

SEP 29 2017

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

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:) BAP No. CC-16-1412-LTaKu
)
 JOHN EMIL ALLE and MARY REILLY) Bk. No. 2:13-bk-38801-SK
 ALLE,)
)
 Debtors.) Adv. No. 2:14-ap-01146-SK
)
)
)
 JOHN EMIL ALLE; MARY REILLY)
 ALLE,)
)
 Appellants,)
)
)
 v.) **MEMORANDUM***
)
)
 EARL E. GALES, JR.; STARLA)
 GALES; ROBERT L. OPPENHEIM;)
 LOIS J. OPPENHEIM,)
)
 Appellees.)
)
)

Argued and Submitted on June 22, 2017
at Pasadena, California

Filed - September 29, 2017

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

Honorable Sandra R. Klein, Bankruptcy Judge, Presiding

Appearances: David Brian Lally argued for Appellants; Anthony
J. Napolitano of Buchalter Law Firm argued for
Appellees.

Before: LAFFERTY, TAYLOR, and KURTZ, Bankruptcy Judges.

*This disposition is not appropriate for publication.
Although it may be cited for whatever persuasive value it may
have (see Fed. R. App. P. 32.1), it has no precedential value.
See 9th Cir. BAP Rule 8024-1.

1 **INTRODUCTION**

2 This appeal challenges the bankruptcy court's
3 determinations that certain claims are nondischargeable under
4 § 523(a)(4)¹ as resulting from defalcation by a fiduciary and
5 embezzlement. In brief, the bankruptcy court concluded that the
6 defendant, who was the managing member of Shadow Mountain
7 Properties, LLC ("SMP"), a California limited liability company
8 ("LLC") in which plaintiffs were the only other members and
9 which was formed for the express purpose of acquiring and
10 operating for-profit real property, was a fiduciary to the
11 plaintiffs via the application of California law governing LLCs.
12 We agree with this conclusion.

13 The bankruptcy court also concluded that: (i) the
14 defendant's failure to provide monthly bank statements and
15 written accountings of the financial condition of the LLC and
16 apparent misappropriation of SMP's funds were defalcations
17 committed by defendant in his fiduciary capacity, and that SMP's
18 loss of its real property through foreclosure supported
19 nondischargeable claims against defendant of \$800,000, their
20 original investment; and (ii) SMP's loss of the real property
21 also supported a claim for embezzlement against defendant, in
22 the same damage amount of \$800,000. We cannot agree with these
23 conclusions.

24 As an initial matter, the bankruptcy court's ruling did not
25

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

1 contain a finding that defendant acted with the mental intent
2 required to support a claim of defalcation. And the record does
3 not support the bankruptcy court's ruling that the alleged
4 defalcations - failure to report SMP's financial condition and
5 misuse of funds - while certainly breaches of defendant's
6 fiduciary duties, "caused" the damages here, as required by the
7 law defining claims for defalcation under § 523(a)(4). Nor does
8 the law support the bankruptcy court's finding that the
9 defendant's misuse of funds adequately supported a judgment on
10 the embezzlement claim in the amount of the plaintiffs' original
11 investment. Indeed, neither the law nor the record support the
12 conclusion that the proper measure of damages for the alleged
13 defalcations or embezzlement was the amount of plaintiffs'
14 initial investment in SMP.

15 Accordingly, we AFFIRM in part, REVERSE in part, VACATE the
16 judgment, and REMAND.

17 **FACTS²**

18 **A. Formation of Shadow Mountain Properties, LLC**

19 In January 2006 Debtor John Alle and his wife Mary Alle,
20 Earl and Starla Gales, and Robert and Lois Oppenheim formed SMP
21 as a California LLC. Each couple owned a one-third interest in
22 SMP. SMP was formed to purchase, operate, and manage a 12-unit
23 residential income property on Shadow Mountain Drive in Palm
24 Desert, California (the "Property"). Under the Operating
25 Agreement ("OA") for SMP, Alle was designated managing member
26

27
28 ²The facts are taken from the bankruptcy court's findings on
summary judgment and are undisputed except as noted.

1 with direct and sole responsibility for the day-to-day
2 management and operation of the Property.

3 Alle arranged for SMP to purchase the Property from the
4 Humiston Family Trust ("HFT") for \$1,600,000. The Gales and the
5 Oppenheims (collectively, "Plaintiffs") each contributed
6 \$400,000 toward the acquisition of the Property, and HFT carried
7 back a note and deed of trust for the \$800,000 balance of the
8 purchase price.

9 **B. The Operating Agreement**

10 The OA provided that Alle, as managing member of SMP, would
11 have full authority in connection with the management of the
12 Property, including tenant relations and services, vendor
13 relations, record-keeping, accounting, and cash flow management.
14 For his services, Alle was to be paid a management fee of \$300
15 per month. He was also entitled to "reimbursement for any and
16 all out-of-pocket expenses paid or incurred by him in connection
17 with the Property," except costs associated with the formation
18 of the LLC and the purchase of the Property, as well as funds
19 required for the operation of the Property through December 31,
20 2010.

21 The OA authorized the managing member to require members
22 under appropriate circumstances to make capital contributions in
23 ratio to their ownership interests. It further obligated the
24 managing member to deposit partnership monies into the
25 partnership bank account, to provide members with monthly
26 financial reports and bank statements and annual financial
27 statements, and to distribute profits on a monthly basis.

1 **C. SMP's Cash Flow Problems**

2 Sometime during 2008, the Property began experiencing cash
3 flow problems. Over the next several years, Alle communicated
4 several times with Gales and Oppenheim,³ orally and in writing,
5 to inform them that the Property was no longer making money and
6 that he recommended they sell it. Alle initially approached
7 Gales and Oppenheim in 2008 about selling the Property, but they
8 did not want to sell because, according to Alle, they "had no
9 place else to put their money, . . . did not want to pay capital
10 gains taxes . . . [and] they didn't want to give up their
11 monthly/annual cash-on-cash returns of 9% per month."

12 Although Alle was communicating generally with Gales and
13 Oppenheim regarding SMP's financial condition, sometime in 2010
14 Alle stopped sending monthly operating reports and bank
15 statements to them. Alle also fell behind on sending
16 distribution checks.

17 Around 2010 to 2011, the Property's revenues decreased
18 because tenants either moved out or were evicted. Also, some
19 units became uninhabitable due to tenant damage. Alle requested
20 that Plaintiffs pay expenses for plumbing, eviction fees, legal
21 fees, insurance, taxes, trash, monthly maintenance, remedial
22 expenses (such as paint, appliance repairs, broken fixtures,
23 accounting, and bookkeeping), but Plaintiffs refused, insisting
24 that Alle should pay for those expenses from his personal funds.

25
26 ³References to "Gales" and "Oppenheim" are to Earl Gales and
27 Robert Oppenheim, respectively. Although their spouses were
28 members of the LLC, they did not actively participate in the
communications with Alle.

1 As noted, the OA provided that Alle was entitled to be
2 reimbursed for his out-of-pocket expenses related to the
3 Property.

4 Gales admitted in his deposition testimony that Alle told
5 Plaintiffs that the Property was losing money and that they
6 should sell it, but "we never received any documentation."
7 Gales also testified that during 2010, in an attempt to
8 determine the value of the Property, he personally investigated
9 comparables near the Property.

10 Over the next several months, Gales and Oppenheim requested
11 monthly reports and distribution checks; despite promises to do
12 so, Alle did not provide any financial reports. Alle also
13 continued to broach the subject of selling the Property, but
14 Gales and Oppenheim were opposed to the idea.

15 Eventually, in July 2011, Alle met personally with Gales
16 and Oppenheim at his office and warned them about the financial
17 challenges facing SMP. The parties reviewed bills and rent
18 rolls. Alle told Gales and Oppenheim that there was
19 insufficient cash in the operating account to maintain the
20 building properly, fix units for new tenants, and pay taxes and
21 that, even if the Plaintiffs' distributions were reduced, SMP
22 could not afford to maintain the Property.

23 **D. Alle uses SMP funds for his personal expenses.**

24 According to bank statements and check copies admitted in
25 the bankruptcy court, during 2009, 2010, and 2011, Alle withdrew
26 from the SMP bank account \$44,529.84 in cashier's checks,
27 \$15,097.84 in unidentified checks, and \$7,924.10 in cash
28 withdrawals, along with \$26,921.86 of expenditures that appeared

1 to be solely for Alle's personal expenses or expenses related to
2 other properties he owned.

3 **E. The Notice of Default**

4 In the meantime, SMP fell behind on payments on the debt
5 secured by the Property. As early as May 2009, HFT informed
6 Alle that late payments on the note would no longer be
7 tolerated. Alle did not inform Plaintiffs of this default or
8 his correspondence with the creditor.

9 Eventually, in August 2011, HFT recorded a Notice of
10 Default and Election to Sell ("NOD"), which stated that the
11 reinstatement amount was \$12,478.33. Alle admitted that he
12 received a copy of the NOD shortly after it was recorded and
13 asserted that the next day, he met with Gales and Oppenheim in
14 his office and notified them that he had received the NOD. Alle
15 testified that at that meeting Gales and Oppenheim told Alle
16 that they were unwilling to contribute further capital and were
17 unwilling to accept less than \$3,000 per month in distributions
18 from SMP, and they instructed Alle to negotiate a settlement
19 with HFT. Gales and Oppenheim, however, asserted that Alle
20 never informed them of the NOD.

21 According to Alle, a few weeks later, Alle met with Gales
22 and Oppenheim again to discuss the foreclosure, delinquent
23 property taxes, a cut-off notice from utilities, outstanding
24 rents, and timing of distribution checks.

25 **F. Alle's Attempts to Negotiate a Loan Modification**

26 Beginning in October 2011, HFT's attorney and Alle began
27 negotiating a potential loan modification. It is undisputed
28 that Alle did not notify Plaintiffs of any of these

1 negotiations. The final modification proposed by HFT in
2 December 2011 provided that HFT would cancel the trustee's sale
3 on satisfaction of various conditions, including the payment by
4 December 21 of \$16,666.65, representing interest payments due on
5 the note, along with legal fees and trustee's fees,
6 reimbursement for insurance premium advances, payment of current
7 property taxes, and proof of an installment agreement with
8 Riverside County for the payment of property tax arrears. Alle
9 did not accept this proposal but requested additional time to
10 pay the property taxes in exchange for paying a higher interest
11 rate. HFT rejected this proposal. The day before the scheduled
12 foreclosure sale, Alle made one more modification proposal in
13 which he requested a two-week continuance of the sale.

14 HFT did not respond to Alle's final proposal, and the
15 foreclosure sale occurred on December 22, 2011. A trustee's
16 deed for the Property was issued to HFT. According to Alle, he
17 notified Plaintiffs orally of the completion of the sale, but
18 Gales and Oppenheim testified that he did not.

19 **G. Post-Foreclosure Events**

20 Communications among Alle, Gales, and Oppenheim after the
21 foreclosure sale belie Alle's assertion that he had informed
22 Plaintiffs of the foreclosure sale. For example, about a week
23 after the sale, Oppenheim wrote to Alle to inquire about the
24 status of the financial information and documentation that Alle
25 had promised in July. In response, Alle defended his management
26 of the Property, pointed out that he had not taken any
27 distributions from the Property other than \$300 per month as a
28 management fee during the first year of ownership, and noted

1 that he had complied with Gales' and Oppenheim's desire to keep
2 the Property. Alle also promised that Gales and Oppenheim would
3 not lose any money on their investments.

4 Oppenheim and Alle exchanged similar correspondence again
5 in February 2012, with Oppenheim expressing concerns regarding
6 Alle's failure to satisfy the OA's reporting requirements and
7 Alle defending himself. This time Alle asserted that he had
8 provided all requested information and promised to send a letter
9 "with the game plan for the property."

10 According to Oppenheim, he discovered the foreclosure sale
11 in April 2012 when he received an email from a real estate
12 broker attaching a copy of the trustee's deed. Immediately
13 thereafter, Oppenheim emailed Alle to ask for an explanation.
14 According to Plaintiffs, Alle responded with an email stating
15 that he had decided to sell the property to the lender due to
16 unpaid property taxes. Alle promised that Plaintiffs would not
17 lose any money and that he would continue making distributions
18 over the next eight years. Alle contended that this email,
19 which was presented as an exhibit to the declaration of Earl
20 Gales in support of Plaintiffs' motion for summary judgment, was
21 a "sham exhibit." In any event, the bankruptcy court made clear
22 that this email was not material to its ruling.

23 In November 2012, Plaintiffs filed a complaint against the
24 Alles in Los Angeles County Superior Court, asserting several
25 causes of action, including breach of contract, breach of
26 fiduciary duties, fraud, conversion, and for an accounting.
27 Trial in the state court was set for December 2013.

28

1 **H. The Alles' Bankruptcy Filing and the Adversary Proceeding**

2 A few days before the date set for trial in the state
3 court, the Alles filed a chapter 7 bankruptcy petition, which
4 stayed the state court litigation. Thereafter, Plaintiffs filed
5 an adversary proceeding against Alle seeking a declaration of
6 nondischargeability under (i) § 523(a)(4) for defalcation while
7 acting in a fiduciary capacity and embezzlement and (ii) under
8 § 523(a)(2)(A) for fraud. Plaintiffs sought to have declared
9 nondischargeable their initial investments totaling \$800,000
10 plus attorneys' fees and costs.⁴

11 In June 2016, Plaintiffs filed a motion for summary
12 judgment ("MSJ") seeking entry of judgment on all causes of
13 action. In support of the MSJ, Plaintiffs submitted
14 declarations that attached, among other documentary evidence,
15 copies of SMP's bank statements, cancelled checks, and
16 supporting documents.

17 After hearing argument on the MSJ, the bankruptcy court
18 granted Plaintiffs' MSJ with respect to Plaintiffs' claims under
19 § 523(a)(4) for defalcation and embezzlement and denied the MSJ
20 with respect to Plaintiffs' claim under § 523(a)(2)(A). The
21 bankruptcy court awarded Plaintiffs' requested damages of
22 \$800,000 but did not articulate the basis for the award. The
23 bankruptcy court declined to award damages on the \$94,473.64
24 embezzlement claim because Plaintiffs had not requested those

25
26 ⁴Alle was initially represented by counsel in this adversary
27 proceeding. However, on June 10, 2016, Alle's attorney filed a
28 Substitution of Attorney substituting Alle in pro per. Alle
thereafter participated in the adversary proceeding without
counsel until the filing of this appeal in November 2016.

1 damages in their MSJ. The bankruptcy court deferred the issue
2 of attorneys' fees to permit Plaintiffs to file a motion
3 substantiating the fees.

4 Thereafter, Plaintiffs dismissed their § 523(a)(2)(A) claim
5 in its entirety and their § 523(a)(4) claim for embezzlement,
6 but only with respect to the portion of damages attributable to
7 Alle's misappropriation of funds from the SMP checking account.
8 The bankruptcy court entered judgment on the § 523(a)(4) claims
9 for \$800,000 plus attorney's fees and costs and post-judgment
10 interest. The bankruptcy court subsequently awarded Plaintiffs
11 their attorneys' fees and costs in the amount of \$351,730.02 and
12 entered an amended judgment reflecting the fee award.

13 In the meantime, Alle filed a motion to vacate the
14 bankruptcy court's ruling on summary judgment pursuant to Civil
15 Rules 59(e) and 60(b), applicable in bankruptcy via Rules 9023
16 and 9024. He thereafter filed an amended motion to vacate,
17 which included the amended judgment. After a hearing, the
18 bankruptcy court denied the motion to vacate. Alle timely
19 appealed.

20 **JURISDICTION**

21 The bankruptcy court had jurisdiction pursuant to 28 U.S.C.
22 §§ 1334 and 157(b)(2)(I). We have jurisdiction under 28 U.S.C.
23 § 158.

24 **ISSUES**

25 1. Did the bankruptcy court err in granting summary
26 judgment on Plaintiff's § 523(a)(4) claim for defalcation while
27 acting in a fiduciary capacity?

28 2. Did the bankruptcy court err in granting summary

1 judgment on Plaintiffs' § 523(a)(4) claim for embezzlement?

2 3. Did the bankruptcy court apply an incorrect legal
3 standard in awarding damages based on Plaintiffs' initial
4 investment in SMP?

5 **STANDARDS OF REVIEW**

6 We review de novo the bankruptcy court's decision to grant
7 summary judgment. Plyam v. Precision Dev., LLC (In re Plyam),
8 530 B.R. 456, 461 (9th Cir. BAP 2015); Gertsch v. Johnson &
9 Johnson Finance Corp. (In re Gertsch), 237 B.R. 160, 165 (9th Cir
10 BAP 1999). Likewise, whether the bankruptcy court used the
11 correct legal standard in computing damages is reviewed de novo.
12 Neptune Orient Lines, Ltd. v. Burlington N. and Santa Fe Railway
13 Co., 213 F.3d 1118, 1119 (9th Cir. 2000).

14 Under de novo review, we look at the matter anew, as if it
15 had not been heard before, and as if no decision had been
16 rendered previously, giving no deference to the bankruptcy
17 court's determinations. Freeman v. DirectTV, Inc., 457 F.3d 1001,
18 1004 (9th Cir. 2006).

19 **DISCUSSION**

20 **A. The bankruptcy court erred in granting summary judgment on**
21 **Plaintiff's claim under § 523(a)(4) for defalcation while**
22 **acting in a fiduciary capacity.**

23 Section 523(a)(4) excepts from discharge any debt "for fraud
24 or defalcation while acting in a fiduciary capacity,
25 embezzlement, or larceny." To prevail under § 523(a)(4) for
26 defalcation while acting in a fiduciary capacity, the plaintiff
27 must show by a preponderance of the evidence that (1) an express
28 trust existed; (2) the debt was caused by fraud or defalcation;

1 and (3) the debtor acted as a fiduciary to the creditor at the
2 time the debt was created. Stephens v. Bigelow (In re Bigelow),
3 271 B.R. 178, 186 (9th Cir. BAP 2001) (citing Otto v. Niles
4 (In re Niles), 106 F.3d 1456, 1459 (9th Cir. 1997), abrogated on
5 other grounds, Bullock v. BankChampaign, N.A., 133 S. Ct. 1754
6 (2013)).

7 Whether a relationship is a "fiduciary" one within
8 the meaning of section 523(a)(4) is a question of
9 federal law. The broad, general definition of
10 "fiduciary" is inapplicable in the dischargeability
11 context. Instead, the fiduciary relationship must be
12 one arising from an express or technical trust that was
13 imposed before and without reference to the wrongdoing
14 that caused the debt.

12 Lewis v. Scott (In re Lewis), 97 F.3d 1182, 1185 (9th Cir. 1996)
13 (citing Ragsdale v. Haller, 780 F.2d 794, 795 (9th Cir. 1986)).

14 The bankruptcy court did not err in concluding that a
15 qualifying trust under § 523(a)(4) existed and that Alle acted as
16 a fiduciary at the time the Property was lost to foreclosure.
17 The bankruptcy court's findings, however, were inadequate to
18 support the conclusion that there was a defalcation: the
19 bankruptcy court made neither a sufficient finding that Alle's
20 state of mind satisfied the applicable standard, nor an explicit
21 finding that Alle's conduct caused Plaintiffs' damages.

22 **1. The bankruptcy court did not err in concluding that a**
23 **trust existed for purposes of § 523(a)(4).**

24 For purposes of § 523(a)(4), a trust may be created by
25 statute or by agreement. In re Bigelow, 271 B.R. at 186; Lovell
26 v. Stanifer (In re Stanifer), 236 B.R. 709, 715 (9th Cir. BAP
27 1999). State law is relevant to determine whether there is an
28 express or technical trust within the meaning of § 523(a)(4).

1 Id. at 714.

2 For a technical trust to be created by statute, "[t]he
3 statute must define the trust res, spell out the trustee's
4 fiduciary duties[,] and impose a trust prior to and without
5 reference to the wrong which created the debt." Id. at 715
6 (citation omitted). Under California law, creation of an express
7 trust by agreement requires (1) sufficient words to create a
8 trust; (2) a definite subject; and (3) a certain and ascertained
9 object or res. Id. at 714.

10 In the OA, the parties agreed to form and become members of
11 SMP and that Alle would be the managing member. The OA further
12 provided that SMP's purpose was to "own, operate, and manage the
13 . . . Property, and to do all things incidental to or in
14 furtherance of said purpose." The OA also specified that Alle
15 was "responsible for the management and operation of the
16 Property" and that he had "full authority in connection with the
17 Property." Further, the OA authorized Alle, as managing member,
18 to make withdrawals from the SMP bank account. The OA required
19 Alle to provide financial reports and to distribute the profits
20 to members on a monthly basis.

21 Contrary to the bankruptcy court's finding, the OA by itself
22 did not create an express trust under California law because it
23 did not include language expressing an intent to create a trust.
24 See Lonely Maiden Prods., LLC v. GoldenTree Asset Mgmt, LP,
25 135 Cal. Rptr. 3d 69, 78, 201 Cal. App. 4th 368, 379 (2011). It
26 is undisputed, however, that the OA created a limited liability
27 company and spelled out the obligations of its members. Under
28 California law in effect when SMP was formed, the fiduciary

1 duties a manager owed to a limited liability company and its
2 members were those of a partner to a partnership and the other
3 partners. Cal. Corp. Code § 17153.⁵ And, under California
4 partnership law, partners are trustees over the assets of the
5 partnership; thus, those partners are fiduciaries under
6 § 523(a)(4). Ragsdale v. Haller, 780 F.2d 794, 796-97 (9th Cir.
7 1986). Accordingly, when considered in light of California law,
8 a technical trust was created for purposes of § 523(a)(4), while
9 the OA specified the trust res, here, the Property and its
10 profits and defined the managing partner's fiduciary duties.

11 On appeal, Alle seems to dispute that the requirement of a
12 "certain and ascertained res" was met because "while there was
13 real property involved, the issue of rents was a moving target
14 and thus the "res" was not defined for purposes of a fiduciary
15 relationship. Although this argument is not convincing, it
16 highlights that the bankruptcy court did not make clear what the
17 defalcation was with respect to the Property; we address that
18 issue below.

19 **2. The bankruptcy court did not err in finding that Alle**
20 **acted as a fiduciary at the time the debt was created.**

21 As discussed above, California law imposed fiduciary duties
22 upon Alle as managing member of SMP. Alle was acting as a
23 fiduciary with respect to the trust assets during all relevant
24 times.

25
26 _____
27 ⁵Cal. Civ. Code § 17704.09, which became effective on
28 January 1, 2014, addresses the fiduciary duties of members of
limited liability companies.

1 **3. The bankruptcy court erred in concluding that the debt**
2 **was caused by defalcation under § 523(a) (4) .**

3 Defalcation is the misappropriation of trust funds or money
4 held in any fiduciary capacity.⁶ In re Lewis, 97 F.3d at 1186
5 (9th Cir. 1996). Defalcation also includes the failure by a
6 fiduciary to account for money or property that has been
7 entrusted to him. Pemstein v. Pemstein (In re Pemstein),
8 492 B.R. 274, 282 (9th Cir. BAP 2013). Once a creditor has shown
9 that the debtor is a fiduciary to whom funds have been entrusted,
10 the burden shifts to the fiduciary to account fully for all funds
11 received. In re Niles, 106 F.3d at 1462. Additionally, a
12 defalcation under § 523(a) (4) requires a culpable state of mind
13 involving either bad faith, moral turpitude or an intentional
14 wrong. Bullock, 133 S. Ct. at 1759. Thus, in order to find a
15 defendant liable for a defalcation under § 523(a) (4), in addition
16 to finding that he occupied the requisite fiduciary relationship
17 at the time of the alleged wrongdoing (which we agree was
18 established here), the bankruptcy court must also find that any
19 misappropriation or failure to account was done with the
20 requisite mental state and was the cause of the damage to the
21 plaintiff.

22 **a. Intent**

23 The bankruptcy court did not make any finding that Alle
24 possessed the requisite state of mind to support liability under
25 § 523(a) (4). At a minimum, the court needed to find that Alle

26 _____
27 ⁶“Misappropriation” is “the application of another’s
28 property or money dishonestly to one’s own use.” Black’s Law
Dictionary (10th ed. 2014).

1 committed an intentional wrong, which includes

2 not only conduct that the fiduciary knows is improper
3 but also reckless conduct of the kind that the criminal
4 law often treats as the equivalent. . . . we consider
5 conduct as equivalent if the fiduciary consciously
6 disregards (or is willfully blind to) a substantial and
7 unjustifiable risk that his conduct will turn out to
8 violate a fiduciary duty. That risk must be of such a
9 nature and degree that, considering the nature and
10 purpose of the actor's conduct and the circumstances
11 known to him, its disregard involves a gross deviation
12 from the standard of conduct that a law-abiding person
13 would observe in the actor's situation.

9 Bullock, 133 S. Ct. at 1759-60 (internal quotations and citations
10 omitted).

11 Although the bankruptcy court recited the applicable
12 standard - that defalcation requires a culpable state of mind
13 involving knowledge of, or gross recklessness with respect to,
14 the improper nature of the conduct - its only reference to Alle's
15 intent was to note that "he must have known he was required to
16 provide [financial information] to Plaintiffs." The bankruptcy
17 court needed to have found that the debt resulted from (i) acts
18 of bad faith, moral turpitude, or other immoral conduct;
19 (ii) intentional improper conduct or criminally reckless conduct;
20 or (iii) conscious disregard or willful blindness to a
21 substantial and unjustifiable risk. Heers v. Parsons
22 (In re Heers), 529 B.R. 734, 742-43 (9th Cir. BAP 2015). The
23 court made no findings that would satisfy this standard. Nor is
24 it clear whether the bankruptcy court could have made such
25 findings on summary judgment, see Provenz v. Miller, 102 F.3d
26 1478, 1489 (9th Cir. 1996) (scienter should not ordinarily be
27 determined on summary judgment), but we leave such determinations
28 to the bankruptcy court on remand.

1 **b. Causation**

2 One of the required elements for a defalcation claim is that
3 the debt was "caused by" the fraud or defalcation.

4 In re Bigelow, 271 B.R. at 186. In circumstances where the trust
5 res consists of funds that are to be invested by a fiduciary,
6 causation is usually easy to ascertain. To the extent the funds
7 are missing or dissipated via improvident investments, coupled
8 with the requisite mental state (post-Bullock), numerous opinions
9 confirm that such conduct can support a claim of defalcation.
10 See, e.g., In re Lewis, 97 F.3d at 1187 (commingling partner's
11 investment with other funds and failure to provide partner with
12 complete accounting). By comparison to the facts presented in
13 this case, these "funds are missing" fact patterns generally do
14 not require extensive analysis on the question of causation. If
15 cash entrusted to a fiduciary is missing from where it is
16 supposed to be, the inherent cause of its absence is usually the
17 fiduciary having put it somewhere else. But where assets other
18 than funds are at issue, causation needs to be more fully
19 explained.⁷

21 ⁷Certainly, assets other than funds may constitute a trust
22 res subject to defalcation under § 523(a)(4): See, e.g., Cora v.
23 Jahrling (In re Jahrling), 816 F.3d 921 (7th Cir. 2016)
24 (attorney's breach of fiduciary duty in selling elderly client's
25 real property at a price far below market value and failing to
26 include in the closing documents the retention of a life estate
27 was a defalcation under § 523(a)(4)); Baker v. Friedman
28 (In re Friedman), 298 B.R. 487 (Bankr. D. Mass. 2003) (partner's
failure to disclose to other partner impending cancellation of
life insurance policies owned by partnership for nonpayment
constituted a defalcation); Brawer v. Gelman (In re Gelman),
47 B.R. 735 (Bankr. S.D. Fla. 1985) (attorney's failure to
(continued...)

1 Plaintiffs listed in their MSJ several alleged breaches of
2 fiduciary duties by Alle: failure to remain current with mortgage
3 and property tax payments and to cure defaults on those
4 obligations; failure to provide monthly financial reports and
5 bank statements; failure to make complete and timely tax and
6 governmental filings on behalf of SMP; failure to advance funds
7 required for the operation of the Property through 2010; and
8 failure to notify Plaintiffs of the NOD and the impending
9 foreclosure sale.

10 Although the bankruptcy court stated in its ruling that it
11 agreed with Plaintiffs that Alle's conduct resulted in the debt
12 owed to Plaintiffs - seemingly agreeing that all of the
13 identified conduct was the defalcation - the bankruptcy court
14 explicitly found that Alle's defalcation consisted only of
15 (1) his failure to properly account for the Property's income and
16 expenses, and (2) his misappropriation of SMP's funds. The
17 bankruptcy court did **not** make an explicit finding that Alle's
18 failure to inform Plaintiffs of the impending foreclosure was a
19 defalcation, probably because there was conflicting evidence as
20 to whether Alle informed Plaintiffs of the impending foreclosure
21 in time for them to take any action.⁸

22
23 ⁷(...continued)
24 disclose his disbarment and his subsequent abandonment of
client's claim was a defalcation).

25 ⁸Alle testified in his declaration that he informed the
26 Plaintiffs of the NOD shortly after he received it and discussed
27 the impending foreclosure with them at meetings in August and
September of 2011. Plaintiffs denied this, and subsequent
28 correspondence between the parties, which did not mention the

(continued...)

1 The evidence on summary judgment supported a finding that
2 Alle breached his fiduciary duties as managing member of SMP by
3 failing to provide financial reports and bank statements after
4 2009. But the only evidence presented with respect to causation
5 was Gales' and Oppenheim's declaration testimony that "[b]ecause
6 Alle never provided us with any information regarding the default
7 on the Humiston loan, the pending foreclosure sale and the
8 proposed loan modification agreement, [we] were never given any
9 opportunity to cure defaults or otherwise save our investments in
10 Shadow Mountain or the Property." Notably, that testimony does
11 not mention as a cause Alle's failure to provide monthly
12 financial statements or bank statements or his misappropriation
13 of funds from the SMP checking account. Thus, strictly speaking,
14 the record does not support a finding that the identified
15 defalcations caused the damages to Plaintiffs.

16 And more importantly, the bankruptcy court did not explain
17 how Alle's identified breaches of fiduciary duties - the failure
18 to provide monthly reports and bank statements and the diversion
19 of SMP's funds - was the cause of Plaintiffs' damages. Such an
20 explanation would necessarily have required the court to identify
21 precisely what those damages were, as the two issues are
22
23
24

25 ⁸ (...continued)
26 foreclosure, seemed to support Plaintiffs' version of events.
27 There is no evidence in the record that Alle informed Plaintiffs
28 of the specific date of the foreclosure sale, and it is
undisputed that Alle did not inform Plaintiffs of his last-minute
attempts to negotiate a modification of the note.

1 intertwined.⁹ It is undisputed that the funds contributed by
2 Plaintiffs were invested as agreed by the parties. It appears,
3 then, that a defalcation could have occurred only with respect to
4 the LLC's assets: the Property and its profits. But the
5 bankruptcy court did not articulate the connection between Alle's
6 conduct and the ultimate loss of SMP's primary asset.

7 In sum, the bankruptcy court did not err in finding that a
8 qualifying trust existed or that Alle was acting as a fiduciary
9 when he failed to provide the required financial information to
10 Plaintiffs or when he used SMP's funds for non-SMP expenses. The
11 bankruptcy court erred, however, in failing to make the necessary
12 findings regarding the state of mind element of a defalcation
13 under § 523(a)(4) and in implicitly finding, without explanation,
14 that Alle's identified fiduciary breaches were the cause of the
15 damage to Plaintiffs.

16 **B. The bankruptcy court erred in entering judgment for**
17 **Plaintiffs on their embezzlement claim.**

18 The bankruptcy court also granted summary judgment to
19 Plaintiffs for embezzlement under § 523(a)(4) but did not award
20 damages in the amount of the misappropriated funds because
21 Plaintiffs' motion had not put Alle on notice that Plaintiffs
22 sought additional damages for that claim. Thereafter, Plaintiffs
23 dismissed the embezzlement claim in part. Their notice of
24 dismissal stated that Plaintiffs were **not** dismissing the
25 embezzlement claim to the extent it formed a basis for the
26

27 ⁹As discussed in Section C below, neither the parties nor
28 the bankruptcy court specified the basis for the damages award.

1 \$800,000 in damages. The judgment awarded Plaintiffs \$800,000 on
2 the embezzlement claim.

3 Section 523(a)(4) excepts from discharge debts for
4 embezzlement. A fiduciary relationship is not a predicate for
5 recovery under this theory. Transamerica Comm. Fin. Corp. v.
6 Littleton (In re Littleton), 942 F.2d 551, 555 (9th Cir. 1991).
7 Under federal law, embezzlement is defined as "the fraudulent
8 appropriation of property by a person to whom such property has
9 been entrusted or into whose hands it has lawfully come." Id.
10 (citing Moore v. United States, 160 U.S. 268, 269 (1885)). To
11 prevail on an embezzlement claim under § 523(a)(4), a creditor
12 must prove three elements: (1) property rightfully in the
13 possession of a nonowner; (2) the nonowner's appropriation of the
14 property to a use other than that for which it was entrusted; and
15 (3) circumstances indicating fraud. Id.

16 The bankruptcy court found that the foregoing elements had
17 been proven, but it did not award damages in the amount of the
18 embezzled funds. And it is not clear how the embezzlement claim
19 could have been the basis for the \$800,000 damage award. See
20 Patel v. Patel (In re Patel), 551 B.R. 488, 496 (Bankr. D.N.M.
21 2016) (damages for embezzlement are generally equal to the value
22 of the misappropriated property); Telmark, LLC v. Booher
23 (In re Booher), 284 B.R. 191, 214 (Bankr. W.D. Pa. 2002) (same).
24 Accordingly, the bankruptcy court erred in entering judgment on
25 Plaintiffs' embezzlement claim.

26 **C. The bankruptcy court did not make sufficient findings to**
27 **support the amount of damages awarded.**

28 In their MSJ, Plaintiffs requested damages of \$800,000,

1 representing Plaintiffs' total investment in SMP, but did not
2 state the legal basis for the amount sought. The bankruptcy
3 court seemed to accept this number as the proper measure of
4 damages without any analysis.

5 The Code does not define the appropriate measure of damages
6 for defalcation under § 523(a)(4); thus the bankruptcy court
7 should look to state law. See Light v. Whittington
8 (In re Whittington), 530 B.R. 360, 407-08 (Bankr. W.D. Tex. 2014)
9 (because there was no pre-existing judgment on plaintiff's
10 claims, bankruptcy court determined defendant's nondischargeable
11 liability arising from fraud and breach of fiduciary duty by
12 looking to Texas state law) (citing Morrison v. W. Builders of
13 Amarillo, Inc. (In re Morrison), 555 F.3d 473, 479 (5th Cir.
14 2009)).

15 As noted, it does not appear that Plaintiffs' initial
16 investment was the proper measure of damages. See Destino v.
17 Bockting, 2012 WL 258408, at *2-3, 467 Fed. App'x 678, 680-81
18 (9th Cir. Jan. 30, 2012) (holding that bankruptcy court erred in
19 awarding damages for defalcation in the total amount of invested
20 funds where some of those funds were spent in accordance with the
21 parties' agreement, and remanding for recalculation of damages
22 that plaintiff could prove were misapplied); see also
23 In re Friedman, 298 B.R. at 505 (where debtor's defalcation
24 involved partnership assets and not the creditor's initial
25 investment in the partnership, the proper measure of damages was
26 the value of what the plaintiff would have received had the
27 contract been performed); and Int'l Fid. Ins. Co. v. Fox
28 (In re Fox), 357 B.R. 770, 778 (Bankr. E.D. Ark. 2006) (where

1 misappropriation forms the basis for a defalcation claim, only
2 that portion of the trust res inappropriately expended is
3 nondischargeable, citing Matter of Thomas, 729 F.2d 502 (7th Cir.
4 1984)).

5 Thus, on remand, the bankruptcy court should make findings
6 as to the proper measure of damages under California law and the
7 facts of this case.

8 **D. The bankruptcy court's ruling on the motion to vacate is**
9 **moot.**

10 Because we are vacating and remanding the bankruptcy court's
11 judgment, we need not address whether the bankruptcy court abused
12 its discretion in denying Alle's motion to vacate.

13 **CONCLUSION**

14 For the reasons set forth above, although the bankruptcy
15 court did not err in finding that a qualifying trust existed,
16 that Alle was acting as a fiduciary, and that he breached his
17 fiduciary duties under the OA, it erred in granting summary
18 judgment to Plaintiffs on their § 523(a)(4) claim. We therefore
19 AFFIRM in part, REVERSE in part, VACATE, and REMAND for further
20 proceedings in accordance with this disposition.