

BURR ALERT

Bullock v. BankChampaign: Defalcation under § 523(a)(4)

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Whether because of the declining docket of the Court or the technical subject-matter involved, bankruptcy topics have come before the United States Supreme Court infrequently in recent years. This term, the Court heard a case out of the Eleventh Circuit, *Bullock v. BankChampaign*, to decide the following issues: (a) what degree of misconduct by a trustee constitutes “defalcation” under 11 U.S.C. § 523(a)(4) of the Bankruptcy Code, and (b) whether that definition of defalcation includes actions that result in no loss of property.

FACTS OF BULLOCK

In 1978, Randy Curtis Bullock (“Bullock”) became the trustee of his father's irrevocable living trust. As trustee, Bullock was only allowed to borrow from the trust to: (i) pay the life insurance premiums, and (ii) satisfy a withdrawal request from a beneficiary. Nonetheless, Bullock borrowed from the trust three times: to satisfy a debt on his father’s business, to allow him and his mother to purchase certificates of deposit, and to allow him and his mother to purchase real estate. All of the loans were fully repaid with six percent interest. The trust did not earn any additional profit on the loans.²

After learning of the loans, Bullock's siblings sued him in Illinois state court, claiming he breached his fiduciary duty by making self-dealing loans. The siblings moved for summary judgment, which the court granted, finding that although there was no evidence Bullock had a malicious intent, the loans were clearly self-dealing and ordering Bullock to pay \$250,000 in damages and \$35,000 in attorneys’ fees. As security for the judgment, the court placed the property Bullock purchased with the loan, a mill, and Bullock's beneficial interest in constructive trusts. These trusts were awarded to BankChampaign (“Bank”), Bullock's successor as trustee of his father’s trust. As a result of the trusts, Bullock was unable to sell the property to satisfy the Illinois judgment.³

Subsequently, in 2009, Bullock filed a Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the Northern District of Alabama. The Bank instituted an adversary proceeding, arguing that debts arising out of “defalcation” in a fiduciary capacity were non-dischargeable in bankruptcy. The Bank moved for summary judgment, and the bankruptcy court granted the motion. Bullock appealed the bankruptcy court’s judgment to the district court, which affirmed. The district court recognized that the only way for Bullock to satisfy the judgment debt was to sell the property, and the bank could not hold it

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² Petition for a Writ of Certiorari, p. 1-5, *Bullock v. BankChampaign, N.A.*, ___ U.S. ___, 133 S. Ct. 1754 (2013).

³ *Id.*

in perpetuity, but found that the Bank's actions were not a basis for finding that the judgment debt should be discharged. The Eleventh Circuit also affirmed the judgment.⁴

CIRCUIT SPLIT

The Bankruptcy Code is silent as to the meaning of "defalcation" under § 523(a)(4), but the Courts of Appeals deciding the mental state required for defalcation have either required: (i) conscious misbehavior or extreme recklessness, (ii) known breach of a fiduciary duty, such that the conduct is "objectively reckless," or (iii) mere negligence or innocent mistake.

Drawing from the securities context, the First and Second Circuits require a mental state similar to scienter, which the Supreme Court has defined as "a mental state embracing intent to deceive, manipulate, or defraud."⁵ The First Circuit noted that defalcation is "more than the mere conscious taking of risk associated with the usual torts standard of recklessness. Instead, defalcation requires something close to a showing of extreme recklessness."⁶ The Second Circuit has explained that "these concepts-well understood and commonly applied in the securities law context-strike the proper balance under § 523(a)(4)."⁷

In *Bullock*, the Eleventh Circuit joined the Fifth, Sixth, and Seventh Circuits, adopting a less rigorous standard for defalcation, based on a theory of ordinary recklessness. The Fifth Circuit explained that "defalcation is a willful neglect of duty, even if not accompanied by fraud or embezzlement."⁸ Furthermore, "[w]illful neglect 'does not require actual intent, as does fraud,' and is 'essentially a recklessness standard.'"⁹ The standard is an objective one and willfulness in the defalcation context "is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably should have known."¹⁰

Finally, the lowest threshold for the required mental state for defalcation has been adopted by the Fourth, Eighth, and Ninth Circuits, whose definition of defalcation includes mere negligence or innocent mistake which results in misappropriation or failure to account.¹¹

THE BRIEFS

Appreciating the parties' respective positions is essential to understanding the Supreme Court's decision in *Bullock*. *Bullock* argued that the Court should adopt the First and Second Circuit's requirement of conscious misbehavior or extreme recklessness to except fiduciary debts from discharge. *Bullock*

⁴ *Id.*

⁵ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 96 S. Ct. 1375, 1381, 47 L. Ed. 2d 668 (1976).

⁶ *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002) (internal citations omitted).

⁷ 502 F.3d 61, 68 (2d Cir. 2007).

⁸ *Matter of Moreno*, 892 F.2d 417, 421 (5th Cir. 1990).

⁹ *In re Harwood*, 637 F.3d 615, 624 (5th Cir. 2011) (quoting *Schwager v. Fallas*, 121 F.3d 177, 185 (5th Cir. 1997)).

¹⁰ *Office of Thrift Supervision v. Felt*, 255 F.3d 220, 226 (5th Cir. 2001). See *in re Berman*, 629 F.3d 761, 766 (7th Cir. 2011); see *In re Patel*, 565 F.3d 963, 970 (6th Cir. 2009) (holding that "the debtor must have been objectively reckless in failing to properly account for or allocate funds"); *In re Johnson*, 691 F.2d 249, 257 (6th Cir. 1982) (finding that defalcation must be measured by an objective standard).

¹¹ See, e.g., *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (finding that "negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient" for defalcation); *In re Cochran*, 124 F.3d 978, 984 (8th Cir. 1997) (holding that "defalcation 'includes the innocent default of a fiduciary who fails to account fully for money received'" (quoting *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996))).

asserted that the legislative history and canons of statutory construction support this reading, particularly the inclusion of the crimes of fraud, embezzlement and larceny in § 523(a)(4). Furthermore, he claimed that a failure to account for entrusted property or the “loss” element is an essential component of defalcation, an element missing from his case.¹²

In contrast, the respondent Bank's central premise from a policy perspective is that the protection of the trust's beneficiaries takes priority over Bullock's fresh start.¹³ The Bank asserts that the duty of loyalty is the highest duty of a trustee to the beneficiaries and that Bullock's self-dealing was extremely reckless under an objective standard in light of this duty. Thus, Bullock's intent regarding the loans does not change the self-dealing nature of the loans.¹⁴ In addition, the Bank argued that failure to account, or loss to the trust, is a not necessary element of defalcation because the statutory language does not contain any requirement of failure to account in order to commit a defalcation. Alternatively, even if a failure to account is required by the statute, Bullock failed to account to the trust by failing to turn over the profits that he earned.¹⁵

ORAL ARGUMENT

Though oral argument rarely provides clear insight into how a given Supreme Court may rule, the focus of the Justices' questions can help ascertain the analytical difficulties with a case. At oral argument, the Justices attempted to draw out: (1) the mental state required by defalcation, (2) the type of loss, if any, necessary for defalcation, and (3) the parameters of this "weird" trust.

The Court pushed the petitioner on the mental state requirement, with Justice Breyer questioning whether Bullock took out the loans knowingly, a stronger mental state than the extreme recklessness standard advocated by the petitioner. And although he may or may not have known that the acts were illegal, ignorance of the law is not an excuse to any of the other three exclusions listed in § 523 (a)(4). In contrast, when asked, the respondent defined defalcation as "monetary deficiency from a breach of trust"¹⁶ with a required mental state of recklessness.¹⁷ Justice Alito asserted that the other exclusions in § 523(a)(4) are well-known "bad acts," requiring "moral turpitude," but that defalcation is distinct. Respondent replied that the appropriate standard is that of a reasonable trustee, who would know that defalcation is wrongful.¹⁸ Justice Kennedy noted that the respondent's argument is not consistent with the three other words in the statute or the idea that discharge is granted freely.¹⁹

With regard to loss, the petitioner argued that loss is the economic loss from point A to point B.²⁰ Chief Justice Roberts questioned whether an opportunity cost or increased risk to the trust and its beneficiaries could still be defined as a loss, despite no difference in the trust *res* between points A and B.²¹ Along this same line, Justice Ginsberg questioned the \$250,000 profit that Bullock made that was

¹² Reply of Petitioner, p. 7-8, *Bullock v. BankChampaign, N.A.*, ___ U.S. ___, 133 S. Ct. 1754 (2013).

¹³ Brief of Respondent, p. 5-20, *Bullock v. BankChampaign, N.A.*, ___ U.S. ___, 133 S. Ct. 1754 (2013).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Transcript of Oral Argument, p. 34, lines 9-10.

¹⁷ *Id.* at 25.

¹⁸ *Id.* at 29..

¹⁹ *Id.* at 34.

²⁰ *Id.* at 19.

²¹ *Id.* at 14.

not returned to the trust.²² With the respondent, the Justices grappled with whether any loss must be in the "traditional sense." Justice Scalia, stated first that there may be no loss in the traditional sense, but later told respondent that he should not concede no loss in the traditional sense.²³ Lastly, the Justices repeatedly brought up the unusual nature of this trust asked the petitioner to help them create a rule that would apply to other, more typical trusts.

THE HOLDING

In an unanimous opinion, with Justice Stephen Breyer writing for the Court, the Supreme Court held that the term "defalcation" in § 523(a)(4) of the Bankruptcy Code includes a culpable state of mind requirement similar to the other terms in the statute, involving knowledge of, or gross recklessness in respect to, the improper nature of the fiduciary behavior.²⁴ This holding follows the interpretation of the First and Second Circuits.

The relatively short opinion relied on the history of the meaning of the statutory meaning, canons of construction, and the precedential value of interpretation of "fraud" in the *Neal v. Clark*²⁵ decision. The Court noted that the meaning of "defalcation" has been unclear since its inclusion into the federal bankruptcy statute in 1867 and that neither contemporary nor dictionaries are useful to elucidate the term's meaning. Thus, the Court looked to precedent, namely the *Neal* decision, for guidance. In *Neal*, Justice Harlan writing for the Court found that fraud as an exception to discharge "means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality."²⁶ Breyer also made reference to statutory context and the canon of construction *noscitur a sociis*, noting the fact that Justice Harlan in *Neal* looked to "fraud's linguistic neighbor," embezzlement. Embezzlement requires a showing of moral turpitude or an intentional wrong. Hence, the *Neal* Court held that fraud required the same mental state.²⁷

Thus, the *Bullock* Court held that the term "defalcation" should have a similar meaning as fraud and embezzlement. In explaining the mental state requirement, the Court held that "where the conduct at issue does not involve bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong."²⁸ Included in the meaning of intentional wrong is the recklessness standard used by the Model Penal Code, meaning the conscious disregard of or willful blindness to "a substantial and unjustifiable risk."²⁹

Finally, the Court attempted to clarify why this interpretation makes logical sense, responding, in a way, to the aforementioned arguments of the parties. The Court specifically denied that this interpretation made defalcation identical to its neighbors, stating that "[d]efalcation'...can encompass a breach of

²² *Id.* at 16.

²³ *Id.* at 27-28.

²⁴ *Bullock v. BankChampaign, N.A.*, ___ U.S. ___, 133 S. Ct. 1754, 1757 (2013)

²⁵ 95 U.S. 704 (1877).

²⁶ 133 S.Ct. at 1759 (quoting 95 U.S. at 709).

²⁷ *Id.* at 1760.

²⁸ *Id.*

²⁹ *Id.* (quoting ALI, Model Penal Code § 2.02(2)(c), p. 226 (1985)).

fiduciary obligation that involves neither conversion, nor taking and carrying away another's property, nor falsity.”³⁰ Further, the Court explained that:

Nor are embezzlement, larceny, and fiduciary fraud simply special cases of defalcation as so defined. The statutory provision makes clear that the first two terms apply outside of the fiduciary context; and “defalcation,” unlike “fraud,” may be used to refer to nonfraudulent breaches of fiduciary duty.³¹

Finally, the Court held that the interpretation follows the principle that exceptions to discharge should be clearly expressed and that where an intentional wrong has occurred, exceptions to discharge should follow from strong policy considerations to aid the generally more honest creditor.³²

In conclusion, the Court laid out a specific, clear standard for the term “defalcation” under § 523(a)(4), interpreting it with regard to its statutory neighbors. Given oral argument and the briefs, this result was not surprising. The Court did not, however, offer any guidance regarding whether loss of the trust property is required. This absence can most likely be explained by: (i) the “weird” type of trust at issue in *Bullock*, and (ii) the Court’s longstanding practice of making as narrow of decisions as possible. Because the Court had already decided the mental state issue, it was able to defer to the lower court’s finding of whether the fiduciary in *Bullock* had the requisite state, regardless of any loss of trust property.

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³⁰ *Id.* at 1760.

³¹ *Id.* at 1761.

³² *Id.*