UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

In re:

Jerome E. Moen and Jane M. Moen, BKY No. 97-36925

Debtors.

The Merchants National Bank of Winona,

ADV No. 98-3014

Plaintiff,

v.

Jerome E. Moen, ORDER FOR JUDGMENT

Defendant.

This matter came before the court for trial on November 2, 1998 to determine the dischargeability of a debt owed Merchant's National Bank of Winona by the Defendant Jerome E. Moen. Joe E. Abrahamson appeared for the Plaintiff, The Merchants National Bank of Winona (Merchants Bank), and David A. Harbeck appeared for the Defendant, Jerome E. Moen. Plaintiff Merchants Bank is a Creditor of the Defendant Jerome E. Moen in the Chapter 7 Case of Debtors Jerome E. Moen and Jane M. Moen. This adversary proceeding is brought pursuant to Fed. R. Bankr. P. 7001(6); 11 U.S.C. Section 523(a)(2); and, is a core proceeding under 28 U.S.C. Section 157 and 1334.

The Court must determine whether at the time Mr. Moen drew on Merchants Bank's line of credit: the credit facility was no longer available to him; the credit line remained open due to an error of the bank; Mr. Moen knew of the error; and, whether the debt is nondischargeable under 11 U.S.C. 253(a)(2)(A).

Based on the testimony of witnesses, the proceedings, and upon all of the files and records herein, the Court makes the following ORDER pursuant to the Federal and Local Rules of Bankruptcy Procedure:

I. Facts

Jerome E. Moen and Jane M. Moen filed a

voluntary petition seeking protection under Chapter 7 of the Bankruptcy Code on October 20, 1997, in large part because of financial problems with Mr. Moen's business, the Minnesota City Sweatshirt Company (MN Sweatshirt). Schedule F of the Moens' Petition shows a total of 235 unsecured claims(1) totaling $2,386,942.03.

Mr. Moen and a partner started MN Sweatshirt in 1993 retailing sweatshirts at two mall locations. By 1995 the company had expanded to eight stores and Mr. Moen had bought out his partner. The following year Mr. Moen began a phase of rapid expansion which would lead to a peak of 25 stores and eventual financial disaster. Sales dropped from an average of over $80,000 per store to under $48,000 and Mr. Moen had serious staffing and management problems with the increased number of locations and larger geographic reach of his company. In addition, initial capitalization estimates proved over optimistic as Mr. Moen struggled to fill his stores with the merchandise he believed necessary to succeed.

Mr. Moen's relationship with Merchants Bank predated his MN Sweatshirt venture. In 1990 Mr. Moen did all his banking at Merchants, but by the time he bought out his business partner in 1995 Mr. Moen was seeking some banking services elsewhere. At the time he filed for bankruptcy protection Mr. Moen had a checking account and boat loan with Merchants; two vehicle loans with Norwest Bank of Winona; a home equity loan with First Bank of South Dakota in the amount of $40,156.75; a home equity line of credit, secured by a first lien on his homestead, in the amount of $126,000 with the Town and Country State Bank of Winona; and, an unsecured debt of $73,805.77 with Merchants Bank which is the basis of this suit.

Mr. Moen admits that he was forced to seek lending from other banks because Merchants Bank was unwilling to increase his line of credit to capitalize Mr. Moen's ambitious business plans.

Originally, Mr. And Mrs. Moen(2) executed and delivered a mortgage encumbering their homestead in favor of Merchants Bank in return for a $75,000 revolving line of credit memorialized in a December 27, 1990 equity credit agreement. The line of credit was available through the use of special purpose checks and Mr. Moen typically maintained a loan balance of over $70,000. He also made monthly payments on the line of credit.

In 1996 Mr. Moen approached Merchants Bank about increasing his line of credit from $75,000 to $150,000 but the bank was unwilling to extend additional credit on this secured account. Town and Country State Bank (TCSB) did agree to provide a $150,000 line of credit, but only if Merchants Bank released their lien to allow TCSB to take a first security interest in the homestead. All of the parties agreed, and after executing the

required paperwork with his new bank, Mr. Moen left the transaction's details to his bankers. He understood that his existing loan balance, as well as the security interest in his home, would be transferred from Merchants Bank to TCSB.

The result was a doubling of his line of credit, although the existing loan balance transferred from Merchants Bank meant that only about half of the $150,000 equity line would be available for new borrowing. Mr. Moen still had a checking account at Merchants Bank and had recently been approved for a boat loan, but he understood that his home equity line of credit would terminate with the release of lien on his home. He also understood that TCSB would not assume the existing loan balance from Merchants Bank unless Merchants Bank released their lien on the Moen homestead.

The transaction occurred as planned on or about July 8, 1996 and Mr. Moen received a statement from Merchants Bank in August 1996 which reflected the $73,805.77 payoff made by TCSB. His equity credit line with Merchants Bank now stood at zero and the account should have been closed. Mr. Moen began to draw on the new line of credit at TCSB, and as reflected in Schedule D of the Moen's bankruptcy filing, the TSCB account had an outstanding balance of $126,000 by October 3, 1997.

But by August of 1996 MN Sweatshirt had a critical and growing need for cash. When Mr. Moen reviewed his August 1996 statement from Merchants Bank he noticed what he believed was an error, an indication that he had $75,000 of available credit. Merchants Bank admits that through their error Mr. Moen's home equity account was not closed after the loan payoff and mortgage release.(3) In fact, the bank's computer system continued to show the line of credit as active and secured by the now non-existent mortgage. Not until after the Moens' bankruptcy filing did the bank realize its error.

What happened next was hotly disputed at trial. Mr. Moen claims he made a phone call to the bank to determine if the line of credit was now available on an unsecured basis. He claims he spoke to a teller or bookkeeper who told him he could continue to access the credit facility on an unsecured basis. The bank claims no call was made and argue that even if Mr. Moen did call, it was impossible for any bank employee to indicate that the loan was unsecured since the computer system still showed the loan as secured.

It is undisputed that Mr. Moen continued to make regular payments on the loan, and that Merchants Bank continued to accept those payments.

II. Analysis

A. Applicable Law

The Merchants National Bank of Winona advances several arguments why Mr. Moen's debt of $71,340.18 should be excepted from discharge under 11 U. S. C. Section 523(a)(2). The text of this code section provides:

> Exceptions to discharge
> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) 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 . . .
> 11 USCA Section 523(a)(2)(A).

The courts have spent considerable energy in attempts to distinguish between false pretenses, false representations, and actual fraud.(4) In large part these cases seek to reconcile these three phrases with the state statutory and common law language of fraud. As useful as these attempts may have been in distinguishing Section 523(a) discharge exceptions under the various provisions of state law, the Supreme Court made clear in Field v Mans that Section 523(a)(2)(A) cases were to be decided under the law of Restatement (Second) of Torts (1976). Field v. Mans, 516 U.S. 59, 116 S.Ct. 437 (1995). "We construe the terms in Section 523(a)(2)(A) to incorporate the general common law of torts, the dominant consensus of common-law jurisdictions, rather than the law of any particular State." Mans, 516 U.S. 59, n.9. The Supreme Court noted that:

> we will look to the concept of "actual fraud" as it was understood in 1978 when that language was added to Section 523(a)(2)(A). Then, as now, the most widely accepted distillation of the common law of torts was the Restatement (Second) of Torts (1976), published shortly before Congress passed the Act. Id. at 70.

Sections 525 through 552 of the Restatement (Second) of Torts provide this Court's guidance in deciding whether or not Mr. Moen committed actual fraud(5) when he accessed his home equity line of credit, knowing the account should have been closed.

> There is no mention in the Restatement of false pretenses, false representation, or actual fraud. The only tort that could properly be characterized as "fraud" is

> called "fraudulent misrepresentation," and is modeled on the common law tort of deceit. Since the Mans Court relied upon this tort of fraudulent misrepresentation to determine the issue before it, this court concludes that it should apply the same standard in any action under Section 523(a)(2)(A), despite the fact that the Restatement's terminology differs from that found in the Bankruptcy Code. LA Capitol Federal Credit Union v. Melancon (In re Melancon), 223 B.R. 300 at 307 (Bankr. M.D. La. 1998), footnotes omitted.
>
> Under the Restatement (Second) of Torts Section 525,
>
> One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, its subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation. Restatement (Second) of Torts Section525 (1976).

This rule is consistent with the long established case law in the 8th Circuit that prevailing in an adversary proceeding under 11 U.S.C. 523(a)(2)(A) requires proving five elements:

> 1. The debtor made false representations;
> 2. The debtor knew the representations to be false at the time the debtor made them;
> 3. The debtor made the representations with the intention and purpose of deceiving the creditor;
> 4. The creditor actually relied on the debtor's representations; and
> 5. The creditor sustained the alleged injury as the proximate result of the making of the representations. Check Control, Inc. v. Anderson (In re Anderson), 181 B.R. 943 at 948 (Bankr. D. Minn. 1995).

B. Standard of Proof

A plaintiff must prove all five elements of their Section 523(a) claim by the preponderance of the evidence. "Preponderance of the evidence is the standard of proof for Section 523(a)'s dischargeabilty exceptions. Neither Section 523 and predecessor prescribes a standard of proof, a

silence that is inconsistent with the view that Congress intended to require a clear and convincing evidence standard." Grogan v. Garner, 111 S.Ct. 654 at 655 (1991). See also, Universal Pontiac-Buick-GMC Truck Inc. v. Routson (In re Routson), 160 B.R. 595 at 602 (Bankr. D. Minn. 1993). In light of this standard, the Plaintiff's proof under the five elements of fraudulent misrepresentation are discussed below.

C. False Representation

> "Misrepresentation" is used in this restatement to denote not only words spoken or written but also any other conduct that amounts to an assertion not in accordance with the truth. Thus, words or conduct asserting the existence of a fact constitute a misrepresentation if the fact does not exist. Restatement (Second) of Torts Section 525 (1976).

Mr. Moen's testimony on the nature of his alleged call to the bank was less than precise, but the Court concludes that Mr. Moen did call the bank. He did so because his business needed cash and the statement from Merchants Bank indicated that the bank would probably continue to honor Mr. Moen's special purpose checks. He called not to determine if the bank had approved a new, unsecured line of credit, but to determine what would happen if he wrote checks drawing against the old account.

Once he determined that the bank did not recognize its error, and that the checks would be honored, he wrote a series of drafts on this "line of credit" consistent with his earlier borrowing habits while the loan was secured. Mr. Moen did not alert the bank to what he knew to be an error because he planned to use the error to his advantage. The bank had just refused to extend an additional $75,000 of credit on a secured basis and Mr. Moen, an experienced businessman and entrepreneur, knew Merchants Bank would not extend the same $75,000 of credit on an unsecured basis. Mr. Moen knew he was not authorized to use the equity credit line because he knew it was no longer secured by a lien on his home.

Mr. Moen's behavior takes him beyond the critical issue in most Section 523(a) cases involving bad checks, the debtor's intent to repay. See Check Control, Inc. v. Anderson (In re Anderson), 181 B.R. 943 at 948 (Bankr. D. Minn. 1995)(6). The writing and presentation of a check denotes a representation that the bank will honor the check. In most cases the court must determine whether the check constitutes a misrepresentation of the debtor's intent to pay the debt. "[A] check is nothing more than a directive to transfer funds from the account of the drawer . . . upon

the presentation of the instrument." Id. at 950. But this Court's determination is much simpler: Did Mr. Moen represent he had a right to credit with the special purpose checks? Since Mr. Moen had no right or reasonable expectancy that Merchants Bank should honor the checks, any such representation was false.

The Restatement (Second) of Torts clearly addresses the issue of whether a check can constitute a representation under Section 525. Section 532, "Misrepresentation Incorporated In Document or Other Thing" states:

> One who embodies a fraudulent misrepresentation in an article of commerce, a muniment of title, a negotiable instrument or similar commercial document, is subject for liability for pecuniary loss caused to another who deals with him or with a third person regarding the article or document in justifiable reliance upon the truth of the representation. Restatement (Second) of Torts Section 532 (1976).

Mr. Moen presented special purpose checks, originally issued in conjunction with his secured home equity credit line, to borrow on an account he understood should have been closed. The Court need not fault Mr. Moen for anything said or unsaid in his conversation with Merchants Bank, but signing and negotiating a check on an account he knew was not open to his borrowing manifested a false representation that he was entitled to borrow additional funds on an unsecured basis.

D. Debtor Knew the Representations Were False When Made

The Defendant argues that his intention to repay the loan when he presented the special purpose checks suggests a lack of knowledge that his representations were false. The Court accepts the Defendant's testimony that he intended to repay the loan, the payments made to the bank before filing bankruptcy provide further credible support for this position.(7) His reasons for doing so, and his intent to pay back the loan at the time he presented the special purpose checks, are irrelevant. Given the purpose and scope of Mr. Moen's phone conversation to Merchants Bank, the Court can only conclude that when he wrote the checks he knew the account was no longer available, and that he had no right to access it. His actions fall squarely within the "Conditions Under Which Misrepresentation Is Fraudulent (Scienter)" detailed in Section 526:

> A misrepresentation is fraudulent if the maker

> (a) knows or believes that the matter is not as he represents it to be,
> (b) does not have the confidence in the accuracy of his representation that he states or implies, or
> (c) knows that he does not have the basis for his representation that he states or implies. Restatement (Second) of Torts Section 526 (1976).

E. Intent and Purpose of the Representations was to Deceive

Mr. Moen clearly hoped and believed the bank would extend additional credit when he wrote the special purpose checks. That places the Plaintiff within the "class of persons whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation[.]" Restatement (Second) of Torts Section 531 (1976). The evidence of Mr. Moen's intent is circumstantial, but sufficient to establish his intent to deceive. "Because direct proof of intent (i.e. the debtor's state of mind) is nearly impossible to obtain, the creditor may present evidence of the surrounding circumstances from which intent may be inferred." Caspers v. Van Horne (In re Van Horne), 823 F.2d 1285 at 1287 (8th Cir. 1987).

Mr. Moen admits he never told anyone at the bank that he believed his credit line had been left active by mistake. He claims he was under no duty to do so. This claim is inconsistent with the 8th Circuit's holding in Caspers v. Van Horne.

> A borrower has the duty to divulge all material facts to the lender. While it is certainly not practicable to require the debtor to "bare his soul" before the creditor, the creditor has the right to know those facts touching upon the essence of the transaction. Id. at 1288, citations omitted.

Mr. Moen's failure to alert the bank of their error is a further demonstration of his intent.

F. Justifiable Reliance and Proximate Cause

The Defendant claims that since the bank knew that their lien had been released on Mr. Moen's home, they were not justified in relying on any representation, fraudulent or otherwise, made in this case. The Supreme Court chose to look to the Restatement (Second) of Torts in determining that justifiable, not reasonable, reliance was the standard under which Section 523(a) cases should be decided. Field v. Mans, 516 U.S. 59, 116 S.Ct. 437 (1995); see also, Restatement (Second) of

Torts Section 537 (1976).

The testimony at trial was that the bank was unaware of any error on their part until the bankruptcy filing by Mr. Moen and his wife. Bank officers also testified that the special purpose checks were handled automatically by the same check clearing process as normal checks. Loan officers did not see or handle the checks, when the lien was released and the home equity loan paid off by TCSB the computer should have been updated to close the account.

Without this mistake Mr. Moen would have been unable to borrow money. But this mistake was not the proximate cause of the bank's injury. But for Mr. Moen's actions, Merchants Bank would not have advanced money on an unsecured basis, and the $71,340.18 debt at issue in this case would not exist. "The recipient of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation." Restatement (Second) of Torts Section 540 (1976). Mr. Moen's failure to alert a bank official who could have corrected the mistake, coupled with his presentation of the special purpose checks, was the proximate cause of Merchants Bank's loss.

III.

Based upon the proceedings and upon all of the files and records herein,

IT IS HEREBY ORDERED THAT:

1) Judgment shall be entered against the Defendant that the debt of $71, 340.18, plus interest, owed to Merchants National Bank of Winona by Jerome E. Moen is nondischargeable under 11 U.S.C. 523(a)(2)(A) for actual fraud;

2) Judgment shall be entered against the Defendant in the amount of $71,340.18, plus interest from the date of the filing of the complaint; and

3) Judgment shall be entered against Defendant for Plaintiff's costs and attorney's fees.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: February 4, 1999 By the Court:

Dennis D. O'Brien
Chief United States
Bankruptcy Judge

(1) Schedule F indicates that 226 of the 235

unsecured claims, totaling $2,182,465.30, were debts of the Minnesota City Sweatshirt Company for which Mr. Moen was co-debtor. The other nine claims, including Merchants Bank's, were apparently for personal lines of credit.

(2) Although the original loan agreement included Mrs. Moen, the Bank makes no claim against Jane M. Moen in the context of this nondischargeability action.

(3) Defendant's arguments to the contrary, the conduct of the bank is not an issue in this case because it has no relevance in determining the fraud of the Defendant. See Manufacturers Hanover Trust Co. v. Marlar (In re Marlar), 142 B.R. 304 at 306 (Bankr. E.D. Ark. 1992).

(4) See Check Control, INC. v. Anderson (In re Anderson), 181 B.R. 943 (Bank. D. Minn. 1995); see also the exhausting analysis in LA Capitol Federal Credit Union v. Melancon (In re Melancon), 223 B.R. 300 (Bankr. M.D. La. 1998).

(5) The facts in this case would result in the same outcome under the analysis in Check Control, Inc. v. Anderson (In re Anderson), 181 B.R. 943 at 950 (Bankr. D. Minn. 1995), although the court in that decision would apparently rest its analysis upon a finding of "false pretenses," not "actual fraud."

(6) "In proceedings under 523(a)(2)(A) where the underlying event is the passing of an NSF check by a debtor, the first element of this test is somewhat problematic. The whole notion of a `false representation' suggests an affirmative statement of fact, objectively and actively manifested by the debtor." 181 B.R. 943 at 948.

(7) The Plaintiff argues that the Defendant's payments were made to prevent discovery by the bank of its mistake. Such a conclusion is not supported by the evidence and is unnecessary for a finding of nondischargeability in this case.