

**IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF VIRGINIA
HARRISONBURG DIVISION**

DENNIS C. LILLY and)	
SHARON L. LILLY,)	
Appellants,)	Civil Action No. 5:04CV00017
)	
v.)	<u>MEMORANDUM OPINION</u>
)	
ROY B. HARRIS,)	By: Samuel G. Wilson
Appellee.)	United States District Judge
)	

This is an appeal by creditors, Dennis and Sharon Lilly (the Lillys), from a final decision of the United States Bankruptcy Court for the Western District of Virginia discharging a portion of a debt owed them by debtor, Roy B. Harris (Harris). The court has jurisdiction pursuant to 28 U.S.C. § 158. Harris filed a Chapter 7 proceeding and the Lillys challenged the dischargeability of Harris' debt pursuant to 11 U.S.C. § 523(a)(2)(A) and § 523(a)(4). The bankruptcy court held a portion of the debt nondischargeable pursuant to § 523(a)(4), essentially because Harris embezzled money from the Lillys. However, the court found \$293,000 of the debt dischargeable pursuant to § 523(a)(2)(A) because the Lillys failed to prove by a preponderance of the evidence that they justifiably relied on Harris' false assertions.¹ For the reasons stated, this court reverses the decision of the bankruptcy court and remands for further proceedings in accordance with this opinion.

¹ This court extended a previous filing deadline for Appellants' brief to April 16, 2004, at the request of the Lillys. The Lillys, however, did not mail their brief until April 21, 2004, and it was not filed until April 23, 2004. On that same day, but before the brief was filed, the court ordered the Lillys to show cause why the court should not dismiss their appeal, and they responded on April 30, 2004. Finding good cause, the court now considers the Lillys' appeal.

I.

Harris and his sister contracted to purchase the Lillys' house and all the tangible personal property within the house for \$1,029,000.00. Harris obtained a loan from Blue Ridge Finance for the purchase price and for additional funds to establish a bed and breakfast on the property. Before closing, Blue Ridge Finance informed Harris that he would need \$110,000 for closing costs, and he asked Sharon Lilly, who lived in Naples, Florida, to loan him the money. Mrs. Lilly agreed and prepared a promissory note and security agreement that secured the loan with all the personal property in the house, and Harris and his sister executed both documents.

Blue Ridge Finance also informed Harris that he needed \$180,000 in order to demonstrate liquidity. Again, Harris requested the funds from Mrs. Lilly, who verified the need with Blue Ridge Finance and agreed to deposit the money in Harris' bank account.² Mrs. Lilly prepared an escrow agreement, stating that the funds were to remain in the account as proof of liquidity and that Harris would return the money to Mrs. Lilly at closing.³

On the day of the scheduled closing, Blue Ridge Finance informed Harris that he did not qualify for the loan because he was a credit risk, and Harris and Mrs. Lilly, who claims she did not know the reason for the delay, postponed the closing to allow Harris to find alternative financing. Harris then obtained replacement financing, but for an amount "substantially less" than he needed to meet the

²This court questioned the propriety of a transaction in which the seller of property provides the purchaser with such "show money." At oral argument, counsel for Appellants assured the court that the transfer was made with approval of the lender.

³ Mrs. Lilly also prepared a security agreement giving her a security interest in Harris's West Virginia home, but she never perfected it.

purchase price. At closing, Harris told Mrs. Lilly that he needed to apply the \$180,000 in escrow toward the purchase price and that he still had a \$3,000 shortfall. Mrs. Lilly loaned Harris the additional \$3,000, agreed to let him use the escrow funds, and postponed the date he was to repay her. Harris used the entire \$293,000 that Mrs. Lilly provided for cash at closing, and the Lillys received \$834,017.47 at settlement.

In addition to the security agreements, notes, and other promises to repay, Harris offered to use \$200,000 from the sale of his sister's house and \$75,000 from the sale of his house to repay the three loans from Mrs. Lilly.⁴ Harris, according to Mrs. Lilly, stated that the sale of his sister's house was "pending" and that he had listed his house for sale. Mrs. Lilly, however, never investigated the veracity of Harris' statements, requested to see the sister's contract for sale, or otherwise substantiated the value of the two houses.

Harris, without repaying any portion of the three loans, filed for bankruptcy protection in the Bankruptcy Court for the Western District of Virginia. The Lillys claimed that Harris' debt was nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(A)⁵ because Harris obtained his debt through false and fraudulent pretenses. After an adversary proceeding, the bankruptcy court concluded that Harris made fraudulent representations about the value of both his house and his sister's house and falsely stated that his house was listed for sale and that his sister's house was under contract. However,

⁴ Harris informed Mrs. Lilly that the value of his property was \$175,000 but that he owed approximately \$100,000 on the house, leaving \$75,000 in equity to use for payment.

⁵ 11 U.S.C. § 523. Exceptions to discharge. (a) A discharge ... 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 ...

the court determined that the debt was dischargeable because the Lillys failed to prove “justifiable reliance on the false statements.” In doing so, the court stated:

The court observed both Defendant and Mrs. Lilly at trial. The Defendant did not present himself in a way that would evidence he was sophisticated when dealing with financial matters. Mrs. Lilly gave the appearance of an individual who was familiar with and accustomed to dealing with financial matters. Further, she prepared loan documents and security agreements prior to closing to evidence the loans she was making to Defendant and the security for those loans.

* * *

In the evolution of the transaction a number of “red flags” appeared. In the beginning, there was the need for \$110,000.00 to cover closing costs, then the need for \$180,000.00 of “show money”, then, on November 14, the eve of closing, the need to convert the \$180,000.00 for use as cash at closing and then on the day of closing the need for a relatively small sum to finally get the deal done.

The bankruptcy court noted that, despite these obvious indications of Harris’ questionable financial health and the opportunity to refuse to close on November 15, the Lillys nevertheless went through with the transaction.

II.

Justifiable reliance presents a “mixed” question of law and fact, requiring inquiry into both the legal conclusions and the factual findings of the bankruptcy court. To the extent the decision of the bankruptcy court turned on whether the Lillys’ reliance was justifiable, the decision is erroneous. On the other hand, the bankruptcy could have concluded, based on its factual findings, that the Lillys did not actually rely on Harris’ misrepresentation.

The issue of reliance requires a twofold inquiry: first, whether the appellant actually relied upon the misrepresentation, and second, whether the reliance was justifiable. Field v. Mans, 516 U.S. 59, 70 (1995). The issue of actual reliance is a factual finding, while the question of whether that reliance is

justifiable is a legal conclusion. A district court reviews a bankruptcy court's conclusions of law de novo and its factual findings for clear error. U.S. v. Bullion Hollows Ent., 185 Bankr. 726, 728 (W.D. Va. 1995) (citing In re Midway Partners, 995 F.2d 490, 493 (4th Cir. 1993)). "The standard of review on appeal requires that we respect, unless 'clearly erroneous,' all findings of fact by the bankruptcy court...pertinent to the issue of justifiable reliance. The definition of the standard of justifiability is a purely legal issue, reviewable de novo." Lentz v. Spadoni, 316 F.3d 56, 58 (1st Cir. 2003). In addition, "due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of witnesses." Farouki v. Emirates Bank Int'l., 14 F.3d 244, 250 (4th Cir. 1994).

After considering divergent testimony and the credibility of various witnesses, the bankruptcy court concluded that the Lillys failed to prove by a preponderance of the evidence that Mrs. Lilly justifiably relied on Harris's false statements. To the extent the bankruptcy court found that Mrs. Lilly's reliance was not justifiable, that finding is erroneous.

In determining whether reliance was justifiable, the bankruptcy court applies a subjective standard by examining "the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case...." Field, 516 U.S. at 71 (citations omitted). Justifiable reliance is a minimal standard, but one is "required to use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." Id. "[O]nly where, under the circumstances, the facts should be apparent to one of his knowledge and intelligence from a cursory glance, or he has discovered something which should serve as a warning that he is being deceived, that he is required to make an investigation of his own." Id. The opinion of the bankruptcy court focuses on the relative

sophistication of the parties, finding that Mrs. Lilly “gave the appearance of an individual who was familiar with and accustomed to dealing with financial matters.” The Fourth Circuit has held, however, that sophistication does not itself render reliance unjustifiable. In re. Biondo, 180 F.3d 126, 135 (4th Cir. 1999); See also In re. McNew, 270 B.R. 593, 621 (E.D. Va. 2001) (“A sophisticated entity is not required to examine financial statements but can justifiably rely on the debtor’s representation”). The Fourth Circuit expressly rejected the argument that a more sophisticated person or entity should be held to a higher standard of justifiable reliance. Biondo, 180 F.3d at 135. The bankruptcy court’s opinion points to no factors clearly indicating that “by the use of [her] senses” alone, Mrs. Lilly could have appreciated the falsity of Harris’ representation. See Field, 516 U.S. at 71.

On the other hand, the “minimal standard” set forth by the Field court still requires actual reliance in order to establish fraud. “Actual reliance may be shown by unchallenged testimony that a creditor would not have extended that credit had it known the truth.” In re. Jaquinta, 95 B.R. 576 (N.D. Ill. 1989). “The greater the distance between the reliance claimed and the limits of the reasonable, the greater the doubt about reliance in fact.” Field, 516 U.S. at 76. To the extent the decision of the bankruptcy court turned on actual reliance, the facts as found by the bankruptcy court are not clearly erroneous. Mrs. Lilly was aware of Harris’ financial status and his apparent difficulty in closing the transaction. She provided \$290,000 to Harris for closing costs and “show money”; she agreed to postpone the original closing date; when Harris did not have sufficient funds on the day of closing, Mrs. Lilly postponed the date for repayment; and despite Harris’ apparent financial shortfall, she made no effort to verify the value or sales status of Harris’ and his sister’s properties. The opinion of the bankruptcy court notes that when Harris made a third request for money from Mrs. Lilly, he

again held out the “carrot” of the sale of his sister’s property. At this point, Harris had obtained \$290,000 from Mrs. Lilly. The maximum he had represented as sales proceeds from the sale of his own and his sister’s properties was \$275,000. Mrs. Lilly nevertheless agreed to the additional loan. From these facts, the bankruptcy court could have concluded that Mrs. Lilly did not in fact rely on Harris’ false representations regarding the sale of his and his sister’s properties as an impetus for the loan.

It is unclear from the bankruptcy court’s opinion whether it found actual reliance by Mrs. Lilly on Harris’ misrepresentation. For this reason, the court reverses and remands the decision for further proceedings.

III.

For the reasons stated, the court reverses the decision of the bankruptcy court, and remands for further proceedings in accordance with this opinion.

ENTER: This 1st day of September, 2004.

UNITED STATES DISTRICT JUDGE

**IN THE UNITED STATES DISTRICT COURT
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DENNIS C. LILLY and)	
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ROY B. HARRIS,)	By: Samuel G. Wilson
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In accordance with the accompanying memorandum opinion entered this day, it is **ORDERED** and **ADJUDGED** that the decision of the United States Bankruptcy Court for the Western District of Virginia is **REVERSED AND REMANDED**.

This case shall be stricken from the docket of the court.

ENTER: This 1st day of September, 2004.

UNITED STATES DISTRICT JUDGE