In the United States Bankruptcy Court

for the Northern District of Iowa

DAVID A. JOHNSON, dba Johnson Livestock and Johnson Trucking, and ANNE M. JOHNSON
Debtors.

Bankruptcy No. 95-60071KW

Chapter 7

THE FIRST NATIONAL BANK OF WAVERLY
Plaintiff
vs.
DAVID A. JOHNSON and ANNE M. JOHNSON
Defendants.

Adversary No. 95-6074KW

ORDER

The above-captioned matter came on for trial before the undersigned on December 11 and 12, 1995 on the Plaintiff's Complaint to Determine Dischargeability of Debt. Plaintiff First National Bank of Waverly (the "Bank") was represented by Attorney Christopher Foy. Defendant/Debtor David A. Johnson was represented by Michael Cross and Defendant/Debtor Anne M. Johnson was represented by Robert Dieter. After the presentation of evidence and argument, the Court took the matter under advisement. The time for filing briefs has now passed and this matter is ready for resolution. This is a core proceeding pursuant to 28 U.S.C. 157(b)(2)(I).

STATEMENT OF THE CASE

Debtors filed their Chapter 7 petition on January 17, 1995. The Bank seeks a determination that certain debts owed it by Debtors are nondischargeable under 11 U.S.C. 523(a)(6) and 523(a)(2)(B). The Bank asserts that Debtor David Johnson converted some if its collateral by selling it without its knowledge and consent. The Bank also asserts that both Debtors prepared and delivered a false financial statement upon which it relied in extending further credit.

Debtor David Johnson has been in the business of buying and selling feeder pigs, doing business as "Johnson Livestock". Debtor Anne Johnson is a third grade teacher. In 1991, David Johnson executed a note and line of credit agreement to establish a checking reserve for his business checking account ("Reserve Agreement"). Debtor Anne Johnson is allegedly liable under this agreement based on an unlimited, absolute Guaranty she signed on September 11, 1989. Both Debtors are signatories on the account. The debt under this agreement eventually exceeded $59,000 through advances made May 3 and 4, 1994.

In 1993, the Bank agreed to issue a $40,000 letter of credit in Debtors' names ("Credit Agreement"). The Bank advanced the $40,000 under this agreement on May 6, 1994 to cover some of the Johnson Livestock overdrafts. The Bank was later required to turn this amount over in settlement of a lawsuit brought against it by the Packers and Stockyards Administration. Therefore, it requests a determination of nondischargeability of the more than $49,000 still due after credits under the Reserve Agreement from the overdrafts in early May and $40,000 under the Credit Agreement, plus interest, attorney fees, expenses and costs.

Debtors both signed security agreements in 1987 and 1993 granting the Bank security interests in all business property of Johnson Livestock. The agreements prohibited Debtors from disposing of any of the collateral without advance written permission of the Bank. Debtor David Johnson admits to selling the following items of property between

January 1992 and January 1995, which were listed with the following values on the February 8, 1994 Financial Statement:

Property Value	
1. 1985 truck	$ 4,000
2. 1988 livestock trailer	7,000
3. 1988 Gehl skidloader	4,000
4. 50% interest in 1954 M Farmall tractor	1,500
5. two grain storage bins and grain dryer	16,000
6. John Deere 1020 Loader	4,500
7. a U.S. savings bond	2,500
8. an I.R.A.	4,500
9. a woods lawnmower	1,200
Total	$45,200

The Bank asserts that the debt arising from the Reserve Agreement is nondischargeable as to Debtor David Johnson to the extent of the value of the listed property which it considers collateral. It does not challenge dischargeability on these grounds with respect to Debtor Anne Johnson. The Bank states that the values of its collateral listed in Debtors' financial statement total $37,450. The Bank requests a judgment that $22,470, or 60% of $37,450, is nondischargeable in David Johnson's Chapter 7 case.

On this issue, David Johnson asserts that he thought he had the Bank's permission to sell the collateral when, in late 1993, one of the Bank's Vice Presidents, David Huser, suggested that David Johnson "get rid of his toys". Mr. Huser explained that the "toys" to which he was referring included the motorcycle upon which David Johnson was seated at the time of the comment. The Bank denies having knowledge of or giving consent to David Johnson selling the listed items. David Johnson asserts that throughout his relationship with the Bank he had bought and sold not only feeder pigs but vehicles and equipment used in his business without the need for the Bank's consent.

At trial, David Johnson asserted that he did not know these items constituted collateral under his security agreements with the Bank. Mr. Johnson did, however, admit in the Joint Pretrial Statement that he sold the items with full knowledge that they were subject to the Bank's perfected security interest. He also stated in deposition testimony that he understood that the Bank's security interest covered all of Debtors' assets.

David Johnson's testimony and exhibits indicate the following disposition of the listed property:

1. 1985 truck -	traded 1/94 for a dually truck
2. 1988 livestock trailer -	traded in 1993 for a truck and trailer later transferred to an agent in return for assumption of debt exceeding value of the trailer
3. 1988 Gehl skidloader -	sold in 6/94 for $4,500
4. 50% interest in 1954 M Farmall tractor -	sold in 1994 for $350 (Bank has settled with purchaser)
5. two grain storage bins and grain dryer -	sold in 2/94 for $5,500
6. John Deere 1020 Loader -	traded for van in 1992; Bank has security interest in van
7,8. a U.S. savings bond and an I.R.A. -	not pledged as security, not business assets
9. a woods lawnmower -	sold in 6/94 for $500.00

In February 1994, Debtors both executed a financial statement for the Bank. The statement lists these items as if Debtors continued to own them and includes their values as part of Debtors' net worth. Debtors did not disclose in the statement that some of the listed items had already been disposed of.

Anne Johnson signed the financial statement. She insists, however, that she only signed at the Bank's request and that she does not have any involvement in Johnson Livestock. Mrs. Johnson states that she did not have any knowledge of the finances of the business or the existence or value of any business assets. She did not participate in the sale of any assets.

In 1993 and 1994, Debtor David Johnson was involved in legal proceedings instituted by the State regarding alleged unlawful and fraudulent practices in connection with Johnson Livestock and revocation of his license to act as a feeder pig dealer. The Bank was aware of these proceedings but did not believe they would have long-term adverse consequences on Johnson Livestock. On October 17, 1995, Debtor David Johnson pleaded guilty to an aggravated misdemeanor, Tampering With Records under Iowa Code sec. 715A.5.

In the Management Evaluation attached to the Bank's Loan Request/Annual Review dated 02-16-94 signed by Loan Officers Steve Willemssen and David Huser, they proposed approving loan requests for a $30,000 loan for intermediate term debt plus $20,000 open ended for feeder pig purchases. The evaluation comments that a major problem is a lawsuit against Johnson Livestock alleging violations of animal disease control laws and the Consumer Fraud Act and a charge of falsifying veterinary records. It also states that the Johnsons were showing approximately $25,800 earned net worth gain and sales of Johnson Livestock were growing steadily. The comments make note that David likes to trade vehicles on a regular basis.

The total listed on Debtors' 2/8/1994 Financial Statement for "Machinery, Equipment, Cars, Trucks" is $168,300. The "Statement Value" listed for "Vehicles & Mach." on the Bank's Loan Request/Annual Review dated 02-16-94 is $90,500. The Bank's other "Statement Values" more accurately correlate with the respective values on Debtors' Financial Statement. It is unclear from the record how the Bank arrived at the $90,500 value for vehicles and machinery. The Court must assume this is the amount the Bank relied upon when considering whether to approve Debtors' loan requests in February 1994. The Bank discounted this amount to 60%, or $54,300, when calculating collateral value.

The Bank had a history of providing credit to Debtors since approximately 1986. It financed the purchase of vehicles, made a home mortgage loan and extended other forms of credit as well as entering into the Reserve Agreement and Credit Agreement with Debtor David Johnson. Each year, the Bank would request an updated financial statement from Debtors. The statements showed steady growth in Debtors' assets and net worth over the years. Occasionally, the Bank covered overdrafts written on the Johnson Livestock business account but any negative balances were always covered within one or two days.

The Bank's loan officers all believed that Debtors' consistent growth in net worth and clean payment history, as well as the overall profitability of Johnson Livestock, made Debtors good credit risks. Apparently they were surprised when Debtors' financial condition deteriorated in late April and early May, 1994. The Johnson Livestock account became overdrawn in the total amount of $59,435 and Debtors were unable to cover the negative balance.

CONCLUSIONS OF LAW

The Bank has the burden to prove the elements of its claims under 11 U.S.C. 523 by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291, 111 S. Ct. 654, 661 (1991). 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).

FALSE FINANCIAL STATEMENT

The Bank claims that, pursuant to 523(a)(2)(B), the entire debt should be excepted from discharge as to both Debtors because they executed and delivered a false financial statement upon which the Bank relied in extending credit. Section 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 was a writing respecting the debtor's financial condition; (2) the financial statement was materially false; (3) the debtor intended to deceive; and (4) the creditor reasonably relied upon the false statement. In re Walderbach, No. L92-00780C, Adv. No. 92-1135LC, slip op. at 7 (Bankr. N.D. Iowa Aug. 31, 1993); In re Simpson, 29 B.R. 202, 210 (Bankr. N.D. Iowa 1983). If the Bank fails to prove every element contained in 523(a)(2)(B), the debt is dischargeable. In re Jones, 31 F.3d 659, 662 (8th Cir. 1994).

The two most definitive elements are intent and reasonable reliance. Because direct proof of intent is nearly impossible to obtain, the Bank may present evidence of the surrounding circumstances from which intent can be inferred. Van Horne, 823 F.2d at 1297; Simpson, 29 B.R. at 211. Courts have held that a creditor can establish intent to deceive by proving reckless indifference to or reckless disregard of the accuracy of the information in a debtor's financial statement. In re Jones, 88 B.R. 899, 903 (Bankr. E.D. Wis. 1988); 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").

The requisite intent to deceive may be inferred by a debtor's total disregard for arriving at the true value of assets listed in a financial statement. In re Warner, 169 B.R. 155, 159 (Bankr. W.D. Tenn. 1994). In In re Lefeve, 131 B.R. 588, 600 (Bankr. S.D. Miss. 1991), the court inferred an intent to deceive under 523(a)(2)(B) from the debtor's nondisclosure of his limited ownership interest in certain property and failure to amend the value of another property upon learning it was overinflated. The requisite intent to deceive also exists where the debtor knows the financial statement inaccurately reflects assets the debtor does not own. In re Hodges, 116 B.R. 558, 562 (Bankr. N.D. Ohio 1990). In Hodges, the court stated that, at minimum, the debtor acted with gross recklessness by not informing the creditor that his wife owned certain assets in her name alone. Id.

Under the foregoing, the Court concludes that the Bank has proved by a preponderance of the evidence that Debtor David Johnson had the requisite intent to deceive under 523(a)(2)(B). He knew on February 8, 1994 when he delivered the financial statement to the Bank listing certain property as assets that he had in fact already disposed of such property. Although he still owned some of the property at that time, he admitted at trial that at least the following property had previously been sold, traded or otherwise disposed of: (1) 1985 truck - traded 1/94 for a dually truck, valued at $4,500; (2) 1988 livestock trailer - traded in 1993 for a truck and trailer later transferred to an agent in return for assumption of debt exceeding value of the trailer, valued at $7,000; (3) two grain storage bins and grain dryer - sold in 2/94 for $5,500, valued at $16,000; (4) John Deere 1020 Loader - traded for van in 1992, valued at $4,500; Bank has security interest in van. The total value of these missing assets listed on the Financial Statement was $32,000. From David Johnson's continuing to list these items as assets on his financial statement, the Court can infer he had the intent to deceive the Bank.

This intent to deceive cannot as easily be inferred regarding Debtor Anne Johnson. She signed the financial statement and had entered into a guaranty with the Bank which would arguably make her liable for the relevant debts. However, the issue remains open whether her liability for the debts is nondischargeable under 523(a)(2)(B).

In In re Walker, 726 F.2d 452, 453 (8th Cir. 1984), the Eighth Circuit considered the issue where the debtor's wife committed fraud after taking over the debtor's hardware business when he became ill. Considering principles of agency law, the court held that proof of an agent's fraud does not justify denial of discharge as to the debtor unless there is also proof justifying the inference that the debtor knew or should have known of the fraud. Id. at 454. This inference could arise if the debtor was recklessly indifferent to the acts of the agent, or where the debtor signed a false document without examining it or had no good reason for lack of knowledge. Id. The court must look at the extent of the debtor's involvement in the business and the nature of that involvement. Id.

This Court considered a similar issue in In re Anderson, 29 B.R. 184 (Bankr. N.D. Iowa 1983). The question was whether a partner's intent to deceive can be imputed on the "innocent" partner/debtor. Id. at 190. The Court noted that the Code's policy of discharging honest debtors would be negated by imputing the deceptive intent of one partner to an honest, innocent partner/debtor. Id. at 191. The court considered whether the debtor had seen the financial statement and whether the errors were such that he knew or should have known of the falsity. Id. It held that, though the debtor had seen the financial statement, he was not in the position to know it was materially false and thus did not have the requisite intent to deceive under 523(a)(2)(B). Id.

Similar reasoning was applied more recently in other jurisdictions to find that a wife, unfamiliar with the business affairs or the specific transaction, did not have the intent to deceive based on her husband's false financial statement. In re Boice, 149 B.R. 40, 48 (Bankr. S.D.N.Y. 1992) (finding wife/debtor had no intent to deceive where husband had falsely stated they owned their home; wife had only signed the statement after it was substantially completed by her husband); In re Rental Journal, Inc., 111 B.R. 1012, 1016 (Bankr. S.D. Fla. 1989) (holding that wife/debtor who did not sign the financial statement or negotiate the loans did not have intent to deceive; she was a housewife unfamiliar with the business affairs and was only involved because she had signed a guaranty).

Debtor Anne Johnson, likewise, did not have the requisite intent to deceive regarding the financial statements prepared by her husband. The record shows that she had no involvement in the business affairs of Johnson Livestock. She did sign the financial statement but she had no reason to know that her husband had disposed of some of the listed business assets. Therefore, the Bank, having failed to prove Anne Johnson had the intent to deceive, fails in its claim that her debt to the Bank be declared nondischargeable.

Since the Bank has proved that Debtor David Johnson had the requisite intent to deceive under 523(a)(2)(B), the Court will consider the element of reliance. There are two components to the reliance requirement of this section: 1) actual reliance and 2) reasonable reliance. Teachers Credit Union v. Johnson, 131 B.R. 848, 854 (W.D. Mo. 1991). Actual reliance exists where the false financial statement is a substantial factor in causing the extension of credit. In re Myers, 124 B.R. 735, 742 (Bankr. S.D. Ohio 1991).

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. Regarding reasonableness, the Court should further consider (1) whether there were "red flags" which would have alerted the ordinarily prudent lender that the representations upon which it was relying were accurate and (2) whether minimal investigation would have revealed the inaccuracy of the representations. Jones, 31 F.3d at 661. Whether the Bank's reliance was reasonable should be judged in light of the totality of the circumstances. Id.

The Bank had been engaged in financing Johnson Livestock's feeder pig business for several years. It relied, in part, on Debtors' positive financial history in deciding to cover Johnson Livestock's overdrafts with advances under the Reserve and Credit Agreements. The record does not clearly establish that the Bank relied on the values listed in Debtors' financial statement for vehicles and machinery, considering the discrepancy between that total figure of $168,300 and the total of $90,500 on the Bank's loan request/annual review papers.

The only inaccuracy in the financial statement proven by the Bank was inclusion of approximately $32,000 of property previously disposed of by Debtor David Johnson. Considering Debtors' reported net worth of $302,511, it does not appear that the inaccurate inclusion of this amount of property would constitute a substantial factor in the Bank's annual review. Therefore, the Court cannot conclude that the Bank actually relied on the inaccurate listing of this property on the financial statement in deciding to extend credit at that time or at the time of the overdrafts in early May, 1994.

Prior to receiving the February 8, 1994 Financial Statement and prior to covering the overdrafts, the Bank was aware of David Johnson's legal difficulties related to his business. It noted in annual review comments that Debtors had high living expenses and that David Johnson was known to trade vehicles on a regular basis. These circumstances should raise red flags causing a prudent investor to question the accuracy of the financial statement. The record does not disclose any attempt by the Bank to investigate the accuracy of the financial statement's listing of vehicles and machinery. Based on these circumstances, it is difficult to conclude that the Bank would have been reasonable in relying on Debtors' accounting of collateral on the financial statement.

The Court concludes that the Bank has failed to prove by a preponderance of the evidence that it reasonably relied on Debtors' financial statement. The record does not support a finding that the Bank actually or reasonably relied on the statement in extending credit. Therefore, the debt to the bank is not excepted from discharge under 523(a)(2)(B).

CONVERSION

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 included as an "injury" under 523(a)(6). In re Wolfson, 56 F.3d 52, 54 (11th Cir. 1995); In re Holtz, 62 B.R. 782, 785 (Bankr. N.D. Iowa 1986). In Holtz, the debtor's failure to apply sales proceeds against the Bank's loans constituted conversion. 62 B.R. at 786. 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 willful and malicious injury does not follow from every act of conversion. Wolfson, 56 F.3d at 54. A mere technical conversion does not satisfy 523(a)(6). Holtz, 62 B.R. 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). In Long, the Eighth Circuit 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. Id. Some factors indicative of willful and malicious conduct include the debtor's experience in business, concealment of disposition of the collateral and admission that the debtor read the security agreement or at least understood its terms. In re Lau, 140 B.R. 172, 173 (Bankr. N.D. Ohio 1992). Where the debtor is aware that selling or otherwise disposing of property would deprive the creditor of collateral, the debtor's conduct is deliberate and intentional in knowing disregard of the creditor's rights. Id. at 174. This constitutes a malicious and willful injury under 523(a)(6). Id.

The record contradicts David Johnson's assertion that he did not know the items of property he disposed of constituted part of the Bank's collateral. The Court concludes from this record that he knew on some level that disposing of the property without notice to the Bank or paying over the proceeds to the Bank was contrary to the Bank's security interest. Therefore, David Johnson's conduct was willful.

The Bank has further met its burden of proving that his conduct was malicious. Aggravating factors exist which demonstrate that David Johnson's disposal of the collateral was targeted at financially harming the Bank's security interest. Mr. Johnson was sufficiently sophisticated in business to run a livestock company with sales in the millions of dollars, in several states and with several employees. Continuing to list the property as assets on his financial statement appears to be an attempt to conceal his disposition of the collateral. David Johnson has admitted in deposition testimony and the pretrial statement that he understood that the property he disposed was the Bank's collateral.

Debtor argues that he thought the Bank acquiesced in his disposition of the property when Mr. Huser told him to get rid of his toys. The Court finds that it was not reasonable for Mr. Johnson to interpret that comment to mean that he had permission to liquidate business vehicles and machinery. Even if the Court were to conclude that this casual comment constituted permission to liquidate the collateral, it does not explain or address the complete failure to turnover the proceeds. The record supports a finding by a preponderance of the evidence that David Johnson's conduct constituted willful and malicious conversion when he disposed of the Bank's collateral property.

The amount of a debt which is nondischargeable under 523(a)(6) is the lesser of the value of the converted property or the amount of the debt. Lau, 140 B.R. at 174. The Bank states that the value of the converted collateral property is $22,470, or 60% of the total value of $37,450. The Court concludes that the debt owed the Bank in the amount of $22,470 is nondischargeable under 523(a)(6).

WHEREFORE, the debt of Debtors David and Anne Johnson to the First National Bank of Waverly is not excepted from discharge under 523(a)(2)(B).

FURTHER, judgment shall enter against Debtor David Johnson and for Plaintiff First National Bank of Waverly in the amount of $22,470 based on Debtor David Johnson's conversion of the Bank's collateral.

FURTHER, Debtor David Johnson's debt to the First National Bank of Waverly in the amount of $22,470 is excepted from discharge under 523(a)(6).

SO ORDERED this 12th day of February, 1996.

Paul J. Kilburg
U.S. Bankruptcy Judge