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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

ROBERT PATRICK FISHER and
LARA MARGARET FISHER,

Debtors.

Case No.97-50092-JRG

Chapter 7

HAGEN & SONS CONSTRUCTION,
INC.,

Plaintiff,

Adversary No. 97-5142

vs.

MEMORANDUM DECISION

ROBERT PATRICK FISHER, et
al.,

Defendants.

I. FACTUAL BACKGROUND

Robert Patrick Fisher ("Defendant"), an attorney, represented Hagen & Sons ("Plaintiff"), who were contractors, in various litigation matters during the past twenty years. Due to the personal relationship between Defendant and Plaintiff, Defendant did not always provide regular fee statements to Plaintiff and, in fact, would work for years without payment of fees. Between 1990-1992 Plaintiff also performed construction services for Defendant on numerous personal projects, for which

1 Defendant still owes Plaintiff money.

2 In 1993, Defendant represented Plaintiff in a lawsuit
3 against Philippe Kahn that arose out of a construction project.
4 Defendant settled the lawsuit and received a \$171,089.83 check
5 from the opposing party. Defendant deposited the check in his
6 client trust account (Acct. # 10-015098-6) on June 17, 1993. At
7 the time of this deposit, the trust account contained \$311.35.
8 Defendant did not disclose to Plaintiff the terms of the
9 settlement, the receipt of the settlement funds, nor did he
10 distribute the settlement funds to Plaintiff. Defendant instead
11 told Plaintiff that it would be paid in installments. Bank
12 records indicate that at this time Defendant's law firm was
13 experiencing financial problems and had numerous checks returned
14 due to insufficient funds in the firm's account.

15 Defendant used the settlement funds for his own purposes by
16 making payments out of his client trust account. He made a
17 \$53,493 payment on a personal loan. He transferred a total of a
18 \$36,500 to his law firm's accounts. He paid \$70,800 to a former
19 client, Woodside Commons, pursuant to a malpractice judgment.
20 By the end of June, Defendant had used all the settlement funds
21 without making a payment to Plaintiff, leaving the client trust
22 account with a balance of \$354.23.

23 Defendant claims that he did not distribute the full amount
24 of the funds to Plaintiff due to an offset arrangement, under
25 which Defendant would deduct from the settlement funds for
26 attorney's fees and other money owed by Plaintiff to Defendant's
27 law firm. Mark Hagen, a partner of Plaintiff Hagen & Sons,
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1 claims that he never discussed this offset arrangement with
2 Defendant.

3 Shortly after the settlement, Defendant sent several checks
4 to Plaintiff. Defendant tendered payments to Plaintiff in July
5 1993, December 1993, January 1994 and March 1994, which totaled
6 approximately \$100,000. However, only the January 1, 1994
7 payment of \$25,000 referenced the Kahn settlement. Plaintiff
8 claims that the payments represented money owed to it for
9 construction projects and that only the January 1 check was a
10 settlement payment from the Kahn matter. Defendant testifies
11 that these later payments reflected an agreement to reverse the
12 fee offset in order to help Plaintiff with its financial
13 troubles.

14 During this same period Defendant continued making
15 disbursements to other parties. Defendant made several payments
16 to McDow Electric, one of the other parties involved in the Kahn
17 litigation whom he represented. These checks specifically
18 referenced the Kahn matter.

19 In general, Defendant did not provide an accounting of
20 attorney's fees. In fact, Mark Hagen claimed that he never
21 received any billing statements from Defendant on the Kahn
22 matter. Mark Hagen requested an accounting of Defendant's
23 attorney fees and a copy of the settlement agreement, but
24 received no response. In April 1995, Defendant finally provided
25 an accounting to Plaintiff of the settlement funds, which
26 reflected the December and January payments and the setoff for
27 \$44,000 in attorney's fees.

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1 Defendant filed for chapter 11 bankruptcy on January 7,
2 1997. On or about March 18, 1997, Plaintiff filed an adversary
3 proceeding to determine the dischargeability of the debt owed to
4 it by Defendant. Plaintiff alleged in its Complaint and Pre-
5 Trial Statement that Defendant committed fraud, breached his
6 fiduciary duties to Plaintiff, breached an oral contract, and
7 committed legal malpractice. Defendant filed a counter-claim
8 based on negligence for construction services, which was
9 settled. Defendant is currently incarcerated for mail fraud and
10 wire fraud and has been disbarred.

11 The trial was held on July 15 and 16, 1999. At trial,
12 Plaintiff argued that Defendant had taken the settlement funds
13 that were owed to Plaintiff, deposited them in the client trust
14 account without informing the Plaintiff and proceeded to spend
15 those funds for his own purposes, thereby breaching his
16 fiduciary duty. Plaintiff claimed that it was owed \$146,000.83
17 remaining on the Kahn settlement plus \$61,000 interest.

18 **II. DISCUSSION**

19 In this action, Plaintiff prays for relief under §§
20 523(a)(4) and 523(a)(6). Section 523(a)(4) states that a
21 discharge under Chapter 7 does not discharge an individual
22 debtor from any debt for fraud or defalcation while acting in a
23 fiduciary capacity, embezzlement, or larceny. See 11 U.S.C. §
24 523(a)(4). In order to find a debt nondischargeable under §
25 523(a)(4), the creditor/plaintiff must show that the debt was
26 obtained through fraud or defalcation while acting as a
27 fiduciary, larceny or embezzlement. To establish a claim for
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1 fraud or defalcation under § 523(a)(4), a plaintiff must first
2 prove that a fiduciary relationship existed between the
3 plaintiff and the defendant, that the requisite trust
4 relationship existed prior to and without reference to the
5 wrongdoing, and that the defendant committed fraud or
6 defalcation while acting in a fiduciary capacity. See In re
7 Baird, 141 B.R. 198 (B.A.P. 9th Cir. 1990). Claims arising under
8 § 523 need only be proven by a preponderance of the evidence.
9 See Grogan v. Garner, 498 U.S. 279 (1991).

10 Plaintiff's complaint alleges only breach of fiduciary
11 duty, breach of oral contract, legal malpractice and fraud.
12 Although the Plaintiff does not use the word defalcation, this
13 court is not restricted by the four corners of the complaint.
14 See Jodoin v. Samyoa (In re Jodoin), 209 B.R. 132 (B.A.P. 9th
15 Cir. 1997)(affirming bankruptcy court's judgment for relief
16 based on Code section not mentioned in complaint). The court
17 has discretion to grant relief based on a theory not
18 specifically pled so long as the Defendant has ample notice of
19 the issue.

20 Procedurally, the court may, in certain circumstances,
21 grant relief not specifically sought. The court is obliged by
22 Federal Rule of Civil Procedure 54(c) and Bankruptcy Rule
23 7054(a) to award the party the relief to which the party is
24 entitled under the evidence introduced at trial, even if the
25 party has not demanded such relief in the pleadings. The key
26 qualification is that the failure to demand the appropriate
27 relief must not have prejudiced the adversary in the defense of
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1 the matter. See Samayoa v. Jodoin (In re Jodoin), 196 B.R. 845,
2 852 (Bankr. E.D. Cal. 1996), aff'd 209 B.R. 132 (B.A.P. 9th Cir.
3 1997).

4 Case law supports the court's ability to grant relief on
5 theories not explicitly stated in the pleadings. The 5th Circuit
6 Court of Appeals addressed the failure to specifically plead
7 defalcation in Schwager v. Fallas (In re Shwager), 121 F. 3d
8 177, 187 (5th Cir. 1997). In that case, the defendant argued
9 that the plaintiffs failed to raise defalcation as a ground for
10 dischargeability because they did not use the word "defalcation"
11 in their complaint. The court stated, "[defendant] had ample
12 notice of a defalcation claim because the [plaintiffs] pleaded §
13 523(a)(4) as a basis of nondischargeability." Id. at 187.

14 The 9th Circuit Bankruptcy Appellate Panel ("B.A.P.") has
15 concluded on a number of occasions that a debt may be found
16 nondischargeable, despite the fact that the specific grounds
17 were not raised in the complaint. The B.A.P. in In re Jodoin,
18 209 B.R. 132, 143 (B.A.P. 9th Cir. 1997), affirmed the bankruptcy
19 court's judgment that certain debts were nondischargeable under
20 § 523(a)(5), despite the fact that the complaint only stated a
21 cause of action under § 523(a)(15). The BAP found that the
22 defendant implicitly consented to the 523(a)(5) issue when he
23 failed to object to the reference to 523(a)(5) during trial and
24 to evidence offered in support of the 523(a)(5) determination.
25 Id. at 137. The B.A.P. made a similar determination in Sarbaz
26 v. Feldman (In re Sarbaz), 227 B.R. 298 (B.A.P. 9th Cir. 1998),
27 when it held that, since the defendant did not object to

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1 plaintiff's opening statement or evidence, the defendant
2 implicitly consented to a 523(a)(6) claim not raised in the
3 complaint. See also Talliant v. Kaufman(In re Talliant), 218
4 B.R. 58, 63 n. 9 (B.A.P. 9TH Cir. 1998)(affirming bankruptcy
5 court's finding of nondischargeability of a claim under §
6 523(a)(2), which was not alleged in the complaint, but raised at
7 trial without objection).

8 Based on the case law, the court finds that it may make a
9 determination of nondischargeability for defalcation under §
10 523(a)(4). There was no prejudice to Defendant as the pleadings
11 put him on notice that Plaintiff brought the claim for relief
12 under § 523(a)(4) and the evidence established Defendant's
13 fiduciary capacity and misappropriation and failure to account
14 for funds. Based on this reasoning, it is proper to examine the
15 elements of defalcation under 523(a)(4).

16 Defalcation consists of failing to produce funds while in a
17 fiduciary capacity. A debt is nondischargeable under §
18 523(a)(4) where "1) an express trust existed, 2)the debt was
19 caused by [fraud or] defalcation, and 3) the debtor acted as a
20 fiduciary to the creditor at the time the debt was created."
21 Otto v. Niles (In re Niles), 106 F.3d 1456, 1459 (9th Cir.
22 1997)(quoting Klingman v. Levinson, 831 F.2d 1292, 1295 (7th Cir.
23 1987)).

24 "Fiduciary" is a narrowly defined term in the bankruptcy
25 context. "[T]he fiduciary relationship must be one arising from
26 an express or technical trust that was imposed before and
27 without reference to the wrongdoing that caused the debt." In
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1 re Lewis, 97 F.3d 1182, 1185 (9th Cir. 1996). Although
2 determination of a fiduciary relationship for § 523(a)(4)
3 purposes is a question of federal law, this determination relies
4 upon the existence of an express or technical trust pursuant to
5 state law. See Ragsdale v. Haller, 780 F.2d 794 (9th Cir.
6 1986).

7 Although attorneys hold the position of fiduciaries of
8 their clients, more is required in order to be considered a
9 "fiduciary" for the purposes of 523(a)(4). "It is well
10 established in California that the relationship of attorney and
11 client is one of trust and confidence and that the attorney owes
12 to his client all of the obligations of a trustee." In re
13 Stokes, 142 B.R. 908, 909 (Bankr. N.D. Cal. 1992). However, the
14 attorney must hold the position of trustee of an actual or
15 express trust in order to be elevated to trustee status under
16 California law. See id. at 909.

17 Defendant occupied the position of trustee in relation to
18 the Attorney Trust Fund, in which he deposited the settlement
19 funds. Although, the attorney-client relationship generally
20 does not rise to the level of trustee, the one exception is the
21 relationship created by California Rule of Professional Conduct
22 4-100, which requires the creation of a separate client trust
23 account. See Stokes, 142 B.R. at 910 & n.3. Rule 4-100(A)
24 requires "[a]ll funds received or held for the benefit of
25 clients by a member or law firm, . . . shall be deposited in one
26 or more identifiable bank accounts labelled [sic.] 'Trust
27 Account,' 'Client's Funds Account' or words or similar import .
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1 . . .” This rule prohibits commingling of attorney funds with
2 the client trust funds and requires the attorney to notify the
3 client of the receipt of funds, maintain complete records and
4 provide an accounting to client and promptly pay or deliver any
5 funds the client is entitled to receive. See id. at 4-100(A) &
6 (B). The Bankruptcy Court for the Northern District of
7 California has interpreted this rule as elevating the attorney-
8 client relationship to one of trustee-beneficiary status. See
9 Stokes, 142 B.R. at 910 & n.3. This interpretation is similar
10 to that of courts in other states with similar rules. See, e.g.
11 Bennett v. Hollingsworth (In re Hollingsworth), 224 B.R. 822
12 (Bankr. M.D. Fla. 1998); Ball v. McDowell (In re McDowell), 162
13 B.R. 136 (Bankr. N.D. Ohio 1993); Ducey v. Doherty (In re
14 Ducey), 160 B.R. 465 (Bankr. D.N.H. 1993); People v. Kaemingk,
15 770 P.2d 1247 (Colo. 1989).

16 A trustee-beneficiary relationship existed between
17 Defendant and Plaintiff at the time Defendant received the
18 settlement funds. The \$171,089.83 deposit made up the trust res
19 in question. Defendant had a duty to act as a fiduciary with
20 respect to these funds under Rule 4-100. However, Defendant did
21 not act as a fiduciary with the settlement funds. Instead, he
22 used the funds to pay off his own debts as well as transferring
23 a portion of the funds to his law firm accounts.

24 The definition of defalcation is quite broad and
25 encompasses a number of misuses of funds, intentional or not.
26 Defalcation is defined as “the misappropriation of trust funds
27 or money held in any fiduciary capacity; the failure to properly
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1 account for such funds An individual may be liable for
2 defalcation without having the intent to defraud." In re Lewis,
3 97 F.3d 1182, 1186-87 (9th Cir. 1996). When Defendant received
4 the settlement funds, failed to notify Plaintiff and used the
5 funds for his own purposes he committed defalcation. Because
6 the debt is nondischargeable under § 523(a)(4), an analysis of
7 the claim for relief under § 523(a)(6) is unnecessary at this
8 time. The only remaining issue is to determine the measure of
9 damages.

10 Plaintiff requests compensatory damages equal to the amount
11 of settlement funds still owed to it, plus interest, as well as
12 punitive damages, recovery of Defendant's secret profits and
13 attorney's fees and costs.

14 Based on the evidence, it appears that Defendant made only
15 one payment to Plaintiff from the Kahn settlement. The January
16 1, 1994 check for \$25,000 expressly noted that it was for Kahn.
17 None of the other checks, written both before and after the
18 January 1994 payment for Kahn, referenced any specific matter.
19 The Plaintiff states that it assumed that these other checks
20 were for their construction services and the court finds that
21 assumption reasonable.

22 Defendant appears to have made a regular practice of
23 referencing matters when making payments from the client trust
24 account. The evidence indicates that when Defendant made
25 payments to McDow Electric pursuant to the Kahn settlement he
26 referenced the Kahn matter on the checks. If Defendant was
27 making payments to Plaintiff on the Kahn settlement he would
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1 have so noted as he did on the other checks. Accordingly,
2 Plaintiff is entitled to compensatory damages equal to the
3 remaining settlement funds, totaling \$146,089.83.

4 Plaintiff requests prejudgment interest on the compensatory
5 damages. Since this is a matter under federal statute the
6 determination of interest is governed by federal law. The award
7 of prejudgment interest under federal law is left to the sound
8 discretion of the trial court. See Acequia, Inc. v. Clinton, 34
9 F.3d 800, 818 (9th Cir. 1994). Although § 523(a)(4) does not
10 mention interest, the Supreme Court has held that "the failure
11 to mention interest in [federal] statutes which create
12 obligations has not been interpreted by this Court as
13 manifesting an unequivocal Congressional purpose that the
14 obligation shall not bear interest." Rodgers v. United States,
15 332 U.S. 371, 373 (1947). Prejudgment interest is computed at
16 the Federal Rate equal to the 52-week treasury bill rate. See
17 28 U.S.C. § 1961 (1991); Bequelin v. Volcano Vision, Inc. (In re
18 Bequelin), 220 B.R. 94 (B.A.P. 9th Cir. 1998). Since Defendant
19 was, in effect, withholding funds that belonged to Plaintiff, it
20 is appropriate that Plaintiff receive interest on its damages
21 from the time the settlement check was deposited on June 17,
22 1993 until the date of this judgment.

23 The award of punitive damages by a bankruptcy court is an
24 issue involving federal law. It is clear that a bankruptcy
25 court may award punitive damages under § 523. See Cohen v. De
26 La Cruz, 523 U.S. 213 (1998) (affirming award of punitive
27 damages under 523(a)(2)); Bugna v. MacArthur (In re Bugna), 33
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1 F.3d 1054, 1059 (9th Cir. 1994) (barring discharge of punitive
2 damages under 523(a)(4)); Klause v. Thompson (In re Klause), 181
3 B.R. 487, 492 (Bankr. C.D. Cal. 1995) (citing In re Adams, 761
4 F.2d 1422 (9th Cir. 1985)). Bankruptcy courts look to state law
5 for guidance in awarding punitive damages. See Klause, 181 B.R.
6 at 492; Sunclipse, Inc. v. Butcher (In re Butcher), 200 B.R.
7 675, 678-79 (Bankr. C.D. Cal. 1996).

8 California Civil Code § 3294(a) provides for punitive
9 damages for "oppression, fraud, or malice." Under § 3294,
10 Plaintiff must prove, by clear and convincing evidence, that
11 Defendant's conduct was fraudulent, oppressive, or malicious.
12 Section 3294(c)(1) defines malice as "conduct which is intended
13 by the defendant to cause injury to the plaintiff or despicable
14 conduct which is carried on by the defendant with a willful and
15 conscious disregard of the rights or safety of others."
16 Plaintiff failed to meet the elements of fraud and offered no
17 evidence that Defendant intended to inflict injury on Plaintiff.
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19 Policy reasons further illustrate that punitive damages
20 would be inappropriate in this case. Punitive damages are
21 imposed to deter future misconduct by the defendant. See Adams
22 v. Murakami, 54 Cal. 3d 105, 110 (1991). Defendant is currently
23 incarcerated for conduct similar to the conduct at issue in this
24 proceeding. An award of punitive damages will not provide
25 significantly more deterrence than imprisonment. Similarly, the
26 court takes into consideration the defendant's wealth in setting
27 an award of punitive damages. See Professional Seminar
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1 Consultants, Inc. v. Sino Am. Technology Exch. Council, Inc.,
2 727 F.2d 1470, 1473 (9th Cir. 1984). Defendant in this case is
3 in bankruptcy, is imprisoned and has been disbarred by the
4 California State Bar. Based on the nature of Defendant's acts,
5 the amount of compensatory damages, and Defendant's current and
6 potential wealth, punitive damages seem improper in this case.

7 Plaintiff also requests damages in the form of attorney's
8 fees and costs. An award of attorney's fees and costs in this
9 type of action is proper and will be granted. See Cohen v. De
10 La Cruz, 523 U.S. 213 (1998). Plaintiff also requests
11 Defendant's secret profits. However, Plaintiff offered no
12 evidence that Defendant profited from this misappropriation of
13 funds. On the contrary, it appears that Defendant was only
14 trying to keep his practice afloat. The request for attorney's
15 fees and secret profits is denied.

16 The Court finds that Defendant's debt to Plaintiff of
17 \$146,089.83 is nondischargeable under § 523(a)(4) for
18 defalcation. The Court also awards pre-judgment interest on the
19 damages and attorney's fees and litigation costs.

20 The foregoing shall constitute the court's findings of fact
21 and conclusions of law pursuant to Bankruptcy Rule 7052 and
22 Federal Rule 52.

23 Counsel for Plaintiff shall lodge a proposed form of
24 judgment with the court within 15 days. It need not contain the
25 findings and conclusions which the court has made orally on the
26 record.

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