

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

IN RE:

NAHED SOBHY,

Debtor.

BK #88-20642-WHB
Chapter 7

AEDC CREDIT UNION,

Plaintiff,

v.

Adversary Proceeding
No. 88-0108

NAHED SOBHY,

Defendant.

MEMORANDUM OPINION AND ORDER ON PLAINTIFF'S
COMPLAINT TO DETERMINE DISCHARGEABILITY OF DEBT

At issue in this core proceeding ¹ is whether the evidence supports a finding that the defendant debtor's obligation to the plaintiff ("AEDC") should be excepted from discharge pursuant to 11 U.S.C. §523(a)(2)(B). The following constitutes findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.

The record reflects that the debtor filed a Chapter 13 petition for relief on June 2, 1986. The plaintiff was not listed as a creditor in the Chapter 13 schedules or plan, but the defendant made some payments to AEDC "outside her plan" payments. The instant Chapter 7 petition was filed on

¹ See, 28 U.S.C. §157(b)(2)(I).

January 28, 1988 and the plaintiff is listed on the debtor's Chapter 7 schedules as the holder of a \$21,166.00 claim.

The record further reflects that the debtor is a physician duly licensed to practice medicine in Tennessee since 1978. She was formerly self-employed on a contractual basis to provide emergency care services to area hospitals. In addition, she was formerly the owner of the Bartlett Family Clinic where she engaged in the practice of family medicine from November 1985 until December 1987. She testified that she is presently self-employed at various area hospitals where she is paid by the hour.

The plaintiff is a federal credit union whose members are teachers, government employees, and military personnel. The debtor is indebted to the plaintiff by virtue of two guaranty agreements she executed as consideration for loans made by the plaintiff to its member, Vera Mae Cawthorn.

Ms. Cawthorn, an acquaintance and employee of the debtor, had been a member of the plaintiff credit union since 1979. As such, it was she who applied for the loans at issue although the proceeds were paid to the debtor for use in establishing her clinic. The first loan, in the original principal amount of \$5,000.00, was obtained on October 25, 1985. The second, in the original principal amount of \$20,000.00, was obtained on February 10, 1986.

It is the plaintiff's position that it would not have made either unsecured loan to Ms. Cawthorn because her stated income was insufficient to warrant the loans. Thus, according to the plaintiff, the decision to grant the loans was based on acquisition of the debtor's guaranties and the financial information in support thereof that the debtor provided. The debtor acknowledged that she understood her guaranty and repayment obligations.

The financial information provided by the debtor is found on the credit applications completed for purposes of obtaining the loans. These applications were introduced as exhibits 4 and 8 at the hearing on this matter. Exhibit 4 is the debtor's credit application completed in connection with the \$5,000.00 loan obtained on October 25, 1985. This application reflects total income of \$164,400.00 and outstanding debts with total balances due of \$96,900.00. There is no indication on the application itself whether the income figures refer to gross or net income although the debtor testified that the figures reflected gross income. The sources of income are shown as the Bartlett Family Clinic, \$96,000.00, and Spectrum Emergency Care, \$68,400.00. Preceding the \$96,000.00 income is an asterisk which was placed there to indicate that the clinic had "just opened" according to the plaintiff's representative. However, a "no" answer is shown as the debtor's response to the question "[i]s your income likely to reduce in the next two years?" The handwriting on this application is that of the plaintiff's loan officer rather than the debtor. However, the debtor signed the application and did not refute any of its contents in her testimony.

The debtor testified that at the time this application was completed, she was in the process of opening the Bartlett Family Clinic and negotiating an employment contract with the Emergency Care Group. The \$96,000.00 income was in part anticipated from her "promised" contract with the Emergency Care Group for which she would provide emergency care services at St. Joseph and St. Francis Hospitals. She further testified that the \$68,400.00 income was what she anticipated receiving by the year's end from Spectrum Emergency Care. She arrived at these amounts from multiplying the number of hours she expected to work by the amount she was paid or to be paid per hour.

According to the debtor, during 1985 she was paid \$5,000.00 to \$6,000.00 per month for her work with Spectrum which comprised, at the minimum, approximately sixty hours of her time per week. In addition, the Emergency Care contract was to allow her to be compensated at \$45.00 per hour for forty hours per week after a three month probationary period. Pursuant to this "promised" contract, she was to begin working at St. Joseph Hospital on January 1, 1986.

Moreover, the debtor testified that she expected to obtain "weekend work" and that the clinic would provide further income as she expected it to "do better." The clinic originally opened in October 1985 but was closed by the city due to plumbing problems. It reopened in December 1985.

In contrast to this information on this credit application, the debtor's 1985 income tax return shows total net business income of \$40,781.00. (Tr. Ex. 14) The income tax return was completed by a C.P.A. and the debtor testified that she did not know why the return reflected \$40,852.00 as a total net taxable income figure because during 1985 she made between \$5,000.00 and \$6,000.00 gross income per month pursuant to her contract with Spectrum. This apparent discrepancy is explained at least in part by the absence of Schedule C for business income and expenses from exhibit 14. The debtor further testified that she knew the clinic was not open when she applied for the first loan but that she expected it to become her full time occupation. As discussed above, the clinic's status at that time was apparently disclosed to the plaintiff's representative because AEDC had placed an asterisk preceding the \$96,000.00 income entry to indicate that the clinic, from which they believed she would derive this amount, had "just opened."

The second loan of \$20,000.00 was obtained on February 10, 1986. In connection therewith, the debtor completed a second credit application which is trial exhibit 8. This application reflects full time employment by the debtor at Spectrum Emergency Care, Inc., Emergency Care Group, P.C.

and Bartlett Family Clinic. This application was partially completed by the debtor in her own handwriting. Exhibit 8 reflects less projected income than did Exhibit 4. Gross income entries of \$61,000.00 per year from Spectrum and \$80,000.00 to \$90,000.00 per year from the "clinic," "St. Francis," and "St. Joseph," are disclosed on this financial statement. Outstanding debts with total balances due of \$111,000.00 are listed. As with the initial application, the debtor answered "no" to the question "[i]s your income likely to reduce within the next two years?" The debtor signed the application.

In contrast to the information provided on this credit application, the debtor's 1986 income tax return reflects total net taxable income of \$45,491.00. (Tr. Ex. 13) This tax return was completed by a C.P.A. and again the debtor testified that she did not understand the total income figure because she had gross income of more than \$110,000.00 to \$120,000.00 in 1986. The return shows \$17,747.00 received in 1986 from Emergency Care Group, and Schedule C is attached to the return. This schedule is difficult to read but shows net self-employment income of \$27,734.00 and a gross of what appears to be \$80,451.00 or \$90,451.00. Some of the expense figures are illegible.

With respect to this second application, the plaintiff's representative testified that the \$61,000.00 income was believed to be the amount received by the debtor from Spectrum. She further testified that the \$80,000.00 to \$90,000.00 income figure was the amount the plaintiff's representative believed that the debtor would receive from patients who were referred to the Bartlett Clinic by St. Francis and St. Joseph hospitals. Apparently, it was not clear to the plaintiff that the debtor was under contract to perform emergency care services at these hospitals.

However, that in fact was the debtor's arrangement with these hospitals pursuant to her employment contract with Emergency Care Group, Inc. executed on January 1, 1986. The contract,

introduced as trial exhibit 10, is dated January 1, 1986 and provides that for the initial three months of the contract, the corporation had the exclusive right to terminate the contract for any reason whatsoever. Thereafter, the contract was to continue for one year. Thus, according to the debtor, this was the anticipated source of the debtor's \$80,000.00 to \$90,000.00 projected gross income. The debtor expected to eventually make her clinic her full-time employment.

Further, according to the debtor, the initial three months of the contract was a probationary period during which she did not work full time at St. Joseph. For that reason, she needed the \$20,000.00 loan. Her checks and check stubs from this period were introduced as collective trial exhibit 11. These items reflect that during January and February, 1986, the debtor was paid gross income of \$3,393.00 for 54.25 hours of services performed at St. Joseph or St. Francis hospitals. In March of 1986, she received \$5,720.00 gross income for 143 hours of service; in April, she received \$7,050.00 gross pay for 176.25 hours of service; and in May, she received \$1,440.00 for thirty-six hours of service. Her contract was terminated by the Emergency Care Group's president on May 12, 1986. The termination letter was introduced as trial exhibit 12 and reflects that it was the employer's decision to terminate the agreement, not the debtor's.

After May, 1986, the debtor continued to work for Spectrum pursuant to her contract and at her clinic. The clinic had no other physicians.

The debtor testified that at no time did she intend to deceive the plaintiff. Moreover, she had intended to pay the borrowed funds back and had appreciated the plaintiff's help "when she had a rough time in February [1986]." She further testified that although she had never run a clinic before, her "faith was great that the clinic would make money." In addition, she anticipated continued employment with St. Joseph and St. Francis hospitals as well as spending increasingly more time at

the clinic. The debtor was engaging in great and perhaps unfounded hope for her emergency and clinic income, but did this hope rise to the level of deceit?

As noted above, it is the plaintiff's position that when she obtained these loans, the debtor violated Section 523(a)(2)(B) of the Bankruptcy Code. In pertinent part, that section provides as follows:

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

(2) for money . . ., to the extent obtained by -

...

(B) use of a statement in writing -

(i) that is materially false;

(ii) respecting the debtor's . . . financial condition;

(iii) on which the creditor to whom the debtor is liable for such money . . . reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive . . .

It is well settled in this Circuit that the party seeking an exception from discharge under Section 523(a)(2) has the burden of proof by clear and convincing evidence. In re Martin 761 F. 2d 1163, 1165 (6th Cir. 1985). This burden must be met with respect to each element of Section 523(a)(2)(B). Bankruptcy Rule 4005. Thus, in the instant proceeding, there must be a clear and convincing showing that the credit applications were materially false regarding the debtor's financial condition; were reasonably relied upon by the plaintiff; and were completed by the debtor with intent to deceive. A gross recklessness on the part of a debtor satisfies the statutory intent to deceive. In re Martin, 761 F. 2d at 1167. "However, any doubt about the dischargeability must still be weighed in the balance favoring the general discharge for the honest debtor and the strict construction against

the objecting creditor." In re Denkler, 79 B.R. 749-753 (Bankr. W.D. Tenn. 1987), citing Gleason v. Thaw, 236 U.S. 558 (1915).

AEDC's proof showed that it relied upon the credit applications. However, AEDC assisted in filling out the applications and the loan proceeds were given on the same dates as the dates of the applications. AEDC was aware of the formative stage of the debtor's Bartlett Clinic, and AEDC was apparently aware that the income projections were gross rather than net figures. (See Tr. Ex. 8) AEDC was on notice that the income projections declined between the time of exhibits 4 and 8. Nevertheless, the Court cannot say that AEDC acted unreasonably in its reliance on the financial information.

However, reasonable reliance is only one element. The financial information was hopeful but not necessarily materially false when given. The 1986 tax return supports that, had the debtor retained her work with Emergency Group, P.C., she could have approximated the gross income projected on exhibit 8. As observed, the debtor may have been overly optimistic but she had a basis upon which to found her optimism. The debtor was a credible witness, and the Court does not find that the debtor acted with actual intent to deceive AEDC. Further, the Court cannot find clear and convincing evidence that the debtor acted in such a grossly reckless manner as to satisfy the necessary deceit. The evidence taken as a whole shows that the debtor believed that she was making or would make the amounts projected in the two applications.

THEREFORE, the Court finds and concludes that the plaintiff AEDC failed to carry its burden of proving each element of §523(a)(2)(B), and judgment is given for the defendant. Both debts and the related costs and attorney's fees are dischargeable. Since these loans were for

business, rather than consumer purposes, the defendant's request for attorney fees under 11 U.S.C. §523(d) is denied.

SO ORDERED this 27th day of December, 1988.

WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE

cc:

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