

1 According to Debtors, who claim to have invested almost twice as much in the Club as
2 Plaintiffs, they never used the Club's income for personal expenses without paying the
3 Club back. While Debtors had great hopes and plans for the Club's success, for most of
4 its life, it operated on the edge of financial disaster. Debtors assert that Plaintiffs, all of
5 whom worked or exercised at the Club, were well aware of the Club's fragile financial
6 condition. According to Debtors, they never misrepresented the state of the Club when
7 seeking investments or loans.
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9 Determining whose version of the facts is correct is critical to the determination of
10 Plaintiffs' individual claims. If Plaintiffs' version is correct, they justifiably relied on
11 Debtors' misrepresentations regarding the Club's financial condition when they
12 advanced funds. If Debtors' version is correct, Plaintiffs' reliance is unjustified because
13 Plaintiffs understood the Club was in financial peril from the day it opened its doors. The
14 parties' different versions of the facts also impact any determination regarding whether
15 Debtors intended to defraud Plaintiffs at the time they asked Plaintiffs to invest or loan
16 money. If Plaintiffs are correct, Debtors knew, at the time they were soliciting money
17 from Plaintiffs, either that the money would be used for Debtors' personal benefit or
18 Debtors were misrepresenting the Club's financial status. If Debtors are correct, they
19 never used Club funds, including amounts paid by Plaintiffs, for their personal benefit
20 and never misrepresented the Club's financial condition. The different versions of the
21 facts are also critical in determining if Debtors subjectively intended to harm Plaintiffs
22 when funds were being solicited.¹
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27 ¹ Each of these determinations is critical to Plaintiffs' claims under § 523(a)(2) and (a)(6). Plaintiffs also
28 have alleged violations of § 523(a)(4), but have failed to explain how Debtors' conduct constituted either
larceny or embezzlement. Nor has there been any demonstration that Debtors owed Plaintiffs a fiduciary
duty. As a result, it is unlikely that any of Plaintiffs could prevail under § 523(a)(4).

1 seek financial assistance in the form of investments or loans from Club members and
2 instructors to keep the Club operating.

3 The financial practices and recordkeeping for the Club were less than perfect.
4 Debtors admit that they intermingled business income from the Club with their personal
5 income in a number of different bank accounts. Debtors also admit that they paid both
6 personal and business expenses from those intermingled accounts, but assert that all
7 payments for personal expenses were reimbursed to the Club.
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9 In January 2006, a QuickBooks system ("QuickBooks") was set up for the Club.
10 Prior to that time, all of the Club's financial records were kept on Excel spreadsheets.
11 The QuickBooks program was installed on multiple computers—one of which, an H.P.
12 laptop, was the Club computer ("Club Computer"). QuickBooks was also apparently
13 installed on a Dell computer maintained at Debtors' residence. (March 5, 2012 Trial
14 Transcript, p. 43, lns 17-21.)
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16 Ultimately, both Debtors and Amparan filed Chapter 7 cases: Amparan filed her
17 case in 2009 and received a discharge. Debtors filed their Chapter 7 petition on July 7,
18 2010.
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20 On November 12, 2010, a number of the Club members ("Plaintiffs")—who had
21 invested in the club, lent it money, or were allegedly due wages—filed a non-
22 dischargeability complaint against Debtors alleging that Debtors' obligations to them
23 were non-dischargeable under 11 U.S.C. §§ 523(a)(2)(A), 523(a)(4) and 523(a)(6).⁴ In
24 addition, Plaintiffs sought to deny Debtors their discharge under §§ 727(a)(2) and
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27 contributed \$350,000 to \$420,000 to try to keep the Club afloat. Plaintiffs assert that Debtors cannot
document the alleged additional contributions.

28 ⁴ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C.
§§ 101-1532. All "Rule" references are to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

1 727(4)(B) and (C). On August 8, 2011, an amended complaint ("Amended Complaint")
2 was filed, which added § 727(a)(3) to Plaintiffs' claims.

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4 Contentious litigation ensued, with discovery battles over Debtors' turnover of
5 financial records—in particular, a complete copy of the QuickBook records ("QuickBook
6 Records"). During a 2004 exam, Debtors agreed to print the complete QuickBook
7 Records and provide them to their attorney for turnover to Plaintiffs' counsel. (Trial
8 Ex. KB, p. 118, Ins 10-16.) Debtors failed to do so and, as a result, Plaintiffs filed a
9 motion to compel Debtors to provide documents and a request for limited sanctions
10 ("Discovery Motion').

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12 On June 14, 2011, a hearing was held on the Discovery Motion, which included
13 requests for the QuickBook Records and a listing of monthly accounts receivable and
14 accounts payable from March 2005 to October 2008. At the hearing, Debtors were
15 required to turn over some of the documents requested and to file with the Court and
16 serve on Plaintiffs' counsel a statement about their ability to provide other requested
17 documents, including the QuickBook Records. The Discovery Motion also indicated that
18 Debtors had agreed to turn over the Club Computer, a Dell desktop computer,⁵ and a
19 printer to Landlord's attorney.

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21 On June 24, 2011, Debtors filed a notice regarding their ability to produce the
22 requested documents, including the QuickBook Records ("June 24 Notice"). In that
23 notice, Debtors asserted that all of the financial records for the two LLCs had already
24 been turned over, including all of the QuickBook Records. Debtors further stated that
25 the Club had no accounts payable records due to a "lack of time and knowledge."
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28 ⁵ The Dell desktop was replaced by the Club Computer.

1 According to Debtors, the Club's accounts payable could only be tracked through bank
2 statements previously turned over. Lastly, Debtors asserted that the Club Computer had
3 been turned over and that both the printer and the requested Dell desktop computer no
4 longer existed.

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6 Plaintiffs later served subpoenas on various banks in order to obtain all of the
7 Club's and Debtors' bank statements. Plaintiffs also continued to seek copies of, or
8 direct access to, the QuickBooks Records.⁶ All parties agree that Debtors turned over a
9 printout from QuickBooks. That printout, however, did not include any information about
10 the Club's payables. Debtor Heidi Kolb testified at a continued 2004 exam that the Club
11 maintained a file of receipts, which would have documented at least some of the Club's
12 payables. According to Heidi Kolb, those files were maintained in a black file box
13 located at the Club's first location, but access to the records was lost when Landlord
14 locked out the Club out. (Ex. LB, p. 146, Ins 19-20.)⁷ Heidi Kolb testified that Amparan
15 maintained records of the accounts payable between 2005 and 2008 on an Excel
16 spreadsheet on Amparan's individual laptop computer. However those accounts
17 payable records were never re-created after Amparan left in 2008 and took her personal
18 computer with her. Therefore, there were no accounts payable records for the Club for
19 the 2005-2008 time period. (Ex. LB, p. 172, Ins 16-23.)⁸

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23 As noted earlier, Landlord held a security interest in all of the Club's personal
24 property, including the Club Computer. After the Debtors filed for bankruptcy, Landlord
25 demanded that the Club Computer be turned over. Before turning the Club Computer

26 ⁶ As far as the Court can determine from its review of the record, Plaintiffs never requested that the Club
27 Computer, itself, be provided to them.

28 ⁷ Apparently, neither Debtors nor Plaintiffs ever requested that Landlord release any Club records.

⁸ Neither Debtors nor Plaintiffs appear to have done anything to obtain any Club records from Amparan.

1 over to their lawyer for delivery to the Landlord's lawyer, Debtors had the computer
2 "scrubbed." As a result, the QuickBook program and QuickBook Records were
3 completely removed from the Club Computer. Heidi Kolb testified that the Club
4 Computer was scrubbed because her lawyer advised Debtors that third-party personal
5 information, including credit card numbers of Club members, needed to be protected
6 from disclosure. The "scrub" was performed by a personal acquaintance of Debtors
7 whose last name and whereabouts were unknown to Debtors at the time of the
8 discharge trial. (Ex. LB, pp. 174-175.)
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11 After the Club Computer was delivered to Debtors' counsel, one of the Plaintiffs
12 appeared at Debtors' counsel's office and picked it up. It is unclear why or how that
13 happened, but there is no evidence that either Debtors or Landlord agreed that Plaintiffs
14 could take the Club Computer. Eventually, the Club Computer was delivered to
15 Landlord.
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17 On March 5, May 2, and May 14, 2012, a trial was conducted on the Amended
18 Complaint. Closing briefs have been filed. The matter is past due for decision.

19 **III. ISSUES**

- 20 1. Did the Debtors fail to maintain adequate financial records and/or destroy
21 financial records without just cause?
- 22 2. Are the individual claims of the seven Plaintiffs non-dischargeable?
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24 **IV. JURISDICTION**

25 This Court has jurisdiction in this matter pursuant to 28 U.S.C. §§ 1334(b) and
26 157(b)(2)(G).
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1 kind of business, or produce adequate reasons why the debtor was not required to keep
2 such records. Id., citing Meridian Bank v. Alten, 958 F.2d 1226, 1232 (3d Cir. 1992).

3 This legal framework must now be applied to the facts of this case.
4

5 **B. Lack of Adequate Records**

6 The evidence demonstrates that the creditors have met their *prima facie* burden.
7 Debtors indisputably did not keep records of the Club's payables. As a result, it is
8 impossible for creditors to ascertain the Club's business transactions or Debtors' true
9 financial condition. The question, therefore, is whether Debtors' failure to keep adequate
10 records was justified in the circumstances of their case.
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12 Plaintiffs allege that Debtors were sophisticated in business and, therefore, there
13 was no justification for their failure to maintain adequate records. However, the
14 evidence did not demonstrate that Debtors were experienced at owning and operating a
15 health club. Jeffrey Kolb worked at other jobs and was not involved in the day-to-day
16 operation of the Club. Heidi Kolb had experience as a successful Mary Kay salesperson
17 and had also worked as a manager for other health clubs, but apparently had never had
18 complete responsibility for operating a business, including creating business plans and
19 keeping a complete set of financial records. Yet, even if Debtors were not sophisticated
20 business operators, they were not completely at sea with respect to understanding
21 financial transactions. They maintained multiple bank accounts and wrote at least one
22 operating agreement for one of the LLCs. Debtors introduced no evidence that failure to
23 maintain records of business payables is common in the operation of health clubs.
24 Furthermore, Debtors suffered no medical problems which would have made adequate
25 recordkeeping difficult. They did not confront any language or cultural problems,
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1 problems which would have justified the inadequate recordkeeping. Accordingly,
2 Debtors have failed to demonstrate that the records produced are customarily kept by a
3 person doing the same kind of business or that they had adequate reasons for not
4 maintaining adequate records. Meridian Bank, 928 F.2d at 1232.

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6 Some courts have found that a discharge cannot be denied under § 727(a)(3)
7 when the inadequate records are corporate records and the corporation is a separate
8 entity. See In re Nipper, 186 B.R. 284, 289 (M.D. Fla. 1995). However, that rule cannot
9 help Debtors because they intermingled their corporate and personal financial affairs,
10 making it impossible to separate Debtors' financial records from the Club's.

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12 Further, Debtors' failure to keep adequate records created problems for all
13 parties. For example, Debtors testified that they and family members invested between
14 \$300,000 and \$400,000 in the Club, but the only evidence of those investments were
15 deposits listed on their bank statements. Without documents identifying the source of
16 the deposits, Debtors had to fall back on the assertion that deposits above a certain
17 amount represented their personal investment in the Club. The lack of any other
18 evidence to corroborate that testimony made it impossible for Debtors to prove the
19 amount of their contributions to the Club.⁹

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21 Similarly, because Debtors intermingled Club and personal money, it was
22 important that records be kept to document what each withdrawal was used for. This
23 was especially true in this case, where Debtors have asserted that any amounts paid for
24 personal expenses were either paid from personal funds deposited into the bank
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27 ⁹ While Debtors emphasize their own financial contribution to the Club, the amount of such contributions
28 is irrelevant to a § 727(a)(3) analysis. A debtor may invest millions in a business, but if he fails to maintain
adequate records, his discharge may still be denied under § 727(a)(3).

1 accounts or, if paid from Club money, reimbursed. However, there simply are no
2 records available to corroborate these assertions.

3 C. Destruction of Records

4 Failure to keep adequate records is, by itself, grounds for denial of Debtors'
5 discharge. But Debtors did not only maintain inadequate records, they also destroyed
6 records postpetition.
7

8 Debtors promised Plaintiffs they would turn over all of the QuickBook Records.
9 Debtors assert that they complied. Both sides agree that the records exchanged contain
10 only accounts receivable information. Plaintiffs argue that the QuickBook Records also
11 should have included accounts payable information. Debtors argue that was not the
12 case, and that there are no payable records for the Club in the QuickBook Records. It is
13 impossible, though, to determine if Plaintiffs are correct because Debtors scrubbed the
14 QuickBook Records from the Club Computer.¹⁰ Debtors' explanation that they scrubbed
15 the Club Computer days before delivering it to their attorney makes no sense. By then,
16 they had already delivered a printout of all the alleged QuickBook Records to Plaintiffs.
17 Presumably any sensitive client information would have been included in that
18 information. Even if that were not the case, there were undoubtedly less drastic
19 measures Debtors could have used to protect sensitive information, such as creating a
20 backup file for the QuickBook Records. There is no evidence they pursued such
21 alternatives.¹¹
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26 ¹⁰ Plaintiffs should not have seized the Club Computer from the office of Debtors' counsel, but Plaintiffs'
27 bad conduct did not damage Debtors, who had already damaged themselves by destroying the
QuickBook Records.

28 ¹¹ The record is less than clear, but the QuickBook Records may remain on Debtors' home computer. If
that is the case, there is no plausible reason why the QuickBook Records from that computer were not

1 Debtors' scrubbing of the Club computer destroyed books and records which
2 could have shed light on their financial situation and constitutes a second basis for
3 denying Debtors' discharge under § 727(a)(3). See In re Allison, 2004 WL 3622637
4 (Bankr. N.D. Tex. Sept. 20, 2004).
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6 **D. Plaintiffs' Individual Claims**

7 Because Debtors' discharge is being completely denied under § 727(a)(3), none
8 of the other allegations in Plaintiffs' Complaint need to be addressed. In particular, no
9 determinations will be made as to the amount or dischargeability of each Plaintiff's
10 claim. As a result of the denial of Debtors' discharge, Plaintiffs are free to pursue their
11 claims, pursuant to applicable law, in a court of competent jurisdiction. To the extent
12 there are assets in the estate, Plaintiffs may also seek a pro rata distribution on their
13 claims, when allowed, from the Chapter 7 trustee.
14

15 **VI. CONCLUSION**

16 Debtors, without just cause, failed to maintain adequate records to permit
17 creditors to ascertain Debtors' financial condition and the financial condition of a
18 business they controlled. In addition, after their case was filed, Debtors destroyed some
19 of their financial records. Accordingly, Debtors' discharge is denied under § 727(a)(3). A
20 judgment to that effect will be entered this date.
21

22 The foregoing constitutes the Court's statement of facts and conclusion of law as
23 required by Fed. R. Bankr. P. 7054.
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25 Dated and signed above.
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28 provided to Plaintiffs or the computer made available to confirm Debtors' assertion that the QuickBook
Records contain no information about payables.

1 Notice to be sent through
2 the Bankruptcy Noticing Center
to the following:

3 Dennis J. Clancy
4 Raven Clancy & McDonagh PC
5 182 North Court Avenue
Tucson, AZ 85701
6 Attorney for Plaintiffs

7 Eric Slocum Sparks
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9 Attorney for Debtors/Defendants

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