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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
FRESNO DIVISION

In re Craig Raymond Mundy and Angela Sue Mundy, Debtors.	Case No. 14-14382-B-7
MUFG Union Bank, N.A., fka Union Bank, N.A., Plaintiff, v. Craig Raymond Mundy and Angela Sue Mundy, Defendants.	Adversary Proc. No. 15-1013

ORDER DISMISSING ADVERSARY PROCEEDING WITH PREJUDICE

Mark A. Serlin, Esq., of Serlin & Whiteford, LLP, appeared on behalf of the plaintiff, MUFG Union Bank, N.A., fka Union Bank, N.A.

Marshall D. Moushigian, Esq., of the Law Office of Marshall D. Moushigian, appeared on behalf of the debtors, Craig Raymond Mundy and Angela Sue Mundy.

This adversary proceeding was initiated by MUFG Union Bank, N.A., fka Union Bank, N.A. (the "Bank") to determine the dischargeability of its claim against the debtor, Craig Raymond Mundy (the "Debtor"). The Bank also seeks relief against the co-debtor, Angela Sue Mundy (collectively, the Debtor and his wife are referred to as the "Debtors"). The Bank has now made three attempts to plead a plausible claim for relief. The court has twice dismissed *sua sponte* the Bank's complaints with leave to amend in response to the court's concerns. For

the reasons set forth below, it does not appear that the Bank can plead a claim sufficient to except its claim from discharge under any subsection of 11 U.S.C. § 523 and the adversary proceeding will be dismissed with prejudice.

For purposes of this ruling, the court must accept as true the factual allegations in the operative pleadings. Therefore, no findings of fact are necessary or appropriate. This order does contain the court's conclusions of law. The court has jurisdiction over this matter under 28 U.S.C. § 1334 and 11 U.S.C. § 523[1] and General Orders 182 and 330 of the U.S. District Court for the Eastern District of California. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I).

Procedural Background.

The Bank timely filed this adversary proceeding on January 28, 2015. The original complaint included three claims for relief seeking (1) complete denial of the Debtors' discharge under subsections 727(a)(2) & (4); (2) exception of the Bank's entire claim from the chapter 7 discharge under § 523(a)(6); and (3) the imposition of a constructive trust against the Debtors' house. The Debtors filed a motion to dismiss (Docs. No. 8-12) which the Bank opposed. (Doc. No. 18.) The Debtors requested that the complaint be dismissed with prejudice based on the anticipated expense and hardship of having to defend "unnecessary" litigation. The dismissal motion was heard and denied on April 30, 2015. However, the court *sua sponte* dismissed the original complaint without prejudice for reasons stated on the record relating to the sufficiency of the pleadings.

In a civil minute order dated April 30, 2015 (Doc. No. 28), the court set a date by which the amended complaint had to be filed and directed that no

[1]Unless otherwise indicated, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as enacted and promulgated *after* October 17, 2005, the effective date of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, Apr. 20, 2005, 119 Stat. 23.

responsive pleading was required unless and until ordered by the court after review of the sufficiency of any new factual allegations. The Bank filed its first amended complaint on May 8, 2015 (Doc. No. 33) and a further status conference was held on May 28.

The first amended complaint essentially repled the same three claims for relief. After reviewing the pleadings, the court *sua sponte* dismissed the first amended complaint with leave to amend for reasons stated on the record relating to the sufficiency of the pleadings. By civil minute order dated May 28, 2015 (Doc. No. 37), the court again directed that no responsive pleading would be required unless so ordered at a later hearing.

The operative pleading now before the court, the second amended complaint (the "SAC"), was filed on June 9, 2015 (Doc. No. 41). In the SAC, the Bank dropped the § 727 objection to discharge in response to questions previously raised by the court. At the status conference on June 25, 2015, the court again expressed concerns about the sufficiency of the pleadings and the theories for relief with regard to the remaining two claims for relief. After oral argument, the court took the matter under submission to consider an appropriate disposition.

Background.

This ruling is based upon facts as alleged in the Bank's SAC as well as matters that appear in the record which have been judicially noticed. *See United States v. Ritchie*, 342 F.3d 903, 908 (9th Cir. 2003) (allowing the court to consider matters properly subject to judicial notice in a motion to dismiss). However, this decision deals solely with the sufficiency of the Bank's pleadings and all factual allegations must be accepted as true. Accordingly, nothing in the discussion that follows constitutes a finding of fact.

The Debtor is a dentist and has worked in that profession for many years. The co-Debtor is a dental hygienist. Both of the Debtors were employed by the Debtor's professional corporation, Craig R. Mundy DDS, Inc. (the "Dental

Corp."). They report a combined gross monthly income from their services of approximately $9,100.

The Debtors commenced this bankruptcy with the filing of a chapter 7 petition on September 2, 2014. On Schedule B, the Debtors listed personal property including their interest in the Dental Corp., valued at $0, various deposit accounts and retirement accounts, and five term and whole life insurance policies valued at approximately $5,300.[2] The schedules report unsecured debts totaling more than $608,000. The Debtor apparently closed his dental practice prior to, or in conjunction with, the bankruptcy. All but three of the unsecured debts (less than $10,000) listed on Schedule F are described as "business obligation." On Schedule G, the Debtor states his intention to reject the lease for his dental office.[3]

The life insurance policies at issue in this adversary proceeding are identified in the schedules as a "Whole Life Policy" written by Massachusetts Mutual, valued at $1,620, and a "First to Die policy" written by Principal Financial valued at $3,706 (together, the "Policies"). The full value of the Policies was claimed as exempt under Cal. Code of Civil P. ("CCP") § 704.100(a). The Debtors did not list any of the life insurance companies as creditors on Schedule F, however, they did disclose on Schedule J the monthly payment of a "Loan against Life Insurance/Health Savings Account" in the amount of $1,140.

On Schedule A, the Debtors listed their single-family residence located on Andrews Avenue in Fresno, California (the "Residence"). They valued the Residence at $208,992 with an underlying mortgage of approximately $130,000.[4]

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[2]The Debtors did not separately list the dental equipment or accounts receivable related to the Dental Corp.

[3]On April 30, 2015, the Bank filed a motion for relief from the § 362 automatic stay to pursue its remedies against the dental equipment held by the Dental Corp. The motion was unopposed and was granted on May 14, 2015.

[4]The mortgage is held and/or serviced by Citadel Servicing Corporation.

The Debtors exempted the full amount of the equity in their Residence pursuant to CCP § 704.730. The chapter 7 trustee determined that the Debtors had no nonexempt assets and issued a no-asset report on November 25, 2014. The Debtors' discharge was entered August 4, 2015, and the case appears ready to close after final resolution of this adversary proceeding.

In the SAC, the Bank alleges the following material facts which are relevant to the dischargeability issue:

1. Prior to formation of the Dental Corp., the Bank made a business loan to the Debtor for use in his dental practice (the "Business Loan"). Exhibit "A" attached to the SAC is a copy of the security agreement for the Business Loan showing that the Loan was made to Craig R. Mundy DDS on or about January 15, 2011.[5]

2. The Business Loan was secured by all of the Debtor's personal property and the proceeds thereof (the "Collateral"). Exhibit "B" attached to the SAC is a copy of the UCC-1 financing statement filed with the California Secretary of State on January 27, 2011. The security agreement describes the Bank's Collateral as follows:

> *All present and hereafter acquired personal property* including but not limited to all accounts, chattel paper, instruments, *contract rights*, general intangibles, goods, equipment, inventory, documents, certificates of title, deposit accounts, returned or repossessed goods, fixtures, commercial tort claims, insurance claims, rights and *policies*, letter of credit rights, investment property, supporting obligations, *and the proceeds*, products, parts, accessories, attachments, accessions, replacements, substitutions, additions, and improvements of or to each of the foregoing. (Emphasis added.)

3. Sometime in March 2014, the Debtors borrowed approximately $100,000 against the cash surrender value of the Policies and used that money to help purchase the Residence (the "Policy Loan"). The Debtors did not give the

[5]The Bank alleges in its prior pleadings that the Dental Corp. was formed in March 2014, and that all of the assets related to the Debtor's "sole proprietorship'" dental practice were transferred to the Dental Corp.

Bank notice of their intent, or get the Bank's consent to "effectively cash out" the Policies.

4. In May 2014, the Debtor defaulted on the Business Loan by failing to make the payments when they came due. The amount owed at the commencement of this adversary proceeding was approximately $364,000, plus interest and attorney's fees (the "Bank's Claim").

Issues Presented.

The Bank contends that the Policies were part of the Bank's Collateral, that the money which the Debtor "cashed out" with the Policy Loan was "proceeds" of the Collateral, and that the Debtor is liable for conversion of those proceeds by not paying them over to the Bank. The ultimate issue addressed in this ruling is whether the SAC contains "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). If not, the court must decide whether the Bank should be granted leave to amend its pleadings a third time.

The Bank's case is rooted in the theory of the "conversion" under California law and the statutory exceptions to discharge under bankruptcy law. Assuming for now, without deciding, that the Policy Loan constituted proceeds of the Bank's Collateral, this ruling turns on the following question: do the factual allegations plausibly suggest that the Debtor borrowed against the Policies to help fund the purchase of the Residence with subjective intent to injure the Bank, or a belief that injury to the Bank was substantially certain?

Analysis and Conclusions of Law.

Bankruptcy relief is afforded to the honest but unfortunate debtor. Exceptions from discharge are construed narrowly and generally represent social policy in the allocation of liability. For example, claims for injuries under certain specific conditions, such as those that result when a debtor is driving under the influence, are *per se* nondischargeable. § 523(a)(9). However, other exceptions to

discharge are limited to circumstances where the debtor possesses some moral culpability and require some level of scienter.

Conversion and the Willful and Malicious Injury Standard. The Bank contends its claim should be excepted from discharge pursuant to § 523(a)(6). Section 523(a)(6) applies to those debts which arise from willful and malicious injuries by the debtor to persons or property. The plaintiff bears the burden of proof, and the two elements, willfulness and malice, must be pled separately. *Albarran v. New Form, Inc. (In re Barboza)*, 545 F.3d 702, 706 (9th Cir. 2008). As the Supreme Court explained the first element of a § 523(a)(6) claim in *Kawaauhau v. Geiger*, 523 U.S. 57, 61, 118 S.Ct. 974 (1998), "[t]he word 'willful' in (a)(6) modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional *injury*, not merely a deliberate or intentional *act* that leads to injury." (Emphasis in original.) This does not include injuries which are neither desired nor anticipated by the debtor. *Id.* The "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." *In re Ormsby*, 591 F.3d 1199, 1206 (9th Cir. 2010) (citation omitted).

In order to plead the "malice" element of § 523 (a)(6) claim, the plaintiff must include facts to show that it is plausible that plaintiff's injuries were the result of, "(1) a wrongful act, (2) done intentionally, (3) which necessarily causes injury, and (4) is done without just cause or excuse." *Ormsby*, 591 F.3d at 1207.

"Although federal law determines the nondischargeability of a debt, state law governs the elements of a conversion respecting property." *Thiara v. Spycher Brothers (In re Thiara)*, 285 B.R. 420, 427 (9th Cir. BAP 2002) (citation omitted). Under California law, conversion constitutes the debtor's "wrongful exercise of dominion over the personal property of another." *Id.* at 429. The act of conversion can apply to the wrongful withholding of a secured creditor's collateral. *Id.* at 428. However, the act of conversion "does not necessarily decide

the type of wrongful intent on the part of the debtor that is necessary for the damages to be a nondischargeable debt under § 523(a)(6)." *Id.* at 429 (citations omitted). "The court must also find that the conversion was intentional, as defined in *Geiger* and its progeny." *Id.*

"The conversion of another's property without his knowledge or consent, done intentionally and *without justification and excuse, to the other's injury*, constitutes a willful and malicious injury within the meaning of § 523(a)(6)." *Petralia v. Jercich (In re Jercich)*, 238 F.3d 1202, 1208 (9th Cir. 2011) (footnote omitted) (emphasis added).

Rule 12(b)(6) and the Twombly/Iqbal Pleading Standards. Under current federal pleading practice, the plaintiff's "'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do . . . ." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007) (citation omitted). The court has an affirmative obligation to review the underlying factual allegations and supporting evidence to make sure the plaintiff has pleaded and can prove its *prima facie* case. In light of the new heightened pleading standard established by the Supreme Court in *Twombly*, 550 U.S. 544 and *Iqbal*, 556 U.S. at 662, the plaintiff must plead more than a recitation of the underlying statute with the mere possibility of damages. The bankruptcy court cannot accept as true any legal conclusions couched as factual allegations. *See Twombly*, 550 U.S. at 555 (citing *Papasan v. Allain*, 478 U.S. 265, 286 (1986)).

The potential for abuse in the filing of dischargeability complaints, together with the more rigid pleading standards now applicable in the federal courts, underscore the importance of judicial scrutiny of a complaint filed against debtors who often cannot defend themselves. *See AT&T Universal Card Servs. Corp. v. Grayson (In re Grayson)*, 199 B.R. 397, 403 (Bankr. W.D. Mo. 1996). That tension was thoughtfully considered by one court in a recent unpublished opinion:

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> A debtor who files leaves all non-exempt assets with a trustee, and seeks to emerge with only his future income, his exempt assets, and a discharge from personal liability. If that debtor is sued by a creditor claiming its debt cannot be discharged, the choice is either to fight the charge, though lacking the resources to pay a lawyer to do so, or simply to settle with the creditor, often agreeing to reaffirm the debt. And this is motivated often by the simple fact that the debtor cannot afford the fight—never mind whether the allegations are well taken or not. . . . It is thus important to apply the *Twombly* standard rigorously to these sorts of complaints.

FIA Card Servs. v. Travis (In re Travis), No. 10-5118-C, 2011 WL 1334387, at *2 (Bankr. W.D. Tex. Apr. 7, 2011) (citing *In re Grayson*, 199 B.R. at 403) (citations omitted) (emphasis in original).

Determining whether a complaint states a plausible claim for relief is a context-specific task that requires the court to draw on its judicial experience and common sense. But where the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged—but it has not "show[n]"—"that the pleader is entitled to relief." Fed. Rule Civ. Proc. 8(a)(2). *Iqbal*, 556 U.S. at 679 (citations omitted).

Dismissal of an adversary proceeding is appropriate where there is no cognizable legal theory or there are insufficient facts alleged to support a cognizable legal theory. *Id.* The court assumes the truth of factual allegations and construes them in the light most favorable to the claimant. *Id* . But the court may disregard conclusions not supported by underlying factual allegations. *Iqbal*, 556 U.S. at 678-79. The court then draws upon its experience and common sense to answer a context-specific question: do the alleged facts support a plausible claim on which relief might be granted? *Id*. at 679. The alleged facts must provide the opposing party fair notice and an opportunity to defend itself effectively, and those facts must suggest it would be fair to subject the opposing party to the expense of defending against the claim. *Eclectic Properties East, LLC v. Marcus & Millichap Co.*, 751 F.3d 990, 996 (9th Cir. 2014) (collecting cases and discussing pleading standards). *Stromberg v. Harder*, No. 15-CV-02765-HRL, 2015 WL 6152780, at *1-2 (N.D. Cal. Oct. 20, 2015).

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The court must therefore scrutinize the Bank's pleadings and the supporting documentary evidence to determine whether it has established at least a plausible *prima facie* case under § 523(a)(6).

The § 523(a)(6) Claim is not Plausible. In support of its first claim for relief, and in addition to the factual allegations summarized above, the Bank alleges conclusively:

> The conversion of proceeds of the Bank's collateral . . . was made with malicious intent to injure the Bank's property and deprive the Bank of its personal property collateral. . . . The conversion of proceeds of the Bank's collateral was . . . a wrongful act, done intentionally, and necessarily and actually caused harm to the Bank, and was done without just cause or excuse.

SAC at 3, ¶10.

Perhaps the biggest problem with the factual allegations in the SAC is that they are void of any basis upon which the court can infer wrongful conduct. The exceptions to discharge require some showing of culpable conduct. *Bullock v. Bankchampaign, N.A.*, 133 S.Ct. 1754, 1761 (2013). "Congress normally confines [the statutory discharge exceptions] to circumstances where strong special policy considerations, such as fault, argue for preserving the debt, thereby benefitting, for example, a typically more honest creditor." *Id.* The statements from paragraph 10 recited above are legal conclusions, not allegations of fact. In the words of the U.S. Supreme Court,

> A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a complaint pleads facts that are merely consistent with a defendant's liability, it stops short of the line between possibility and plausibility of entitlement to relief.

Iqbal, 556 U.S. at 678 (citations and internal quotation marks omitted).

Simply put, the act of borrowing against a common personal asset, such as a life insurance policy, to fund the purchase of another common personal asset, such as a residence, is not the kind of inherently dishonest or culpable conduct from

which the court can infer malice or a subjective intent to cause injury to a specific creditor, even if it was done in preparation for a bankruptcy. The act of converting an asset into exempt property in preparation for a bankruptcy is not *per se* wrongful. *See* 4 *Collier on Bankruptcy* ¶ 522.08[4] at 522-48 (Alan N. Resnick and Henry J. Sommer (16th Ed.) ("The legislative history indicates that under section 522, the debtor may convert nonexempt property into exempt property immediately before commencement of the case.").

This case is wholly unlike the situation which arose in *In re Jercich*, 238 F.3d at 1202. There, the debtor had a legal obligation to pay his employee, had both the funds and the ability to pay his employee, and intentionally directed those funds for other extravagant purposes, the purchase of a horse farm. Mr. Jercich's conscious disregard of his legal duty was inherently wrongful and it necessarily harmed his employee. Here, there was nothing wrong with purchasing the Residence and (assuming the Debtors actually knew the Policies were the Bank's Collateral (discussed below)) there was nothing illegal or inherently culpable about borrowing against the Policies. In the absence of some inherently wrongful conduct, the court must dig even deeper into the factual allegations seeking a plausible claim.

The second problem with the SAC is that the factual allegations would not support a finding, or even an inference of a subjective intent to injure the Bank. Indeed, the circumstances strongly suggest that neither the Debtors, nor the Bank, even knew of or seriously considered the Bank's interest in the Policies in connection with the Business Loan. The Business Loan was made to fund the Debtors' dental practice. The Policies were personal property unrelated to the dental practice. Notwithstanding the reference to "all personal property," "contract rights," and "policies" in the security agreement, the court cannot infer that the Debtor actually understood that his personal life insurance Policies may technically be Collateral for the Business Loan.

Nothing in the security agreement specifically refers to the Policies. The oblique reference to "insurance claims" and "policies" is contained deep within the boilerplate language of the security agreement. Nothing in the SAC suggests that the Bank relied on the Policies for repayment of the Business Loan, or for that matter, that the Bank even knew about the Policies before it reviewed the Debtors' bankruptcy schedules and saw the Policies listed on Schedule B. The Bank apparently never gave notice to the insurance companies of its security interest in the Policies as required to perfect that interest. Pursuant to Cal.Comm.C. § 9312(b)(4), a "security interest in, or claim in or under, any policy of insurance [except a health care insurance receivable], including unearned premiums, may be perfected only by giving written notice of the security interest or claim to the insurer." Unless the Bank complied with this notice requirement, the Bank did not even have a perfected security interest in the Policies. Unless the facts show that the Debtor and the Bank clearly knew of the Bank's interest in the Policies, it is simply not plausible that the Debtor intended to injure the Bank when he borrowed against the Policies.

Finally, the facts as pled do not show that the Policy Loan has necessarily injured the Bank. To begin with, the Debtors are still alive and the Policies appear to still be in existence, notwithstanding the Bank's contention that the Policies were "cashed out" with the Policy Loan. The Bank had no present right to any money from the Policies.[6] Second, the Loan Payment entry on Schedule J suggests that the Debtors are actually trying to repay the Policy Loan, presumably to reinstate the diminished value of the Policies. Third, the Policy Loan was only

[6]The Bank's counsel argued at the hearing that the Bank could have filed a civil action to foreclose and then "cashed out" the Policies on its own. Alternatively, the Bank argued that it could have held a UCC sale of the Policies and liquidated them for an unknown amount. Neither of these actions were in process when the bankruptcy was filed and the suggestion of damages here is simply too speculative to satisfy the "plausibility" test.

$100,000. Nothing in the SAC discloses the "death benefit" value of the Policies. Assuming the Business Loan is secured by the Policies, if the Debtors were to die tomorrow, it is quite probable that the Policies would still pay enough to satisfy the remaining balance of the Business Loan.[7]

The Constructive Trust Claim. The Bank's second claim for relief seeks the imposition of a constructive trust on the Debtors' Residence for the value of its "converted" collateral. "A constructive trust is an involuntary equitable trust created by operation of law as a *remedy to compel the transfer of property from the person wrongfully holding it to the rightful owner*. The essence of the theory of constructive trust is to prevent unjust enrichment and *to prevent a person from taking advantage of his or her own wrongdoing*." *Meister v. Mensinger*, 230 Cal. App. 4th 381, 399 (2014), reh'g denied (Oct. 30, 2014) (citations omitted) (emphasis added). Since the right to such a remedy depends, *inter alia*, on the Bank's ability to plead a plausible claim for wrongdoing under § 523(a)(6), the court need not address the constructive trust issue.[8]

Dismissal with Prejudice. Civil Rule 15(a)(2), incorporated by FRBP 7015, permits amendment of the Bank's pleadings only with the Debtor's consent or leave of the court. Such leave to amend "should freely" be given "when justice so requires." *Id*. However, "liberality in granting leave to amend is subject to several limitations." *Ascon Props., Inc. v. Mobil Oil Co.*, 866 F.2d 1149, 1160 (9th Cir. 1987). For example, where amendment would cause the defendants undue prejudice, would be futile, or create undue delay, leave need not be granted.

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[7]The court has raised this issue with the Bank at each status conference and requested more information regarding the face value and the "death benefit" of the Policies. The Bank has declined to divulge that information which further illustrates that the Bank did not even know about the Policies before the bankruptcy was filed.

[8]Even if the Bank were to prevail on its § 523(a)(6) conversion claim, it is not clear to the court that a constructive trust against an otherwise exempt asset, the Debtors' homestead, would be an appropriate remedy.

This is especially true where the complaint has been previously amended.

The question here is whether the Bank should be given a further opportunity to plead a claim that plausibly fits within the definition of "conversion" and the restraints of § 523(a)(6). The court has already dismissed this complaint twice, shared its concerns with regard to the "conversion" theory, and instructed the Bank's counsel of the need for more facts. The court must assume at this point that the SAC represents the Bank's best effort at pleading a plausible claim and that any further amendment would be futile. Further amendment would prejudice the Debtors and cause undue delay.

Conclusion.

If this matter were allowed to proceed to trial, and if the Bank was able to prove all of the factual (nonconclusory) allegations in the SAC, the court would still be compelled to rule for the Debtors for the reasons set forth above. Based thereon,

IT IS HEREBY ORDERED that this adversary proceeding is DISMISSED with prejudice. The parties shall bear their own costs and attorney fees.

Dated: November 3, 2015

/s/ W. Richard Lee
W. Richard Lee
United States Bankruptcy Judge