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UNITED STATES
DISTRICT COURT
DISTRICT OF UTAH
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IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH - CENTRAL DIVISION

KENNETH L. ROTHEY,

Appellant,

vs.

SURESH SHAH,

Appellee.

MEMORANDUM DECISION
AND ORDER

83C-03261
84PC-0059

Civil No. C86-1059G

This matter came before the court on appellant Kenneth L. Rothey's ("Rothey") appeal from a final judgment entered on November 12, 1986 by the United States Bankruptcy Court for the District of Utah. Rothey was represented by Lynn J. Clark, and appellee Suresh C. Shah ("Shah") was represented by Benjamin P. Knowlton. Counsel submitted memoranda and presented oral argument, after which the court took the matter under advisement. Now being fully advised, the court enters its Memorandum Decision and Order.

FACTUAL BACKGROUND

Shah negotiated to borrow approximately \$63,800.00 from Rothey sometime in early 1982 for the purpose of obtaining inventory for a used car dealership. The funds were distributed to Shah on or about May 18, 1982 in the form of thirteen Promissory Notes (the "Notes") secured by various items of

property including Shah's used car inventory. The Notes were payable on demand with interest payable monthly at fifteen percent. Shah paid the monthly interest payments until September 1983.

In May 1983, Rothery demanded Shah to begin payment of the principal balance of the Notes. Shah assured Rothery that his business was profitable and that the Notes were adequately secured. Shah agreed to reduce the principal by \$10,000.00 per month beginning June 1983 if Rothery would stay his payment demand until that time. In support of such an agreement, Shah provided Rothery with what he represented to be an accurate accounting of current inventory and accounts receivable. Such accounting showed assets of approximately \$107,000.00. Rothery claims that the figure was in fact false and that the Notes actually were undersecured by Shah's inventory and receivables. Rothery further claims that in reliance upon the false and misleading accounting he forbore in demanding payment of the Notes or exercising his rights in the collateral until the agreed upon date of June 1983. When that payment date arrived, Shah informed Rothery that he was unable to make the \$10,000 payment but represented that the Notes were adequately secured. Shah thereupon promised payment in July 1983. However, Shah failed to make the promised payment in July well as August and September 1983.

In September 1983 Rothey met with Shah who once again assured Rothey that his business was running at a profit and that the Notes were fully secured. At this meeting Shah presented Rothey with what he represented to be a current and accurate accounting of his inventory and accounts receivable. That accounting, which reflected assets worth approximately \$85,000.00, was false and vastly overstated as admitted later by Shah. Shah has failed to pay any portion of the principal amount of the Notes. Rothey subsequently filed suit in state court for the amount due him under the Notes. Shortly thereafter Shah filed for Chapter 7 bankruptcy protection in the United States Bankruptcy Court for the District of Utah.

In an adversary proceeding before the bankruptcy court, Rothey claimed that his forbearance in demanding payment of the Notes was a direct result of his reliance upon the false and overstated accounting and oral representations provided by Shah. Accordingly, Rothey claims that such forbearance constitutes an extension, renewal, or refinancing of credit within the meaning of 11 U.S.C. § 523(a)(2), thereby rendering Shah's debt nondischargeable. The bankruptcy court ruled, as a matter of law, that Rothey's forbearance did not constitute a renewing or refinancing of credit within the meaning of 11 U.S.C. § 523(a)(2) even though such forbearance was allegedly induced by Shah's submission of knowingly fraudulent financial statements.

Accordingly, the bankruptcy court held that Shah's debt to Rothery was dischargeable under the Bankruptcy Code.

ANALYSIS

The issue for consideration in the present appeal is: Does Rothery's forbearance from calling in demand notes, as a result of reliance upon false financial statements (assuming arguendo that they were false), constitute an extension, renewal, or refinance of credit within the meaning of 11 U.S.C. § 523(a)(2)?

Section 523 of Title 11 provides in part:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-- . . .

(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 than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing--

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive; . . .¹

In the present case, it is clear that Shah did not

¹ 11 U.S.C. § 523(a)(2) (Supp. 1988) (emphasis added).

obtain a "renewal" or "refinancing" of credit from Rothey at the time the false financial accountings were provided. The question presented here turns, rather, on whether Rothey's forbearance constitutes an "extension" of credit. At first blush it might appear that the question could be answered negatively considering that the Notes, payable on demand, have no fixed maturity date. However, Rothey did demand at least partial payment which demand was in fact extended as a result of the alleged reliance upon the false reports submitted to him by Shah. Rothey clearly could have persisted in his payment demand. Accordingly, this court holds that the decision not to do so, thereby allowing Shah to continue the "debtor-creditor" relationship, in substance and effect constituted an extension of credit within the meaning of 11 U.S.C. § 523 (a)(2).

Such a holding is not without precedent. In First Federal Savings and Loan Ass'n v. Mancini,² the defendant executed a promissory note in favor of the plaintiff which was payable on demand. The terms of the note were that the defendant was to keep the interest current and the loan would be reviewed annually after submission of the defendant's financial statement. If at any time the plaintiff felt insufficiently secured, payment of the indebtedness could be demanded. In October 1985, the

² 77 B.R. 913 (Bkrtcy. M.D. Fla. 1987).

defendant submitted a financial statement to the plaintiff which was allegedly relied upon in extending the loan rather than calling the note due. The financial statement was also alleged to have been false and the plaintiff therefor claimed the debt owed it should be nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(B). In ruling the debt nondischargeable the court stated, "it is clear that not to exercise a legal right when it could have been exercised and to permit the borrower to continue to enjoy credit is tantamount to an extension of credit which is clearly one of the elements of a claim of nondischargeability under § (1)(2)(B)."³ In reaching its decision, the Mancini court rejected cases like In re Colasante⁴ which held "forbearance by a creditor to call demand notes is not 'an extension or renewal of credit' within the meaning of [11 U.S.C. § 523(a)(2)]."⁵ Likewise, this court rejects such an interpretation and holds under the facts of this case that forbearance in demanding payment on the demand Notes constituted an extension of credit within the meaning of 11 U.S.C. § 523(a)(2). Accordingly, as a matter of law, the bankruptcy court is reversed on this issue.

³ Id. at 916.

⁴ 12 B.R. 635 (Bkrtcy. E.D. Pa. 1981).

⁵ Id. at 638.

Finally, because the bankruptcy court ruled prior to the trial on this matter that to forbear and refrain from calling a demand note for payment does not constitute an extension of credit, there was no direct testimony taken as to the other elements of Section 523(a)(2) necessary to bar a discharge. However, if all other elements of the Section are met, such debts are nondischargeable. For this reason, the matter is remanded to the bankruptcy court to hear evidence and determine whether Shah's representations were false, and if so whether they were reasonably relied upon in extending credit, and made with intent to deceive.

For the reasons stated, it is hereby

ORDERED that the final Judgment of the United States Bankruptcy Court for the District of Utah entered on November 12, 1986 in the above captioned matter is REVERSED and REMANDED for further proceedings not inconsistent with this opinion.

DATED: December 13, 1988.



J. THOMAS GREENE
UNITED STATES DISTRICT JUDGE

COPIES TO: 12-13-88jm

Lynn J. Clark, Esq.
Benjamin P. Knowlton, Esq.
Marilyn Weaver,
Appeals Clerk