

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE**

In re:

Bk. No. 03-10496-JMD
Chapter 7

Scott T. Fagnant,
Debtor

Cohen Steel Supply, Inc.,
Plaintiff

v.

Adv. No. 03-01348-JMD

Scott T. Fagnant,
Defendant

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MEMORANDUM OPINION

I. INTRODUCTION

Scott Fagnant (the “Debtor”) filed his petition under chapter 7 of the Bankruptcy Code¹ on February 19, 2003. Cohen Steel Supply, Inc. (the “Plaintiff”), brought suit against the Debtor in five counts seeking to deny the Debtor his discharge under 11 U.S.C. § 727 and one count, under section 523, seeking to deny the dischargeability of the debt owed to it (the “Complaint”). In count I of the Complaint, the Plaintiff seeks to deny the Debtor’s discharge under section

¹ In this opinion, the words “Bankruptcy Code” or “Code” shall mean Title 11 of the United States Code and, unless otherwise indicated, all references to “section” or “§” refer to the Code.

727(a)(3) for failure to keep adequate records. In Counts II, III, and IV, the Plaintiff seeks to deny the Debtor's discharge under section 727(a)(4)(A) for making false statements in connection with his bankruptcy case. In Count V, the Plaintiff seeks to deny the Debtor's discharge under section 727(a)(2)(A) for the Debtor's fraudulent transfer and concealment of assets. In Count VI, the Plaintiff seeks a determination that a sum of money owed to it, plus costs and fees, is nondischargeable under section 523(a)(2)(A). The Court held a two-day evidentiary hearing on the Complaint. At the close of the hearing, the Plaintiff withdrew its complaint under Counts II through V, leaving only Counts I and VI, which the Court took under advisement.

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

A. Debtor's Employment and His Debt to the Plaintiff

The parties had a long-standing business relationship. The Debtor is a steel fabricator who operated a welding business known as Scott's Welding, Inc. ("Welding"). Welding purchased supplies from the Plaintiff on a regular basis since the 1990s. In early 2001, Welding's orders increased dramatically but its payments did not keep pace. When the outstanding indebtedness reached \$53,000, in lieu of pursuing collection actions, the Plaintiff allowed the Debtor to personally guarantee a note (the "Note"). The Note was signed on August 31, 2001.

Debtor made payments on the Note but the payments were always late. In late 2001, the Debtor's business volume declined. In early 2002, Debtor closed Welding and began operating through a new business entity, New England Steel Design, Inc. ("Steel"). Steel was formed by the Debtor and two partners. The Debtor was a minority shareholder and president of the corporation. Welding's equipment was relocated to Steels' new site, and its accounts receivable were deposited into the Steel account and used to pay Welding's outstanding bills. The Debtor also testified that, at some point during his ownership of Welding, he built custom motorcycles under the d/b/a of Scott's Cycles ("Cycles"). He was doing this work essentially as a sole proprietor, although there were deposits into and out of Welding's accounts for work related to Cycles.

In the spring of 2002, the Debtor left Steel, taking the equipment he brought into the venture with him. On June 20, 2002, the Plaintiff obtained an attachment on the Debtor's bank account and equipment and took possession of much of the equipment. Within weeks of leaving Steel, sometime during the summer of 2002, the Debtor became a salaried employee of another company in which he had no ownership interest. His bankruptcy Schedules indicate his new employer paid him \$9,683.60 per month. The Debtor filed his bankruptcy petition on February 19, 2005.

B. Debtor's Record Keeping

While the Debtor was running Welding, he employed an office manager who did the bookkeeping for the company. From 1998 through 2001, his bookkeeper used a computerized system to record business transactions. Before leaving the company, in the fall of 2001, the bookkeeper trained the Debtor's fiancé, who then took responsibility for the computerized bookkeeping system. The Debtor produced computer-generated reports on Welding for any

period until it ceased operations and most of Welding's paper records.² However, there were irregularities in the characterization of some transactions and in the Debtor's personal use of company funds. Furthermore, there was no documentation of the transactions between Welding and Steel which would support a determination of whether Welding's equipment and accounts receivable were a contribution of capital to Steel or a loan to Steel from Welding or the Debtor. Additionally, there was no documentation of the transfer of assets to the Debtor when he left Steel, and the Debtor has not accounted for these assets or their proceeds.

The Debtor also supplied records from his personal bank account. The records showed regular deposits and withdrawals from the account for the time period during which he was the owner of Welding. After he left Welding, however, the use of the account declined precipitously. Beginning in July 2002, all activity in the account ceased. The Debtor testified that he stopped using his bank account after the Plaintiff got its attachment. Additionally, his bankruptcy petition indicates that, as of the petition date and for six months prior to filing, he was being paid nearly \$10,000 per month. However, the Debtor did not provide any documentation of his employment or the amount he was being paid. Furthermore, he did not provide any receipts or other paperwork to indicate how his income was being spent from July 2002 onward.

III. DISCUSSION

The Plaintiff challenges the Debtor's discharge under section 727(a)(3) and the discharge of the Debtor's obligations to it under section 523(a)(2)(A).

² The Debtor testified that some of the paper records were misplaced during the move to Steel.

The First Circuit has held that “[e]xceptions to discharge are narrowly construed in furtherance of the Bankruptcy Code’s fresh start policy.” In re: Schifano, 378 F.3d 60, 66 (1st Cir. 2004) (quoting Palmacci v. Umpierrez (In re: Umpierrez), 1121 F.3d 781, 786 (1st Cir. 1997)). Nonetheless, the First Circuit has noted that “the very purpose of certain sections of the law, like section 727(a)(2), is to make certain that those who seek the shelter of the Bankruptcy Code do not play fast and loose with their assets or with the reality of their affairs.” Id. (internal citations omitted).

A. Count I: Denial of Discharge Under Section 727(a)(3)

The Debtor may be denied a discharge under section 727(a)(3) of the Bankruptcy Code if the Plaintiff can prove, by a preponderance of the evidence, that either:

1. The debtor failed to keep or preserve recorded information, including books, documents, records, and papers, and that by failing to keep or preserve such books, documents, records, and papers, it is impossible to ascertain the financial condition or material business transactions of the debtor; or
2. The debtor destroyed, mutilated, falsified, or concealed recorded information including books, documents, records, and papers, and that by destroying, mutilating, falsifying, or concealing such books, documents, records, and papers, it is impossible to ascertain the financial condition or material business transactions of the debtor.

See 11 U.S.C. § 727(a)(3). The Plaintiff did not make any allegations the Debtor “destroyed, mutilate, falsified, or concealed” any documents, records, or papers. Accordingly, the Plaintiff bases its objection to discharge on the Debtor’s failure to keep adequate written records of business and personal transactions.

Under the Bankruptcy Code, the failure to keep the records of a business entity that is an insider to a debtor, and which has also filed for bankruptcy protection within a year, can be grounds for denial of discharge. 11 U.S.C. § 727(a)(7). Section 727(a)(2) could have been made

to apply to the Debtor's corporate record keeping in this case because "the terms of § 727(a)(7) . . . prohibit[] a debtor from committing an act proscribed under § 727(a)(2) in connection with the bankruptcy case 'concerning and insider.'"³ Groman v. Watman (In re Watman), 301 F.3d 3, 8 (1st Cir. 2002) (quoting 11 U.S.C. § 727(a)(7)). In this case, the Plaintiff did not raise section 727(a)(7) in its pleadings or argue it at the hearing, and the Plaintiff has not amended its Complaint to assert section 727(a)(7) as grounds for denial of discharge.⁴ Nonetheless, because the parties presented evidence about the Debtor's business record keeping, the Court will discuss this evidence without deciding the case under section 727(a)(7).

When a debtor's right to discharge is challenged under section 727(a)(3), the objecting party has the initial burden to establish that the debtor's records are inadequate for determining the financial affairs or business transactions of the debtor. See McGowan v. Beausoleil (In re Beausoleil), 142 B.R. 31, 37 (Bankr. D.R.I. 1992); American Motor Leasing Corp. v. Morando (In re Morando), 116 B.R. 14, 15 (Bankr. D. Mass. 1990). Once the objecting party has met its initial burden, the burden shifts to the debtor to establish either that the debtor maintained adequate books and records from which his financial condition can be ascertained or that the failure to keep adequate books and records can be justified under the circumstances. See

³ Where the debtor is an individual, the term "insider" is defined to include a "corporation of which the debtor is a director, officer, or person in control." 11 U.S.C. § 101(31)(A)(iv). The application of section 727(a)(7) has been explained as follows:

Section 727(a)(7) extends the basis for denial of discharge to the debtor's misconduct in an substantially contemporaneous related bankruptcy case. Thus if the debtor engages in objectionable conduct in a case involving [an insider], the debtor may be denied a discharge in the debtor's own case.

King et al., Collier on Bankruptcy ¶ 727.10 (15th rev. ed. 1998).

⁴ It still may be possible to amend the Complaint, see Fed. R. of Civ. P. 15, but it is unnecessary because, for the reasons stated in this opinion, the Debtor will be denied a discharge under section 727(a)(3).

Beausoleil, 142 B.R. at 37; Morando, 116 B.R. at 15. “Whether a failure to keep records, total or partial, will be justified is a question of fact to be determined in each instance under the particular circumstances of the case. . . . In short, what is required is records that are ‘reasonable under the circumstances.’” Harman v. Brown (In re Brown), 56 B.R. 63, 66 (Bankr. D.N.H. 1985). Furthermore, “[b]ecause the standard for a claim of failure to maintain records is based on ‘reasonableness under all circumstances,’ the education and sophistication of the Debtor is relevant.” In re Schifano, 378 F.3d 60, 68 (1st Cir. 2004). “It is sufficient if the books and records are kept, if required at all, so as to reflect with a fair degree of accuracy, the debtor’s financial condition and in a manner appropriate to his business.” In re Brown at 67. The Court has wide discretion in determining whether the books and records produced by debtors are sufficient to meet the requirements of section 727(a)(3). See id. at 66; Morando, 116 B.R. at 15. Doubts as to the adequacy of the records should be resolved in favor of the honest debtor. See Workman v. Ridley (In re Ridley), 115 B.R. 731, 733 (Bankr. D. Mass. 1990). However, a creditor need only show that a debtor’s failure to maintain sufficient records was unreasonable, and the “failure to maintain an bank account by an individual involved in many transactions of extensive character raises serious doubt about the truthfulness of [a] [d]ebtor’s purported financial status.” In re Schifano, 378 F.3d at 69.

The Plaintiff alleges the Debtor’s records are unreasonable under the circumstances because, for the eight months prior to filing bankruptcy, the Debtor did not use a bank account or maintain other financial records. The Plaintiff cited the confusion about how the income related to a custom-built motorcycle was classified as another example of the Debtor neglecting to keep adequate records of his personal financial affairs. Finally, the Plaintiff argued the Debtor’s records are inadequate because the Debtor moved the assets of Welding to Steel without

documentation or consideration and then took personal possession of them, again without documentation, upon leaving Steel. The Plaintiff alleges these failures made it impossible for the Plaintiff to accurately determine the Debtor's financial condition at the time the Debtor filed his bankruptcy petition. The Debtor maintains he kept adequate records for the various periods of time addressed in the Complaint.

The evidence presented at the trial focused on the Debtor's record keeping during three distinct time periods: namely the period of time the Debtor was (1) running Welding, (2) involved with Steel, and (3) working as an employee of a company in which he had no ownership interest.

1. Prior to the Shut Down of Scott's Welding, Inc.

The Debtor provided computer-generated reports regarding his business records and statements from his personal bank account for this period. Although the Plaintiff's expert witness stated there were some irregular bookkeeping techniques, such as how the proceeds for the custom-built motorcycle were classified, he also testified that all records were reflected in the general ledger and there was no evidence of missing documents. Furthermore, the Debtor provided his 2001 tax returns, and there was enough activity in his personal bank account to be able to determine the Debtor's general, personal financial status during this period. Therefore, the Court finds the Debtor's record keeping, prior to his involvement with Steel, was reasonable under the circumstances.

2. During Involvement with New England Steel Design, Inc.

The Debtor's record keeping during his involvement with Steel is spottier. The Debtor provided bills of sale for two items he sold personally, copies of several personal checks, and personal bank statements showing some activity, although it was significantly diminished from

the prior period. He also produced computer reports of Welding's business activity during this period. Nonetheless, the evidence indicates there may have been commingling of assets or conversions of business assets to personal assets. For example, the Debtor failed to offer any explanation as to why there was no documentation of the transfers of Welding's assets into and out of Steel other than that he was a key person in both operations and he had the intention of paying Welding's debts from Steel. This explanation is insufficient regarding the transfer into Steel and fails entirely to address the transfer of assets out of Steel to the Debtor personally.

The Debtor has significant business experience, as evidenced by his involvement in numerous, extensive business ventures over more than twenty years. Furthermore, there is other documentation from this time period, such as a Stock Purchase and Sales Agreements, that indicate the Debtor had significant business sophistication. Therefore, the Court finds the Plaintiff has established that the Debtor failed to keep adequate records of the transfer of assets to him during his involvement with Steel and at the time he terminated that involvement.

3. Personal Records After Involvement with New England Steel Design, Inc.

During this period, the Debtor did not use his bank account, and he provided no receipts or other documentation of either his income or expenditures. Furthermore, the Debtor testified that there were no records from which his personal financial condition or business records could be ascertained for the eight months prior to his filing.⁵ For this reason, the Plaintiff met its burden of establishing that the Debtor's records are inadequate for determining his financial affairs or business transactions during the eight month period preceding the filing of his bankruptcy petition.

⁵ The Plaintiff's expert corroborated this assessment.

4. Justification for Failure to Maintain Adequate Records

Because the Plaintiff established that the Debtor failed to maintain adequate records during two of the time periods, the burden of going forward with evidence that adequate books and records were maintained or that the failure to do so was justified under the circumstances shifts to the Debtor. Schifano, 378 F.3d at 70. “The issue of justification depends largely on what a normal, reasonable person would do under similar circumstances.” Meridian Bank v. Alten, 958 F.2d 1226, 1231 (3d Cir. 1992). When an individual chooses to function on a cash-only basis, the individual will face a higher burden in bankruptcy. In re Schifano, 378 F.3d at 70. As is the case generally in bankruptcy, debtors must provide sufficient records to ascertain the amount of their income, the nature of their expenses, the extent of their assets, and the use of the proceeds of their assets. For a debtor with nominal assets, receipts for rent paid, W2s, and tax returns showing standard deductions may be enough. However, more will be required from a debtor who has substantial material assets or is personally involved in business affairs. Goff v. Russell Co., 485 F.2d 199, 201-02 (5th Cir. 1974) (“Obviously an unsophisticated wage earner dealing primarily in cash should not be denied a discharge because he failed to keep books of account. A higher standard of care is required, however, for a merchant actively engaged in credit transactions.”).

The Debtor’s only justification for the absence of records for the eight months prior to filing was that he stopped using his bank account when the Plaintiff obtained its attachment. While avoidance of loss of funds to a judicial attachment might justify the failure to use a bank account, it does not provide justification for failure to maintain records. Alten, 958 F.2d at 1234 (“Fear of liens by creditors can never by itself constitute adequate justification for a failing to candidly disclose the financial status of a debtor.”). The Debtor operated a business for more

than twenty years prior to filing his bankruptcy petition. The Debtor's general knowledge of record keeping protocol is indicated by the fact that, when he was operating his business, the Debtor maintained adequate records, including retaining annotated, dated cash receipts. Additionally, the Debtor's Schedules indicate that, at the time of filing, he received a substantial monthly income, nearly \$10,000 per month, and owned personal property valued in excess of \$30,000. Therefore, the Debtor was an individual who had substantial material assets, a substantial income, and experience in business affairs.

Even a reasonable person without prior, business-ownership experience would realize that keeping receipts for major cash transactions is a reasonable thing to do, if for no other reason than to later be able to prove to creditors that payments were made. This is all the more true for an individual who must account for nearly \$10,000 per month. However, the Debtor—a sophisticated, past-business owner who knew or should have known the value of maintaining records—was unable to provide any records of income or expenditures for the eight months prior to filing or offer a legally sufficient explanation why he failed to do so. The Court finds the Debtor's explanations for his failure to maintain records or to justify why there were none was inadequate.

The policy underlying section 727(a)(3) is to restrict a discharge in bankruptcy to debtors who provide a full and complete disclosure of their financial condition. In this case, a full and complete disclosure of the Debtor's financial condition is impossible because the Debtor failed to maintain adequate financial records for eight months to a year prior to the filing of his bankruptcy petition. The Debtor was unable to justify this failure. Accordingly, the Court finds for the Plaintiff on Count I and the Debtor shall be denied a discharge under 11 U.S.C. § 727(a)(3).

B. Claim VI: Nondischargeability of a Debt Under Section 523(a)(2)(A)

Plaintiff also brought a claim under section 523(a)(2)(A), seeking to deny the dischargeability of its debt. In light of the denial of discharge under 11 U.S.C. § 727(a)(3), Count VI of the Plaintiff's complaint is moot.

IV. CONCLUSION

For the reasons outlined above, the Court denies the Debtor a discharge pursuant to 11 U.S.C. § 727(a)(3). This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. The Court will issue a separate judgment consistent with this opinion.

ENTERED at Manchester, New Hampshire.

Date: April 14, 2005

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge