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U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:)	BAP No.	NC-12-1081-MkHPa
)		
RAUL MACHUCA, JR.,)	Bk. No.	10-55227
)		
Debtor.)	Adv. No.	10-05301
)		
HERITAGE PACIFIC FINANCIAL, LLC,)		
)		
Appellant,)		
)		
v.)		
)		
RAUL MACHUCA, JR.,)		
)		
Appellee.)		
)		

O P I N I O N

Argued and Submitted on October 18, 2012
at San Francisco, California

Filed - December 14, 2012

Appeal from the United States Bankruptcy Court
for the Northern District of California

Honorable Charles D. Novack, Bankruptcy Judge, Presiding

Appearances: Brad A Mokri, Esq. argued for Appellant Heritage Pacific Financial, LLC; and Stanley Zlotoff, Esq. argued for Appellee Raul Machuca, Jr.

Before: MARKELL, HOLLOWELL and PAPPAS, Bankruptcy Judges.

1 MARKELL, Bankruptcy Judge:
2

3 **I. INTRODUCTION**

4 Heritage Pacific Financial, LLC ("HPF") sued debtor Raul
5 Machuca, Jr. ("Machuca"), alleging that a debt incurred by
6 Machuca was nondischargeable. HPF not only lost, but the
7 bankruptcy court entered summary judgment for Machuca. HPF did
8 not appeal that order. Machuca thereafter sought an award of
9 roughly \$9,000 in attorneys' fees under 11 U.S.C. § 523(d).¹
10 The bankruptcy court granted Machuca's attorneys' fees motion.
11 HPF then appealed from the fee order. We AFFIRM.

12 **II. FACTS**

13 In January 2007, Machuca purchased a single-family
14 residence in Salinas, California ("Property"). To finance his
15 purchase, Machuca obtained two real estate secured loans. The
16 senior loan was for \$1 million. The junior loan, which is the
17 subject of this appeal, was for \$147,000 ("Loan"). It was made
18 by National City Bank ("National City").

19 Most of Machuca's actions in obtaining the Loan are
20 undisputed. In December 2006, Machuca telephoned Westar Real
21 Estate and Mortgage, a loan brokerage firm, seeking to obtain a
22 loan to purchase the Property. During this phone call, Machuca
23 answered many questions regarding his finances. These included
24 the name of his employer and the amount of his salary.

25
26
27 ¹Unless specified otherwise, all chapter and section
28 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and
all "Rule" references are to the Federal Rules of Bankruptcy
Procedure, Rules 1001-9037.

1 Sometime later, Machuca was notified that National City had
2 approved his Loan. He was asked to and did attend a meeting to
3 sign the necessary loan documentation. At the meeting, he
4 signed and initialed a stack of documents. Machuca testified
5 that he did not read any of the documents, although he admits
6 that he signed them in order to obtain the Loan. These
7 documents included a standard form loan application
8 ("Application").

9 Most of the documents that Machuca signed are not in the
10 record before us. We do have, however, multiple copies of the
11 Application signed by Machuca. They are each dated January 16,
12 2007. We also have multiple copies of the signed promissory
13 note ("Note"). They are each dated January 12, 2007 - four days
14 before the date of the Application.

15 The record also includes:

- 16 1. An unsigned and undated version of the Application
17 ("Unsigned Application"), presumably filled out by
18 Westar during or after the telephone call between
19 Machuca and Westar.
- 20 2. A document entitled Uniform Underwriting and
21 Transmittal Summary ("Underwriting Summary").
- 22 3. A Buyer Estimated Closing Statement ("Closing
23 Statement") dated January 16, 2007, and referring to a
24 closing date of January 17, 2007.
- 25 4. Closing Instructions from National City to Chicago
26 Title Co. ("Closing Instructions") anticipating a
27 disbursement date of January 17, 2007.

28 The Application stated that Machuca was a correctional

1 officer who had worked for the California Department of
2 Corrections for five years. That much was true. It also
3 stated, however, that his "base employment income" was \$20,725
4 per month, or almost \$250,000 a year. That was untrue.
5 According to Machuca, however, not only was the stated salary
6 amount false, it was patently absurd.² For purposes of this
7 litigation, however, both sides agreed that the \$20,750 amount
8 was inaccurate.

9 Machuca made his Loan payments for a little over a year.
10 He then defaulted. After several more years, in May 2010, he
11 filed a chapter 13 bankruptcy. During this time, HPF had
12 acquired National City's rights under the Loan. After Machuca
13 filed his bankruptcy, HPF filed an adversary proceeding seeking
14 a determination that the Loan was a nondischargeable debt under
15 § 523(a)(2)(A) and (B).

16 Machuca responded by filing a motion to dismiss the
17 § 523(a)(2)(A) claim, which the bankruptcy court granted.
18 Machuca then filed a motion for summary judgment on HPF's
19
20

21
22 ²The Unsigned Application and the Underwriting Summary
23 listed Machuca's income differently than did the Application.
24 Those documents listed his base employment income as \$7,250 per
25 month, plus additional "other income" of \$13,475 per month.
26 According to the Unsigned Application, \$3,725 of the "other
27 income" consisted of Machuca's overtime wages. The source of the
28 remaining \$9,750 per month in "other income" was not specifically
described in either document.

These documents perhaps suggest that whoever filled out the
final version of the Application erroneously listed Machuca's
claimed aggregate monthly income - his base employment income and
his "other income" - as his base employment income.

1 remaining § 523(a)(2)(B) claim.³

2 In his summary judgment motion, Machuca primarily argued a
3 lack of reasonable reliance on the Application. He asserted
4 that National City did not actually rely on his income
5 representation and that, even if it did, such reliance would
6 have been unreasonable. Machuca's argument focused on the
7 discrepancies in income between the Application and the Unsigned
8 Application. Machuca also noted that the cover sheet
9 accompanying the Underwriting Summary identified the loan type
10 as a "stated income" loan, the upshot of which was that National
11 City had never asked Machuca to provide any tax returns or pay
12 stubs to verify any of his income.⁴ Machuca further pointed out

14 ³Section 523(a)(2)(B) provides that a debt is
15 nondischargeable if the debtor obtained "money, property,
16 services, or an extension, renewal, or refinancing of credit" by
17 using a statement in writing -

18 (i) that is materially false;

19 (ii) respecting the debtor's or an insider's financial
20 condition;

21 (iii) on which the creditor to whom the debtor is
22 liable for such money, property, services, or credit
23 reasonably relied; and

24 (iv) that the debtor caused to be made or published
25 with intent to deceive

26 11 U.S.C. § 523(a)(2)(B).

27 ⁴By identifying his Loan as a stated income loan, Machuca
28 implicated the now-discredited practice of indiscriminately
making mortgage loans without verifying the income stated on the
loan application. Lenders who made these so-called "liar's
loans" often did not care what income the borrowers listed and
sometimes actively encouraged misstatements of income. Indeed,

(continued...)

1 that the dates on the loan documents indicated that National
2 City had approved the Loan before he signed the Application.

3 In its opposition to the summary judgment motion, HPF
4 contested Machuca's claim of a lack of reasonable reliance. It
5 supported its contentions with three items of evidence: (1) the
6 language in the Application; (2) the declaration of HPF's
7 managing partner Ben Ganter ("Ganter"); and (3) the declaration
8 of HPF's expert Mark G. Schuerman ("Schuerman").

9 According to HPF, the Application's certification of the
10 truth and correctness of the Application's information supported
11 both National City's and HPF's reliance without HPF's
12 introduction of any independent evidence of that reliance. In
13 the same vein, HPF also pointed to the Application's provision
14 stating that the lender and its successors and assigns "may
15 rely" on the information in the Application.

16 Ganter's declaration attempted to establish that both
17 National City and HPF had relied on the information regarding
18 Machuca's income set forth in the Application. Although
19 possibly relevant for HPF, Ganter's declaration did not explain
20

21 ⁴(...continued)
22 the economic incentives associated with originating such high-
23 risk, high-interest rate loans led some brokers to falsify loan
24 applications without the borrower's knowledge or active
25 participation. For a discussion of these and related points, see
26 Charles W. Murdock, Why Not Tell the Truth?: Deceptive Practices
27 and the Economic Meltdown, 41 Loy. U. Chi. L.J. 801, 843-46
28 (2010); see also Andrea J. Boyack, Lessons in Price Stability
from the U.S. Real Estate Market Collapse, 2010 Mich. St. L. Rev.
925, 947-50 (2010); Patricia A. McCoy, Andrey D. Pavlov & Susan
M. Wachter, Systemic Risk Through Securitization: the Result of
Deregulation and Regulatory Failure, 41 Conn. L. Rev. 1327, 1351-
53 (2009).

1 how he would have any reason to know anything about National
2 City's reliance.

3 Finally, Schuerman opined that both lenders and loan
4 purchasers routinely rely on the certifications, acknowledgments
5 and information contained in loan applications, and that this
6 reliance is a crucial factor in the secondary mortgage market.
7 He also opined that income representations are particularly
8 important to junior secured debt holders and purchasers because
9 any collateral supporting their junior position would be lost if
10 a senior lienholder foreclosed.

11 Schuerman did not attempt to give any opinion as to how the
12 types of patent defects evident in Machuca's application might
13 have affected a lender's or a successor's reliance. In fact,
14 Schuerman's declaration mostly ignored: (1) the income
15 discrepancies between the Application and the Unsigned
16 Application; (2) the implausible amount of base employment
17 income claimed by a five-year state corrections officer; (3) the
18 last-minute signing of the Application, just before funding of
19 the Loan and after the date of the promissory note; (4) National
20 City's approval and funding of the Loan without income
21 verification; and (5) HPF's purchase of the loan without income
22 verification.⁵

24 ⁵Schuerman did claim that HPF and the secondary mortgage
25 market typically rely on the "stated income" in loan
26 applications. If he meant to suggest, however, that such
27 reliance actually and reasonably occurs without independent
28 income verification, especially when there are red flags extant
on the face of the loan documents, his suggestion contradicts
everything that has been revealed about stated income loans in

(continued...)

1 The bankruptcy court heard the summary judgment motion on
2 November 28, 2011. It adopted Machuca's lack-of-reliance
3 argument, and granted summary judgment. According to the
4 bankruptcy court, Boyajian v. New Falls Corp. (In re Boyajian),
5 564 F.3d 1088 (9th Cir. 2009) made only the original lender's
6 reliance relevant with respect to § 523(a)(2)(B)'s reliance
7 element.⁶

8 The bankruptcy court further ruled that HPF had not met its
9 burden of presenting evidence from which National City's actual
10 or reasonable reliance could be inferred. HPF attempted to show
11 reasonable reliance from the contents of the loan documents
12 Machuca signed, and from an unsupported inference that Machuca
13 inserted the contents to induce a lender's reliance. But the
14 bankruptcy court was unpersuaded. It identified the following

15 ⁵(...continued)
16 the wake of the subprime lending crisis. In other words, there
17 is a reason why knowledgeable people in the mortgage lending
18 industry cynically referred to these loans as "liar's loans."
See note 4, supra.

19 ⁶Actually, this misstates Boyajian's holding. Boyajian held
20 that an assignee's reliance was not necessary to satisfy
21 § 523(a)(2)(B)'s reliance element when the assignee had already
22 established the original lender's reasonable reliance. See id.
at 1090. Boyajian did not address the question of whether, and
23 under what circumstances, the assignee's reliance might be
sufficient by itself under § 523(a)(2)(B).

24 The Panel has indicated that an assignee's reliance, under
25 appropriate circumstances and when not contested, can support a
finding of reliance under § 523(a)(2)(B)(iii). See Tustin Thrift
26 & Loan Ass'n v. Maldonado (In re Maldonado), 228 B.R. 735,
737-740 (9th Cir. BAP 1999). Given the bankruptcy court's
27 finding that no reasonable person could rely upon the income and
other contents of the Application, this case does not present the
unaddressed issue of whether an assignee's alleged but contested
28 reliance is sufficient to satisfy § 523(a)(2)(B)(iii). Cf. id.
at 737 (such reliance conceded and not contested).

1 as reasons it rejected HPF's argument: (1) HPF presented no
2 competent evidence from which the court could ascertain National
3 City's business practices in making stated income loans; (2) the
4 Application was signed and dated after the date on the
5 promissory note, and just before the loan closed; and (3) "red
6 flags" – that is, facts which would require a reasonable person
7 to investigate further before making the loan – were present,
8 and these red flags should have caused National City to question
9 and investigate Machuca's income representations if National
10 City sufficiently cared about the income representations to
11 constitute reliance. Combined with other arguments, these
12 factors persuaded the bankruptcy court that HPF had failed to
13 carry its summary judgment burden with respect to
14 § 523(a)(2)(B)'s reliance element.

15 As the bankruptcy court put it, HPF had not presented any
16 evidence from which the court reasonably could infer National
17 City's reasonable reliance on Machuca's income representations.
18 Moreover, the court stated that no lender could have reasonably
19 relied upon the Application and the other evidence in the
20 record, given the numerous red flags contained in those
21 documents. Accordingly, the bankruptcy court granted Machuca's
22 summary judgment motion, and entered its order confirming that
23 grant on December 19, 2011.⁷ HPF did not appeal that order, nor

24
25 ⁷The bankruptcy court also stated that it was going to
26 sustain Machuca's evidentiary objections to both Ganter's
27 declaration and Schuerman's declaration. We could not, however,
28 find these objections in the record. Nonetheless, the propriety
of the bankruptcy court's evidentiary rulings is not at issue in
this appeal. For purposes of determining whether the bankruptcy
(continued...)

1 has it challenged it under Rule 9024.

2 Machuca then filed a motion to recover his attorneys' fees
3 under § 523(d). HPF opposed, arguing that its filing and
4 prosecution of the adversary proceeding was substantially
5 justified, as it had a reasonable basis in both law and fact for
6 its position.

7 Relying on its then-final summary judgment order, the
8 bankruptcy court rejected HPF's substantial justification
9 argument. More specifically, the court focused on the complete
10 absence of competent evidence that could support an inference of
11 reasonable reliance. According to the bankruptcy court, this
12 absence of evidence established that HPF did not have a
13 reasonable basis in law and fact for its defense of the summary
14 judgment motion. As the court explained:

15 The law is straightforward: You need reasonable
16 reliance by National City. Yet despite this clear
17 requirement, no admissible facts of any kind were
18 presented, no personal knowledge offered by any
19 personal – was again, was offered to establish
20 reasonable reliance. This is not surprising given the
21 fact that stated income loans were magnets for
22 misrepresentations and a convenient excuse by lenders
23 to bypass even the most rudimentary attempt at due
24 diligence of the borrower's income, all in an effort
25 to make the loan and sell it on the secondary market.

26 Hr'g Trans. (Jan. 24, 2012) at 8:7-16.

27 The bankruptcy court entered an order on January 26, 2012,

28

⁷(...continued)

29 court erred in finding that HPF lacked substantial justification
30 for its position, we can and will consider the contents of both
31 declarations, even though the bankruptcy court considered them
32 inadmissible for purposes of the summary judgment motion. See
33 First Card v. Hunt (In re Hunt), 238 F.3d 1098, 1103 (9th Cir.
34 2001) (stating that a finding regarding substantial justification
35 "need not be based solely on the admissible evidence before the
36 court").

1 granting Machuca's fee motion. HPF timely filed a notice of
2 appeal on February 7, 2012.⁸

3 III. LIMITED REVIEW

4 HPF's February 7, 2012 notice of appeal only refers to the
5 bankruptcy court's January 26, 2012 order granting Machuca's fee
6 motion. It does not mention the court's December 19, 2011
7 summary judgment ruling. Nonetheless, HPF's opening appeal
8 brief suggests that HPF is now seeking appellate review of both
9 the fee order and the summary judgment. That we cannot do. An
10 order granting summary judgment on all remaining counts is final
11 for purposes of filing an appeal. Key Bar Invs., Inc. v. Cahn
12 (In re Cahn), 188 B.R. 627, 630 (9th Cir. BAP 1995).⁹ HPF's
13 election not to appeal the bankruptcy court's summary judgment
14 ruling means that the summary judgment order is now final, and
15 cannot be collaterally attacked.

16 Accordingly, the scope of our review in this appeal is
17 limited to the bankruptcy court's fee order.

18 IV. APPLICATION OF § 523(d)

19 HPF's appeal challenges the bankruptcy court's substantial
20

21 ⁸The bankruptcy court had jurisdiction pursuant to 28 U.S.C.
22 §§ 1334 and 157(b)(2)(I) and (O). We have jurisdiction under 28
23 U.S.C. § 158, subject to the jurisdictional issue discussed
below.

24 ⁹The pendency of Machuca's fee motion did not toll the time
25 to appeal the summary judgment ruling. It was a collateral
26 matter to the disposition of the adversary proceeding; see Rule
27 8002(b). See also Lindblade v. Knupfer (In re Dyer), 322 F.3d
28 1178, 1186 (9th Cir. 2003) ("[W]e have held that unresolved
issues related to attorneys' fees do not defeat finality,
regardless of whether the attorneys' fees are available under a
statute, by contract, or as a sanction for bad faith
litigation.").

1 justification ruling. "Substantial justification" has a long
2 history, and one not wholly within the Bankruptcy Code. We thus
3 begin our analysis with a review of the origins and purpose of
4 § 523(d)'s substantial justification standard.

5 A. Statutory Development of § 523(d)

6 Prior to 1984, § 523(d) did not contain a substantial
7 justification standard for awarding attorneys' fees. Rather, it
8 contained an explicit shifting of fees in favor of the consumer
9 debtor, unless such a shift was "clearly inequitable."¹⁰ The
10 purpose of § 523(d) as originally drafted was to deter
11 groundless nondischargeability actions brought primarily to
12 coerce settlements from honest debtors who couldn't effectively
13 fight back. See S. Rep. No. 95-989 at 80 (1978).

14 When Congress enacted the Bankruptcy Amendments and Federal
15 Judgeship Act of 1984, Pub. L. 98-353, § 307(b), 98 Stat. 333
16 ("BAFJA"), however, it cut back on this broad grant. It
17 replaced the "clearly inequitable" standard with a standard that
18 allowed attorneys' fees under § 523(d) only if the creditor's
19 position was not "substantially justified."

20 This standard was not created out of whole cloth. Congress
21 borrowed it from the Equal Access to Justice Act ("EAJA"). See

22
23 ¹⁰Before 1984, § 523(d) read as follows:

24 If a creditor requests a determination of
25 dischargeability of a consumer debt under subsection
26 (a)(2) of this section, and such debt is discharged,
27 the court shall grant judgment against such creditor
28 and in favor of the debtor for the costs of, and a
reasonable attorney's fee for, the proceeding to
determine dischargeability, unless such granting of
judgment would be clearly inequitable.

1 First Card v. Hunt (In re Hunt), 238 F.3d 1098, 1103 (9th Cir.
2 2001) (citing First Card v. Carolan (In re Carolan), 204 B.R.
3 980, 987 (9th Cir. BAP 1996)). In adopting this different, more
4 creditor-friendly, standard, Congress wished to shift incentives
5 so that creditors would not be unduly discouraged from pursuing
6 well-founded nondischargeability actions. As Congress put it:

7 The original congressional intent in the drafting S.
8 523(d) of the existing Bankruptcy Code was to
9 discourage frivolous objections to discharge of
10 consumer debts, but not to discourage well-founded
11 objections by honest creditors. The language of the
12 subsection, however, makes the award of the debtor's
13 costs and attorney's fees virtually mandatory in an
14 unsuccessful challenge of a consumer debt. It has
15 been interpreted as requiring the award of fees and
16 costs even when the creditor acted in good faith.
17 CF., In re Majewski, 7 B.R. 904 (Bd. D. Conn. 1981).
18 The net effect of this provision has been to preclude
19 creditors from objecting to discharge of any consumer
20 debt unless they are certain that the court will
21 sustain the objection.

22 The Committee, after due consideration, has concluded
23 that amendment of this provision to incorporate the
24 standard for award of attorney's fees contained in the
25 Equal Access to Justice Act strikes the appropriate
26 balance between protecting the debtor from
27 unreasonable challenges to dischargeability of debts
28 and not deterring creditors from making challenges
when it is reasonable to do so. This standard
provides that the court shall award attorney's fees to
a prevailing debtor where the court finds that the
creditor was not substantially justified in
challenging the dischargeability of the debt, unless
special circumstances would make such an award unjust.

S. Rep. No. 98-65, at 9-10 (1983).¹¹

///

¹¹Senate Report 98-65 accompanied a predecessor bill that ultimately led to the enactment of BAFJA. That predecessor bill, commonly known as the Omnibus Bankruptcy Improvements Act of 1983 ("OBIA"), contained proposed amendments to § 523(d)'s attorneys' fees provision identical to those contained in BAFJA. See OBIA, S. 445, 98th Cong. § 209(b) (1983).

1 B. Application of the Substantial Justification Standard
2 to HPF

3 To support a request for attorneys' fees under § 523(d), a
4 debtor initially needs to prove: (1) that the creditor sought to
5 except a debt from discharge under § 523(a), (2) that the
6 subject debt was a consumer debt, and (3) that the subject debt
7 ultimately was discharged. Stine v. Flynn (In re Stine), 254
8 B.R. 244, 249 (9th Cir. BAP 2000). "Once the debtor establishes
9 these elements, the burden shifts to the creditor to prove that
10 its actions were substantially justified." Id.; see also In re
11 Hunt, 238 F.3d at 1103 (citing In re Carolan, 204 B.R. at 987,
12 and holding that "the creditor bears the burden of proving that
13 its position is substantially justified").

14 To satisfy the substantial justification standard, HPF
15 needed to demonstrate that it had a reasonable factual and legal
16 basis for its claim. See In re Hunt, 238 F.3d at 1103 (citing
17 Pierce v. Underwood, 487 U.S. 552, 565 (1988)). As stated in
18 the legislative history, and mirrored in subsequent cases:

19 To avoid a fee award [under § 523(d)], the creditor
20 must show that its challenge had a reasonable basis
21 both in law and in fact. The requirement that the
22 creditor must show that it was substantially justified
23 to avoid a fee award is necessary because it is far
24 easier for the creditor to demonstrate the
25 reasonableness of its action than it is for the debtor
26 to marshal the facts to prove that the creditor was
27 unreasonable.

28 S. Rep. No. 98-65 at 59.

1. The Relationship Between Summary Judgment and
 Substantial Justification

 Substantial justification is thus a higher standard than
that used to determine whether litigation is frivolous. Pierce,

1 487 U.S. at 566 (interpreting EAJA). Although frivolous
2 litigation is never substantially justified, under EAJA some
3 nonfrivolous litigation also fails the test. The issue often
4 arises when a creditor loses an action otherwise filed in good
5 faith by summary judgment, directed verdict, or a judgment on
6 the pleadings. In such cases, the bankruptcy court must
7 scrutinize the merits of the action with particular care, as
8 these types of outcomes often suggest a lack of substantial
9 justification. See Keasler v. United States, 766 F.2d 1227,
10 1231 (8th Cir. 1985) (interpreting EAJA); see also F.J. Vollmer
11 Co. v. Magaw, 102 F.3d 591, 595 (D.C. Cir. 1996) ("In some
12 cases, the standard of review on the merits is so close to the
13 reasonableness standard applicable to determining substantial
14 justification that a losing agency is unlikely to be able to
15 show that its position was substantially justified.").

16 But not all such losses lead to fee-shifting. There is no
17 presumption of a lack of substantial justification just because
18 a debtor prevailed on summary judgment. As this Panel has said
19 on prior occasions, the substantial justification requirement
20 "should not be read to raise a presumption that the creditor was
21 not substantially justified simply because it lost." In re
22 Carolan, 204 B.R. at 987; see also Hill v. INS (In re Hill), 775
23 F.2d 1037, 1042 (9th Cir. 1985); S. Rep. No. 98-65 at 59 ("The
24 standard, however, should not be read to raise a presumption
25 that the creditor was not substantially justified, simply
26 because it lost the challenge.").

27 For instance, a novel but reasonable legal theory in
28 support of its opposition to Machuca's summary judgment motion

1 might have served as a basis for concluding that HPF's
2 opposition was substantially justified. See Renee v. Duncan,
3 686 F.3d 1002, 1017-18 (9th Cir. 2012) (interpreting EAJA and
4 citing Timms v. United States, 742 F.2d 489, 492 (9th Cir.
5 1984)). So too might have a legal theory subject to a split of
6 non-binding authority when there is no case on point. See
7 Mattson v. Bowen, 824 F.2d 655, 656-57 (8th Cir. 1987) (also
8 interpreting EAJA).

9 HPF asserts none of these justifications. Instead, it
10 defends on the record the bankruptcy court used to grant summary
11 judgment against it. In particular, it asserts that it was
12 substantially justified in its position on reliance under
13 § 523(a)(2)(B)(iii).

14 In so doing, it burdened itself with an almost
15 insurmountable task. HPF did not appeal the summary judgment
16 ruling and must contend with the issue preclusive effect of that
17 judgment. See Steen v. John Hancock Mut. Life Ins. Co., 106
18 F.3d 904, 912 (9th Cir. 1997) ("The determination of an issue on
19 a motion for judgment on the pleadings or a motion for summary
20 judgment is sufficient to satisfy the 'litigated' requirement
21 for collateral estoppel.") (citing Restatement (Second) of
22 Judgments § 27 cmt. d (1982); and Papadakis v. Zelis (In re
23 Zelis), 66 F.3d 205, 208 (9th Cir. 1995)).

24 As noted above, the bankruptcy court's order granting
25 summary judgment was final. HPF cannot collaterally attack that
26 judgment through the § 523(d) proceeding. At most, after the
27 appeal time had run, it might have sought relief under Rule 9024
28 (incorporating Federal Rule of Civil Procedure 60(b)). See 18B

1 Charles Alan Wright et al., FEDERAL PRACTICE AND PROCEDURE § 4478 (2d
2 ed. 2012) (“After final judgment, direct relief from the
3 judgment is governed by the rules governing direct and
4 collateral attack—principally found in Civil Rule 60(b) . . .
5 .”).

6 But HPF neither appealed nor sought relief under Rule 9024.
7 In the face of such inaction, this Panel must take the grant of
8 the summary judgment at its face value: HPF’s complaint and
9 response to the summary judgment motion presented no genuine
10 issue of material fact regarding reliance under
11 § 523(a)(2)(B)(iii). See In re Hunt, 238 F.3d at 1102 n.5
12 (failure to appeal merits decision meant that creditor waived
13 “any right to challenge the evidentiary rulings that led to it”
14 in subsequent proceeding seeking attorneys’ fees under
15 § 523(d)). In short, the doctrine of issue preclusion estops
16 HPF from arguing that the bankruptcy court was wrong, or that
17 HPF had an undisclosed basis in law and fact for its reliance
18 claim. Id.; Steen, 106 F.3d at 912. As a consequence, HPF
19 cannot argue that it had a reasonable factual and legal basis
20 for its fraud claim. See In re Hunt, 238 F.3d at 1103. Its
21 position was thus not substantially justified.

22 2. Substantial Justification, Abuse of Discretion,
23 and the Record on Reasonable Reliance

24 Even if HPF could surmount its issue preclusion hurdle, it
25 would then face another virtually insuperable hurdle: the abuse
26 of discretion standard. This circuit has specifically held that
27 § 523(d) orders are subject to the abuse of discretion appellate
28 review standard. In re Hunt, 238 F.3d at 1101.

1 Under this highly deferential standard of review, we first
2 “determine de novo whether the [bankruptcy] court identified the
3 correct legal rule to apply to the relief requested.” United
4 States v. Hinkson, 585 F.3d 1247, 1262 (9th Cir. 2009) (en
5 banc). And if the bankruptcy court identified the correct legal
6 rule, we then determine under the clearly erroneous standard
7 whether its factual findings and its application of the facts to
8 the relevant law were: “(1) illogical, (2) implausible, or (3)
9 without support in inferences that may be drawn from the facts
10 in the record.” Id. (internal quotation marks omitted).

11 In order to apply the first part of this standard – whether
12 the bankruptcy court used the correct legal rule – we examine
13 the bankruptcy court’s ruling on Machuca’s summary judgment
14 motion. This in turn requires us to consider its treatment of
15 § 523(a)(2)(B)’s reliance element, on which the summary judgment
16 motion hinged.

17 Reasonable reliance is not defined in the Bankruptcy Code;
18 to ascertain whether it exists, the bankruptcy court must employ
19 a “prudent person” test. Cashco Fin. Servs., Inc. v. McGee (In
20 re McGee), 359 B.R. 764, 774 (9th Cir. BAP 2006). Under the
21 prudent person test, the bankruptcy court must objectively
22 assess whether the creditor exercised the same degree of care
23 expected from a reasonably prudent person entering into the same
24 type of business transaction under similar circumstances. See
25 First Mut. Sales Fin. v. Cacciatori (In re Cacciatori), 465 B.R.
26 545, 555 (Bankr. C.D. Cal. 2012); see also Gertsch v. Johnson &
27 Johnson, Fin. Corp. (In re Gertsch), 237 B.R. 160, 170 (9th Cir.
28 BAP 1999). Bankruptcy courts must make this assessment on a

1 case-by-case basis in light of the totality of the
2 circumstances. See In re McGee, 359 B.R. at 774; In re Gertsch,
3 237 B.R. at 170.

4 Against this background, it is standard learning that a
5 creditor cannot simply ignore red flags that directly call into
6 question the truth of the statements on which the creditor
7 claims to have relied. See In re McGee, 359 B.R. at 775. Under
8 such circumstances, the creditor must support its reasonable
9 reliance claim with evidence explaining why it was reasonable
10 for it to rely on the statements notwithstanding the red flags.
11 Id. As the bankruptcy court used this standard, it "identified
12 the correct legal rule." Hinkson, 585 F.3d at 1262.

13 It also applied that legal rule correctly. In response to
14 the summary judgment, HPF argued that a trier of fact reasonably
15 could infer reasonable reliance from: (1) the language of the
16 Application; (2) Ganter's self-serving statement that HPF and
17 National City had relied on Machuca's income representation; and
18 (3) Schuerman's statement that mortgage lenders and the
19 secondary mortgage market typically rely on income
20 representations. But HPF's evidence does not contradict the
21 fact that it and its witnesses ignored the red flags associated
22 with the Loan. HPF's response to the summary judgment motion
23 simply failed to account in any meaningful way for the impact
24 those red flags necessarily would have had on a hypothetical
25 prudent person's assessment of whether any reliance should be
26 placed on Machuca's income representation.

27 Against this background, it was not illogical, implausible
28 or without adequate support in the record, Hinkson, 585 F.3d at

1 1262, to determine that neither HPF nor National City reasonably
2 could have relied on Machuca's income representation given the
3 many "red flags." These red flags included: (1) the income
4 discrepancies between the Application and the Unsigned
5 Application; (2) the implausible amount of base employment
6 income claimed by a five-year state corrections officer; (3) the
7 last-minute signing of the Application, just before funding of
8 the Loan and after the date of the promissory note; (4) National
9 City's approval and funding of the Loan without income
10 verification; and (5) HPF's purchase of the loan without income
11 verification.

12 As the Supreme Court has advised:

13 When opposing parties tell two different stories, one
14 of which is blatantly contradicted by the record, so
15 that no reasonable jury could believe it, a court
should not adopt that version of the facts for
purposes of ruling on a motion for summary judgment.

16 Scott v. Harris, 550 U.S. 372, 380 (2007).

17 Here, HPF claimed that both it and National City reasonably
18 relied on Machuca's income representation, but the undisputed
19 facts in the record regarding the red flags associated with the
20 Loan wholly undermined HPF's reasonable reliance claims. In the
21 parlance of Scott, HPF's "version of events is so utterly
22 discredited by the record that no reasonable jury could have
23 believed" it. Id.¹²

24 _____
25 ¹²Scott acknowledged that, in the summary judgment context,
26 the district court had to "view the facts and draw reasonable
27 inferences 'in the light most favorable to the party opposing the
[summary judgment] motion.'" Id. at 378 (quoting United States
v. Diebold, Inc., 369 U.S. 654, 655 (1962) (per curiam)).

28 Nonetheless, Scott held that "the light most favorable" to the

(continued...)

1 In sum, given the undisputed facts before the bankruptcy
2 court undermining HPF's reasonable reliance claims, no trier of
3 fact reasonably could have found § 523(a)(2)(B)'s reliance
4 element satisfied. With the correct legal rule applied, and an
5 application of the facts to that rule supported by logical,
6 plausible and supportable inferences from the record, there was
7 no abuse of discretion in finding a lack of substantial
8 justification for HPF's position.

9 **V. CONCLUSION**

10 For all of the reasons set forth above, we AFFIRM the order
11 granting Machuca's fee motion.

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¹² (...continued)
28 opposing party did not include ignoring the reality of undisputed
facts in the record.