

**Intentional Conduct May Be Required to Prove Defalcation under Section 523(a)(4) In
Certain Circuits**

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Introduction

In the average bankruptcy case, individual debtors seek to discharge some, all, or most of their debts. The Bankruptcy Code (the “Code”) sets certain limits on the dischargeability of obligations. For example, section 523 of the Code provides circumstances in which certain debts are not dischargeable.¹ Specifically, section 523(a)(4) provides that an individual debtor will not be discharged from any debt “for fraud or defalcation while acting in a fiduciary capacity.”² In the bankruptcy context, defalcation means “the failure to meet an obligation.”³ However, the Code is silent as to the level of culpability required to prove defalcation. The circuit courts have established varying standards to prove defalcation under the Code, ranging from intentional conduct to an innocent mistake as sufficient to prove defalcation, rendering the debt nondischargeable.

Part I of this memorandum generally discusses defalcation. Part II discusses and compares the various standards adopted by the circuits as to the level of culpability required to prove defalcation. Part III discusses the various policy goals of discharge and how it relates to

¹ 11 U.S.C. § 532.

² 11 U.S.C. § 532(a)(4).

³ BLACK'S LAW DICTIONARY (9th ed. 2009).

section 523(a)(4). The memorandum concludes that courts should follow a standard similar to that laid out in *In re Mueller*, a standard requiring a plaintiff show a defendant committed a willful, knowing, or reckless breach of a fiduciary duty.⁴ This standard allows an “honest but unfortunate debtor”⁵ to emerge from bankruptcy with a fresh start, a goal achieved through the discharge.

I. Background on Defalcation

The confusion relating to the level of culpability required to constitute defalcation began with the seminal case *Central Hanover Bank & Trust Co. v. Herbst*.⁶ Judge Learned Hand’s interpretation of defalcation created an ambiguity regarding the level of culpability required to constitute defalcation that has been interpreted in varying ways, each requiring that a plaintiff show a different level of a defendant’s intent. Judge Hand stated, “[c]olloquially perhaps the word, ‘defalcation,’ ordinarily implies some moral dereliction, but in this context it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts.”⁷ *Herbst* left the courts with uncertainty regarding the level of culpability required to constitute defalcation. Since then, most of the circuit courts have weighed in on the issue, but they do not agree with one another.⁸

⁴ *In re Mueller*, No. 10–23917–skv, 2011 WL 2360122, at *4 (Bankr. E.D. Wis. June 8, 2011).

⁵ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

⁶ 93 F.2d 510 (2d Cir. 1937).

⁷ *Id.* at 511.

⁸ *Compare* *Republic of Rwanda v. Uwimana (In re Uwimana)* 274 F.3d 806, 811 (4th Cir. 2001) (stating that “negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient” to a finding of defalcation), *with* *Denton v. Hyman (In re Hyman)* 502 F.3d 61, 68 (2d Cir. 2007) (holding that “defalcation under § 523(a)(4) requires a showing of conscious misbehavior or extreme recklessness), *with* *In re Rieck* 439 B.R. at 702 (stating that “innocent or unintentional defalcations may be discharged, and nondischargeability is premised upon a showing of something more than mere negligence, which need not rise to the level of fraud but still must be akin to a reckless, willful, or knowing breach of fiduciary responsibility.”).

II. The Circuits are Split as to the Culpability Required to Constitute Defalcation

A. The Fourth, Eighth, and Ninth Circuits Conclude an Innocent Mistake is Sufficient to Prove Defalcation

In the Fourth, Eighth, and Ninth Circuits, a debtor's negligent or even innocent acts while acting in a fiduciary capacity that result in misappropriation or failure to account are sufficient to prove defalcation.⁹ In *Baird v. Baird*, the Ninth Circuit upheld strict liability-type standard and determined that debtor committed defalcation, even though he demonstrated that his conduct was standard in the industry. Debtor, as general contractor of a construction project, disbursed funds to a sub-contractor that, by statute, were supposed to be held in a statutory trust to be disbursed to other sub-contractors. The debtor claimed that he was following common industry standards and thus his conduct was not intentionally wrongful. Regardless, the court found that the debtor committed defalcation because the plain meaning of the statute that created the trust stated that a "trust arises only in favor of those working on the project for which the payments are made."¹⁰ The debtor believed that his actions were warranted because of the common industry standard; however, the court relied on the strict standard stating, "the term 'defalcation' includes innocent,

⁹ See *In re Uwimana*, 274 F.3d 806 (foreign government of Republic of Rwanda brought adversarial proceeding against their former Ambassador to United States, Uwimana, alleging that Uwimana owed Republic nondischargeable debt resulting from defalcation while acting in fiduciary capacity. The Fourth Circuit concluded that debt was nondischargeable because at least some of the disputed funds were used for personal case of asylum for Ambassador and his family). See also *Tudor Oaks Limited Partnership v. Cochrane*, 124 F.3d 978 (8th Cir. 1997) (partner of dissolved partnership brought adversarial proceeding to determine whether debtor-attorney committed defalcation rendering portion of his debt nondischargeable. The debtor-attorney was retained by Tudor Oaks to represent it in bank foreclosure on the partnership's failing condominium project. The attorney-debtor appropriated funds to himself as a "fee" that his clients expected to retain and constituted defalcation rendering debt nondischargeable.).

¹⁰ *In re Baird*, 114 B.R. 198, 204 (B.A.P. 9th Cir. 1990).

as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts.”¹¹

In *Tudor Oaks Limited Partnership v. Cochrane*,¹² the Eighth Circuit applied a similar standard to the Fourth Circuit,¹³ stating that “a finding of ‘defalcation’ does not require evidence of intentional fraud or other intentional wrongdoing.”¹⁴ The attorney and debtor, Cochrane, represented the partnership, Tudor Oaks, in a foreclosure action of a condominium project, thereby, creating a fiduciary relationship between Cochrane and Tudor Oaks.¹⁵ Under the representation, Cochrane was to be paid a flat fee of \$20,000 and led his client to believe that Tudor Oaks would retain a 20% interest in the project, with the other 80% going to KSCS, a business-consulting firm.¹⁶ Cochrane failed to inform Tudor Oaks that he was a 25% shareholder in KSCS, and further, Cochrane retained the 20% interest for himself as a “fee”.¹⁷ An adversary proceeding was brought in Minnesota state court by a former partner of Tudor Oaks against Cochrane alleging a breach of fiduciary duties resulting in a \$1.7 million judgment holding Cochrane liable to Tudor Oaks for the damages.¹⁸ Following the judgment, Cochrane filed for Chapter 11 relief, which was converted into a Chapter 7 proceeding, citing Tudor Oaks as a creditor.¹⁹ Cochrane claimed that because his acts as fiduciary were not intentionally fraudulent, that his debt to Tudor Oaks is dischargeable under the Code.²⁰ The Court denied

¹¹ *Id.* (citing *In re Gonzales* 22 B.R. 58, 59 (B.A.P. 9th Cir. 1982)).

¹² 124 F.3d 978 (8th Cir. 1997).

¹³ *See In re Uwimana*, 274 F.3d 806, 811 (stating that negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient to prove defalcation).

¹⁴ *Id.* at 984.

¹⁵ *Id.* at 980.

¹⁶ *Id.* at 981.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 981.

²⁰ *Id.* at 984.

Cochrane's contention stating that defalcation includes innocent acts by a fiduciary that fails to account for money received.²¹

B. The Fifth, Sixth, and Seventh Circuits Require Proof of a Reckless, Willful, or Knowing Breach of a Fiduciary Duty to Prove Defalcation

The standard to prove defalcation in the Fifth, Sixth, and Seventh Circuits is less strict than the standard in the Fourth, Eighth, and Ninth circuits and requires that the debtor have acted in a reckless or willful manner, or knowingly breached a fiduciary duty.²² In *Moreno v. Ashworth*, the court determined the dischargeability of the debt of a corporate president, Moreno, who improperly took cash advances from the company.²³ Moreno, as an officer of an energy company, transferred nearly \$200,000 to himself and companies in which he owned a 50% or greater interest.²⁴ There were no records of any loan agreements, promissory notes, security agreements, or interest in relation to the transfers and no portion was repaid.²⁵ The court affirmed the lower court's decision finding that these actions constituted defalcation, stating "a defalcation is a willful neglect of duty, even if not accompanied by fraud or embezzlement."²⁶ As fiduciary, Moreno's duties included a responsibility not to lend the energy company's money to himself or corporations controlled by him unless dealing at arm's length.²⁷ Failing to find an

²¹ *Id.*

²² *See* Carlisle Cashway, Inc., v. Johnson (*In re Johnson*), 691 F.2d 249, 257 (6th Cir. 1997) (applying standard requiring a reckless, willful, or knowing breach of a fiduciary duty to prove defalcation and holding the debtor committed defalcation when he knowingly used monies from building contracts for personal or other business expenses).

²³ 892 F.2d 417, 418 (5th Cir. 1990).

²⁴ *Id.* at 421.

²⁵ *Id.*

²⁶ *Id.* at 421.

²⁷ *Id.*

arm's length exchange with respect to the \$200,000, the Court determined that Moreno willfully neglected his fiduciary duty, rendering his debt to the energy company nondischargeable.²⁸

In *In re Mueller*,²⁹ the Bankruptcy Court for the Eastern District of Wisconsin, bound by the 7th Circuit,³⁰ recently stated that to commit defalcation, a debtor acting as a fiduciary must have committed acts constituting a willful, knowing, or reckless breach of a duty to prove defalcation.³¹ Prior to bankruptcy, the debtor failed to make certain required fringe benefit contributions to the plaintiffs under certain collective bargaining agreements entered into in connection with three construction projects.³² The plaintiffs claimed that the debtor's failure to make such contributions violated Wisconsin's theft by contract statute and supported a finding of defalcation.³³ The debtor argued that his failure to pay was inadvertent and reflective of the problems arising in the contracted projects and constituted a "mistake of fact which was merely negligent, but not reckless, knowing, or willful."³⁴ The Court was then left with the decision of which circuit's approach to proving defalcation it should follow. The Court acknowledged the wide range of interpretations provided by the various circuits regarding the level of culpability required to prove defalcation, and the Court elected to follow the Seventh Circuit's approach, requiring the debtor, acting as a fiduciary, to commit acts constituting a willful, knowing, or reckless breach of a duty to prove defalcation.³⁵

²⁸ *Id.*

²⁹ *In re Mueller*, 2011 WL 2360122, at *1.

³⁰ *See Meyer v. Rigdon*, 36 F.3d 1375, 1385 (7th Cir. 1994) (stating a mere negligent breach of a fiduciary duty is not defalcation under the Code).

³¹ *Id.* at *3.

³² *Id.* at *1.

³³ *Id.*

³⁴ *Id.* at *4.

³⁵ *In re Mueller*, No. 10-23917-sky, 2011 WL 2360122, at *3 (Bankr. E.D. Wis. June 8, 2011).

C. The First and Second Circuits Require Proof of Extreme Recklessness or Conscious Misbehavior to Prove Defalcation

The First and Second Circuits' standard only provides an exception to discharge in a case where the debtor's conduct is extremely reckless or a conscious misbehavior.³⁶ In *In re Baylis*, the First Circuit concluded that to prove defalcation, "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."³⁷ The debtor, Baylis, was a co-trustee of the Antonia Quevillon Trust, comprised of several apartment buildings.³⁸ While acting as a co-trustee, Baylis was faced with a lawsuit stemming from the potential sale of the property of the trust.³⁹ In defending the lawsuit, Baylis used funds from the trust to not only pay attorneys' fees, but also to settle the lawsuit itself.⁴⁰ The court interpreted defalcation in light of section 523(a)(4) as a whole and concluded that the exceptions to discharge in this section are all fault-based exceptions, meaning that defalcation requires a showing of fault not necessarily to the level of the criminal and civil fraud exceptions, but requiring a high degree of fault.⁴¹ Given Baylis' position as a co-trustee of the trust that brought about the lawsuit, the Court found that Baylis had breached his fiduciary duty to a level almost equivalent of fraud.⁴²

³⁶ See *Hyman v. Denton (In re Hyman)*, 502 F.3d 61, 69 (Second Circuit affirming district court's decision that there was no finding of defalcation because defalcation requires a showing of conscious misbehavior or extreme recklessness and there was no evidence of debtor's mental state).

³⁷ *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18–19 (1st Cir. 2002).

³⁸ *Id.* at 14.

³⁹ *Id.* at 21.

⁴⁰ *Id.*

⁴¹ *Id.* at 20.

⁴² *Id.*

D. The Tenth Circuit Follows a Standard Requiring Some Degree of Fault

The Tenth Circuit's standard for proving defalcation is unclear, but it is understood to require some degree of fault by the fiduciary.⁴³ In *In re Millikan*, the debtor-fiduciary placed funds held in trust into bank accounts that were later closed out by one of the debtor's creditors.⁴⁴ The court acknowledged the various definitions of defalcation among the circuits, stating "We need not reconcile those authorities' definitions of 'defalcation.' 'Defalcation' requires, at least, 'some portion of misconduct.'"⁴⁵ The court found that the debtor's failure to establish a separate bank account designated as a trust constituted defalcation, rendering the debts nondischargeable.⁴⁶

III. Policy

A. Policy Motivating Discharge of Debt

Modern bankruptcy law is primarily motivated by two competing policy goals: providing an "honest but unfortunate debtor" with a fresh start and providing a collection mechanism for worthy creditors to get paid to them what is owed.⁴⁷ The discharge provides the backbone for the policy of providing the "honest but unfortunate debtor" with a fresh start by allowing the debtor to emerge from bankruptcy unencumbered.⁴⁸ In fact, without a discharge, an honest debtor would not have the ability to emerge from bankruptcy unencumbered. Discharge provides a unique opportunity for a debtor to be freed from their debt, which clearly competes with the policy of maximizing creditors' collections throughout the bankruptcy process.

⁴³ *Millikan v. Millikan (In re Millikan)*, 188 Fed. Appx. 699, 702 (10th Cir. 2006). See *In re Storie*, 216 B.R. 283, 290 (B.A.P. 10th Cir. 1997) (reversing the Bankruptcy Court's Order finding that defalcation requires evidence of moral dereliction or an intentional wrong).

⁴⁴ *In re Millikan*, 188 Fed. Appx., at 700–01.

⁴⁵ *Id.* (quoting *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937)).

⁴⁶ *Id.* at 702–03.

⁴⁷ *Grogan v. Garner*, 498 U.S. 279 (1991).

⁴⁸ *Id.*

Therefore, exceptions to discharge ought to be narrowly construed because a finding of nondischargeability can be extremely detrimental to a debtor's "fresh start." It also leaves creditors unable to collect certain debts from the debtor.

Section 523(a) provides several instances in which a debtor's debt is nondischargeable, providing a specific provision for debtors acting in a fiduciary capacity. Certain exceptions to discharge, such as for a tax or a custom duty or for a domestic support obligation, indicate that Congress believed these debts to be so important that the even an honest debtor should not be relieved from these debts. Other exceptions to discharge, such as for defalcation or fraud, seek to punish dishonest debtors. Therefore, it seems reasonable to punish a debtor for the latter category only where there is culpable conduct. A debtor-fiduciary is in the unique position of being held to a higher standard than the layperson in fulfilling their obligations under their duty; however, their responsibilities are often complex. Therefore, it is important only to punish those fiduciaries that truly neglect their responsibilities, rather than those that make innocent or negligent mistakes.

B. The Fifth, Sixth, and Seventh Circuits' Definition of Defalcation is in Line with the Policy Motivating a Discharge of Debt

Where ambiguities exist in the Code, such as in the definition of defalcation, the courts must interpret the Code to achieve an equitable balance between the competing policy interests. The Fourth, Eighth, and Ninth Circuits have failed to find this balance, adopting a strongly pro-creditor view that may excessively punish an honest debtor. The standard adopted by these circuits unjustly punish the debtor in that these circuits seek to punish a fiduciary-debtor for even honest mistakes. This standard not only unjustly punishes the honest fiduciary-debtor, but it also may discourage those from acting in a fiduciary capacity from the start for fear of a mistake causing a debt to be rendered nondischargeable in bankruptcy. On the other hand, the First and

Second Circuits adopted a strongly pro-debtor standard that falls above the desired level of culpability to prove defalcation by a debtor while acting in a fiduciary capacity. Allowing a fiduciary a discharge of debt for any conduct that falls below extreme recklessness or conscious misbehavior allows a fiduciary too much leeway in upholding their duties as fiduciary.

Among the various standards adopted by various circuits, the standard adopted by the Fifth, Sixth, and Seventh Circuits is most in line with the policy of allowing an “honest but unfortunate debtor” the ability to emerge from bankruptcy with a fresh start.⁴⁹ In requiring the creditor prove the debtor’s actions constituted a reckless, willful, or knowing breach of a fiduciary duty, these circuits punish the debtor that fails to adequately fulfill its role as a fiduciary. This standard allows the fiduciary to balance its complex duties without undue fear of punishment for truly honest mistakes. Without this fear, the fiduciary is able to fulfill its duties but is also not free to act extremely reckless while fulfilling these important responsibilities.

The Bankruptcy Court for the Eastern District of Wisconsin’s ruling in *In re Mueller*, by aligning with the Fifth, Sixth, and Seventh Circuits, created an identifiable standard for fiduciaries to follow that is in line with the policy of both discharge and the exceptions to discharge. Fiduciaries in this district are now able to fulfill their often-complex obligations without unjustly being punished for innocent or honest mistakes.

Conclusion

The exception for discharge under section 523(a)(4) of the Code for defalcation while acting in a fiduciary capacity should only be applied to debtors that have engaged in a reckless or willful manner, or knowingly breaches a fiduciary duty. The standard adopted by the Fifth, Sixth, and Seventh Circuits most adequately ensures that a fiduciary diligently perform its duties

⁴⁹ *Id.*

by not punishing innocent mistakes and only punishing those that act recklessly, willfully, or knowingly in breaching a fiduciary duty. If the courts were to adopt a lower standard where debts are nondischargeable when the fiduciary has committed an honest mistake, a fiduciary would be unable to effectively and efficiently fulfill its role that often entails complicated responsibilities. On the other hand, if the courts were to adopt a higher standard where a debtor-fiduciary is only punished where his acts constitute extreme recklessness or conscious misbehavior, the fiduciary would be afforded too much protection when its acts clearly breach its fiduciary duties. Therefore, the courts should align with the Fifth, Sixth, and Seventh Circuits to provide a uniform definition of defalcation that is in line with the broader policy goal of providing an honest but unfortunate debtor with a fresh start.

