

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re:]	Case No. 05-56449-ASW
]	
David Dennis Webster,]	Chapter 7
]	
Debtor.]	
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Eric G. Shedlarski,]	Adversary No. 05-5627
]	
Plaintiff,]	
vs.]	
]	
David Dennis Webster,]	
]	
Defendant.]	
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MEMORANDUM DECISION
DETERMINING DEBT TO BE DISCHARGEABLE

Before the Court is a complaint by Eric G. Shedlarski ("Creditor") against David Dennis Webster, the Debtor in this Chapter 7 case ("Debtor"). The complaint seeks a determination of non-dischargeability for a stipulated judgment of \$8,039.27 plus interest and costs based upon 11 U.S.C. §523(a)(2).¹

The matter has been tried and submitted for decision. Debtor is represented by Henry B. Niles III, Esq. Creditor is pro se. At

¹ Unless otherwise noted, all statutory references are to Title 11, United States Code, as amended in 2005 ("Bankruptcy Code").

1 trial, Creditor called himself as witness. Debtor called himself
2 as witness.

3 This Memorandum Decision constitutes the Court's findings of
4 fact and conclusions of law, pursuant to Rule 7052 of the Federal
5 Rules of Bankruptcy Procedure.

6
7 I.

8 FACTS

9 Debtor works in the computer industry in business development.
10 Debtor is not an attorney. Debtor leased residential property
11 located at 16040 Redwood Lodge Road, Los Gatos, California 95033
12 (the "Property") to Creditor pursuant to a written lease agreement
13 dated January 24, 2004. Debtor and his ex-wife formerly utilized
14 the Property as their residence. Under the lease agreement,
15 Creditor paid Debtor a security deposit of \$7,000.

16 Creditor vacated the Property on February 8, 2005. Debtor and
17 Creditor agreed that certain items would be deducted from the
18 security deposit, leaving \$4,790 of the security deposit owed to
19 Creditor. Debtor failed to return the \$4,790 to Creditor.
20 Creditor tried to work with Debtor to obtain the return of the
21 security deposit to no avail. Creditor hired counsel and, on
22 March 24, 2005, Creditor sued Debtor in state court for the return
23 of the \$4,790 deposit, \$9,580 in penalty damages, plus attorneys
24 fees and costs of suit.

25 In early 2005, Debtor knew he was in financial trouble.
26 Debtor had not paid the mortgage on the Property since November
27 2004. Debtor put the Property on the market in January or February
28 2005. On May 12, 2005, a Notice of Default was recorded against

1 the Property on behalf of Debtor's mortgage lender. On August 24,
2 2005, a Notice of Trustee's Sale ("Notice") was recorded against
3 the Property. The Notice set a trustee's sale for September 13,
4 2005. Debtor attempted to find a buyer for the Property prior to
5 the trustee's sale. Debtor testified that he believed, on the
6 basis of his correspondence with real estate professionals, that
7 there was \$150,000 of equity in the Property in August 2005.
8 Debtor's realtor held an open house on the Property on August 28,
9 2005.

10 Debtor represented himself in the state court litigation with
11 Creditor. A trial was set on or about September 7, 2005. In early
12 August 2005, Debtor testified that Creditor called Debtor when
13 Debtor was in Canada visiting relatives. Debtor testified that he
14 was unable to talk with Creditor at that time and Debtor
15 established another time to call Creditor.

16 Debtor testified that he returned Creditor's call the next day
17 and had a fifteen-minute telephone conversation. Debtor testified
18 that, during that conversation, Debtor told Creditor that the
19 Property was in foreclosure and that Debtor was contemplating
20 bankruptcy, but that Debtor anticipated that the Property would
21 sell before bankruptcy at a price great enough to pay Creditor's
22 debt. Debtor testified that he also told Creditor that Debtor's
23 marital difficulties were complicating the sale of the Property.
24 Debtor distinctly recalled offering Creditor a lien on the Property
25 in that phone conversation since Debtor believed there was
26 sufficient equity in the Property to pay such a lien. Debtor did
27 not recall if Debtor or Creditor initiated the idea of a lien.

28

1 Creditor acknowledged that Debtor communicated with Creditor
2 and Creditor's state court counsel regarding the state court
3 action. Creditor testified that he recalled one personal telephone
4 call with Debtor in August 2005 that lasted about five minutes.
5 Creditor testified that Creditor was aware of Debtor's financial
6 distress during the relevant time period and knew that the Property
7 was for sale. Creditor was also aware that Debtor and his wife
8 were separated. Creditor maintained that he was unaware that the
9 Property was in foreclosure.

10 On the eve of the state court trial, Creditor's counsel
11 confirmed with Debtor that Debtor had agreed to a lien on the
12 Property, and Creditor and Debtor entered into a stipulated
13 judgment in the state court action. Pursuant to the stipulated
14 judgment filed on September 7, 2005, Creditor agreed to reduce his
15 claim from approximately \$14,500.00 to \$8,039.27 and to forebear
16 from further collection actions. The parties also agreed that the
17 stipulated judgment would operate as a lien on the Property.

18 Creditor testified that Debtor failed to mention the pending
19 foreclosure proceedings during the settlement negotiations.
20 Creditor asserted that he would not have entered into the
21 stipulated judgment if he had known of the pending foreclosure
22 proceedings. Creditor testified that he did not believe that
23 either a judgment or a judgment lien guaranteed payment of what
24 Debtor owed Creditor.

25 Debtor testified that during this period, Debtor was under the
26 mistaken belief of fact and law that, if he provided Creditor with
27 a judgment lien against the Property, that lien would survive a
28 non-judicial foreclosure sale under California law. Debtor

1 believed in August and September 2005 that at a foreclosure sale,
2 the Property would be subject to auction and would sell at the
3 highest price and all liens on the Property would be paid in order
4 of preference, i.e., that Creditor's junior lien would be paid as
5 part of the foreclosure.

6 The trustee's sale took place on September 13, 2005, and the
7 Property reverted to the lender. Debtor filed for bankruptcy on
8 September 29, 2005. Creditor testified that he did not learn of
9 the foreclosure sale until November 15, 2005. Creditor filed this
10 action on December 27, 2005.

11 Debtor asserts there was no factual basis for Creditor's non-
12 dischargeability complaint and seeks an award of fees and costs
13 under 11 U.S.C. §523(d).

14
15 II.

16 APPLICABLE LAW

17 A debt arising from actual fraud "other than a statement
18 respecting the debtor's or an insider's financial condition" is
19 excepted from a Chapter 7 discharge pursuant to §523(a)(2)(A). The
20 elements of a claim under this statute are:

21 (1) a representation, fraudulent omission or deceptive
22 conduct by the debtor;

23 (2) knowledge of the falsity or deceptiveness of his
24 statement or conduct;

25 (3) an intent to deceive;

26 (4) justifiable reliance by the creditor on the debtor's
27 statement or conduct;
28

(5) damage to the creditor proximately caused by its reliance on the debtor's statement or conduct.

In re Harmon, 250 F.3d 1240, 1246 (9th Cir. 2001).

"A debtor's failure to disclose material facts constitutes a fraudulent omission under §523(a)(2)(A) if the debtor was under a duty to disclose and the debtor's omission was motivated by an intent to deceive." Harmon, 250 F.3d at 1246 n.4.

Absent a duty to disclose, the intent that must be shown for a determination of nondischargeability under §523(a)(2)(A) is actual intent, not merely intent implied in law, or constructive intent, Id. at 1249 n.10.

"Regardless of whether one is under a duty to speak or disclose facts, one who does speak must speak the whole truth, and not by partial suppression or concealment make the utterance untruthful and misleading." American Trust Co. v. California Western States Life Ins. Co., 15 Cal. 2d 42, 65 (1940).

The fact that a party had "constructive notice of the truth from public records is no defense to fraud." Bishop Creek Lodge v. Scira, 46 Cal. App. 4th 1721, 1734 (1996). The existence of such records "may be relevant to whether the victim's reliance was justifiable, but it is not, by itself, conclusive." Id.

The Bankruptcy Code is "designed to afford debtors a fresh start, and we interpret liberally its provisions favoring debtors." In re Bugna, 33 F.3d 1054, 1059 (9th Cir. 1994). The Code's limited exceptions to the general policy of discharge are to be construed narrowly. In re Riso, 978 F.2d 1151, 1154 (9th Cir. 1992).

1 The plaintiff in an action for determination of
2 dischargeability under §523(a) bears the burden of proving all
3 elements of the claim(s) for relief asserted by a preponderance of
4 the evidence. Grogan v. Garner, 498 U.S. 279, 287 (1991).

5
6 III.

7 ANALYSIS

8 **1. Dischargeability Under Section 523(a)(2)**

9 Here, Creditor has not met his burden of proof that Debtor
10 knowingly made a fraudulent omission with the intent to deceive
11 Creditor during settlement negotiations related to the state court
12 action. Despite Creditor's allegations, the evidence does not
13 support a finding that Debtor knew or should have known that the
14 judgment lien would not survive foreclosure or that the Debtor
15 misrepresented the utility of that lien as consideration for
16 settlement.

17 The alleged fraudulent omission by Debtor is Debtor's failure
18 to inform Creditor of the foreclosure proceedings pending against
19 the Property at the time of the settlement negotiations. Under the
20 terms of the settlement, Debtor conveyed a judgment lien against
21 the Property to Creditor. Creditor testified that he was not aware
22 that foreclosure proceedings were underway against the Property at
23 the time of the settlement negotiations. On the other hand, Debtor
24 testified that he informed Creditor of the pending foreclosure by
25 phone while Debtor was in Canada visiting his family.

26 Debtor testified that he was certain he had informed Creditor
27 of the pending foreclosure because Debtor had written several notes
28 to himself as to what Debtor planned to say to Creditor when Debtor

1 returned Creditor's call. Debtor emphasized that he included the
2 foreclosure in his notes and reiterated that he described his
3 financial trouble, his plans to sell the Property, his marital
4 problems, and the pending foreclosure during the fifteen minute
5 conversation with Creditor.

6 Creditor testified that he recalled having a phone
7 conversation with Debtor in August 2005 and also testified that he
8 knew the Property was for sale, that Debtor was experiencing
9 marital problems, and that Debtor was in financial trouble.
10 Creditor testified that he did not know about the pending
11 foreclosure. Creditor indicated that Creditor's counsel, who
12 represented Creditor in the state court action, may have received
13 such a call from Debtor about the pending foreclosure. Creditor's
14 counsel did not testify and Creditor did not present any other
15 evidence to rebut Debtor's testimony that Debtor informed Creditor
16 of the foreclosure.

17 Debtor and Creditor presented equally credible testimony. The
18 Court believes that Creditor is sure that Debtor did not tell him
19 of the pending foreclosure. It is possible that Debtor thought he
20 told Creditor of the foreclosure but did not, e.g., because Debtor
21 was sure Creditor would get paid on his lien even in a foreclosure.
22 It also is very possible that Debtor informed Creditor's counsel,
23 but not Creditor, of the pending foreclosure. That is perhaps the
24 most likely scenario of what occurred. Either way, Debtor's
25 conduct does not constitute fraud.

26 The parties agreed to settle their state court dispute on
27 terms that included a judgment lien against the Property in the
28 amount of \$8,039.27. A judgment lien is of speculative value and

1 the lien's worth turned on the ultimate exchange price of the
2 Property. The Property did not fetch a high enough price to pay
3 all claims against it, and Creditor received no compensation post-
4 sale. Had the Property sold on different terms, however,
5 Creditor's lien might well have entitled him to payment.

6 Creditor asserts that Debtor was aware at the time of the
7 settlement negotiations that the judgment lien would not survive
8 the pending foreclosure sale and Debtor therefore knew that
9 Debtor's failure to mention the foreclosure was deceptive. Debtor
10 credibly testified that he had no such knowledge.

11 Debtor testified that he in fact anticipated that the Property
12 would sell at a high enough price that the Creditor's junior lien
13 would have been paid. Debtor testified that the Property had a
14 mortgage of \$800,000 and that he believed the Property would sell
15 for \$1,060,000. Debtor further testified that the experienced real
16 estate professionals with whom Debtor dealt failed to anticipate
17 the low sale price at which the Property ultimately transferred.
18 To corroborate Debtor's testimony, Debtor admitted documents
19 indicating that the Property had a listing price of \$1,060,000 when
20 Debtor and Creditor entered settlement negotiations. Debtor also
21 testified that he was under the mistaken belief of fact and law
22 that, if the Property underwent a foreclosure sale, an auction
23 would take place and all liens would be paid.

24 Creditor presented no evidence to rebut Debtor's credible
25 testimony other than his own equally credible testimony. Creditor
26 did not prove by a preponderance of the evidence that Debtor knew
27 or should have known of the judgment lien's worthlessness.
28 Accordingly, it cannot be found that Debtor knew that a failure to

1 mention the foreclosure would be deceptive. Whether or not Debtor
2 informed Creditor or Creditor's counsel of the pending foreclosure,
3 Debtor's conduct did not constitute fraud because Debtor lacked the
4 requisite intent. Harmon, 250 F.3d at 1249 n.10.

5 Creditor did not prove by a preponderance of the evidence that
6 Debtor intended to or acted with the purpose of deceiving Creditor.
7 Creditor did not introduce any evidence to suggest that he was
8 justified in his reliance on Debtor's representations. The Court
9 notes in this regard that Creditor does not allege that Debtor
10 represented that the Property was not in foreclosure. Debtor
11 argues that Creditor was represented by counsel in the state court
12 action and that it was the responsibility of Creditor's counsel to
13 investigate the status of the Property. The Notice was a matter of
14 public record and Creditor's failure to investigate the status of
15 the Property by himself or by his counsel may not constitute
16 justifiable reliance. Bishop Creek, 46 Cal. App. 4th at 1734.

17 As for damages, Debtor argues that if Creditor had gone to
18 trial rather than accept the stipulated judgment lien, Creditor
19 would have, at best, received a judgment lien like the one offered
20 by Debtor during the settlement negotiations and that such a lien
21 also would not have survived the foreclosure sale. On this basis,
22 Debtor argues that the alleged fraud left Creditor in the same
23 position among other creditors that he would have held had Creditor
24 proceeded with his state court claim.

25 Debtor's argument assumes Creditor was faced with only two
26 options -- pursue the state court action and, if successful,
27 recover a judgment lien, or agree to a stipulated judgment and
28 accept a lien as settlement. Creditor testified that, had he known

1 of the foreclosure, Creditor might have sought alternative
2 consideration during the settlement negotiations. Creditor's
3 testimony was vague and speculative and Creditor failed to
4 substantiate his argument that he would have acted differently if
5 he had knowledge of the pending foreclosure sale. Creditor did not
6 prove by a preponderance of the evidence that he suffered damage as
7 a result of Debtor's alleged fraud.

8 **2. Costs and Attorney's Fees Under Section 523(d)**

9 Debtor seeks recovery of his attorney's fees and costs
10 incurred during the course of this adversary proceeding under 11
11 U.S.C. §523(d). Bankruptcy Code Section 523(d) provides:

12 If a creditor requests a determination of
13 dischargeability of a consumer debt under subsection
14 (a)(2) of this section, and such debt is discharged, the
15 court shall grant judgment in favor of the debtor for the
16 costs of, and a reasonable attorney's fee for, the
proceeding if the court finds that the position of the
creditor was not substantially justified, except that the
court shall not award such costs and fees if special
circumstances would make the award unjust.

17 A consumer debt is defined in Bankruptcy Code Section 101(8) as
18 "debt incurred by an individual primarily for a personal, family,
19 or household purpose."

20 Once a debtor establishes that the obligation is a
21 dischargeable consumer debt, the burden shifts to the creditor to
22 show that the position of the creditor was "substantially
23 justified" or that "special circumstances" would make the award
24 unjust. In re Stine, 254 B.R. 244, 249 (9th Cir. BAP 2000). The
25 standard of substantial justification is met if the creditor
26 demonstrates a reasonable basis in law or fact to file an action.
27 Id.

1 Here, Debtor failed to establish that the discharged debt is a
2 consumer debt. The debt here is comprised of an unreturned
3 security deposit that arose from the relationship of Debtor and
4 Creditor as landlord and tenant. Debtor testified that Debtor's
5 activity as a landlord was clearly second to Debtor's primary
6 career in the computer industry. It was while conducting business
7 as a landlord that Debtor became obligated to Creditor. Debts
8 related to rental activity incurred by part-time landlords are not
9 consumer debts under Section 101(8). In re Pedigo, 296 B.R. 485,
10 491 (Bankr. S.D. Ind. 2003).² In Pedigo, a retired widower
11 incurred a loan accrued to prepare his property for use by a
12 tenant. The Pedigo court determined that the debtor's dealings as
13 a part-time landlord were business oriented and held that the debt
14 was not a consumer debt. Id. Here Debtor's obligation to Creditor
15 likewise developed from Debtor's dealings as a part-time landlord
16 when he leased the Property to Creditor. Under Pedigo, the debt in
17 this case is not a consumer debt.

18 Debtor also asserts that Creditor lacked substantial
19 justification to bring this action. Debtor asserts Debtor's
20 actions or omissions were not fraudulent. Debtor also argues that
21 whether or not Creditor agreed to accept the stipulated judgment
22 lien as consideration for settling the state court action, Creditor
23 would have received such a judgment lien after trial and that,
24 therefore, Creditor had no grounds to assert that Creditor suffered
25 damage as a result of fraud as a matter of law. Debtor's argument
26 assumes Creditor was faced with only two options -- pursue the

27
28 ² The Pedigo court interpreted Bankruptcy Code §101(7), the predecessor section to
Bankruptcy Code §101(8). Bankruptcy Code §101(8) continues former Bankruptcy Code §101(7)
without change.

1 state court action and, if successful, recover a judgment lien, or
2 agree to a stipulated judgment and accept a lien as settlement.
3 The Court disagrees with Debtor.

4 First, Creditor waived any penalty damages by settling with
5 Debtor. Had Creditor proceeded to trial rather than settle with
6 Debtor, Creditor might have obtained a larger judgment. Second,
7 Creditor suggested that, had he known of the foreclosure, Creditor
8 might have sought alternative consideration for settlement and that
9 Creditor thereby suffered damage as a result of fraud and had a
10 reasonable basis in law to assert his claim. Debtor did not
11 introduce evidence to rebut Creditor's testimony. Finally, the
12 Court notes that a material fact was in dispute, e.g., whether or
13 not Debtor informed Creditor of the pending foreclosure. It was
14 necessary for the Court to review substantial testimony in order to
15 make a determination on that matter.

16 In sum, Creditor demonstrated that Creditor had a reasonable
17 basis in law and in fact to assert his §523(a)(2) action. Stine,
18 254 B.R. at 249. Accordingly, the Court finds that Creditor had
19 substantial justification for filing this claim and Debtor's
20 request for fees and costs is denied. Id.

21
22 CONCLUSION

23 For the foregoing reasons, the claim asserted by Creditor
24 against Debtor is discharged under 11 U.S.C. §523(a). Debtor's
25 request for attorney's fees and costs under 11 U.S.C. §523(d) is

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1 denied. Counsel for Debtor shall submit a proposed judgment after
2 review by Creditor as to form.

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5 Dated:

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8 ARTHUR S. WEISSBRODT
9 UNITED STATES BANKRUPTCY JUDGE
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