

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE

SOUTHERN DISTRICT OF GEORGIA
Statesboro Division

In the matter of:)	
)	Adversary Proceeding
HUEY FRANKLIN FUNDERBURKE)	
JACKIE FUNDERBURKE)	Number <u>687-0026</u>
(Chapter 7 Case <u>687-00082</u>))	
)	
Debtors)	
)	
)	
THE CITIZENS BANK OF)	
SWAINSBORO)	
)	
Plaintiff)	
)	
v.)	
)	
HUEY FRANKLIN FUNDERBURKE)	
)	
Defendant)	

FILED
at 3 O'clock & 15 min. P.M.
Date 1-18-88
MARY C. BECTON, CLERK
United States Bankruptcy Court
Savannah, Georgia *PCB*

MEMORANDUM AND ORDER

On September 30, 1987, the complaint of The Citizens Bank of Swainsboro ("Citizens Bank") came on to be heard. Citizens Bank alleges, and sought to prove, that Huey Franklin Funderburke obtained a \$54,000.00 loan from them under circumstances which would require the debt to be excepted from discharge.

FINDINGS OF FACT

1) In March, 1985, Huey Funderburke opened Adventureland Video in Dublin, Georgia. Beginning in May, 1985, the business was financed in part by The Central Bank of Swainsboro ("Central Bank"). Central Bank renewed this loan from time to time, the latest being in January of 1986. Approximately \$50,000.00 was due and payable to Central Bank on March 28, 1986.

2) Huey Funderburke had no banking relationship with Citizens Bank prior to March, 1986. In early March, 1986, Huey Funderburke approached Bill Simmons, a vice-president at Citizens Bank, in an attempt to establish credit with another bank in order to expand his business. Mr. Funderburke applied for a \$54,000.00 loan which he intended to use to pay off The Central Bank note and to buy additional inventory for his business. Mr. Simmons was aware of what Huey Funderburke intended to do with the proceeds from the loan.

3) Bill Simmons had authority to approve unsecured loans which were less than \$10,000.00 and secured loans which were less than \$25,000.00. Loans which exceeded these ceilings required approval of the bank president. Furthermore, Citizens Bank required a corporate financial statement and a "personal financial statement" for all loans which were greater than \$20,000.00.

4) Conversations in early April of 1986 gave Mr. Funderburke the impression that the loan was approved as requested and that the financial statements were a mere formality which had to be filled out to complete the file. On April 17, 1986, Huey Funderburke hand wrote both financial statements. (Exhibits P-1 and P-4). The personal financial statement was incomplete in several material respects. In the asset column, it failed to list \$29,600.00 of equity in JS&F Enterprises, the video business. In the liabilities column, it failed to list approximately \$50,000.00 owed to Central Bank by JS&F but guaranteed by Debtor and a \$35,242.46 note given to Spivey State Bank secured by a junior lien on Mr. Funderburke's home. If these omitted liabilities and assets had been disclosed on Mr. Funderburke's personal financial statement it would have shown that he had a net worth (total assets minus total liabilities) of approximately \$53,000.00.¹ Upon returning to the bank with his handwritten personal financial statement Mr. Funderburke was instructed to sign a blank personal financial statement and was assured by the bank that the information contained on his handwritten form would be transferred onto the blank form. In completing the blank form the bank officer added Mr.

¹ Mr. Funderburke's handwritten personal financial statement (Exhibit P-1) indicates that he had a net worth of \$58,250.00.

Funderburke's \$29,600.00 of equity in JS&F Enterprises, but failed to include the \$50,000.00 owed to Central Bank by JS&F.² (Exhibit D-1).

5) Pursuant to bank policy, Bill Simmons sought approval for the loan from the bank president, Mr. William Green. A \$54,000.00 loan to Mr. Funderburke was approved on the basis of the statements. In particular, Mr. Funderburke's approximate \$42,000.00 of equity in his home and his business assets convinced the bank president that it was a safe loan.

6) Notwithstanding the significance which the bank placed on Mr. Funderburke's \$42,000.00 of equity in his home, Citizens Bank neither checked the courthouse records nor took a second deed to secure debt in the Debtor's property. Instead, Citizens Bank was content to take only a security interest in all the inventory, furniture and fixtures incidental to the Debtor's business, as security for the loan.

² While it is evident that Bill Simmons was aware of the \$50,000.00 debt owed to Central Bank, there is no evidence which would indicate that he was aware of the \$35,242.46 owed to Spivey State Bank at the time the personal financial statement was completed.

7) On April 28, 1986, the loan transaction between the Citizens Bank and Mr. Funderburke was completed.

CONCLUSIONS OF LAW

"Because of the very nature and philosophy of the bankruptcy law the exceptions to dischargeability are to be construed strictly, Gleason v. Thaw, 236 U.S. 558, 35 S.Ct. 287, 59 L.Ed. 717 (1915), and the burden is on the creditor to prove the exception. Danns v. Household Finance Corp., 558 F.2d 114 (2nd Cir. 1977)." In re Hunter, 780 F.2d 1577, at 1579 (11th Cir. 1986). In order to except a debt from discharge pursuant to Code Section 523(a)(2)(B), a creditor must prove that the debt was obtained by the

"(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;"

The first issue which confronts this Court is whether the Debtor's omission of Spivey State Bank's second lien

on his home is "materially false" within the contemplation of Section 523(a)(2)(B)(i). The Eleventh Circuit in In re Hunter, supra., adopted the rule set forth in Davison-Paxon Co. v. Caldwell, 115 F.2d 189 (5th Cir. 1941), cert. denied, 313 U.S. 564, 61 S.Ct. 841, 85 L.Ed. 1523 (1941). In the context of an action to determine dischargeability under Section 17(a)(2) of the Bankruptcy Act,³ the Fifth Circuit held that the statute excepted from discharge only those obligations where there was

³ Under Section 17(a)(2) of the Bankruptcy Act of 1938 "liabilities for obtaining money or property by false pretenses or false representations . . ." were excepted from discharge. Section 14(c)(3) of the Bankruptcy Act of 1938 completely denied discharge to a bankrupt who ". . . obtained money or property on credit, or obtained an extension or renewal of credit, by making or publishing or causing to be made or published in any manner whatsoever, a materially false statement in writing respecting his financial condition". The 1960 amendment to the Bankruptcy Act limited to application of Section 14(c)(3) to bankrupts engaged in business. The Senate Report indicates that a complete denial of discharge is too severe a penalty for a noncommercial bankruptcy who is typically unsophisticated as to the practice of unscrupulous lenders who in anticipation of bankruptcy condone or encourage the issuance of incomplete financial statements with the deliberate intention of obtaining a false financial statement. Under the 1960 amendment the noncommercial bankrupt, although no longer subject to a complete bar to discharge under Section 14(c)(3), became subject to a less severe exception to discharge for the use of false financial statements under Section 17(a)(2). In effect, the 1960 Amendments to the Bankruptcy Act lumped together false pretense, false representations and the use of a materially false financial statement under Section 17(a)(2) of the Act. See generally 1A Collier on Bankruptcy, §14 and §17 (14th ed. 1978).

actual overt false pretense or representation. The court held that the debtor's concealment of her insolvency and present inability to pay did not constitute a false pretense or false representation. "There was merely the obtaining of credit without full disclosure with the knowledge that if full disclosure had been required, credit might well not have been given, but that was all." Id. at 191.

Because the use of materially false financial statements was lumped together with false pretenses and false representations in Section 17(a)(2) of the Bankruptcy Act as amended in 1960 it is arguable that the Davison-Paxson rule applies to actions brought to except from discharge liabilities obtained through the use of materially false financial statements. I do not find this argument persuasive. I conclude that the Eleventh Circuit intended the Davison-Paxson rule to apply only to cases arising under 11 U.S.C. Section 523(a)(2)(A), not cases arising under Section 523(a)(2)(B). In part, my reasoning is based upon the fact that both the Davison-Paxson and Hunter decisions adjudicated questions of false pretenses, false representations or fraud. These decisions did not address the use of materially false financial statements. Furthermore, the clear language of Code Section 523(a)(2)(A) specifically excludes "a statement respecting the debtor's or an insider's financial condition". These financial statements are governed by the

independent 523(a)(2)(B) provision of the Code. Moreover, the Davison-Paxson rule is distinguishable. In Davison-Paxson full disclosure was not expressly required, whereas these financial statements required full disclosure by the borrower.

A substantial body of case law has arisen in other circuits which holds that under certain circumstances the omission, concealment, or understatement of liabilities constitutes a "materially false statement" within the contemplation of Code Section 523(a)(2)(B)(i). See 3 Collier on Bankruptcy, ¶523.09(2), at 523-54 Footnote 5 (15th ed.supp. Mar. 1987). I have found no cases within the old Fifth Circuit or within the present Eleventh Circuit which address the question of whether an omission can be "materially false" within the contemplation of Section 523. The Seventh Circuit in Matter of Bogstad, 779 F.2d 370 (7th Cir. 1985), spoke at length on the "materially false" element. The court stated that:

"Material falsity has been defined as 'an important or substantial untruth . . . ' A recurring guidepost used by the courts has been to examine whether the lender would have made the loan had he known of the debtor's true financial condition.

Id. at 375 (citations omitted).

The Debtor's listing of only a \$23,000.00

mortgage due on his \$65,000.00 home is a substantial untruth because it led Citizens Bank to believe that the Debtor had approximately \$42,000.00 of equity in his home when, in fact, he only had \$7,000.00 equity. An accurate disclosure by the Debtor was clearly "material" as to having an impact on the decision to extend the loan. See generally In re Howard, 73 B.R. 694 (Bankr. D.Ind. 1987) (The case contains an excellent discussion of the "materially false" element.)

"False" within the context of the "materially false" element of 523(a)(2)(B) "means more than erroneous or untrue and imparts an intention to deceive". 3 Collier on Bankruptcy, ¶523.09(a), at p.523-56 (15th ed.supp. Mar. 1987). The proper test in the Eleventh Circuit for determining whether a financial statement is "false" is whether it "was known to be false by the bankrupt or made by him with such recklessness or abandon as to impute knowledge to him". Fidelity & Deposit Co. of Maryland v. Browder, 291 F.2d 34 at 35 (5th Cir. 1961). Whether the second lien on the Debtor's residence was knowingly or recklessly omitted may logically be inferred if the Debtor knew or should have known that the omission would have induced Citizens Bank to make the loan. See Matter of Garman, 625 F.2d 755, at 764 (7th Cir. 1980) cert.denied, 450 U.S. 910 (1980). Notwithstanding the Debtor's protestations that he was an "unsophisticated borrower" and his impression that the personal financial statement was a "mere formality" he either knew or

should have known that his net worth, which in large part would be determined by the equity in his home, would play a significant role in determining whether Citizens Bank would extend him a loan.⁴ Debtor's omission was more than erroneous or untrue, it was an action in which the Debtor either had actual intent to deceive or was recklessly indifferent so as to impute such intent to him.

Debtor's "personal financial statement" clearly satisfies the requirement that the statement in writing is one "respecting the debtor's . . . financial condition". Section 523(a)(2)(B)(ii).

Bill Simmons and Bill Green testified that they relied on the Debtor's financial statement in determining whether to make a loan to him. "The creditor must not only have relied

⁴ Although the Debtor only had a high school education and had never filled out a personal financial statement prior to the one required for Citizens Bank, he was not the "unsophisticated borrower" that he would have this Court believe. He not only owned his own home, but was able to negotiate a first mortgage and a second mortgage with apparently little difficulty. He was a sole proprietor of his own video business since March of 1985. It is inconceivable to this Court that the Debtor could have expected a \$54,000.00 loan to be extended to him on the strength of his business' balance sheet alone.

on a false statement in writing, the reliance must have been reasonable." In re Kreps, 700 F.2d 372 at 376 (7th Cir. 1983), quoting H.R.Rep.No.595, 95th Cong. 1st Sess. 364 (1977); S.Rep.No. 989, 95th Cong., 2nd Sess. 77-79 (1978), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5864, 6320. The courts have found a lack of reasonable reliance in a variety of facts situations. See: In re Howard, supra. at p.705-706.

Given the facts and circumstances surrounding the decision to grant a loan in this case and despite the overwhelming evidence that Debtor was not acting in good faith, I am compelled to conclude, though reluctantly, that the bank's reliance on the false financial statement was not reasonable. The evidence shows that Citizens Bank perfected a security interest over all the inventory, furniture and fixtures incidental to that business. This was a prudent measure which one would expect of a lender who intends to reasonably rely on the net worth of a prospective business in determining whether or not to make a loan. From the record adduced at trial, no evidence was introduced which would indicate that the bank conducted a prudent investigation into the Debtor's equity in his home, or to otherwise protect whatever equity it thought may be in the home. At the very least, the bank could have required a second deed to secure debt on the home if it actually relied on this equity in determining whether or not to make the loan. While it is not the Court's duty to second guess a creditor's

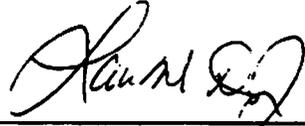
decision to make a loan or set a loan policy for the creditor, Matter of Garman, supra. at 1258, I cannot find as a matter of law that the bank's reliance on the Debtor's stated equity in his home was reasonable when the record shows that the bank did nothing except to "assume the position of an ostrich with its head in the sand and ignore facts which were readily available to it". In re Yeiser, 2 B.R. 98 at 101 (Bankr. M.D.Tenn. 1979). In my opinion, it is unreasonable to permit a lender to rest his case on reliance upon the debtor's stated equity in his home without undertaking any independent verification that such equity, in fact, exists or taking steps to secure its interest in that equity.

Given all the facts and circumstances, this appears to have been a business loan, made to the Debtor's corporation, based only on his business assets. Since Debtor guaranteed the loan, the Bank took his personal statement in order to fully document the file, but it does not appear that there was any real reliance on that statement or that such reliance as existed was reasonable.⁵

⁵ Even if I apply the "business-practices-and-industries-customs" inquiry, as stated in In re Allen, 65 B.R. 752 (Bankr. E.D.Va. 1986), I would still have to hold against the bank on the question of "reasonable reliance". I would hold so because the bank failed to introduce evidence as to its own normal business practices or the standards and customs of its industry by which it could carry its burden by a showing of clear and convincing evidence that it had reasonably relied on the Debtor's financial statement.

O R D E R

IT IS ORDERED, ADJUDGED AND DECREED that Huey Franklin Funderburke's \$54,000.00 debt to The Citizens Bank of Swainsboro is discharged.



Lamar W. Davis, Jr.
United States Bankruptcy Judge

Dated at Savannah, Georgia.

This 18th day of January, 1988.