

2013

Does “Defalcation” by a Fiduciary, Rendering a Debt Nondischargeable, Include Unknowing Breach of the Duty of Loyalty? (Bullock v. Bank Champaign, N.A.)

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Recommended Citation

40 Preview U.S. Sup. Ct. Cas. 267 (March 18, 2013)

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Does “Defalcation” by a Fiduciary, Rendering a Debt Nondischargeable, Include Unknowing Breaches of the Duty of Loyalty?

CASE AT A GLANCE

Petitioner Randy Curtis Bullock, trustee of a family trust, loaned trust funds to himself, jointly with his mother, for business purposes. These loans were all repaid. A state court entered judgment against him for breach of fiduciary duty, ordering that profits from the loaned moneys be paid to the trust. The Supreme Court must decide whether Bullock’s liability for self-dealing, without conscious misbehavior, is nondischargeable as a “defalcation while acting in a fiduciary capacity.”

Bullock v. BankChampaign, N.A.
Docket No. 11-1518

Argument Date: March 18, 2013
From: The Eleventh Circuit

by Marshall Tracht
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ISSUE

Is a trustee’s liability for breach of the duty of loyalty through self-dealing nondischargeable as “defalcation” under 11 U.S.C. § 523(a)(4) even if there is no showing of conscious misconduct and no loss to the trust?

FACTS

In 1978, petitioner Randy Curtis Bullock’s father established a trust for the benefit of Bullock and his four siblings, appointing Bullock as the trustee. The sole asset in the trust was the father’s life insurance policy, which had an accumulated cash value. In 1981, the father asked Bullock, who was at that point unaware that he had been appointed trustee, to loan \$117,545.96 from the trust to his mother for use in the family garage-construction business. Two additional loans were made to Bullock and his mother together, each for business purposes, one in 1984 for approximately \$200,000 and another in 1990 for roughly \$66,000. All loans were repaid with interest.

In 1998, Bullock resigned as trustee at the request of some of the other beneficiaries, and BankChampaign, N.A., took over as trustee. In 1999, two of the beneficiaries sued Bullock in Illinois state court for breach of fiduciary duty. The state court held that although there had been no loss to the trust and Bullock did “not appear to have had a malicious motive in borrowing funds from the trust,” self-dealing by a trustee is a breach of the duty of loyalty and all profits derived from it had to be paid to the trust. The state court entered judgment for \$250,000, as an estimate of the benefit realized by Bullock, plus \$35,000 in attorney’s fees.

In 2009, Bullock filed for bankruptcy; at this point, Bullock had not satisfied the judgment entered against him. BankChampaign, acting

as trustee for the trust, filed an adversary proceeding asserting that the judgment in favor of the trust was nondischargeable under 11 U.S.C. §523(a)(4). The Bankruptcy Court granted summary judgment to BankChampaign based on the state court judgment, holding the debt nondischargeable. The district court and the Eleventh Circuit Court of Appeals affirmed.

CASE ANALYSIS

Section 523 of the United States Bankruptcy Code provides: “(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 ... (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. ...”

“Defalcation” is an uncommon term, and courts have split widely on its meaning. The Fourth, Eighth, and Ninth Circuits have taken a strict view, holding that defalcation includes even an innocent failure by the trustee to fully account for trust assets. The Fifth, Sixth, and Seventh Circuits have interpreted defalcation more narrowly, holding that it requires a showing of objectively reckless conduct. The First and Second Circuits have gone a step further, holding that defalcation requires extreme recklessness, meaning conscious misbehavior and wrongful intent.

The Eleventh Circuit agreed with the Fifth, Sixth, and Seventh that defalcation requires a “known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless.” On the present facts, the Eleventh Circuit found this standard had been met:

Because Bullock was the trustee of the trust, he certainly should have known that he was engaging in self-dealing,

given that he knowingly benefitted from the loans. Thus, his conduct can be characterized as objectively reckless, and as such, it rises to the level of a defalcation under § 523(a)(4).

Bullock argues that the Supreme Court should hold that defalcation requires extreme recklessness or conscious misconduct, the standard adopted by the First and Second Circuits. This standard, he argues, is required by the canon of construction *noscitur a sociis*: that the meaning of a word may be ascertained by examining the neighboring words with which it is associated. Section 523(a)(4) renders nondischargeable debts that result from “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” Fraud (as used in § 523), embezzlement, and larceny all require intentional wrongdoing, so the natural reading according to Bullock is that defalcation, too, is intended to cover intentional wrongdoing.

This argument, Bullock further asserts, is supported by rulings holding that exceptions to discharge should be construed narrowly in order to protect the “fresh start.” One of the primary goals of bankruptcy is to relieve honest debtors from overwhelming indebtedness so they can start again free from the burdens of past misfortune. Discharge exceptions fall into two broad categories, Bullock argues: (1) specific categories of debt that should not be discharged for various policy reasons, such as taxes, domestic support obligations, and educational loans; and (2) debts that are the product of wrongdoing, such as willful and malicious injury, fraud, or driving while intoxicated. Holding that defalcation includes mere negligence or even recklessness would be inconsistent with this framework, concludes Bullock.

As a second line of argument, Bullock maintains that defalcation requires the creditor to show that it has suffered a loss: defalcation “refers to a failure to produce funds entrusted to a fiduciary.” He was found liable for a breach of his duty of loyalty, but as he had already repaid the loans with interest, Bullock argues, the trust suffered no losses. The breach, therefore, did not amount to defalcation.

Further, the bankruptcy court held the debt nondischargeable by relying on the state court determination that there had been a breach of fiduciary duty, even though the state court had found that there was no “malice” in his actions and no further evidence on mental state had been admitted in the bankruptcy case. Thus, Bullock argues, there is no factual basis on which the bankruptcy court could have held that any mental state beyond negligence had been shown. The Eleventh Circuit found that Bullock “should have known” the loans were improper and that he therefore met the “objective recklessness” standard, but Bullock argues that he should have the opportunity to introduce evidence of mental state rather than have it presumed on the basis of what he “should have known.”

In its response, BankChampaign essentially tries to finesse the question of the requisite mental state by focusing on the high standards to which fiduciaries are held and the fundamental importance of the duty of loyalty owed by a trustee to a trust and its beneficiaries. By “disregarding the high standards of loyalty that a trustee owes to a trust and beneficiaries, Bullock’s self-dealing was a defalcation regardless of the mental status that is implied by that term.”

According to BankChampaign, even the toughest standard, “extreme recklessness,” has been met: “By knowingly and intentionally lending Trust assets for his personal benefit, Bullock’s acts departed extremely from the absolute duty of loyalty that the law demands of fiduciaries.” Outside of a fiduciary context, it argues, intentional wrongdoing or extreme recklessness may be required, but in a fiduciary context the breach of the duty of loyalty itself warrants nondischargeability, regardless of the trustee’s mental state.

BankChampaign responds to Bullock’s claim that he did not know the loans were improper with the common maxim that “ignorance of the law is no excuse.” The Illinois state court had held that he breached the duty of loyalty through his self-dealing even though he acted without malice. “Defalcation,” BankChampaign argues, “is an objective standard regarding conduct, not a subjective standard relating to mental states.”

In essence, BankChampaign is arguing that the breach of the duty of loyalty by self-dealing is enough to satisfy the wrongdoing element in § 523(a)(4), even if the trustee was unaware that he was breaching his duty. Bullock argues that liability under state law may exist on this basis (breach of loyalty, even if unintentional), but that the standards for nondischargeability under the Bankruptcy Code are higher than the standards for liability under state law.

As to the argument that there can be no defalcation where there was no loss to the trust, BankChampaign argues that there was a “failure to account” for trust assets by not reporting annually to the beneficiaries about the status of the trust, including the loans. Moreover, it argues that there was a loss in this case because the profits earned by Bullock from the improper loans were owed to the trust, but not paid to it.

Finally, BankChampaign responds to Bullock’s arguments about the importance of the fresh start policy and narrow construction of discharge exceptions by noting that discharge is intended for the “honest but unfortunate debtor,” not to trustees who breach their fiduciary duties. Moreover, giving a narrow construction to defalcation would promote the fresh start at the expense of the trust beneficiaries, an outcome that Congress intended to prevent by providing that debts caused by defalcation cannot be discharged.

SIGNIFICANCE

Family trusts are an important estate planning tool, and as this case shows, the complexity of family relationships and ignorance of some family trustees sometimes can make it difficult to adhere to fiduciary standards. This case will provide guidance on dischargeability in cases of misconduct. However, because the case involves the question of whether unintentional breaches are nondischargeable, it is unlikely to directly affect trustee behavior. The greater significance of this case is likely to come in other contexts.

Although the issues are not raised in the briefs, the outcome in this case is likely to have an impact in a variety of situations far from the family trust setting. Suits against officers of a labor union, partners in a partnership, pension plan trustees, and mutual funds all can involve allegations of breach of fiduciary duty. Mortgage-backed securities are issued by trusts that hold the underlying notes and mortgages. Courts have split on whether the obligations of corporate

officers and directors are “fiduciary duties” within the meaning of § 523(a)(4). Thus, the defalcation question can arise in a wide range of securities law and commercial settings apart from family trusts, and this case may therefore set the standard for when liability for corporate malfeasance is, or is not, dischargeable.

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PREVIEW of United States Supreme Court Cases, pages 267–269.
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