

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

In Re:

HOWARD L. BLUME & KAY ANN BLUME,

BK. NO. 94-21245

Debtors.

Alternatives Federal Credit Union,

Plaintiff,

vs.

A.P. NO. 94-2091

Howard L. Blume & Kay Ann Blume,

Defendants.

BACKGROUND

On June 10, 1994, Howard L. Blume ("Howard Blume") and Kay Ann Blume ("Kay Blume") (sometimes collectively referred to as the "Debtors") filed a petition initiating a Chapter 7 case. A Section 341 meeting of creditors was conducted on July 22, 1994 and on July 26, 1994 the Debtors' Trustee filed a Report of No Assets.

In their schedules, the Debtors listed their ownership of real property on Tunison Road, Interlaken, Seneca County, New York (the "Interlaken Property").¹

In early August, 1994, orders were entered terminating the automatic stay to allow First

¹ Lienholders had historically broken the Interlaken Property into two parcels. An approximately five acre parcel, which included a residence, barn and goat cheese processing facility (the "Business Property") and a second parcel consisting of approximately seventy-four acres of vacant land (the "Farm Property"). At the time of the filing of the Debtors' petition, First Federal Savings and Loan Association ("First Federal") held a first mortgage of \$75,000 on the Business Property; the New York Job Development Authority (the "JDA") held a second mortgage of \$43,000 on the Business Property; Denise Forant, an heir of Ian Zeiler, who sold the Interlaken Property to the Debtors in 1986, ("Forant") held a third mortgage on the Business Property and a first mortgage on the Farm Property of \$59,000; and Alternatives Federal Credit Union ("Alternatives") held a fourth mortgage on the Business Property and a second mortgage on the Farm Property of \$75,000.

Federal and Forant to commence or continue mortgage foreclosure proceedings against the Interlaken Property.

On September 20, 1994, Alternatives commenced an adversary proceeding (the "Adversary Proceeding") to have the Court determine that the debt owed to it by the Debtors was nondischargeable under Section 523(a)(2)(A).²

In its Complaint, Alternatives alleged that: (a) the Debtors were the principals of Kay and Howard Blume, Inc. which did business as Goat Folks Farm ("Goat Folks") and operated the goat cheese processing facility on the Interlaken Property; (b) Goat Folks and the Debtors had borrowed \$75,000.00 from Alternatives, evidenced by a February 25, 1993 Collateral Note and Security Agreement (the "Alternatives Note"), under which advances had been made on February 25, 1993, March 5, 1993 and March 12, 1993; (c) between the initial loan application in September of 1992 and the submission of certain requested financial information to Alternatives in October, November and December of 1992 and the actual closing of the loan and the disbursements of the loan proceeds in February and March of 1993, Goat Folks experienced a material unfavorable change in its financial condition which Alternatives was never informed of; (d) in making the loan to the Debtors

² Section 523(a)(2)(A) provides:

- (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, other than a statement respecting the debtor's or an insider's financial condition.

and Goat Folks, Alternatives had relied on the financial information presented to it in September, November and early December of 1992; (e) if Alternatives had known the true financial condition of Goat Folks at the time of the closing of the loan, it would not have closed the loan; and (f) the Debtors had failed to inform Alternatives of the material unfavorable change in the financial condition of Goat Folks with the intent to deceive Alternatives.

The Debtors interposed a general denial and the Court conducted several pretrial conferences and on February 2, 1995 it conducted a trial at which the Court heard the testimony of Howard Blume, Kay Blume, Mary Ziegler ("Ziegler"), a loan officer of Alternatives, and James Salk, Esq. ("Attorney Salk"), the attorney who represented Alternatives in connection with the loan to the Debtors and Goat Folks.

The testimony of the witnesses and the exhibits admitted at trial indicated that:

(1) In December, 1986, the Debtors purchased the Interlaken Property from Ian Zeiler, who maintained a goat herd and produced goat cheese on the Property.

(2) Prior to purchasing the Interlaken Property in 1986, Kay Blume worked from 1968 - 1986 as a commercial film actress in New York City, attended Mercy College from 1982 - 1985 (majoring in psychology) and attended the New York Restaurant School.

(3) Prior to purchasing the Interlaken Property in 1986, Howard Blume worked from 1961 - 1986 as an art director, creative director and commercial film director in Chicago and New York City.

(4) The Debtors expended considerable efforts in their goat cheese producing business, increasing sales by approximately 84% from 1986 to 1991; receiving a grant from the New York State Department of Agriculture in 1990 to produce and market a goat milk ice cream; receiving a number of awards from the food industry; expanding their production facilities in 1990 financed in part by a loan from the New York State Job Development Authority; being the first domestic goat

cheese producers to vacuum pack a fresh goat cheese; and receiving an acknowledgement by Food and Wine Magazine in its December, 1990 issue to the effect that, "Goat Folks cheese sets the standard for the entire industry".

(5) In September, 1992 the Debtors had obtained a mortgage commitment from the JDA for a three thousand square foot addition to the processing plant on the Interlaken Property which would add additional curing rooms, bulk storage facilities, walk-in coolers, a new pasteurizer and other improvements to increase the production capacity of the plant and allow for an increased number of tours to be conducted at a charge to the public.

(6) With the JDA commitment in hand and the need to complete the expansion by the summer of 1993 so that Goat Folks could process an anticipated higher milk supply from the increasing herd sizes of its primary suppliers, and therefore supply projected new customers, the Debtors began construction on the expansion, even though the JDA funding could not close until the construction was completed, and they applied to Alternatives for a bridge loan to complete the construction which it was anticipated would be repaid from the JDA loan closing proceeds.

(7) Throughout September, 1992 preliminary discussions were had among the Debtors, various of their representatives and Ziegler, which resulted in a \$10,000 loan being approved on October 7, 1992 (Def.'s Ex. B) which was secured by amounts the Debtors had on deposit at Alternatives.

(8) In October, November and December, 1992, the Debtors supplied Alternatives with various items of information and documentation, including: (a) CPA-compiled financial statements as of September 30, 1992 (the CPA's cover letter was dated November 24, 1992); (b) a copy of the Application for Financial Assistance submitted to the JDA; (c) copies of prior tax returns; (d) 1991 internally prepared financials; (e) a September, 1992 Open Invoice Aging (accounts payable) Statement; and (f) a copy of the JDA commitment.

(9) The JDA commitment included requirements that: (a) the Interlaken Property have an appraised value of not less than \$200,000; (b) the JDA's mortgage would be a second lien on the Interlaken Property (as set forth above, JDA already had a second mortgage lien on the Business Property); and (c) financial statements satisfactory to the JDA as of a date within four months immediately preceding the loan closing.

(10) Although the bridge loan to the Debtors was approved in December, 1992, on what may best be described as a "credit scoring analysis", the loan closing did not take place until February 25, 1993 so that Alternatives and its counsel, at their insistence, could complete as many of the JDA real estate closing requirements as possible.

(11) Notwithstanding Alternatives desire to complete as many of the JDA real estate closing requirements as possible, between the approval of the loan and the closing on February 25, 1993, Alternatives did not insist upon or require that an updated appraisal be obtained or that the Debtors update the Goat Folks financials.

(12) Although the JDA commitment required a subordination of the mortgage held by Forant (the "Forant Mortgage"), because of apparent miscommunications between Alternatives and Attorney Salk, a subordination of the Forant Mortgage was obtained (at least in part in consideration of a payment of approximately \$13,500 made from the Alternatives loan closing proceeds), but it was only in favor of the JDA, not Alternatives, and covered only the Business Property and not the Farm Property.

(13) As testified to by Attorney Salk, Alternatives failed to obtain an updated appraisal of the Interlaken Property in part because the Debtors had made available to it a 1989 appraisal for \$172,000 (this appraisal pre-dated the 1990 and current expansions and did not include the Farm Property).

(14) On March 2, 1994, after its loan had gone into default, Alternatives obtained an

appraisal of the Interlaken Property which indicated a fair market value of \$147,000 (\$103,000 for the Business Property and \$44,000 at \$600 an acre for the Farm Property).

(15) In December, 1992 when Alternatives approved the loan to the Debtors a substantial portion of Goat Folks' accounts payable were due over ninety days; a fact which the Debtors never conveyed to Alternatives.

(16) In December, 1992 and January, 1993, prior to the closing of the Alternatives loan and the disbursements of the loan proceeds, approximately 25% of Goat Folks' primary milk supplier's herd (the "Kellog Farm") was taken off line because of suspected disease, which reduced the projected milk supply of Goat Folks that year by approximately 48,000 pounds, a product supply drop far in excess of any prior milk supply drop experienced by Goat Folks since 1986 because of herd or supplier problems.

(17) Unlike the dairy industry, the goat milk industry is only emerging in the United States and there are not numerous milk suppliers so that herds tend to grow with the growth of a particular producer or handful of producers.

(18) Prior to August, 1993, the Debtors did not advise Alternatives of this herd and resulting milk supply problem.

(19) In June, 1993, the Kellog Farm, which supplied Goat Folks with a large proportion of its goat milk, advised the Debtors that it would no longer supply Goat Folks with milk. Unable to obtain an alternative supply, Goat Folks was forced to terminate its business.

(20) In September, 1993, Goat Folks' former plant general manager and the principal of the Kellog Farm began producing goat cheese using essentially Goat Folks' recipes which the principal had learned while working at Goat Folks for several months.

(21) Because subordinations of the Forant mortgage had not been obtained on behalf of Alternatives in connection with its loan, when Goat Folks terminated business, Alternatives was

unable to realize any recovery from its mortgage which was in a fourth position on the Business Property and in a second position on the Farm Property behind the Forant mortgage.

DISCUSSION

A number of courts have held that the concealment of a material fact, which leaves another party with a false impression, and which is done with the intent to deceive and to in fact create that false impression, constitutes false pretenses, and can result in a debt incurred under such circumstances being determined to be nondischargeable within the meaning and intent of Section 523(a)(2)(A). See *Matter of Weinstein*, 31 B.R. 804 (Bankr. E.D.N.Y. 1983); *Matter of Newmark*, 20 B.R. 842 (Bankr. E.D.N.Y. 1982); and *In re Dunston*, 117 B.R. 632 (Bankr. D. Colo. 1990), *aff'd in part and rev'd in part, remanded*, 146 B.R. 269 (D. Colo. 1992)³.

Although after hearing their testimony the Court was left with the impression that the Debtors are more sophisticated than they would have it believe, and the Court would hope that there would always be full and complete disclosure in all business and lending transactions⁴, nevertheless: (1) the Court does not believe that within the factual framework of the lending transaction with Alternatives, the problem with the Kellogg Farm herd in December, 1992 was in fact material; (2) the Court believes that the failure of the Debtors to disclose the problem with the Kellogg Farm herd was not done with the intent to deceive or defraud Alternatives; (3) the Court believes that, given the

³ U.S. Bankruptcy Judge Sidney B. Brooks in his decision in *In re Dunston* provides an excellent summary of the law regarding false pretenses and the memorable quote: "'False pretense' is more like a con game than a stickup", 117 B.R. at 641.

⁴ The U.S. Court of Appeals for the Second Circuit has indicated that parties have a duty in a business transaction to disclose all the facts, the concealment of which would mislead the other side. See *Peerless Mills, Inc. v. American Telephone and Telegraph Co.*, 527 F.2d 445 (2d Cir. 1975).

factual framework of the lending transaction with Alternatives, the Debtors reasonably believed that: (a) notwithstanding the problem with the Kellogg Farm herd, Goat Folks would ultimately be able to close on the loan with the JDA, which would pay off the Alternatives loan; and (b) even if the loan with the JDA did not close, the Alternatives loan would be fully secured and ultimately paid by the mortgage granted to Alternatives which the Debtors believed was superior to the mortgage in favor of Forant; and (4) the Court believes that the 1992 problem with the Kellogg Farm herd was not the proximate cause of the loss incurred by Alternatives.

A. Materiality

_____The loan from Alternatives to Goat Folks and the Debtors was structured and treated in all respects and by all of the parties as a secured bridge loan which would allow the Goat Folks processing plant expansion to be completed and the permanent loan with the JDA to be closed. Although Alternatives required, received and reviewed financials for Goat Folks which covered the period ending September 30, 1992, it never required updated financials (not even for the fourth quarter of 1992) when the loan closing was delayed into the first quarter of 1993. Alternatives never issued a formal commitment letter which required updated financial information or the disclosure of a material change in the borrowers' financial condition or business, or even what might reasonably be considered to be such a material change. From the testimony at trial, it appears that no representative of Alternatives ever: (a) visited the Goat Folks business premises until after the closing; (b) tried to fully understand the Goat Folks business, including its strengths and weaknesses; or (c) tried to acquire the detailed information one would expect a lender to obtain and analyze when it intended to establish a long-term relationship with a borrower knowing that its repayment would be from ongoing operations. Notwithstanding the Debtor's pleas to Alternatives that it close the bridge loan as soon as possible, because Goat Folks was experiencing cash flow problems,

Alternatives delayed the closing to complete as many of the JDA real estate closing requirements as possible, clearly evidencing the character of this lending relationship as a transactional bridge loan relationship.

As testified to by the Debtors, the problem with the Kellog Farm herd, although it was more severe than in prior instances, was not the first time that Goat Folks had experienced goat milk supply problems. However, it had overcome such problems in the past. Furthermore, the Court finds credible the Debtors' testimony that they believed that the completion of the processing plant expansion, the anticipated increased milk supply in 1993 and the opening of anticipated new markets in addition to a stable and expanding customer base, would allow Goat Folks to overcome whatever negative financial impact might be experienced from the Kellog Farm herd problem. Also, it does not appear that the Debtors were capable in December, January and February of fully assessing the nature and extent of the ultimate negative financial impact from the herd problem. Most importantly, prior to March, 1993, no one could have anticipated that in June, 1993 the Kellog Farm would stop supplying milk to Goat Folks and then go into direct competition with it.

For all of the foregoing reasons, the Court does not believe that upon all the facts and circumstances presented in this case that the problem with the Kellog Farm herd was at the time a material fact that the Debtors should have advised Alternatives of, or, that they would have believed that their failure to advise Alternatives of the problem would have created a false impression with Alternatives as to the long-term financial condition and viability of Goat Folks or its ultimate ability to close on the loan with the JDA.

B. Intent to Deceive

On this issue, the credible testimony of the Debtors indicated that in February and March of 1993 Goat Folks had a stable and expanding customer base, a prospective long-term increased goat

milk supply, and with the processing plant expansion and its resulting increased production capability, a reasonable potential for an even further expanded long-term customer base.

The Debtors' testimony further indicated that, based on their perceived excellent relationship with the JDA, political and community support and projected long-term increased production and expanded customer base, notwithstanding the Kellog Farm herd problem and any resulting negative financial impact, Goat Folks would be able to close the loan with the JDA, pay off the Alternatives Note and ultimately have an expanding and thriving business.

Furthermore, it appears that the Debtors reasonably believed, based on the conduct of Alternatives in the loan relationship which it had established, that it was strictly a bridge loan lender, not particularly interested in the Goat Folks business operations, but only interested in the ultimate closing of the loan with the JDA, which the Debtors reasonably believed would occur. In addition, the Debtors had every reason to believe, based on the perceived value of the real property secured by the mortgage, that the mortgage taken by Alternatives, which was to be superior to the mortgage held by Forant (and would have been but for failings of Alternatives and its representatives), would fully secure and ultimately pay, if necessary, the Alternatives Note. Even Alternatives and its representatives, who it is presumed were much more knowledgeable about real estate values than the Debtors, believed that such would be the case, since they did not obtain an updated appraisal prior to closing, but relied on a prior appraisal which with subsequent improvements indicated that the Alternatives Note would be fully secured.

In addition, the Debtors appear to have been up front with Alternatives in conveying that Goat Folks was in a difficult financial position and had an urgent need to close the loan because of cash flow problems.⁵

Based on the foregoing, the Court cannot find that the Debtors failed to disclose the problem

⁵ This should have alerted Alternatives to request updated financials or at least a current statement of accounts payable.

with the Kellog Farm herd to Alternatives with an intent to deceive and defraud Alternatives into making the loan to them and Goat Folks.

C. Proximate Cause

_____The proximate causes of the Alternatives loss were the actions of the Kellog Farm in June and September of 1993 which caused the cessation of the Goat Folks business and the failure of Alternatives to have obtained an updated pre-closing appraisal of the Interlaken Property and a properly subordinated mortgage.⁶

CONCLUSION

The indebtedness due from the Debtors to Alternatives was not obtained by false pretenses within the meaning and intent of Section 523(a)(2)(A), and therefore is dischargeable.

IT IS SO ORDERED.

/s/
HON. JOHN C. NINFO, II
U.S. BANKRUPTCY JUDGE

Dated: June 9, 1995

⁶ If a proper subordination of the Forant mortgage had been obtained, Alternatives would have at least realized the value of the Farm Property (\$44,000). If the 1989 appraisal was correct, Alternatives would have been paid in full. If Alternatives had obtained its 1994 appraisal pre-closing, it presumably would: (a) not have made the loan; (b) made a smaller loan; or (c) worked with Goat Folks and the JDA on a renegotiated arrangement.