

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
Northern Division

In re:)
) Bankr. No. 87-10275
HOFFMAN FARMS,) (consolidated case)
)
) Chapter 12
Debtor.)
) MEMORANDUM OF DECISION RE:
) MOTIONS TO DISMISS OR CONVERT

The matters before the Court are the Motion to Dismiss Chapter 12 Case filed by Trustee A. Thomas Pokela, the Motion to Dismiss filed by the Internal Revenue Service, the Amended Motion to Dismiss filed by the Farmers Home Administration, the Motion to Convert filed by Trustee A. Thomas Pokela, and the Motion to Amend Amended Motion to Dismiss to Conform to Evidence filed by Farmers Home Administration. These are core proceedings under 28 U.S.C. § 157(b)(2). This Memorandum and accompanying Order shall constitute findings and conclusions under F.R.Bankr.P. 7052.

I.

Milton P. (Pete) Hoffman filed a Chapter 12 petition on September 21, 1987. His son and daughter-in-law, Joel A. and Sheila D. Hoffman, also filed a Chapter 12 petition on September 21, 1987. By Order entered April 6, 1988, the cases were substantively consolidated into *In re Hoffman Farms*, Bankr. No. 87-10275. A plan was confirmed on January 26, 1989.

Debtors filed their final report and account on December 23, 1993. Trustee A. Thomas Pokela filed a Motion to Dismiss on

January 6, 1994 on the grounds that Debtors had not made all plan payments. The Internal Revenue Service (IRS) filed a Motion to Dismiss on January 24, 1994. It alleged Debtors had failed to pay a priority claim to it for \$7,237.58, the amount due after offsets of some refunds. Farmers Home Administration (FmHA) filed a Motion to Dismiss on January 24, 1994. It alleged Debtors had failed to pay the current real estate taxes on property secured to FmHA as required by Debtors' confirmed plan.

Debtors filed a response to the three motions to dismiss on January 27, 1994. They stated their plan did not require any payments to IRS but that they had paid IRS under the terms of a separate agreement. Debtors further stated that all pre-petition real estate taxes had been paid in compliance with the plan and that all post-petition real estate taxes would be paid before discharge.

On February 28, 1994, FmHA amended its motion to dismiss to request, in the alternative, relief from the automatic stay for lack of adequate protection. FmHA alleged several post-petition creditors had obtained judgments against Debtors. Further, FmHA alleged Debtors had converted \$9,700.00 in insurance proceeds secured by FmHA by not using the proceeds in the manner authorized by FmHA.

An evidentiary hearing was held March 22, 1994. Appearances included James E. Carlon for Debtors and Assistant U.S. Attorney Thomas A. Lloyd for FmHA and IRS. The evidence established that Debtors had not paid \$27,402.49 in post-petition real estate taxes

and that post-confirmation judgment totaling over \$16,000.00 had been obtained against Debtors, with some becoming liens on estate real property.

Daniel Whetham, the FmHA county supervisor for Edmunds County, testified that FmHA and Debtors had several supervised bank accounts that required both parties to sign checks for disbursements. He stated that in 1988 Debtors received \$20,000.00 in insurance proceeds on a Steiger tractor that was pledged to FmHA. FmHA then obtained a secured interest in the insurance proceeds. In February 1989, Debtors requested and received permission from FmHA to use \$9,700.00 of the insurance proceeds to buy a newer tractor with dual rear tires from Mr. Randy Reuer. FmHA issued a check payable to Randy Reuer.

Debtor Joel Hoffman testified that he gave Randy Reuer \$6,000.00 in hay in exchange for the tractor. Randy Reuer endorsed the \$9,700.00 check and exchanged it for a money order payable to Debtor Joel Hoffman. Debtor Joel Hoffman used \$7,700.00 of the \$9,700.00 to pay on a loan he had with Farmers State Bank. He used the remaining \$2,200.00 to pay miscellaneous expenses. Debtor Joel Hoffman testified that his father, Debtor Milton Hoffman, negotiated the deal with Randy Reuer.

After presenting conflicting explanations of why Debtors did not complete the tractor transaction with Randy Reuer as they had told FmHA they would and following questioning by the Court, Debtor Milton Hoffman corroborated Debtor Joel Hoffman's testimony that Randy Reuer received \$6,000.00 in hay for the tractor and that

Debtor Joel Hoffman spent the \$9,700.00 released by FmHA on a loan and for some miscellaneous expenses.

FmHA's file notes prepared by Owen Anderson, the former FmHA county supervisor, support the testimony that Randy Reuer received only \$6,000.00 in hay for the tractor and that Reuer used the \$9,700.00 check provided by FmHA to obtain a money order for Debtor Joel Hoffman. Daniel Whetham testified that FmHA would not have released the insurance funds to pay Debtor Joel Hoffman's loan at Farmers State Bank under FmHA current practices because the Bank did not hold a prior lien.

Debtors Joel and Milton Hoffman testified that they would borrow \$26,000.00 from a close friend of Debtor Milton Hoffman's to pay delinquent post-petition real estate taxes. This friend would receive a note or a lease on real property in exchange and the Hoffman's would farm it for her, with additional labor hired or exchanged. Debtors did not present any documentation of this deal. The Hoffmans also testified that, except for a potential \$2,500.00 from a land lease to a relative, they presently did not have sufficient funds or a plan to cure the delinquent payments or to make the current payments due to FmHA. Debtor Milton Hoffman stated they were willing to sell some land purchased post-petition to cure their delinquency but had not obtained FmHA's permission to do so.

The Court asked the parties to provide any stipulation between Debtors and FmHA that would indicate whether the terms of the notes and mortgages were incorporated into the confirmed plan. None was

located. FmHA argued that the plan indirectly incorporated the notes and mortgages because § 1225(a)(5)(B) requires a plan to provide that secured creditors will retain the lien securing their claim. FmHA also argued that the plan did not expressly alter any of the mortgage terms regarding payment of real estate taxes.

On March 30, 1994, FmHA filed a Motion to Amend Amended Motion to Dismiss to Conform to the Evidence. It requested that the case be converted to Chapter 7 for fraud under 11 U.S.C. § 1208(d) based on the March 22, 1994 evidence that Debtors had not used the \$9,7000.00 in secured insurance proceeds released by FmHA for the purpose intended -- to buy a tractor from Randy Reuer. Debtors filed a response on April 5, 1994 that denied their use of the insurance proceeds was fraudulent.

Trustee Pokela filed a Motion to Convert on March 31, 1994 on the grounds that Debtors "defrauded a creditor by obtaining funds under false pretenses by failing to make use of the funds in the manner intended when such were obtained." Debtors filed a response on April 13, 1994 that incorporated their response to FmHA's motion to amend.

A hearing was held April 26, 1994 on FmHA's motion to amend based on the evidence presented at the March 22, 1994 hearing and on Trustee Pokela's Motion to Convert. Appearances included James E. Carlon for Debtors, Assistant U.S. Attorney Thomas A. Lloyd for FmHA, and Trustee Pokela. The matter was taken under advisement after receipt of argument.

II.

Post-hearing Amendment of A Pleading.

Rule 15 of the Federal Rules of Civil Procedure contemplates that amendments to pleadings should be allowed liberally where the amendment is necessary to further justice and where the adverse party will not be prejudiced. *Corsica Livestock Sales v. Sumitoma Bank of Cal.*, 726 F.2d 374, 377 (8th Cir. 1983); *Gallon v. Lloyd-Thomas Co.*, 264 F.2d 821, 823 (8th Cir. 1959). Under F.R.Civ.P. 15(b), a pleading may be amended *post-hearing* to comply with the evidence presented if the "issues not raised by the pleadings are tried by express or implied consent of the parties. . . ." *Pariser v. Christian Health Care Systems, Inc.*, 816 F.2d 1248, 1253 (8th Cir. 1987). Implied consent is found when a party fails to object to evidence relating to issues beyond the pleading. *Corsica Livestock Sales*, 726 F.2d at 377. However, evidence relevant to an issue originally raised will not support an amendment that brings in some "entirely extrinsic issue or changes the theory on which the case was actually tried." *Gallon v. Lloyd-Thomas Co.*, 264 F.2d 821, 825 n.3 (8th Cir. 1959) (quoting Vol. 3, Moore's Federal Practice § 15.13, pp.846-47).

Dismissal of a Chapter 12 Case for Cause.

A Chapter 12 case may be dismissed for cause, including

- (1) unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors; . . .
- (6) material default by the debtor with respect to a term of a confirmed plan; . . . or
- (9) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation.

11 U.S.C. § 1208(c) (in pertinent part). A "multiplicity of factors may be considered in the aggregate to meet the cause requirement" for dismissing a Chapter 12 case. *Euerle Farms, Inc. v. State Bank in Eden Valley (In re Euerle Farms, Inc.)*, 861 F.2d 1089, 1091 (8th Cir. 1988). Where payment of creditors is conjectural at best, the case is properly dismissed. *Id.* at 1092.

Dismissal or Conversion of Chapter 12 Case to Chapter 7 for Fraud.

A Chapter 12 case may be dismissed or converted to a Chapter 7 case if "the debtor has committed fraud in connection with the case." 11 U.S.C. § 1208(d). This section, not found in other Chapters of the Bankruptcy Code, was added to encourage good faith and honest dealings by a Chapter 12 debtor throughout the case. 132 Cong.Rec. S15076, Oct. 3, 1986 (cited in *In re Zurface*, 95 B.R. 527, 539 (Bankr. S.D. Ohio 1989)).

A finding of fraud is a factual matter. *Reinbold v. Dewey County Bank*, 942 F.2d 1304, 1306 (8th Cir. 1991); *Graven v. Fink (In re Graven)*, 936 F.2d 378, 382 (8th Cir. 1991). The debtor must make a representation in connection with his case that was known by debtor to be false at the time it was made. See *Agribank, FCB v. Kingsley (In re Kingsley)*, 162 B.R. 249, 253 (Bankr. W.D. Mo. 1994) (citing *Ophaug v. Thul (In re Ophaug)*, 827 F.2d 340, 342 n.1 (8th Cir. 1987)). Fraudulent intent may be inferred from the circumstances of the transaction. *Graven*, 936 F.2d at 383 (cite therein).

Under § 1208(d), if fraud in connection with the case is found, the Court may dismiss the case or convert it to Chapter 7.

Conversion is appropriate if dismissal would benefit only the debtor by allowing further delay in paying creditors and possible dissipation of assets. *Zurface*, 95 B.R. at 539. Conversion also is appropriate if a Chapter 7 trustee may recover fraudulently transferred assets. *Id.*

III.

The evidence presented at the March 22, 1994 hearing clearly establishes cause for dismissal. First, Debtors have defaulted on plan payments and have no reasonable prospect for curing the delinquencies *and* meeting future payments to creditors. In fact, Debtors' plans to lease or sell some land will further diminish the estate because the income derived from these deals will not be sufficient to bring taxes and creditor payments current and will jeopardize future farm income. Second, Debtors have fallen further in debt post-petition. Real estate taxes of \$26,000.00 are unpaid. Several post-petition creditors have obtained judgment liens totaling over \$16,000.00. Finally, Debtors defrauded a key creditor in connection with the case. Based on the testimony of the several witnesses, including Debtors' own, and the exhibits presented, it is clear that Debtors never intended to pay Randy Reuer \$9,700.00 for a tractor when they sought \$9,700.00 from FmHA. Moreover, Debtor Joel Hoffman used the majority of those funds to pay another creditor. FmHA's secured position was eroded by this ploy.

Having found that Debtors committed fraud in connection with

the case, the Court concludes that conversion of the case to Chapter 7 is more appropriate than dismissal. Dismissal would not aid creditors -- pre or post-petition creditors -- from recovering on their claims and would only delay any payment of claims. Litigation between Debtors and creditors or among creditors may only proliferate with dismissal. In contrast, a Chapter 7 trustee can marshal and liquidate assets expediently. Creditors will be assured of an orderly distribution of assets.

Debtors may find that dismissal of their case is a harsh penalty where the fraud involved only one creditor and one tractor. But fraud is fraud. As the Supreme Court stated, the purpose of bankruptcy is to provide a "fresh start" for insolvent debtors. *Grogan v. Garner*, 111 S.Ct. 654, 659 (1991). This relief, however, is limited to the "honest, but unfortunate debtor." *Id.* (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (cited in *Graven*, 936 F.2d at 385)). Debtors were given a fresh start opportunity at confirmation. They abused that opportunity when they defrauded a creditor involved in the case. Accordingly, the penalty of conversion is warranted.

Finally, the Court concludes that Debtors are not prejudiced by FmHA's post-hearing amendment of their pleading which seeks conversion of the case for fraud based on the evidence presented March 22, 1994. Debtors' fraudulent actions regarding the tractor were raised in FmHA's first amended motion to dismiss filed February 28, 1994. Further, a hearing was held April 26, 1994 on FmHA's motion to amend to conform to the evidence. Debtors could

have presented evidence in rebuttal to FmHA's showing of fraud on March 22, 1994 but did not.

An order will be entered converting this case to a Chapter 7 proceeding.

Dated this ____ day of July, 1994.

BY THE COURT:

Irvin N. Hoyt
Chief Bankruptcy Judge

ATTEST:

PATRICIA MERRITT, CLERK

By _____
Deputy Clerk

(SEAL)

UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH DAKOTA
Northern Division

In re:)
HOFFMAN FARMS,) Bankr. No. 87-10275
) (consolidated case)
)
) Chapter 12
Debtor.)
) ORDER CONVERTING CASE
) TO CHAPTER 7

In recognition of and compliance with the Memorandum of Decision Re: Motions to Dismiss or Convert entered this day,

IT IS HEREBY ORDERED that Farmers Home Administration's motion to amend its Amended Motion to Dismiss to conform to the evidence presented at the March 22, 1994 hearing is GRANTED; and

IT IS FURTHER ORDERED this Chapter 12 case is CONVERTED to a Chapter 7 case.

So ordered this ____ day of July, 1994.

BY THE COURT:

Irvin N. Hoyt
Chief Bankruptcy Judge

ATTEST:

PATRICIA MERRITT, CLERK

By _____
Deputy Clerk

(SEAL)