UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re: Bk. No. 99-10013-JMD
Chapter 7

Carol A. Oakley,
Debtor

HP Family Federal Credit Union,
Plaintiff

v. Adv. No. 99-1070-JMD

Carol A. Oakley,
Defendant

Jay P. Johnson, Esq.
Attorney for Plaintiff

Joseph Dubiansky, Esq.
Attorney for Defendant

MEMORANDUM OPINION

I. BACKGROUND

Before the Court is a complaint filed by HP Family Federal Credit Union ("Plaintiff") against Carol A. Oakley ("Debtor") objecting to the dischargeability of a number of debts, pursuant to 11 U.S.C. § 523(a)(2)(B).[1] A trial was held concerning this matter on September 30, 1999. Both parties presented documentary evidence and testimony concerning the debts at issue. The basic facts of this case are uncontested. The Debtor was employed by Hewlett Packard, an entity whose legal status is separate from the Plaintiff, when each of the debts at issue were created. All of the applications related to the relevant debts were obtained by the Debtor and largely dealt with by representatives of the Plaintiff at a branch office located within the same building where the Debtor was employed by Hewlett Packard.

[1] Unless otherwise noted, all section references hereinafter are to Title 11 of the United States Code.

The debts at issue in this case involve the following three unsecured loans from the Plaintiff to the Debtor: (1) a loan for $6,245.00,[2] executed on March 30, 1995 ("Loan One"); (2) a loan for $10,000.00, executed on January 16, 1996 ("Loan Two"); and (3) a loan for $3,500.00, executed on July 8, 1997 ("Loan Three"). See Ex. 3, Promissory Note Disclosure Statement And Security Agreement, dated March 30, 1995; Ex. 6, Promissory Note Disclosure Statement And Security Agreement, dated January 16, 1996; Ex. 9, Promissory Note Disclosure Statement And Security Agreement, dated July 8, 1997. Loan One and Loan Two involved identical loan applications. Loan Three involved a loan application similar in substance to those used for Loan One and Loan Two, but different in form.

At the time that the Debtor submitted the loan applications regarding all three debts at issue, she was obligated, in connection with an earlier divorce, to pay her former husband child support. The Debtor's Schedule J filed with her bankruptcy petition lists the child support obligation as $551.46 per month. Exhibits submitted by the Plaintiff list the Debtor's child support obligation, as of September 15, 1989, as $106.13 per week, which converts to a monthly figure of $456.36.[3] See Ex. 10, Decree On Motion To Modify, dated September 15, 1989; Ex. 11, Stipulation On Motion To Modify. This discrepancy was not explained at trial. Accordingly, the Court finds that at all relevant times with respect to the debts at issue, the Debtor had a child support obligation equal to $551.46 per month. In any event, the Court notes that precision with respect to the child support amount is not critical to its findings; its ultimate conclusions would follow whether the amount is $456.36 or $551.46, or somewhere in between. It is uncontested that the Debtor did not list this obligation on any of the loan applications connected with the three debts at issue.

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[2] The total loan amount of $6,245.00 represented, as of March 30, 1995, "new value" amounting to $1,500.11. The remainder involved repayment of a previous loan. See Ex. 3, Promissory Note Disclosure Statement And Security Agreement, dated March 30, 1995 (stating that $1,500.11 was given to the Debtor directly and that $4,744.89 was paid to an existing account). The Plaintiff did not allege or produce any evidence that the previous loan was fraudulently obtained or that the purpose of Loan One was to extend, renew or refinance credit. Accordingly, any finding for the Plaintiff with respect to Loan One would be limited to the "new value" advanced at the closing on such loan. See Family Credit Union v. Schuster (In re Schuster), 69 B.R. 352, 353-54 (Bankr. D. Conn. 1987).

[3] $106.13 x 4.3 = $456.36.

Nor is it contested that, at all relevant times, the Debtor's child support obligation was paid through wage assignment, i.e., deductions from the Debtor's Hewlett Packard paycheck.

The Debtor filed for bankruptcy under Chapter 7 on January 4, 1999, and therefore seeks a discharge of the three debts at issue. The Plaintiff objects to the dischargeability of all three debts on the ground that the Debtor's failure to disclose her child support obligation on the three loan applications satisfies the requirements of § 523(a)(2)(B), thus barring discharge for Loan One, Loan Two, and Loan Three. The Debtor argues that all of the elements of § 523(a)(2)(B) are not satisfied and therefore discharge is available.

The Court has jurisdiction of this subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. DISCUSSION

A. Section 523(a)(2)(B)

The Plaintiff's complaint is based solely upon § 523(a)(2)(B), which provides:

> (a) A discharge under section 727 . . . does not discharge an individual debtor from any debt –
>
> > (2) for money . . . 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;
> > > > (iii) 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 . . . .

11 U.S.C. § 523(a)(2)(B). Accordingly, § 523(a)(2)(B) requires that five elements be satisfied before the relevant debt may be excepted from discharge. The Plaintiff bears the burden of proof with respect to all elements under § 523(a)(2)(B). See Commerce Bank & Trust Co. v. Burgess (In re Burgess), 955 F.2d 134, 136 (1st Cir. 1992), overruled on other grounds by Field v. Mans, 516 U.S. 59 (1995). The Plaintiff

must prove each element by a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279, 291 (1991). Moreover, because exceptions to discharge are narrowly construed in an effort to further the "fresh start" policy underlying the Bankruptcy Code, the Plaintiff must show that its claim "comes squarely within an exception enumerated in Bankruptcy Code § 523(a)." See Century 21 Balfour Real Estate v. Menna (In re Menna), 16 F.3d 7, 9 (1st Cir. 1994). At trial, the Debtor conceded that the first and third elements, i.e., that there was a statement in writing and that it concerned the Debtor's financial condition, are not in dispute. Consequently, the Plaintiff must prove the following before the relevant debts may be excepted from discharge: (1) materiality; (2) reasonable reliance; and (3) intent to deceive.

B. Materiality

A financial statement is materially false for purposes of § 523(a)(2)(B) if it "paints a substantially untruthful picture of a financial condition by misrepresenting information of the type which would normally affect the decision to grant credit . . . ." Northmark Bank v. Herzog (In re Herzog), 140 B.R. 936, 938 (Bankr. D. Mass. 1992). See also 4 King et al., Collier on Bankruptcy ¶ 523.08[2][b] (15th rev. ed. 1998). At trial, the former loan officer of the Plaintiff who approved the loans at issue testified as to the lending practices and criteria in place when the relevant loans were made. She testified that the Plaintiff utilized an initial "debt ratio" computation for the purpose of evaluating loan applications. The ratio is a simple comparison of monthly income to monthly expenses. If the total fixed monthly expenses were greater than 50 percent of an applicant's gross monthly income, then the loan officer could not approve the loan and it would be given to a loan manager for secondary review. There was ample testimony at trial showing that if the Debtor's monthly child support obligation had been included in the debt ratio calculus, the loan officer would not have been able to approve any of the loans.[4] Thus, inclusion of the Debtor's child support obligation would have normally affected the Plaintiff's decision to grant credit. Accordingly, the Court finds that the Plaintiff has fulfilled its burden of proof with respect to the materiality element.

C. Reasonable Reliance

[4] No testimony was offered as to whether or not approval would have been granted after secondary review by a loan manager.

Pursuant to the express terms of § 523(a)(2)(B), not only must a creditor prove that it relied upon a false statement or omission in granting a loan, but it also must prove that such reliance was reasonable. The testimony at trial indicates that the Plaintiff relied on the Debtor's omission concerning her child support obligation in approving the loans at issue. The fact that disclosure of the obligation would have tipped the debt ratio over 50 percent supports such a conclusion. See In re Coughlin, 27 B.R. 632, 637 (B.A.P. 1st Cir. 1983) ("Evidence demonstrating that the loan would not have been granted if the lender had received accurate information is sufficient to show reliance."). See also Shawmut Bank, N.A. v. Goodrich (In re Goodrich), 999 F.2d 22, 25 (1st Cir. 1993) ("Indeed, there is case law that supports the view that it is enough if the misstatement or omission is a 'substantial factor' in the decision to make or renew a loan."). The issue, therefore, is whether the Plaintiff's reliance was reasonable.

There is no fast and simple test to determine whether a creditor's reliance on a false statement or omission is reasonable for purposes of § 523(a)(2)(B). At bottom, the determination is made in light of the totality of the circumstances. See Collier on Bankruptcy, at ¶ 523.08[2][d]. Ideally, one would compare the transaction at issue with standard industry practice as an aid in determining whether reliance was reasonable. See Herzog, 140 B.R. at 938. Here, however, there was no testimony concerning standard industry practices.

The difficulty in determining whether the Plaintiff acted reasonably in relying on the Debtor's loan applications, which all reflected an omission of the child support obligation, is in large part due to the relatively informal manner in which the loans at issue were handled. With respect to Loan One and Loan Two, testimony at trial revealed that the Debtor completed the general information portion of the loan applications, signed the applications, and left the section requesting information about current obligations and debts largely blank. Upon submitting the incomplete applications to the loan officer for the Plaintiff, testimony suggested that the loan officer indicated to the Debtor that the loan officer would supply the missing information. The loan officer then completed the debts and obligations section of the application for Loan One with information culled from the Debtor's credit report. The debts and obligations section of the application for Loan Two does not provide a complete listing of the Debtor's obligations, but instead

includes a reference to a previous loan application dated June 8, 1995. See Ex. 4, Loan Application, dated January 17, 1996. Testimony at trial indicated that the Debtor did complete the debt section of the application for Loan Three.

Within the debts and obligations section of the applications for Loan One and Loan Two, there is an area indicating that any child support obligations should be disclosed, an area that was left blank on both applications. In addition, the heading for the debts section of the application for Loan Three includes the following statement: "In addition to Rent/Mortgage list all other debts; for example, auto loans, credit cards, second mortgage, alimony, child support." See Ex. 7, Loan Application, dated July 1, 1997. Thus, the Debtor was formally on notice that she should include her child support obligation on the loan applications. However, the informal nature of the process, specifically the fact that the loan officer for the Plaintiff assumed the duty to complete the debts and obligations section on the applications for Loan One and Loan Two, raises the question of whether the Plaintiff reasonably relied on the information contained in the Debtor's loan applications. Moreover, the Court can reasonably infer that the informality that characterized the process of applying for Loan One and Loan Two carried over to the Debtor's later application for Loan Three.

These circumstances raise questions regarding whether the Plaintiff's reliance was reasonable. Because the Plaintiff created an environment in which it gave the impression that it would shoulder some, if not much, of the burden of listing the Debtor's current obligations, it seems less reasonable to have relied upon the Debtor to provide all information concerning her obligations. Moreover, testimony at trial revealed that it was not the Plaintiff's practice to verify the income amount provided by Hewlett Packard employees on loan applications, verification of which, through examination of payroll records, may have provided notice of the Debtor's child support obligations since they were satisfied through payroll deductions. This circumstance also raises the question of whether the Plaintiff's reliance was reasonable.

There are circumstances, however, that cut toward a reasonableness determination. As stated, all three of the loan applications included explicit language indicating that the Debtor should disclose her child support obligations. Moreover, there is authority for the proposition that, in the context of determining

whether reliance was reasonable for purposes of § 521(a)(2)(B), a bank does not have a duty to make affirmative inquiries regarding a submitted financial statement, especially when the statement does not raise obvious "red flags." See Smith v. Cunningham (In re Cunningham), 163 B.R. 657, 661 (Bankr. D. Mass. 1994); Herzog, 140 B.R. at 938-39. The Debtor's loan applications do not appear to have raised any obvious "red flags." There was conflicting testimony at trial concerning whether the loan officer for the Plaintiff, subsequent to the Debtor submitting the loan applications, specifically asked the Debtor by telephone whether she had disclosed all of her debt obligations. The former loan officer testified that she was confident such an inquiry had been made. The Debtor testified that such a question was never posed. However, based on the authority cited above, even if the Plaintiff never made an explicit inquiry subsequent to receiving the loan application, such inaction may have been reasonable and therefore the reliance on the Debtor's applications was reasonable. Although a close call, the Court finds, based on the totality of the circumstances, that the Plaintiff's reliance on the Debtor's applications, which necessarily involved her child support omission, was reasonable.

D. Intent to Deceive

Not surprisingly, the thorniest issue in this case concerns whether the Plaintiff has satisfied its burden of proof with respect to the question of whether the Debtor failed to disclose her child support obligation with an "intent to deceive." For purposes of § 523(a)(2)(B), an intent to deceive can be inferred when it is shown that the relevant debtor knew that the financial statement was false or was reckless in not knowing of such falsity. See Coughlin, 27 B.R. at 636 ("A creditor can establish intent to deceive by proving reckless indifference to, or reckless disregard of, the accuracy of the information in the financial statement by the debtor."); Martin v. Bank of Germantown (In re Martin), 761 F.2d 1163, 1167 (6th Cir. 1985) ("[F]ull discharge may be disallowed if the debtor either intended the statement to be false, or the statement was grossly reckless as to its truth."); AVCO Fin. Serv. v. Lesher (In re Lesher), 80 B.R. 121, 124 (Bankr. E.D. Ark. 1987) ("[I]t is sufficient to show that the false statement was rendered with reckless indifference and disregard of actual facts."). See also Collier on Bankruptcy, at

¶ 523.08[2][e][ii] ("It must be shown that the debtor's alleged false statement in writing was either knowingly false or made so recklessly as to warrant a finding that the debtor acted fraudulently."). This proposition squares with statements made in In re Lyons, a case cited by the Plaintiff, wherein Judge Yacos remarked that "even where the debtor does not know of the actual falsity of an item on a financial statement, the debtor may still be found guilty of an intent to deceive pursuant to § 523(a)(2)(B)(iv) if such debtor evidenced a reckless indifference to the accuracy of the information in the financial statement." Shawmut Bank v. Lyons (In re Lyons), 153 B.R. 95, 99 (Bankr. D.N.H. 1993). An important question, therefore, is whether at the time of submitting the relevant loan applications, the Debtor knew, or was reckless in not knowing, that her applications were false in that they failed to disclose the existence of her child support obligation. If this question is answered affirmatively, then an intent to deceive may be inferred.

The Debtor has not alleged that she forgot about her child support obligation at the time of submitting the relevant loan applications. Instead, her primary defense is that she thought Hewlett Packard and the Plaintiff were the same entity and that, because she was told that the loan officer for the Plaintiff would obtain all required information missing from the loan applications, the Plaintiff would have received notice of her child support obligation by verifying her payroll records. See Ex. 16, Plaintiff's First Set of Interrogatories To Defendant, Response No. 11. Given the relatively informal nature of the application process with respect to the relevant loans, whether or not the Debtor knew, or was reckless in not knowing, of the falsity of her applications should be considered in light of the entire application procedure. As discussed above, the Plaintiff appears to have fostered an environment in which it created a view on the part of the Debtor that the Plaintiff would shoulder a portion of the burden regarding obtaining information about all of the Debtor's obligations. Based on the testimony at trial and the documentary evidence submitted, the Court finds that the Debtor did not know that her three loan applications were false in that they failed to disclose her child support obligation. The Court finds that the Debtor thought that her applications encompassed both the submitted application and subsequent retrieval of information that the Plaintiff's loan officer told her would occur. It appears that the Debtor thought that the Plaintiff would obtain information

regarding her child support obligation and therefore thought that her applications, overall, were not false. Moreover, the Court finds credible the Debtor's testimony that the Plaintiff's loan officer never asked her by telephone whether she had listed all of her obligations. Because the Court finds that the Debtor did not know that her applications were false, the question becomes whether such thinking was reckless.

The Court finds that the Debtor's view that her applications were not false because she thought the Plaintiff would fill in the child support "gap" was not reckless. The Debtor was perhaps negligent in her thinking, but not reckless. The Plaintiff's relatively informal approach to evaluating loan applications, and its close proximity to the Debtor's workplace, appears to have created an atmosphere in which it would not be reckless to believe that the Plaintiff would fill in various gaps on a loan application, and therefore conclude that, on the whole, an incomplete application would not be false overall. At least one court has stated that "[a] finding of intent to deceive is unwarranted when an omission on a credit application can reasonably be laid to a defect in the format of the credit application combined with a lack of instruction by a lender to a loan applicant." Family Fed. Credit Union v. Schuster (In re Schuster), 69 B.R. 352, 355 (Bankr. D. Conn. 1987).

Here, it appears that the relevant credit applications contained defects in the sense that the Plaintiff gave the impression to the Debtor that it approved of incompleteness regarding loan applications by accepting incomplete loan applications and representing to the Debtor that it would effectively "fill in the blanks." Immediately above the box on the loan applications for Loan One and Loan Two, where the Debtor correctly inserted the amount of her monthly gross income, are the words "Except HP, all other sources of income require . . . verification." The former loan officer testified that even though pay stubs were required for all non-HP employees, not only were pay stubs not required for HP employees, but no income verification was made.[5] The Debtor testified that she believed that the Plaintiff verified income with Hewlett Packard and, therefore, would be aware of the child support deducted from her pay check. In

[5] The Court notes that the Plaintiff's practice was to not verify monthly gross income for its major source of loan applicants, employees of Hewlett Packard, despite the importance of this number to the calculation of the "debt ratio" in approving a loan.

addition, the evidence indicates that the Plaintiff's representatives never affirmatively instructed the Debtor to supply them with information concerning any child support obligations, apart from written directives on the applications themselves. Moreover, as discussed, the Court finds that the Plaintiff's representatives did not ask the Debtor whether she provided all information relevant to her obligations. Accordingly, the Court finds that the Debtor's belief that her loan applications were not false was not reckless.

The Court finds that the Plaintiff has not proven, by a preponderance of the evidence, that the Debtor's omission concerning her child support obligation resulted from an actual intent to deceive or a reckless indifference to the truth of her loan applications, as required by § 523(a)(2)(B). Accordingly, the Plaintiff has not proven all of the elements necessary to support a § 523(a)(2)(B) claim.

III. CONCLUSION

For the reasons stated above, the Court concludes that the Plaintiff has not proven that Loan One, Loan Two, and Loan Three should be excepted from discharge pursuant to § 523(a)(2)(B). A separate judgment has been entered.

This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Fed. R. Bankr. P. 7052.

DONE and ORDERED this 15th day of October, 1999, at Manchester, New Hampshire.

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J. Michael Deasy
Bankruptcy Judge