



**UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF CALIFORNIA
SAN FERNANDO VALLEY DIVISION**

In re:

CHAPTER 7

Rumio Sato
Junko Sato

Case No.: 1:11-bk-22220-MT

Adv No: 1:12-ap-01157-MT

Debtor(s).

Michael Williams

Plaintiff(s),

v.

**MEMORANDUM OF DECISION RE: TRIAL
ON SECOND AMENDED COMPLAINT FOR:
EXCEPTION TO DISCHARGE OF DEBT
PURSUANT TO 11 U.S.C. 523(a)(2), (a)(4),
AND (a)(19)**

Rumio Sato

Defendant(s).

Date: February 10, 2014

Time: 9:00 a.m.

Courtroom: 302

Plaintiff Michael Williams (the “Plaintiff” or “Williams”) has brought a nondischargeability action against Debtor Rumio Sato (the “Defendant” or “Sato”), claiming that Sato committed fraud in soliciting his investment in a real estate development project in 2006. As discussed below, the Court finds that the debt is not dischargeable under 11 U.S.C. §§ 523(a)(2) and 523(a)(19).

On or about October 18, 2011, Debtors Rumio and Junko Sato filed a voluntary chapter 11 petition (the “Debtors”). Upon Debtors’ motion, the case was later converted to chapter 7. On or about May 4, 2012, Williams filed an adversary complaint against Sato to determine the

1 dischargeability of Plaintiff's debt under §§ 523(a)(2), (a)(4), and (a)(19). The debt arose from
2 Plaintiff's investment of \$150,000 in Defendant's real estate development project located at 2470
3 Lynnfield Circle, El Sereno, California (the "Lynnfield Property" or "Lynnfield Project"). The
4 trial was held on February 10, 2014.

4 **Findings of Fact and Conclusions of Law**¹

5 Sometime in 2006, Williams was introduced to Sato through Sato's assistant, with whom
6 Williams became acquainted with at a car wash he frequented. Williams and Sato had no
7 business or personal relationship prior to the Lynnfield Project at issue. At that time, Williams
8 was considering entering into some short-term investments.

9 Sato held numerous meetings with Williams at Sato's house, where Sato introduced his
10 prosperous real estate business. Sato explained that he had a history of purchasing properties at
11 low cost and then developing and selling them for a lucrative return. Sato indicated he was able
12 to do so because of his access to inside information. Sato showed Williams his own house as
13 one of his remodeling projects. Sato had his real estate broker and contractor licenses hanging
14 on the walls in his house, together with pictures of his real estate developments. Sato also had
15 notebooks describing the portfolio of his different real estate projects. See Plaintiff's Trial
16 Exhibit 24. During the initial meetings, Sato drove Williams to see large parcels of undeveloped
17 land which he stated he owned and was going to develop.

18 After learning that Williams was looking for a quick turnaround, Sato recommended the
19 Lynnfield Property as a "ready-to-go" project. Sato told Williams that he could get the
20 Lynnfield Project running once he had an investment of \$150,000. Sato explained he would then
21 obtain a construction loan on the property. Sato showed Williams the blueprints of a single
22 family residence that he was going to build on the property. The construction was estimated to take
23 only 9-10 months. See Plaintiff's Trial Exhibit 17; Defendant's Trial Exhibit J. Sato provided
24 Williams with a Construction Timeline and Events detailing the different stages of construction.
25 See Plaintiff's Trial Exhibit 18; Defendant's Trial Exhibit K. Sato also took Williams to meet
26 with the professionals who would undertake the Lynnfield project and they discussed the
27 timeline and other construction matters in Williams' presence.

28 Sato eventually proposed an investment opportunity to Williams. In exchange for the
investment of \$150,000, Williams would receive: (1) 50% ownership in the Lynnfield Property
through a Quitclaim Deed (the "Quitclaim Deed"), (2) 20% interest on the investment due June
30, 2007, and (3) repayment of the investment upon sale or refinancing of the completed
Lynnfield Property. Sato executed the Quitclaim Deed in favor of Williams, see Defendant's
Trial Exhibit L, but he convinced Williams not to record it so that Sato could more easily obtain
a construction loan. In addition, Sato later wrote a check for \$30,000 payable to Williams as an
interest payment dated June 30, 2007. See Defendant's Trial Exhibit R.

The terms of the deal are evidenced in two documents. Sato first executed a "Note
Secured by Deed of Trust" dated December 22, 2006 (the "Note"). See Plaintiff's Trial Exhibit
22; Defendant's Trial Exhibit H. The Note was roughly drafted with handwritten remarks. The
Note only contained the terms of the interest payment and repayment of the investment upon sale

¹ The findings of fact and legal conclusions constitute the court's findings under Federal Rule of Civil Procedure
52(a), applicable in this bankruptcy proceeding under Federal Rule of Bankruptcy Procedure 9014. To the extent
any findings of fact constitute conclusions of law, they are adopted as such. To the extent that any of the
conclusions of law constitute findings of fact, they are adopted as such.

1 of the Lynnfield Property. Id. It was never recorded. On January 1, 2007, the parties then
2 drafted and executed a Real Estate Partnership Agreement (the “Agreement”). See Plaintiff’s
3 Trial Exhibit 17; Defendant’s Trial Exhibit J. The Agreement laid out the major terms of the
4 deal.

5 The construction took four years and was finally completed in March 2011. The real
6 estate market changed dramatically from 2007 to 2011. During this period, Williams frequently
7 emailed Sato, asking for progress reports and repayment of his investment. See Defendant’s
8 Trial Exhibits V to JJ. When the Lynnfield Property was in a marketable condition, Williams
9 urged Sato to sell it. See Defendant’s Trial Exhibit O p. 3-4. The sale turned out to be futile and
10 the property was worth much less than the secured debt on the property. Furthermore, Sato
11 could not afford the mortgage payments. Sato requested Williams to pay the mortgage with him,
12 or warned that the property could be foreclosed. Williams declined to pay the mortgage. In
13 December 2011, the secured lender foreclosed on the Lynnfield Property.

14 At trial, the key facts in dispute were: 1) what did Sato represent to Williams; 2) what
15 was the actual transaction between them; and 3) whether Williams reasonably and justifiably
16 relied on Sato’s representations. The specific disputed facts are discussed in the context of each
17 element of the § 523 counts. During the trial, there was substantial direct and cross examination
18 of both parties. Williams’ testimony was detailed, consistent, and credible. Sato, on the other
19 hand, appeared to be evasive and cautious.²

20 In an action to determine the dischargeability of a debt, Plaintiff has the burden of proof
21 to establish the elements of discharge exceptions by a preponderance of evidence. See Grogan v.
22 Garner, 498 U.S. 279, 291 (1991). The provisions of the § 523(a) exceptions to discharge should
23 be construed narrowly. See, e.g., Cal. Franchise Tax Bd. v. Jackson (In re Jackson), 184 F.3d
24 1046, 1051 (9th Cir.1999); Bowen v. Francks (In re Bowen), 102 B.R. 752, 756 (B.A.P. 9th Cir.
25 2001).

26 **I. Fraud under § 523(a)(2)**

27 Section 523(a)(2) excepts from discharge any debt to the extent obtained by

- 28 (A) false pretenses, a false representation, or actual fraud, other than a
statement respecting the debtor’s or an insider’s financial condition;
- (B) use of a statement in writing
 - (i) that is materially false;
 - (ii) respecting the debtor’s or an insider’s financial condition;
 - (iii) on which the creditor to whom the debtor is liable for such
money ... reasonably relied; and
 - (iv) that the debtor caused to be made or published with intent to
deceive

29 Section 523(a)(2)(A) and (B) are mutually exclusive, although they have substantially
30 similar elements. See In re Kirsh, 973 F.2d 1454, 1457 (9th Cir. 1992). Section 523(a)(2)(A)

31 ² For instance, he first claimed that the notebooks of his real estate portfolio did not exist until 2010 or 2011. He
32 later conceded that they could have existed in 2006 as Williams had stated, after he was pointed to the copyright
notation of 2006 on the notebook. See Plaintiff’s Trial Exhibit 24.

1 applies to misrepresentations other than those respecting the debtor's financial condition; while §
2 523(a)(2)(B) refers specifically to *written* statements of financial condition. Therefore, oral
3 misrepresentations regarding the debtor's financial condition are not under the purview of §
4 523(a)(2). See In re Joelson, 307 B.R. 689, 692-93 (10th Cir. B.A.P. 2004), *aff'd* 407 F.3d 700
(10th Cir. 2006), *cert denied* 126 S.Ct. 2321 (2006). Such oral misrepresentations are not at
5 issue here.

6 There is another key difference between the two subsections on the reliance element.
7 Section 523(a)(2)(A) employs a subjective standard that "justification is a matter of the qualities
8 of the particular plaintiff." Field v. Mans 516 U.S. 59, 70, 71 (1995). Section 523(a)(2)(B), on
9 the other hand, has an objective standard for reliance in examining the facts and circumstances
10 surrounding the misuse of the statement in writing regarding the debtor's financial condition. In
11 re Trejo, 2011 WL 5557423, at *5 (Bankr. N.D. Cal. Nov. 3, 2011).

12 As discussed below, the Court finds that Defendant engaged in fraud in luring Plaintiff to
13 invest in his Lynnfield Project under § 523(a)(2)(A). There is no need to analyze § 523(a)(2)(B)
14 because written statements of Sato's financial condition were not actually an issue or pursued at
15 trial.

16 The Ninth Circuit has held that a claim for fraud under § 523(a)(2)(A) includes five
17 elements: (1) the debtor made a false statement or engaged in deceptive conduct; (2) the debtor
18 knew the representation to be false; (3) the debtor made the representation with the intent to
19 deceive the creditor; (4) the creditor justifiably relied on the representation; and (5) the creditor
20 sustained damage from its reliance. In re Slyman, 234 F.3d 1081, 1085 (9th Cir. 2000).

21 (i) *Misrepresentations of Fact by Debtor*

22 Plaintiff alleges that Defendant misrepresented to him, orally and in writing that: (1)
23 Sato was an experienced real estate developer, with a history of successful real estate deals; (2)
24 Sato made an informed estimate that the construction on the Lynnfield Property would be
25 completed within a year, based on his experience as well as information from the professionals
26 he took Williams to meet; and (3) the investment proceeds would be spent on the Lynnfield
27 Property as implied by the language of the Note and the Agreement.

28 These representations are solely regarding Sato's real estate developer experience and
expertise as well as the details of the investment in the Lynnfield Property. They are not about
Sato's net worth or income, although his financial condition was part of the image he crafted for
Williams.

The purpose of the misrepresentations was to create the impression that Sato was an
experienced, successful, and knowledgeable real estate developer. Sato held the meetings with
Williams in his house, where he showed his work product and his financial capability. He drove
Williams to see the real estate empire he was developing, simply to strengthen Williams'
confidence in his business. Sato testified that he did not intend to solicit Williams' investment in
the other projects, because they were in a very preliminary stage and they required large
investments that Williams probably could not afford. He prepared notebooks of his real estate
portfolio with pictures of land he owned and the flowery descriptions of the proposed buildings.
Accordingly, Sato appeared to be a successful business developer.

Sato held himself out as having professional and insider knowledge to ensure the success
of his business. Sato showed glimpses of the arrogance behind his sales pitch in his testimony
during trial. Sato claimed to have the ability to procure inside information of discounted land.
Sato had professional credentials as a broker and a contractor. Sato appeared to be on top of the

1 technicalities of the construction plan in his presentation of blueprints and the construction
2 timeline. Sato took Williams to meet with construction professionals and he led the discussion
about the construction on the Lynnfield Property.

3 (ii) *That Debtor knew to be false*

4 The evidence also shows that Sato knew these statements to be false when he made them,
5 or alternatively, he made them with reckless disregard for the truth of the statements. See In re
6 Gertsch, 237 B.R. 160, 167 (9th Cir. B.A.P. 1999), citing In re Houtman, 568 F.2d 651, 656 (9th
Cir. 1978).

7 Sato knew the impression he conveyed to Williams of his real estate experience and
8 expertise was fabricated. Sato knew he was far from being an experienced real estate developer.
9 He had little, if any, experience as a real estate developer when he met Williams. He had just
10 obtained his contractor license in 2005, only one year prior to meeting Williams. The pretty
pictures and flowery language in his real estate portfolio notebooks that he presented to Williams
were his dreams and ambitions, not what had actually been done.

11 Furthermore, Sato recklessly estimated the construction time on the Lynnfield Property.
12 He knew it was simply a general estimate with little, if any, investigation into the particular
13 landscape of the Lynnfield Property or the relevant administrative approval process. He made
little effort to provide Williams with a good faith estimate of the construction time. Nonetheless,
he told Williams that it would be a quick turnaround and put in the Agreement that the project
was to take approximately 9 to 10 months, absent unforeseen events.

14 Even if Sato had believed the estimate to be true, he knowingly or recklessly made false
15 statements regarding the reliability of the estimate. Although he insisted in putting in the
16 language about delay caused by unforeseen events in the Agreement, he had no experience or
basis to predict what types of events could be foreseen at that time as he had never even built a
single family residence.

17 Sato also knew that he would not deposit Williams' investment in a separate account
18 dedicated to the Lynnfield Property. At the time, Sato knew he would use the money for
19 whatever he needed. Although Williams made the investment specifically for the Lynnfield
20 Property, Sato deposited Williams' investment funds in his personal account. The Note and the
21 Agreement both identified the deal as development on the Lynnfield Property. According to his
22 testimony, however, Sato withdrew substantial amounts of cash from his personal account
23 shortly after depositing Williams' investment funds and then purchased several properties for his
own real estate portfolio. Sato never provided Williams with an accounting of his investment
funds. The only accounting Sato provided Williams was for "out-of-pocket" expenses and not
for Williams' investment funds. See Plaintiff's Trial Exhibit 20. At trial, Sato denied he had
used the money elsewhere but claimed he could have used it however he wanted.

24 (iii) *Made with the intent to deceive Plaintiff*

25 Sato made the representations, discussed in section (i) above, with the intent to deceive
26 Williams. Sato's career goal was to use the funds from others for his budding real estate
27 business, even if he had to shade the truth to reach it. Sato's statements and conduct were
28 designed to impress Williams to get him to invest in the Lynnfield Project. Scienter is also
demonstrated by Sato's argument during trial that there were no strings attached to Williams'
money and he could do whatever he wanted with it, although Williams was made to believe
differently. Sato's attitude throughout the trial revealed his state of mind from the start.

1
2 Sato argued that had he intended to deceive Williams he would not have executed the
3 Quitclaim Deed or made the \$30,000 interest payment. The argument however, is not
4 convincing. The Quitclaim Deed was used to induce Williams to continue with the investment.
5 While Sato executed the Quitclaim Deed transferring 50% interest in the Lynnfield Property to
6 Williams, he persuaded Williams not to record the Quitclaim Deed. Therefore, the Quitclaim
7 Deed had very limited legal effect. Sato then had to make the \$30,000 interest payment so that
8 Williams would not sue him earlier. Sato's actions were just lulling activities that kept the deal
9 going.

10 Sato's beliefs that things would all work out and that he would be able to perform under
11 the Agreement are irrelevant as to his scienter at the time he made the misrepresentations. He
12 knowingly made false statements in order to obtain Williams' investment. Sato's belief that he
13 and Williams would both make money from the booming real estate market, is consistent with
14 his intent to deceive Williams, as he believed, in the end, he could probably get away with any
15 consequences of his fraudulent representations.

16 *(iv) Plaintiff justifiably relied on the misrepresentations*

17 In terms of justifiable reliance under §523(a)(2)(A), we inhabit the particular mindset and
18 circumstances of the plaintiff in question to determine whether or not a plaintiff is willfully blind
19 to the potential for fraud presented to them. In re Trejo, 2011 WL 5557423, at *4 (Bankr. N.D.
20 Cal. Nov. 3, 2011). A person cannot purport to rely on preposterous representations or close his
21 eyes to avoid discovery of the truth. In re Kirsh, 973 F.2d at 1459.

22 In this case, Williams justifiably relied on Sato's representations. With only a technology
23 background, Williams had limited knowledge or experience with real estate development.
24 Williams' only real estate experience was the purchase of his residential property. Williams met
25 Sato several times before finally deciding to invest in the Lynnfield Property. Sato used each
26 occasion to present himself as an experienced real estate developer who knew what he was
27 doing. Sato took Williams on trips to other real estate projects. Williams only knew what Sato,
28 a successful and experienced real estate developer, had told him. Williams relied on Sato's
choice of the Lynnfield Property to be the one to invest in. He relied on Sato's promise that the
construction would be completed within a year and he would get his investment back in full
together with interest and profits. Without the misrepresentations about Sato's experience, the
estimate of a 10-month turnaround, and the promise to use the investment on the Lynnfield
Property, Williams would not have invested in the Lynnfield Project.

During the trial, Sato argued that Williams should have discovered that he was not an
experienced real estate developer and Williams should not have blindly trusted Sato. As the
contractor license shown in Sato's house displayed an issuing date in 2005, Williams should
have realized that Sato only had at most one-year of contractor experience. Sato contends that
Williams could have and should have contacted other professionals before he made a decision on
the investment and before deciding not to record the Quitclaim Deed. Sato also testified that
when he took Williams to meetings with construction professionals they talked about the fact
that the Construction Timeline and Events were just a general estimate and a soil sample of the
Lynnfield Property had not yet been taken.

With the benefit of the hindsight, it is true that Williams should have sensed the red flags
and should have consulted with some professionals. This is not the legal standard, however.
The test is whether a person with Williams' experience and mindset is justified in trusting Sato.
The fraud statutes also protect the gullible and the unsophisticated.

1
2 The meeting with other construction professionals might have given Williams an
3 inclination that the anticipated construction time might be off but not by four years. In addition,
4 there was insufficient information at that point to warn Williams from relying on Sato's
5 misrepresentations. With the buildup of trust and the complicated technicalities of real estate
6 construction, Williams was justified in deferring to Sato's experience and judgment.

7 (v) *Plaintiff sustained damages as a result of the misrepresentations*

8 Williams' loss of \$150,000 was actually and proximately caused by Sato's
9 misrepresentations. Williams lost his investment when the Lynnfield Property was foreclosed on
10 by the secured lender. But for Sato's misrepresentations, Williams would not have invested in
11 the Lynnfield Property and subsequently lost his investment.

12 Sato argued that the misrepresentations were not the proximate cause of the loss. Prior to
13 the foreclosure, Sato told Williams that he could no longer make the loan payments and, if
14 Williams did not repay the loan, the secured lender could foreclose on the property. He argued
15 that Williams' refusal to repay the loan was the proximate cause of his loss.

16 Williams' only obligation under the Agreement, however, was to invest \$150,000 in the
17 Lynnfield Property. Sato took out the construction loan under his own name. Williams never
18 assumed the duty to repay the loan. The foreclosure was therefore caused by Sato's default.
19 Williams had no obligation to put in more money when Sato initially asked him. It is also
20 speculative to know whether paying the loan would have saved Williams' investment.

21 Sato also argued that he and Williams formed a partnership, so Williams should take the
22 losses along with the profits. Williams and Sato both testified that the Agreement was drafted
23 with input from both parties, but Sato was the one calling it a "partnership" agreement.

24 The Court determined that the relationship between the parties was not a partnership,
25 notwithstanding the title of the Agreement. Williams did not intend to form a partnership with
26 Sato. Williams expected to recover the investment in full upon completion. There were no
27 formalities for a partnership. Sato testified that he did not have bank accounts for the
28 partnership. Sato never filed a partnership tax return or felt he should do so.

Sato argued that Williams had control over the project because Williams frequently
emailed him for progress reports, and it was Williams' decision to sell the Lynnfield Property.
Sato, in fact, obtained written consent from Williams before he listed the property for sale.

Williams did not have the control he would have had, had they formed a partnership. The
progress reports Sato gave to Williams upon Williams' request were consistent with updating an
investor on the progress of an investment project. Williams did not choose subcontractors,
materials, or even the listing price. He did not get bank account statements or sign on the
construction loan. Instead, Williams listened to Sato and acceded to Sato's decisions during each
step of the project.

Therefore, the Court finds that Sato committed fraud when he engaged Williams in the
real estate development on the Lynnfield Property. Williams' claim is nondischargeable under §
523(a)(2)(A).

1
2 **II. Fraud in Connection with Securities Transactions under § 523(a)(19)**

3 Williams also alleges a cause of action under § 523(a)(19). That section provides that any
4 debt is not discharged if it -

- 5 (A) is for –
 - 6 (i) the violation of any of the federal securities laws ..., any of the
 - 7 state securities law, or any regulations or order issued under such
 - 8 federal or state securities laws, *or*
 - 9 (ii) common law fraud, deceit, or manipulation in connection with the
 - 10 purchase or sale of any security; **and**
- 11 (B) results, before, or, or after the date on which the petition was filed, from –
 - 12 (i) any judgment, order, consent order, or decree entered in any
 - 13 federal or state judicial or administrative proceeding;
 - 14 (ii) any settlement agreement entered into by the debtor; or
 - 15 (iii) any court or administrative order for any damages, fine, penalty,
 - 16 citation, restitutionary payment, disgorgement payment, attorney
 - 17 fee, cost, or other payment owed by the debtor.

18 11 U.S.C. § 523(a)(19) (emphasis added).

19 The two subparts of § 523(a)(19) are conjunctive requirements. Plaintiff must establish
20 both parts by a preponderance of evidence.

21 § 523(a)(19)(B)

22 A threshold question is whether § 523(a)(19)(B) requires that Plaintiff’s claim be first
23 memorialized in an order or settlement outside of this Court. There is a split in authority on this
24 question. The narrower view holds that § 523(a)(19)(B) requires the debt to be first
25 memorialized in a settlement or order by a nonbankruptcy forum. See In re Collier, 497 B.R.
26 877, 903 (Bankr. E.D. Ark. 2013); In re Bundy, 468 B.R. 916, 922 (Bankr. E.D. Wash. 2012); In
27 re Pujdak, 462 B.R. 560, 574 (Bankr. D.S.C. 2011); In re Jafari, 401 B.R. 494, 497 (Bankr. D.
28 Colo. 2009); In re Zimmerman, 341 B.R. 77, 80 (Bankr. N.D. Ga. 2006).

29 The more expanded view holds that the bankruptcy court can determine the liability,
30 damages, and dischargeability of the debt for securities violations and securities fraud and issue
31 its own judgment to satisfy § 523(a)(19)(B). See In re Hill, 495, B.R. 646, 661 (Bankr. D.N.J.
32 2013); In re Jensen-Ames, 2011 WL 1238929, *8 (Bankr. W.D. Wash. March 30, 2011)
33 (unpublished); In re Jansma, 2010 WL 282511, *5 (Bankr. N.D. Ill. Jan 21, 2010); In re Chan,
34 355 B.R. 494, 505 (Bankr. E.D. Penn. 2006).

35 This Court concludes that the language of the provision, as well as the legislative history
36 and policy considerations, warrants the more expanded view. The more expanded approach to §
37 523(a)(19)(B) is closer in line with the broad language of the Code, the effort to make it even
38 broader by the BAPCPA amendment and the need to litigate all exceptions to discharge in one
proceeding. To require a piecemeal adjudication of a § 523(a)(19) issue elsewhere would not
make sense where a § 523(a)(2) exception is already being litigated.

1
2 § 523(a)(19)(A)

3 Section 523(a)(19)(A) includes both securities violations under § 523(a)(19)(A)(i) and
4 common law fraud in securities transactions under § 523(a)(19)(A)(ii). In re Civiello, 348 B.R. at
5 464. As the Court has already decided that Defendant committed actual fraud in the transaction
6 under § 523(a)(2), thus, the sole remaining issue is whether the transaction is a security.

7 Cal. Corp. Code § 25019 defines a security and includes an expansive list of transactions
8 and instruments deemed to be securities. Under California law, a transaction is an investment
9 contract if it meets either the “risk capital” test under Silver Hills Country Club v. Sobieski, 55
10 Cal.2d 811, 815 (1961), or the federal test under SEC v. W.J. Howey Co., 328 U.S. 293, 298-99
11 (1946) (“Howey”). Reiswig v. Dep’t of Corp., 144 Cal.App.4th 327, 334 (Cal. Ct. App. 2006).
12 Under the federal Howey test, a security is a contract, transaction or scheme whereby a person
13 invests his money in a common enterprise and is led to expect profits solely from the efforts of
14 the promoter or a third party. 328 U.S. at 298-99. There are three elements: (1) an investment of
15 money, (2) in a common enterprise, and (3) with an expectation of profits produced by the efforts
16 of others. SEC v. Rubera, 350 F.3d 1084, 1090 (9th Cir. 2003).

17 In Howey, the defendant offered investors a contract to purchase a small portion of an
18 orange grove together with a 10-year service contract under which the defendant agreed to
19 maintain and harvest the orange grove plot for the investor. See 328 U.S. at 295-96. The
20 investors were individuals who lacked the knowledge or resources for orange cultivation and
21 harvesting. Id. The Supreme Court ruled that the transaction was a security. 328 U.S. at 298-
22 99. The defendant was offering an opportunity to contribute money and to share in the profits of
23 a large citrus fruit enterprise. Id. at 299. The investors had no desire to occupy the land or to
24 develop it themselves; they were attracted solely by the prospects of a return on their investment.
25 Id. at 300.

26 The Lynnfield property transaction is similar to that in Howey, although on a much
27 smaller scale and duration. Sato, as the owner of the property, offered Williams the opportunity
28 to contribute money toward building a single-family residence on the property to sell in the
future. Williams invested money in the project with an expectation of profits produced by Sato’s
efforts in managing the construction and the sale of the property. Williams had no experience in
this area or desire to actively participate in the construction or sale of the property. The success
of the project was completely under Sato’s control.

29 Sato alleges that because Williams was the only investor in the transaction, it cannot
30 constitute a security. The number of investors is a factor to be considered; but it is not
31 conclusive. As stated in People v. Park, when considering the meaning of an investment
32 contract, courts have consistently emphasized whether or not the investor has substantial power
33 to affect the success of the enterprise. 87 Cal.App.3d 550, 563 (Cal. Ct. App. 1978). In Park, the
34 defendant solicited only two investors in his condominium construction project and the court
35 found it to be an investment contract. 87 Cal.App.3d at 563.

36 An investment of money requires the investor be subject to financial loss. Rubera, 350
37 F.3d at 1090. Here, Sato does not allege the transaction was not an investment of money, but he
38 contends that the investment was adequately secured by the Note and thus, a loan. The evidence
shows, however, that Sato himself referred to the transaction as an “investment” and not a loan in
his email to Plaintiff. See Defendant’s Trial Exhibit AA. Form should be disregarded for
substance and emphasis should be placed on the economic reality. Howey, 328 U.S. at 298.
Thus, the Court finds the transaction was not a loan.

1
2 Sato argues that there was no common enterprise because Williams' funds should be
3 counted solely towards the Note. In addition, Sato claims he transferred 50% interest in the
4 property with the Quitclaim Deed. The value of the Note and the granting of the Deed are
5 irrelevant because Williams was instructed not to record them and they were not recorded. Also,
6 Williams was not really protected by the deed because the investment structure required him not
7 to record it.

8 Williams had a reasonable expectation of profits. Sato agreed in his testimony that
9 Williams bargained for the Agreement because he wanted to take advantage of the profit from
10 the Lynnfield Project. Williams and Sato discussed a 50/50 distribution of the profit from the
11 proposed sale of the completed project.

12 The Ninth Circuit has rejected a strict interpretation in favor of a more flexible focus on
13 whether the efforts made by those other than the investor are undeniably significant ones, those
14 essential managerial efforts that affect the failure or success of the enterprise. Rubera, 350 F.3d
15 at 1091.

16 Sato argues that Williams actively participated in the project and had an interest in the
17 property; therefore, Williams was not expecting profit solely from Sato's efforts. The evidence
18 shows, on the contrary, that Williams had no meaningful power over the project. Besides his
19 initial capital contribution, Williams' alleged participation had little effect on the success of the
20 project. Williams' emails merely requested progress reports. Williams' 50% interest in the
21 Lynnfield Property had limited effect, as Sato told him not to record the Deed or he could not get
22 a construction loan. Williams did push Sato to sell the property after three years but he had no
23 control up to then, and the sale price and listing process were all under Sato's control. Sato
24 could have refused to list the property for sale at that time under the terms of the Agreement.
25 Williams could have done little with the unrecorded Deed. Even if Williams were to have
26 recorded the Deed at some point, it did not give him meaningful power in the project, as it would
27 come after the lien of the construction loan.

28 As discussed, Sato's argument that they formed a partnership to share profits and loss is
rejected. Even if their relationship was a partnership, the interest in the partnership would be a
security under Consolidated Management Group, LLC v. Dep't of Corp. See 162 Cal. App. 4th
598, 610 (Cal. Ct. App. 2008). A limited partner's membership in a typical limited liability
partnership is a security, as the profits came substantially from efforts of the general partner. Id.

21 The factors to determine when the a general partnership or joint venture can be
22 designated as a security include: (1) the agreement leaves so little power in the hands of the
23 partner or venturer that the arrangement in fact mimics a limited partnership; or (2) the partner or
24 venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of
25 intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so
26 dependent on some unique entrepreneurial or managerial ability of the promoter or manager that
27 he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or
28 venture powers." Id. at 611.

26 The distribution of power under the Agreement accorded Sato with full control of the
27 "partnership" as (1) he was the owner of the property; (2) he was the general contractor of the
28 construction; (3) he was the broker in selling the property; and (4) Williams had no power,
expertise, or desire, to engage in the construction and sale of the property. If it was a
partnership, Williams would be a typical "passive" partner or venturer whose sole responsibility
is to make capital investment in exchange for a return of the fixed interest plus property value

1 appreciation.

2 In conclusion, the transaction between the parties constitutes an investment contract
3 under the federal test. Therefore, it is a security as defined under Cal. Corp. Code § 25019.
4 With this Court's finding of fraud in connection with this transaction in Plaintiff's § 523(a)(2)
claim, Defendant also committed fraud in connection with the sale of a security.

5 **Conclusion**

6 Plaintiff has met his burden of proving by a preponderance of evidence that Defendant
7 engaged in fraud in soliciting an investment from Plaintiff in the Lynnfield Project. The
8 transaction involved a sale or an offer of a security. Therefore, Plaintiff's claim is not
9 dischargeable under both §§ 523(a)(2) and (a)(19).

10 **Claim Amount**

11 Regarding the amount of claim, Plaintiff seeks damages of \$150,000 plus interest at the
12 federal interest rate from January 1, 2010. Defendant has objected, contending that \$30,000 was
13 paid and received by Plaintiff in 2007 and there was no basis for a provision of interest. It is
unclear why Plaintiff accumulated interest from January 2010. Plaintiff also needs to explain
why the \$30,000 payment is not counted towards the damages.

14 A hearing will be held as to the damages amount on July 31, 2014, at 11:00 a.m. Plaintiff
15 is ordered to file an explanation of how damages should be calculated by July 3, 2014. Defendant
may respond by July 15, 2014. An order and judgment will be entered following that hearing.

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25 Date: June 18, 2014


Maureen A. Tighe
United States Bankruptcy Judge