UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE

In re:
Thomas Harrison,
Debtor.

Case No. 04-27841whb
Chapter 7

Prime Capital, L.L.C.,
Plaintiff,

Adv. Proc. No. 04-0638

Thomas Harrison,
Defendant.

MEMORANDUM OPINION AND ORDER ON
COMPLAINT TO DETERMINE DISCHARGEABILITY

This adversary proceeding was filed by Prime Capital, L.L.C. ("Prime") against Mr. Thomas Harrison, the Debtor in this chapter 7 case, with Prime's complaint asserting that the personal obligations of the Debtor were excepted from discharge. At the conclusion of the trial, the Court took the issues under advisement, and the Court has now

considered the proof, exhibits and all positions taken by the parties. This opinion contains the Court's findings of fact and conclusions of law.

ISSUES

The issues in this proceeding are whether the Debtor's obligations to Prime are excepted from discharge under 11 U.S.C. § 523(a)(2), (4), or (6). A conclusion on these legal issues requires the Court to determine certain facts and inferences drawn from the proof introduced at trial.

FACTUAL ALLEGATIONS

The complaint filed by Prime asserts that on May 2, 2002, Prime purchased the accounts receivable of Spring Manufacturing and Design, Inc. ("Spring"), a corporation of which the Debtor Thomas Harrison was the sole shareholder and president. Spring was in the business of manufacturing springs of various types. The Accounts Receivable Purchase Agreement (Exhibit 9) is a typical factoring agreement, and it contains standard terms and representations by the parties. Under section 2.J., provision is made for Prime to have recourse against Spring

> for the gross amount of each Account not paid, in the event of the occurrence of any of the following:
> 1. If SELLER [Spring] has breached any representations, warranties or promises in this Agreement, or misrepresented any material facts with regard to the unpaid Account.

Moreover, in Addendum 2.a. to the Agreement, it is specified that Prime will have recourse against Spring, when an "incorrect and/or erroneous invoice is submitted" by Spring to Prime. Exhibit 9. Under section 3 of the Agreement, the warranties and representations of Spring include that each account sold to Prime "is an accurate statement of a bona fide sale or transaction, and represents completed delivery of goods or services." This representation underlies the heart of the complaint and the proof presented in this proceeding, since Prime alleges that Spring fabricated substantial accounts and sold them to Prime as if they were legitimate.

Mr. Harrison signed the Agreement with Prime as Spring's president, but more importantly, he executed a personal guaranty of Spring's liabilities to Prime. Moreover, this guaranty, which is a part of Exhibit 9, personally obligated Mr. Harrison to pay "reasonable attorney's fees and all costs of court and other expenses incurred by Prime in

enforcing" either the guaranty or the underlying agreement. No disputes of fact were raised about the terms of the factoring Agreement or Mr. Harrison's personal guaranty.

The complaint asserts that Spring secured its receivable sales with a UCC Financing Statement that was properly recorded, and no dispute was raised about the fact that Prime held a valid security interest in Spring's assets, including specific machinery and equipment.

From May 2, 2002 into 2003, the majority of the accounts that Prime purchased from Spring were represented by Spring to be valid sales of products to Cor-Tec, Inc. or Cor-Tec Corporation, also known as Corporate Technologies, Inc. ("Cor-Tec"). The complaint alleges that Spring's invoices were fraudulent and that Spring did not actually manufacture and sell to Cor-Tec the volume of springs that the invoices represented. Until November, 2002, the monthly invoices sold by Spring to Prime averaged $30,000, but in December, 2002, those invoices increased to $45,000, and the invoices continued to increase, finally reaching $100,000 monthly by May, 2003.

Prior to the bankruptcy filing by Mr. Harrison, Prime obtained a judgment in state court against Spring and Harrison, but Prime has recovered only approximately $60,000 from receivable proceeds and the sale of some of Spring's equipment. As to the equipment, the complaint alleges that Spring misrepresented both the amount and value of its assets, and that Spring "fraudulently hid some of the collateral."

The complaint seeks a nondischargeable judgment against Mr. Harrison of $325,644.06, plus Prime's attorney's fees and costs, asking for an exception from Mr. Harrison's discharge of these debts under §§ 523(a)(2), (4) and (6) of the Bankruptcy Code.

The Debtor's answer denies the substantive allegations of the complaint, insofar as they would impose personal liability on the Debtor.

DISCUSSION

The proof offered by Prime included support for its allegation that Mr. Harrison and Spring were alter ego entities. The uncontradicted fact is that Mr. Harrison's personal guaranty justifies a finding that this individual Debtor is liable for any of the corporate debt, because Mr. Harrison obligated himself to pay in full the debts owing to Prime. The legal issue is whether Mr. Harrison's personal liability is dischargeable. In

that regard, the proof is overwhelming that Mr. Harrison controlled every aspect of Spring's activities. Mr. Harrison was the sole shareholder and the president of Spring, but there is no evidence that proper corporate procedures were followed. Rather, the Court is persuaded that Mr. Harrison did with Spring what he wished to do, and the control he exerted over Spring included his control over the improper and fraudulent activities of Spring. As a result of this control, the Court has no difficulty finding that Mr. Harrison and Spring were in reality one and the same, and that the corporate shield should be pierced; thus, Mr. Harrison is exposed to nondischargeable liability. As just two examples of the lack of true corporate structure, the Court notes that a business card attached to Exhibit 8, which is one of Spring's financial statements furnished to Prime, shows "Spring Manufacturing and Design Tom Harrison Owner." No mention is made of Spring being a corporation, with the representation being that it was a sole proprietorship. Exhibit 18 is an invoice for equipment sold or leased to "Tom Harrison" at Spring's business address. The totality of the evidence and all inferences drawn from the evidence supports a finding that Mr. Harrison did not treat Spring as a true corporate entity.

The Court finds from the evidence overwhelming and persuasive proof that Mr. Harrison and Spring engaged in a fraudulent scheme to fabricate invoices that were sold to Prime. By May, 2003, an aging report of Spring's accounts receivables that had been sold to Prime showed that 86% consisted of sales represented to be to Cor-Tec. See Exhibits 4 & 14. Cor-Tec was alleged to be another corporation that was supposedly buying large quantities of springs from Spring for sale to Cor-Tec's customers; however, there were relatively few actual sales by Cor-Tec. There was no evidence that Cor-Tec had any significant customer base. The proof was that Cor-Tec hoped to sell substantial inventory to such customers as Federal Express, but there were never any contracts between Cor-Tec and such customers. Unfounded hope does not justify Cor-Tec's continuing to purchase large inventory at Prime's expense, assuming arguendo that Cor-Tec did in fact purchase the inventory from Spring.

The Court is not persuaded that Cor-Tec did in fact purchase the large amounts of inventory represented by the invoices produced to Prime. The proof clearly established that Cor-Tec was controlled by Mr. Harrison. It was formed by Mr. Harrison and its

shares then were supposedly sold by him to Kathy Weatherly, who had formerly worked for Spring. This Court is not required to make a finding as to whether this sale was a sham, but there is clear and convincing evidence that Mr. Harrison continued to control Cor-Tec after the alleged stock sale. Exhibit 6 depicts that Spring made deposits totaling $436,164 into Cor-Tec's bank accounts between January 6 and August 13, 2003, and during that time only $43,867.27 in deposits from other sources were made into that account. Cor-Tec was being funded substantially by Spring, without Prime's knowledge. During this time, Prime deposited $724,623.21 into Spring's accounts for purchases of receivables, including those allegedly due from Cor-Tec.

Because Cor-Tec was not succeeding in selling the inventory that it claimed to have purchased from Spring, the two actually entered into a Loan Agreement in September, 2002 for Spring to be a lender to Cor-Tec, up to $600,000. Exhibit 27. That Agreement was signed by Mr. Harrison as President of Spring and by Kathy Weatherly as President of Cor-Tec. Of course, it is no surprise that this Agreement was not disclosed to Prime. It is obvious that Spring was using Prime's funding to in turn fund Cor-Tec, but what the overall proof established is that there was a circular scheme: Cor-Tec fabricated bogus invoices for spring inventory purchases and transmitted them to Spring, which fabricated that it actually manufactured those springs and then fabricated to Prime that it had the accounts receivable from Cor-Tec. Prime then purchased those accounts, with a substantial amount of Prime's money then flowing back to Cor-Tec.

Unfortunately for everyone, Cor-Tec only repaid Spring a small amount of the "loan," which is no surprise since Cor-Tec had no significant real customers, and Prime ended up with a serious defaulted balance due from Spring. Exhibit 5 shows that from January 3, 2003 to June 12, 2003, Spring received $727,414 from Prime, of which $523,616.45 represented invoices from Cor-Tec. During this time, Spring transferred $436,164 from its bank account to Cor-Tec, while Cor-Tec paid Prime, on its alleged accounts payable, $419,110. Had Spring and Cor-Tec not been defrauding Prime with faked invoices, it can be assumed that Prime would have advanced Spring one half a million dollars less than it did. Prime's loss, not including attorney fees is less than that. It is obvious to the Court that Spring and Cor-Tec concocted a scheme that produced Prime's loss.

To cap a finding that Mr. Harrison controlled Cor-Tec, the proof established that he was a signatory on Cor-Tec's bank account, the same account that was used to funnel Prime's money from Spring to Cor-Tec. It is so obvious to the Court that this was in fact a fraudulent scheme that little more need be said; however, the Court adds that it found both Mr. Harrison and Ms. Weatherly to lack credibility in every respect.

The scheme to defraud Prime didn't stop with Cor-Tec. When Spring's financial position became untenable, Mr. Harrison formed a new entity, called Spring Engineers, Inc. ("Engineers") in June of 2003, moving some of Spring's equipment to Engineer's location (bay 14), which was next door to Spring's location (bay 16). The formation of Engineers was done without advising Prime, and the equipment, which was part of Prime's collateral, was moved without Prime's knowledge. Mr. Harrison of course owned 100% of Engineer's stock, and he set up Kimberly Matthews as the "president" of Engineers. Ms. Matthews had previously been employed by Spring. Engineers began to use the equipment to manufacture springs, the same products that Spring had manufactured, and Engineers continued to use that equipment from June to December, 2003. It required legal pressure from Prime to cause the equipment to be moved back to the Spring location, and the Court is persuaded that all of Prime's collateral was never returned. Engineers was so brazen as to use Spring's bank account into August of 2003 to pay some of Engineers' bills. It was only when Prime was told that it had collected on an Engineer account that Prime learned what was going on. See Exhibit 15.

The totality of this scheme leaves the Court wondering why Mr. Harrison would think that any finder of fact would fail to find fraud. Because the Court does find overwhelming (beyond the required preponderance of evidence, even exceeding clear and convincing) evidence of fraud in the scheme to keep Prime funding the bogus accounts receivable, it is unnecessary for the Court to make any finding about the other allegations in the complaint; however, as previously noted, the Court does not believe that Mr. Harrison, Spring or Engineers returned all of Prime's collateral. There is, in fact, no plausible reason why Spring would have moved the equipment other than to attempt to prevent Prime's recovery of the collateral. The explanations offered by Mr. Harrison why the equipment was moved are unconvincing.

CONCLUSION AND ORDER

Having made these findings, the Court concludes that the fraud committed against Prime results in a nondischargeable debt. As the Seventh Circuit observed in *McClellan v. Cantrell (In re McClellan)*, 217 F.3d 890 (7th Cir. 2000), § 523(a)(2) encompasses all types of fraud for purposes of nondischargeability. It is unnecessary for the Court to reach any further conclusions under § 523(a)(4) or (6), since only one basis for exception from discharge is sufficient.

As to the Court's finding that piercing the corporate veil is justified in this case to impose nondischargeable liability on this individual Debtor, there is certainly authority for piercing the veil when fraud is involved. *See Fed. Deposit Ins. Corp. v. Allen,* 584 F. Supp. 386, 397098 (D.C. Tenn. 1984) ("[W]hen a corporation is dominated by an individual or individuals not only as to finance but also as to policy and business practices so that the corporation has no mind, will, or existence of its own and this domination is used to commit a wrong, or fraud or perpetrate a violation of statutory or positive legal duty, the corporate veil will be pierced."). *See also Oceancis Schools, Inc. v. Barbour,* 112 S.W.3d 135 (Tenn. Ct. App. 2003) (piercing the corporate veil may be done "where necessary to accomplish justice").

IT IS THEREFORE ORDERED, based on the Court's findings and conclusions, that the Debtor is personally liable for the debt to Prime, that his personal liability is nondischargeable and that he is liable for Prime's reasonable attorney's fees and costs. The prebankruptcy judgment of the state court fixed the amount of the debt, which is nondischargeable, but the amount of Prime's attorney fees and costs subsequent to the state court judgment must be determined. Prime's counsel should submit an affidavit of those fees and costs within 15 days of entry of this opinion and order. If the Debtor/Defendant objects to those fees and costs within 15 additional days, a hearing will be set; if, however, no objection is timely filed, counsel for Prime may submit an order allowing Prime's fees and costs as an additional nondischargeable judgment.

Cc:
Roger A. Stone
Stone, Higgs 7 Drexler
Attorney for Prime Capital, L.L.C.
200 Jefferson Avenue, Suite 1000
Memphis, TN 38103

James W. Surprise
Attorney for Debtor/Defendant
780 Ridge Lake Blvd., Suite 202
Memphis, TN 38120

U.S. Trustee