

Defalcation, Defined: The U.S. Supreme Court Resolves Longstanding Circuit Split Concerning Scope of Misconduct Contemplated by Section 523(a)(4) Defalcation

Section 523(a)(4) of the Bankruptcy Code prevents an individual debtor from obtaining a discharge from any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). Of the terms contained in section 523(a)(4), "defalcation" has historically caused the most confusion amongst the circuits, despite having been an exception to discharge since 1867.

Until the U.S. Supreme Court's recent clarification of the term in *Bullock v. BankChampaign, N.A.*, 133 S.Ct. 1754 (2013), various circuit courts of appeal struggled to define the mental state contemplated by "defalcation" as used in section 523(a)(4). Some circuits held that even an innocent act by a fiduciary could constitute defalcation. *In re Uwimana*, 274 F.3d 806 (4th Cir. 2001); *In re Cochrane*, 124 F.3d 978 (8th Cir. 1997); *In re Sherman*, 658 F.3d 1009 (9th Cir. 2011). Others, including the Eleventh Circuit Court of Appeals in its *Bullock* decision that was the subject of the appeal to the U.S. Supreme Court, held that defalcation required a showing of recklessness or similar conduct. *Bullock v. BankChampaign, N.A.*, 670 F.3d 1160 (11th Cir. 2012); *In re Harwood*, 637 F.3d 615 (5th Cir. 2011); *In re Patel*, 565 F.3d 963 (6th Cir. 2009); *In re Berman*, 629 F.3d 761, 766 n.3 (7th Cir. 2011) (requiring "more than negligence or mistake, but less than fraud"). Still others held that defalcation required establishment of "extreme" recklessness. *In re Baylis*, 313 F.3d 9 (1st Cir. 2002); *In re Hyman*, 502 F.3d 61 (2nd Cir. 2007). Neither the Third Circuit Court of Appeals nor the Tenth Circuit Court of Appeals has weighed in on the meaning of defalcation in a published opinion.

In May 2013, the U.S. Supreme Court held that where there is no bad faith, moral turpitude or other immoral conduct, defalcation as used in 11 U.S.C. § 523(a)(4) requires an "intentional wrong." *Bullock*, 133 S. Ct. at 1759. This includes not only conduct that the fiduciary "knows is improper," but also "reckless conduct of the kind that the criminal law often treats as the equivalent," *i.e.*, reckless conduct "of the kind found in the Model Penal Code." *Id.* Thus, where actual knowledge of wrongdoing is lacking, conduct will be considered sufficiently reckless to

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constitute defalcation where the fiduciary consciously disregards (or is willfully blind to) a substantial and unjustifiable risk that his/her conduct will turn out to violate a fiduciary duty. *Id.* That risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him/her, its disregard involves a "gross deviation" from the standard of conduct that a law-abiding person would observe in the actor's situation. *Id.* at 1760. The U.S. Supreme Court therefore vacated the Eleventh Circuit Court of Appeals' decision in *Bullock*, which applied an "objective recklessness" standard, and remanded the case for further proceedings consistent with the "heightened" standard set forth in its opinion. *Id.* at 1761.

In reaching this decision, the U.S. Supreme Court considered the fact that the other terms used in section 523(a)(4) (embezzlement, larceny and fraud) all require some level of intent. *Id.* at 1760. The Court also noted that its definition of "defalcation" did not make the word identical to the other terms in the statute, nor were the other terms in the statute simply special cases of defalcation. *Id.* The Court also viewed its interpretation of the term as consistent with the longstanding principle that exceptions to discharge should be "confined to those plainly expressed." *Id.* (citations omitted).

In its ruling, the U.S. Supreme Court aligned itself with the First Circuit Court of Appeals and the Second Circuit Court of Appeals, noting that those courts "interpreted the statute similarly" in the *Baylis* and *Hyman* decisions. *Id.* at 1761.

Conclusion

The U.S. Supreme Court's *Bullock* decision clarifies that a finding of "defalcation" requires a higher degree of intent or recklessness than that previously applied by the majority of circuit courts of appeal. Thus, the *Bullock* decision will have a substantial impact on nondischargeability litigation in many circuits, including Seventh Circuit states such as Wisconsin, which previously applied a lower standard of misconduct than what is now required. This will make it more difficult for creditors to obtain a denial of discharge pursuant to 11 U.S.C. § 523(a)(4).

Please contact your Reinhart attorney or any attorney in Reinhart's Business Reorganization Practice Area if you have any questions concerning challenges to discharge pursuant to 11 U.S.C. § 523(a)(4).

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