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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

BRIEF IN SUPPORT OF RESPONDENT FOR *AMICI CURIAE* PROFESSORS RICHARD AARON, JAGDEEP S. BHANDARI, SUSAN BLOCK-LIEB, JOHN COLLEN, JESSICA DAWN GABEL, KENNETH N. KLEE, GEORGE W. KUNEY, LOIS LUPICA, THERESA J. PULLEY RADWAN, NANCY B. RAPOPORT, MARIE T. REILLY, KEITH SHARFMAN, AND ROBERT ZINMAN

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INTEREST OF THE *AMICI CURIAE*[1]

The *Amici Curiae* are law professors who have a keen interest in bankruptcy law.[2] They study difficult and important issues that have troubled bankruptcy and appellate courts. The issue posed by this appeal, namely, what constitutes "defalcation" by a fiduciary within the meaning of the nondischargability provision of 11 U.S.C. § 523(a)(4), has vexed the nine Circuit Courts of Appeal, including the Eleventh Circuit below, that have addressed the issue. Their decisions neither provide any analytical basis for their varied holdings about the meaning of "defalcation" under clause (4), nor any meaningful guidance to the lower courts for applying that provision.

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1 Pursuant to Rule 37 of this Court, the *Amici* file this brief with the written consent of both parties, which is on file with the Clerk. No counsel for a party authored this brief in whole or in part. No person or entity including the *Amici* or their counsel made a monetary contribution for the preparation of this brief.

2 The *Amici* are the following law professors who teach at the law schools indicated next to their names: Richard Aaron, University of Utah- S.J.Quinney College of Law; Jagdeep S. Bhandari, Florida Coastal College of Law; Susan Block-Lieb, Fordham University School of Law; John Collen, St. John's University School of Law; Jessica Dawn Gabel, Georgia State University College of Law; Kenneth N. Klee, UCLA School of Law; George W. Kuney, University of Tennessee College of Law; Lois Lupica, University of Maine School of Law; Theresa J. Pulley Radwan, Stetson University College of Law; Nancy B. Rapoport, William S. Boyd School of Law-University of Nevada, Las Vegas; Marie T. Reilly, Penn State University-Dickinson School of Law; Keith Sharfman, St. John's University School of Law; Robert Zinman, St. John's University School of Law.

The *Amici* offer this *pro bono amicus* brief in support of Respondent to assist the Court as it considers the meaning of "defalcation" under clause (4). This brief sets forth a unique analysis of the meaning of "defalcation" based on the purpose of clause (4), its legislative history, and the jurisprudence of this Court. The analysis is also based on this Court's explanation of the meaning of the fiduciary defalcation provision first set forth in the Bankruptcy Act of 1841 and the circumstances that led to its enactment, which underpin the fiduciary defalcation provision in the four major revisions of the bankruptcy laws, including the current fiduciary defalcation provision in § 523(a)(4) of the 1978 Bankruptcy Code.

The *Amici* represent no institution, group, or association, and they are not predisposed to the interests of debtors or creditors. Their sole purpose is to bring to the Court an understanding of the meaning of "defalcation" by a fiduciary under clause (4) based on a new analysis that is not offered by the Circuit Courts or by the parties to this appeal.

SUMMARY OF ARGUMENT

The *Amici* urge affirmance of the order of the Circuit Court below, which held that the debtor's self-dealing conduct consisting of borrowing from a trust fund of which he was the trustee, in violation of the trust agreement, was "a defalcation while acting in a fiduciary capacity" within the meaning of clause (4), and that his resulting debt thus was excepted from his discharge. Although the *Amici* believe that the result reached below was correct, they disagree with the approach used

by the Circuit Court below and the other Circuit Courts to determine what constitutes "defalcation" under clause (4).[3]

The *Amici* submit that "defalcation" under clause (4) means: noncompliance by the debtor with the standard of conduct required by the non-bankruptcy law of trusts under the particular fiduciary duty that has been breached by the debtor. They urge that "defalcation" under clause (4) depends upon a breach by the debtor of a fiduciary duty established by the law of trusts, which body of law provides the standards of conduct required for compliance with the various fiduciary duties. Whether there has been a breach of such duty turns on whether the debtor has failed to comply with such duty's standard for compliance. Accordingly, "defalcation" within the meaning of clause (4) consists of a debtor's noncompliance with the standard of conduct required by the particular fiduciary duty that he or she has breached. The *Amici's* approach to determine whether a debtor has defalcated carries out the purpose of clause (4) to protect the beneficiaries of specific trust funds and offers a single approach to replace the many different standards for "defalcation" under clause (4) promulgated by the various Circuit Courts.

There are two types of fiduciary duties under the law of trusts. One type, such as the duty requiring undivided loyalty of the fiduciary to the beneficiary, demands absolute compliance, for

[3] The eight other Circuit Court decisions that address the meaning of "defalcation" under clause (4) are cited in the opinion of the Circuit Court below. *See Bullock v. BankChampaign, N.A.*, 670 F.3d 1160, 1165-66 (11th Cir. 2012).

which honesty of purpose, mistake, or mere negligence, is not a defense. The other type, such as the fiduciary's duty to invest trust assets productively, calls for reasonable care, and is the basis for imposing personal liability on a fiduciary who, although having made an honest mistake, has performed negligently. In short, whether a debtor has defalcated turns on whether he or she has failed to comply with the standard of conduct required under the particular fiduciary duty imposed on him or her.

By sharp contrast, nine Circuit Courts, including the Circuit Court below, have failed to recognize that the particular fiduciary duty that has been breached itself fixes the level of conduct required by clause (4). Instead, those courts have concluded that, in order to decide whether a debtor has defalcated, it was necessary for them to consider various levels of misconduct, ranging from negligence to extreme recklessness, without regard to the standard of conduct required by the specific fiduciary duty that was breached, and then to choose one of those levels as the test for "defalcation." Each of these Circuit Courts thus selected a single level of culpability which, in its judgment, warranted nondischargability, and thereafter courts in that Circuit and some other Circuit Courts adopted that single standard as a universal standard for deciding whether the debtor defalcated under clause (4). Specifically, six of the Circuit Courts, including the Circuit Court below, ended up choosing some level of recklessness, while the other three Circuit Courts selected

a lesser standard.[4] In short, each Circuit has come up with its own "one size fits all" test. In the present case, the Circuit Court below chose "objective recklessness" as the standard for "defalcation." In contrast, the *Amici* offer an analytical approach for determining under <u>any</u> state of facts whether a debtor has defalcated, which provides guidance needed by the lower courts not found in the opinions of the Circuit Courts that addressed the meaning of "defalcation" under clause (4).

The *Amici's* suggested meaning of "defalcation" under clause (4) is based on several grounds. First, and most importantly, it is grounded on the fundamental historical purpose of the fiduciary defalcation provisions to protect the beneficiaries of specific trust funds, a goal which has never changed or been questioned. That purpose, which continues to underpin clause (4), reflects a strong public policy to ensure that trust beneficiaries, who rely heavily on their anticipated receipt of the trust fund, will ultimately receive the assets that have been placed in safekeeping for them. In light of the purpose of clause (4)'s defalcation provision, Congress must have intended to tether each fiduciary duty's required standard of conduct to clause (4)'s defalcation provision, rather than having defalcation depend on a subjective judicial conclusion as to the level of misconduct thought to be sufficiently egregious to warrant nondischargability generally (i.e., in all cases).

[4] The Circuit Court below grouped the eight other Circuit Court decisions according to the level of the debtor's misconduct they selected as warranting nondischargability under clause (4). *Bullock*, 670 F.3d at 1165-1166.

Second, the *Amici's* approach is grounded on the jurisprudence of this Court. This Court's understanding of the first fiduciary defalcation provision, enacted as part of the Bankruptcy Act of 1841, strongly underpins the *Amici's* view of the meaning of "defalcation." In *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844), this Court interpreted the fiduciary defalcation provision in the 1841 Bankruptcy Act as limited to certain types of fiduciaries, specifically trustees and estate executors and administrators who manage specific trust funds for specified beneficiaries. This limitation was based on the need to prevent trustees and similar fiduciaries from escaping liability for breaches of fiduciary duties by means of bankruptcy. In so holding, this Court observed that these fiduciaries are "special" fiduciaries who serve under what it called a "technical" trust, specifically holding that the fiduciary defalcation provision did not apply to trusts implied in law.

In the succeeding four major revisions of the bankruptcy statutes enacted after the 1841 Act was passed, including the 1978 revision, the wording of the fiduciary defalcation provisions changed so as to merge the named specific, or "special," fiduciaries into a single composite category making nondischargable debts arising from "defalcation while acting in a fiduciary capacity." These changes in wording were made without any indication, either in the text of the provisions or in legislative history, that Congress intended to eliminate (as opposed to supplement) its original understanding of "defalcation" as explained in *Chapman*. Nor do such word changes or their legislative history suggest that Congress intended to

depart from the understanding that making "defalcation" by a fiduciary nondischargable is the specific means to protect trust beneficiaries from the failure of trustees who serve under express trusts to comply with the standards of conduct established by the law of trusts.

Third, the *Amici's* understanding of "defalcation" in clause (4) is further supported by its legislative history, which, in rejecting a specific recommendation in 1973 by a congressionally created bankruptcy review commission to eliminate a fiduciary defalcation provision altogether, continued to provide for a fiduciary defalcation provision in its 1978 enactment of clause (4).

Fourth, the *Amici* urge that grounding defalcation on the fiduciary's failure to comply with the standard of conduct required by the particular fiduciary duty that has been breached, provides the appropriate measure of protection against a breach of each of the different types of fiduciary duties. Moreover, as this Court has explained, in the context of the 19 clauses of § 523(a) excepting various debts from the debtor's discharge, clause (4) should be understood to reflect a congressional decision that the interest of the trust beneficiaries it protects outweighs the interest in a complete "fresh start" for a trustee who has breached his fiduciary duty to them.

In short, fidelity to clause (4) requires preserving a trust beneficiary's right of recovery for a trustee's breach of fiduciary duty by denying a free pass for the liability by means of bankruptcy.

ARGUMENT

POINT I

THE FIDUCIARY DEFALCATION PROVISION OF § 523(a)(4) SHOULD BE INTERPRETED TO IMPLEMENT THE CONGRESSIONAL PURPOSE TO PROTECT BENEFICIARIES OF TRUST FUNDS FROM NONCOMPLIANCE BY TRUSTEES AND SIMILAR FIDUCIARIES WITH THE STANDARDS OF CONDUCT REQUIRED BY THE FIDUCIARY DUTIES IMPOSED BY THE LAW OF TRUSTS

At its inception in the Bankruptcy Act of 1841, the fiduciary defalcation provision was enacted to protect trust fund beneficiaries from the failure of trustees and others who manage specific trust funds to comply with their fiduciary duties. "Defalcation," as understood by both Congress and this Court from the inception of defalcation provisions, depends upon whether there has been a breach of a fiduciary duty established by the non-bankruptcy law of trusts. For a court to decide whether there has been a breach of a fiduciary duty necessarily requires it to determine whether the fiduciary failed to comply with the standard of conduct required by such law for compliance with that duty. That standard of conduct thus inheres in a fiduciary defalcation provision.

The *Amici's* approach focuses on the various fiduciary duties and their required standards of conduct. The fiduciary duty of loyalty, and the fiduciary duty of due care in the administration of a trust fund, each provides its own standard for

compliance, the former requiring absolute compliance and the latter requiring reasonable care. Because Congress based defalcation provisions on the breach of fiduciary duties, the only plausible inference is that it intended that the standard required by the law of trusts for compliance with the particular fiduciary duty at issue would be the basis for determining whether a debtor defalcated. Congress essentially incorporated all segments of the law of trusts into its fiduciary defalcation provisions, not merely the portion of trust law imposing fiduciary duties while leaving behind the critically important portion establishing the standard of conduct required for compliance with them.

Congress thus looked to the law of trusts, an established body of state law, for the required standard of conduct for fiduciaries who control trust funds. This Court recognizes that Congress commonly bases its legislation on pre-existing state law. *See BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-545 (1994) ("[T]he Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law."); *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 740 (1979) (holding that, absent a congressional directive, state law governs the relative priority of federally held mortgages).

Congress provided no suggestion that it intended to leave it to a court to determine whether a debtor has defalcated on the basis of its own subjective judgment of what conduct it considers to be sufficiently egregious to warrant excepting a fiduciary's debt from discharge. Accordingly, "defalcation" under clause (4) must

mean a failure of a debtor to comply with the standard of conduct under the law of trusts required by the particular fiduciary duty that he or she has breached.

A. The Origin Of Fiduciary Defalcation Provisions

The first defalcation provision, in the Bankruptcy Act of 1841, is rooted in an 1838 scandal of national proportions involving defalcation by an important official of the United States Treasury Department, Samuel Swartout. App. to the Cong. Globe, 25th Cong., 2nd Sess. 16 (December 1838). When it became known that Swartout, the New York Collector of Customs, which was the primary source of revenue for the United States Government, may have taken in excess of $200,000 of customs duties to pay personal expenses, the Treasury Department conducted an audit, which revealed that the then massive sum of over $1,300,000 of customs duties collected in the New York office could not be accounted for. The Secretary of the Treasury then prepared a special report on Swartout's defalcation, which President Martin Van Buren delivered to Congress with his own message dated December 8, 1838 calling for enactment of measures "for increasing the public security against similar defalcations hereafter." *Id.* The President's message to Congress repeatedly characterized Swartout's actions as "defalcation," *id.*, urging that Congress enact criminal penalties "against the loan or embezzlement of the public money by collectors, as well as all classes of officers, and the strictist prohibitions against its use in any way for private purposes." *Id.* at 18.

The nation's first bankruptcy statute, the Bankruptcy Act of 1800, had a life of only two years. Sufficient interest for enactment of another bankruptcy act developed some years later, resulting in passage of the Bankruptcy Act of 1841. Swartout's defalcation and the President's message of concern for defalcations was the focus of the legislators when including the first fiduciary defalcation provision in the 1841 Act. With the Swartout defalcation scandal fresh in their minds, the need to protect against defalcation by a fiduciary was appropriately reflected by the legislators in the 1841 legislation. In light of Swartout's defalcation, the 1841 defalcation provision understandably singled out "public officers" for special attention in the legislation in order to prevent public officers who failed to perform their fiduciary duties from escaping liability by means of a bankruptcy discharge.[5] Significantly, however, the

[5] This appeal does not raise the issue whether clause (4) may be interpreted, as suggested by a few lower courts, to be applicable to fiduciaries such as corporate directors and officers, who are trustees under trusts that are implied in law and do not manage a specific trust *res* under an express trust. However, in connection with defining the scope and meaning of "defalcation" under clause (4), the *Amici* note their view that, under this Court's analysis of the defalcation provision at issue in *Chapman,* clause (4) should not be read as applicable to corporate directors and officers because their duties are not imposed by an express or technical trust that creates a trust *res* for a named beneficiary. In *Chapman*, this Court observed that it limited the application of the fiduciary defalcation clause so that it would not operate on debts arising from "commercial transactions," *Chapman,* 43 U.S. at 208, which indicates that a fiduciary defalcation provision is not intended to be applicable to corporate directors and officers or others who function in the commercial context and whose fiduciary duties are implied in law. It is also significant that, whereas each of the fiduciary defalcation pro-

1841 bankruptcy legislation went beyond the "public officer" defalcation segment of the provision. The legislators recognized that all fiduciaries who manage specific trust funds for beneficiaries, not only public officers, likewise required coverage in the defalcation provision in the advent of their bankruptcy filing. The 1841 defalcation provision thus covered "defalcation as a public officer; or as executor, administrator, guardian, or trustee, or while acting in any other fiduciary capacity."[6]

In interpreting the original defalcation provision in *Chapman,* this Court held that the phrase "or while acting in any other fiduciary capacity"

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visions in the Bankruptcy Acts of 1841, 1867, 1898, and 1938 specifically included a "public officer" or "an officer," clause (4) of the 1978 Bankruptcy Code omits "an officer" from its scope. The *Amici* further note that, even if the term "officer" under the earlier provisions had been intended to include corporate officers, Congress presumably did not, in view of this change in language, intend them to be covered by clause (4). *See Crawford v. Burke*, 195 U.S. 176, 190 (1904) ("[A] change in phraseology creates a presumption of a change in intent. . . ."). More recently, in *Commonwealth Land Title Co. v. Blaszak*, 397 F.3d 386, 391 (6th Cir. 2005), the court, in careful analysis, ruled that defalcation by a fiduciary under clause (4) requires "the existence of a pre-existing express or technical trust whose res encompasses the property at issue," (citing *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934)).

[6] The Bankruptcy Act of 1841, unlike its 1800 predecessor statute, authorized the voluntary commencement of a bankruptcy case. So as to prevent trustees and others who control trust funds to escape liability from a breach of fiduciary duty, Congress provided in Section 1 of the 1841 Act that such fiduciaries were not eligible to file in bankruptcy. 5 Stat. 440 (1841). The fiduciary defalcation provision in each of the subsequent Bankruptcy Acts, which permitted such fiduciaries to file in bankruptcy, provided that their debts arising from a breach of fiduciary duty were nondischargable.

was intended to cover only the same type of trusts as those specifically enumerated, namely those of trustees and others who manage specific trust funds for trust beneficiaries under technical trusts, not those implied in law. *Chapman*, 43 U.S. at 208. As stated by this Court, this limitation recognized that trustees and similar fiduciaries posed a special risk to the beneficiaries:

> In almost all the commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and a violation of these is, in a commercial sense, a disregard of trust. But this is not the relation spoken of in the first section of the act.
>
> The cases enumerated, "the defalcation of a public officer," "executor," "administrator," "guardian," or "trustee," are not cases of implied but special trusts, and the "other fiduciary capacity" mentioned, must mean the same class of trusts.

Id. at 208.

From its inception, the purpose of fiduciary defalcation provisions has been to protect trust fund beneficiaries from a breach of fiduciary duty by a trustee and others in the special class of fiduciaries, who file in bankruptcy to shed liability for their breach.This Court reaffirmed its understanding of "defalcation," as expressed in *Chapman,* in each of its later decisions involving the fiduciary defalcation provisions of subsequent bankruptcy statutes. *See Neal v. Clark,* 95 U.S. 704, 708 (1877); *Hennequin v. Clews*, 111 U.S. 676, 679 (1884); *Upshur v. Briscoe,* 138 U.S. 365, 372

(1891); *Crawford*, 195 U.S. at 189; *Davis,* 293 U.S. at 333 (1934).

While courts interpreting the fiduciary defalcation provision of clause (4) often cite *Chapman*, they fail to recognize *Chapman's* understanding that "defalcation" is built on the non-bankruptcy law of trusts governing fiduciary duties, which provides the standards of conduct required for compliance. Accordingly, the result below should be affirmed on the ground that Petitioner, by self-dealing in violation of the duty of loyalty, breached the standard requiring absolute compliance with that fiduciary duty, as established by the law of trusts.

B. Defalcation Consists Of Conduct That Fails To Comply With The Standard Required For Compliance With The Particular Fiduciary Duty That Has Been Breached

The *Amici's* approach focuses on the fiduciary duty that has been breached and the standard of conduct required for compliance with it. The fiduciary duty of loyalty and the fiduciary duty of due care in the administration of a trust fund, each provides its own standard for compliance. One type of fiduciary duty requires strict compliance, whereas other types of fiduciary duties allow a measure of discretion.

1. Types of Fiduciary Duties and Their Compliance Standards Under the Law of Trusts

The law of trusts imposes two types of fiduciary duties. Whether a debtor has defalcated within the meaning of clause (4) turns on whether he or

she has failed to comply with the standard of conduct required for compliance with the particular fiduciary duty that has been breached.

One type of fiduciary duty, for example the duty requiring undivided loyalty, exacts the highest degree of loyalty, demanding that the fiduciary act solely in the interest of the beneficiary. It is no defense to a breach of such duty that the action was taken in good faith or honestly, or that the terms of the transaction were fair. Restatement (Third) of Trusts § 78, at 95, cmt. b (2007). The fiduciary duty of undivided loyalty "is particularly intense so that, in most circumstances, its prohibitions are absolute for prophylactic reasons.The rationale begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty." *Id.* at 96. The only exceptions to the strict prohibitions of this duty involve transactions authorized by court order or by the terms of the trust instrument. *Id.* at 97. In this case, Petitioner placed his personal interests above those of the beneficiaries in taking self-dealing loans of trust funds, which, under the law of trusts, is not excused by his claim of good faith, and was not authorized by the trust agreement. The Petitioner's self-dealing conduct in this case, in taking trust assets for personal use, constituted a *per se* defalcation under clause (4).

The other type of fiduciary duty imposed by the law of trusts involves the administration of trust funds, such as the fiduciary duty to invest trust funds productively. The law of trusts calls for a trustee to exercise reasonable care in the performance of such duty. 2A A. Scott, The Law of

Trusts § 170.25 (W.F. Frachter ed., 4th 2001). Negligent performance of that duty, though constituting an honest mistake, constitutes a breach of trust and thus defalcation.

The difference between the two types of duties imposed by the law of trusts and the standards of conduct they require for compliance, is well illustrated by *Dickerson v. Camden Trust Co.*, 53 A.2d 225 (N.J. Ch. 1947). In that case, the court surcharged an executor for losses in "non-legal" securities retained in the estate by the executor in contravention of a provision of the will. It was held that this provision of the will did not allow for any exercise of discretion because noncompliance with a provision of the trust instrument violates the fiduciary duty of loyalty, which imposes an absolute obligation to comply with the instrument. The court went on to hold that the breach of the duty of loyalty was not excused by the fact that the executor "may have acted in perfect good faith" in attempting to generate sufficient income to meet the testator's objective. *Id.* at 231. By contrast, as noted by the court, the executor would be afforded a reasonable time to dispose of securities in compliance with such direction, and also would have been under a duty to exercise "good faith and reasonable discretion" in retaining "non-legal" securities in the absence of the direction by the will to dispose of them. *Id.* at 237. The court thus focused on the particular standard of conduct required for compliance with the fiduciary duty that has been breached, rather than on a degree of fault that the court believed warranted the imposition of a surcharge. On appeal, the surcharge order in *Dickerson* was affirmed by the New Jersey Supreme Court. *Dickerson v. Camden Trust*

Co., 64 A.2d 214, 217 (N.J. 1949) (per Arthur T. Vanderbilt, C.J.) (stating that where action taken by the fiduciary is not authorized by the trust instrument, the breach of a fiduciary duty is not excused by "the exercise of reasonable care and discretion in good faith"). *Accord Gilbert v. Kolb*, 37 A. 423 (Md. 1897) (stating that acts not permitted by the trust instrument, though "done in the utmost good faith," constitute a breach of fiduciary duty, while an exercise of discretionary authority constitutes a breach of fiduciary duty if the trustee fails to act "in good faith and with diligence"). *See also* Bogert's Trusts and Trustees § 541 at 161-162 ("Any attempt to take action contrary to the settlor's directions may be deemed to constitute a unilateral and invalid deviation from the trust terms though the trustee is otherwise given broad discretions in administering the trust.")

In surcharging a bankruptcy reorganization trustee for profits earned by his employees in trading outstanding securities of the debtor company, this Court, in *Mosser v. Darrow*, 341 U.S. 267, 275 (1951), refused to entertain as a defense that the trustee had no personal interest in his employees' profits and acted in good faith. Significantly, this Court reversed the decision of the lower court denying a surcharge because that decision was based on the fact that the trustee's conduct was merely negligent. In holding the trustee responsible, this Court stated that in a strict trusteeship, "[e]quity tolerates in bankruptcy trustees no interest adverse to the trust," explaining that "[t]his is not because such interests are always corrupt but because they are always corrupting." *Id.* at 271. For this reason, a

trustee is under an absolute obligation to comply with the fiduciary duty of loyalty, because "strict adherence" to the duty of loyalty will ensure compliance with the high standard it requires for performance of that paramount duty. *See Woods v. City Nat. Bank & Trust Co. of Chicago,* 312 U.S. 262, 269 (1941), quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) ("Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd.'").

The diversion of trust funds for use for a trustee's own business purposes thus constitutes a clear breach of the fiduciary duty of undivided loyalty and constitutes defalcation under the fiduciary defalcation provision, even assuming *arguendo* that the default was innocent. This reflects the basic rule under the law of trusts that a trustee's use of trust money to make personal investments constitutes a breach of the fiduciary duty of loyalty, to which there is no defense. See *Whitaker v. Estate of Whitaker*, 663 N.E.2d 681, 685 (Ohio Ct. App. 1995) (surcharging an executor for self-dealing consisting of borrowing from the trust fund); *Feinberg v. Adolph K. Feinberg Hotel Trust*, 922 S.W.2d 21, 25-26 (Mo. Ct. App. 1996) (same).

2. Petitioner Wrongly Urges Fraud, Embezzlement and Larceny as the Standard Under Clause (4), and Misapplies the Canon, *Noscitur a Sociis*

Petitioner asserts that a debt cannot be nondischargable under clause (4) unless it arises from "the degree of culpability commensurate with

fraud, embezzlement, and larceny." Pet. Br. 7, 23. There is, however, no basis in the text or legislative history of clause (4) for finding congressional intent to limit defalcation to serious criminal conduct "involving moral turpitude or intentional wrong," which are the hallmarks of fraud and embezzlement. *See Neal*, 95 U.S. at 709; *Noble v. Hammond,* 129 U.S. 65, 69 (1889) (stating "moral turpitude or intentional wrong" is required to be nondischargable as "fraud" or "misappropriation").

Moreover, using "moral turpitude or intentional wrong" as the standard for defalcation would render the fiduciary defalcation provision meaningless, as covering nothing other than what is already covered by the fraud, embezzlement and larceny. As stated by Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (1937), "defalcation" must cover something other than "fraud or embezzlement."

Nor does clause (4) require willful misconduct for defalcation, as Petitioner contends. Pet. Br. 21-23. Clause (4) does not mention willfulness as the standard of conduct for defalcation, which is required by § 523(a)(6) to render nondischargable an injury to another person or property. It would make no sense to interpret clause (4) as requiring willful conduct in light of Congress' use of that word in providing for nondischargability in clause (6) and not in clause (4). As stated in *BFP v. Resolution Trust Co.*, 511 U.S. 531, 538 (1994): "It is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another." (quoting *City of Chicago v. Envtl. Def. Fund*, 511 U.S. 328, 338 (1994)).

Petitioner also relies heavily on the interpretive canon, *noscitur a sociis*. Pet. Br. 21-23. His reliance on that canon, however, is misplaced. "Defalcation" occurs in clause (4) directly in connection with the words "fiduciary capacity," and it is to those immediate specific word "companions" (what the Latin word "*sociis*" refers to) to which one must turn to construe "defalcation" and not to the remote companions "fraud," "embezzlement," or "larceny," as Petitioner contends.

3. Negligent Conduct Constitutes Defalcation When Reasonable Care is the Applicable Standard of Conduct Under the Law of Trusts

The *Amici* recognize that, whereas many debts incurred by debtors as a result of negligent conduct are discharged by bankruptcy, under their approach the debt of a fiduciary for negligent conduct in breach of a fiduciary duty requiring reasonable care would be nondischargable under clause (4). This is best understood in light of the special duty that a trustee owes to the beneficiary, and the design of the fiduciary defalcation provision to hold a fiduciary to the standard of conduct fixed by the law of trusts. Moreover, from the point of view of the beneficiary, which is the focus of clause (4), not that of the debtor, the injury to be guarded against is no less hurtful to the beneficiary where the fiduciary's conduct constitutes negligence rather than of a more egregious level.

Several Circuit Courts have recognized that negligent misdeeds, though innocent, constitute defalcation under clause (4), although their opinions likewise lack an analytical basis for their cho-

sen standard. *See In re Uwimana*, 274 F.3d 806, 811 (9th Cir. 2001); *In re Sherman,* 658 F.3d 1009, 1014 (9th Cir. 2011); *In re Cochrane,* 124 F.3d 978, 984 (8th Cir. 1997).

In this connection, the *Amici* note that, contrary to Petitioner's contention, this Court's opinion in *Kawaauhau v. Geiger*, 523 U.S. 57 (1998), sheds no light on the meaning of "defalcation" in clause (4). *Geiger* held that a debtor's debt arising from negligence was nondischargeable under clause (6) of § 523(a) because it did not arise from a "willful and malicious injury" as required by clause (6). *Id.* at 63-64. *Geiger*, however, does not bear on the meaning of defalcation under clause (4) because, although its opinion discussed several other clauses of § 523(a), *Geiger* did not involve clause (4) and its opinion did not discuss or even cite clause (4) once. Petitioner's reliance on *Geiger* illuminates his failure to understand that, in enacting clause (4), Congress determined as a matter of policy that the bankruptcy of a trustee or similar fiduciary should not preclude trust beneficiaries from pursuing all remedies to collect the trust funds placed in safekeeping for them. Clause (4)'s purpose to fully protect trust beneficiaries can be fulfilled only if a trustee's debts for breach of fiduciary duty, whether arising from intentional or negligent conduct, survive a bankruptcy.

4. Judge Learned Hand's Opinion in *Herbst* Illuminates that Fiduciary Duties Are Inherent in Clause (4)

Many courts have looked to Judge Learned Hand's opinion in *Herbst* to find a test for defalcation under a fiduciary defalcation provision in the

bankruptcy law, or for a pathway to an understanding of its meaning.[7] Although some Circuit Courts have viewed *Herbst* merely as a "carefully equivocal opinion," *In re Patel*, 565 F.3d at 970; *In re Baylis*, 313 F.3d at 18, *Herbst* indeed offers insight into what Congress meant by defalcation. The *Amici* read Judge Hand's opinion as reflecting his understanding that defalcation consists of a violation of a fiduciary duty imposed by the law of trusts, and that where, as in *Herbst*, the particular fiduciary duty requires absolute compliance, a breach of that duty constitutes defalcation, which is not excused by good faith or the honesty of a mistake.

In that case, Judge Hand explored defalcation in terms of levels of a debtor's misconduct, indicating that some measure of wrongdoing is required.[8] Although Judge Hand did not articulate a concrete test for what constitutes defalcation, the *Amici* suggest that the significance of his opinion is found in his understanding that defalcation is

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[7] *See Bullock*, 670 F.3d at 1164, where the Circuit Court below described *Herbst* "as containing 'perhaps the best' analysis of the meaning of 'defalcation' under § 523(a)(4)" (citing *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993), and noting that *Herbst* addressed the predecessor statute). The following Circuit Court decisions referred to in the opinion of the Circuit Court below also cited *Herbst* in addressing the meaning of "defalcation" under § 523(a)(4): *In re Patel*, 565 F.3d 963, 970 (2009); *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002); *In re Hyman*, 502 F.3d 61, 69 (2d Cir. 2007); *In re Berman*, 629 F.3d 761, 766 (7th Cir. 2011).

[8] The current edition of Collier on Bankruptcy merely cites *Herbst* without any discussion or comment, and cites many cases applying clause (4) without setting forth the meaning of "defalcation." *See* 16 Collier on Bankruptcy ¶ 523.10[1][d] at p. 523-75 and n 37 (16th ed. 2012).

dependent upon there having been a breach of a fiduciary duty. *Herbst*, 93 F.2d at 512. The concept that for there to be a defalcation there must be a breach of a fiduciary duty is at the core of the *Amici's* understanding of what Congress meant by defalcation, which the Circuit Courts addressing clause (4) have overlooked. Although Judge Hand did not directly state that the standards of conduct required by the various fiduciary duties are built into the fiduciary defalcation provisions enacted by Congress, the conclusion that defalcation means noncompliance with those standards of conduct is a necessary inference from his holding.

In *Herbst*, the debtor, a non-lawyer, was a dentist who was appointed as a foreclosure receiver to handle a trust fund consisting of the proceeds from the sale at foreclosure of the mortgaged property. The foreclosure court's order awarded the debtor a fee for his service as foreclosure receiver, which he took from the trust fund. Although the debtor was authorized by court order to take his fee from the trust fund, the order was later reversed, by which time he had become insolvent without having returned the funds and filed for bankruptcy relief. The debtor thus placed his self-interest in getting paid ahead of his fiduciary duty to maintain the trust fund solely for the beneficiary's benefit, in that case the foreclosing mortgagee. Judge Hand ruled that the debtor's defalcation consisted of his failure to return trust funds, which, although lawfully taken pursuant to a court order, he had no right to keep and had an absolute fiduciary duty to return when the order was later reversed.

Herbst should thus be read as ruling that defalcation means noncompliance by the debtor with

the standard of conduct required by the fiduciary duty that has been breached, in that case the duty of undivided loyalty, which was held to impose an absolute duty on the debtor to return trust funds he had no legal right to retain. In so holding, Judge Hand rejected as defenses to the debtor's defalcation that his taking of the fee was permitted by a court order at the time of the taking, and that, as a non-lawyer, he should not be charged with knowledge of the law or be required to anticipate that a court order might be reversed. The debtor's defalcation in *Herbst* occurred when he failed to return trust funds he had no right to keep, for which the law accepted no excuse. Likewise, in the present case, the debtor's self-dealing use of trust funds constituted defalcation at the moment of the taking, for which the law of trusts does not accept as defenses his claims of good faith and honest intentions, including the later return of the money, though without the profit he now seeks to keep for himself.

The *Amici's* understanding of defalcation is thus illuminated by the opinion in *Herbst*, which supports the holding of the Circuit Court below that the debtor's self-dealing borrowing of trust funds constituted defalcation under clause (4).

In re Baylis, upon which Petitioner relies, likewise pronounced that defalcation under clause (4) is based on the breach of a fiduciary duty:

> Inherent in 'defalcation' is the requirement that there be a breach of fiduciary duty; if there is no breach, there is no defalcation.

Baylis, 313 F.3d at 17.

Baylis went on to recognize that there are two types of fiduciary duties, each with a different standard of conduct required for compliance, with the duty of loyalty requiring absolute compliance, and other fiduciary duties requiring reasonable care. In analyzing the non-bankruptcy law of trusts, the court in *Baylis,* quoting 2A A. Scott, The Law of Trusts § 170.25 (W.F. Frachter ed. 4th 2001), stated:

> In evaluating whether there is a defalcation of a fiduciary duty, there must be reference to the duty involved.
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> **********
>
> As long as [a trustee] is not acting in his own interest the standard fixed for his behavior is only that of a reasonable degree of care, skill and caution. But when the trustee acts in his own interest in connection with the performance of his duties as trustee, the standard of behavior becomes more rigorous. In such a case his interest must yield to that of the beneficiaries.
>
> 2A *id.* § 170.25. As with the other fault-based exceptions, fault may be presumed from the circumstances, here a violation of the duty of loyalty.

Baylis, 313 F.3d at 20-21

Significantly, however, in the face of these principles of the law of trusts it considered to be essential to determining whether a debtor defalcated, the court in *Baylis* chose "extreme recklessness," *id.* at 22-23, as a sufficiently egregious

singular standard coming close enough to that required for fraud, embezzlement and larceny to constitute defalcation. *Id.* at 19-20. The court in *Baylis* then applied its "extreme recklessness" standard of conduct both to the duty of loyalty, which requires absolute compliance, and to the duty to use reasonable care in the sale of trust property to a third party, which it held excuses conduct that is "not so reckless as to rise to the level of fault needed to constitute a defalcation." *Id.* at 23.

Baylis got it wrong. It referred to nondischargability of various debts under other clauses of § 523(a) as precluding the use of bankruptcy to nullify certain types of debts, "the repayment of which are important for policy reasons," and as to which "[t]he level of fault of the debtor has no bearing." *Id.* at 19. It is beyond comprehension, however, that the court in *Baylis* did not see clause (4)'s specification of defalcation as based on policy reasons, while at the same time recognizing that Congress singled out, as based on policy reasons warranting nondischargability, debts based on non-payment of taxes, alimony, and educational loans, among others. Without explanation or citation to *Chapman, Baylis* merely asserted that it was "unlikely" to read clause (4) as reflecting Congressional intent "to reinforce the high standard of care owed by fiduciaries by making debts for defalcation non-dischargeable." *Id.* at 19. In reaching its understanding of defalcation, *Baylis*, like many courts in search of the meaning of defalcation, cited *Herbs*t for the notion that "[d]efalcation is to be measured objectively," *id.* at 17, but nevertheless chose to measure it according

to its own subjective judgment as to the level of misconduct that warrants nondischargability.

C. Clause (4)'s Legislative History Indicates That Defalcation Means Noncompliance With The Standard Fixed By The Particular Fiduciary Duty In Question

Petitioner's test for defalcation under § 523(a)(4) based on "culpability commensurate with fraud, embezzlement and larceny," Pet. Br. 7, 23, would require a finding of "fraudulent intent" reflective of "moral turpitude or intentional wrong" akin to criminal intent. Such reading of cause (4) lacks any support in its text or legislative history, and would make defalcation merely duplicative of the other clause (4) grounds for nondischargability, reading it out of the statute.

The original fiduciary defalcation provision, enacted in 1841, was limited to "a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity," without mentioning fraud or embezzlement. Ch. 9, 5 Stat. 440 § 1 (1841). The bankruptcy amendments of 1867 introduced fraud and embezzlement as a basis for nondischargability, declaring such intentional conduct to be nondischargable without regard to whether the debtor was acting in a fiduciary capacity. The 1867 Act used the following words: "[N]o 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, shall be discharged. . . ." Ch. 176, 14 Stat. 517 § 33 (1867). As made clear by Judge Hand in *Herbst*, "defalcation" in the 1867 version did not gain meaning from Congress' addition of "fraud" and "embezzle-

ment." *Herbst*, 93 F.2d at 511. As he stated: "Whatever was the original meaning of 'defalcation,' it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'" *Id*. Petitioner's reliance on "fraud" and "embezzlement" as the standard for "defalcation" flies in the face of *Herbst*.

Thereafter, in enacting § 17a(4) of the Bankruptcy Act of 1898, Congress amended the fiduciary defalcation provision to tie fraud, embezzlement, and misappropriation to activity in a fiduciary capacity, not as independent bases for nondischargability, as under the 1867 statute. Ch. 541, 30 Stat. 544 § 17 (1898). The 1898 provision continued to make nondischargable debts for "defalcation while acting as an officer or in any fiduciary capacity." Congress' purpose in 1898 in also rendering nondischargable debts created by "fraud while acting in any fiduciary capacity" is unclear, given that prior to the amendment of that provision in 1903 non-fiduciary debts based on fraud were not made nondischargable, and the language of the 1898 provision does not suggest that defalcation was intended to be based on the intentionally wrongful intent required to establish fraud.

Nor does the minor change in the version of the fiduciary defalcation provision enacted in the Bankruptcy Act of 1938 shed any light on what Congress intended defalcation to mean. The 1938 provision rendered nondischargable debts of the debtor "created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity," using the exact language of the 1898 provision, except for its

omission of a comma after the word "misappropriation," a change for which its meaning is unclear. Ch. 575, 52 Stat. 840 § 17 (1938).

While the subject of fiduciary defalcation received a measure of attention during the legislative process in the 1970s, which led to the enactment of clause (4) in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598 (1978), Congress left the courts wondering what it meant by defalcation by a fiduciary. No pattern or understanding of it emerges from the text of clause (4) or its legislative history. The enactment of clause (4) came about after the congressionally-created Commission on the Bankruptcy Laws of the United States filed its 1973 report, which included a draft that would have only excepted from a discharge "any liability for embezzlement or larceny," without a provision for nondischargability of debts arising from "defalcation" or "misappropriation," which it stated to be "overbroad and uncertain in meaning." *See* Commission Report, H.R.Doc. No. 93-137, Pt. 2, at 136 n 139 (1973).

Adopting the recommendation of the 1973 Commission Report to jettison the fiduciary defalcation provision of the prior Bankruptcy Acts, a bill introduced in the House in 1977 would have limited nondischargability to debts for "embezzlement or larceny," without providing for nondischargability of debts for "defalcation." Petitioner's brief, however, wrongly asserts that <u>Congress</u> relied on the Commission Report, Pet. Br. 14 n.3, failing to tell this Court that Congress <u>rejected</u> the House's bill. The Senate responded to the House's bill, providing in its own bill that nondischargability under clause (4) would consist of "defalcation" without connecting it to fiduciary

capacity, as well as fraud while acting in a fiduciary capacity, embezzlement, and misappropriation. *See* S.Rep. No. 95-989 at 79 (1978) ("Paragraph (4) excepts debts for fraud incurred by the debtor while acting in a fiduciary capacity or for defalcation, embezzlement, or misappropriation."). The final version of clause (4), as enacted, was a compromise between the Senate and House versions, and lacked any legislative explanation of its ultimate wording. *See Estate of Neilson v. Simpson*, 37 B.R. 132, 135-136 (Bankr. D. N.H. 1984) (reviewing the legislative history of clause (4), and holding that a debtor's debt for self-dealing, akin to the debtor's debt in *Herbst*, constituted defalcation). *See also* floor statements by Congressman Edwards, 124 Cong. Rec. H32,399 (daily ed. Sept. 28, 1978) (stating that § 523(a)(4) represents a compromise between the House version and the Senate bill) and by Senator DeConcini, 124 Cong. Rec. S33,998 (daily ed. Oct. 5, 1978) (same). For clause (4), as enacted, Congress included the House's standard of "embezzlement or larceny," adopted the Senate's standard of "fraud while acting in a fiduciary capacity," and added back "defalcation while acting in a fiduciary capacity," which latter element was introduced by the 1841 Act and had been among the nondischargability provisions in each of the subsequent Bankruptcy Acts. It is understandable why the Circuit Courts had difficulty in interpreting clause (4).

Petitioner's *Amicus* patently misleads this Court regarding clause (4)'s legislative history by his quotation from H. Rep. No. 95-595, at 364 (1977). That Report discussed the House's proposed

nondischargability provision that, if it had been enacted, would have only excepted from discharge debts for embezzlement or larceny, without any provision for excepting debts for fiduciary defalcation. In his brief, Petitioner's *Amicus* asserts that the 1977 House Report establishes that the intent of clause (4) is that a fiduciary's borrowing of trust funds is nondischargable as a defalcation only if the debtor acted "willfully and maliciously," and that there can be no defalcation if the debtor "acted without malicious intent."Pet'r's *Amicus* Br. 28. Petitioner's *Amicus*, however, failed to tell this Court that the House's version of its nondischargablility provision was not enacted and that its Report did not deal with or even mention fiduciary defalcation, each a critical point making that Report utterly irrelevant to the meaning of defalcation, which could not have escaped from the attention of Petitioner's *Amicus*. Nor did he mention that the House's bill discussed in its Report was at odds with the fact that every prior bankruptcy act, commencing with 1841, included a fiduciary defalcation provision, which the House would have jettisoned. His attempt to squeeze out of the House Report an intent by Congress to require for defalcation "malfeasance" by a debtor consisting of "willful and malicious" conduct, is misleading and misguided.

The Congressional notion of fiduciary defalcation was rooted at its inception in the non-bankruptcy law of trusts. Congress has given no hint in its text or legislative history, or during any of the four amendatory opportunities it had (in 1867, 1898, 1938, and 1978) after the original enactment in 1841, that it intended a new and dif-

ferent meaning for defalcation than had emerged from *Chapman*. *See Midlantic Nat. Bank v. New Jersey Dep't of Envtl. Prot.,* 474 U.S. 494, 500-501 (1986) (relying on a "judicially created doctrine," stating that "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."); *Dewsnup v. Timm,* 502 U.S. 410, 419 (1992) (stating that "to effect a major change [requires] at least some discussion in the legislative history."); *BFP*, 511 U.S. at 544-545 ("[T]he Bankruptcy Code will be construed to adopt, rather than displace, pre-existing state law.").

POINT II

CONGRESS AND THIS COURT DETERMINED THAT THE INTERESTS OF TRUST BENEFICIARIES PROTECTED UNDER § 523(a)(4) ARE PARAMOUNT TO A DEBTOR'S "FRESH START"

Section 523(a)'s exception of particular debts from the broad scope of a debtor's discharge in bankruptcy implements Congress' conclusion that the interests of those persons for whom it determined to provide protection under its nondischargability provisions are stronger than the interests of debtors in gaining a "fresh start" through bankruptcy. Clause (4)'s meaning is not guided by the "fresh start" policy of the Bankruptcy Code, which denies a refuge to a debtor who has breached a fiduciary duty by failing to comply with the standard of conduct required by the law

of trusts for compliance with such duty. In interpreting the meaning of defalcation under clause (4), however, the Circuit Courts, in searching for the meaning of defalcation, failed to implement Congress' concept of § 523(a), the focus of which is on the injury to those harmed by the debtor's misconduct, not on the debtor who is seeking to escape liability through bankruptcy for his breach of fiduciary duty.

In *Grogan v. Garner*, 498 U.S. 279, 287-288 (1991), this Court, in determining the applicable burden of proof in § 523(a) litigation, explained that in the nondischargability context, the interests of those protected under each of the clauses of § 523(a) take precedence over the "fresh start" policy of the Bankruptcy Code. As stated by this Court in *Grogan* in explaining Congress' approach to nondischargability: "[T]he creditors' interest in recovering full payment of debts in these categories [of § 523(a)] outweigh[s] the debtors' interest in complete fresh start." *Id*. at 287. This Court thus rejected the lower court's reliance on the principle that "the general 'fresh start' policy that undergirds the Bankruptcy Code militated in favor of a broad construction favorable to the debtor." *Id*. at 283. *Accord Cohen v. De La Cruz*, 523 U.S. 213, 222 (1998) ("The various exceptions to discharge in § 523(a) reflect a conclusion on the part of Congress 'that the creditors' interest in recovering full payment of debts in these categories outweigh[s] the debtors' interest in a complete fresh start.'" (quoting *Grogan*, 498 U.S. at 287)). In other circumstances, this Court, as in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), has likewise limited a debtor's

right to a "fresh start" based upon his or her misconduct.

Despite the inapplicability of the "fresh start" policy to a determination of what constitutes defalcation under clause (4), the Circuit Court below, and the other Circuit Courts upon whose opinions it relied, drew upon that policy in reaching the conclusion that defalcation means conduct that violates a heightened standard of recklessness consisting of "extreme recklessness," "objective recklessness," or plain "recklessness." *See Bullock*, 570 F.3d at 1164; *In re Hyman*, 502 F.3d at 66; *In re Baylis*, 313 F.3d at 18; *In re Berman,* 629 F.3d at 765; *In re Harwood*, 637 F.3d 615, 619 (5th Cir. 2011).

In the present case, the Circuit Court below erroneously proceeded on the basis that "[a] central purpose of the Bankruptcy Code is to provide an opportunity for certain insolvent debtors to discharge their debts and enjoy a fresh start." *Bullock*, 670 F.3d at 1164. It thus saw the issue with the wrong focus, relying on the "fresh start" goal, rather than on the injury to trust beneficiaries, to whom Congress granted special protection under clause (4). Moreover, in the present case, that goal should not have been applied to protect the debtor, who, as a trustee of other persons' money, could not resist the temptation to use it for his own benefit.

CONCLUSION

Based on the foregoing, the order appealed from should be affirmed upon the grounds urged herein, rather than upon those in the opinion below.

Respectfully submitted,

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