In the United States Bankruptcy Court

for the Northern District of Iowa

DOUGLAS FLICKINGER *Debtor(s).*	Bankruptcy No. 98-02247-C Chapter 7
RICHARD NUNEMAKER EVELYN NUNEMAKER *Plaintiff(s)* vs. DOUGLAS FLICKINGER *Defendant(s)*	Adversary No. 98-9274-C

ORDER

This matter came before the undersigned on September 15, 1999 for trial. Plaintiffs Richard and Evelyn Nunemaker were represented by Attorney Mark Seidl. Defendant/Debtor Douglas Flickinger was represented by Attorney Todd Forsythe. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. §157(b)(I), (J).

STATEMENT OF THE CASE

Plaintiffs loaned Debtor $30,000 to purchase a bar business. They assert the debt is excepted from discharge for fraud or misrepresentation under §523(a)(2)(A). They also assert Debtor should be denied discharge under §727(a) for failing to explain loss of assets, fraudulently transferring business assets or failing to keep accurate records. Debtor denies any intent to defraud Plaintiffs. He asserts he is entitled to a discharge.

FINDINGS OF FACT

In December 1995, Debtor was considering purchasing a bar on 16th Street in Cedar Rapids. The bar he had previously owned and operated had recently closed. Debtor was dating Plaintiffs' daughter, Nancy, and they discussed operating the bar together with financing from Plaintiffs. Plaintiffs were initially approached by their daughter, Nancy. Subsequently, Debtor and Nancy jointly talked to Plaintiffs. Plaintiff Richard Nunemaker had worked with Debtor's father for many years and was a friend of Debtor's.

Plaintiffs loaned Debtor $30,000 (the "Loan") to allow Debtor to purchase what came to be known as Flick's Racing Bar (the "Bar"). The purchase of the Bar and the transfer of funds all occurred within 24 hours on December 12 or 13, 1995. The transfer occurred so quickly because it was allegedly represented by the seller that the offer was only good for 24 hours. The entire transaction between

Plaintiffs, Defendant, and Nancy Booher was oral. Based upon the evidence, it is fair to conclude that no extensive or in-depth discussions were held concerning the purchase of the business or the terms of the Loan. There were discussions that the Loan was to accrue interest at the rate of 9% per annum and was to be repaid from profits of the business. The parties never negotiated specific payment terms or an amortization schedule for the Loan, however, and none of the terms were ever reduced to writing.

The Bar opened for business on December 15, 1995. On December 22, 1995, Debtor filed articles of incorporation with the Iowa Secretary of State for D E & F, Inc. (the "Corporation"). He was the sole officer and shareholder of the Corporation. The Corporation owned and operated the Bar from December 22, 1995 until the Bar discontinued operations sometime in May 1998. Neither Debtor nor the Corporation made any payments to Plaintiffs on the Loan. Debtor filed for Chapter 7 relief on July 24, 1998

Plaintiff Richard Nunemaker testified there were no discussions about who would own the business. He testified that Debtor did not say anything about forming a corporation. There was some reference to Debtor making Plaintiffs silent partners. Mrs. Nunemaker testified, however, that it was her understanding that they loaned the money to the Corporation. Plaintiffs' Complaint alleges that they looked to the Corporation for repayment of the Loan. The Corporation is the sole defendant in Plaintiffs' state court law suit.

The purchase of the business included tables, booths, coolers, freezers, etc. Some of the money from Plaintiffs' loan went to purchase additional equipment and odds and ends. Nancy worked at the Bar without pay initially. She began receiving wages in May 1996. She testified that she thought the plan was for her to work at the Bar and that she would eventually become part-owner.

After some time without receiving payment from Debtor, Plaintiffs became impatient. When they presented Debtor with an amortization schedule for payments in March of 1996, Debtor gave them a check for five months of payments. They did not deposit the check, however, because they learned from Nancy that the check would not clear. The record is unclear whether this was correct. Subsequently, Plaintiffs spoke to Debtor about making payments and asked him to sign a promissory note. Debtor refused but said "Don't worry about it - I'm not going to take you." He had earlier assured Plaintiffs "You don't have to worry. We have your initials on the corporation." Ultimately, when no payment was forthcoming, Plaintiffs filed a State court law suit against the Corporation as the owner of the Bar.

In 1998, Plaintiffs attempted to buy the Bar from Debtor for $2,000 and settle what was owed. Debtor rejected their offer. He was apparently attempting to negotiate a sale to a third party. When those negotiations failed, he sold some of the business property for approximately $7,300. Debtor testified he used this money to pay corporate debts such as utility bills, insurance and rent. Other business property, i.e. tables, booths, kitchen equipment, etc., remained in the Bar when it closed. Debtor essentially abandoned the remainder to the landlord, from whom he originally purchased the Bar. The Bar ceased operations in mid-May, 1998.

The landlord called Plaintiffs and Nancy after the Bar closed to let them into the Bar to get whatever they wanted. Plaintiffs testified the Bar was stripped, electricity was turned off spoiling some food, and very little was left for them. Some corporate records were left on the premises. The landlord subsequently sold the business to a third party for approximately $21,000. It is currently operating under a different name.

Debtor testified he thought the Bar would be profitable and he intended to pay the debt to Plaintiffs out of business proceeds. Mrs. Nunemaker testified she believed Debtor intended, at the time of the loan, to repay them from business profits. She also felt that Debtor would be personally responsible for the debt if the business failed.

FRAUDULENT TRANSFERS (§727(A)(2))

Plaintiffs assert Debtor's discharge should be denied pursuant to §727(a)(2). Under this provision, a discharge will be denied if "the debtor, with the intent to hinder, delay, or defraud a creditor or an officer of the estate ... has transferred, removed, destroyed, mutilated, or concealed ... (A) property of the debtor, within one year before the date of the filing of the petition...." 11 U.S.C. §727(a)(2). Plaintiffs bear the burden of establishing by a preponderance of evidence that Debtor transferred his own property with the actual intent to hinder, delay, or defraud creditors. Lovell v. Mixon, 719 F.2d 1373, 1376 (8th Cir. 1983); In re Adams, 31 F.3d 389, 393-94 (6th Cir. 1994) (applying the preponderance of the evidence standard of Grogan v. Garner, 498 U.S. 279, 291 (1991), to §727), cert. denied, 513 U.S. 1111 (1995); In re Fischer, Adv. No. 96-5137-W, slip op. at 6 (Bankr. N.D. Iowa June 27, 1997).

The Court may utilize circumstantial evidence, often referred to as "badges of fraud," to determine if actual fraud occurred. In re Boughner, 173 B.R. 406, 410 (Bankr. S.D. Iowa 1994); Fischer, slip op. at 6. Specifically, the Court may look to: 1) the lack or inadequacy of consideration the debtor received; 2) whether the transfer was to a family member, friend, or other close associate of the debtor; 3) the debtor's retention of possession, benefits, or use of the property in question; 4) whether the debtor's financial condition significantly worsened after the transfer; 5) the imminency or pendency of a suit at the time of the transfer; and 6) the general chronology of events leading to the transfer. Boughner, 173 B.R. at 410.

Plaintiffs point to Debtor's transfer of property belonging to the Corporation as grounds to deny Debtor's discharge. Under Iowa law, corporate property belongs to the corporation, not to its shareholders. Sullivan Graphics, Inc. v. Board of Review, 533 N.W.2d 213, 214 (Iowa 1995). A court may not deny a discharge under §727(a)(2) based upon a transfer of corporate property by an individual debtor. See In re Thurman, 901 F.2d 839, 841 (10th Cir. 1990) (refusing to deny discharge where debtor caused corporation to transfer substantially all of its assets, rendering debtor's ownership interest in corporation worthless). This result applies even if a debtor acted with the actual intent to defraud the debtor's creditors. In re Cassis, 220 B.R. 979, 984 (Bankr. N.D. Iowa 1998); In re Magnani, 223 B.R. 177, 183 (Bankr. N.D. Iowa 1997).

Plaintiffs urge the Court to disregard the corporate form and treat the assets of the corporation as Debtor's assets. Iowa law provides that the corporate veil may be pierced, thereby rendering assets of the corporation available to creditors of a shareholder, under limited circumstances. Benson v. Richardson, 537 N.W.2d 748, 761-62 (Iowa 1995). Iowa law allows a court to disregard the corporate form when: 1) the corporation is undercapitalized; 2) the corporation lacks separate books; 3) the corporation's finances are not kept separate from individual finances, or the corporation pays individual obligations; 4) the corporation is used primarily to promote fraud or illegality; 5) the corporate formalities are not followed; or 6) the corporation is a mere sham. Benson, 537 N.W.2d at 761; National Automotive Trading Corp. v. Pioneer Trading Co., 46F.3d 842, 843-44 (8th Cir. 1995). The fact that the corporation has a single shareholder, however, is not alone sufficient for a court to disregard the corporate form. In re Murray's Marriage, 213 N.W.2d 657, 660 (Iowa 1973). The record does not support a finding that the business assets were the personal property of Debtor. The Court finds that all transfers were of property belonging to the Corporation.

Plaintiffs urge the Court to disregard the corporate form and treat the transfer of the Corporation's property as a transfer of Debtor's property. In support of this position, Plaintiffs assert that the Corporation is a sham and undercapitalized. The record does not support such a conclusion. Aside from Debtor's sole ownership of the Corporation, Plaintiffs have not established any basis to justify piercing the corporate veil. There is no evidence that Debtor used the corporate form to shield assets from creditors or to otherwise perpetrate a fraud. The record is inadequate to allow the Court to disregard the corporate form on the grounds of abuse.

Similarly, there is no evidence to conclude that the Corporation was a sham. The Corporation was established with a valid purpose - to acquire and operate the Bar. The Corporation conducted that business for two and one-half years. Because Debtor established the Corporation for a valid purpose, it can not be considered a sham corporation. See 18 C.J.S. Corporations §9, n.1 (1990) ("[o]nly those corporations that were established with no valid purpose are considered sham corporations").

Plaintiffs have not proven that the Corporation was undercapitalized. While never a financial success, the Bar operated actively for approximately two and one-half years. Debtor contributed $2,000 to the formation of the corporation. The Bar's eventual failure is the only indication that Debtor's capital contribution was insufficient for the type of business the Corporation was to conduct. The failure of a business soon after commencement may support a finding of undercapitalization. When a business operates for two and one-half years, however, the failure is not sufficient by itself to support a finding of undercapitalization.

There was a suggestion at trial that the Debtor did not receive adequate consideration for the property transferred as grounds for fraud under §727(a)(2). Because of this Court's determination that the property belonged to the Corporation rather than Debtor, issues concerning fraud are irrelevant. Even so, aside from the allegation of inadequate consideration, the record contains no evidence indicating actual fraud. Debtor sold business assets and used a significant portion of the proceeds therefrom to pay liabilities of the business. The record as a whole, even if Debtor received inadequate consideration for business assets, does not support a finding of actual intent to hinder, delay, or defraud Debtor's creditors.

Plaintiffs argue that Debtor's preference of other creditors indicates the actual fraud necessary to deny Debtor's discharge under §727(a)(2). Preferential treatment of creditors without more, however, does not establish the actual fraud necessary to deny a discharge under §727(a)(2). In re Miller, 39 F.3d 301, 307 (11th Cir. 1994). Even assuming Debtor preferred other creditors over Plaintiffs, that preference is not sufficient grounds for the Court to deny Debtor's discharge under §727(a)(2).

In summary, Plaintiffs have failed to carry their burden of proof under §727(a)(2). The property Debtor transferred when the Bar went out of business belonged to the Corporation. No basis exists to pierce the corporate veil and treat these transfers as transfers of Debtor's property. Even if the Court were to conclude that Debtor transferred his own property, there is insufficient evidence to conclude that these transfers were made with fraudulent intent.

DEFICIENT RECORDS (§727(A)(3))

Plaintiffs urge the Court to deny Debtor's discharge for failing to keep adequate records. The Court may deny a debtor's discharge if the debtor has:

> concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's

> financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case....

11 U.S.C. §727(a)(3). The purpose of this provision is to allow creditors and the trustee to form a picture of the debtor's financial landscape and track the debtor's assets for a reasonable period of time before bankruptcy. In re Caulfield, 192 B.R. 808, 822 (Bankr. E.D.N.Y. 1996); In re Juzwiak, 89 F.3d 424, 427 (7th Cir. 1996); In re Mathern, 137 B.R. 311, 317 (Bankr. D. Minn.), aff'd, 141 B.R. 667 (D. Minn. 1992).

The initial burden of proof under §727(a)(3) is on the objecting party to establish that the debtor's records are inadequate. In re Pulos, 168 B.R. 682, 690 (Bankr. D. Minn. 1994). Once the objecting party meets this burden, the debtor must go forward and establish that the inadequacy of the records is justified. Id. Records are adequate if they identify the parties to major transfers of the debtor's property, address distributions from a debtor's business, and identify major sources of the debtor's income. Pulos, 168 B.R. at 691-92; Juzwiak, 89 F.3d at 426-27. A determination of adequacy, however, is made on a case-by-case basis. Mathern, 137 B.R. at 317; In re Page, Adv. No. 98-9013S, slip op. at 26 (Bankr. N.D. Iowa June 1, 1999).

Once an objecting party establishes a prima facie case, the court must make an objective determination of whether the deficiencies in the debtor's records are justified. Pulos, 168 B.R. at 692. The debtor has a duty to preserve the records that those who are similarly situated would preserve. Id. When determining if a debtor's deficient record-keeping is justified, courts look to the sophistication of the debtor, and the character of the business that the debtor conducted. Caulfield, 192 B.R. at 823; compare Juzwiak, 89 F.3d at 426-27 (denying discharge where debtor had six years industry experience); andPulos, 168 B.R. at 692 (holding debtors to higher standard based on above-average sophistication); with Page, slip op. at 26 (granting discharge where business was informal and debtors had not post-high school training); and In re Wood, Adv. No. 95-4086XM, slip op. at 13-14 (Bankr. N.D. Iowa Sept. 20, 1996) (granting discharge where debtors operated "penny ante" business).

A debtor's records are inadequate if they consist of unorganized "mounds" of documents. Mathern, 137 B.R. at 317. The debtor must provide some type of organization that is sufficient to reasonably guide creditors through the records. Id. A debtor may rectify any inadequacy of the debtor's records by supplementing them at any time before the conclusion of the trial on the §727(a)(3) complaint. Id.at 317-18. The business records of a non-debtor entity are only relevant to a debtor's discharge to the extent necessary to determine the debtor's prepetition financial condition. Magnani, 223 B.R. at 183 (court may deny debtor's discharge for inadequate corporate or partnership records when those records are necessary to determine debtor's financial condition). In this case, Debtor is an individual, employed by the Corporation, and its sole office and shareholder. Whether Debtor kept adequate records for the Corporation is relevant to the extent that any inadequacy affects Plaintiffs' ability to determine Debtor's finances.

Debtor's records are adequate. The records reveal his capital contributions to the Corporation. (Plaintiffs' Exs. 2, 5). He has provided information regarding his salary from the Corporation, his ownership interest in the corporation, his credit applications, and his payment of debts for a reasonable period preceding his petition for relief. These records are sufficient to give Plaintiffs a reasonably clear picture of Debtor's finances. Plaintiffs testified at some length concerning the corporate records left at the business location. However, any deficiency in the Corporation's records does not impair Plaintiffs' ability to reasonably determine Debtor's prepetition financial condition. Plaintiffs have not identified any particular deficiency in Debtor's personal records. Because these records appear adequate and Plaintiffs have not delineated any particular deficiencies, the Plaintiffs have failed to establish a prima facie case under §727(a)(3).

LOSS OF ASSETS (§727(A)(5))

Plaintiffs urge the Court to deny Debtor's discharge for failure to adequately explain the loss of an asset. The Court may deny a debtor's discharge if the debtor fails to "explain satisfactorily, before determination of denial of discharge ... any loss of assets ...." 11 U.S.C. §727(a)(5). Under §727(a)(5), the creditor bears the initial burden of establishing that the debtor no longer has assets that the debtor once owned. Caulfield, 192 B.R. at 821; In re Gearhart, Adv. No. 93-1184KC93, slip op. at 2 (Bankr. N.D. Iowa June 17, 1994).

Once a creditor establishes a loss of assets, the debtor bears the burden of explaining the loss "to the court's satisfaction." In re Bernstein, 78 B.R. 619, 623 (S.D. Fla. 1987); see also Fischer, slip op. at 6. An explanation is sufficient if it is "credible and believable" and does not "arouse suspicion that the facts are other than those presented by the debtor." Bernstein, 78 B.R. at 623.

While Plaintiffs have introduced substantial evidence regarding assets the Corporation once owned, they have failed to meet their initial burden of establishing that Debtor owned assets that have now disappeared. Section727(a)(5) requires Plaintiffs to show that Debtor once owned an asset that is now lost. For reasons already discussed, the Court will not treat the Corporation's assets as Debtor's assets. Therefore, Plaintiffs have not made a prima facie case under §727(a)(5).

Even if Plaintiffs had established a prima facie case under §727(a)(5), Debtor adequately explained the loss of the assets in question. There is substantial evidence indicating that the Corporation sold the assets at issue and used the proceeds therefrom to pay corporate debt. This explanation is satisfactory under §727(a).

NONDISCHARGEABILITY OF PLAINTIFFS' CLAIM (§523(A)(2)(A))

Plaintiffs ask the Court to declare Debtor's obligation to them nondischargeable pursuant to §523(a)(2)(A). A court may declare an individual debt nondischargeable if the debtor incurred the debt for money obtained through "false pretenses, a false representation, or actual fraud, other than a debtor's statement respecting the debtor's or an insider's financial condition...." 11 U.S.C. 523(a)(2)(A). The Court must construe this exception narrowly against the creditor and liberally in favor of the debtor. In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987). Under §523(a), the creditor bears the burden of establishing the elements of nondischargeability by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 283 (1991).

To establish that a debt is nondischargeable under §523(a)(2)(A), the creditor must show that:

(1) the debtor made false representations;
(2) at the time made, the debtor know them to be false;
(3) the representations were made with the intention and purpose of deceiving the creditor;
(4) the creditor justifiably relied on the representations; and
(5) the creditor sustained the alleged injury as a proximate result of the representations having been made.

Van Horne, 823 F.2d at 1287 (as modified by Field v. Mans, 516 U.S. 59, 74-75 (1995)); In re Schlitter, Adv. No. 98-9072-D, slip op. at 3 (Bankr. N.D. Iowa May 14, 1999).

A statement regarding future performance, such as the payment of an obligation, is only fraudulent if the party making the statement did not intend to perform when he made the statement. In re Hyman, 219 B.R. 699, 702 (Bankr. D.S.C. 1998). A debtor's failure to make any payments on an obligation is insufficient by itself to allow the Court to infer that the debtor did not intend to repay the obligation at the time the debtor incurred the obligation. Id.

An affirmative statement is not necessary to establish fraud under §523(a)(2). A court may find fraud through silence if the debtor knows that the creditor is making a loan relying on a misconception and the debtor does nothing to correct that misconception. See Van Horne, 823 F.2d at 1288; In re Moen, 238 B.R. 785, 791 (B.A.P. 8th Cir. 1999).

Plaintiffs allege that Debtor made two fraudulent representations. First, Plaintiffs claim Debtor represented that the Corporation would assume liability for the Loan. (Complaint, Adv. No. 98-9275-C at 2). Second, Plaintiffs claim Debtor represented that they would be equal shareholders with him in the Corporation. Id. At trial, Plaintiffs failed to establish that Debtor made these assertions. Even if Debtor made these assertions, Plaintiffs failed to show that they justifiably relied on the statements or that this reliance proximately caused damage to them.

Plaintiffs assert Debtor's promise that the corporation would pay them in full was fraudulent. They base this assertion on the fact that the Corporation did not repay the Loan. Plaintiffs argue that this alleged fraud renders Debtor's liability for the Loan nondischargeable under §523(a)(2)(A). This argument proves too much. Plaintiffs' position, if accepted, would render all debts nondischargeable because there is an implicit assumption in every loan that the borrower will repay the obligation. As other courts have held, a promise of future payment is only fraudulent if the debtor made the promise with a present intention never to repay the obligation. Debtor's failure to make payments on the obligation, without more, is insufficient to allow the Court to infer that Debtor did not intend to pay the obligation at the time he incurred it. In fact, Mrs. Nunemaker testified that she felt Debtor intended to repay the loan at the time the loan was made. As there is no other evidence in the record to indicate Debtor did not intend that the Corporation repay the Loan at the time he asserted as much to Plaintiffs, Plaintiffs have failed to establish that this representation was fraudulent.

Plaintiffs' second contention is that Debtor misrepresented that he would make Plaintiffs equity owners in the Corporation. The record does not support a finding that Debtor made this representation. Debtor is listed as the sole shareholder of the corporation on the articles of incorporation Debtor filed with the Iowa Secretary of State on December 22, 1995. Plaintiffs never received any evidence of ownership in the Corporation. Had Debtor actually made this representation, and had Plaintiffs actually relied on the representation, it is fair to conclude that they would have acted promptly to correct this problem. Plaintiffs allowed three years to pass before objecting to the Corporation's ownership structure. Based on the circumstances, the Court must conclude that Debtor never made the representation or, alternatively, Plaintiffs did not rely on it, if in fact it was made.

CONCLUSION

Plaintiffs have failed to carry their burden of proof on their §727(a)(2), (3) and (5) complaint. There is no evidence to support the conclusion that Debtor transferred any personally-owned property. The circumstances of this case do not allow the Court to pierce the corporate veil and treat the Corporation's property as Debtor's property. Consequently, Plaintiffs have failed to make a prima facie case under §727(a)(2). The record indicates that Debtor kept sufficient records under the circumstances to give his creditors and the trustee a reasonable picture of his finances, as required by §727(a)(3). Debtor has satisfactorily explained the disposition of assets under §727(a)(5).

Plaintiffs have similarly failed to carry their burden of establishing the necessary elements to prevail under §523(a)(2)(A). Plaintiffs have failed to identify any fraudulent statement Debtor made that Plaintiffs relied on which proximately caused them harm.

WHEREFORE, for all of the reasons set forth herein, Plaintiffs' Complaints are DENIED.

FURTHER, the obligation owed by Debtor to Plaintiffs Richard and Evelyn Nunemaker is dischargeable.

FURTHER, Plaintiffs have failed to prove that Debtor's discharge should be denied under §727(a).

FURTHER, Plaintiffs have failed to establish that the obligation should be excepted from discharge under §523.

SO ORDERED this 20th day of October, 1999.

Paul J. Kilburg
Chief Bankruptcy Judge