WRITTEN DECISION – NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re:	BANKRUPTCY NO: 12-07812-MM7
JEROLD DENNIS BURKE,	ADVERSARY NO: 12-90311-MM
Debtor.	CHAPTER: 7
FIBER-TECH MANUFACTURING, INC.,	MEMORANDUM DECISION RE MOTION TO DISMISS FILED BY FIBER TECH MANUFACTURING, INC.
Plaintiff,	
v.	DATE: August 1, 2013 TIME: 3 p.m. CRTRM: 1
JEROLD DENNIS BURKE,	JUDGE: Margaret M. Mann
Defendants.	

Before the Court is the Second Amended Complaint ("Complaint") of Plaintiff Fiber-Tech Manufacturing, Inc., originally Fiber-Tech Engineering, Inc., (hereinafter "Old Co." or "Plaintiff"). The Complaint, the third filed by Plaintiff, claims that debtor Jerold Dennis Burke ("Burke") debt to it should be excepted from discharge. Burke filed a motion to dismiss this Complaint ("Motion"), asserting as in the case of the First Amended Complaint and the initial Complaint, that Plaintiff could not allege a viable cause of action. Three causes of action are alleged in the Complaint: (i) under 11 U.S.C. §§ 523(a)(2)[1] for fraud for failing to identify certain retirement counts as exempt in a 2006 financial statement; (ii) under § 523(a)(4) for embezzlement of Plaintiff's property arising from a foreclosure sale by the senior lender, and (iii) willful and malicious injury under § 523(a)(6) also relating to the foreclosure.

[1]All reference to a statutory section will be to the Bankruptcy Code unless otherwise noted.

Despite being whittled down substantially due to the Court's rulings on the previous Motions to Dismiss, the Complaint is still not a model of clarity; however, more detail about the dealings between the parties, particularly in the numerous exhibits attached to the Complaint, has been alleged. This detail has helped elucidate some of Plaintiff's claims, but contradicts other claims. The Motion to Dismiss largely relies upon the contradictions between the text of the Complaint and the exhibits it attached.

As amended, the Complaint now alleges a viable claim under § 523(a)(6). The Motion to Dismiss will be denied on that basis. On the other hand, Plaintiff has failed to allege a plausible claim under either § 523(a)(2)(B) or § 523(a)(4) because those claims alleged are not consistent with the facts presented in the exhibits attached to the Complaint. Those causes of action will be dismissed with prejudice since ample opportunity to amend has been provided to Plaintiff, and the defects cannot be cured. In fact, Plaintiff was offered the opportunity to submit further briefing at the hearing, which he declined.

Motion to Dismiss Standard

To survive a motion to dismiss, the Complaint must be construed in the light most favorable to the Plaintiff, accepting as true all material allegations, as well as reasonable inferences to be drawn from them. *Pareto v. FDIC*, 139 F.3d 696, 699 (9th Cir. 1998). While a complaint "does not need detailed factual allegations," those allegations "must be enough to raise a right to relief above the speculative level." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007). Federal Rule Bankruptcy Procedure 7008 requires a claim for relief contain only "a short and plain statement of the claim showing that the pleader is entitled to relief," but this claim must have "facial plausibility," which is met "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Id.* "So

when the allegations in a complaint, however true, could not raise a claim of entitlement to relief, this basic deficiency should be exposed at the point of minimum expenditure of time and money by the parties and the court." *Twombly,* 550 U.S. at 558 (internal quotations omitted). Particularly where fraud is alleged, as here under Rule 9(b), Fed. Rules Civ. Proc., incorporated by Federal Rule of Bankruptcy Procedure 7009, the details must be alleged with particularity.

In additional to the documents attached to the Complaint, the Court takes judicial notice of the documents attached to the filings in the main bankruptcy case and the public record UCC filings that were attached by Burke in his request for judicial notice. For purposes of this Rule 12(b)(6) motion, the Court need not accept as true allegations that contradict facts which may be judicially noticed. *Von Saher v. Norton Simon Museum of Art at Pasadena*, 592 F.3d 954, 960 (9th Cir. 2010); *Intri-Plex Technologies, Inc. v. Crest Group, Inc.,* 499 F.3d 1048, 1052 (9th Cir. 2007). The Court also need not accept as true legal inferences the Complaint asserts, particularly where as here, the legal conclusions are based upon a misstatement of secured transaction law. *Iqbal*, 556 U.S. at 678-79 (court need not accept as true legal conclusions couched as factual assertions); *Sambreel Holdings LLC v. Facebook, Inc.*, 906 F. Supp. 2d 1070, 1075 (S.D. Cal. 2012) ("[T]he Court need not accept as true 'legal conclusions' contained in the complaint.").

Allegations of Complaint

The Complaint as amended alleges that in 2006, Burke purchased Plaintiff's assets through a new entity, i.e., Fiber-Tech Engineering, Inc. (hereinafter "New Co.") for $1.62 million. The purchase was financed by a $1.25 million loan from CIT Small Business Lending Corporation ("CIT") and a $400,000 carry back note from New Co. to Plaintiff. The items sold included the equipment and goodwill of Old-Co, and both CIT and Plaintiff took liens in these assets as collateral to secure their financing. Plaintiff's lien was indisputably junior in priority to CIT's lien, since the contracts between the

parties reflect that Plaintiff's lien would be subordinated to the SBA financing lien. Burke personally guaranteed both loans. As part of the loan approval process, Burke by a September 18, 2006 email provided a list of all his assets to Plaintiff, which included his retirement accounts that were designated as such. Plaintiff alleges that Burke promised to provide his retirement accounts as collateral for the guarantee and concealed that he had no intention of doing so. There are no allegations Burke in fact provided any security interest in personal assets to secure his guarantee to Plaintiff.

By March 1, 2011, New Co. had defaulted on both of these loans and Plaintiff and CIT each began collection efforts. Burke and New Co. hired a work out company at the time, Second Wind Consultants, Inc. ("Second Wind") and its consultant Harry Greenhouse. The work out contract stated they would devise a plan to protect the business assets "from the secured creditors." Second Wind on behalf of Burke and New Co. began negotiating with Plaintiff and CIT to resolve the default. Second Wind sought unsuccessfully to find a buyer for the business. When the default on its debt was not cured, Plaintiff filed a judicial foreclosure action in state court on May 12, 2011, and served Burke and New Co. with a summons. CIT was neither named a party, nor was it served with process for this suit. As such, the suit could have no effect on CIT's lien. *See Oliver v. Bledsoe,* 5 Cal. App. 4th 998, 1006 (Cal. App. 1st Dist. 1992) (when on notice of a lien, the creditor "cannot hope to extinguish it by strict foreclosure, without notice and an opportunity to object"); *see also Monterey S. P. P'ship v. W. L. Bangham*, 49 Cal. 3d 454, 459 (Cal. 1989) (holding that a default judgment on a real estate judicial foreclosure action could only affect the interests of the parties named in the complaint and served with summons).

On August 26, 2011, a default judgment on the suit was entered against Burke and New Co. (the "Default Judgment"), granting Plaintiff possession of the collateral and the right to sell the collateral to satisfy the debt. The Default Judgment stated that the collateral was "deemed transferred to Plaintiff as

of March 2, 2011," and also provided provisions for sale of the collateral with the proceeds to be paid to Plaintiff. Plaintiff served notice of the Default Judgment upon Burke and New Co. by mail on August 29, 2011. Plaintiff alleges that the Default Judgment eliminated New Co.'s interests in the assets, but there are no allegations that Plaintiff enforced its judgment by later conducting a foreclosure sale or by actually taking physical possession of the collateral as it was entitled to do under the Default Judgment. The Complaint also alleges the later CIT sale to Kolbus was subject to Plaintiff's lien that remained outstanding, indicating that Plaintiff's lien was not discharged by the Default Judgment.

In the meantime, on July 29, 2011, CIT began a non-judicial foreclosure of its liens and executed a "Notification of Disposition of Collateral," claiming to intend to sell its "collateral" to the "highest qualified bidder" through a public auction. On August 2, 2011, Plaintiff gave CIT notice of its objection to the public action and requested to participate in the auction. Thereafter Plaintiff was sent a confidentiality agreement to sign to participate in the CIT workout, but the Exhibits attached to the Complaint reflect that Plaintiff was not interested in acquiring the assets.

Separately on August 2, 2011, Fiber-Tech LLC, a Nevada limited liability company controlled by Burke's brother-in-law Stanley Kolbus (collectively "Kolbus"), purported to execute a private purchase agreement with Burke wherein New-Co. agreed to sell its property and business operations for $40,000 in derogation of Plaintiff's rights under the Default Judgment. Second Amended Complaint, Docket #45, at ¶25. The purchase agreement stated the Buyer "requests" that CIT conduct a foreclosure sale to deliver it "clean title to the assets," although CIT was not a party to the contract. At the time, CIT's lien had been reduced by payment to $881,000 per the exhibits attached to the Complaint. Whether the sale closed or not is not clear.

Where the allegations of the Complaint are particularly unclear is on the issue of how New Co.'s assets ended up held with Kolbus. In one place, it is alleged the Kolbus was the fraudulent transferee of

New Co. In another it is alleged that New Co. transferred its assets to CIT, who then transferred them to Kolbus. The most specific allegation of the Complaint is that in September of 2011, CIT sold the equipment to Kolbus for $40,000 when the assets had been previously sold to Burke/New Co. for $1,600,000, despite Plaintiff's Default Judgment. Second Amended Complaint, Docket #45, at ¶27. Perhaps both CIT and New Co. each transferred their separate rights to Kolbus. The Complaint alleges that CIT had no title to transfer, and then references the Default Judgment Plaintiff had obtained in state court, even though that judgment could not affect CIT.

CIT did not comply with the public auction process it had originally noticed to Plaintiff. Rather, the Complaint alleges CIT foreclosed pursuant to an invalid private sale, as part of a fraudulent scheme to deprive Plaintiff of the value of the collateral. As additional details of the fraudulent scheme, Plaintiff alleges that Kolbus was a silent owner and Burke remained employed at the business under an unwritten employment agreement, which continued to function exactly as it had when still formally owned by Burke. The purpose of the sale was allegedly to prevent Plaintiff from collecting the debt owed by Burke and from realizing on Plaintiff's security interest.

The § 523(a)(2)(B) Claim

Plaintiff alleges the September 18, 2006 email from Burke, in conjunction with the attached financial statement, constitutes a materially false statement in writing because Burke misrepresented the availability of his retirement accounts to pay Plaintiff's note of $400,000 and "support his debts." Plaintiff also alleges that "at the time Burke represented that his retirement accounts would serve as collateral for debts incurred, Burke actually had no intent on ever making those assets available." There are two ways for the Court to interpret these allegations: (i) Burke promised to provide the retirement accounts as formal collateral for the debt and then failed to do so, or (ii) Burke falsely failed state that the retirement accounts were exempt. Burke claims the allegations are time barred, and that the written

financial statement is not false. The Court concludes that either way these allegations might be interpreted, they do not state a cause of action.

Under §523(a)(2)(B), Plaintiff must allege the same five elements of a 523(a)(2)(A) claim as applicable to a written financial statement: (1) Burke's misrepresentation, fraudulent omission, or deceptive conduct on the written financial statement; (2) Burke's knowledge of the falsity or deceptiveness of his own statement; (3) Burke's intent to deceive; (4) Plaintiff's justifiable reliance; and (5) damage to Plaintiff proximately caused by relying on Burke's statement or conduct. *Tallant v. Kaufman (In re Tallant)*, 218 B.R. 58, 69 (B.A.P. 9th Cir. 1998). Justifiable reliance is a subjective standard based on "the knowledge and relationship of the parties themselves." *Id.* quoting *Eugene Parks Law Corp. Defined Benefit Pension Plan v. Kirsh (In re Kirsh)*, 973 F.2d 1454, 1458 (9th Cir. 1992). As to damages, "proximate cause is something more than speculation as to what the creditor might have done in hypothetical circumstances and that proximate cause inevitably turns upon conclusions in terms of legal policy." *Candland v. Insurance Co. of N. Am. (In re Candland)*, 90 F.3d 1466, 1471 (9th Cir. 1996) (finding proximately caused damage because any misrepresentation would have resulted in the creditor's refusal to issue bonds).

While the Court assumes for the purpose of this Motion that Burke had the intent to deceive, the actual financial statement attached as an exhibit eliminates the plausibility of other elements of the claim: false representation, reliance and proximately caused damages. *Sierra Invs., LLC v. SHC, Inc. (In re SHC, Inc.)*, 329 B.R. 438, 442 (Bankr. D. Del. 2005) ("[I]f the allegations of [the] complaint are contradicted by documents made a part thereof, the document controls and the Court need not accept as true the allegations of the complaint."); *Cooper v. Yates*, 2010 U.S. Dist. LEXIS 125420 (E.D. Cal. Nov. 26, 2010) (disregarding factual allegations contradicted by facts established by reference to exhibits attached to the complaint).

Based on the Court's review of the written financial statement, Plaintiff cannot satisfy the requirement under § 523(a)(2)(B) that the writing itself be false. The writing does not make the alleged misrepresentation at all. Burke merely provided a list of assets as his "net-worth," including all his retirement accounts that were detailed as "IRA or Other Retirement Accounts." Second Amended Complaint, Docket #45, Exhibit 2. Burke never states in the email attaching the financial statement or the financial statement itself that his retirement accounts could be used to "support his debts" or were available to pay Burke's guarantee. And it was certainly not false or concealed that the retirement accounts were IRA's and 401K accounts subject to exemption. It is not alleged that Burke did not in fact hold those accounts, or that the amounts were inaccurate.

The inference that Plaintiff seeks the Court to draw — the inclusion of these accounts meant that Burke was implicitly representing or promising their availability to pay his debt in the future — is implausible since Burke was within his legal rights to claim his retirement accounts exempt when he filed for bankruptcy. 11 U.S.C. § 522(b)(3)(c) ("retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986"); Cal. Civ. Proc. Code § 704.115. No cases were cited to the Court in support of this theory, and the Court could find none in its own search. In fact, Ninth Circuit law even permits non-exempt assets to be converted to exempt assets immediately prior to bankruptcy, if no other circumstances of fraud are present. *Gill v. Stern (In re Stern),* 345 F.3d 1036, 1044 (9th Cir. Cal. 2003). Under the Bankruptcy Code and applicable California law, exemptions are to be broadly and liberally construed in favor of the debtor. *See In re Gardiner*, 332 B.R. 891, 894 (Bankr. S.D. Cal. 2005). Implementing Plaintiff's interpretation would directly contradict this policy. If Plaintiff's claim were valid, all financial statements would have to reserve the right to assert exemptions as to homes and cars and accounts or risk being threatened with fraud.

To the extent that the Complaint can be liberally construed as a § 523(a)(2)(A) false promise claim that alleges that Burke had promised to secure the guarantee with a security interest in the retirement accounts in 2006 without an intention to so, that promise would have been a known breach when the deal closed. As such, the claim would be barred by the statute of limitations and not tolled until this suit was filed more than 3 years later. There is a three-year statute of limitations for state law fraud claims under Cal. Code Civ. Pro. § 338(d). Even if Burke had made this promise in 2006, Plaintiff would know what he received in this deal, a security interest in the retirement accounts or not, when it closed at the end of 2006, and he received the final documentation for the deal. It is not knowledge of the existence of the legal claim, but the knowledge of the facts giving rise to the alleged injury that triggers the date of discovery under state law for statute of limitations tolling purposes. *See Grisham v. Philip Morris USA, Inc.*, 40 Cal. 4th 623, 646, 54 Cal. Rptr. 3d 735, 151 P.3d 1151 (2007) (personal injury claim for a tobacco company's misrepresentation accrued at the time that "the physical ailments themselves were, or reasonably should have been, discovered"). A cause of action will accrue when the plaintiff is with "presumptive knowledge" of his injury, and the statute commences to run, once he has "'notice or information of circumstances to put a reasonable person on inquiry, or has the opportunity to obtain knowledge from sources open to his investigation'" *Gutierrez v. Mofid*, 39 Cal. 3d 892, 896-897 (Cal. 1985) (citations omitted.). The Motion to Dismiss the § 523(a)(2)(B) claim is granted with prejudice.

Alter Ego

Plaintiff's allegations of the § 523(a)(4) and § 523(a)(6) claims are based in part on the theory of alter ego, since the transactions did not involve Burke's individual assets but rather New Co.'s, the company he allegedly owned and controlled. The necessary elements of alter ego are: (1) "unity of interest and ownership between the corporation and its equitable owner that the separate personalities of

the corporation and the shareholder do not in reality exist"; (2) "an inequitable result if the acts in question are treated as those of the corporation alone." *Hub City Solid Waste Services, Inc. v. City of Compton*, 186 Cal. App. 4th 1114, 1122 (Cal. App. 2d Dist. 2010). "Factors considered in applying the doctrine include whether there was commingling of funds or assets, use of the entity as a shell or conduit for the affairs of the other, inadequate capitalization, disregard of corporate formalities, and lack of segregation of corporate records." *Mohsen v. Wu (In re Mohsen)*, 2010 Bankr. LEXIS 5074, 4-5 n.7 (B.A.P. 9th Cir. Dec. 21, 2010) (unpublished) citing *Sonora Diamond Corp. v. Superior Court*, 83 Cal. App. 4th 523, 539 (2000). The California Supreme Court has stated that the corporate form will be disregarded only in narrowly circumscribed circumstances and only when the ends of justice so require. *See Mesler v. Bragg Mgmt Co.*, 39 Cal. 3d 290, 300 (1985); *see also Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1116 (C.D. Cal. 2003)

Beyond alleging the elements of alter ego, Plaintiff must also allege specific facts supporting each element. *See Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1116 (C.D. Cal. 2003) ("a plaintiff must allege specifically both of the elements of alter ego liability, as well as facts supporting each."). "[A]llegations in a complaint or counterclaim may not simply recite the elements of a cause of action, but must contain sufficient allegations of underlying facts to give fair notice and to enable the opposing party to defend itself effectively." *Starr v. Baca* , 652 F.3d 1202, 1216 (9th Cir. 2011); *see also Rubin v. CHHP Holdings II, LLC (In re Karykeion, Inc.)*, 2013 Bankr. LEXIS 2690, at *11-12 (B.A.P. 9th Cir. 2013) (unpublished). "Conclusory allegations of 'alter ego' status are insufficient to state a claim. Rather, a plaintiff must allege specifically both of the elements of alter ego liability, as well as facts supporting each." *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1116 (C.D. Cal. 2003); *see also Television Events & Mktg., Inc. v. Amcon Dist. Co.*, 416 F. Supp. 2d 948, 963 (D. Haw. 2006) ("Courts have stated that a plaintiff may not simply make 'conclusory allegations' to find

liability under an alter ego theory."). "It is the plaintiff's burden to overcome the presumption of the separate existence of the corporate entity." *Mid-Century Ins. Co. v. Gardner*, 9 Cal. App. 4th 1205, 1212 (Cal. App. 3d Dist. 1992).

Plaintiff has three alter ego allegations. It alleges that Burke was the sole shareholder of New Co., and owned and controlled it, and actively participated in the conduct alleged in the Complaint. It also alleges: "Defendant Debtor Burke operated the New Co. without following corporate formalities, as set forth herein engaged in related party transactions, failed to adequately capitalize the business, commingled business and personal expenses, and entirely dominated and controlled the New-Co., to the detriment its creditors, i.e., the alter-ego. " Second Amended Complaint, Docket #45, at ¶5. Plaintiff also states that "the corporate separateness of New-Co should be disregarded as the unity of interest and ownership between the corporation and its equitable owner Debtor Defendant Burke, herein, that the separate personalities of the corporation and the shareholder do not in reality exist. To recognize such a separateness of personality will result in an inequitable consequence if the acts in question are treated as those of the corporation alone." Second Amended Complaint, Docket #45, at ¶5.

While these allegations are conclusory, the other allegations of facts in the case as a whole support the alter ego claim regarding Burke's liability for a wrongful foreclosure: Burke used personal funds to pay for the planning to resolve New Co.'s debts with Second Wind and with CIT, New Co. was failing, Burke controlled the process, and Burke still works at the place of business with the same assets. As in *In re PW Commer. Constr. Co., Inc.*, 2012 Bankr. LEXIS 4676 (Bankr. N.D. Cal. Oct. 4, 2012) (unpublished) (the bankruptcy court found it inequitable not to hold a sister corporation liable as debtor's alter ego when the debtor had transferred substantially all its assets to it), the Court finds that the alter ego allegations are sufficient at this stage of pleading.

The Motion to Dismiss is denied to the extent that the § 523(a)(4) and § 523(a)(6) claims depend upon valid alter ego allegations.

Embezzlement under § 523(a)(4)

Section 523(a)(4) provides that a debt for embezzlement is nondischargeable. The elements of embezzlement in the context of nondischargeabililty are: (i) property rightfully in the possession of a non-owner; (ii) non-owner's appropriation of the property to a use other than which it was entrusted and (iii) circumstances indicating fraud. *Littleton v. Transamerica Commercial Financial Corp. (In re Littleton)*, 942 F.2d 551, 555 (9th Cir. 1991). "Acts intrinsically meriting nondischargeability under § 523(a) can be attributed to a debtor who did not perform them, if the debtor was a 'knowing active participant' in a scheme or conspiracy through which a third-party malefactor performed the acts." *Moore Automotive Group, Inc. v. Lewis (In re Lewis)*, 424 B.R. 455, 460 (Bankr. E.D. Mo. 2010) (finding question of fact as to "the nature and extent of [d]ebtor's knowledge and participation" in a third party's embezzlement of plaintiff's funds); *see also Qwest Communs. Corp. v. Weisz*, 278 F. Supp. 2d 1188, 1192 (S.D. Cal. 2003) (finding that plaintiff properly alleged a claim for a fraudulent conveyance based conspiracy).

Plaintiff alleges it was the rightful owner of the collateral and that Burke committed embezzlement under § 523(a)(4) because Plaintiff's judicial foreclosure of its lien transferred the ownership of the collateral from New Co. to Plaintiff as of March 2, 2011. Because Plaintiff was the owner, it alleges, Burke/New Co. was therefore a non-owner in possession of the equipment at the time of the CIT foreclosure sale as this claim requires. Plaintiff alleges Burke appropriated that property when it participated in the CIT foreclosure sale under circumstances amounting to fraud. Plaintiff also asserts Burke was the trustee for the collateral somehow giving rise to embezzlement or larceny. This allegation is not specific enough for the Court to fathom since it ignores the established elements of this

claim. In any event, a constructive trustee is not within the scope of § 523(a)(4) since its fiduciary duties arise only upon the wrongdoing. *Blyler v. Hemmeter (In re Hemmeter)*, 242 F.3d 1186, 1189-90 (9th Cir. 2001). Burke's Motion to Dismiss is based upon the exhibits proving that New Co. was still the owner of the equipment at the CIT foreclosure sale, so Plaintiff cannot claim embezzlement. The Court agrees.

The Court must first determine whether the Default Judgment was a valid transfer of the title of the collateral. Based upon the plain language of the Default Judgment viewed in the context of applicable secured transaction law, the Court concludes that the Default Judgment only gave Plaintiff the *right* to possess the collateral to the extent the collateral constituted tangible assets. It remained for this right to be enforced due to the taking of physical possession. *See* 8 Witkin, Cal. Proc., *Enforcement of Judgment*, §§ 329 & 331 (5th ed. 2008). While the Default Judgment states that the collateral is "deemed transferred to Plaintiff as of March 2, 2011," it then states that the collateral was also to "be sold, and the proceeds of which shall be transferred to Plaintiff." This second part of the order corroborates that the Default Judgment was only a transfer of possession instead of a transfer of title. The two steps in the order follow the recognized sequence of a personal property judicial foreclosure action. "Generally speaking, foreclosure and transfer of title must be accomplished by a sale, lease or other disposition of the collateral, or by compliance with the strict foreclosure procedures in Article 9." *Wright Flight Aviation, Inc. v. Krasnoff (In re Mach I Aviation, Inc.)*, 2011 Bankr. LEXIS 4334, at *22 (B.A.P. 9th Cir. Sept. 15, 2011) (unpublished).

The exception to this dual step process is in the case of strict foreclosure, which the state court did not order in the Default Judgment. Instead, it ordered the further sale of the collateral. *See Crosby v. Reed (In re Crosby)*, 176 B.R. 189, 191 (B.A.P. 9th Cir. 1994) (holding that secured creditors did not accept repossessed collateral in satisfaction of debt when they temporarily retained the collateral before

sale but never carried out any of the steps required for strict foreclosure); Cal. Comm. Code §§ 9610; 9620 - 9623. In any event, a strict foreclosure required the express consent of the Burke that was not given; implicit consent is insufficient as the Advisory Committee notes to Cal. Comm. Code § 9620 make clear in comment 3. *See Braunstein v. Gateway Mgmt. Servs. (In re Coldwave Sys., LLC),* 368 B.R. 91, 95 (Bankr. D. Mass. 2007). Additionally, the second step ordered would be surplusage if the state court intended a strict foreclosure. There would be no need to sell the collateral to complete Plaintiff's foreclosure if it had already received title.

Because there are no allegations that Plaintiff had either taken physical possession of the collateral or conducted a valid strict foreclosure sale, Plaintiff fails to plausibly allege the first element of an embezzlement claim; to wit, property rightfully in the possession of a non-owner. When CIT foreclosed on its lien, Burke, the alleged alter ego of New Co., was still the owner of the collateral despite the Default Judgment. Burke was not a non-owner because Plaintiff had not perfected its ownership rights. Regardless of whether the CIT sale was an improperly conducted foreclosure due to failure to give notice to Plaintiff, these defects do not destroy the validity of sale, but instead give rise to a claim for damages for Plaintiff. *See* Advisory Committee Notes to Cal. Comm. Code § 9620 (the failure to comply with the notification requirement of § 9-621 does not render the acceptance of collateral ineffective. Rather, the acceptance can take effect notwithstanding the secured party's noncompliance. A person to whom the required notice was not sent has the right to recover damages under § 9-625(b).)

Even though the Court must conclude the other elements of embezzlement are alleged here, including circumstances amounting to fraud, the lack of a plausible basis to satisfy the first and second elements that require Burke to be a non-owner, is fatal to this claim. Accordingly, the Motion to Dismiss is granted with prejudice.

Willful and Malicious Injury Claims under § 523(a)(6)

Section 523(a)(6) provides that a discharge under § 727 will not except a debt for "willful and malicious injury." "Willful" means that the debtor has a subjective intent to harm, or the subjective belief that harm is substantially certain. *Carrillo v. Sue (In re Su)*, 290 F.3d 1140, 1144 (9th Cir. 2002). The "malicious" element involves a debtor's wrongful act, done intentionally and without just cause or excuse, that necessarily causes injury. *Id.* at 1146-47.

Plaintiff alleges: "Greenhouse, as part of his regularly conducted scheme and plan, collaborated with Debtor Burke and Kolbus to devise a means to avoid the outstanding obligations Burke owed to Plaintiff by way of a series of sham transactions using Kolbus as a straw buyer of the assets of New-Co from CIT." These allegations considered alone are sufficient to allege a willful and malicious injury. *Ewers v. Cottingham (In re Cottingham)*, 473 B.R. 703, 711 (B.A.P. 6th Cir. 2012) (finding debt nondischargeable under 523(a)(6) based on conspiracy to commit a willful and malicious injury due to the active participation by debtor in the wrongful and the absence of just cause or excuse); *see also Twombly*, 550 U.S. at 556 (2007) ("[A] well pleaded complaint may proceed even if it appears that a recovery is very remote and unlikely.").

Each of the required elements of active participation, intent to harm and lack of excuse is alleged or can be inferred here. However, Burke's Motion to Dismiss this claim relies largely on the size of the senior CIT lien in the amount of $881,000 per the exhibits to the Complaint. From this, he claims the cause of action for willful and malicious injury is implausible since Plaintiff was out of the money in its junior position since there was no value left to this lien. Since there is no dispute that Plaintiff had the junior lien and CIT the senior lien, the Court notes the collateral would need to have been worth more than CIT's lien ($881,000) for the collateral to have value after the senior lien was satisfied. The Court also cannot accept as plausible Plaintiff's claim that the Default Judgment released the CIT lien because

CIT was not a party. While these facts may limit Plaintiff's right to recovery, the Court cannot conclude no damages at all were incurred based upon the Complaint, particularly since CIT may have released its lien after the Kolbus sale. In any case, the amount of damages presents a factual issue for the Court to address at trial. Therefore, the Motion to Dismiss is denied as to the § 523(a)(6) claim.

Conclusion

For the reasons stated above, the Motion to Dismiss is denied as to the § 523(a)(6) claim and the alter ego allegations and granted with prejudice as to the remaining claims.

Dated: August 8, 2013

MARGARET M. MANN, JUDGE
United States Bankruptcy Court