In the United States Bankruptcy Court

for the Northern District of Iowa

LONNY L. KARR, TERRILL L. KARR Debtors.	Bankruptcy No. 94-10547KC Chapter 7
DENNY BERGER Plaintiff vs. LONNY L. KARR, TERRILL L. KARR Defendants.	Adversary No. 94-1082KC

ORDER

On February 7, 1995, the above-captioned matter came on for hearing pursuant to assignment. Plaintiff Denny Berger appeared in person with his attorney, James Goodman. Debtors Lonny and Terrill Karr appeared with their attorney, Barton Schwieger. Evidence was presented after which the Court took the matter under advisement.

The matter before the Court is an adversary complaint filed July 5, 1994, seeking denial of dischargeability of an obligation under the provisions of 11 U.S.C. 523(a)(2)(A) and 523(a)(2)(B). This is a core proceeding and this ruling constitutes findings of fact, conclusions of law, and order pursuant to Fed.R.Bankr.P. 7052.

FINDINGS OF FACT

Denny Berger (Berger) farms near Traer, Iowa. He hired Debtor Lonny L. Karr (Karr) in 1989 as a farm laborer. In 1990, Berger and Karr formed a partnership known as K & B Farms. As a partnership, Berger and Karr purchased and fattened cattle for subsequent sale. Berger provided most of the assets during the initial stages of this partnership. He supplied all of the farm equipment, the land, and a substantial amount of the capital. Karr provided few, if any, assets or capital to the business. Nevertheless, Berger testified that he believed the partnership to be 50-50.

In March of 1992, Berger and Karr requested a commercial loan from the National Bank of Waterloo. Bank officer, Darrell Heaford (Heaford), requested financial statements from both Berger and Karr. Previously, Berger and Karr had been banking with and had submitted financial statements to Farmers Savings Bank. Berger and Karr provided the National Bank of Waterloo with the same financial statements, and in turn, the Bank of Waterloo loaned Berger and Karr between $44,000 and $45,000 for business operations on a master note basis.

In 1992, Karr's salary was approximately $1,000 per month, and Terrill Karr's salary from outside employment was approximately $1,500 per month. The facts suggest that Karr was in debt from the time Berger first hired him until the present, and that Berger was unaware of the extent of the debt for most of this time.

In May of 1993, Berger and Karr refinanced and renewed the note, and the Bank requested updated financial statements from both partners. At that time, the principal owed on the loan was approximately $17,600. Berger prepared and submitted his own personal financial statement and a financial statement for K & B Farms. Both Berger and Karr signed the K & B Farms financial statement. Karr also submitted a personal financial statement. However, Karr's statement was unsigned, and provided minimal information. It failed to list Karr's credit card liabilities which were substantial.

These statements were presented to Heaford. Berger saw Karr's financial statement in Heaford's office. He testified that the financial statement did not list any credit card debt. It listed a $6,000 van debt, and the van and some cash as assets. Heaford, the Bank's loan officer, also saw this financial statement. Heaford agrees that the financial statement was unsigned, contained no credit card debt, included the van debt, and listed the van and cash as assets. Heaford stated that he subsequently discarded this financial statement, in part because it was unsigned.

Heaford testified that he did not rely on Karr's financial statement to approve the loan, and would not have relied on it even if the financial statement had listed the substantial credit card debt. He said he was relying on Berger's financial statement and not on Karr's. In fact, Heaford advised Berger in the existing business arrangement between Berger and Karr that Berger had everything to lose and nothing to gain because Karr had no assets. The Bank extended a credit line to the partnership of approximately $45,000. This note was later renewed in Berger's name alone. Presently, the loan balance is approximately $44,000, and the value of the collateral securing the note is approximately $22,000.

Berger testified that, in spite of their ongoing business relationship, he was unaware of Karr's substantial credit card debt. Berger stated that he did not see the 1990 financial statement, presented to both banks at about the same time Berger and Karr formed their partnership. He testified that he relied on the 1993 financial statement, however, in considering whether to renew the bank note. Berger stated that he was unaware of the credit card debt because it was not included in the financial statement presented to the Bank. He testified that he dislikes credit card transactions and would not have renewed the note with the bank had he known of Karr's substantial credit card obligations.

The facts also establish, however, that at no time did Berger personally request a financial statement from Karr, not even when they first entered into the partnership. The facts also reveal that Berger and Karr had no agreement limiting the Karrs from incurring debt after the partnership was formed. Berger testified that he became aware of Karr's significant financial problems for the first time in the Spring of 1994.

Debtor Lonny Karr and his wife, Terrill Karr, have accrued credit card debt, at least from 1990 forward. The credit card debt was substantial at the time Karr presented Heaford the financial statement to renew the K & B Farms note. Karr testified that he was unaware at that time of the extent of the credit card debt he and his wife might have had, because his wife personally handled those matters. He further testified that he does not particularly recall not having signed the 1993 financial statement. He testified that this financial statement was submitted to the National Bank, not for the

partnership, but to obtain a personal loan as he intended to enter into his own separate farming operation. Heaford, however, did not approve this loan because the FmHA would not underwrite it.

Karr states that he only recalls submitting to Heaford the 1992 financial statement for the K & B Farms partnership business. He claims that the other financial statement, as indicated, was for a personal loan. Accordingly, Karr claims that he never made any false statements to Berger, and that Berger never asked and was never given a financial statement. It is agreed by all parties that, Terrill Karr, was not a party to any of these business transactions or alleged misrepresentations.

CONCLUSIONS OF LAW

Plaintiff relies on the following provisions of 11 U.S.C. 523 to support its dischargeability complaint:

(a) A discharge under section 727...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

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[.] [Emphasis added]

While Berger has alleged the applicability of both 523(a)(2)(A) and 523(a)(2)(B), the ultimate question in this case is whether Karr misrepresented his financial condition in certain financial statements. Since the questions presented relate to statements in writing respecting Karr's financial condition, 523(a)(2)(A) is not applicable to this case. Ordinarily, subsections (A) and (B) are mutually exclusive. In re Liming, 797 F.2d 895, 897 (10th Cir. 1986); Chamberlain Employees Credit Union v.

Douglas Daniel Bagenstos and Judith Ann Bagenstos, Adv. No. L-89-0112W, slip op. at 3 (Bankr. N.D. Iowa Jan. 4, 1990). This Court will, therefore, examine the facts as they relate to 523(a)(2)(B) to determine dischargeability.

This Court considers a four elements test when considering whether a debt will be excepted from discharge under 523(a)(2)(B). The elements are: (1) the false financial statement is a writing respecting the debtors financial condition; (2) the financial statement is materially false; (3) the debtor intended to deceive; and (4) the creditor relied on the statement. In re Mutschler, 45 B.R. 482, 490 (Bankr. D.N.D. 1984); In re Hennings, No. 92-11755LC, Adv. No. 92-1269LC, slip op. at 7 (Bankr. N.D. Iowa Dec. 22, 1993). Berger must prove each of the four elements by a preponderance of the evidence. Grogan v. Garner, 111 S. Ct. 654, 659 (1991); In re Hennings, slip op. at 7.

FINANCIAL STATEMENT AS A WRITING

Karr submitted a financial statement which was unsigned by him. It is nevertheless undisputed that the financial statement, as presented, constituted a writing respecting Karr's financial condition. The fact that the financial statement was unsigned by Karr does not alter its status as a financial statement. The requirements of 523(a)(2)(B) are that the statement be in writing. However, there is no requirement that a debtor sign the financial statement. In this case, Karr does not seriously contend that the financial statement presented does not satisfy the first requirement of 523(a)(2)(B) as a statement in writing. In re Shelton, 42 B.R. 547, 548 (Bankr. E.D. Mo. 1984).

MATERIALLY FALSE

A materially false statement "is one which paints a substantially untruthful picture of a financial condition by misrepresenting information of the type which would normally affect the decision to grant credit." In re Walderbach, No. L92-00780C, Adv. No. 92-1135LC, slip op. at 8 (Bankr. N.D. Iowa Aug. 31, 1993), citing Mutschler 45 B.R. at 490.

The Karrs' credit card debt in 1993 was not reflected on the 1993 financial statement. While this record fails to specifically disclose the extent of the Karrs' credit card debt, it is fair to conclude that it was substantial. Karr does not deny that he and his wife have credit card debt. He does, however, deny any knowledge of such debt prior to preparation of the financial statement in question. He testified that if such credit card debt does exist, it was solely his wife's responsibility because she was to handle credit card obligations through her employment.

A financial statement is materially false "if it not only contains erroneous information, but rather contains information that is substantially inaccurate." In re Dammen, 167 B.R. 545, 550 (Bankr. D.N.D. 1994). Other courts have considered a statement materially false if "the statement [is] grossly reckless as to its truth." Howard, 73 B.R. at 702, citing In re Bogstad, 779 F.2d 370, 372 (7th Cir. 1985); In re Martin, 761 F.2d 1163, 1167 (6th Cir. 1985).

A statement is material if it "is substantially inaccurate and [contains or lacks] information that effect [s] the [plaintiff's] decision making process." Howard, 73 B.R. at 703; Greene, 96 B.R. at 283. "Material falsity in a financial statement can be premised upon the inclusion of false information or upon the omission of information about a debtor's financial condition." Greene, 96 B.R. at 283, citing In re Anzman, 73 B.R. 156, 163 (Bankr. D. Colo. 1986). See also Birmingham Trust Nat'l Bank v. Case, 755 F.2d 1474, 1476 (11th Cir. 1985) (considering reckless indifference to the truth sufficient to bar discharge). Cf. In re Greene, 96 B.R. 279, 283 (Bankr. 9th Cir. 1989) (explaining that "[a]n incorrect or erroneous financial statement is not necessarily false."); In re Howard, 73 B.R. 694, 702

(Bankr. N.D. Ind. 1987) (stating that actual knowledge of the falsity of financial information is not required).

Having considered the entire evidentiary record, it is the ultimate conclusion of this Court that Berger has established by a preponderance of evidence that the financial statement submitted was materially false. In establishing material falsity, the burden is upon Berger to prove that Karr either knew of the falsity or presented an erroneous financial statement with reckless indifference to the truth of that statement. Under the present record, Karr asserts that he did not know of this credit card debt. Within the context of a family obligation, it is difficult to conceive that Mr. Karr was unaware of a substantial credit card obligation. Even if the Court were to accept such an assertion, Karr was required to analyze his personal finances with sufficient specificity to present an accurate financial statement. As a minimum, Karr's claim of lack of knowledge of credit card obligations must be considered reckless indifference to the truth of the financial statement. This was not a minor obligation but rather constituted a significant portion of Karr's entire debt load. Because of the substantial nature of this obligation, its absence from a financial statement does not simply constitute an inaccurate representation of his financial condition, but rather skews his entire financial picture to the extent that it creates a substantially untruthful picture regarding his overall financial obligations. As such, this Court must conclude that the financial statement, as presented, was materially false.

INTENT TO DECEIVE

Berger must further establish that Karr intended to deceive him. "Discharge is barred under 523(a)(2)(B) only if, among other things, the debtor acted with the intent to deceive." In re Jones, 31 F.3d 659, 661 (8th Cir. 1994). This Court has stated that "intent can be gleaned from surrounding circumstances." In re Capps, No. 93-20229KD, Adv. No. 93-2106KD, slip op. at 3 (Bankr. N.D. Iowa Nov. 24, 1993); Walderbach, slip op. at 8. Some factors persuasive on the issue of intent to deceive include "whether the Debtor was intelligent and had experience in financial matters, and whether there was a clear pattern of purposeful conduct." Capps, slip op. at 5; Walderbach, slip op. at 8-9. See also In re Joyner, 132 B.R. 436, 442 (Bankr. D. Kan. 1991) (considering the omission of significant contingent liabilities in financial statement as strong evidence of intent to deceive.) In Walderbach, debtor filed a credit card application and as a result was granted a credit card. However, debtor used inflated financial numbers as her projected household income in the application. This Court held that the debtor intended to deceive the creditor through the use of these inflated financial figures. The debtor's use of inflated figures was simply to improve "the chances of approval of the application for a credit card and to achieve an initially higher credit limit." Walderbach, slip op. at 9. As was the case in Walderbach, Karr's intent to deceive can be inferred from the financial figures used in the financial statement.

Courts have held that "[a] creditor can establish intent to deceive by proving reckless indifference to or reckless disregard to the accuracy of the information in the financial statement of the debtor." Jones, 88 B.R. at 903. See also In re Black, 787 F.2d 503, 506 (10th Cir. 1986) (stating that the "requisite intent may be inferred from a sufficiently reckless disregard of the accuracy of the facts"). It is the conclusion of this Court that Karr's reckless disregard for the accuracy of the facts, in conjunction with the record as a whole, establishes an intent by Karr to deceive Berger. Berger has met his burden under the third element.

RELIANCE

Berger must finally establish that he "reasonably relied" on Karr's 1993 financial statement. In re Ophaug, 827 F.2d 340, 343 (8th Cir. 1987). A two-part test is used to determine whether a creditor

reasonably relied on the debtor's false financial statement. Creditor must establish that: (1) the creditor actually did rely on the financial statement; and (2) the reliance was reasonable. Hennings, slip op. at 8, citing In re Myers, 124 B.R. 735, 742 (Bankr. S.D. Ohio 1991).

This Court held in Hennings that "actual reliance exists where the false financial statement is a substantial factor in causing the extension of credit." Hennings, slip op. at 8. Berger claims that he relied upon the document in committing himself to a substantial financial obligation. This claim is unpersuasive because Berger had already been in the K & B Farms partnership with Karr since 1990 and had never previously sought a financial statement from him. Nor had he discussed with Karr his financial condition in any significant detail. The record reflects that Berger only casually examined Karr's financial statement while at the bank, when he and Karr were seeking to renew the note. This strongly suggests that Berger was determined to refinance and renew the note independently of any full knowledge of Karr's financial condition. It is difficult for this Court to conclude that Berger committed himself to this financial obligation based on this unsigned incomplete document.

Even if it could be concluded that Berger relied on Karr's financial statement, such reliance must be reasonable. The Eighth Circuit holds that "[t]he reasonableness of a [plaintiff's] reliance should be judged in light of the totality of the circumstances." In re Jones, 31 F.3d at 662. The entire record must be reviewed to determine "whether there were any red flags that would have alerted an ordinarily prudent lender to the possibility that the representations relied upon were not accurate; and whether even minimal investigation would have revealed the inaccuracy of the debtor's representations." Id.

The unrebutted evidence establishes that Heaford told Berger, in reference to the partnership, that Berger had everything to lose and nothing to gain because of Karr's financial condition. The evidence shows that Karr's financial statement was not signed and lacked substantial information. This financial statement was so lightly regarded by the Bank that it was eventually thrown away. These are significant "red flags" which Berger, as a prudent co-borrower, should have considered. Minimal inquiry as to Karr's financial condition would have revealed the inaccuracy of Karr's financial statement. Berger did not ask Karr to sign the financial statement. More importantly, he never asked Karr for a separate financial statement, not even when they first entered into the partnership.

This Court must conclude that any reliance which Berger placed on this financial statement was misplaced and unreasonable. There were numerous "red flags" which Berger either ignored or unreasonably failed to acknowledge. Berger has not met his burden of proof on the issue of reasonable reliance. Accordingly, Berger's complaint requesting that the bank note debt excepted from discharge under 523(a)(2)(B) must be denied.

WHEREFORE, for all the reasons set forth herein, Plaintiff's complaint to deny discharge under 11 U.S.C. 523(a)(2)(A) and 523(a)(2)(B) is DENIED.

SO ORDERED this 4th day of April, 1995.

Paul J. Kilburg
U.S. Bankruptcy Judge