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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

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TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	i
TABLE OF AUTHORITIES	iii
ARGUMENT	1
I. A State Court Finding of Fiduciary Self-Dealing Does Not Render the Fiduciary's Resulting Debt a *Per Se* Bankruptcy Defalcation	1
A. Ignorance of the Law Is No Excuse—Except When It Is	2
B. Not Every Breach of Fiduciary Duty Is a "Defalcation"	9
C. Not Every Instance of Self-Dealing Is a "Defalcation"	11
D. The Statutory Text, Context, and History Indicate That a Culpable Mental State Is Required to Establish Defalcation	14
1. Contradictory dictionary definitions supply no answers	15
2. The government's statutory context argument is overextended	15
3. Applying *noscitur a sociis* as petitioner urges would have no undesirable collateral consequences	16
4. The anti-surplusage canon would not be violated	17

TABLE OF CONTENTS – Continued

Page

5. The government's historical-practice argument is unenlightening 18

II. The Fresh Start Policy Is Embodied in the *Gleason* Rule and Reinforced by the Rule of Lenity 19

III. Failure to Produce the Entrusted Property Is Required for "Defalcation" 20

CONCLUSION 23

TABLE OF AUTHORITIES

Page

CASES

Am. Express Travel Related Servs. Co. v. Hashemi (*In re Hashemi*), 104 F.3d 1122 (9th Cir. 1996) 8

BedRoc Ltd., LLC v. United States, 541 U.S. 176 (2004) 16–17

In re Birkenstock, 87 F.3d 947 (7th Cir. 1996) 6

Bruner v. United States (*In re Bruner*), 55 F.3d 195 (5th Cir. 1995) 6

C & J Rentals, Inc. v. Purdy (*In re Purdy*), 231 B.R. 310 (Bankr. E.D. Mo. 1999) 22

Central Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510 (2d Cir. 1937) 17–18

Cheek v. United States, 498 U.S. 192 (1991) 3–4, 5, 8–9

Conn. Nat'l Bank v. Germain, 503 U.S. 249 (1992) 17

Consumer United Ins. Co. v. Bustamante (*In re Bustamante*), 239 B.R. 770 (Bankr. N.D. Ohio 1999) 22

Crandon v. United States, 494 U.S. 152 (1990) 19

Denton v. Hyman (*In re Hyman*), 502 F.3d 61 (2d Cir. 2007) 17

Gilbert v. United States, 370 U.S. 650 (1962) 7

Gleason v. Thaw, 236 U.S. 558 (1915) 19–20

Grogan v. Garner, 498 U.S. 279 (1991) 10

Groh v. Ramirez, 540 U.S. 551 (2004) 5

TABLE OF AUTHORITIES – Continued

Page

Kawaauhau v. Geiger, 523 U.S. 57 (1998)............6, 16

Local Loan Co. v. Hunt, 292 U.S. 234 (1934) 12

In re Maurice, 21 F.3d 767 (7th Cir. 1994)..............8–9

Meyer v. Rigdon, 36 F.3d 1375 (7th Cir. 1994) 10

Morissette v. United States, 342 U.S. 246 (1952).......16

Moskal v. United States, 498 U.S. 103 (1990) 19

Mosser v. Darrow, 341 U.S. 267 (1951).....................12

Neder v. United States, 527 U.S. 1 (1999) 7

Patel v. Shamrock Floorcovering Servs., Inc. (*In re Patel*), 565 F.3d 963 (6th Cir. 2009)....................10

Pearson v. Callahan, 555 U.S. 223 (2009)...................5

Ratzlaf v. United States, 510 U.S. 135 (1994) 4–5

Rutanen ex rel. Quevillon v. Baylis (*In re Baylis*), 313 F.3d 9 (1st Cir. 2002) 10, 13, 17

State v. McRae, 983 A.2d 286 (Conn. App. Ct. 2009)..8

State v. Papandrea, 991 A.2d 617 (Conn. App. Ct. 2010)..8

CONSTITUTIONAL PROVISIONS

U.S. Const. art. I, § 8, cl. 4 11

TABLE OF AUTHORITIES – Continued

Page

STATUTES AND REGULATIONS

11 U.S.C. § 523(a)(1)(C) 5

11 U.S.C. § 523(a)(4) 7, 8, 10, 15

11 U.S.C. § 523(a)(6) 6, 15, 16

11 U.S.C. § 523(a)(19) 16

31 U.S.C. § 5322 5

Act of Aug. 19, 1841, ch. 9, 5 Stat. 441, 614 (repealed 1843) 18, 20

Act of Mar. 3, 1843, ch. 82, 5 Stat. 614 18

Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1978) 16, 18

Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 ....11, 18, 20

Act of Apr. 20, 2005, Pub. L. No. 109-8, 119 Stat. 23 11

RULES

U.S. Supreme Court Rule 32.3 2

OTHER AUTHORITIES

BLACK'S LAW DICTIONARY (9th ed. 2009) 18

MARK GROSSMAN, POLITICAL CORRUPTION IN AMERICA: AN ENCYCLOPEDIA OF SCANDALS, POWER, AND GREED (2003) 8

WAYNE R. LAFAVE, CRIMINAL LAW (4th ed. 2003) 8

TABLE OF AUTHORITIES – Continued

Page

ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS (2012) 19, 20

ARGUMENT

I. A State Court Finding of Fiduciary Self-Dealing Does Not Render the Fiduciary's Resulting Debt a *Per Se* Bankruptcy Defalcation.

The precise issue before the Court is whether the Illinois state court's finding of self-dealing, on which respondent relied exclusively in seeking summary judgment, is conclusive as to whether petitioner committed a discharge-disqualifying "defalcation," even in the face of uncontradicted evidence that the petitioner lacked knowledge that his actions were unlawful under Illinois trust law and the state court's additional findings that he acted without any apparent ill motive and that the loans in issue were all repaid in full, with interest.

Other than the state court findings, respondent offered no evidence in support of its summary judgment motion granted by the bankruptcy court. In this Court, respondent asserts that "the Circuit Court below relied on the same record as the Bankruptcy Court; the detailed record of the Illinois state court." (R. Br. 14.) But this assertion is incorrect. The complete record from the Illinois state court was not before the bankruptcy court, the district court, or the Eleventh Circuit. The only submissions from respondent were the Illinois court's two orders, the complaint and answer in that case, and the Illinois

summary judgment motion, without exhibits.[1] (RE, Vol. 1, Tabs J & K.) Respondent neither submitted nor relied on evidentiary material from the Illinois proceedings.

Respondent and its *amici* offer three different positions on the meaning of "defalcation" as it applies to this case: (1) the Richard Aaron, *et al*. *amici* argue that any breach of fiduciary duty under state law is a defalcation under bankruptcy law; (2) respondent argues that whatever is characterized as self-dealing under non-bankruptcy law automatically constitutes bankruptcy defalcation; and (3) the United States contends that defalcation occurs "where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized." (U.S. Br. 20.) Each of these positions shares a common assumption: that petitioner's unawareness that his actions were unlawful and his good faith are irrelevant. Before turning to the particular arguments about defalcation's meaning, petitioner begins with an examination of that common assumption.

A. Ignorance of the Law Is No Excuse—Except When It Is.

Respondent and its *amici* contend throughout their briefs that petitioner is charged with knowledge

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[1] Pursuant to Rule 32.3, the parties have submitted a letter to the Clerk jointly proposing to lodge with the Court the trust instrument itself.

of all of the restrictions on a trustee under Illinois law, and that his avowed unawareness of the legal principle involved is no excuse and thus entirely irrelevant. But the Court has held that the general principle that citizens are charged with knowledge of the law is not inviolate. In *Cheek v. United States*, 498 U.S. 192 (1991), the issue was whether the defendant's objectively unreasonable but professed belief that the tax laws were being unconstitutionally enforced was a defense to charges of federal tax evasion and failure to file tax returns. The defendant, who was not a lawyer, testified that he had been advised by a lawyer that his beliefs were correct and had attended seminars where these beliefs were reinforced. The government countered with evidence of the defendant's contrary knowledge, such as his attendance at trials of other tax resisters where their views were rejected by courts. The district court ultimately instructed the jury that an objectively unreasonable view of the tax laws was not a defense. The defendant was convicted and his case was accepted for review by the Court.

The case turned on the meaning of the statutory term "willfully," which was an element of the offenses of which the defendant was convicted. The Court explained that ignorance of the law was in fact relevant because willful conduct was required:

> The general rule that ignorance of the law or a mistake of law is no defense to criminal prosecution is deeply rooted in the American legal system. . . . Based on the notion

> that the law is definite and knowable, the common law presumed that every person knew the law. This common-law rule has been applied by the Court in numerous cases construing criminal statutes.
>
> The proliferation of statutes and regulations has sometimes made it difficult for the average citizen to know and comprehend the extent of the duties and obligations imposed by the tax laws. Congress has accordingly softened the impact of the common-law presumption by making specific intent to violate the law an element of certain federal criminal tax offenses.

Id. at 199–200 (internal citations omitted). The Court noted that the standard for statutory willfulness is the "voluntary, intentional violation of a known legal duty." *Id.* at 201 (citation omitted). The Court accordingly held that the instruction that the defendant's belief must be objectively reasonable was erroneous. "Characterizing a particular belief as not objectively reasonable transforms the inquiry into a legal one and would prevent the jury from considering it." *Id.* at 203.

Exceptions to the "ignorance of the law is no excuse" maxim are not confined to tax law. The Court identified another such exception in *Ratzlaf v. United States*, 510 U.S. 135 (1994), in which the defendant appealed his conviction under a federal statute prohibiting the structuring of financial transactions to evade currency reporting requirements. The Court

again analyzed the meaning of "willfully," this time in the anti-structuring statute,[2] and held that the defendant was improperly convicted because the jury was not instructed that he must be found to have known that the structuring in which he was engaged was unlawful. As the Court explained, "we are unpersuaded by the argument that structuring is so obviously 'evil' or inherently 'bad' that the 'willfulness' requirement is satisfied irrespective of the defendant's knowledge of the illegality of structuring." *Id.* at 146. *See also Pearson v. Callahan*, 555 U.S. 223, 231 (2009) ("The protection of qualified immunity applies regardless of whether the government official's error is 'a mistake of law, a mistake of fact, or a mistake based on mixed questions of law and fact.' ") (quoting *Groh v. Ramirez*, 540 U.S. 551, 567 (2004) (Kennedy, J., dissenting)).

The *Cheek* definition of "willfully," requiring actual knowledge of a violation of the law, has been carried over into the exception to bankruptcy discharge found in § 523(a)(1)(C), which provides, in pertinent part: "A discharge under section 727 . . . of this title does not discharge an individual debtor from any debt . . . for a tax or a customs duty . . . with respect to which the debtor made a fraudulent return or *willfully* attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C) (emphasis added). Echoing *Cheek*, courts construing this section

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[2] 31 U.S.C. § 5322.

require the creditor to prove that "the debtor . . . both (1) know that he has a tax duty under the law, and (2) voluntarily and intentionally attempt to violate that duty." *In re Birkenstock*, 87 F.3d 947, 952 (7th Cir. 1996) (citing *Bruner v. United States* (*In re Bruner*), 55 F.3d 195, 197 (5th Cir. 1995)).[3]

The common thread in situations where willfulness has been required is the existence of a specialized legal regime encountered by people who are ill-equipped to cope with it when armed only with an average citizen's experience and capabilities. In these instances, the Court has determined that Congress did not intend to visit harsh consequences on violators without proof that they knew their actions actually violated the law. Fiduciary law, encountered by untrained lay people with increasing frequency, is just such a regime, littered with traps for the unwary. Petitioner's case is an exemplar. The trust was created by petitioner's father who contributed his life insurance policy to establish it. The beneficiaries were his children. At first, petitioner had no idea that he was trustee. The first loan, to his mother, was requested by his father. It is hardly self-evident to a lay person that such a loan could be improper. Nor is

[3] Willfulness is also an element of the exception of debts from discharge found in 11 U.S.C. § 523(a)(6), which excludes debts "for willful and malicious injury by the debtor to another entity or to the property of another entity." In *Kawaauhau v. Geiger*, 523 U.S. 57, 64 (1998), the Court held that this language did not reach negligent or reckless torts, which are dischargeable.

impropriety apparent in the other two loans, to his mother and himself, which were secured and ultimately used in a family business. Petitioner was advised in these actions by the family's insurance agent. All of the loans were fully repaid. None of the conduct was so manifestly evil that the legal order demands that petitioner be charged with knowledge of the law when it comes to assessing his eligibility for discharge in bankruptcy. Faced with these facts, respondent retorts that petitioner "did not owe either his mother or his father a duty of loyalty." (R. Br. 15.) Few would agree.

The discharge exception at issue here, paragraph (a)(4), does not include an express willfulness component or specify a required mental state for any of the listed offenses of fiduciary fraud, defalcation, embezzlement, or larceny. This is likely because these terms found their way into the discharge-exception statute more than 140 years ago, and the requisite culpable mental states were regarded as commonly understood. A statute that adopts a common law term without defining it is construed to adopt the common law meaning. *Neder v. United States*, 527 U.S. 1, 23 (1999); *Gilbert v. United States*, 370 U.S. 650, 655 (1962). The well-established mental states required for fraud, embezzlement, or larceny entail a showing of willfulness or the equivalent: specific intent to defraud, to fraudulently convert, or to steal. Consistent with these *mens rea* requirements, mistake of law was a defense to larceny and embezzlement at common law and it generally remains so today, because a mistake of law precludes a finding of the

required mental state. WAYNE R. LAFAVE, CRIMINAL LAW § 19.5 at 944, § 19.6 at 955 (4th ed. 2003); *see State v. Papandrea*, 991 A.2d 617, 623 (Conn. App. Ct. 2010) (larceny) (citing *State v. McRae*, 983 A.2d 286, 290 (Conn. App. Ct. 2009)).

Defalcation was not a term used to describe a common law crime,[4] but there is no reason why a trustee's *bona fide* mistake of law should not be similarly relevant to consideration of whether his breach of fiduciary duty warrants denial of a bankruptcy discharge for a resulting debt. To slam the door on such evidence, by characterizing conduct as "objectively unreasonable" without further inquiry, not only disassociates defalcation from the other offenses in the same sentence of paragraph (a)(4) but also affords too little weight to the fresh start policy. No substantial countervailing concerns are apparent. Taking into consideration evidence of a debtor's lack of knowledge that he was violating the law would not require the bankruptcy court to credit fanciful claims or adopt unreasonable conclusions.[5] *See Cheek*, 498

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[4] As the Aaron *amici* point out, the term's origin in bankruptcy law may have been a response to an 1838 scandal that certainly involved knowing wrongdoing by Samuel Swartwout. (Aaron Br. 10–11.) *See* MARK GROSSMAN, POLITICAL CORRUPTION IN AMERICA: AN ENCYCLOPEDIA OF SCANDALS, POWER, AND GREED 315 (2003).

[5] The bankruptcy court acts as factfinder in discharge exception cases. *Am. Express Travel Related Servs. Co. v. Hashemi* (*In re Hashemi*), 104 F.3d 1122, 1124–25 (9th Cir. 1996) (holding that dischargeability actions are equitable in nature and thus debtor had no constitutional right to jury trial); *In re Maurice*,

(Continued on following page)

U.S. at 203–04 ("Of course, the more unreasonable the asserted beliefs or misunderstandings are, the more likely the jury will consider them to be nothing more than simple disagreement with known legal duties imposed by the tax laws and will find that the government has carried its burden of proving knowledge.").

In sum, whatever the requisite mental state is for defalcation, the debtor should be allowed to demonstrate at a trial that, because of a good faith mistake of law, he did not act with it.

B. Not Every Breach of Fiduciary Duty Is a "Defalcation."

The Aaron *amici* argue that any breach of fiduciary duty under state law is a defalcation under bankruptcy law. (Aaron Br. 8, 16.) The first sign of trouble for this argument is its threshold concession that no federal circuit has adopted this approach (*id*. at 2), though the *amici* chide those courts for failing to provide "meaningful guidance to the lower courts" or "any analytical basis for their varied holdings." (*Id*. at 1.) In fact, courts have roundly rejected the idea that every state law breach of fiduciary duty is a defalcation, in decisions with analysis aplenty. *E.g.*,

21 F.3d 767, 773 (7th Cir. 1994) (debtor not entitled to jury trial in dischargeability case).

Patel v. Shamrock Floorcovering Servs., Inc. (*In re Patel*), 565 F.3d 963, 970 (6th Cir. 2009); *Rutanen ex rel. Quevillon v. Baylis* (*In re Baylis*), 313 F.3d 9, 18 (1st Cir. 2002); *Meyer v. Rigdon*, 36 F.3d 1375, 1384–85 (7th Cir. 1994). The *amicus* brief of the United States also disclaims this argument. (U.S. Br. 29 n.18.) Another early sign of trouble is that the *amici* are compelled almost immediately to launch into an unconvincing explanation of why corporate officers and directors must be exempted from the sweeping breadth of their proposed standard. (Aaron Br. 11 n.5.)

But the central failing of the Aaron *amici*'s standard soon becomes plain enough: it would entirely cede to non-bankruptcy law (usually state law) the responsibility for administering an exception to the availability of federal bankruptcy discharge. That has not been the Court's approach for more than a century in construing what is now paragraph (a)(4); time and again, the Court has refused to allow state law notions of what defines a trust to be conclusive in interpreting the defalcation exception. (P. Br. 11–15.) Dischargeability instead is a matter of federal law governed by the terms of the Bankruptcy Code. *Grogan v. Garner*, 498 U.S. 279, 284 (1991). The Aaron *amici* never explain why the "subjective judgments" of state courts are to be preferred over those of federal courts when it comes to applying federal bankruptcy law. (Aaron Br. 9.) Requiring a uniform standard for determining exceptions from discharge is more consistent with the "uniform" bankruptcy law

that is authorized by the Constitution. U.S. Const. art. I, § 8, cl. 4.

There is also the intent of Congress as reflected in the text and history of the provision. The *amici* never explain why Congress did not expressly provide that every debt resulting from a breach of fiduciary duty would be non-dischargeable in bankruptcy, despite many opportunities to do so in any of the several comprehensive revisions of the bankruptcy act over the span of more than a century. By the time of the enactment of 1978's complete overhaul of bankruptcy law, it was clear that courts were not construing "defalcation" to be established whenever there was a breach of fiduciary duty. Nonetheless, Congress retained "defalcation" instead of substituting "breach of fiduciary duty," and has not disturbed that choice in several subsequent revisions, including the extensive Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Pub. L. No. 109-8, 119 Stat. 23 (Apr. 20, 2005).

C. Not Every Instance of Self-Dealing Is a "Defalcation."

For its part, respondent argues that whatever is characterized as self-dealing under non-bankruptcy law automatically constitutes bankruptcy defalcation, under any of the standards applied by the circuits, and that any resulting monetary remedy is a non-dischargeable debt. Like the Aaron *amici*'s standard,

this is overbroad and cedes too much domain over federal bankruptcy discharge to state law.

Respondent's argument overlooks the wide variety of technical trust infractions that can be the product of unintentional or good faith mistakes yet still constitute fiduciary self-dealing under trust law, especially in family-related trusts. For example, a trustee might overcompensate herself based on an honest misreading of the trust instrument; should the resulting debt be *per se* non-dischargeable? A trustee might engage in a transaction on fair terms with a related company without realizing any impropriety, but face a legal challenge later; should a judgment for disgorgement of any profits always be an insolvent trustee's lifetime obligation? Should a trustee who purchases trust property as the highest bidder at a public auction, under the honest belief that she was acting properly, be denied a discharge? Here, transactions to which the beneficiaries might have consented were adjudged, more than a decade after the fact, to be prohibited self-dealing because the petitioner failed to obtain their consents. Debts arising from ruinous but honest mistakes, however, have seldom been regarded as ineligible for discharge in bankruptcy, which is calibrated to provide relief for the "honest but unfortunate debtor." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

Respondent and its *amici* frequently quote stern admonitions from trust *liability* cases such as *Mosser v. Darrow*, 341 U.S. 267 (1951), and imply that trust law liability means that bankruptcy defalcation is

established. (*E.g.*, U.S. Br. 24, 28.) The United States concedes, however, that not every breach of fiduciary duty necessarily constitutes a defalcation. (*Id.* at 29 n.18.) The potential liabilities of modern fiduciaries alone are sufficiently draconian to dissuade wrongdoers, without the overkill of categorical denial of bankruptcy discharge whenever such liabilities arise, regardless of extenuating circumstances. Liability should not be confused with dischargeability.

Respondent points out that the First Circuit's opinion in *Baylis*, 313 F.3d at 20–21, states that defalcation may be presumed from a breach of the duty of loyalty (R. Br. 9–10), but that presumption should be rebuttable in an appropriate case. *Baylis* presented entirely different facts. The trustee in *Baylis* was a lawyer, and there evidently was no contention that he was unaware of the illegality of paying his personal expenses from the trust. Here, petitioner has shown, without contradiction, that he had no knowledge of any legal problem with following his parents' wishes with respect to the three loans. That showing and the other evidence should have been enough to earn him at least a trial, so that he could make his case for discharge, and the Eleventh Circuit erred in affirming the summary judgment for the plaintiff-respondent. Petitioner has no quarrel with a presumption of defalcation arising where there has been a loss to the trust *res* as a result of self-dealing, so long as a debtor can rebut the presumption with evidence that he acted neither in conscious disregard of the law nor with extreme recklessness.

D. The Statutory Text, Context, and History Indicate That a Culpable Mental State Is Required to Establish Defalcation.

In his opening brief, petitioner argued that requiring scienter for bankruptcy defalcation is faithful to the statutory text, structure, and purpose. (P. Br. 21.) As with fraud, embezzlement, and larceny, dishonesty is the touchstone of defalcation. In its *amicus* brief, the United States never affirmatively offers a comprehensive definition of defalcation, but does argue that no scienter requirement exists "at least in the context of a self-dealing and unauthorized diversion of trust assets." (U.S. Br. 17.) A premise for this argument's applying here is that a court found the three loans to be "unauthorized" (a term that appears at least 17 times in the government's brief) but, strictly speaking, this is incorrect. The Illinois court denied respondent's motion for summary judgment on whether the loans were authorized by the trust instrument. The issue was never decided because of the court's additional ruling that the loans, even if permitted investments, were nevertheless unlawful self-dealing. Pet. App. 53a, 54a. The government urges that its proposed rule be applied in any case in which trust assets are diverted to a use that is ultimately held to be unauthorized (U.S. Br. 20), but no court has so held here.

Putting aside the facts of petitioner's case, the government's appeals to dictionary definitions, statutory context, and historical practice are unpersuasive.

1. Contradictory dictionary definitions supply no answers.

In his main brief, petitioner pointed out that contemporary dictionary definitions are contradictory and offer little guidance on the meaning of "defalcation" (P. Br. 21), a point also made by petitioner's *amicus* (Brunstad Br. 19) and apparently not disputed by respondent. The United States nonetheless argues that dictionary definitions of "defalcation" do not require intentional wrongdoing, but its own catalogue of those definitions only serves to establish petitioner's point. Those definitions include frequent references to "fraudulent" or "fraud" and "embezzlement" and "misappropriation." (U.S. Br. 10–11.) The United States winds up its discussion of dictionaries with an unconvincing assertion that defalcation "generally" does not require "a showing of intentional wrongdoing" (*id.* at 12), but the only conclusion that can fairly be drawn from its own survey of the contradictory definitions is that they are inconclusive on the required mental state.

2. The government's statutory context argument is overextended.

The United States also argues that the statutory context counsels against requiring a "heightened mental state," citing paragraph (a)(6), which requires "willful and malicious injury," and other paragraphs that expressly require willfulness as well. (U.S. Br. 12–13.) The United States concludes from these references that, since paragraph (a)(4) includes no

mention of the mental states, none is required. But, as pointed out above, this argument is clearly overextended. These common law terms—fraud, embezzlement, larceny—carry their common law meanings, which include mental states. *See Morissette v. United States*, 342 U.S. 246, 250 (1952). In paragraph (a)(6), a provision not added until the Bankruptcy Act of 1898, the modifiers "willful" and "malicious" were necessary to make clear that negligent or reckless torts were not excepted from discharge. *See Geiger*, 523 U.S. at 64.

3. Applying *noscitur a sociis* as petitioner urges would have no undesirable collateral consequences.

In response to petitioner's argument that *noscitur a sociis* links defalcation with the nearby statutory terms "fraud," "embezzlement," and "larceny," the United States contends that application of this contextual canon would spell trouble for interpretation of the securities-law discharge exception found in 11 U.S.C. § 523(a)(19). (U.S. Br. 14.) But this is a false dilemma. The government cites no cases exhibiting the confusion it fears. The language of paragraph (a)(19) is unambiguous as to the specified nondischargeable offenses. "The preeminent canon of statutory interpretation" requires the Court to "'presume that [the] legislature says in a statute what it means and means in a statute what it says there.' . . . Thus, our inquiry begins with the statutory text, and ends there as well if the text is unambiguous."

BedRoc Ltd., LLC v. United States, 541 U.S. 176, 183 (2004) (quoting *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992)) (alteration in original). No resort to contextual canons is required.

4. The anti-surplusage canon would not be violated.

The argument of respondent's *amici* that petitioner's argument would deprive "defalcation" of any independent role in the statute is addressed in *Denton v. Hyman* (*In re Hyman*), 502 F.3d 61 (2d Cir. 2007) and in *Baylis*, as the United States acknowledges. (U.S. Br. 15–16.) As *Hyman* explained, the requirement of a showing of conscious misbehavior or extreme recklessness "ensures that the term 'defalcation' complements but does not dilute the other terms of the provision—'fraud,' 'embezzlement,' and 'larceny'—all of which require a showing of actual wrongful intent." 502 F.3d at 68.

Respondent and its *amici* liberally cite *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937), but Judge Hand's "carefully equivocal opinion," *Baylis*, 313 F.3d at 18, is regarded by the Second Circuit itself as "wrestl[ing] with this problem without resolving it." *Hyman*, 502 F.3d at 67. The holding in *Herbst*, in which the fiduciary was a court-appointed receiver, is quite limited: "All we decide is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a 'defalcation' though

it may not be a 'fraud,' or an 'embezzlement' or perhaps not even a 'misappropriation.'" 93 F.2d at 512. As petitioner's *amicus* details, *Herbst*'s analysis is flawed (Brunstad Br. 29–30) and the case now mostly serves to illustrate the struggles courts have had in interpreting "defalcation."

5. The government's historical-practice argument is unenlightening.

The United States suggests that ambiguity in the statute can be resolved by reference to "historical practice." (U.S. Br. 17.) But the discussion that follows this suggestion sheds no light on the meaning of defalcation. The United States points out that bankruptcy discharge was unavailable in the 1841 Act to "any person who, after the passing of this act, shall apply trust funds to his own use," but concedes that the term "defalcation" itself was actually used elsewhere in the statute. (*Id.*) Moreover, the "apply trust funds to his own use" language disappeared from the statute when the 1841 Act was repealed in 1843. Ch. 82, 5 Stat. 614 (1843). The concept resurfaced, perhaps, in the 1898 Act, which for the first time added "misappropriation" to the list of discharge-excepted acts. (P. Br. 13.) Misappropriation is commonly defined as "[t]he application of another's property or money dishonestly to one's own use." BLACK'S LAW DICTIONARY 1088 (9th ed. 2009). Yet "misappropriation" itself was deleted from the 1978 Act. In short, the government's historical-practice argument is off

the mark because history headed in a different direction.

II. The Fresh Start Policy Is Embodied in the *Gleason* Rule and Reinforced by the Rule of Lenity.

The Court has held that discharge exceptions are to be "confined to those plainly expressed," *Gleason v. Thaw*, 236 U.S. 558, 562 (1915), a principle that safeguards bankruptcy's "fresh start" policy as it applies to exceptions to discharge. No serious argument can be made that "defalcation" has a plain meaning that is dispositive here. The contextual guidance supplied by *noscitur a sociis*, however, parallels the application of the rule of lenity, which has been invoked in civil contexts as well as in criminal cases: "Ambiguity in a statute defining a crime or imposing a penalty should be resolved in the defendant's favor." ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS § 49 at 296 (2012); *see Crandon v. United States*, 494 U.S. 152, 158 (1990) (applying rule in civil context). The rule is applicable when reasonable doubt of a term's meaning still persists after available tools of interpretation have been applied. *Moskal v. United States*, 498 U.S. 103, 108 (1990). Excepting a debt from discharge in bankruptcy is arguably worse than a civil penalty; where the debt is substantial it is a sentence of permanent insolvency. Applying the rule of lenity to resolve uncertainties in the scope of exceptions to discharge would reinforce the "fresh start" policy embodied in

the *Gleason* principle. "On the whole, it might fairly be said that the rule of lenity is underused in modern judicial decision-making—perhaps the consequence of zeal to smite the wicked." SCALIA & GARNER at 301 (footnote omitted). Overzealousness is in abundant supply here, but wickedness is absent. The only court to hear testimony could find no malicious intent by petitioner. No finding has been made that he acted dishonestly. The profits-recovery judgment against him should have been ruled dischargeable because there was no evidence that he acted with a culpable mental state. At the very least, he was entitled to a trial on the dischargeability of that debt.

III. Failure to Produce the Entrusted Property Is Required for "Defalcation."

Assuming a culpable mental state is established, the issue is what *act* is required to commit a bankruptcy defalcation. Petitioner argued in his main brief that a failure to produce the funds entrusted to the fiduciary is a requirement for a "defalcation," as understood when the term was first introduced, in the 1841 Bankruptcy Act. (P. Br. 26.)

Respondent counters that "[b]y making self-dealing loans Bullock committed defalcation by misappropriation of the Trust corpus." (R. Br. 21.) But this argument overlooks the deletion of "misappropriation" from the current statute in 1978. The United States acknowledges that deletion but suggests that it was solely attributable to a desire to eliminate

redundancy. (U.S. Br. 22.) That suggestion, however, presumes a pre-repeal redundancy and thus collides with the anti-surplusage canon. A more plausible inference is that Congress did not intend that every minor misappropriation be regarded as a defalcation that results in a bar to discharge of any resulting debt. An act of "misappropriation" is not necessarily a defalcation; something more is required, some real harm or loss.

Respondent and its *amici* argue that a trustee's failure to send annual reports to beneficiaries where required, as the court here found, is itself the sort of misconduct that should constitute defalcation and deny the errant trustee a discharge of any associated debt. (R. Br. 21.) But they cite no support in the case law for this harsh result. Here, in any event, the supposed profits that were the subject of the judgment were attributed to the three loans, not the failure to tender reports. And no one could seriously argue that a trustee's failure to provide reports that did not result either in a loss to the trust or in profits to the trustee could be a basis for bankruptcy defalcation.

The United States points out that a person who commits fraud, embezzlement, or larceny does not necessarily escape criminal liability by returning the property. (U.S. Br. 24–26 & n.16.) But the United States cites no case in which a bankruptcy discharge of a debt has been denied for someone found to have committed one of those offenses where all of the property was returned before legal action. Such return

tends to negate the mental state required to find fraud, embezzlement, or larceny, as well as eliminate any loss. *See Consumer United Ins. Co. v. Bustamante* (*In re Bustamante*), 239 B.R. 770, 777 (Bankr. N.D. Ohio 1999); *C & J Rentals, Inc. v. Purdy* (*In re Purdy*), 231 B.R. 310, 312–13 (Bankr. E.D. Mo. 1999).

The question here is whether the conduct underlying the judgment for disgorgement of profits, essentially a penalty, plus attorneys' fees incurred in obtaining that judgment, qualifies as defalcation. Respondent refers several times to petitioner's "harm [to] the Trust" (R. Br. 3), but cites nothing in the record establishing any actual harm to the trust. The life insurance policy retained the same value at the conclusion of petitioner's tenure as trustee that it had when he (unwittingly) began his service. The loans that were made to his mother and himself were repaid, with interest.

Notably, any of the estimated profits that resulted from the loans were presumably captured by the broad constructive trust imposed by the Illinois court, which installed respondent as trustee of that trust. Specifically, the court found that the Springfield, Ohio mill was the "first property acquired through the wrongful use of trust property" and imposed a constructive trust on the mill. Pet. App. 47a. The court also imposed a constructive trust on the assets of petitioner, including real estate, and on the two family-related companies that conceivably could have benefited from the loans. *Id.* Consequently, the profits that petitioner could have received were

subject to the constructive trust—of which respondent was the trustee. Yet respondent did nothing in the ensuing years to apply any of those assets to the judgment. Respondent is incorrect that petitioner's evidence of respondent's failure to sell some of the assets despite his repeated requests has "never been put in evidence in the record in this case." (R. Br. 2 n.1.) Petitioner's *pro se* opposition to summary judgment, received in the bankruptcy court without objection by respondent, chronicles respondent's multiple failures to act to protect the trust and permit him to pay the judgment by liquidating the constructive trust's assets before they deteriorated in value. The district court took note of such evidence, and lambasted *respondent's* "abusing its position of trust by failing to liquidate the assets." Pet. App. 27a. Not only was there no loss of trust *res*, but there could have been recovery of the disgorged benefits if respondent had acted responsibly.

At the very least, the absence of any loss of trust *res* or any showing of any risk of such loss should be relevant to a determination of whether petitioner acted with a mental state sufficiently culpable to warrant excepting the judgment against him from discharge.

CONCLUSION

Petitioner suffered summary judgment on respondent's claim that his debt should be excepted

from discharge, but neither his actions nor his accompanying mental state amounts to the sort of intentional misconduct that would warrant exclusion from discharge. At a minimum, the state court's "self-dealing" finding, by itself, was insufficient to deprive him of his right to a trial on the issues. The Eleventh Circuit's judgment should be vacated and the case remanded for further proceedings consistent with the Court's opinion.

Respectfully submitted,

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