

"FRAUD JUNIOR": AN ANALYSIS OF THE SUPREME COURT'S
CONSTRUCTION OF DEFALCATION AND PENSION-FUND
TRUSTEE DECISIONS IN BANKRUPTCY LAW

ABSTRACT

Defalcation is a cause of action listed in a provision in the exceptions-to-discharge section of the Bankruptcy Code. Beneficiaries raise this claim when their expressly appointed debtor-trustee seeks to discharge his debts incurred from mismanaging the trust funds. Congress has neither defined defalcation nor indicated its intent with respect to the term's meaning.

The Supreme Court recently heard Bullock v. BankChampaign to resolve the prolonged circuit split regarding whether defalcation requires a mental state. The Court held defalcation requires the fiduciary-trustee to have had knowledge of, or to have been grossly reckless with respect to, his improper fiduciary behavior.

The practical outcome of the Bullock decision is that litigators will aim solely to prove recklessness with respect to defalcation, because to prove "knowledge of" is akin to a showing of fraud. Further, the "knowledge of" requirement effectively becomes subsumed by fraud. This confluence of fraud and defalcation amounts to an impermissible surplusage problem—"fraud junior." Another consequence of defalcation's heightened mental state is that it allows trustees to take advantage of their roles by making needlessly riskier investments to the potential detriment of the beneficiaries.

The Bullock decision divorces defalcation from Congress's intentional "fiduciary-capacity" connection and from the established principals of trustee-fiduciary duties. The solution this author proposes is to break embezzlement and larceny from "fraud or defalcation while acting in a fiduciary capacity" and to place the terms in a different provision of the code.

A court subsequently analyzing the issue will stress the importance of disaggregating defalcation from fraud and will focus on the actions, rather than the intent, of the debtor. Therefore, courts will view defalcation under an objectively reckless standard and engage in a two-step analysis: (1) whether the debtor was a fiduciary; and (2) whether a defalcation occurred. This analysis charges fiduciaries with knowledge of the law and their duties, and it makes the unclear history of defalcation clear and consistent for future beneficiary-plaintiffs. Under this standard of review, beneficiaries can prevent trustee-debtors from discharging their debts and can recover their entrusted funds.

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I. INTRODUCTION

Defalcation, an arcane word with unclear meaning, can profoundly affect the lives of fiduciary-trustees and beneficiaries.¹ Typically, these trustees are relatives who have expressly agreed to manage the family trust while acting as family caretakers as well;² however, there are many situations in which an attorney or a corporate officer is the named trustee charged with managing the trust for the beneficiaries.³ The trust may authorize the trustee to either prudently invest the trust funds or hold the funds until the beneficiaries request a withdrawal.⁴

The issue gets particularly hazy when the trustee invests the trust funds for the purported benefit of the beneficiaries, but in fact, the investment turns out to be detrimental.⁵ Consider, for example, an individual who signs an express agreement to be a trustee board member of an employee pension fund.⁶ The trust document charges him and his fellow

¹Interview with the Hon. Christopher S. Sontchi, U.S. Bankr. Ct., Dist. of Del., in Wilmington, Del. (Oct. 30, 2013). Historically, defalcation is a cause of action brought by beneficiaries against their trustee, who previously filed for bankruptcy, for the trustee's failure to fully account for the trust funds owed to the beneficiaries. See *In re Frankel*, 77 B.R. 401, 402 (Bankr. W.D.N.Y. 1987). If the reviewing court finds the trustee-debtor committed defalcation while acting as a fiduciary, he will be denied discharge of the debt. 11 U.S.C. § 523(a)(4) (2012). Prior to 2013, and dating back to 1937, courts have held trustee-debtors' actions to different standards depending on the mental state required to prove defalcation in that circuit. See *Bullock v. BankChampaign N.A.*, 133 S. Ct. 1754, 1758-60 (2013) (stating lower courts have disagreed about whether defalcation requires a mental state, and if so, what kind; some courts have held innocent mistakes or negligence that resulted in a loss of trust funds sufficient to show defalcation, other courts have required something more than negligence that resulted in misappropriation of funds, and still other courts have required a showing of extreme recklessness); see also *Cent. Hanover Bank v. Herbst*, 93 F.2d 509, 511-12 (2nd Cir. 1937).

²Interview with the Hon. Brendan Linehan Shannon, U.S. Bankr. Ct., Dist. of Del., in Wilmington, Del. (Oct. 31, 2013).

³See, e.g., *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 13-14 (1st Cir. 2002) (attorney); *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 221-22 (5th Cir. 2001) (corporate officer); *Meyer v. Rigdon*, 36 F.3d 1375, 1377 (7th Cir. 1994) (corporate director).

⁴See RESTATEMENT (THIRD) OF TRUSTS §§ 77, 78 (2007) (stating trustees are held to a duty of loyalty to administer the trust solely in the interest of the beneficiaries and to a duty of care to prudently invest the trust funds as a prudent person would); see also 3 AUSTIN WAKMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, SCOTT AND ASHER ON TRUSTS 1078 (5th ed. 2001) (stating it is the fundamental duty of the trustee to administer the trust for the sole benefit of the beneficiaries).

⁵See *infra* notes 6-12 and accompanying text.

⁶Pension-fund management has become a pressing issue of late given the coupling of an aging population and higher life expectancies, which affects the way that individuals and companies plan for retirement. See *Life Expectancy Links: The Quiet Revolution in Pension Policy*, OECD, archived at <http://perma.cc/4DEJ-WUZ8> (describing the effects of higher life expectancy on pension-fund management); see also Daniel Solin, *Indefensible Decisions by*

board members with investing the funds for the benefit of the beneficiaries (the employees), and he does so.⁷ He conducts market research and identifies an opportunity to invest funds from the trust in a real estate development project that offers a higher return than the average market rate.⁸ The board agrees to take out a sizable loan from the trust to invest in the project.⁹ Despite the board member's research, the real estate development project fails miserably, and the money is gone.¹⁰ The loan nearly sinks the trust.¹¹ The trust-fund management company, including the individual board members, seeks bankruptcy protection.¹² The employee-beneficiaries want their money back. Has that board member, as well as the others, committed "defalcation while acting in a fiduciary capacity"?¹³

After the Supreme Court's decision in *Bullock v. BankChampaign*, courts will have to wrestle with the question of whether the board member had knowledge of, or was reckless with respect to, the detrimental investment.¹⁴ In other words, did the board member know the investment was imprudent, or should he have known the investment could drain the trust funds and invested anyway?¹⁵

Part I of this Note discusses the history of defalcation, highlighting the way courts have applied defalcation in different factual scenarios.¹⁶ This section also discusses the circuit split that led to the *Bullock* decision.¹⁷ Part II analyzes the Supreme Court's decision in *Bullock*.¹⁸ Part III explores *Bullock's* consequences by examining how courts will handle future defalcation issues, provides practice points for litigators applying *Bullock*, and proposes that the decision created an impermissible surplusage

Pension Fund Managers, U.S. NEWS & WORLD REPORT: MONEY RETIREMENT (Jul. 18, 2013), archived at <http://perma.cc/G39F-A8PQ> (describing the abuse of trust-fund money by pension-fund trustees, and the fact that beneficiaries have little-to-no say regarding the management of the trust).

⁷See *infra* note 8.

⁸This hypothetical is taken from the recent settlement of a pension-fund board of trustees and their employee-beneficiaries. See Alison Knezevich, *Baltimore County Repays Loan From Pension Fund*, BALT. SUN (Oct. 4, 2013), archived at <http://perma.cc/V55C-HUPL>; see also Alison Knezevich, *Baltimore Co. Police Union Sues Over \$25 Million Loan From Pension Fund*, BALT. SUN (Feb. 6, 2013), archived at <http://perma.cc/9ZKB-LNEJ>.

⁹See *supra* note 8 and accompanying text.

¹⁰See *supra* note 8 and accompanying text.

¹¹See *supra* note 8 and accompanying text.

¹²See *supra* note 8 and accompanying text.

¹³11 U.S.C. § 523(a)(4) (2012).

¹⁴See *Bullock v. BankChampaign*, N.A., 133 S. Ct. 1754, 1759-60 (2013).

¹⁵*Id.*

¹⁶See *infra* Part I.

¹⁷See *infra* Part I.

¹⁸See *Bullock*, 133 S. Ct. at 1759-60; see also *infra* Part II.

problem—"fraud junior."¹⁹ Part IV proposes a solution to the "fraud junior" problem: Congress must amend the Bankruptcy Code to bifurcate fiduciary fraud and defalcation from embezzlement and larceny, thus comporting with the originally intended reach of defalcation.²⁰

II. BACKGROUND

Defalcation first appeared in the Bankruptcy Act of 1841.²¹ This enactment began Congress's movement from a pro-creditor to a pro-debtor bankruptcy scheme.²² Although the Act of 1841 was short-lived,²³ defalcation resurfaced in the exceptions-to-discharge section of the Bankruptcy Act of 1867.²⁴

Congress has neither defined defalcation nor revealed any legislative intent regarding its meaning.²⁵ The only hint is that Congress once again placed defalcation in the exceptions provisions of the Bankruptcy Act of 1867, and it has remained there ever since.²⁶ Congress's placement of defalcation in the exceptions section suggests its intent to preclude discharge as a way to trump the undergirding "fresh start" policy of the Bankruptcy Code.²⁷ The deeply ingrained policy behind the right to

¹⁹ See *infra* Part III.

²⁰ See *infra* Part IV.

²¹ Defalcation entered into the exceptions provisions in 1841 after a Treasury Department official purportedly took over \$200,000 of customs duties to pay his personal expenses. See Brief in Support of Respondent for Amici Curiae Professors Richard Aaron, et al., at 10, *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754 (2013) (relying on App. to the Cong. Globe, 25th Cong., 2d Sess. 16 (December 1838)). An audit of the department revealed that over \$1,300,000 of customs duties were unaccounted for. *Id.* The Secretary of the Treasury petitioned Congress to characterize the officer's actions as "defalcation." *Id.* The subsequent enactment of the Bankruptcy Act of 1841 excepted discharge of debts incurred as a result of "defalcation as a public officer." *Id.* at 11; see also Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 352 (1991) (stating the statute's only exceptions to discharge were the result of "'defalcation as a public officer' and fiduciary obligations").

²² See Tabb, *supra* note 21, at 349 (finding the Bankruptcy Act of 1841 sought to protect debtors by allowing them to file voluntary bankruptcy petitions, a remedy previously unavailable under bankruptcy law).

²³ *Id.* at 350-51 (noting the Act was repealed a year later).

²⁴ See *Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993) (stating the language of the exceptions provisions has remained relatively the same since its inception in 1841).

²⁵ See *Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 286 (B.A.P. 10th Cir. 1997).

²⁶ See *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 17 (1st Cir. 2002); Tabb, *supra* note 21, at 396 (stating that the Bankruptcy Act of 1867 excepted the discharge of fraud, embezzlement, or defalcation); see also *supra* note 24 and accompanying text.

²⁷ See *Bullock v. BankChampaign, N.A. (In re Bullock)*, 670 F.3d 1160, 1164 (11th Cir. 2012) (finding that an undergirding purpose of the Bankruptcy Code is to give debtors a fresh

discharge is the belief in giving the "honest but unfortunate debtor" a fresh start.²⁸ This policy allows the debtor to start over without being encumbered by prior financial indiscretions.²⁹ Over time, Congress expanded the exceptions section to punish those who committed certain crimes and to discourage dishonest debtors from abusing the system.³⁰ The general understanding of defalcation stems from its historical application in circumstances in which a fiduciary had mismanaged the funds entrusted to him.³¹

Today, if a trustee commits "defalcation while acting in a fiduciary capacity" the debtor cannot discharge that particular debt.³² Further, a person can only become a trustee by way of an "express" or "technical" appointment prior to the defalcation.³³ This agreement carries with it fiduciary duties, namely the duty of loyalty and the duty of care.³⁴

start; however, Congress must have concluded defalcation's placement in the exceptions section outweighed that purpose).

²⁸See *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991); see also *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) ("[The Bankruptcy Act] . . . gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt."); Charles J. Tabb, *The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 GEO. WASH. L. REV. 56, 56-57 (1990).

²⁹See *supra* note 28 and accompanying text.

³⁰Charles J. Tabb explains how Congress expanded the exceptions in the following areas:

Excepted debts were those based on: taxes; fraud, or obtaining property by false pretenses; willful and malicious injuries; unsecured claims . . . and fiduciary misconduct. Thus, Congress in 1898 did not suddenly decide to be totally forgiving of fraudulent and dishonest bankrupts; it just wanted to make the punishment fit better the financial "crime." . . . What the 1898 scheme did attempt was to draw more carefully and precisely the rules and sanctions implementing the "honesty" limitation on discharges. This more tailored approach continues today.

Tabb, *supra* note 21, at 368.

³¹See *Cent. Hanover Bank v. Herbst*, 93 F.2d 509, 511-12 (2nd Cir. 1937) (concluding defalcation applies when a fiduciary spends money given to him conditionally when he knows it may be revoked); see also *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 256 (6th Cir. 1982) ("[D]efalcation may exist when there is a diminution, abatement or deficit in an account as a result of a mistake or negligence in addition to misconduct.") (relying on 3 William Miller Collier, *Collier on Bankruptcy* § 523.14(b), nn.3-4 (15th ed. 1981)).

³²11 U.S.C. § 523(a)(4) (2006).

³³See *Chapman v. Forsyth*, 43 U.S. 202, 208 (1882) (holding that to commit defalcation there must first be a "technical trust[,] and not [one] which the law implied from the contract").

³⁴See *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 21 (1st Cir. 2002) (stating trustees assume important responsibilities under the law and courts require strict adherence to those obligations).

A. *Central Hanover Bank v. Herbst*:
"Some Portion of Misconduct"

Judge Learned Hand's dicta from *Central Hanover* initiated the circuit split regarding the mental state attached to defalcation.³⁵ In that case, the debtor spent the proceeds of his awarded judgment before waiting for the opposing party to file an appeal.³⁶ His adversary filed and won on appeal, with costs to be paid by the debtor.³⁷ The debtor subsequently filed for bankruptcy, and the surety brought suit claiming the judgment was non-dischargeable.³⁸ Judge Hand concluded that the debtor's actions constituted defalcation.³⁹ He began his analysis by stating defalcation "implies some moral dereliction, but in this context it may have included innocent defaults[.]"⁴⁰ After reviewing defalcation's neighboring terms—fraud, embezzlement, and misappropriation—Judge Hand expressed the need to "give the words different meanings[;]" otherwise, embezzlement, fraud, and defalcation would be reduced to synonyms.⁴¹ Judge Hand further concluded defalcation must "have covered other defaults than deliberate malversations[;]" otherwise, it would add nothing to fraud or embezzlement.⁴² He concluded "defalcation may demand some portion of misconduct"⁴³ and the debtor's conduct in prematurely spending the award constituted defalcation.⁴⁴

B. *The Split*

The split that emerged from *Central Hanover* divided the circuits into three groups with respect to the mental state required for defalcation—innocent mistake, something more than negligence, or extreme recklessness.⁴⁵

³⁵ See *id.* at 17-18.

³⁶ See *Central Hanover*, 93 F.2d at 511.

³⁷ *Id.* at 511-12.

³⁸ *Id.* at 511.

³⁹ *Id.*

⁴⁰ See *Central Hanover*, 93 F.2d at 511.

⁴¹ *Id.* at 512.

⁴² *Id.* at 511.

⁴³ *Id.* at 512 (internal quotation marks omitted).

⁴⁴ See *Central Hanover*, 93 F.2d at 512.

⁴⁵ See *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18 (1st Cir. 2002) (describing the three camps of mental states that resulted from the *Central Hanover* decision).

1. An Innocent Mistake Suffices: The Fourth, Eighth, and Ninth Circuits

The Fourth,⁴⁶ Eighth,⁴⁷ and Ninth⁴⁸ Circuits held that an innocent or negligent mistake made by a fiduciary, without a showing of intent to commit a wrongdoing, was enough to constitute defalcation.⁴⁹ The Fourth Circuit held that for an act to constitute defalcation, the act need only amount to negligence or an innocent mistake resulting in the misappropriation of, and failure to account for, the trust funds.⁵⁰ It reasoned that the debtor's use of "at least some of the funds belonging to the" beneficiaries to gain a benefit constituted defalcation.⁵¹ Following the Ninth Circuit, which held innocent defaults by the fiduciary amounted to defalcation,⁵² the Eighth Circuit similarly held defalcation need not require evidence of intentional wrongdoings.⁵³ The court accepted that a fiduciary

⁴⁶See *infra* note 50 and accompanying text.

⁴⁷See *infra* note 53 and accompanying text.

⁴⁸See *infra* note 52 and accompanying text.

⁴⁹See *infra* notes 50-54.

⁵⁰See *Republic of Rwanda v. Uwimana (In re Uwimana)*, 274 F.3d 806, 811 (4th Cir. 2001). Aloys Uwimana, Rwandan ambassador to the United States, transferred the embassy's money to an attorney to set up his and two other families' asylum in the United States. *Id.* at 809. The two other families did not take asylum in the United States; however, Uwimana did, and he later refused to pay back the money allotted for the two other families. *Id.* at 809-10. The Republic of Rwanda brought suit for the money owed; Uwimana filed for bankruptcy to discharge the debt, and the Republic sought to have the debt determined non-dischargeable, claiming Uwimana committed defalcation when he refused to tender the money. *Id.* at 810. The court, using the negligence-or-innocent-mistake standard, stated that it could not "conceive of any theory that would relieve an ambassador . . . from fiduciary responsibility . . ." *Id.* at 811. The court found Uwimana's use of the money, without disclosing it to his government, was defalcation. *Id.* at 812.

⁵¹*Id.* at 812. The court did not analyze the debtor's mental state under its purported negligence theory. Instead, the court viewed the facts as presented by the Republic of Rwanda and seemingly focused on the debtor's misappropriation of the funds coupled with his failure to disclose receiving a benefit to Rwanda. *Id.*

⁵²See *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1186 (9th Cir. 1996). Michael Scott invested money in Byron and Irene Lewis's business after signing a partnership agreement. *Id.* at 1184. The Lewises never accounted to Scott regarding his investment money; instead, they commingled Scott's funds with their business funds, and subsequently filed for bankruptcy. *Id.* at 1184-85. The court found the Lewises' failure to provide an accounting of Scott's funds, and subsequently commingle them with other funds, met the innocent-or-negligent standard of defalcation. *Id.* at 1187. The court focused on the result, the fiduciary-trustee's failure to account without analyzing the debtor's mental state, and found his act constituted defalcation. *Id.* at 1186.

⁵³See *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997). Tudor Oaks sued Cochrane for breaching his fiduciary duties; the jury found for Tudor Oaks and awarded damages. *Id.* at 980. Cochrane filed for bankruptcy, and Tudor Oaks brought suit claiming that the judgment was non-dischargeable because Cochrane committed defalcation while acting as a fiduciary. *Id.* at 981. As a preliminary matter, the court found that Cochrane

who misappropriated, failed to account for, or engaged in an innocent default of trust funds sufficed to show defalcation.⁵⁴

2. Something More Than Negligence: The Fifth, Sixth, Seventh, and Eleventh Circuits

The Fifth,⁵⁵ Sixth,⁵⁶ Seventh,⁵⁷ and Eleventh⁵⁸ Circuits all required something more than negligence.⁵⁹ The Sixth Circuit held that an inquiry into the subjective intent of the fiduciary was irrelevant.⁶⁰ The court reasoned that using an objective standard would prevent fiduciaries from claiming ignorance of the law and encourage them to learn their obligations.⁶¹ Aligning itself with the Sixth Circuit, the Seventh Circuit held that mere negligent breaches of fiduciary duties did not amount to defalcation.⁶² It reasoned that if Congress desired to apply defalcation to those who intended to commit defalcatory acts, it would have added a mental element.⁶³ It further stated a mere negligent breach of duty would contradict the fresh-start policy.⁶⁴

was a fiduciary prior to committing the defalcation. *Id.* at 984. The court found Cochrane's non-disclosure of his interest in the other firm, along with his keeping a "fee" from the deal, breached his fiduciary duties and constituted defalcation. *Id.* at 984.

⁵⁴*Id.* at 984. The court did not engage in a mental state analysis, but instead focused on the actions of the debtor and found his monetary benefit from his failure to disclose his interest in the transaction constituted defalcation. *Id.*

⁵⁵*See infra* note 70 and accompanying text.

⁵⁶*See infra* note 60 and accompanying text.

⁵⁷*See infra* note 62 and accompanying text.

⁵⁸*See infra* note 72 and accompanying text.

⁵⁹*See infra* notes 60-72.

⁶⁰*Carlisle Cashaway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 257 (6th Cir. 1982). Johnson operated a business that constructed pole barns, and he agreed to build pole barns for three clients. *Id.* at 250. Johnson's clients paid up front, allowing Johnson to purchase supplies from Cashway. *Id.* Johnson only paid Cashway \$2,000.00 of his \$11,579.75 allowance and used the remaining money to pay other expenses. *Id.* Cashway brought suit claiming that Johnson, a fiduciary under Michigan law, committed defalcation by using the funds for unrelated purposes. *Id.* at 251. The court held defalcation need only be evaluated using an objective standard. *Id.* at 256-57.

⁶¹*Id.* at 257.

⁶²*Meyer v. Rigdon*, 36 F.3d 1375, 1384-85 (7th Cir. 1994). The Federal Deposit Insurance Company ("FDIC") determined that the debtor's bank was insolvent. *Id.* at 1377. The FDIC brought suit against Rigdon, the bank's president and controlling shareholder, and the remaining directors for breaching their fiduciary duties relating to the management of collecting and supervising loans. *Id.* The district court entered a default judgment against Rigdon. *Id.* Rigdon subsequently filed for bankruptcy, and the board brought an action claiming Rigdon's judgment was non-dischargeable because he committed defalcation as a fiduciary. *Id.* at 1377-78.

⁶³*See id.* at 1382-85.

⁶⁴*Id.* at 1385.

Although the Tenth Circuit never decided the issue, the Tenth Circuit Bankruptcy Appellate Court⁶⁵ agreed with the Sixth Circuit's holding, stating a fiduciary who pays himself a salary prior to paying the beneficiaries clearly has committed defalcation regardless of his intent.⁶⁶ The bankruptcy court reasoned that not requiring a showing of mental culpability is consistent with the language in the provision, which does not expressly require a mental state.⁶⁷ The court explained that not requiring a mental state aligns with the purpose of the exceptions-to-discharge section: debts arising from the debtor's bad acts cannot be discharged.⁶⁸ The court stated that, in light of a fiduciary's heightened duties, to excuse his debts despite his failures would be contrary to public policy.⁶⁹

The Fifth Circuit adopted a "willful neglect" standard, which it described as a recklessness standard.⁷⁰ The court sought to clarify its standard by stating "willfulness is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably should have known . . . [and this] objective standard charges the debtor with knowledge of the law without regard to an analysis of his actual intent or motive."⁷¹ The Eleventh Circuit followed its sister circuits' holdings that the

⁶⁵See *infra* note 66 and accompanying text.

⁶⁶See *Antlers Roof-Truss Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 289-90 (B.A.P. 10th Cir. 1997). The debtors, who were unlicensed contractors, hired the plaintiffs as sub-contractors for various services and materials. *Id.* at 285. Once the construction funds were received, the debtors paid themselves salaries but never paid the plaintiffs for their work. *Id.* The debtors subsequently filed for bankruptcy, and the plaintiffs brought suit claiming their outstanding payments were non-dischargeable because the debtors committed defalcation as a fiduciary. *Id.* The court held the debtors committed defalcation. *Id.* at 290.

⁶⁷*Id.* at 288-89.

⁶⁸*Id.*

⁶⁹*In re Storie*, 216 B.R. at 288-89.

⁷⁰See *The Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001). Felt bought Bowie County Savings and Loan Association, renamed it Reliance, and became the sole stockholder, president, and CEO of the company. *Id.* at 221-22. Felt engaged in self-dealing with Reliance and American Guaranty, Inc. ("AGI"), another company owned by Felt. *Id.* at 221-22. As a result of Felt's actions, the Federal Home Loan Bank Board ("FHLBB") sought to remove Felt as a director and an officer of Reliance. *Id.* at 222. Felt, without the consent of the FHLBB, reached out to the note-holders of AGI and offered them an exchange—their notes for Reliance stock. *Id.* Felt sold all of his shares in Reliance to the note-holders and to other investors. *Id.* at 223. The sale forced the financially distressed company into receivership. *Id.* The FHLBB sought an injunction and a rescission order of the transfers. *Id.* at 223-24. The district court found in favor of FHLBB and ordered Felt to pay damages. *Id.* at 224. Felt filed for bankruptcy, and the beneficiaries of the judgment brought suit claiming Felt committed fiduciary defalcation. *Id.* The court held Felt committed defalcation under its "willful neglect" standard. *Id.* at 226-27.

⁷¹*Id.* at 226. See also *Schwager v. Fallas (In re Schwager)*, 121 F.3d 177, 185 (5th Cir. 1997); *LSP Inv. P'ship v. Bennett (In re Bennett)*, 989 F.2d 779, 790 (5th Cir. 1993); *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417, 421 (5th Cir. 1990).

debtor's transfer amounted to defalcation because the act was greater than negligence or innocent mistake.⁷²

3. Extreme Recklessness: The First and Second Circuits

The First⁷³ and Second⁷⁴ Circuits required a showing of extreme recklessness.⁷⁵ The First Circuit acknowledged the inadequacies of the mental states attached to defalcation across the circuits and held defalcation required a "degree of fault, closer to fraud, without the necessity of meeting a strict specific intent requirement."⁷⁶ It reasoned that this strict approach conformed as a whole to the exceptions-to-discharge section and that the act of defalcation must have been a serious one with some fault involved as it related to its surrounding terms.⁷⁷ This higher standard separated

⁷²See *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993). Quaif, the sole shareholder and officer of Overseas & Domestic Underwriters, Ltd. ("Overseas"), entered into a contract with Ambassador Insurance Co. ("Ambassador") for the sale of insurance to other commercial entities. *Id.* at 952. A provision in the agreement required Overseas to hold a trust for Ambassador's funds and to pay it premiums. *Id.* Overseas collected the fees but failed to keep them separate from other insurance company funds. *Id.* Ambassador was adjudged insolvent, and a receiver was appointed on its behalf. *Id.* The receiver discovered Overseas failed to pay Ambassador its premiums; instead, Overseas used the money to pay its operating expenses. *Id.* The receiver brought suit to collect Ambassador's outstanding premiums, but Overseas sought bankruptcy protection. *Id.* The receiver filed a complaint alleging Overseas committed fiduciary defalcation. *Id.* The court found that the state's statute imposed a fiduciary duty upon Quaif and that he committed defalcation when he transferred Ambassador's funds to his payroll. *Id.* at 954-55; see also *Bullock v. BankChampaign, N.A. (In re Bullock)*, 670 F.3d 1160, 1164 (11th Cir. 2012) ("[D]efalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless.").

⁷³See *infra* note 76 and accompanying text.

⁷⁴See *infra* note 79 and accompanying text.

⁷⁵See *infra* notes 76-79.

⁷⁶*Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18-19 (1st Cir. 2002). Baylis, an attorney, drafted his client's trust, into which his client transferred her rental properties to provide income for her children. *Id.* at 13-14. Baylis and Estelle Ballard (one of the income beneficiaries) were made co-trustees. *Id.* at 14. Ballard managed the properties; in return, the trust paid for her living expenses. *Id.* Baylis informed all the beneficiaries that the trust was out of money, and the beneficiaries decided to sell the properties and invest the money elsewhere. *Id.* Ballard refused to consent to the sale; despite Ballard's refusal, Baylis acquired buyers. *Id.* The Youngs, third-party buyers, signed a Purchase-and-Sale Agreement; meanwhile, Baylis assured Ballard that he would sell her the very same property. *Id.* at 14-15. The Youngs brought suit against the trust and Baylis for fraud. *Id.* at 15. The probate court found in favor of the Youngs and ordered Baylis to pay damages. *Id.* at 15-16. Baylis sought bankruptcy protection, but the trust beneficiaries brought a suit claiming that Baylis committed defalcation as a fiduciary. *Id.* at 16. The court held Baylis committed defalcation by virtually guaranteeing the litigation between the Youngs and the trust and by using the trust's funds to pay for his defense. *Id.* at 22.

⁷⁷*Id.* at 19 (reasoning that Section 523, as a whole, excepts two types of debts: (1) debts that cannot be discharged based on policy; and (2) debts that cannot be discharged based on fault;

defalcation from the other terms in the provision and, as a result, aligned it with the scienter requirement in securities fraud cases.⁷⁸ The Second Circuit agreed, holding that the non-dischargeability sanction should be reserved for fiduciaries who demonstrate "some portion of misconduct."⁷⁹ The court reasoned the heightened standard should not reach those fiduciaries who inadvertently mishandled funds, but rather it would only hold accountable those who meet the standard of culpability.⁸⁰ Moreover, the Second Circuit determined that the heightened-culpability standard will be applied more easily by courts and litigants because of the "robust body of securities law examining what these terms mean."⁸¹

III. THE SUPREME COURT'S ANSWER TO THE SPLIT: THE *BULLOCK* DECISION

Randy Bullock's father set up a trust and named Bullock, the petitioner, as the trustee.⁸² The trust's single asset was an insurance policy for the benefit of the father's children.⁸³ The trust allowed the trustee to borrow money against the policy so long as the funds were returned with interest.⁸⁴ Bullock did exactly that: he borrowed from the trust three times

given the structure of the exceptions-to-discharge provision, defalcation's placement in the fault section requires fault that there be some fault involved in the action).

⁷⁸*Id.* at 20 (stating that in order to give the words a separate meaning, defalcation did not require the specific intent that fraud requires; instead, the mental state should be akin to the recklessness required in securities fraud cases).

⁷⁹*Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 68-69 (2nd Cir. 2007). Denton and Hyman formed their own insurance agency, Denton-Hyman Agency ("Denton-Hyman"). *Id.* at 63. They also jointly owned unprofitable pension service businesses. *Id.* Denton unexpectedly died after starting the businesses, and the company still owed \$1.6 million in start-up debt. *Id.* at 63-64. In order to repay this debt, Hyman contracted with Guardian Life Insurance Company of America ("Gaurdian"). *Id.* at 64. In addition, Hyman negotiated with Denton's estate to buy Denton's shares in Denton-Hyman. *Id.* The negotiations failed, and the estate brought suit to recover the profits that Hyman earned from the Guardian contract, claiming Hyman exploited the assets of the jointly-owned company. *Id.* The Surrogate Court found in favor of the estate and ordered Hyman to pay damages. *Id.* Hyman sought bankruptcy protection, but the estate intervened and brought suit alleging the judgment was non-dischargeable because Hyman committed fiduciary defalcation. *Id.*

⁸⁰*Id.* at 68-69.

⁸¹*Id.* at 69.

⁸²*Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013); *see also* Brief for Petitioner at 2, *Bullock*, 133 S. Ct. 1754 (No. 11-1518) (stating that Bullock was unaware of his capacity as trustee until his father told him about the trust); Brief for Respondent at 1, *Bullock*, 133 S. Ct. 1754 ("Bullock executed the Trust document as the trustee and accepted the legal obligations of a trustee.").

⁸³*See Bullock*, 133 S. Ct. at 1757.

⁸⁴*Id.* *But see Bullock v. BankChampaign, N.A. (In re Bullock)*, 670 F.3d 1160, 1162 (11th Cir. 2012) ("The terms of the trust provided that Bullock, as trustee, could borrow from the trust in only two situations: (1) to pay the life insurance premiums, and (2) to satisfy a

and repaid the principal with interest.⁸⁵ Bullock's brothers brought suit against him for breaching his fiduciary duties by self-dealing.⁸⁶ After a judgment was awarded against Bullock to pay damages to the trust, Bullock tried to liquidate his assets, failed to do so, and then filed for bankruptcy.⁸⁷

The Supreme Court heard the case to resolve the prolonged circuit split regarding defalcation's mental state and held "[w]here the conduct at issue does not involve bad faith,^[88] moral turpitude,^[89] or other immoral conduct, the term requires an intentional wrong.^{[90][91]} It added, "[w]e include as intentional not only the conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent."⁹² In other words, if knowledge of the wrongdoing is absent, the Court has allowed a showing of the Model Penal Code's recklessness.⁹³ When a fiduciary consciously disregards a substantial and unjustifiable risk that his conduct could breach a fiduciary duty, and when such disregard is "a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation[,]" the fiduciary has committed defalcation.⁹⁴

The Court seems to have disregarded Judge Hand's command to avoid surplusage by giving separate meaning to each statutory term.⁹⁵ The Court applied the Latin maxim *noscitur a sociis*,⁹⁶ reasoning defalcation must have a criminal intent because embezzlement, larceny, and fraud each

beneficiary's request for withdrawal.").

⁸⁵See *Bullock*, 133 S. Ct. at 1757 (finding Bullock first borrowed trust funds to pay off his father's indebted business; Bullock then borrowed trust funds to pay for certificates of deposit to buy a mill; Bullock finally borrowed funds to buy real property for himself and his mother).

⁸⁶See *id.*; *In re Bullock*, 670 F.3d at 1162 (iterating that Bullock's brothers claimed Bullock engaged in self-dealing by taking out the three loans, and the Illinois state court found Bullock's self-dealing constituted defalcation, awarding damages to be paid to the trust).

⁸⁷See *Bullock*, 133 S. Ct. at 1757.

⁸⁸BLACK'S LAW DICTIONARY 159 (9th ed. 2009) (defining bad faith as "[d]ishonesty of belief or purpose").

⁸⁹*Id.* at 1101 (defining moral turpitude as "[c]onduct that is contrary to justice, honesty, or morality").

⁹⁰*Id.* at 1751 (defining the *mens rea* of intentional wrong as "intention, purpose, or design").

⁹¹See *Bullock*, 133 S. Ct. at 1759.

⁹²*Id.* at 1759.

⁹³*Id.* at 1759-60 (relying on MODEL PENAL CODE § 2.02(c) (1985)).

⁹⁴*Id.* (quoting MODEL PENAL CODE § 2.02(c) (1985)).

⁹⁵See *Cent. Hanover Bank v. Herbst*, 93 F.2d 509, 512 (2nd Cir. 1937) ("We must give the words a different meaning so far as we can . . ."). The heightened mental state renders defalcation nearly identical to its statutory neighbors, especially fraud and embezzlement, which both similarly require a specific-intent mental state. See *Neal v. Clark*, 95 U.S. 704, 709 (1877).

⁹⁶See BLACK'S LAW DICTIONARY 1160-61 (9th ed. 2009) ("A canon of construction holding that the meaning of an unclear word or phrase should be determined by the words immediately surrounding it.").

require it.⁹⁷ The Latin maxim *ejusdem generis*, which the Court also used, instructs that terms within the same statutory provision be given the same meaning.⁹⁸ Although the Court generally construes Congress's statutory terms distinctly so as to avoid surplusage,⁹⁹ the Court here effectively reduced "fraud," "embezzlement," and "defalcation" to synonyms.¹⁰⁰

Looking to the application of defalcation and *not* to the mental state involved, the Court reasoned that defalcation differs from the other statutory terms because it does not necessarily involve the actions of embezzlement, larceny, or fraud.¹⁰¹ Under Judge Hand's analysis, the Court's delineation would not have sufficiently separated the terms to give defalcation a separate and distinct application.¹⁰² The criminal intent that the Court affixed to defalcation makes the term similar to its statutory neighbors and yet still ambiguous regarding its application in bankruptcy suits.¹⁰³

Answering the question charged by the specific facts of the case,¹⁰⁴ the Court acknowledged the difficulty faced by nonprofessional trustees

⁹⁷*Bullock*, 133 S. Ct. at 1760 (observing that embezzlement is similar to fraud in that it requires a showing of wrongful intent, involving moral turpitude, or an intentional wrong).

⁹⁸*See id.* (noting *ejusdem generis* means of the same kind); *see also* BLACK'S LAW DICTIONARY 594 (9th ed. 2009) ("A canon of construction holding that when a general word or phrase follows a list of specifics, the general word or phrase will be interpreted to include only items of the same class as those listed.").

⁹⁹*See* *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (concluding it is a cardinal canon of construction to give effect to every word and clause of a statute to avoid any clause, sentence, or word to be superfluous, especially when a term is placed in a pivotal section of a statutory scheme).

¹⁰⁰*See* *Bullock*, 133 S. Ct. at 1759-60 (holding defalcation requires an intentional wrongdoing, specifically either knowledge of or recklessness with respect to the act); *see also* *Neal*, 95 U.S. at 709 (finding fraud and embezzlement are associated directly with each other, therefore fraud and embezzlement require intentional wrongs); *Central Hanover*, 93 F.2d at 511-12 (finding fraud and embezzlement are redundant terms). The Court's imposition of an intentional wrong, especially the "knowledge-of" requirement, makes defalcation unjustifiably similar to its statutory neighbors. *See* *Central Hanover*, 93 F.2d at 512.

¹⁰¹*See* *Bullock*, 133 S. Ct. at 1760 (noting that embezzlement relates to the conversion of property, larceny relates to the taking and carrying away of property, and fraud relates to false statements or omissions; conversely, defalcation's common understanding relates to a breach of a fiduciary obligation that does not necessarily involve embezzlement, larceny, or fraud).

¹⁰²Requiring a heightened mental state similar to fraud, embezzlement, and larceny makes defalcation a superfluous statutory term. *See* *Central Hanover*, 93 F.2d at 511-12 (finding the linkage of fraud and embezzlement to defalcation makes the words redundant, even if the term included faults other than "deliberate malversations").

¹⁰³*See* *Bullock*, 133 S. Ct. at 1760 (stating defalcation involves a breach of fiduciary duty that does not necessarily involve a conversion, larceny, or falsity). The Court failed to articulate a definition of defalcation. Further, it failed to accept the way in which defalcation has historically been applied.

¹⁰⁴*See* *Empire Healthchoice Assurance, Inc. v. McVeigh*, 547 U.S. 677, 681 (2006) (finding Petitioner's "fact-bound and situation-specific" argument was improper for the Court to

when saddled with debt incurred by the mismanagement of trust funds, especially in light of the overarching fresh start policy that allows discharge to the honest-but-unfortunate debtor.¹⁰⁵ According to the Court, these intrafamily, trustee-beneficiary relationships make the determination of criminal intent hard to "evaluate in terms of comparative fault" because of intrafamily conflict.¹⁰⁶ Whether or not nonprofessional, intrafamily trustees are a common occurrence, the Court expressed its desire to protect this class of trustee-people.¹⁰⁷ This fact-bound analysis represents an under-inclusive group and is at odds with other instances of defalcation that do not involve nonprofessional, intrafamily trustees.¹⁰⁸ While the Court professed its desire to protect against intrafamily conflict, it overlooked that beneficiaries would have to pay attorney's fees to litigate whether or not the relative-trustee knew his actions were improper and in clear violation of the law.¹⁰⁹

The Court also noted that several circuits, namely the First and Second, have held this way for years without difficulty in applying a heightened mental state.¹¹⁰ The First and Second Circuits, however, have only recently held that they would require a heightened mental state akin to that required in securities fraud cases.¹¹¹ Moreover, it was the Second

address as it did not present a pure issue of law that would be applicable in future cases alike); *see also* *Gunn v. Minton*, 133 S. Ct. 1059, 1068 (2013) (concluding Petitioner's specific fact-bound argument did not present a proper question for the Court). Further, it is telling that the Court denied *certiorari* to the litigants in *In re Hyman*, in which a corporate officer engaged in self-dealing that allegedly constituted fiduciary defalcation. *See* *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 63 (2nd Cir. 2007), *cert. denied*, 555 U.S. 1097 (2009).

¹⁰⁵*See Bullock*, 133 S. Ct. at 1761. Following the principle that exceptions to discharge should be plainly expressed, the court also reasoned that under the current set of exceptions, a discharge can be excepted because of either policy or fault-based reasons. *Id.* at 1760-61; *see, e.g.*, 11 U.S.C. § 523 (a)(8) (2012) (educational loans); 11 U.S.C. § 523 (a)(14A) (2012) (taxes); 11 U.S.C. § 523 (a)(15) (2012) (spousal and child support); 11 U.S.C. § 523(a)(4) (2012) (fault based acts).

¹⁰⁶*See Bullock*, 133 S. Ct. at 1761.

¹⁰⁷*Id.*

¹⁰⁸*See In re Hyman*, 502 F.3d at 61; *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 9 (1st Cir. 2002); *Meyer v. Rigdon*, 36 F.3d 1375, 1375 (7th Cir. 1994); *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993). The Court's reasoning fails to adequately address the role of all potential trustees, namely professional trustees. A question remains from the Court's reasoning: should professional trustees be held to a lower threshold when a court reviews their mental culpability?

¹⁰⁹*See* Interview with the Hon. Brendan Linehan Shannon, *supra* note 2.

¹¹⁰*See Bullock*, 133 S. Ct. at 1761.

¹¹¹*See In re Baylis*, 313 F.3d at 9 (decided in 2002); *see also In re Hyman*, 502 F.3d at 61 (decided in 2007). Furthermore, the same argument can be made in reference to the seven other circuits that have followed their respective precedents with ease for years. *See* *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220 (5th Cir. 2001); *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978 (8th Cir. 1997); *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182 (9th Cir. 1996); *Quaif v. Johnson*, 4 F.3d 950 (11th Cir. 1993); *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417 (5th Cir. 1990); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249 (6th Cir. 1982).

Circuit's decision in *Central Hanover* in which Judge Hand wrestled with the meaning of and the mental state attached to defalcation.¹¹²

Finally, the Court expressed the need to have a uniform federal law.¹¹³

While the Court's pronouncement did create a uniform federal law,¹¹⁴ the decision effectively amounted to a convergence of the meaning of "fraud" and "defalcation."¹¹⁵

IV. THE CONSEQUENCES OF DEFALCATION'S HEIGHTENED STATE: A PRACTITIONER'S GUIDE TO ARGUING DEFALCATION, AND THE CONSTRUCTION OF "FRAUD JUNIOR"

Bullock requires practitioners to show knowledge of, or gross recklessness with respect to, improper fiduciary behavior.¹¹⁶ It is likely that practitioners will attempt to grab "the lowest-hanging fruit" from the proverbial tree and seek to prove defalcation under the recklessness standard.¹¹⁷ This may be the practical outcome of the *Bullock* decision, considering that "knowledge of" a breach of a fiduciary duty is similar to the need for direct evidence required to prove fraud.¹¹⁸ The Court in *Neal v.*

¹¹²See *Cent. Hanover Bank v. Herbst*, 93 F.2d 509, 511-512 (2nd Cir. 1937).

¹¹³See *Bullock*, 133 S. Ct. at 1761.

¹¹⁴See Interview with the Hon. Brendan Linehan Shannon, *supra* note 2 (stating it is the Supreme Court's job to announce what the law is, especially when there are circuit splits, and that is what the Court did here); see also interview with the Hon. Christopher S. Sontchi, *supra* note 1 (stating the decision creates a uniform federal law, and now courts do not have to look to state law to decide what constitutes defalcation).

¹¹⁵See *supra* Part III.

¹¹⁶See *Bullock*, 133 S. Ct. at 1759-60. Although this is the synthesized holding of *Bullock*, the Court also expressly required an "intentional wrong," which is defined as having a *mens rea* of "intention, purpose, or design[.]" BLACK'S LAW DICTIONARY 840 (9th ed. 2009). Courts could interpret the "knowledge of" requirement to weigh more while analyzing whether the trustee-debtor committed defalcation because of the Court's emphasis on the debtor committing an intentional wrong. Therefore, although recklessness is a lower threshold, it is unclear whether a court will similarly focus on the higher-culpability standard upon proving defalcation.

¹¹⁷See Interview with the Hon. Christopher S. Sontchi, *supra* note 1 (characterizing recklessness as being the lowest mental state to prove, from a practitioner's standpoint).

¹¹⁸*Id.*; see also *Neal v. Clark*, 95 U.S. 704, 709 (1877). Compare *Giles v. California*, 554 U.S. 353, 385-86 (2008) (Breyer, J., dissenting) ("A man who performs an act . . . known [to] produce a particular result is . . . presumed to have anticipated that result and to have intended it."), and *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2069 (2011) ("Defining knowledge of the existence of a particular fact to include a situation in which a person is aware of a high probability of the fact's existence, unless he actually believes that it does not exist.") (citations omitted), with *Candelora v. Clouser*, 621 F. Supp. 335, 341-42, *aff'd*, 802 F.2d 446 (3d Cir. 1986) (holding for an action of fraud the appellant must show an intentional misrepresentation, knowingly given to another who relied on it and was deceived), and RESTATEMENT (SECOND) OF TORTS § 525 (1977) ("One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to

Clark expressly rejected a constructive application of fraud to the exceptions-to-discharge provision; therefore, direct evidence is required to show fraud.¹¹⁹ In related provisions involving fraud, courts have recognized that a direct evidentiary showing of fraud is an extremely heavy burden; consequently, courts infer fraudulent intent from a showing of "badges of fraud."¹²⁰ Thus, it is likely that practitioners will choose the alternative showing of recklessness simply because of the lesser burden.¹²¹

Considering the prohibition of constructive fiduciary fraud and the leniency afforded to litigants in proving fraud in other areas of the exceptions section, defalcation will likely become a showing of recklessness and fiduciary fraud will be devoid of application.¹²² This confluence of the meaning of fraud and defalcation creates what the Honorable Christopher S. Sontchi termed "fraud junior."¹²³ The "knowledge of" requirement for defalcation effectively becomes subsumed by fraud,¹²⁴ and practitioners will likely only show recklessness with respect to the defalcation; thus, "fraud junior" is created.¹²⁵

The defalcation standard does not change much in the way of court proceedings:¹²⁶ bankruptcy courts will still have an evidentiary hearing on whether the debtor was a fiduciary and whether defalcation was committed;¹²⁷ the creditor now has to prove, in addition to the defalcatory act, the heightened mental state required for defalcation.¹²⁸

Another consequence of defalcation's heightened mental state is that it allows trustees to take advantage of their fiduciary positions by making riskier investments to the potential detriment of the beneficiaries.¹²⁹ A rise

refrain from action in reliance upon it . . .").

¹¹⁹See *Neal*, 95 U.S. at 709 (holding that fraud, under the Bankruptcy Act of 1867, required positive fraud or fraud in fact, and not constructive fraud).

¹²⁰See *Kelly v. Armstrong*, 141 F.3d 799, 802 (11th Cir. 1998) ("Some badges of fraud are: (1) actual or threatened litigation against the debtor; (2) a transfer of all or substantially all of the debtor's property; (3) insolvency on the part of the debtor; (4) a special relationship between the debtor and the transferee; and (5) retention of the property by the debtor after the transfer.").

¹²¹See Interview with the Hon. Christopher S. Sontchi, *supra* note 1; see also *supra* note 117 and accompanying text.

¹²²See *supra* note 117 and accompanying text.

¹²³See Interview with the Hon. Christopher S. Sontchi, *supra* note 1.

¹²⁴See *supra* notes 117-18 and accompanying text.

¹²⁵See *supra* notes 117-18 and accompanying text.

¹²⁶See Interview with the Hon. Brendan Linehan Shannon, *supra* note 2.

¹²⁷See *id.*

¹²⁸See *id.* While there is no additional procedural step, litigants will still have to pay legal fees to argue whether the trustee-debtor possessed the heightened mental state. See Interview with the Hon. Brendan Linehan Shanon, *supra* note 2.

¹²⁹Depending on the structure of the trust, the trustee could receive a commission based on the income and interest of the trust. See RESTATEMENT (THIRD) OF TRUSTS § 38 (2003) (stating trustees are entitled to reasonable compensation out of the trust funds for services rendered, unless

of poor investment-decisions and a greater potential loss of trust funds may result from these riskier investments.¹³⁰ If funds are depleted due to poor investments and the trustee subsequently files for bankruptcy for failure to repay his obligations to the trust, the beneficiaries' only recourse is to file suit to recover lost funds.¹³¹ The beneficiaries would have to pay up front for legal fees to bring suit against their trustee.¹³² Following the *Bullock* decision, litigants have to prove a heightened mental state that their trustee had knowledge of his imprudent investment or had disregard for the consequences of that investment.¹³³ Trustees can and will hide behind defalcation's heightened mental-state standard, resulting in the discharge of their incurred debt without liability.¹³⁴ This is contrary to the honest-but-unfortunate debtor standard.¹³⁵ More importantly, it is contrary to Congress's initial intent: defalcatory actions cannot be discharged.¹³⁶

Consider again the hypothetical member on the pension board of trustees.¹³⁷ Under the Court's analysis, it is likely that he will be able to discharge his debt despite the beneficiaries' defalcation claim to the contrary. To meet their burden, the beneficiaries would have to show that he had knowledge of, or was reckless with respect to, the improper investment.¹³⁸ At most, to meet the standard for knowledge, the beneficiaries would need to show that the trustee knew the real estate development project would fail and that his decision to invest the funds would damage the trust.¹³⁹ It is unlikely that the beneficiaries will be able to prove this "knowledge of" standard, short of discovering an email to another board member that reveals his intent to damage the trust and hurt the beneficiaries.¹⁴⁰ Alternatively, the beneficiaries must at least show that the trustee recognized a substantial risk that his investment decision could

the terms of the trust state otherwise). It follows that if the compensation is tied to the investment, the trustee may take unnecessary risks in hopes of higher compensation.

¹³⁰*Id.*

¹³¹*But see* Interview with the Hon. Brendan Linehan Shannon, *supra* note 2 (stating that beneficiaries have a disincentive to bring suit against the trustee due to their lack of trust funds and their desire not to spend or lose money through litigation).

¹³²*Id.*

¹³³*See* *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013).

¹³⁴*Id.*

¹³⁵*See supra* note 28 and accompanying text.

¹³⁶*See* 11 U.S.C. § 523(a)(4) (2012); *see also supra* note 28 and accompanying text.

¹³⁷*See supra* note 8 and accompanying text.

¹³⁸*See Bullock*, 133 S. Ct. at 1757.

¹³⁹*Id.*

¹⁴⁰*See* Interview with the Hon. J. Christopher S. Sontchi, *supra* note 1 (describing that a "knowledge-of" culpability requirement can be and has been shown by an email exchange expressing the actor's intent to defraud another party, although it is an extremely rare circumstance); *see also* Interview with the Hon. J. Brendan Linehan Shannon, *supra* note 2 (describing the same).

damage the trust and beneficiaries, yet still invested despite the level of risk.¹⁴¹ It is very possible that a court analyzing the board member's recklessness would consider his market research as substantially mitigating his potential disregard for the risk.¹⁴² Furthermore, in light of the market research, a court could acknowledge the low likelihood of the project's failure and hold that his investment was not a defalcation.¹⁴³

V. A CALL UPON CONGRESS TO AMEND: THE "FIDUCIARY CAPACITY" CONNECTION AND THE AVOIDANCE OF SURPLUSAGE

The Court effectively interpreted fraud out of the exceptions provision through its statutory construction and the resulting practical application.¹⁴⁴ It also effectively blended part of defalcation into fraud through the same process.¹⁴⁵ Moreover, the Court failed to remain true to the history of defalcation and its "fiduciary-capacity" connection.¹⁴⁶ The *Bullock* decision divorces defalcation from Congress's intentional "fiduciary-capacity" connection and from the established principals of trustee-fiduciary duties by adding a heightened mental state requirement

¹⁴¹See *Bullock*, 133 S. Ct at 1757.

¹⁴²See *id.*

¹⁴³But see Knezevich, *supra* note 8 (stating the employee-beneficiaries alleged that the board members received neither adequate security on the loan nor advice on the consequences of the loan). The Court's focus on the subjective intent of the debtor will likely distract from thorough scrutiny of the facts that would indicate whether an investment represented a substantial risk. A court may deem the inadequate loan advice or security as ancillary to the affirmative actions of the trustee and his ostensibly pure intent. *Id.*

¹⁴⁴See *supra* Part III.

¹⁴⁵See *supra* Part III.

¹⁴⁶See, e.g., *Neal v. Clark*, 95 U.S. 704, 709 (1877) ("The Bankruptcy Act of 1841 exempted from discharge debts 'created in consequence of a *defalcation* as a public officer, or as executor, administrator, guardian, or trustee, or while acting in any *fiduciary capacity*.'") (emphasis added); *The Andy Warhol Found. for Visual Arts, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162, 168 n.3 (2d Cir. 1999) ("[T]he Bankruptcy Act of 1898 excepted from discharge any debts 'created by . . . fraud, embezzlement, misappropriation, or *defalcation* while acting as an officer, or in any *fiduciary capacity*.'") (emphasis added); Tabb, *supra* note 21, at 359 ("The only statutorily excepted debts were those 'created by fraud or embezzlement of the bankrupt, or by his *defalcation* as a public officer, or while acting in any *fiduciary capacity*.'") (emphasis added). The current Code states a debtor is exempted from discharging debts resulting from "fraud or *defalcation* while acting in a *fiduciary capacity*, embezzlement, or larceny[.]" 11 U.S.C. § 523(a)(4) (2012) (emphasis added); see also *Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993) (stating the language of the exceptions provision has remained relatively the same since its inception in 1841). Throughout the development of bankruptcy law, Congress has systematically placed "defalcation" adjacent to "fiduciary capacity[.]" *Id.* This suggests that Congress intended that defalcation be scrutinized through a fiduciary-duty lens.

that allows trustees to subvert their duties or even claim ignorance of the law.¹⁴⁷

This Note proposes that Congress isolate fiduciary fraud and defalcation from their statutory neighbors, thereby necessitating that courts review fiduciary-trustee defalcatory acts solely under an objectively reckless standard.¹⁴⁸

Congress created an exceptions section, and although discharge is the rule, the purpose of the exceptions section is to hold the debtor accountable for his actions.¹⁴⁹ The fiduciary's obligations, juxtaposed to the fresh start policy, must prevail. Solely using an objectively reckless standard will charge the fiduciary with knowing his legal obligations.¹⁵⁰ Moreover, claiming ignorance of the law will not allow the debtor to invoke the honest-but-unfortunate-debtor plea.¹⁵¹ As a result, fiduciaries will adhere to their legal duties, and most importantly, beneficiaries will have their entrusted money returned.¹⁵²

¹⁴⁷See Brief For Petitioner at 23, *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754 (2013) (No. 11-1518) (claiming petitioner did not know that taking loans from the trust funds was improper). *But see* RESTATEMENT (THIRD) OF TRUSTS §§ 77, 78 (2007) (describing that a fiduciary-trustee owes a duty of loyalty and care to the beneficiaries). *Bullock* essentially made the argument that he was ignorant of his duties under the law.

¹⁴⁸See *infra* Part IV.A. It would be most helpful if Congress defined the term and declared what it thought defalcation means and whether a mental state should attach to it; however, in light of the uncertainty of the term's original congressional meaning, it is certainly plausible that Congress would accept how it has been traditionally applied and defined. Regarding a mental state, as this author will argue, an objectively reckless standard should be applied to protect the fiduciary duties already required of trustees under the law. The most efficient legislative way to import an objectively reckless mental state is to bifurcate the provision, separating embezzlement and larceny from fiduciary fraud and defalcation.

¹⁴⁹See *supra* notes 27-28 and accompanying text.

¹⁵⁰See *Antlers Roof-Truss Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 288-90 (B.A.P. 10th Cir. 1997).

¹⁵¹*Id.*

¹⁵²See RESTATEMENT (THIRD) OF TRUSTS §§ 77, 78 (2007). The duty owed to the beneficiaries will determine what standard is necessary to prove whether a defalcation occurred, and that will translate to money saved in attorney's fees by the beneficiaries. If the beneficiaries are owed a duty of loyalty, they will have to show the trust funds were not given to them upon disbursement. *See id.* If the beneficiaries are owed a duty of care, they will have to show the trustee's investment was objectively reckless such that the investment was imprudent under the circumstances. *Id.* at § 78.

A. *Bifurcate the Provision*

The only way to avert this devastating effect is for Congress to amend the Bankruptcy Code, as it did in 2005.¹⁵³ Specifically, Congress should separate embezzlement and larceny from "fraud or defalcation while acting in a fiduciary capacity[.]"¹⁵⁴ Embezzlement and larceny should be placed in provision 11 U.S.C. § 523(a)(6), which excepts discharge "for willful and malicious injury by the debtor to another entity or to the property of another entity[.]"¹⁵⁵

B. *The Correct Analysis after the Bifurcation*

Separating fraud and defalcation from embezzlement and larceny will make fraud separate and distinct from defalcation.¹⁵⁶ A court subsequently analyzing whether a trustee-debtor committed defalcation will likely stress the importance of the segregation and attempt to disaggregate defalcation from fraud as much as possible.¹⁵⁷ The clear opportunity to distinguish between defalcation and fraud is to focus on the actions—rather than the intent—of the debtor.¹⁵⁸ Therefore, courts would view defalcation under an objectively reckless standard.¹⁵⁹ A court would engage in a two-step analysis: (1) whether the debtor was a fiduciary; and (2) whether a

¹⁵³See *Floyd v. Hill (In re Hill)*, 495 B.R. 646, 660 (Bankr. D.N.J. 2013) (noting the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amendments substantively changed the bankruptcy code).

¹⁵⁴11 U.S.C. § 523(a)(4) (2012).

¹⁵⁵*Id.* § 523(a)(6). Placing embezzlement and larceny in a provision that already has a specified mental state that includes harm to "another entity" or "property" directly implicates embezzlement and larceny. *See id.*; *see also* *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1760 (2013) (noting embezzlement requires conversion of one's *property* and larceny requires taking away one's *property*, both of which require a specific intent) (emphasis added); Brief For The United States As Amicus Curiae Supporting Respondent at 13, *Bullock v. BankChampaign*, 133 S. Ct. 1754 (2013) (No. 11-1518) (stating if Congress intended for defalcation to have a specific intent, it would have included a mental state in the provision as it has in other provisions within the exceptions section).

¹⁵⁶*See Boumediene v. Bush*, 553 U.S. 723, 738 (2008) (holding if Congress amends a statute, the Court must respect its intent); *see also* *Miller v. French*, 530 U.S. 327, 349 (2000) (holding when Congress amends applicable law, the Court's previous interpretation no longer takes hold). Separating embezzlement and larceny from fraud and defalcation will inform courts that Congress desired defalcation to be separate and distinct from fraud.

¹⁵⁷*See supra* note 156 and accompanying text.

¹⁵⁸*See Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 286 (B.A.P. 10th Cir. 1997).

¹⁵⁹*See* RESTATEMENT (THIRD) OF TRUSTS § 77, Comment on Subsections (1) and (2) (2007).

defalcation occurred.¹⁶⁰ It follows that since the trustee relationship must be an express one,¹⁶¹ a preliminary analysis should examine the trust document to determine what fiduciary duty is owed—loyalty or care.¹⁶² If the trust requires a prudent investment scheme on the part of the trustee, the duty of care is triggered and the court must look to whether a reasonable, prudent trustee-investor would have invested the funds as the trustee-debtor did under the same or similar circumstances.¹⁶³ If the court finds the trustee's actions were imprudent in light of his fiduciary duties, his actions shall be deemed objectively reckless.¹⁶⁴ If the trust requires the trustee to disburse the funds directly to the beneficiaries, the duty of loyalty is triggered and the court must consider whether the actions taken by the trustee were performed with the utmost care.¹⁶⁵ This analysis charges fiduciaries with knowledge of the law and their duties, and it makes the unclear history of defalcation clear and consistent for future beneficiary-plaintiffs.

C. Consequences of the Amendment

Bifurcating and construing the new provision will create a clear, consistent, and unified federal law for courts and practitioners to follow.¹⁶⁶ Under this construction, fiduciary-trustees are on double notice—actual notice upon signing the trusteeship agreement and constructive notice of the

¹⁶⁰See *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997) (analyzing first whether the debtor was a fiduciary and then determining whether the debtor's actions constituted defalcation); see also *In re Wimbrow*, 2012 WL 3069527, at *3 (Bankr. D. Del. July 27, 2012) (holding the debtor did not commit defalcation because he was not a fiduciary during the relevant period of time).

¹⁶¹See *supra* note 33 and accompanying text.

¹⁶²See RESTATEMENT (THIRD) OF TRUSTS §§ 77, 78 (2007).

¹⁶³*Id.*; see also *id.* § 90 (2007) (stating the trustee has a duty to invest and manage the funds as a prudent investor would, in light of the requirements of the trust). The reasonably prudent person standard is similar to the objectively reckless standard because both are objective. The objectively reckless standard should be used in conjunction with the reasonably prudent person standard because both terms of art are tied to a degree of fault of the actor, which ultimately comports with the design of the exceptions section.

¹⁶⁴See *supra* note 152 and accompanying text.

¹⁶⁵Under a duty of loyalty analysis, the court will need only review whether the fiduciary-trustee disbursed the funds solely for, and to, the benefit of the beneficiaries. See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."); *supra* note 4 and accompanying text.

¹⁶⁶See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1761 (2013) (expressing the desire to have a clear and uniform federal law); see also Interview with the Hon. Brendan Linehan Shannon, *supra* note 2 (explaining that solely using an objective standard would be akin to a bright-line rule, whereas requiring a subjective standard amounts to an ad hoc determination of what constitutes defalcation).

existing trustee fiduciary-duty laws—therefore, any lingering concern over the trustee's competence becomes irrelevant.¹⁶⁷ Moreover, no class of persons is treated differently because under this standard a trustee's actions are reviewed and not his subjective intents.¹⁶⁸ Beneficiaries will not shy away from filing a lawsuit against their undutiful trustees.¹⁶⁹ Instead, their wrongs will be righted under this standard of review.¹⁷⁰

Consider for a final time the hypothetical member on the pension-fund board of trustees.¹⁷¹ Under this proposed standard of review, a court will consider the trustee's investment decision with his fiduciary duties in mind.¹⁷² The beneficiaries will show that the board member was a trustee and that his investment decision was objectively reckless, amounting to defalcation.¹⁷³ The beneficiaries will need to show, and a court will conclude, that at the time of the investment, the board member was a fiduciary: he accepted his board position by signing an express agreement to invest the funds for the benefit of the beneficiaries.¹⁷⁴ The beneficiaries will then need to prove that the board member's investment decision was objectively reckless based on his actions.¹⁷⁵ A court will first review the terms of the trust to decide whether the trustee had a duty to distribute or to prudently invest the funds for the benefit of the beneficiaries.¹⁷⁶ The requirements of the trust trigger which fiduciary duty is owed—the duty of loyalty or the duty of care.¹⁷⁷ Here, since the trustees were charged to invest the trust, the court will analyze the trustee-debtor's actions through a duty-of-care lens. Accordingly, a court will likely consider the board member's market research, the massive loan taken out of the trust, and the lack of adequate advice or security on the loan and decide that the investment was

¹⁶⁷Interview with the Hon. Brendan Linehan Shannon, *supra* note 2; *see also* United States v. Detroit Timber & Lumber Co., 200 U.S. 321, 333 (1906) (defining constructive notice as, in the absence of actual notice, the petitioner could and should have acquired the readily available information; the question turns on whether his failure to obtain the knowledge in question was a gross negligence); U.C.C. § 1-202 (2001) ("[A] person 'receives' a notice . . . when: (1) it comes to that person's attention; or (2) it is duly delivered in a form reasonable under the circumstances . . . through which the contract was made.").

¹⁶⁸*See supra* pp. 14-15 and note 108.

¹⁶⁹*Cf. supra* note 131 and accompanying text (inferring that with a greater chance of success in court, beneficiaries will be more likely to file suit).

¹⁷⁰*See supra* Part IV.A.1.

¹⁷¹*See supra* notes 6-13 and accompanying text.

¹⁷²*See supra* Part IV.A.1 (discussing the proper analysis under the proposed standard).

¹⁷³*See supra* Part IV.A.1.

¹⁷⁴*See supra* notes 6-13 and accompanying text; *supra* Part IV.A.1.

¹⁷⁵*See supra* Part IV.A.1.

¹⁷⁶*See supra* Part IV.A.1.

¹⁷⁷*See supra* Part IV.A.1.

imprudent in light of his fiduciary duty to the beneficiaries.¹⁷⁸ Without relying on the trustee-debtor's subjective intent, the court will scrutinize the actions of the debtor and determine that the investment decision was objectively reckless despite his market research.¹⁷⁹ Under this standard of review, the beneficiaries will prevent the board member's discharge and have the opportunity to recover their money as a result of his defalcation.¹⁸⁰

VI. CONCLUSION

Congress must separate fiduciary fraud and defalcation from embezzlement and larceny in order to protect innocent beneficiaries from their potentially ignorant trustees.¹⁸¹ Allowing the Supreme Court's interpretation of defalcation to remain the law would undercut defalcation's historical meaning, and ultimately contradict Congress's intent for the exceptions section.¹⁸² Bifurcating the provision will give beneficiaries an incentive to bring suit against their trustees to have their entrusted money returned.¹⁸³ Until the section is amended, trustees will hide behind the Supreme Court's imposed heightened mental state that protects solely the trustees and leaves beneficiaries without recourse.

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¹⁷⁸ See *supra* notes 6-13, 143 and accompanying text.

¹⁷⁹ See *supra* Part IV.A.1.

¹⁸⁰ See *supra* Part IV.A.1.

¹⁸¹ See *supra* Part III.

¹⁸² See *supra* Part III-IV.

¹⁸³ See *supra* Part IV.