2010 California Conference on Self-Represented Litigants

BANKRUPTCY AND WHAT IT MEANS TO THE CLAIMANT IN SMALL CLAIMS COURT

Presented by: Hon. Ronald H. Sargis
United States Bankruptcy Court
Eastern District of California
April 30, 2010
10:30 - 12:00

Judicial Council of California
Administrative Office of the Courts

I. The Art of Collections

A. Words of Wisdom From Coach Lou Holtz – "What's Important Now."

1. Separating the "teaching a lesson" bias from obtaining payment on the judgment recovery.

2. Is the debt really non-dischargeable?

3. Non-dischargeable vs. unfair.

II. Bankruptcy

A. The Purpose of the Discharge

B. Exceptions to Discharge

1. Fraud

2. Breach of Fiduciary Duty

3. Wilful and Malicious Injury to Person or Property

III. The *Pro Se* in Bankruptcy Court

A. Frustration of a Second Court Proceeding.

B. Bankruptcy Proceedings Geared to Granting of a Discharge.

C. Federal Rules of Civil Procedure.

1. Not Informal Procedure of Small Claims Court.

D. No Moral Outrage That a Judgment is Not Paid.

E. Identifying the Real Issues In a Non-Dischargeability Action.

IV. Proving Non-Dischargeability

A. Issue Preclusion of Non-Dischargeability Issues For the State Court Judgment

1. *Khaligh v. Hadaegh* (*In re Khaligh*) 338 B.R. 817 (9th Cir. BAP 2006)

> The narrow question is whether issues that were actually litigated and necessarily decided in the course of obtaining an arbitration award that was confirmed as a judgment by a California court are eligible for issue preclusive effect under California law.
>
> If so, then issue preclusion may be applied in subsequent bankruptcy nondischargeability litigation. *Grogan v. Garner,* 498 U.S. 279, 284-85 n.11, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991).
>
> If a state court would give preclusive effect to a judgment rendered by courts of that state, then the Full Faith and Credit Statute (28 U.S.C. § 1738) imports the same consequence to an action in federal court based on the same award. *McDonald v. City of W. Branch*, 466 U.S. 284, 287, 104 S. Ct. 1799, 80 L. Ed. 2d 302 (1984); *Harmon v. Kobrin* (*In re Harmon*), 250 F.3d 1240, 1245 (9th Cir. 2001)....
>
> The basic features of California issue preclusion law were restated by the California Supreme Court in *Lucido v. Superior Ct., 51 Cal. 3d 335, 341-43, 272 Cal. Rptr. 767, 795 P.2d 1223, 1225-27 (1990),* and then qualified with respect to arbitration awards in *Vandenberg v. Superior Ct., 21 Cal. 4th 815, 824, 88 Cal. Rptr. 2d 366, 982 P.2d 229, 234 (1999).*
>
> Six basic elements must be satisfied before issue preclusion will be applied. Five of the elements are described as "threshold" requirements: (1) identical issue; (2) actually litigated in the former proceeding; (3) necessarily decided in the former proceeding; (4) former decision final and on the merits; and (5) party against whom preclusion sought either the same, or in privity with, party in former proceeding.
>
> The sixth element is a mandatory "additional" inquiry into whether imposition of issue preclusion in the particular setting would be fair and consistent with sound public policy. *Lucido, 51 Cal. 3d at 341-43, 795 P.2d at 1225-27*; [3] 1 ANN TAYLOR SCHWING, CAL. AFFIRMATIVE DEFENSES § 15:4 (2005 ed.) ("SCHWING").

B. Common Non-Dischargeability Pitfalls in State Court Judgments

1. Judgment not Clear as to Legal Basis on Which the Judgment is Based.

2. Elements of Non-Dischargeable Claim Not Stated in Judgment or Findings of Fact and Conclusions of Law in Support of Judgment.

V. Fraud

A. Statute

11 U.S.C. §523(a)(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;
>
> (B) use of a statement in writing--
>
> > (i) that is materially false;
> > (ii) respecting the debtor's or an insider's financial condition;
> > (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
> > (iv) that the debtor caused to be made or published with intent to deceive;
> > ....

B. *Turtle Rock Meadows Homeowners Ass'n v. Slyman* (*In re Slyman*), 234 F.3d 1081 (9th Cir. 2000).

> Under §523(a)(2)(A) of the Bankruptcy Code, a debt for services obtained by the debtor under "false pretenses, a false representation, or actual fraud" is nondischargeable. 11 U.S.C. §523(a)(2)(A) (2000). "The purposes of this provision are to prevent a debtor from retaining the benefits of property obtained by fraudulent means and to ensure that the relief intended for honest debtors does not go to dishonest debtors." 4 Collier on Bankruptcy Par. 523.08[1][a] (15th ed. rev. 2000).
>
> Consistent with these purposes, the Ninth Circuit has consistently held that a creditor must demonstrate five elements to prevail on any claim arising under §523(a)(2)(A). See, e.g., *Britton v. Price* (*In re Britton*), 950 F.2d 602, 604 (9th Cir. 1991). The five elements, each of which the creditor must demonstrate by a preponderance of the evidence, are: (1) misrepresentation, fraudulent omission or deceptive conduct by the debtor; (2) knowledge of the falsity or deceptiveness of his statement or conduct; (3) an intent to deceive;

(4) justifiable reliance by the creditor on the debtor's statement or conduct; and (5) damage to the creditor proximately caused by its reliance on the debtor's statement or conduct. *American Express Travel Related Servs. Co. v. Hashemi* (*In re Hashemi*), 104 F.3d 1122, 1125 (9th Cir. 1997); *Citibank (South Dakota), N.A. v. Eashai* (*In re Eashai*), 87 F.3d 1082, 1086 (9th Cir. 1996).

VI. Fraud or Defalcation while action in a fiduciary capacity, embezzlement, or larceny.

A. 11 U.S.C. §523(a)(4)

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

B. *Blyler v. Hemmeter* (*In re Hemmeter*), 242 F.3d 1186 (9th Cir. 2001).

Whether a person is a fiduciary under §523(a)(4) is a question of federal law. *Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1185 (9th Cir. 1996) (citing *Ragsdale v. Haller (In re Haller)*, 780 F.2d 794, 795 (9th Cir. 1986)). The origins of the fiduciary capacity discharge exception date to the Bankruptcy Act of 1841. 5 Stat 440. From 1884 to the present, courts have construed "fiduciary" in the bankruptcy discharge context as including express trusts, but excluding trusts ex maleficio, i.e., trusts that arose by operation of law upon a wrongful act. *Davis v. Aetna Corp.*, 293 U.S. 328, 333, 79 L. Ed. 393, 55 S. Ct. 151 (1934); *Chapman v. Forsyth*, 43 U.S. 202, 2 HOW 202, 208, 11 L. Ed. 236 (1844). We have adhered to this construction in interpreting the scope of 11 U.S.C. §523(a)(4), refusing to deny discharge to those whose fiduciary duties were established by constructive, resulting and implied trusts. *Runnion v. Pedrazzini* (*In re Padrazzini*), 644 F.2d 756, 758 (9th Cir. 1981); *Schlecht v. Thornton* (*In re Thornton*), 544 F.2d 1005, 1007 (9th Cir. 1976)." The core requirements are that the relationship exhibit characteristics of the traditional trust relationship, and that the fiduciary duties be created before the act of wrongdoing and not as a result of the act of wrongdoing." *Runnion*, 644 F.2d at 758. Fiduciary relationships imposed by statute may cause the debtor to be considered a fiduciary under §523(a)(4). *Quaif v. Johnson*, 4 F.3d 950, 953-54 (11th Cir. 1993); *Runnion*, 644 F.2d at 758 n. 2. In general, a statutory fiduciary is considered a fiduciary for the purposes of §523(a)(4) if the statute: (1) defines the trust res; (2) identifies the fiduciary's fund management duties; and (3) imposes obligations on the fiduciary prior to the alleged wrongdoing. Cf. *Windsor v. Librandi*, 183 B.R. 379, 383 (M. D. Pa. 1995) (discussing whether a fiduciary under state securities act qualifies as a fiduciary under §523). See also *Runnion*, 644 F.2d at 759...

Holding that statutory ERISA fiduciaries qualify as fiduciaries under §523(a)(4) does not end our inquiry. We must also decide whether the violations of those duties alleged in the complaint are viable claims for defalcation under §523(a)(4). The definition of defalcation includes both the "misappropriation of trust funds or money held in any fiduciary capacity; [and the] failure to properly account for such funds." *Lewis*, 97 F.3d at 1186 (quoting Black's Law Dictionary 417 (6th ed. 1990)). Even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required. *F.D.I.C. v. Jackson*, 133 F.3d 694, 703 (9th Cir. 1998); *Lewis*, 97 F.3d at 1186.

However, regardless of the mens rea required, the essence of defalcation in the context of §523(a)(4) is a failure to produce funds entrusted to a fiduciary. *Quaif*, 4 F.3d at 954. This concept does not embrace the normal acts within the business judgment of the fiduciary that, however flawed, do not involve failure to account for or produce a beneficiary's funds. Thus, we have declined to extend the concept of defalcation to include the acts alleged by the Plan Participants. There are no allegations of accounting failure or misappropriation. Rather, the Plan Participants allege only damages resulting from a decline in value of the MK stock, in which the Plans were specifically authorized to invest. Thus, although we have as yet not fully defined the contours of defalcation under §523(a)(4), the breach of duties alleged by the Plan Participants with respect to the ESOP and 401K Plans does not amount to a "defalcation while acting in a fiduciary capacity" within the meaning of §523(a)(4).

VII. Willful and Malicious Injury

A. Statute

(6) willful and malicious injury by the debtor to another entity or to the property of another entity

B. *Ormsby v. First Am. Title Co.* (*In re Ormsby*), 591 F.3d 1199 (9th Cir. 2010).

The Supreme Court in *Kawaauhau v. Geiger (In re Geiger), 523 U.S. 57, 118 S. Ct. 974, 140 L. Ed. 2d 90 (1998),* made clear that for *section 523(a)(6)* to apply, the actor must intend the consequences of the act, not simply the act itself. *Id. at 60*. Both willfulness and maliciousness must be proven to block discharge under *section 523(a)(6).*

In this Circuit, " § 523(a)(6)'s willful injury requirement is met only when the debtor has a subjective motive to inflict injury or when the debtor believes that injury is substantially certain to result from his own conduct." *Carrillo*

v. Su (*In re Su*), 290 F.3d 1140, 1142 (9th Cir. 2002). The Debtor is charged with the knowledge of the natural consequences of his actions. *Cablevision Sys. Corp. v. Cohen* (*In re Cohen*), 121 B.R. 267, 271 (Bankr. E.D.N.Y. 1990); see *Su*, 290 F.3d at 1146 ("In addition to what a debtor may admit to knowing, the bankruptcy court may consider circumstantial evidence that tends to establish what the debtor must have actually known when taking the injury-producing action.").

"A malicious injury involves (1) a wrongful act, (2) done intentionally, (3) which necessarily causes injury, and (4) is done without just cause or excuse." *Petralia v. Jercich* (*In re Jercich*), 238 F.3d 1202, 1209 (9th Cir. 2001) (internal citations omitted). Malice may be inferred based on the nature of the wrongful act. See *Transamerica Commercial Fin. Corp. v. Littleton* (*In re Littleton*), 942 F.2d 551, 554 (9th Cir. 1991). 7 To infer malice, however, it must first be established that the conversion was willful. See *Thiara*, 285 B.R. at 434.