders still unfilled as at October 5, 1973, was never returned to the customers.

RECEIPTS

For the period August 1, 1973 to October 5, 1973, our examination revealed that the company had received \$55,871.00 in cash, with an integral part being the \$39,648.00 received as customer deposits with the orders. For the same period we identified disbursements of \$40,578.00. We were unable to identify the use of the remaining \$14,293.00, even after the opportunity was given to defence counsel to make available further suppliers' invoices.

Included in the receipts is an amount of \$5,000.00 which represented the proceeds of a loan from R. Lackey, secured by a lien on the company's machinery. This same machinery was already pledged as partial security to the bank, under their chattel mortgage for the company's bank loan of \$38,700.00. H. Scheel later arranged the sale of this machinery (unknown to the bank) to Mr. Gall for \$7,262.00 of which \$5,060.00 was personally delivered by Gall to R. Lackey.

Also included in the receipts are cash proceeds realized by the company from the sale of lumber. The sale occurred at a time when the company was having difficulty getting lumber from its suppliers due to the lack of credit. It appears that these sales were made to generate cash.

DISBURSEMENTS

The disbursements include payment of \$5,640.00 to N. Clements (bookkeeper debt) and \$2,500.00 to S. Spurr. The cheques issued to N. Clements contains a reference, "lumber purchases". The payment to S. Spurr apparently represents the repayment of a personal loan. The source of funds was customer deposits, the only

occasion when customer payments were deposited to the bank account of the company. Thus, although the company was far behind in completing its orders and was in a difficult cash position, only 59% of its receipts could be traced to payments made on behalf of the company's business.

OTHER COMMENTS

For the months of August, September and October, we could find no evidence of the company maintaining any books of account. Consequently, we constructed the following:

- A list of known sales/orders accepted by the company for these months
- A summary of known receipts and disbursements, and
- A listing of accounts receivable at August 27, 1973.

The results of this examination, together with our review of the company's banking position, enabled us to produce a statement of deficiency in working capital covering the period July 31, to October 5, 1973. The statement discloses the

company's position at various dates based on their liquid assets. At August 31, 1973, the deficiency amount to 66,602.00 representing a 50% increase from the previous amount and increasing to \$89,076.00 at October 5, 1973.

In the course of our work, other finance-related matters came to our attention:

- On May 17, 1973 B. Brooks acquired a personal loan of \$3,000.00 from the bank to pay off an existing company loan to the bank. As of August 25, 1973, 32 payments of \$99.34 remained on this loan.
- B. Brooks offered to resign from the partnership on August 16, 1973 for a sum of \$1,800.00. On a cheque dated August 16, 1973 for \$1,500.00 (obtained as a deposit from a customer named Kavchak) H. Scheel wrote in the name of B. Brooks as payee. He could do this because he received the cheque completely filled out except for the payee's name.
- B. Brooks, now an employee along with another employee, Al, cashed several cheques received by H. Scheel as deposits which accompanied the orders. These cheques were not deposited to the bank account of the company since the bank, under its agreement with the company, was entitled to apply the proceeds of any deposits to reduce its loan. This situation continued until October 5, 1973, when the bank demanded payment in full from the company.
- H. Scheel became the sole cheque-signing authority near the end of August.
- A review of the lumber suppliers indicates that the company had to switch from supplier to supplier as its credit diminished until September 27, 1973, when J. W. Robinson Ltd. would deliver lumber only on the receipt of cash.

CONCLUSION

By October 5, 1973, the following situations had transpired:

1. The company was indebted to the bank for \$38,845.00; to its other creditors for \$36,878.00; and to its customers for \$28,396.00, for the total amount of \$103,988.00.
2. The company had completed only 15% or 725 of the orders for 4,960 boxes.

3. The amount of \$14,293.00 remained unaccounted for, while another \$8,140.00 was paid to satisfy a gambling debt and a personal loan of H. Scheel.
4. The company had always been undercapitalized. This fact was clearly evidenced by the financial statements produced at July 31, 1973, which showed the bank and creditors to be financing the company's operations. Furthermore, the company's sales revenue could barely cover its cost of sales (gross profit \$204.51 or 6/10th of 1%).

As this need for cash became more critical, cashing customers' deposits independently of the bank account became the only means by which the company could maintain its cash flow. This could explain why the company was selling at less

than the fair market price and only to those customers who would leave a deposit.

In view of the cash shortage and the various methods used to alleviate this problem, it was significant that the use of \$14,293.00 remained unexplained and that a further \$8,140.00 was used to satisfy personal gambling debts and a loan. With only 15% of the orders completed, H. Scheel should have realized at some point that the business would not succeed. The crucial question was: why did he continue to accept deposits and make promises of completion when he knew that the company was unable to fulfill existing orders?

The Crown alleged that the accused had that knowledge as of the third week of August for the following reasons:

- resignation of partner Brooks
- preparation of false list of accounts receivable submitted to bank for credit
- publication of penciled financial statements disclosing the company's position as at July 31, 1973
- minimal bank deposits
- cheques issued for personal debt, although referenced to "lumber"
- pledging of collateral for a loan from Lackey at time when the collateral was already pledged to bank, and
- lumber suppliers would only sell C.O.D.