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UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF CALIFORNIA
FRESNO DIVISION

In re Jeffrey Kerr and Lindsay Kerr, Debtors.	Case No. 14-13285-B-7
River Rail Community Federal Credit Union, Plaintiff, v. Jeffrey Kerr and Lindsay Kerr, Defendants.	Adversary Proceeding No. 14-1128 Date: July 9, 2015 Time: 10:00 a.m. Place: Dept. B, Courtroom 12 5th Floor, U.S. Courthouse 2500 Tulare Street Fresno, CA

ORDER DENYING MOTION FOR ENTRY OF DEFAULT JUDGMENT AND ORDER TO SHOW CAUSE REGARDING DISMISSAL

Before the court is a motion for entry of a default judgment filed by River Rail Community Federal Credit Union (the "Credit Union"), a creditor and plaintiff in this adversary proceeding. The Credit Union seeks an order liquidating its claim against the debtors, Jeffrey and Lindsay Kerr (the "Debtors" or "Defendants") in the amount of $11,643.70. It also seeks a determination that the claim is nondischargeable under 11 U.S.C. § 523(a) subsections (2)(A) (actual fraud), (a)(4) (larceny) and (a)(6) (intentional injury)[1] (the "Motion"). The Debtors were properly served with the

[1] Unless otherwise indicated, all chapter, section, and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101–1532, and to the Federal Rules of Bankruptcy Procedure, Rules 1001–9036, as enacted and promulgated *after* October 17, 2005, the

summons and complaint, but did not file a responsive pleading. Pursuant to the Credit Union's request, the court entered the Debtors' default and issued an order requiring the Credit Union to file this Motion for entry of a default judgment.

In support of its Motion, the Credit Union has offered, *inter alia*, a declaration from Kimberly McAtee, Vice-President of Lending for the Credit Union ("McAtee Decl.") with copies of the relevant loan and security agreements. However, the well-pleaded facts in the complaint which the court can accept as true, together with the admissible testimony and documentary evidence offered in support of the Motion, do not establish the elements necessary, under any of the stated theories, to except the Credit Union's claim from the chapter 7 discharge. Therefore, the Credit Union's Motion will be denied and the court is issuing an order to show cause why the adversary proceeding should not be dismissed.

BACKGROUND.

This ruling is based upon facts as alleged in the Credit Union's complaint (the "Complaint"), as well as admissible testimony and documentary evidence set forth in the supporting declarations, and facts that have been judicially noticed at the request of the Credit Union. *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 Credit Union's pleadings and evidence. The Debtors' default has been entered and they have not offered anything for the court to consider in their defense. Accordingly, nothing in the discussion that follows constitutes a finding of fact or a conclusion of law on the merits of the adversary proceeding itself.

This bankruptcy was filed as a voluntary chapter 7 on June 27, 2014. It is not

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effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 119 Stat. 23.

clear when the Debtors moved to California; however, for some time prior to the bankruptcy, they lived in or near Casper, Wyoming. While in Wyoming, the Debtor, Jeffrey Kerr ("Jeffrey"), worked in the oilfield service business.[2] However, after moving to California, Jeffrey found employment as a warehouse repairman and was so employed at the commencement of this case. (Debtors' Schedule I.)[3] The co-Debtor, Lindsay Kerr ("Lindsey"), was unemployed.

In October 2013, the Debtors signed a "Loanliner" loan and security agreement to borrow $12,057.75 from the Credit Union (the "Loan") (McAtee Decl. Ex. 1.) The Loan was payable over 36 months at the rate of $422 per month. To secure the Loan, the Debtors pledged as collateral a 2000 Ford F350 Supercab truck (the "Truck") and a 2007 Lincoln Vantage diesel welder (the "Welder"), which was installed on the Truck. The Truck and the Welder are sometimes referred to herein and in the pleadings as the "Collateral." Based on the Loan documents, $5,434.57 was "paid to [the Debtors'] account," presumably to cover an existing debt. The sum of $6,603.18 was paid to Pro Fab Welding, LLC, presumably to purchase the Welder, and $20 was paid to the Natrona City Clerk.

Shortly before filing bankruptcy, the Debtors relocated to California.[4] They made only four payments on the Loan, reducing its balance to $11,643.70. In connection with the relocation, the Welder was removed from the Truck and sold to an undisclosed party for an unknown amount of money.[5] The Debtors retained the

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[2] The Debtors' Statement of Financial Affairs ("SOFA") states that Jeffrey was self-employed under the name TCM Welding in 2012. No income is reported for 2013 or 2014.

[3] Schedule I states that Jeffrey had been employed for approximately one month.

[4] None of the creditors listed on Schedule D or F are in California. Many are listed with addresses in Wyoming and Colorado.

[5] The disposition of the Welder is not reflected in the SOFA, but neither is the Welder listed as an item of personal property on Schedule B.

Truck at their new place of residence, subject to the Credit Union's security interest. (Schedules B and F.)

After the bankruptcy was filed, the Credit Union's attorney attempted unsuccessfully to contact the Debtors' attorney to ascertain their intention with regard to payment of the Loan or surrender of the Collateral. The Truck was eventually surrendered to the Credit Union, but the transmission had been removed and the Truck was inoperable. The Credit Union has never recovered the Welder.

ISSUE PRESENTED.

Dischargeability complaints are frequently filed in the bankruptcy courts. The debtor-defendants often do not respond for economic reasons or otherwise, in which case, the dischargeability question ultimately comes before the court, as here, in the form of a motion for entry of a default judgment. The fundamental issue presented here is whether the Credit Union has made an adequate showing, based on well-pleaded facts in the Complaint and any admissible supporting evidence, that the Credit Union's claim represents a debt for money obtained by "false pretenses, a false representation, or actual fraud" under § 523(a)(2)(A), or a debt for "willful and malicious injury" under § 523(a)(6), or that the Debtors' failure to surrender the Collateral before they moved to California constituted "larceny" within the meaning of § 523(a)(4). The Credit Union had the burden to make that showing.

DISCUSSION.

Judgment by Default. Default judgments are governed by Federal Rule of Civil Procedure 55, which is made applicable to adversary proceedings by Federal Rule of Bankruptcy Procedure 7055. The entry of a default judgment in an adversary proceeding is a two-step process, requiring (1) the entry of the party's default and then (2) the entry of a default judgment. *See* Fed. R. Civ. P. 55(a), (b); *Brooks v. United States*, 29 F. Supp. 2d 613, 618 (N.D. Cal.), *aff'd*, 162 F.3d 1167 (9th Cir.

1998) (unpublished table decision).[6]

The bankruptcy court is given broad discretion to enter a default judgment in an adversary proceeding; however, the plaintiff is not entitled to such judgment as a matter of right. *Cashco Fin. Servs., Inc. v. McGee (In re McGee)*, 359 B.R. 764, 771 (9th Cir. BAP 2006) (citing *Kubick v. FDIC (In re Kubick)*, 171 B.R. 658, 659–60 (9th Cir. BAP 1994)). The court is permitted, but is not required, to draw inferences in a default judgment context. "In order to do justice, a trial court has broad discretion to require that a plaintiff prove up even a purported *prima facie* case by requiring the plaintiff to establish the facts necessary to determine whether a valid claim exists that would support relief against the defaulting party." *Id.* at 773 (emphasis omitted) (citing *Wells Fargo Bank v. Beltran (In re Beltran)*, 182 B.R. 820, 823 (9th Cir. BAP 1995) (noting that entry of default does not automatically entitle plaintiff to default judgment, regardless of general effect of entry of default that deems well-founded allegations as admitted); *Quarré v. Saylor (In re Saylor)*, 178 B.R. 209, 212 (9th Cir. BAP 1995) (finding no abuse of discretion by trial court in denying entry of default judgment after trial court directed plaintiff to submit evidence of a *prima facie* case in support of default judgment), *aff'd*, 108 F.3d 219 (9th Cir. 2007).

The analysis of any adversary proceeding that culminates in the entry of a judgment by default should begin with the pleadings. *See id.* at 771 (noting that one factor considered for entry of default judgment is "the sufficiency of the complaint"). Pursuant to Federal Rule of Civil Procedure 8, a pleading, such as a complaint, must state a "short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2), *incorporated by* Fed. R. Bankr. P. 7008. A complaint

[6] The Debtors did not respond to the Complaint, and their default was entered on December 8, 2014.

alleging fraud must plead the circumstances constituting the fraud "with particularity." Fed. R. Civ. P. 9(b), *incorporated by* Fed. R. Bankr. P. 7009.

The plaintiff's duty to show its "'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). 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 *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), 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, coupled with the more rigid pleading standards applicable to fraud claims, underscore the importance of judicial scrutiny of both the complaint and the ensuing default proceedings, 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). The tension here was thoughtfully considered by one court in a recent unpublished opinion:

> 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. Indeed, if anything, the more rigorous pleading standards applicable to fraud actions makes this scrutiny even more important.

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).

The court must therefore scrutinize the Credit Union's Complaint and the supporting declarations and documentary evidence to determine whether it has established at least a *prima facie* case under § 523(a)(2)(A), (a)(4), and/or (a)(6).

"Fraud" Exception to Discharge Under § 523(a)(2)(A). To balance the fresh start afforded to "honest but unfortunate" debtors through a discharge of debts, the Bankruptcy Code excepts from discharge any debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or *actual fraud*." § 523(a)(2)(A) (emphasis added). To prove actual fraud, a creditor must establish each of the following five elements: (1) that the debtor made false representations; (2) that at the time he knew they were false; (3) that he made them with the intention and purpose of deceiving the creditor; (4) that the creditor relied on such representations; and (5) that the creditor sustained the alleged loss and damage as the proximate result of the representations having been made. *Citibank (S.D.), N.A. v. Eashai (In re Eashai)*, 87 F.3d 1082, 1086 (9th Cir. 1996). These five elements mirror those of common law fraud. *See Field v Mans*, 516 U.S. 59, 69 (1995). In the nondischargeability action, the creditor must prove these elements by a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279, 286 (1991).

Here, the problem with the Credit Union's Motion lies in the probative value of the facts offered to establish the first three elements of its fraud claim: that the Defendants (1) falsely represented their intent to repay the Loan; (2) knew they wouldn't, or couldn't repay the Loan; and (3) nevertheless intended to deceive the Credit Union. The Debtors' fraudulent intent is generally determined by the totality of the circumstances; "a court may infer the existence of the debtor's intent not to pay

if the facts and circumstances of a particular case present a picture of deceptive conduct by the debtor." *In re Eashai*, 87 F.3d at 1087. The facts and circumstances must show that they did not intend to repay the debt to the Credit Union at the time the debt was incurred. *Cf. Anastas v. Am. Sav. Bank (In re Anastas)*, 94 F.3d 1280, 1285 (9th Cir. 1996) (stating that "central inquiry in determining whether there was a fraudulent representation [in credit card fraud cases] is whether the card holder lacked an intent to repay at the time he made the charge").

Here, the evidence offered to show that the Defendants obtained the Loan with fraudulent intent is unpersuasive. The Credit Union essentially asks the court to infer fraudulent intent from the circumstances; that the Loan was not fully repaid and that the Defendants subsequently moved out of Wyoming without surrendering the Collateral. These facts suggest little more than a breach of contract, which is not excepted from discharge. A substantial portion of the Loan ($5,434.57) was apparently applied to roll over a pre-existing debt owed to the Credit Union (McAtee Ex. 1, at 2.) No facts are offered with regard to the circumstances of the pre-existing debt so the court cannot find that it was incurred through fraud. The remainder of the Loan was used to purchase the Welder which, presumably, Jeffrey intended to use in his oilfield service business. In addition, the court must consider the undisputed circumstances that (1) the Debtors made at least four payments to the Credit Union; and (2) the Debtors' motive for relocating to California was employment related. Why would the Debtors purchase a diesel powered welder, only to sell it a few months later, if they didn't intend to use the Welder in furtherance of Jeffrey's business? Without substantially more, the court simply cannot infer that the Debtors obtained the Loan and purchased the Welder with fraudulent intent.

The Larceny/Embezzlement Exception to Discharge Under § 523(a)(4).

The Credit Union's second claim for relief is based on its contention that the Debtors'

failure to surrender the Collateral, before they left Wyoming, constituted larceny, "Defendants have effectively misappropriated the Collateral, or stolen the same, with the intent to permanently deprive Plaintiff of the Collateral to which it is rightfully entitled . . . ." (Compl. at ¶ 14.)

The Bankruptcy Code excepts from discharge any debt, "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." § 523(a)(4). Here, the Credit Union does not contend that the Debtors were fiduciaries with regard to the Truck and the Welder, however, a debt for larceny or embezzlement may be nondischargeable under § 523(a)(4) in the absence of a fiduciary relationship. *See Transamerica Commercial Finance Corporation v. Littleton (In re Littleton)*, 942 F.2d 551, 555 (9th Cir. 1991). Neither does the Credit Union contend that the Debtors committed embezzlement, however, embezzlement is closely related to larceny and the court will address that theory below. The only issue before the court is whether the facts offered in support of the Motion, specifically the Debtors' "unauthorized" disposition of the Welder, their initial failure to surrender the Truck, and the unexplained removal of the transmission, collectively support a claim for "larceny" under applicable law.

To state a claim under § 523(a)(4) for larceny, the plaintiff must show that the defendant's initial possession of the property was wrongful. *Ormsby v. First Am. Title Co. (In re Ormsby)*, 591 F.3d 1199, 1205 (9th Cir., 2010); see also 4 Collier on Bankruptcy ¶ 523.10[2] (Alan R. Resnick & Henry J. Sommer eds., 16th ed.) ("As distinguished from embezzlement, [with larceny] the original taking of the property must be unlawful."). Just as in the case with embezzlement, the "stolen" property must belong to a third party. A person cannot commit larceny with respect to property that belongs to him.

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Here, the Credit Union cannot prove its claim for larceny because it is clear from the pleadings that the Truck and the attached Welder *did not belong to the Credit Union and were never in the possession of the Credit Union*. The Welder was apparently purchased by the Debtors from Pro Fab Welding, LLC. The Credit Union admits that its interest in the Welder was that of a security interest perfected under the UCC. As for the Pickup, the Credit Union holds the first position lien. (Compl. 2:4-9.) It is not clear when that lien was first acquired, but the Debtors were the owners and in lawful possession of the Truck. The Complaint and record do not suggest that the Credit Union *ever* had more than a security interest in the Welder and Pickup, which includes the right to enforce the provisions of the contract between the parties.

Before leaving the "larceny" discussion, the court will also consider the law applicable to "embezzlement." If the facts would support a claim for embezzlement, the Credit Union might also be entitled to relief under § 523(a)(4) even though it seeks relief under a different name. Unfortunately for the Credit Union, an "embezzlement" claim would fail for essentially the same reasons that the larceny claim cannot stand.

The Ninth Circuit dealt with a claim similar to the case at bar in *Transamerica Commercial Finance Corporation v. Littleton (In re Littleton)*, 942 F.2d 551, 555 (9th Cir. 1991). There, the debtors owned a retail appliance business. The inventory was financed by the plaintiff under an agreement that required the debtors to report any sale of inventory and to put the sale proceeds into a segregated account. Needless to say, the inventory was sold, plaintiff did not receive the proceeds, the debtors sought bankruptcy protection, and the finance company objected to the dischargeability of its claim on both "conversion" and "embezzlement" theories. With regard to the embezzlement argument, the court addressed the application of § 523(a)(4) to these facts:

> Under federal law, embezzlement in the context of nondischargeability has often been defined as "*the fraudulent appropriation of property* by a person to whom such property has been entrusted or into whose hands it has lawfully come." Embezzlement, thus, requires three elements: "(1) property rightfully *in the possession of a nonowner*; (2) nonowner's appropriation of the property to a use other than which [it] was entrusted; and (3) *circumstances indicating fraud*."

In re Littleton, 942 F.2d at 555 (citations omitted) (emphasis added).

Here, the problem with a hypothetical "embezzlement" claim is twofold. First, it is clear from the pleadings and the Declarations and documents, that the Truck and the Welder were never *in the possession of a nonowner*; indeed, the Debtors owned or were in the process of purchasing both the Truck and the Welder at the time they were pledged as Collateral for the Loan, and they retained ownership of the Collateral up until the time they sold the Welder to a new owner and surrendered the Truck to the Credit Union.

Second, the record is insufficient to show that the Debtors fraudulently appropriated the Truck and the Welder, or did anything under *circumstances indicating fraud*. The federal pleading rules require that the circumstances of fraud must be pled with particularity. Fed.R.Civ.P. 9(b) (made applicable to this adversary proceeding by Fed.R.Bankr.P. 7009). The requisite facts showing "circumstances of fraud" are not present here.

"Willful and Malicious Injury" Exception to Discharge Under § 523(a)(6).

The Credit Union alternatively contends that its claim should be excepted from discharge under § 523(a)(6). That Code section applies to "any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity." To be nondischargeable under this provision, the Credit Union's loss must be the result of an act "by the debtor." § 523(a)(6). In addition, the debtor's conduct must first be tortious (i.e., it constitutes a tort under state law). *See Lockerby v.*

Sierra, 535 F.3d 1038, 1040–42 (9th Cir. 2008); *Petralia v. Jercich (In re Jercich)*, 238 F.3d 1202, 1205 (9th Cir. 2001). The alleged "injury" must also be willful and malicious, with the "malicious" requirement being separate from the "willful" requirement. *Barboza v. New Form, Inc. (In re Barboza)*, 545 F.3d 702, 706 (9th Cir. 2008).

Here, the Credit Union has not established any tortious conduct by the Defendants. Although actual fraud may constitute a tort under state law, the Credit Union's inability to establish a *prima facie* case for actual fraud prevents the court from finding that the Debtors' alleged conduct was tortious. *See Field*, 516 U.S. at 69 (providing that common law elements of fraud define the elements of a § 523(a)(2)(A) claim); *Lazar v. Superior Court*, 12 Cal. 4th 631, 638 (1996) (setting forth same elements of fraud). All that remains from the Complaint is a possible breach of contract claim. However, "[i]t is well settled that a simple breach of contract is not the type of injury addressed by § 523(a)(6)." *Snoke v. Riso (In re Riso)*, 978 F.2d 1151, 1154 (9th Cir. 1992).

With regard to sale of the Welder, again, that act may constitute a breach of contract, but the court cannot infer that the Debtors sold the Welder with a malicious intent to injure the Credit Union. In its own pleadings, the Credit Union suggests that the Welder was sold to raise money to help pay for the Debtors' relocation to California. Presumably, Jeffrey was also abandoning his welding business. The fact that the Debtors needed to move in search of employment does not necessarily establish that they intended to harm the Credit Union in the process by selling part of its Collateral. Indeed, their efforts to seek employment suggests just the opposite, that they were endeavoring, at least at that time, to pay their debts. Thus, the court is not persuaded on the facts before it that the Debtors willfully and maliciously injured the Credit Union when they sold the Welder. Further, the court is not persuaded that sale

of the Welder actually injured the Credit Union. Presumably, it still has a security interest in the Welder and a right to enforce that security interest against the present owner or person in possession.

Finally, with regard to removal of the transmission, the court can imagine numerous "nontort" reasons why the transmission might be removed from a fourteen-year-old commercial vehicle. The most obvious explanation is that the transmission failed, it was removed for diagnosis, and the Debtors could not afford the cost of repairing or replacing it. Without more, the court is not persuaded that the transmission was removed purposely to injure the Credit Union.

Claims Against the Co-Debtor. The Credit Union seeks a nondischargeable judgment against *both* Jeffrey and Lindsay based on the three theories discussed above. Indeed, both the Debtor and co-Debtor are identified together in paragraph 1 of the Complaint and given the singular pseudo-name "Defendants." Thereafter, there is no attempt to identify in the pleadings which of the "Defendants" actually did the acts alleged. Is the court to simply infer that Jeffrey and Lindsay both acted with intent to defraud the Credit Union? Did they both "steal" the Collateral with an intention of keeping it from the Credit Union? Did Lindsay have any role in removal and sale of the Welder, or removal of the Truck's transmission? Did they both act, separately or together at any time, with a subjective intent to harm the Credit Union? If so, then those claims should have been separately pled as to each of the Defendants. Specifically, the fraud claims under § 523(a)(2)(A) must be pled with particularity. Federal Rule of Civil Procedure 9(b) (made applicable to this adversary proceeding by Rule 7009). Similarly, liability under § 523(a)(6) is predicated as "willful and malicious injury *by the debtor*." (Emphasis added.) One defendant cannot be vicariously liable for intentional injury committed by another. *See In re Chien*, 2008 WL 8240422 (9th Cir. BAP) (actions taken by someone other than the debtor do not

give rise to relief under § 523(a)(6) against the debtors, even if the debtor conspired with the tortfeasor).

Conclusion.

In summary, if the Credit Union was given an opportunity to present its case at an evidentiary hearing, and successfully proved all of the well-pled nonconclusory facts offered here in support of the Motion, the court would still rule in favor of the Debtors. The Credit Union has not shown that its claim should be excepted from discharge on any of the theories stated in the Complaint. Based thereon,

IT IS HEREBY ORDERED that the Credit Union's Motion for entry of a default judgment in the above-referenced adversary proceeding will be denied without prejudice.

IT IS FURTHER ORDERED that the Credit Union shall appear and show cause why this adversary proceeding should not be dismissed. The Credit Union has failed to provide competent evidence sufficient to establish *prima facie* liability and a right to relief against the Debtors on any of the claims pled in the Complaint. The hearing on this matter will be held on July 9, 2015, at 10:00 a.m., in Department B, Courtroom 12, 5th Floor, U.S. Courthouse, 2500 Tulare Street, Fresno, California. The Credit Union's responsive pleading with additional evidence, if any, shall be filed and served not later than July 2, 2015.

Dated: June 18, 2015

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