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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

In re:	
JAMES A. ARROWSMITH,	Bankruptcy Number 88B-02960
Debtor.	[Chapter 7]
RAYMOND T. IRWIN, et al.,	Adversary Proceeding Number 88PB-0699
Plaintiff,	
v.	
JAMES A. ARROWSMITH,	
Defendant.	

MEMORANDUM DECISION

Donald J. Winder, Esq., Winder and Haslam, of Salt Lake City, Utah, appeared on behalf of Plaintiffs.

Walter P. Faber, Jr., of Salt Lake City, Utah, appeared on behalf of Defendant.

This matter comes before the court upon trial of the issues in the adversary proceeding asserting the debt owed by James A. Arrowsmith (Arrowsmith), debtor and defendant herein, to Donald E. Hedrick as Trustee of the Donald E. Hedrick, D.D.S., P.C.

Defined Benefit Pension Plan and Trust, and as Trustee of the Donald E. Hedrick, D.D.S., P.C., Profit Sharing Pension Plan and Trust (collectively Hedrick) is nondischargeable under 11 U.S.C. § 523(a)(4) or (6). The court has carefully considered and reviewed the arguments of counsel, assessed the credibility of the witnesses, and made an independent review of the pertinent authorities. The court, being fully advised, hereby renders the following decision.

BACKGROUND

The following is a summary of the facts adduced at trial.

1. Arrowsmith, a resident of Salt Lake County, State of Utah, filed a petition under chapter 7 of the Bankruptcy Code on May 30, 1988, in the United States Bankruptcy Court, District of Utah, Central Division. Thereafter, Hedrick timely filed a complaint in this court on August 19, 1988, objecting to the discharge of the debt owed by Arrowsmith and seeking a determination of the secured status of creditors.[1] Arrowsmith was personally served with the complaint on August 23, 1988.

2. The parties do not dispute this court's jurisdiction or venue, or that this is a core proceeding.

3. Arrowsmith is and has been a licensed member of the Utah State Bar since 1973.

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[1] Summary judgment in favor of Arrowsmith narrowed the claims for relief to those dealt with herein.

4. Hedrick is the trustee of and a participant in both the Donald E. Hedrick, D.D.S., P.C., Defined Benefit Pension Plan and Trust and the Donald E. Hedrick, D.D.S., P.C., Profit Sharing Pension Plan and Trust.

5. Arrowsmith was an attorney, shareholder, officer, and director of the law firm of Bradley, Arrowsmith & Jackson, a professional corporation (Law Firm), at all times relevant hereto.

6. Richard H. Bradley (Bradley), Daniel W. Jackson (Jackson), and Arrowsmith shared office expenses as a part of their working arrangement while shareholders in the Law Firm.

7. In January of 1983, Arrowsmith assisted Bradley by performing research and other legal services for Hedrick at the direction of Bradley.

8. Arrowsmith did not bill Bradley directly for the time spent working on Hedrick's legal problems, nor did Bradley pay Arrowsmith from his own funds for such services.

9. When payment from Hedrick was received by the Law Firm, it was distributed among the attorneys, including Arrowsmith, according to the time spent on Hedrick's legal problems.

10. The Law Firm held itself out to the public to be an integrated entity. No disclosure was made to the public or to clients that the professional corporation was anything other than a law firm or that the individual attorneys were acting as sole practitioners.

11. Hedrick was a client of the Law Firm.

12. On or about August 2, 1983, Arrowsmith, Bradley, and Jackson executed a promissory note in the principal amount of $10,000 (Hedrick Note I).

13. When Arrowsmith signed Hedrick Note I, the document was substantially incomplete. Omissions included the name of the payee and the default interest rate. Bradley told Arrowsmith at that time that the money was being borrowed at 14% simple interest from Preferred Pension Services (PPS) and that PPS would be the payee. Arrowsmith made a copy of the incomplete promissory note for his records.

14. At the time Hedrick Note I was executed, Arrowsmith thought the funds were to be borrowed from PPS and did not know that the funds came from Hedrick.

15. At a later point in time, without Arrowsmith's knowledge or authorization, unknown persons filled in the name "DONALD E. HEDRICK DEFINED BEN. PLAN" as the payee and added the note interest rate of 14%, the default interest rate of 16%, the place of payment, and the words "personal guarantees" to the lower portion of the note.

16. On or about August 3, 1983, the Law Firm received a check from PPS in the amount of $10,000 and deposited it in the Law Firm's account. The check stated in its memorandum portion that it was a "loan from Donald E. Hedrick Retirement Trust".

17. On or about August 9, 1983, Arrowsmith, Bradley, and Jackson executed a second promissory note (Hedrick Note II) in the principal amount of $15,000 payable to PPS.

18. When Hedrick Note II was executed, Arrowsmith thought the borrowed funds were to come from PPS.

19. On or about August 10, 1983, the Law Firm received a check in the amount of $15,000 from PPS and deposited it in the Law Firm's account. The check stated in its memorandum portion that it was a "loan from Donald E. Hedrick Def. Benefit Plan".

20. The money loaned under Hedrick Notes I and II was received by and used to pay the operating expenses of the Law Firm.

21. The loan proceeds received by the Law Firm under Hedrick Notes I and II came from Hedrick's pension plans.

22. During August of 1983, Arrowsmith was the Law Firm's "firm liaison"[2] or attorney assigned to manage personnel and accounts payable. Arrowsmith was generally familiar with the deposits made to and checks written from the Law Firm's bank account.

23. As "firm liaison", Arrowsmith had supervisory responsibilities over the employee charged with reconciliation of the Law Firm's books. The cumulative

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[2] Arrowsmith objected to the use of the term "office manager" and instead characterized himself as the "firm liaison".

circumstantial evidence presented at trial is sufficient to convince the court that Arrowsmith had actual knowledge that Hedrick was the source of the funds for Hedrick Notes I and II at or about the time funds were received, though not at the time the notes were executed.

24. Arrowsmith, Bradley, and Jackson, as guarantors, and the Law Firm defaulted in the payment of Hedrick Notes I and II.

25. On May 20, 1988, a Judgment on Hedrick Notes I and II was entered in the United States District Court for the District of Utah in favor of Hedrick against Arrowsmith in the case of *Ira Fine, et al. v. Professional Pension Services, et al.*, Civil No. 87C-326J. The Judgment awarded Hedrick $40,992.61, plus accruing interest at 14% and attorneys' fees in the amount of $7,325.75. The court further ruled that Arrowsmith was entitled to a credit for any sums collected by Hedrick from Jackson.

26. Hedrick has thus far received $35,000 from Jackson as payment on Hedrick Notes I and II.

27. The testimony of Shirley Riter indicated that in accounting for the loans, PPS allocated the $10,000 loan to the account of the Donald E. Hedrick, D.D.S., P.C., Defined Benefit Pension Plan and Trust and the $15,000 loan to the account of the Donald E. Hedrick, D.D.S., P.C., Profit Sharing Pension Plan and Trust. Arrowsmith was not informed of such allocations and was unaware that PPS had made such allocations at or about the time Hedrick Notes I and II were executed. Arrowsmith subsequently became aware of the allocations.

28. Hedrick did not consent to the transfer of funds to the Law Firm under Hedrick Notes I and II.

29. Hedrick was not advised, either at the time of execution of Hedrick Notes I and II or thereafter, of any potential ethical conflict with regard to the borrowing of monies by the Law Firm.

30. Arrowsmith claimed ignorance of Disciplinary Rule 5-104(A) of the Utah Code of Professional Responsibility[3] at the time he signed Hedrick Notes I and II.

31. Arrowsmith knew that PPS was in the business of administering pension plans. Arrowsmith knew that PPS had no money of its own to lend.

32. Hedrick Notes I and II provided for "reasonable attorney's fees" in the event of collection.

DISCUSSION

1. JURISDICTION

Jurisdiction of the court is properly invoked pursuant to 28 U.S.C. § 1334 and this action is a core matter under 28 U.S.C. § 157. Venue in this division is proper.

2. 11 U.S.C. § 523(a)(6)

Hedrick asserts that the debt evidenced by the District Court Judgment should be nondischargeable under 11 U.S.C. § 523(a)(6) as a debt arising from the willful

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[3] The Utah Code of Professional Responsibility (1971) was in effect at the time the transactions took place. The Utah Rules of Professional Conduct became effective January 1, 1988.

and malicious injury by Arrowsmith to the property of Hedrick. Hedrick argues that Arrowsmith, as a member of the same Law Firm, has imputed liability arising from the knowledge of Bradley as to the source of the borrowed funds. Bradley assertedly knew the funds came from Hedrick; therefore, Arrowsmith should be held vicariously liable for that knowledge.

Hedrick urges the court to consider various cases holding that professional corporations cannot shield an attorney from acts of malpractice or obligations arising from a breach of a duty to a client. In so doing, Hedrick distinguishes *Stewart v. Coffman*, 748 P.2d 579 (Utah Ct. App. 1988). Hedrick argues that Bradley's breach of a fiduciary duty may, therefore, be imputed to Arrowsmith. Although the cases argued are helpful in determining civil liability in state court under similar fact circumstances, they do not address vicarious or imputed liability in the context of a nondischargeability action.

The court can find no basis in law to indicate that a claim of nondischargeability under 11 U.S.C. § 523(a)(6) can be supported by anything other than the *debtor's* actual knowledge or the reasonable foreseeability that the *debtor's* conduct will result in injury to the creditor. *C.I.T. Fin. Services, Inc. v. Posta (In re Posta)*, 866 F.2d 364, 367 (10th Cir. 1989). The statute clearly specifies that a willful and malicious act must be committed *by the debtor.* 11 U.S.C. § 523(a)(6). This is a clarification of former Bankruptcy Act § 17(a)(8) which contained no specific designation as to whose conduct was involved. Therefore, no basis exists for imputing Bradley's conduct to Arrowsmith even if such conduct had been proven to be willful and malicious. *Bowse v. Cornell (In*

re Cornell), 42 B.R. 860 (Bankr. E.D. Wash. 1984). Hedrick has failed to show by clear and convincing evidence that the execution of Hedrick Notes I and II was done by Arrowsmith with "knowledge of the creditor's rights and that, with that knowledge, proceeded to take action in violation of those rights." *In re Posta*, 866 F.2d at 367.

3. 11 U.S.C. § 523(a)(4)

Exceptions to discharge under section 523(a)(4) must be narrowly construed against the creditor and in favor of the debtor. *Orem Postal Credit Union v. Twitchell (In re Twitchell)*, 91 B.R. 961, 963 (D. Utah 1988). Hedrick must prove that the debt evidenced by the District Court Judgment arose as a result of Arrowsmith's defalcation while acting as a fiduciary as defined by federal, not state law. *Joseph v. Stone (In re Stone)*, 91 B.R. 589, 593 (D. Utah 1988).

Under the *Stone* and *Twitchell* cases in this district, as well as *Purcell v. Janikowski (In re Janikowski)*, 60 B.R. 784 (Bankr. N.D. Ill. 1986) relied upon by Hedrick, for a debt to be nondischargeable the plaintiff must first establish an express, technical or statutory trust. Hedrick argues that Article VIII of the Constitution of Utah, Utah Code Ann. § 78-2-4(3), Utah Code Ann. § 78-51-26(9), and the Disciplinary Rules promulgated by the Bar of the State of Utah create a statutory trust envisioned by section 523(a)(4). This court makes no determination whether this analysis is correct or whether collectively a "statutory" trust is created because these citations were inapplicable as of the date these

transactions occurred.[4] It is arguable, however, that certain of the Disciplinary Rules

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[4] At trial, counsel for Hedrick relied upon Article VIII, Section 4 of the Constitution of Utah which states:

> **Section 4. [Rulemaking power of Supreme Court - Judges pro tempore - Regulation of practice of law.]**
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> The Supreme Court shall adopt rules of procedure and evidence to be used in the courts of the state and shall by rule manage the appellate process. The Legislature may amend the Rules of Procedure and Evidence adopted by the Supreme Court upon a vote of two-thirds of all members of both houses of the Legislature. Except as otherwise provided by this constitution, the Supreme Court by rule may authorize retired justices and judges and judges pro tempore to perform any judicial duties. Judges pro tempore shall be citizens of the United States, Utah residents, and admitted to practice law in Utah. The Supreme Court by rule shall govern the practice of law, including admission to practice law and the conduct and discipline of persons admitted to practice law.

Utah Const. art. VIII, § 4 (1896) (amended 1985). Counsel for Hedrick also relied upon Utah Code Ann. § 78-2-4(3) which states:

> **78-2-4. Supreme Court -- Rulemaking, judges pro tempore, and practice of law.**
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> . . . .
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> (3) The Supreme Court shall by rule govern the practice of law, including admission to practice law and the conduct and discipline of persons admitted to the practice of law.

Utah Code Ann. § 78-2-4(3) (as amended 1986).

These provisions were not in effect in 1983 when the events complained of occurred. Article VIII, Section 4 of the Constitution of Utah was amended in 1985. The legislative history following section 78-2-4(3) indicates the original section 78-2-4 was repealed in 1986 and replaced with the section argued at trial.

In 1983, Article VIII, Section 4 of the Constitution of Utah stated:

> **Section 4. [Jurisdiction of Supreme Court - Terms.]**
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> The Supreme Court shall have original jurisdiction to issue writs of mandamus, certiorari, prohibition, quo warranto and habeas corpus. Each of the justices shall have power to issue writs of habeas corpus, to any part of the State, upon petition by or on behalf of any person held in actual custody, and may make such writs returnable before himself or the Supreme Court or before any district court or judge thereof in the State. In other cases the Supreme Court shall have appellate jurisdiction only, and power to issue writs necessary and proper for the exercise of that jurisdiction. The Supreme Court shall hold at least three terms every year and shall sit at the capital of the State.

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evidence an intent to create a trust relationship between attorney and client in certain instances. For example, DR 9-102 *Preserving Identity of Funds and Property of a Client* provides as follows:

> (A) All funds of clients paid to a lawyer or law firm, other than advances for costs and expenses, shall be deposited in one or more identifiable bank accounts maintained in the state in which the law office is situated and no funds belonging to the lawyer or law firm shall be deposited therein except as follows:
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> (1) Funds reasonably sufficient to pay bank charges may be deposited therein.
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> (2) Funds belonging in part to a client and in part presently or potentially to the lawyer or law firm must be deposited therein, but the portion belonging to the lawyer or law firm may be withdrawn when due unless the right of the lawyer or law firm to receive it is disputed by the client, in which event the disputed portion shall not be withdrawn until the dispute is finally resolved.

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[4](...continued)
Utah Const. art. VIII, § 8 (1896).

Section 78-2-4 of the Utah Code in effect in 1983 states:

78-2-4. Rules-making power.

The Supreme Court of the State of Utah has power to prescribe, alter and revise, by rules, for all courts of the State of Utah, the forms of process, writs, pleadings and motions and the practice and procedure in all civil and criminal actions and proceedings, including rules of evidence therein, and also divorce, probate and guardianship proceedings. Such rules may not abridge, enlarge or modify the substantive rights of any litigant. Upon promulgation the Supreme Court shall fix the date when such rules shall take effect and thereafter all laws in conflict therewith providing for procedure in courts only shall be of no further force and effect. Nothing in this title, anything therein to the contrary notwithstanding, shall in any way limit, supersede or repeal any such rules heretofore prescribed by the Supreme Court.

Utah Code Ann. § 78-2-4 (1953) (repealed 1986).

The parties did not address whether the provisions in effect in 1983 created a statutory trust when construed together. Not having been fully briefed by the parties, the court does not reach the issue of whether the provisions in effect in 1983 create a statutory trust. In any event, such an analysis is unnecessary because the plaintiff has failed to carry his burden of proof on the remaining elements necessary to establish a cause of action under section 523(a)(4) of the Bankruptcy Code.

(B) A lawyer shall:

(1) Promptly notify a client of the receipt of his funds, securities, or other properties.

(2) Identify and label securities and properties of a client promptly upon receipt and place them in a safe deposit box or other place of safekeeping as soon as practicable.

(3) Maintain complete records of all funds, securities, and other properties of a client coming into the possession of the lawyer and render appropriate accounts to his client regarding them.

(4) Promptly pay or deliver to the client as requested by a client the funds, securities, or other properties in the possession of the lawyer which the client is entitled to receive.

Utah Code of Professional Responsibility DR 9-102 (1971). A similar rule, with the benefit of drafter's comment, is set forth in Rule 1.13 *Safekeeping Property* of the Utah Rules of Professional Conduct which became effective January 1, 1988. By way of comparison, it provides:

> (a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.
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> (b) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this Rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.
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> (c) When in the course of representation a lawyer is in possession of property in which both the lawyer and another person claim interests, the property shall be kept separate by the lawyer until there is an accounting and severance or their interests. If a dispute arises concerning their

respective interests, the portion in dispute shall be kept separate by the lawyer until the dispute is resolved.

Comment

A lawyer should hold property of others with the care required of a professional *fiduciary*. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property which is the property of clients or third persons should be kept separate from the lawyer's business and personal property and, if monies, in one or more trust accounts. Separate trust accounts may be warranted when administering estate monies or acting in similar *fiduciary* capacities. (Emphasis added).

Utah Rules of Professional Conduct Rule 1.13 (1988). A prominent treatise on the subject states, "A lawyer or law firm that receives a clients' money or property for safekeeping acts as a fiduciary in regards to such property". Law. Man. on Prof. Conduct (ABA/BNA) 45:101 (July 24, 1985). It is evident that Disciplinary Rule 9-102 of the Code of Professional Responsibility and Rule 1.13 of the Rules of Professional Conduct establish an express trust and trust res as anticipated by section 523(a)(4). *In re Janikowski*, 60 B.R. at 789.

Many of the Disciplinary Rules however, merely establish appropriate ethical conduct, the breach of which may be actionable and result in sanctions or disciplinary action. The duty created by various Disciplinary Rules may be described properly as a fiduciary obligation. *Giovanazzi v. State Bar of California*, 619 P.2d 1005, 1009 (Cal. 1980) (en banc). Merely characterizing the relationship between attorney and client as a fiduciary relationship does not establish all the elements necessary to create the fiduciary relationship contemplated in section 523(a)(4). In order to do so, the debtor must be the

trustee of an intentionally created technical or statutory trust, having property of the creditor constituting the trust res in his control. *In re Twitchell*, 91 B.R. at 965-66.

Hedrick asserts Arrowsmith has breached the fiduciary obligation owed to him as set forth in DR 5-104 *Limiting Business Relations with a Client*. That Disciplinary Rule provides:

> (A) A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his professional judgment therein for the protection of the client, unless the client has consented after full disclosure.

Utah Code of Professional Responsibility DR 5-104 (1971). This rule establishes a duty from the attorney to the client which, in the general sense of the term, could be characterized as fiduciary. The elements necessary to establish "fiduciary capacity" for the purpose of section 523(a)(4), however, are missing. No property of the client is entrusted to the attorney under an express, technical or statutory trust. Rather, this disciplinary rule sets forth a standard of conduct that an attorney must adhere to if an attorney enters into a business transaction with a client. Such a commercial transaction will not support an action under section 523(a)(4) because no property of the client is held in trust by the attorney. "Further, the debt alleged to be nondischargeable must arise from a breach of the trust obligations imposed by law and not from any breach of contract." *In re Janikowski*, 60 B.R. at 788. The trustee's duties must be independent of the parties contractual relationship. The fiduciary relationship set forth in section 523(a)(4) does not

encompass ordinary commercial transactions such as debtor-creditor relationships. *In re Twitchell*, 91 B.R. at 965 and *In re Stone*, 91 B.R. at 593-94.

The court is convinced that Arrowsmith committed a breach of Disciplinary Rule 5-104(A)[5] when he borrowed money from a client of the Law Firm. Arrowsmith knew the source of the funds once they were received by the Law Firm yet he failed to take remedial action to rectify the impropriety. Arrowsmith also failed to inform Hedrick that he was entitled to full disclosure regarding the transaction or to advise him to seek independent representation either prior to or after the transaction was completed.

Hedrick must prove by clear and convincing evidence the establishment of a statutory trust or an express trust. The failure to properly address the correct constitutional or legislative grant in effect at the time, which may have established a statutory trust, need not be considered by the court because Hedrick failed to prove the remaining elements required by the statute. The breach of the Disciplinary Rule by Arrowsmith is not actionable under section 523(a)(4) because no clearly defined trust res was established, no intent to create a trust relationship existed prior to the alleged breach, and no funds of Hedrick were held by Arrowsmith in a trust capacity. *In re Stone*, 91 B.R. at 594. The debt owed by Arrowsmith arises from the District Court Judgment on Hedrick Notes I and II. Nowhere in Hedrick Notes I and II is evidence of an intent to

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[5] Disciplinary Rule 5-104(A) prohibits transactions absent full disclosure where an attorney and client have differing interests. Being a debtor and being a creditor are differing interests. Therefore, a lawyer cannot enter into a debtor-creditor business transaction with a client without full disclosure and compliance with the rule. *People v. Stineman*, 716 P.2d 1079 (Colo. 1986) (en banc).

create an express trust. The funds borrowed by Arrowsmith became the actual property of the Law Firm subject only to Hedrick's right of repayment. No trust res was created for Arrowsmith to administer.

For Hedrick to prevail he must establish a debt which arose from Arrowsmith's defalcation. The only evidence of a debt upon which Hedrick relies is the failure of Arrowsmith to repay Hedrick Notes I and II as evidenced by the District Court Judgment. No other evidence was presented of a debt arising from the mere failure to inform independent of the failure to repay. The defalcation complained of by Hedrick must be the failure of Arrowsmith to repay the notes because that is the only action from which a debt arose.[6]

Under the current case law, the court cannot find that the failure to repay Hedrick Notes I and II was a defalcation under the statute.[7] Instead, the claim is based on a money judgment arising from nonpayment of a promissory note. Hedrick has failed to sustain his burden of establishing by clear and convincing evidence that a debt arose as a result of Arrowsmith's defalcation while acting in a fiduciary capacity imposed by

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[6] The result may well be different if the District Court Judgment had been a malpractice judgment but it is, instead, a judgment on two commercial notes.

[7] This is not to say that the court condones the breach of ethics committed by Arrowsmith. Nor does it sanction the imprudent business conduct of executing promissory notes in blank, or the practice of the Law Firm of borrowing from clients to pay overhead without either investigation as to the source of funds or disclosure as appropriate under applicable ethical standards.

statute only an express trust. The court cannot find that the failure to repay is a defalcation.

CONCLUSION

The court determines that Hedrick has failed to meet his burden of proof and has not shown that Arrowsmith committed defalcation while acting in a fiduciary capacity and that the debt owed to Hedrick arose as a result thereof. The Judgment entered by the District Court is, therefore, dischargeable.

Arrowsmith is hereby directed to prepare an order consistent with this decision.

DATED this 27th day of July, 1989.

JUDITH A. BOULDEN
United States Bankruptcy Judge