IN THE UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF ARKANSAS
JONESBORO DIVISION

IN RE: ROY LESTER TAINTER, JR. AND KELLI MAY TAINTER, Debtors.

CASE NO. 99-31381M
CHAPTER 7

KEN SHORT; SHORT STOP, INC. PLAINTIFF

VS. AP NO. 00-3008

ROY LESTER TAINTER, JR. DEFENDANT

MEMORANDUM OPINION

This matter comes before the Court upon the complaint of Ken Short and Short Stop, Inc. ("Plaintiffs") to have the debt of Roy Tainter ("Debtor") declared nondischargeable pursuant to section 523 of title eleven of the United States Code. The issue to be determined is whether the Debtor committed fraud in connection with indebtedness arising out of Plaintiff's sale of a convenience store business to the Debtor. A trial before the Court took place on October 30, 2000, in Jonesboro, Arkansas, and the matter was taken under advisement. For the reasons stated below the debt is determined to be dischargeable.

The following shall constitute the Court's findings of fact and conclusions of law required by Federal Rule of Bankruptcy Procedure 7052. This matter is a core proceeding in accordance with 28 U.S.C. § 157(b)(2)(I), and this Court has jurisdiction to enter a final judgment pursuant to 28 U.S.C. § 1334 and 28 U.S.C. § 157.

I.

In approximately October 1996, Plaintiff was the owner and operator of a convenience store in Jonesboro, Arkansas, called the Short Stop. The Debtor was an employee working in the store. Throughout late August and the month of September 1996, Plaintiff and the Debtor had several discussions regarding the sale of the business to the Debtor, and eventually the parties reached an agreement concerning the terms of the sale.

The agreement was entirely oral. The Debtor agreed to purchase assets, including inventory, accounts receivable, and goodwill, for a total purchase price of $75,000.00. Plaintiff owned the land and the building used in connection with the business, but these items were not part of the transaction. Plaintiff testified that he and the Debtor agreed that the Debtor would maintain inventory at the October 1996 levels existing when the sale occurred.

The Debtor also agreed to lease the building including fixtures and equipment for an amount not precisely shown by the record. The Debtor borrowed the sum of $80,000.00 from Mid-South Bank of Jonesboro to pay the $75,000.00 purchase price and to supply $5000.00 in initial operating costs. The Plaintiff negotiated the loan with Mid-South Bank and personally guaranteed repayment.

Approximately six months after the transaction, Plaintiff requested that the Debtor furnish Plaintiff with monthly operating statements. These statements generally itemized assets and liabilities according to Plaintiff's instructions and included fuel inventory but not inventories of food and other items sold inside the store.

At trial, Plaintiff stated that the reports in late 1998 and early 1999 did not reflect "an insolvency position of the business." (Tr. at 87.) However, Plaintiff testified that he became aware that Debtor had accumulated a significant unpaid fuel bill owed to Matthews Oil. In April 1999, Debtor asked Plaintiff for financial help in purchasing some additional fuel. On May 6, 1999, the Debtor advised Plaintiff that "the end is here," (Tr. at 93) and that he was going to abandon the business to Plaintiff, which he did.[1]

Plaintiff testified that as a result of the Debtor's abandonment of the business, Plaintiff was required to honor his guarantee to the bank in the sum of $72,762.48. Plaintiff stated that when he resumed operation of the business, he spent $26,461.75 to replenish depleted fuel and inside inventories and that he also spent approximately $3000.00 to pay for deferred cleaning and repairs and delinquent payroll, vendor, and utility expenses. The Plaintiff argues that he relied to his detriment on Debtor's intentional misrepresentations as to the solvency of the Debtor and the business during the period when Debtor operated the Short Stop.

II.

The United States Bankruptcy Code excepts from a chapter 7 discharge those debts incurred by false pretenses, a false representation, or actual fraud, 11 U.S.C. §

[1]Debtor was probably under no obligation to return any of the tangible assets to Plaintiff because Plaintiff had not obtained a lien to secure his contingent debt.

523(a)(2)(A)(1994). The party seeking a finding of nondischargeability of a debt must establish the elements of this subsection by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291 (1991). Exceptions to discharge are narrowly construed against the creditor and in favor of the debtor. Long v. Donley (In re Donley), 115 B.R. 502, 503 (Bankr. E.D. Pa. 1990) (citing Koltman v. Hammill (In re Hammill), 61 B.R. 555 (Bankr. E.D. Pa. 1986)).

To succeed in a section 523(a)(2)(A) claim for actual fraud, a creditor must prove the five common law elements of fraud. These include (1) the debtor made a false representation or pretense; (2) the debtor knew the representation was false when it was made or acted with reckless disregard as to its veracity; (3) the debtor intended to deceive the creditor or to induce him to act upon the representation; (4) the creditor relied upon the representation; and (5) the creditor sustained the alleged loss and damage as a proximate result of the representation. Thul v. Ophaug (In re Ophaug), 827 F.2d 340, 342 n.1 (8th Cir. 1987); Caspars v. Van Horne (In re Van Horne), 823 F.2d 1285, 1287 (8th Cir. 1987); 4 Collier on Bankruptcy ¶ 523.08[1][e] (Lawrence P. King et al. eds., 15th ed. rev.2000). The creditor may establish fraudulent intent through circumstantial evidence. Eastern Food Serv., Inc. v. Leger (In re Leger), 34 B.R. 873, 877 (Bankr. D.Mass. 1983) (citing Mick v. Hosking (In re Hosking), 19 B.R. 891, 895 (Bankr. W.D.Wis. 1982)).

Subsequent conduct contrary to any former representation, contractual or otherwise, does not necessarily render the original representation false. Resin v. Barr (In re Barr), 194 B.R. 1009, 1018 (Bankr. N.D. Ill. 1996) (finding a statement about prior fact may be the basis for a fraudulent representation, but a statement about subsequent fact ordinarily may not); Leeb v. Guy (In re Guy), 101 B.R. 961, 978 (Bankr. N.D. Ind. 1988) (citing in re Boese, 8 B.R. 660, 662 (Bankr. D.N.D. 1981); P.A.M. Transport, Inc. v. Arkansas Blue Cross & Blue Shield, 315 Ark. 234, 240, 868 S.W.2d 33, 36 (1993) (quoting 1 E.Allen Farnsworth, Farnsworth on Contracts § 4.11 (1990)(observing that a statement about a future event may impose liability for breach of contract but is not a misrepresentation as to that event)).

Thus, in establishing the element of misrepresentation, creditors may not rely solely on a failure to fulfill a contract. Starling v. Valmac Indus., Inc., 589 F.2d 382, 387 (8th Cir. 1979) (observing that an individual is not necessarily guilty of fraud because he fails to perform a contractual obligation); In re Barr, 194 B.R. at 1017-18 (citing 3 Collier on Bankruptcy ¶ 523.08 (Lawrence P. King ed., 15th ed. 1994); Garza v. Baker (In re Baker), 139 B.R. 692, 694 (Bankr. N.D. Ohio 1992)). To establish a contract as a fraudulent misrepresentation with intent to deceive, the creditor must demonstrate that the debtor entered into the agreement intending not to comply with the terms. In re Barr, 194 B.R. at 1018; First Baptist Church v. Maurer (In re Maurer), 112 B.R. 710, 713 (Bankr. E.D. Pa. 1990); In re Guy, 101 B.R. at 978.

Moreover, negligence or mismanagement does not establish false representation with intent to deceive. The fact that a debtor's negligence caused the debt is insufficient to prove the type of fraud that bars discharge of a debt under section 523(a)(2)(A). Leger v. Semora (In re Semora), 204 B.R. 26, 28 (Bankr. E.D. Ark. 1996) (stating that evidence of a poorly constructed house did not prove fraudulent intent on the part of the debtor-contractor); Long v. Donley (In re Donley), 115 B.R. 502, 504 n.2 (Bankr. E.D. Pa. 1990) (commenting that evidence of negligent repairs would not establish fraud).

The Plaintiff seems to argue that the Debtor intentionally misrepresented his financial condition at the time of the sale and throughout the parties' relationship. The Plaintiff stated that he was unaware that the Debtor was engaged in a chapter 13 reorganization at the time the sale was consummated and implied that the Debtor's failure to disclose that fact amounts to a misrepresentation.

However, facts adduced at trial imply the Plaintiff was aware the Debtor was working three part time jobs and had a family to support at the time of the sale. Furthermore, the Plaintiff did not rely on the Debtor's credit worthiness in any fashion, choosing instead to negotiate with the bank directly and offering his own personal guarantee to ensure the sale occurred. The Plaintiff was also aware that the entire purchase price, as well as some operating expenses, was being financed by the Debtor, whose only collateral for the loan was the store's inventory and accounts. These facts lead to the conclusion that the Plaintiff did not rely on any representation of the Debtor as to the Debtor's financial condition at the time of the transaction.

Moreover, the fact that the Debtor may not have maintained inventory at pre sale levels as agreed, while perhaps a breach of contract, was not a misrepresentation at the time the parties contracted. Without further proof of fraudulent intent and detrimental reliance, the Debtor's failure to maintain inventory cannot be construed as fraud.

The Plaintiff bases his case chiefly on the Debtor's monthly balance sheets, which the

Plaintiff claims he relied on in continuing to offer his personal guarantee in the subsequent renewal and refinancing of the Debtor's loan from Mid-South Bank. The Plaintiff argues that the balance sheets were purposely deceptive in not accurately reflecting the shaky financial condition of the business.

The Court cannot draw this inference for many reasons. First, the Plaintiff admitted that he did not require the Debtor to include an accounting for inside inventory; thus, by the Plaintiff's own admission, the statement he himself designed was not an accurate picture of business assets and liabilities. Second, the Plaintiff has not shown that the figures on the balance sheets were false. Third, contrary to Plaintiff's allegations, three of the four balance sheets submitted by the Plaintiff as evidence reflect that the business had substantially more liabilities than assets. Although the February 1999 balance sheet shows assets exceed liabilities, the debt owed to Matthews Oil is not listed, having been replaced by the Debtor's $1500.00 monthly payment on the arrearage to Matthews Oil. However, testimony revealed that even though the entire indebtedness is not listed on the February 1999 balance sheet, the Plaintiff knew that the Debtor had accrued a significant arrearage on his account with the supplier and was defraying the arrearage on a monthly basis. Thus, the insolvency of the business, rather than being concealed by the Debtor, was readily apparent from the balance sheets the Debtor prepared.

The Court can discern no evidence of any knowing misrepresentation by the Debtor to deceive the Plaintiff, either at the time of the sale or in subsequent years as levels of inventory dwindled and the debt to the fuel supplier burgeoned.[2] The evidence shows that the Debtor and his wife drew modest salaries from the business, despite the fact that the Debtor worked from 60 to 100 hours a week to keep the business going. They also acquired fuel and some food for personal needs from the store's supply but kept a detailed log of such gratuities. Accordingly, there was no showing that the Debtor deceptively looted the business assets for his personal gain.

Furthermore, throughout the three years during which the Debtor operated the business, the Plaintiff visited the store at least once a week, according to the Debtor's testimony, and was free to observe and advise on the daily operation of the Short Stop. Plaintiff never asked to see the store's accountant's monthly balance sheets, which were available for his examination. On one occasion he was shown the business's checkbook when the Plaintiff requested to see it. Testimony at trial established that on at least one occasion, the Plaintiff met with the oil supplier in support of the Debtor's efforts to work out his debt to Matthews Oil and on another occasion he paid for fuel supplies when the Debtor was unable to do so. To some extent not apparent from the record, Plaintiff was aware of the increasing indebtedness to Matthews Oil.

In short, the Debtor simply operated the business in an unsuccessful manner until June 1999 when he gave up his interest and surrendered the remaining inventory to Plaintiff. The evidence does not reveal acts of concealment or other conduct by the Debtor that would rise to the level of fraudulent misrepresentation upon which Plaintiff relied.

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[2]On Schedule F of his bankruptcy petition, the Debtor listed the unsecured, nonpriority claim of Northeast Arkansas Oil Co., LLC d/b/a Matthews Oil Company as $72,000.00.

Therefore, for these reasons, the Plaintiff's Complaint is dismissed.

IT IS SO ORDERED.

James G. Mixon

U. S. BANKRUPTCY JUDGE

DATE: 02-14-02

cc: A. Jan Thomas, Trustee
Scott Davidson, Esq.
Jeannette Robertson, Esq.
Debtor