UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

LOS ANGELES DIVISION

In re JOSEPH ALAN KRAFKA and JACQUELINE SUE KRAFKA, Debtors. JILL STANDISH VACARRO, Plaintiff, vs. JOSEPH ALAN KRAFKA and JACQUELINE SUE KRAFKA, Defendants.	Case No. 2:12-bk-16238 RK Chapter 7 Adv. No. 2:12-ap-01343 RK MEMORANDUM DECISION ON ADVERSARY COMPLAINT TO DETERMINE DISCHARGEABILITY OF DEBT AND ORDER VACATING FURTHER HEARING

This adversary proceeding was tried before the undersigned United States Bankruptcy Judge on May 31, 2012 on the second amended complaint of plaintiff Jill Standish Vacarro ("Vacarro") to determine dischargeability of debt against defendants Joseph Alan Krafka and Jacqueline Sue Krafka pursuant to Section 523(a)(2)(A) of the Bankruptcy Code, 11 U.S.C. Geoff Conner Newland, Juris Doctor California, appeared

for plaintiff. Defendants Joseph Alan Krafka and Jacqueline Sue Krafka appeared for themselves.

On October 27, 2009, defendants filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code, 11 U.S.C. The case was assigned case number 8:09-bk-21706 RK.[1] A discharge was entered for both defendants on May 6, 2010.

On February 5, 2010, plaintiff commenced this adversary proceeding by filing her complaint against defendants, seeking a declaration that debts based on the loan she made to defendants be deemed non-dischargeable pursuant to 11 U.S.C. § 523(a)(2)(A).[2] *Complaint to Determine Dischargeability of Debt ("Complaint"),* filed on February 5, 2010. Defendants filed a motion to dismiss, which was granted, and on May 27, 2010, plaintiff filed a first amended complaint. Defendants filed a motion to dismiss the first amended complaint, which was granted, and on July 21, 2010, plaintiff filed a second amended complaint. On August 5, 2010, defendants served and filed an answer denying the substantive allegations of the second amended complaint. *Answer to Second Amended Complaint,* filed on August 5, 2010.

On March 29, 2012, the court approved and filed the joint pretrial order, which was entered on March 30, 2012.

On May 31, 2012, the court conducted the trial in this adversary proceeding. At the close of the evidence at trial, the parties orally stipulated to the dismissal of Jacqueline Sue Krafka as a party defendant, and the court ordered that Mrs. Krafka be dismissed from the adversary proceeding. The court further ordered the parties to submit proposed findings of fact and conclusions of law on or before June 21, 2012 for plaintiff and July 12, 2012 for defendant. The parties submitted a stipulation to extend these

[1] When the bankruptcy case was transferred to the Los Angeles Division on or about February 7, 2012, it was renumbered Case No. 2:12-bk-16238-RK Chapter 7.

[2] When the bankruptcy case was transferred to the Los Angeles Division, this adversary proceeding was renumbered Adv. No. 2:12-ap-01343-RK.

dates, which the court approved. Plaintiff lodged her proposed findings of fact and conclusions of law on July 2, 2012. Defendant filed his response to plaintiff's proposed findings of fact and conclusions of law and his own proposed findings of fact and conclusions of law on July 26, 2012. Plaintiff filed a reply to defendants' proposed findings of fact and conclusions of law on August 6, 2012. The court set a further hearing after the deadline for filing objections to proposed findings of fact and conclusions of law for September 5, 2012, which was continued to September 26, 2012.

Having considered the testimony and other evidence admitted at trial and the oral and written arguments of the parties, the court now takes the matter under submission and issues this memorandum decision.

The court has jurisdiction over this adversary proceeding under 28 U.S.C. §§ 157(a), (b)(1), (2)(I), and § 1334. Venue is proper in this judicial district. This adversary proceeding is a core matter.

FACTS

The court makes the following findings of facts based on facts previously determined in the court's joint pretrial order entered on March 30, 2012 as well as facts determined on the evidence admitted at trial. *Joint Pre-Trial Order ("JPTO"),* entered on March 30, 2012.

Joe Krafka as an officer of the corporation, JAK Designs, Inc., signed a promissory note to Jill Vacarro for $100,000. JPTO, Stipulated Facts at 1:24-25. Joe Krafka as an individual signed that same promissory note to Jill Vacarro for $100,000, referred here as "the Loan." JPTO, Stipulated Facts at 1:26-27. Jill Vacarro funded the Loan represented by that promissory note. JPTO, Stipulated Facts at 1:28. The Loan was not paid according to its terms. JPTO, Stipulated Facts at 2:1. The Loan is in default. JPTO, Stipulated Facts at 2:2. Jill Vacarro made demand for payment on the Loan. JPTO, Stipulated Facts at 2:3. The Loan has not been repaid. JPTO, Stipulated Facts at 2:4. Before entering the Loan agreement, Joe Krafka told Jill Vacarro that he had secured an asset-based line of credit from First Heritage Bank from which he would repay the Loan.

JPTO, Stipulated Facts at 2:5-7. Before entering the Loan, Joe Krafka did not inform Jill Vacarro that First Heritage Bank had been taken over by the FDIC on July 26, 2008. JPTO, Stipulated Facts at 2:8-9; Defendant – Response Proposed Findings and Conclusions at 1:23-24. The asset-based line of credit was not approved after the FDIC take over. JPTO, Stipulated Facts at 2:10.

The Loan was made to JAK Design Services, Inc. JPTO, Stipulated Facts at 2:12. The Loan was bridge financing to exit the Factoring contract that JAK had with another lender and to enter the Asset-Based Lending program with First Heritage Bank of Newport Beach, California. JPTO, Stipulated Facts at 2:13-14. JAK Design Services, Inc., had begun banking with First Heritage Bank in February 2008 (several months prior to the Loan) in preparation for the Asset-Based Lending relationship. JPTO, Stipulated Facts at 2:15-16. A Business Line of Credit with First Heritage Bank was approved pending conclusion of the Factoring relationship JAK Design Services, Inc., had with Continental Business Credit ("CBC") and the expiration of CBC's UCC lien filing on JAK Design Services, Inc. JPTO, Stipulated Facts at 2:17-19. First Heritage Bank failed on July 25, 2008. JPTO, Stipulated Facts at 2:20. JAK paid $10,000 interest fee when the Loan came due, and extension to the terms of the Loan were agreed upon. JPTO, Stipulated Facts at 2:21-22.[3] Financial conditions of the economy worsened through the third and fourth quarters of 2008, and many retail customers of JAK cancelled orders or closed operations without paying the company. JPTO, Stipulated Facts at 2:23-24. JAK ended the year 2008 with over of $100,000 of uncollectable receivables and unseasonal clothing inventory. JPTO, Stipulated Facts at 2:25-26. JAK closed operations in March 2009. JPTO, Stipulated Facts at 2:27. Joseph Alan Krafka and Jacqueline Sue Krafka filed for Chapter 7 bankruptcy protection in 2009. JPTO, Stipulated Facts at 3:1-2.

[3] According to Vacarro, the loan had a 60-day term for an amount of $100,000 with a rate of interest of 5 percent per month, yielding an interest payment of $10,000 at the end of the loan term. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:21 a.m.

According to Joseph Krafka, he had 20 years in the garment manufacturing business, and his business had gross revenue of $2 million in 2007, of which 50 percent was the cost of goods sold. Trial Testimony of Joseph Krafka, May 31, 2012, at 9:57 to 9:59 a.m. Mr. Krafka testified that previously, 75 to 80 percent of his accounts receivable was committed to his factor and the remaining 20 percent were from credit card and cash on delivery orders. *Id.* at 11:49 to 11:50 a.m. Mr. Krafka was introduced by his accountant to a banker at First Heritage Bank, Ted Dalessi. *Id.* at 11:50 a.m. Based on a credit analysis prepared by Mr. Dalessi, Mr. Krafka learned that he could increase his business cash flow by $30,000 a month and give him more control over the business if he switched his business financing from the factor to an asset-based line of credit with First Heritage Bank. *Id.* at 11:50 to 11:52 a.m. However, the bank could not fund the line of credit until the factor's security interest based on the UCC-1 financing statement expired. *Id.* at 10:35 to 10:36 a.m.

According to Ted Dalessi, he was employed at First Heritage Bank from 2006 to 2009. Trial Testimony of Ted Dalessi, May 31, 2012, at 10:42 a.m. Dalessi was a vice president of the bank and was in charge of the bank's asset-based small business lending program co-sponsored by the State of California in its California Capital Access Program ("Cal CAP"). *Id.* Though this program, Dalessi on behalf of First Heritage Bank had worked with Joseph Krafka and his business since February 2008, and the bank started to make loans to Krafka and his business secured by the business's unencumbered accounts receivable. *Id.* at 10:49 and 10:57 a.m. Dalessi performed a credit analysis of Krafka's business and this analysis persuaded Krafka that exiting his existing factoring arrangement in favor of an asset-based line of credit at First Heritage Bank under Cal CAP would result in considerable savings for him. *Id.* at 10:47 to 10:50 a.m. Mr. Krafka applied for a line of credit under this program which required the approval of the bank and the state, and both the bank and the state approved the line of credit. *Id.* at 10:52 to 10:53 a.m. However, Mr. Dalessi testified that First Heritage Bank could not provide additional financing, such as the asset-based line of credit under Cal

CAP, to Krafka until CBC's UCC-1 lien expired on his accounts receivable since First Heritage Bank was a collateral-based lender and the collateral was encumbered by CBC's lien. *Id.* at 10:57 a.m.

At this point, Mr. Krafka discussed the possibility of a bridge loan with Mr. Vacarro, a childhood friend, whom Mr. Krafka had made a previous loan. *Id.* at 11:53 to 11:55 a.m. (As discussed previously, the bridge loan was to allow Mr. Krafka to exit his factoring contract and to enter the asset-lending program with First Heritage Bank. JPTO, Stipulated Facts at 2:13-14.) Mr. Vacarro encouraged Mr. Krafka to take out the bridge loan, and Mr. Krafka called Mrs. Vacarro over the telephone to discuss the possibility of her making the bridge loan to him. *Id.* at 11:55 a.m. In consultation with Mr. Dalessi's team, Mr. Krafka gave the notice of termination of the factoring arrangement to the factor, and the factor restricted further advances to the business to "earn out", or recover from Mr. Krafka's accounts receivable, the remaining funds it advanced to him. *Id.* at 11:54 to 11:55 a.m; Trial Testimony of Ted Dalessi, May 31, 2012, at 10:59 to 11:01 a.m.

According to Jill Vacarro, the $100,000 she lent to Joseph Vacarro came from the life insurance proceeds she received on the death of her first husband, who died in an airplane crash in November 2004. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:13 a.m. Vacarro testified that she had planned to use the money to invest in a real estate project with her daughter in January 2009, but because Mr. Krafka did not repay the loan she made to him, she had to borrow money herself to make the investment. *Id.* at 9:14 a.m. Vacarro said that her only previous experience in lending money was to make two loans of $100,000 to two friends, who repaid the loans. *Id.* at 9:15 a.m. Vacarro testified that she knew Joseph Krafka through her new husband, James Vacarro, who told her that Mr. Krafka was a long time friend of his who needed a short-term bridge loan for his business. *Id.* at 9:15 to 9:16 a.m. Mr. Vacarro and Mr. Krafka were close friends from childhood, Mr. Vacarro was "best man" at the Krafkas' wedding, and Mr. Vacarro was the godfather to the Krafkas' children. *Id.* at 9:53 to 9:54 a.m.

Vacarro had an email exchange with Joseph Krafka and talked with him on the telephone about the loan on Thursday July 24, 2008. *Id.* at 9:17 to 9:23 a.m. Mr. Krafka told Vacarro about his business, saying that he had a T-shirt line with lots of orders, that his customers included notable stores, such as Anthropologie, that his goal was to get out of a factoring relationship, and that he needed bridge financing to help him through a 60-day period after he gave notice of termination of the factoring relationship. *Id.* at 9:24 a.m. Mr. Krafka told Vacarro that he had an approved line of credit with First Heritage Bank that he could access once the factoring relationship was terminated in about 60 days, and for Vacarro, the approval of the line of credit was important to her because it demonstrated the ability to repay a loan if she made one to him. *Id.* at 9:25 a.m. Vacarro agreed to make the loan to Mr. Krafka and his business, and the terms of the loan were to lend him and the business $100,000 for 60 days with a payment of interest of $10,000, or 5 percent per month. *Id.* at 9:24 a.m. On Friday July 25, 2008, Vacarro sent Mr. Krafka a "boilerplate" form promissory note to fill in, and he filled out the form promissory note and sent it back to her with a request and instructions for her to send the loan proceeds to him by wire transfer to his bank, First Heritage Bank. *Id.* at 9:30 a.m.

Vacarro explained that she relied upon more than one factor in making the loan to Mr. Krafka, and these factors included: (1) Mr. Krafka had a sound plan to repay the loan to her, that is, he had a good business plan with financing to pay back the loan; (2) his customers included well-known stores like Anthropologie; (3) in making the loan, she would be helping one of her new husband's friends; and (4) the loan paid good interest. *Id.* at 9:35 a.m. Vacarro was aware that Mr. Krafka had told her that his anticipated line of credit was with First Heritage Bank, but she did not know that the bank was taken over by the FDIC before she made the loan to him. *Id.* According to Vacarro, if she had known before the loan that the bank had been taken over by the FDIC, this would have impacted her decision to make the loan, and she would not have funded the loan and would have waited until she heard that the line of credit would be funded. *Id.* at 9:36 to

9:37 a.m. She said that she did not consult an attorney in negotiating the loan to Mr. Krafka. *Id.* at 9:21 a.m.

On the morning of Saturday July 26, 2008, Mr. Krafka heard on his car radio that First Heritage Bank had been taken over by the FDIC. Trial Testimony of Joseph Krafka, May 31, 2012, at 10:00 a.m. Mr. Krafka did not know how the FDIC takeover affected the status of his line of credit approved by First Heritage Bank, so he called his banker at First Heritage Bank, Ted Dalessi. *Id.* at 10:00 and 10:28 a.m.

At trial, Mr. Dalessi recounted the events of the FDIC takeover of First Heritage Bank as he was present when it occurred on Friday July 25, 2008 and Saturday July 26, 2008. Trial Testimony of Ted Dalessi, May 31, 2012, at 11:03 to 11:22 a.m. Mr. Dalessi testified that in accordance with standard procedures, the FDIC employees arrived at the bank late on a Friday afternoon to minimize any panic among the employees and in the public from a government seizure of a bank, which in this instance occurred at about 4:30 p.m. on Friday July 25, 2008. *Id.* at 11:03 to 11:04 a.m. Upon arrival, the FDIC representatives spoke with senior management at a meeting, at which they discussed the government takeover of the bank. *Id.* at 11:03 to 11:05 a.m. According to Mr. Dalessi, the FDIC officially seized the bank at 5:55 p.m. and notified the employees and the public that the bank deposits had been sold to Mutual of Omaha Bank. *Id.* The FDIC kept the employees on at work at the bank premises, and as of the takeover, the bank employees were no longer employees of the bank, but employees of the FDIC reporting to its Dallas office to assist it in the takeover. *Id.* at 11:05 and 11:20 a.m. Afterwards, the FDIC provided dinner to the employees to calm them down and to provide sustenance while they continued to work that evening from 7:00 to 11:00 p.m. to assist the FDIC in the takeover. *Id.* at 11:03 to 11:05 a.m. and 11:18 to 11:20 a.m. Mr. Dalessi said that he was asked by the FDIC to continue working that night and over the weekend to help in the takeover. *Id.* He said that upon the takeover, he became employed by the FDIC. *Id.* Mr. Dalessi came into work on Saturday, and later that morning, he received a call from Mr. Krafka left on his voicemail. *Id.* at 11:05 to 11:07 a.m. He was not able to respond to

Mr. Krafka's call until lunchtime because he was busy working for the FDIC in the morning. *Id.*

Mr. Dalessi spoke with Mr. Krafka about the situation at the bank during his lunch hour at the bank on Saturday July 26, 2008 and told him about the takeover of First Heritage Bank and its parent company, which resulted in losses to the FDIC of $885 million. *Id.* at 11:05 a.m. Mr. Dalessi testified that Mr. Krafka asked him how the takeover of the First Heritage Bank affected their business together, that is, the lending relationship and the approved line of credit. *Id.* at 11:05 to 11:07 a.m. Mr. Dalessi told Mr. Krafka that it was "business as usual" as to bank deposits, but that the FDIC was not necessarily required to fund working capital loans and that there would be a freeze on the making of loans until the FDIC was able to "check these things out". *Id.* at 11:07 a.m. and 11:22 a.m. Mr. Dalessi said that he recommended to Mr. Krafka that he should put his working capital into another bank, his Bank of America account, in the interim while everything got "sorted out" at the bank. *Id.* at 11:08 a.m. Mr. Dalessi told Mr. Krafka that that loan advances were going to be delayed, that FDIC told him that it was going to continue to make business loan advances, that there was going to be a short term cash flow crunch because the bank had no cash to lend and that funds needed to come from the FDIC to fund any new loans. *Id.* at 11:08 11:09 a.m. As to the prior approval of Mr. Krafka's line of credit by the State of California, Mr. Dalessi testified that he did not know what the state's position would be because the state did not have a set policy regarding a seized financial institution, the state loan program was funded by bonds, and when he spoke to state program representatives on Monday July 28, 2008, they told him that they needed to research the issue and did not know what the state's position was at that time. *Id.* at 11:09 a.m. Mr. Dalessi testified that his advice to Mr. Krafka was to "move your cash," "conserve your cash," "give me 48 hours to figure out what --- how this is going to play out" and "business was as usual." *Id.* at 11:11 a.m. Mr. Dalessi testified that after the FDIC takeover, he did not know the status of Mr. Krafka's line of credit "from a timing standpoint," but that there was "no question of funding" because the loan would have

been funded by the FDIC according to Mr. Dalessi in his testimony. *Id.* at 11:35 to 11:37 a.m. (However, the court finds that Mr. Dalessi's testimony on this point that—the doubt over Mr. Krafka's line of credit was only a matter of timing, but that there was "no question of funding"—not to be very credible because the FDIC did not fund the credit line and Mr. Dalessi had no authority to approve such funding on behalf of the FDIC.)

On the afternoon of Saturday July 26, 2008, Mr. Krafka emailed Vacarro with new wire transfer instructions, requesting that she wire the funds to a different bank, Bank of America. Testimony of Jill Vacarro, May 31, 2012, at 9:31 a.m.' Trial Testimony of Joseph Krafka, May 31, 2012, at 12:03 p.m. Later, Mr. Krafka sent Vacarro a reminder email message to remind her of the new wire transfer instructions and faxed a copy of the promissory note that he signed and sent the original signed promissory note to her by Federal Express. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:32 a.m. According to Vacarro, the changed wire transfer instruction did not mean anything to her. *Id.* at 9:35 a.m.. On Monday July 28, 2008, Vacarro sent the loan funds of $100,000 by wire transfer to Mr. Krafka. *Id.* at 9:33 a.m. At the time she made the loan and sent Mr. Krafka the loan funds on Monday July 28, 2008, she had not known that the FDIC had taken over the First Heritage Bank and became aware of that fact only three years later. *Id.* at 9:35 to 9:37 a.m. Mr. Krafka testified that he did not tell Mrs. Vacarro about the FDIC takeover of the First Heritage Bank because he did not think it was an issue and he felt it had no impact on his loan (i.e., the line of credit) from it. Trial Testimony of Joseph Krafka, May 31, 2012, at 12:03 to 12:06 p.m.

ANALYSIS

11 U.S.C. 523(a) provides that "[a] discharge under section 727, 1141, 1228(a), 1228 (b) or 1328(b) of this title does not discharge an individual debtor from any debt— . . . . (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by—(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." *See also, Ghomeshi v. Sabban (In re Sabban),* 600 F.3d 1219, 1222 (9th Cir. 2010); *Citibank*

(South Dakota), N.A. v. Eashai (In re Eashai), 87 F.3d 1082, 1086 (9th Cir. 1996). To render a debt nondischargeable under § 523(a)(2)(A), the following must be shown by a preponderance of the evidence: (1) that the debtor made the representations at issue; (2) that at the time the debtor knew they were false; (3) that the debtor made those representations with the intention and purpose of deceiving the creditor; (4) that the creditor justifiably relied on such representations; and (5) that the creditor sustained the alleged losses as the proximate result of the representations having been made. *In re Sabban,* 600 F.3d at 1222; *In re Eashai*, 87 F.3d at 1086; *see also, 4 March, Ahart and Shapiro, California Practice Guide: Bankruptcy,* ¶ 22:452 at 22-56 (2012). Plaintiff Vacarro must prove each of these elements of a claim under § 523(a)(2)(A) by a preponderance of the evidence. *In re Eashai*, 87 F.3d at 1086; *see also, Grogan v. Garner*, 498 U.S. 279, 291 (1991).

§ 523(a)(2)(A) – First Element: Joseph Krafka Made Representations to Vacarro: Under § 523(a)(2)(A), Vacarro must prove that Joseph Krafka made the representations at issue. *In re Eashai*, 87 F.3d at 1086. In the second amended complaint, Vacarro alleges that the Krafka made misrepresentations by failing to disclose material information to her, inducing her to make the loan which she otherwise would not have made. Second Amended Complaint at 2:10-24. Specifically, Vacarro alleged that with respect of the promissory note secured by purchase orders that the Krafkas gave to her for the loan, the Krafkas failed to disclose that "those Purchase Orders had already been pledged by Joseph Krafka and Jacqueline Krafka as security for another loan or line of credit." *Id.* at 2:17-18. However, it appears that this allegation was superseded by the joint pretrial order which asserted different allegations to support Vacarro's nondischargeability claim based on fraudulent misrepresentation. This is confirmed by Vacarro's proposed findings of facts and conclusions of law submitted after trial, which only refers to the allegations in the joint pretrial order and not in the second amended complaint. Accordingly, the court deems that the allegations of the second amended complaint to be superseded by the allegations in the joint pretrial order. JPTO at 4:2-4

("The foregoing admissions have been made by the parties, and the parties have specified the foregoing issues of fact and law remaining to be litigated. Therefore, this order supersedes the pleadings and governs the course of trial of this cause, unless modified to prevent manifest injustice."); *see also,* Fed. R. Bankr. P. 7016; Fed. R. Civ. P. 16; Local Bankruptcy Rule 7016-1.

The joint pretrial order submitted by the parties and approved by the court stated that one of the two issues of law to be litigated, and no others, remain to be litigated was:

> 1. Whether Joe Krafka failed to disclose the facts set forth above constitute a material non-disclosure that constitutes a fraudulent misrepresentation,

JPTO at 3:7-8.

The facts referenced in the issue of law were described in the JPTO as follows:

> 8. Before entering the Loan agreement, Joe Krafka told Jill Vacarro that he had secured an asset-based line of credit from First Heritage Bank from which he would repay the loan.
>
> 9. Before entering the Loan Joe Krafka did not inform Jill Vacarro that First Heritage Bank had been taken over by the FDIC on 07/26/2008.

JPTO at 2:5-9.

In the proposed findings of fact and conclusions of law submitted by Vacarro, she contended that "[t]here were at least two (2) facts that Krafka knew before he took Vacarro's money that would have justifiably induced her to refrain from acting:

> 1. FDIC Take-over: In the joint pre-trial order the parties stipulated at (A)(9) that "before entering the Loan Joe Krafka did not inform Jill Vacarro that First Heritage Bank had been taken over by the FDIC on 07/25/2008."
>
> This fact alone, if known by Vacarro, would have stopped the loan from funding, so that the parties could determine what impact, if any, the FDIC take-over would ultimately have on the Krafkas' business financing through First Heritage Bank ("FHB"). . . ,
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> * * * *

> 2. Application was no longer "approved": . . . The only reasonable conclusion is that Dalessi did say and Krafka did know on that Saturday [July 26, 2008] that the successor [bank] needed more information and time to analyze Krafka's line of credit application.
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> * * * *
>
> Vacarro should have been told this and was not, because it put in question Krafka's [FHB] financing.

Plaintiff's Proposed Findings and Conclusions by Court, lodged on July 2, 2012, at 2:1 to 4:16.

In this circuit, the courts have recognized that a debtor's silence or omission of a material fact can constitute a false representation which is actionable under 11 U.S.C. § 523(a)(2)(A). *In re Eashai*, 87 F.3d at 1088-1089, *citing inter alia, Restatement (Second) of Torts* § 551 (1976); *Apte v. Japra (In re Apte),* 96 F.3d 1319, 1323-1324 (9th Cir. 1996), *also citing, Restatement (Second) of Torts* § 551 (1976); *Cooke v. Howarter (In re Howarter)*, 114 B.R. 682, 684 n. 2 (9th Cir. BAP 1990). In *Eashai,* the Ninth Circuit cited with approval decisions of the Fifth and Eighth Circuits recognizing that an omission can satisfy the element of misrepresentation under § 523(a)(2)(A):

> Actual fraud, by definition, consists of any deceit, artifice, trick or design involving direct and active operation of the mind, used to circumvent and cheat another—something said, done or *omitted* with the design of perpetrating what is known to be a cheat or deception.

In re Eashai, 87 F.3d at 1089, *citing, RecoverEdge, L.P., v. Pentecost,* 44 F.3d 1284, 1293 (5th Cir. 1996) (citing 3 *Collier on Bankruptcy* ¶ 523.08[5] (Lawrence P. King et al. eds., 14th ed. 1994) and *Caspers v. Van Horne (Matter of Van Horne),* 823 F.2d 1285, 1288 (8th Cir. 1987), *abrogated on other grounds, Grogan v. Garner*, 498 U.S. 279 (1991); *but see, In re Eashai,* 87 F.3d at 1089, *citing, Schweig v. Hunter (In re Hunter),* 780 F.2d 1577 (11th Cir. 1986) (holding that debt was dischargeable because representations regarding the financial condition of the debtor must be explicit).

In *Eashai,* the Ninth Circuit also observed that the bankruptcy courts have recognized that "a debtor's silence or omission regarding a material fact can constitute a false representation which is actionable under § 523(a)(2)(A)." 87 F.3d at 1089, *citing, Cooke v. Howarter (In re Howarter),* 114 B.R. at 684 n.2 (noting that the debtor's silence or concealment of a material fact can create a false impression which constitutes a misrepresentation actionable under § 523(a)(2)(A)) and *Trizna & Lepri v. Malcolm (In re Malcolm),* 145 B.R. 259, 263 (Bankr. N.D. Ill. 1992) (stating that "when the circumstances imply a particular set of facts, and one party knows the facts to be otherwise, that party may have a duty to correct what would otherwise be a false impression.").

As the Ninth Circuit stated in *Eashai,* in order to find liability for fraud based upon omission or silence, there must also be a duty to disclose. *In re Eashai*, 87 F.3d at 1088-1089. In this regard, the Ninth Circuit in *Eashai* also cited the *Restatement (Second) of Torts* § 551, which stated:

> (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.
>
> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, . . .
>
> (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; . . . .

In re Eashai, 87 F.3d at 1089, *citing, Restatement (Second) of Torts* § 551 (1976).

In a similar vein, the Ninth Circuit in *Apte* held that a party to a business transaction had a duty to disclose facts basic to the transaction if he or she knows that

the other party is about to enter into it under a mistake as to them and the other would reasonably expect disclosure of such facts based on their relationship, trade custom or other objective circumstances. *In re Apte,* 96 F.3d at 1324, *citing inter alia, Restatement (Second) of Torts* § 551. In this regard, the Ninth Circuit in *Apte* also cited the *Restatement (Second) of Torts* § 551, which provided:

> (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.
>
> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
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> * * * *
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> (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts . . . .

Id.

As set forth in the stipulated facts in the joint pretrial order, before the parties entered into the loan agreement, Joseph Krafka told Vacarro that he had secured an asset-based line of credit from First Heritage Bank from which he would repay the loan that she was making to him, but he did not inform Vacarro that First Heritage Bank had been taken over by the FDIC on July 26, 2008. JPTO, Stipulated Facts at 2:5-9. The asset-based line of credit was not approved after the FDIC take over. JPTO, Stipulated Facts at 2:10. The promissory note signed and dated by the parties (namely, Joseph

Krafka, and Jill and James Vacarro) on July 28, 2008 corroborates the stipulated facts. Plaintiff's Exhibit 1. The term of the promissory note was short-term, July 28, 2008 to September 25, 2008, the time needed to bridge the gap between the Krafkas' factor which stopped providing financing and the asset-based financing to start from First Heritage Bank. *Id.; see also, Defendant's Proposed Findings of Fact and Conclusions* at 2:5-7 ("1. **Bridge Financing.** In trial both parties confirmed loan was bridge financing, enabling defendants business to exit Factoring facility and enter into a more cost effective Asset Based Lending program with First Heritage Bank of Newport Beach."). The promissory note indicates that "Joe Krafka and J.A.K. Design Services, Inc., dba TLuxury Apparel" was the "Borrower." Plaintiff's Exhibit 1.

The trial testimony of Joseph Krafka and Vacarro are consistent with these stipulated facts as well. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:21 to 9:30 a.m; Trial Testimony of Joseph Krafka, May 31, 2012, at 10:10 a.m. and 11:51 to 11:55 a.m. According to Vacarro, she was first contacted by Joseph Krafka about a loan on Thursday July 24, 2008. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:23 a.m. They exchanged email messages that day and spoke over the telephone that evening. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:21 to 9:27 a.m. and 9:30 a.m. Vacarro testified at trial that Joseph Krafka told her that he was in need of a short term bridge loan to finance his business until he obtained a line of credit with First Heritage Bank, that he had also told her that the line of credit at First Heritage Bank had been approved and that he would repay her when the line of credit was funded. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:26 To 9:27 a.m. At trial, Joseph Krafka testified that he expected to use the line of credit to repay the loan to Vacarro. Trial Testimony of Joseph Krafka, May 31, 2012, at 10:19 a.m.

Based on the stipulated facts, the promissory note and the testimony of the parties, the evidence indicates in this case that Joseph Krafka represented that he had an approved line of credit from First Heritage Bank, which he would use to repay the loan to Vacarro, but did not tell Vacarro the facts that approval of the loan became uncertain

after the bank was taken over by the FDIC before the parties entered their loan agreement based on his knowledge of the FDIC takeover and his discussions with Mr. Dalessi, his banker, about the uncertain status of the line of credit after the takeover. Mr. Krafka had told Vacarro that he would repay the bridge loan he wanted from her from an approved line of credit from First Heritage Bank, and she indicated that she would be willing to make the loan after hearing this information. Mr. Krafka subsequently acquired information that First Heritage Bank which had approved the line of credit that Vacarro was relying upon as assurance of repayment of the loan she was willing to make to him had been taken over by the FDIC and based on his discussions with his banker, Mr. Dalessi, the status of the approved line of credit was uncertain after the takeover. As Mr. Dalessi testified, he told Mr. Krafka that the FDIC took over the bank, that there would be a temporary freeze on any First Heritage Bank business loans, that funds from any new business loans would have to come from the FDIC, but that the FDIC was not required to fund business loans, that Mr. Dalessi recommended to Mr. Krafka that he move his available cash from First Heritage Bank to another bank and conserve his cash and that Mr. Krafka give him some time to find out information about the status of the line of credit, and that Mr. Dalessi had no information whether the state would fund the business loans of a failed financial institution under Cal CAP. This evidence indicates that the status of Mr. Krafka's line of credit from First Heritage Bank was uncertain and that Mr. Krafka knew that it was uncertain. When Mr. Krafka and Vacarro subsequently entered into the loan agreement and she funded the loan, Mr. Krafka did not disclose what he knew about FDIC takeover and the uncertain status of the line of credit to Vacarro, even though these facts meant that his prior representation that he would use the line of credit to repay the loan may no longer be true and these facts were basic to the transaction since she was relying upon the line of credit as the source of repayment of her loan. Therefore, the court finds that Vacarro has shown by a preponderance of the evidence that Joseph Krafka did in fact make these representations to Vacarro and omitted telling her material facts basic to the transaction that he knew that indicated that his representations to her

may no longer be true, and as such, Vacarro has satisfied the first element of § 523(a)(2)(A). *In re Eashai,* 87 F.3d at 1089, *citing, Restatement (Second) of Torts* § 551(1)(c); *In re Apte,* 96 F.3d at 1324, *citing, Restatement (Second) of Torts* § 551(1)(e).

§ 523(a)(2)(A) – Second Element: Joseph Krafka Knew at the Relevant Time the Representations Were False: Second, under § 523(a)(2)(A), Vacarro must prove that at the relevant time Joseph Krafka made the representations at issue, he knew they were false. *In re Eashai*, 87 F.3d at 1086. For a debt for money or property obtained through "false pretenses or representations" to be nondischargeable under § 523(a)(2)(A), plaintiff must show by a preponderance of the evidence that "the maker of the statement chose to assert a fact that he has neither knowledge nor belief in its truth "and recognizes that there is a chance, more or less great, that the fact may not be as it is represented." *Advanta Nat'l Bank v. Kong (In re Kong),* 239 B.R. 815, 826-827 (9th Cir. BAP 1999), *citing, Restatement (Second) of Torts* § 526, comment e. "This is often expressed by saying that fraud is proved if it is shown that a false representation has been made without belief in its truth or recklessly, careless of whether it is true or false." *Id.* at 827. As such, a debt that is obtained by a debtor who does not have an honest belief as to his intent to repay it is exempt from discharge under 11 U.S.C. § 523(a)(2)(A). *Id.* at 828.

In this case, it appears that in their original discussions on or about Thursday July 24, 2008, when Joseph Krafka made the representations that he had approval of a line of credit from First Heritage Bank and that he would repay the loan made by Vacarro to him from the line of credit, these representations were not false or misleading at the time they were made. However, Joseph Krafka learned shortly thereafter at least by Saturday July 26, 2008 that the FDIC had taken over First Heritage Bank and after his discussions with his banker, Ted Dalessi, at First Heritage Bank on July 26, 2008, he had reason to believe that the status of his line of credit from that bank was uncertain, and this was before the parties entered into the loan agreement and Vacarro funded the loan on Monday July 28, 2008.

As previously stated, "fraud is proved if it is shown that a false representation has been made without belief in its truth or recklessly, careless of whether it is true or false." *In re Kong,* 239 B.R. at 827, *citing, Restatement (Second) of Torts* § 526, comment e. As noted earlier, the *Restatement (Second) of Torts* states that a party "who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose." *In re Eashai, 87 F.3d at 1089, citing, Restatement (Second) of Torts* § 551 (1976). Liability exists if the nondisclosing party was "under a duty to the other to exercise reasonable care to disclose the matter in question." *Id.* Here, the court concludes that Joseph Krafka, one of the parties to the subject business transaction involving the loan, was "under a duty to exercise reasonable care to disclose to the other before the transaction is consummated, . . . subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so." *Id.* The evidence indicates that Joseph Krafka knew that Vacarro was making the loan to him on a short-term basis based on his representations that he had an approved line of credit from First Heritage Bank and that he would repay the loan from the line of credit when the line of credit was funded. This is shown by the terms of the promissory note signed by Joseph Krafka and the Vacarros as well as the trial testimony of the parties, which the court finds credible. Exhibit 1; Trial Testimony of Jill Vacarro, May 31, 2012, at 9:35 to 9:37 a.m.; Trial Testimony of Joseph Krafka, May 31, 2012, at 10:19 a.m.

The evidence also indicates that before the parties entered into the subject business transaction, the loan from Vacarro to Joseph Krafka, he learned that the FDIC had taken over the bank which he expected to extend him the line of credit and that his application for the line of credit was uncertain in light of the bank's seizure by the FDIC. These facts are undisputed as shown by the stipulated facts in the joint pretrial order as well as the trial testimony of Mr. Krafka and his banker, Mr. Dalessi. Because approval of

the line of credit became uncertain, this meant that repayment of the loan by Vacarro from that line of credit became uncertain. Joseph Krafka was aware of the problems that the FDIC takeover of the bank meant with respect to the prospects of getting the line of credit because his banker told him that the status of the loan program he had applied for was uncertain after the takeover and that Mr. Krafka accepted his banker's advice that he should move his funds to another bank.

Accordingly, the court finds that Vacarro has met her burden of proof of showing by a preponderance of the evidence that Joseph Krafka knowingly made a false misrepresentation by remaining silent and failing to correct the false impression left by his original representations that he had an approved line of credit from First Heritage Bank and that he would repay her the loan from that line of credit after he became aware that the bank which approved that line of credit had been seized and leaving in doubt his ability to get financing to repay the loan, which were also facts basic to the transaction that he had a duty to disclose.

§ 523(a)(2)(A) – Third Element: Joseph Krafka Made the Representations with Intent to Deceive: Third, under § 523(a)(2)(A), Vacarro must prove that Joseph Krafka made the representations with the intention and purpose of deceiving her as the creditor. *In re Eashai*, 87 F.3d at 1086. The third element of § 523(a)(2)(A)--the intent to deceive—is a question of fact. *Rubin v. West (In re Rubin),* 875 F.2d 755, 758 (9th Cir. 1989). Since a debtor will rarely admit to his fraudulent intentions, the creditor must rely on circumstantial evidence to infer an intention to deceive. *In re Eashai,* 87 F.3d at 1090. The court may infer an intent to deceive from a false representation. *In re Rubin,* 875 F.2d at 759 (citation omitted).

Vacarro contends that Joseph Krafka intended to deceive her because he became aware of material facts that cast doubt on his representations to her to repay the loan as promised from the line of credit with First Heritage Bank after it was seized by the FDIC. Trial Testimony of Joseph Krafka, May 31, 2012, at 10:00 to 10:06 a.m. As Mr. Krafka testified in his deposition taken in this case on March 30, 2011, after he learned of the

FDIC takeover of First Heritage Bank on Saturday July 26, 2008 and he talked it over with his banker, Mr. Dalessi, at First Heritage Bank that day, he was unsure about the status of his loan application and what loan programs would still be available after the FDIC takeover. *Id.* at 10:02 to 10:06 a.m. The court finds that Vacarro has shown by a preponderance of the evidence that Joseph Krafka had the requisite intent to deceive her into loaning them money. The evidence in this case shows that Joseph Krafka had promised Vacarro that the loan she was making to him was a short-term bridge loan to be repaid when he was able to access the line of credit from the First Heritage Bank, which he told her had been approved, and that due to the bank's seizure by the FDIC, his ability to repay the loan was uncertain. While Mr. Krafka was waiting to hear from the FDIC and the State of California about whether they would fund the line of credit in light of the takeover of First Heritage Bank, he did not wait for this clarification to press Mrs. Vacarro to make the bridge loan to him, emailing her new wire transfer instructions to send the loan money to a different bank because he was concerned about being able to take the money out if it was sent to the First Heritage Bank based on the warning of his banker, Mr. Dalessi, and without telling her the material facts that he may not be able to get the line of credit which he promised he would use to repay her bridge loan.

Accordingly, the court finds that Vacarro has shown by a preponderance of evidence that Joseph Krafka intended to deceive her when he borrowed the $100,000 pursuant to the loan agreement they made by failing to disclose the uncertainty of his ability to repay her from the line of credit after hearing about the FDIC takeover of First Heritage Bank. Accordingly, the court finds that Vacarro has satisfied the third element of § 523(a)(2)(A).

§ 523(a)(2)(A) – Fourth Element: Vacarro Justifiably Relied upon Joseph Krafka's Representations: Fourth, under § 523(a)(2)(A), Vacarro must prove that she justifiably relied on Joseph Krafka's representations. *In re Eashai*, 87 F.3d at 1086. In regards to the fourth element of § 523(a)(2)(A), Vacarro must show that her reliance on Joseph Krafka's promise to repay was "justified." *Field v. Mans,* 516 U.S. 59, 73-76 (1995)

(holding that reliance need not reach a level of "reasonableness" to establish nondischargeability under § 523(a)(2)(A) but must still be justifiable. In regards to the fourth element of § 523(a)(2)(A), Vacarro must show that her reliance on Joseph Krafka's promise to repay when he got the asset-based financing from First Heritage Bank was justified. Here, the court finds that Vacarro has shown by a preponderance of the evidence that she justifiably relied upon Joseph Krafka's representations that he would repay the loan and that the funds for repayment of her loan would come from his First Heritage Bank line of credit. Vacarro testified at trial that she relied upon Joseph Krafka's representations that he had an approved line of credit from First Heritage Bank, that her bridge loan would be repaid from that line of credit in 60 days to make the loan to him and that she would not have made the loan to him if she had known what he knew that First Heritage Bank was taken over by the FDIC and that the line of credit was uncertain because the bank had new ownership. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:21 to 9:27 a.m. and 9:35 to 9:37 a.m. According to Vacarro, the existence of the approved line of credit was an important factor in her decision to make the loan to Joseph Vacarro because it demonstrated ability to repay the loan. *Id.* The court finds that Vacarro's testimony to be credible because Joseph Krafka had identified no means of repayment of the loan other than the line of credit by the end of the 60-day term of the loan and a lender would have not made the loan absent a source of likely repayment. It was reasonable for Vacarro to have justifiably relied upon Joseph Krafka's representations that from what he told her he seemed to have a good business, he had a good business plan and he had a commitment of future financing from a bank, First Heritage Bank, to take out her loan, and thus, only a short–term need for "bridge financing."

Mr. Krafka may argue that there is no justifiable reliance on his representations because Vacarro did not conduct "due diligence." *See* Trial Testimony of Jill Vacarro, May 31, 2012, at 9:44 to 9:46 a.m. (cross-examination of Mrs. Vacarro by Joseph Krafka of her due diligence in making loans); Trial Testimony of Ted Dalessi, May 31, 2012, at

11:28 a.m. The court would reject such an argument because the problem here is not Vacarro's "due diligence," but Mr. Krafka's "due disclosure, which he failed to make of the material facts relating to the FDIC's takeover of First Heritage Bank and the uncertain status of his line of credit approved by the bank after the takeover, which line of credit he promised he would use to repay her loan to him.

Accordingly, the court finds that Vacarro has satisfied the fourth element of § 523(a)(2)(A).

§523(a)(2)(A) – Fifth Element: Losses Proximately Resulted from the Representations Made by Joseph Krafka to Vacarro: Fifth, under § 523(a)(2)(A), Vacarro must prove that she sustained the alleged losses as the proximate result of Joseph Krafka's representations. *In re Eashai*, 87 F.3d at 1086. In regards to the fifth element of § 523(a)(2)(A), Vacarro has shown she has suffered damages based on Joseph Krafka's misrepresentation about his ability to repay the loan from the First Heritage Bank line of credit and his failure to repay the loan as he promised. The loan was partially paid by Mr. Krafka when he paid Vacarro $10,000 in "interest" in October 2008, but the balance of the loan remains unpaid.

Mr. Krafka argues that Vacarro's loan loss is not attributable to him, but to market conditions, that is, the worldwide economic decline in 2008 resulted in less discretionary retail spending by consumers, which meant fewer orders for his clothing manufacturing business and slower payments by his customers causing reduced revenue and cash flow to repay the loan. Defendant – Response Proposed Findings and Conclusions at 3:8-12 ("Defendant objects to Vacarro suggestion of fraud. Defendant sought bridge capital to assist growing business during transitional period moving from Factoring to Asset Based Lending. With compounding fiscal issues in the economy thru the third and fourth quarters of 2008, the JAK Design Services business was severely impacted, the company was not able sustain operations, and ultimately led to owners insolvency. In doing so [sic] unable to repay Vacarro loan."). In Mr. Krafka's view, the loan was simply a business transaction, and Vacarro was a sophisticated business lender who failed to conduct

appropriate due diligence in making the loan to him. *See* Defendant – Response Proposed Findings and Conclusions at 2:9-10 ("The fact Vacarro had previously executed business loans of this type, Vacarro was aware of inherent risk involved."); Trial Testimony of Joseph Krafka, May 31, 2012, at 12:02 p.m.

While it may be true that market conditions caused his business to decline and become insolvent and unable to pay its debts, the court finds, however, that Vacarro's loss is in large part attributable to Mr. Krafka's failure to disclose material facts to her in this business transaction that his means to repay her on the loan became uncertain. Mr. Krafka knew and had reason to know that his lender, First Heritage Bank, may not be able to extend him the line of credit it had approved because it had been seized by the government as he heard on the radio, and he did not know whether the line of credit would be funded because of this based on his discussions with his banker, Mr. Dalessi. Mr. Dalessi testified about the seizure of the bank on Friday, the sale of the bank's deposits to Mutual of Omaha Bank, and the control of the bank's assets and business by the FDIC. When Mr. Dalessi spoke to Mr. Krafka on Saturday, he could not longer speak on behalf of either First Heritage Bank or the State of California, which had approved the line of credit before the seizure, because he was not an employee of the First Heritage Bank anymore, but an employee of the FDIC in keeping the bank open after seizure. Mr. Dalessi testified that he did not know the status of the line of credit because he did not know whether his new supervisors at the FDIC would authorize funding of the line of credit or whether the State of California would approve the funding, because this was apparently the first time that the state was involved with a federally seized bank in its small business lending program. Mr. Krafka said that he saw no need to disclose these uncertainties to Mrs. Vacarro because Mr. Dalessi told him it would be "business as usual." Trial Testimony of Joseph Krafka, May 31, 2012, at 10:00 to 10:03 a.m., 10:29 a.m. and 11:56 a.m.; *see also,* Defendant – Response Proposed Findings and Conclusions at 2:19-23 ("With witness Dalessi[']s] thorough understanding of Defendants business following extensive background check and due diligence in loan approval

process, and six months of day to day communication regarding banking and business matters, in addition to his position at First Heritage Bank as vice president, Cal Cap Lending Manager, Defendant took him at his word that business would continue as usual.").

In the court's view, Mr. Krafka could not reasonably rely upon this purported assurance from Mr. Dalessi, because as Mr. Dalessi admitted in his trial testimony—that he was no longer an employee of the First Heritage Bank which approved the loan, but an employee of the FDIC—that the authorization to fund the loan was subject to review of his new supervisors at the FDIC and the State of California, which would have to approve funding based on these changed circumstances. Trial Testimony of Ted Dalessi, May 31, 2012, at 11:05 to 11:12 a.m.

Moreover, the court concludes that Mr. Krafka's reliance on Mr. Dalessi's advice and comment that it was "business as usual" was misplaced. It was not "business as usual" if the government had to oust a bank's management and take over and sell its deposits to protect depositors from losses of a bank failure under a federal deposit insurance program. It was not "business as usual" that if a banker at a failed bank had to tell the loan applicant that there was an interim freeze on loans at the bank after its takeover by the government, that the banker did not know the status of the line of credit approved by the failed bank after its takeover, that the banker did not know what the policy of the State of California, one of the approving authorities for the line of credit, would take on the credit line approved by the failed bank, and that the banker suggested that he and the applicant needed to wait for about 48 hours until the bank reopened for business under government control to find out more information about the status of the line of credit from the FDIC and the state. In other words, at the time Mr. Dalessi and Mr. Krafka had their discussion on Saturday July 26, 2008, the day after the FDIC takeover, Mr. Dalessi had no idea whether the approval of the line of credit for Mr. Krafka by the failed bank would be honored by the FDIC and the State of California. As it turned out, neither the FDIC nor the state would allow the line of credit to be funded as previously

approved by the failed bank as Mr. Krafka found out three weeks later, and thus, he did not have the means to repay the loan to Vacarro as he previously represented to her. Trial Testimony of Joseph Krafka, May 31, 2012, at 10:30 a.m.

Mr. Krafka testified that he accepted Mr. Dalessi's advice to wait and see in 48 hours about his line of credit and not to worry about it. However, he did not give Mrs. Vacarro the benefit of that advice. As she testified, she, too, would have waited because she wanted to make sure that she was going to be repaid. Instead, Mr. Krafka gave her instructions and a reminder email message to fund the loan as if nothing had changed. There was no "wait and see" for Mrs. Vacarro because Mr. Krafka wanted the money then and there, regardless of whether the line of credit was actually funded, and even though it was his one and only plan to repay her from funds on the line of credit. In effect, Mr. Krafka shifted the risk of nonpayment of the loan to Mrs. Vacarro if the line of credit was not funded without her being fully informed of all the relevant risks and circumstances. Apparently, Mr. Krafka felt pressed to get the loan money without telling Mrs. Vacarro about the uncertainty of the line of credit from the bank takeover because he had a business to run. It would have been an inconvenient truth for Mr. Krafka to have told Mrs. Vacarro about the FDIC takeover of his lender because she then might not have made the loan if she had been informed of all the facts. Mr. Krafka then would have had a cash crunch because he had already told the factor that he was phasing it out for a new financing arrangement with another institution. Despite knowing the relevant facts of the uncertainty of the line of credit from his lender being taken over by the government, his promised means of repaying Mrs. Vacarro, Mr. Krafka simply chose the expedient thing for him, which was not to tell her, so he could get the loan from her. Without giving a second thought about telling Mrs. Vacarro, Mr. Krafka signed the promissory note and faxed a signed copy to her, sent the original note to her by Federal Express, provided her with amended wire transfer instructions to send the funds to another bank (because on advice of his banker, Mr. Dalessi, he was worried about taking the money out of the seized bank), and sent her a reminder email about the amended wire transfer instructions

to make sure he received her loan money. Trial Testimony of Joseph Krafka, May 31, 2012, at 11:56 to 11:57 a.m. Mr. Krafka was able to wait and see what the FDIC and the State of California would do about his line of credit approved by the failed bank. For Mrs. Vacarro, however, due to Mr. Krafka's insistence, she went ahead with making the loan and without the benefit of his knowledge that his promised means of repayment, the line of credit from a failed bank, might not be good after all due to this uncertainty.

Mr. Krafka chalks up his inability to repay her due to market conditions, saying that she "was aware of inherent risk involved." Defendant – Response Proposed Findings and Conclusions at 2:9-10. The court also finds this assertion lacking in merit because Mrs. Vacarro was not informed of the inherent risk involved in this transaction that the loan would not be repaid because the promised form of repayment in the First Heritage Bank line of credit had become problematic after the government takeover of the bank. Mr. Dalessi had advised Mr. Krafka to wait and see in 48 hours as to whether the FDIC and the State of California would authorize the funding of the line of credit approved by the failed bank, and Mr. Krafka heeded this advice. But as to Mrs. Vacarro, Mr. Krafka did not give her the opportunity to wait and see what would happen with the line of credit. Instead, in the interim, he pressed her to make the loan without disclosing what he knew that the funding of the line of credit was unclear and uncertain due to the lender's takeover, so she had no clue that the source of repayment of her loan Mr. Krafka promised her had become uncertain. Mr. Krafka could have told her that he needed to wait and see in about 48 hours as to whether he would still get the line of credit from which he could repay her, but he did not because this would not have been expedient for him and his business. He knew or should have known that Mrs. Vacarro might have hesitated in making the bridge loan if she was not certain he could obtain the line of credit to repay her. The court does not believe that there is any other reasonable explanation of why he did not tell her what he knew before she made the loan.

Mr. Krafka contends that, "Defendant did not knowingly withhold information from Vacarro." Defendant – Response Proposed Findings and Conclusions at 2:24. The court

finds that this statement is not true and further finds that he did knowingly withheld information material to her decision to make the loan or not to him. Mr. Krafka knew or should have known what he told her about the approval of the line of credit may have become untrue when he learned that the FDIC had taken over the bank. Mr. Krafka testified at trial that he did not do anything wrong because this was simply a business transaction, but as indicated by the Restatement (Second) of Torts, there are still ethical principles that apply to business transactions, such as this one. *See* Trial Testimony of Joseph Krafka, May 31, 2012, at 11:58 a.m. to 12:02 p.m. Before consummation of the loan transaction, Mr. Krafka, as a party to the business transaction of the bridge loan by Mrs. Vacarro to him, had a duty to exercise reasonable care to disclose to her, as the other party to the transaction, the subsequently acquired information that, due to the government takeover, the line of credit was uncertain. Mr. Krafka knew that these additional facts rendered untrue or misleading his previous truthful representation that he would repay her loan from the line of credit when it was made. *In re Eashai,* 87 F.3d at 1089, *citing, Restatement (Second) of Torts* § 551 (1976). Based on the evidence presented at trial, the court finds that Vacarro has proven by a preponderance of the evidence that she sustained losses as a proximate result of the representations made by Joseph Krafka that he would repay the loan with an approved line of credit and ultimately he did not.

Mr. Krafka testified at trial that he put everything into the business and "lost everything" when the business failed. Trial Testimony of Joseph Krafka, May 31, 2012, at 12:01 to 12:30 p.m. The court finds this testimony poignant because Mr. Krafka has indeed suffered financial hardship due to the failure of his business. However, Mrs. Vacarro's trial testimony was equally poignant that she was the mother of six young children and had lost her first husband who tragically died in a plane crash and that she had lost the money lent to Mr. Krafka from the proceeds of her first husband's life insurance policy when Mr. Krafka failed to repay the loan. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:13 to 9:15 a.m. However moving the testimony of both Mr. Krafka and

Mrs. Vacarro on these points may be, such testimony is extraneous to the issues before the court and should not be considered in determining whether Mr. Krafka is liable or not on Mrs. Vacarro's claim.

Based on the evidence presented at trial and the applicable law discussed herein, the court finds that Vacarro has proven by a preponderance of the evidence the elements to establish a claim under § 523(a)(2)(A) that: (1) Joseph Krafka made the representations to Vacarro for the loans made to them; (2) the representations were false and (3) Joseph Krafka made the representations with the intention and purpose of deceiving Vacarro; (4) Vacarro justifiably relied on such representations; and (5) Vacarro sustained the alleged losses as the proximate result of the representations having been made.

Accordingly, the court hereby holds in favor of plaintiff Jill Vacarro and concludes that the loan debt owed by Joseph Krafka to Vacarro is not excepted from discharge under 11 U.S.C. § 523(a)(2)(A). Vacarro is entitled to recover on this claim.

However, the court is unable at this time to determine the amount of the judgment based on Vacarro's losses due to insufficient information before the court and will require further evidence and briefing from the parties. The undisputed facts indicate that Joseph Krafka paid Vacarro the agreed-upon "interest" payment of $10,000 for the 60-day term of the loan based on a rate of interest at 5 percent per month. However, this interest rate for a nonconsumer business loan of 5 percent per month, or 60 percent per year, exceeds the maximum legal rate permitted under California law, which appears to be 10 percent per year under California Constitution, Article XV, and is a usurious rate under California law, which is unlawful. *Green v. Future Two,* 179 Cal. App. 3d 738, 741-743 (1986). The court cannot base any judgment on a usurious interest rate in violation of applicable law. Presumably, Mr. Krafka objects to the computation of damages attributable to interest based on a usurious rate in violation of applicable law. It appears that if the note included a usurious interest rate, the note should be treated as calling for no interest, and that interest would only be permitted from the date of maturity to the date

of judgment at the constitutional rate of 7 percent per year under Article XV of the California Constitution. *Green v. Future Two,* 179 Cal. App. 3d at 744. Thus, it also appears that, if the note's interest rate is usurious, the $10,000 "interest" payment made by Mr. Krafka in October 2008 cannot legally be characterized as interest, and the payment should be perhaps instead recharacterized as a repayment of loan principal.

Because the second cause of action for attorneys' fees is based on the disposition of the first cause of action, the court holds in favor of plaintiff and concludes that any debt for the attorneys' fees incurred by Vacarro to enforce the promissory note is not excepted from discharge under 11 U.S.C. § 523(a)(2)(A) for the same reasons. *See, Cohen v. de la Cruz,* 523 U.S. 213, 223 (1998). However, the only evidence of the appropriate amount of attorneys' fees incurred by Vacarro in enforcing the promissory note was her testimony that she incurred $35,000, more or less, in such fees, and the court considers her trial testimony on this point to be speculative and not supported by sufficient evidence to make a determination of an award of attorneys' fees. Vacarro did not provide a detailed explanation or other substantiation to justify an award of attorneys' fees under the agreement in the promissory note. Trial Testimony of Jill Vacarro, May 31, 2012, at 9:40 to 9:41 a.m.; *see also,* California Civil Code, § 1717(a) (an award of attorneys' fees based on a contract must be reasonable).

This memorandum decision constitutes the court's findings of fact and conclusions of law.

The court having issued this memorandum decision adjudicating the matters raised by the second amended complaint hereby vacates the further hearing in this adversary proceeding set for September 26, 2012 at 2:30 p.m. No appearances are required on September 26, 2012.

However, in order to determine the amount of the judgment, the court orders that the parties file further briefing and evidence regarding computation of Vacarro's losses based on a proper application of the $10,000 "interest" payment based on a legal and appropriate rate of interest and on evidence to substantiate her claim for attorneys' fees.

The court orders that Vacarro file and serve supplemental briefing and evidence to support her claimed losses on or before October 23, 2012. The court further orders Joseph Krafka to file any response, including any evidence to be considered by the court, to Vacarro's supplemental briefing and evidence on or before November 20, 2012. Vacarro may file briefing in reply to Mr. Krafka's response, if any, on or before December 4, 2012. The court sets a further hearing on the determination of the amount of the judgment on December 11, 2012 at 3:00 p.m. in Courtroom 1675, Roybal Federal Building, 255 East Temple Street, Los Angeles, California.

IT IS SO ORDERED.

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DATED: September 18, 2012

United States Bankruptcy Judge

NOTICE OF ENTERED ORDER AND SERVICE LIST

Notice is given by the court that a judgment or order entitled (*specify*) ORDER ON DEBTOR'S MOTION TO CONVERT CASE was entered on the date indicated as "Entered" on the first page of this judgment or order and will be served in the manner indicated below:

I. SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING ("NEF") – Pursuant to controlling General Order(s) and Local Bankruptcy Rule(s), the foregoing document was served on the following person(s) by the court via NEF and hyperlink to the judgment or order. As of ***9/18/12***, the following person(s) are currently on the Electronic Mail Notice List for this bankruptcy case or adversary proceeding to receive NEF transmission at the email address(es) indicated below.

- Thomas H Casey (TR) msilva@tomcaseylaw.com, tcasey@ecf.epiqsystems.com
- United States Trustee (SA) ustpregion16.sa.ecf@usdoj.gov

II. SERVED BY THE COURT VIA U.S. MAIL: A copy of this notice and a true copy of this judgment or order was sent by United States Mail, first class, postage prepaid, to the following person(s) and/or entity(ies) at the address(es) indicated below:

Plaintiff's Attorney
Geoff Conner Newlan
735 State Street, Suite 631
Santa Barbara, CA 93101

Debtor
Joseph Alan Krafka
5 N Vista de la Luna
Laguna Beach, CA 92651

Jacqueline Sue Krafka
5 N Vista de la Luna
Laguna Beach, CA 92651

III. TO BE SERVED BY THE LODGING PARTY: Within 72 hours after receipt of a copy of this judgment or order which bears an "Entered" stamp, the party lodging the judgment or order will serve a complete copy bearing an "Entered" stamp by U.S. Mail, overnight mail, facsimile transmission or email and file a proof of service of the entered order on the following person(s) and/or entity(ies) at the address(es), facsimile transmission number(s), and/or email address(es) indicated below: