

NOT FOR PUBLICATION

FILED & ENTERED

AUG 16 2016

CLERK U.S. BANKRUPTCY COURT
Central District of California
BY Ogier DEPUTY CLERK

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

SAN FERNANDO VALLEY DIVISION

In re:

BENI ATOORI,

Debtor.

Case No.: 1:12-bk-20010-MB

Chapter 7

Adv. Proc. No. 1:14-ap-01164-MB

STUBBS ALDERTON & MARKILES, LLP, and
ACP 1509 WINONA, LLC,

Plaintiffs,

vs.

BENI ATOORI, and DOES 1 TO 10,

Defendants.

MEMORANDUM OF DECISION
FOLLOWING TRIAL

1 The Court conducted a trial in this adversary proceeding on January 27, 2016 and February
2 1, 2016. Plaintiffs Stubbs Alderton & Markilies, LLP (“SAM”) and ACP 1509 Winona, LLC
3 (“Winona,” together with SAM, the “Plaintiffs”) were represented by Allan Herzlich of Herzlich
4 and Blum, LLP. Defendant Beni Atoori (“Atoori” or “Defendant”), the chapter 7 debtor herein,
5 was represented by Deborah Young of Ayayo Law Offices, APC. The Court requested post-trial
6 briefing, which has since been completed, and this matter is ripe for decision. This Memorandum
7 of Decision constitutes the Court’s findings of fact and conclusions of law pursuant to the Federal
8 Rule of Bankruptcy Procedure 7052.

9 Plaintiffs hold joint and several debts totaling in excess of \$70,000.00 against Defendant
10 and non-debtor Tripod Entertainment, LLC (“Tripod”). Plaintiffs allege that these debts are
11 nondischargeable in the Defendant’s chapter 7 case pursuant to Bankruptcy Code sections
12 523(a)(4) (defalcation while acting in a fiduciary capacity or embezzlement) and 523(a)(6) (willful
13 and malicious injury).

14 Plaintiffs contend that these claims are nondischargeable against the Defendant, not because
15 of the circumstances under which the claims first arose, but instead because Defendant, as co-
16 managing member of Tripod, subsequently violated his fiduciary duties to the Plaintiffs as creditors
17 of Tripod under California’s trust fund doctrine. Specifically, Plaintiffs argue that in May 2008,
18 Defendant caused Tripod to enter into a settlement of unrelated litigation that resulted in the
19 misappropriation of a valuable Tripod asset, at a time when Tripod was insolvent. Plaintiffs
20 contend that Defendant is therefore liable for the full amount of their claims as nondischargeable
21 debts.

22 After conducting a trial, observing the witnesses, assessing their credibility, and considering
23 all of the evidence admitted, the Court concludes that Plaintiffs have failed to demonstrate by a
24 preponderance of the evidence that they hold nondischargeable debts against the Defendant under
25 either section 523(a)(4) or section 523(a)(6). Accordingly, the Court will enter judgment in favor
26 of the Defendant.

I.

JURISDICTION

This Court has jurisdiction over this adversary proceeding pursuant to 28 U.S.C. § 1334(b). Venue in this Court is proper pursuant to 28 U.S.C. § 1409(a). This Adversary Proceeding is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(I). This Court has the constitutional authority to enter a final judgment on Plaintiffs' claims in this proceeding. *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

II.

FACTUAL BACKGROUND

The Parties.

Starting in or around 2006, Defendant, a movie producer, and his business partner, Al Jayez ("Jayez"), now deceased, were co-managing members of Tripod, a movie production company. As between the two co-managing members, Defendant was responsible for identifying potential movie projects in which Tripod might invest, and Jayez was responsible for handling all of the day-to-day operations of the business, including paying the bills and handling the finances. Individually and separate from Tripod, Defendant was the sole member of a different movie production company, Stonelock Media Group, Inc. ("Stonelock"), and Jayez was the sole member of yet another movie production company, Cheyenne Studios, LLC ("Cheyenne").

The Winona Debt.

The debt held by Winona, which totals \$45,473.68 (the "Winona Debt"), arises from a purchase agreement signed on April 16, 2007, between Tripod and Winona (the "Winona Purchase Agreement") for the purchase of real property located at 1509 Winona Boulevard, Los Angeles, CA. Shortly after the Winona Purchase Agreement was signed, a dispute arose, and Tripod and Winona entered into arbitration.

On May 1, 2008, the arbitrator found in favor of Winona and against Tripod in the amount of \$40,225.00 (the "Arbitration Award"). Seven months later, on December 8, 2008, the California Superior Court (the "State Court") entered an order confirming the Arbitration Award and

1 additionally awarding Winona attorney's fees and costs, and prejudgment interest, for a total award
2 of \$44,960.25 (case number BS115420) (the "Arbitration Award Order").

3 On March 1, 2010, in a separate proceeding arising out of the Arbitration Award and the
4 Arbitration Award Order (case number BC410691), the State Court entered a default judgment in
5 favor of Winona and against Defendant, Jayez, Cheyenne, and Stonelock, jointly and severally, in
6 the amount of \$45,473.68 (the "Winona Default Judgment"). The validity of the Winona Default
7 Judgment was not challenged at trial. The Winona Default Judgment, however, does not specify
8 the factual or legal basis on which Defendant, Jayez, Cheyenne, and Stonelock were held liable—
9 only that the judgment was entered on the basis of a default.

10 *The Stubbs Alderton & Markiles, LLP Debt.*

11 The debt held by SAM, which totals \$28,245.33 (the "SAM Debt"), allegedly arises from
12 unpaid legal services provided by SAM, a law firm. The only evidence offered into evidence of the
13 SAM Debt comprises of (i) a default judgment entered on December 9, 2008, by the State Court, in
14 case number 08E06162, in favor of SAM and against Tripod for \$24,908.17 (the "Initial
15 SAM/Tripod Default Judgment") and (ii) a default judgment in a separate proceeding against
16 Defendant, Jayez, Cheyenne, and Stonelock, jointly and severally, in the amount of \$28,245.33 (the
17 "SAM Default Judgment"). The SAM Default Judgment appears to be related to the Initial
18 SAM/Tripod Default Judgment. The validity of these judgments was not questioned at trial.
19 However, nothing in the record establishes the factual and legal basis of *either* of those
20 judgments—only that the judgments were entered on the basis of a default.

21 *Dispute Regarding the AIM Film Library and the Settlement Agreement.*

22 Plaintiffs contend that their claims against Defendant should be nondischargeable in his
23 chapter 7 case because, as its co-managing member, Defendant authorized Tripod in 2008 to enter
24 into a settlement of *unrelated* litigation with third parties, under which Tripod did not receive any
25 consideration. Plaintiffs contend that Tripod had valid claims against one or more of the parties to
26 that litigation and that a portion of the consideration distributed under the settlement should have
27 gone to Tripod. Plaintiffs contend that by facilitating this settlement, Defendant diverted a valuable
28 asset of Tripod to himself and/or Jayez, in violation of his fiduciary duties to Tripod's creditors.

1 To fully appreciate Plaintiff’s argument, it is necessary first to briefly describe—to the
2 extent the record permits—the nature of that dispute and the settlement agreement pursuant to
3 which it was resolved. The dispute originates with the unsuccessful efforts of Tripod to obtain the
4 film library of an unrelated third-party, AIM Group, LLC (“AIM”).

5 In or around February 2007, Tripod entered into a contract with AIM for the purchase of its
6 library, consisting of over 1,300 films (the “AIM Film Library”). The contract specified a purchase
7 price of \$5,500,000.00 and 50% of the stock of an unknown entity¹ (the “Tripod/AIM Contract”).
8 Between February 2007 and August 2007, Tripod paid AIM incremental payments totaling
9 \$632,000.00. In August 2007, AIM terminated the Tripod/AIM Contract. The Tripod/AIM
10 Contract, itself, was never introduced into evidence, although Defendant did introduce a letter from
11 AIM’s Chief Executive Officer purporting to cancel that contract.

12 Based on his belief that the Tripod/AIM Contract had terminated, Defendant sought other
13 potential buyers for the AIM Film Library in an attempt to broker a deal. In or about October
14 2007, Defendant and a third-party, Fred Faramarzi (“Faramarzi”), formed Visionary Artists, LLC
15 (“VA”). Later that month, VA entered into a contract with AIM to purchase the AIM Film Library
16 under terms similar to the Tripod/AIM Contract: purchase AIM’s Film Library for \$5,500,000.00
17 and 50% of the stock of VA (the “VA/AIM Contract”).

18 In or about December 2007, after the consummation of the VA/AIM Contract, Faramarzi
19 purchased Defendant’s interest in VA for \$1,680,000.00 (the “Buyout Amount”). Shortly
20 thereafter, a dispute arose surrounding Faramarzi’s purchase of Defendant’s interest in VA among
21 Defendant, Jayez, Tripod, Stonelock, Faramarzi, and VA.

22 On March 21, 2008, Faramarzi and VA filed an interpleader action in State Court, case
23 number LC080896 (the “Interpleader Action”), and deposited the Buyout Amount with the State
24 Court. The Interpleader Action claimed that Defendant, Jayez, Tripod, and Stonelock each had
25 conflicting claims to the Buyout Amount. Shortly thereafter, Jayez and Tripod filed a cross-

26 _____
27 ¹ The entity in which AIM was to obtain 50% stock is unclear based on the evidence provided to
28 the Court.

1 complaint against Defendant, Stonelock, Faramarzi, and VA. The details of Jayez and Tripod's
2 cross-complaint are unknown because no evidence was introduced regarding the cross-complaint.

3 On May 29, 2008, Defendant, Jayez, Tripod, and Stonelock entered into a settlement
4 agreement resolving the Interpleader Action in its entirety (the "Settlement Agreement"), which
5 was subsequently approved by the State Court. Under the Settlement Agreement, Defendant's
6 company, Stonelock, received \$1,000,000.00 of the Buyout Amount. The balance of the Buyout
7 Amount, \$680,000.00, was paid to Jayez's company, Cheyenne. No other amounts were paid to
8 any other parties, including Tripod.

10 III.

11 PROCEDURAL BACKGROUND

12 On November 13, 2012, Defendant filed a voluntary petition under chapter 7 of the
13 Bankruptcy Code. Case Dkt. 1. On June 11, 2013, the chapter 7 trustee filed her "no-asset" report,
14 Case Dkt. 35, and Debtor's discharge was subsequently entered on December 3, 2014. Case Dkt.
15 52. However, prior to the entry of discharge, on September 19, 2014, Plaintiffs commenced this
16 adversary proceeding. Adv. Dkt. 1. Pursuant to a motion to dismiss by Defendant, the court
17 dismissed Plaintiffs' original complaint, with leave to amend. Adv. Dkt. 5. Plaintiffs then filed a
18 first amended complaint, which is the operative complaint herein (the "Complaint").² Adv. Dkt.
19 10.

20 The parties entered into a pre-trial stipulation (the "Pre-Trial Stipulation"), agreeing to
21 certain facts, and the Court approved the stipulation (the "Pre-Trial Order"). Adv Dkt. 36. At the
22 conclusion of evidence, the Court admitted Plaintiffs' Exhibits 1³ through 8 and Defendant's
23

24 _____
25 ² Defendant filed another motion to dismiss, which the Court denied. Adv. Dkt. 19.

26 ³ The Court admitted Plaintiffs' Exhibit 1 into evidence for the limited purpose of establishing the
27 date on which the Arbitration Award was issued.
28

Exhibits A⁴, F, and G. At trial, the Court heard oral argument and requested post-trial briefing. That briefing is now complete, and the action is ripe for determination.

IV.

LEGAL ANALYSIS

The Complaint alleges two claims for relief in support of Plaintiffs' assertion that their claims are nondischargeable. The creditor-plaintiff bears the burden of proof to establish, by a preponderance of the evidence, that its claim is not dischargeable under section 523 of the Bankruptcy Code. *Grogan v. Garner*, 498 U.S. 279, 287 (1991). As discussed herein, the Court finds that Plaintiffs have failed to meet their burden of proof on both their claims for relief under section 523.

A. Nondischargeability under 11 U.S.C. §523(a)(4)

Plaintiffs assert their claims are nondischargeable pursuant section 523(a)(4) of the Bankruptcy Code under a theory of: (i) defalcation while acting in a fiduciary capacity and (ii) embezzlement. The Court addresses each argument under section 523(a)(4) below, and for reasons discussed herein, determines that Plaintiffs have failed to carry their burden for both claims under section 523(a)(4).

Plaintiffs argue that (i) at the time of the Settlement Agreement, Tripod was insolvent, thereby imposing certain fiduciary duties on Defendant in favor of Tripod's creditors, and (ii) that by directing payment of the Buyout Amount to Stonelock and Cheyenne under the Settlement Agreement, Defendant misappropriated funds that rightfully belonged to Tripod. Plaintiffs contend that Tripod had a right to \$632,000.00 of the Buyout Amount because Tripod previously paid AIM \$632,000.00 in connection with its failed acquisition of the AIM Library. For these reasons,

⁴ The Court admitted Defendant's Exhibit A for the limited purpose of establishing Defendant's state of mind.

1 Plaintiffs contend that Defendant breached his fiduciary duty to Tripod's creditors under
2 California's trust fund doctrine.⁵

3 Defendant contends that Tripod had no rightful claim to any part of the Buyout Amount.
4 Defendant argues that the \$632,000.00 Tripod paid to AIM under the Tripod/AIM Contract was in
5 consideration for AIM extending the deadline for Tripod to fully consummate the Tripod/AIM
6 Contract. Thus, when AIM terminated the Tripod/AIM Contract, no amount was due to Tripod on
7 account of its payments to AIM. Further, any contractual claim of Tripod for a refund would be
8 against AIM, the entity that received the payments. AIM was not a party to the Interpleader Action
9 that resulted in the Settlement Agreement.

10 **1. Defalcation While Acting in a Fiduciary Capacity**

11 Under section 523(a)(4) of the Bankruptcy Code, debts that arise from defalcation while the
12 debtor was acting in a fiduciary capacity are nondischargeable. *Ragsdale v. Haller*, 780 F.2d 794,
13 795-96 (9th Cir. 1986). The fiduciary relationship must be imposed prior to any wrongdoing. *Id.* at
14 796.

15 While federal law governs who is a fiduciary under section 523(a)(4), courts consult state
16 law when determining whether a fiduciary relationship existed. *Ragsdale*, 780 F.2d at 796.
17 California state law follows the "trust fund doctrine" where "all of the assets of a corporation,
18 immediately upon becoming insolvent, become a trust fund for the benefit of all [of the
19

20 ⁵ The internal affairs doctrine states that the law of the state of incorporation governs the
21 liability of a corporation's officers and shareholders. *First Nat. City Bank v. Banco Para El*
22 *Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983). The internal affairs doctrine applies to
23 claims relating to the fiduciary duties of a corporation's officers. *See, e.g., In re Textainer P'ship*
24 *Sec. Litig.*, 2005 WL 1791559, at *5 (N.D. Cal. July 27, 2005); *Scouler & Co., LLC v. Schwartz*,
2012 WL 1502762, at *3 (N.D. Cal. Apr. 23, 2012); *Banjo Buddies, Inc. v. Renosky*, 399 F.3d 168,
24 179 n. 10 (3d Cir.2005); *Gabriel v. Preble*, 396 F.3d 10, 13 (1st Cir.2005); *Hollis v. Hill*, 232 F.3d
24 460, 465-66 (5th Cir.2000); *Nagy v. Riblet Products Corp.*, 79 F.3d 572, 576 (7th Cir.1996);
25 *Hausman v. Buckley*, 299 F.2d 696, 703 (2d Cir.1962) ("the internal affairs rule has been applied
26 repeatedly in order to determine the fiduciary duty of a foreign corporation's directors").

27 Plaintiffs and Defendant agree in their post-trial briefing that California state law applies.
28 The Court has nothing in the record to persuade it otherwise.

1 corporation’s] creditors . . .” *Berg & Berg Enter., LLC v. Boyle*, 100 Cal. Rptr. 3d 875, 893 (Cal.
2 Ct. App. 2009). Upon insolvency, the corporation’s directors are limited to “avoidance of actions
3 that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay
4 creditors[’] claims” by “divert[ing] assets of the corporation for the benefit of insiders or preferred
5 creditors.” *Id.* at 893–94.

6 The Ninth Circuit, in accordance with several Ninth Circuit Bankruptcy Appellate Panel
7 decisions, has determined that the obligations arising from California’s trust fund doctrine satisfy
8 the fiduciary relationship requirement under section 523(a)(4). *In re Houn*, 636 F. App’x 396,
9 400 (9th Cir. 2016) (citing *Oney v. Weinberg (In re Weinberg)*, 410 B.R. 19, 28–29 (B.A.P. 9th
10 Cir. 2009); *Nahman v. Jacks (In re Jacks)*, 266 B.R. 728, 737 (B.A.P. 9th Cir. 2001); *Flegel v. Burt*
11 *& Assocs., P. C. (In re Kallmeyer)*, 242 B.R. 492, 496 (B.A.P. 9th Cir. 1999)).

12 Therefore, in deciding whether Plaintiffs’ debts against Tripod are nondischargeable debts
13 of the Defendant under section 524(a)(4), the Court must first determine whether (i) Tripod was
14 insolvent at the time of the alleged misappropriation, and if so, (ii) whether Defendant
15 misappropriated Tripod’s funds.

16 **a. Insolvency**

17 Plaintiffs bear the burden, by a preponderance of the evidence, to show that Tripod was
18 insolvent at the time Defendant signed the Settlement Agreement. *See In re Weinberg*, 410 B.R. 19,
19 33 (B.A.P. 9th Cir. 2009), *aff’d*, 407 F. App’x 176 (9th Cir. 2010) (finding that the creditor had not
20 met its burden in showing insolvency). Plaintiffs have failed by any measure to meet their burden
21 on this issue. Insolvency may be shown by demonstrating (i) under California Corporations Code
22 section 501 that “as a result of a prohibited distribution, [the debtor] would be unlikely to meet its
23 liabilities as they mature,” *Berg & Berg Enter., LLC*, 178 Cal. App. 4th at 1043 n.23 or (ii) under
24 the “balance sheet test,” showing that the value of the debtor’s liabilities exceeds the value of its
25 assets. *Id.* (citing *In re Kallmeyer* 242 B.R. at 496–97).

26 **i. California Corporations Code section 501**

27 Under California Corporations Code section 501, Plaintiffs must provide a “general
28 showing of the debtor’s financial condition and debt structure [rather] than merely establishing the

1 existence of a few unpaid debts.” *Semel v. Dill (In re Dill)*, 731 F.2d 629, 632 (9th Cir. 1984). The
2 Ninth Circuit Bankruptcy Appellate Panel has determined that “failure to pay one creditor, even
3 repeatedly, did not sufficiently show insolvency [under California Corporations Code
4 section 501]. . .” *In re Jacks*, 266 B.R. 728, 738 (B.A.P. 9th Cir. 2001). The creditor in *Jacks* failed
5 to provide sufficient evidence of the quantity of the debtor’s other creditors, the amounts owing to
6 those creditors, or whether they were paid during the relevant time frame. *Id.* The court in *Jacks*
7 determined that even where the creditor introduced evidence of checks for insufficient funds,
8 delinquent invoices, and an admission by the debtor that it was unable to pay certain debts due to a
9 lack of funds available in the corporation, the creditor did not meet the requisite evidentiary
10 standard to prove insolvency. *Id.* at 732, 738.

11 Here, Plaintiffs have not met their burden to establish Tripod’s financial condition and debt
12 structure at the time of the Settlement Agreement, or that Tripod generally was unable to pay its
13 various debts as they became due. Plaintiffs did not offer any witness of their own, and instead
14 relied on the testimony provided by Defendant—the very same person who testified that he was not
15 the manager principally responsible for handling Tripod’s financial affairs and other day-to-day
16 operations. To the extent Defendant testified on this issue, he testified to his belief that Jayez
17 caused Tripod’s recurring debts for rent, utilities, and payroll to be paid on a regular basis.
18 Plaintiffs offered no evidence to the contrary.

19 At trial, Plaintiffs focused heavily on Defendant’s testimony that in or around May 2008,
20 Tripod had approximately \$6,000.00 to \$8,000.00 in cash on hand and no immediate prospects for
21 additional revenue. Plaintiffs argue that because the cash on hand was insufficient to pay *their*
22 debts, that Tripod generally was unable to pay its debts as they matured. But these facts are
23 insufficient. Plaintiff did not provide any evidence to demonstrate that Tripod would not have been
24 able to obtain funds from other sources. Indeed, Defendant testified that Jayez had on multiple
25 occasions infused Tripod with cash to ensure its debts were paid pending a deal to distribute one of
26 the films in its library. *See In re Weinberg*, 410 B.R. 19, 34 (B.A.P. 9th Cir. 2009) *aff’d*, 407 F.
27 App’x 176 (9th Cir. 2010) (finding that the debtor was not insolvent because, *inter alia*, there were
28 other possible sources debtor could have sought to pay the creditor’s debt).

1 Thus, Plaintiffs have not met their burden to establish that Tripod generally was not paying
2 its debts as they came due, and therefore insolvent, at the time Tripod entered the Settlement
3 Agreement.

4 **ii. Balance Sheet Approach**

5 Under California law, Plaintiffs alternatively may show that Tripod was insolvent on a
6 balance sheet basis, meaning the value of its liabilities at the time exceeded the value of its assets.
7 *Berg & Berg Enter., LLC*, 178 Cal. App. 4th at 1043 n.23 (citing *In re Kallmeyer* 242 B.R. at 496–
8 97); *see also* 11 U.S.C. § 101(32) (defining “insolvent” as the “financial condition such that the
9 sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation . . .”).
10 Plaintiffs failed to meet their burden to demonstrate insolvency by a preponderance of the evidence.
11 Again, Plaintiffs relied exclusively on Defendant’s testimony. The facts adduced from the
12 Defendant failed to meet Plaintiffs’ burden.

13 At trial, Plaintiffs did not produce an actual balance sheet. Instead, they adduced testimony
14 establishing the following: (i) Tripod incurred regular monthly bills for expenses including rent,
15 payroll, and utilities, but these bills generally were paid, (ii) as of the date of the Settlement
16 Agreement, Tripod owed the Winona Debt, in the amount of \$45,473.68, and (iii) as of an
17 unknown date, the SAM Debt arose in the amount of \$28,245.33. On this record—the burden of
18 which was on Plaintiffs to establish—the Court is unable to determine the amount of Tripod’s
19 liabilities as of the date of the Settlement Agreement.

20 As for the value of Tripod’s assets, the evidence adduced at trial established that, as of the
21 date of the Settlement Agreement, Tripod had approximately \$6,000.00 to \$8,000.00 in cash on
22 hand and an interest in two film productions that were not the subject of any film distribution deal
23 and therefore had not yet been monetized. The Defendant testified to his belief that those films, at
24 the time of the Settlement Agreement, were worth at least \$100,000.00 each (i.e., substantially
25 more than the Winona Debt and Sam Debt).⁶ Plaintiffs spent much of their cross-examination of
26

27 ⁶ Defendant testified that he graduated from the American Film Institute in 1994 and has
28 been producing movies since. Defendant further testified that he has produced or co-produced

(Continued...)

1 the Defendant establishing that neither film actually was picked up by a distributor since then, and
2 neither film has generated income.

3 The problem here is that it was *Plaintiffs'* burden to demonstrate by a preponderance of the
4 evidence the value of Tripod's assets as of the date of the Settlement Agreement. Plaintiffs offered
5 no affirmative evidence of their own. Plaintiffs ask this Court to infer that the two films were
6 worthless in May 2008, because Tripod has not entered into a distribution agreement with respect
7 to those films. But the record does not establish that the films were valueless on a balance sheet
8 basis, *at the time of the Settlement Agreement*. There is insufficient evidence in the record to
9 understand why they have not yet been sold. This could be the result of several years of poor
10 marketing efforts, changing conditions in the marketplace, or bad business decisions. It is *possible*,
11 as Plaintiffs contend, that the films are intrinsically valueless. But Plaintiffs failed to persuade the
12 Court that their interpretation of subsequent events is the correct one.

13 To be sure, this Court is permitted to consider subsequent events in valuing assets and
14 determining liabilities as of a particular date. *See In re Sierra Steel, Inc.*, 96 B.R. 275, 278 (B.A.P.
15 9th Cir. 1989). But the Court determines that it would not be appropriate to do so here. In *In re*
16 *Sierra Steel, Inc.*, the Bankruptcy Appellate Panel affirmed a bankruptcy court's decision to ignore
17 a balance sheet line item for deferred taxes, where it was established at trial that the entity was
18 operating at a loss and ultimately would not be liable for those taxes. *Id.* Here, Plaintiffs have
19 failed to establish the amount of the film assets as of May 2008, only that they were not sold in
20 subsequent years. This is wholly unlike the circumstances in *In re Sierra Steel, Inc.*, where the
21 entity's subsequent unprofitable operations *necessarily* meant that an actual balance sheet line-item
22 for deferred taxes at the time of the transaction was conclusively proven not to reflect a genuine
23 liability.

24 _____
25 (...Continued)

26 approximately 30 movies. Notwithstanding Defendant's experience, the Court did not admit
27 Defendant's testimony as to the truth of the value of the two film productions, but admitted his
28 testimony for the limited purpose of establishing his state of mind at the time he signed the
Settlement Agreement, which the Court found credible.

1 Thus, Plaintiffs have not met their burden to establish that Tripod's balance sheet liabilities
2 exceeded its balance sheet assets at the time Tripod entered the Settlement Agreement.

3 **b. Defalcation**

4 Even if it is assumed that Tripod was insolvent at the time Defendant signed the Settlement
5 Agreement, Plaintiffs defalcation claim under section 523(a)(4) still fails. Defalcation is defined as
6 the misappropriation of trust funds or money held in any fiduciary capacity.⁷ *Lewis v. Scott (In re*
7 *Lewis)*, 97 F.3d 1182, 1186 (9th Cir. 1996). An innocent defalcation does not suffice; scienter is
8 necessary to satisfy section 523(a)(4). *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1759-60
9 (2013). Scienter requires "intentional, improper conduct and reckless conduct of the kind that the
10 criminal law often treats as the equivalent . . . [W]here actual knowledge is lacking, intent can be
11 shown . . . if the fiduciary consciously disregards or is willfully blind to a substantial and
12 unjustifiable risk that his conduct will turn out to violate a fiduciary duty." *In re Bacino*, No., 2015
13 WL 9591904, at *19 (B.A.P. 9th Cir. Dec. 31, 2015) (citing *Bullock*, 133 S. Ct. at 1759) (internal
14 quotations omitted). "That risk must be of such a nature and degree that, considering the nature and
15 purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross
16 deviation from the standard of conduct that a law-abiding person would observe in the actor's
17 situation." *Bullock*, 133 S. Ct. at 1760.

18 **i. The Alleged Misappropriation.**

19 Plaintiffs contend that Defendant misappropriated funds from Tripod when he caused the
20 Buyout Amount—the amount paid by Faramarzi to buy out Defendant's interest in VA—to be paid
21 to Stonelock and Cheyenne under the Settlement Agreement, which resolved the Interpleader
22 Action. Plaintiffs contend that Tripod was somehow entitled to \$632,000.00 of the Buyout
23 Amount because Tripod had at one time made payments to AIM under the Tripod/AIM Contract.
24 But the record does not support these arguments.

25 _____
26 ⁷ Defalcation is also defined as the failure to properly account for trust funds or money held
27 in a fiduciary capacity. *Lewis*, 97 F.3d at 1186. However, Plaintiffs do not assert that Defendant
28 failed to properly account for such funds.

1 First, Plaintiffs failed to demonstrate at trial that Tripod ever had an enforceable claim
2 against AIM for the \$632,000.00 it paid under the Tripod/AIM Contract, prior to the cancellation of
3 that contract. Plaintiffs did not offer the Tripod/AIM Contract itself or any other evidence to
4 substantiate their theory. Instead, Plaintiffs elicited Defendant's uncontroverted testimony
5 establishing: (i) that Tripod made payments to AIM totaling \$632,000.00 in order to extend the
6 deadline for Tripod to fully consummate the purchase contemplated under the Tripod/AIM
7 Contract, (ii) when Tripod failed to timely consummate the purchase, AIM cancelled that contract,
8 and (iii) Tripod had no entitlement to a refund of the \$632,000.00 in payments. The Court found
9 Defendant's testimony credible.

10 Plaintiffs urged the Court at trial to infer the existence of a \$632,000.00 claim of Tripod
11 against AIM from the Recitals to the Settlement Agreement. The Court will not do so, however,
12 because (i) AIM is not a party to the Settlement Agreement (or its Recitals) and is not bound by the
13 statements contained in that document and (ii) nothing in the text of the Recitals actually supports
14 Plaintiffs' contention that Tripod was entitled to a refund from AIM. At trial, Plaintiffs succeeded
15 in demonstrating that the Recitals are inartfully drafted and that they contain several internal
16 inconsistencies. But Plaintiffs did not succeed in persuading the Court that Tripod held a
17 \$632,000.00 claim against AIM under the terminated Tripod/AIM Contract.

18 Second, Plaintiffs failed to demonstrate how any claim of Tripod against AIM—even if it
19 existed—would in any way entitle Tripod to a share of the Buyout Amount that was the subject of
20 the Interpleader Action, and that was ultimately distributed pursuant to the Settlement Agreement.
21 AIM was *not a party* to the Interpleader Action or the Settlement Agreement. Nor was AIM a
22 party to the transaction under which Faramarzi purchased Defendant's interest in VA in exchange
23 for the Buyout Amount.

24 Plaintiffs alternatively suggest that Tripod was entitled to a share of the Buyout Amount
25 distributed under the Settlement Agreement because Tripod and Jayez had filed a cross-complaint
26 against Defendant, Stonelock, Faramarzi, and VA in the Interpleader Action. Plaintiffs seem to
27 suggest that Tripod may have asserted a claim against the other parties to the extent of the
28 \$632,000.00 it had paid to AIM under the Tripod/AIM Contract. But the Plaintiffs did not offer

1 the cross-complaint into evidence, and otherwise failed to substantiate this argument by a
2 preponderance of the evidence.

3 Finally, Defendant never held the Buyout Amount in a fiduciary capacity. The Buyout
4 Amount was an amount Faramarzi was obligated to pay in connection with his buyout of
5 Defendant's interest in VA, and which Faramarzi chose to interplead because of a dispute between
6 Defendant and Jayez. The Buyout Amount was not Tripod's money and it was never held in trust
7 by Defendant.

8 Thus, the Court finds that there was no misappropriation of any funds by Defendant that
9 would constitute a defalcation.

10 **ii. Scienter.**

11 Even if Plaintiffs had demonstrated a misappropriation, Plaintiffs failed to establish
12 adequate evidence from which the Court could infer that Defendant acted with knowledge that his
13 conduct was improper, or acted recklessly, when entering into the Settlement Agreement.

14 Plaintiffs urge the Court to infer an improper motive because the Settlement Agreement
15 came four weeks after the Arbitration Award in favor of Winona. But the Court is not persuaded
16 that such an inference is appropriate. Defendant testified that he had no knowledge of Plaintiffs'
17 debts against Tripod at the time he signed the Settlement Agreement. The Court found Defendant's
18 testimony credible on this point. Moreover, the Court notes that neither the Arbitration Award nor
19 the Arbitration Award Order that were offered into evidence regarding the Winona Debt include
20 proofs of service to establish if and/or when Defendant or anyone else associated with Tripod
21 received notice of the Winona Debt.

22 As previously discussed, the Defendant testified that he believed Tripod was solvent at the
23 time he signed the Settlement Agreement because he believed the value of Tripod's interest in its
24 two film productions totaled at least \$100,000.00 each in May 2008. The Court found Defendant's
25 testimony to be credible; i.e., that he believed the films were worth at least \$100,000.00 each and
26 that Tripod was solvent at the time he entered into the Settlement Agreement.

1 Thus, the Court finds that at the time Defendant entered into the Settlement Agreement, he
2 did not have the requisite wrongful intent to constitute a defalcation under Bankruptcy Code
3 section 523(a)(4).

4 **c. Timing of the SAM Debt.**

5 In addition to all of the other infirmities with Plaintiffs' defalcation claim under Bankruptcy
6 Code section 523(a)(4), the claim fails as to SAM for an additional reason: SAM failed to introduce
7 any evidence as to the precise date on which the SAM Debt arose. To succeed on a defalcation
8 claim under Section 523(a)(4), debtor must be acting as a fiduciary to the creditor *at the time of the*
9 *alleged wrongdoing*. *Ragsdale*, 780 F.2d at 796. SAM fails to carry its burden on this issue. The
10 only evidence in the record as to when the SAM Debt arose is the Initial SAM/Tripod Default
11 Judgment, which was entered on December 9, 2008. Defendant signed the Settlement Agreement
12 on May 29, 2008—over six months earlier. Based on the record, the Court cannot conclude that
13 the SAM Debt even existed at the time the Settlement Agreement was signed.

14 **2. Embezzlement**

15 Alternatively, Plaintiffs assert under section 523(a)(4) that their claims are
16 nondischargeable under a theory of embezzlement. Under federal law, embezzlement is defined as
17 “the fraudulent appropriation of property by a person to whom such property has been entrusted or
18 into whose hands it has lawfully come.” *In re Littleton*, 942 F.2d 551, 555 (9th Cir. 1991) (citing
19 *Moore v. United States*, 160 U.S. 268, 269 (1885)). Therefore, to prove embezzlement, Plaintiffs
20 must show, “(i) property rightfully in the possession of a nonowner; (ii) nonowner's appropriation
21 of the property to a use other than which it was entrusted; and (3) circumstances indicating fraud.”
22 *Id.*

23 The gravamen of Plaintiffs' embezzlement argument is that by entering into the Settlement
24 Agreement Defendant somehow embezzled Tripod's funds or its right to collect funds from another
25 party. Plaintiffs' claim fails for several reasons.

26 First, section 523(a)(4) does not grant a creditor a nondischargeable claim where the
27 allegedly embezzled property is not the creditor's property. *See In re Razavi*, 539 B.R. 574, 600
28 (Bankr. N.D. Cal. 2015); *In re Bradley*, 507 B.R. 192, 200 (B.A.P. 6th Cir. 2014) *appeal dismissed*,

1 588 F. App'x 480 (6th Cir. 2014); *Bankers Trust Company, N.A. v. Hoover (In re Hoover)*, 301
2 B.R. 38, 52 (Bankr. S.D. Iowa 2003) (“This Court concurs with those decisions that have held or
3 implied there is a requirement that the embezzled property belonged to the adversary complaint
4 plaintiff. To hold otherwise would widen the pool of creditors who could utilize the embezzlement
5 prong of section 523(a)(4) beyond that contemplated by Congress.”); *Chrysler First. Comm. Corp.*
6 *v. Nobel (In re Nobel)*, 179 B.R. 313, 315 (Bankr. M.D. Fla.1995) (embezzlement claim could not
7 be maintained by a plaintiff which lacked ownership of the allegedly embezzled funds); *Sheriden*
8 *Woods Health Care Center, Inc. v. Floyd (In re Floyd)*, 359 B.R. 431 (Bankr. D. Conn. 2007)
9 (citing *Nobel* for the proposition that a plaintiff cannot assert an embezzlement claim unless the
10 property that was embezzled was the plaintiff's property); *In re Amari*, 483 B.R. 836, 852 (Bankr.
11 N.D. Ill. 2012); *In re Fowers*, 360 B.R. 888, 898 (Bankr. N.D. Ind. 2007); *In re Marshall*, 497 B.R.
12 3, 13 (Bankr. D. Mass. 2013) (“The creditor's ownership of the funds is what distinguishes an
13 embezzlement from a mere debtor-creditor relationship where the debtor simply uses his own
14 money for purposes other than paying the creditor.”) *In re Dryja*, 259 B.R. 629, 632 (Bankr. N.D.
15 Ohio 2001); *In re Hunnicutt*, 466 B.R. 797, 801 (Bankr. D. S.C. 2011). Plaintiffs argue that *In re*
16 *Littleton* supports a nondischargeability claim under circumstances similar to that of Plaintiffs’, but
17 *In re Littleton* simply does not address the issue.

18 Second, as the foregoing discussion regarding Plaintiffs’ defalcation claim explains, Tripod
19 did not own and was not entitled to any portion of the Buyout Funds. Defendant was not entrusted
20 with possession of the Buyout Funds by Tripod and did not thereafter appropriate those funds for a
21 use other than that which it was entrusted. The Buyout Funds represent the purchase price for
22 Defendant’s interests in VA paid by Faramarzi, which amount was deposited with the court in the
23 Interpleader Action, and thereafter distributed pursuant to the Settlement Agreement to Stonelock
24 and Cheyenne. These funds were not Tripod’s funds and could not be embezzled from Tripod.
25 Further, as discussed above, there is no evidence to suggest any fraudulent intent on the part of the
26 Defendant in connection with the Settlement Agreement.

27 * * *

1 Accordingly, the Court finds in favor of Defendant on Plaintiffs' claim for relief under
2 Bankruptcy Code section 523(a)(4).

3 **B. Nondischargeability under 11 U.S.C. §523(a)(6)**

4 Finally, Plaintiffs argue that Defendant's alleged misappropriation of the Buyout Amount
5 distributed pursuant to the Settlement Agreement satisfies the requirements of Bankruptcy Code
6 section 523(a)(6). Section 523(a)(6) precludes discharge of a debt arising from a willful and
7 malicious injury by the debtor to another entity or to the property of another entity. Whether a
8 particular debt is for willful and malicious injury under section 523(a)(6) requires the creditor to
9 prove that the debtor's conduct in causing the creditor's injuries was both willful *and* malicious.
10 *Barboza v. New Form, Inc. (In re Barboza)*, 545 F.3d 702, 711 (9th Cir. 2008). This Court must
11 evaluate these two prongs separately, notwithstanding the overlap between them. *Id.*

12 Plaintiffs fail to meet their burden under both prongs.

13 **1. Willful**

14 To show that a debtor's conduct was willful requires proof that the debtor deliberately or
15 intentionally injured the creditor or the creditor's property, and that in doing so, the debtor intended
16 the consequences of his act, not just the act itself. *Kawaauhau v. Geiger*, 523 U.S. 57, 60–61
17 (1998). In other words, the debtor must act with a subjective motive to inflict injury, or with actual
18 knowledge that injury is substantially certain to result from the conduct. *In re Su*, 290 F.3d 1140,
19 1143 (9th Cir. 2002); *Petralia v. Jercich*, 238 F.3d 1202, 1208 (9th Cir. 2001). Injuries arising
20 from reckless or negligent acts do not satisfy the wrongful intent required by section 523(a)(6). *In*
21 *re Peklar*, 260 F.3d 1035, 1038 (9th Cir. 2001).

22 As discussed above, there is no evidence that Defendant intentionally injured the Plaintiffs
23 by causing Tripod to enter into the Settlement Agreement. The evidence does not support the
24 contention that Tripod had any legal entitlement to the Buyout Amount distributed under the
25 Settlement Agreement to other parties, or that Tripod relinquished any valuable right to payment
26 pursuant to the Settlement Agreement. Thus, neither Tripod nor its creditors (i.e., Plaintiffs) were
27 injured by the Settlement Agreement. Further, even if Plaintiffs suffered an injury as a result of the
28 Settlement Agreement, the evidence does not support a finding that Defendant entered into the

1 Settlement Agreement with the intent to harm Plaintiffs. The uncontroverted evidence is that
2 Defendant was not aware of the Plaintiffs' claims at the time he caused Tripod to enter the
3 Settlement Agreement and believed Tripod was solvent.⁸

4 **2. Malicious**

5 In addition to showing that Defendant acted willfully, Plaintiffs must show that the
6 Defendant acted maliciously. An injury is malicious within the meaning of section 523(a)(6) if the
7 debtor: (i) commits a wrongful act, (ii) done intentionally, (iii) which necessarily causes injury, and
8 (iv) the act is done without just cause or excuse. *In re Su*, 290 F.3d at 1147.

9 Plaintiffs allege that Defendant intentionally misappropriated funds of Tripod (or an
10 entitlement to funds), causing injury to Tripod and its creditors, without just cause or excuse. But
11 Plaintiffs fail to sustain their burden of proof on these elements. For the reasons discussed above,
12 Plaintiffs fail to prove *any* misappropriation or other wrongful conduct by Defendant, and they fail
13 to prove any wrongful intent by Defendant in causing Tripod to enter into the Settlement
14 Agreement. See *In re Thiara*, 285 B.R. 420, 434 (B.A.P. 9th Cir. 2002) (*citing Jercich*, 238 F.3d at
15 1209) ("The 'done intentionally' element of a 'malicious' injury brings into play the same
16 subjective standard of intent which focuses on the converter's knowledge of harm to the creditor.")

17 Accordingly, the Court finds in favor of Defendant on Plaintiffs' claim for relief under
18 Bankruptcy Code section 523(a)(6).

21 ⁸ Plaintiffs attempt to suggest that the Settlement Agreement was somehow improper because
22 a portion of the Buyout Funds went to Jayez's company, Cheyenne. Plaintiffs suggest that this was
23 somehow suspect because Jayez was not a contractual participant in the deal involving Defendant,
24 Faramarzi and VA. But Defendant testified at trial that he agreed to permit consideration to go to
25 Jayez's entity because Defendant and Jayez had a longstanding business relationship and
26 Defendant hoped it would continue. In other words, even if Defendant might have prevailed in a
27 dispute over Jayez's entitlement to any part of those funds, Defendant made a business decision to
28 reach a compromise. The Court found Defendant's testimony credible. Nothing about the
Settlement Agreement, including the payment of consideration to Jayez's entity, Cheyenne,
supports the contention that Defendant intended it to harm Plaintiffs or any other creditors of
Tripod.

V.

CONCLUSION

Based on the record before the Court in this adversary proceeding, Plaintiffs have failed to meet their burden of proof as established under *Grogan v. Garner*, 498 U.S. 279 (1991). Accordingly, the Court will enter judgment against Plaintiffs and in favor of Defendant. The Court will enter a separate order in accordance with this Memorandum of Decision.

Date: August 16, 2016



Martin R Barash
United States Bankruptcy Judge