UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF WISCONSIN

Cite as: [Unpublished]

Robert E. Disch, Plaintiff v. Faye F. Rasmussen, Defendant
(In re Faye F. Rasmussen, Debtor)
Bankruptcy Case No. 02-10821-7
Adv. Case No. 02-80-7

United States Bankruptcy Court
W.D. Wisconsin, Madison Division

February 11, 2003

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Michael E. Kepler, Kepler & Peyton, Madison, WI for Debtor-Defendant

Robert D. Martin, United States Bankruptcy Judge

MEMORANDUM DECISION

This is a complex case challenging the scope of the debtor's discharge and questioning whether the discharge granted to the debtor should be revoked. It should be and it is.

I. Background Facts

Faye Rasmussen, the debtor, owned and operated Faval, Inc. ("Faval"), a café and catering service, which did some of its business as Silverado Café. In late 1999, Faval struggled financially.

Robert Disch, the plaintiff, was a successful businessman who had known Rasmussen socially for over 40 years. At the end of 1999, he owned a restaurant and two rental buildings in Madison, none of which were encumbered. Disch also worked for Ameritech SBC, a job that he had held for 33 years.

On January 14, 2000, Rasmussen and Disch met to discuss Faval for the first time. Rasmussen advised Disch of Faval's problems, explaining that the business could not obtain credit, two bank loans would come due in January 2000, and Faval would go "belly-up" without additional financing. Rasmussen also said that Faval would eventually turn a profit, perhaps as soon as June 2000. However, Rasmussen did not provide and Disch did not request any documentation supporting Rassmussen's assessment of Faval. At the conclusion of the meeting, Disch gave Rasmussen a check for $20,000 and promised to provide her more money soon thereafter.

Between January 2000 and May 2001, Disch gave Rasmussen more than $810,000 to use in Faval. Approximately $590,000 of that money came through loans and lines of credit that Disch obtained for Rasmussen with his collateral and personal guarantees.[1] Disch also wrote numerous checks to Rasmussen, amounting to $219,700, intended by him to cover Faval operating expenses, such as payroll and supplier costs.[2] He also gave her $15,000 in cash and occasionally paid Faval employees and creditors directly.

The parties agreed that Rasmussen would make all payments when due on Disch's bank loans, but would not begin to repay Disch for his personal loans until Faval became "profitable." However, the parties did not execute formal documents regarding any of the loans and Disch did not take collateral or Rasmussen's personal guarantees of the obligations. Although they discussed the possibility of Disch becoming a Faval shareholder, they never decided on the amount of stock that Disch would own and no stock was ever delivered to him.[3] Disch relied solely on Rasmussen's oral promises and representations that all of the money was going into Faval.

In August 2000, Disch purchased the building in which Silverado Kitchen and The Ice House, an antiques store, were located, on East Main Street in Stoughton, Wisconsin ("East Main Street building"). Disch was to be paid rent for Silverado Kitchens. Rasmussen assisted Disch in collecting rent from the other East Main Street building occupants and hired an employee to run The Ice House. At all times, Faval and The Ice House remained separate entities.

Rasmussen was an experienced bookkeeper and understood the importance of maintaining financial records. Prior to purchasing Faval, Rasmussen worked for 18 years as a bookkeeper at an oil company with over 100 employees and $26 million in annual sales. However, during the time at issue in this case, Rasmussen adopted a number of unusual

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[1]Rasmussen received the proceeds of the following loans and lines of credit: $200,000 from M&I Bank on January 27, 2000; $140,000 from Anchor Bank on March 17, 2000; $200,000 from Anchor Bank on May 22, 2000; $35,121.05 from M&I Bank on August 4, 2000; and $15,000 from M&I Bank on September 21, 2000.

[2]During this period, Disch wrote 18 checks to Rasmussen and two checks to Faval creditors. The checks range from $500 to $120,000 in value. Disch wrote each check for round dollar amounts such as $120,000, $7,500, and $5,000.

[3]As time went on, Disch pressed Rasmussen for information regarding how she allocated the money and a more definite agreement about the stock. Even when she failed to provide the requested information, he continued to lend her money.

bookkeeping methods that made tracking Faval's finances virtually impossible.

First, Rasmussen did not keep a general ledger for the business nor accurate records of her personal business transactions. She stored information at various locations but generally relied on her memory instead of books and records.[4] As a result, Rasmussen cannot concretely explain an alarming number of transactions. For example, Rasmussen claims that while running the business, she made a number of short term loans to Faval. She is sure that she paid herself back but she does not know the amount of the loans, the source of the funds, when she paid herself back, or from what funds she did so. Rasmussen even lost track of large loans made by other "investors." She can give only general statements as to when multiple loans of $100,000 each were made, whether Faval gave the lenders security, and the extent to which the loans were repaid. She does not recall receiving a salary while she worked for Faval but her husband testified that she did receive a salary during that time. Similarly, Rasmussen cannot recall the exact use to which she put money from many of Disch's checks. She repeatedly testified at trial that she thought certain checks were used for payroll or supplier costs. Rasmussen allocated Disch's contributions in approximate, round dollar amounts to general expenses and did not explain what she did with the funds in excess of those allocations. The failure to maintain simple books and records made keeping track of such transactions substantially more difficult.

Second, in an effort to avoid a Wisconsin Department of Revenue levy for unpaid income taxes, Rasmussen dealt in cash as much as possible. She frequently converted checks from Disch into cash and cashiers checks instead of depositing them into a Faval account.[5] She usually bought the cashiers checks in her name and she said that she used them to pay suppliers, employees and other creditors of Faval.[6] While some suppliers demanded that Faval pay by cashiers check because earlier checks were returned for insufficient funds, Rasmussen paid most creditors by cash or cashiers check, regardless of whether they stated a preference. Likewise, Rasmussen seems to have paid employees in cash about half the time.[7]

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[4]At trial, Rasmussen claimed that she stored some records on a computer but the hard drive crashed sometime in 2001. At her depositions, Rasmussen also claims that she lost some records in a basement flood.

[5]Even funds deposited into bank accounts were difficult to follow: Rasmussen maintained as many as eight accounts at as many as seven banks.

[6]Between January 27, 2000, and August 10, 2001, Rasmussen purchased at least 19 cashiers checks, ten of which were payable to her. The checks payable to Rasmussen totaled at least $122,600.

[7]Discerning how Rasmussen paid employees is no small task. At trial, she testified that she began paying employees in cash in the summer of 1999. At her deposition, she testified that she began paying employees in cash in 2000. Donna Vogel, a former Faval employee, testified that

Even in situations where her lack of bookkeeping and her efforts to avoid state income tax were not the direct causes of the problem, Rasmussen engaged in questionable behavior. For example, in October 2000, Rasmussen sent a potential investor a Disch financial statement that she created and that Disch neither saw nor approved.

In January 2001, Disch gave Rasmussen his employer's credit card number so she could purchase approximately $3,000 worth of materials from a supplier that would only accept a credit card. Rasmussen reneged on her promised to reimburse Disch within a week. For the following five months, Rasmussen used the card number without Disch's permission to purchase other supplies, incurring $6,879.03 in charges.[8] Eventually, Disch had to reimburse Ameritech for the unauthorized use of the card from his own funds.

In the Spring of 2001, Rasmussen contacted one of the banks with whom Disch took out a loan for Faval's benefit and requested that the address be changed from Disch's home address to Rasmussen's business address. Rasmussen testified that she did so to save Disch the hassle of being notified when she was late in making a payment on the loan. Rasmussen did not tell Disch about the request; instead, the bank notified him because it needed his authorization to make the change.

When Disch became sufficiently concerned about Rasmussen's management, he asked Christina Mandeville, his personal accountant, to examine Faval's records and prepare the business' 2000 tax returns. However, Mandeville could not trace Disch's funds beyond their initial payment. Although she repeatedly asked Rasmussen for original bank records, Rassmussen failed to provide them. Furthermore, based on the little documentation that Rasmussen maintained and Rasmussen's spotty memory as to significant financial transactions, Mandeville discovered a disturbing pattern of misappropriation and uncertainty as to how Rasmussen allocated Faval funds. For example, Rasmussen cashed Disch's January 14, 2000, check for $20,000 and bought three cashiers checks. She used one cashiers check to repay a personal loan in the amount of $6,500. She used another cashiers check to pay the café's $1,800 rent. She used the third cashiers check to pay an employee $4,000. Rasmussen cannot recall, and has no documentation to indicate, what she did with the $7,700 balance. Similarly, Rasmussen produced check stubs for checks written on April 7, 2000, from a Faval bank account. Two of the stubs indicate that Rasmussen wrote checks to "Silverado Kitchens" and "Faye Rasmussen" for $2,000 and $16,000, respectively. However, Rasmussen has no recollection why she wrote the checks or what became of the funds. Mandeville encountered many of the same and additional obstacles when trying to prepare Faval's 2000 tax returns.

Rasmussen paid her in cash about half the time.

[8]At trial, Rasmussen admitted that the unauthorized charges were non-dischargeable but claimed that Vogel lied when testifying that Rasmussen directed her to use the card to make the charges.

Based on the summary of Faval's sales and expenses for 2000 that Rasmussen did provide, Mandeville concluded that despite Rasmussen's constant complaints of Faval's financial difficulties, the business' assets, including cash infusions from Disch, exceeded its liabilities by approximately $550,000. At trial, Rasmussen attempted to explain away a portion of this discrepancy as being due to a number of Faval expenses that she simply failed to list in the documents given to Mandeville. For instance, Rasmussen claimed that the documents did not reflect expenses for coolers purchased in 2000 and expensed in 2001, employee compensation for 1999 paid in 2000, the decrease of Ice House and Faval's accounts payable, an increase in accounts receivable, carry-over costs of kitchen repairs paid in 2000, and 1999 accounts payable paid in 2000. Rasmussen offered no documentation to support these claims and Faval did not file tax returns in 2000 or 2001.

When questioned at her December 3, 2002 deposition, Rasmussen did not mention the large, unallocated expenses. At trial, Mandeville explained that some of the alleged losses, such as those associated with The Ice House, would not have affected Faval's balance sheet.

On August 9, 2001, Disch's attorney demanded Rasmussen repay $120,000 of the personal loans by the end of the month. Rasmussen failed to do so and, on October 7, 2001, Disch changed the locks of the East Main Street building. In response, Rasmussen apparently shut down all the businesses of Faval.

On February 12, 2002, Rasmussen filed her Chapter 7 petition. On April 4, 2002, at her §341 meeting, she asserted her Fifth Amendment privilege as to her personal and business financial statements, the dates on which she incurred debts to Denis Poffenberger and Monona State Bank, and the use to which she put those funds.[9]

In his adversary complaint, Disch argued that this Court should draw a negative inference from Rasmussen's use of her Fifth Amendment privilege and that Rasmussen's debt to him is non-dischargeable pursuant to 11 U.S.C. §§523(a)(2), (4), and (6). At trial, Disch withdrew his claim under §523(a)(2)(B). He also argued that Rasmussen's behavior warranted the denial of her discharge pursuant to 11 U.S.C. §§727(a)(2), (3), and (5), although he did not formally move to amend his pleadings to conform to proofs of that claim. In total, Disch seeks to recover $657,700 of the funds that he loaned to Rasmussen.

Rasmussen responded that the §727 claims should not be considered because they had not been pled and that none of the elements of §523 had been proved.

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[9] At trial, Rasmussen asserted her Fifth Amendment privilege as to all matters related to Poffenberger and Monona State Bank.

II.

A. Dischargeability under §523

To establish non-dischargeability of a debt under §523(a)(2)(A), a plaintiff must show by a preponderance of the evidence that the debtor obtained property through false pretenses, false representations, or actual fraud by means *other* than a financial statement.[10] See e.g., In re Martin, 698 F.2d 883, 887 (7th Cir. 1983). Six elements must be proved: (1) the debtor obtained money, property, services, or the extension, renewal, or refinancing of credit; (2) through actual fraud, an express misrepresentation, or an implied misrepresentation (i.e., a false pretense); (3) the debtor knew the representation was false; (4) the debtor intended to defraud or deceive the creditor; (5) the creditor justifiably relied upon the representation; and (6) the creditor was damaged or injured as a proximate result of relying on the misrepresentation. Robert E. Ginsberg, et al., Ginsberg & Martin on Bankruptcy, §11.06[D], 11-70 (4th ed. 2000).

Rasmussen represented that she would put the proceeds of Disch's loans into Faval. To the extent that she failed to do so, Disch argues that her debt is non-dischargeable under §523(a)(2)(A). The failure to perform a promise is not alone sufficient to make a debt non-dischargeable. A statement of intention may not be a misrepresentation if intervening events cause the debtor's future action to deviate from the previously expressed intention. Goldberg Sec. v. Scarlata (Matter of Scarlata), 979 F.2d 521, 525 (7th Cir. 1992); Lawrence P. King, Collier on Bankruptcy, ¶523.08[1][d], 523-44 (15th ed. 2002). In Scarlata, the debtor failed in his promise to trade with funds advanced on"Black Monday" until he had recovered prior losses. Instead, his losses mounted in the rapidly falling market. The Seventh Circuit said that the statement of future intention may not have been a misrepresentation if it was true when made and intervening events caused the debtor to deviate from it.[11] Scarlata, 979 F.2d at 525.

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[10]Section 523(a)(2)(A) of the Code provides:

> A discharge under section 727...of this title does not discharge an individual debtor from any debt...
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> ....
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by–
>
> (A) false pretenses, a false representation, or actual fraud, other that a statement respecting the debtor's or an insider's financial condition....

[11]The Court did not elaborate on the kind of intervening events necessary to justify a debtor deviating from previously stated intentions. Instead, the Court affirmed the District's Court's ruling that the plaintiff failed to meet the requirements of §523(a)(2)(A).

Here, Disch has proved that only $6,500 of the loans–that portion of Disch's January 14, 2000, check that Rasmussen used to repay a personal loan–did not go into Faval. As to the remainder of Disch's payments to Rasmussen, some certainly went into Faval, some went directly to Faval's employees and creditors, and some (possibly the largest amount) is effectively unaccounted for. The evidence does not suggest, much less compel, a specific alternative destination for the Disch funds. But fraudulent acts must often be proved by circumstantial evidence and Rasmussen's failure to account for or explain the use of the Disch funds other than in exceedingly general statements ("it was used to pay suppliers"), without any documentary foundation, supports an inference that some of the funds may not have been used as promised. Whether such a diversion was the sort that would be deemed excusable is unclear. Any number of intervening events could have justified Rasmussen's action.

Far more damaging to Disch's claim under §523(a)(2)(a) is the requirement of "justifiable reliance" on the representations made. Justifiable reliance requires that the creditor actually relied, and that such reliance was justified under the circumstances. Ginsberg, et al., §11.06[D][4], at 11-75. In Field v. Mans, 516 U.S. 59 (1995), the Supreme Court adopted a quasi-subjective, quasi-objective test that takes into account actual knowledge and characteristics of the parties and the circumstances surrounding the transaction. Id. In the present case, Disch did not conduct even a cursory investigation of Rasmussen's management of Faval before he agreed to lend her money at a time when he knew Faval could not pay its bank debt. In fact, he continued to lend her money after she failed to provide any accounting to prove that she had been putting his money into the business. When signs suggest that the need for an investigation is present, a lender cannot hide his head in the sand and ignore them. Rasmussen and Disch had no prior business relationship that would lead Disch to trust that Rasmussen would use the money for Faval. It appears that Disch acted out of affection or friendship and would have acted in the exact same manner if Rasmussen had not represented that she was putting the money into Faval. So little proof of fidelity was required of Rasmussen that the transaction has much the appearance of a series of gifts. Disch cannot establish justifiable reliance on any representation or promise of Rasmussen.

Disch also failed to demonstrate that he can prevail under either §§523(a)(4) or (6). Section 523(a)(4) provides that a §727 discharge does not include debts created by, among other things, defalcation while acting as a fiduciary or embezzlement.[12] Disch has not established the existence of a fiduciary relationship, either through an express or technical

[12]Section 523(a)(4) of the Code states:

> A discharge under section 727...of this title does not discharge an individual debtor from any debt...
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> > ....
> >
> > (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny....

trust, Matter of Marchiando, 13 F.3d 1111 (7th Cir. 1994); In re Koch, 197 B.R. 654, 656 (Bankr. E.D. Wis. 1996); In re Eisenberg, 189 B.R. 725, 730 (Bankr. E.D. Wis. 1995), or as created by a shareholder agreement between the parties, In re Frain, 230 F.3d 1014 (7th Cir. 2000).[13] See also, Ginsberg, et al., §11.06[G][1], 11-103. Embezzlement for the purpose of the Code is the fraudulent appropriation of property by a person to whom such property was entrusted or into whose hands it lawfully came. Pierce v. Pyritz, 200 B.R. 203, 205 (N.D. Ill. 1996) To prove embezzlement, the plaintiff must show by a preponderance of the evidence that (1) the debtor appropriated the subject funds for his own benefit and (2) he did so with fraudulent intent or deceit. Id. Fraud may be somewhat loosely defined and may be proved by circumstantial evidence. See McClellan v. Cantrell, 217 F.3d 890, 893 (7th Cir. 2000) (stating "fraud" "embraces all the multifarious means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false suggestions or by the suppression of the truth"). But embezzlement requires something more than proof that funds have not been fully accounted for. That proof has not been provided in this case.

Similarly, §523(a)(6) states that a §727 discharge does not include debts created by a debtor's willful or malicious injury to another entity.[14] The section relates to the discharge of intentional tort liability; mere economic injury is insufficient. Matter of Haynes, 19 B.R. 849, 851 (Bankr. E.D. Mich. 1982). Negligent and reckless conduct do not fall within the exception. Kawaahau v. Geiger, 523 U.S. 57 (1998) (concluding that §523(a)(6) exception is limited to intentional torts).

Two economic intentional torts are generally acknowledged to be within the contemplation of §523(a)(6): embezzlement and conversion. For the reasons discussed

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[13]Compare the facts of In re Frain and those of the case at hand. In Frain, the Seventh Circuit evaluated a shareholder agreement providing that the debtor could not be removed as chief operating officer of a business for cause without his consent. 230 F.3d at 1018. While the debtor possessed greater power and superior knowledge of the day-to-day operations of the business than did the other shareholders, the Court did not look solely to those factor in making its decision. Id. at 1017. Instead, the Court concluded that the shareholder agreement gave the debtor a position of ascendancy over other shareholders and, therefore, created a fiduciary relationship. Id. at 1018. Here, Rasmussen enjoyed similar advantages over Disch in running Faval. However, Disch was never a shareholder and the parties did not have a shareholder agreement. Thus, Rasmussen did not enjoy a position of ascendancy such that a fiduciary relationship existed.

[14]Section 523(a)(6) of the Code provides:

> (a) A discharge under section 727...of this title does not discharge an individual debtor from any debt...
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> ....
>
> (6) for willful and malicious injury by the debtor to another entity or to property of another entity....

above, Disch has not established an embezzlement. Likewise, Disch has not established that Rasmussen failed or refused to turn over property of Disch after it was demanded she do so.[15] See Lampi v. Hundman Lumber Mart Co., Inc. (In re Lampi), 152 B.R. 543 (C.D. Ill. 1993). There is evidence that the credit card was retained after demand, but as to the monies advanced to Faval or Rasmussen, Disch relinquished ownership of them upon transfer. His only claim in those funds was a right to be repaid (or possibly a right to receive stock of Faval in exchange) but he did not retain ownership. The right to be repaid in these circumstances is not the same as the right to have property returned. Disch has shown that Rasmussen used $6,500 of Disch's January 14, 2000, check to repay a personal loan. But even that amount was property of Rasmussen or Faval, in which Disch retained no interest except a right to repayment in the future.

B. Dischargeability under §727

Although it is usually to the creditor's advantage to seek a determination under §523 that the debt owed to it is not dischargeable rather than seeking a denial of the debtor's discharge under §727, the evidence elicited to prove and, particularly, to defend actions under the two statutes can be very similar. For instance, to defend a claim of defalcation under §523(a)(4), there must be proof of fidelity through accounting records and other evidence showing how entrusted funds were used. The defense to a claim that the debtor failed to explain a loss of assets to meet liabilities under §727(a)(5) would often require exactly the same evidence. Other examples could easily be given. The importance of this is that whatever is pled, the proofs of the charge and, more frequently, the defenses presented, are often very similar under §523(a) and §727(a).

Bankruptcy Rule 7015 and Federal Rule of Civil Procedure 15(b) require a court to treat the issues tried by the parties as if they had been raised in the pleadings, provided that the debtor has not been prejudiced.[16] Matter of Nett, 70 B.R. 868, 871 (Bankr. W.D. Wis.

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[15] Wisconsin statute 943.20(1)(b) provides, in part:

> (A) Whoever does any of the following may be penalized as provided in sub. (3):
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> (b) By virtue of his or her office, business or employment...having possession or custody of money...intentionally uses, transfers, conceals, or retains possession of such money...without the owner's consent, contrary to his or her authority, and with intent to convert to his or her own use or to the use of any person except the owner.

Under this statute, the refusal to deliver money that is in one's possession, upon the demand of a person entitled to receive it, is prima facie evidence of the intent to convert the money to one's own use. State v. Wolter, 270 N.W. 2d 230, 239 (Wis. Ct. App. 1978).

[16] Federal Rule of Civil Procedure 15(b) states, in part:

1987). Even without a formal amendment by the parties, the court may consider constructively amending the pleadings to conform to the evidence. See Walton v. Jennings Cmty. Hosp. Inc., 875 F.2d 1317, 1320 n.3 (7th Cir. 1989); 3 James Wm. Moore et al., Moore's Federal Practice §15.18[3] (3d ed. 1999). In the present case, Seventh Circuit case law indicates that the pleadings have been constructively amended, and Rasmussen has not been prejudiced by the amendment, for at least three reasons.

First, Rasmussen implicitly consented to trial of the §727 issues. In Prescott, the Seventh Circuit stated:

> The key factor in determining whether the pleadings have been amended is whether the issue has been tried with the express or implied consent of the parties. The test for such consent is whether the opposing party had a fair opportunity to defend and whether he could have presented additional evidence had he known sooner the substance of the amendment. One sign of implied consent is that issues not raised by the pleadings are presented and argued without proper objection by opposing counsel. To demonstrate lack of consent, the objection should be on the ground that the contested matter is not within the issues made by the pleadings. Implied consent may also be found if the opposing party itself presents evidence on the matter. (Citations omitted).

In re Prescott, 805 F.2d 719, 725 (7th Cir. 1986). Here, Rasmussen implicitly consented to the trial of the §727 issues when she failed to object and presented evidence on the matters. Aside from hearsay and relevance objections made throughout the trial, Rasmussen only addressed the §727 issues specifically in closing arguments, saying,

> Many of the arguments made today...are more directed to §727 of the Bankruptcy Code than they are to §523 of the Bankruptcy Code.... No mention whatsoever of §727 of the Bankruptcy Code in the complaint that was filed here.

> When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issue may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues.

Furthermore, under Bankruptcy Rule 7054 and Federal Rule of Civil Procedure 54(c), the court must grant relief to which the party in whose favor it is rendered is entitled. See e.g., Nett, 70 B.R. at 871, 874. Federal Rule of Civil Procedure 54(c) provides:

> Except as to a party against whom a judgment is entered by default, every final judgment shall grant the relief to which the party in whose favor it is rendered is entitled, even if the party has not demanded such relief in the party's pleadings.

> (sic) There's been no motion to conform the pleadings to the evidence presented in this case. With that being suggested, I suggest that there is no cause of action under 727 of the Bankruptcy Code.

These comments are insufficient because Rasmussen did not object to specific *issues* that Disch raised as being outside the pleadings. Prescott, 805 F.2d at 725. Instead, she argued that Disch's conclusion–that Rasmussen's behavior implicated both sections 523 and 727–had not been included in the original complaint. In this context, the form of the objection is crucial. Id. (reasoning that bankruptcy court was within its substantial discretion in admitting evidence of issue not raised in pleadings because opposing counsel objected on grounds of hearsay and relevance, not that evidence was outside pleadings, and opposing counsel did not make showing of prejudice resulting from evidence, argue inability to defend issue, or seek continuance for additional time to meet new evidence); see also, Underwriters Salvage Co. of New York v. Davis & Shaw Furniture Co., 198 F.2d 450, 453 (10th Cir. 1952) (stating, "it is the duty of the court to consider issues raised by evidence received without objection even though no formal application is made to amend").

Rasmussen also implicitly consented to trial of the §727 issues when she testified regarding her efforts to evade the Wisconsin Department of Revenue. Id. That testimony did not make it more or less probable that Rasmussen obtained loans from Disch by false oaths and fraud or incurred the debt by willfully and maliciously injuring Disch's property. The evidence was not relevant to Disch's §523 claims. However, the testimony did make it more probable that Rasmussen concealed Faval property within one year of the filing, failed to keep records necessary to ascertain her financial status, and failed to explain satisfactorily her losses. Thus, the evidence was relevant to a claim under §727. In presenting evidence herself that was relevant to the unpled issues, Rasmussen implicitly consented to trial of the §727 issues.[17] Id.

Second, Rasmussen has not been prejudiced because the breadth of discovery provided adequate notice that she would be required to explain what she did with assets and their proceeds. See Nett, 70 B.R. at 874. In considering another rule, the Seventh Circuit stated:

> [P]leading is important only to inform the opposing party of what is claimed and the grounds upon which the claim rests. And in deciding whether a complaint fairly notifies a defendant of matters sought to be litigated, courts have often

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[17] In Rodriguez v. Doral Mortgage Corp., the First Circuit explained its more demanding standard for a party's implicit consent to trial of an unpled issue: "[C]onsent to the trial of an issue may be implied if, during the trial, a party acquiesces in the introduction of evidence which is relevant *only* to that issue" (emphasis added). 57 F.3d 1168, 1172 (1st Cir. 1995). Even against this standard, though, Rasmussen implicitly consented to trial of the §727 issues by failing to object to evidence regarding her efforts to defraud the Wisconsin Department of Revenue.

> looked beyond the pleadings to the pretrial conduct and communications of the parties. (citations omitted). The fruits of discovery, in particular, provide a wealth of information relevant to discerning the breadth of a complaint.

Sundstrand Corp. v. Standard Kollsman Indus., Inc., 488 F.2d 807, 811 (7th Cir. 1973). In his complaint, Disch alleged that Rasmussen "failed and refused to provide Robert Disch with an accounting of the monies which were taken by Faye Rasmussen and purported to be invested in Faval, Inc., or to provide an adequate accounting of the business activities and financial status of Faval, Inc." Plaintiff's Complaint, ¶ 11. At her October 21, 2002, and December 3, 2002, depositions, Rasmussen was questioned at length about what she did with Disch's loans and the extent to which she kept personal and business records. Rasmussen had notice that she would be asked to explain such things at trial. See Nett, 70 B.R. at 874 (reasoning that debtors had adequate notice of an issue not raised in the pleadings because, in part, discovery indicated that they would be required to explain what they had done with assets and proceeds from those assets); see also, Brandon v. Holt, 469 U.S. 464, 471 (1985) (stating, "it is appropriate [for the Court] to...decide legal issues without first insisting that...a formal amendment be filed; this is because we regard the record as plainly identifying petitioner's claim for damages on [a different legal theory]").

Third, it is unclear what additional evidence Rasmussen could have offered to refute Disch's §727 allegations. At trial, she had an opportunity to explain the disappearance of the assets but could not do so because, as discussed below, she had neither sufficient records nor a satisfactory explanation for the absence of the records. Earlier notice of the §727 issues would not have changed Rasmussen's predicament. See Nett, 70 B.R. at 874-75 (stating that it was unclear what additional evidence debtors could offer to refute a §727(a)(5) discharge objection since they were given full opportunity at trial to explain the disappearance of assets and the loss of proceeds therefrom but the court found their explanations unsatisfactory).

In considering Disch's §727 claims, we must look to both the debtor's personal financial records and Faval's financial records. The debtor's financial affairs were so closely related to those of Faval that an understanding of both is necessary to evaluate the claims. See Union Planters Bank. N.A. v. Connors, 293 F.3d 896, 900 (7th Cir. 2002) (evaluating debtors' business and personal records in §727(a)(3) claim because of the significance of the businesses to the debtors' bankruptcy and the intertwining of personal and business expenses necessitated the study of both personal and business records). Disch made most of the checks payable to Rasmussen personally, although the funds were intended to benefit Faval. So any funds reaching Faval were handled by Rasmussen in the first instance as her personal property. Had she been able to show the funds went to Faval, her personal estate might no longer be responsible to Disch, but even that showing would require a resort to the books of Faval.

To sustain an objection under §727(a)(2), the plaintiff must show: (1) that the actor committed the act within the one year before the date of the filing of the petition; (2) that the actor actually intended to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under the Bankruptcy Code; (3) that the debtor or her duly authorized agent committed the act; and (4) that the act consisted of transferring, removing, destroying, or concealing any of the debtor's property or permitting any of those acts to be done. Kellogg-Citizens Nat'l Bank of Green Bay v. DeBruin (In re DeBruin), 144 B.R. 90, 92 (Bankr. E.D. Wis. 1992).[18] The plaintiff bears the burden of proving the objection by a preponderance of evidence, In re Scott, 172 F.3d 959 (7th Cir. 1999); DeBruin, 144 B.R. at 92, but once the objecting party presents a prima facie case, the burden shifts to the debtor to show that the property in question was dealt with in an honest way and that it has been properly accounted for.

In the present case, Rasmussen admitted that, at all times, she ran Faval as a cash-based business to conceal assets from the State of Wisconsin and avoid a potential tax levy. Such concealment involved property of the debtor within one year of the filing of her petition. Thus, Rasmussen's action falls squarely within §727(a)(2).[19]

Section 727(a)(3) requires the denial of a discharge if the debtor has failed to keep or produce adequate books and records, making the privilege of discharge dependent on a true presentation of the debtor's financial affairs.[20] Scott, 172 F.3d at 969. The statute ensures

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[18] Section 727(a)(2) of the Code provides:

> The court shall grant the debtor a discharge, unless–
>
> (2) the debtor, with the intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed–
>
> (A) property of the debtor, within one year before the date of the filing of the petition; or
>
> (B) property of the estate, after the date of the filing of the petition....

[19] Generally, establishing actual intent is the most difficult task for a plaintiff arguing under §727(a)(2). As a result, courts often look to badges of fraud as indirect evidence of intent. See e.g., DeBruin, 144 B.R. at 93; Ginsberg, et al., §11.02[C] at 11-17. However, in the present case, Rasmussen admitted that she dealt in cash so as to conceal assets from a creditor. Thus, actual intent is apparent and there is no need to conduct a badges of fraud analysis.

[20] Section 727(a)(3) of the Code reads:

> (a) The court shall grant the debtor a discharge unless–
>
> (3) 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.

that creditors will receive sufficient information to enable them to trace the debtor's financial history, ascertain the debtor's financial condition, and reconstruct the debtor's financial transactions. Id. Where the debtor is sophisticated in business and operates a business involving significant assets, creditors have an expectation of better record keeping. Id. at 970. While the debtor may seek to excuse her failure to keep such records, vague testimony and explanations will not justify the absence of records. In re Calisoff, 92 B.R. 346, 357 (Bankr. N.D. Ill. 1988); see also, Union Planters Bank, 293 F.3d at 900 (stating neither courts nor creditors are required to shift through a morass of cancelled checks and bank statements to reconstruct a debtor's financial affairs); Ginsberg, et al., §11.02[D][1], at 11-22.

In the present case, Rasmussen failed to keep records regarding most of her and Faval's business transactions. Rasmussen testified that she made numerous loans to Faval but neither her nor Faval's records produced in connection with this case reflect the loans. While most individual bankruptcies do not involve complex business transactions sufficient to implicate §727(a)(3), this case does. See Scott, 172 F.3d at 970; Union Planters Bank, 293 F.3d at 900. Rasmussen offered inadequate justifications for her failure to keep records. Her desire to thwart the state taxing authority *explains* why she dealt in cash and did not keep accurate records but it does not *justify* her actions. Rasmussen's failure to maintain books and records from which her financial condition could be ascertained warrants the denial of her discharge under §727(a)(3).

Section 727(a)(5) gives bankruptcy courts broad power to decline to grant a discharge where the debtor does not adequately explain a shortage, loss, or disappearance of assets.[21] Quaid v. Martin (In re Martin), 698 F.2d 883, 886 (7th Cir. 1983). At trial, the party objecting to the discharge must establish the basis for the objection. Nett, 70 B.R. at 873 (quoting In re Chalik, 748 F.2d 616, 619 (11th Cir. 1984)). Once the objecting party meets its burden, the burden shifts to the debtor to explain satisfactorily the loss. Id. An explanation is satisfactory if it eliminates the need for the court to speculate as to what happened to assets and is supported by sufficient documentation as to free the court from the need to speculate as to its veracity. In re Martin, 145 B.R. 933, 950 (Bankr. N.D. Ill. 1992).

At trial, Disch established that he contributed over $800,000 to Rasmussen and Faval during the 20 months before she filed her petition. The burden then shifted to Rasmussen to explain why that money was not available to pay her debts and the liabilities of Faval. See e.g., Baum v. Earl Millikin, Inc. (In re Baum), 359 F.2d 811, 813 (7th Cir. 1966) (holding objecting party met its burden under §727(a)(5) predecessor §14(c)(7) of Bankruptcy Act by

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[21]Section 727(a)(5) of the Code states:

> (a) The court shall grant the debtor a discharge unless–
>
> (5) the debtor has failed to explain satisfactorily before determination of denial of discharge under this paragraph, any loss of assets of deficiency of assets to meet the debtor's liabilities.

showing that a debtor's financial statement indicated the loss of approximately $366,000 in the 21 months prior to the petition); Chalik, 748 F.2d at 619 (upholding the trial court's determination that plaintiffs met their burden by establishing that the debtor received a $130,000 loan prior to filing his petition); Nett, 70 B.R. at 873 (concluding objecting party met its burden under §727(a)(5) by showing that the debtors' pre-petition assets included cows, corn, hay, soybeans, milk, a running gear, and $11,000).

Rasmussen's explanation was not satisfactory. Primarily, what testimony she presented amounted to an uncorroborated, general description of vague financial transactions. She provided only round dollar allocations to expenses such as payroll and supplier costs; stated that she engaged in complicated transactions that affected Faval's profitability, such as the coolers purchase; and testified that, in 2001, she repaid personal and third-party loans made to Faval. Such vague explanations leave Rasmussen's creditors and this Court to guess what she did with her assets.[22]

Second, Rasmussen was not credible. She admitted that, in an effort to defraud the Wisconsin Department of Revenue, she designed Faval to be as opaque as possible. Nothing in her testimony reduced that opacity. See Nett, 70 B.R. at 873 (stating that the debtors' failure to identify expenses with sufficient detail to permit verification contributed to a finding as to the debtors' lack of credibility). Other witnesses controverted her testimony regarding issues such as whether she took a salary. Her testimony was conflicting as to when she began paying employees in cash. She made statements about not seeing the need to record transactions, implausible given her sophistication as a business person and her admission that she wanted to avoid a tax levy. Negative inferences drawn from her use of the Fifth Amendment at trial undercut Rasmussen's credibility, as well. See Baxter v. Palmigiano, 425 U.S. 308, 318 (1976) (holding the Fifth Amendment does not forbid adverse inference against parties to civil actions when they refuse to testify in response to probative evidence offered against them); see also Grant v. Simmons (In re Simmons), 113 B.R. 741, 745 (Bankr. M.D. Fla. 1990) (drawing negative inference from a debtor's use of his Fifth Amendment privilege in his bankruptcy case). Therefore, Rasmussen is not entitled to a discharge under §727(a)(5).

C. Revoking the Debtor's Discharge

This Court granted Rasmussen her discharge before hearing Disch's adversary

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[22]See Matter of D'Agnese, 86 F.3d 732, 735 (7th Cir. 1996) (concluding bankruptcy court did not commit clear error in finding debtor's explanation of losses inadequate when debtor failed to provide evidence supporting claim that she transferred certain assets to third party); Baum, 359 F.2d at 814 (holding debtor failed to explain satisfactorily his losses when he offered only "unconvincing" testimony that he made poor investments); Nett, 70 B.R. at 873 (reasoning that general statements regarding use of assets, without amount paid, identity of recipients, or time of payments, was unsatisfactory).

proceeding. In the vast majority of cases, parties plead adequately in adversary proceedings and the Clerk of Court's staff can determine whether a claim has been filed under §727. If none has, the clerk follows the standard procedure of granting a debtor's discharge 60 days after his §341 meeting as to all debts that are not the subject of a pending adversary proceeding brought under §523.[23] Disch's complaint alleged grounds for relief under §523, not §727. Thus, on August 19, 2002, following its standard procedure and without evaluating the substance of Disch's claims, this Court issued Rasmussen her discharge as to all debts not subject to a pending adversary proceeding.[24] Only at trial did it became apparent that the pleadings should be constructively amended to include the §727 objections and that Rasmussen should not have received her discharge.

The Bankruptcy Code and Rules place very strict limits on when a court may revoke a discharge. They provide that a discharge can only be revoked for fraud determined in an adversary proceeding.[25] The discharge-granting procedures of this Court were adopted (as

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[23] The Bankruptcy Court of the Western District of Wisconsin's Case Administrators' Procedure Manual reads:

> All Chapter 7 cases (except corporations and partnerships) can be discharged as soon as the last day to object to the discharge has passed (60 days from the 341 meeting) unless: filing fee has not been paid; 341 meeting has not been concluded; the objection date has not passed or an extension was granted; 727 adversary is pending; [or] debtor's motion to dismiss is pending.

This local statement of clerking procedure is consistent with the Bankruptcy Clerk's Manual, published and disseminated by the Administrative Office of United States Courts.

[24]The order read:

> It appearing that the debtor is entitled to a discharge, IT IS ORDERED: The debtor is granted a discharge under section 727 of title 11, United States Code, (the Bankruptcy Code).
>
> This order does not affect any pending adversary proceeding to determine dischargeability.

[25]Section 727(d) of the Code provides:

> (d) On request of the trustee, a creditor, or the United States trustee, and after notice and a hearing, the court shall revoke a discharge granted under subsection (a) of this section if–
>
> > (1) such discharge was obtained through fraud of the debtor, and the requesting party did not know of such fraud until after the granting of such discharge;
> >
> > (2) the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to

they have been in nearly all courts) to provide efficiency, certainty, and early notice of discharge to creditors.[26] But, if those procedures render the discharge irrevocable in this case, the constructive amendment of the pleadings is rendered meaningless.

Section 105(a) provides bankruptcy courts with an equitable power to prevent such a manifest injustice.[27] Although this Court is reluctant to invoke §105(a), doing so is perhaps the only way to enforce the Code provisions requiring denial of Rasmussen's discharge and ensure that Disch receives the judgment to which he is entitled.

Bankruptcy courts are necessarily trusted with broad equitable power under §105(a). Pioneer Inv. Serv. Co.v. Brunswick Assoc. Ltd., 507 US 380, 389 (1993). That equitable power is not "free-floating": a bankruptcy court must exercise it in a manner consistent with the Code and as a means to fulfill some specific Code provision. Matter of Lloyd, 37 F.3d 271, 275 (7th Cir. 1994) (citing Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988)); Matter of Fresco Plastics Corp., Inc., 996 F.2d 152, 154 (7th Cir. 1993) (stating, "[A] bankruptcy court is simply not authorized to do whatever is necessary to reach an equitable result; it may only do whatever is necessary to enforce the Code....").

Our situation presents a choice between provisions of the Code. On one hand, Rasmussen's conduct merits denying her discharge pursuant to §§727(a)(2), (3), and (5). On the other hand, the facts do not support revoking her pursuant to §727(d). I am satisfied that the merits of the case must trump the procedure. The granting of the discharge was, in retrospect, inappropriate, although it was procedurally correct at the time. Rasmussen's discharge must be revoked to carry out the primary provisions of the Bankruptcy Code.

> such property, or to deliver or surrender such property to the trustee; or
> (3) the debtor committed an act specified in subsection (a)(6) of this section.

[26]Federal Rule of Bankruptcy Procedure 7001 reads, in part:

> An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings:
>
> ....
> (4) a proceeding to object to or revoke a discharge....

[27]Section 105(a) of the Code states:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

This careful use of equitable power is in line with Seventh Circuit case law. The power is used to enforce a specific Code provision and not to circumvent the law. In Matter of Lloyd, a bankruptcy court used its equitable power to direct a trustee to obtain a zoning change as to a portion of land so a debtor could build a residence and enjoy the benefit of her homestead exemption. 37 F.2d at 274. The Seventh Circuit held that in so doing, the bankruptcy court carefully adhered to the prescriptions of the Code's homestead exemption and "did not overstep the bounds of its considerable equitable power." Id. at 275. Here, equitable powers have been invoked to enforce the prescriptions of §§727(a)(2), (3), and (5), not to bring about a result not contemplated by Code provisions.

Our case is distinguishable from Matter of Greenig. In that case, the Seventh Circuit held that a bankruptcy court improperly used its equitable power to circumvent Bankruptcy Rule 3002(c) when it allowed a creditor to file an untimely proof of claim. 152 F.3d 631 (7th Cir. 1998). The bankruptcy court's rationale was that the debtors had shortened the claims allowance process by submitting a plan, which the court confirmed, before the deadline for filing proofs of claim. Id. at 633. The Seventh Circuit reasoned that a bankruptcy court's equitable power could not be used to prevent windfalls to debtors and grave injustices to creditors; instead, it must be used to enforce a specific Code provision. Id. at 635. Today, we are choosing between Code provisions, three of which are applicable on the merits of the case and one of which is applicable because of a procedural mishap. Using equitable power to enforce the Code's standards for denying discharges does not circumvent the law.[28]

D. *Granting a Money Judgment*

Disch has submitted ample, uncontroverted evidence that he advanced more than $657,700 to Rasmussen which has not been repaid.[29] Because that sum is the one sought

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[28]A second basis on which this Court may revoke Rasmussen's discharge is Bankruptcy Rule 9024, which applies Federal Rule of Civil Procedure 60(a). Federal Rule of Civil Procedure 60(a) states, in relevant part:

> Clerical mistakes in judgments, orders or other parts of the record and errors therein arising from oversight or omission may be corrected by the court at any time of its own initiative or on the motion of any party and after such notice, if any, as the court orders.

Although the procedures that led to the discharge normally work to create efficiency and certainty, they produced an unintended result in this case. To the extent that the inadvertent discharge was a mistake, then, this Court may correct it by revoking the discharge of its own initiative. In re Stovall, 256 B.R. 490, 492 n.2 (Bankr. N.D. Ill. 1999) (stating, "Discharge orders entered through clerical error or through mistake such as [a] Chapter 13 Trustee's mistake...can be corrected by motions under Rule 9024....")

[29]Disch gave Rasmussen personally $590,121.05 in loan proceeds and $217,200 in checks.

by Disch in final argument, a money judgment may be entered in that amount in favor of Disch.[30]

III. Conclusion

For the reasons stated above, Rasmussen's discharge, granted August 19, 2002, is revoked and her discharge should be denied pursuant to §§727(a)(2), (3), and (5). Moreover, a money judgment in the amount of $657,700 shall be entered in favor of Disch. This Memorandum Decision shall stand as the Court's findings of fact and conclusions of law.

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[30]The Seventh Circuit has concluded that bankruptcy courts have jurisdiction to enter money judgments. N.I.S. Corp. v. Hallahan (In re Hallahan), 936 F.2d 1496, 1508 (7th Cir. 1991). In Hallahan, the Court stated:

> ...[A]llowing the bankruptcy judge to settle both the dischargeability of the debt and the amount of the money judgment accords with the rule generally followed by courts of equity that having jurisdiction of the parties to controversies brought before them, they will decide all matters in dispute and decree complete relief. (Citing Alexander v. Hillman, 296 U.S. 222 (1935)). Once properly before a court of equity, a party subjects himself or herself to "all the consequences that attach to an appearance," id. at 241....

936 F.2d at 1508; see also, Haines, Randolph J., Old Rules Reveal *Pacor*'s Shortcomings, 2003 No. 1 Norton Bankr. L. Advisor 1.