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NOTES

BANKRUPTCY — THE DEFALCATION EXCEPTION TO DISCHARGE: SHOULD A FIDUCIARY'S MISTAKE PROHIBIT A DISCHARGE FROM DEBT?

INTRODUCTION

The Bankruptcy Code¹ allows debtors to be discharged² from financial obligations when they become too burdensome, but it also provides a number of special exemptions³ to ensure that this relief is afforded to the “honest but unfortunate debtor.”⁴ One exemption, 11 U.S.C. § 523(a)(4), the focus of this Note, states that an individual’s debt will not be discharged for “defalcation while acting in a fiduciary capacity.”⁵ This exemption has been at the root of much judicial debate because courts disagree as to whether a fiduciary must have intent to commit defalcation.⁶ For the debtor, the difference between a standard of defalcation requiring intent and

1. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) and Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 33 (1984) (codified as amended at 11 U.S.C. §§ 101-133Q (2004)).

2. Theresa J. Pulley Radwan, *Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy*, 54 MERCER L. REV. 987, 987-88 (2003) (“In exchange for participating . . . in this orderly distribution of one’s assets, a debtor is given the ability to nullify all debts remaining after the distribution concludes, known as a discharge.”).

3. 11 U.S.C. § 523(a) (2004) (providing for nineteen exceptions to discharge including those for fraudulently filed taxes, false pretenses used to obtain credit, monies owed for child support or alimony, money owed for willful or malicious injury to person or property of another, etc.). See also Andrew Kessler, *Exceptions to Discharge: The Supreme Court Adopts A Preponderance of the Evidence Standard of Proof in Section 523 Proceedings*, 15 NOVA L. REV. 1411, 1412 (1991).

4. *Grogan v. Garner*, 498 U.S. 279, 287 (1991). See also *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (Bankruptcy “gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort.”).

5. § 523(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.”).

6. See *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002) (“The present range of interpretations of ‘defalcation’ among the circuits, [extends] from innocent mistake to a civil recklessness.”); see also *Meyer v. Rigdon*, 36 F.3d 1375, 1383 (7th Cir. 1994) (“[C]ourts have split over the question of whether mere negligent acts may be ‘defalcations.’”); Reinhardt & Horlbeck, *infra* note 8, at 1774.

one in which no intent is required is crucial. If no intent to commit defalcation is necessary, then a debt created as a result of the fiduciary's mistake or negligence could be denied discharge. On the other hand, if a creditor is forced to prove that the debtor intended to commit a defalcation, there is a much higher standard for the creditor to meet and more debts of the fiduciary would be discharged.

The absence of a definition of "defalcation" in the Bankruptcy Code⁷ has led to the popularity of the § 523(a)(4) exception amongst creditors seeking to prevent a debtor from obtaining discharge, since it typically encompasses a vast array of conduct and because a majority of courts have held that intent is not required.⁸ As a result, fiduciaries who cannot account for entrusted funds have often been denied discharge for the debt in bankruptcy proceedings for committing "defalcation while acting in a fiduciary capacity."⁹ Even innocent mistakes in accounting can prevent a fiduciary from receiving a discharge.¹⁰ This Note, prompted by a recent First Circuit case, addresses whether this lack-of-intent standard is appropriate to apply in § 523(a)(4) proceedings.¹¹

The current broad reach of § 523(a)(4) has given the courts the difficult task of having to dissect a variety of factual circumstances and, without a definition of "defalcation," determine whether a defalcation was committed. Consider this simple example where an attorney who is the trustee for a client's trust is holding \$100,000 on behalf of the trust. The trustee deposits the funds in a bank, which appears on all accounts to be federally insured, but later goes bankrupt and in fact, the bank was misrepresenting itself as federally insured when it was not. After the trust wins a judgment against the trustee, that trustee files for bankruptcy. Should the trustee be denied discharge for committing defalcation while acting in a fiduciary capacity? What if the trustee deposits money in a bank which does not advertise itself to be federally insured and this institution

7. See, e.g., *In re Twitchell*, 72 B.R. 431, 434 (Bankr. D. Utah 1987) ("The term 'defalcation' . . . does not have a precise definition and no legislative history or comment exists to aid the interpretation.").

8. Peter M. Reinhardt & William G. Horlbeck, *Defalcation While Acting in a Fiduciary Capacity: What Does it Mean?*, 79 COLO. LAW. 1773, 1773 (1995).

9. *Id.* ("Creditors often prefer to assert the defalcation in a fiduciary capacity exception because the term 'defalcation' has consistently been interpreted to encompass a wider spectrum of conduct . . .").

10. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997); *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996).

11. *Baylis*, 313 F.3d at 17.

goes bankrupt as well? Consider instead, that the trustee invests the money in his own start-up company as a temporary loan, which later fails and as a result the \$100,000 is lost. Finally, imagine the trustee takes the money outright, buys a vacation home, and refuses to refund the trust funds. Courts must examine facts like these, which will be revisited later, and determine in which, if any, of these situations the trustee has committed defalcation that would prevent a discharge under § 523(a)(4).

Adding to the confusion is the tension between the conflicting purposes of the Bankruptcy Code: a fresh start for the “honest but unfortunate debtor”¹² versus repayment to similarly situated creditors.¹³ Those courts that favor a standard requiring a lower level of intent (thereby making discharge more difficult for the debtor while providing easier collection for creditors) agree that the need to hold fiduciaries accountable in their special legal roles outweighs the desire for a fresh start policy.¹⁴ These courts maintain that one who commits a defalcation while in a fiduciary capacity should not be considered an “honest but unfortunate debtor” and that “the requisite ‘badness’ . . . is supplied by an individual’s special legal status with respect to another”¹⁵ On the other hand, the courts that require some sort of wrongful intent on behalf of the debtor hold the fresh start policy in very high regard and strictly construe exceptions in favor of the debtor.¹⁶ These divergent approaches to policy priorities have culminated in the current split among the circuit courts over the question of whether defalcation under § 523(a)(4) requires intent. While the circuit split is of considerable modern-day significance, its origins date back to the earlier part of the 20th century.

The Second Circuit, in the 1937 decision in *Central Hanover Bank & Trust Co. v. Herbst*, first raised the possibility that an innocent default may be all that is required to constitute defalcation by

12. *Grogan v. Garner*, 498 U.S. 279, 287 (1991); Mark S. Summers, *The Exception to Discharge in Bankruptcy for Defalcation by a Fiduciary*, 92 *COM. L.J.* 314, 315 (1987).

13. Summers, *supra* note 12, at 314. Further, the conflict between that fresh start policy and the continually expanding list of exceptions seemingly provides even less optimism for reconciliation between these two policies. Compare 11 U.S.C. § 523(a) (1988) with 11 U.S.C. § 523(a) (2003) (In 1988, there were ten exceptions to discharge; today there are nineteen.).

14. *In re Johnson*, 691 F.2d 249, 256 (6th Cir. 1982).

15. *Id.*

16. *Meyer v. Rigdon*, 36 F.3d 1375, 1385 (7th Cir. 1994) (“[E]xceptions to discharge are strictly construed against the objecting creditor and in favor of the debtor.”) (citation omitted).

suggesting that defalcation *may* include innocent defaults.¹⁷ Since, courts have split on what standard, or level, of intent should be used to determine whether a fiduciary has committed a defalcation pursuant to § 523(a)(4).¹⁸ The camps of interpretation have variously held that an innocent mistake, negligence, or recklessness constitutes defalcation.¹⁹ The Fourth, Eighth, and Ninth Circuits read the open-ended question in *Central Hanover* in its broadest sense so that a minute mistake will make a fiduciary's debts non-dischargeable.²⁰ The Tenth Circuit has rested with the notion that negligence on the part of a fiduciary will constitute defalcation.²¹ Thus, four circuits, the Fourth, Eighth, Ninth, and Tenth, do not require any specific intent or motive on behalf of the debtor.

In contrast, three circuits require intent. The Fifth and Seventh Circuits each require a standard similar to recklessness, that of willful neglect.²² The First Circuit was confronted with this issue for the first time in 2002²³ and held that "defalcation requires some degree of fault, closer to fraud, without the necessity of meeting a strict specific intent requirement."²⁴

This Note examines the issue central to this circuit split: whether defalcation under § 523(a)(4) requires intent on the part of the debtor in order for a debt to be denied discharge. Part I of this Note will give a background of the Bankruptcy Code, a history of the evolution of its envisioned purposes and an introduction to discharge and defalcation. Part II will introduce the principal cases throughout the circuits that have split on this issue. Part III will

17. *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) ("'[D]efalcation,' ordinarily implies some moral dereliction, but in this context it may have included innocent defaults . . ."). *But see infra* note 97 and accompanying text (the wording "in this context" seems to be directed toward the introductory use of "defalcation" which was as a definition rather than as an exception).

18. *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002); *In re Storie*, 216 B.R. 283, 287 (B.A.P. 10th Cir. 1997).

19. *Baylis*, 313 F.3d at 18.

20. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997); *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996).

21. *Storie*, 216 B.R. at 287 followed by *In re Merrill*, 252 B.R. 497, 506 (B.A.P. 10th Cir. 2000). *See also In re Johnson*, 691 F.2d 249, 256 (6th Cir. 1982) (promoting the objective standard which is similar to that of the negligence standard in that the important legal status seemingly eradicates the need for intent or motive on the part of the fiduciary).

22. *Matter of Schwager*, 121 F.3d 177, 185 (5th Cir. 1997); *Meyer v. Rigdon*, 36 F.3d 1375, 1385 (7th Cir. 1994) (each finding that a fiduciary's willful neglect of his duties are not dischargeable).

23. *Baylis*, 313 F.3d at 16.

24. *Id.* at 18-19.

present an analysis of § 523(a)(4), a discussion of defalcation, and a determination of whether any level of intent is required for defalcation under § 523(a)(4). This Note will conclude with a recommendation that a standard of intent similar to willful neglect should be used to determine whether a fiduciary has committed defalcation.

I. BACKGROUND

This section will begin with an overview of bankruptcy's emergence into American law and the changes that took place in its conversion from English law. Continuing on this theme, the section will examine the view in American bankruptcy law that honest debtors should be afforded a fresh start and therefore be granted a discharge from their debts. Next, exceptions to this discharge of debt will be discussed, as well as the policies that underlie such exceptions and the contradictions between these policies and the fresh start policy. A discussion of the exception for "defalcation while acting in a fiduciary capacity" will follow with an emphasis on its ambiguity.

A. *History of the Bankruptcy Code and Discharge*

The origins of American bankruptcy law are traced to English bankruptcy law,²⁵ the purpose of which was to promote commerce by providing a means of collection for creditors.²⁶ Since only the creditor could bring a charge of bankruptcy against a debtor, bankruptcy was involuntarily thrust upon the debtor.²⁷ In early English bankruptcy law, the debtor received little mercy and severe punishment, often by imprisonment²⁸ and occasionally even death,²⁹ for failure to pay his creditors. The type of debt or the intent of the debtor was of no concern, only that the debt to the creditor remained outstanding.³⁰

The Constitution granted Congress the power to legislate on

25. Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 7 (1995) [hereinafter *The History of the Bankruptcy Laws*].

26. Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 327 (1991) [hereinafter *Evolution of the Bankruptcy Discharge*].

27. *Id.* at 330.

28. *Id.* Bankruptcy was "quasi-criminal in nature." See also *id.* at 329 (articulating that English law's first bankruptcy law, 34 & 35 Hen. 8, c. 4 (1542), was more of a criminal statute).

29. *Id.* at 337.

30. *Id.* at 330-31.

the subject of bankruptcy.³¹ Though the congressional power to legislate in this area was established early on, the body of legislation that has come to form bankruptcy law today developed slowly. In the beginnings of American bankruptcy law, federal statutes were sporadic³² and states freely enacted their own legislations³³ that varied in severity.³⁴ From 1800 to 1803, federal bankruptcy law greatly resembled early English law and provided a low threshold for discharge of a merchant's debt, but did not provide a remedy for individual debtors.³⁵ Though discharge was, in general, readily provided, the fraudulent debtor merchant was still subject to criminal punishment.³⁶

The temporary legislation enacted in 1841³⁷ introduced the revolutionary idea of voluntary bankruptcy for not only merchants, but also individual debtors.³⁸ For the first time, an individual could use bankruptcy as a remedy to cure debt. The later Bankruptcy Act of 1867 maintained the availability of voluntary bankruptcy and in addition, it allowed corporations to apply for voluntary discharge.³⁹ Though the 1867 Act, like those before it, addressed a need for federal bankruptcy laws (since state laws could not reach nonresident debtors),⁴⁰ congressional power to develop bankruptcy laws was not fully exercised until more lasting federal legislation went into

31. U.S. CONST. art. I, § 8, cl. 4. In 1787, the Constitution empowered Congress to pass "uniform Laws on the subject of Bankruptcies." *Id.*

32. *The History of the Bankruptcy Laws*, *supra* note 25, at 13-14 (federal statutes existed temporarily from 1800-1803, 1841-1843, and 1867-1878 with each following a "major financial disaster").

33. *Id.* at 12-13.

34. *Id.* at 13 (stating that varying state bankruptcy laws made interstate commerce difficult and unpredictable).

35. *Id.* at 17. *See Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) ("Under the Act of 1800, 2 Stat. 19, 30 (Section 34), a discharge relieved bankrupts of all their debts without exception, provided they conducted themselves properly; but the statute applied only to those engaged in commerce and was confined to involuntary bankruptcies.").

36. *Evolution of the Bankruptcy Discharge*, *supra* note 26, at 336; *see also The History of the Bankruptcy Laws*, *supra* note 25, at 14 (debtors were not subject to death as under English bankruptcy law).

37. An Act to Establish a Uniform System of Bankruptcy throughout the United States, Ch. 9, 5 Stat. 440, 441 (1841) (repealed 1843).

38. *The History of the Bankruptcy Laws*, *supra* note 25, at 17.

39. Ch. 176, 14 Stat. 517 (1867), *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99 (1878). *See The History of the Bankruptcy Laws*, *supra* note 25, at 19-21 (the 1867 Act also established the modern court system of bankruptcy giving district courts original jurisdiction as bankruptcy courts).

40. *The History of the Bankruptcy Laws*, *supra* note 25, at 19.

effect in 1898.⁴¹ This legislation gave birth to “the modern era of liberal debtor treatment in United States bankruptcy laws”⁴² marked by a limited number of exceptions to discharge.⁴³ The Bankruptcy Code of 1898 firmly planted itself into American law and continued until the Bankruptcy Reform Act of 1978,⁴⁴ which has since been subject to a number of amendments.⁴⁵ American bankruptcy law has thus evolved over time from its pro-creditor stance, which criminalized debtors, into its modern day pro-debtor rationale.⁴⁶

B. *A Fresh Start for Honest Debtors*

With the arrival of the modern era of bankruptcy came the novel idea that the “honest but unfortunate debtor” should be afforded a “fresh start” through the discharge of his debt, which would, in turn, benefit both the debtor, by relieving him of his oppressive debt, and society, by allowing the debtor to become productive once freed from this debt.⁴⁷ The Bankruptcy Code allows

41. An Act to Establish a Uniform System of Bankruptcy Throughout the United States, Ch. 541, 30 Stat. 544 (1898) (repealed 1979); *The History of the Bankruptcy Laws*, *supra* note 25, at 13-14 (Prior to the 1898 legislation, federal bankruptcy laws were in existence from 1800 to 1803 (a reprise of the old English bankruptcy model), from 1841 to 1843 (broke new ground introducing voluntary bankruptcy) and again from 1867 to 1878. From 1867 to 1878, corporations as well as individuals were allowed to take advantage of bankruptcy laws.).

42. *The History of the Bankruptcy Laws*, *supra* note 25, at 24.

43. *See id.* at 24 n.153 (citing ch. 541, § 14, 30 Stat. at 550 (discharge granted unless debtor commits crime or fraudulently conceals financial condition)). *See also id.* at 19-20 (explaining how the 1898 law followed the 1878 repeal of the 1867 law, which laid down so many exceptions for discharge that only one-third of debtors actually received discharge).

44. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

45. *The History of the Bankruptcy Laws*, *supra* note 25, at 32. *See also* S. REP. NO. 521-32 (1976) (“widely regarded as a debtor’s bill”).

46. *Evolution of the Bankruptcy Discharge*, *supra* note 26, at 364.

47. *Id.* at 364-65. This was also thought to be a more humane view than previously taken by the English model of bankruptcy. *See id.* at 364.

Under this bill no assent is required from the creditors. If the debtor has acted dishonestly by committing certain acts forbidden in the bill he will not be discharged; if he has acted honestly he will be. The granting of a discharge is justified by a wise public policy. The granting or withholding of it is dependent upon the honesty of the man, not upon the value of his estate.

Id. *See also* *Perez v. Campbell*, 402 U.S. 637, 660 (1971) (“[O]ne of the purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh. . . .’”) (quoting *Williams v. United States Fidelity & Guaranty Co.*, 236 U.S. 549, 554-55 (1915)); Bankruptcy Abuse Prevention & Consumer Protection Act of 2001, H.R. REP. NO. 107-3(I), at 6 (2001).

for a “fresh start” either through a liquidation or reorganization.⁴⁸ Through liquidation, the debtor surrenders his or her property, unless it is exempted, which is then liquidated and distributed amongst his or her creditors.⁴⁹ Under reorganization, the debtor must follow an approved, structured plan to reorganize his or her finances.⁵⁰

Through either liquidation or reorganization, the major goal for the debtor is to be discharged of his or her provable debts⁵¹ and freed from personal liability following the bankruptcy proceedings.⁵² The fresh start that allows debtors to be relieved of their debts and collection by creditors is, however, to be made available only to honest debtors.⁵³ The Supreme Court has repeatedly stated that the purpose of bankruptcy is to “relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh”⁵⁴ However, the current list of exceptions to discharge

48. 1 NORTON BANKRUPTCY LAW & PRACTICE 2D § 3:10 (2003).

49. *Id.*

50. *Id.* A debtor may file for liquidation under Chapter 7 (liquidation) of the Bankruptcy Code while reorganization, and payment through installments, is granted to the debtor under Chapters 11 and 13 (reorganization). See Bradley Kendall Mahanay, *An Analysis of the Matter of Bennett and Its Effect on Non-Dischargeability of Debt for Defalcation While Acting in a Fiduciary Capacity*, 46 BAYLOR L. REV. 281, 283 (1994) (Chapter 7 allows for discharge unless it is protested by a creditor, Chapter 11 provides discharge to non-individual debtors after a plan is approved, and Chapter 13 grants discharge after payments on the plan are concluded). See also Karen Gross, *Preserving a Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59, 62-63 n.10 (1986) (explaining various remedies to bankruptcy).

51. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 331 (1934) (“The effect of a discharge in bankruptcy is to ‘release a bankrupt from all of his provable debts,’ with excepted liabilities enumerated in the statute.”) (citing Bankruptcy Act § 17 (1867), 11 U.S.C. § 35 (1898)).

52. See 3 NORTON BANKRUPTCY LAW & PRACTICE 2D § 48:1, 48:2, 48:3 (2003) (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) for the proposition that one of the main purposes of bankruptcy is to provide a manner in which a debtor can be freed from his creditors and enjoy “a new opportunity in life”) [hereinafter 3 NORTON BANKRUPTCY LAW]. Cf. Charles G. Hallinan, *The “Fresh Start” Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 54 (1986) (stating that the fresh start “was originally conceived not as a relief measure but as a reward for the debtor’s efforts to maximize the return to his creditors”).

53. *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502, 514 (1938) (“The development of bankruptcy legislation has been towards relieving the honest debtor from oppressive indebtedness and permitting him to start afresh.”).

54. *Williams v. U.S. Fidelity & Guaranty Co.*, 236 U.S. 549, 554-55 (1915). See, e.g., *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991) (“But in the same breath that we have invoked this ‘fresh start’ policy, we have been careful to explain that the Act limits the opportunity for a completely unencumbered new beginning to the ‘honest but unfortunate debtor.’”) (citation omitted). See also H.R. REP. NO. 523-14 (1977) (explaining “there is a Federal interest in seeing that a debtor that goes through bankruptcy comes out with adequate possessions to begin his fresh start”).

is long, nineteen to be exact, and not all are based on debtors who commit intentionally dishonest acts, such as fraud.⁵⁵ Others are related to general policy categories, such as payment of alimony.⁵⁶

C. *Exceptions to Discharge and Balancing Bankruptcy Policies*

The Bankruptcy Code⁵⁷ may deny a debtor discharge entirely or may deny discharge on only a particular debt.⁵⁸ Today, the Bankruptcy Code may deny discharge of nineteen categories of debt.⁵⁹ Provisions like 11 U.S.C. § 523(a) “create exceptions only in situations where fairness to the parties warrants a deviation from accepted bankruptcy policies,”⁶⁰ meaning that in certain circumstances the primary policy of a fresh start for the honest debtor is outweighed either by the importance of the debt or a societal goal.⁶¹ These exceptions to discharge exist either because forgiveness of a certain type of debt (“type-based” exceptions), such as child support payments, would impede a social policy, or because

55. 11 U.S.C. § 523(a)(2) (2003).

56. § 523(a)(5); *Grogan*, 498 U.S. at 287.

57. *The History of the Bankruptcy Laws*, *supra* note 25, at 32 n.232 (noting the Bankruptcy Reform Act of 1978 is often called “The Act” or “The Code”).

58. Radwan, *supra* note 2, at 988 n.6 (11 U.S.C. §§ 727(a), 727(d), 1141(d)(3), 1228(b), 1228(d), 1328(b), and 1328(e) deny discharge completely and 11 U.S.C. §§ 523(a), 1222(b), and 1322(b) deny specific debts from discharge).

59. § 523(a) (discharge will be denied for (1) debts for tax or customs duty; (2) for money or property obtained fraudulently; (3) not listed at the time of filing for bankruptcy; (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny; (5) for alimony or child support; (6) for willful and malicious injury by the debtor to another entity or to the property of another entity; (7) for fines or penalties payable to the government; (8) for educational loan; (9) for death or personal injury caused by driving while intoxicated; (10) for debts previously waived in a bankruptcy proceeding; (11) arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union; (12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution; (13) for any payment of an order of restitution issued under U.S.C. title 18; (14) incurred to pay a nondischargeable tax; (15) incurred by a separation agreement; (16) for condominium fees; (17) for court fees; (18) owed under state law or to a municipality; (19) for violation of securities law).

60. Radwan, *supra* note 2, at 993-94. *See also id.* at 994 n.22 (quoting George H. Singer, *Section 523 of the Bankruptcy Code: The Fundamentals of Nondischargeability in Consumer Bankruptcy*, 71 AM. BANKR. L.J. 325, 326 (1997)) (“The exceptions from discharge are set forth at § 523 of the Bankruptcy Code and are essentially the product of countervailing policy considerations in which the scales of justice tip in favor of certain creditors by allowing enumerated categories of obligations to remain virtually unscathed by the bankruptcy discharge.”).

61. Radwan, *supra* note 2, at 1000 (stating that the two purposes of the exceptions of 523 are “prevention of improper behavior by debtors and repayment of important debts”).

the debt resulted from some immoral or dishonest act committed by the debtor ("fault-based" exceptions),⁶² such as fraudulently filed tax returns.⁶³ These § 523(a) exceptions deny discharge from debts that would "violate the bankruptcy objective" if a discharge were granted.⁶⁴

Bankruptcy law does not afford discharge that would not promote the primary objective of granting a fresh start to the honest debtor.⁶⁵ Thus, debts arising out of fraud,⁶⁶ from the debtor's "willful and malicious" injury of person or property,⁶⁷ and from personal injury and wrongful death claims based on the debtor's drunk driving are not dischargeable.⁶⁸ Bankruptcy law also denies discharge to a debtor who has evaded an important social financial obligation⁶⁹ such as taxes,⁷⁰ a divorce settlement,⁷¹ child support or ali-

62. See *In re Baylis*, 313 F.3d 9, 19 (1st Cir. 2002) ("The other large category of bankruptcy exceptions [aside from type-based exceptions] relies on fault.").

63. *Id.* at 18-19. The *Baylis* court suggests that type-based exceptions include debts for: taxes or customs duties, § 523(a)(1), or debts incurred to pay tax, § 523(a)(14); alimony and child support payments, § 523(a)(5); fines, penalties or forfeitures to the government, § 523(a)(7); educational loans made or insured by the government or a nonprofit institution, § 523(a)(8); orders of restitution, § 523(a)(13); court fees, § 523(a)(17); and support owed under state law and enforceable under the Social Security Act, § 523(a)(18).

Id. at 19 (internal citations omitted). On the other hand, fault-based exceptions include debts for "money, goods or services obtained by fraud or falsehood, § 523(a)(2); willful and malicious injury, § 523(a)(6); death or injury caused by driving under the influence of alcohol or drugs, § 523(a)(9)" *Id.*

64. A narrow set of specified types of claims, however, are 'nondischargeable' in bankruptcy, which means that they remain owing to the creditor to the full extent unpaid. These are claims for which discharge would violate the bankruptcy objective of giving a fresh start only to honest debtors (such as claims relating to fraud, or claims for criminal restitution obligations to victims) or which are considered to be of paramount societal importance (such as tax obligations, and alimony and child support).

Radwan, *supra* note 2, at 1000 (quoting H.R. REP. NO. 102-1085, at 50-51 (1992); H.R. REP. NO. 103-835, at 3341-42 (1994)); cf. Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. REP. NO. 107-3 pt. 1, at 459 (2001); Bankruptcy Reform Act of 1999, H.R. REP. NO. 106-123, pt. 1, at 387 (1999) ("The Bankruptcy Code does not permit the discharge of certain debts whose payments are considered to be important to society. [Such debts include those] incurred through the debtor's misconduct, such as debts arising from fraud and intentional injuries.").

65. Radwan, *supra* note 2, at 1000.

66. 11 U.S.C. § 523(a)(2) (2004).

67. § 523(a)(6).

68. § 523(a)(9); see Lawrence Kalevitch, *Cheers? The Drunk-Driving Exception to Discharge*, 63 AM. BANKR. L.J. 213, 217 (1989) (explaining that the reforms of 1978 require that exceptions for fraud (§ 523(a)(2)), fraud or defalcation while acting in a fiduciary capacity (§ 523(a)(4)), and willful and malicious injury (§ 523(a)(6)) must be adjudicated by the courts before an exception to discharge will be implemented).

69. Radwan, *supra* note 2, at 1000.

mony,⁷² or an educational benefit or loan.⁷³ Therefore, exceptions are designed either to promote the fresh start policy for “honest debtors,” by deterring people from acting dishonestly, or to protect the interest of the creditor, by assuring that certain debts of importance, as dictated by Congress, remain an obligation of the debtor.⁷⁴

D. *Confusion Surrounding the Defalcation Exception*

The exception to discharge for “defalcation while acting in a fiduciary capacity” does not so clearly fit into one of the two categories of type-based debt, for which fault on behalf of the debtor is not required, or fault-based debt, for which fault is required.⁷⁵ If fault is required, then a fiduciary debtor committing defalcation must have some sort of intent to do so.⁷⁶ On the contrary, if the defalcation exception exists to promote the societal goal of ensuring that the special legal status of a fiduciary is held to the highest standards, then no intent would be required on behalf of the debtor.⁷⁷ Much of the uncertainty surrounding this exception stems from the fact that the Bankruptcy Code fails to provide definitions of “defalcation” and “fiduciary” and further because legislative history sheds little light on the terms.⁷⁸

To prove that a defalcation exception under § 523(a)(4) ap-

70. § 523(a)(1).

71. § 523(a)(15).

72. § 523(a)(5).

73. § 523(a)(8).

74. H.R. REP. NO. 102-1085, at 50-1 (1992):

The first [objective of bankruptcy law] is to give honest debtors who have fallen on hard times the opportunity for a fresh start in life, after they have made a good-faith attempt to pay what they can . . . [t]he second objective of the bankruptcy system is to protect creditors in general by preventing an insolvent debtor from selectively paying off the claims of certain favored creditors at the expense of others.

Id.

75. § 523(a)(4). See *In re Baylis*, 313 F.3d 9, 19 (1st Cir. 2002) (“[M]ost of the exceptions to discharge in bankruptcy are in place for one of two basic reasons[,] . . . policy . . . [and] type of debt . . .”).

76. *Baylis*, 313 F.3d at 18-19.

77. 3 NORTON BANKRUPTCY LAW, *supra* note 52, at § 47:29 (“The ‘badness’ related to defalcation by a fiduciary is supplied ‘by an individual’s special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching these duties.’”) (citation omitted).

78. *In re Storie*, 216 B.R. 283, 286 (B.A.P. 10th Cir. 1997); *In re Twitchell*, 72 B.R. 431, 434 (Bankr. D. Utah 1987). See also Radwan, *supra* note 2, at 1029 (citing to Sheet Metal Workers Int’l Assoc. v. Carter, 450 U.S. 949, 952 (1981)) (“When that statute is not entirely clear, however, legislative history may be used to aid in determining the true interpretation of the statute.”).

plies, the creditor must first prove that the debtor was a fiduciary and then, establish that defalcation has occurred while the debtor was acting in that fiduciary capacity.⁷⁹ Initially, the courts had difficulty in determining when a debtor was acting in a “fiduciary capacity”⁸⁰ because, like the term “defalcation,” the Bankruptcy Code lacks a definition.⁸¹ In 1934, the Supreme Court solved half of this problem when it determined that unlike the term fiduciary by itself, which generally means a relationship of trust, acting in a “fiduciary capacity” requires the formation of a relationship in which a person entrusts his or her property to the care of another.⁸² Since the Supreme Court decision of *Chapman v. Forsyth*, “fiduciary capacity” is to be read strictly to constitute express trusts, meaning “special” or “technical” trusts, rather “than implied” trusts created by the debtor’s conduct.⁸³ Therefore “fiduciary capacity” is limited to relationships such as those of an attorney-client, managing partner-partner, or corporate office-corporation, where an express trust is created.⁸⁴ Further, the trust relationship must exist prior to any

79. Leah A. Kahl & Peter C. Ismay, *Exceptions to Discharge for Fraud or Defalcation While Acting in a Fiduciary Capacity*, 7 J. BANKR. L. & PRACT. 119, 120 (1998). See also Mahanay, *supra* note 50, at 284 (citing to *In re Bennett*, 989 F.2d 779, 784 (5th Cir. 1993) for the proposition that the court must first find a trust obligation that rises to the level of a fiduciary relationship and must then determine if a defalcation was committed).

80. Kahl & Ismay, *supra* note 79, at 120.

81. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934). See also Kahl & Ismay, *supra* note 79, at 120 (“The Code does not define ‘fiduciary capacity’ . . .”).

82. *Davis*, 293 U.S. at 332 (interpreting the term “fiduciary capacity” as stated in § 17(a)(4) of the Bankruptcy Act, now § 523(a)(4) of the Bankruptcy Code). See also Summers, *supra* note 12, at 316 (citing *In re Interstate Agency, Inc.*, 760 F.2d 121, 124 (6th Cir. 1985)) (state law determines whether the trust is express and therefore can be subject to § 523(a)(4) (§ 17(a)(4) at the time this case was decided). See also *Bennett*, 989 F.2d at 784 (5th Cir. 1993) (“The scope of the concept of fiduciary under [§ 523(a)(4)] is a question of federal law; however, state law is important in determining whether or not a trust obligation exists.”).

83. *Chapman v. Forsyth*, 43 U.S. (2 How.) 202, 208 (1844), cited by *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937). See also Kahl & Ismay, *supra* note 79, at 120 (an express trust is one which is marked by clear language and intent to create a trust relationship). But see *In re Hayes*, 183 F.3d 162, 168 (2d Cir. 1999) (“[N]umerous cases have applied the defalcation exception to debts owed by corporate officers, notwithstanding the absence of any express trust.”).

84. Kahl & Ismay, *supra* note 79, at 122-23 (distinguishing ordinary commercial relationships or personal/familial relationships that do not constitute a fiduciary capacity under § 523(a)(4)). See *id.* for a discussion of types of fiduciary relationships that may be affected by § 523(a)(4). See also Janet A. Flaccus, *Attorney Malpractice Judgments, Bankruptcy Discharge and Professional Responsibility*, 4 J. BANKR. L. & PRACT. 219, 223 (1995). Many cases involving a contractor who is required to pay his material-man have found that the contractor is acting in a fiduciary capacity because the statutes

wrongdoing.⁸⁵

Under the present construction of § 523(a)(4), the term “fiduciary” is read narrowly, to include only express trusts. This, coupled with a broad reading of “defalcation,” is not easily “reconciled with the concept of a fresh start for the ‘honest but unfortunate’ debtor”⁸⁶ because it presents a lower threshold of proof for a creditor than any of the other exceptions for discharge.⁸⁷ With such a construction, once evidence of the existence of an express trust is shown the creditor needs to prove only that the debtor had an obligation to the trust which was not met in order to find the debtor guilty of a defalcation while acting in a fiduciary capacity.⁸⁸

Similarly, Congress has given no evidence of its intentions in using the word defalcation in the context of exceptions to discharge and, as a result, courts have been in disagreement as to how the word should be interpreted.⁸⁹ Some definitions of defalcation accepted by the courts include: “the failure to meet an obligation” or a “nonfraudulent default,”⁹⁰ embezzlement,⁹¹ “misappropriation of

regarding this relationship determined which beneficiaries were to be paid first. *Id.* (citing *Carlisle Cashway Inc. v. Johnson*, 691 F.2d 249, 251-54 (6th Cir. 1982)).

85. *Bennett*, 989 F.2d at 784 (citing *Upshur v. Brisco*, 138 U.S. 365, 378 (1890)). *See also Davis*, 293 U.S. at 333 (adding the criteria that these special trust must be created prior to the alleged fraud or defalcation and stating the trust must exist prior to the circumstances leading to bankruptcy).

86. 3 NORTON BANKRUPTCY LAW, *supra* note 52, at § 47:29. The narrow reach of fiduciary could therefore preclude some deviant acts that simply did not fall under the express trust category while honest debtors making innocent mistakes could be held to have committed defalcation if they are entrusted to an express trust when making the unfortunate mistake. *Id.*

87. *Kahl & Ismay*, *supra* note 79, at 136.

88. *Id.* A fiduciary can be charged with defalcation if there is a decrease in funds and can also be charged with defalcation for inappropriately using funds, since a fiduciary is charged with knowledge of the law and his obligations to the trust. *Id.*

89. *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002). *See also Flaccus*, *supra* note 84, at 229-30; *In re Janikowski*, 60 B.R. 784, 789-90 (N.D. Ill. 1986) (suggesting that defalcation may be applied to property, perhaps even a cause of action, as well as funds). Thus another question, which will not be answered by this Note, is to which type(s) of property should defalcation be applied?

90. *See In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (citing BLACK'S LAW DICTIONARY 427 (7th ed. 1999)) (defining “defalcation”). *But see A DICTIONARY OF MODERN AMERICAN USAGE* (B. Garner ed. 1998), *cited by Baylis*, 313 F.3d at 18 n.4 (“[S]ome writers have misused defalcation when referring to a non-fraudulent default.”).

91. *See Baylis*, 313 F.3d at 17 (citing BLACK'S LAW DICTIONARY 427 (7th ed. 1999)) (defining “defalcation”). This edition of *Black's* also uses defalcation as a synonym for embezzlement (meaning, according to this edition of *Black's*, “[t]he fraudulent taking of personal property with which one has been entrusted, esp[ecially] as a fiduciary”).

trust funds or money held in a fiduciary capacity; [the] failure to properly account for such funds,”⁹² or “the embezzlement, misappropriation of trust funds held in a fiduciary capacity, and failure to properly account for trust funds.”⁹³ When the term defalcation is used outside of the § 523(a)(4) exception, it is usually to show that fiduciaries breached their duty; most often in association with accounting for funds entrusted to them.⁹⁴

In 1937, the Second Circuit stated in *Central Hanover* that “‘defalcation,’ ordinarily implies some moral dereliction. . . .”⁹⁵ This was the first case to map out thoroughly the history of the term in bankruptcy legislation⁹⁶ and was the first to question (but leave unanswered) whether an act of defalcation requires specific intent.⁹⁷ In tracing the history of the term, Judge Learned Hand noted that “defalcation” was first used in the Bankruptcy Act of 1841, not as an exception to discharge, but as part of a definition for those who would be eligible for voluntary bankruptcy.⁹⁸ In 1867, the term was used as one of the original exceptions to discharge, that of “defalcation as a public officer, or while acting in any fiduciary character.”⁹⁹ Searching for the original meaning of the term,

92. *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997).

93. *In re Friedman*, 298 B.R. 487, 503 (Bankr. D.Mass. 2003).

94. *See, e.g., Pac. Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 13 (1991) (where a licensed insurance agent committed defalcations in misappropriating payments for life insurance premiums when the policies had expired); *U.S. v. Porter*, 90 F.3d 64, 70 (2d Cir. 1996) (where an employee of financial brokerage firms committed defalcations in misdirecting customers’ funds to her own banking account).

95. *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937).

96. *In re Storie*, 216 B.R. 283, 288 (B.A.P. 9th Cir. 1997).

97. *Hanover*, 93 F.2d at 511 (“[D]efalcation,’ 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.”) (emphasis added). Also note the use of “in this context” seems to suggest that the use of defalcation as part of a definition, its original use in the Bankruptcy Code, rather than as an exception, “may have included innocent defaults.”

98. *Id.* Defalcation first appears in 5 Stat. 440 § 1:

All persons whatsoever, residing in any state, district or territory of the United States, owing debts, which shall not have been created in consequence of defalcation as a public officer, or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity, who shall by petition . . . apply to this proper court . . . shall be deemed bankrupts within the purview of this act.

An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 9, 4 Stat. 440, 441 (1841) (repealed 1843)).

99. *Hanover*, 93 F.2d at 511 (citing section 33 of the Act of 1867). *See also supra* note 43 and accompanying text (stating the 1867 law was repealed because it laid down so many exceptions for discharge that only one-third of debtors actually received discharge).

the court posited that “defalcation” must not mean “fraud or embezzlement,” since the terms were juxtaposed in the Act of 1867, and therefore defalcation “must here have covered defaults other than deliberate malversions. . . .”¹⁰⁰ Since *Central Hanover*, the circuit courts have disagreed on whether a debtor must have intent to constitute defalcation.¹⁰¹

E. *The Circuit Split*

Although *Central Hanover* began the discussion and proposed some possible considerations as to the meaning of defalcation, the court held only that “when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a ‘defalcation’ though it may not be a ‘fraud,’ or an ‘embezzlement,’ or perhaps not even a ‘misappropriation.’”¹⁰² The court did not conclude whether any level of *mens rea* was required to constitute defalcation. However, Judge Learned Hand’s opinion provoked controversy by stating: “defalcation . . . may have included innocent defaults”¹⁰³ Relying on this dictum as precedent, some circuits have ruled that even innocent mistakes made by a fiduciary could cause a particular debt to be excepted from discharge.¹⁰⁴ Others have held that a standard of negligence is required for a defalcation exception.¹⁰⁵ Still other circuits have held that a “willful neglect of duty” or “recklessness” standard must be

100. *Hanover*, 93 F.2d at 511; *The History of the Bankruptcy Laws*, *supra* note 25, at 19-20. See An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 176, 14 Stat. 517, 533 (1867) (codified in Title LXI Rev. Stat. § 5117 (1878) (repealed 1878)) (“No debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged under this act.”).

101. *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002) (recognizing that *Hanover’s* suggestion that a defalcation may exist where a fiduciary commits an innocent mistake has caused differing camps of interpretations to spring up among the courts).

102. *Hanover*, 93 F.2d at 512.

103. *Id.* at 511.

104. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (“[N]egligence or even an innocent mistake which results in misappropriation or failure to account is sufficient [for defalcation].”); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997) (“[D]efalcation ‘includes the innocent default of a fiduciary who fails to account fully for money received.’”) (citing *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996)); *Lewis*, 97 F.3d at 1186 (“‘[D]efalcation’ includes innocent, as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts.”) (quoting *In re Baird*, 114 B.R. 198, 204 (B.A.P. 9th Cir. 1990)).

105. *In re Storie*, 216 B.R. 283, 287 (B.A.P. 10th Cir. 1997) (reasoning that negligence would be appropriate since “a fiduciary [should] be charged with knowledge of his . . . duties and of the law . . .”) (citing *In re Johnson*, 691 F.2d 249, 257 (6th Cir. 1982)). See generally *Hoff v. Carroll*, 140 B.R. 313 (Bankr. D. Mass. 1992).

adopted to establish whether defalcation by a fiduciary occurred.¹⁰⁶

II. STATEMENT OF THE CASES

Throughout the circuits, courts that have addressed the issue of whether intent is necessary for defalcation have done so against a background of vastly different factual circumstances. This section will explore those facts and the resulting decisions of the courts by beginning with the introductory case of *Central Hanover*. Next, this section will discuss *In re Johnson* which took an objective approach and held that specific intent is not required. A discussion of those cases which have held negligence or innocent mistake is required will follow. This section will conclude with a discussion of cases that determined some type of intent is required on behalf of the debtor to deny discharge for defalcation.

A. *Initiating the Discussion in Central Hanover*

As mentioned above, *Central Hanover* was the case that first asked what standard must be met for a debtor acting in a fiduciary capacity to be denied discharge under then 35 U.S.C. § 17(a)(4) of the Bankruptcy Act, today's 11 U.S.C. § 523(a)(4).¹⁰⁷ In a foreclosure proceeding, the New York Supreme Court appointed a dentist, Herbst, as receiver of the land subject to foreclosure and, as a receiver, acted in a fiduciary capacity.¹⁰⁸ Upon sale of the land, Herbst applied to the court and received fees for his work as receiver, which he either knew or should have known he would be forced to return if the plaintiff was successful on appeal.¹⁰⁹ Before the appeal was entered, Herbst spent the money in question.¹¹⁰ On appeal, the New York Court of Appeals instructed him to return the money that he had already spent.

Herbst then filed for bankruptcy seeking discharge of this debt.¹¹¹ Herbst was adjudicated a voluntary bankrupt. The district court, however, determined that this particular debt could not be discharged because his actions constituted "fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any

106. Matter of Schwager, 121 F.3d 177, 185 (5th Cir. 1997); *In re Meyer*, 36 F.3d 1375, 1384 (7th Cir. 1994).

107. *Hanover*, 93 F.2d at 511.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

fiduciary capacity.”¹¹² The Second Circuit took up the case, and having determined that Herbst was acting in a fiduciary capacity when he spent the money entrusted to his care, dealt only with whether the act was defalcation.¹¹³ The court reasoned that Herbst’s debt was non-dischargeable because it was taken upon conditional authority, which Herbst, as a fiduciary, should have known at the time would prohibit him from spending the money.¹¹⁴ Under these factual circumstances, the Second Circuit determined that the debtor, who “had not been entirely innocent,” would not be allowed to discharge the debt because his actions constituted defalcation.¹¹⁵ The court asked, but did not answer, if there were other instances in which an innocent mistake on the part of a fiduciary could satisfy the exception for defalcation.¹¹⁶

Since this question was initially posed in *Central Hanover*, courts have struggled to determine whether an innocent mistake is all that is required to satisfy “defalcation while acting in a fiduciary capacity.”¹¹⁷ Some courts have answered this question affirmatively. Others have not.

B. *View of the Defalcation Exception as a Type-Based Debt*

This section will focus on decisions that have interpreted § 523(a)(4) as a type-based debt exception.¹¹⁸ It will begin with a look at the *In re Johnson*¹¹⁹ decision, which determined an objective approach requiring no intent is appropriate. It will then discuss cases determining that negligence or an innocent mistake will constitute a defalcation.

112. *In re Herbst*, 22 F. Supp. 353, 354 (S.D.N.Y. 1937). *See also* 35 U.S.C. § 17(a)(4) (repealed 1979).

113. *Hanover*, 93 F.2d at 511.

114. *Id.*

115. *Id.* at 512 (indicating that some misconduct must be inferred from Herbst’s actions, since he should have known that the funds were subject to return, but also noted that a deficiency in funds alone might be defalcation). *See* Flaccus, *supra* note 84, at 231. *See also In re Hayes*, 183 F.3d 162, 172 (2d Cir. 1999) (assuming, as did the court in *Hanover*, that “defalcation demands ‘some portion of misconduct’” and holding that the attorney/executor of Andy Warhol’s estate committed a defalcation in basing his fees for legal services on an invalid retainer agreement).

116. *Hanover*, 93 F.2d at 512.

117. *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002).

118. *See Radwan, supra* note 2, at 993-94 (such exceptions to the fresh start policy and discharge will only be created “in situations where fairness to the parties warrants a deviation from [these] accepted bankruptcy policies”).

119. *In re Johnson*, 691 F.2d 249 (6th Cir. 1982), *questioned by In re Little*, 163 B.R. 497 (Bkrcty. E.D. Mich. 1994).

1. No Intent Required

The Sixth Circuit case of *In re Johnson*¹²⁰ followed the lead of previous decisions¹²¹ to determine that an objective standard should be used to establish whether a contractor had committed a defalcation subject to § 523(a)(4) by failing to pay his material suppliers in violation of a Michigan statute.¹²² The *Central Hanover* court's statement that "defalcations were not limited to deliberate malversions" was interpreted by the *In re Johnson* court to mean that no intent is required for a fiduciary to commit a defalcation and be denied discharge of the debt.¹²³ This conclusion was backed by the policy consideration that the bankrupt is charged with knowledge of the law.¹²⁴ Charging such knowledge of the law, the court's reasoning is in line with the fresh start policy since it does not weigh the intent or motive of the debtor.¹²⁵ Unlike other exceptions of the Bankruptcy Code, where the language clearly re-

120. *Id.* See *In re Storie*, 216 B.R. 283, 288 (B.A.P. 10th Cir. 1997) (using similar analysis with similar factual circumstances to conclude that "[d]efalcation . . . is . . . failure to account for funds . . . whether intentional, willful, reckless, or negligent"); *Little*, 163 B.R. at 499 (agreeing with *In re Johnson* that intent is not required for defalcation, but arguing that, to the extent that *In re Johnson* ruled that federal law alone brought a cause of action for defalcation, it is overruled, since state law determines the nature of the trust).

121. See *Carey Lumber Co. v. Bell*, 615 F.2d 370, 376 (5th Cir. 1980); *Matter of Kawczynski*, 442 F. Supp. 413, 418 (W.D.N.Y. 1977); *Matter of Polidoro*, 12 B.R. 867, 870 (E.D.N.Y. 1981).

122. *Johnson*, 691 F.2d at 252. The Michigan Building Contract Fund Act created a trust by statute between a contractor and subcontractors (trustee) and also imposed a duty on the contractor to pay the subcontractors prior to making any other purchases or payments with such funds. *Id.* The Act also provided that a contractor would be guilty of a felony if he intentionally used such funds for any other purpose. *Id.* See also *Turner v. Ward*, 154 U.S. 618 (1876); *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960) (articulating that state law determines the nature of the trust).

123. *Johnson*, 691 F.2d at 254-55. While the language in the case suggests that a mistake would constitute defalcation, because no intent is required, the court makes the clarifying statement that "[w]e hold that the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers . . . first is sufficient to constitute a defalcation under section 17(a)(4) so long as the use was not the result of mere negligence or a mistake of fact . . ." *Id.* at 257. See also *Flaccus*, *supra* note 84, at 231-32 (suggesting that this language may indicate that "the act must be intentional but the motive is irrelevant").

124. *Johnson*, 691 F.2d at 257 (arguing that the objective standard would prevent fiduciaries from using ignorance of the law as an excuse). See also *id.* at 255-56 ("An objective standard for finding a defalcation, that does charge a bankrupt with knowledge of the law and that does not weigh intent or motive, is consistent with the policy behind the bankruptcy laws of giving an honest debtor the opportunity for economic rehabilitation.") (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 234 (1934)).

125. *Johnson*, 691 F.2d at 255-56.

quires unscrupulous conduct,¹²⁶ such “badness” or dishonesty (or fault) is inferred in 11 U.S.C. § 523(a)(4) from the debtor’s failure to conform with the requirements of the fiduciary’s special legal status.¹²⁷ The court expressed that dispensing with the need for intent in this case would further ensure that the fiduciary would take extra precaution in caring for funds that belong to another and in avoiding the possibility of breaching such duties.¹²⁸

However, as noted by the dissent in *In re Johnson*, this case involved the question of whether the debtor violated the Michigan Building Contract Fund Act, specifically requiring proof of intent to defraud.¹²⁹ Therefore, although the court in *In re Johnson* declared a standard that “does not weigh intent or motive,” a finding of intent was required in the state’s statute.¹³⁰ The dissent also stated that “no interpretation of state law” could eliminate federal law’s fresh start opportunity and that without proof of intent of fraud or defalcation, the debtor should be discharged of his debt.¹³¹

2. Negligence or Innocent Mistake is Sufficient

In a case involving an ambassador, by definition a fiduciary of the country represented, the Fourth Circuit decided that the ambassador’s actions need not “rise to the level of embezzlement or even misappropriation” to make the debt non-dischargeable.¹³² Since the responsibilities of an ambassador are so crucial to the embassy he serves, it mattered only that the ambassador had used embassy funds to further his own interests; his intent at the time he did so was of no consequence.¹³³ Using the dictionary definition that de-

126. 11 U.S.C. § 523(a)(2)(A) (2002) (exception for “actual fraud”); 11 U.S.C. § 523(a)(6) (2004) (exception for “willful and malicious injury” to another).

127. *Johnson*, 691 F.2d at 256.

128. *Id.* at 255-56. When entrusted funds are used for other than intended purposes, defalcation is sufficiently met “so long as the use was not the result of mere negligence or a mistake of fact” *Id.* at 257.

129. *Id.* at 260 (Edwards, C.J., dissenting). *See also supra* note 122 and accompanying text (the Michigan Statute itself provided that a contractor would be guilty of a felony if he intentionally used such funds for any other purpose).

130. *Johnson*, 691 F.2d at 260 (Edwards, C.J., dissenting). *See also supra* note 128 and accompanying text.

131. *Johnson*, 691 F.2d at 261 (Edwards C.J., dissenting).

132. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (citing *Pahlavi v. Ansari*, 113 F.3d 17, 20 (4th Cir. 1997)).

133. *Uwimana*, 274 F.3d at 811-12 (the agent, *Uwimana*, committed a defalcation by failing to disclose his acts to, or seek consent from, the principal, the government of the state he represented).

falcation is the “failure to meet an obligation,”¹³⁴ the court rejected the ambassador’s argument that the transfer of money was “within the scope of his discretion as ambassador.”¹³⁵ Instead, it found that because the ambassador used funds that belonged to the country he represented without disclosing the act, he had committed defalcation and therefore his debt should remain outstanding.¹³⁶ For the Fourth Circuit, “negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient”¹³⁷ to prove defalcation.

The Eighth and Ninth Circuits have also reasoned that a fiduciary need not have a specific intent to commit defalcation.¹³⁸ In *In re Cochrane*, an attorney representing his partnership failed to disclose pertinent information in order to continue to participate personally in the deal without the partnership’s knowledge.¹³⁹ The court held that when an express trust exists in an attorney-client relationship, no evidence of an intentional wrongdoing is required for defalcation.¹⁴⁰

The Ninth Circuit has changed its view of whether defalcation requires some sort of intent on the part of the debtor. In 1993, the *In re Martin* opinion noted that defalcation has a broad range of meanings and may entail “moral dereliction . . . imply[ing] some bad faith or misconduct” or may include innocent defaults as noted by *Central Hanover*.¹⁴¹ The court stated that “[a]n exception to discharge impairs the debtor’s fresh start and should not be read more broadly than necessary to effectuate policy. . . .”¹⁴² Using this approach, the court held that defalcation must require some bad faith intent.¹⁴³ The *In re Martin* court also found it inconsistent to require intent for “fraud,” “embezzlement,” and “larceny” in § 523(a)(4), but not for a finding of “defalcation.”¹⁴⁴

134. *Id.* at 811 (citing BLACK’S LAW DICTIONARY 427 (7th ed. 1999)) (defining “defalcation”).

135. *Uwimana*, 274 F.3d at 811.

136. *Id.*

137. *Id.*

138. *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997); *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996).

139. *Cochrane*, 124 F.3d at 984.

140. *Id.* Interestingly, the Eighth Circuit states that fraud, embezzlement and larceny, also included in § 523(a)(4), are “solely intentional wrongs” while defalcation “include[s] innocent or negligent misdeeds.” *Id.*

141. *In re Martin*, 161 B.R. 672, 677 (B.A.P. 9th Cir. 1993).

142. *Id.* at 678.

143. *Id.*

144. *See id.* (noting that cases such as *In re Short*, 818 F.2d 692 (9th Cir. 1987),

Three years later, *In re Lewis* overruled this decision.¹⁴⁵ In determining that Arizona state law defined a partnership as “embod[ying] an express . . . trust,” the Ninth Circuit found that members of a partnership committed defalcation in commingling their partnership funds with their own independent venture.¹⁴⁶ Overruling *In re Martin*,¹⁴⁷ the court held that “an individual may be liable for defalcation without having the intent to defraud.”¹⁴⁸

Though the fiduciary relationships in the above cases varied, each circuit ruled that defalcation occurs if there is an express trust creating a fiduciary relationship within the meaning of § 523(a)(4)¹⁴⁹ and if the fiduciary breached that duty in failing to account for funds.¹⁵⁰ In coming to this conclusion, the Fourth, Sixth, Eighth, and Ninth Circuits did not have to determine if the fiduciaries in question did, in fact, have intent to breach their duties.¹⁵¹ The only inquiry needed was whether the fiduciaries improperly used funds entrusted to them.¹⁵²

C. *View of the Defalcation Exception as a Fault-Based Debt*

Reasoning that exceptions to discharge should be narrowly construed to provide the debtor with a fresh start, other circuits present an opposing view and require some type of intent on the part of the debtor to constitute “defalcation” under § 523(a)(4).¹⁵³

which hold that defalcation includes failure to account for funds, “contain facts which indicate some degree of culpability greater than mere negligence”). *Cf. id.* at 679-80 (Perris, B.J., concurring in part and dissenting in part) (stating that the requisite culpability need only be found in failure to conform to the fiduciary’s special legal status).

145. *In re Lewis*, 97 F.3d 1182, 1186-87 (9th Cir. 1996).

146. *Id.* at 1185-86.

147. *Martin*, 161 B.R. at 678 (“[M]ere failure to use ordinary care in accounting for an asset does not *per se* constitute ‘defalcation’ within the context of § 523(a)(4).”).

148. *Lewis*, 97 F.3d at 1187.

149. *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997).

150. *Lewis*, 97 F.3d at 1186.

151. Though in some of the cases the judges outright doubted that the fiduciaries were innocent in their actions. *See Cochrane* 124 F.3d at 984; *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993).

152. *Cf. In re Johnson*, 691 F.2d 249, 257 (6th Cir. 1982) (stating that as long as the “funds were used for purposes other than to pay laborers . . . so long as the use was not the result of mere negligence or a mistake of fact . . . subjective intent . . . is irrelevant”).

153. *In re Baylis*, 313 F.3d 9, 18-19 (1st Cir. 2002); *Matter of Schwager*, 121 F.3d 177, 185 (5th Cir. 1997); *In re Martin*, 161 B.R. 672, 677-78 (B.A.P. 9th Cir. 1993); *Matter of Moreno*, 892 F.2d 417 (5th Cir. 1990). *See also Meyer v. Ridgon*, 36 F.3d 1375, 1380-81 (7th Cir. 1994). In defining § 523(a)(11) (exempts discharge for debts arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union), the *Meyer* court

These courts reason that the exceptions to discharge should be narrowly construed to provide the debtor with a fresh start.¹⁵⁴

*Matter of Moreno*¹⁵⁵ was the first of the Fifth Circuit cases that defined defalcation as “a willful neglect of duty.”¹⁵⁶ As president, and hence, officer and fiduciary of a large corporation, Moreno transferred more than \$200,000 to himself and other companies in which he maintained a separate interest without repaying any portion, securing promissory notes, or paying interest.¹⁵⁷ In *Matter of Schwager*, the court found that the managing partner of a partnership involved in restaurant operation had breached his fiduciary duty to the partnership by acting “intentionally, maliciously or with heedless and reckless disregard of the rights of the limited partners.”¹⁵⁸ The court determined that such an intentional or reckless action met the elements of defalcation,¹⁵⁹ but also noted that these Fifth Circuit cases concerning such intentional conduct also involved a degree of financial impropriety.¹⁶⁰ Its interpretation of *Central Hanover* led this circuit to conclude that “defalcation requires a lesser standard than fraud, and . . . does not require actual intent” and therefore a standard of “recklessness”¹⁶¹ was appropri-

looked to the almost identical language of § 523(a)(4) to conclude that § 523(a)(4) must have been added to “limit the bankruptcy court’s ability to nullify regulatory victories through its independent power to determine dischargeability” in order to prevent bankers from using discharge as an escape for their misconduct. *Id.* The court agreed that “defalcation,” as interpreted by the Fifth and Sixth Circuits must mean more than “negligent breach of a fiduciary duty.” *Id.* at 1384-85.

154. *Meyer*, 36 F.3d at 1385.

155. *Moreno*, 892 F.2d at 421.

156. *Schwager*, 121 F.3d at 184. *See also In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993) (determining that a managing partner had committed defalcation “as a result of the willful neglect of his fiduciary duties as the managing partner of the limited . . . partnership” when he charged limited partners for expenses that were meant to be charged to the partnership).

157. *Moreno*, 892 F.2d at 421 (concluding that such activities constituted defalcation, the court determined that whether Moreno personally benefited from the funds was “significant but not necessarily determinative” in its decision).

158. *Schwager*, 121 F.3d at 182 n.4 (defining “maliciously” as “conduct that is specifically intended to cause substantial injury or damage; or . . . an act that is carried out with flagrant disregard for the rights of others and with actual awareness,” and “heedless and reckless disregard” as “more than a momentary thoughtlessness, inadvertence or error of judgment”).

159. *Id.* at 185.

160. *Id.* *Cf. Carey Lumber Co. v. Bell*, 615 F.2d 370 (5th Cir. 1980) (holding no intentional conduct is required for § 523(a)(4)).

161. *Schwager*, 121 F.3d at 185 n.12 (citing *U.S. v. Boyle*, 469 U.S. 241, 245 (1985), which defined “willful neglect,” though not in the context of bankruptcy, as “a conscious, intentional failure or reckless indifference”).

ately applied to § 523(a)(4).¹⁶²

The First Circuit most recently joined this discussion in *In re Baylis*, which stated that defalcation “requires some degree of fault, closer to fraud, without the necessity of meeting a strict specific intent requirement.”¹⁶³ *Baylis*, a case of first impression for this circuit, examined the fiduciary relationship between an attorney, acting as a co-trustee, and the beneficiaries of the trust.¹⁶⁴ Attorney Baylis drafted the trust and was appointed trustee along with the settlor’s daughter, who also served as paid manager of certain income properties benefiting the trust.¹⁶⁵ The beneficiaries of the trust claimed that Baylis had committed defalcation in two ways. First, they claimed he failed to properly advise to his co-trustee of her obligations to the trust when she made her decision not to sign an agreement to sell income properties to buyers who had already signed purchase and sale agreements.¹⁶⁶ Second, the beneficiaries claimed that he used trust funds to pay for and settle a lawsuit brought against him by the prospective buyers of the income properties, as well as to pay his own legal expenses after being sued by the trust itself.¹⁶⁷

In determining if either of these actions constituted defalcation, the First Circuit applied its new interpretation of § 523(a)(4).¹⁶⁸ The court plainly stated that Baylis, as an attorney specializing in trusts and estates, had knowledge of the law and the duties to which he was bound as a fiduciary of the trust.¹⁶⁹ Though

162. *Schwager*, 121 F.3d at 185 (citing 4 COLLIER ON BANKRUPTCY § 523.10(1)(b) (Lawrence P. King ed., 15th rev. ed. 1997) and 2 DAVID G. EPSTEIN ET AL., BANKRUPTCY, § 7-28 at 368 (1992)) (“Fraud requires some intent; defalcation requires none.”). The *Schwager* court interpreted this to mean that “[w]hile defalcation may not require actual intent, it does require some level of mental culpability.” *Id.*

163. *In re Baylis*, 313 F.3d 9, 18-19 (1st Cir. 2002).

164. *Id.* at 14-16.

165. *Id.* at 14.

166. *Id.* at 15. The beneficiaries also claimed that the debts should not be discharged as they resulted from Baylis’s “willful and malicious injury . . . to the property of another” under 11 U.S.C. § 523(a)(6) (2004). *Id.* at 16. *See also* *Rutanen v. Ballard*, 678 N.E.2d 133, 136-37 (Mass. 1992). In addition, Baylis was aware that his co-trustee did not desire to sell the properties. *Baylis*, 313 F.3d at 14. Regardless, Baylis acquired purchasers for the properties and drew up purchase and sale agreements which Ballard, the co-trustee, then refused to sign. *Id.* at 14.

167. *Baylis*, 313 F.3d at 21. Baylis’s own actions, in obtaining the buyers and in failing to properly advise the co-trustee of her need to sell, brought about the original lawsuit between the proposed purchasers of the properties and the trust. *Id.* at 14-15, 22.

168. *Id.* at 21-22.

169. *Id.*

Baylis was obligated to use reasonable care to advise his co-trustee and prevent her from committing a breach of her own duty to the trust, the court stated that if Baylis had acted "reasonably" in regard to his duties there would be no defalcation.¹⁷⁰ Since Baylis initially went to the probate court to receive instructions to sell (though he did not disclose his co-trustee's aversion to the sale), the court held that his actions did not constitute defalcation because "it was not unreasonable for Baylis to think the matter would be resolved if the court gave instructions to sell the property."¹⁷¹

In deciding whether the second matter, Baylis's use of money from the trust to fund his own legal expenses, constituted defalcation, the First Circuit noted that it is not always inappropriate for a trustee to receive payments from the trust.¹⁷² However, the probate court's lower decision found that the trust had no obligation to defend Baylis, because he had brought about the lawsuit by his own careless actions and inactions.¹⁷³ Baylis violated his duty of loyalty by causing the suit against the trust (over his failure to sell the properties) and then by using money from the trust to settle that lawsuit, as well to defend against allegations of his own personal fraud.¹⁷⁴ This circuit court found that these actions by Baylis satisfied the "defalcation" exception under the Bankruptcy Code.¹⁷⁵

The varying factual circumstances described above and the diverse holdings of the circuit courts gives an overview of the manner in which numerous courts have dealt with the issue of intent and defalcation. The analysis that follows will strive to provide clarity on the issue for the future use of courts faced with this historical dilemma.

III. ANALYSIS

This section will begin with a discussion of the balancing act

170. *Id.* at 22.

171. *Id.* at 22-23 (noting that the breach of loyalty of Ballard, the co-trustee, in refusing to sign purchase and sale agreements giving rise to the lawsuit, was also egregious enough to be defalcation). *See also id.* at 23 (stating that Baylis's judgments about how to deal with the actions of his co-trustee were "clearly negligent, but not so reckless as to rise to the level of fault needed to constitute a defalcation").

172. *Id.* at 21.

173. *Id.*

174. *Id.* at 22.

175. *Id.* "Baylis's actions as to this component of the debt do constitute defalcation. He used trust monies to . . . settle the lawsuit His breach of the duty of loyalty is exacerbated by the fact that Baylis . . . brought about the conditions that led to the lawsuit." *Id.* at 22.

between the fresh start policy and the need to repay creditors and will consider whether the defalcation exception should be placed in either the type-based or fault-based category of exceptions. It will then interpret “defalcation” within the context of the § 523(a)(4) exception, analyze why a requirement of intent is appropriate in light of bankruptcy law’s fresh start policy, and continue with a discussion of intent to do the act as opposed to intending the consequences of that act. The analysis will conclude with a suggestion of which type of intent to apply to the defalcation exception.

A. *Balancing Act*

In interpreting § 523(a)(4), courts must reconcile the fresh start policy with the notion that some particular debts should not be discharged. While the Bankruptcy Code originally allowed discharge for all provable debts,¹⁷⁶ Congress has tempered this initial leniency by extending over time the list of debts that cannot be discharged.¹⁷⁷ While the premier purpose of the Bankruptcy Code is to provide certain debtors with “a new opportunity . . . unhampered by the pressure and discouragement of preexisting debt,”¹⁷⁸ this fresh start is available only to honest debtors. A delicate balance exists between the needs of the debtor and the creditor,¹⁷⁹ but if

176. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 331 (1934). *See also Williams v. U.S. Fidelity and Guaranty Co.*, 236 U.S. 549, 556 (1915) (“[P]rovable debts include all liabilities of the bankrupt founded on contract, express or implied, which, at the time of the bankruptcy, were fixed in amount or susceptible of liquidation.”).

177. *See* 11 U.S.C. § 523(a) (2004). *See also* Susan Elaine Sieger, et al., *Survey: Fraud As An Impediment To Discharge—Denial of Discharge And Exceptions To Discharge Under the Bankruptcy Code*, 3 J. BANKR. L & PRAC. 469, 494 (1994) (citing Bankruptcy Act of 1898 § 17a(2), 30 Stat. 544, 550) (“The 1898 Act excepted from discharge only those ‘liabilities for obtaining property by false pretenses or false representations.’”).

178. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (citing *Williams*, 236 U.S. at 554-55) (stating that “the purpose of the Bankruptcy Act [is] to convert the assets of the bankrupt into cash for distribution among creditors, and then to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes”). *See also* Summers, *supra* note 12, at 314 (articulating the two bankruptcy policies as the fresh start policy and repayment to similarly situated creditors); Hallinan, *supra* note 52, at 51 (noting that the Supreme Court often decides bankruptcy issues on the basis of the fresh start policy) (citing *Perez v. Campbell*, 402 U.S. 637 (1971) (seeking to give the debtor a “new opportunity”) and *Local Loan*, 292 U.S. at 244 (stating that the “purpose of the act . . . is a new opportunity in life”)); *supra* note 74 and accompanying text (legislative history indicates that the fresh start policy is the first objective of bankruptcy law and repayment to creditors is the second).

179. Gross, *supra* note 50, at 60 (“[B]ankruptcy legislation reflects a longstanding struggle to reconcile the debtor’s ability to retain future earnings with her creditors’

debtors happen upon honest failure, the Bankruptcy Code must construe their actions in the broadest sense to provide them with a fresh start while also properly deterring the debtors from acting dishonestly.¹⁸⁰

B. *Categorizing § 523(a)(4) as a Type-Based or Fault-Based Exception*

As stated earlier, § 523(a) exceptions to discharge generally fall into one of two categories: type-based and fault-based.¹⁸¹ Congress created exceptions in these two categories to balance the need to maintain debtor liability for certain debts against the policy allowing honest debtors to discharge their debts and start afresh. To find whether intent is necessary to constitute defalcation, it is helpful to determine in which category § 523(a)(4) belongs.

Type-based exceptions to discharge do not require proof of debtor's wrongful intent and cannot be discharged, even if incurred by an honest debtor.¹⁸² Debts that may not be discharged because of their type include those for a tax or customs duty,¹⁸³ child support or alimony,¹⁸⁴ a fine or penalty,¹⁸⁵ an educational loan or benefit,¹⁸⁶ death or personal injury caused by a debtor's driving while intoxicated,¹⁸⁷ any payment of an order of restitution,¹⁸⁸ a condominium ownership fee,¹⁸⁹ or court fees.¹⁹⁰ These exceptions do not

legitimate desires to maximize their recoveries"). *See also infra* note 182 and accompanying text; *Grogan v. Garner*, 498 U.S. 279, 287 (1991) ("Requiring the creditor to establish" that the debtor committed fraud "by a preponderance of the evidence," rather than by clear and convincing evidence, "reflects a fair balance between these conflicting interests.").

180. *See In re Spar*, 176 B.R. 321, 326 (Bankr. S.D.N.Y. 1994) (stating that an equally important policy consideration is to "prevent the dishonest 'debtor's attempts to use the law's protections to shield his or her wrongdoing'" (quoting *Matter of Newark*, 20 B.R. 842, 852 (Bankr. E.D.N.Y. 1982)).

181. *In re Baylis*, 313 F.3d 9, 19 (1st Cir. 2002) (articulating that type-based debts are not discharged because forgiveness of a certain type of debt would not further a social policy and fault-based debts are not discharged because the debt resulted from some immoral or dishonest act done by the debtor).

182. *Id.*

183. 11 U.S.C. §§ 523(a)(1)(A) and (B) (2004).

184. § 523(a)(5). *See also* § 523(a)(15) (debts incurred in the course of a divorce or separation will not be discharged).

185. § 523(a)(7).

186. § 523(a)(8).

187. § 523(a)(9). *But see Baylis*, 313 F.3d at 19 (labeling this exception as a fault-based debt with fault being inferred from voluntary intoxication).

188. § 523(a)(13).

189. § 523(a)(16).

190. § 523(a)(17).

include, either through implication or expressly, words indicating that the debtor must possess some level of intent, but instead stand on their own as a matter of law.

Other § 523(a) exceptions do contain words that look to the conduct of the debtor. These fault-based exceptions include debts for property obtained by false pretenses, by actual fraud¹⁹¹ or by use of a written statement that is materially false and that the debtor made with intent to deceive,¹⁹² debts involving willful and malicious injury by the debtor to another entity or to the property of another entity,¹⁹³ and malicious or reckless failure of the debtor to fulfill any commitment to a Federal depository institution's regulatory agency to maintain the capital of an insured depository institution.¹⁹⁴

The § 523(a)(4) defalcation exception can be viewed as type-based, holding fiduciaries liable for debts that occur while he or she acts in his or her special legal role.¹⁹⁵ While this view is arguable, even cases that tout the defalcation exception as type-based involve some wrongdoing on behalf of the fiduciary.¹⁹⁶ The exception is fault-based if it requires dishonesty or wrongdoing on behalf of the fiduciary. Section 523(a)(4) is probably more like fault-based exceptions, in that it contains language that suggests dishonesty on the part of the debtor.¹⁹⁷ If one has committed fraud while acting in a fiduciary capacity (interpreted by *Neal v. Clark* to be actual fraud)¹⁹⁸ then the fiduciary has committed a dishonest act with the intention to do so. Likewise, if one commits embezzlement¹⁹⁹ or

191. § 523(a)(2)(A).

192. § 523(a)(2)(B).

193. § 523(a)(6).

194. § 523(a)(12).

195. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997); *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996). *See also In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002). According to the *Baylis* court:

It is arguable that defalcation by a fiduciary fits into this 'type of debt' category—that is, that Congress intended to reinforce the high standard of care owed by fiduciaries by making debts for defalcation non-dischargeable. That reading is, we think, an unlikely one, and we see no strong federal interest in making every debt from breach of a fiduciary duty non-dischargeable.

Id.

196. *See supra* note 151 and accompanying text.

197. *See supra* note 140 (the Eighth Circuit states that fraud, embezzlement and larceny, also included in § 523(a)(4), are "solely intentional wrongs" while defalcation "include[s] innocent misdeeds").

198. *Neal v. Clark*, 95 U.S. 704, 709 (1877).

199. *See supra* note 91; *In re Belfry*, 862 F.2d 661, 662 (8th Cir. 1988) (asserting that for the purposes of § 523(a)(4), embezzlement "is the fraudulent appropriation of

larceny,²⁰⁰ then intent is inferred, since the debtor dishonestly appropriated entrusted funds. It is inconsistent to arbitrarily place the word "defalcation," which can be read to include innocent misallocations or more deliberate defaults,²⁰¹ among these fault-based exceptions if it were not to be read as requiring some sort of intent on behalf of the debtor.²⁰² To determine which view is more appropriate, it is necessary to look at the meaning of defalcation.

C. *Deciphering Defalcation*

Due to the scarcity of legislative history²⁰³ regarding how Congress intended the courts to interpret the § 523(a)(4) meaning of defalcation, we are forced to look elsewhere for an appropriate meaning.²⁰⁴ We may look to the wording of the statute, including use and positioning of words, as well as how they have changed over the history of the Code;²⁰⁵ the way in which interpretation of the term coincides with the intended purposes of the Code,²⁰⁶ and; the methods the various circuit courts have used in defining the term.

property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come"). See also 3 NORTON BANKRUPTCY LAW, *supra* note 52, at § 47:47 ("The elements of embezzlement under Code § 523(a)(4) are: (1) appropriation of funds by the debtor; (2) for the debtor's use or benefit; (3) done with fraudulent intent.").

200. See *infra* note 228 and accompanying text. See also 3 NORTON BANKRUPTCY LAW, *supra* note 52, at § 47:47 (stating that the elements of larceny under common law are: "a finding that the debtor wrongfully, and with fraudulent intent, took the property of another").

201. *In re Martin*, 161 B.R. 672, 677 (B.A.P. 9th Cir. (Cal.) 1993) ("The primary difficulty is that definitions vary on whether defalcation includes some element of culpable conduct . . .").

202. *Id.* at 678. See also *infra* note 238 and accompanying text.

203. Reinhardt & Horlbeck, *supra* note 8, at 1774.

204. *Ardenstani v. INS*, 502 U.S. 129, 135 (1991); *Rubin v. U.S.*, 449 U.S. 424, 430 (1981) (explaining when a statute's language is ambiguous, we may look not only to the language of the statute to determine its intended meaning, but also to the expressed intent of the legislature).

205. *Neal v. Clark*, 95 U.S. 704, 708 (1877). In interpreting fraud, the Supreme Court looked to the "familiar rule in the interpretation of written instruments and statutes that 'a passage will be best interpreted by reference to that which precedes and follows it.' So, also, 'the meaning of a word may be ascertained by reference to the meaning of words associated with it.'" *Id.* (citation omitted).

206. *K-mart v. Cartier, Inc.*, 486 U.S. 281, 291 (1988) ("In ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole."). See also *U.S. v. Boisdore's Heirs*, 49 U.S. (8 How.) 113, 122 (1850) ("In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.").

As noted above, “defalcation” has been defined by standard dictionaries in a variety of ways ranging from “the failure to meet an obligation” to “misappropriation of trust funds [by a fiduciary].”²⁰⁷ In the mid-1800s, which is the time of the word’s origin in bankruptcy law, defalcation meant either “the reduction of a claim of one of the contracting parties against the other, by deducting from it a smaller claim due from the former to the latter” or “the act of a defaulter.”²⁰⁸ It is not clear whether Congress wanted a narrower or broader reading of the word.

In interpreting the Bankruptcy Code, courts have continued to fill in gaps left, whether intentionally or otherwise, by Congress. In 1878, the Supreme Court made a crucial decision in determining how “fraud” should be read in the section of the 1867 Bankruptcy Act that is analogous to today’s § 523(a)(4).²⁰⁹ In *Neal v. Clark*, the Supreme Court determined that fraud, which could mean “actual fraud . . . implied or constructive fraud, or gross negligence, which may be equivalent to fraud,” meant positive fraud involving “moral turpitude” or bad faith.²¹⁰ The Court noted that “[a] different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt[cy] system.”²¹¹ Similarly, in 1844 the Supreme Court reasoned that “fiduciary” should be read more narrowly within bankruptcy law to include only those fiduciary duties created by express trusts.²¹² Therefore, in § 523(a)(4), fiduciary ex-

207. See *supra* notes 90-91 and accompanying text for definitions of defalcation. See also *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (citing BLACK’S LAW DICTIONARY 427 (7th ed. 1999)) (defining “defalcation”). But see *In re Baylis*, 313 F.3d 9, 18 n.4 (1st Cir. 2002) (citing A DICTIONARY OF MODERN AMERICAN USAGE 191 (B. Garner ed., 1998)) (“[S]ome writers have misused defalcation while referring to a non-fraudulent default . . .”).

208. A LAW DICTIONARY BY JOHN BOUVIER (6th ed. 1856) (citing the Bankruptcy Act of 1841), available at http://www.constitution.org/bouv/bouvier_d.htm (last visited Feb. 28, 2005).

209. *Neal*, 95 U.S. at 707. See also An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 176, 14 Stat. 517, 533 (1867) (codified at Title CXI Rev. Stat. § 5117 (1878) (repealed 1878)) (“No debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged under this act.”). Cf. 11 U.S.C. § 523(a) (2004) (noting that the legislative history comments state that “subparagraph (A) of 523(a)(2)(A) is intended to codify current case law, e.g., *Neal v. Clark*, 95 U.S. 704 (1887), which interprets ‘fraud’ to mean actual or positive fraud rather than fraud implied in law”).

210. *Neal*, 95 U.S. at 707-08.

211. *Id.* at 709.

212. *Chapman v. Forsyth*, 43 U.S. (2 How.) 202 (1844) (interpreting “fiduciary” under the Bankruptcy Act of 1841). See also *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 393 (1934) (further limiting “fiduciary” to include only those debts created prior to

cludes many traditional dictionary definitions of the word.²¹³ These Supreme Court interpretations show that a term may not always be defined by its traditional meaning and may be narrowed to suit the “liberal spirit” of the Bankruptcy Code.²¹⁴ While many courts have read defalcation in its traditional broad sense, there is reason to question whether this approach is consistent with bankruptcy policy and if “defalcation” should have a narrower meaning within § 523(a)(4).

The word “defalcation” appeared initially in the Bankruptcy Code in 1841 and has remained to the modern day, although its positioning in text has changed.²¹⁵ In *Neal v. Clark*, the Supreme Court, in interpreting the meaning of fraud within the Bankruptcy Act, used the maxim that “the coupling of words together shows that they are to be understood in the same sense.”²¹⁶ It also acknowledged that if the meaning of a statute is unclear, the intent of the drafters may be ascertained by looking at neighboring words.²¹⁷

the wrong). *But see Baylis*, 313 F.3d at 13 (stating that the notion that “fiduciary capacity” relates only to express trusts is no longer clear).

213. *Kahl & Ismay*, *supra* note 79, at 121 (stating that the traditional meaning of fiduciary, a confidence or trust, is too broad a definition within the bankruptcy context; commercial relationships, such as those of agents, bailees, brokers, factors and partners, are not contemplated by this section of the Code).

214. *Neal*, 95 U.S. at 709.

215. *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937). *See also Flaccus*, *supra* note 84, at 231. The 1841 statute provided that:

[a]ll persons whatsoever, residing in any State, District or Territory of the United States, owing debts, which shall not have been created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity, who shall, by petition . . . apply to the proper court . . . shall be deemed bankrupts within the purview of this act

An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 9, 5 Stat. 440, 441 (1841) (repealed 1843).

The 1867 statute said, “no debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged under this act” An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 176, 14 Stat. 517, 533 (1867) (codified at Title LXI Rev. Stat. § 5117 (1878) (repealed 1878)).

The 1898 act said, “[a] discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as . . . (4) were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity.” An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, 30 Stat. 544, 550-51 (codified at 11 U.S.C. § 17(a)(4) (1898) (repealed 1979)).

Finally, the current Code says, “[a] discharge . . . does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny.” 11 U.S.C. § 523(a)(4) (2003).

216. *Neal*, 95 U.S. at 708-09.

217. *Id.* at 708 (“It is a familiar rule in the interpretation of written instruments

At that time, “fraud” was coupled with the term “embezzlement.”²¹⁸ The Court reasoned that since “embezzlement” involved an intentional wrong²¹⁹ and “fraud” was in direct association with the term, then Congress must have intended “fraud” to mean actual or positive fraud in this exception, even though it could have meant implied fraud.²²⁰

Applying such reasoning to elucidate the 1898 Act, one could presume that in choosing the placement of the words “fraud, embezzlement, misappropriation, or defalcation,” Congress meant each to encompass some level of intent.²²¹ The 1898 phraseology was repealed in 1979 and replaced with the current structure placing “fraud” and “defalcation” in direct association with one another and modifying both these words with “while acting in a fiduciary capacity.”²²² Courts have construed this arrangement to mean that “while acting in a fiduciary capacity” limits only “fraud” and “defalcation,” while “embezzlement” and the newly added “larceny” have a much broader scope and include non-fiduciaries.²²³ Not only was the positioning of these terms altered in 1979, but “misappropriation” was eliminated and “larceny” was added.²²⁴ It is interesting to note that “misappropriation,” which was interpreted by

and statutes that ‘a passage will be best interpreted by reference to that which precedes and follows it.’”) (citation omitted).

218. See *supra* note 215 and accompanying text.

219. See *In re Belfry*, 862 F.2d 661, 662 (8th Cir. 1988) (quoting *In re Shultz*, 46 B.R. 880, 889 (Bankr. D. Nev. 1985)) (restating that for the purposes of § 523(a)(4), embezzlement “is the fraudulent appropriation of property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come.”).

220. *Neal*, 95 U.S. at 709 (stating that this reading was justified if not required and “[s]uch a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency”).

221. See *supra* note 215 and accompanying text. The 1898 act said, “[a] discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as . . . (4) were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity.” An Act to Establish a Uniform System of Bankruptcy Throughout the United States, ch. 541, 30 Stat. 544, 550-51 (codified at 11 U.S.C. § 17(a)(4) (1898) (repealed 1979)).

222. See *supra* note 215 and accompanying text. See also 11 U.S.C. § 523(a) (2000) (noting the legislative statements in S. REP. NO. 95-989, at 79 (1978) discussed that § 523(a)(4) “excepts debts for fraud incurred by the debtor while acting in a fiduciary capacity or for defalcation, embezzlement, or misappropriation”).

223. See *In re Graziano*, 35 B.R. 589, 594 (Bankr. E.D.N.Y. 1983) *questioned by In re Goux*, 72 B.R. 355 (Bankr. N.D.N.Y. 1987); *In re Carlton*, 26 B.R. 202, 205 (Bankr. Tenn. 1982).

224. See *supra* note 215. See also *Graziano*, 35 B.R. at 593 (stating that the addition of the word larceny along with rearrangement of the phrase “while acting in a fiduciary capacity” constitute “significant revision[s]”).

the Fifth Circuit to require no intent,²²⁵ was dropped and replaced by “larceny,” defined as “the fraudulent and wrongful taking and carrying away the property of another with intent to convert such property to the taker’s use without the consent of the owner.”²²⁶

The modification of “fraud” and “defalcation” with “while acting in a fiduciary capacity” can be interpreted in a variety of ways. “Fraud” may require intent while “defalcation” requires none (this conclusion can be drawn from the argument that, Congress would not have added both words where one would be sufficient²²⁷); “fraud” and “defalcation” may take on the same level of intent, or; “fraud” and “defalcation” may each require some intent but the level of intent may be different for each. Taking cues from the Supreme Court in *Neal v. Clark* as to how the Bankruptcy Code should be interpreted,²²⁸ “fraud” and “defalcation” are like terms that should be read together and thus, both should require intent.²²⁹ Since *Neal v. Clark* held that both “fraud” and “embezzlement” in the 1898 Act required an intentional wrong on the part of the debtor, it follows that “defalcation,” which is in direct association with “fraud” in the Bankruptcy Code, would also require an intentional wrong.²³⁰ Such an interpretation is in accordance with the

225. *Carey Lumber Co. v. Bell*, 615 F.2d 370, 376 (5th Cir. 1980). *But see In re Brown*, 4 B.R. 539, 544 (Bankr. N.D. Ill. 1980) (“To find a ‘misappropriation’ as that term is used in § 17a(4) of the Bankruptcy Act, there must be a taking, the taking must be intentional, and it must be improper or unlawful.”).

226. *Graziano*, 35 B.R. at 594 (also noting that larceny and embezzlement differ only in the manner with which the debtor takes possession of the funds).

227. *Hibbs v. Winn*, 124 S. Ct. 2276, 2286 (2004) (“A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant . . .”) (citation omitted).

228. 11 U.S.C. § 523(a) (2000) (quoting N. SINGER, *STATUTES AND STATUTORY CONSTRUCTION* § 46.06, (rev. 6th ed. 2000)) (stating subparagraph (A) [of § 523(a)(2)(A)] is intended to codify current case law, *e.g. Neal v. Clark*, 95 U.S. 704 (1887) [24 L.Ed. 586], which interprets ‘fraud’ to mean actual or positive fraud rather than fraud implied in law).

229. *Neal*, 95 U.S. at 709. *See also Flaccus*, *supra* note 84, at 229-30. Flaccus states that

if fraud means moral turpitude or intentional wrongdoing, this could influence the interpretation of the word ‘defalcation’ with which ‘fraud’ is coupled in the statutory language. The argument could be made that defalcation, too, should mean some type of wrongdoing, that putting intentional lies along with innocent defalcations without covering some type of intermediary misconduct seems odd.

Id. *See also Singer*, *supra* note 60, at 368 (“The fraud [in the context of §523(a)(4)] must involve a moral turpitude or intentional wrong; fraud implied in law, or constructive fraud, which may exist without the imputation of immorality or bad faith, is insufficient.”).

230. *Neal*, 95 U.S. at 709.

fresh start policy.

The Ninth Circuit in *In re Martin*²³¹ raised a similar argument. That court stated that it would be inconsistent to read defalcation as not requiring any intent, when every other act in § 523(a)(4) requires “some element of bad faith.”²³² Following *Neal v. Clark*’s logic that like words are grouped together, this court said that “defalcation” must involve bad faith of a sort, since it is included in the same section as “fraud,” “embezzlement,” and “larceny.”²³³ Since it would be redundant to include terms with the same level of intent,²³⁴ the Court resolved that defalcation requires intent but at a lesser level than fraud.

D. *Requiring Intent: In Accordance With Fresh Start Policy*

A requirement of intent gives § 523(a)(4) a narrow construction, which is consistent with the Bankruptcy Code’s fresh start policy.²³⁵ In deference to this policy, the Supreme Court provided lower courts with a general rule of liberal construction favoring the debtor and has suggested that limits to discharge under § 523 “should be construed narrowly so as to assure that the basic policy of giving the honest debtor a fresh start is not frustrated.”²³⁶ The Court also stated that exceptions “should not be read more broadly

231. *In re Martin*, 161 B.R. 672, 678 (B.A.P 9th Cir. 1993), *overruled by In re Lewis*, 97 F.3d 1182, 1187 (9th Cir. 1996).

232. *Martin*, 161 B.R. at 678. *See also supra* note 140 (stating that fraud, embezzlement and larceny, also included in § 523(a)(4), are “solely intentional wrongs,” while defalcation “include[s] innocent . . . misdeeds”).

233. *Neal*, 95 U.S. at 709. *See also infra* section III.B (categorizing § 523(a)(4) as a Type-Based or Fault-Based Exception). This is also consistent with the notion that entire exceptions, rather than parts of them, may be divided into categories of type-based and fault-based debt. Reading defalcation to require no intent would fit it into the type-based category while fraud, embezzlement and larceny would all fit into the fault-based category. Such a reading would make the § 523(a)(4) exception vastly different from all other § 523(a) exceptions.

234. *Hibbs v. Winn*, 124 S.Ct. 2276, 2286 (2004).

235. *See supra infra* section I.B (A Fresh Start for Honest Debtors). *See also Halinan, supra* note 52, at 51 (arguing that the fresh start policy is not only an objective but perhaps the sole principle of bankruptcy law). *See also supra* note 74, at 50-51 (the fresh start policy is the first objective of bankruptcy law).

236. *Martin*, 161 B.R. at 678 (citing *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)). *See also Neal*, 95 U.S. at 709 (determining that its decision to construe “fraud” as requiring moral turpitude was “consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency,” and further that “[a] different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt system”).

than necessary to effectuate policy.”²³⁷ To remain consistent with such precedent, it is reasonable to conclude that defalcation should require some level of intent on the part of a fiduciary debtor.

A fresh start benefits the debtor, by providing freedom from debt and collection efforts, and the public, by allowing the debtor to become a productive member of society once again.²³⁸ It also furthers the original goal of bankruptcy law, that of promoting commerce.²³⁹ Embarking on a business endeavor or taking on the responsibility of a fiduciary is risky. Providing discharge as a relief reduces this risk, thereby giving individuals an incentive, or at least a safeguard, for their commercial efforts and also providing a fresh start for those who wish to make a second attempt after unintended failure.²⁴⁰ Since it “is impossible to identify in advance ‘which individuals will conceive the best ideas’” that will ultimately benefit society, the relief provided by bankruptcy must be afforded to all individuals.²⁴¹ There remains the possibility that an “honest but unfortunate” professional or entrepreneur could commit a defalcation while acting in a fiduciary capacity by making an innocent default.²⁴² Therefore, requiring some level of intent for defalcation is a proper construction that would not frustrate bankruptcy’s primary objective, to promote the fresh start policy.²⁴³

237. *Martin*, 161 B.R. at 678.

238. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1933) (noting the “purpose of the act [to provide a fresh start] has been again and again emphasized by the courts as being of public as well as private interest”).

239. *Evolution of the Bankruptcy Discharge*, *supra* note 26, at 327 (stating that originally bankruptcy protected creditors, “protecting creditors protected commerce, and commerce was king”).

240. *Local Loan*, 292 U.S. at 244; Hallinan, *supra* note 52, at 63 (stating the “productivity rationale itself was rooted in the established conception of financial failure as an unavoidable consequence of entrepreneurial risk taking”).

241. See John M. Czarnetzky, *The Individual and Failure: A Theory of The Bankruptcy Discharge*, 32 ARIZ. ST. L.J. 393, 405 (2000) (for a complete discussion of the entrepreneurial theory behind discharge).

242. *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) (suggesting that an innocent default may constitute defalcation). See also Czarnetzky, *supra* note 241, at 412 (suggesting that the entrepreneur who undertakes a business risk that results in failure is such an “‘honest, but unfortunate’ debtor[]”).

243. See *supra* note 235 and accompanying text; see also notes 64 and 74 and accompanying legislative history discussing the importance of the fresh start policy. See also Hallinan, *supra* note 52, at 54 (asserting that the fresh start “was originally conceived not as a relief measure but as a reward for the debtor’s efforts to maximize the return to his creditors”; therefore, this liberal construction favoring the debtor and discharge may also provide the debtor with incentive to initiate bankruptcy proceedings that in turn, promotes the second policy of bankruptcy law—repayment to creditors).

E. *Intent To Do The Act*

Reading the § 523(a)(4) defalcation exception as requiring intent on the part of the debtor is consistent with the policies of the Bankruptcy Code and with statutory interpretation used by the Supreme Court in interpreting the Bankruptcy Code. However, it is not clear whether this means that the debtor must simply intend to commit the act, which itself triggers defalcation, or whether he or she must intend to produce the outcome that results from the act.²⁴⁴

Section 523(a)(6) of Title 11, an exception for willful (meaning deliberate and more than merely reckless)²⁴⁵ and malicious²⁴⁶ injury to an entity or its property, articulates an exemption to discharge for those who willfully cause injury. It would be redundant for defalcation to require a similar mental state.²⁴⁷ In *Kawaauhau v. Geiger*, the Supreme Court determined that the § 523(a)(6) exception for “willful and malicious injury” requires the debtor to “intend the [actual] consequences of an act, not simply the act itself.”²⁴⁸ Therefore, § 523(a)(6) does not cover instances in which the act is intended, but the resulting injury is not the desired outcome of the debtor,²⁴⁹ nor does it encompass debts arising from recklessly or negligently inflicted injuries.²⁵⁰ As a result of the Supreme Court decision in *Kawaauhau v. Geiger*, a creditor would have to show that the debtor intended to cause the injury, not only to do the act causing the injury, in order to deny discharge of a debt

244. *In re Baylis*, 313 F.3d 9, 19 (1st Cir. 2002) (“Specific intent requires that the accused have the intent to accomplish the precise criminal act with which he is charged.”).

245. *Singer*, *supra* note 60, at 376-77.

246. *Id.* at 377 (stating the element of maliciousness “requires a heightened level of culpability which transcends mere willfulness” but does not require spite or ill will).

247. *Baylis*, 313 F.3d at 17. *See* BANKRUPTCY LAW MANUAL § 4:36 (5th ed. 2003) (“In order to avoid redundancy within Section 523(a), defalcation must mean something . . . different from willful and malicious injury because that is covered by Section 523(a)(6).”). *See also In re Martin*, 161 B.R. 672, 680 (9th Cir. 1993) (stating that intentional tortious conduct would be unnecessary for § 523(a)(4) “in light of the broad definition of willful and malicious conduct applied under [§ 523(a)(6)]”).

248. *Kawaauhau v. Geiger*, 523 U.S. 57, 57-58 (1998) (finding that “a debt arising from a medical malpractice judgment attributable to negligent or reckless conduct” does not fall within the § 523(a)(6) exception).

249. *Id.* at 62 (noting that a broader reading of the exception “would be incompatible with the ‘well known’ guide that exceptions to discharge ‘should be confined to those plainly expressed’”).

250. *Id.* at 64; 6 NORTON BANKR. L. ADVISER 12, *The New “Intentional Tort” Standard Under Section 523(a)(6)* (1998). This holding adjusted one of the common uses of § 523(a)(6) by creditors who argued that discharge should not be granted to the debtor who converted the creditor’s property without its consent.

under § 523(a)(6).²⁵¹

In *In re Johnson*, which used an objective standard to decide if a debtor has committed defalcation,²⁵² the Sixth Circuit stated that “mere negligence or a mistake of fact” was not sufficient to constitute a defalcation, but also refused to require a specific motive or wrongful intent.²⁵³ One can resolve the seemingly contradictory parts of the opinion by interpreting it as saying that a debtor does not need to intend the consequences of his or her actions, but that the act that brings about the consequences was intentional and did not occur by mistake. Since willful and malicious intent to injure property is covered by section § 523(a)(6), it is fitting to read § 523(a)(4) as requiring intent on the part of the debtor to do the act, but not necessarily to intend the consequences of that act.²⁵⁴

Let us revisit the introduction’s hypothetical²⁵⁵ while using the standard that the defalcation exception requires an intent to do the act, but not intent to cause the deleterious outcome. The trustee described in the above hypothetical situation who placed funds in a bank that misrepresents itself as federally insured did not intend to place the funds in a non-federally insured bank, nor did he intend that the bank go belly-up. Therefore, this fiduciary made a mistake, but did not commit a defalcation. The trustee who placed funds in a non-insured bank that did not advertise itself as insured is a bit trickier. The court would need to determine whether the trustee intended to place the funds in a bank that was not insured; if he did, even though he did not intend the bank to go bankrupt, he could still be liable for defalcation. However, if he was merely negligent in placing the funds in a non-insured bank, it would be consistent with the Bankruptcy Code to allow him a discharge of the debt and a fresh start. In opposite, the trustee who intended to invest trust funds in his own company as a temporary loan, against the owner’s instructions to secure the funds in a federally insured bank would be liable for defalcation if the funds were lost even though he did not intend to lose the funds. The last scenario given, where the trustee took the money and ran, would be considered fraud since he intended the act and the consequences of the act.

Reading defalcation to require intent to do the inappropriate

251. *Kawaauhau*, 523 U.S. at 64.

252. *In re Johnson*, 691 F.2d 249, 255 (6th Cir. 1982). See also *In re Baylis*, 313 F.3d at 17 (“Defalcation is to be measured objectively.”).

253. *Johnson*, 691 F.2d at 257.

254. *Id.* at 256-57.

255. See *supra* Introduction.

act rather than to intend the harmful consequences is also fitting in light of legislative history that exists with respect to amendments to § 523(a)(4), which suggests that the exception is a compromise between the House bill and the Senate amendment.²⁵⁶ While misappropriation is no longer in the wording of § 523(a)(4) itself, legislative history states that this section is intended to “except[] debts for fraud incurred by the debtor while acting in a fiduciary capacity or for defalcation, embezzlement, or misappropriation.”²⁵⁷ The contemporaneous House Report indicates that § 523(a)(4) excepts debt for embezzlement or larceny and that “intent is to include . . . debts . . . which the debtor willfully and maliciously intends to borrow for a short period of time with no intent to inflict injury but on which injury is in fact inflicted.”²⁵⁸ This statement also suggests that Congress anticipated some level of intent in doing the act to be required by § 523(a)(4),²⁵⁹ even if the specific injury is not intended.

F. *Which Level of Intent Should Be Applied?*

After determining that intent should be required on the part of the debtor committing the defalcation, it is proper to discuss which level of intent should be applied to § 523(a)(4). The court in *In re Baylis* suggested that the level of intent should be “closer to fraud, without . . . meeting a strict specific intent requirement.”²⁶⁰ In articulating this standard, the First Circuit determined that where the fiduciary in question “used reasonable care” in his role as a co-trustee, he was not liable for defalcation.²⁶¹ It also found that the debtor, in using trust assets to pay for his own legal defense, acted

256. 8 NORTON BANKRUPTCY LAW & PRACTICE 2D, 11 U.S.C. § 523 *Debtor's Duties and Benefits* (2003). The Editor's Comments state that § 523(a)(4) is a compromise between HR 8200 and S 2266. S 2266 excepted “fraud while acting in a fiduciary capacity, defalcation, embezzlement or misappropriation.” However, an earlier version of S 2266 was similar to HR 8200, and only referred to embezzlement or misappropriation.

257. S. REP. NO. 95-989, at 79 (1978). See also 11 U.S.C. § 523(a) (2000) (noting also that the placement of “fiduciary capacity” differs from that of the actual text of the statute).

258. H.R. REP. NO. 95-595, at 364 (1977).

259. This also supports the idea that § 523(a)(4) is a fault-based exception.

260. *In re Baylis*, 313 F.3d 9, 18-19 (1st Cir. 2002).

261. *Id.* at 22. The court determined that the debtor, acting as a co-trustee, was obligated “to use reasonable care to prevent a co-trustee from committing a breach of the trust.” *Id.* However, it also stated that “[r]easonableness, . . . is not the test for whether a breach is a defalcation, but if the trustee acted reasonably, there is no defalcation.” *Id.* See also *id.* at 23 (stating that the debtor's judgments in dealing with his co-trustee “were flawed and clearly negligent, but not so reckless as to rise to the level of fault needed to constitute defalcation”).

with “extreme[] reckless[ness] . . . in light of his duty of loyalty,” thus making him liable for defalcation.²⁶² In *Moreno*,²⁶³ *Bennett*,²⁶⁴ and *Schwager*,²⁶⁵ the Fifth Circuit defined defalcation as a “willful neglect of duty, even if not accompanied by fraud or embezzlement,”²⁶⁶ and said the “willful neglect” standard was “a standard of recklessness.”²⁶⁷

A “willful neglect” standard is consistent with the fresh start policy. Reading “defalcation” in a narrow sense, it requires more than mere negligence or mistake. It is consistent with *Central Hanover*, in that a willful neglect standard would require less intent than fraud, which requires actual intent.²⁶⁸ Since actual intent requires the actor to intend the consequences of his actions, this willful neglect standard is also consistent with the notion that defalcation requires only intent to commit the act itself and not to intend the outcome.²⁶⁹ It is consistent with the facts of the defalcation cases where the court said that mere negligence or mistake is sufficient because, even in those cases, “there is generally some appearance of wrongdoing within the facts of each such case.”²⁷⁰

CONCLUSION

In light of the fresh start policy, requiring an interpretation favoring the debtor, exceptions for discharge should be construed narrowly so as not to frustrate this primary objective of bankruptcy law. A rule that mere negligence or mistake may constitute a defalcation while acting in a fiduciary capacity would contrast with this ideal. Therefore, it is appropriate to require a debtor acting in a fiduciary capacity to intend to commit a defalcation if his or her

262. *Id.* at 22.

263. *In re Moreno*, 892 F.2d 417, 421 (5th Cir. 1990).

264. *In re Bennett*, 989 F.2d 779 (5th Cir. 1993).

265. *Id.* at 184 (the debtor was the managing partner of a partnership that stopped making payments on a note after financing its purchase of property with a loan).

266. *Id.* at 790.

267. *Id.* at 185. *See also In re Gaubert*, 149 B.R. 819, 827 (Bankr. E.D. Tex. 1992) (stating that the definition of “willful neglect” is not clear but has been stated to “impose a standard of recklessness” or is “understood to refer to conduct that is not merely negligent”).

268. *See Schwager*, 121 F.3d at 185 (citing *Cent. Hanover Bank & Trust v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937)) (stating that defalcation requires a lesser standard than fraud). *See also* BARRON’S LAW DICTIONARY (4th ed. 1996) (defining intent as “a state of mind wherein the person knows and desires the consequences of one’s own act”).

269. *See supra* discussion in III.E (Intent to do the Act).

270. *In re Martin*, 161 B.R. at 677.

debt will be denied discharge per § 523(a)(4). However, this requirement of intent should apply only to the act bringing about the consequence, rather than to the consequence itself, thus making the exception distinguishable from the § 523(a)(6) exception for willful or malicious injury to property. In conclusion, the “willful neglect” standard adopted by the Fifth Circuit most appropriately complies with bankruptcy’s policy of providing a “fresh start to the honest debtor” while distinguishing the § 523(a)(4) exception from § 523(a)(6) and should be adopted as the standard of intent required for “defalcation while acting in a fiduciary capacity.”

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