No. 11-1518

In The Supreme Court of the United States

RANDY CURTIS BULLOCK,

Petitioner,

v.

BANKCHAMPAIGN, N.A.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF FOR PETITIONER

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QUESTIONS PRESENTED

What degree of misconduct by a trustee constitutes "defalcation" under § 523(a)(4) of the Bankruptcy Code that disqualifies the errant trustee's resulting debt from a bankruptcy discharge—and does it include actions that resulted in no loss of trust property?

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The opinion of the court of appeals is reported at 670 F.3d 1160 (11th Cir. 2012). Pet. App. 1a–14a. The respective memorandum opinions of the district and bankruptcy courts for the Northern District of Alabama are unreported. Pet. App. 16a–28a, 29a–44a.

JURISDICTION

The judgment of the court of appeals was entered on February 14, 2012. The court denied rehearing on March 16, 2012. Pet. App. 15a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 523 of the United States Bankruptcy Code provides: "(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . ."

STATEMENT OF THE CASE

1. This case began as a dispute among family members over administration of the father's life insurance trust and ultimately resulted in the Chapter 7 bankruptcy of one of the children, petitioner Randy

Curtis Bullock, who had been appointed by his father as trustee. Petitioner's father, Curt Bullock, created the trust, the Curt Bullock Trust No. 2, in 1978. The trust's sole asset was the father's life insurance policy, which featured a $1 million death benefit and accumulated cash value. Petitioner and his siblings were named as beneficiaries. Until his father approached him about a loan from the trust, petitioner did not know that he was the trustee. In fact, neither he nor any of his four siblings was aware that the trust existed. Pet. App. 45a.

2. The dispute involved three loans taken against the cash value of the life insurance policy. All three loans were repaid in full, with six percent interest. Pet. App. 17a, 45a, 50a. The first loan, for $117,545.96, was made in 1981 at the request of petitioner's father, the settlor of the trust. The loan went to petitioner's mother, Imogene Bullock, so that she could repay a debt that she owed to the family garage-construction business. Pet. App. 2a; RE, Vol. 1, Tab M, Exs. 1 & 2.[1] The second loan, for $80,257.04, was made in 1984 to petitioner and his mother. The loan proceeds were used to purchase certificates of deposit, which later were cashed and used, along with other funds, to purchase a garage-fabrication mill in Springfield, Ohio, for approximately $200,000.00. Pet. App. 2a. The third loan, for $66,223.96, was made in 1990 to

[1] The abbreviation "RE" refers to record excerpts filed in the Eleventh Circuit.

petitioner and his mother and used in the purchase of an office building and other Springfield real estate. Pet. App. 2a. The loans, totaling $264,026.96, were secured by first mortgages on property appraised for approximately $477,000.00. RE, Vol. 1, Tab M, Exs. 8 & 9. Payments were made on the loans for 13 years. RE, Vol. 2, Ex. 18. Relying on the insurance agent who sold his father the policy and advised him on creation of the trust, petitioner did not believe the loans were improper and regarded them as safe investments of the cash value. RE, Vol. 1, Tab M at 13–14. The trust instrument itself did not expressly prohibit transactions with family members or with the trustee.

3. Petitioner resigned as the trustee for the trust in 1998 at the request of some of the beneficiaries. *Id.* at 2. Respondent, BankChampaign, N.A., was designated successor trustee. Within a few months after resigning, petitioner paid the remaining balance of the loans, with interest. *Id.* The payments made on the loans by petitioner and his mother totaled $455,440.76. *Id.* The trust's sole asset, the life insurance policy, had the same value it had when the trust was created. RE, Vol. 2, Ex. 18.

4. In 1999, two of the five beneficiaries of the trust, petitioner's two brothers, filed an action in the Circuit Court of Vermilion County, Illinois, asserting claims that petitioner breached his fiduciary duty as trustee of the Curt Bullock Trust. Petitioner's brothers claimed that any profits earned by petitioner and his mother as a result of the loans should be

turned over to the trust. The action also named as defendants other businesses in which petitioner had an interest and sought a constructive trust on all profits, proceeds, and assets obtained by petitioner and the other defendants. Pet. App. 47a.

5. In 2002, the Illinois court found that petitioner did "not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a. The court also found that petitioner "has shown his willingness to make the Trust whole by a pattern of payments he has made to repay the loans from the Trust." *Id.* The court made no other finding concerning petitioner's intent, knowledge, purpose, or state of mind. The court found that the trust did not earn any profit on the loans, which were repaid at the same interest rate charged by the insurance company for the loans of the policy's cash value. But the court granted summary judgment in favor of petitioner's brothers because the fully repaid loans were deemed self-dealing transactions and thus breaches of fiduciary duty under Illinois law. Pet. App. 57a. The court awarded damages to the trust of $250,000, which the court estimated to be the benefit obtained by petitioner from the breaches of duty, though characterizing the "actual monetary benefit" as "difficult to ascertain." Pet. App. 46a. The court added an award of $35,000 in attorneys' fees to the trust, $25,000 of which respondent, as successor trustee, was directed to pay to the two brothers who commenced the action. Pet. App. 47a–49a.

6. The Illinois court also imposed a constructive trust on the assets of petitioner and of two affiliated entities in the amount of the judgment against petitioner. The constructive trust expressly included the Springfield mill property and petitioner's beneficial interest in the Curt Bullock Trust. Pet. App. 47a–48a. The effect of this order was to put petitioner's assets, which he might have used toward payment of the judgment, in respondent's control. Over the years following entry of the Illinois judgment in 2002, respondent rejected petitioner's repeated pleas and demands that the property subject to the constructive trust be liquidated to pay the judgment. RE, Vol. 1, Tab M at 3, 15–18.

7. On October 21, 2009, petitioner filed for bankruptcy under Chapter 7 of the Bankruptcy Code seeking a discharge of his debts. Respondent, as successor trustee of the Curt Bullock Trust, filed an adversary proceeding on January 11, 2010, to obtain a ruling excepting petitioner's obligations under the Illinois judgment from discharge under 11 U.S.C. § 523(a)(4). Petitioner answered and, though not a lawyer, defended himself *pro se* in the adversary proceeding. Respondent filed a motion for summary judgment contending that petitioner should be collaterally estopped from contesting issues that were decided by the Illinois court and that the Illinois court's judgment established § 523(a)(4) "defalcation" as a matter of law. Respondent submitted no other evidence in support of the motion, which the bankruptcy court granted. Pet. App. 29a–44a. Though

sharply criticizing respondent for its own administration of the trust, the district court affirmed in an unpublished order. Pet. App. 16a–28a.

8. On further appeal, the United States Court of Appeals for the Eleventh Circuit acknowledged a split among the circuits as to the definition of "defalcation." The court aligned itself with the Fifth, Sixth, and Seventh Circuits to hold that "defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless." Pet. App. 10a–11a. The Eleventh Circuit deemed "self-dealing" to be objectively reckless and from that concluded that petitioner's actions amounted to defalcation sufficient to except petitioner's debt from discharge. Pet. App. 11a.

SUMMARY OF ARGUMENT

I.–III. For more than a century, the Court has resisted attempts to broaden the discharge exception that is now found in 11 U.S.C. § 523(a)(4), consistent with the principle that exceptions of particular debts from bankruptcy discharge should be restricted to those plainly expressed. The Court has held that fiduciary fraud, also excepted from discharge by § 523(a)(4), requires a showing of moral turpitude or intentional wrong, not merely constructive fraud. Embezzlement and larceny, the other offenses specified in the section, also require criminal intent. "Defalcation" has never been defined in the statute

and is not a term in common or ordinary use. Under the interpretive maxim *noscitur a sociis*, however, the fact that "several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well." *Beecham v. United States*, 511 U.S. 368, 371 (1994). No reason exists to withhold bankruptcy relief for fiduciary debts that arise from circumstances lacking the degree of culpability commensurate with fraud, embezzlement, and larceny.

The First and Second Circuits' requirement of conscious misbehavior or extreme recklessness, drawing from the scienter requirement of securities law, is the most faithful to the statutory context and overall objectives of bankruptcy law, particularly the paramount "fresh start" policy. As to petitioner's mental state here, there is no indication, much less any finding, that petitioner *knew* that the three loans, made from his father's *inter vivos* life insurance trust and ultimately repaid, were improper. The loans were made in accordance with the wishes of one or both of his parents. The Eleventh Circuit erred in conclusively presuming, in effect, that he did know he was committing a breach of trust, without considering the actual evidence that he did not.

Respondent sought summary judgment relying exclusively on the findings in the underlying state court action. But there was no state court finding that petitioner acted with a culpable mental state. The *only* express judicial finding concerning petitioner's mental state was that he did not appear to have a

malicious motive in borrowing funds from the trust. The burden to produce evidence of the requisite mental state was at all times on respondent. Respondent could have attempted to offer other evidence, *Brown v. Felsen*, 442 U.S. 127, 138–39 (1979), but offered none. Accordingly, petitioner was not shown to have acted with the requisite mental state to have been found to have committed a discharge-ineligible "defalcation."

IV. Mental state aside, a "failure to account" for entrusted property or a "shortage in accounts" is an element that must be proven to establish the exception. This requirement is consistent with dictionary definitions of "defalcation" likely available at the time of enactment of the 1841 Act, which introduced the term into bankruptcy law. And the deletion of "misappropriation" from the 1978 Act reinforces the interpretation that misappropriations that do not ultimately result in a shortage in accounts do not fall within § 523(a)(4). There was no proof of a failure to account for trust property in petitioner's case. The loans were repaid with interest. There was no loss of the trust principal. When petitioner resigned as trustee, the net policy value of the trust's only asset was the same as when his tenure began. The debt sought to be discharged was not based on any calculation of a loss to the trust but was instead only an unexplained estimate of the benefit he received. This does not amount to "defalcation" within the meaning of § 523(a)(4).

ARGUMENT

I. Exceptions of Debts from Discharge Are Construed to Safeguard the "Fresh Start" That Is the Primary Objective of Individual Bankruptcy.

The Court has posited that the exceptions of particular debts from bankruptcy discharge "should be confined to those plainly expressed." *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998) (quoting *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)). This admonition reinforces the Bankruptcy Code's "fresh start" policy, a foundation of bankruptcy law: "One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.'" *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554–55 (1915)). *See* 4 COLLIER ON BANKRUPTCY ¶ 523.05 (16th ed. 2012) ("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.").

The current discharge-exception provision, 11 U.S.C. § 523(a), is basically divisible into two groups of exceptions. *See Grogan v. Garner*, 498 U.S. 279, 287–88 (1991). The first group consists of debts that are *per se* non-dischargeable for various policy reasons: certain taxes, domestic support obligations, educational loans, restitution orders, and the like. The

second group of non-dischargeable debts are the products of wrongdoing, including debts resulting from willful and malicious injury, § 523(a)(6); fraud or certain false representations, § 523(a)(2); and death or injury caused by driving while intoxicated, § 523(a)(9). In this second group is § 523(a)(4)'s exception "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."[2]

In *Geiger*, the Court considered the proper interpretation of § 523(a)(6), which excludes from discharge any debt "for willful and malicious injury by the debtor to another." 11 U.S.C. § 523(a)(6). The debt in question was a medical malpractice judgment attributable to the debtor's negligent or reckless conduct. The Court held unanimously that the exception covered only acts done with actual intent to cause injury and not all deliberate or intentional acts that lead to injury. Not every intentional tort, the Court held, is excepted from bankruptcy discharge. *Geiger*, 523 U.S. at 64. The Court noted that the judgment creditor's broader proposed interpretation would except even knowing breaches of contract from discharge and found so expansive an interpretation to

[2] Section 523(a)(11) includes a parallel exception from discharge of debts created by judgments, orders, or settlements "arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. § 523(a)(11). This exception was added in 1990 in reaction to the savings and loan crisis. *See* Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 370 n.363 (1991).

clash with *Gleason*'s longstanding rule of narrow construction for exceptions to discharge. *Id*. at 61–62. The Court also pointed out that a broader interpretation would render other portions of § 523 superfluous. *Id.* at 62.

II. The Court Has Repeatedly Resisted Expansion of the Defalcation Exception, but Has Not Addressed the Question Presented.

The term "defalcation" first appeared in the Bankruptcy Act of 1841. Since then, the Court has consistently deflected efforts to expand the reach of the provision in which it appears. The 1841 provision excluded from eligibility for discharge debts "created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity." Act of Aug. 19, 1841, ch. 9, 5 Stat. 441 (repealed 1843). Construing the statute in *Chapman v. Forsyth*, 43 U.S. (2 How.) 202 (1844), the Court held that a debtor could obtain discharge of non-fiduciary debts even if he also owed non-dischargeable debts that were incurred through defalcation as a public officer or trustee. *Id.* at 208. The Court further held that the debt of a factor who wrongfully retained the money of his principal was a non-fiduciary debt that was eligible for bankruptcy discharge. "The act speaks of technical trusts, and not those which the law implies from the contract. A factor is not, therefore, within the act." *Id.*

In 1867, Congress enacted a new bankruptcy law that excepted from discharge any "debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533 (repealed 1878). Construing this provision in *Neal v. Clark*, 95 U.S. 704 (1877) (Harlan, J.), the Court held that a debt created by the "fraud" of the bankrupt

> means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality. Such a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency. A different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt system.

Id. at 709. The Court rejected the view that constructive fraud or gross negligence fell within the exception. Citing the interpretive maxim *noscitur a sociis*, the Court reasoned that "the meaning of a word may be ascertained by reference to the meaning of words associated with it," *id.* at 708, and that the association of "fraud" with "embezzlement" must mean that actual fraud was required by the statute. *Id.* at 709. *See also Upshur v. Briscoe*, 138 U.S. 365 (1891) (under 1867 Act, failure to pay interest under trust

arrangement not breach of technical trust triggering exception); *Hennequin v. Clews*, 111 U.S. 676 (1884) (failure of lender to return collateral was breach of contract, not breach of trust excepted from discharge).

The next comprehensive bankruptcy statute, the Bankruptcy Act of 1898, deemed non-dischargeable those debts "created by . . . fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550–51 (repealed 1979). In *Crawford v. Burke*, 195 U.S. 176 (1904), the Court construed this language to have narrowed the 1867 Act because the limiting phrase "while acting as an officer or in any fiduciary capacity" modified not only "defalcation" but also "fraud, embezzlement, and misappropriation." *Id.* at 189–90. The debtor, a stockbroker who sold his client's stock and was charged with conversion, was held to be entitled to discharge the resulting debt.

In *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) (Cardozo, J.), the Court again rejected an expansionary interpretation of the exception. The Court held that an auto dealer's conversion of the proceeds of a sale by failing to promptly pay the secured inventory lender did not result in a non-dischargeable debt under § 17(4) of the 1898 Act. The Court pointed out that the trial court found that the defendant was not "actuated by willful, malicious or criminal intent in disposing of the car in question." *Id.* at 332. The lender argued that, irrespective of willfulness or malice, the debt arose from fraud or misappropriation

while acting in a fiduciary capacity, but the Court rejected that argument on the ground that "[i]t is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong without reference thereto." *Id.* at 333. The use of a "trust receipt" to structure the transaction was not enough to change the nature of the transaction from a security arrangement into a trust falling within the discharge exception.

The 1978 Bankruptcy Reform Act introduced the present text of § 523(a)(4) at issue here. Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. The term "misappropriation" was deleted, as recommended by the Commission on the Bankruptcy Laws of the United States.[3] The commission had also recommended the

[3] Congress relied on the report issued in 1973 by the Commission on the Bankruptcy Laws of the United States in drafting the new Bankruptcy Code. In its proposed model act, the Commission excluded fraud, misappropriation, and defalcation from the analogue for § 523(a)(4). Specifically, the proposed model act provided that "[a] discharge extinguishes all debts of an individual debtor . . . except . . . any liability for embezzlement or larceny." REP. OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2, at 136 (1973). The Commission explained its rationale for the omissions as follows:

> The terms "misappropriation" and "defalcation" are discarded as overbroad and uncertain in meaning. See *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937). The standard of "fraud" is moved to a more appropriate location in clause (2), and

(Continued on following page)

deletion of "defalcation," which was nonetheless retained in the law. The provision's language was also altered to clarify that embezzlement and larceny were not limited to fiduciary situations, and that only fiduciary fraud was covered, since other frauds fell within subsection (a)(2).

Although the Court's precedents since the 1840s have consistently resisted attempts to expand the scope of what is now the (a)(4) exception, the Court has not addressed the precise meaning of "defalcation." Lower courts seem to agree that not every breach of fiduciary duty amounts to a discharge-ineligible defalcation. "The mere failure to meet an obligation while acting in a fiduciary capacity simply does not rise to the level of defalcation . . . ." *R.E. Am., Inc. v. Garver* (*In re Garver*), 116 F.3d 176, 177–80 (6th Cir. 1997); *accord Rutanen ex rel. Quevillon v. Baylis* (*In re Baylis*), 313 F.3d 9, 19 (1st Cir. 2002). The cases also agree that the meaning is a question of federal law. *E.g.*, *Otto v. Niles* (*In re Niles*), 106 F.3d 1456, 1460 (9th Cir. 1997). But the consensus ends there. The federal circuits fall into three camps regarding the mental state required for a misappropriation or a failure to account to constitute "defalcation" under § 523(a)(4) of the Bankruptcy Code: (1) conscious misbehavior or extreme recklessness, required by the

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> the precisely definable term "larceny" is added to the remaining term "embezzlement" to cover conduct clearly within the intended scope of this ground for nondischargeability.

Id., pt. 2, at 139.

First and Second Circuits; (2) known breach of a fiduciary duty, such that the conduct can be characterized as "objectively reckless," applied by the Eleventh Circuit in this case and by the Fifth, Sixth, and Seventh Circuits; and (3) mere negligence or innocent mistake resulting in a failure to account for entrusted property, applied by the Fourth, Eighth, and Ninth Circuits.

1. Conscious Misbehavior or Extreme Recklessness

The First and Second Circuits require "a mental state embracing intent to deceive, manipulate, or defraud" paralleling the scienter requirement in the well-developed law of securities fraud. *Baylis*, 313 F.3d at 20 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)). The standard can be met with a showing of extreme recklessness constituting "an extreme departure from the standards of ordinary care." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999). The "mere conscious taking of risk associated with the usual torts standard of recklessness" is insufficient. *Baylis*, 313 F.3d at 20. In *Denton v. Hyman* (*In re Hyman*), 502 F.3d 61 (2d Cir. 2007), the Second Circuit explicitly aligned itself with the First Circuit and adopted *Baylis's* conscious misbehavior or extreme recklessness standard: "We believe that these concepts—well understood and commonly applied in the securities law context—strike the proper balance under § 523(a)(4). This standard ensures that the term 'defalcation' complements but

does not dilute the other terms of the provision, . . . all of which require a showing of actual wrongful intent." *Id.* at 68.

Hyman involved co-owners of an insurance agency. One of the co-owners died. The other co-owner continued to run the agency, while engaging in protracted and ultimately unsuccessful negotiations to buy his deceased co-owner's share from his estate. The estate subsequently sued him in state court and won a $2.7 million judgment for breach of fiduciary duty. The state court, however, made no findings on Hyman's state of mind. Hyman filed for bankruptcy protection, and the estate brought a proceeding to except the judgment from discharge for "defalcation," relying exclusively on collateral estoppel. The Second Circuit affirmed the bankruptcy court's rejection of this claim, reasoning that the record contained evidence of Hyman's good faith. "[W]e are loath to conclude that an identical issue was necessarily decided or that Hyman had a full and fair opportunity to contest his state of mind." *Id.* at 70.

Baylis involved a lawyer acting as co-trustee who was accused of various acts of defalcation. In its analysis, the First Circuit pointed out that the defalcation exception is located in the same sentence with exceptions for fraud, embezzlement, and larceny, all of which require specific intent. *Baylis*, 313 F.3d at 20 (excepting from discharge any debts "for fraud and defalcation while acting as a fiduciary, and embezzlement and larceny generally"). The court reasoned that an act that constitutes a defalcation "must be a

serious one indeed, and some fault must be involved." *Id.* at 19. "[A] creditor must be able to show that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny." *Id.* at 20. The court concluded that requiring "a mental state embracing intent to deceive, manipulate, or defraud," borrowed from securities law, properly calibrated the meaning of defalcation with the level of culpability of fraud, embezzlement, and larceny also listed in subsection (a)(4), while avoiding redundancy with fiduciary "fraud" by encompassing as well "extreme recklessness," a "lesser form of intent." *Id.* (quoting *Ernst & Ernst*, 425 U.S. at 193 n.12, and *Rizek v. SEC*, 215 F.3d 157, 162 (1st Cir. 2000)). The court reversed the lower court's exception from discharge of all of Baylis's debts to the trust, but affirmed the exception from discharge to the extent he used trust funds to pay his personal expenses without reimbursement.

2. Knowing Breach or Objective Recklessness

The Eleventh Circuit in this case joined the circuits that have adopted a recklessness standard that is less rigorous than the First and Second Circuits' standard. *Bullock v. BankChampaign, N.A.* (*In re Bullock*), 670 F.3d 1160 (11th Cir. 2012), Pet. App. 1a–14a. These circuits require varying degrees of willfulness, knowledge, and objective recklessness, but all require something more than "mere negligence." *See, e.g.*, *FNFS, Ltd. v. Harwood* (*In re Harwood*), 637

F.3d 615 (5th Cir. 2011); *Patel v. Shamrock Floorcovering Servs., Inc.* (*In re Patel*), 565 F.3d 963 (6th Cir. 2009); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994).

The Fifth Circuit requires "a willful neglect of duty," which is "essentially a recklessness standard." *Schwager v. Fallas* (*In re Schwager*), 121 F.3d 177, 184–85 & n.12 (5th Cir. 1997) (quoting *Moreno v. Ashworth* (*In re Moreno*), 892 F.2d 417, 421 (5th Cir. 1990)). Willfulness is assessed "objectively" based on "what a reasonable person in the debtor's position knew or reasonably should have known." *Harwood*, 637 F.3d at 624 (quoting *Office of Thrift Supervision v. Felt* (*In re Felt*), 255 F.3d 220, 226 (5th Cir. 2001)). The Sixth and Seventh Circuits have recited a standard for defalcation that requires "something more than negligence or mistake, but less than fraud." *Follett Higher Educ. Grp. v. Berman* (*In re Berman*), 629 F.3d 761, 765 n.3 (7th Cir. 2011) (citing *Meyer*, 36 F.3d at 1385)); *see Patel*, 565 F.3d at 970 (labeling the standard as "objectively reckless" and rejecting "defalcation per se").

3. Negligent or Innocent Mistake

The most expansive reading of defalcation withholds discharge for even purely innocent mistakes and has been adopted by the Fourth, Eighth, and Ninth Circuits. *Republic of Rwanda v. Uwimana* (*In re Uwimana*), 274 F.3d 806, 811 (4th Cir. 2001) (citing *Pahlavi v. Ansari* (*In re Ansari*), 113 F.3d 17, 20 (4th

Cir. 1997)); *Tudor Oaks Ltd. P'ship v. Cochrane* (*In re Cochrane*), 124 F.3d 978, 984 (8th Cir. 1997); *Sherman v. SEC* (*In re Sherman*), 658 F.3d 1009, 1017 (9th Cir. 2011); *Blyler v. Hemmeter* (*In re Hemmeter*), 242 F.3d 1186, 1190–91 (9th Cir. 2001). In these circuits, "negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient." *Uwimana*, 274 F.3d at 811. *See Sherman*, 658 F.3d at 1017 ("[E]ven innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required.") (quoting *Hemmeter*, 242 F.3d at 1190).

4. The Requirement of Failure to Account

The circuits also appear to conflict on the degree to which they require a creditor seeking to except an alleged defalcation debt from discharge to show that it has sustained a loss. The Eleventh Circuit here did not require that respondent prove a loss of principal; the court regarded the Illinois court's judgment for disgorgement of the purported benefit alone as sufficient. Other circuits appear to require a demonstration of the loss of the entrusted property. *Commonwealth Land Title Co. v. Blaszak* (*In re Blaszak*), 397 F.3d 386, 390 (6th Cir. 2005) ("resulting loss" is required element); *Garver*, 116 F.3d at 178 (same); *see Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1186 (9th Cir. 1996) (requiring "fail[ure] to account fully for money received").

III. Conscious Misbehavior or Extreme Recklessness Should Be Required to Except Fiduciary Debts from Discharge—and Is Absent Here.

The Court's task is to define an undefined statutory term that is not in common use. Contemporary dictionaries offer an inconclusive menu of alternative meanings. *E.g.*, BLACK'S LAW DICTIONARY 479 (9th ed. 2009) ("1. Embezzlement. 2. Loosely, the failure to meet an obligation; a nonfraudulent default."). Petitioner submits that the First and Second Circuits' requirement of conscious misbehavior or extreme recklessness, drawing from the scienter requirement of securities law, is the most faithful to the statutory context and overall objectives of bankruptcy law. That standard comports with "the commonsense canon of *noscitur a sociis*—which counsels that a word is given more precise content by the neighboring words with which it is associated." *Freeman v. Quicken Loans, Inc.*, ___ U.S. ___, 132 S. Ct. 2034, 2042 (2012) (quoting *United States v. Williams*, 553 U.S. 285, 294 (2008)). *See generally* ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS § 31 (2012).

The Eleventh Circuit's definition of defalcation is simply too lax to be ranked among the likes of "fraud . . . , embezzlement, or larceny" found in the same clause, all of which require findings of wrongful intent. *See Neal*, 95 U.S. at 708–09 (applying *noscitur a sociis* to determine meaning of "fraud"). Specifically, fraud in a fiduciary relationship as contemplated by

§ 523(a)(4) requires fraudulent intent. *See id.* at 709 (fiduciary fraud involves "moral turpitude or intentional wrong"); *McClellan v. Cantrell*, 217 F.3d 890, 893–94 (7th Cir. 2000). The other offenses listed in § 523(a)(4), embezzlement and larceny, require criminal intent. "Embezzlement is the fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come. It differs from larceny in the fact that the original taking of the property was lawful, or with the consent of the owner, while in larceny the felonious intent must have existed at the time of the taking." *Moore v. United States*, 160 U.S. 268, 269–70 (1895). Cases construing § 523(a)(4) follow *Moore*'s classic definition. Larceny under § 523(a)(4) has been defined to be a wrongful taking of personal property "with intent to convert it or deprive the owner" of it. *Ormsby v. First Am. Title Co.* (*In re Ormsby*), 591 F.3d 1199, 1205 (9th Cir. 2010) (citation omitted). Embezzlement is the "fraudulent conversion of the property of another by one who is already in lawful possession of it." *Sherman v. Potapov* (*In re Sherman*), 603 F.3d 11, 13 (1st Cir. 2010) (citation omitted).

To construe "defalcation" more expansively, so as to allow an exception from discharge based on a significantly lower threshold of wrongdoing, would be out of step with the accompanying provisions in the statute. "That several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well." *Beecham v. United States*, 511 U.S. 368, 371 (1994). No reason exists to withhold bankruptcy relief for fiduciary

debts that arise from circumstances lacking the degree of culpability commensurate with fraud, embezzlement, and larceny. "The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress." *Jarecki v. G. D. Searle & Co.*, 367 U.S. 303, 307 (1961). Mere negligence or even recklessness should not be enough to warrant an exception from discharge under § 523(a)(4). An honest trustee who, for instance, invests imprudently and produces a loss of *res* that results in his being held civilly liable should not be denied a bankruptcy discharge. Requiring a showing of "a mental state embracing intent to deceive, manipulate, or defraud," *Ernst & Ernst*, 425 U.S. at 193 n.12, or "extreme recklessness," would ensure that a fresh start is denied only for the most serious misconduct that results in a loss to another. *Hyman*, 502 F.3d at 68; *Baylis*, 313 F.3d at 20. *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (scienter is "wrongful state of mind").

As to petitioner's mental state here, there is no indication, much less any finding, that petitioner *knew* that the three loans made from his father's *inter vivos* life insurance trust were improper. The Eleventh Circuit erred in conclusively presuming, in effect, that he did know, without considering the actual evidence, invoking a purportedly "objective" standard and declining to examine the particular circumstances of petitioner's case. *Cf. Field v. Mans*,

516 U.S. 59, 70–75 (1995) (justifiable reliance is all that is required to establish fraud under § 523(a)(2)(A); must consider qualities and characteristics of individual plaintiff, not simply hypothetical "reasonable man"). A *per se* rule that any act or omission by a fiduciary that could be deemed self-dealing under state law is conclusively presumed to constitute "defalcation" strays too far off course from bankruptcy's fresh start policy. This is especially so in light of the proliferation of fiduciary obligations in recent decades, many imposed by statute. *See Angelle v. Reed* (*In re Angelle*), 610 F.2d 1335, 1339 (5th Cir. 1980). The capabilities of persons acting as trustees vary widely, as petitioner's case exemplifies. Petitioner's father was sold a life insurance policy and advised to create a trust for estate planning purposes. Petitioner was unaware that he was even named as trustee for at least two years, and he had no legal or comparable training in trust administration. To hold trustees civilly liable under a one-size-fits-all standard may be sound as a matter of state trust law, but to deny a bankruptcy discharge without consideration of the debtor's individual circumstances loses sight of the proper role of discharge exceptions in bankruptcy law: to withhold relief only from true malefactors who cause serious harm. Here, the Eleventh Circuit erred by imputing to petitioner knowledge of an impropriety that he lacked.

The record shows nothing beyond petitioner's acting in accordance with his parents' wishes with respect to his father's primary asset, a whole life

insurance policy with a $1,000,000 death benefit. The policy's cash value was borrowed to pay premiums to keep the policy in force (no quarrel from anyone there); to make a loan to his mother, as requested by his father, the trust settlor; and to make two other secured loans to his mother and him. Petitioner was advised in these transactions by the agent who sold the policy. The three loans were repaid in full, with interest. If petitioner had sought and obtained the beneficiaries' consents, there would have been no basis for complaint. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(3) (2007). But petitioner did not believe the loans were improper, and regarded them instead as safe investments of the cash value. At the end of petitioner's tenure as trustee, the policy had the same net value and benefit that it had when his father created the trust. The Eleventh Circuit should have considered these circumstances, along with the state court's findings, and concluded that a "defalcation" did not occur. Imputed knowledge that any self-dealing could be a violation of trust law, a ramification of which he had no actual knowledge, is insufficient to establish the mental state needed to except a debt from discharge for "defalcation" under § 523(a)(4).

Without imputed knowledge of impropriety, respondent's case for defalcation falls apart. Respondent sought summary judgment relying exclusively on the findings in the underlying state court action. But there was no state court finding that petitioner acted with a culpable mental state. The *only* judicial finding concerning petitioner's mental state was that

he "did not appear to have a malicious motive in borrowing funds from the trust." Pet. App. 45a. The burden to produce evidence of the requisite mental state was at all times on respondent. *See Palmacci v. Umpierrez*, 121 F.3d 781, 787 (1st Cir. 1997). Respondent could have attempted to offer other evidence, *Brown v. Felsen*, 442 U.S. 127, 138–39 (1979), but did not. Like the creditor in *Hyman*, by relying exclusively on the state court's findings, respondent failed to carry its burden to demonstrate that petitioner acted with a wrongful state of mind sufficient to support a finding of defalcation under § 523(a)(4). The state court's finding of no apparent ill intent, coupled with the absence of loss of *res*, falls far short of establishing the sort of grave misconduct that should deprive a financially ruined individual from the statutory last refuge of discharge in bankruptcy.

IV. Failure to Account for Entrusted Property Is an Essential Element of "Defalcation"—and Is Absent Here As Well.

Mental state aside, the cases frequently recite that a "failure to account" for entrusted property or a "shortage in accounts" is an element that must be proven to establish the exception now found in § 523(a)(4). "'Defalcation' refers to a failure to produce funds entrusted to a fiduciary . . . ." *Guerra v. Fernandez-Rocha* (*In re Fernandez-Rocha*), 451 F.3d 813, 817 (11th Cir. 2006) (quoting *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993)); *Hemmeter*, 242 F.3d at 1190–91 ("The definition of defalcation includes both

the misappropriation of trust funds or money held in any fiduciary capacity; and the failure to properly account for such funds." (internal quotation marks omitted)); *Cundy v. Woods* (*In re Woods*), 284 B.R. 282, 291 (D. Colo. 2001) ("[I]t was legal error to conclude that defalcation occurred since there was no failure of the assumed fiduciary to account for the *res* . . . ."). This requirement is consistent with dictionary definitions of "defalcation" likely available at the time of enactment of the 1841 Act, which introduced the term into bankruptcy law. *See, e.g.*, SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE 6L (1755) ("diminution; abatement; excision of any part of a customary allowance"); NOAH WEBSTER, AN AMERICAN DICTIONARY OF THE ENGLISH LANGUAGE 56 (1828) ("The act of cutting off, or deducting a part; deduction; diminution; abatement; as, let him have the amount of his rent without *defalcation*."). And the deletion of "misappropriation" from the 1978 Act—a "baffling word," *Herbst*, 93 F.2d at 512, added by the 1898 Act—suggests that misappropriations that do not ultimately result in a shortage in accounts no longer fall within § 523(a)(4), if they did before.

This key element is absent in petitioner's case. There was no failure to account for the entrusted property and no loss of the trust principal. When petitioner resigned as trustee, the net policy value of the trust's only asset was the same as when his tenure began. The investments of cash value chosen by petitioner, to a large degree for the benefit of his

mother—the spouse of the trust settlor—were loans that were repaid periodically, with interest. The first loan, to his mother only, was actually requested by his father. The other two secured loans were made to himself and his mother. The judgment against petitioner was for the state court's unexplained estimate of the benefit he received, not a reckoning for any loss; there was no loss from the loans. At the least, a *prima facie* case for "defalcation" should include a demonstration of a failure to account for the entrusted property. The burden of production would then shift to the errant fiduciary to show he acted without the wrongful state of mind that would disqualify the debt from discharge.

The loans here were made without the consent of each of the trust's beneficiaries, which could have cured any defect, and so were technical breaches of trust. But the evidence was that petitioner, upon his resignation as trustee, still produced the entrusted property intact. Petitioner thus was entitled to discharge of the debt in question on this additional independent ground.

CONCLUSION

This was a squabble about family trust administration that escalated perversely, spawning more than a decade of litigation and culminating in financial disaster for petitioner. No showing has been made that he engaged in the sort of culpable misconduct causing serious harm to others that would

warrant excepting a debt from discharge. For the foregoing reasons, the Eleventh Circuit's judgment affirming the order of summary judgment against petitioner should be vacated, and the case remanded for further proceedings consistent with the Court's opinion.

Respectfully submitted,

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