

FOR PUBLICATION

**UNITED STATES BANKRUPTCY COURT  
EASTERN DISTRICT OF CALIFORNIA**

In re: )  
RAUL MIRAZO SOTO, JR., ) Case No. 24-21939-C-7  
Debtor. )  
\_\_\_\_\_)  
SAI SUPERMARKETS, INC. dba DEL ) Adversary No. 24-02174  
VALLE SUPERMARKET, )  
Plaintiff, )  
v. )  
RAUL MIRAZO SOTO dba SOTO )  
REFRIGERATION & BEVERAGE CO., )  
Defendant. )  
\_\_\_\_\_)

**OPINION**

CHRISTOPHER M. KLEIN, Bankruptcy Judge

Is the essential element of "circumstances indicating fraud" for nondischargeable embezzlement under 11 U.S.C. § 523(a)(4) satisfied when a licensed contractor fails to account for, and does not refund, advances for labor and special-order equipment that were not ordered before the contract was terminated?

A California licensed contractor's failure to refund and substantially to account for advances and deposits is a ground for discipline, including restitution orders, by the California Contractors State License Board and, if willful, is an offense under the California Penal Code.

To the narrow question whether the "circumstances indicating fraud" essential element for nondischargeable embezzlement is satisfied in such circumstances, the answer is, "yes."

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1 modification before construction reached the installation stage.  
2 It was understood that changes in specifications might require  
3 price increases.

4       There were two components to Soto's duties under the  
5 contract: (1) order and deliver the equipment; and (2) provide  
6 the labor to install the equipment.

7       Soto's purchase orders specified "There are NO refunds on  
8 deposits" and "All materials are special order items and there is  
9 no return on special order items." E.g., Ex. 4-1.

10       Between February 12, 2021, and September 21, 2021, SAI made  
11 six advances at Soto's demands totaling \$149,741.68. Some of the  
12 demands were based on unilateral price increases by Soto.

13       In seeking advances of \$149,741.68, Soto represented that  
14 all funds were needed for and would be used in SAI's project.

15       Soto's bank records reflect that during the period February-  
16 August, 2021, Soto withdrew \$142,112.74 from his business  
17 checking account (\$54,732.74 cash and \$87,380.00 transfers to his  
18 personal checking account). As of July 31, 2021, his business  
19 checking account had a negative balance (-\$422.59).

20       After an advance in September with no apparent work having  
21 been accomplished, SAI lost confidence in Soto, terminated the  
22 contract, and demanded refund of all advances.

23       Soto responded to SAI by invoking the "no-refund" language  
24 in his purchase orders. Soto later admitted that, except for  
25 \$7,562.00 spent for 2000 feet of copper pipe, he neither  
26 purchased nor installed the required equipment.

27       Soto testified at trial that SAI funds were used on non-SAI  
28 projects or for personal purposes. On June 14, 2021, Soto spent

1 \$4,443.38 from his business checking account for a Louis Vuitton  
2 purse for his wife.

3 SAI sued Soto in state court in January 2022, which action  
4 was pending when Soto filed his chapter 7 case on May 6, 2024.

5 This adversary proceeding ensued.

### 6 7 Analysis

8 The Complaint alleges two counts: § 523(a)(4) embezzlement  
9 and § 523(a)(2) fraudulent misrepresentation. SAI contends that  
10 § 523(a)(4) embezzlement squarely fits the facts. Analysis here  
11 focuses on the law regarding embezzlement.

12 Decisions on § 523(a)(4) embezzlement are relatively scarce.

### 13 14 I

#### 15 § 523(a)(4) Embezzlement

16 The § 523(4) discharge exception applies to any debt “for  
17 fraud or defalcation while acting in a fiduciary capacity,  
18 embezzlement, or larceny.” 11 U.S.C. § 523(a)(4).

### 19 A

#### 20 Embezzlement Basics

21 No fiduciary relationship is required to except embezzlement  
22 debt from discharge. As the Supreme Court explains, the syntax of  
23 § 523(a)(4) separates “embezzlement” and “larceny” from “fraud or  
24 defalcation while acting in a fiduciary capacity.” Bullock v.  
25 BankChampaign, NA, 569 U.S. 267, 275 (2013) (construing fiduciary  
26 defalcation); 4 COLLIER ON BANKRUPTCY ¶ 523.10[1] n.14 (Richard  
27 Levin & Henry J. Sommer, eds) (“COLLIER”).

28 The term “embezzlement” in the Bankruptcy Code is a federal

1 law concept. Hence, federal law, not state law, controls the  
2 meaning of "embezzlement" in § 523(a)(4). First Del. Life Ins.  
3 Co. v. Wada (In re Wada), 210 B.R. 572, 576 (9th Cir. BAP 1997).

4 The Supreme Court's classic statement of the meaning of  
5 "embezzlement" in a federal statute is that "embezzlement" is the  
6 fraudulent appropriation of property by a person to whom the  
7 property has been entrusted or into whose hands it has lawfully  
8 come. Moore v. United States, 160 U.S. 268, 269 (1895). Moore  
9 remains good law. See 4 COLLIER AT ¶ 523.10[2].

10 The three essential elements of "embezzlement" are: (1)  
11 property rightfully in the possession of a nonowner; (2)  
12 nonowner's appropriation of the property to a use other than  
13 which it was entrusted; and (3) circumstances indicating fraud.  
14 Transam. Comm. Fin. Corp. v. Littleton (In re Littleton), 942  
15 F.2d 551 (9th Cir. 1991); Wada, 210 B.R. at 576-77; accord,  
16 COLLIER ¶ 523.10[2].

17 All three essential elements - possession by nonowner,  
18 misappropriation, and circumstances indicating fraud - are  
19 questions of fact for the trial court to determine by  
20 preponderance of evidence. See Grogan v. Garner, 498 U.S. 279,  
21 291 (1991) (§ 523(a)(2)).

22 The first two essential elements are straightforward and  
23 ordinarily easily established.

24 The third essential element, circumstances indicating fraud,  
25 is a question of fact focused on knowledge and intent of the  
26 actor. Littleton, 942 F.2d at 556.

27 The analyses by the Ninth Circuit and its Bankruptcy  
28 Appellate Panel in Littleton and Wada regarding the fraud-related

1 element were essentially validated by the subsequent Supreme  
2 Court decision in BankChampaign that fraud in this connection  
3 means positive fraud, or fraud in fact, involving moral turpitude  
4 or intentional wrong, leading to the imputation of bad faith or  
5 immorality. BankChampaign, 569 U.S. at 274-76.; Neal v. Clark, 95  
6 U.S. 704, 709 (1877).

7 Putting a finer point on the pencil, and comparing  
8 defalcation to embezzlement, the Supreme Court explained in  
9 BankChampaign that defalcation includes conscious disregard of or  
10 willful blindness to a substantial and unjustifiable risk of a  
11 violation. The risk “must be of such a nature and degree that,  
12 considering the nature and purpose of the actor’s conduct and the  
13 circumstances known to him, its disregard involves a gross  
14 deviation from the standard that a law-abiding person would  
15 observe in the actor’s situation.” BankChampaign, 569 U.S. at  
16 274, quoting ALI Model Penal Code § 2.02(2)(c), p. 226 (1985).

17 In other words, there must be a showing of “wrongful  
18 intent.” BankChampaign, 569 U.S. at 27. Accord, Kim v. Kim (In re  
19 Kim), 2025 WL 3654696, at \*5 (9th Cir. BAP 2025); Newman v. Lee  
20 (In re Newman), 2022 WL 2100905, at \*7 (9th Cir. BAP 2022).

21 The Supreme Court’s willful blindness analysis of  
22 defalcation in BankChampaign likewise informs the analysis of  
23 “circumstances indicating fraud” in § 523(a)(4) embezzlement.

24 As with other forms of fraud-related intent, the trier of  
25 fact may draw inferences from circumstantial evidence. Particular  
26 circumstances surrounding nonpayment/nonremittance of entrusted  
27 property may suffice to persuade the court to infer the requisite  
28 fraudulent intent.

1 For example, in Wada a false statement regarding the reason  
2 for improper appropriation and failure to refund warranted  
3 inferring circumstances indicating fraud. Wada, 210 B.R. at 577.

4 Finally, it should be emphasized that the "circumstances  
5 indicating fraud" essential element lies in the penumbra of  
6 fraud, is not congruent with actual fraud, and does not require  
7 proof of actual fraud. Rather, it suffices to establish a gross  
8 deviation from the standard that a law-abiding person would  
9 observe in the actor's situation.

## 10 II

### 11 This Defendant's Context

12 The context of the applicable nonbankruptcy law regime in  
13 which California licensed contractors operate is crucial to  
14 understanding the embezzlement theory in this case and what a  
15 law-abiding licensed contractor would do.

16 The California Business and Professions Code proscribes  
17 diversions by licensed contractors of funds received from  
18 contracting parties and failures to account for application or  
19 use of funds. Discipline for violations is authorized.<sup>1</sup>

20 The permitted forms of discipline under § 7108 include  
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22  
23 <sup>1</sup>The Business and Professions Code § 7108 (Diversions of  
24 funds or Property) provides:

25 Diversion of funds or property received for prosecution  
26 or completion of a specific construction project or  
27 operation, or for a specified purpose in the prosecution or  
28 completion of any construction project or operation [...] for which such funds or property were received constitutes a cause for disciplinary action.

Cal. Bus. & Prof. Code § 7108.

1 license suspension, restitution, just terms and conditions  
2 regarding continued operations, and payment of costs of  
3 investigation.<sup>2</sup>

4 Worse, a contractor's willful failure to complete the  
5 improvement for which funds were provided, willful failure to pay  
6 for services, labor, materials or equipment provided incident to  
7 such construction, or willful diversion of funds to a use other  
8 than that for which the funds were received constitutes criminal  
9 construction fraud under California Penal Code § 484b.<sup>3</sup>

10 \_\_\_\_\_  
11 <sup>2</sup>Business & Professions Code § 7095 (Mode of Discipline)  
12 provides in part:

13 (a) The decision may:

14 (1) Provide for the immediate complete suspension by  
15 the licensee of all operations as a contractor during the  
16 period fixed by the decision.

17 ...

18 (3) Impose upon the licensee compliance with such  
19 specific terms and conditions as may be just in connection  
20 with the licensee's operations as a contractor disclosed at  
21 the hearing and may further provide that until those terms  
22 and conditions are complied with no application for  
23 restoration of the suspended or revoked license shall be  
24 accepted by the registrar.

25 ...

26 (b) The specific terms and conditions imposed pursuant to  
27 paragraph (3) or (4) of subdivision (a) may include, but are  
28 not limited to, any of the following:

(1) Payment of restitution to persons injured as a  
result of the violation

(2) Payment of the costs of investigation and enforcement  
pursuant to Section 125.3.

Cal. Bus. & Prof. Code § 7095 (emphasis supplied).

<sup>3</sup>California Penal Code 484b provides:

§ 484b. Any person who receives money for the purpose of  
obtaining or paying for services, labor, materials or  
equipment and willfully fails to apply such money for such  
purpose by either willfully failing to complete the  
improvements for which funds were provided or willfully



1 As part of the licensing process, California contractors are  
2 trained in these provisions and agree to be held responsible for  
3 obeying state law regarding permitted uses of funds. They know  
4 they cannot divert project funds for other uses. They know they  
5 must be prepared to account for uses of project funds.

6  
7 III

8 Essential Elements of § 523(4) Embezzlement

9 A

10 Possession by Nonowner

11 The element of possession by nonowner is admitted and beyond  
12 dispute in this case. SAI is the owner of the subject funds,  
13 which it delivered into the possession of Soto.

14 B

15 Misappropriation

16 The element of misappropriation is likewise beyond cavil.  
17 Soto testified that project funds were used on other projects.  
18 Nor did he contest that project funds were transferred to his  
19 personal account and used for personal purposes, including

20 \_\_\_\_\_  
21 failing to pay for services, labor, materials or equipment  
22 provided incident to such construction, and wrongfully  
23 diverts the funds to a use other than that for which the  
24 funds were received, shall be guilty of a public offense and  
25 shall be punishable by a fine not exceeding ten thousand  
26 dollars (\$10,000), or by imprisonment in a county jail not  
27 exceeding one year, or by imprisonment pursuant to  
28 subdivision (h) of Section 1170, or by both that fine and  
that imprisonment if the amount diverted is in excess of two  
thousand three hundred fifty dollars (\$2,350). If the amount  
diverted is less than or equal to two thousand three hundred  
fifty dollars (\$2,350), the person shall be guilty of a  
misdemeanor.

Cal. Penal Code § 484b.

1 payment of \$4,443.38 for a Louis Vuitton purse.

2 C

3 Circumstances Indicating Fraud

4 As to the "circumstances indicating fraud" essential  
5 element, BankChampaign provides the matrix for analysis.

6 One begins with the premises that licensed contractors know  
7 their duties under state law governing their licenses and that no  
8 law-abiding contractor would violate those duties.

9 The question in any particular case is whether, in the words  
10 of the Supreme Court, the contractor consciously disregarded or  
11 was willfully blind to a substantial and unjustifiable risk of a  
12 violation of contractor duties of such a nature and degree that,  
13 considering the nature and purpose of the actor's conduct and the  
14 circumstances known to him, its disregard involves a gross  
15 deviation from the standard that a law-abiding person would  
16 observe in the actor's situation.

17 Circumstances "known to the contractor" include the state-  
18 law criminal prohibition of diverting funds, the duty to account,  
19 and the exposure to a restitution order as disciplinary action.

20 The burden of proof is preponderance of evidence. The  
21 unsupported contrary assertion by Soto's counsel that clear and  
22 convincing evidence is required is rejected as lacking merit in  
23 light of the Supreme Court decision in Grogan that preponderance  
24 of evidence is the standard of proof in § 523 dischargeability  
25 litigation. Grogan, 498 U.S. at 291. If preponderance is the  
26 standard for proof of actual fraud, then a higher standard cannot  
27 apply to the lower showing of "circumstances indicating fraud."

28 While the precise degree of fraud "indications" required for

1 § 523(a)(4) embezzlement may be uncertain, at a minimum, facts  
2 that could support an actual criminal prosecution are sufficient.

3 This Court is persuaded, and finds as fact, that Defendant  
4 Soto consciously disregarded or was willfully blind to a  
5 substantial and unjustifiable risk of violation of his California  
6 contractor duties of such a nature and degree that, considering  
7 the nature and purpose of his conduct and the circumstances known  
8 to him, its disregard involved a gross deviation from the  
9 standard that a law-abiding licensed contractor would have  
10 observed in Soto's situation.

11 The reality is that Soto was using SAI as, in effect, an  
12 automatic teller machine in a manner not permitted by the law  
13 governing licensed contractors.

14 The debt of Soto to SAI is excepted from discharge as an  
15 embezzlement by virtue of 11 U.S.C. § 523(4).

16  
17 IV

18 § 523(a)(2) Fraud

19 SAI asserts that 11 U.S.C. § 523(a)(2) arguably provides a  
20 ground for excepting at least some of Soto's debt from discharge  
21 but candidly concedes that its case is not so strong as its  
22 § 523(a)(4) case. This Court agrees.

23 Evidence probative of fraudulent intent at the time of  
24 formation of the SAI-Soto contract, the time of some of the early  
25 representations, and knowledge of their falsity is ambiguous.

26 To be sure, each advance made by SAI to Soto during the  
27 contractual relationship came with a representation by Soto that  
28 the funds needed to be advanced would be used for project

1 purposes. But their untruth and Soto's knowledge of the untruth  
2 evolved over time and would require a stretch of inferences that  
3 could affect the measure of nondischargeable damages.

4 Moreover, time limitations imposed by this trier of fact  
5 during the management of the trial attenuated SAI's and Soto's  
6 presentations of § 523(a)(2) evidence to an extent that could  
7 merit further proceedings that would be wasteful in light of the  
8 embezzlement determination. Fed. R. Bankr. P. 1001(a).


9 Accordingly, the prudent course is to dismiss the  
10 § 523(a)(2) count without prejudice.

11  
12 Conclusion

13 This Court is persuaded by preponderance of evidence that  
14 the debt of Defendant Raul Soto to Plaintiff SAI in the amount of  
15 \$149,741.68 represents embezzlement within the meaning of  
16 § 523(a)(4) and is to be excepted from discharge.

17 An appropriate separate judgment shall be entered.

18  
19 Dated: February 05, 2026

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United States Bankruptcy Judge