

§ 523(a)(4)  
§ 101(5)(A)  
§ 101(12)  
§ 101(32)(A)  
Trust Fund Doctrine  
Insolvency

In re Kallmeyer and Flegel, BAP No. OR-99-1371-RyKMe  
Flegel v. Burt & Assocs., Adv. No. 98-3209-elp  
In re Kallmeyer and Flegel, Case No. 395-36652-elp7

12/3/99

BAP, aff'g ELP

published

The BAP affirmed the bankruptcy court's order ruling that the debt owed by debtor Flegel's corporation was nondischargeable under § 523(a)(4). Debtor was the sole director, officer and shareholder of the corporation. After the corporation ceased doing business, Debtor paid corporate funds to herself. Plaintiff Burt & Associates remained unpaid.

The BAP held that once the corporation became insolvent and ceased doing business, the trust fund doctrine imposed a fiduciary duty on Debtor to hold the corporation's assets in trust for the benefit of creditors and to distribute those assets equally among the corporation's creditors.

The BAP also affirmed the bankruptcy court's finding that the corporation was insolvent.

99-12(9)

# ORDERED PUBLISHED

## UNITED STATES BANKRUPTCY APPELLATE PANEL OF THE NINTH CIRCUIT

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In re )  
KENNETH P. KALLMEYER and )  
KATHRYN J. FLEGEL, )  
Debtors. )  
\_\_\_\_\_)  
KATHRYN J. FLEGEL, )  
Appellant, )  
v. )  
BURT & ASSOCIATES, P.C., )  
Appellee. )  
\_\_\_\_\_)

BAP No. OR-99-1371-RyKMe  
Bk. No. 395-36652-elp7  
Adv. No. 98-3209-elp

# FILED

OPINION

DEC 3 1999

NANCY B. DICKERSON, CLERK  
U.S. BKCY. APP. PANEL  
OF THE NINTH CIRCUIT

Argued and Submitted on October 21, 1999  
Portland, Oregon

Filed - December 3, 1999

Appeal from the United States Bankruptcy Court  
for the District of Oregon

Honorable Elizabeth L. Perris, Bankruptcy Judge, Presiding.

Before: RYAN, KLEIN, and MEYERS, Bankruptcy Judges.

99-12(a)

1 RYAN, Bankruptcy Judge:  
2

3 In 1994, Kathryn Flegel ("Debtor"), a physician, formed  
4 Northwest Internal Medicine ("NIM") and provided patient and  
5 billing services through NIM until October 1995. As of October 1,  
6 1995, Debtor ceased providing services through NIM and organized  
7 Primary Care Associates ("PCA"), providing and billing all of her  
8 patient services through PCA after this date. Although she was no  
9 longer providing services through NIM, NIM distributed \$71,800 to  
10 or on behalf of Debtor subsequent to October 1, 1995.

11 In September 1995, Burt & Associates ("Plaintiff") sued NIM  
12 for unpaid legal fees and later reduced its claim to judgment (the  
13 "Judgment").

14 In September 1995, Debtor and her husband filed their chapter  
15 13<sup>1</sup> bankruptcy petition. In 1998, they converted the case to  
16 chapter 7. Plaintiff filed a complaint (the "Complaint") to obtain  
17 a determination that the Judgment was nondischargeable under  
18 §§ 523(a)(4) and (a)(6). After trial, the bankruptcy court held  
19 that the Judgment was nondischargeable under § 523(a)(4) as a debt  
20 for defalcation while acting in a fiduciary capacity. Debtor  
21 timely appealed.

22 We AFFIRM.  
23

24 I. FACTS

25 The following facts are undisputed. In December 1994, Debtor  
26 formed NIM and was its sole director, officer, and shareholder.

27 \_\_\_\_\_  
28 <sup>1</sup>Unless otherwise indicated, all chapter and section references  
are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

1 Debtor provided patient and billing services through NIM from  
2 December 1994 until October 1995, when she formed PCA. After  
3 October 1, 1995, all of Debtor's medical and billing services were  
4 provided through PCA. Despite the fact that NIM ceased its  
5 operations upon the formation of PCA, between October 1, 1995 and  
6 October 1, 1996, NIM paid to Debtor or to taxing authorities on her  
7 behalf a total of \$71,800.

8 On September 15, 1995, Plaintiff sued NIM for \$47,451 in  
9 unpaid legal fees. In September 1996, Plaintiff obtained the  
10 Judgment, which was in the amount of \$56,737.02 plus interest.  
11 Plaintiff only recovered \$520.86 of the Judgment.

12 On September 29, 1995, Debtor and her husband filed a chapter  
13 13 bankruptcy petition. Debtor listed as assets her 100%  
14 shareholder interest in NIM, valued at \$25,000, and \$1,900 in  
15 accrued wages owed by NIM for services performed in September 1995.  
16 Debtor also scheduled the Judgment. On March 3, 1998, the case was  
17 converted to chapter 7.

18 In February 1999, Plaintiff filed the Complaint. The  
19 Complaint alleged that Debtor, as NIM's sole shareholder, officer,  
20 and director, had breached her fiduciary duty to Plaintiff,<sup>2</sup>  
21 because subsequent to NIM's insolvency, NIM transferred \$71,800 to  
22 Debtor, a sum substantially in excess of the \$1900 she was owed for  
23 wages. Therefore, the Complaint sought a determination that the  
24 Judgment was nondischargeable under § 523(a)(4) as a defalcation  
25 while acting in a fiduciary capacity. The Complaint also alleged  
26 that Debtor willfully and maliciously injured Plaintiff and that

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28 <sup>2</sup>It its opening brief, Plaintiff states that it was NIM's sole  
unpaid creditor.

1 the Judgment was nondischargeable under § 523(a)(6).

2 After a trial, the bankruptcy court ruled in favor of Debtor  
3 on the § 523(a)(6) cause of action. However, it held that because  
4 NIM was insolvent as of October 1, 1995 and ceased its operations  
5 as of that date, Oregon law imposed a fiduciary duty on Debtor, as  
6 a director, to preserve NIM's assets for the benefit of its  
7 creditors. By transferring \$69,900 to herself without  
8 justification, the bankruptcy court held that Debtor breached her  
9 fiduciary duty to Plaintiff and committed a defalcation.  
10 Therefore, the bankruptcy court determined that the Judgment was  
11 nondischargeable under § 523(a)(4).

12 The nondischargeability judgment was entered on April 30,  
13 1999, and Debtor timely appealed.

## 14 15 II. ISSUES

- 16 A. Whether the bankruptcy court erred in determining that Debtor  
17 was a fiduciary within the meaning of § 523(a)(4).  
18 B. Whether the bankruptcy court erred in determining that NIM was  
19 insolvent as of October 1, 1995.

## 20 21 III. STANDARD OF REVIEW

22 We review de novo the bankruptcy court's determination that  
23 Debtor was a fiduciary within the meaning of § 523(a)(4). See  
24 Ragsdale v. Haller, 780 F.2d 794, 795 (9th Cir. 1986).

25 We review the bankruptcy court's factual determination that  
26 NIM was insolvent as of October 1, 1995 for clear error. See  
27 Sierra Steel, Inc. v. Totten Tubes, Inc. (In re Sierra Steel,  
28 Inc.), 96 B.R. 275, 277 (9th Cir. BAP 1989). "A finding is clearly

1 erroneous if, after review of the record, the Panel is left with a  
2 definite and firm conviction that error has been committed." Id.

4 IV. DISCUSSION

5 A. The Bankruptcy Court Did Not Err in Determining that Debtor  
6 Was a Fiduciary Within the Meaning of § 523(a)(4).

7 The bankruptcy court held that Debtor was a fiduciary within  
8 the meaning of § 523(a)(4), which requires either an express or  
9 technical trust that arises before and independently of any  
10 wrongdoing. See Ragsdale, 780 F.2d at 796. The bankruptcy court  
11 determined that Debtor was a fiduciary because of Oregon's "trust  
12 fund doctrine," which provides that a director of an insolvent  
13 corporation that has ceased doing business is a trustee for the  
14 corporation's creditors and must hold the corporate assets for the  
15 creditors' benefit. See Gantenbein v. Bowles, 203 P. 614, 619 (Or.  
16 1922). The bankruptcy court held that NIM was insolvent as of  
17 October 1, 1995 and that Debtor, as its sole director, was a  
18 fiduciary of NIM's creditors as of that date. Because the  
19 fiduciary duty arose independent of any wrongdoing by Debtor, the  
20 court held that it satisfied the requirements of § 523(a)(4).

21 On appeal, Debtor argues that although Oregon law imposed a  
22 fiduciary duty on her, this fiduciary obligation is not the narrow  
23 obligation required by § 523(a)(4). Debtor contends that the  
24 fiduciary obligation arose only after NIM distributed money to  
25 Debtor after October 1, 1995, not prior to that date, and that she  
26 therefore was not a fiduciary within the meaning of § 523(a)(4).  
27 We disagree.

28 Section 523(a)(4) excepts from discharge any debt "for fraud

1 or defalcation while acting in a fiduciary capacity." 11 U.S.C.  
2 § 523(a)(4). Whether a debtor is a fiduciary within the meaning of  
3 § 523(a)(4) is a question of federal law and is narrowly  
4 interpreted. See Ragsdale, 780 F.2d at 796. The Ninth Circuit has  
5 held that "[t]he trust giving rise to the fiduciary relationship  
6 must be imposed prior to any wrongdoing; the debtor must have been  
7 a 'trustee' before the wrongdoing and without reference to it.  
8 These requirements eliminate constructive, resulting or implied  
9 trusts." Id. (citation omitted); see also Lewis v. Scott (In re  
10 Lewis), 97 F.3d 1182, 1186 (9th Cir. 1996) (holding that Arizona law  
11 imposes upon business partners a fiduciary duty within the meaning  
12 of § 523(a)(4) because the duty arises independently of any  
13 wrongdoing); Woodworking Enters., Inc. v. Baird (In re Baird), 114  
14 B.R. 198, 203-04 (9th Cir. BAP 1990) (holding that Arizona law  
15 imposes a fiduciary duty within the meaning of § 523(a)(4) by  
16 requiring certain sums paid to contractors to be held in trust for  
17 the benefit of subcontractors or suppliers because the trust exists  
18 independent of and prior to any wrongdoing). Although federal law  
19 determines whether the debtor is a fiduciary, state law must be  
20 consulted to determine whether a trust exists. Ragsdale, 780 F.2d  
21 at 796.

22 Oregon has adopted the trust fund doctrine which provides that  
23 directors of a corporation owe its creditors a fiduciary duty if  
24 either of the following occurs: (1) the corporation suspends its  
25 business and becomes insolvent or (2) the corporation's assets are  
26 placed in the possession of the court and it ceases to be a going  
27 concern. See Gantenbein, 203 P. at 617. Once that occurs, the  
28 corporation's directors hold its assets in trust for equal

1 distribution among its creditors and "cannot use those assets to  
2 prefer themselves as creditors . . . to the prejudice of general  
3 creditors." Id. at 619. Directors who fulfill their fiduciary  
4 duties by preserving the corporation's assets and properly  
5 distributing them to its creditors will not be subject to  
6 liability. However, a director who breaches this fiduciary duty by  
7 misappropriating corporate assets for personal gain will be held  
8 liable under the trust fund doctrine.

9 Here, once NIM became insolvent and ceased doing business, the  
10 trust fund doctrine imposed a fiduciary duty upon Debtor to hold  
11 NIM's assets in trust for the benefit of its creditors and to  
12 distribute those assets equally. The fiduciary duty was imposed  
13 prior to any defalcation, and no personal liability arose until  
14 Debtor breached this fiduciary obligation. Because the fiduciary  
15 duty arose independently of any wrongdoing and existed prior to and  
16 without reference to it, we hold that the bankruptcy court properly  
17 concluded that the trust fund doctrine imposes a fiduciary  
18 obligation upon directors within the meaning of § 523(a)(4).<sup>3</sup>

19 B. The Bankruptcy Court Did Not Err in Including the Debt Owed to  
20 NIM in Calculating Whether Debtor Was Insolvent.

21 In analyzing whether NIM was insolvent as of October 1, 1995,  
22 the bankruptcy court utilized a balance sheet approach, using NIM's  
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24 <sup>3</sup>We note that other courts that have considered the issue have  
25 similarly held that a breach of the fiduciary duty imposed by the  
26 trust fund doctrine may create a nondischargeable debt under §  
27 523(a)(4). See Energy Prods. Eng'g, Inc. v. Reuscher (In re  
28 Reuscher), 169 B.R. 398, 403 (S.D. Ill. 1994); Mercedes-Benz Credit  
Corp. v. Carretta (In re Carretta), 219 B.R. 66, 73-74 (Bankr. D.N.J.  
1998); Miramar Resources, Inc. v. Shultz (In re Shultz), 208 B.R. 723,  
728-29 (Bankr. M.D. Fla. 1997); Berres v. Bruning (In re Bruning), 143  
B.R. 253, 255-56 (Bankr. D. Colo. 1992).



1 tax return for the fiscal year from October 1, 1995 through  
2 September 30, 1996 and a balance sheet attached to the tax return.  
3 The bankruptcy court reconstructed the balance sheet to add several  
4 omitted assets and liabilities.<sup>4</sup> As of October 1, 1995, this  
5 balance sheet reflected that liabilities exceeded assets by  
6 \$10,021.60. The bankruptcy court therefore found that NIM was  
7 insolvent as of October 1, 1995, prior to Debtor's defalcation.

8 On appeal, Debtor contends that the bankruptcy court clearly  
9 erred in finding that NIM was insolvent as of October 1, 1995  
10 because in calculating liabilities, it included the Judgment, which  
11 Debtor contends was disputed and therefore erroneously included.  
12 We disagree.<sup>5</sup>

13 The Code defines "insolvent" as a "financial condition such  
14 that the sum of such entity's debts is greater than all of such  
15 entity's property." 11 U.S.C. § 101(32)(A).<sup>6</sup> A debt is a  
16 liability on a claim. See 11 U.S.C. § 101(12). A claim, in turn,  
17 is defined as including a right to payment, "whether or not such

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19 <sup>4</sup>The bankruptcy court added the following items: (1) \$96,321 in  
20 accounts receivable; (2) a \$56,737.02 liability owed to Plaintiff; (3)  
21 a \$47,386.07 liability owed to Dr. Zeller; (4) \$319.51 owed to Dr.  
Werdland; and (5) \$1,900 owed to Debtor for unpaid wages.

22 <sup>5</sup>Debtor also argues for the first time on appeal that Plaintiff  
23 was bound by its statement in its trial brief that NIM had been  
24 insolvent since early 1996. However, Debtor did not raise this  
25 objection before the bankruptcy court and did not object to  
Plaintiff's argument or evidence at trial that NIM was insolvent as  
of October 1, 1995. Debtor cannot raise this issue for the first time  
on appeal. See O'Rourke v. Seaboard Surety Co. (In re Fegert, Inc.),  
887 F.2d 955, 957 (9th Cir. 1989).

26 <sup>6</sup>The Code excludes from the insolvency calculation "property  
27 transferred, concealed, or removed with intent to hinder, delay, or  
28 defraud such entity's creditors" and "property that may be exempted  
from property of the estate under section 522 of this title." 11  
U.S.C. §§ 101(32)(A), (B).

1 right is reduced to judgment, liquidated, unliquidated, fixed,  
2 contingent, matured, unmatured, disputed, undisputed, secured, or  
3 unsecured." 11 U.S.C. § 101(5)(A). Debtor has cited no case law  
4 to the contrary. Although Debtor may have disputed her personal  
5 liability for the Judgment, the Judgment against NIM was final and  
6 undisputed.<sup>7</sup> Therefore, the bankruptcy court properly included the  
7 Judgment when calculating NIM's insolvency.

8

9

#### V. CONCLUSION

10 When a corporation becomes insolvent and ceases doing  
11 business, Oregon law requires the directors to hold the  
12 corporation's assets in trust for the benefit of the corporate  
13 creditors. Because this fiduciary relationship arises independent  
14 of any wrongdoing, a defalcation committed after the fiduciary duty  
15 arises may be nondischargeable pursuant to § 523(a)(4). Effective  
16 October 1, 1995, NIM was insolvent and Debtor, as NIM's sole  
17 director, owed NIM's creditors a fiduciary duty to hold NIM's  
18 assets in trust for their benefit. Because this fiduciary  
19 relationship arose independently of any wrongdoing, the bankruptcy  
20 court did not err in determining that Debtor was a fiduciary within  
21 the meaning of § 523(a)(4).

22

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In addition, the bankruptcy court properly included the  
Judgment as a liability when determining whether NIM was insolvent.

24

Accordingly, we AFFIRM.

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<sup>7</sup>The transcript of the trial reflects that NIM initially opposed Plaintiff's lawsuit against it but that by the time of trial, NIM had decided not to continue defending the lawsuit.