In the United States Bankruptcy Court

for the Northern District of Iowa

DENMEN KENT HENNINGS,
d/b/a West Benton Cattle,
d/b/a West Benton Feedyard,
and
GWENDOLYN PEARL HENNINGS,
a/k/a Gwen Hennings
Debtors.

Bankruptcy No. 92-11755LC

Chapter 11

TAMA-BENTON COOPERATIVE COMPANY
Plaintiff

vs.

DENMEN KENT HENNINGS and
GWENDOLYN PEARL HENNINGS
Defendants

Adversary No. 92-1269LC

ORDER

On October 25, 1993, the above-captioned matter came on for trial pursuant to assignment. Plaintiff Tama-Benton Cooperative Company appeared by its counsel, Morris Eckhart. Debtor-Defendant Denmen Hennings appeared with his counsel, Thomas Fiegen. Evidence was presented after which the Court took the matter under advisement.

STATEMENT OF THE CASE

Tama-Benton Cooperative (the "Coop") filed this adversary proceeding seeking denial of discharge and exception from discharge of debts owed by Debtors to the Coop in the amount of $730,224.34 plus interest. The Coop contends that the disappearance of 195 head of cattle from Debtors' farm provides grounds under § 727(a)(2)(A) and § 727(a)(5) for a denial of discharge. It further claims that Debtors obtained credit from the Coop through the use of a false financial statement dated October 17, 1991, rendering its debt nondischargeable pursuant to § 523(a)(2)(B). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I, J).

FINDINGS OF FACT

Debtor Denmen Hennings operated a consignment cattle-feeder lot in Benton County, Iowa. Debtor had feeder pens on his property and additional feeder pens on property located nearby belonging to his son, Drew Hennings. Debtor would place cattle belonging to other individuals in his feeder lots for a period of time on consignment. He would enter into individualized contracts with the consignors in which he was paid a daily rate for fattening these cattle. The consignors would determine when the cattle were ready for market and would pick out the cattle which they determined were ready to be sold.

Over the years, Debtor entered into numerous consignment contracts with various individuals. Among the consignors were E. DeWayne Nickless of Panora, who had entered into consignment contracts with Debtor from 1988 to 1992, and William Bogaards, who had a substantial number of feeder cattle in Debtor's lots in 1992. To acquire feed, feed

supplements, and other farm supplies required for the consignment feeding, Debtor entered into a business relationship with the Coop in 1987. From 1987 through October of 1991, the Coop provided Debtor with supplies necessary to feed the consignment cattle. Over the years, Debtors' outstanding accounts payable increased until they reached the Coop's claimed amount of $730,224.34 plus interest.

The Coop's claim for denial of discharge under § 727(a) relates to the disappearance of approximately 195 head of cattle belonging to Mr. Nickless and Mr. Bogaards in March of 1992. Mr. Nickless and Mr. Bogaards had a substantial number of cattle in Debtors' consignment pens in February and March of 1992. In March of 1992, Mr. Nickless came to the property to determine which cattle were ready for market. He observed that some of the pens appeared to have an inadequate number of cattle present. A count was done of his cattle, as well as Mr. Bogaards'. It was determined that approximately 134 head of Mr. Nickless' cattle and approximately 61 head of Mr. Bogaards' cattle were unaccounted for.

Mr. Hennings disclaims any knowledge of the disappearance of these cattle. No overt evidence of theft was presented. Most of the cattle were within one month of market weight. They weighed between 1,100 and 1,200 lbs. and their value at that time was approximately $.75 per pound. The Coop asserts that Debtors should be denied discharge under § 727(a)(2)(A) in that Debtors, with the intent to hinder, delay or defraud a creditor, transferred, removed or concealed property. Based on these facts, the Coop also seeks denial of discharge under § 727(a)(5), claiming that Debtors have failed to adequate explain the loss of assets.

On October 17, 1991, Debtors prepared a financial statement. This financial statement forms the basis for the Coop's claim under § 523(a)(2)(B). The Coop argues that the debt should be excepted from discharge because it relied on the allegedly false financial statement in extending credit to Debtors. Debtors assert that the statement is not false and they did not intend to deceive any creditor.

At the time Debtors prepared the statement, they were operating under Chapter 12. The same day the Coop received the statement, it informed Debtors that it would not extend them any more credit. On November 14, 1991, the Coop did enter into a court-approved harvesting agreement whereby it advanced funds through Debtors' bankruptcy proceeding to facilitate the harvesting of Debtor's mature 1991 corn crop in which it had a perfected security interest.

DENIAL OF DISCHARGE UNDER 11 U.S.C. § 727(a)

11 U.S.C. §§ 727(a)(2)(A) and 727(a)(5) are made applicable to Chapter 11 cases pursuant to 11 U.S.C. § 1141(d)(3) which excepts from discharge debtors who meet the following requirements:

A. the plan provides for the liquidation of all or substantially all of the property of the estate;
B. the debtor does not engage in business after consummation of the plan; and
C. the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

See Norwest Bank Neb. v. Tveten, 848 F.2d 871, 874 (8th Cir. 1988) (concluding that "the proscription against discharging a debtor [under 11 U.S.C. § 727(a)(2)] in a Chapter 7 proceeding is equally applicable against a debtor applying for a Chapter 11 discharge."); In re Reveal, 148 B.R. 288, 294 (Bankr. S.D. Ohio 1992) (holding that § 727(a) is applicable under section 1141(d)(3) where subsections (A) through (C) are satisfied).

Debtors appear to meet the requirements of §§ 1141(d)(3)(A) and (B) and have not raised them as a defense in this adversary proceeding. The § 727(a) provisions in controversy are therefore appropriately raised in this Chapter 11 proceeding.

A. Denial of Discharge Under 11 U.S.C. § 727(a)(2)(A)

The Coop objects to Debtor's discharge pursuant § 727(a)(2)(A) which provides that:

a. the court shall grant the debtor a discharge, unless--

. . .

2. the debtor, with 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.

To prevail under section 727(a)(2)(A), the Coop must prove: (1) that a transfer, removal or concealment of property has occurred; (2) that the property was owned by Debtors; (3) that the transfer occurred within one year of filing bankruptcy; and (4) that Debtors had, at the time of the transfer, the intent to hinder, delay or defraud a creditor. In re Schroff, 156 B.R. 250, 254 (Bankr. W.D. Mo. 1993) (citing In re Cook, 126 B.R. 261, 266 (Bankr. E.D. Tex. 1991); In re Penner, 107 B.R. 171, 174 (Bankr. N.D. Ind. 1989)). The standard of proof in a § 727(a) action is by a preponderance of the evidence. In re Serafini, 938 F.2d 1156, 1157 (10th Cir. 1991); In re Schroff, 156 B.R. at 254; In re Maletta, 159 B.R. 108, 111 (Bankr. D. Conn. 1993).

The Coop committed a substantial amount of its trial testimony as well as a large amount of its post-trial brief to the first element relating to disappearance of the cattle. The Coop presented substantial testimony that the disappearance of these cattle was suspicious with no one apparently able to provide an explanation as to how 195 cattle disappeared from various pens without being observed by anyone.

However, as previously stated, the Coop must establish all four elements of this claim by a preponderance of the evidence. The second element requires that the Coop prove that the missing property was owned by the Debtors. 11 U.S.C. § 727(a)(2)(A); see also In re Holtz, 62 B.R. 782, 787 (Bankr. N.D. Iowa 1986); Rosen v. Bezner, 996 F.2d 1527, 1531 (3d Cir. 1993). Actions under § 727(a)(2)(A) are limited to those transfers of property in which the debtor has a direct proprietary interest. In re Wines, 114 B.R. 794, 796 (Bankr. S.D. Fla. 1990) aff'd, 997 F.2d 852 (11th Cir. 1992). A debtor who does not own the subject property cannot be said to have transferred or concealed it under § 727(a)(2)(A). In re Drenckhahn, 77 B.R. 697, 706 (Bankr. D. Minn. 1987).

The record is devoid of any evidence that Debtors possessed an ownership interest in the missing cattle. It is undisputed that the missing cattle were the property of E. DeWayne Nickless and William A. Bogaards. The Coop has failed to prove by a preponderance of the evidence that Debtors possessed an ownership interest in the 195 missing cattle and Debtors must prevail under § 727(a)(2)(A).

B. Denial of Discharge Under 11 U.S.C. § 727(a)(5)

The Coop objects to Debtors discharge pursuant to § 727(a)(5). This section provides for the denial of discharge if "the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities."

This claim was first raised by the Coop in its post-trial brief. The Coop's Complaint and Pre-Trial Statement asserted only claims under § 523(a)(2)(B) and § 727(a)(2)(A). The Coop made neither a motion to amend during trial nor a post-trial motion to amend to conform to the evidence.

Fed. R. Civ. P. 15(b), applicable to bankruptcy adversary proceedings pursuant to Bankruptcy Rule 7015, states as follows:

b. **Amendments to Conform to the Evidence.** 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 issues 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.

Under Rule 15(b), the Court is required to treat as raised in the pleadings those issues not previously raised that were tried by express or implied consent of the parties. In determining whether an issue has been tried through implied consent, the 8th Circuit has focused on the evidence introduced during trial. Pariser v. Christian Health Care Sys. Inc.,

816 F.2d 1248, 1253 (8th Cir. 1987). Pariser held that a plaintiff could not use evidence also relevant to a pleaded claim to assert that the defendant impliedly consented to the trying of a non-pleaded claim.

> While Pariser did introduce some evidence that would be relevant to a tortious-interference claim, this evidence was also relevant to Pariser's other claims, so its introduction did not provide the defendant any notice that a claim for tortious interference with contractual relations was being tried.

Id.

Here, the evidence introduced by the Coop in support of its non-pleaded § 727(a)(5) claim was also relevant to its § 727(a)(2)(A) claim. As such, Debtors did not have notice that the § 727(a)(5) claim was being tried and, therefore, could not have consented to defend the claim upon the merits. Under these circumstances, the Court will not consider the Coop's § 727(a)(5) claim raised for the first time in post-trial briefs as part of this adversary proceeding. In re Burrow, 146 B.R. 813, 815 (Bankr. E.D. Ark. 1992).

Nevertheless, even if the Coop had properly raised § 727(a)(5) during the proceedings, its claim is deficient. The Coop contends that Debtors failed to satisfactorily explain the disappearance of 195 head of cattle belonging to Nickless and Bogaards. However, assets as defined by § 727 (a)(5) are assets available "to meet the debtor's liabilities".

The cases considering § 727(a)(5) require that the lost assets be owned by the debtors or at least that the debtor have some ownership interest in them. See, e.g., In re Beausoleil, 142 B.R. 31, 37 (Bankr. D.R.I. 1992) (establishing that an objection must establish that the debtor possessed a "cognizable ownership interest" in the lost asset); In re Radcliffe, 141 B.R. 1015, 1023 (Bankr. E.D. Ark. 1992) (questioning the loss or deficiency of the debtor's assets from his financial statement); In re Turpin, 142 B.R. 491, 496 (Bankr. M.D. Fla. 1992) (concluding that the debtor had a "cognizable ownership interest" in certain properties); In re Claassen, 93 B.R. 192, 196 (Bankr. D. Neb. 1988) (questioning the debtors' disposition of their cattle). These cases reason that an ownership interest is necessary if the assets are to be available to meet a debtor's liabilities.

Debtors are under no duty to explain the loss of a third party's assets. In re Chachra, 138 B.R. 397, 403 (Bankr. S.D.N.Y. 1992). "They are only under a duty, by virtue of § 727(a)(5), to explain the loss of their own assets." Id. Where missing property is not owned by the debtors, a transfer of such property cannot be considered a loss of the debtors' assets. In re Holmes, 121 B.R. 505, 509 (Bankr. N.D. Tex. 1990).

Thus, for the Coop to establish its prima facie case, it must prove, at a minimum, that the missing cattle were Debtors' assets. As noted in regard to the § 727(a)(2)(A) claim, the evidence establishes without controversy that the cattle belonged to Nickless and Bogaards. The Coop has offered no evidence that Debtors had any ownership interest in the missing cattle that would entitle them to dispose of the cattle in satisfaction of their liabilities. As the Coop cannot establish that the missing cattle were assets of Debtors which were available to meet their liabilities, the Court finds that the Coop has failed to establish a prima facie case under § 727(a)(5).

NONDISCHARGEABILITY UNDER 11 U.S.C. § 523(a)(2)(B)

11 U.S.C. § 523(a)(2)(B) 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--

. . .

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[.]

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). For Plaintiff to prevail in its nondischargeability action, it must prove all four elements. In re Bagenstos, No. L-89-00489W, Adv. No. L-89-0112W, slip op. at 3 (Bankr. N.D. Iowa Jan. 4, 1990) ("If any one of the elements of proof is absent, irrespective of how overwhelming the proof as to the others might be, the plaintiff may not prevail in a section 523(a)(2) action."). The burden of proof for each element 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 dispositive issue in this case is whether the Coop relied on Debtors' October 17, 1991 Financial Statement. The 8th Circuit has construed the plain meaning of § 523(a)(2)(B) as requiring that a creditor's reliance be "reasonable." In re Ophaug, 827 F.2d 340, 343 (8th Cir. 1987).

> Because creditors might induce debtors to falsify financial statements in order to make a debt nondischargeable, Congress explicitly required that nondischargeability under section 523(a)(2)(B) be premised upon a showing of reasonable reliance.

Id. (citation omitted).

A two-part analysis is utilized to determine whether a creditor reasonably relied on the debtor's false financial statement: "(1) did the creditor actually rely on the financial statement; and (2) was the reliance reasonable?" In re Myers, 124 B.R. 735, 742 (Bankr. S.D. Ohio 1991). Under the first part, actual reliance exists where the false financial statement is a substantial factor in causing the extension of credit. Id. (citation omitted). The second part of the test is satisfied where the lender's financial statement and lending practices contain reasonable criteria upon which to base a lending decision. Id. at 743.

The evidence in this case calls into question whether the Coop ever actually relied upon Debtors' October 17, 1991 Financial Statement. The subsequent harvesting agreement was a court-approved settlement between the parties with respect to financing the harvest of Debtors' 1991 corn crop. There is no evidence in this record that the Coop relied on Debtors' Financial Statement in reaching the settlement. The Coop's own complaint seeking to restrain Debtors from harvesting the 1991 corn, filed October 18, 1991, states that on October 17, 1991, the Coop's manager, Barry Orness, informed Denmen Hennings that the Coop would no longer extend credit to Debtors for purposes of buying corn. The complaint also states that on October 17, 1991 the Coop stopped selling protein supplements, grain and all other supplies to Debtors without adequate assurance of payment.

The concept of "reasonable reliance" was analyzed in In re Duncan, 35 B.R. 323 (Bankr. W.D. Ky. 1983), in the context of farm loan transactions. The parties in Duncan had been engaged in business for a several years. Id. at 325. The bank sought the nondischargeability of debts after the debtor was forced into Chapter 7 because of a crop failure. Id. at 324. Finding that the bank did not reasonably rely on the debtor's false financial statement, the court observed:

> The Duncan case is typical in that it points up once more the remarkable homogeneity of the small agricultural community as contrasted with the large and diversified urban society. The commonality of enterprise to be found in such places and a highly developed awareness of the status of individuals within the community makes it possible for lenders to frequently know much more about their borrowers than the printed pages of a financial statement, standing alone, could ever reveal.

Id. at 326.

Similar to the circumstances in Duncan, Plaintiff had been engaged in financing Debtors' farming operations for several

years. The Coop was involved with Debtors as a creditor during Debtors' prior Chapter 12. For at least four years prior to the making of the October 17, 1991 Financial Statement, the Coop had intimate knowledge of Debtors' adverse financial situation. As in Duncan, this Court must consider the information the Coop had at its disposal about Debtors' financial condition when determining whether any reliance on Debtors' financial statement was reasonable.

In these circumstances, this Court cannot conclude that the Coop relied, in any measure, on a financial statement within the context of the harvest agreement settlement. Furthermore, if the Coop had relied on the financial statement, such reliance would have been unreasonable considering the extent of the Coop's understanding of Debtors' true financial condition. The Court concludes that the Coop has not proved the elements of § 523(a)(2)(B) by a preponderance of the evidence.

WHEREFORE, the Coop's claim under § 727(a)(2)(A) is DENIED.

FURTHER, the Coop's claim under § 727(a)(5) is DENIED.

FURTHER, the Coop's claim under § 523(a)(2)(B) is DENIED.

FURTHER, judgment is entered for Debtors and against the Coop.

SO ORDERED this 22nd day of December, 1993.

Paul J. Kilburg, Judge
U.S. Bankruptcy Court