UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In Re	:	**Case No. 97-02562-CH**
WILLIAM M. LUDWIG and JOYCE M. LUDWIG,	:	**Chapter 7**
Debtors.	:	
- -	:	
LIBERTY SAVINGS BANK,	:	**Adv. No. 97-97192**
Plaintiff,	:	
v.	:	
WILLIAM M. LUDWIG and JOYCE M. LUDWIG,	:	
Defendants.	:	

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ORDER—COMPLAINT TO DETERMINE DISCHARGEABILITY OF DEBT

On May 4, 1998, trial was held on the Plaintiff's Complaint to Determine Dischargeability of Debt. Debtors, William M. and Joyce M. Ludwig, were represented by attorney Donald F. Neiman; Creditor Liberty Savings Bank was represented by attorney Jon P. Sullivan. At the conclusion of the trial, the Court took the matter under advisement upon a briefing schedule. Post-trial briefs have been filed and the Court now considers the matter fully submitted.

The Court has jurisdiction of this matter pursuant to 28 U.S.C. § 157(b)(1) and § 1334. This is a core proceeding. 28 U.S.C. § 157(b)(2)(I). The Court, upon review of the briefs, pleadings, evidence, and arguments of counsel, now enters its findings and conclusions pursuant to Fed.R.Bankr.P. 7052.

FINDINGS OF FACT

1. The Ludwigs have had a credit relationship with Liberty Savings Bank ("Liberty") since approximately April 1994. The Ludwigs periodically have executed and delivered business credit applications and financial statements to Liberty. Financial Statements were supplied by the Ludwigs annually to Liberty and other banking institutions on or about April 1 of each year after the Ludwigs' tax returns were completed.

2. Two security agreements, one dated January 4, 1995, and executed and delivered to Liberty by Mr. Ludwig, and one dated July 17, 1996 executed and delivered by both Ludwigs, purported to grant Liberty a security interest in Mr. Ludwig's "accounts" and other rights to payment of money, including promissory notes and rights to tax refunds. Liberty also held a specific assignment of Ludwig's Renaissance Stock Account and a second real estate mortgage on certain development property in Altoona, Iowa.

3. The most recent financial statement provided by the Ludwigs to Liberty, dated January 15, 1996, reflects a net worth of $4,127,200. The single asset with the greatest value included in said financial statement was Mr. Ludwig's one-half interest in Environmental Design Group, Ltd. ("EDG"), the architectural firm in which Mr. Ludwig is employed, to which the Ludwigs attributed a value of $1,279,224.00.

4. On or about December 1, 1996, Mr. Ludwig sold his stock in EDG to Alan W. Bowman ("Bowman"), in exchange for which he received Bowman's promissory note payable to Mr. Ludwig in the original principal amount of $150,000.00 (the "Bowman Note"). The sale resulted in the cancellation of an account receivable of EDG to Ludwig in the approximate amount of $71,000.00.

5. On or about December 9, 1996, Mr. Ludwig first consulted his counsel in this bankruptcy proceeding, Donald F. Neiman.

6. On or about December 20, 1996, Mr. Ludwig granted a security interest in, assigned, and delivered the Bowman Note to West Des Moines State Bank ("West Bank") as security for indebtedness they owed. In connection with the financing obtained by the Ludwigs from West Bank in December of 1996, Mr. Ludwig provided West Bank with a copy of the Ludwigs' January 1996 financial statement, with various hand-written modifications by Mr. Ludwig dated December 1, 1996 which had been requested by West Bank. The modified financial statement reflects a net worth of $280, 735.

7. At the time of Mr. Ludwig's sale of his interest in Environmental Design Group, Ltd. to Bowman and his assignment of the Bowman Note to West Bank, the Ludwig's total obligations to Liberty were approximately $195,000, all of which was scheduled to become due on December 31, 1996 and March 19, 1997.

8. On or about December 23, 1996, the Ludwigs mailed to Liberty a letter proposing a loan arrangement combining three other notes held by Liberty. Liberty was under no obligation to extend or renew the Ludwigs' obligations. In response, Liberty prepared and delivered to the Ludwigs a business credit application on or about January 28, 1997. The Ludwigs signed and returned the application to Liberty on or about January 31, 1997. As a result of this exchange, Liberty presently holds a promissory note signed by the Ludwigs in the original principal amount of $170,000 dated January 28, 1997, with an unpaid principal balance of $130,099.25 ("January 1997 loan"). The proceeds of the January 1997 loan, along with a cash payment from the Ludwigs of $26,516.15, were used to repay prior obligations owed by the Ludwigs to Liberty.

9. On May 29, 1997, William Ludwig paid $43,051.00 to Liberty from the sale of Altoona real estate on which Liberty held a second mortgage lien, which required Liberty to release its second mortgage for less than the full amount owed on the obligations secured by the mortgage.

10. Subsequent to the making of the January 1997 loan, and prior to the filing of their bankruptcy proceeding, the Ludwigs purported to give Frank R. Gillotti a security interest in their right to a refund for the tax year 1996, and actually paid Gillotti $25,000 of a tax refund they received for that year.

11. Mr. and Mrs. Ludwig filed a voluntary petition for bankruptcy relief under Chapter 7 on May 30, 1997. At no time prior to the commencement of their bankruptcy proceeding did the Ludwigs disclose to Liberty any of the following:

(a) that Mr. Ludwig had forgiven the $71,000 account receivable owing to him by EDG and sold his interest in that business to Bowman in exchange for the Bowman Note;

(b) that Mr. Ludwig had assigned and delivered the Bowman Note to West Bank;

(c) that their financial condition had changed since January 1996, as shown in the updated statement dated December 1, 1997;

(d) that they had assigned and paid their 1996 tax refund to Frank Gilloti.

12. On August 22, 1997, Liberty filed a Complaint to Determine Dischargeability of Debt against the Debtors.

DISCUSSION

Liberty advances three distinct grounds upon which it believes the court should find that the Debtors' obligation to Liberty in the amount of $130,099.25 is nondischargeable in the Debtors' Chapter 7 bankruptcy proceeding: 11 U.S.C. §523(a)(2)(A), §523(a)(2)(B), and §523(a)(6). Liberty has the burden to prove the elements of their claims under 11 U.S.C. § 523(a) by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 291 (1991).

First, Liberty contends that the Debtors obtained the January 1997 loan by false pretenses, false representations or actual fraud, and is therefore nondischargeable under 11 U.S.C. § 523(a)(2)(A). That section states:

> A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(a) 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 . . . .

Liberty bases this claim on the fact that the Debtors failed to disclose certain information to them at the time the loan was made, specifically: that Mr. Ludwig sold his stock in EDG to Mr. Bowman in December 1996 for a $150,000.00 promissory note; that Mr. Ludwig subsequently assigned and delivered the note to West Bank; and that the Ludwigs were planning to file bankruptcy.

If these omissions can be considered "statement[s] respecting the debtor's . . . financial condition," then they would not establish nondischargeability under §523(a)(2)(A). "Since [§523(a)(2)(B)] covers only statements 'respecting a debtor's . . . financial condition' and subsection (A) excludes such statements, the subdivisions 'are . . . expressly mutually exclusive.'" First National Bank or Olathe, Kansas v. Pontow, 111 F.3d 604, 608 (8th Cir. 1997)(citing In re Long, 774 F.2d 875, 877, n. 1 (8th Cir. 1985)).

Thus, as the Debtors argue in their brief, unwritten misrepresentations of financial condition would not provide a basis for nondischargeability under §523(a)(2)(A). See, e.g., In re Barrack, 217 B.R. 598, 605 (9th Cir. BAP 1998) ("[A]llegations of fraudulent misrepresentation concerning Debtors' financial condition may only be pled under the specific statute, §523(a)(2)(B)."); Engler v. Van Steinburg (In re Van Steinburg), 744 F.2d 1060, 1061 (4th Cir. 1984) (oral assurances of a first priority security interest did not render debt nondischargeable under either §523(a)(2)(A) or §523(a)(2)(B)); Bank One Columbus, N.A. v. Schad (In re Kountry Korner Store), 221 B.R. 265 (Bankr. N.D. Okla. 1998) ("[B]ecause Section 523(a)(2)(B) requires that any misrepresentation of financial condition be in writing, a creditor may not claim that an oral misrepresentation of financial condition is fraud under subsection (A), because such a result would eviscerate the writing requirement contained in subsection (B)."); Alden State Bank v. Anderson (In re Anderson), 29 B.R. 184, 189 (N.D. Iowa 1983) ("False statements concerning the debtor's or an insider's financial condition will be analyzed under 11 U.S.C. §523(a)(2)(B); representations which do not deal with the debtor's or an insider's financial condition will be analyzed under 11 U.S.C. §523(a)(2)(A).").

The Engler court stated:

> Concededly, a statement that one's assets are not encumbered is not a formal financial statement in the ordinary usage of that phrase. But Congress did not speak in terms of financial statements. Instead it referred to a much broader class of statements--those "respecting the debtor's ... financial condition." A debtor's assertion that he owns certain property free and clear of other liens is a statement respecting his financial condition. Indeed, whether his assets are encumbered may

> be the most significant information about his financial condition. Consequently, the statement must be in writing to bar the debtor's discharge.

Engler, 744 F.2d at 1060-61 (citation omitted). Clearly, then, unwritten representations respecting a debtor's financial condition are not actionable under either §523(a)(2)(A) or §523(a)(2)(B).

The only misrepresentations alleged by Liberty are those respecting the Ludwigs' financial condition: the sale of stock and assignment of the proceeds to Westbank, the deteriorating financial picture, and the plans for bankruptcy. Indeed, the omission of this information left Liberty with an inaccurate picture of the Ludwigs' financial condition, upon which basis Liberty agreed to refinance prior loans. Section 523(a)(2)(A) is therefore inapplicable to this case by its terms.

Liberty secondly contends that the Debtors' obligation to them is nondischargeble by virtue of 11 U.S.C. § 523(a)(2)(B), which excepts from discharge:

> . . . debt[s] . . . for . . . an extension of credit to the extent obtained by . . . use of a statement in writing —
>
> (i) that is materially false;
> (ii) respecting the debtor's . . . financial condition;
> (iii) on which the creditor to whom the debtor is liable for such . . . credit reasonably relied; and
> (iv) that the debtor caused to be made or published with intent to deceive . . . .

11 U.S.C. § 523(a)(2)(B). Liberty argues that it reasonably relied on the Debtors' financial statements in making the January 1997 Loan.

In order to receive the January 1997 loan from Liberty, the Ludwigs executed a loan application which specifically described all of the security interests they previously granted to Liberty as the "Collateral Offered" for the new loan, and which recited that "everything stated in the application and in my/our financial information is correct to the best of my/our knowledge." (Plaintiff's Exhibit 21). The Ludwigs also executed a new promissory note, which included the following statement: "I warrant that the financial statements and information I provide to you are or will be accurate, correct and complete." (Plaintiff's Exhibit 21). The most recent financial statement the Ludwigs had provided to Liberty was dated January 6, 1996 and indicated a net worth of $4,127,200.00. On this basis, Liberty refinanced previous loans which it had extended to the Ludwigs.

The elements of §523(a)(2)(B) have been clearly established in this case. The loan documents in which the Ludwigs reaffirmed that their financial information was up to date are statements "respecting the debtor's . . . financial condition." While some courts take a narrow view of the meaning of that phrase, limiting it to formal financial statements, see, e.g., Gehlhausen v. Olinger (In re Olinger), 160 B.R. 1004, 1009 (Bankr. S.D. Ind. 1993); Jokay Co. v. Mercado (In re Mercado), 144 B.R. 879, 885 (Bankr. C.D. Cal. 1992), this Court adopts the view that any written statement signed or adopted by the debtor concerning the debtor's financial condition meets the requirements of §523(a)(2)(B). See Bellco First Federal Credit Union v. Kaspar (In re Kaspar), 125 F.3d 1358, 1361 (10th Cir. 1997); Engler v. Van Steinburg (In re Van Steinburg), 744 F.2d 1060 (4th Cir. 1984); First International Bank v. Kerbaugh (In re Kerbaugh), 162 B.R. 255, 261 (D. N.D. 1993); Household Finance Corp. v. Howard (In re Howard), 73 B.R. 694, 702 (N.D. Ind. 1987).

The next question is whether the written statements are materially false. A materially false statement has been described as "'one that contains an important or substantial untruth. The measuring stick of material falsity is whether the financial institution would have made the loan if the debtor's true financial condition had been known.'" Fleming Companies, Inc. v. Eckert (In re

Eckert), 221 B.R. 40, 44 (Bankr. S.D. Fla. 1998)(citing In re Stratton, 140 B.R. 720, 722 (Bankr.N.D.Ill.1992)). Mr. Kalianov testified that he could not and would not have extended credit to the Ludwigs without first having received the required executed documents, which included reaffirmations that the financial information the Ludwigs had previously provided was accurate and up to date. In fact, the Ludwigs' financial situation had changed drastically since January of 1996, which was the date of the most recent financial statement provided to Liberty by the Ludwigs. In December of 1996, the Ludwigs reported their net worth as $280,735.00 to West Bank. (Plaintiff's Exhibit 17). Thus, the statements on their loan documents were materially false.

The Court must next consider whether Liberty reasonably relied on the financial statements provided by the Ludwigs in refinancing their loans. Reasonable reliance is a determination to be made in light of "the totality of the circumstances." First National Bank of Olathe, Kansas v. Pontow, 111 F.3d 604, 610 (8th Cir. 1997). The inquiry into the totality of the circumstances includes asking whether there had been previous business dealings between debtor and creditor that gave rise to a relationship of trust; 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. City Bank & Trust Co. v. Vann (In re Vann), 67 F.3d 277, 280-81 (11th Cir. 1995)(citing Coston v. Bank of Malvern (In re Coston), 991 F.2d 257, 261 (5th Cir.1993) (en banc) (per curiam)).

In this case, Liberty, and more specifically, Mr. Kalianov, had established a long-term credit relationship with the Ludwigs which resulted in a relationship of trust. The January 1997 loan was for the purpose of refinancing prior loans. There were no red flags which would have alerted Mr. Kalianov to the drastic change in circumstances which motivated the Ludwigs to conceal their updated financial condition. In fact, the Ludwigs asked for a renewal of their previous loans as part of an overall plan to *reduce* their total indebtedness with Liberty. (Plaintiff's Exhibit 21). Thus Liberty's reliance on the loan documents executed by the Ludwigs was reasonable.

Lastly, it must be determined whether the Ludwigs intended to deceive Liberty when they submitted the loan documents to them. The court may find such intent if it can be shown that the debtors knew their misrepresentation or omission would induce Liberty to extend credit to the Ludwigs. Citibank v. Harris (In re Harris), 203 B.R. 117, 122 (Bankr. N.D. Ill. 1996)(citations omitted). It seems apparent that the Ludwigs knew that being candid with Mr. Kalianov concerning their deteriorating financial condition would detrimentally impact their chances at refinancing their loans. Mr. Ludwig possesses an above-average level of business acumen and financial experience, and he knew the kinds of information that lending institutions use to evaluate a credit applicant. Courts may properly consider the level of intelligence and business experience of a debtor in determining intent to deceive. In re Coughlin, 27 B.R. 632, 636 (1st Cir. BAP 1983). A reckless disregard for the accuracy of the information on a financial statement will also suffice to establish intent to deceive. In re Batie, 995 F.2d 85 (6th Cir. 1993); Harris, 203 B.R. at 122. At the very least, the Ludwigs' reaffirmation of the accuracy of their financial information on the loan documents submitted to Liberty was in reckless disregard of the fact that their financial information had changed considerably.

Thus, Liberty has established all of the elements of 11 U.S.C. §523(a)(2)(B) by a preponderance of the evidence, rendering the Ludwigs' debt to them nondischargeable in their Chapter 7 bankruptcy.

The third basis for Liberty's objection arises under 11 U.S.C. § 523(a)(6). Under that section, "a discharge does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. §523(a)(6). Liberty argues that the Ludwigs wrongfully converted the following collateral pre-bankruptcy: (1) the $71,000 account receivable owed to Mr. Ludwig by EDG, which Mr. Ludwig forgave at the time he sold his stock in EDG to Bowman; (2) the $150,000 promissory note Mr. Bowman gave to Mr. Ludwig, which Mr. Ludwig assigned and delivered to Westbank; (3) approximately $60,000 in non-Renaissance securities, which the Ludwigs liquidated to pay down their homestead mortgage; and (4) a $25,000 tax refund, which the Ludwigs also used to pay down their mortgage.

In the Eighth Circuit, the test under §523(a)(6) for situations in which conversion of collateral is in issue has been articulated: "When transfers in breach of security agreements are in issue, . . . 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, 880-81 (8th Cir. 1985). As to the element of willfulness, it is undisputed that the Ludwigs converted collateral in contravention of their security agreement with Liberty. While Mr. Ludwig claims not to have understood that Liberty had a security interest in the collateral he converted, he is obviously a sophisticated businessman. He has been in the architect business for 25-30 years, has been heavily involved in investment activity and has numerous long-term lending relationships with various financial institutions. It is thus implausible that Mr. Ludwig did not realize he was converting property which was collateral on loans made by Liberty. Therefore, the first part of the test under §523(a)(6) is satisfied.

Liberty must also establish that the Ludwigs acted with malice to prevail on their §523(a)(6) claim. Long held that a knowing conversion of property is not enough in itself to prevent discharge of a debt. Long, 774 F.2d at 879. "Debtors who willfully break security agreements are testing the outer bounds of their right to a fresh start, but unless they act with malice by intending or fully expecting to harm the economic interests of the creditor, such a breach of contract does not, in and of itself, preclude a discharge." Id. at 882.

A finding of malice requires finding intent to do the claimed harm, not merely that the harm was caused by negligence or recklessness. In re Zentz, 157 B.R. 145, 148 (Bankr. W.D. Mo. 1993), aff'd 81 F.3d 166 (8th Cir. 1996); In re Minihan, 794 F.2d 340, 344 (8th Cir. 1986). The conduct must also be targeted at the creditor, and must be certain or almost certain to cause financial harm. Long, 774 F.2d at 880-81.

In this case, Mr. Ludwig testified in his deposition that the reason for selling the collateral subject to security agreements with Liberty was to pay down and renegotiate the numerous loans that the Ludwigs had with various banks. Mr. Ludwig also testified that he desired to "take care of" Westbank first and Norwest Bank second. By selling collateral in which Liberty had a security interest, the Ludwigs were "taking care of" other financial institutions to the detriment of Liberty. Their actions were purposefully and knowingly harmful to Liberty in particular. The Ludwigs converted all of Liberty's collateral and then filed for Bankruptcy, leaving Liberty without recourse. The Court finds that this was willful and malicious injury under §523(a)(6), establishing the nondischargeability of the Ludwigs' debt to Liberty.

ORDER

IT IS THEREFORE ORDERED that the debt owed Liberty Savings Bank is nondischargeable pursuant to 11 U.S.C. §523(a)(2)(B) and 11 U.S.C. §523(a)(6).

Dated this __________ day of December, 1998.

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RUSSELL J. HILL, CHIEF JUDGE
U.S. BANKRUPTCY COURT