



SO ORDERED.

SIGNED this 30 day of August, 2011.

**ROBERT E. NUGENT
UNITED STATES CHIEF BANKRUPTCY JUDGE**

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

IN RE:

KEVIN ANDREW CHRISTENSEN,)	
MANDY SUE CHRISTENSEN,)	Case No. 10-11853
)	Chapter 7
Debtors.)	
_____)	
FIRST BANK KANSAS,)	
)	
Plaintiff,)	
)	
v.)	Adversary No. 10-5172
)	
KEVIN ANDREW CHRISTENSEN,)	
)	
Defendant.)	
_____)	

MEMORANDUM OPINION

First Bank Kansas (“FBK” or “Bank”) claims that its customer, High Class Homes, Inc. (“HCH”), acting through its president, the debtor Kevin Christensen, made false representations in

support of applications for construction loan draws and that Christensen's guaranty debt should be excepted from his discharge under 11 U.S.C. § 523(a)(2)(A). Christensen denies that he made false statements to the Bank and further denies that the Bank has suffered any harm as a result of his statements because all of the funds HCH borrowed were either expended on building projects in which the Bank claimed a lien or applied to HCH's overhead expenses. In addition, Christensen argues that the Bank's course of conduct makes it clear that it did not "justifiably rely" on his draw requests. The parties tried this proceeding to the Court on July 20, 2011.¹

Jurisdiction

This exception to discharge proceeding is a core proceeding under 28 U.S.C. § 157(b)(2)(I) of which the Court has subject matter jurisdiction pursuant to 28 U.S.C. §§ 1334 and 157(b)(1).

Facts

Kevin Christensen began his home-building career in Salina after briefly attending college and working for his father in the tire business. He and his company first borrowed money from the Bank in 2004 and, since that time, the company has taken out 47 construction loans. The first 46 ended successfully with the Bank being paid in full. The Bank made the 47th and final loan to HCH in 2009 to fund a home project at 2120 Columbine Terrace ("Columbine") and that loan is the basis for the Bank's cause of action. Christensen always dealt with Melissa Bixby, a vice president and loan officer at the Bank. She worked with Christensen on new home construction loans, loans to fund acquisition of vacant lots for building, equipment loans, and direct loans to Christensen for his personal use. When Christensen filed his bankruptcy case on May 28, 2010, he and HCH owed the

¹ First Bank Kansas appeared by its attorney Terry Criss. Debtor Kevin Christensen appeared by his attorney David Eron.

Bank \$102,125.39 according to a journal entry of default judgment entered February 2, 2010 in Saline County District Court. The journal entry also included a finding that HCH and Christensen had incurred \$46,320 of that amount by fraud.² The Bank attached a copy of the partial journal entry to its proof of claim. The journal entry does not include a foreclosure decree concerning any real estate, but does foreclose personal property security interests in some of HCH's property, including a skid steer and three trailers.

HCH and Christensen's construction lending relationship with the Bank involved HCH taking loans to purchase building lots, then consolidating the lot loan into a larger construction loan to fund 80 percent of the construction costs. As HCH required funds, it would issue a draw request supported with invoices for labor and materials. In general, each project had a separate construction loan and HCH often had several projects in progress at a time, until the housing market weakened and the Bank cut HCH off, leaving only the Columbine project to complete.

Each loan consisted of a six-month short term promissory note and the Bank's mortgage on the corresponding real property. Christensen signed an unconditional continuing personal guaranty

² The partial default judgment was not introduced into evidence at trial but is attached to the Bank's proof of claim 20 filed February 2, 2011. The Bank did not preserve the preclusive effect of the pre-petition state court default judgment as an issue in the final pretrial order. Bank's counsel referred to the default judgment in his opening statement but stated that because the judgment was entered on default the Bank was not contending that it should be given preclusive effect on its § 523(a)(2) claim under the doctrine of *res judicata*. The Bank has waived or abandoned the offensive use of *res judicata* on the fraud issues before it today and this order therefore does not apply *res judicata* in this case even though both federal and Kansas law suggest that the doctrine might apply. *See Grogan v. Garner*, 498 U.S. 279, 284 n. 11, 111 S.Ct. 654, 112 L.Ed. 2d 755 (1991) (prior fraud judgment would be given preclusive effect in § 523(a)(2) proceeding); *Banister v. Carnes*, 9 Kan. App. 2d 133, 675 P.2d 906 (1983) (giving *res judicata* effect to a default judgment); *Miller v. Miller*, 107 Kan. 505, 192 P. 747 (1920) (judgment by default is as conclusive against defendant as if he had personally appeared and contested the plaintiff's right to recover).

of HCH's debt. The note form used on the Columbine loan was generic and in no way specific to construction financing. In particular, it contained no special terms governing the construction draw process. Likewise, the Columbine mortgages were on standard commercial real estate mortgages forms. The mortgages provided that the real estate they encumbered secured not only the specific construction loan, but also any other loans HCH has at the Bank. There was no separate loan agreement or other writing that outlined the parties' rights and obligations or detailed the process for requesting and obtaining construction draws. The Bank supplied Christensen with a draw request form he was to use.

When HCH began a construction project, it would supply the Bank with a set of plans for the house and the Bank would obtain an "as-built" appraisal of it. HCH could borrow up to 80 per cent of the "as-built" value. HCH would execute the promissory notes and mortgages described above. In order to draw from the construction loan, Christensen would execute on behalf of HCH a "Construction Loan Request for Draw" that outlined the original amount of the note, the amount of all previous draws, the amount of the current draw, the running total draws, and the remaining loan proceeds.³ The request also contained blanks for the loan number, the checking account into which the draw proceeds were to be deposited, and the borrower's signature. There was no warranty, representation or certification language on the draw form, nor was it required to be signed under oath. Christensen would attached the invoices comprising the amount of the draw requested to the form. Sometimes Christensen would sign these draw requests as HCH's representative, sometimes not; the Bank honored them either way.

The debt that the Bank seeks to except from Christensen's discharge arose out of his

³ See e.g. Ex. 12.

guaranty of HCH's promissory note in the amount of \$231,200 dated May 15, 2009 (the "Columbine Note").⁴ The Columbine Note was secured by two mortgages, one for \$23,000 securing the purchase of the bare ground and the other for \$208,200 for the proposed construction of the house.⁵ The Bank's claim against Christensen is based on his August 19, 2008 unconditional guaranty of all of HCH's bank debt.⁶ The Columbine Note, the mortgages, the guaranty, and the 12 construction draw requests between May 23, 2009 and October 1, 2009 are the only documents evidencing the parties' agreement concerning the Columbine property.⁷

Both Ms. Bixby and Christensen testified to the mechanics of how construction draws were funded. The parties' implicit understanding was that all funds drawn on a particular note were to be spent on the invoices that were attached to it. Christensen agreed in principle that this was the case but stated that, from time to time, Ms. Bixby allowed HCH to draw from one project to complete another--"to rob Peter to pay Paul" in Ms. Bixby's words, a point she did not deny. In fact, at the very outset of their dealings, the Bank permitted HCH to draw "in advance" for work that had yet to be done in order to support the Bank's funding the beginning of work on HCH's first project. Christensen's credible testimony was that it became common practice for the Bank to permit HCH to draw funds from a new project to complete an old one. All loan proceeds were deposited in the HCH commercial account commingling the proceeds of several loans, along with the proceeds of

⁴ Ex. 1.

⁵ Ex. 2 and 3.

⁶ Ex. 4.

⁷ Ex. 12-23 (Draw request nos. 1-12).

any HCH receivables in a single account.⁸ So long as the Bank did not suffer a loss, the Bank did not object.

Instead of routinely auditing draw requests, the Bank and Ms. Bixby relied on their general trusting relationship with Christensen in considering whether to approve the draws. Frequently Ms. Bixby was not even involved in approvals, leaving that to other bank officers or a loan secretary. “Approval” generally entailed Christensen delivering the completed form to the Bank with the proposed payables or filling out the form at the Bank with the assistance of Ms. Bixby or another loan officer. Ms. Bixby inspected projects from time to time as did other bank officers, but no records of inspection were offered in evidence. So long as there were funds to draw, the draws were allowed. Indeed no draw requests were ever denied until the Columbine note proceeds were finally exhausted.⁹

The only time a controversy arose in connection with the use of construction loan proceeds was in 2009 when the Bank conducted a file review or audit on the Briargate project, an HCH project begun prior to Columbine. That review revealed that some Briargate funds were used on other projects. Despite that finding, the Bank did not monitor the Columbine draw requests any differently nor did it audit the Columbine project until sometime after the final Columbine draw request in October of 2009.

Christensen conceded that there were at least two specific instances when draw request

⁸ See e.g., Ex. 5 where loan proceeds from note 12649 were deposited in the HCH account on 4/24/09 and Ex. 7 where loan proceeds from note 12687 (the Columbine note) were deposited in the HCH account on 6/26/09.

⁹ Ms. Bixby estimated that construction on the Columbine property was 60% complete when all of the loan proceeds had been advanced.

proceeds were not used for the property for which the loans were intended, but added that those draws were at Bixby's direction or authorization. Bixby directed Christensen to draw \$6,500 in the first Columbine draw request on May 23, 2009 in order to get the HCH bank account out of overdraft status.¹⁰ Bixby also authorized HCH to use proceeds from the construction loan for the Joanie Street property to tear down a house on the Henderson property. According to Christensen, the Bank never complained to him that any of the Columbine loan proceeds were being used on other Bank-HCH projects.

Draw requests from a number of projects were placed in evidence by both sides. Some of the Columbine draw requests included invoices that appeared to be related to other projects, some of which on their face identify a construction project other than Columbine. The Bank suggests that submitting other project invoices amounts to a misrepresentation but admits that the invoices were not in and of themselves false. Several invoices were presented twice and others appear to have been altered. Christensen contends that all of the invoices HCH submitted relate to projects financed by the Bank.

Ms. Bixby prepared a summary of these invoices in which she attempted to reconcile requested payments against HCH's checking account to show whether the invoices were ever paid or if they were, whether the materials and services they covered went into Columbine.¹¹ This summary purports to show which invoices were paid by HCH checks and which invoices showed the Columbine address. The Bank offered no evidence, however, that it had to pay unpaid invoices

¹⁰ Ex. 12 and 6. The draw request post-dated the \$6,500 deposit on May 20, 2009 to bring the HCH account back to a positive balance.

¹¹ Ex. 24.

when it took over the project or that the claimed-for services were not performed. Some of the invoices are marked paid and one is illegible. Many of the invoices are summary in nature and most do not designate the Columbine project specifically. Yet, Bank counsel argued in closing that the total of these “unexplained” invoices made up the extent of the Bank’s damages, totaling about \$49,000, a number greater than the \$46,000 found in the state court’s journal entry to be the result of fraud.

Some of the questioned draws paid for labor and materials at another project on 1525 Briargate. Once the Briargate project was completed, HCH sold it to a customer and paid the construction loan in full. Christensen spent all of the money drawn on the Columbine loan either on the Columbine project or other Bank-HCH projects. He also testified that HCH completed other work on Columbine and did not submit invoices for it to the Bank. HCH provided labor and some design services on all of the projects.

At trial, the Bank showed that, on occasion, funds from HCH’s business account were applied to obligations other than project-specific invoices. The Bank claims that Christensen appropriated some of the Columbine loan proceeds for his personal use. In particular, the Bank noted a series of credit card payments. Christensen said that the payments were for company credit cards that HCH used to charge materials or to pay invoices for materials when draws were unavailable or HCH had met his credit limit with vendors. HCH paid life insurance premiums on an American General policy, but Christensen noted that this was for life insurance on him that the Bank had required as a condition of its agreement to lend. The premiums were paid via bank draft from the HCH account and had been since the account’s inception. Similarly, the Bank questioned HCH making a loan payment to Toyota Credit with funds from HCH’s checking account suggesting

that Columbine draws funded that payment. Christensen indicated that this loan was secured by his work pickup that was titled in HCH and that the payment was paid via bank draft from the HCH account. Similarly, drafts to Westar Energy were for utility service to the construction sites. Because funds in the HCH account consisted of more than Columbine construction draw proceeds, the Bank failed to prove that the above expenditures were funded by the Columbine draw requests.

As the housing market deteriorated in Salina in the wake of the 2008 financial crisis of 2008-2009, HCH's business declined. Added to HCH's woes was Christensen's costly divorce that resulted in his wife taking some \$78,000 from the HCH bank accounts (she had kept the books of the company).¹² As the market and HCH's business contracted, the Bank adapted by limiting HCH's activity to building custom homes as opposed to "spec" homes. At the end, HCH only had the Columbine project in progress.

On October 1, 2009, HCH sought its last draw of \$22,213 on the Columbine project, leaving about \$1,100 available. HCH then defaulted on its other loans. The Bank repossessed HCH's equipment, effectively shutting HCH down. Then the Bank foreclosed, generating the judgment upon which this case is predicated, and resulting in the forced sale of the uncompleted Columbine project as well as another lot and a rental property that Christensen owned. Finding the Columbine home to be incomplete, the Bank bid in its judgment to the extent of \$170,000 at the sale and worked to complete the home. The Bank claims that it has expended another \$120,000 to get the property ready to sell. Bixby says that when she inspected the house after the HCH relationship unraveled, she found that the house had been framed, sheet-rocked and textured, but there were no floor

¹² Christensen and his wife have since reconciled and remarried. She is the co-debtor in this case.

coverings, no cabinets, and the air conditioner was missing. Once the Bank completed the house, it marketed it at a price of \$309,900 – at the time of trial, the house had been on the market for six months.

Other than Ms. Bixby’s testimony that the Bank spent \$120,000 completing the house, the Bank offered no other evidence about the nature of the expenses it incurred in completing the Columbine house. Ms. Bixby testified that in her lay person’s opinion, the house was only 60 per cent completed at foreclosure.

Analysis

The Bank seeks to except from discharge an indeterminate sum of up to \$49,000 of Kevin Christensen’s guaranty of HCH’s debt on the basis that he procured the guaranty debt by fraud that he committed as HCH’s officer. Section 523(a)(2)(A) excepts from an individual debtor’s discharge debts that are based on false statement, false pretenses, or actual fraud, other than statements concerning the debtor’s financial condition.¹³ To prevail under this section, the Bank must show that the debtor made a false statement with the intent to deceive the Bank, that the Bank justifiably relied on the misrepresentation, and that the misrepresentation caused the Bank to sustain a loss.¹⁴ Justifiable reliance is a subjective determination, based upon the Court’s view of all the circumstances.¹⁵

A preliminary issue here is whether Mr. Christensen may be sanctioned under this section

¹³ *Watson v. Parker (In re Parker)*, 264 B.R. 685, 699 (10th Cir. BAP 2001), *aff’d* 313 F.3d 1267 (10th Cir. 2002), *cert. denied* 540 U.S. 965 (2003) (Fraud as used in § 523(a)(2)(A) means actual or positive fraud, rather than fraud implied by law.).

¹⁴ *Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1373 (10th Cir. 1996).

¹⁵ *Field v. Mans*, 516 U.S. 59, 71, 116 S. Ct. 437, 133 L.Ed. 2d 351 (1995) (concluding that “justifiable reliance” is a less demanding standard than “reasonable reliance”).

for the alleged fraud of HCH. Many courts, including the Tenth Circuit Bankruptcy Appellate Panel, have held that a corporate debt fraudulently incurred with the participation of the guarantor or as a result of the guarantor's fraud may be excepted from the guarantor's discharge.¹⁶ Here, Christensen's debt arises from his personal guaranty of the HCH construction loan for Columbine. If Christensen's statements or representations made in support of any of the unpaid Columbine loan balance are sufficient to support a finding of fraud within the meaning of § 523(a)(2)(A), the corresponding amount of his guaranty debt may be excepted from his discharge.

The Bank asserts that Christensen's attachment of the questioned invoices to the draw requests are the "false representations" or "actual fraud" that support excepting his debt from discharge. The draw requests merely seek funding and have invoices attached. They lack any specific "representation" language. Nowhere does Christensen certify that the attached invoices were incurred on the corresponding project. While both witnesses testified that the general idea was that funds from a particular construction note would be expended on the corresponding project, that requirement is found nowhere in writing. Ms. Bixby testified that during the Briargate project, the one preceding Columbine, she discussed with Mr. Christensen the need for funds drafted from the Briargate note to be applied to the Briargate project rather than other projects. At the same time, the Bank allowed Christensen to "rob Peter to pay Paul" when it was necessary to complete trailing projects with funds from newer ones. While one could interpret or construe Christensen's signature on the draw requests as "representations" that the funds would be used only in the Columbine project, the custom developed between the parties over the preceding 46 projects does not support

¹⁶ *Columbia State Bank, N.A., v. Daviscourt (In re Daviscourt)*, 353 B.R. 674 (10th Cir. BAP 2006).

that interpretation. Christensen signed less than half of the Columbine draw requests. Moreover, several of the draw request invoices on their face accurately identified the construction project to which they pertained. In these instances, Christensen openly disclosed to the Bank that some invoices were attributable to a different construction project than Columbine. To that extent, the invoices were not “false,” and this disclosure negates any intent to deceive by Christensen.¹⁷ Christensen denied any intent to defraud the Bank. The fact that all of the money HCH drew on the Columbine note appears to have been spent in some manner on the business, whether on a specific project or on general overhead, lends him credibility. Ms. Bixby testified that he was a trustworthy individual with whom she worked well. A house was erected at the Columbine site and there is no evidence that any of the draw money went into Christensen’s pocket as opposed to the Columbine project.

Even if the draw requests constitute false statements, the Bank still had to prove that it relied on those statements and that reliance must have been “justifiable” under the circumstances.¹⁸ The falsity of Christensen’s representations was or should have been readily apparent to the Bank. As noted in *Daviscourt*, the Bank’s reliance is justifiable if the falsity of the representation is not patent from a cursory examination or investigation.¹⁹ Where, as here, numerous draw request invoices indicated on their face that they were incurred on projects other than the Columbine house, the

¹⁷ The Court found Christensen’s demeanor and his testimony to be honest, forthcoming and credible.

¹⁸ *Field v. Mans*, 516 U.S. at 71: “Justification is a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than of the application of a community standard of conduct to all cases,” quoting the Restatement (Second) of Torts (1976).

¹⁹ 353 B.R. at 686 (Citing *Field v. Mans*, *supra*).

Bank's reliance is not "justifiable." A simple examination of the invoices would have placed the Bank on inquiry that the debtor and HCH were borrowing on the strength of invoices from projects other than Columbine. Ms. Bixby admitted that the Bank did not review the invoices in any detail other than "checking the math" to check the total of the invoices against the draw request until after Christensen defaulted. In addition, the Bank knew from the parties' course of conduct with respect to the prior construction loans, as well as its review of the Briargate draw requests, that draw requests were regularly made on invoices other than on the corresponding construction project. If the representations were false, that falsity was patently shown on many of the invoices attached to the draw requests and the Bank could or should have readily detected that.

In addition, the Bank employed inspectors to view the progress of HCH's projects. This supplied it with a means of determining whether the funds being drawn were in fact being spent on the projects at hand. Given that the Bank had previously sanctioned the use of funds from one construction note on other projects, the Bank cannot now say that it justifiably relied on the questioned draw requests. Indeed, there is no evidence that the Bank would not have extended this credit had it known some of the funds would be for trailing projects.

In short, the draw request process appears to have been loosely administered. The Bank contends that it relied not only on the draw requests but also on its periodic construction inspections as well as its inherent trusting relationship with Christensen who Ms. Bixby described as "one of our stars." Each of HCH's and Christensen's 46 prior projects resulted in no loss to the Bank. There is no persuasive evidence that this debtor expended any of the draw money on goods or services that did not go into a project secured to the Bank. Even if Christensen incurred some portion of the guaranteed indebtedness by misrepresentation or fraud, there is no evidence upon which to base a

determination of what that portion might be.

The Bank did not demonstrate that the draw requests were “false representations” or that it “justifiably relied” on them. Further, the Bank did not satisfy the remaining element of § 523(a)(2) - that its loss was caused by the misrepresentation. It did not show with any measurable precision what draws, if any, were made in reliance on these representations and should make up the non-dischargeable portion of Christensen’s guaranty debt to it. Moreover, the evidence in this case showed that the construction draws benefitted the Bank on one or more of HCH’s construction projects in which the Bank had a lien. Given the fact that the HCH account contained not only Columbine loan proceeds, it is impossible on this record to trace payments or disbursements from the HCH account to any specific draw requests or to establish that Christensen used the draw requests for personal benefit.

Demonstrating an exception to discharge for fraud is never an easy task and here the Bank falls short, even under the applicable preponderance of the evidence standard.²⁰ Christensen is truly the “honest but unfortunate debtor” deserving of a fresh start. Judgment should therefore be entered on the complaint for the defendant Kevin Christensen, each party to bear its costs. A judgment on decision will issue this day.

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²⁰ *Grogan v. Garner*, 498 U.S. 279, 286-87, 111 S. Ct. 654, 112 L.Ed. 2d 755 (1991).