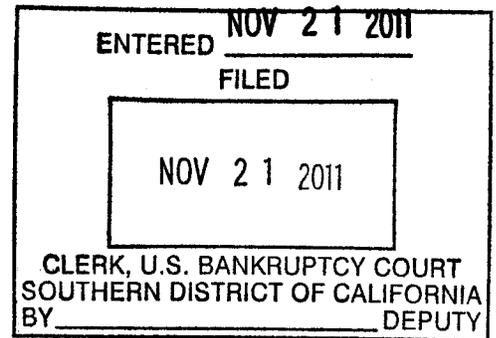


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WRITTEN DECISION – NOT FOR PUBLICATION



UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re:) BANKRUPTCY NO: 10-19165-MM7
)
THEO HANSON AND KIMBERLY DAWN) ADVERSARY NO: 11-90361-MM
HANSON,)
) CHAPTER: 7
)
Debtors,) MEMORANDUM DECISION RE DEBTORS'
) MOTION TO DISMISS ADVERSARY
_____) COMPLAINT
FRED WENDT,)
)
Plaintiff,) DATE: 12/15/11
) TIME: 10:00 a.m.
v.) DEPT: 1
)
THEO HANSON AND KIMBERLY DAWN) JUDGE: Margaret M. Mann
HANSON,)
)
Defendants,)
)
_____)

1 *Pro se* debtors, Theo and Kimberly Hanson ("the Debtors"), brought a Motion to
2 Dismiss ("Motion") *pro se* plaintiff Fred Wendt's ("Wendt") complaint filed against them
3 ("Complaint"). Wendt alleged non-dischargeability claims for "actual fraud" and "fraud or
4 defalcation while acting in a fiduciary capacity" under 11 U.S.C. §§ 523(a)(2) and (4). The
5 Motion was brought under Federal Rule of Bankruptcy Procedure 7012 (which incorporates
6 Fed. R. Civ. P. 12) based in part upon a California default judgment for breach of contract, and
7 in part on the insufficiency of the allegations to state a claim for relief.

8 Having considered the parties' oral presentation at the hearing and all papers filed in
9 regard to this Motion, the Court denies the Motion on collateral estoppel and res judicata
10 grounds except to the extent of declining to allow the parties to re-litigate the amount of
11 Wendt's debt. The Court also grants in part and denies in part the Motion's challenge to the
12 sufficiency of the pleadings. For the benefit of these *pro se* parties, the Court explains its
13 analysis in this Memorandum Decision.

14 **I. FACTUAL BACKGROUND**

15 In September 2005, the Debtors approached Wendt and requested his financial
16 assistance with a business opportunity. Exactly what business opportunity was to be pursued is
17 unclear, but it can be gleaned from the Complaint that Wendt would provide the capital
18 investment, while the Debtors would provide the services and products to the customers as part
19 of a marketing business.

20 At the Debtors' urging, Wendt entrusted substantial sums of money in this business
21 opportunity by writing checks to HP Media, Inc., an alleged sham corporation used as a device
22 to prevent others from dealing directly with the Debtors as individuals. Although the Debtors
23 claimed they would immediately establish the business, this did not occur. Three months after
24 Wendt entrusted his money in the business opportunity, the Debtors did open a checking
25 account where HP Media Inc. began doing business under the name "Sixth Sense Studio." In
26 the meantime, much of Wendt's money had already been spent.

1 After the Debtors failed to repay the loan, Wendt obtained a California default judgment
2 in the amount of \$210,000 plus interest, specifically on the two breach of contract claims
3 asserted, even though fraud was also alleged in the state court complaint. The Debtors then
4 filed bankruptcy, and Wendt then filed his Complaint.

5 **II. ANALYSIS**

6 **A. Motion to Dismiss Legal Standard**

7 The liberal pleading standards set out in Federal Rule of Civil Procedure 8(a)(2)
8 (incorporated by reference into Bankruptcy Rule 7008) require only "a short and plain statement
9 of the claim showing that the pleader is entitled to relief," in order to "give the defendant fair
10 notice of what the ... claim is and the grounds upon which it rests." *Bell Atl. Corp. v. Twombly*,
11 550 U.S. 544, 555 (2007). These lax pleading standards are further relaxed for pleadings filed
12 by *pro se* litigants. *Erickson v. Pardus*, 551 U.S. 89, 94 (2007); *accord Hebbe v. Pliler*, 627
13 F.3d 338, 342 (9th Cir. 2010).

14 While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed
15 factual allegations, a plaintiff's obligation to provide the "grounds" of his "entitle[ment] to
16 relief" requires more than labels and conclusions, and a formulaic recitation of the elements of a
17 cause of action will not do. *See Papasan v. Allain*, 478 U.S. 265, 286 (1986) (courts "are not
18 bound to accept as true a legal conclusion couched as a factual allegation"). Even for *pro se*
19 litigants, the court need not accept as true unreasonable inferences or conclusory legal
20 allegations cast in the form of factual allegations. *Western Min. Council v. Watt*, 643 F.2d 618,
21 624 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981). A *pro se* litigant must nevertheless be given
22 an opportunity to amend the complaint to state a claim, unless it is clear the deficiencies cannot
23 be cured by amendment. *McGuckin v. Smith*, 974 F.2d 1050, 1057 (9th Cir. 1992), *overruled*
24 *on other grounds by WMX Technologies, Inc. v. Miller*, 104 F.3d 1133 (9th Cir. 1997).

25 Other than taking judicial notice of appropriate matters, *see Lee v. City of Los Angeles*,
26 250 F.3d 668, 688 (9th Cir. 2001); Fed. R. Evid. 201, a court *may not* look beyond the
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1 complaint to a plaintiff's moving papers. *Schneider v. California Dept. of Corr.*, 151 F.3d 1194,
2 1197, n.1 (9th Cir. 1998) (emphasis in original).

3 Having taken judicial notice of the default judgment and the state court complaint, and
4 having read the *pro se* pleadings here with the higher tolerance due them, the Court nevertheless
5 finds that some of Wendt's claims are precluded by the default judgment and others are not
6 viable based upon the facts alleged.

7 **B. The Preclusive Effect of the Default Judgment**

8 **1. Res Judicata**

9 Both parties point to the default judgment as dispositive of their respective claims
10 without articulating the legal theory on which these assertions are based. Wendt asserts the
11 state court complaint alleges fraud, so the matter has already been litigated in his favor. The
12 Debtors claim the judgment was for breach of contract not fraud, so Wendt's claim is fully
13 dischargeable. These claims implicate collateral estoppel and res judicata principles, which can
14 be addressed on a *sua sponte* basis even when not formally raised by the parties. *Columbia*
15 *Steel Fabricators v. Ahlstrom Recovery*, 44 F.3d 800, 802 (9th Cir. 1995) (*sua sponte*
16 consideration of preclusion issues upheld).

17 Res judicata, also known as claim preclusion, prevents litigation of all grounds for, or
18 defenses to recovery that were previously available to the parties, regardless of whether they
19 were asserted or determined in the prior proceeding. *Chicot Cnty. Drainage Dist. v. Baxter*
20 *State Bank*, 308 U.S. 371, 378 (1940). A successful defense of claim preclusion requires: (1) a
21 final judgment on the merits in the prior action; (2) an identity of claims; and (3) the prior action
22 must involve the same parties. *Stewart v. U.S. Bancorp*, 297 F.3d 953, 956 (9th Cir. 2002).
23 Because the element of identity of claims is not present, fraud non-dischargeability claims
24 actions are not precluded by prior state court judgments. *Brown v. Felsen*, 442 U.S. 127, 131
25 (1979) (claim preclusion did not apply because its application in dischargeability proceedings
26 would inspire needless litigation by an otherwise unwilling party to try bankruptcy issues to
27 protect against the mere possibility that a debtor may file bankruptcy in the future).

1 As was held in *Brown, id.*, the claim preclusion arguments here fail the second
2 requirement from *Stewart*, 297 F.3d at 956. The claims raised are not identical in both actions.
3 The state court judgment was for breach of contract while the Complaint alleges non-
4 dischargeability for fraud and defalcation while acting in a fiduciary capacity. Even if the state
5 court judgment was for fraud, it is different from the non-dischargeability claims. *Brown*, 442
6 U.S. at 131. Applying the claim preclusion doctrine, the default judgment thus neither
7 establishes nor bars Wendt's non-dischargeability claims.

8 **2. Collateral Estoppel**

9 That claim preclusion does not apply does not mean the default judgment is irrelevant to
10 this proceeding. Collateral estoppel, otherwise known as issue preclusion, may bar the re-
11 litigation of certain issues raised in the context of the claim to be considered. *See Collins v.*
12 *D.R. Horton, Inc.*, 505 F.3d 874, 880 (9th Cir. 2007). Unlike the case with claim preclusion,
13 issue preclusion can be applicable in dischargeability cases. *Grogan v. Garner*, 498 U.S. 279,
14 284 (1991).

15 Because the default judgment is a California state court judgment, California law
16 determines if collateral estoppel applies. As a matter of full faith and credit, 28 U.S.C. § 1738
17 requires courts apply the collateral estoppel principles of the state from which the judgment was
18 entered. *In re Honkanen*, 446 B.R. 373; 382 (B.A.P. 9th Cir. 2011) (citing *Grogan*). Under
19 California law, collateral estoppel requires that: (1) the issue to be precluded from re-litigation
20 be identical to that decided in the prior proceeding; (2) the issue have been actually litigated; (3)
21 the issue have been necessarily decided; (4) the decision on the issue be final and on the merits;
22 and (5) the party be the same as, or in privity with, the party in the prior proceeding. *In re*
23 *Younie*, 211 B.R. 367, 373 (9th Cir. B.A.P. 1997) (default judgment based upon fraud given
24 collateral estoppel effect).

25 These elements are each analyzed for the two separate components of this suit: whether
26 the Debtors owe a debt to Wendt, and if so, whether the debt is non-dischargeable.

1 **a) Do the Debtors Owe Wendt a Debt?**

2 On the debt issue, the California default judgment satisfies all five elements required for
3 collateral estoppel.

4 **(1) Identical Issues**

5 The "'identical issue requirement' concerns whether 'identical factual allegations' are at
6 stake in the two proceedings..." *Murphy v. Murphy*, 164 Cal. App. 4th 376, 400 (2008) (citing
7 *Lucido v. Superior Court*, 51 Cal. 3d 335, 342 (1990)). The factual issues for breach of contract
8 and fraud are identical in the instant and prior state court proceedings. In both proceedings,
9 Wendt sought to recover money he invested with the Debtors. Even if non-dischargeability was
10 not litigated in state court, the factual allegations supporting both claims are identical. The first
11 element of the collateral estoppel test is thus satisfied.

12 **(2) Actually Litigated**

13 *Younie* held that a California "default judgment satisfies the 'actually litigated'
14 requirement for the application of collateral estoppel" even though the debtors were never
15 involved in the state court proceeding and the state court did not make full findings on the
16 elements of fraud. *Younie*, 211 B.R. at 374-375. A default judgment is as conclusive on the
17 allegations in the non-dischargeability complaint as would be a trial on the issues. *See In re*
18 *Moore*, 186 B.R. 962, 972 (Bankr. N.D. Cal. 1995) (citing *Burnett v. King*, 33 Cal. 2d 805, 810
19 (1949)). All that needs to be demonstrated is that the judgment is regular and valid, and that the
20 judgment was based on a cause of action in the non-dischargeability complaint. *Id.*; *Younie*,
21 211 B.R. at 375. The state court here entered a regular, valid judgment and demonstrated
22 distinctly that its judgment was entered only on the breach of contract claim. The "actually
23 litigated" element for whether the Debtors owe Wendt a debt has been met here.

24 **(3) Necessarily Decided**

25 The issue of whether the Debtors owe Wendt a debt was necessarily decided in the
26 California default judgment for breach of contract. The contract was a loan from Wendt to the
27 Debtors that was to be repaid. Therefore, the California default judgment for breach of contract
28

1 necessarily decided that the Debtors owe Wendt a debt for breach. The third collateral estoppel
2 element is satisfied.

3 **(4) Final and On the Merits**

4 The California default judgment is final and on the merits. The Debtors included in their
5 Motion the California default judgment entered by the Clerk. (Exh. B. to the Debtors' Motion to
6 Dismiss). The Court can take judicial notice of this judgment. *Lee v. City of Los Angeles*, 250
7 F.3d at 688. There is nothing in the record that suggests the matter is on appeal.

8 **(5) Same Party or in Privity**

9 The parties in both the state court action and this current adversary case are identical.
10 The fifth element of collateral estoppel is satisfied. Therefore, this issue of whether the Debtors
11 owe Wendt a debt cannot be re-litigated in this Court.

12 **b. Is Wendt's California Default Judgment Non-dischargeable for Fraud?**

13 On the separate issue of fraud, four of the five elements of collateral estoppel discussed
14 above are met. The judgment was final, the parties were the same, the claims were actually
15 litigated, and the issues relating to Wendt's investment in the Debtors' business venture were the
16 same. However, fraud was not necessarily decided. While fraud was alleged generally, only
17 breach of contract claims were formally pled. The judgment expressly by its terms states
18 judgment was entered only on the breach of contract claims.

19 The collateral estoppel effect of a California default judgment only precludes the party
20 from challenging the material factual issues that were both raised in the state court pleadings
21 and necessary to uphold the judgment. In the previous action, the state court expressly entered
22 its default judgment only for breach of contract, without finding that the Debtors committed
23 fraud. *In re Harmon*, 250 F. 3d 1240, 1248-49 (9th Cir. 2001) (judgment for constructive fraud
24 not tantamount to a determinative of actual fraud so collateral estoppel cannot be applied).
25 Fraud was thus not necessarily decided. *Id.* Therefore, collateral estoppel principles leave the
26 issue of non-dischargeability for fraud or defalcation while acting in a fiduciary capacity to be
27 decided in this Court.

1 Since Wendt's allegations of non-dischargeability under 11 U.S.C. §§ 523(a)(2) for fraud
2 and (4) for defalcation survive to be litigated in part in this Court, whether these claims are
3 properly alleged must be addressed.

4 **C. Dischargeability under 11 U.S.C. § 523(a)(2)**

5 Wendt's fraud allegations, liberally construed, are that his debt is not dischargeable
6 under 11 U.S.C. § 523(a)(2) since it was incurred through fraud and a false representation of the
7 Debtors' financial condition. To prove fraud under 11 U.S.C. § 523(a)(2)(A), Wendt must
8 prove that: (1) the Debtors made a representation; (2) the Debtors knew the representation was
9 false at the time it was made; (3) the Debtors made the representation with the intention and
10 purpose of deceiving the creditor; (4) Wendt relied on the representation; and (5) Wendt
11 sustained damages as a proximate result. *In re Kirsh*, 973 F.2d 1454, 1457 (9th Cir. 1992)
12 (quoting *In re Britton*, 950 F.2d 602, 604 (9th Cir. 1991)). Under a separate sub-section of the
13 statute, 11 U.S.C. § 523(a)(2)(B), Wendt's allegations also can be liberally construed as
14 claiming that the Debtors fraudulently presented a false picture of their overall financial health.
15 *In re Joelson*, 427 F.3d 700, 714 (10th Cir. 2005); *In re Medley*, 214 B.R. 607, 612 (B.A.P. 9th
16 Cir. 1997) (statements of specific financial facts actionable, while general hopes of a sale of
17 assets or vague opinions are not).

18 Applying these legal standards, the Court concludes Wendt adequately alleges facts for a
19 non-dischargeability claim due to fraud concerning two of the eight misrepresentations.

20 **1. The Debtors Made Representations**

21 Wendt alleges the Debtors made false representations, citing multiple instances throughout
22 the Complaint:

- 23
- 24 1. Representation that the Debtors had a solid contract with Red Bull (Wendt's Exh. B)
 - 25 2. Representation that Wendt's investment was safe and secure (Compl. at 4)
 - 26 3. Representation that agreements with Red Bull were so solid that the Debtors
27 guaranteed repayment of all money advanced to them by Wendt (Compl. at 4)
 - 28 4. Representation that the only thing that could go wrong was if Debtor Theo Hanson
died (Compl. at 4)
 5. Representation that the Debtors had already invested a sum of \$16,000 into the
business venture (Compl. at 4)

- 1 6. Representation that the Debtors had assets which would be used to invest in the
business enterprise in the amount of \$40,000 (Compl. at 4)
- 2 7. Sum of \$200,000 used for non-business expenses for HP Media, Inc. and Sixth Sense
Studios (Compl. at 6)
- 3 8. Check No. 1086 for \$20,000 from Sixth Sense Studios given to Wendt as partial
4 payment, which was returned for insufficient funds (Compl. at 6).

5 The Debtors misguidedly focus much of their Motion on the eighth representation; the
6 insufficiency of funds check. Knowingly writing a check with insufficient funds is not a "false
7 statement" within the meaning of the federal criminal law. *Williams v. United States*, 458 U.S.
8 279, 284 (1989). This type of representation is thus not a basis to state a claim and the Motion
9 is granted to this extent.

10 Fraud also cannot be based upon mere opinion or predictions of future events. *Caldwell v.*
11 *Hanes (In re Hanes)*, 214 B.R. 786, 810 (Bankr. E.D. Va. 1997); *Lisk v. Criswell (In re*
12 *Criswell)*, 52 B.R. 184, 196 (Bankr. E.D. Va. 1985); *Wilder v. Waller (In re Waller)*, 210 B.R.
13 370, 378 (Bankr. D. Colo. 1997); *see also In re Jogert, Inc.*, 950 F.2d 1498, 1507 (9th Cir.
14 1991) (applying California law). The first four examples of fraudulent misrepresentations are
15 predictions and opinions, not misrepresentations. The Motion is granted to eliminate these
16 allegations as part of the fraud cause of action.

17 Two of the remaining fraud claims, representations five and six, are actionable
18 misstatements of fact: that the Debtors had already invested a sum of \$16,000 into the business
19 venture and that the Debtors had assets which would be used to invest in the business enterprise
20 in the amount of \$40,000. These representations also fit within the 11 U.S.C. § 523(a)(2)(B)
21 test for non-dischargeability as claims that the Debtors fraudulently presented a false picture of
22 their overall financial health. *In re Barrack*, 201 B.R. 985, 987-88 (Bankr. S.D. Cal. 1996).

23 The seventh representation, that the sum of \$200,000 invested by Wendt was not used as
24 promised, but instead for non-business expenses for HP Media, Inc. and Sixth Sense Studios, is
25 not actually a representation of fact, but instead a claim for misuse of the money Wendt
26 invested. While this claim may be recoverable under the defalcation or a false promise theory,
27 it is not a statement of fact. A debtor's failure to perform some promised action is not enough to
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1 prove false pretense, false representation, or actual fraud. *Matter of Bercier*, 934 F.2d 689, 691-
2 92 (5th Cir. 1991). Wendt must prove either defalcation or the Debtors' intent to misuse these
3 funds before the investment was made for this cause of action to be viable. *In re Woodman*, 451
4 B.R. 31, 38 (Bankr. D. Idaho 2011); *see Matter of Bercier*, 934 F.2d 689, 692 (5th Cir. 1991);
5 *see also Palmacci v. Umpierrez*, 121 F.3d 781, 788 (1st Cir. 1997).

6 **2. The Debtors Knew Representation Was False**

7 As to the remaining allegations, Wendt, as a *pro se* party, has adequately alleged that the
8 Debtors knew these representations were false at the time they were made. From their nature,
9 the Court can infer that the Debtors would have known that the representations were false.
10 Because these facts were fully within their personal knowledge, the Debtors would have known
11 if they had already paid \$16,000 of their own money into the company at the time they made the
12 representation, and whether they had \$40,000 to invest. As Wendt is proceeding without
13 representation, the Court holds his pleadings to less stringent standards, and therefore can infer
14 that Wendt is claiming the Debtors knew the representation was false at the time it was made
15 even if he did not specifically allege this fact. *Hebbe*, 627 F.3d at 342.

16 **3. The Debtors Had Intent and Purpose of Deceiving Creditor**

17 Wendt adequately alleged that the Debtors made the false representations that the
18 Debtors had already invested \$16,000 of their own money, and had \$40,000 of their own to
19 invest to induce Wendt into investing in the company. The nature of these actions likewise
20 implies an intent and purpose to deceive Wendt into investing in the business opportunity. *See*
21 *In re Kennedy*, 108 F3d 1015, 1018 (9th Cir. 1997) (intent to defraud is a question of fact that
22 can be inferred from surrounding circumstances).

23 **4. Creditor Relied on Representations**

24 Wendt adequately alleged he relied on the Debtors' false representations and would not
25 have entered into the agreements with the Debtors or incurred the unpaid debt that the Debtors
26 are seeking to discharge.

- 1 3. Misappropriation of \$4,500 as repayment of a loan to Rick Frederick, who was not
involved with the business enterprise
- 2 4. Checks issues for \$2,000 to Phyllis and Wensel, the parents of Debtor Kimberly Dawn
Hanson, as repayment of a loan
- 3 5. Misappropriation of \$10,800 from the company checkbook given to Debtor's son, Adam
Mills, not in connection with the business enterprise
- 4 6. Check issued from Sixth Sense Studio business account to Alliance Title and Escrow for
an unknown purpose

5
6 These allegations are classic examples of defalcation. *Ragsdale*, 780 F.2d at 797.

7 Representation 7 of the Complaint, that the sum of \$200,000 invested by Wendt was not used as
8 promised, but instead for non-business expenses for HP Media, Inc. and Sixth Sense Studios,
9 also presents a classic case of defalcation. *Id.* These allegations are sufficient, and the Motion
10 for failure to state a claim for defalcation by a fiduciary is denied.

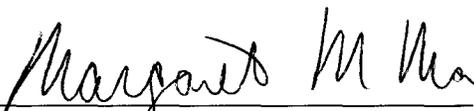
11 **III. CONCLUSION**

12 The Motion is denied to the extent it seeks to bar or establish the non-dischargeability
13 claims on res judicata grounds. The Motion is also denied to the extent it seeks to re-litigate the
14 amount of the debt owing to Wendt, as this issue is established as a matter of law on collateral
15 estoppel grounds.

16 The Motion is granted to the extent it challenges the sufficiency of the Complaint regarding
17 the allegations of a bad check and opinions relating to the future success of the business, and
18 denied on all other sufficiency grounds. The Court notes that exceptions to discharge are
19 construed liberally in favor of the debtor and the party seeking to establish an exception to
20 discharge bears the burden of proof. *In re Barr*. 194 B.R. 1009, 1016 (Bankr. M.D. Ill. 1996).
21 While Wendt can proceed with his claims in this Court, whether Wendt can prove his fraud and
22 defalcation claims will need to be resolved at trial.

23 IT IS SO ORDERED.

24
25 Dated: November 21, 2011

26 
27 MARGARET M. MANN, JUDGE
28 United States Bankruptcy Court