Arizona Bankruptcy American Inn of Court

Pupilage 6

"Trial Practice"

Fawn MacGyver is an individual Chapter 7 bankruptcy debtor. Prior to filing for bankruptcy, Ms. MacGyver owned and operated The Leaky Goblet, a Harry Potter memorabilia store in Florence, Arizona.

In connection with her store, Ms. MacGyver sought out a hard money loan from Tori Sminkelman, a notoriously tough and aggressive lender who is now transitioning to help people with healthcare legal issues.

Prior to closing the loan, Ms. MacGyver orally represented to Ms. Sminkelman that the memorabilia store was a massive success and that its accounts receivable from layaway purchases were worth at least $1 million. Ms. Sminkelman did not conduct any due diligence prior to funding the loan.

Ms. Sminkelman provided a $1 million loan to Ms. Sminkelman, and she recorded a blanket lien against the store's assets. Ms. MacGyver guaranteed the loan and continually told Ms. Sminkelman in conversations and emails that she was good for the money.

After Ms. MacGyver filed for bankruptcy, it is clear that the store's accounts receivable were old and only 30% collectable, and Ms. MacGyver's personal money was all invested in Bitcoin, so on any given week she was either rich or insolvent depending on the price fluctuation.

Ms. Sminkelman filed a complaint against Ms. MacGyver under 11 U.S.C. § 523(a)(2)(A) and (a)(2)(B), and the matter is proceeding quickly to trial.

Law

- Default judgments not given preclusive effect in § 523 because the underlying judgment must have been "actually litigated." *In re Harmon*, 250 F.3d 1240 (9th Cir. 2001).

    - Under Full Faith and Credit Act, the preclusive effect of a state court judgment in a subsequent bankruptcy is determined by the preclusion law of the state in which the judgment was issued.
        - *In re Comer*, 723 F.2d 737 (9th Cir. 1984)
        - *Daghighfekr v. Mekhail (In re Daghighfekr)*, 161 B.R. 685, 687 (B.A.P. 9th Cir. 1993)
        - *Roussos v. Michaelides (In re Roussos)*, 251 B.R. 86, 92 (B.A.P. 9th Cir. 2000)

        - The Bankruptcy Court must rely on a pre-bankruptcy judgment as to the amount of a debt, but may provide a new judgment excepting the debt from discharge under § 523
            - *Sasson v. Sokoloff (In re Sasson)*, 424 F.3d 864 (9th Cir. 2005)

    - Issue preclusion has five elements: (1) an issue was actually litigated in a previous proceeding, (2) there was a full and fair opportunity to litigate the issue, (3) resolution of the issue was essential to the decision, (4) a valid and final decision on the merits was entered, (5) and there is common identity of parties. *Hullett v. Cousin*, 63 P.3d 1029, 1035 (Ariz. 2003) (*citing Collins v. Miller & Miller, Ltd.*, 943 P.2d 747, 757 (Ariz. Ct. App. 1996)).

    - Bankruptcy Court's grant of summary judgment as to preclusive effect of default judgment was not an abuse of discretion where Debtor had full and fair opportunity to represent his own interests during the underlying state court litigation. *See In re Baloch*, 2014 WL 764357 (B.A.P. 9th Cir. 2014)

- Standard of proof for § 523 exceptions to discharge is ordinary preponderance of the evidence standard. *See Grogan v. Garner*, 498 U.S. 279, 286 (1991).

Code § 523(a)(2)

- §§ 523(a)(2)(A) and 523(a)(2)(B) are (at least somewhat) mutually exclusive.
    - § 523(a)(2)(B) requires a statement in writing. § 523(a)(2)(A) does not.
    - § 523(a)(2)(B) involves a statement respecting the debtor's or an insider's financial condition. § 523(a)(2)(A) involves a statement "other than a statement respecting the debtor's or an insider's financial condition."
    - § 523(a)(2)(B) is commonly referred to as "false financial statement fraud" as it typically involves a claim that the debtor issued a financial statement that materially misrepresented the debtor's financial condition in order to induce the creditor to extend credit.
    - § 523(a)(2)(A) involves other types of false representations.
- To except a claim from discharge under § 523(a)(2)(B) a creditor must prove (1) a representation of fact by the debtor, (2) that was material, (3) that the debtor knew at the time to be false, (4) that the debtor made with the intention of deceiving the creditor, (5) upon which the creditor relied, (6) that the creditor's reliance was reasonable, (7) that damage proximately resulted from the representation. *In re Candland*, 90 F.3d 1466, 1469 (9th Cir. 1996), *as amended* (Oct. 2, 1996).
- The standard for excepting a debt from discharge as a fraudulent representation within the meaning of § 523(a)(2)(A) is not reasonable reliance but the less demanding one of justifiable reliance on the representation. *Field v. Mans*, 516 U.S. 59 (1995).
- Under Section § 523(a)(2)(A), the creditor must show actual intent, not merely intent implied in law, or constructive intent. The requisite intent may, however, be inferred from the totality of the surrounding circumstances. *Dakota Steel, Inc.*, 284 B.R. 711, 721 (Bankr. N.D. Cal. 2002) (*citing In re Anastas*, 94 F.3d 1280 (9th Cir. 1996)).
- The fraud exception to dischargeability includes compensatory damages, punitive damages, and treble damages authorized by state statute. *Cohen v. de la Cruz*, 523 U.S. 213 (1998).
- Once a portion of money has been obtained from a creditor by fraud, the full amount of that creditor's claim is subject to being excepted from discharge
    - *Cohen v. de la Cruz, et al.*, 523 U.S. 213 (1998)
    - *Ghomeshi v. Sabban (In re Sabban)*, 600 F.3d 1219 (9th Cir. 2010)

- *Muegler v. Bening*, 413 F.3d 980 (9th Cir. 2005)
- *Kadjevich v. Kadjevich (In re Kadjevich)*, 220 F.3d 1016 (9th Cir. 2000)

- Intentional use of loan proceeds other than as agreed between lender and borrower is fraud making the debt non-dischargeable under § 523(a)(2)
  - *Gosney v. Law (In re Gosney)*, 205 B.R. 418 (B.A.P. 9th Cir. 1996) *aff'd*, 161 F.3d 12 (9th Cir. 1998)

- A debtor's failure to disclose material facts constitutes a fraudulent omission under § 523(a)(2)(A) if the debtor was under a duty to disclose and the omission was motivated by an intent to deceive. *Harmon v. Kobrin (In re Harmon)*, 250 F.3d 1240, 1246 n.4 (9th Cir. 2001).

Code § 523(a)(4)

- § 523(a)(4) excepts from discharge a debt for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

  - Note the distinction between fraud and defalcation. Defalcation only requires a "willful neglect of duty"—that plaintiff prove that trust assets were expended for purposes other than those allowed for by the trustee agreement or statute—fraud is not required

    - In *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182 (9th Cir. 1996), the Ninth Circuit held that "defalcation includes the innocent default of a fiduciary who fails to account fully for money received," and that "an individual may be liable for defalcation without having the intent to defraud."

  - "The meaning of 'fiduciary capacity' under section 523(a)(4) is a question of federal law, which has consistently limited this term to express or technical trust relationships." *In re Baird*, 114 B.R. 198, 202 (B.A.P. 9th Cir. 1990) (concluding that "an officer who causes a corporate trustee to commit a breach of trust causing loss to the trust administered by the corporation is personally liable to the beneficiaries for the loss"). State statutes that refer to funds as trust funds but do not explicitly impose specific and detailed duties with respect to those funds create true fiduciary relationships for dischargeability purposes. *Id.* at 203.

  - If an otherwise ordinary financing contract requires the borrower to hold funds "in trust," an express trust is not created for purposes of section 523(a)(4). *Nat'l Gold Exch., Inc. v. Stern (In re Stern)*, 403 B.R. 58, 66 (Bankr. C.D. Cal. 2009) ("Neither a floor plan financing relationship between debtor and creditor nor an insurance agent's indebtedness for premiums paid created a trust relationship of the kind

mentioned in § 523(a)(4)”). Without the actual imposition of fiduciary duties, the court will consider such language evidencing a trust as “mere boiler plate.” *In re Chick*, 53 B.R. 697, 702–03 (Bankr. D. Or. 1985)

Code § 523(a)(6)

- 523(a)(6) excepts from discharge a debt “for willful and malicious injury by the debtor to another entity or to the property of another entity.” For the purposes of this section, the injury must be willful (intentional) and malicious (without just cause). The case law requires that the debtor must not only intend the act, but the injury, as well. *Kawaauhua v. Geiger*, 523 U.S. 57 (1998.)
  - There are two typical scenarios. The first is an intentional tort. The second is where the debtor sells the collateral of a secured creditor and does not remit the proceeds to the creditor (a state law conversion action).
    - “The Ninth Circuit . . . has consistently held since *Geiger* that conversion is not per se a willful and malicious injury to property of another.” *Morley v. Gamache (In re Gamache)*, 2007 Bankr. LEXIS 404, at *4-5 (Bankr. D. Ariz. Feb. 5, 2007). However, other findings of fact regarding intent and malice can make a conversion claim nondischargeable under § 523(a)(6). *Tomkow v. Barton (In re Tomkow)*, 563 B.R. 716, 729 (B.A.P. 9th Cir. 2017).

- For a debt connected to a breach of contract to be excepted from discharge under § 523(a)(6), the breach “must be accompanied by some form of ‘tortious conduct’ that gives rise to ‘willful and malicious injury.’” *Lockerby v. Sierra*, 535 F.3d 1038, 1041 (9th Cir. 2008). In addition, conduct is tortious only if it constitutes a tort under state law. *Id.* “It is well settled that a simple breach of contract is not the type of injury addressed by § 523(a)(6).” *In re Riso*, 978 F.2d 1151, 1154 (9th Cir. 1992).

- Damages resulting from a fraudulent scheme or a pattern of intentional conduct that necessarily results in an injury may be nondischargeable under § 523(a)(6). *See, e.g., Murray v. Bammer (In re Bammer)*, 131 F.3d 788, 791 (9th Cir. 1997), (scheme to conceal equity in home from injured victims, pre *Kawaauhau v. Geiger*, 523 U.S. 57 (1998)); *Johnson v. JP Morgan Chase Bank*, 395 B.R. 442, 448 (E.D. Cal. 2008) (refusing to dismiss complaint that alleged a fraudulent scheme to injure); *Kim v. Michel (In re Kim)*, 2006 WL 6810943, at *3 (B.A.P. 9th Cir. March 17, 2006) (*affirming* bankruptcy court’s non-dischargeability judgment based on pattern of intentional concealment of property issues); *see generally* 4 COLLIER ON BANKRUPTCY ¶ 523.12[1] (16th ed. 2014) (by its terms, § 523(a)(6) applies to “broad range of conduct”).

STANDARDS IN PRO SE LITIGATION

As the Court unanimously held in *Haines v. Kerner,* 404 U.S. 519 [92 S.Ct. 594, 30 L.Ed.2d 652] (1972), a pro se complaint, "however inartfully pleaded," must be held to "less stringent standards than formal pleadings drafted by lawyers" and can only be dismissed for failure to state a claim if it appears " 'beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.' " *In re Nordeen*, 495 B.R. 468, 477 (B.A.P. 9th Cir. 2013)

The courts are to make reasonable allowances for *pro se* litigants and are to construe *pro se* papers and pleadings liberally. *Read v. Duck (In re Jacksen),* 105 B.R. 542, 543 (9th Cir. BAP 1989) (*citing McCabe v. Arave,* 827 F.2d 634, 640 n. 6 (9th Cir.1987)). *In re Kashani*, 190 B.R. 875, 883 (B.A.P. 9th Cir. 1995)

But despite liberal construction, *pro se* litigants are still required to abide by court rules. *Arnold v. Gill (In re Arnold),* 252 B.R. 778, 781 n. 2 (9th Cir. BAP 2000). *In re Jensen-Edwards,* 535 B.R. 336, 339, n. 2 (Bankr. D. Idaho 2015). Ignorance of court rules does not constitute excusable neglect, even if a litigant appears *pro se. Briones v. Riviera Hotel & Casino,* 116 F.3d 379, 381 (9th Cir.1997) (*quoting Swimmer v. IRS,* 811 F.2d 1343, 1345 (9th Cir.1987)); *King v. Atiyeh,* 814 F.2d 565, 567 (9th Cir.1987) ("Pro se litigants must follow the same rules of procedure that govern other litigants."). *In re Hofman*, 488 B.R. 157, 162 (Bankr. D. Mont. 2013)

Proceeding pro se with full knowledge and understanding of the risks does so with no greater rights than a litigant represented by a lawyer, and the trial court is under no obligation to become an 'advocate' for or to assist and guide the pro se layman through the trial thicket." *Jacobsen,* 790 F.2d at 1365 n. 5 (quoting *United States v. Pinkey,* 548 F.2d 305 (10th Cir.1977)). *In re Manning,* 2013 WL 4428761, at *9 (B.A.P. 9th Cir. Aug. 19, 2013)

A party's lack of counsel may be considered in evaluating the willfulness of discovery violations and the failure to obey court orders and in weighing the other factors regarding dismissal, but *pro se* status does not excuse intentional noncompliance with discovery rules and court orders. *See Lindstedt v. City of Granby,* 238 F.3d 933, 937 (8th Cir.2000) (affirming the imposition of the sanction of dismissal and holding that "[a] pro se litigant is bound by the litigation rules as is a lawyer, particularly here with the fulfilling of simple requirements of discovery"); *Gordon v. County of Alameda,* 2007 WL 1750207, at *5 (N.D.Cal. June 15, 2007) ("pro se plaintiffs must abide by the rules of discovery, and when they fail to do so in bad faith dismissal is warranted"). The severe sanction of dismissal with prejudice may be imposed even against a plaintiff who is proceeding pro se, so long as a warning has been given that noncompliance can result in dismissal," because "all litigants, including pro ses, have an obligation to comply with court orders." *Valentine v. Museum of Modern Art,* 29 F.3d 47, 50 (2d Cir.1994) (affirming Rule 37(b)(2) dismissal of *pro se* plaintiff's case in view of his failure to appear for deposition "in the face of repeated and explicit warnings from the court that the refusal to comply with court orders to appear for his deposition would result in the dismissal of his action"). *Sanchez v. Rodriguez*, 298 F.R.D. 460, 470 (C.D. Cal. 2014)