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SECURED TRANSACTIONS

‘Excellent Home’: Fraud and Creditor Reliance

By
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Most creditors recognize that it’s difficult to fully insulate a financing transaction from the risk of fraud. Representations, warranties and covenants can only go so far. Even diligence and structural protections have their limitations. It is therefore reassuring to know that §523(a) of the U.S. Bankruptcy Code limits in certain circumstances the ability of a debtor to discharge the claim of a victimized creditor. But that protection only goes so far. What many creditors may not know is that they don’t get a free pass when faced with fraud, no matter how blatant it is or rather, particularly when it is blatant.

A recent decision of a U.S. Court of Appeals highlights these issues for practitioners. In May of this year, the Eighth Circuit in *Excellent Home Props. v. Kinard (In re Kinard)*, 998 F.3d 352 (8th Cir. 2021), on appeal from the U.S. District Court of the Western District of Missouri, ruled that an individual debtor could be discharged from its debt to a creditor, even though the debtor had clearly defrauded that creditor. Why? Because the creditor had not “justifiably” relied on the fraudulent conduct. In so doing, the court clearly hammered home the message that diligence is required not only at the initial stages of a transaction, but in exercise of rights and remedies as well.

The Facts

The story behind the *Excellent Home* case begins in 2001. That year, Cheryl Thompson, a Missouri resident, started a “house flipper” business which she named Manor Place, LLC. She employed her daughter, Candice Kinard, in that business.

Manor Place started experiencing financial difficulty and by 2016 was the defendant in what was described in the *Excellent Home* District Court opinion (621 B.R. 231 W.D. Mo. 2020)) as “numerous collection lawsuits.” In March 2016, Thompson reached out to Excellent Home Properties, Inc., a real estate development company located in Northridge, Calif. (apparently through an online intermediary), to solicit funding for several properties. In May of that year Thompson requested a

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$47,000 loan for a house located in Independence, Mo. that Manor Home wanted to purchase for $30,000, renovate for $17,000 and then resell for an estimated $99,000-$105,000. Excellent Home requested documentation supporting the estimated value and in June

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extended a 12% nine month loan, secured by a deed of trust on the property, to enable Manor Home to acquire and improve the Independence, Missouri house.

Manor Home acquired the home, but made no improvements. It nevertheless represented six different fictitious expected closing dates to Excellent Home for the sale of the home. It also misrepresented the condition of the property, leading Excellent Home to believe the property had in fact been renovated. After making a few interest payments, Manor Place defaulted on the loan and discontinued further communications with Excellent Home, at which point Excellent Home resolved to foreclose on the home and credit bid its debt.

In late 2017, Excellent Home engaged a local Missouri attorney and foreclosed on its deed of trust. As part of the foreclosure it credit bid $50,000 and, that being the only bid, acquired title to the house. Only after it took possession of the property did it discover that the property had not been renovated. Following receipt of a $68,000 cost estimate to complete the renovations proposed by Manor Home, Excellent Home decided not to repair the property and sold it for $19,000.

Manor Home, Thompson and Kinard all separately filed for bankruptcy. Excellent Home filed an unsecured proof of claim for $50,000 in Kinard's Chapter 13 proceeding. Kinard nevertheless did not list Excellent Home as a creditor in her schedule of claims. Thereafter, Excellent Home filed an adversary complaint in Kinard's bankruptcy proceeding, alleging fraudulent misrepresentation, negligent misrepresentation, civil conspiracy and objection to discharge. After a trial, the bankruptcy court found for Kinard on all four counts. The District Court affirmed the findings on appeal. Thereafter, Excellent Home appealed to the Eighth Circuit.

The Bankruptcy Code and Dischargeable Debt

Section 1328(b) of the Bankruptcy Code allows a Chapter 13 debtor that has not completed payments under its plan to be discharged from all unsecured debts covered by the plan, with certain exceptions. One of those is fraud. Section 523(a)(2)(A) of the Code provides that "(a) A discharge under section …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 … ."

According to the Circuit Court in *Excellent Home*, to prevent discharge of a debt under §523(a), a "creditor must prove by a preponderance of evidence that a debtor (1) made a representation, (2) with knowledge of its falsity, (3) deliberately for the purpose of deceiving the creditor, (4) who justifiably relied on the representation, and which (5) proximately caused the creditor damage." There was no dispute that Kinard had knowingly and falsely misrepresented to Excellent Home the condition of the home and that there was an intent to deceive it. The issue then came down to "justifiable" reliance by Excellent Home. Both the Bankruptcy Court and the District Court held that Excellent Home had not justifiably relied on the misrepresentations. The Eighth Circuit panel unanimously affirmed.

What About Reliance?

All three courts required Excellent Home to demonstrate reliance on the fraudulent misrepresentations. Interestingly, though, §523(a)(2)(A) doesn't require or even mention reliance, although "reasonable reliance" is specifically required by its statutory companion, §523(a)(2)(B) (which preserves claims of creditors who relied on materially false written financial statements). In reaching

its conclusion that justifiable reliance is necessary, the Circuit Court reached back to a 1995 Supreme Court decision of *Field v. Mans*, 516 U.S. 59, 71, 116 (1995).

The Supreme Court in *Mans* wrote that while §523(a)(2)(A) was itself silent on reliance, actual reliance was nevertheless a given. Further, that since common law fraud generally required "justifiable" rather than "reasonable" reliance, Congress intended this to be the standard in §523(a)(2)(A). In the court's view, at least in *Mans*, justifiable is, generally speaking, a lesser standard than reasonable. Reasonable reliance is based on a "reasonably prudent" person standard, an objective standard, while justifiable reliance looks at the individual circumstances. However, the Supreme Court also noted that the "subjectiveness of justifiability cuts both ways" and that "[n]aifs may recover … in bankruptcy, but lots of creditors are not at all naïve."

According to the Eighth Circuit, justification "is a matter of the qualities and characteristics of the particular plaintiff and the circumstances of the particular case." Citing another recent Eighth Circuit decision (*Hernandez v. Gen. Mills Fed. Credit Union (In re Hernandez)*, 860 F.3d 591 (8th Cir. 2017)), and *Mans*, the court stated that a "victim of fraud is not justified in relying on a representation, and a duty to investigate arises, where 'the facts should be apparent to one of his knowledge and intelligence from a cursory glance, or he has discovered something which should service as a warning that he is being deceived.'"

The Duty To Investigate: How Much Is Enough?

The District Court conceded that Excellent Home was not *required* to investigate the property. However, in that court's view, once it decided to foreclose, factual circumstances undermined its ability to demonstrate justifiable reliance without such investigation. Citing the multiple delays in the sale closing date, and the debtor ceasing to pay interest and cutting off phone contact, the court noted there were clearly signs of trouble. While Excellent Home asserted it did not have access to the property until after it took possession, the District Court quickly dispensed with that argument. Characterizing the circumstances as "an extreme situation," the court held that Excellent Home's lawyer should at a minimum have confirmed "on the day of the foreclosure sale, that the $50,000.00 bid could reflect the condition of the Property as it existed on that day."

The Eight Circuit agreed, ruling that as a "non-novice sufficiently sophisticated investor," Excellent Home had obvious "red flag" warnings that Manor Place did not complete its renovation and repair work. Agreeing with the District Court, it stated that submitting a bid on a house sight unseen, when it had a lawyer who could at least take a "cursory glance," was not justifiable.

Conclusion

Excellent Home underscores the importance to creditors of proper diligence, both in entering into a transaction and thereafter, including in the exercise of rights and remedies. Not only does diligence facilitate analysis of the risks of extending credit or taking remedial steps, but it also provides additional legal protection in the event of fraud, especially when it comes to sophisticated financiers. In the example of *Excellent Home*, while a reasonable reliance standard might have excused greater diligence, justifiable reliance did not, to the detriment of this plaintiff.

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