

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In re:

GARY L. STEWART
DARLA J. STEWART,

Debtor.

BKY Case No. 02-32136-GJK

Chapter 7

FIDELITY & DEPOSIT COMPANY
OF MARYLAND,

Plaintiff,

vs.

GARY L. STEWART
DARLA J. STEWART,

Defendants.

Adv. Proc. No. 03-3125 GJK

TRIAL BRIEF

INTRODUCTION

This action arises out of line of credit extended to Gary L. Stewart and Darla J. Stewart (collectively the "Stewarts") by First Federal Bank ("First Federal"). In connection with obtaining the line of credit from First Federal, the Stewarts granted First Federal a mortgage in certain property which they owned. The Stewarts represented to First Federal that the property was subject to only one other mortgage in the amount of \$80,000.00. In fact, however, the property was encumbered by two mortgages in the amount of \$100,000.00 and \$74,500.00 respectively. Unaware of the extent to which the Stewarts had already encumbered their home and relying on the representations made by the Stewarts in their application, First Federal extended a line of credit to the Stewarts in the amount of \$95,000.00. Because the Stewarts obtained the line of credit from First Federal by misrepresenting their financial condition the

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Defendants.

UNSWORN DECLARATION FOR PROOF OF SERVICE

Susanne M. Hoffman of Fabyanske, Westra & Hart, P.A., attorneys licensed to practice law in this court, with their office address at 800 LaSalle Avenue, Suite 1900, Minneapolis, Minnesota, declares under penalty of perjury that on the 2nd day of August, 2004, I served the Trial Brief of Fidelity & Deposit Company of Maryland in this Adversary Proceeding on each person referenced below, by placing a true and correct copy thereof in sealed envelopes, postage prepaid and depositing the same in the U.S. Mail in Minneapolis, Minnesota addressed as follows:

Joel A. Montpetit
Montpetit, Freiling & Kranz
222 Grand Ave. West, Suite 100
South St. Paul, MN 55075-1139

And I declare, under penalty of perjury, that the foregoing is true and correct. Dated this 2nd day of August, 2004.

s/ Susanne M. Hoffman

Susanne M. Hoffman

Court should find that they are not entitled to a discharge under 11 U.S.C. § 523(a)(2)(A) or (a)(2)(B).

FACTS

On or about August 18, 2000, Gary Stewart applied to First Federal for a line of credit in the amount of \$50,000. To induce First Federal to grant him a line of credit, Gary Stewart and his wife, Darla Stewart, agreed to grant First Federal a mortgage on the property identified as follows:

Lot 25, Block 4, Pinetree Pond 5th Addition

(the "Property"). The Property is located at 7715 Iverson Avenue South, Cottage Grove, Minnesota 55016.

In connection with its efforts to ascertain the priority of any mortgage that it could obtain against the Property, First Federal required Gary Stewart and Darla Stewart to identify all "Lenders or Other Lienholder" who held an interest in the Property. In this regard, on or about August 21, 2000, the Defendants filled out and signed a Property Owner(s) Affidavit (the "First Affidavit"). In the First Affidavit, the Defendants averred that they were the owners of the Property and that there was only mortgage, a mortgage evidence by a lien of \$80,000 from US Bank, against the Property. The Defendants did not list any other entity as having an interest in or lien on the Property. The First Affidavit further provided that:

This Affidavit is given to induce FIRST FEDERAL FSB (Lender) to make the loan and THE EMPIRE INDEMNITY INSURANCE COMPANY to issue its Processors Liability Policy. We (I) state that the above information is true and complete and understand that any intentional or negligent misrepresentation(s) of the information contained in this Affidavit may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code. Section 1001. Et seq. And liability for monetary damages to Lender, its agents, successors and assigns, insurers and

any other person who may suffer any loss in reliance upon any misrepresentations when made in this Affidavit.

Both Gary Stewart and Darla Stewart executed the First Affidavit immediately below this provision.

In reliance on the First Affidavit, First Bank extended a line of credit to Gary Stewart in the principal amount of \$50,000 pursuant to a Home Equity Line of Credit Agreement entered into on or about August 21, 2000 (the "Initial Credit Agreement").

To secure its obligation to repay First Federal for monies advanced by First Federal to Gary Stewart pursuant to the Initial Credit Agreement, the Defendants executed a Mortgage in favor of First Federal (the "Mortgage"). The Mortgage granted First Federal the power of sale with regard to the Property. The Mortgage was filed with the Washington County Recorder as document number 3119171 on September 5, 2000.

On or about August 30, 2000, Gary Stewart applied to First Federal for an increase in the First Line of Credit in the amount of \$45,000. To induce First Federal to grant an increase in the line of credit, Gary Stewart and Darla Stewart agreed to modify the Mortgage to reflect the increase in the line of credit.

In connection with processing Gary Stewart's request for an increase in his line of credit, First Federal required Gary Stewart and Darla Stewart to identify all "Lenders or Other Lienholder" who held an interest in the Property. In this regard, on or about September 1, 2000, the Defendants filled out and signed a Property Owner(s) Affidavit (the "Second Affidavit"). In the Second Affidavit, the Defendants again averred that they were the owners of the Property and that there was only mortgage, a mortgage evidence by a lien of \$80,000 from Bank America, against the Property. The Defendants did not list any other entity as having an interest in or lien on the Property. The Second Affidavit further provided that:

This Affidavit is given to induce FIRST FEDERAL FSB (Lender) to make the loan and THE EMPIRE INDEMNITY INSURANCE COMPANY to issue its Processors Liability Policy. We (I) state that the above information is true and complete and understand that any intentional or negligent misrepresentation(s) of the information contained in this Affidavit may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code. Section 1001. Et seq. And liability for monetary damages to Lender, its agents, successors and assigns, insurers and any other person who may suffer any loss in reliance upon any misrepresentations when made in this Affidavit.

Both Gary Stewart and Darla Stewart executed the Second Affidavit immediately below this provision.

In reliance on the Second Affidavit, First Bank increased the line of credit granted in the Initial Credit Agreement to the Defendants in the principal amount of \$45,000 for a total line of credit in the principal amount of \$95,000 pursuant to a Home Equity Line of Credit Amendment entered into on or about September 1, 2000 (the "Amended Credit Agreement").

To secure its obligation to repay First Federal for monies advanced by First Federal to Gary Stewart pursuant to the Amended Credit Agreement, the Defendants executed a Home Loan Modification Agreement in favor of First Federal (the "Amended Mortgage"). The Amended Mortgage granted First Federal the power of sale with regard to the Property. The Amended Mortgage was filed with the Washington County Recorder as document number 3132312 on December 6, 2000.

Pursuant to the terms of the Initial Credit Agreement and the Amended Credit Agreement First Federal advance monies to the Defendants.

At the time Defendants filled out and signed the First Affidavit and Second Affidavit the Property was subject to two mortgages, one in favor of Bank of America, N.A. in the amount of \$100,000.00 (One Hundred Thousand and No/100ths Dollars) and another in favor of Firststar

Bank, U.S.A. N.A. in the amount of \$74,900.00 (Seventy-Four Thousand Nine Hundred and No/100ths Dollars). Defendants failed to disclose the existence and amount of these mortgages to First Federal.

In October 2001, Defendants defaulted under the terms and conditions of the Amended Credit Agreement. In connection with its efforts to foreclose the Amended Mortgage due to Defendants defaults there under, First Federal discovered that Defendants had misrepresented to First Federal the number of liens they had against the Property. These misrepresentations materially reduced the value of First Federal's mortgage thereby damaging First Federal's ability to recover its loan.

As of February 19, 2002, the principal balance due and owing under the terms of the Amended Credit Agreement was \$93,194.51 and interest and fees of \$3,898.56. Interest has continued to accrue and Fidelity continues incur additional costs, including reasonable attorneys' fees, in connection with collecting the sums due and owing.

First Federal assigned to Fidelity all of its rights under the Amended Credit Agreement and the Amended Mortgage.

Since February 19, 2002, First Federal and Fidelity have received two payments reducing the sums due and owing under the terms of the Amended Credit Agreement. The first payment was made by Defendants pursuant to order of this Court on or about October 9, 2003, in the amount of \$896.00 and was applied to Fidelity's attorneys' fees incurred in connection with bringing a motion for default judgment. The second payment was received on or about February 4, 2004, and was in the amount of \$87,206.09 and was applied to the Debtor's debt to Fidelity as required by the Initial Credit Agreement, Mortgage, Amended Credit Agreement and Amended Mortgage.

LEGAL ANALYSIS

Fidelity brings this action against the Stewarts under subsections A and B of 11 U.S.C. § 523(a)(2). Subsections A and B of 11 U.S.C. § 523(a)(2) are mutually exclusive of each other in that Subsection B covers only statements "respecting a debtor's . . . financial condition" and Subsection A excludes such statements. *Barclays Am./Bus. Credit, Inc. v. Long (In re Long)*, 774 F.2d 875, 877, n.1 (8th Cir. 1985). Because the law is uncertain on whether the First Affidavit and the Second Affidavit concern the Stewart's financial condition, Fidelity has alternatively asserted a claim under each of these sections.

A. 11 U.S.C. § 523(a)(2)(B)

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;
 - ii. 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.

To establish a claim under § 523(a)(2)(B), Fidelity must establish that: (1) the false statements contained in the First Affidavit and the Second Affidavit were writings respecting the Stewarts' financial condition; (2) the statement was materially false; (3) the Stewarts intended to deceive; and (4) First Federal reasonably relied upon the false statement. *In re Walderbach*, 1993 Bankr. LEXIS 2324, 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).

As explained above, it is unclear whether the Stewarts' representations in the First Affidavit and the Second Affidavit qualify as a statement "respecting the debtor's financial condition." To the extent that the First Affidavit and Second Affidavit do represent the Stewarts' financial condition then the first element of § 523(a)(2)(B) is met.

The Stewarts' representations, contained in the First Affidavit and the Second Affidavit, as to the extent to which the Property was encumbered are materially false. Courts considering this element of § 523(a)(2)(B) have held that any false statement that paints a substantially untruthful picture of a financial condition by misrepresentation of the type which would normally affect the decision to grant credit is "materially false." *Norris v. First Nat'l Bank (In re Norris)*, 70 F.3d 27, 30 (5th Cir. 1995). In this case, the information contained in the First Affidavit and the Second Affidavit is clearly the type of information upon which First Federal based its lending decision. In fact the First Affidavit and Second Affidavit specifically provide that the information contained therein is being provided by the Stewarts to induce First Federal to make the loan. Further, the Stewarts misrepresented the amount by which the Property was encumbered by \$95,900.00, over twice the amount the Stewarts represented the Property was encumbered.

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 Lefevre*, 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.*

In the present case, the Stewarts knowingly misrepresented the amount by which the Property was encumbered by \$95,900.00. By misrepresenting the liens on the Property to this extent the Stewarts showed total disregard for arriving at the unencumbered true value of the Property.

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). Fidelity does not have to show that the writing was the only influential factor in the decision to extend or renew credit. *Teachers Credit Union v. Johnson*, 131 B.R. 848, 854-55 (W.D. Ma. 1991). It is sufficient for § 523(a)(2)(B) if Fidelity establishes that First Federal partially relied on the false statement or that the false statement was the principal precipitant for the extension of credit, in the absence of which credit would not have been made. *Id.*

The "reasonableness" of a creditor's reliance on a false statement is an objective determination, i.e. that degree of care which a reasonably prudent creditor in an average business transaction under similar circumstances would exercise. *Marx v. Reeds (In re Reeds)*, 145 Bankr. 703, 707 (Bankr. N.D. Okla. 1992); *In re Mutschler*, 45 Bankr. 482, 492-93 (Bankr. D. Md. 1982). In articulating the requisite objective inquiry, several courts have stated:

The reasonableness of a creditor's reliance on a [false] statement should be judged by comparing the creditor's actual conduct with (1) the creditor's own normal business practices, and (2) the standards and customs of the industry, (3) in light of the

surrounding circumstances existing at the time the application was made and credit was extended [or renewed].

Mutschler, 45 Bankr. at 493 (quoting *In re Patch*, 24 Bankr. 563 (Bankr. D. Md. 1982)).

Although a creditor is generally not under a per se duty of verification or under an absolute duty to make independent inquiries into the financial condition of a debtor or to confirm the accuracy of a written financial statement, a creditor's reliance on a false statement has readily been found to be unreasonable where the false writing was obviously false on its face, when the creditor knows or has reason to know that the writing is incomplete or inaccurate, or when the creditor's own investigation suggests that the writing was incomplete or inaccurate. *Mutschler*, 45 Bankr. at 493 (citing various authorities). Moreover, creditors that receive financial information in connection with a loan:

are entitled to rely on a written statement as being an accurate representation of what it purports to be as long as fraud is not apparent from the document itself. To rule otherwise would render the use of financial statements meaningless and would run contrary to long established business practice regarding their preparation and use.

Mutschler, 45 Bankr. at 493. The imposition of an absolute duty to verify "requires the creditor to be wary of any applicant and to assume that the material within the statement is not accurate. Such a defensive posture will most certainly restrict the flow of credit." Matthew D. Amhut, Section 523(A)(2)(B); Exceptions to Discharge for Fraudulently Obtained Loans, 5 Bank. Dev. J. 151 (1987).

In this case, the evidence establishes that the First Affidavit and the Second Affidavit played a substantial role in First Federal's decision to extend the line of credit to the Stewarts. The First Affidavit and the Second Affidavit were the precipitating cause in the extension of the line of credit. There was nothing on the face of the First Affidavit and the Second Affidavit that raised any red flags which put, or reasonably should have put, First Federal on notice that the

First Affidavit and the Second Affidavit were fraudulent or that further investigation was warranted.

B. 11 U.S.C. § 523(a)(2)(A)

The Eighth Circuit has long held that in order for a plaintiff to prevail under 11 U.S.C. § 523(a)(2)(A), the plaintiff must prove:

- 1) That the debtor made a representation;
- 2) That at the time the debtor knew the representation was false;
- 3) That the debtor made the representation deliberately and intentionally with the intention and purpose of deceiving the creditor;
- 4) That the creditor justifiably relied on such representation; and
- 5) That the creditor sustained the alleged loss and damages as the proximate result of the representation having been made.

Merchants National Bank of Winona v. Moen, 238 B.R. 785, 790 (B.A.P. 8th Cir. 1999).

To qualify as a false representation or false pretense under 11 U.S.C. § 523(a)(2)(A), a statement must relate to a present or past fact. *Shea v. Shea*, 221 B.R. 491, 496 (Bankr. D. Minn. 1998). Further, a false pretense involves implied misrepresentation, or conduct intended to create or foster a false impression. *Merchants National Bank*, 238 B.R. at 791, citing *In re: Guy*, 101 B.R. 961, 978 (Bankr. N.D. Ind. 1988). Further, a debtor's silence regarding a material fact may constitute a false representation actionable under section 523(a)(2)(A). The *Merchants National Bank*, 238 B.R. at 290.

In the case at hand, the Stewarts made false representations to First Federal when on the First Affidavit and the Second Affidavit the Stewarts misrepresented the number of mortgages on the Property and the amount of those mortgages. The Stewarts, having granted these other mortgages in the Property, clearly made these false representations knowingly.

A plaintiff may present evidence of the surrounding circumstances from which intent may be inferred since direct proof of intent (i.e., the debtor's state of mind) is nearly impossible

to obtain. *In re Oligschlaeger*, 239 B.R. 553, 556 (Bankr. W.D.Mo. 1999) (citing *In re Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987)). "Intent to deceive will be inferred where a debtor makes a false representation and the debtor knows or should know that the statement will induce another to act." *In re Duggan*, 169 B.R. 318, 324 (Bankr. E.D.N.Y. 1994).

In the instant case, the Stewarts made a false representation in the First Affidavit and Second Affidavit. The Stewarts clearly knew that First Federal would rely on the information contained on the First Affidavit and Second Affidavit in determining whether to grant a line of credit to the Stewarts as the First Affidavit and Second Affidavit explicitly provided that the information contained therein was being provided to induce First Federal to make the loan and the Stewarts can therefore be found to have made the above referenced misrepresentations with the intent to cause First Federal to extend the line of credit.

Justifiable, not reasonable, reliance is required under § 523(a)(2)(A). *Field v. Mans*, 516 U.S. 59, 71 (1995). Whether reliance is justifiable is "a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than the application of a community standard of conduct to all cases." *Id.* The standard for showing justifiable reliance under § 523(a)(2)(A) is fairly low. *In re Guske*, 243 B.R. 359, 363 (B.A.P. 8th Cir. 2000).

Courts have found that a party may justifiably rely on a misrepresentation even when the party could have ascertained its falsity by conducting an investigation. *In re Biondo*, 180 F.3d 126, 135 (4th Cir. 1999). The *Field* case, which identified the standard, provides a cogent example of a seller of land claiming it to be free of encumbrances. A buyer's reliance on such a factual representation is justifiable, even if he could have "walked across the street to the office

of the register of deeds in the courthouse" and easily learned of an unsatisfied mortgage. *Field*, 516 U.S. at 70 (quoting Restatement (Second) of Torts § 540 (1976)).

In the instant case, First Federal relied on the representations made by the Stewarts in the First Affidavit and the Second Affidavit. First Federal collected this information for the specific purpose of determining whether to extend credit to the Stewarts and relied on the information that they supplied.

Because First Federal relied on the false statements contained in the First Affidavit and the Second Affidavit it extended credit to the Stewarts. First Federal would not have extended credit to the Stewarts if First Federal were aware of the incurred this loss absent the Stewarts' false representations on the First Application and the Second Application.

CONCLUSION

For the foregoing reasons, Fidelity respectfully requests that the Court enter judgment in favor of Fidelity and against the Gary Stewart and Darla Stewart, jointly and severally, in a principal amount to be determined at trial, plus interest and attorneys' fees, and declare that the Stewarts' debt to the Fidelity is hereby excepted from discharged under 11 U.S.C. § 523(a)(2)(A) and/or (a)(2)(B).

DATED: August 2, 2004

FABYANSKE, WESTRA & HART, P.A.

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