In the United States Bankruptcy Court

for the Northern District of Iowa

GEORGE PETER AHLHELM *Debtor(s).*	Bankruptcy No. L92-00617W Chapter 7
MAYNARD SAVINGS BANK *Plaintiff(s)* vs. GEORGE PETER AHLHELM *Defendant(s)*	Adversary No. 92-1231LC

ORDER

The above-captioned matter came on for trial on September 27, 1993 on a Complaint to Determine Dischargeability of Debt. Plaintiff Maynard Savings Bank was represented by Attorney John W. Hofmeyer III. Defendant/Debtor George Ahlhelm appeared pro se. After the presentation of evidence, the Court took the matter under advisement.

STATEMENT OF THE CASE

Prior to filing this Chapter 7 petition, Debtor was in the business of buying salvage cars, rebuilding them and then selling them. He entered into financing arrangements whereby Plaintiff financed various vehicles with the understanding that when Debtor sold the vehicles he would repay the bank out of proceeds. A financial statement signed by Debtor in September 1987 showed his net worth at $31,266. An August 1990 financial statement showed a net worth of $46,080. Both of these statements list Debtor and his wife as owners of their home. In reality, the home was owned solely by Debtor's wife. Shop equipment or tools are valued on the two statements at $8,300 and $6,725, respectively. However, all of Debtor's tools which Plaintiff repossessed generated a total of only $130 at sale. Both financial statements list vehicles at various values. The three vehicles which Plaintiff eventually repossessed were sold for a total of $420.

Plaintiff seeks a determination of nondischargeability of three debts. A note dated March 13, 1991 in the amount of $15,169.08 consolidated earlier notes and was secured by interests in various vehicles. Plaintiff obtained a default judgment based on this obligation on February 10, 1992 in the amount of $16,731.27. A second note dated March 13, 1991 in the amount of $2,775 constituted a loan for tools and operating costs. It was secured by a blanket security interest including accounts receivable, tools, inventory, etc.

Plaintiff also received a small claims default judgment in the amount of $704.91 based on a third note dated March 11, 1991 which was for a 1985 Chevy Cavalier. Debtor testified that he has the money to pay off the Cavalier from salvaging out parts. Therefore, the Court will direct Debtor to pay the small claims judgment including interest and court costs.

Plaintiff alleges various theories under § 523(a) for the nondischargeability of these debts. These include § 523(a)(2)(A) or (B) false statements, § 523(a)(4) embezzlement and § 523(a)(6) conversion. Plaintiff claims Debtor lied on his financial statements, disposed of collateral without authorization, failed to keep adequate records of disposition of car parts from Plaintiff's collateral vehicles, failed to preserve accounts receivable records, and failed to protect collateral.

Plaintiff states that it relied on Debtor's false financial statements to its detriment. Debtor states that Plaintiff had

knowledge at the time he made the statements regarding the true state of his financial affairs. Plaintiff states that Debtor disposed of valuable collateral without authorization. Debtor states that many of the vehicles securing the debt were essentially worthless and were disposed of accordingly. He states that the accounts receivable were likewise worthless and uncollectible. Unfortunately, the Court cannot make an independent determination because Debtor destroyed all records of accounts receivable when he closed his business.

The parties dispute the disposition of a 1987 Conquest. This automobile was valued on Debtor's 1990 financial statement at $7,900. Plaintiff claims Debtor disposed of this vehicle without its authorization. The evidence on the issue is, at best, murky. Debtor states that there were two 1987 Conquests. He testified that he destroyed one of the Conquests after burning up the engine in the Arizona desert. He states, however, that Plaintiff did not have a security interest in that car.

Debtor testified that there also existed a second Conquest which he fixed and sold in California. Apparently, however, he never had title to it. The result of this is that through a mistake in VIN numbers, Plaintiff took steps to hold a security interest in the Conquest which Debtor never had title to but did not perfect a security interest in the Conquest which was titled in Debtor. Plaintiff states that, even though the evidence is confusing, it is irrelevant because Plaintiff always had a valid security interest in all the vehicles as "inventory" under its blanket security interest provisions.

Debtor testified at a debtor's exam on October 22, 1992 that he shredded the Conquest which ended up in Arizona "because I knew they [Plaintiff] were after the car. I knew I owed them no money on that car after finding the title to it, and I knew they would get it, so I shredded it." Transcription of Tapes of Debtor's Exam, October 28, 1992 at p. 58. Debtor asserts that Plaintiff wrongfully allowed an auto dealer to sell two vehicles, a Honda Prelude and a 1983 Buick, while he was out of town. He complains that Plaintiff signed off on the titles but refused to cancel the notes secured by those cars. There is little evidence in the record to establish the details of this transaction.

Plaintiff lists several other vehicles which are not accounted for. Debtor has indicated that these vehicles were worthless and were parted out or salvaged in the course of his business. He testified that two of the vehicles were accidentally destroyed when an uninsured driver sideswiped them.

CONCLUSIONS OF LAW

The U.S. Supreme Court has determined that the standard of proof on dischargeability exceptions under 11 U.S.C. § 523 is by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654, 661, 112 L. Ed. 2d 755 (1991). The preponderance of the evidence standard reflects a fair balance between effectuating the "fresh start" policy of the Bankruptcy Code and limiting the opportunity for a completely unencumbered new beginning to the "honest but unfortunate debtor". Grogan, 111 S. Ct. at 659. Exceptions to discharge must be "narrowly construed against the creditor and liberally construed against the debtor. These considerations, however, 'are applicable only to honest debtors.'" In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I).

False Statements (§ 523(a)(2))

False financial statements are controlled by 11 U.S.C. § 523(a)(2) which states:

a. A discharge under section 727. . . 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 the intent to deceive.

Courts use a five element test to determine whether a debt will be excepted from discharge under § 523(a)(2)(A). In re Thomas, No. L-92-00524C, Adv. No. L-92-0115C, slip op. at 4 (Bankr. N.D. Iowa Sept. 22, 1993). The elements are: (1) the debtor made false representations; (2) the debtor knew the representations were false at the time they were made; (3) the debtor made the representations with the intention and purpose of deceiving the creditors; (4) the creditor relied on the representations. Id.; In re Ophaug, 827 F.2d 340, 343 (8th Cir. 1987); and (5) the creditor sustained the alleged injury as a proximate result of the representations having been made. In re Van Horne, 823 F.2d 1285, 1287 (8th Cir. 1987).

The elements of proof for § 523(a)(2)(B) require that: "(1) the false financial statement be a writing respecting the debtor's financial condition; (2) the financial statement be materially false; (3) the debtor intended to deceive; and (4) there be reliance on the part of the creditor." In re Walderbach, No. L92-00780C, Adv. No. 92-1135LC, slip op. at 7 (Bankr. N.D. Iowa Aug. 31, 1993).

The debtor's intent is the most critical element of an analysis under § 523(a)(2). This Court in Walderbach recently stated that "intent can be gleaned from surrounding circumstances." Slip op. at 8; see also Van Horne, 823 F.2d at 1287 (concluding that intent in a § 523(a)(2)(A) action can be inferred from the surrounding circumstances). In assessing intent, Courts, including the Northern and Southern Districts of Iowa, have adopted a totality of the circumstances approach. Walderbach, slip op. at 5; In re Davis, No. X91-01771F, slip op. at 7 (Bankr. N.D. Iowa Aug. 21, 1991); In re Stewart, 91 B.R. 489, 495 (Bankr. S.D. Iowa 1989).

The Court concludes that Plaintiff has failed to show by a preponderance of the evidence that it relied on false information or that Debtor intended to deceive Plaintiff. There appears to be little dispute that the values placed on the tools and vehicles were accurate at the time the statement was made. Considering the low value of Debtor's homestead, the status of the ownership of the homestead should have had little bearing on Plaintiff's decision to loan money for Debtor's business. Plaintiff has failed to prove that it relied on Debtor's joint ownership of his homestead in granting loans to Debtor or that Debtor intended to deceive Plaintiff in allowing the statement to show he was a joint owner of the home. The debt to Plaintiff should not be excepted from discharge under § 523(a)(2).

Embezzlement, (§ 523(a)(4))

Embezzlement for purposes of § 523(a)(4) is the "fraudulent appropriation of property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come." In re Phillips, 882 F.2d 302, 304 (8th Cir. 1989). A primary issue is whether allegedly embezzled property is "property of another". Id. "The determination of whether the debtors 'owned' the funds . . . is critical to ascertaining whether the debtors embezzled the funds." Id. Thus, where the debtor owns the funds subject to a security interest, the debtor could not have embezzled the funds and the debt is not excepted from discharge under § 523(a)(4).

Debtor owned vehicles subject to Plaintiff's security interest. Embezzlement does not occur where the debtor actually owns the missing property. Therefore, Plaintiff's claim of nondischargeability under § 523(a)(4) must be denied.

Conversion, (§ 523(a)(6))

Section 523(a)(6) states that a debtor is not discharged from any debt "for willful and malicious injury by the debtor to another entity or to the property of another entity". A willful and malicious conversion is an "injury" under § 523(a)(6). In re Ewing, No. 92-11343LC, Adv. No. 92-1231LC, slip op. at 6 (Bankr. N.D. Iowa Nov. 3, 1993); In re Holtz, 62 B.R. 782, 785 (Bankr. N.D. Iowa 1986). "Bankruptcy Courts must look to state law to define conversion. Iowa defines conversion as 'the act of wrongful control or dominion over chattels in derogation of another's possessory right thereto.'" Holtz, 62 B.R. at 785 (citations omitted). In Holtz, the debtor's failure to apply sales proceeds against the Bank's loans constituted conversion. Id. at 786. The Bank had a security interest in the proceeds. Id. at 785. The court focused on aggravating features of the debtor's conduct such as the concealment of funds and the deliberateness of the sale after the creditor had attempted to assert its rights in concluding that the debt was nondischargeable. Id.

A mere technical conversion does not satisfy § 523(a)(6). Id. at 786. Nondischargeability turns on whether the conduct is (1) headstrong and knowing ("willful") and, (2) targeted at the creditor ("malicious"), at least in the sense that the conduct is certain or almost certain to cause financial harm. In re Long, 774 F.2d 875, 881 (8th Cir. 1985). Long held that the debtor's conduct was willful because the debtor knew the diversion of funds was contrary to the collateral agreement. Id. at 882. However, the malice element was not met because the debtor did not intend or expect to harm the economic interests of the creditor.

In re Sain, 101 B.R. 30, 32 (Bankr. C.D. Ill. 1988), held that a debtor's misconduct in misappropriating proceeds from the sale of collateral is conversion under § 523(a)(6) which calls for nondischargeability of the debt to the extent of the value of the collateral. In Sain, the creditor had informal, ongoing financing with the debtor who bought and sold used cars. The nondischargeability claim arose from debtor's sale of a rebuilt pickup which was pledged as security for the creditor's note.

Even if the debtor could sell collateral vehicles without specific permission from the secured creditor, conversion occurs when the debtor fails to remit sale proceeds. In re Iaquinta, 98 B.R. 919, 925 (Bankr. N.D. Ill. 1989). The court in Iaquinta held that the debtor, in the business of selling used cars, is presumed to know harm will result from the sale of collateral. Although the creditor could be criticized for not monitoring the collateral or perfecting its security interest, the debtor had expressly granted a security interest which is binding between the two parties even though not perfected as to third parties. Id. The debtor's deprivation of the creditor's unperfected property rights constitutes a conversion. Id. The appropriate measure of damages is the fair market value of the converted collateral. Id.; see also In re Iaquinta, 95 B.R. 576, 582 (Bankr. N.D. Ill. 1989) (holding that sale of two Mercedes was conversion excepting debt from discharge in amount of the fair market value of the collateral evidenced by the sales prices).

The Court concludes that Plaintiff has presented sufficient evidence of conversion of the 1987 Conquest automobile. Even though Plaintiff did not technically have a perfected security interest in the vehicle which was actually titled in Debtor's name, Debtor expressly granted a security interest in a 1987 Conquest as well as a blanket security interest which covered all Debtor's vehicles. Debtor's failure to remit the proceeds from the sale of a 1987 Conquest constitutes conversion. His statement at the debtor's exam in light of surrounding circumstances shows willfulness and maliciousness.

Although the amount Debtor received from the sale does not appear in the record, the parties both stated at the hearing that the value of $7,900 placed on the vehicle in the August 1990 financial statement was fair. Therefore, the Court concludes that the debt to Plaintiff is excepted from discharge in the amount of $7,900. Also, as indicated above, the debt is nondischargeable to the further extent of the small claims judgment of $704.91, plus interest and court costs, as Debtor admits that funds are available from the proceeds from the 1985 Chevy Cavalier. There is insufficient evidence in the record upon which to base a determination of nondischargeability regarding any other vehicles or other collateral.

WHEREFORE, Plaintiff's claim of nondischargeability under § 523(a)(2), false financial statement, is DENIED.

FURTHER, Plaintiff's claim of nondischargeability under § 523(a)(4), embezzlement, is DENIED.

FURTHER, Plaintiff's claim of nondischargeability under § 523(a)(6) is proved by Debtor's failure to turn over proceeds from the 1987 Conquest and the 1985 Chevy Cavalier. Plaintiff's claim under § 523(a)(6) is GRANTED.

FURTHER, the debt to Plaintiff is excepted from discharge in the amount of $7,900 for the 1987 Conquest and $704.91, the small claims judgment plus interest and court costs, for the 1985 Chevy Cavalier.

FURTHER, judgment is entered for Plaintiff and against Debtor in those amounts.

SO ORDERED this 7th day of December, 1993.

Paul J. Kilburg
U.S. Bankruptcy Judge