PERSISTENT CONFUSION: THE CIRCUIT SPLIT OVER THE EXCEPTION TO DISCHARGE FOR DEFALCATION UNDER 11 U.S.C. § 523(a)(4)

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I. INTRODUCTION

Section 523(a)(4) of the Bankruptcy Code[1] provides one of several exceptions to the discharge of debts[2] that an individual debtor enjoys in bankruptcy. Specifically, that provision contains an exception to a debtor's discharge "for . . . defalcation while acting in a fiduciary capacity . . . ."[3] This provision regulates an area of personal bankruptcy law where the financial insolvency of the individual debtor

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[1] 11 U.S.C. § 523(a)(4) (2007).

[2] *See* 11 U.S.C. § 727 (2007).

[3] 11 U.S.C. § 523(a)(4) (2007).

intersects with his responsibility for some aspect of the financial dealings of the party to whom he owes a fiduciary duty.[4] Particularly in the wake of recent corporate scandals and the current economic downturn, the ability of beneficiaries to recover from individual debtor-fiduciaries whose acts of defalcation have caused them economic loss can serve as an important remedy for and deterrent to carelessness and malfeasance.[5] The prospect of the non-dischargeability of debts incurred in a fiduciary capacity can deter parties from handling their respective beneficiaries' funds in a way that might lead to a charge of defalcation. The enforcement of the discharge exception will hold those responsible who fail to act with the requisite level of care.

While the § 523(a)(4) exception to discharge may protect the victim of a debtor's defalcation, it must be balanced with the countervailing purpose of the bankruptcy laws to provide

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[4] *See, e.g.*, Carlisle Cashway, Inc. v. Johnson (*In re* Johnson), 691 F.2d 249, 252 (6th Cir. 1982) (describing the Michigan Building Contract Fund Act which "imposes a 'trust' upon the building contract fund paid by any person to a contractor or subcontractor for the benefit of the person making the payment, contractors, laborers, subcontractors and materialmen" created a fiduciary duty on the part of debtor); Wachtel v. Rich (*In re* Rich), 353 B.R. 796, 806 (Bankr. S.D.N.Y. 2006) (where a Chapter 7 debtor owed a fiduciary duty to decedent as investment advisor and accountant). For other examples where a fiduciary capacity within the scope of the § 523(a)(4) exception to discharge has (and has not) been found, see generally Ann K. Wooster, Annotation, *Who Is Acting in "Fiduciary Capacity" Within Meaning of Fraud or Defalcation Discharge Exception in Bankruptcy (11 U.S.C.A. § 523(a)(4))—Fiduciary Capacity of Debtors Other Than Sales, Purchasing, or Leasing Agent Debtors*, 17 A.L.R. FED. 2d 33 (2007).

[5] While this Note discusses cases where the fiduciary capacity of the debtor has been found in a variety of contexts, it is worth noting that perhaps the most contemporarily salient application of the exception may be in the context of ERISA fiduciaries who have abused their authority in the administration of funds that are part of employee benefit plans. *See* Jennifer Liotta, Comment, *ERISA Fiduciaries in Bankruptcy: Preserving Individual Liability for Defalcation and Fraud Debts under 11 U.S.C. § 523(a)(4)*, 22 EMORY BANKR. DEV. J. 725 (2006). Rather than focusing on a specific context for the application of the exception, this Note analyzes the broader ramifications for debtors of the circuit split regarding what mens rea—if any—is necessary for an act to constitute a defalcation.

an honest but unfortunate debtor with a fresh start.[6] Since "[c]ertain relationships . . . commonly impose fiduciary duties upon a party,"[7] a given court's interpretation of the applicability of the defalcation exception to discharge can have a profound impact on the efforts of an individual debtor to organize his financial affairs and emerge from bankruptcy with a clean slate.

Part of a court's analysis in determining the applicability of the defalcation exception entails consideration of the level of intent with which an act of defalcation must be committed in order to qualify for the exception to discharge under § 523(a)(4). In September 2007, after reviewing what it called "persistent confusion"[8] among its sister circuits in determining what exactly a defalcation entails, the U.S. Court of Appeals for the Second Circuit, in the case of *In re Hyman*, held that the exception to discharge for "defalcation under § 523(a)(4) [of the Bankruptcy Code] requires a showing of conscious misbehavior or extreme recklessness . . . ."[9] The Second Circuit thus aligned itself with the First Circuit in the struggle of the nation's circuit Courts of Appeal to articulate what mental state must accompany an act of defalcation[10] for a debt arising from that act to be held nondischargeable. The "persistent confusion" to which the Second Circuit referred is the subject of this Note.

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[6] "This Court has certainly acknowledged that a central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.' But in the same breath that we have invoked this 'fresh start' policy, we have been careful to explain that the Act limits the opportunity for a completely unencumbered new beginning to the 'honest but unfortunate debtor.'" Grogan v. Garner, 498 U.S. 279, 286-87 (1991) (citations omitted).

[7] Leah A. Kahl & Peter C. Ismay, *Exceptions to Discharge for Fiduciary Fraud, Larceny, and Embezzlement*, 7 J. BANKR. L. & PRAC. 119, 122 (1998).

[8] Denton v. Hyman (*In re* Hyman), 502 F.3d 61, 68 (2d Cir. 2007).

[9] *Id.*

[10] BLACK'S LAW DICTIONARY (8th ed. 2004) defines "defalcation" as "2. Loosely, the failure to meet an obligation; a non-fraudulent default."

This Note argues that rather than the extreme recklessness standard of defalcation adopted by the First and Second Circuits or the innocent mistake standard of the Fourth, Eighth, and Ninth Circuits, the Supreme Court of the United States, if confronted with the circuit split, should adopt a mens rea standard modeled on the business judgment rule common to corporate law, which reflects the consensus of the Fifth, Sixth, and Seventh Circuits that more than an innocent mistake is necessary for an act of misappropriation to constitute a defalcation. This willful neglect/recklessness standard makes the most interpretive sense in light of the goals of the Bankruptcy Code in general, and of the structure and logical consistency of § 523 in particular.

Part II discusses the seminal case in the circuit courts' struggle to define the scienter requirement attaching to defalcation, *Central Hanover Bank & Trust Co. v. Herbst*. Part III discusses the current state of the circuit split, with subsections A, B, C, and D each addressing how a particular circuit or group of circuits has decided the issue through analysis of relevant case law. In addition to discussing some of the leading cases from each circuit on the issue, the subparts include an application of the holding of each cluster of circuits to a hypothetical debtor against whom a defalcation has been alleged.[11] Part IV discusses the recommended resolution of the circuit split, and Part V concludes.

II. *CENTRAL HANOVER BANK & TRUST CO. v. HERBST*

Central Hanover Bank & Trust Co. v. Herbst,[12] a 1937 decision of the U.S. Court of Appeals for the Second Circuit

[11] This Note borrows the basic hypothetical proposed by Andrea Johnson in Note, *The Defalcation Exception to Discharge: Should a Fiduciary's Mistake Prohibit a Discharge from Debt?*, 27 W. NEW ENG. L. REV. 93, 94-95 (2005) to compare and contrast the outcomes that would result from application of the different standards adopted by each group of circuits.

[12] 93 F.2d 510 (2d Cir. 1937).

by Judge Learned Hand, lies at the heart of the current circuit split regarding the scienter requirement, if any, that applies to the exception to discharge contained in § 523(a)(4) for defalcation while acting in a fiduciary capacity. The landmark case in the interpretation of this exception to discharge, *Herbst* did not articulate a bright line rule or black and white criteria; rather, it provided a much cited exegesis of the then-current and superseded bankruptcy laws that recognized an exception to discharge for defalcation. Its somewhat indecisive holding left the door open for later courts to craft a more specific mental culpability requirement for defalcation. Today, the lines of demarcation among the circuits concerning the exception to discharge for defalcation have been drawn as responses to the reasoning and analysis of *Herbst*.

In *Herbst*, the debtor, a dentist, was appointed receiver of a piece of real property and had been provided with certain allowances for the property.[13] When the property was sold, he presented his account to the court, which awarded him an additional sum to supplement the prior allowances.[14] However, "[w]ithout waiting for the time to appeal from th[e] order [from the bankruptcy court vacating a stay enjoining proceedings against him in state court] to expire, or consulting the plaintiff in foreclosure as to whether it intended to appeal, [Herbst] withdrew this money and . . . spent it."[15]

The legal analysis begins by pointing out that the word "defalcation" first appeared in § 1 of the Bankruptcy Act of 1841[16] as part of the definition of who may become a voluntary bankrupt.[17] According to that statute, an individual could voluntarily enter bankruptcy as long as he did not owe debts "created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or

[13] *Id.* at 511.

[14] *Id.*

[15] *Id.*

[16] 5 Stat. 440 (1841).

[17] *Herbst*, 93 F.2d at 511.

trustee, or while acting in any other fiduciary capacity . . . ."[18] The court concluded that, "[c]olloquially perhaps the word, '[d]efalcation,' ordinarily implies some moral dereliction, but in this context it may have included innocent defaults, so as to include fiduciaries who for any reason were short in their accounts."[19]

The word "defalcation" also appeared in the Bankruptcy Act of 1867,[20] which for the first time provided exceptions to the discharge of debts in bankruptcy.[21] More specifically, it provided that "no debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged."[22] The construction of this portion of the statute linked defalcation with fraud and embezzlement. Despite the wording of the provision, however, Hand, writing for the court, concluded that, "[w]hatever was the original meaning of 'defalcation,' it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'"[23]

The connection between defalcation and fraud and embezzlement in the Bankruptcy Act of 1867 has endured.[24] Indeed, this connection remained intact in the version of the Bankruptcy Act which was applicable in *Herbst*: the case was decided under the Bankruptcy Act of 1898,[25] and Hand's opinion continues with an analysis of that Act's defalcation exception to discharge.[26] Section 17(a) of the Bankruptcy Act of 1898 provided that, "[a] discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as . . . (4) were created by his fraud, embezzlement,

[18] 5 Stat. 440, 441 (1841).

[19] *Herbst*, 93 F.2d at 511.

[20] 14 Stat. 517 (1867).

[21] *See* Bankruptcy Act of 1867, 14 Stat. 533 § 33.

[22] *Id.*

[23] *Herbst*, 93 F.2d at 511.

[24] *See* 11 U.S.C. § 523(a)(4) (2007) (defining the exception to discharge "for *fraud* or *defalcation* while acting in a fiduciary capacity, *embezzlement*, or larceny . . . .") (emphasis added).

[25] 30 Stat. 544.

[26] *Herbst*, 93 F.2d at 511.

misappropriation, or defalcation while acting as an officer or in any fiduciary capacity."[27] After noting that the Supreme Court had held that the phrase "while acting as an officer or in any fiduciary capacity" applied to all of the exceptions listed in § 17(a)(4) of the Bankruptcy Act of 1898,[28] the court concluded that "[i]t does not seem . . . , however, that this linkage of 'fraud' and 'embezzlement' to 'defalcation' need change its meaning in the [Bankruptcy] Act of 1867."[29] Although "'embezzlement' certainly, and perhaps 'fraud' too, become redundant" when they are read in conjunction with the phrase "while acting as an officer or in any fiduciary capacity," "that is no reason for going still further and reducing 'embezzlement' and 'defalcation' to synonyms . . . ."[30] Rather, Hand reasoned, the words must be given different meanings, "especially when a contrary inter-pretation would wrest 'defalcation,' if not from its original meaning, at least from that which it must have had in the [Bankruptcy] Act of 1867."[31]

Hand had earlier concluded that the meaning of "defalcation" in the Bankruptcy Act of 1867 included "other defaults than deliberate malversations."[32] Any other reading would make the inclusion of "defalcation" in the provision redundant.[33] Hand reasoned that since fraud and embezzlement involved deliberate intent, requiring the same mental culpability to substantiate an allegation of defalcation by a debtor would render the term "defalcation" superfluous. The implication to be drawn from this analysis is that defalcation requires some state of mental culpability that is less demanding than intentional misconduct in order for a debt resulting from an act of defalcation to be excepted from discharge.

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[27] 30 Stat. 550-51.

[28] *Herbst*, 93 F.2d at 511-12 (citing Crawford v. Burke, 195 U.S. 176, 190 (1904)).

[29] *Herbst*, 93 F.2d at 511.

[30] *Id.* at 511-512.

[31] *Id.* at 512.

[32] *Id.* at 511.

[33] *Id.*

While the court's reasoning may make it clear that deliberate intent is too high a level of mental culpability to assign to defalcation, it does not clarify what lower threshold actually should be applied. The court stated that it did "not hold that no possible deficiency in a fiduciary's accounts is dischargeable"[34] and cited a prior decision in which it ruled that "the misappropriation must be due to a known breach of the duty, and not to mere negligence or mistake."[35] While the court warned that the term "misappropriation" itself "probably carries a larger implication of misconduct than 'defalcation,'" it nevertheless assumed arguendo that defalcation "may demand some portion of misconduct."[36]

Applying this analysis to the facts of the case, the court concluded 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.'"[37] Although the court did not state explicitly what sort of mental culpability must attach to an act of defalcation, by contrasting defalcation with these three other types of wrongdoing, it at least signaled that the attendant level of mental culpability hovers between deliberate intent and negligence or mistake. While the court drew the outer bounds of the mental culpability that defines an act of defalcation, it did so in dicta. It thus left the door open for later courts to determine just where on the spectrum of mental culpability the scienter requirement for defalcation should lie.

III. PERSISTENT CONFUSION: THE CURRENT CIRCUIT SPLIT

A modern court has rightly described Hand's approach in the *Herbst* opinion as "carefully equivocal."[38] *Herbst* opened

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[34] *Id.* at 512.

[35] *Id.* (citing *In re* Bernard, 87 F.2d 705, 707 (2d Cir. 1937)).

[36] *Id.*

[37] *Id.*

[38] Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 18 (1st Cir. 2002).

more doors than it closed. Rather than stating what level of mental culpability attaches to defalcation, the court's carefully crafted opinion in *Herbst* left lawyers and judges to formulate legal arguments and analyses that wrestled with the term "defalcation" and with the construction of the relevant provision of the bankruptcy laws. Modern courts of appeal have followed suit and have arrived at different conclusions. The discussion below maps out the contours of the split that has developed among the circuits concerning this issue.

A. Innocent Mistake Suffices: the Fourth, Eighth, and Ninth Circuits

The Fourth, Eighth, and Ninth Circuit Courts of Appeals have held that even an innocent mistake involving the misappropriation of funds can constitute a defalcation. In *Republic of Rwanda v. Uwimana (In re Uwimana)*,[39] the Republic of Rwanda initiated an adversary proceeding against its former ambassador to the United States, Uwimana, who had filed for bankruptcy under Chapter 7 of the current Bankruptcy Code. The Republic of Rwanda alleged that Uwimana owed the nation a nondischargeable debt that arose from his defalcation while acting in a fiduciary capacity, i.e., as ambassador.[40] While his homeland was engulfed in political unrest, Uwimana transferred $55,000 of embassy funds to a Washington, D.C. attorney to fund lobbying projects and to coordinate asylum requests for members of the Rwandan delegation.[41] Uwimana eventually won asylum,[42] but the embassy officials installed by the new Rwandan government requested a refund of the monies from the attorney engaged by Uwimana and from other lawyers brought on to handle the asylum case.[43] Uwimana filed for bankruptcy and the Republic of Rwanda challenged the

[39] 274 F.3d 806 (4th Cir. 2001).

[40] *Id.* at 808.

[41] *Id.* at 808-09.

[42] *Id.* at 809.

[43] *Id.* at 809-10.

discharge of the debt that it claimed was owed to them on account of the fees paid to the lawyers.[44] The district court found that the transfer of a portion of the $55,000 that had not been ratified by the new embassy officials constituted a defalcation by Uwimana and, accordingly, denied the dischargeability of that debt.[45]

The court in *In re Uwimana* defined defalcation as "the failure to meet an obligation" or a "nonfraudulent debt"[46] and stated that "[t]o be defalcation for purposes of 11 U.S.C. § 523(a)(4), an act need not 'rise to the level of... 'embezzlement' or even 'misappropriation.'"[47] Therefore, the court concluded, "negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient" to constitute defalcation.[48] Applying these principles to the facts of the case, the Fourth Circuit reasoned that as ambassador, Uwimana was a fiduciary of his country and that, as such, his discretion to spend embassy funds "arose within the context of a principal-agent relationship."[49] Since Uwimana "used at least some of the funds belonging to the Republic of Rwanda to purchase a substantial benefit—preparation of a case for asylum—for himself and his family" without informing his principal, the Republic of Rwanda, or getting consent therefrom, he committed an act of defalcation.[50] The court's opinion does not state that Uwimana acted recklessly in using some of the transferred embassy funds for the preparation of his asylum application. Indeed, the court's holding that "negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient" to constitute defalcation did not require the court to go that far in examining

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[44] *Id.* at 810.

[45] *Id.* at 810.

[46] *Id.* at 811 (citation omitted).

[47] *Id.* (citing Pahlavi v. Ansari (*In re* Ansari), 113 F.3d 17, 20 (4th Cir. 1997)).

[48] *Id.*

[49] *Id.* at 811-12.

[50] *Id.* at 812.

Uwimana's intent in transferring the funds.[51] Once the Republic of Rwanda had shown by a preponderance of the evidence that there was a transfer which resulted in Uwimana's failure to account for certain of the transferred funds, the debt became nondischargeable.

In holding that "[u]nder section 523(a)(4), defalcation 'includes the innocent default of a fiduciary who fails to account fully for money received,'"[52] the Eighth Circuit's reasoning mirrors that of the Fourth Circuit. The *Uwimana* court focused on the agent-principal relationship that existed between the debtor and his employer, the Republic of Rwanda. Once it was shown that Uwimana had breached his fiduciary duties to his principal by failing to account for funds entrusted to him, there was a breach of duty that established that a defalcation had taken place. Similarly, in *In re Cochrane*, the Eighth Circuit employed a two-step approach: first the court asked whether the debtor occupied a fiduciary capacity; then the court analyzed whether an act of defalcation had occurred while the debtor was acting in that capacity.[53] There, Cochrane, the attorney for a partnership

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[51] *Id.* at 811.

[52] Tudor Oaks Ltd. P'ship v. Cochrane (*In re* Cochrane), 124 F.3d 978, 984 (8th Cir. 1997). While *In re Cochrane* affirmed a district court decision granting the plaintiff summary judgment, the Eighth Circuit based its holding that an innocent mistake suffices to establish a defalcation on Lewis v. Scott (*In re* Lewis), 97 F.3d 1182, 1186 (9th Cir. 1996), which in turn relied on *In re* Short, 818 F.3d 693, 694 (9th Cir. 1987).

[53] *In re Cochrane* 124 F.3d at 984. In *Blyler v. Hemmeter* (*In re Hemmeter*), ESOP Plan and 401k Plan participants filed a class action suit against the company's board of directors (including Hemmeter, who had filed for personal bankruptcy) and the other fiduciaries of the plans seeking recovery of retirement account losses that class members alleged arose due to breaches of fiduciary duties in the administration of the plans. 242 F.3d 1186, 1189 (9th Cir. 2001). There, the Ninth Circuit also employed a two-step analysis to determine whether the debt was nondischargeable under § 523(a)(4). The court concluded that "ERISA satisfies the traditional requirements for a statutory fiduciary to qualify as fiduciary under § 523(a)(4)." *Id.* at 1190 (citation omitted); *but see* Hunter v. Philpott, 373 F.3d 873, 875-76 (8th Cir. 2004) (rejecting the Ninth Circuit's conclusion that a fiduciary under ERISA *ipso facto* occupies a fiduciary capacity within the meaning of 11 U.S.C. § 523(a)(4)); *see generally* Liotta, *supra* note 5, at 729 (proposing a "five-part analysis

whose real estate project was in foreclosure, was engaged to assemble a group of investors to buy out an 80% interest in the project while allowing the partnership to retain the remainder interest.[54] Instead, Cochrane kept the partnership's 20% interest for himself as a fee and failed to disclose to his clients that he was a 25% shareholder in the investment group that was buying the 80% interest in the project.[55] First, the Eighth Circuit asked whether the debtor was acting in a fiduciary capacity. The court concluded that as its attorney, Cochrane did occupy such a capacity vis-à-vis the partnership.[56] Second, the court analyzed whether Cochrane breached his fiduciary duties to his clients: "He breached his fiduciary duties by failing to disclose his status as a . . . shareholder and by usurping [the partnership's] expected 20% interest in the real estate, which, in fact, he kept for himself."[57] Thus, the court held that "the bankruptcy court did not err in finding, for purposes of applying § 523(a)(4), that [Cochrane] had committed an act by defalcation while acting in a fiduciary capacity."[58]

The facts of this particular case point to a nefarious motive on Cochrane's part; indeed, even in *Uwimana*, the fiduciary may have been motivated by self-interest (though perhaps of a more understandable stripe), and it therefore may not be clear why an "innocent mistake suffices" standard is too stringent. However, applying the reasoning of the *Uwimana* and *Cochrane* courts to the hypothetical

addressing the requirements of both statutes [ERISA and the Bankruptcy Code] in determining the applicability of § 523(a)(4) non-dischargeability to ERISA fiduciary debts"). However, the Ninth Circuit disagreed that Hemmeter had committed an act of defalcation since "[t]here [were] not allegations of accounting failure or misappropriation." *In re Hemmeter*, 242 F.3d at 1191.

[54] *In re Cochrane*, 124 F.3d at 984.

[55] *Id.*

[56] *Id.* ("In general, an attorney-client relationship is the type of relationship for which the attorney's breach of fiduciary duties to the client may give rise to a finding of a 'defalcation' within the meaning of § 523(a)(4)." (citation omitted)).

[57] *Id.*

[58] *Id.*

situation of an otherwise innocent debtor-fiduciary who is unable to account for funds, it is not difficult to envision a scenario where the logic of these courts would be inconsistent with the broader purpose of the Bankruptcy Code to exempt the debtor-fiduciary's resulting debt from discharge. Andrea Johnson poses the following hypothetical:

> Consider this simple example where an attorney who is the trustee for a client's trust is holding $100,000 on behalf of the trust. The trustee deposits the funds in a bank, which appears on all accounts to be federally insured, but later goes bankrupt and in fact, the bank was misrepresenting itself as federally insured when it was not. After the trust wins a judgment against the trustee, that trustee files for bankruptcy. Should the trustee be denied discharge for committing defalcation while acting in a fiduciary capacity?[59]

In the Fourth, Eighth, and Ninth Circuits, the answer to that question would be yes. In fact, the reasons why the fiduciary cannot account for the funds entrusted to him would be entirely irrelevant as long as his adversary could show that the fiduciary had failed to account for such funds. This failure in and of itself would suffice to establish a breach of duty that grounds a claim of defalcation regardless of whether, to use the example above, the fiduciary himself was the innocent victim of fraud. Though § 523(a)(4) may be intended to hold fiduciaries accountable for their actions, this result seems to be incongruous with the larger purpose of the Bankruptcy Code, especially where, having used his best efforts to maintain the funds, the debtor-fiduciary is still unable to account for some portion of the funds entrusted to him. If even the honest fiduciary can be found to have committed an act of defalcation that exempts the claimed debt from discharge, that fiduciary will not be able to emerge from bankruptcy with a fresh start and may be less inclined to serve in such a capacity.

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[59] Johnson, *supra* note 11, at 94.

B. More than an Innocent Mistake is Necessary: the Fifth, Sixth, and Seventh Circuits

A second group of circuit courts has adopted a slightly more demanding mental culpability requirement for the defalcation exception to discharge. These circuits—the Fifth, Sixth, and Seventh—have held that defalcation "require[s] a level of fault greater than mere negligence"[60] or mistake.

"It is clear in the Fifth Circuit that a 'willful neglect' of fiduciary duty constitutes a defalcation—essentially a recklessness standard."[61] In *Office of Thrift Supervision v. Felt (In re Felt)*,[62] the Fifth Circuit applied this standard to a case involving several breaches of fiduciary duty in the context of a note for share exchange under regulations promulgated by the Federal Home Loan Bank Board ("FHLBB," the predecessor of the Office of Thrift Supervision). Felt purchased all of the issued and outstanding stock of the Bowie County Savings and Loan Association (which was later renamed Reliance) and became president, CEO, chairman of the board, and a director of the institution.[63] Felt financed his purchase with loans from an independent bank and from a corporation which he wholly owned ("AGI").[64] "Based upon Felt's self-dealing and harm to

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[60] Denton v. Hyman (*In re* Hyman), 502 F.3d 61, 68 (2d Cir. 2007).

[61] Schwager v. Fallas (*In re* Schwager), 121 F.3d 177, 185 (5th Cir. 1997). In *In re Schwager*, members of a limited partnership sought to enforce a state court judgment against the managing partner (the debtor, Schwager) as nondischargeable in the managing partner's personal bankruptcy. The state court judgment was reached in a suit that awarded the limited partners compensatory damages against Schwager for his breaches of the partnership agreement and his fiduciary duties to the limited partners.

[62] 255 F.3d 220 (5th Cir. 2001). *In re Felt* affirmed the decision of the district court below to grant summary judgment to the plaintiff on the issue of nondischargeability and relied on the authority of *Moreno v. Ashworth*, 892 F.2d 417 (5th Cir. 1990), for the proposition that "[a] defalcation is a willful neglect of duty." (citations omitted). *Id.* at 421.

[63] *Id.* at 221.

[64] *Id.*

Reliance through the indirect sale of two loans"[65] by his wholly-owned company, the FHLBB sought Felt's consent to an order removing him from his positions at Reliance and prohibiting him from further involvement in its business.[66] Felt agreed to dispose of the entirety of his 100% interest in Reliance, but at the time both Reliance and AGI were suffering financial distress.[67] To live up to his agreement with the FHLBB and to stave off bankruptcy for both of his companies, Felt wrote to AGI noteholders offering them the chance to exchange their AGI notes for Reliance shares.[68]

The preliminary offering circular that Felt enclosed with this letter to the noteholders failed to disclose certain facts regarding the FHLBB's regulatory actions, among other material omissions.[69] Felt later sent a form offering circular to FHLBB, but it was not approved; despite this, Felt finalized an offering circular and mailed this unapproved document to potential investors.[70] Felt sold all of his shares of Reliance stock, but about one-third of the shares were purchased with financing from another finance company owned by Felt.[71] This portion of the sale precluded the transaction from eligibility for push down accounting treatment; after the reversal of the push down treatment, Reliance was left in a deep insolvency from which it would not recover.[72] The FHLBB brought a rescission action against Felt in which the district court found Felt liable "because he failed to obtain FHLBB approval for the offering circulars" and awarded damages to the Office of Thrift Supervision to hold in trust for the investors who purchased Reliance stock from Felt.[73]

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[65] *Id.* at 222.
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *See id.*
[70] *Id.* at 223.
[71] *Id.*
[72] *Id.*
[73] *Id.* at 223-24.

While the Office of Thrift Supervision attempted to recover these damages from Felt, he filed for personal bankruptcy.[74] The Office of Thrift Supervision filed a claim for the damages against the debtor's estate and brought an adversary proceeding seeking a declaration that the debt was nondischargeable under § 523(a)(4).[75] The Fifth Circuit reasoned that "[t]he defalcation determination turns on the issue of whether Felt's breaches were 'willful.'"[76] In turn, "[W]illfulness is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably should have known."[77] Here, "Felt objectively knew or should have known that the stock sale would not qualify for push-down accounting[;]"[78] the court calls this "probably the most egregious example of Felt's willful behavior which qualifies as defalcation."[79] Given Felt's knowledge of the need for full disclosure in the offering circular, his misstatements and omissions "demonstrate[d] at a very minimum the recklessness required for a finding of defalcation under §523(a)(4)."[80]

Breaches of fiduciary duty by a debtor involved with a financial institution were also at the heart of the Seventh Circuit case of *Meyer v. Rigdon*,[81] where the court decided under § 523(a)(11) [82] "that a mere negligent breach of a

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[74] *Id.*

[75] *Id.*

[76] *Id.* at 226 (citation omitted).

[77] *Id.* (citation omitted).

[78] *Id.* at 227.

[79] *Id.*

[80] *Id.*

[81] 36 F.3d 1375 (7th Cir. 1994).

[82] Section 523(a)(11) provides in relevant 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—
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> > (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

fiduciary duty is *not* a 'defalcation.'"[83] There, Rigdon was president and director of People's State Bank of Clay County, Indiana, in which he also held a controlling interest.[84] After determining that the bank was insolvent and appointing a receiver, "[t]he FDIC then brought suit against Rigdon and the other members of the Bank's board of directors . . . ."[85] "The FDIC's complaint alleged, *inter alia*, that the defendants breached their fiduciary duty to the Bank in 'managing, conducting, supervising, and directing the Bank's making, supervising and collecting of loans.'"[86]

After a default judgment and final money judgment were entered against him, Rigdon filed a personal bankruptcy petition.[87] Rigdon's co-defendants from the FDIC suit, to whom the default judgment had been assigned, "filed a complaint in the bankruptcy court seeking a determination as to whether Rigdon could discharge his debt" arising from the FDIC suit.[88] The co-defendants then moved for summary judgment, arguing that Rigdon's debt was not dischargeable pursuant to § 523(a)(11).[89] The grounding for the defalcation claim against Rigdon was the FDIC's allegation (which had been assigned to Rigdon's former co-defendants) "that it had suffered losses in its capacity as receiver of the Bank 'due to nonpayment and default by debtors and guarantors of

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> 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 . . . .

11 U.S.C. § 523(a)(11) (2007). While the exception to discharge codified in § 523(a)(11) is more narrowly tailored than its § 523(a)(4) counterpart, "section 523(a)(11) prevents the discharge of debts arising from the same substantive conduct as section 523(a)(4), i.e., 'fraud or defalcation while acting in a fiduciary capacity.'" *Meyer*, 36 F.3d at 1380.

[83] *Meyer*, 36 F.3d at 1384-85 (emphasis in original).

[84] *Id.* at 1377.

[85] *Id.*

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.* at 1377-78.

imprudently made loans.'"[90] Rigdon argued in the bankruptcy proceeding that his negligent acts in making such loans were not defalcations.[91]

After reviewing the purposes of the Bankruptcy Code and the extent of the split among the circuits and lower courts at the time, the court concluded that: "Given th[e] well-recognized principle [of providing a debtor with a fresh start], and the split of authority concerning whether a 'defalcation' may result from negligence, we cannot say that Congress intended for a debt arising from a mere negligent breach of fiduciary duty to be excepted from discharge under section 523(a)(11)."[92] Although "[t]he FDIC's complaint [did] not use the magic words 'willful' or 'reckless,'" the court found that it did "allege more than a mere negligent breach of fiduciary duty."[93] The uncontested complaint alleged that Rigdon knowingly breached his duty, and "[s]ince a knowing breach of fiduciary duty is more culpable than a mere negligent breach of duty," the court held that the FDIC's complaint did allege a cognizable claim of defalcation.[94]

The Sixth Circuit also relied on the Bankruptcy Code's goal of giving an honest debtor a fresh start in determining

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[90] *Id.* at 1382.

[91] *See id.*

[92] While the court reached this conclusion in the context of § 523(a)(11), the cases reviewed in its discussion of the circuit split regarding the mental culpability that must accompany an act of defalcation deal largely with the interpretation of "defalcation" under § 523(a)(4). *See id.* at 1382-84.

[93] *Id.* at 1385. More specifically:

> Despite receiving repeated admonitions and warnings against such practices from federal and state banking authorities and other persons who reviewed the Bank's procedures, and in contravention of the Bank's own policies, [Rigdon] approved and disbursed loans without adequate underlying information, or supervised and thereby permitted the approval and disbursal of loans without adequate information about the borrower, guarantor and/or the potential collateral.

Id.

[94] *Id.*

what mental culpability must accompany a defalcation: "[a]n objective standard for finding a defalcation, that does charge a bankrupt with knowledge of the law and that does not weigh intent or motive, is consistent with the policy behind the bankruptcy laws of giving an honest debtor the opportunity for economic rehabilitation."[95] The Sixth Circuit's objective approach[96] charges the bankrupt with knowledge of the law.[97] This approach maintains that "[t]he character of the liability imposed upon a fiduciary for appropriating property held by him in trust is the same whether he has actual knowledge that the law imposes the duty or is merely charged with such knowledge."[98] Thus, because a fiduciary either will have actual knowledge of his duties or be charged with such knowledge, each debtor who commits a defalcation will be held to have had at least the same level of mental culpability as the debtor in *Meyer v. Rigdon*.

This may seem to create a per se rule of defalcation that is just as strict as the "innocent mistake suffices" rule of the Fourth, Eighth, and Ninth Circuits. However, the Sixth Circuit clarified its holding to avoid the strict liability of the "innocent mistake suffices" rule:

> We hold that the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first is sufficient to constitute a defalcation under section 17(a)(4) *so long as the use*

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[95] Carlisle Cashway, Inc. v. Johnson (*In re* Johnson), 691 F.2d 249, 255-56 (6th Cir. 1982).

[96] *In re Johnson* was decided under § 17(a)(4) of the Bankruptcy Act of 1898, 30 Stat. 550-51; *see* discussion *supra* Part II. While the current version of the exception to discharge for defalcation in § 523(a)(4) differs from the text of § 17(a)(4), the Sixth Circuit has continued to apply the framework developed in *In re Johnson*. *See, e.g.*, Kinsler v. Pauley (*In re* Pauley), 205 B.R. 501 (Bankr. W.D. Mich. 1997).

[97] *In re Johnson*, 691 F.2d at 257.

[98] *Id.*

> *was not the result of mere negligence or a mistake of fact. . . .*[99]

The court was thus careful to avoid the inflexible application of a per se rule of nondischargeability. Its more tailored, objective standard is intended not only to respect the goals of the Bankruptcy Code, but also to "prevent[] ignorance of the law from becoming a defense to nondischargeability and [to] provide[] an incentive for individuals . . . who are engaged in occupations subject to special statutes to apprise themselves of their obligations under law."[100] In conjunction with the requirement that the defalcation not be a result of mere negligence or a mistake of fact, the Sixth Circuit's standard, like its sister Fifth and Seventh Circuits, ensures that a level of mental culpability at least equivalent to recklessness must accompany an act of defalcation for it to be held nondischargeable.

Returning to the hypothetical trustee who deposits his client's funds in a bank that claims to be federally insured, but in fact is not, consider what would happen in one of these circuits if the bank holding the funds went bankrupt and the debtor-fiduciary sought to have the judgment against him for the loss of funds discharged in his own personal bankruptcy proceeding. While in the Fourth, Eighth, and Ninth Circuits one would expect the debt to be held nondischargeable, in the Fifth, Sixth, and Seventh Circuits, the heightened intent standard would spare the debtor the continued burden of such a judgment. The debtor-fiduciary's conduct would not have involved willful neglect of the risk of losing the funds or recklessness in the face of such a risk since he would not have known, nor have had any reason to know, that the bank was lying about its insured status. Assuming that some state law did not impose knowledge of required conduct (in this case, perhaps a statutory duty for a fiduciary to investigate the insured status of banks with which he leaves trust funds on deposit) as it did in *In re Johnson*, the debt should fall outside of the limits of the § 523(a)(4) exception.

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[99] *Id.* (emphasis added).

[100] *Id.*

On the other hand, "if the trustee deposits [trust] money in a bank which does not advertise itself to be federally insured and this institution goes bankrupt,"[101] courts in the Fifth, Sixth, and Seventh Circuits may find that such conduct would constitute a nondischargeable defalcation under § 523(a)(4), depending upon the factual circumstances. The inquiry would be whether the debtor recklessly disregarded the fact that the bank was not federally insured; unlike the standard of the Fourth, Eighth, and Ninth Circuits, this standard would not automatically relegate a judgment debt resulting from the loss of funds to the status of nondischargeability. The advantage of this approach is that it respects the effort underway in § 523(a)(4) to hold fiduciaries accountable for their acts of defalcation and the Bankruptcy Code's broader goal of providing the honest but unfortunate debtor with a clean start.

C. "Some Portion of Misconduct"?: the Tenth Circuit

Discussing the law of the Tenth Circuit regarding the mental culpability necessary for a defalcation, the Second Circuit has observed that "[t]he Tenth Circuit's standard is not entirely clear but at least requires 'some portion of misconduct.'"[102] The First Circuit has additionally determined that "negligence by the fiduciary is required but no more."[103]

The Bankruptcy Appellate Panel of the Tenth Circuit has determined that "'defalcation under section 523(a)(4) is a fiduciary-debtor's failure to account for funds that have been entrusted to it due to any breach of fiduciary duty, whether intentional, wilful, reckless, or negligent."[104] In *In re Storie*, the panel concluded that its holding, "requiring no mental culpability on the part of the debtor-fiduciary, is in accord with the express language of section 523(a)(4). There is no

[101] Johnson, *supra* note 11, at 95.

[102] Denton v. Hyman (*In re* Hyman), 502 F.3d 61, 68 (2d Cir. 2007).

[103] Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 18 (1st Cir. 2002).

[104] Antlers Roof-Truss & Builders Supply v. Storie (*In re* Storie), 216 B.R. 283, 288 (B.A.P. 10th Cir. 1997).

mental state required in section 523(a)(4) for a 'defalcation.'"[105] Indeed, the court stated that "[a]ny failure to maintain the standard of care attributable to a fiduciary is a bad act that is nondischargeable under section 523(a)(4)."[106]

On the other hand, however, in *Oklahoma Grocers Ass'n, Inc. v. Millikan* (*In re* Millikan),[107] after reviewing the various definitions of defalcation provided by other courts and declining the opportunity to attempt a reconciliation of the conflicting authorities, the Tenth Circuit held that "'[d]efalcation' requires, at least, 'some portion of misconduct.'"[108] The court did not explicitly overrule the Bankruptcy Appellate Panel's decision in *In re Storie*, but it was asked by the debtor, Millikan, to evaluate the lower courts' application of that decision to his case.[109] The Tenth Circuit declined the invitation. Thus, it is unclear where exactly these decisions leave the issue in the Tenth Circuit. The fact that *In re Millikan* is a more recent (though unpublished) decision and one reached by the circuit itself (as opposed to the Bankruptcy Appellate Panel) may mean that the Tenth Circuit will turn to it for guidance when the time comes. Until then, just what position this court will take on this issue remains unclear.

D. Conscious Misbehavior or Extreme Recklessness: the First and Second Circuits

The last two circuits to weigh in on this issue have held that defalcation "requires a showing of conscious misbehavior or extreme recklessness—a showing akin to the showing required for scienter in the securities law context."[110]

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[105] *Id.* at 289.

[106] *Id.*

[107] 188 Fed.Appx. 699, 702 (10th Cir. 2006) (unpublished).

[108] *Id.* (citing Cent. Hanover Bank & Trust Co. v. Herbst., 93 F.2d 510, 512 (2d Cir. 1937)).

[109] *See id.* at 701.

[110] Denton v. Hyman (*In re* Hyman), 502 F.3d 61, 68 (2d Cir. 2007) (citations omitted).

In reaching this conclusion, the First Circuit reviewed "certain rules [that] are clear about the availability of the [defalcation] exception" to discharge:

> 1) The burden of proof to establish defalcation is on the creditor, given the "fresh start" policy. . . . 2) The creditor must show defalcation by a preponderance of the evidence . . . . 3) The exception to discharge applies to fiduciaries only while they are acting in a fiduciary capacity. . . . 4) Inherent in "defalcation" is the requirement that there be a breach of fiduciary duty; if there is no breach there is no defalcation. 5) In order to avoid redundancy, defalcation must mean something other than fraud and different from "willful and malicious injury," . . . [and] 6) Defalcation is to be measured objectively.[111]

In addition to these factors, the court also considered the structure of the Bankruptcy Code and the goals of the bankruptcy laws in concluding that "[t]he mental state required for defalcation is akin to the level of recklessness required for scienter. It is more than the mere conscious taking of risk associated with the usual tort standard of recklessness . . . . Instead, defalcation requires something close to a showing of extreme recklessness."[112]

In *In re Baylis*, the income beneficiaries of a trust consisting of apartment buildings and the income therefrom sued Baylis, an attorney who acted as co-trustee of the trust, for failing to sell the properties and for knowingly permitting his co-trustee to breach her fiduciary duties "without taking any action."[113] The court identified three elements of the judgment debt that Baylis sought to discharge in his personal bankruptcy: trust expenditures on Baylis's behalf in defense of a suit brought against him in connection with an attempted sale of the trust properties; the loss in the properties' value as a result of the non-sale; and pre-

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[111] Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 17 (1st Cir. 2002) (footnotes and citations omitted).

[112] *Id.* at 20.

[113] *Id.* at 15; *see generally id.* at 13-17 for the facts and procedural history.

judgment interest.[114] Regarding Baylis's use of trust funds to defend himself in a lawsuit relating to trust activities, the court concluded that this was "an extremely reckless thing to do in light of his duty of loyalty."[115] Baylis's breach of duty was "exacerbated by the fact that [he] . . . brought about the conditions that led to the lawsuit."[116] The "combination of the fiduciary breach which caused the lawsuit and the self-dealing to defend against it" were enough for the First Circuit to conclude that Baylis had acted with a sufficient degree of recklessness.[117] Accordingly, it found that the use of such funds did constitute a defalcation.[118]

Despite the loss in value of the properties that resulted from Baylis's failure to effectuate their sale, the portion of the judgment in that amount against Baylis was nevertheless held to be dischargeable.[119] With respect to the failure to sell the properties, Baylis's actions contrast starkly with his reckless disregard for his fiduciary duties in the context of his expenditure of trust funds in his own defense. Indeed, "[h]is various judgments about how best to handle his troublesome co-trustee [who also had to approve a sale] were flawed and clearly negligent, but not so reckless as to rise to the level of fault needed to constitute a defalcation."[120] While the court does not articulate the particular factual circumstances that distinguish its differing conclusions regarding the character of the two portions of Baylis's debt, his violation of the clear and well-established principles that govern a trustee's use of trust assets and that constrain fiduciary self-dealing may have seemed to the court, on their face, to be more egregious than his failure to prevent his co-

[114] *Id.* at 21.

[115] *Id.* at 22.

[116] *Id.* at 22.

[117] *Id.* at 22.

[118] *Id.* The pre-judgment interest that attached to that portion of Baylis's debt was also held nondischargeable. *See id.* at 23.

[119] *See id.* at 23.

[120] *Id.* at 23.

trustee's own defalcation and to deal with its ramifications in a competent manner.[121]

In *In re Hyman*, the Second Circuit aligned itself with the First Circuit on the issue of what mental state must be shown to prove that a debtor-fiduciary committed an act of defalcation.[122] There, Hyman was a partner with Denton in an insurance business that was comprised of three jointly-owned companies.[123] Denton died shortly after the new companies began operations, and, according to the terms of its agreement with Guardian Life Insurance, the Denton-Hyman-Guardian relationship automatically terminated.[124] With the permission of Denton's estate, Hyman sought to liquidate start-up debt with commissions earned by the Denton-Hyman insurance business before Denton's death.[125] After Denton's death, moreover, Guardian accepted Hyman as its agent, which led Hyman to form a new insurance agency, which he owned. However, Hyman continued to use one of the jointly-owned Denton-Hyman entities to generate business for his new insurance agency.[126]

Unable to complete an agreement for the sale of its interest in the entities to Hyman, the Denton estate sued Hyman in Surrogate's Court seeking recovery of profits earned from the use of assets of the jointly-owned companies and damages therefrom.[127] The Surrogate's Court found that Hyman had breached his fiduciary duty, although it made no specific finding regarding his state of mind.[128] Hyman filed for bankruptcy and the Denton estate filed a claim seeking a declaration that the Surrogate's Court's judgment be held

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[121] *See id.* at 22-23.

[122] Denton v. Hyman (*In re* Hyman), 502 F.3d 61, 68 (2d Cir. 2007) (citations omitted) ("In light of this persistent confusion [i.e., the circuit split], we now align ourselves with the First Circuit . . . .").

[123] *Id.* at 63.

[124] *Id.*

[125] *Id.* at 64.

[126] *Id.*

[127] *Id.*

[128] *Id.*

nondischargeable as a debt arising from a defalcation under § 523(a)(4).[129]

The Second Circuit panel recognized the potential severity for a debtor of holding that some portion of his debt is nondischargeable:

> The consequences to a debtor whose obligations are not discharged are considerable; in many instances, failure to achieve discharge can amount to a financial death sentence. In view of these harsh consequences, exceptions to discharge are to be narrowly construed and genuine doubts should be resolved in favor of the debtor.[130]

The court then surveyed the respective approaches other circuits had taken to answer the question whether a defalcation "includes all misappropriations or failures to account or only those that evince some wrongful conduct."[131] The court concluded that its adoption of the First Circuit's approach "ensures that the term 'defalcation' complements but does not dilute the other terms of [§ 523(a)(4)]—'fraud,' 'embezzlement,' and 'larceny'—all of which require a showing of actual wrongful intent."[132] Moreover, "the standard . . . insures that the harsh sanction of non-dischargeability is reserved for those who exhibit 'some portion of misconduct.'"[133] In light of its concerns about the onerous burdens of nondischargeability and its newly adopted standard for defalcation, the Second Circuit upheld the lower courts' decision that Denton was not relieved (by collateral estoppel) from proving that Hyman's debt was nondischargeable as the result of a defalcation.[134]

The extreme recklessness standard of the First and Second Circuits requires some level of mental culpability greater than the willful neglect/recklessness standard of the

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[129] *Id.*

[130] *Id.* at 66.

[131] *Id.*

[132] *Id.* at 68.

[133] *Id.* at 68-69 (quoting Cent. Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510, 512 (2d Cir. 1937)).

[134] *Id.* at 63.

Fifth, Sixth, and Seventh Circuits.[135] A court that applied the First and Second Circuit standard to either of the hypothetical situations discussed above—the fiduciary who deposited trust funds in a bank that lied about being federally insured and the fiduciary who deposited such funds despite there being a question as to whether deposits with the bank were federally insured—would not find that a defalcation had taken place. In neither case would the hypothetical court be able to find the "conscious misbehavior or recklessness" required in these circuits. In the first instance, the debtor was himself the victim of a misrepresentation; in the second, he did not consciously place the funds on deposit with an institution that could not guarantee their security.

To elucidate the practical import of the defalcation standard of the First and Second Circuits, it instead might be helpful to consider a slightly different factual scenario. Perhaps the defalcation standard of the First and Second Circuits is better exemplified by "the trustee [who] invests the [trust's] money in his own start-up company as a temporary loan, which later fails and as a result the [funds are] lost." [136] In this case, the debtor-fiduciary, though not intending the loss of the funds, consciously disregarded his fiduciary duty to avoid self-dealing with trust funds and recklessly disregarded the risks associated with investing in his own start-up business. In the words of the First Circuit in *In re Baylis*, the creditor seeking a declaration of nondischargeability in this case would be able "to show that [the] debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny."[137]

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[135] Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 18 (1st Cir. 2002) ("The present range of interpretations of 'defalcation' among the circuits, from innocent mistake to a civil recklessness standard, does not, in our view, adequately capture Congress's intended meaning of the term in § 523(a)(4).").

[136] Johnson, *supra* note 11, at 95.

[137] *In re Baylis*, 313 F.3d at 20.

IV. RECOMMENDED RESOLUTION OF THE CIRCUIT SPLIT

The circuit courts that have addressed the issue of what mental state must accompany an act of defalcation in order for a debt arising therefrom to be nondischargeable under § 523(a)(4) have differed over what level of intent, if any, must be shown. Were the issue to come before the Supreme Court of the United States, the proper resolution of this split of authority among the circuits would be the adoption of the willful neglect/recklessness standard that is the law of the Fifth, Sixth, and Seventh Circuits. The standard of these circuits should define the mental culpability necessary to prove a defalcation for three reasons: to accomplish the Bankruptcy Code's objective of giving an honest debtor a fresh start; to respect the general structure and logic of the Bankruptcy Code's exceptions to discharge in § 523(a); and to provide consistency across the areas of the law involving fiduciary duties.

"The principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'"[138] The holding of the Fourth, Eighth, and Ninth Circuits that even an innocent mistake can constitute a defalcation conflicts with this principle on its face. The honest debtor who makes an unfortunate, unintentional mistake in his handling of trust funds will be subject to liability under this standard despite his blameless conduct. The holdings of the Fifth, Sixth, and Seventh Circuits and of the First and Second Circuits, respectively, at least provide that the honest debtor remains protected from a blanket rule of nondischargeability for his otherwise innocent failure to account for funds. Indeed, each of these groups of circuits offers a further level of protection for the debtor by requiring that the debtor-fiduciary's default have been more than negligent.

A closer examination of the types of debts for which exceptions exist in § 523 will help clarify why—between these two remaining options—the approach of the Fifth,

[138] Marrama v. Citizens Bank of Mass., 127 S.Ct. 1105, 1107 (2007) (quoting Grogan v. Garner, 498 U.S. 279, 286-87 (1991)).

Sixth, and Seventh Circuits is preferable. The Bankruptcy Code's purpose of giving the honest debtor a fresh start is manifested in the structure of the exceptions to discharge found in § 523(a). The exceptions to discharge provided there are intended to handicap the dishonest debtor's emergence from bankruptcy: they apply to debts deemed so important by Congress that not even the purgation of the bankruptcy process can wash them away.

In *In re Baylis*, the First Circuit analyzed the structure of § 523 as a whole and concluded that most of the exceptions to discharge contained there could be categorized as either "type-based" or "fault-based."[139] Because "bankruptcy [should] not be used to avoid the payment of certain types of debts, the repayment of which are important for policy reasons,"[140] type-based exceptions to discharge survive whether or not the debtor was honest but unfortunate. "The level of fault of the debtor has no bearing on these exceptions; the exception turns on the type of debt."[141] Thus, type-based exceptions to discharge include debts for, *inter alia*: taxes or customs duties,[142] domestic support obligations,[143] and student loans.[144] On the other hand, fault-based exceptions "define not the type of debt itself, but the type of fault that caused the debt."[145] Among these are exceptions for debts that are the result of: willful and malicious injury[146] and death or personal injury caused by the debtor's operation of a car or boat under the influence of drugs or alcohol.[147]

The First Circuit located the exception to discharge contained in § 523(a)(4) for defalcation while acting in a fiduciary capacity in this latter category. Analyzing the

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[139] *In re Baylis*, 313 F.3d at 19-20.

[140] *Id.* at 19.

[141] *Id.*

[142] 11 U.S.C. § 523(a)(1) (2007).

[143] 11 U.S.C. § 523(a)(5) (2007).

[144] *See* 11 U.S.C. § 523(a)(8) (2007).

[145] Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 19 (1st Cir. 2002).

[146] 11 U.S.C. § 523(a)(6) (2007).

[147] 11 U.S.C. § 523(a)(9) (2007).

other fault-based exceptions to discharge, the *Baylis* court concluded that such exceptions "concern extremely serious actions done knowingly or with great risk of harm to others."[148] Similarly, the exception to discharge for defalcation, at least under the holdings of the Fifth, Sixth, and Seventh Circuits, necessitates a showing of willful neglect or recklessness in the face of a risk of harm.

Furthermore, it makes sense to recognize, as the First Circuit did, that the grouping of defalcation with fraud, embezzlement, and larceny in § 523(a)(4) was not coincidental.[149] However, the extreme recklessness required by the First and Second Circuits risks conflating the meaning of defalcation, embezzlement, and fraud within the provision. "Fraud, embezzlement, and larceny are all serious crimes requiring specific intent."[150] To the extent that the mental culpability required for defalcation more closely approximates the mental state necessary for these other offenses (and exceptions),[151] it can render the term "defalcation" mere surplusage. In order to maintain a distinct statutory meaning for defalcation (and the other terms), it is necessary to define it with a lower mens rea threshold that preserves its utility in the provision—that is, as an exception covering acts where the resulting loss of funds or the failure to account are not intended.

The final reason why the Supreme Court, if presented with this circuit split, should adopt the standard articulated by the Fifth, Sixth, and Seventh Circuits is that their position is consistent with the "business judgment rule" that is commonly used to judge the actions of fiduciaries in the

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[148] *In re Baylis*, 313 F.3d at 19.

[149] *See id.* at 20.

[150] *Id.*

[151] "[A] creditor must be able to show that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny." *Id.* The *Baylis* court does not address the argument that a lower threshold, *e.g.*, the willful neglect/recklessness standard of the Fifth, Sixth, and Seventh Circuits, could capture such egregious conduct and do so without potentially threatening the distinct place each term—defalcation, fraud, embezzlement, and larceny—occupies in the statutory formulation.

context of corporate law.[152] Having found that a debtor was acting in a fiduciary capacity as required by § 523(a)(4), it would in turn make sense to inform this area of bankruptcy law with the lessons of a rule developed to handle similar situations in the corporate law context. "The business judgment rule gives directors considerable freedom within which to act honestly, without undue fear of liability."[153] Similarly, the general purpose of the Bankruptcy Code—to give honest debtors a fresh start—ought to provide debtors acting within a fiduciary capacity sufficient freedom to conduct their affairs without fear of liability based on honest mistake. An intent standard for the defalcation exception to discharge that reflects the contours of the business judgment rule—assuming the debtor acted in good faith and not in his own self-interest—will not only satisfy the purposes of the Bankruptcy Code, but will also provide a familiar and understandable norm of conduct for those acting in a fiduciary capacity who face the prospect of personal bankruptcy.

Like the protection of a fresh start afforded by the Bankruptcy Code to a debtor acting in a fiduciary capacity,

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[152] There are significant parallels between the actual and legal duties of the debtors discussed in the cases presented here and corporate fiduciaries to whom the business judgment rule is commonly applied, among them responsibility for the handling of funds and the general duty of care. Indeed, while federal law controls the determination of whether the debtor was acting in a fiduciary capacity, Zohlman v. Zoldan, 226 B.R. 767, 772 (S.D.N.Y. 1998) (citing Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934)), some courts have found that a director of a corporation under state law does act in the fiduciary capacity required by § 523(a)(4). *See, e.g.*, ATR-Kim Eng Capital Partners, Inc. v. Bonilla (*In re* Bonilla), Bankruptcy No. 07-30309 TEC, 2007 WL 3034800, at *3 (Bankr. N.D.Cal. Oct. 16, 2007). Whether the debtor is a person "acting in a fiduciary capacity," 11 U.S.C. § 523(a)(4), or a corporate director upon whom fiduciary duties are imposed, *see, e.g.*, FDIC v. Jackson, 133 F.3d 694, 703 (9th Cir. 1998), the law of bankruptcy (with its focus on providing the honest debtor with a fresh start) and the law of corporations (with the insulation provided by the business judgment rule), respectively, provide some non-absolute protection for those acting in a fiduciary capacity.

[153] EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES, AND LIABILITIES § 2:10 (2007).

"[t]he [business judgment] rule . . . has never been absolute."[154] Pursuant to the business judgment rule, a court will defer to the decision of corporate directors "unless a challenger produces evidence establishing that the directors acted fraudulently, in bad faith, or with gross or culpable negligence . . . . Other terms that have been used to describe the type of conduct not protected . . . include . . . willful abuse of discretionary power or neglect of duty, and recklessness."[155] The Bankruptcy Code can legitimately accommodate an intent standard for defalcation that reflects the type of reckless conduct exempted from the protection of the business judgment rule in the context of corporate law. The willful neglect/recklessness standard of the Fifth, Sixth, and Seventh Circuits best achieves this goal because "willfulness is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably should have known."[156] Adapted to the context of the § 523(a)(4) exception to discharge for defalcation while acting in a fiduciary capacity, this standard, like the business judgment rule, holds fiduciaries accountable for not being fully informed about decisions made in that capacity.[157] Such a standard will offer sufficient freedom to fiduciaries to conduct their affairs without the fear of nondischargeability and the loss of a chance at a fresh start after bankruptcy, but will also hold them accountable when they are not sufficiently informed or act in the face of unacceptable risk.

V. CONCLUSION

The holding of the Fifth, Sixth, and Seventh Circuits that defalcation requires a showing of willful neglect or recklessness best satisfies the Bankruptcy Code's purpose of

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[154] *Id.*

[155] 18B AM. JUR. 2D *CORPS.* § 1472 (footnotes omitted).

[156] Office of Thrift Supervision v. Felt (*In re* Felt), 255 F.3d 220, 226 (5th Cir. 2001) (citation omitted).

[157] "Under the business judgment rule there is no protection for directors who have made an unintelligent or *unadvised* judgment." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (internal quotation marks and citation omitted) (emphasis added).

providing the honest but unfortunate debtor with a fresh start. It does not punish the debtor-fiduciary for innocent or merely negligent acts that result in a misaccounting or misallocation of the assets of the fiduciary relationship. This provides a layer of protection for the trustee (or any debtor who owes fiduciary duties) to carry on his often complex affairs. Moreover, the willful neglect/recklessness standard of mental culpability allows a coherent reading of § 523(a) as a whole and of § 523(a)(4) in particular. Finally, this standard preserves and maintains consistency in the law of fiduciary duties, as it tracks the contours of the business judgment rule used to evaluate the conduct of fiduciaries in the context of corporate law.