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U.S. BANKRUPTCY COURT
EASTERN DISTRICT OF WASHINGTON

UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF WASHINGTON

In Re: MARK A. UNDERWOOD and DEBORA L. UNDERWOOD, Debtor(s).	No. 03-004628-W2N Adv. No. A03-00217-W2N
TEXTRON FINANCIAL CORPORATION, a foreign corporation, Plaintiff, v. MARK A. UNDERWOOD, individually, DEBORA L. UNDERWOOD, husband and wife, Defendants.	MEMORANDUM OF DECISION RE: PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

FACTS

On December 7, 1998, M & R Repair, Inc. ("M & R"), executed a Finance Plan, a Wholesale Security Agreement, and an Amendment to the Wholesale Security Agreement with Textron Financial Corporation ("TFC"). The debtor, Mark Underwood, signed the agreements in his corporate capacity as President of M & R. TFC was the flooring financier of the M & R's retail business. The Wholesale Security Agreement provided TFC with a purchase money security interest ("PMSI") in "[a]ll equipment and inventory" among other things. Page 2, paragraph 7, of the security agreement states:

> Both Debtor and Secured Party intend for Debtor to sell the Collateral, but only in the ordinary course of its business as Debtor normally sells such Collateral.

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> Therefore, Debtor may sell any item of Collateral PROVIDED THAT: (a) Debtor is not in default hereunder, (b) the price obtained for such item of Collateral is not less than the unpaid Total Debt attributable thereto, and (c) Debtor holds all of the proceeds of any such sale in trust for, and promptly remits the unpaid Invoice Cost of such item of Collateral to, Secured Party.

Mr. Underwood also executed a personal guaranty of M & R's debt owing to TFC on December 7, 1998. Debbie Underwood executed a personal guaranty for this debt on September 3, 1999. Pursuant to the aforementioned agreements, the laws of the State of Rhode Island govern the transactions.

TFC sent three notices of default to M & R. The first notice is dated March 13, 2001. The notice stated that TFC accelerated the obligation for a principal amount owing of $149,613.80 and interest of $1,542.17. The second notice is dated May 1, 2002. The principal amount owing as of that date was $79,657.70 and $794.77 of interest. The third notice of default was on October 25, 2002. The principal amount then owing was $56,876.56 with no interest.

Eventually TFC sued M & R and the debtors to recover the unpaid amount of the debt owed. On May 30, 2003, the debtors filed for bankruptcy under Chapter 13 which stayed the state court action as to them. TFC and M & R entered into a Stipulated Judgment in the state court action on June 4, 2003. The judgment liquidated the debt owing to TFC including the principal amount, interest and attorney's fees totaling $68,919.56. The debtors' case converted to Chapter 7 on August 28, 2003. The creditor then commenced this adversary proceeding seeking a determination that the entire obligation of the debtors is not subject to discharge.

LEGAL ANALYSIS

I. STANDARD OF REVIEW

A. Summary Judgment Standard.

A motion for summary judgment can only be granted when there is no issue as to any material fact entitling the moving party to judgment as a matter of law. Fed. R. Civ. P. 56(c). All inferences are to be drawn in the light most favorable to the non-moving party. *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 157 (1970). A party opposing summary judgment must come forward with "specific facts showing there is a genuine issue for trial." *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986).

B. Standard of Proof In Claims for Nondischargeability.

To establish an exception to a discharge pursuant to 11 U.S.C. § 523(a), the complaining creditor has the burden of proof by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279, 291 (1991); *see also,* Matthew Bender, 4 Collier on Bankruptcy § 523.10[1][b] (15th ed. rev. 1998) (stating that the objecting creditor has the burden of proof under § 523(a)(4)); *see also, In re Littleton*, 106 B.R. 632, 634 (9th Cir. BAP 1989) (creditor has the burden of proof in a § 523(a)(6) nondischarge claim), *aff'd*, 942 F.2d 551 (9th Cir. 1991). "In determining whether a particular debt falls within one of the exceptions of section 523, the statute should be strictly construed against the objecting creditor and liberally in favor of the debtor." Collier on Bankruptcy § 523.05.

II. ISSUES

1. Did the security agreement create an express trust thus giving rise to a fiduciary duty owed by M & R and/or the debtors to

plaintiff?

2. Assuming a fiduciary duty existed, did defalcation or a breach of that duty occur?

3. Did the debtors intentionally act to injure the plaintiff when the defendant husband, as the manager and officer of M & R, disposed of plaintiff's collateral?

4. Is the Stipulated Judgment entered into by M & R binding and conclusive as to the amounts owed plaintiff by the debtors?

III. <u>DISCUSSION</u>

A. 11 U.S.C. § 523(a)(4) Claim.

A debt is nondischargeable pursuant to 11 U.S.C. § 523(a)(4) for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." There is no allegation of embezzlement or larceny in this situation. The meaning of "fiduciary capacity," which is a matter of federal law, has been determined to apply only to express or technical trusts. *In re Hemmeter*, 242 F.3d 1186, 1189 (9th Cir. 2001) (citing *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (concluding that trusts arising by operation of law upon a wrongful act are not excepted from discharge)). In order for a fiduciary relationship to exist, the court must determine that the circumstances establish an express trust pursuant to state law. *In re Jacks*, 266 B.R. 728, 736 (9th Cir. BAP 2001); *In re Baird*, 114 B.R. 198, 202 (9th Cir. BAP 1990). If such a relationship exists, the debt is nondischargeable only if the debt was caused by fraud or defalcation. *In re Jacks*, *supra*, at 735.

(1) Did the parties' create an express trust?

TFC claims that an express trust exists pursuant to the parties' contract. TFC neither cites any Rhode Island case law nor statute that authorizes the creation of an express trust through a security agreement. Nor is the court aware of any such cases. The cases cited by TFC are situations where a state statute provided that money would be held in trust for a specific beneficiary. *See In re Pedrazzini*, 644 F.2d 756 (9^{th} Cir. 1981) (holding that the general contractor did not hold funds in trust for sub-contractor pursuant to California statute since no *res* is defined in the statute and the fiduciary duties are not spelled out); *but see*, *In re Baird*, *supra*, (holding that an Arizona statute requires the contractor to hold funds in trust for sub-contractor thereby establishing an express trust).

The relationship between TFC and M & R was an ordinary "garden variety" creditor-debtor relationship. "A debt is not a trust." Restatement (Second) of Trusts § 12 (1959). The transaction between TFC and M & R is merely a security agreement as opposed to a trust instrument. There is no Ninth Circuit decision directly dealing with a security agreement that includes a trust clause like the one at issue. A Bankruptcy Court outside this circuit dealing with such a clause in dispute stated:

> A trust must be distinguished from a debt, which arises when one incurs merely an obligation to pay a certain sum of money. A trust, on the other hand, exists where one takes on a duty to deal as a fiduciary with specific property for the benefit of another. [citation omitted.] Obviously, if a creditor-debtor relationship but not a fiduciary relationship exists between the parties, there can exist no express trust.

In re Shervin, 112 B.R. 724, 734 (Bankr. E.D. Pa. 1990); *see also*, *Upshur v. Briscoe*, 138 U.S. 365, 375 (1891) (holding that the instrument that stated debtor would accept the money in "trust" was insufficient in establishing that the debtor was acting in a "fiduciary capacity" thereby precluding a finding that the debt was nondischargeable).

The parties' agreement clearly establishes that they intended to create a debtor-creditor relationship. The most patent indication of the parties' intentions lies in the fact that the reference to a trust occurs in the context of an inventory financing arrangement. The parties intended the security agreement to "secure the payment and performance by debtor . . . of all present and future indebtedness and obligations of Debtor . . . owing to Secured Party . . . ." (*See* Wholesale Security Agreement, paragraph 3).

One Washington appeals court defined an express trust as

> a fiduciary relationship with respect to property, subjecting the person by whom the title to property is held to equittable duties to deal with the property for the benefit of another person, which arises as a result of a *manifestation of an intention to create it*.

In re Lutz, 74 Wash. App. 356, 365, 873 P.2d 566, 571, (1994) (quoting 1 William F. Fratcher, *Scott on Trusts* § 2.3, at 41 (4th ed. 1987)(emphasis added)); *accord Desnoyers v. Metropolitan Life Insur. Co., 272 A.2d 683, 688 (R.I. 1971); see also*, Black's Law Dictionary 1513 (7th ed. 1999) (stating "[a] trust arises as a result of a manifestation of an intention to create it").

The collection of documents relating to the transaction and the four-corners of the security agreement establish that the parties did not intend to create an express trust. One phrase in one sentence buried on the second page of a standard form commercial transaction document is not sufficient to demonstrate an intent to create an express trust. As one other bankruptcy court stated about a similar clause in a commercial contract:

> As a matter of policy, a trust clause in a commercial contract is inherently suspect and should be avoided if not carefully followed. A commercial debtor should be in no worse shape after a bankruptcy proceeding than other debtors merely because of some artful drafting in a business contract.

In re Pehkonen, 15 B.R. 577, 582 (Bankr. N.D. Iowa 1981). At best, the contract between the parties is ambiguous regarding how the term "trust" applies to this transaction. A classic maxim of contract construction dictates that ambiguous clauses in contracts are construed against the drafter - TFC in this case. The substance of the parties' transaction governs how their relationship is defined rather than the label or form used, and in fact, the label used is "Wholesale Security Agreement."

The Wholesale Security Agreement does not require M & R to segregate the proceeds from the sold collateral, but only requires remittance of the funds. Consequently, M & R could make payment to TFC from funds other than those proceeds received from the sale of the collateral. Allowing the debtors to deposit the proceeds into a general account where those proceeds are commingled is insufficient to create a *res*.

> In general, it is understood that when the 'trustee' of the funds is entitled to use them as his or her own and commingle them with his or her own money, a debtor-creditor relationship exists, not a trust.

Shervin, *supra*, at 734; 4 Collier on Bankruptcy § 541,13 at 541-77 (15th ed. 1990); *accord In re Pehkonen*, 15 B.R. at 581.

For a trust to exist, the *res* must be defined in the trust document and the duties of the trustee defined. Here, the inventory being sold by the alleged trustee corporation was property of the corporation and not property of TFC although it had a lien on the property. Upon sale of the inventory, proceeds were created in which TFC also had a lien. TFC's argument is that M & R placed its property, i.e., the inventory proceeds, into a trust with M & R as trustee exercising all control over the property including the right to commingle it with other property of M & R. TFC's position assumes that this trust must have been non-revocable on the part of M & R or it could have simply revoked the trust by distributing the proceeds to others. Then TFC concludes that solely due to M & R's failure to comply with the purported trust, the debtors personally engaged in defalcation. This entire theory is founded on a single phrase in a single sentence in a document which is a standard form commercial security agreement. The argument that a technical trust existed between M & R and plaintiff is not persuasive.

Because no express trust existed, there can be no fiduciary relationship between TFC and M & R and no resulting fiduciary relationship between TFC and the corporation's officers, directors and agents.

(2) Is there some other basis under federal law to impose a fiduciary duty on debtors?

Courts have "adopted a narrow definition of 'fiduciary' for purposes of § 523(a)(4)." *In re Cantrell*, 329 F.3d 1119, 1125 (9th Cir. 2003). It is well-established precept of corporate law that directors and officers, generally, owe no fiduciary duty to creditors.

Once a corporation becomes insolvent, however, corporate officers do owe a fiduciary duty to creditors. That duty, in essence, is to use the remaining corporate assets for the benefit of creditors. The use of corporate assets for the personal benefit of an officer at the time of corporate insolvency would constitute defalcation. *See In re Jacks, supra,* at 738 (stating that director's fiduciary duties to creditors may only arise when the corporation becomes insolvent); *In re Kallmeyer, supra,* at 495-96 (holding a corporate officer has a fiduciary duty to the corporate creditors pursuant to Oregon's trust fund doctrine which imposes such duty upon insolvency); *accord National Hotel Associates ex rel. M.E. Venture Management, Inc. v O. Ahlborg & Sons, Inc.*, 827 A.2d 646, 656 (R.I. 2003) (recognizing that Rhode Island has used the trust fund doctrine requiring the corporate directors to hold the assets of an insolvent corporation in trust for the benefit of its creditors); *but see, Block v. Olympic Health Spa, Inc.*, 24 Wash. App. 938, 950, fn. 5, 604 P.2d 1317, 1324, (1979) (stating that Washington's "trust fund doctrine has been abrogated").

M & R was selling inventory in the ordinary course of business, depositing income from all sources into a business account and paying expenses in the ordinary course of business from that account. Clearly at some point, M & R became insolvent. Only after insolvency did any fiduciary duty of the debtors arise. For liability to be imposed there must have been a breach of that duty or, as stated in 11 U.S.C. § 523(a)(4), conduct which constituted defalcation.

(3) Did an act of defalcation occur?

The facts are insufficient to establish that the debtors defrauded the plaintiff and committed defalcation. Using corporate assets to guarantee a personal debt or using corporate funds for personal use would constitute defalcation when the corporation is insolvent. *In re Jacks, supra*; *In re Kallmeyer, supra.* There is no evidence that any of M & R's corporate assets were diverted by the debtors for their personal gain. M & R breached its financing plan and security agreement with TFC but much more is needed to establish such conduct rises to the level of fraud or defalcation of M & R's officers. Failing to pay the proceeds of the inventory sales to the secured party when due does not except the debt from discharge pursuant to § 523(a)(4) or (a)(6) in a corporate officer's personal bankruptcy. *In re Littleton, supra.* Failing to make payment on time and in the manner prescribed is insufficient to establish fraud or defalcation either on the part of the corporation or its corporate officers.

The evidence indicates Mr. Underwood returned some of plaintiff's collateral to the manufacturer from whom it was purchased. There is no evidence such action did result or could have resulted in personal benefit to the debtors. Plaintiff has failed to demonstrate a defalcation occurred and its motion under 11 U.S.C. § 523(a)(4) must be denied.

B. 11 U.S.C. § 523(a)(6) Claim.

Pursuant to 11 U.S.C. § 523(a)(6) a debt is excepted from discharge "for willful and malicious injury by the debtor to another entity or to the property of another entity." The conjunction in the text requires that both the "willful" and "malicious" prongs be given effect. *See In re Su*, 290 F.3d 1140, 1146 (9th Cir. 2002). "'Willful' in (a)(6) modifies the word 'injury,' indicating that the nondischargeability takes a deliberate or intentional act that leads to injury." *In re Su, supra*, at 1143 (quoting *Kawaauhau v. Geiger*, 523 U.S. 57, 61-2

(1998)). The willful injury requirement is governed by a subjective standard. *In re Su, supra*, at 1146 (stating that the debtor must have actual knowledge that harm was substantially certain). The malicious prong involves "'(1) a wrongful act, (2) done intentionally, (3) which necessarily causes injury, and (4) is done without just cause or excuse.'" *In re Su, supra*, at 1146-47. The malicious prong also is governed from the debtors' subjective intent. *In re Thiara*, 285 B.R. 420, 434 (9th Cir. BAP 2002). TFC must establish that the debtors willfully and maliciously harmed them when they removed the collateral from the business premises.

On November 22, 2002, TFC filed an action for replevin to recover its secured collateral in M & R's possession. On January 16, 2003, when TFC conducted its ordinary floor checks, it was discovered that certain inventory was not present and it appeared that the business was closed to the public. TFC alleges that the debtors willfully caused injury to TFC by converting inventory subject to TFC's secured interest in violation of the Wholesale Security Agreement by delivering 18 units of woodstoves and hearth products to the manufacturer. The total value of that collateral is $14,549.50. If such act constituted conversion, plaintiff's injury would be measured by the value of the inventory converted.[1]

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[1]Wisely TFC has not claimed that the debtors converted cash proceeds by failing to remit the proceeds from the sale of the secured collateral per the agreement. *See In re Littleton*, 106 B.R. 632, 636 (9th Cir. BAP 1989) (rejecting creditor's claim that debtors willfully and maliciously converted cash proceeds by using funds deposited in the general business account to pay ordinary business expenses instead of secured creditors per their agreement).

Debtors' claim that they are not liable pursuant to 11 U.S.C. § 523(a)(6) based upon the limited liability as a corporate director is without merit. Intentional torts expose the tortfeasor to personal liability. *See* David DeWolf & Keller Allen, 16 Wash. Prac., *Tort Law & Practice* § 3.7 (2d ed. 2004)(citations omitted). Since § 523(a)(6) requires that the harm to property be intentional, the debtors are exposed to personal liability even though Mr. Underwood may have been acting as an agent of the corporation. *See In re Su, supra*, at 1143. Mr. Underwood could be held personally liable as the tortfeasor if TFC establishes that his conduct was willful and malicious.

The evidence of the delivery of remaining inventory to the manufacturer is insufficient to demonstrate willful or malicious injury. The plaintiff's Motion for Summary Judgment under 11 U.S.C. § 523(a)(6) must be denied.

C. Issue and Claim Preclusion.

The only issue left is TFC's issue and claim preclusion argument. State court judgments can be given preclusive effect in nondischargeability proceedings. *See In re Diamond*, 285 F.3d 822, 826 (9th Cir. 2002) (citing *Grogan v. Garner*, 498 U.S. 279, 285, fn. 11 (1991)).

Here, M & R and TFC entered into a Stipulated Judgment on June 4, 2003, in the Franklin County Superior Court for the State of Washington. The Stipulated Judgment contains no findings of fact nor conclusions of law. This judgment merely liquidates the debt that M & R fully admits is owing to TFC. Nothing in the judgment indicates that M & R admitted that it breached a fiduciary duty owing to TFC nor that M & R intentionally caused damage to its property. That Stipulated Judgment liquidated the debt for which debtors are liable under the terms of the personal guaranty. That issue, i.e., the amount of the debt, has been fully resolved. That Stipulated Judgment did nothing to resolve the issues required to be addressed by 11 U.S.C. §§ 523(a)(4) and (a)(6) to except a debt from discharge.

CONCLUSION

The court finds that the plaintiff has not met its burden in establishing that the debts incurred by the debtors are excepted from discharge pursuant to 11 U.S.C. § 523(a)(4) and (a)(6). The facts regarding the return of certain collateral to the manufacturer must be further developed. Currently, material issues of fact exist. Thus, the plaintiff's Motion for Summary Judgment must be **DENIED.**

DATED this 9th day of April, 2004.

Patricia C. Williams

PATRICIA C. WILLIAMS
Chief Bankruptcy Court Judge