SO ORDERED.

Dated: September 18, 2013

Daniel P. Collins, Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF ARIZONA

In re **GARY HIRTH** **Debtor.**	In Chapter 7 proceedings Case No.: 2:10-bk-39593-DPC Adversary No.: 2: 11-ap-00474-DPC
PEGGY and DAVID DONOVAN **Plaintiffs,** **v.** **GARY HIRTH** **Defendant.**	**ORDER GRANTING MOTION FOR PARTIAL SUMMARY JUDGMENT** (Not for Publication- Electronic Docketing ONLY) [1]

Plaintiffs seek partial summary judgment on Count I of their Adversary Complaint asserting that their claim is nondischargeable under § 523(a)(2)(A). The Defendant filed a response in opposition and the Plaintiffs replied. The Court heard oral argument on the motion for partial summary judgment and now grants the motion.

I. Facts

Gary Hirth, the Debtor and Defendant in this adversary proceeding, is the sole owner of Aruba Holdings, Ltd. ("Aruba"). In November 2004, David and Peggy Donovan (the "Plaintiffs"), purchased real property from Aruba located at Lot 11Z Unit 3

[1] This decision sets forth the Court's findings of fact and conclusions of law pursuant to Rule 7052 of the Rules of Bankruptcy Procedure. The issues addressed constitute a core proceeding over which this Court has jurisdiction. 28 U.S.C. §§ 1334(b) and 157(b).

in a development known as Moqui Ranchettes in Coconino County, Arizona (the "Property"). Prior to the purchase of the Property, Defendant executed an affidavit (the "Subdivision Affidavit") stating that the Property was properly subdivided per the requirements of A.R.S. § 11-809.[2] (Dkt. 40, Ex. 1). However, the Property was not properly subdivided under A.R.S. § 11-809 thereby preventing the Plaintiffs from obtaining building permits for the Property.

On or about March 31, 2008, Plaintiffs, Defendant and Aruba entered into a settlement agreement (the "Settlement Agreement") which provided a time period for Defendant and Aruba to comply with all applicable subdivision laws, for liquidated damages to be paid until the subdivision was approved, and for Defendant's and Aruba's obligation to repurchase the Real Property from Plaintiffs if subdivision authority was not granted on or prior to April 4, 2010. (Dkt. 40, Ex. 2). The Defendant and Aruba breached the Settlement Agreement by failing to make liquidated damages payments and refusing to repurchase the Property. On May 3, 2010, Plaintiffs brought suit against the Defendant in the Arizona Superior Court, Maricopa County (the "State Court") for breach of contract under the Settlement Agreement. The State Court entered judgment against the Defendant in the amount of approximately $296,000.00. (Dkt. 40, Ex. 3).

The Arizona Department of Real Estate commenced an investigation regarding the Property. That investigation resulted in a February 2008 consent order (the "Consent Order") where both the Defendant and Aruba consented to the findings of fact and conclusions of law in the Consent Order. (Dkt. 40, Ex. 4). The Consent Order states, in relevant part, that "Respondents, through actions described in the Findings of Fact, acted

[2] The 2004 version of A.R.S. § 11-809, applicable when the affidavit was provided, detailed the requirements to approve land divisions.

in concert to divide parcels of land within Moqui Ranchettes, as defined by A.R.S. § 32-2101(1) and in violation of A.R.S. § 32-2181(D)." (Dkt. 40, Ex. 4 at ¶ 9).

The Defendant later filed bankruptcy in December 2010. The Plaintiffs initiated this adversary proceeding seeking a determination that the State Court judgment is nondischargeable under §523(a)(2)(A) because that obligation was "obtained by false pretenses, a false representation, or actual fraud." Plaintiffs filed a motion for partial summary judgment (the "Motion"), to which the Defendant responded and the Plaintiffs replied. The Court heard oral argument on the Motion and took the matter under advisement.

II. Discussion

Rule 56 of the Federal Rules of Civil Procedure governs summary judgment motions and provides that summary judgment must be granted if the movant shows there is no genuine issue of material fact, and that the movant is entitled to judgment as a matter of law. *See* Fed. R. Civ. P. 56(a); *Celotex Corp. v. Catrett*, 477 U.S. 312, 322 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247 (1986). The movant has the burden of demonstrating that there are no genuine issues of material fact. *See Celotex*, 477 U.S. at 323. "A material fact is genuine 'if the evidence is such that a reasonable jury could return a verdict in favor of the non-moving party.'" *FreecycleSunnyvale v. Freecycle Network*, 626 F.3d 509, 514 (9th Cir. 2010) (quoting *Liberty Lobby*, 477 U.S. at 248).

11 U.S.C. § 523(a)(2)(A) provides that a monetary debt is nondischargeable "to the extent obtained by false pretenses, a false representation, or actual fraud." In the Ninth Circuit, to prove nondischargeablity under §523(a)(2)(A), it must be shown "(1)

that the debtor made the representations; (2) that at the time he knew they were false; (3) that he made them with the intention and purpose of deceiving the creditor; (4) that the creditor justifiably relied on such representations; and (5) that the creditor sustained alleged loss and damage as the proximate result of such representations." *In re Diamond***,** 285 F.3d 822, 827 (9th Cir. 2002); *In re Sabban*, 384 B.R. 1, 5 (9th Cir. B.A.P. 2008); *In re Slyman*, 234 F.3d 1081, 1085 (9th Cir. 2000); *In re Ettell*, 188 F.3d 1141, 1144 (9th Cir. 1999); *In re Hashemi*, 104 F.3d 1122, 1125 (9th Cir. 1996); *In re Eashai*, 87 F.3d 1082, 1086 (9th Cir. 1996). The plaintiff must establish the nondischargeability of a debt by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 284 (1991). In this case, the parties disagree whether there was a material misrepresentation, whether Plaintiffs justifiably relied on the representation and whether the Defendant intended to deceive. [3]

a. Material Misrepresentation

The Court finds that there is no genuine issue of material fact that the Subdivision Affidavit produced by the Defendant was a materially false representation. It provides, in relevant part, that "The sale of the Property meet[s] the requirements of A.R.S. § 11-809 regarding land divisions." (Dkt. 40, Ex. 1). However, the Settlement Agreement and Consent Order establish that the Property did not meet the requirements of A.R.S. § 11-

[3] The Defendant also argues that, because the State Court judgment was based on a claim for breach of contract, § 523(a)(2)(A) should not apply since the claim did not arise from fraud. "It is well settled that an action brought under state law to establish a state created debt is separate and distinct from an action brought under § 523(a) of the Bankruptcy Code to determine the dischargeability of the same debt." *Brown v. Felsen*, 442 U.S. 127, 138-39 (1979). The Settlement Agreement tolled the statute of limitations and preserved the fraud claims. Therefore, the Plaintiff could base the nondischargeability claim on an original fraud claim, despite the State Court judgment being based on a breach of contract. Bankruptcy Judge Case already dismissed this argument when he denied the Defendant's Motion to Dismiss this adversary proceeding. (*See* Minute Entry, Dkt. 11)

809 because it was not properly subdivided. The recitals in the Settlement Agreement, which both Plaintiffs and Defendant agreed to not dispute, provide that

> After purchasing the lot, [Plaintiffs] learned that the legal requirements for land division had not been met and an approved subdivision plat from Coconino County had not been obtained. Consequently, [Plaintiffs] have been denied building permits, have incurred costs, and have been denied the use and enjoyment of their lot as anticipated since the date of purchase.

(Dkt. 40, Ex. 2). The Consent Order, also not subject to dispute by the parties, provides that the Defendant "acted in concert" to evade subdivision rules. (Dkt. 40, Ex. 4). Accordingly, the Court finds that the Subdivision Affidavit constituted a material misrepresentation by the Defendant.

b. Justifiable Reliance

The Defendant points to the deposition of Plaintiff, David Donovan, where he testified that "he probably did not" rely on the Subdivision Affidavit prior to closing his purchase of the Property. However, Peggy Donovan, not David Donovan, actually inspected the documents prior to closing and testified she relied on the Subdivision Affidavit. Moreover, the Settlement Agreement provides that "[Plaintiffs] purchased their lot in reliance upon representations made by [Defendant and Aruba] that Moqui Ranchettes had been legally subdivided, that all the legal requirements for land division had been met, and that building permits could be obtained for immediate construction of homes." (Dkt. 40, Ex. 2). By signing the Settlement Agreement the Defendant acknowledged the Plaintiff's reliance on his false Subdivision Affidavit. The Court finds that there is no genuine dispute that the Plaintiffs relied on the Subdivision Affidavit.

The Plaintiffs were also justified in their reliance. Justifiable reliance is a standard that is lower than reasonable reliance and does not impose a duty to investigate. *See Field*

v. Mans, 516 U.S. 59 (1995) (holding that applying a reasonable person test entailing a duty to investigate exceeded the demand of justifiable reliance). However, one must "use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." *Field*, 516 U.S. at 71 (quoting RESTATEMENT (SECOND) OF TORTS § 541, Comment a (1976)).

In this case, a cursory examination of the Property would not have revealed that the Property was not properly subdivided. The Defendant argues that the Plaintiffs should have known that the Property was not properly subdivided because the Defendant provided the Plaintiffs with a Vacant Land/Lot Seller's Property Disclosure Statement (the "SPDS") which disclosed that the Property was not within a subdivision approved by the Arizona Department of Real Estate. However, this does not necessarily mean that the Property was not properly subdivided. A property can be within a subdivision that is approved in accordance with the requirements of A.R.S. § 32-2181 *et seq.* Alternatively, a landowner can divide property that is outside of an approved subdivision so long as the property is divided into six or fewer lots. *See* A.R.S. §32-2101(56) (providing a definition of "subdivision" and "subdivided lands"). Accordingly, the SPDS does not preclude this Court's finding that the Plaintiffs justifiably relied on the false Subdivision Affidavit prior to the Plaintiffs' purchase of the Property. This Court finds the Plaintiffs justifiably relied on the Defendant's false Subdivision Affidavit.

c. Intent to Deceive

"A finding that a debt is non-dischargeable under § 523(a)(2)(A) requires a showing of actual or positive fraud, not merely fraud implied by law." *In re Anastas*, 94

F.3d 1280, 1286 (9th Cir. 1996). However, "such a rule does not of course preclude the possibility of a finder of fact inferring or implying bad faith and intent to defraud based on the totality of the circumstances when convinced by a preponderance of the evidence." *Id*. at n. 3 (citing *Grogan v. Garner*, 498 U.S. 279, 286 (1991)). Intent to defraud can be established either by actual intent to deceive or reckless disregard for the truth of the representation**.** *Id.* (citing *Houtman v. Mann (In re Houtman)*, 568 F. 2d 651, 656 (9th Cir. 1978) (overruled on other grounds)).

Determinations concerning a debtor's culpable state of mind, for nondischargeability purposes, are usually not appropriate on motions for summary judgment, as it deprives the trier-of-fact of the opportunity to assess the debtor's credibility. *Double v. Cole (In re Cole)*, 428 B.R. 747, 752 (Bankr. N.D. Ohio 2009); *see S.E.C. v. Seaboard Corp.*, 677 F.2d 1297, 1298-99 (9th Cir. 1982); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir. 1980). However, there is no per se rule that state of mind issues relating to denial of discharge in Chapter 7 cases are inappropriate for disposition on summary judgment, as long as there is no possibility that the facts presented at trial would demonstrate a lack of fraud or intent. *Hunter v. Sowers (In re Sowers)*, 229 B.R. 151, 159 (Bankr. N.D. Ohio 1998); *see also Ariz. Laborers, Teamsters and Cement Masons Local 395 Health and Welfare Trust Fund v. Conquer Cartage Co.*, 753 F.2d 1512, 1517-18 (9th Cir. 1985).

The Consent Order's findings of fact and conclusions of law are binding on the parties. In this case, the Consent Order states that the Respondents (one of which was the Defendant) acted in concert to violate A.R.S. § 32-2181(D). (Dkt. 40, Ex. 4 at ¶ 9). Unlawful acting in concert is defined under A.R.S. § 32-2181(D) as requiring "proof that

the real estate licensee or other licensed professional knew or with the exercise of reasonable diligence should have known that property which the licensee listed or for which the licensee acted in any capacity as agent was subdivided land subject to this article."

The Plaintiffs contend that the admission in the Consent Order that the Defendants "knew or with the exercise of reasonable diligence should have known" satisfies the reckless disregard standard establishing that the statement was made with fraudulent intent. The Plaintiffs rely on *Matter of Nelson*, 561 F. 2d 1342, 1346-47 (9th Cir. 1977) which held that under §17(a) of the Bankruptcy Act, which is substantively identical to 11 U.S.C. §523(a)(2), making a false statement with reason to know of its falsity suffices to demonstrate fraudulent intent. The Court knows of no subsequent Ninth Circuit case that has repudiated *Nelson*'s "known or should have known" standard to determine whether a defendant has made an intentionally false representation.[4]

This Court finds that a "know or should have known" test is still appropriate to determine fraudulent intent. The "know or should have known" standard is akin to recklessness. Courts in the Ninth Circuit explain the "reckless disregard" standard to require that the "maker of the statement choose[] to assert it as a fact even though he is conscious that he has neither knowledge nor belief in its existence 'and recognizes that there is a chance, more or less great, that the fact may not be as it is represented.'" *In re Kong*, 239 B.R. 815, 826 (9th Cir. B.A.P. 1999) (quoting RESTATEMENT (SECOND) OF

[4] The Ninth Circuit in *In re Houtman* quoted the "known or should have known" standard in *Nelson* to support its conclusion that reckless disregard that a statement is false may suffice as evidence that the statement was made with fraudulent intent under §523(a)(2). 568 F.2d at 656; *see also In re Barrack*, 217 B.R. 598, 606 (9th Cir. B.A.P. 1998) ("'where the promisor knew or should have known of his prospective inability to perform,' the promise can be found to be fraudulent."); *In re Woodman*, 451 B.R. 31, 34 (Bankr. D. Idaho 2011) (same).
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TORTS § 526, cmt. e.)); *see also In re Houtman*, 568 F.2d at 656; *In re Biswas*, 2009 WL 7809011 at *4 n. 9 (9th Cir. B.A.P. 2009); *In re Levitt*, 2008 WL 8448069 at *4 (9th Cir. B.A.P. 2008); *In re Chang Sup Han*, 2013 WL 23404321 at *3 (C.D. Cal. 2013). In other words, the maker of the statement must have reckless indifference to his actual circumstances to make the statement with reckless disregard satisfying fraudulent intent under § 523(a)(2). When the Defendant signed his false Subdivision Affidavit he knew or should have known it was false and doing so recklessly disregarded the true facts.

Since the Consent Order establishes that the Defendant "knew or with the exercise of reasonable diligence should have known" that the representation was false, this established that the Defendant made the representation with reckless indifference or reckless disregard for its truth. The Defendant cannot now present credible evidence at trial showing that the Defendant was simply negligent when his Subdivision Affidavit stated the Property was properly subdivided. This is an issue that is properly resolved on summary judgment in favor of the Plaintiffs.

III. Conclusion

The Court finds that there is no genuine issue of material fact that the State Court judgment is a nondischargeable debt under §523(a)(2)(A) because it was "obtained by false pretenses, a false representation, or actual fraud." The Defendant made a false representation with the intent to deceive the Plaintiffs. The Plaintiffs justifiably relied on this false representation and suffered damage as a result. Accordingly, the Court grants summary judgment in favor of the Plaintiffs and concludes that the debt owed to Plaintiffs is nondischargeable under § 523(a)(2).

So ordered.

Dated:

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DANIEL P. COLLINS
UNITED STATES BANKRUPTCY JUDGE

COPY of the foregoing mailed by the BNC and/or sent by auto-generated mail to:

All interested parties