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No. 11-1518

# In the Supreme Court of the United States

RANDY CURTIS BULLOCK, PETITIONER

*v.*

BANKCHAMPAIGN, N.A.

*ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT*

**BRIEF FOR THE UNITED STATES
AS AMICUS CURIAE SUPPORTING RESPONDENT**

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## QUESTION PRESENTED

Section 523(a)(4) of the Bankruptcy Code provides that "[a] discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt * * * for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. 523(a)(4). The question presented is as follows:

Whether a trustee's unauthorized and self-dealing diversion of funds from a trust constitutes a "defalcation" for purposes of 11 U.S.C. 523(a)(4) in the absence of any specific finding of ill intent or evidence of an ultimate loss of trust principal.

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## INTEREST OF THE UNITED STATES

The question presented in this case is whether, in the absence of any specific finding of ill intent or evidence of an ultimate loss of trust principal, a trustee's unauthorized and self-dealing diversion of funds from a trust constitutes a "defalcation" for purposes of 11 U.S.C. 523(a)(4).[1] The United States has a substantial interest in the resolution of the question presented because United States Trustees—who are Department of Justice officials appointed by the Attorney General—supervise the administration of bankruptcy cases. See 28 U.S.C. 581-589a (2006 & Supp. V 2011); see also 11 U.S.C. 307 ("The United States trustee

[1] In *Denton* v. *Hyman*, No. 07-952, the United States filed an amicus curiae brief at the Court's invitation to address a similar question. The Court denied certiorari. 555 U.S. 1097 (2009).

may raise and may appear and be heard on any issue in any [bankruptcy] case or proceeding."). In addition, the Secretary of Labor, who is responsible for enforcing Title I of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.*, including ERISA's fiduciary standards, has litigated the scope of the "defalcation" exception to dischargeability in bankruptcy cases involving fiduciaries' use of plan assets for unauthorized purposes or failure to deposit employee contributions.[2]

## STATUTORY PROVISION INVOLVED

Pertinent portions of 11 U.S.C. 523 are reprinted in an appendix to this brief. App., *infra*, 1a-4a.

## STATEMENT

1. In 1978, petitioner's father established a trust with his life-insurance policy as the sole asset. Pet. App. 2a. The father named petitioner and petitioner's four siblings as beneficiaries, and he made petitioner the trustee. *Ibid*. Under the terms of the trust, petitioner could borrow from the trust only to pay the life-insurance premiums or to satisfy a beneficiary's request for a withdrawal. *Ibid*.

On three occasions, petitioner borrowed from the trust for other purposes: (1) in 1981, at his father's request, he borrowed $117,545.96 for his mother to

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[2] See, *e.g.*, *In re Palombo*, 456 B.R. 48, 65 (Bankr. C.D. Cal. 2011) (finding defalcation where debtor caused fund holding assets of ERISA plans to accept existing claims liability from another fund, while setting imprudently low contribution rates that generated commissions for debtor but were insufficient to pay new claims); *In re Gott*, 387 B.R. 17 (Bankr. S.D. Iowa 2008) (finding defalcation where debtor failed to ensure funds withdrawn from his employees' paychecks were remitted to plan administrator, instead of being used for company's day-to-day operations).

use to repay a debt to the father's business; (2) in 1984, he borrowed $80,257.04 to purchase certificates of deposit for himself and his mother (which they later used to purchase a mill); and (3) in 1990, he borrowed $66,223.96, which he used to purchase real estate for himself and his mother. Pet. App. 2a. All three loans were ultimately repaid with 6% interest, but the trust did not earn any profit on them. *Id.* at 2a, 17a, 34a, 45a, 50a. In 1999, petitioner's two brothers (both trust beneficiaries) sued petitioner in Illinois state court for breach of fiduciary duty. *Id.* at 2a, 50a-51a.

In 2002, the state court granted partial summary judgment for the brothers. Pet. App. 50a-58a. The court determined that petitioner had breached his fiduciary duty because he "was clearly involved in self-dealing" when he made loans to his mother and to entities in which he had a financial interest. *Id.* at 52a, 54a-57a. The court also found that petitioner had "breached his fundamental fiduciary duty" by "put-[ting] himself in a position in conflict with the interests of the beneficiaries." *Id.* at 51a, 52a, 57a. The court further found that petitioner had "failed to make an annual accounting of the trust until approximately 1997," and that he had therefore failed to account, as required, for transactions in which "he borrowed money from the life insurance policy and then loaned it out." *Id.* at 58a.

In its order awarding damages, the state court observed that petitioner "does not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a. The court concluded, however, that "neither the facts and circumstances surrounding the loans" nor petitioner's motives for acting as he did "can excuse him from liability" for "a clear breach of

[his] fiduciary duty." *Id.* at 46a. The court ordered petitioner to pay the trust $250,000 "to represent the benefits he received from his breaches," plus $35,000 in attorney's fees and costs. *Id.* at 47a. As collateral for the judgment, the court declared a constructive trust on petitioner's own beneficial interest in the trust and on the mill that had been obtained with borrowed funds. *Id.* at 47a-48a. Those constructive trusts were awarded to respondent, which had already replaced petitioner as trustee for the original trust. *Id.* at 3a, 48a.

2. In 2009, petitioner filed for relief under Chapter 7 of the Bankruptcy Code in the Northern District of Alabama. Pet. App. 30a. Respondent later initiated an adversary proceeding to determine the dischargeability of the debt that petitioner owed as a result of the Illinois judgment. *Ibid.* Under 11 U.S.C. 523(a)(4), the discharge that an individual debtor in bankruptcy might otherwise receive does not extend to any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

The bankruptcy court granted summary judgment in favor of respondent. Pet. App. 29a-44a. Applying principles of collateral estoppel, the bankruptcy court accepted the state court's determination that petitioner's self-dealing conduct had breached his fiduciary duties as trustee. *Id.* at 40a. The bankruptcy court found that the state court's findings of fact and conclusions of law were "clearly sufficient to establish defalcation for purposes of § 523(a)(4)," because petitioner's conduct "was certainly not unintentional, nor a purely innocent mistake." *Ibid.* The bankruptcy

court therefore held that the Illinois judgment debt was nondischargeable. *Id.* at 40a-41a, 44a.[3]

3. Petitioner appealed to the district court, which affirmed. Pet. App. 16a-28a. The district court concluded that petitioner's fiduciary breach had constituted a "defalcation" for purposes of Section 523(a)(4). *Id.* at 21a-23a. The court observed that, "[e]ven though [petitioner] repaid the funds, this is not the same as never having taken them out of the trust in the first place," and that "defalcation includes the fiduciary's failure to account for funds due to any breach of duty, whether it was intentional, willful, reckless, or negligent." *Id.* at 22a. The district court further concluded that collateral estoppel precluded petitioner from relitigating the question, previously resolved against him in the state-court proceedings, whether his borrowing of trust assets constituted a breach of his fiduciary duties. *Id.* at 23a-25a.[4]

4. The court of appeals affirmed. Pet. App. 1a-14a. The court recognized that different circuits have expressed inconsistent understandings of the term "defalcation" under Section 523(a)(4). Pet. App. 9a. The court described three circuits as holding that "even an innocent act by a fiduciary can be a defalcation"; three

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[3] In the alternative, the bankruptcy court found that petitioner's breach of fiduciary duty by self-dealing was also "fraud while acting in a fiduciary capacity for purposes of § 523(a)(4)." Pet. App. 41a-42a.

[4] The district court rejected petitioner's affirmative defense that respondent was wrongfully preventing petitioner from using the assets in constructive trust to satisfy the state-court judgment. Pet. App. 25a-27a. Although the court was "convinced" that respondent was "abusing its position of trust by failing to liquidate the assets," it found that petitioner should raise the issue "in an action in Illinois." *Id.* at 27a.

others as "requir[ing] a showing of recklessness by the fiduciary"; and two as "requir[ing] a showing of extreme recklessness." *Id*. at 9a-10a. The court of appeals concluded that "defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless." *Id.* at 10a-11a.

Applying that standard to the facts of this case, the court of appeals determined that petitioner's conduct as trustee "can be characterized as objectively reckless" because petitioner "certainly should have known that he was engaging in self-dealing, given that he knowingly benefitted from the loans." Pet. App. 11a. The court held that "the Illinois judgment debt was non-dischargeable under § 523(a)(4) as a debt arising from a defalcation while [petitioner] was acting in a fiduciary capacity." *Ibid*.[5]

## SUMMARY OF ARGUMENT

A. The statutory text, context, and history of 11 U.S.C. 523(a)(4) all indicate that proof of a heightened mental state is not a prerequisite to a "defalcation," at least where the relevant fiduciary breach is an unauthorized and self-dealing diversion of trust assets. Dictionary definitions of that term do not suggest such a requirement. While other provisions of Section 523(a) specify the mental state needed to trigger other exceptions to dischargeability, Section 523(a)(4) re-

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[5] In light of its finding of a "defalcation," the court of appeals did not address whether petitioner's "conduct also constituted fraud under § 523(a)(4)." Pet. App. 7a n.2. The court considered and rejected petitioner's affirmative defense premised on respondent's refusal to allow him to liquidate the assets held in constructive trust. *Id*. at 11a-14a. That issue is beyond the scope of the question presented in this Court.

quires only that the debtor have committed defalcation "while acting in a fiduciary capacity." And while scienter is an element of the accompanying terms "fraud," "embezzlement," and "larceny," that fact does not suggest that "defalcation" should be given anything other than its usual dictionary meaning. Indeed, the term "defalcation" in Section 523(a)(4) would be superfluous if it were read to require the *same* heightened mental state as "fraud," "embezzlement," and "larceny." The drafting history of current Section 523(a)(4), and Congress's use of the term "defalcation" in prior versions of the bankruptcy laws, reinforce the conclusion that no heightened mental state is required.

B. Proof of ultimate loss of the trust principal is likewise not a prerequisite to a Section 523(a)(4) "defalcation." Self-dealing with trust assets is a paradigmatic breach of the trustee's duty of loyalty. Even if the diverted funds are eventually returned to the trust, the trustee still must repay any profits realized as a result of the diversion, and may also be required to reimburse attorney's fees and other costs incurred by the trust in recouping the assets. Just as repayment of funds would not negate potential liability for fraud, embezzlement, or larceny, it does not negate the existence of a "defalcation."

C. Petitioner invokes the Bankruptcy Code's policy of giving a "fresh start" to the "honest but unfortunate debtor." Section 523(a), however, reflects Congress's determination that, for specified categories of debts, that policy is overridden by countervailing values. A trustee's diversion of trust assets to his own use is a particularly serious fiduciary breach. There are sound equitable reasons to deny discharge for

debts incurred as a result of such misconduct, and debts of that nature have historically been nondischargeable.

D. The courts below correctly held that petitioner's debt is nondischargeable under Section 523(a)(4). Petitioner's apparent lack of malice does not excuse his diversion of trust assets, since knowledge of fundamental legal obligations has long been imputed to fiduciaries. The fact that petitioner ultimately repaid the trust principal likewise does not render the debt dischargeable. Notwithstanding that repayment, petitioner committed a serious breach of his fundamental duty of loyalty to the trust; his diversion of assets created a temporary shortage until the loans were repaid; and petitioner never fulfilled his obligation to pay over to the trust the profits he had realized from the diversion.

## ARGUMENT

### A TRUSTEE'S UNAUTHORIZED AND SELF-DEALING DIVERSION OF TRUST ASSETS CONSTITUTES A "DEFALCATION WHILE ACTING IN A FIDUCIARY CAPACITY" FOR PURPOSES OF 11 U.S.C. 523(a)(4)

The debt at issue here resulted from petitioner's unauthorized and self-dealing diversion of trust assets, from which he gained financial reward. Petitioner contends that his conduct did not rise to the level of a "defalcation while acting in a fiduciary capacity" for purposes of nondischargeability under 11 U.S.C. 523(a)(4) because "[t]he state court's finding of no apparent ill intent, coupled with the absence of loss of *res*, falls far short of establishing the sort of grave misconduct" that warrants a denial of discharge in bankruptcy. Pet. Br. 26. That argument lacks merit. Petitioner's diversion of trust assets was a sufficiently

grievous breach of fiduciary duty to constitute a "defalcation," even without proof that he had a subjective mental state of at least "extreme recklessness" (*id.* at 21), and even without proof of any ultimate "loss of the trust principal" (*id.* at 27).

**A. The Statutory Text, Context, And History Do Not Make Proof Of A Heightened Mental State A Prerequisite To A "Defalcation"**

Section 523 of the Bankruptcy Code provides in pertinent part:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> * * * * *
>
> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny[.]

11 U.S.C. 523(a)(4).[6] The Bankruptcy Code, which was enacted in 1978, does not define the term "defalcation." But earlier bankruptcy laws—enacted in 1841,[7]

[6] Section 523(a)(11) excepts from discharge debts created by certain judgments, orders, or settlements "arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. 523(a)(11). That provision was added by the Comprehensive Crime Control Act of 1990, Pub. L. No. 101-647, § 2522(a)(1), 104 Stat. 4866.

[7] Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441 (repealed 1843) (making bankruptcy available to "[a]ll persons * * * owing debts, which shall not have been created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity").

1867,[8] and 1898[9]—had each contained similar provisions that, with minor variations of phrasing, generally prevented the discharge of debts arising from "defalcation[s]" in a fiduciary context.

***1. Dictionary definitions of "defalcation" do not require intentional wrongdoing***

Dictionary definitions of "defalcation"—whether current, contemporaneous with the Bankruptcy Code, or contemporaneous with older bankruptcy statutes—do not require any particular mental state, much less the specific intent associated with "fraud" or "embezzlement" that petitioner urges (Br. 21-22) the Court to impose here.

The relevant definition in the *Oxford English Dictionary* reads: "A monetary deficiency through breach of trust by one who has the management or charge of funds; a fraudulent deficiency in money matters[.]" 4 *Oxford English Dictionary* 369 (2d ed. 1989) (*OED*). The first illustrative quotation for that definition is from an 1846 dictionary, which reads: "a breach of trust by one who has charge or management of money." *Ibid.*; see also 3 *Oxford English Dictionary* 124 (1933) (same). Other modern dictionaries similarly include, sometimes in addition to a reference to fraud or embezzlement, a reference to "misuse" or "misappropriation" of funds that connotes no particu-

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[8] Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533 (repealed 1878) (rendering nondischargeable any "debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character").

[9] Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-551 (repealed 1979) (rendering nondischargeable any debt "created by [the debtor's] fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity").

lar mental state. See *American Heritage Dictionary* 475 (4th ed. 2006) ("To misuse funds; embezzle."); *Webster's Third New International Dictionary* 590 (1986) ("misappropriation of money in one's keeping"); *Webster's New International Dictionary* 686 (2d ed. 1958) ("An abstraction or misappropriation of money by one, esp. an officer or agent, having it in trust[.]").

The current edition of *Black's Law Dictionary* similarly defines "defalcation" in part as follows: "1. EMBEZZLEMENT. 2. Loosely, the failure to meet an obligation; a nonfraudulent default." *Black's Law Dictionary* 479 (9th ed. 2009).[10] Earlier editions of the same dictionary, including the one most contemporaneous with the enactment of Section 523(a)(4), repeatedly included the following definitions (and sometimes others): "The act of a defaulter"; "misappropriation of trust funds or money held in any fiduciary capacity"; and "failure to properly account for such funds." *Black's Law Dictionary* 375 (5th ed. 1979); Henry Campbell Black, *A Law Dictionary* 342 (2d ed. 1910); Henry Campbell Black, *A Dictionary of Law* 344 (1891). Similarly, an 1856 law dictionary defined a

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[10] The editor in chief of *Black's Law Dictionary* has elsewhere expressed a preference for the "embezzlement" definition of "defalcation," while acknowledging that the word has been "misused" by "some writers" to refer "merely to a nonfraudulent default." Bryan A. Garner, *Garner's Modern American Usage* 232 (3d ed. 2009). In Garner's view, the term is more properly limited to a "fraudulent" deficiency that is "the fault of someone put in trust of the money." *Ibid.* Congress included Garner's second limitation in Section 523(a)(4), by requiring a defalcation to occur in a fiduciary capacity. The structure of Section 523(a)(4), however, counsels against concluding that Congress intended "defalcation" to be synonymous with "fraud" in a fiduciary capacity or with "embezzlement," because that would render it surplusage.

"defalcation" in relevant part as "the act of a defaulter." 1 John Bouvier, *A Law Dictionary* 388 (6th ed. 1856). In turn, it defined a "defaulter" as "[o]ne who is deficient in his accounts, or fails in making his accounts correct." *Ibid.*

Thus, as a matter of plain meaning, a "defalcation" generally does not require a showing of intentional wrongdoing.

***2. The statutory context counsels against requiring a heightened mental state***

Petitioner contends that, in light of the "statutory context" and "'the commonsense canon of *noscitur a sociis*—which counsels that a word is given more precise content by the neighboring words with which it is associated'"—the Court should construe "defalcation" to ensure that it reflects a "degree of culpability commensurate with fraud, embezzlement, and larceny." Br. 21, 23 (quoting *Freeman* v. *Quicken Loans, Inc.*, 132 S. Ct. 2034, 2042 (2012)). Petitioner therefore contends that the Court should require "a showing of a mental state embracing intent to deceive, manipulate, or defraud, or extreme recklessness." Br. 23 (internal quotation marks and citation omitted). For several reasons, however, the statutory context weighs against petitioner's argument rather than in its favor.

a. In other provisions of Section 523(a), Congress specified the mental state associated with the activity that gives rise to a nondischargeable debt. For instance, one provision applies to debts "for willful and malicious injury by the debtor to another entity or to the property of another entity." 11 U.S.C. 523(a)(6). One refers to a "malicious or reckless failure to fulfill any commitment by the debtor to a Federal deposito-

ry institutions regulatory agency to maintain the capital of an insured depository institution." 11 U.S.C. 523(a)(12). Another refers to a tax duty "with respect to which the debtor * * * willfully attempted in any matter to evade or defeat such tax." 11 U.S.C. 523(a)(1)(C). And another refers to using a materially false written statement "that the debtor caused to be made or published with intent to deceive." 11 U.S.C. 523(a)(2)(B)(iv).

In Section 523(a)(4), by contrast, Congress did not make the dischargeability of debts for "defalcation[s]" turn on proof of any heightened mental state. Instead, it required only that the debtor have committed the defalcation "while acting in a fiduciary capacity." 11 U.S.C. 523(a)(4). That is, to be sure, a significant narrowing of the potentially broad category of "non-fraudulent default[s]" (see p. 11, *supra*), because it requires both that the debtor be a fiduciary and that he commit the defalcation in his fiduciary capacity. Cf. *Davis* v. *Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (holding that, under the 1898 predecessor statute, the debtor "must have been a trustee before the wrong and without reference thereto"). Nevertheless, Section 523(a)(4) does not cabin the meaning of "defalcation" on the basis of the debtor's mental state. Because "Congress has shown elsewhere in the same statute"—indeed, in the same subsection—"that it knows how to make" a mental-state requirement "manifest," the Court should resist the assumption "that Congress has omitted from its adopted text" a mental-state requirement "that it nonetheless intends to apply." *Jama* v. *ICE*, 543 U.S. 335, 341 (2005).

b. Petitioner principally relies (Br. 21, 23) on the *noscitur a sociis* canon of construction. But he does

not explain why the debtor's subjective mental state is the attribute necessary to make "defalcation" more like the other terms in Section 523(a)(4). It might be said with at least equal force that the distinguishing feature of embezzlement or larceny is the acquisition or retention of property to which one is not entitled. At least where (as here) the relevant "defalcation" is a trustee's unauthorized and self-dealing diversion of trust assets, such a violation of the trustee's duty of loyalty bears a close resemblance to the other wrongs enumerated in Section 523(a)(4).

Moreover, the specific use that petitioner attempts to make of the canon in the context of Section 523(a)(4) would be inconsistent with the exception from discharge contained in 11 U.S.C. 523(a)(19). For purposes of Section 523(a)(4), petitioner suggests (Br. 23) that the presence of "fraud" would be inconsistent with allowing "[m]ere negligence or even recklessness * * * to warrant an exception from discharge." But Section 523(a)(19) applies to, *inter alia*, orders for penalties associated with either "the violation of any of the Federal securities laws" *or* "common law fraud, deceit, or manipulation in connection with the purchase or sale of any security." 11 U.S.C. 523(a)(19)(A)(i)-(ii) and (B)(iii). Under petitioner's approach, that reference to "common law fraud, deceit, or manipulation"—which closely tracks much of his proposed mental-state standard (Pet. Br. 23)—should also limit the accompanying securities-law violations to those that were committed with ill intent. But civil penalties are available for violations of the securities laws that involve only negligence or "reckless disregard of a regulatory requirement," *e.g.*, 15

U.S.C. 78u(d)(3)(B)(i)-(iii),[11] and the plain text of Section 523(a)(19) unambiguously encompasses penalties for securities-law violations of that nature. Petitioner's approach would therefore distinguish among securities-law violations for purposes of bankruptcy discharges in a way that Congress did not specify.

c. Petitioner's attempt to remake "defalcation" in the image of fraud, embezzlement, and larceny also threatens to deprive "defalcation" of any independent role in the statute, notwithstanding the Court's "duty to give effect, if possible, to every clause and word of a statute." *Duncan* v. *Walker*, 533 U.S. 167, 174 (2001) (internal quotation marks omitted). As Judge Learned Hand concluded for the Second Circuit when discussing Section 523(a)(4)'s predecessors: "Whatever was the original meaning of 'defalcation,' it must [in the 1867 Act] have covered other defaults than deliberate malversations, else it added nothing to the words 'fraud or embezzlement.'" *Central Hanover Bank & Trust Co.* v. *Herbst*, 93 F.2d 510, 511 (1937).

Indeed, the two courts of appeals that have adopted petitioner's approach have acknowledged that, although they use the *noscitur a sociis* canon to infer a heightened mental state for "defalcation," the anti-surplusage principle prevents them from requiring the *same* mental state that is associated with fraud, embezzlement, and larceny. See *In re Hyman*, 502 F.3d 61, 68 (2d Cir. 2007), cert. denied, 555 U.S. 1097

[11] See *SEC* v. *Moran*, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) (imposing first-tier civil penalty on investment adviser who engaged in no "intentional wrongdoing" but who breached his "duty to act in the best interest" of his client, "fail[ed] to recognize the harm that his negligence caused," and did not adequately understand "the significance of his actions").

(2009); *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002). That inherently malleable process—of lending to one word an attribute that is loosely inspired by, but not the same as, those of its associates—is no longer a recognizable application of the *noscitur a sociis* canon.

d. Finally, the drafting history of Section 523(a)(4) counsels against petitioner's reading. As petitioner notes (Br. 14 n.3), the Commission on the Bankruptcy Laws of the United States recommended in 1973 that the terms "defalcation" and "misappropriation" be omitted from the relevant exception to dischargability because they were "overbroad and uncertain of meaning." *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. 2, at 139 (1973). The version of the Bankruptcy Code adopted by the House of Representatives followed that recommendation and would have eliminated both terms from Section 523(a)(4). See H.R. Rep. No. 595, 95th Cong., 1st Sess. 364 (1977) (*House Report*). The Senate version, however, retained both terms. See S. Rep. No. 989, 95th Cong., 2d Sess. 79 (1978).

The enacted version of the Code reflects Congress's decision to *retain* "defalcation" (but not "misappropriation") and place it alongside fraud in a fiduciary capacity, embezzlement, and larceny. 11 U.S.C. 523(a)(4).[12] In light of that apparently deliberate deci-

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[12] The fact that Congress *rejected* the House's attempt to delete "defalcation" seriously undermines the conclusion of petitioner's amicus (Brunstad Br. 28) that "[t]he limited legislative history that is available indicates that [S]ection 523(a)(4) was intended to reach debts incurred through a debtor's malfeasance." The passage that the amicus quotes is from the *House Report* (at 364). Because the

sion, the Court should not strip "defalcation" of its historic meaning, which, as discussed above, did not require proof of scienter (at least in the context of a self-dealing and unauthorized diversion of trust assets).

***3. Historical practice supports treating a trustee's unauthorized and self-dealing diversion of trust assets as a "defalcation"***

To the extent that the Court finds the term "defalcation" in its present statutory context to be ambiguous, "pre-Code practices * * * can be relevant to the interpretation of an ambiguous text" in the Bankruptcy Code. *RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank*, 132 S. Ct. 2065, 2073 (2012).

As noted above, the term "defalcation" was first connected with nondischargeability in the 1841 bankruptcy law. Section 1 of that law defined the class of persons eligible for bankruptcy to include "persons * * * owing debts, which shall not have been created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity." Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441 (repealed 1843). Section 4 authorized "a full discharge from all [of a bankrupt's] debts," but then made that discharge unavailable to "any person who, after the passing of this act, shall apply trust funds to his own use." *Id.* § 4, 5 Stat. 443-444.

bill discussed in the *House Report* would have included only embezzlement and larceny in the provision that was ultimately enacted as Section 523(a)(4), the *House Report* sheds no light on Congress's understanding of the word "defalcation."

This Court considered Sections 1 and 4 of the 1841 Act in *Chapman* v. *Forsyth*, 43 U.S. (2 How.) 202, 207-208 (1844). It recognized that the reference in Section 4 to a debtor who "appl[ies] trust funds to his own use" would "cover[] the enumerated cases in the first section" (involving a "defalcation" in a fiduciary context). *Ibid.* In order to avoid that potential redundancy, the Court construed Section 1 as withholding specific *debts* from bankruptcy-court jurisdiction, and Section 4 as denying a discharge to the individual *debtor* (even for debts that were not associated with a misuse of trust funds). *Id.* at 208. A necessary premise of the Court's reasoning was its recognition that the application of "trust funds to [the trustee's] own use" was a "defalcation"—even though there was no heightened mental state associated with the statute's bare reference to "apply[ing] trust funds to [one's] own use."

As petitioner notes (Br. 11), subsequent decisions of this Court did not directly address the meaning of "defalcation" in the 1841 Act or its successors. At a time when the nondischargeability provision of the 1867 Act did not require that a fraud—as opposed to a defalcation—occur in a fiduciary capacity (see *Crawford* v. *Burke*, 195 U.S. 176, 189 (1904)), the Court held that the "fraud" must be an actual fraud, rather than one that is merely implied by law and "may exist without the imputation of bad faith or immorality." *Neal* v. *Clark*, 95 U.S. 704, 709 (1878). That holding is now reflected in 11 U.S.C. 523(a)(2)(A), rather than Section 523(a)(4) (in which fraud is expressly limited to the

fiduciary context). See 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards).[13]

The Court's opinion in *Davis*, *supra*, reiterated the longstanding conclusion (which this Court first articulated in 1844 in *Chapman*) that the reference to fiduciary status in Section 523(a)(4)'s predecessors rendered a debt dischargeable only if the debtor was "a trustee before the wrong [that resulted in the debt] and without reference thereto." 293 U.S. at 333. Petitioner appears to read *Davis* as suggesting that the predecessor to Section 523(a)(4), which was located at Section 17(4) of the Bankruptcy Act of 1898 (11 U.S.C. 35(4) (1925)), was not satisfied because the actions at issue in that case were not "actuated by willful, malicious or criminal intent." Pet. Br. 13 (quoting *Davis*, 293 U.S. at 332). In fact, the sentence that petitioner quotes came from a part of the Court's opinion pertaining to the exception from discharge in Section 17(2) of the Bankruptcy Act (11 U.S.C. 35(2) (1925))—a predecessor to what is now in Section 523(a)(6))—which applied to "willful and malicious injuries to the person or property of another." 293 U.S. at 331-332. After finding Section 17(2) inapplica-

[13] Petitioner's amicus focuses (Brunstad Br. 24, 29) on the decision in *Keime* v. *Graff*, 14 F. Cas. 218 (W.D. Pa. 1878) (No. 7650), which described "defalcation" as "import[ing] a greater degree of culpability than that which attaches to a refusal or failure to pay a debt." *Id.* at 220. The passage in question, however, inferred that level of culpability not from the term "defalcation" alone but from the fact that, under the 1867 Act, the defalcation must have occurred while the debtor was "acting in any fiduciary character." *Ibid.* That simply means, however, that the level of culpability is one consistent with a breach of fiduciary duty—which is not the same as the "extreme recklessness" standard that petitioner advocates.

ble because of the lack of willfulness or malice, the Court turned to Section 17(4) (the predecessor to Section 523(a)(4)) to address the respondent's contention that, "irrespective of willfulness or malice," there had been "fraud or misappropriation while acting in a fiduciary capacity." *Id.* at 333. In its discussion of the latter provision, the Court did not suggest that the lack of willfulness, malice, or criminal intent doomed the respondent's claim. Instead, it held merely that the debtor had not been a trustee (*i.e.*, had not been acting in a fiduciary capacity) at the time of the wrong. *Id.* at 333-334.

Finally, Judge Hand's opinion for the Second Circuit in *Herbst, supra*, supports the view that, at least where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized, a "defalcation" occurs regardless of the fiduciary's state of mind. In *Herbst*, an individual was appointed receiver of real property in a foreclosure suit and was awarded $5,674.54 by the trial court after the property was sold. 93 F.2d at 511. He spent the money without attempting to ascertain whether the award would be appealed, and he declared bankruptcy after the state appellate court disallowed the award. *Ibid.* Without purporting to decide the scope of the term "defalcation" in other circumstances, the Second Circuit held 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.'" *Id.* at 512. The court in *Herbst* did not hold that the receiver (who had received the funds pursuant to the state trial court's order) had acted recklessly or with

wrongful intent; rather, the court found it sufficient that the receiver had taken and spent the money with actual or constructive knowledge that the award was subject to possible reversal on appeal. See *ibid.* As the same court explained when it again relied on such constructive knowledge to find misappropriation that made a debt nondischargeable: "The character of the liability imposed upon a fiduciary for appropriating property of his cestui in violation of his duty is the same whether he has actual knowledge that the law imposes the duty or is merely charged with such knowledge." *In re Hammond*, 98 F.2d 703, 705 (2d Cir.), cert. denied, 305 U.S. 646 (1938).

Thus, when Congress enacted Section 523(a)(4) in 1978, retaining the word "defalcation" but omitting "misappropriation," the case law under that provision's statutory predecessors gave Congress no reason to believe that "defalcation" would be read as requiring a mental state of at least extreme recklessness.

**B. Even In The Absence Of Any Ultimate Loss Of The Trust Principal, A Trustee's Diversion Of Trust Assets To His Own Benefit May Be A "Defalcation"**

Petitioner also contends that, even apart from a heightened mental state, a "defalcation" occurs only when there has been "a 'failure to account' for entrusted property or a 'shortage in accounts.'" Pet. Br. 26. Petitioner suggests (*id.* at 8, 27) that those conditions for a "defalcation" cannot be satisfied if there is ultimately "no loss of the trust principal." Petitioner's amicus similarly contends that defalcations are limited to "wrongdoing resulting in actual loss," an "ultimate deficiency in the funds entrusted," or "the depletion of entrusted funds." Brunstad Br. 11, 26, 28. But the

serious breach of fiduciary duty associated with a defalcation is present when the trust's assets are taken away without authorization, even if there is no ultimate loss of trust principal.

1. In support of his suggested "loss" requirement, petitioner quotes dictionary definitions from 1755 and 1828 to the effect that a defalcation means a "diminution," "abatement," or "deduction." Pet. Br. 27 (quoting 1 Samuel Johnson, *A Dictionary of the English Language* s.v. "defalcation" (1755); Noah Webster, *An American Dictionary of the English Language* 56 (1828)). As discussed above, however, by 1846, dictionaries were already attesting to the more relevant (and broader) sense of the term as "a breach of trust by one who has charge or management of money." 4 *OED* 369. Petitioner cannot dispute that an unauthorized and self-dealing diversion of assets from a trust satisfies that definition.

Petitioner suggests (Br. 27) that the omission of "misappropriation" from Section 523(a)(4) in 1978 indicated Congress's intent to permit discharge for "misappropriations that do not ultimately result in a shortage in accounts." But in light of the modern dictionary definitions quoted above, it is more likely that Congress omitted "misappropriation" and kept "defalcation" because it reasonably viewed those two terms as redundant in the context of a fiduciary's misuse of trust assets. Although the *House Report* (at 364) contains a glancing reference to ensuring that certain debts would be nondischargeable when "injury is in fact inflicted," that report assumed that "defalcation" would be omitted from the provision.

2. In any event, a self-dealing trustee who profits from his unauthorized diversion of trust assets has

inflicted an injury on the trust. Such a trustee generally must disgorge his profits to the trust (and may also be required to pay the attorney's fees and costs that were incurred in pursuing his breach, which are themselves a quantifiable loss).

Self-dealing with trust assets is a paradigmatic misuse or misappropriation of funds. It violates the duty of loyalty, which this Court has recognized is "[t]he most fundamental duty owed by the trustee to the beneficiaries of the trust." *Pegram* v. *Herdrich*, 530 U.S. 211, 224 (2000) (quoting 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170, at 311 (4th ed. 1987)); see 3 Restatement (Third) of Trusts § 78(2) (2005) ("Except in discrete circumstances, the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests."); *id.* § 78 cmt. a ("[T]he rule of Subsection (2) strictly prohibits the trustee from entering into transactions involving the trust property * * * if the transaction is for the trustee's personal account (self-dealing)"); *id.* § 78 cmt. d ("nor may the trustee personally borrow money from, lend funds to, or exchange property with the trust"; "it is immaterial to the question of breach of trust * * * that the trustee has acted in good faith and for a fair consideration").[14]

[14] Petitioner notes that his borrowing from the trust could have been authorized if he had secured the consent of all of its beneficiaries. Br. 25 (citing 3 Restatement (Third) of Trusts § 78 cmt. c(3)). But petitioner cannot dispute the state court's finding that his conduct fell within none of the discrete circumstances in which self-dealing by a trustee is permitted. Pet. App. 55a.

Even when the diverted funds are not ultimately lost to the trust because their equivalent has been returned, "the trustee is subject to such liability as may be necessary to prevent the trustee from benefiting individually from the breach of trust." 4 Restatement (Third) of Trusts § 95 cmt. b (2011). That may require the trustee to repay "the amount of any benefit to the trustee personally as a result of the breach," as well as to reimburse "the attorneys fees and other litigation costs of a successful plaintiff." *Id.* § 100(b) & cmt. b(2); see *Mosser* v. *Darrow*, 341 U.S. 267 (1951) (holding reorganization trustee personally liable for profits earned by employees who had traded, with his permission, on securities of subsidiaries of the relevant trusts, even though the trustee himself made no profit and the trust incurred no financial loss); cf. *Leigh* v. *Engle,* 727 F.2d 113, 119-122 (7th Cir. 1984) (mere fact that trust lost no money in challenged investment transactions, and in fact "profited handsomely," did not preclude ERISA cause of action for breach of fiduciary duty).

3. Despite petitioner's reliance on the *noscitur a sociis* canon with respect to mental state, he is notably silent about whether the other terms in Section 523(a)(4) require the actual loss of property he believes is required by "defalcation." Petitioner's amicus asserts (Brunstad Br. 11), without citation, that requiring a "depletion of entrusted funds" would "align[] the concept of 'defalcation' with" the other terms in Section 523(a)(4)—"fraud," "embezzlement," and "larceny"—"all of which also connote some form of financial loss."

Contrary to the amicus's unsupported assertion, the fact that petitioner ultimately repaid the loans he

had taken from the trust would not, by itself, suffice to protect him from charges of fraud, embezzlement, or larceny. "[I]t is well-established law that permanent loss is no part of offenses such as embezzlement, larceny or misappropriation," and that "[r]estitution is no defense to such offenses." *Rakes* v. *United States*, 169 F.2d 739, 743 (4th Cir.), cert. denied, 335 U.S. 826 (1948). There is, for instance, no loss requirement in a federal criminal prosecution under 18 U.S.C. 641 for embezzling, stealing, or converting property of the United States. See, *e.g.*, *United States* v. *Milton*, 8 F.3d 39, 44 (D.C. Cir. 1993) ("No one * * * has explained why Congress would have made property loss an element of a section 641 offense when, historically, there was no such element."), cert. denied, 513 U.S. 919 (1994).[15] Nor is there a loss requirement in prosecutions under 18 U.S.C. 656 (for theft, embezzlement, or misapplication of bank funds by a bank officer or employee), or under various other federal theft or embezzlement statutes. See, *e.g.*, *United States* v. *Bailey*, 734 F.2d 296, 304-305 (7th Cir.) (citing cases applying several statutes), cert. denied, 469 U.S. 931 (1984). Similarly, "the lack of financial loss is no defense" in a criminal fraud case. 3 Wayne R. LaFave, *Substantive Criminal Law* § 19.7(i)(3), at 135 (2d ed. 2003). Furthermore, the intentional taking of assets with the intention of replacing them at a later

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[15] In *United States* v. *Collins*, 464 F.2d 1163 (1972), the Ninth Circuit identified "an actual property loss" as an element of a Section 641 offense. *Id.* at 1165. But, as the D.C. Circuit noted in *Milton*, the Ninth Circuit in subsequent decisions "has itself recast *Collins* to mean that if someone other than the government feels the pinch, this tends to indicate that the stolen property was not the government's." 8 F.3d at 44 (citing cases from 1979 and 1988).

point with an equivalent amount of money would not necessarily preclude criminal liability for embezzlement or fraud.[16]

As the relevant decisions explain, "neither the intention to replace" unlawfully taken property "nor the actual replacement is a defense when conversion is proved" because

> [t]he criminal sanction of the statute is imposed to prohibit the unlawful use of another's property, and the statute does not permit the converter to subject the owner to the risk of loss and relieve the converter of criminal liability if his operations are successful and he makes restitution.

*Elmore* v. *United States*, 267 F.2d 595, 601 (4th Cir.), cert. denied, 361 U.S. 832 (1959).

The same should be true in the context of a defalcation, where the absence of a loss of principal does not establish that a trustee's unauthorized diversion of trust assets is intrinsically less culpable than the other kinds of conduct identified in Section 523(a)(4).

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[16] See 3 LaFave, *Substantive Criminal Law* § 19.6(f)(3), at 111 & n.67 (in the context of embezzlement, "[i]t is uniformly held that the intent to restore" an "equivalent" amount of converted money at a later date "is no defense to embezzlement," even when the defendant has "a substantial ability to do so") (citing cases); *id.* § 19.7(f)(2), at 132 n.87 ("[a]n intent to pay for the property obtained, or otherwise to return the equivalent but not the very property, although it may be accompanied by an ability to do so, does not negative the intent to defraud"). The question is less clear with respect to larceny. See *id.* § 19.5(c), at 92-93 (finding it unclear whether "one who takes another's property intending, and having the financial ability, to pay for it or otherwise to restore the equivalent (rather than the property itself) has a defense to a charge of larceny").

### C. The Policy Interests Underlying Section 523(a)(4) Are Served By Refusing To Discharge Debts Resulting From A Trustee's Unauthorized And Self-Dealing Diversion Of Trust Assets

Petitioner appeals to the Bankruptcy Code's general "fresh start" policy (Br. 9, 23-24), under which a discharge gives a debtor "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Local Loan Co.* v. *Hunt*, 292 U.S. 234, 244 (1934). But Section 523(a) reflects Congress's determination that "the creditors' interest in recovering full payment of debts in [the enumerated] categories outweigh[s] the debtors' interest in a complete fresh start." *Cohen* v. *de la Cruz*, 523 U.S. 213, 222 (1998) (internal quotation marks omitted). Thus, in *United States* v. *Sotelo*, 436 U.S. 268 (1978), the Court noted that the "fresh start" policy provides "little assistance in construing a section expressly designed to make some debts nondischargeable." *Id.* at 280; see *Bruning* v. *United States*, 376 U.S. 358, 361 (1964) (recognizing that Section 523's predecessor "is not a compassionate section for debtors" because "it demonstrates congressional judgment that certain problems * * * override the value of giving the debtor a wholly fresh start."). As a result, the Court has often adopted constructions of Section 523(a) that favored creditors rather than debtors. See, *e.g.*, *Cohen*, 523 U.S. at 223 (holding that treble-damages award for fraud was nondischargeable under 11 U.S.C. 523(a)(2)(A) even when it exceeded the value of what the debtor had fraudulently obtained); *Grogan* v. *Garner*, 498 U.S. 279, 287 (1991) (refusing to impose a heightened burden of proof on

creditors attempting to demonstrate that a debt was one for "actual fraud" under 11 U.S.C. 523(a)(2)(A)).

Even when a fiduciary does not engage in fraud or intentional wrongdoing, his knowing use of trust property for other than its intended purpose constitutes serious misconduct. The equitable arguments against discharge are particularly compelling when the fiduciary diverts trust assets to his own use, thereby enriching himself.[17] As this Court has explained: "To deter the trustee from all temptation and to prevent any possible injury to the beneficiary, the rule against a trustee dividing his loyalties must be enforced with 'uncompromising rigidity.'" *NLRB* v. *Amax Coal Co.,* 453 U.S. 322, 329-330 (1981) (quoting *Meinhard* v. *Salmon,* 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.)); cf. *Mosser,* 341 U.S. at 271 ("Equity tolerates in bankruptcy trustees no interest adverse to the trust.").

As explained above (see pp. 17-18, *supra*), under Section 4 of the 1841 Act, trustees who engaged in such conduct were categorically ineligible for discharge in bankruptcy even as to their *non*-fiduciary debts. Congress relaxed that debtor-based restriction in subsequent bankruptcy legislation, but, in Section 523(a)(4), it has persisted in its "desire to protect trust relationships" by preventing discharge of fiduciary debts. *In re Patel,* 565 F.3d 963, 967 (6th Cir. 2009); see *ibid*. ("[W]hen the bankrupt is a trustee and the creditor is a trust beneficiary, § 523(a)(4) points the

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[17] Whether a fiduciary's receipt of trust funds is authorized will necessarily depend on the type of trust involved and the specific terms of the trust. The court of appeals concluded that petitioner is collaterally stopped from arguing that his self-dealing conduct was authorized. Pet. App. 6a-7a.

needle away from discharge; it is yet another example of the law's imposition of high standards of loyalty and care on trustees."); *In re Johnson*, 691 F.2d 249, 256 (6th Cir. 1982) ("[T]he requisite 'badness[]' * * * is supplied by an individual's special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching these duties.").

There is no reason to conclude that a trustee who engages in an unauthorized and self-dealing diversion of trust assets, from which he gains financial benefits, is the kind of "honest but unfortunate debtor" (*Local Loan Co.*, 292 U.S. at 244) who deserves to be unburdened of the obligation to pay his debt to the trust or its beneficiaries. Such a core breach of fiduciary duty is sufficiently culpable to warrant making the resulting debt nondischargeable.[18]

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[18] This does not mean that *every* breach of fiduciary duty constitutes a defalcation, or that Section 523(a)(4) would never require proof of a particular mental state to establish that a particular kind of breach triggered nondischargeability. Some fiduciary breaches may involve a negligent failure to carry out a fiduciary duty that does not involve a diversion of trust assets to unauthorized purposes, or the kind of constructive knowledge that courts have considered sufficient for a defalcation. Such breaches are relatively far afield from the core breach of trust that was described in Section 4 of the 1841 Act (*i.e.*, application of trust assets to the fiduciary's personal use). Cf. *In re Hemmeter*, 242 F.3d 1186, 1191 (9th Cir. 2001) (declining to find defalcation by debtor for losses associated with ESOP and 401K plan stemming from decline in stock value of stock in which plans were specifically authorized to invest).

**D. Petitioner's Conduct Constituted A "Defalcation While Acting In A Fiduciary Capacity"**

The Illinois state court found that petitioner "was clearly involved" in unauthorized "self-dealing transactions" when he diverted trust assets to himself and his mother, and that he therefore "breached his fundamental fiduciary duty" of loyalty as trustee by "put[ting] himself in a position in conflict with the interests of the beneficiaries." Pet. App. 51a, 52a, 54a-57a. It found that petitioner had "failed to make an annual accounting of the trust until approximately 1997," and that he had therefore failed to account, as required, for transactions in which "he borrowed money from [the trust assets] and then loaned it out." *Id.* at 58a. The state court also concluded that, as a result of his fiduciary breaches, petitioner had "received" \$250,000 in benefits and that the trust was entitled to \$35,000 in attorney's fees and litigation costs (\$25,000 of which would be reimbursed to the beneficiaries that had pursued the suit against petitioner). *Id.* at 47a, 48a-49a. In light of those findings, the court of appeals in the bankruptcy case correctly concluded that, as a trustee, petitioner "certainly should have known that he was engaging in self-dealing, given that he knowingly benefited from the loans," and that the debt was for a defalcation in petitioner's fiduciary capacity. *Id.* at 11a.

1. Petitioner relies on the state court's observation that he did not "appear to have had a malicious motive." Pet. Br. 26 (quoting Pet. App. 45a). The quoted statement, however, does not logically imply that petitioner's conduct was innocent. Although petitioner asserts (*id.* at 3) that he "did not believe the loans were improper," he does not suggest that his belief

was founded on a mistake of fact. It is undisputed that those self-dealing transactions were not actually authorized by trust law or by the terms of the trust. Pet. App. 6a-7a, 24a-25a, 34a, 40a, 54a-57a. Petitioner's status as a trustee imposed special obligations on him, and "[i]gnorance of the law should be no excuse to defalcation, whether due to negligence or not, where that ignorance leads to fiduciary default." *In re Richardson*, 178 B.R. 19, 29 (Bankr. D.D.C.), aff'd, 193 B.R. 378 (D.D.C. 1995), aff'd, 107 F.3d 923 (D.C. Cir.), cert. denied, 522 U.S. 851 (1997); cf. *Mosser,* 341 U.S. at 274 ("[A] trusteeship is serious business and is not to be undertaken lightly or so discharged. The most effective sanction for good administration is personal liability for the consequences of forbidden acts[.]").

For purposes of establishing fiduciary "defalcations," imputing constructive knowledge of fundamental legal obligations to fiduciaries has a distinguished pedigree. See *Herbst*, 93 F.2d at 512; p. 21, *supra*. Even the First Circuit—which has adopted petitioner's proposed mental-state requirement of "extreme recklessness"—is willing to "presume[]" that there is sufficient fault to constitute a defalcation when the circumstances reveal, as here, a breach of the trustee's fundamental duty of loyalty. *Baylis*, 313 F.3d at 20-21. Petitioner would require a creditor in an adversary proceeding, often years after a debt was litigated to judgment, to prove that the debtor had actual knowledge of the most fundamental duty in trust law. That approach would be tantamount to imposing the kind of heightened, clear-and-convincing-evidence standard of proof that this Court rejected in *Grogan* in the context of the discharge exception for actual

fraud. See 498 U.S. at 286-291. The Court should similarly decline petitioner's invitation (Br. 26) to hold that "respondent failed to carry its burden to demonstrate that petitioner acted with a wrongful state of mind sufficient to support a finding of defalcation under § 523(a)(4)."

2. The Court should also reject petitioner's contention (Br. 27) that there was no defalcation here because "[t]here was no failure to account for the entrusted property and no loss of the trust principal." As an initial matter, petitioner's assertion that "[t]here was no failure to account" is belied by the state court's finding that, between 1981 and 1997, petitioner did indeed fail to account to the beneficiaries, as required by state law, for his self-dealing transactions with trust assets. See Pet. App. 58a. Moreover, petitioner's statement that the state-court judgment was only for "the benefit he received" and "not a reckoning for any loss" (Br. 28) is clearly wrong with respect to the $35,000 portion that was to reimburse the trust and its beneficiaries for attorney's fees and other costs incurred to remedy his fiduciary breaches.

In any event, as discussed above (pp. 23-24, *supra*), trust law appropriately requires a trustee who profits from his unauthorized self-dealing with trust assets to disgorge that benefit. Cf. *Mosser*, 341 U.S. at 273 ("[T]he prohibition is not merely against injuring the estate—it is against profiting out of the position of trust."). Thus, apart from the $35,000 in attorney's fees and costs, the remainder of the damages award in the state-court action represented money that petitioner ought to have paid over to the trust but did not. See Resp. Br. 22-24.

The fact that petitioner ultimately returned the borrowed funds—but not the $250,000 in benefits that he had received—did not suffice to remedy his breach. That is so for two reasons. During the interim between the improper loans and their eventual repayment, petitioner's conduct resulted in a tangible "shortage in accounts" (Pet. Br. 27). And even after the loans were repaid, petitioner failed to perform his duty as trustee to pay over the profits he had realized. As with embezzlement, fraud, and larceny, petitioner's subsequent repayment of the "trust principal" (*ibid.*) cannot erase his underlying defalcation. See pp. 24-26, *supra*.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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## APPENDIX

11 U.S.C. 523 (2006 & Supp. V 2011) provides in relevant parts as follows:

**Exceptions to discharge**

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

* * * * *

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; [or]

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive;

* * * * *

(3) neither listed nor scheduled under section 521(a)(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—

(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

* * * * *

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

* * * * *

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commit-

ment which would otherwise be terminated due to any act of such agency; [or]

*  *  *  *  *

(19) that

(A) is for

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results, before, on, or after the date on which the petition was filed, from—

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

*  *  *  *  *

(c)(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the

creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution-affiliated party unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution-affiliated party with respect to such debt.

* * * * *