IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF:	)	
PATRICK & NORIENE MURPHY,	)	CASE NO. BK02-80473
Debtor(s).	)	A02-8045
SIOUXLAND FEDERAL CREDIT UNION,	)	
Plaintiff,	)	CH. 7
vs.	)	
PATRICK & NORIENE MURPHY,	)	
Defendant.	)	

MEMORANDUM

Trial was held in Omaha, Nebraska, on February 3, 2003, on the adversary complaint. Dennis Morland appeared for the debtors, and Jeffrey Mohrhauser appeared for the plaintiff. This memorandum contains findings of fact and conclusions of law required by Fed. R. Bankr. P. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(I).

I. BACKGROUND

This adversary proceeding was brought by Siouxland Federal Credit Union ("Credit Union") against the debtors to obtain an order finding that debtors' obligation to the Credit Union is nondischargeable under 11 U.S.C. § 523(a)(2)(B). That statutory section prohibits the discharge of a debt to the extent it was obtained by the use of a statement in writing that is materially false, respecting the debtors' financial condition, on which the creditor reasonably relied and which the debtor caused to be made with intent to deceive.

II. DECISION

The debtors' debt to the Credit Union is dischargeable in this bankruptcy proceeding.

III. LAW

To except a debt from discharge under 11 U.S.C. § 523(a)(2)(B), a creditor must prove, by a preponderance of the evidence, that (1) the debtor made (2) a statement in writing (3) respecting the debtor's financial condition (4) which was materially false and (5) made with the intent to deceive, and (6) which was reasonably relied upon by the creditor. Heritage Bank of St. Joseph v. Bohr (In re Bohr), 271 B.R. 162, 167 (Bankr. W.D. Mo. 2001).

A. “Materially false”

A financial statement is materially false if it “paints a substantially untruthful picture of a financial condition by a misrepresentation of the type which would normally affect the decision to grant credit.” Id. Likewise, a financial statement is materially false if it falsely represents the debtors’ overall financial condition or has major omissions. Id. In the Bohr case, a financial statement listing real property as an asset was materially false in light of the fact that debtors held only a remainder interest in the property, subject to a life estate, so the interest had no value. Without the real estate, the debtors’ net worth dropped from $270,000 to $8,000, so the misrepresentation was material.

The relevant subjective inquiry, although not dispositive, is whether the complaining creditor would have extended credit had it been apprised of the debtor’s true situation. Fairfax State Sav. Bank v. McCleary (In re McCleary), 284 B.R. 876, 885 (Bankr. N.D. Iowa 2002). In McCleary, the lender argued that the debtor’s financial documents were materially false because they omitted certain outstanding obligations and did not accurately reflect the ownership and value of certain business equipment. The court disagreed, noting that the unlisted debt, a $6,000 balance due on a revolving account with a supplier, was not significant in comparison to the debtor’s net expenditures of $448,000 for the first seven or eight months of the year. Moreover, the debtor’s failure to provide the bank with details of his obligations for leased equipment was not “substantially untruthful” as the information sought was readily apparent from the face of the documents. The court opined that “a cursory review of [the profit and loss statement] should have put [the lender] on notice as to potential outstanding lease obligations.” McCleary, 284 B.R. at 886.

B. “Intent to deceive”

For discharge to be barred, the debtor must have acted with intent to deceive. An intent to deceive does not mean that the debtors acted with a “malignant heart.” Bohr, 271 B.R. 162, 169 (quoting Agribank v. Webb (In re Webb), 256 B.R. 292, 297 (Bankr. E.D. Ark. 2000)). A creditor may establish such intent by proving reckless indifference to or reckless disregard of the accuracy of the information in a debtor’s financial statement. McCleary, 284 B.R. at 888. Factors to consider include whether the debtor was intelligent and experienced in financial matters, and whether there was a clear pattern of purposeful conduct. Id. (citations omitted). Once the creditor establishes that the debtor had actual knowledge of the false statement, the debtor cannot overcome the inference of the intent to deceive with unsupported assertions of honest intent. Bohr, 271 B.R. at 169. The court in Bohr found intent to deceive based on the debtors’ admission that they knew the land did not belong to them and that the financial statements containing information to the contrary were submitted for the purpose of obtaining credit. The inference from those facts was that the debtors intended to deceive the lender. Id.

By contrast, the court in McCleary found no intent to deceive because the bank was so lax in obtaining full disclosure of the debtor’s financial situation. “The Bank was content with the limited information it received about Debtor’s financial picture. Debtor’s failure to provide more relevant and accurate information cannot be interpreted as an intent to deceive in these circumstances.” 284 B.R. at 888.

C. “Reasonable reliance”

The reasonableness of a creditor’s reliance is to be determined in light of the totality of the circumstances. Guess v. Keim (In re Keim), 236 B.R. 400, 402-03 (B.A.P. 8th Cir. 1999) (citing First Nat’l Bank of Olathe v. Pontow, 111 F.3d 604, 610 (8th Cir. 1997)). Among the factors to consider is “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.” Sinclair Oil Corp. v. Jones, 31 F.3d 659, 662 (8th Cir. 1994) (quoting Coston v. Bank of Malvern (In re Coston), 991 F.2d 257, 261 (5th Cir. 1993) (en banc)).

In Keim, the court ruled that the creditor could not have reasonably relied on handwritten and incomplete financial statements. The creditor extended credit primarily because the debtors listed a one-sixth ownership interest in a building. The creditor did not verify the ownership interest, or the value of the interest or of the building. The B.A.P. agreed with the bankruptcy court that no reasonable person would have been able to discern the debtors' financial condition solely from the financial statement provided, and reproved the creditor for not asking for proof of the debtors' ownership interest, not conducting a title search, not procuring an appraisal, and not even verifying the existence of the building. Keim, 236 B.R. at 403 n.2.

In Bohr, supra, the court found that the lender reasonably relied on the debtors' purported ownership of real estate listed in their financial statements, although the debtors actually held only a remainder interest. A creditor is not required to assume that a debtor is lying or misrepresenting facts in a financial statement. Bohr, 271 B.R. at 168. "While a minimal investigation would most likely have revealed the true ownership of the real estate and thereby exposed the falsity of the financial statements, there were no 'red flags' for the Bank that would have triggered such an investigation" until the debtor informed the bank more than a year after the last financial statement that they did not actually own the property outright. Id. at 168-69. At that point, the bank immediately investigated the debtors' assets and learned the truth.

In McCleary, supra, the court concluded that the lender failed to protect its own interests.

> The Bank, in this case, abandoned its normal financial disclosure procedures, it relied upon financial information provided by a third party [the debtor's prior lender], and it showed a lack of critical curiosity about the documents that were produced. Many, if not all, of the grievances made by the Bank at this time could have been easily remedied by obtaining a full financial statement in the beginning. Under all of these circumstances, this Court must conclude that any reliance upon the information provided by Debtor was not reasonable.

284 B.R. at 888.

IV. FACTS & DISCUSSION

In this case, the debtors owned a house which they purchased in 1998. The house is located in Hartington, Nebraska, and is approximately 1200 square feet of living space. In 2001, the debtors decided to remodel the house, add a bathroom and a double garage, do electrical and plumbing work, re-roof the house, and by such remodeling, not only modernize the house, but add approximately 800 square feet of living space.

Mr. Murphy is a carpenter by trade and planned to do most of the work himself. He needed a loan to purchase the necessary materials and to pay for labor that he was not able to provide.

Mr. and Mrs. Murphy had borrowed money from the Credit Union in the past. They had a good repayment record. They had a good employment record. They requested the Credit Union to loan them approximately $10,000 of new money so they could complete the remodeling project. To do so, the Credit Union paid off a second mortgage against the house and loaned them approximately $10,000 of new money. The Credit Union loaned the money based upon conversations with the debtors, a review of their financial circumstances, and the completion of a loan application.

The loan application requires the debtors to inform the Credit Union of the value of the property. In that space on the loan application, the loan officer, after discussion with Mr. Murphy, filled in $120,000. The loan was made in March of 2001 and payments on the loan were made at least until August of 2001 and perhaps for a few months thereafter.

In August of 2001, Mr. Murphy was injured in an on-the-job accident. His injury was so serious that he was unable to work for six to eight months from the date of the accident, and the family, because of the significant loss of income, even though somewhat supplemented by worker's compensation insurance payments, was unable to pay all of its bills. As a result of the injury to Mr. Murphy, the debtors failed to pay all of their first mortgage payments to Wells Fargo Bank and failed to pay the second mortgage payments to the Credit Union. Wells Fargo Bank began foreclosure proceedings and the Credit Union, for the first time, inspected the house to make a determination of whether it, as holder of the second mortgage, should protect its interest by purchasing the interest of Wells Fargo. Upon inspection of the premises, the officers of the Credit Union discovered that the remodeling project had not been completed and that the value of the house was not then, and could never have possibly been in the past, anywhere near $120,000.

When the debtors filed this Chapter 7 case, the Credit Union filed this adversary proceeding on the theory that the loan application which included the value of the house at $120,000 was obviously false, that the debtors must have known the statement was false at the time it was made, that the Credit Union reasonably relied upon the statement of value when making the loan, and that the Credit Union was harmed as a result, because upon foreclosure of the Wells Fargo lien, there were no additional proceeds available to pay the Credit Union note.

At trial, Mr. Murphy testified on direct and cross-examination about the house prior to the beginning of the remodeling project, the purpose of the remodeling project, the level of completion of the remodeling project, and the status of the remodeling project at the time he was injured. His unrebutted testimony is that he discussed with the loan officer what his plans for the house were. He told the loan officer that he wanted to remodel the house to the extent that it would be worth $120,000 when completed. His intention was, upon completion, to refinance both the first and second mortgages to enable the family unit to have one long-term fixed rate mortgage. At the time that he was discussing the matter with the loan officer, the family unit had a first mortgage obligation to Wells Fargo and a second mortgage that had a variable rate which had increased and caused the family unit some payment difficulties. He did not tell the loan officer that the present value, at the time of the application, was $120,000.

In response to the testimony of Mr. Murphy, the Credit Union did not call the loan officer who had conversed with Mr. Murphy at the time of the loan application. Instead, the Credit Union called two other officers who testified concerning the general procedures at the Credit Union when making second mortgage loans. They both testified that they relied upon the credit history, the credit score, the employment status of the borrowers, the information on the loan application, and, occasionally, upon real estate appraisals. They were not required by Credit Union policy or regulations to obtain an appraisal in each case, and could use their best judgment with regard to whether a loan should be made without such an appraisal. In this case, they did not obtain a real estate appraisal.

I find as a fact that the debtors did not make a false statement on their loan application with regard to the value of the house. The testimony of both debtors is credible and their credibility is not questioned by the Credit Union. The unrebutted testimony is that the complete transaction was discussed and that the debtors hoped the value of the house would be $120,000 after completion of the remodeling. The fact that the loan officer filled in the amount of $120,000 for the value and the debtors signed the application with that amount filled in, does not lead me to conclude that the statement was false or that they intended to deceive the Credit Union. They told the loan officer the age of the house. It was built in 1951. They told the loan officer what the remodeling would consist of. They told the loan officer that they anticipated the property would be worth $120,000 upon completion of the remodeling.

From the point of view of the debtors, they were asking to borrow $10,000 and, since they had no control over whether or not the Credit Union would obtain an appraisal, it cannot be said that they had any intent to deceive. Had the Credit Union obtained an appraisal of the house at the time the loan was granted, it would have been obvious that the house was not, at that time, worth $120,000. The Credit Union officers could, had they had obtained such an appraisal, have made a determination of whether they thought the remodeling project as explained would likely increase the market value of the house to $120,000, thereby supporting the loan.

I therefore find that not only did the debtors not make a false statement, and they had no intent to deceive by making the statement that they did make, but the Credit Union did not reasonably rely upon the $120,000 valuation placed upon the loan application document. The Credit Union could easily have verified the current and potential value of the property. The Credit Union also, at trial, could have presented the actual loan officer who may have rebutted the testimony of Mr. Murphy.

I conclude that the debtors told the Credit Union exactly what they wanted and what they hoped to accomplish. The Credit Union gave them the money. The debtors began the remodeling project, but because of the injury incurred by Mr. Murphy, were unable to complete the remodeling project.

V. CONCLUSION

Judgment shall be entered in favor of the debtors and against the Credit Union. The debt is dischargeable.

DATED: February 10, 2003

BY THE COURT:

/s/Timothy J. Mahoney
Chief Judge

Notice given by the Court to:
*Jeffrey R. Mohrhauser, 522 4th Street, Suite 300, Sioux City, IA 51101
Dennis W. Morland, Granite Park Plaza, 1310 North 13th Street, Suite 2, P.O. Box 691, Norfolk, NE 68702-0691
United States Trustee

Movant (*) is responsible for giving notice of this journal entry to all other parties not listed above if required by rule or statute.

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Plaintiff,	)	CH. 7
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vs.	)	
	)	
PATRICK & NORIENE MURPHY,	)	
	)	
Defendant.	)	

JUDGMENT

Trial was held in Omaha, Nebraska, on February 3, 2003, on the adversary complaint. Dennis Morland appeared for the debtors, and Jeffrey Mohrhauser appeared for the plaintiff.

IT IS ORDERED:

For the reasons set forth in the Memorandum of today's date, judgment is hereby entered in favor of the defendants. The debt owed to the Siouxland Federal Credit Union is discharged.

DATED: February 10, 2003

BY THE COURT:

/s/Timothy J. Mahoney
Chief Judge

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