

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)
)
 LARRY AND LYNNE BARLOW,) CASE NO. BK86-3499
)
 DEBTORS)

MEMORANDUM OPINION RE AMENDED MOTION TO DISMISS OR CONVERT

An evidentiary hearing on the amended motion to dismiss or convert filed by First National Bank of O'Neill, Nebraska, was held on February 12, 1987. Appearing on behalf of the movant was Victor Covalt of Lincoln, Nebraska. Appearing on behalf of the debtors was Marion Pruss of Omaha, Nebraska.

Facts

1. Debtors are farmers residing near Ewing, Nebraska, operating a dairy and hog operation. Debtors commenced this proceeding under Chapter 12 of Title 11 on December 9, 1986, by filing a voluntary petition with this Court.
2. Bank is a secured creditor with nine claims allegedly aggregating \$258,731.77 which, for the purposes of this hearing is acknowledged by the debtors, are secured by security interests in farm equipment, farm products, crops and livestock plus real estate.
3. In September of 1986 the debtors liquidated their dairy cattle, upon which the bank claims a lien, and used the proceeds to purchase new cattle. The sale of the dairy cattle was necessary because of an outbreak of mastitis and milk quality problems. The number of head of dairy cattle repurchased with the proceeds of the original herd was far fewer than the original herd. No notice of the sale and replacement was given to the bank.
4. In anticipation of obtaining an FmHA guaranteed loan through the bank to replace a mortgage loan the bank had provided, the debtors delivered to the bank a financial statement which did not accurately reflect either their assets or their liabilities as of October 29, 1986. Evidence of the debtors is that the assets were overstated because the purpose of the financial statement was to show the financial status of the debtors as of a date six weeks following the date the financial statement was submitted. In other words, the debtors claim that they showed the number of hogs

they would have on hand in early December because that was the date that the FmHA guaranty paperwork would be completed. They failed to list all of their liabilities, including a number of lease claims to various cattle, either through oversight or because they didn't think the leases were liabilities. The bank did not use the financial statement for any purpose other than making a decision to terminate the banking relationship with the debtors.

The bank had knowledge from their previous financing and the investigations done with regard to the actual liabilities of the debtors that the debtors owed far more money than they had listed on the October 29 financial statement.

Rather than asking the debtors to explain the discrepancies on the October 29, 1986, financial statement, the bank officers, both of whom were new to this particular loan, simply assumed that the debtors were lying to the bank and put into action a plan to take a physical count of the livestock without the knowledge of the debtors and then to bring a lawsuit for replevin of the assets. To paraphrase the testimony of one bank officer, once he discovered from credit inquiries that the liabilities were significantly different than the amounts placed upon the financial statement, he immediately lost trust in the debtors and went to other bank officers to get a determination by the officers as to the manner in which to proceed.

5. On more than one occasion in the fall of 1986 the bank officers came upon the premises of the debtor and attempted to count the livestock. What actually transpired and the conversations that actually took place are very much in dispute in the evidence. The bank claims the debtor admitted to a certain number of cattle being owned and signed a statement to that effect. The debtor admits he signed a statement but claims that he didn't read it and that he did not ever own as many cattle as are listed on the statement. His testimony is backed up by the testimony of the "hired man", Mr. Lange. Apparently the bank officers did not discuss the number of cattle or pigs with Mr. Lange, the person responsible for caring for the livestock. His testimony, which is believed by this Court, is that the numbers of head of cattle that the bank believes existed and disappeared is erroneous. He testified that there was no more than 24 head of Simmental cattle and that even though the bank thinks there were 32 head, the bank was wrong.

6. The bank complains that several hundred head of hogs have disappeared just prior to the bankruptcy filing. However, they attempt to prove that by using the numbers on the October 29, 1986, financial statement that they know is wrong. Mr. Barlow satisfactorily explained the reason for the numbers on the October 29, 1986, financial statement and Mr. Lange, whose testimony was

not impeached or contradicted in any way, testified that the number of hogs the bank thinks existed and disappeared did not exist and could not have disappeared without his knowledge.

7. The bank filed a replevin action in State District Court in late November of 1986 and served an order upon the debtors prohibiting their use of the collateral pending a hearing on possession scheduled for December 9, 1986. In spite of that, the debtors transferred grain to two creditors, one in payment of a debt owed to the creditor as a custom harvester and the second a payment to the only creditor that was supplying feed supplements to the debtors. This creditor had a three-way agreement with the bank and the debtors under which he had previously supplied feed supplements, the debtors had signed notes and the bank had made payments. As a result of the bank "losing trust" in the debtors, the bank refused to honor its agreement and, although the creditor had provided the feed supplements which benefited the bank to the extent that the pigs remained alive, the bank would not pay. In order to continue to obtain feed supplements, Mr. Barlow traded the grain to the supplier so that the supplier would continue to provide feed supplement pending the final possession hearing on December 9, 1986. He also received from the supplier some cash which he used to pay the hired man and for living expenses.

8. The debtors failed to list on their bankruptcy schedules any of the above transactions, but did admit most at the first meeting of creditors and at a deposition taken pursuant to a voluntary agreement by the parties.

Just prior to filing bankruptcy, the debtors also sold some pigs, did not turn the proceeds over to the bank and used the proceeds for living expenses and operating expenses. Further, the debtors, after selling certain pigs, probably contrary to the order of the State District Court, obtained a check for the proceeds which named the bank as well as the debtors as payees. They turned that check over to another creditor on some type of "security" theory and this third creditor loaned them sufficient money to make a down payment on the attorney fees required by the attorney employed to file the Chapter 12 bankruptcy proceeding. Eventually, the check with the bank's name on it was returned to the bank and applied to the debt.

Issue

Have the debtors acted fraudulently or grossly mismanaged the estate either before or after the filing of the bankruptcy to the extent that the case should either be dismissed or converted to a Chapter 7 pursuant to §§1204 or 1208 of the Bankruptcy Code?

Decision

The actions by the debtors were not intended to defraud the bank, did not defraud the bank, have not yet harmed the bank and, in most cases, were necessary to preserve the operation of the farming entity pending either the State Court replevin hearing or the bankruptcy hearings. Therefore, the motion to dismiss or convert is overruled.

Conclusions of Law and Discussion

This motion was brought pursuant to 11 U.S.C. §1204(a) which provides that "on request of a party in interest, and after notice and a hearing, the Court shall order that the debtor shall not be a debtor-in-possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the commencement of the case." In addition, the moving party has brought this action based upon 11 U.S.C. §1208(d) which provides that "on request of a party in interest, and after notice and a hearing, the court may dismiss a case under this chapter or convert a case under this chapter to a case under Chapter 7 of this Title upon a showing that the debtor has committed fraud in connection with the case."

There are no reported cases upon which either the parties or the Court can rely which interpret these new statutory sections. Since this case is an ongoing one and will be involved in many future evidentiary hearings, if its short history can be used to judge the future, this Court is not going to do a detailed analysis of the requirements under the two statutory sections. However, it appears to the Court, based upon the evidence that has been presented and the facts as outlined above, that the debtors have mainly done what has been necessary to keep the operation alive after their operating lender made a business decision to stop funding the operation.

This Court does not believe that the sale of dairy cattle in September which were diseased and did not provide quality milk, was outside the ordinary course of business. The debtors had a dairy cattle business. They had milk assignments and cash flow needs. The liquidation of a herd which was not providing adequate quality or quantity of milk and the replacement of it by a smaller herd which was intended to provide appropriate quality and quantity of milk to satisfy the cash flow needs, is not outside the ordinary course of business. There still remains a question, which eventually will be resolved in this case, as to whether or not the bank had a lien on the dairy herd in September of 1986.

The debtors adequately explained the purpose of the financial statement on October 29 of 1986 and the banker didn't explain why he asked no questions of the debtor concerning the obvious discrepancies of the financial statement.

The serious matters relate to the use of collateral after receiving a court order from a State District Judge. However, it appears from the evidence that the use of that collateral was to maintain other collateral. Grain was traded to the feed supplier. Without the trade, the debtors had no money to pay for feed. Without paying for feed, the debtors believed that the hogs would not make it to December 9, the date of the hearing on possession. The bank does not disagree that the hogs had to be fed and that the bank wasn't going to pay for the feed. Therefore, there is nothing fraudulent about this activity, even though it is in direct violation of a State Court order. This Court believes the State Court Judge would have permitted the use of the grain to obtain feed pending the hearing.

Trading grain to a custom operator to convince the custom operator to continue the harvest is not fraudulent and does not harm the creditor. Somebody had to harvest the crop. The custom farmer's lien would likely come ahead of the blanket lien of the bank anyway. If the bank disputes this legal analysis, it has the opportunity to bring an action to determine the validity of the lien and to set aside the payment.

It is obvious to the Court that the debtor has not been completely honest with the bank. The debtor has conveniently found explanations for providing erroneous information to the bank on a financial statement, has sold either his own cattle in the name of someone else or someone else's cattle in his name and hasn't bothered to explain to his wife exactly how the transaction worked. The explanation that Mr. and Mrs. Barlow gave to the Court concerning the cattle sales and payments to Mr. Thiele, are scrambled, unintelligible and unbelievable. However, those matters do not go to the issues the bank has raised. Delivering a check with the bank named as payee to a third creditor benefited no one and harmed the bank by putting some of its collateral out of its reach for a short time. However, such action does not arise to the level of fraud or gross mismanagement necessary for a dismissal or conversion of this case.

This Court concludes that the facts as found by this Court are not facts under which this Court will find fraudulent activity by the debtors. Much of the "facts" that the bank believes are speculation. Much of the problem here was caused by miscommunication or noncommunication between the parties, failure to live up to financing agreements on both sides, and the absolute necessity to keep livestock alive for the benefit of all parties.

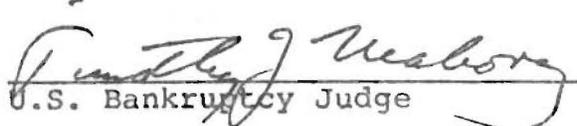
This Court, although not usually one to give advisory opinions, feels that it is appropriate to give one at this time. The posture of the major secured creditor as it is and the posture of the debtors looking to the month of March and the future without decent hog facilities, and the need to review the cash collateral order in a very short time, the various disputes pending between creditors with regard to the validity and extent

of security interests, in the short time limits that this Court has in a Chapter 12 case, it appears to this Court that this case would be much better off in a Chapter 11. Neither the parties nor the Court have the time, let alone the energy, to hold full evidentiary hearings on a monthly basis in this case with regard to all of the issues that have been raised by this creditor and now by another creditor. This Court is tempted, but has overcome the temptation, to suggest that this case would be dismissed unless converted to a Chapter 11 within a certain amount of time. However, with the facts as the Court has found them, it cannot in good conscience find specific grounds for making such a ruling.

The motion of the creditor to convert or dismiss is overruled. Separate Journal Entry shall be entered.

DATED: February 26, 1987.

BY THE COURT:


U.S. Bankruptcy Judge

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