In the United States Bankruptcy Court

for the Northern District of Iowa

MICHAEL JOHN TURNER *Debtor.*	Bankruptcy No. 94-61008KW Chapter 7
AVCO FINANCIAL SERVICE OF DENISON INC. *Plaintiff(s)* vs. MICHAEL JOHN TURNER *Defendant(s)*	Adversary No. 94-6137KW

ORDER

On August 28, 1995, the above-captioned matter came on for hearing pursuant to assignment in Waterloo, Iowa. Plaintiff, Avco Financial Service of Denison, Inc. ("Avco") appeared by Attorney Larry Eide. Defendant/Debtor, Michael J. Turner appeared in person pro se. The matter before the Court is Plaintiff's complaint to deny discharge under § 727 or alternatively to except a debt from discharge under § 523(a). Evidence was presented after which the Court took the matter under advisement. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I) and (J).

STATEMENT OF THE CASE

The evidence establishes that Avco sent a solicitation to former customers which stated that Avco guaranteed a $5,000 loan to the recipient. This is apparently a common advertising practice of Avco. Debtor received such a solicitation. On May 13, 1994, Debtor contacted Mr. Christopher Edel at Avco Finance in Mason City. Edel took the majority of the information necessary to process Debtor's loan application over the phone in order to expedite the loan approval process. On the same day, Debtor went into the Avco office and completed his credit application. In the process of applying for the loan, Debtor filled out and executed a document entitled Statement of Indebtedness. The loan was closed on May 14, 1994. The total amount borrowed by Debtor was $5,046. This debt is evidenced by a promissory note from Debtor to Avco, dated May 13, 1994.

Avco filed a § 727 action asserting that Debtor filed false and fraudulent schedules in his bankruptcy petition and as such should be denied a general discharge of debts pursuant to § 727(a)(4) and (a)(5). Additionally, Avco asserts that Debtor gave false statements in applying for the loan and that, as an alternative to a denial of discharge, Debtor's debt to Avco should be excepted from discharge pursuant to § 523(a)(2)(A) and/or (B).

The evidence substantiates that Debtor's schedules were carelessly done and omitted many matters which are required to be included in bankruptcy schedules. However, Debtor subsequently amended

those schedules and it now appears that the schedules accurately reflect the state of Debtor's affairs. It is the conclusion of this Court that Debtor should not be denied a § 727 general discharge based on these inadequate schedules, particularly in light of the fact that they were subsequently amended, albeit tardily.

The more fundamental problem relates to Debtor's alleged false statements upon which Avco's action for an exception to discharge under § 523(a) is based. Avco alleges that Debtor made false statements in three specific instances:

1. Debtor stated to Avco that the purpose of the loan was to purchase an anniversary gift for his wife, the remainder being earmarked to finance a vacation. The evidentiary record establishes that, at the time of the loan, Debtor and his wife were separated and that the loan was not used for either of the suggested purposes but rather, the loan proceeds were ultimately used to pay other indebtedness of Debtor.
2. Debtor hand-wrote a statement on the Statement of Indebtedness form indicating that the document accurately reflected all of his debts. Comparing the Statement of Indebtedness, which was completed approximately one month prior to the filing of the bankruptcy, with Debtor's original, as well as the amended bankruptcy schedules, it is clear that information regarding many of the debts listed on the schedules was not provided to Avco in Debtor's Statement of Indebtedness. Debtor testified that he asked Mr. Edel at the time he filled out the statement whether he needed to include obligations independently owed by his spouse. Debtor claims that he was informed that the statement need not include his wife's debts. Therefore, he did not list obligations which he felt were appropriately the responsibility of his wife.
3. A question on the Statement of Indebtedness form specifically asked if Debtor had "ever filed bankruptcy or discussed bankruptcy with an attorney?". ("Bankruptcy Question"). Debtor answered by writing the word, "No", in the corresponding blank. The Bankruptcy Question had a follow-up request for information which instructed Debtor to explain such filing or attorney consultation in detail. The follow-up request is worded so that a loan applicant need respond only if the answer to the Bankruptcy Question is "yes". Debtor, having answered the Bankruptcy Question in the negative, did not respond to the follow-up request.

At trial, Avco presented two letters from Debtor's former attorney, Russell Schroeder, Jr. The letters, written on Debtor's behalf and sent to another creditor of Debtor, relating to the purchase of an automobile ("Automobile Creditor"). The letters indicate that Debtor had considered filing bankruptcy prior to the time at which the problem with Automobile Creditor occurred. The letters state that if the letter recipient continued to pursue Debtor regarding its claim, Debtor may choose or be forced to file for bankruptcy protection. These letters, authorized by Debtor, were written and sent in March and April of 1994. The loan transaction was completed with Avco on May 13 and 14, 1994. Debtor filed his Chapter 7 Petition on June 17, 1994.

Debtor testified that he understood the Bankruptcy Question to ask whether he seriously intended to file bankruptcy. That is, whether he had talked seriously or at great length to his attorney about filing for bankruptcy. He testified that, when he and Schroeder had discussed the possibility of bankruptcy, the communication amounted to mere casual conversation. Defendant asserted that he did not feel that this kind of exchange qualified as a discussion within the meaning of the Bankruptcy Question on the Statement of Indebtedness.

Subsequent to the trial, the Court received a letter from Debtor stating that he had intended to have Attorney Schroeder present at this trial but because he was proceeding pro se and didn't understand bankruptcy trial procedure, he had failed to give Schroeder notice of the new trial date after the

original date had been postponed. Debtor included a letter from Schroeder to Debtor's wife, written at her bequest. Debtor contends that this letter supports his testimony regarding the nature of any discussions between himself and Schroeder regarding the possibility of bankruptcy. Schroeder's letter states that while he and Debtor had talked about bankruptcy, it had been in fairly casual conversations. Schroeder's letter explains that the possibility of filing bankruptcy was presented to Debtor as one option to consider as a response to the Automobile Creditor's claim, but that no lengthy discussion took place and no decision was made to file for bankruptcy protection. Debtor asks that the Court reopen the record to consider the Schroeder letter as evidence in this proceeding.

The letter from Attorney Schroeder to Debtor's wife is clearly proffered late and in an untimely manner. The Court need not rule on the letter's admissibility because even if the Court assumes the truth of what Mr. Schroeder's letter avers, the result of the Court's analysis and final ruling does not change.

CONCLUSIONS OF LAW

Avco requests that the Court except from discharge the May 14, 1994 debt discussed above, pursuant to 11 U.S.C. § 523(a)(2)(A) and/or (B) which state:

> a. A discharge under section 727 . . . does not discharge an individual debtor from any debt--
>
> . . .
>
> 2. for money, property, services, or an extension, or 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 published with intent to deceive[.]

These two subsections constitute the fraud exceptions to discharge. Ordinarily, subsection (A) and (B) are mutually exclusive. In re Liming, 797 F.2d 895, 897 (10th Cir. 1986); In re Bagenstos , Adv. No. L-89-0112W, slip op. at 3 (Bankr. N.D. Iowa Jan. 4, 1990). That is, a plaintiff may not sustain a claim regarding a single statement under both subsections. This is because subsection (B) deals only with a debtor using false written statements respecting his or her financial condition, whereas, subsection (A) covers all other kinds of misrepresentations, false pretenses or actual fraud. Unlike subsection (B), a subsection (A) misrepresentation need not be in writing and must not be in regards to the debtor's financial condition. 11 U.S.C. § 523(a)(2)(A-B).

This Court considers a four element test when determining whether a debt will be excepted from discharge under § 523(a)(2)(B). The test is:

1. whether the allegedly false statement is a writing respecting the debtor's financial condition;
2. whether the financial statement is materially false;
3. whether the debtor intended to deceive the lender; and

4. whether the lender reasonably relied upon the statement in extending the credit.

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).

Although subsection (A) does not contain explicit statutory elements, the subsection contains the common law elements of fraud. In re Earhart, 68 B.R. 14, 16 (Bankr. N.D. Iowa 1986). This Court uses the following five element test to determine whether a debt is nondischargeable under subsection (A):

1. whether the debtor made a false representation;
2. whether at the time made, the debtor knew them to be false;
3. whether the representations were made with the intention and purpose of deceiving the creditor;
4. whether the creditor relied upon the false representation; and
5. whether 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), as modified by In re Ophaug, 827 F.2d 340, 343 n.1. (8th Cir. 1987).

The tests are essentially the same. The only differences being that: (1) subsection (B) requires the debtor's statement to be in writing and be respecting the debtor's financial condition; and (2) subsection (B) requires the creditor to "reasonably rely" upon the debtor's statement, whereas, subsection (A) requires that the creditor merely "rely" on the debtor's misrepresentation. As such, the test under subsection (B) is more rigorous than the test under subsection (A).

The Court will analyze each of the three specific instances which Avco asserts to be grounds for denial of discharge by applying the test for the appropriate subsection in each instance. Avco must prove each element, under either subsection, by a preponderance of the evidence. Grogan v. Garner, 111 S. Ct. 654, 659 (1991);

I. **Representation That Loan Was For Gift For Debtor's Wife**

Avco asserts that Debtor represented that the proceeds of the loan were to be used to purchase a gift for Debtor's wife and to finance a vacation, when in fact they were used to reduce other indebtedness. Since the asserted misrepresentation in this instance was not a writing regarding Debtor's financial condition, § 523(a)(2)(A) applies. Applying the subsection (A) test laid out above, the Court finds that Avco failed to sustain its burden of proof as to their reliance upon Debtor's representation regarding the purpose of the loan. Avco offered no evidence that it relied upon Debtor's assertion as to the purpose of the loan in making the decision to extend the loan to Debtor. It is the conclusion of the Court that this statement does not constitute grounds for excepting this debt from discharge.

II. Representation That Debtor Had No Other Debts

At the bottom of the document entitled Statement of Indebtedness, Defendant wrote the following in his own handwriting, "I owe no other debts." This is clearly a written statement respecting Defendant's financial condition and thus subject to subsection (B) analysis.

Courts have held that the requisite intent to deceive may be inferred from a sufficiently reckless disregard of the accuracy of the facts. In re Black, 787 F.2d 503, 506 (10th Cir. 1986). Debtor's

statement regarding his indebtedness was inaccurate at the time Debtor made it. However, Debtor testified that, to aid him in making this statement, he asked Mr. Edel, an Avco employee, whether his statement needed to include obligations independently owed by his wife. Debtor asserts that Edel responded that he need not list such debts. As the inaccuracies in Debtor's Statement of Indebtedness relate to omissions of his wife's debts, it was reasonable for Debtor to conclude that the substance of his statement was accurate. Debtor's good faith request for clarification precludes a finding that Debtor was recklessly indifferent to the accuracy his statement. This Court concludes that Debtor did not intend to deceive Avco as he reasonably believed the statement to be accurate in substance.

III. **Representation That Debtor Had Not Discussed Bankruptcy With An Attorney**

For the purposes of this analysis, the Court concludes that Debtor's answer to the Bankruptcy Question was a written statement respecting Debtor's financial condition. As such, the Court applies the four element subsection (B) test to determine whether the Avco debt is nondischargeable.

WRITTEN STATEMENT RESPECTING DEFENDANT'S FINANCIAL CONDITION

Debtor's written response of "no" to the Bankruptcy Question, when put into statement form affirmatively states that Debtor never filed nor discussed bankruptcy with an attorney. This statement, when given in the context of a Statement of Indebtedness, is a written statement regarding Debtor's financial condition. If Debtor answered the Bankruptcy Question in the affirmative, he would then be required to explain in detail the circumstances of such bankruptcy filing or discussion. The answer to the Bankruptcy Question and the omission of information pursuant to the follow-up request, taken together, constitute Debtor's statement. The Court concludes that Debtor's written response to the Bankruptcy Question constituted a written statement regarding his financial condition.

MATERIALLY FALSE STATEMENT

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). Other courts have held financial statements to be materially false if they are substantially inaccurate and contain or lack information that would effect a creditor's decision making process. In re Greene, 96 B.R. 279, 283 (9th Cir. 1989). A material falsity may be premised upon false information or the omission of information. Id.

Debtor admits that, at least in the context of discussing how to deal with the Automobile Creditor, Debtor and his attorney had discussed the option of filing bankruptcy. The letters from Debtor's attorney to that creditor establish that this discussion took place prior to Debtor applying for the loan from Avco. Regardless of how Debtor characterizes the nature of these discussions, Debtor was required to answer the Bankruptcy Question in the affirmative in order to give a truthful answer, especially since Debtor was given the opportunity to clarify any affirmative answer. Therefore, the Court concludes that Debtor's answer to the Bankruptcy Question was false.

The magnitude or substantiality of the inaccuracy of the statement does not help to determine whether the misrepresentation was material. The Bankruptcy Question was a yes or no question and Debtor's answer was false. Materiality, in this case turns on whether Debtor's statement is of the kind that would affect Avco's decision making process. Id. An affirmative answer to this question, in the context of a consumer loan application, would serve as a red flag for Avco, particularly in the case of

unsecured loans. Had Debtor answered truthfully, Avco would have certainly demanded more information. This assumption is reinforced by the self-activating follow-up information request to the Bankruptcy Question. If Debtor truthfully answered the Bankruptcy Question in the affirmative and gave accurate details of his discussions with his attorney, Debtor's application for an unsecured loan would most likely have been denied. The information received from the Bankruptcy Question and the follow-up information request is of the kind that would normally affect Avco's decision-making process. Therefore, it is the conclusion of this Court that Debtor's answer to the Bankruptcy Question was materially false.

INTENT TO DECEIVE

To prove intent to deceive, Avco may show that Debtor had a reckless indifference to or reckless disregard for the accuracy of the information in the financial statement. Jones, 88 B.R. at 903. A debtor's "intent [to deceive a creditor by making of a false statement] can be gleaned from the surrounding circumstances." In re Capps, No. 93-20229KD, Adv. No. 93-2106KD, slip op. at 3 (Bankr. N.D. Iowa Nov. 24, 1993).

Debtor testified that he believed the Bankruptcy Question addressed only serious conversations regarding bankruptcy. Debtor implies that he did not intend to deceive Avco by stating that he had never discussed bankruptcy with an attorney because by answering in the negative, Debtor believed that he was not withholding any information in which Avco was interested. Debtor's implication that he misunderstood the question is suspect for two reasons. First, when Debtor was unsure as to the interpretation of the request that he list all of his debts, he asked Mr. Edel to clarify the request for him. Debtor did not ask for clarification regarding the Bankruptcy Question, even though he knew that he had recently had at least a casual conversation with his attorney regarding the possibility of filing for bankruptcy. Debtor's willingness to seek clarification regarding other portions of the application and his failure to seek the same regarding the Bankruptcy Question, leads the Court to conclude that Debtor either knew he was answering falsely and intended to deceive Avco by doing so or that he recklessly disregarded the accuracy of his answer. Jones, at 903.

Second, the Bankruptcy Question had a self-activating follow-up information request. This would have allowed Debtor to qualify his answer and to explain the supposed casual nature of his conversations with his attorney. If Debtor truly believed that Avco was not interested in these kinds of conversations and had Debtor truly intended not to deceive Avco with his answer, he would have simply answered the Bankruptcy Question in the affirmative and explained the nature of the conversation without concern for the effect upon his loan application. The circumstances of Debtor's answer to the Bankruptcy Question establish at least a reckless indifference on the part of Debtor as to the truth of his answer.

Based upon the entire record, the Court concludes that Debtor intended to deceive Avco by falsely answering the Bankruptcy Question.

REASONABLE RELIANCE

To establish reasonable reliance upon Debtor's false financial statement, Avco must meet a two-part test. First, Avco must establish that it did rely on the financial statement. Second, Avco must establish that its reliance was reasonable. Hennings, slip op at 8.

"[A]ctual reliance exists where the false financial statement is a substantial factor in causing the extension of credit." Id. The Court finds that Debtor's false statement was such a substantial factor in causing Avco to extend credit to Debtor. Had Debtor answered truthfully in the affirmative, this Court believes Debtor would have had little chance of obtaining an unsecured loan from Avco. This question performs a screening function. Debtor's false statement increased substantially the likelihood of a favorable response by Avco. As such, the negative response becomes a critical factor in causing Avco to extend credit to Debtor. The Court concludes that Avco relied upon Debtor's false financial statement in extending him credit.

Regarding the reasonableness of Avco's reliance, the entire record must be reviewed to determine whether there are any "red flags" that would tip off an ordinarily prudent lender that the representation relied upon was not accurate. In re Karr, No. 94-105447KC, Adv. No. 94-1082KC (Bankr. N.D. Iowa Apr. 4, 1995). Nothing in the record is of such a nature that it should have alerted Avco to the possibility that Debtor's answer to the Bankruptcy Question might be false. The relationship between the parties was limited. Debtor's credit report, obtained by Avco at the time of Debtor's application, stated that all of Debtor's reported debts had been or were being repaid. Therefore, the Court concludes that, in deciding to extend credit to Debtor, Avco's actual reliance upon Debtor's answer to the Bankruptcy Question was reasonable.

CONCLUSION

The Court holds that Avco did not sustain its burden of proof as to the statement of Debtor regarding the intended purpose of the loan, nor did it sustain its burden regarding Debtor's statement that he owed no other debts then those listed in his Statement of Indebtedness. Finally, it is the conclusion of the Court that Debtor's answer to the Bankruptcy Question and the follow-up information request was a written statement respecting Debtor's financial condition; that it was materially false; that Debtor intended to deceive Avco by publishing it; and that Avco reasonably relied upon the statement in deciding to extend the unsecured loan of May 14, 1995 to Debtor.

WHEREFORE, Plaintiff Avco's request that the Court deny Debtor a general discharge pursuant to 11 U.S.C. §§ 727(a)(4) and/or (5) is DENIED.

FURTHER, Avco's request that the debt of $5,046.00, incurred by Debtor on May 14, 1994, be excepted from discharge pursuant to 11 U.S.C. §§ 523(a)(2)(A) and/or (B) is GRANTED.

SO ORDERED this 18th day of October, 1995.

Paul J. Kilburg
U.S. Bankruptcy Judge