
DOWJONES | Daily Bankruptcy Review**Viewpoint: What in the World Is Defalcation?***May 07, 2013*

By Susan E. Trent

Debts for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny are nondischargeable in bankruptcy. However, "defalcation" is not defined in § 101 of the Bankruptcy Code. Moreover, bankruptcy courts have repeatedly acknowledged that the term's meaning is entirely unclear-irrespective of its debut in the Bankruptcy Act of 1841. How is defalcation distinguishable from fraud, embezzlement and larceny? Can an innocent or merely negligent party commit defalcation or must recklessness accompany the conduct? Fortunately, the **U.S. Supreme Court** is on the verge of demystifying defalcation after 172 years!

The Supreme Court is considering an appeal from the 11th U.S. Circuit Court of Appeals in *Bullock v. BankChampaign NA*. The story begins when the appellant, Randy Bullock, became the trustee of his father's trust. The main asset of the trust was a life insurance policy, and Mr. Bullock and his brothers were the beneficiaries. Withdrawals from the trust were permitted in only two circumstances, to pay the premiums or satisfy a beneficiary's request, but Mr. Bullock borrowed from the trust: First, at his father's request so that his mother could repay his father's business; second, at his mother's request for the purchase of a garage-fabrication mill; and third, for Mr. Bullock and his mother to purchase investment real estate. All loans were fully repaid to the trust.

In consequence, two of Mr. Bullock's brothers sued for breach of fiduciary duty and self-dealing. A \$285,000 judgment was entered against Mr. Bullock for self-dealing, and the amount was based on the value of the investment benefit that Mr. Bullock received and his brothers' attorney fees. Despite entering the judgment, the state court expressly noted Mr. Bullock's lack of malice. The judgment was secured by placing the mill and Mr. Bullock's beneficial interest in the trust into constructive trusts, which constructive trusts were awarded to the BankChampaign NA. Mr. Bullock attempted to sell the mill to satisfy the judgment, but BankChampaign prevented the sale. Mr. Bullock sought Chapter 7 relief to discharge the judgment.

The bankruptcy court concluded that the judgment collaterally estopped Mr. Bullock from revisiting whether his conduct amounted to fraud and defalcation. Mr. Bullock appealed, and the district court affirmed the bankruptcy decision but, nevertheless, expressed its sympathy for Mr. Bullock. Mr. Bullock appealed again-this time to the 11th Circuit.

The 11th Circuit noted that the considerations behind the narrow exceptions to discharge outweighed the fresh-start goals of the Code. The court focused on whether the bankruptcy court correctly characterized Bullock's conduct as defalcation under § 523(a)(4) and undertook an effort to define defalcation.

First, the 11th Circuit indicated that defalcation must mean something other than "fraud and embezzlement." For example, a fiduciary that takes money on conditional or revocable authority commits defalcation but not fraud, embezzlement or misappropriation. The court also highlighted the circuit split on whether an innocent act by a fiduciary results in defalcation. The Fourth, Eighth and Ninth Circuits have concluded that an innocent act can constitute defalcation while the Fifth, Sixth and Seventh Circuits have required a showing of recklessness. The First and Second Circuits require extreme recklessness, while the Third Circuit has not addressed the question; the 10th Circuit only has an unpublished decision on the matter. Ultimately, the 11th Circuit adopted a recklessness standard and determined that Mr. Bullock acted recklessly and committed defalcation-although BankChampaign was likely abusing its position of trust in prohibiting the sale of the mill. Mr. Bullock appealed, and the Supreme Court's grant of certiorari means that the responsibility for untangling the elusive meaning of defalcation and the necessary mens rea now rests in the Court's hands.

At oral argument, Mr. Bullock highlighted the following: (1) the trust was established by his father, (2) his father and mother requested the loans, (3) the loans were fully repaid with interest, (4) a distinction exists between liability and dischargeability and (5) BankChampaign unjustifiably prohibited the sale of the mill to satisfy the judgment. Mr. Bullock implored the Court to consider his lack of malice, the totality-of-the-circumstances and his status as permanently insolvent absent a favorable ruling.

The bank countered with the following positions: (1) a reasonable person should know that making personal loans from the trust creates a conflict of interest; (2) despite repayment, the self-dealing resulted in a loss because the trust should not have been investing the money in the first place; (3) Mr. Bullock's gains, as awarded by the judgment, were

not returned to the trust; and (4) protection against self-dealing is precisely why a trust is established. BankChampaign disputed Mr. Bullock's claim of misconduct.

The court has the opportunity to clarify the meaning of "defalcation" and the associated mens rea required for purposes of determining if a debt is nondischargeable. Ignorance of either the law or the terms of the trust should not be a basis for a fiduciary to escape liability. Mr. Bullock was-and should have been-held liable. Dischargeability, however, is a different matter.

For example, an individual who obtains and uses multiple credit cards should know that, at some point, her debt is unreasonable and that repayment is unrealistic as his or her financial condition sours. Yet charges accrue. However, in bankruptcy, while the individual is liable (and likely reckless) that does not mean the debt is nondischargeable. Substantial repayment should be an important consideration in assessing the mens rea of the fiduciary. Mr. Bullock was reckless because he ignored the trust limitations; however, extreme recklessness of a fiduciary (e.g., going to the track and gambling trust proceeds), as adopted by the First and Second Circuits, ought to be the mens rea standard for defalcation for purposes of nondischargeability. Hold fiduciaries liable, but save nondischargeability for intentional or extremely reckless behavior.

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