



1 **I. BACKGROUND**

2 On January 2, 2024 (“Petition Date”), Debtors filed their voluntary chapter 11  
3 bankruptcy petition. Debtors timely commenced this two-count Adversary Proceeding  
4 seeking to hold non-dischargeable the sum of \$500,000 plus interest which he claims is  
5 owed to him by Mr. Connelly and the marital community consisting of Mr. and Mrs.  
6 Connelly. The original complaint cited 11 U.S.C. §§ 523(a)(2)(A) and (6) as the statutory  
7 bases for declaring this claim non-dischargeable.

8 Plaintiff amended his complaint on June 17, 2024. Defendants filed their Motion  
9 on July 1, 2024, alleging a number of defects in the FAC noting, among other things, that  
10 the FAC must be dismissed because (1) Mr. Connelly’s note executed in favor of Plaintiff  
11 is a non-recourse obligation, (2) Plaintiff’s security interest was against future  
12 distributions from Natural Frosty (a valid Delaware company) and there have been no  
13 distributions to Mr. Connelly from Natural Frosty, (3) the alleged misrepresentations  
14 cannot be the basis of fraud because they were not made by Mr. Connelly to Plaintiff and  
15 the emails attached to the FAC do not demonstrate that such representations were actually  
16 facts as opposed to mere conclusions, or false statements, or even immaterial “facts,”  
17 (4) that claims against Mrs. Connelly must be dismissed because there are no allegations  
18 of Mrs. Connelly’s wrongful conduct and any of Mr. Connelly’s wrongdoing cannot be  
19 implied to her, and (5) the Economic Loss Rule applies to bar a fraud claim for losses on  
20 an alleged claim for breach of a promissory note. Defendants also seek attorney’s fees  
21 under A.R.S. § 12-341.01.

22 Plaintiff filed his response<sup>3</sup> (“Response”) to the Motion and Defendants filed their  
23 reply<sup>4</sup> (“Reply”). Oral argument was held by the Court on August 5, 2024. This matter  
24 was taken under advisement on August 13, 2024.

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25 <sup>3</sup> DE 18.

26 <sup>4</sup> DE 19.

1 **II. JURISDICTION**

2 This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and  
3 157(b)(2)(I).

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5 **III. ISSUE**

6 Should Plaintiff's FAC be dismissed pursuant to Bankruptcy Rule 7012?

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8 **IV. ANALYSIS**

9 **A. Motion to Dismiss Standard**

10 Bankruptcy Rules 7008 and 7012 apply Rules 8 and 12 of the Federal Rules of  
11 Civil Procedure, respectively. Rule 8(a) states:

12 (a) Claim for Relief. A pleading that states a claim for relief must contain:

- 13 (1) a short and plain statement of the grounds for the court's jurisdiction,  
14 unless the court already has jurisdiction and the claim needs no new  
15 jurisdictional support;  
16 (2) a short and plain statement of the claim showing that the pleader is  
entitled to relief; and  
17 (3) a demand for the relief sought, which may include relief in the  
alternative or different types of relief.

18 To survive a motion to dismiss, a complaint must contain sufficient factual matter,  
19 accepted as true, to "state a claim to relief that is plausible on its face . . . ." <sup>5</sup> A claim  
20 has facial plausibility when the pleaded factual content allows the court to draw the  
21 reasonable inference that the defendant is liable for the misconduct alleged. <sup>6</sup>

22 Although detailed factual allegations are not required, a Rule 12(b)(6) dismissal  
23 may be based on either the lack of a cognizable legal theory or the absence of sufficient  
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25 <sup>5</sup> *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)).

26 <sup>6</sup> *Iqbal*, 556 U.S. at 663.

1 facts to support a cognizable legal theory.<sup>7</sup> That said, “[w]hen ruling on a motion to  
2 dismiss, [the Court] accept[s] all factual allegations in the complaint as true and  
3 construe[s] the pleadings in the light most favorable to the nonmoving party.”<sup>8</sup>

#### 4 5 **B. Pleading Standards for Fraud**

6 In the Ninth Circuit, to establish fraud, a plaintiff must show:

- 7 (1) the debtor made ... representations;  
8 (2) that at the time he knew they were false;  
9 (3) that he made them with the intention and purpose of deceiving the  
10 creditor;  
11 (4) that the creditor relied on such representations; [and]  
12 (5) that the creditor sustained the alleged loss and damage as the proximate  
13 result of the misrepresentations having been made.<sup>9</sup>

14 “In alleging fraud or mistake, a party must state with particularity the circumstances  
15 constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a  
16 person's mind may be alleged generally.”<sup>10</sup> The plaintiff must plead “who, what, when,  
17 where, and how that would suggest fraud.”<sup>11</sup> The circumstances constituting the alleged  
18 fraud must be specific enough to put the defendant on notice.<sup>12</sup>

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<sup>7</sup> *Johnson v. Riverside Healthcare Sys., LP*, 534 F.3d 1116, 1121 (9th Cir. 2008).

23 <sup>8</sup> “When ruling on a motion to dismiss, [the Court] accept[s] all factual allegations in the complaint as true and  
24 construe[s] the pleadings in the light most favorable to the nonmoving party.” *Kniesel v. ESPN*, 393 F.3d 1068,  
1072 (9th Cir. 2005).

<sup>9</sup> *In re Hashem*, 104 F.3d 1122, 1125 (9th Cir.1996) (quoting *In re Britton*, 950 F.2d 602, 604 (9th Cir.1991).

25 <sup>10</sup> Fed. R. Civ. P. 9(b); Fed. R. Bankr. P. 7009.

<sup>11</sup> *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1997) (internal quotation marks omitted).

26 <sup>12</sup> *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1106 (9th Cir. 2003).

1 **V. APPLICATION OF THE LAW TO THE ALLEGED FACTS**

2 **A. Natural Frosty Is Not Registered With the Arizona Corporation**  
3 **Commission**

4 Defendants' Motion refers to a promissory note from Mr. Connelly to Mr. Haddad  
5 attached as Exhibit B to the FAC and points out that Mr. Connelly's note is without  
6 recourse to him and, in any event, is secured by and to be paid only from income  
7 Mr. Connelly might otherwise be entitled to from Natural Frosty.

8 The Motion urges the Court to take judicial notice of the formation of Natural  
9 Frosty, LLC under the laws of Delaware. This suggestion is made to counter Plaintiff's  
10 allegations at ¶ 16 of the FAC where Plaintiff alleges "Natural Frosty was not ever  
11 registered with the Arizona Corporation Commission" and at ¶¶ 27 and 29 where it is  
12 alleged that . . . "Natural Frosty was [/is] not authorized to do business in Arizona . . . ."  
13 Paragraph 17 of the FAC reiterates this point.

14 The Court need not take judicial notice of Natural Frosty's Delaware formation  
15 because Plaintiff does not contend otherwise. Rather, Plaintiff only alleges Natural Frosty  
16 was and is not authorized to do business in Arizona. For the purposes of this Motion, the  
17 Court will assume these allegations are true. However, this allegation does little to  
18 advance Plaintiff's case because A.R.S. § 29-3901(c) notes:

19 [t]he failure of a foreign limited liability company or a foreign series to  
20 register to do business in this state does not impair the validity of a contract  
21 or act of the foreign company or foreign series or preclude it from  
defending an action or proceeding in this state.

22 Natural Frost could contract with Plaintiff or otherwise do business in Arizona but would  
23 be barred from suing in this state unless it filed its papers to do business in Arizona.<sup>13</sup>  
24 Natural Frosty, of course, is not suing anyone in this Adversary Proceeding. More

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26 <sup>13</sup> See A.R.S. § 29-3902(b).

1 importantly, Plaintiff's FAC does not indicate how Natural Frosty's failure to register to  
2 do business in Arizona is a fact that supports its fraud or willful and malicious injury  
3 causes of action.

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5 **B. The Non-Recourse Note and Security Interest**

6 Defendants acknowledge a non-recourse note was signed in favor of Plaintiff and  
7 such note was secured by money Mr. Connelly would otherwise receive from Natural  
8 Frosty. However, Defendants indicate Natural Frosty paid nothing on account of  
9 Mr. Connelly's ownership interest in Natural Frosty so Plaintiff would not be entitled to  
10 any payments on the note. While this may or may not be true (as this "fact" is not alleged  
11 in the FAC), at oral argument Plaintiff's counsel made it clear that Plaintiff was not  
12 alleging a mere breach of the note. Rather, counsel argued, essentially, that Plaintiff was  
13 fraudulently induced to enter into the loan agreement memorialized by the note and  
14 security agreement/assignment.

15 This Court finds that the FAC must clarify the role the non-recourse note and  
16 security agreement/assignment play with Plaintiff's two causes of action. If Plaintiff  
17 claims fraudulent inducement, he should explicitly say so and must allege facts that  
18 support these allegations. Presently, the FAC is deficient in this regard or is at least  
19 confusing as to the role the note and security agreement/assignment play in the alleged  
20 fraud or willful injury claimed by Plaintiff.

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22 **C. Representations vs. Conclusions vs. Facts**

23 The FAC alleges that Mr. Connelly represented to Plaintiff that:

- 24 a. Natural Frosty was entering into a Joint Venture  
25 Agreement with Revlon Cultivation for an "approved, zoned,  
26 and ready to outfit" cultivation facility;

- b. Natural Frosty's joint venture with Revlon Cultivation was most favorable to Natural Frosty and its investors.
- c. There was an existing relationship with a major entity (Curaleaf) to purchase the production;
- d. Natural Frosty had the brand "Subcool", which was one of the best in the industry; and
- e. Natural Frosty's joint venture partner was making a deal with Mike Tyson, "making our combined future joint venture a potential juggernaut in the industry."<sup>14</sup>

Plaintiff points to Exhibit D to the FAC as evidence of these representations. However, Exhibit D does not demonstrate that Mr. Connelly made any representations to Plaintiff. Exhibit D is an email from Mr. Connelly to a third party named Steve Finelli. Another third party named Jim Bullinger forwarded Mr. Connelly's email to Plaintiff nearly a month later. Nothing in Exhibit D shows that Mr. Connelly made these statements to Mr. Haddad or that he did so with the intent to deceive Plaintiff or that Mr. Connelly ever knew Plaintiff would receive the email.

Even if Exhibit D to the FAC could be construed as a series of representations to Plaintiff, the email states that the relationship between Revlon and Curaleaf was "contemplated" and not an existing reality as the FAC suggests. Similarly, the email states that other parties were in the process of "establishing a relationship with Mike Tyson."<sup>15</sup> Again, the email suggest a potential relationship with Tyson, not an actually formed relationship. Plaintiff alleges that "Natural Frosty not only did not have contracts in place to operate in an established [location], it also lacked a permitted location, license agreements with established brands, and buyers obligated to purchase Natural Frosty's products."<sup>16</sup> However, this conclusory statement does not suggest that these joint ventures were never contemplated nor in prospect. Instead, the FAC summarily

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<sup>14</sup> DE 14 at page 2-3.

<sup>15</sup> DE 14, Exhibit D

<sup>16</sup> DE 14 at ¶15.

1 concludes that these representations were false and that Natural Frosty never conducted  
2 any business.<sup>17</sup> The falsity of the alleged representations must be pled with particularity,  
3 not conclusory statements.<sup>18</sup>

4 Plaintiff also alleges that he was to receive a 5% membership interest in Natural  
5 Frosty and that never occurred. However, Plaintiff does not allege that the failure to make  
6 him a 5% member actually has a causal connection to his damage. If a 5% membership  
7 interest in Natural Frosty was worthless or never produced a return to the member, the  
8 failure to make Mr. Haddad a member of Natural Frosty did not cause him harm and his  
9 fraud claim must fail.

10 The FAC contends Mr. Connelly never produced information reflecting what  
11 Mr. Connelly did with the \$500,000 Plaintiff transferred to him. However, Plaintiff fails  
12 to reveal what duty Mr. Connelly had to do so nor why or how this fact advances his  
13 fraud or willful injury claims. What representations were made by Mr. Connelly to  
14 Mr. Haddad regarding the intended use of these proceeds? Were such representations  
15 false? Did Mr. Haddad reasonably rely on such representations, etc.?

16 At oral argument, counsel for Plaintiff stated that there may be other instances  
17 where Mr. Connelly made representations to Plaintiff, but such representations have not  
18 been sufficiently pled to provide notice to Defendants of when and where these  
19 representations occurred. Because Plaintiff has not alleged representations by  
20 Mr. Connelly to Mr. Haddad that were factually false, the FAC must be dismissed.  
21 However, leave to amend is granted to allow Plaintiff to allege other representations that  
22 may have been made directly by Mr. Connelly to Plaintiff which Plaintiff contends were  
23 false.

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25 <sup>17</sup> DE 14 at ¶ 18.

26 <sup>18</sup> *Riverside Healthcare Sys., LP*, 534 F.3d at 1121.



1           **D.     Claims Against Mrs. Connelly**

2           Defendants contend that the FAC contains no allegations of wrongdoing by  
3 Mrs. Connelly so she should be dismissed from this Adversary Proceeding. Plaintiff  
4 contends Mrs. Connelly is named in the FAC simply to bind the Connelly’s marital  
5 community. This Court has already entered an order resolving this issue.<sup>19</sup>  
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7           **E.     The Economic Loss Rule**

8                   **a.     The Law of the Economic Loss Rule**

9           Federal courts look to state courts’ interpretation of the economic loss rule to  
10 determine its applicability.<sup>20</sup> In Arizona, the economic loss rule prohibits certain tort  
11 actions seeking “pecuniary or commercial damage, including any decreased value or  
12 repair costs for a product or property that is itself the subject of a contract between the  
13 plaintiff and defendant, and consequential damages such as lost profits.”<sup>21</sup> The Arizona  
14 Supreme Court has applied this rule barring purely economic losses in the context of  
15 products liability and construction defects.<sup>22</sup> The Arizona Supreme Court further  
16 explained that “[t]he economic loss [rule] may vary in its application depending on  
17 context-specific policy considerations” and the policy of allowing tort remedies has to  
18 outweigh the contract policy of “upholding the expectations of the parties” and allocating  
19 risks in the contract.<sup>23</sup>

20           In *Cook v. Orkin Exterminating Co., Inc.*, the Arizona Court of Appeals rejected  
21 the “argument that the [economic loss rule] does not apply to [the plaintiffs’] fraud and  
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23 <sup>19</sup> See DE 24 entered September 3, 2024.

24 <sup>20</sup> *Evans v. Singer*, 518 F. Supp. 2d 1134, 1139 (D. Ariz. 2007) (citing *Powell v. Lambert*, 357 F.3d 871, 874 (9th Cir. 2004)).

25 <sup>21</sup> *Sullivan v. Pulte Home Corp.*, 232 Ariz. 344, 346 ¶ 8 (2013).

26 <sup>22</sup> See *Salt River Project Agr. Imp. & Power Dist. v. Westinghouse Elec. Corp.*, 143 Ariz. 368, 379, 694 P.2d 198, 209 (1984). *Flagstaff Affordable Hous. Ltd. P’ship v. Design All., Inc.*, 223 Ariz.320, 322 ¶ 10, (2010).

<sup>23</sup> *Flagstaff*, 223 Ariz. at 325.

misrepresentation claims.”<sup>24</sup> In *Cook*, the plaintiff brought various tort claims including negligent and intentional misrepresentation and fraud after the defendant extermination company failed to eradicate termites from the plaintiff’s home.<sup>25</sup> The court found the contract policy outweighed any policy to impose tort liability “[b]ecause the [plaintiffs] [were] seeking remedies for purely economic loss from [defendant’s] alleged failure to adequately perform its promises under the [a]greement.”<sup>26</sup> Therefore, the court found the economic loss rule barred the plaintiff’s tort claims.<sup>27</sup>

In *Jes Solar Co., Ltd v. Matinee Energy, Inc.*, the Arizona Federal District Court distinguished *Cook* by explaining that in *Cook*, the plaintiffs had bargained for the risk that formed the basis of the claim because the extermination contract did not include any “promise to rid the house of termites or to pay for damage caused by new termite activity.”<sup>28</sup> The court found that the economic loss rule did not apply in *Jes Solar Co.* because the plaintiff did not bargain for the risk that the defendant would steal the money invested and never put it to its intended use.<sup>29</sup> Similarly, in *Martin v. Weed*, the Arizona Federal District Court found that the defendant had not bargained for the possibility that the plaintiff would use the company to pay personal expenses and the company would be left worthless.<sup>30</sup>

#### **b. Application to the Facts of this Case**

Unlike the analysis above where Defendants are challenging the sufficiency of the pleading, here Defendants are arguing, even if the Court takes Plaintiff’s facts as true,

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<sup>24</sup> 227 Ariz. 331, 336 20 n.6 (Ariz. Ct. App. 2011).

<sup>25</sup> *Id.* at 332–333.

<sup>26</sup> *Id.* at 335.

<sup>27</sup> *Id.*

<sup>28</sup> 2015 WL 10943562 at \*4 (Ariz. Dist. Ct. Nov. 2, 2015).

<sup>29</sup> *Id.* at 5

<sup>30</sup> 2018 WL 2431837 at \*7 (Ariz. Dist. Ct. May 30, 2018).

1 relief would be barred by the economic loss rule. Taking Plaintiff's alleged facts as true,  
2 Mr. Connelly represented to Plaintiff that in return for a \$500,000 investment, Plaintiff  
3 was going to receive a 5% interest in a company with established business relationships  
4 and brands. Plaintiff received the Promissory Note that directed some of the profits from  
5 Natural Frosty, LLC to be paid to Plaintiff to repay his initial investment but also  
6 provided that the Promissory Note was non-recourse as to Mr. Connelly. Defendant  
7 argues that Plaintiff bargained for the risks under the contract and must be held to  
8 contractual remedies meaning Mr. Connelly cannot be held liable. However, Plaintiff is  
9 not arguing that Mr. Connelly or any party failed to perform under the contract. Instead,  
10 Plaintiff is arguing that he would never have made the investment but for the allegedly  
11 fraudulent statements made by Mr. Connelly. Under the Note, it may be true that Plaintiff  
12 bargained for the risk that Natural Frosty would not be profitable, but he did not bargain  
13 for the risk that he was investing in a company with a much different financial condition  
14 than was stated. Plaintiff did not bargain for the risk that his \$500,000 investment would  
15 not even be paid to the company. The general contract policy of upholding the parties'  
16 expectation under the contract does not outweigh the policy of imposing liability under  
17 tort because Plaintiff would not have been in the contract but for the alleged fraudulent  
18 contract. The economic loss rule does not bar Plaintiff's claims in this case.

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20 **F. Attorneys' Fees**

21 Defendants demand for attorney fees pursuant to A.R.S. § 12-341.01 is premature.  
22 The propriety of an award of fees in this Adversary Proceeding, if any, will be addressed  
23 by the Court at the conclusion of this Adversary Proceeding.  
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1 **VI. CONCLUSION**

2       Based on the foregoing, Plaintiff's FAC is hereby dismissed pursuant to Rule 7012  
3 but Plaintiff is granted 30 days from entry of this Order to file its seconded amended  
4 complaint.

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6       **IT IS ORDERED**

7       **DATED AND SIGNED ABOVE.**

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19 **To be Noticed through the BNC to:**  
20 Interested Parties  
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