11 USC § 523(a)(2)(A)
Attorney/Client
Failure to disclose

Clearspring Trust v. Patrick, Adversary No. 02-6092-fra
Clayton Patrick and Mary Muller, Case No. 601-69644-fra7

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Michael Tandy and Susan Quan are the trustees and beneficiaries of the plaintiff trust. Tandy and the Defendant Patrick had been friends since they attended law school together in the mid 60's. Tandy practiced law for a few years and then moved on to other pursuits. Patrick moved to Oregon after law school and practiced law. Beginning in 1991 and continuing for a number of years, Tandy or his trust made a series of loans to Patrick which, by June 1998, totaled $313,684. The note documenting the first loan was prepared by Patrick. Subsequent notes were generally prepared by Tandy using the original form, making any adjustments agreed to by the parties. In 1998, a note was prepared monumenting the entire amount then due. Patrick filed bankruptcy in December 2001 and Tandy filed this adversary proceeding seeking a declaration that the debt is nondischargeable under Code § 523(a)(2)(A).

The Ninth Circuit has held that nondisclosure of a material fact in the face of a duty to disclose can establish the requisite reliance and causation for actual fraud. Oregon State Bar disciplinary rules require that an attorney may not enter into a business transaction with a client unless the client consents after full disclosure. Full disclosure would require an explanation of the potential adverse impact on the client and a recommendation that the client seek independent legal advice. Tandy argued that Patrick established an attorney/client relationship with him as far back as 1973 when they had a conversation about Tandy’s pending divorce. Patrick’s failure to make required disclosures prior to the loan transactions would, therefore, constitute fraud under Code § 523(a)(2)(A). Patrick denied that an attorney/client relationship ever existed.

The court determined that there was sufficient evidence produced at trial to establish that an attorney/client relationship existed in 1997 when Patrick prepared documents for Tandy’s loans to third parties. Reliance and causation were therefore deemed established due to Patrick’s failure to make the required disclosures, which the court found to be material. Intent was established by circumstantial evidence. All loans made after the date that an attorney/client relationship was formed were held to be nondischargeable. The court did not accept the

argument made by Plaintiff that the entire amount due should be excepted from discharge because the loan made in 1998 monumenting the entire amount then due was made after the attorney/client relationship was formed. It likened the loan to the settlement of a preexisting debt and, based on the reasoning in a recent Supreme Court case, held that the debt was only nondischargeable to the extent of the underlying fraud.

UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF OREGON

In Re:	)	Bankruptcy Case No. 601-69644-fra7
CLAYTON C. PATRICK and MARY M. MULLER,	)	
Debtors.	)	
CLEARSPRING TRUST; MICHAEL K. TANDY; and SUSAN A. QUAN,	)	Adversary Proceeding No. 02-6092-fra
Plaintiffs,	)	
vs.	)	
CLAYTON C. PATRICK,	)	
Defendant.	)	MEMORANDUM OPINION

I. INTRODUCTION

In this dispute between two long-time friends, the Court finds that Defendant, a practicing attorney, had a professional duty to make certain disclosures to the Plaintiff once the professional relationship arose. His failure to do so operates to except from discharge obligations incurred after the professional relationship was established.

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II. FACTS

Plaintiff Clearspring Trust is a California trust created May 19, 1997 by Susan Ann Quan and Michael Tandy to manage Quan and Tandy's personal funds. Quan and Tandy are the trustees and beneficiaries. Some of the debts discussed in this opinion were originally loans by Quan and/or Tandy individually, or the Quan/Tandy Trust, a predecessor to the Plaintiff trust. However, all obligations arising out of those transactions were transferred to, and are now held by, the Plaintiff trust. While the Clearspring Trust is the nominal plaintiff, it was stipulated at trial that the actual parties in interest are Quan and Tandy, as trustees, and that the case caption should be modified accordingly.

Defendants Clayton Patrick and Mary Muller are husband and wife. Mr. Patrick is a practicing attorney in Marion County, Oregon. At the conclusion of the Plaintiff's case in chief, the Court found that there was no evidence to sustain Plaintiff's claim against Ms. Muller, and allowed her motion to dismiss the complaint.

Mr. Tandy and Mr. Patrick first met as law students in the mid-sixties. They became fast friends almost immediately, and, as years of correspondence reflects, remained close for many years thereafter.

After they graduated, Mr. Patrick moved north to start a private practice in Oregon. Mr. Tandy remained in California, where he spent a few years as a deputy prosecutor. After that he left the law for other pursuits. Over the years the two socialized and corresponded frequently, often by e-mail.

In time, Mr. Patrick began to encounter financial difficulties, apparently because his practice was not succeeding as well as he might have hoped. In June 1991, there began a series of loans from Tandy, or his trust, to Mr. Patrick. The first loan was a relatively modest $5,000. Within three years, sums as large as $30,000-$40,000 were being advanced.[1] By June of 1998, the total amount owed, including accrued interest, had grown to $313,684. At that time the parties agreed that Mr. Patrick and Ms. Muller would execute and deliver a promissory note payable to the trust, or its order, in that amount. The note would bear interest at 11.5%. The note provided that

> At the option of the promisee, all present and future outstanding notes by these promisors naming this promisee may be treated as a whole. All promisee's rights included in any unretired notes (or connected security agreements and collateral documents) existing between these parties or their beneficiaries or successors in interest may be incorporated into any such note. (This paragraph shall not apply to rate of interest nor amount of principal.) Promisee may treat default on any note as a default on any or all notes.

The first note issued in connection with these loans, in 1991, was drafted by Mr. Patrick. Notes documenting subsequent advances were generally prepared by Mr. Tandy, using Mr. Patrick's original form, together with any changes the two had agreed on.

As might be expected from two law school friends, Tandy's and Patrick's conversations and correspondence often turned to legal matters, including discussions about a dispute between Mr. Tandy and

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[1] The parties stipulated that the best evidence of the amounts and dates of disbursal is Plaintiff's Exhibit A.

his neighbors, and Mr. Tandy's divorce proceedings in 1973. The parties have different views over the extent of Mr. Patrick's involvement in these matters, but it does not appear that he participated to the extent that a reasonable person would conclude that he was actually representing Mr. Tandy as his attorney. This is particularly so in light of the fact that these controversies took place in California, while Mr. Patrick was licensed and practicing in Oregon.

By 1993 Tandy began to make loans to people other than Patrick. It is not clear which of the two (or, for that matter, a third party) came up with the idea. Whoever first thought of it, Patrick located potential borrowers amongst his colleagues and acquaintances in Oregon. The first of these were Nancy and Kristofer Neslund. In May of 1993 the Neslunds borrowed $55,000 from the Tandy/Quan trust. The loan was secured by real property owned by the Neslunds, and was eventually paid in full. Tandy asserted in his testimony that Patrick had drafted the promissory note and mortgage issued in connection with the Neslund loan. Patrick denies any such involvement. Mr. Patrick's memory notwithstanding, there was evidence produced which suggests that he was involved, if not at the outset, then later on, when he prepared release documents after the loan had been paid. In a letter dated May 16, 1995, Nancy Neslund wrote to Tandy and Quan, enclosing a satisfaction and release of mortgage which she had drafted and submitted in lieu of one drafted by Mr. Patrick. This suggests that Patrick was involved in the transaction, and performing duties

ordinarily performed by attorneys. However, the evidence presented is insufficient to establish by a preponderance that Mr. Patrick was acting in this transaction as Tandy's attorney.

In January 1997, the Tandy/Quan trust lent $25,000 to Timothy and Kimberly Holman. The Holmans were clients of Mr. Patrick, which Mr. Tandy knew at the time. Mr. Patrick personally guaranteed payment of the loan. He also acted as the lender's attorney: for example, Patrick wrote to the escrow company in Vancouver, Washington on March 10, 1997, advising that he represented the Tandy/Quan trust, holder of a second mortgage on certain real property. On February 14, 1997, Mr. Patrick wrote to Mr. Tandy referring to loan documents he had prepared and to legal actions he would take regarding the loan. The Holman loan was also paid in full.

A third loan from Tandy to a Patrick acquaintance was a loan to a Mr. Meadowbrook, who, for a time, was Mr. Patrick's law partner. This loan was also secured, and paid in full.

As noted, by June 1, 1998 the total amount owed by Mr. Patrick to the trust or its predecessors was $313,684, and was monumented by the promissory note described above. The final addition to the principal debt was made in August of 2000, when $10,000 was lent. From the time of the original loan through December of 2001, Patrick made payments of nearly $300,000. It is not clear how the payments were allocated between principal and interest.

Throughout this time Mr. Patrick would, in correspondence with Mr. Tandy, write of his efforts to improve his financial condition, and his efforts to pay the loans.

III. ISSUES

Plaintiffs assert that, throughout the parties' dealings with each other, Patrick acted as their attorney. Given the attorney/client relationship, Patrick was obligated under the Oregon State Bar's Rules of Professional Responsibility to advise Plaintiffs that they should seek independent counsel before entering into any sort of business transaction with Patrick. His failure to give that advice constitutes, in Plaintiffs' view, a material misrepresentation made in connection with the loans. The loans should, therefore, be excepted from discharge under the Bankruptcy Code. § 523(a)(2)(A).

Plaintiffs further assert that the misrepresentation applied to the 1998 note, and that the entire debt reflected by the note is excepted from discharge.

Patrick does not deny that he never made the disclosures contemplated by Oregon's Professional Rules. His position is that the professional relationship giving rise to such an obligation never arose, and that the loans were the result not of any professional relationship, but the personal one existing between the parties.

The issues before the Court now are:

1. Whether Mr. Patrick and Mr. Tandy had an attorney/client relationship giving rise to a duty by Patrick to disclose that the

business relationship was adverse, and admonish Tandy to seek independent legal advice;

2. If such a duty existed, the time it arose;

3. The effect of the failure to make the disclosure; and

4. The effect of the new note.

IV. ANALYSIS

A. *Statutory Provisions*

1. Bankruptcy Code § 523(a)(2)(A)

Bankruptcy Code § 523(a)(2)(A) provides that:

> (a) A discharge under section 727. . .of this title does not discharge an individual debtor from any debt –
>
> . . .
>
> (2) for money. . .to the extent obtained by –
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or insider's financial condition. . . .

In order to except a debt from discharge, the creditor must prove by a preponderance of the evidence:

(1) That the debtor made a representation;

(2) The debtor knew at the time the representation was false;

(3) The debtor made the representation with the intention and purpose of deceiving the creditor;

(4) The creditor relied on the representation; and

(5) The creditor sustained damage as the proximate result of the representation. In re Apte, 96 F.3d 1319, 1322 (9th Cir. 1996), In re Tallant, 218 B.R. 58 (9th Cir. BAP 1998).

2. Oregon Code of Professional Responsibility

Members of the Oregon State Bar are governed by a Code of Professional Responsibility formulated by the State Bar's Board of Governors, and adopted by the State Supreme Court. ORS 9.490. Provisions of the Oregon Code, referred to as "disciplinary rules," of interest here:

> D.R. 5-104(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 the lawyer's professional judgment therein for the protection of the client, unless the client has consented after full disclosure.
>
> D.R. 10-101 Definitions:
> . . .
>
> (B)(1) "Full disclosure" means an explanation sufficient to apprise the recipient of the potential adverse impact on the recipient, of the matter to which the recipient is asked to consent.
>
> (2) As used in. . .D.R.5-104. . .or when a conflict of interest may be present in D.R.4-101, "full disclosure" shall also include a recommendation that the recipient seek independent legal advice to determine if consent should be given and shall be contemporaneously confirmed in writing.

B. Effect of Failure to Disclose

It is the relationship between parties as lawyer and client which gives rise to the duty to disclose, not simply the fact that one of the parties is a lawyer. Mr. Patrick's active involvement as an attorney in the Holman loan and subsequent transactions gave rise to a duty to make the disclosures to Quan and Tandy required by D.R. 5-104 and 10-101. There is no exception in the Code of Professional Responsibility for pre-existing personal relationships: indeed, it

is just that sort of situation where the lawyer's duty to disclose may be most important. In addition, there is nothing in the Code of Professional Responsibility which relates the business transaction to the professional relationship. In other words, it does not matter if the attorney/client relationship existed in a context separate from the business relationship. An attorney who chooses to do business with a client has a duty to disclose, even if the new business is totally unrelated to the subject matter of the representation. The disclosure must, at least, point out that the parties' business and legal interests are, or may be, adverse, and that the client should seek independent legal advice.

It is well established that borrowing money from a client constitutes a business transaction with the client for the purposes of the Code of Professional Responsibility, and that the interest of the attorney/borrower and client/lender "differ." In re Luebke, 301 Or. 321, 722 P.2d 1221 (1986). The professional relationship, and the duties derived therefrom, are not altered by the fact that the parties involved may be friends. In re Germundeson, 301 Or. 656, 724 P.2d 793 (1986). See generally, Oregon State Bar Formal Opinion No. 1991-32.

Clearly, by February 14, 1997, Patrick had a duty to advise Tandy prior to borrowing any more money from him that his interest and Tandy's were opposed, that certain risks were or might exist for Tandy in the transaction, and that Tandy should seek independent legal advice before proceeding. No such disclosure was made. A preponderance of the evidence establishes that Tandy expected

Patrick to use legal judgment to protect his and Quan's interest. Patrick denies that he served, or intended to serve, as Tandy's attorney; however, Patrick's intention or belief is immaterial: the duty to disclose is based on the *client's* expectations, and a lawyer fails to understand such expectations at his peril. No doubt the expectations must be reasonable, and based on some objective circumstance. Tandy's expectations in this case were reasonable, and should have been apprehended by Patrick in light of activities such as drafting documents and representing himself to third parties as Tandy's attorney.

A failure to disclose material information that an individual has a duty to disclose can constitute a fraudulent misrepresentation for the purposes of Code § 523(a)(2)(A). Apte, 96 F.3d 1319, 1323(9th Cir. 1996). Moreover, the elements of reliance and proximate cause, in cases involving non-disclosure of material facts, are established not by actual reliance on the part of the deceived party, but by the materiality of the information withheld. Id.

The requirement that the debtor knew that the representation was false is satisfied in non-disclosure cases by defendant's knowledge that the disclosure was required. Oregon law requires all members of the Oregon State Bar to comply with the Code of Professional Responsibility, and knowledge of the various disciplinary rules is imputed to Bar members as a matter of law. A lawyer cannot escape the consequences of failing to make mandatory

disclosures by pleading that he was ignorant of the requirement, or of his activities which put the requirement into play.

In Tallant, a case with facts similar to this one, the Panel noted that it is particularly difficult for a plaintiff to prove how he might have acted had the omitted material information been provided. Citing to Apte, 96 F.3d at 1323, the Panel noted that

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material . . .this obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Tallant, 218 B.R. at 68.

If a Plaintiff is not required to prove his state of mind at the time information is withheld from him, the test of materiality may be an objective one: information is deemed material if a reasonable person would have taken it into account in deciding whether to proceed with the transaction. See Apte at 1323 [internal citation omitted]. The advice that the party's interests are adverse, and that independent legal representation should be sought, is clearly material since it puts the recipient on notice that the lawyer's full attention and talent may not be applied to the recipient's advantage.

C. Defendant's Intentions

The Debtor's intent to deceive a creditor by withholding material information may be inferred from the totality of the circumstances. In re Young, 91 F.3d 1367, 1375 (10th Cir. 1996); In re Tallant, 218 B.R. at 65. The intent to deceive may be found

where the defendant withholds information lest the plaintiff reconsider or reject a course of action that the defendant wishes him to take. See generally, In re Tallant, 218 B.R. at 66.

The evidence established that, among other things:

1. Patrick relied on his long-term relationship with Tandy to obtain loans from him;

2. Patrick had a duty on several occasions to advise Tandy to seek independent advice, and failed to do so each time;

3. Patrick continually advised Tandy that his financial condition was improving, but failed to advise Tandy to get outside advice, knowing that such advice might have been to urge Tandy to verify the information.

4. Patrick failed to advise Tandy as to whether the final loan should be secured, as several previous ones were, and of the fact that anyone providing competent independent counsel might have counseled Patrick concerning the risk of further extensions of unsecured credit.

Patrick knew, or should have known, that he had a duty to disclose. He chose not to do so on more than one occasion. The information to be disclosed included advice to seek advice which might have induced Tandy to decline further credit, at least on the favorable terms proposed by Patrick. The Court concludes that his failure to disclose was intended to deny to Tandy information that might have benefitted him. See, In re Tallant, 207 B.R. 923, 932 (Bankr. E.D. Ca. 1997), aff'd 218 B.R. 58 (9th Cir. BAP 1998).

D. *Effect of 1998 Promissory Note*

As stated earlier, a promissory note was executed in 1998 between Patrick and Plaintiffs monumenting the entire amount then due under all previous loans. Plaintiffs argue that because Patrick had, by 1998, established an attorney/client relationship with Plaintiffs, Patrick's misrepresentation regarding his failure to make proper disclosures applies to the entire amount due under the 1998 note.

An analogous situation exists where an agreement is entered into between a debtor and a creditor in settlement of a pre-existing debt based on fraud. In that situation, the question arises as to whether the court should look only to the new agreement to determine the extent to which the debt was obtained by fraud for purposes of Code § 523(a)(2), or whether the court should look to the underlying debt. In Archer v. Warner, 123 S.Ct. 1462 (2003), the Supreme Court held that the debt represented by the settlement agreement may be found to be nondischargeable under Code § 523(a)(2) to the extent it arises out of the underlying fraud.

In this case, the 1998 promissory note is analogous to an agreement settling a pre-existing debt. Even if the earlier debt may be released by the superceding one[2], Archer instructs us to find that the later debt was obtained by "false pretenses, a false representation, or actual fraud" to the extent the underlying debt was so based. Accordingly, the debt represented by the 1998

[2] The language of the 1998 note quoted above suggests that it was not.

promissory note is nondischargeable under Code § 523(a)(2)(A) only to the extent the underlying debt would be nondischargeable.

V. CONCLUSION

After Patrick undertook to provide legal services to Tandy, there ensued a professional relationship which required Patrick to make certain disclosures to Tandy before borrowing any more money from him. This he failed to do. Accordingly, any debt owed by Patrick to Plaintiff based on advances of funds on or after February 14, 1997, and any accrued interest thereon, is excepted from discharge.

The complaint does not seek a judgment liquidating the debt, or determining the dollar amount excepted from discharge, and the Court will not undertake to do so on this record.

This opinion constitutes the Court's findings of fact and conclusions of law. Counsel for Plaintiff shall submit a form of judgment consistent with this opinion.

FRANK R. ALLEY, III
Bankruptcy Judge