

IN THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF  
IOWA

IN RE: )

) Chapter 7

GERALD SCOTT OVEL, )

)

Debtor. ) Bankruptcy No . L-90-0118J C

----- FIRSTAR BANK CEDAR RAPIDS, N.A., )

) Adversary No. L-90-0199C

Plaintiff, )

)

vs. )

)

GERALD SCOTT OVEL, )

)

Defendant. )

ORDER

This matter came on for trial before the undersigned on October 12, 1993 on Complaint to Determine Dischargeability of Debt. Plaintiff Firststar Bank Cedar Rapids was represented by attorneys Tim White and Lynn Hartman. Defendant/Debtor G. Scott Ovel was represented by attorney Peter Riley. Evidence was presented after which the Court took the matter under advisement.

FINDINGS OF FACT

Firststar Bank made loans to Debtor's business, Wholesale Liquors, Inc., for use as operating funds. Debtor personally guaranteed such loans. State court litigation based on the loan agreements ensued. A jury found that Firststar (a) encouraged Wholesale Liquors to purchase Warehouse Liquors, its main competitor, (b) terminated its practice of honoring Wholesale Liquors' overdrafts without adequate notice and (c) failed to provide Wholesale Liquors a reasonable opportunity to refinance the indebtedness after default. The jury awarded Firststar \$38,081 which is approximately one-half of the principal obligation borrowed by Wholesale Liquors.

Count I of Firststar's present adversary complaint asserts that the State Court judgment should be excepted from discharge under § 523(a)(2)(B) because Debtor induced the loan through false financial statements. Debtor executed the promissory note evidencing the line of credit on October 7, 1987. The due date of renewal of the note was June 10, 1988. Pursuant to an informal agreement with Firststar, Debtor prepared monthly financial statements starting in November 1987. No monthly statements were prepared between February 1988 and June 1988. Debtor testified that his business affairs were moving so rapidly that he failed to prepare the statements. He did prepare the statements after Firststar's request in early June. The financial statement for July 1988 was prepared more than a year later as part of the discovery process in the State Court litigation.

After Firststar received Debtor's financial statements in June, it discontinued honoring Wholesale Liquor's overdrafts and decided not to renew the note. Debtor was unable to meet Firststar's demands for additional security and requested additional time to find refinancing. Firststar agreed to wait a few weeks to allow Debtor to look for refinancing. When it became apparent that refinancing would not be available, Firststar allowed Debtor to conduct a going-out-of-business sale. When Firststar replevied on the business in September 1988, it recovered approximately \$13,000 worth of inventory.

Firststar asserts in Count I that Debtor's financial statements between November 1987 and July 1988 misstated the amount of Wholesale Liquors' inventory. Firststar claims that it detrimentally relied on those false financial statements in extending the due date beyond June 10, 1988 and allowing Debtor to liquidate the business himself. Firststar alleges that providing Debtor with this additional time allowed Debtor to dissipate business assets. Debtor testified that the financial statements were accurate to the best of his

knowledge . He

stated that he did not intend to mislead Firststar, nor did he dispose of assets in an inappropriate manner.

Count II of the Firststar's complaint asserts that Debtor should be denied discharge under § 727 (a) (5) because he has failed to adequately explain the loss of assets listed on the financial statements. Firststar specifically points to a

reporting of inventory of \$72,000 as of July 31, 1988. It asserts that Debtor has failed to sufficiently account for the approximately \$60,000 difference between the \$72,000 of inventory reported for July, 1988 and the \$13,000 worth of inventory Firststar received from its replevin action.

Debtor testified that he made disbursements which adequately explain the differences. He testified that he paid Mike Runkle \$11,500 for repayment of loan. Debtor paid his father approximately \$20,000 in cash to repay a cash loan. He paid taxes of approximately \$8,000. He paid the proceeds of the liquidation sale to Firststar. This is either approximately \$6,000 or \$7,500 (parties dispute exact amount) . He paid operating expenses of approximately \$10,000. These amounts total approximately \$55,500 or \$57,000. Though some paperwork is more complete than others, all payments except the payment to Debtor's father are documented.

## 2

### CONCLUSIONS OF LAW

The standard of proof on objections to discharge under 11 u.s.c. § 523(a) (2) or § 727(a) is a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654, 661, 112 L. Ed. 2d 755 (1991). Exceptions to discharge must be "narrowly construed against the creditor and liberally construed against the debtor. These considerations, however, are applicable only to honest debtors." In re Van Horne, 823 F.2d 1285, 1287 (8th cir. 1987). This is a core proceeding pursuant to 28 u.s.c. § 157 (b) (2) (I) and (J).

#### False Financial statement - § 523 (a) (2) (B)

11 U.S.C. 523 (a) (2) states:

(a) A discharge under section 727. . . does not discharge an individual debtor from any debt

...

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by--

(B) use of a statement in writing-

{i} that is materially false;

{ii} respecting the debtor's or an insider's financial condition;

{iii} on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

{iv} that the debtor caused to be made or published with the intent to deceive.

The requisite elements for a § 523(a) (2){B} claim are: {1} there is a false financial statement in writing respecting the debtor's financial condition; {2} the financial statement is materially false; {J} the debtor intended to deceive; and {4} there is reliance on the part of the creditor. In re Walderbach, No. L92- 00780C, Adv. No. 92-1135LC, slip op. at 7 (Bankr. N.D. Iowa Aug. 31, 1993). The debtor's intent is a critical element of the analysis under § 523(a) (2). Intent can be gleaned from surrounding circumstances, using a totality of the

circumstances approach. Walderbach, slip op. at 8; see Van Horne, 823 F.2d at 1287; In re Stewart, 91 B.R. 489, 495 (Bankr. S.D. Iowa 1989).

3

Debtor vigorously denies that Firststar actually made an extension of credit in reliance on the allegedly false financial statements. An extension of credit under § 523(a) (2) includes an indulgence by a creditor giving a debtor further time to pay existing debt. In re Gerlach, 897 F.2d 1048, 1050 (10th Cir. 1990). Van Horne noted that a waiver of the right to foreclose on the original note when due or postponing the date of maturity are the types of "extensions" contemplated by Congress. 823 F.2d at 1289.

The purpose of the statute is to afford the defrauded party an opportunity to collect so much of the debt as exists by reason of the fraud. In re Richards, 71 B.R. 1017, 1023 (Bankr. D. Minn. 1987). Courts have held that forbearance in collection efforts is sufficient detrimental reliance to establish actionable fraud. Id. ; see also In re Cerar, 97 B.R. 447, 451 (C.D. Ill. 1989) (holding that tacit agreement to forego collection efforts based on false financial statement is sufficient) ; In re Hoffman, 89 B.R. 924, 927 (Bankr. N.D. Ill. 1988) (stating that an extension includes lengthening of credit or agreeing to forego enforcement of a contract right to collect the debt); In re Mancini, 77 B.R. 913, 916 (Bankr. M.D. Fla. 1987) (stating that not exercising a legal right and permitting the debtor to continue to enjoy credit is tantamount to an extension of credit) .

In In re Schmidt, 70 B.R. 634, 645 (Bankr. N.D. Ind. 1986), the court considered whether an extension of credit occurred where the parties had entered into a mutual release in a settlement agreement. Noting that mere forbearance of collection efforts does not constitute an extension of credit, the court stated that the settlement agreement was in fact an attempt to extinguish the debtor/creditor relationship and was not an extension of credit under § 523(a) (2) .

The Court has carefully reviewed the evidence and applied it to the foregoing legal principles. It is the conclusion of this Court that Firststar has failed to establish the elements of § 523(a) (2) (B) by a preponderance of the evidence . There is scant evidence that Debtor's financial statements were materially false. Firststar offered no evidence that Debtor had less inventory than stated in his financial statements at the time the statements were made . In light of the testimony by Debtor and by Firststar's expert witnesses, the court concludes that any discrepancy in Debtor's reporting of inventory is explainable by the parties' use of differing accounting methods . See ITT Commercial Finance Corp. v. Walz, 115 B.R. 353, 357 (Bankr. N.D. Fla. 1990). Firststar's proof of intent to deceive is likewise lacking. Where direct proof of falsity is lacking, intent to deceive cannot be presumed.

4

Firststar's reliance on the financial statement is also in serious dispute . Firststar's reaction to the financial statements it received in June 1988 was to refuse to renew Debtor's note, though it did forbear from collecting for a short period of time to allow Debtor to seek refinancing. Firststar also allowed Debtor to have a going-out-of-business sale . This chain of events indicates an extinguishment of the debtor/creditor relationship rather than an extension of credit . Firststar has offered no compelling evidence to support its allegation that Debtor surreptitiously dissipated assets during this time. Considering the totality of the circumstances, the Court concludes that Firststar's claim should not be excepted from discharge under § 523 (a) (2) (B) .

#### Explanation of Loss of Assets -- § 727 ( a ) ( 5 )

"The court shall grant the debtor a discharge, unless . . . the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities." 11 U.S.C. § 727 (a) (5). Firststar asserts that Debtor should be denied discharge because he has failed to sufficiently explain the reduction of inventory from \$72,000 in July 1988 to \$13,000 in September 1988 when Firststar took possession. To prevail on a § 727 (a) (5) claim, the creditor must prove that the debtor at one time owned identifiable assets and that the assets are no longer available to the debtor's creditors . ITT Commercial Finance Corp. v. Walz, 115 B.R. 353,

357 (Bankr. N.D. Fla.- 1990).

Once the plaintiff demonstrates a loss of assets, the burden of proof shifts to the debtor to explain the loss. If the debtor's explanation is too vague, indefinite, or unsatisfactory then the debtor is not entitled to a discharge. Debtor must also "explain his losses or deficiencies in such a manner as to convince the Court of good faith and businesslike conduct."

In re Schroff, 156 B.R. 250, 256 (Bankr. W.D. Mo. 1993) citations omitted). Debtor's explanation must be reasonable and credible, leaving the creditor no cause to wonder where the assets went. In re Farouki, 133 B.R. 769, 777 (Bankr. E.D. Va. 1991). Denial of discharge under § 727 (a) (5) is left to the sound discretion of the bankruptcy court. In re Suttles, 819 F.2d 764, 766 (7th Cir. 1987) (holding that grant of discharge was not abuse of discretion; bankruptcy court found that debtor's failure to keep satisfactory records was honest mistake).

A satisfactory explanation is one that induces a mental attitude of contentment in the court's evaluation of the debtor's explanation. In re Johnson, 80 B.R. 70, 75 (E.D. La. 1987). A lack of documentary evidence may justify denial of discharge.

Farouki, 113 B.R. at 777. However, the failure to produce corroborating documentation does not mandate denial of discharge where the debtor's testimonial explanation bears sufficient credibility. In re Drenckhahn, 77 B.R. 697, 710 (Bankr. D. Minn. 1987). The court should gauge debtor's credibility in light of all surrounding circumstances. In re Losinski, 80 B.R. 464, 470 (Bankr. D. Minn. 1987).

In ITT Commercial Finance, the creditor, like Firststar, complained under both § 523(a) (2) and § 727 (a) (5). The court stated:

On one hand, ITT complains that Walz fraudulently misrepresented the value of those assets in the 1987 statement and then turns around and argues that the assets were in fact there but have now been dissipated without satisfactory explanation. Based on the evidence presented, we are not satisfied . . . that Walz had assets with the values as set forth in the financial statements. Furthermore, we find the explanation given by Walz as to the diminution of his assets between 1987 and 1989 to be reasonable.

ITT Commercial Finance, 115 B.R. at 357.

Having considered the evidence and applied the appropriate legal principals, the Court concludes that Firststar has failed to establish its § 727 (a) (5) claim by a preponderance of the evidence. Firststar is in a position similar to the creditor in ITT Commercial Finance. First, Firststar has not satisfactorily proven that Debtor had a \$72,000 inventory in July 1988. The July 1988 statement upon which Firststar bases its calculations was prepared more than a year later for purposes of litigation. The evidence at trial provided a somewhat confusing explanation of Debtor's accounting of inventory for its separate wholesale and retail businesses as well as its method of accounting for "cash in transit". Firststar used different methods of calculation in concluding that inventory remains unaccounted for. The debtor's explanation of its methods of accounting in itself may

Further, Debtor has provided a sufficiently reasonable explanation for the disposition of most of the amount Firststar claims is missing. Debtor testified about several disbursements and offered documentation for most of them. Overall, his testimony appeared credible and is largely un rebutted by Firststar other than by mere allegations of misappropriation of funds. Under such circumstances, the Court must conclude that Debtor should not be denied a discharge under § 727 (a) (5).

**WHEREFORE**, Count I of Firststar's Complaint under § 523(a) (2) (B) for exception of its claim from discharge is DENIED.

**FURTHER**, count II of Firststar's Complaint under § 727 (a) (5) for denial of discharge is DENIED.

**FURTHER**, judgment is entered for Defendant/Debtor G. Scott Ovel and against Plaintiff Firststar Bank Cedar Rapids.

**SO ORDERED** this *28th* day of December, 1993.

----- PAUL J. KILBURG, Judge  
U.S. Bankruptcy Court

Copy (w/judgment)  
to Lynn Wickham Hartman, Tim White,  
Joseph Schmall, Peter C. Riley  
U.S. Trustee  
this December 29, 1993

Deputy Clerk, Bankruptcy Court PO Box 74890  
Cedar Rapids, IA 52407