No. 11-1518

In The
Supreme Court of the United States

RANDY CURTIS BULLOCK,

Petitioner,

v.

BANKCHAMPAIGN, N.A.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF OF RESPONDENT

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QUESTION PRESENTED

The Bankruptcy Code excepts from discharge all debts incurred on account of defalcation while acting in a fiduciary capacity. Bullock, while a trustee of a trust, made self-dealing loans that harmed the trust. Can Bullock discharge his debts to the trust incurred on account of his self-dealing?

TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES – Continued

TABLE OF AUTHORITIES – Continued

STATEMENT OF THE CASE

In December 1978, Curt Bullock established the Curt Bullock Trust No. 2 (the "Trust"). Pet. App., 33a. Curt Bullock appointed his son, the Petitioner (hereinafter, "Bullock"), as the trustee of the Trust. *Id*. The corpus of the Trust was a life insurance policy on the life of Curt Bullock. Pet. App., 33a. The beneficiaries of the trust were Bullock and Bullock's four siblings. Pet. App., 17a. Bullock executed the Trust document as the trustee and accepted the legal obligations of a trustee. Pet. App., 53a.

After becoming the trustee of the Trust, Bullock made three self-dealing loans. Pet. App., 54a. Bullock first made a loan to and for the benefit of his mother, Imogene Bullock, in the amount of $117,545.96. The purpose of this first loan was to enable Imogene Bullock to repay a debt that she owed to the family garage-construction business, a business in which Bullock held an equity interest. Pet. App., 2a. Bullock made a second loan in 1984 in the amount of $80,257.04, to his mother and himself to purchase certificates of deposit, which they later cashed in and used toward the purchase of a garage fabrication mill in Ohio. Pet. App., 17a. Third, in 1990, Bullock loaned $66,223.96 to his mother and himself to purchase real estate. Pet. App., 17a.

Thus, on account of the three loans, Bullock received substantial personal benefits. First, his business received repayment on a loan to Bullock's mother thus providing Bullock's business with additional

capital. Second, Bullock was able to purchase a garage fabrication mill, a business that Bullock owned and operated and from which he profited. Third, Bullock was able to make a profitable investment in real estate. Bullock repaid all three loans to the trust with interest but retained all of the personal benefits that he accrued from the self-dealing loans.

In 2001, two of Bullock's brothers and Trust beneficiaries sued Bullock in Illinois state court, for breaches of fiduciary duty. Pet. App., 17a. The Illinois court found that the loans from the Trust were for the benefit of Bullock and therefore self-dealing. Pet. App., 54a. The Illinois court concluded that Bullock had breached his fiduciary duties to the Trust and the beneficiaries. Pet. App., 54a. Accordingly, the Illinois court found Bullock liable to the Trust for the personal benefits he obtained from the self-dealing loans in the amount of $250,000 and for the Trust's legal expenses of $35,000. Pet. App., 47a. To secure Bullock's obligations to the Trust, the Illinois court imposed a constructive trust on certain of Bullock's assets and on certain assets of companies that Bullock owned. Pet. App., 47a.[1]

[1] While Bullock has made certain allegations concerning his attempts to sell some of the assets subject to the constructive trusts, such allegations have never been put into the evidence in record in this case and therefore constitute mere speculation.

In October 2009, Bullock filed for bankruptcy relief pursuant to Chapter 7, Title 11, United States Code, 11 U.S.C. § 101, *et seq*. (the "Bankruptcy Code"). Pet. App., 30a. BankChampaign, as successor trustee to the Trust, filed an adversary proceeding in Bullock's bankruptcy case, objecting to Bullock's discharge of his obligations to the Trust. Pet. App., 30a. Specifically, BankChampaign alleged that Bullock's obligations to the Trust were non-dischargeable pursuant to 11 U.S.C. § 523(a)(4), as a debt incurred by defalcation while acting as a fiduciary. Pet. App., 30a. The bankruptcy court held that Bullock's self-dealing breaches of his fiduciary duties constituted a defalcation. Pet. App., 43a-44a. The United States District Court for the Northern District of Alabama affirmed the bankruptcy court's judgment. Pet. App., 16a. The United States Court of Appeals for the Eleventh Circuit affirmed the judgment. Pet. App., 1a. This Court granted Certiorari.

Bullock requests that this Court allow him to self-deal in trust assets, reap a substantial benefit from the self-dealing, harm the Trust and the innocent beneficiaries, and then discharge in bankruptcy his obligations to the Trust. This is not what Congress intended when it made debts on account of defalcations by a fiduciary non-dischargeable.

SUMMARY OF ARGUMENT

Bullock's self-dealing with the Trust corpus constitutes a defalcation while acting in a fiduciary capacity, resulting in a non-dischargeable debt. There is no issue whether a trustee of an express trust holds a fiduciary capacity. He does. Courts, however, have articulated three different general standards for determining whether a fiduciary's misconduct constitutes a defalcation: extreme recklessness, objective recklessness, and negligence. By disregarding the high standard of loyalty that a trustee owes to a trust and beneficiaries, Bullock's act of self-dealing satisfies each or any of these standards. Thus, Bullock's debt to the Trust is properly non-dischargeable regardless of which standard applies.

Under an extreme recklessness standard, a defalcation occurs when the fiduciary's acts are an extreme departure from the standards of ordinary care of fiduciaries. By knowingly and intentionally lending Trust assets for his personal benefit, Bullock's acts departed extremely from the absolute duty of loyalty that the law demands of fiduciaries.

Likewise, Bullock's acts of making loans for his own benefit (and from which he did in fact benefit) satisfy the objectively reckless standard. Bullock willfully made loans in his own interest and benefit, and with complete disregard to the interest or benefit of the Trust. These acts of self-dealing were objectively reckless and therefore constituted a defalcation by Bullock.

Additionally, Bullock's loans for his own benefit were more than negligent. Bullock did not commit an unwitting or careless default of a fiduciary duty; he *deliberately* made self-dealing loans from the Trust to himself and for his own self-interest. Therefore, Bullock's misconduct was at least negligent. Bullock's debts to the Trust are therefore non-dischargeable under the negligence standard for determining defalcation, as well as under any other standard.

ARGUMENT

I. Any Act of Self-Dealing by a Trustee Will Always Be Defalcation While Acting in a Fiduciary Capacity.

Of all of the duties that a trustee owes to trust beneficiaries, the duty of loyalty is the most sacrosanct. Accordingly, breaching the duty of loyalty is the most egregious breach of trust a trustee can commit. The Bankruptcy Code excepts from discharge "any debt . . . (4) for . . . defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). Because a breach of the duty of loyalty by self-dealing is so egregious, it will always be a defalcation.

Courts define defalcation as "[a] monetary deficiency through breach of trust by one who has the management or charge of funds," *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18 (1st Cir. 2002) (citing the Oxford English Dictionary (2d ed. 1989)), or the "misappropriation of trust funds or money held in any

fiduciary capacity; [or the] failure to properly account for such funds," *Pahlavi v. Ansari (In re Ansari)*, 113 F.3d 17, 20 (4th Cir. 1997) (citing Black's Law Dictionary 417 (6th ed. 1990)), or "the failure to meet an obligation" or a "nonfraudulent default." *Republic of Rwanda v. Uwimana (In re Uwimana)*, 274 F.3d 806, 811 (4th Cir. 2001) (citing Black's Law Dictionary 427 (7th ed. 1999)). All of the definitions of defalcation contemplate a breach of a trustee's fiduciary obligations to its beneficiaries, such as occurred in this case.

A. The Duty of Loyalty Is the Highest Duty of a Trustee to the Beneficiaries.

A trustee owes many duties to its beneficiaries, *see generally Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559 (1985), but a trustee's duty of loyalty is "[t]he most fundamental duty owed by the trustee to the beneficiaries of the trust." *Pegram v. Herdrich*, 530 U.S. 211, 224 (2000) (quoting 2A A. Scott & W. Fratcher, The Law of Trusts § 170, 311 (4th ed. 1987)); *United States v. Jicarilla Apache Nation*, 131 S. Ct. 2313, 2336 (2011) ("Among the most fundamental fiduciary obligations of a trustee is to administer the trust solely in the interest of the beneficiaries") (internal citations omitted). Accordingly, the duty of loyalty is the highest duty known to the law. *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 294 (5th Cir. 2000) (discussing trustee obligations under ERISA). Likewise, a breach of the duty of loyalty by self-dealing is

one of the most serious offenses that the law recognizes. *Niehoff v. Maynard*, 299 F.3d 41, 51 (1st Cir. 2002) (recognizing that under Delaware law, allegations of "self-dealing significantly taint the fiduciary relationship" and that "[t]hey implicate *serious* breaches of loyalty.") (emphasis added).

It is in this context that the Bankruptcy Code excepts from discharge *any* debt incurred on account of defalcations while acting in a fiduciary capacity. If a trustee's self-dealing breach of the most fundamental duty of loyalty did not constitute a defalcation under 11 U.S.C. § 523(a)(4), then the statute would be meaningless because nothing would ever count as a defalcation.

B. Bullock's Breach of His Duty of Loyalty by Self-Dealing Constitutes a Defalcation Under Any Standard.

Courts have articulated three different standards for determining what degree of misconduct constitutes a defalcation under 11 U.S.C. § 523(a)(4). Some courts have held that defalcation requires an act of extreme recklessness similar to scienter in the context of securities law. *Denton v. Hyman (In re Hyman)*, 502 F.3d 61 (2d Cir. 2007) (stating that defalcation requires a showing of conscious misbehavior or extreme recklessness – a showing akin to the showing required for scienter in the securities law context); *Baylis*, 313 F.3d 9 (1st Cir. 2002) (ruling that defalcation requires something close to a showing of

extreme recklessness). Other courts have held that an objectively reckless act is sufficient misconduct for a defalcation. *Patel v. Shamrock Flooring, Inc. (In re Patel)*, 565 F.3d 963 (6th Cir. 2009) (finding that a debtor must have been objectively reckless in failing to properly account for or allocate funds); *Schwager v. Fallas (In the Matter of Schwager)*, 121 F.3d 177 (5th Cir. 1997) (holding that willful neglect of fiduciary duty constitutes a defalcation – essentially a recklessness standard). Finally, some courts have adopted a negligence standard for determining a defalcation by a fiduciary. *Sherman v. S.E.C. (In re Sherman)*, 658 F.3d 1009, 1017 (9th Cir. 2011) ("Even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required") (internal citations omitted); *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978 (8th Cir. 1997) (stating that defalcation includes the innocent default of a fiduciary who fails to account fully for money received; an individual may be liable for defalcation without having the intent to defraud).

Under any of the foregoing standards, breaching the duty of loyalty by self-dealing is always a defalcation.

1. Breach of the Duty of Loyalty by Self-Dealing Is an Extremely Reckless Act.

If (assuming arguendo) "extreme recklessness" is the correct standard for generally determining

whether misconduct is a defalcation, Bullock's conduct of making self-dealing loans was extremely reckless and therefore was a defalcation. The extreme recklessness standard requires "a showing of conscious misbehavior or extreme recklessness – a showing akin to the showing required for scienter in the securities law context." *In re Hyman*, 502 F.3d at 68. Here, Bullock acted extremely recklessly by knowingly taking trust assets for personal loans, hoping to profit thereby; and he did.

a. Bullock's Self-Dealing Was Extremely Reckless in Light of His Duty of Loyalty.

In *Baylis*, the First Circuit articulated an extreme recklessness standard for non-dischargeability pursuant to 11 U.S.C. § 523(a)(4). *Baylis*, 313 F.3d at 20. The court in *Baylis* however, made a crucial distinction between a strict test for non-dischargeability for debts incurred by a trustee by reason of self-dealing, and debts resulting from other types of conduct that are governed by less stringent standards. *Id*. *Baylis* made clear that there is a defalcation within the meaning of section 523(a)(4) if a trustee breaches his or her duty of loyalty. Where, as here, a trustee engages in self-dealing the trustee is held "to a very strict standard," and cannot discharge the resulting debt. As stated in *Baylis*:

> In evaluating whether there is a defalcation of a fiduciary duty, there must be reference to the duty involved. Of the various duties,

> the duty of loyalty is "[t]he most fundamental duty owed . . . the duty of a trustee to administer the trust solely in the interest of the beneficiaries." 2A A. Scott, The Law of Trusts § 170 (W.F. Fratcher ed., 4th ed. 2001).

Id. at 20. As further stated in *Baylis*:

> Defalcation may be presumed from breach of the duty of loyalty, the duty not to act in the fiduciary's own interest when that interest comes or may come into conflict with the beneficiaries' interest.
>
> A trustee occupies a position in which the courts have fixed a very high and very strict standard for his conduct whenever his personal interest comes or may come into conflict with his duty to the beneficiaries.

Id. at 20-21 (internal citation omitted). The court there concluded that the debtor's use of trust money for personal attorney's fees and to settle a lawsuit brought against him personally was "in violation of his duty of loyalty," and thus, that the debtor-trustee's "actions as to this component of the debt do constitute defalcation." *Id*. at 22. Where a trustee borrows money from the trust for personal use in violation of the trust instrument, the trustee's breach of the duty of loyalty constitutes a defalcation which is non-dischargeable as a matter of law under § 523(a)(4).

Bullock in this case unquestionably breached his duty of loyalty by self-dealing. Pet. App., at 57a ("It is

undisputed that Defendant lent money to entities in which he had a financial interest or to relatives. This placed him in a position where he would be tempted to act in his interest, possibly against the interests of the beneficiaries."). As this Court has stated with regard to the duty of loyalty and self-dealing,

> Among the most fundamental fiduciary obligations of a trustee is "to administer the trust solely in the interest of the beneficiaries." 2A A. Scott & W. Fratcher, Law of Trusts § 170, p. 311 (4th ed. 1987); *see Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C. J.) ("Not honesty alone, but the punctilio of an honor the most sensitive," is "the standard of behavior" for trustees "bound by fiduciary ties").

United States v. Jicarilla Apache Nation, 131 S. Ct. 2313, 2336 (2011). It is this conduct of self-dealing that is characterized as "extremely reckless" by the First Circuit. *Baylis*, 313 F.3d at 22. In essence, the court imposed a strict rule governing non-dischargeability, ruling that self-dealing constitutes a defalcation under section 523(a)(4). Thus, because of the serious nature of a breach of the duty of loyalty, even if extreme recklessness is the correct standard for determining defalcation, Bullock's breach of the duty of loyalty by self-dealing is a defalcation.

b. The Extreme Recklessness Standard Is an Objective Standard.

Bullock erroneously states that his conduct was not extremely reckless because Bullock did not subjectively know "that the three loans made from his father's *inter vivos* life insurance trust were improper." Pet. Br., 23. First, Bullock's argument posits ignorance of the law as an excuse; an argument that the Illinois state court rejected when it held Bullock liable under Illinois law. *See* Pet. App., 53a. Such an argument is especially misplaced with regard to trustees, who are charged to strictly comply with their duties. *Woods v. City Nat. Bank & Trust Co. of Chicago*, 312 U.S. 262, 269 (1941) (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) ("Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd.'")).

Furthermore, Bullock mistakenly equates defalcation with fraud, arguing that because he did not have specific intent to defraud the Trust and the beneficiaries, he did not commit a defalcation. *See* Pet. Br., 23-24 (citing the fraud requirements under 11 U.S.C. § 523(a)(2) as articulated in *Field v. Mans*, 516 U.S. 59 (1995)). Bullock incorrectly concludes, therefore, that "[i]mputed knowledge that any self-dealing could be a violation of trust law, a ramification of which he had no actual knowledge, is insufficient to establish the mental state needed to except a debt from discharge for 'defalcation' under § 523(a)(4)." Pet. Br., 25.

That conclusion is mistaken because even under the extreme recklessness standard for defalcation, a trustee need not have specific intent to commit defalcation. *Baylis*, 313 F.3d at 18-19 ("we find that a defalcation requires some degree of fault, closer to fraud, without the necessity of meeting a strict specific intent requirement."). Defalcation is an objective standard regarding conduct, not a subjective standard relating to mental states. *Id*. at 17 ("Defalcation is to be measured objectively."). In *Baylis*, the court stated that a creditor "need not prove that a debtor acted knowingly or willfully, in the sense of specific intent" and that "a debtor fiduciary may not escape the exclusion from discharge of his debt arising out of defalcation by saying he had no specific intent." *Id*. at 20. All that a creditor must show is "that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny." *Id*.

In this case, Bullock's act of self-dealing was so egregious that it was extremely reckless. As the court in *Baylis* explained, extreme recklessness is "an extreme departure from the standards of ordinary care." *Id*. at 20 (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 2000)). The standard of care for a trustee of a trust is clear: Bullock must administer the Trust solely in the interest of the beneficiaries. *Jicarilla*, 131 S. Ct. at 2336. Bullock failed to do so. Instead, he used the Trust corpus for his own benefit. Bullock made loans from the Trust that benefitted himself and his companies. Pet. App.,

53a-54a. Thus, by disregarding his fiduciary obligations to administer the Trust for the beneficiaries and making self-beneficial loans to himself, Bullock's conduct was an extreme departure from the most fundamental duties of a trustee. Bullock's actions of self-dealing constitute a defalcation and the debts incurred on account of the defalcation are non-dischargeable.

Nonetheless, Bullock assigns error to the Circuit Court below, objecting that the court "conclusively presume[ed], in effect, that he did know, without considering the actual evidence . . . and declining to examine the particular circumstances of petitioner's case." Pet. App., 23. However, the Circuit Court below reviewed the facts *de novo* (Pet. App., 5a.), the same standard of review the District Court applied. Pet. App., 19a. The Bankruptcy Court applied collateral estoppel to the facts as determined by the Illinois state court. Pet. App., 38a. Thus, the Circuit Court below relied on the same record as the Bankruptcy Court; the detailed record of the Illinois state court. Bullock never appealed or challenged the facts of that record and is now collaterally estopped from doing so. *See Grogan v. Garner*, 498 U.S. 279, 285 n.11 (1991).

c. Bullock's Reasoning for Making Self-Dealing Loans Does Not Make the Loans Less Self-Dealing.

Bullock errs further by arguing that his self-dealing was permitted because he made some of the

loans, in whole or in part, for the benefit of his mother or at the request of Bullock's father – the Trust settlor. Pet. Br., 2, 25, 28. Bullock, however, did not owe either his mother or his father a duty of loyalty. Bullock owed a duty of loyalty to the Trust beneficiaries. Bullock breached the duty of loyalty by self-dealing when he made the loans, even if a portion of the loan proceeds went to his mother. Pet. App., 54a-55a (finding by the Illinois court that "using trust assets for the benefit of family members is also considered self-dealing."). The duty of loyalty prevents Bullock from finding quarter for his self-dealing in accordance with his father's request or in the fact that his mother was a borrower. Bullock's self-dealing is a defalcation while acting in a fiduciary capacity. The Court should not permit Bullock to discharge a debt that the Illinois state court found to arise from his self-dealing.

2. Bullock's Breach of His Duty of Loyalty by Self-Dealing Satisfies the Objectively Reckless Standard.

Bullock's self-dealing as a trustee is objectively reckless conduct that constitutes a defalcation. The objectively reckless standard is a willfulness standard. *Schwager*, 121 F.3d at 185 ("A 'willful neglect' of fiduciary duty constitutes a defalcation – essentially a recklessness standard"). Objective recklessness "does not require actual intent, as does fraud." *Id*. The objective standard prevents ignorance of the law from becoming a defense to non-dischargeability and

provides an incentive to trustees to apprise themselves of their obligations under the law. *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 257 (6th Cir. 1982).

In *In re Patel*, the Sixth Circuit addressed the issue of whether self-dealing was objectively reckless conduct. *Patel*, 565 F.3d 963 (6th Cir. 2009). In *Patel*, the debtor was the president of Empire Builders of Michigan, Inc. *Id*. at 966. Empire Builders was engaged in home construction. *Id*. Empire incurred debt to Shamrock Floorcovering for materials and supplies. *Id*. Michigan law imposed a trust on Empire's revenue whereby Empire held certain funds in trust to pay its suppliers and materialmen, such as Shamrock. *Id*.

As Empire completed construction projects and received payment, Empire used some of the funds to cover its general and administrative expenses and only then paid some funds to Shamrock. *Id.* at 966-67. Empire eventually collapsed and the debtor filed for bankruptcy. *Id*. at 967. Shamrock objected to the debtor's discharge of the balance due to Shamrock. *Id*. The bankruptcy court ruled that the debt to Shamrock was dischargeable, but the district court reversed. *Id*.

On appeal, the circuit court affirmed the district court. The court found that the debtor had "paid his own operating expenses – including payroll, utilities, taxes and wages to himself for services rendered as

president – before he sent any money to Shamrock." *Id*. at 971. The court reasoned that

> the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first is sufficient to constitute defalcation under section 523(a)(4) so long as the use was not the result of mere negligence or a mistake of fact.

Id. at 970. The court therefore concluded that the debtor "recklessly misallocated funds and failed to pay his subcontractors first as required by [Michigan law]." *Id*. at 971.

Just as the debtor in *Patel* committed a defalcation by self-dealing, so too did Bullock in this case. Bullock made loans from the Trust to himself in violation of his duty to administer the Trust for the sole benefit of the beneficiaries. Specifically, the Illinois state court found that "[t]he Defendant borrowed against the cash value of the life insurance policy on three occasions. He then loaned the proceeds to his mother and to business entities that he had an interest in." Pet. App., 50a. Bullock's intent with regard to making the loans is immaterial. *Patel*, 565 F.3d at 970 ("subjective, deliberate wrongdoing was not an element required to establish defalcation.").

Bullock's act of making a loan from trust property was willful and therefore objectively reckless. Willfulness in this context "is measured objectively by

reference to what a reasonable person in the debtor's position knew or should have known." *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001). *See also Safeco Ins. Co. v. Burr*, 551 U.S. 47 (2007) (defining recklessness for purposes of the Fair Credit Reporting Act under an objective standard as "action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known."). Bullock, as trustee of the Trust, is held to "[n]ot honesty alone, but the punctilio of an honor the most sensitive." *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928). Bullock disregarded his obligations and engaged in self-dealing. This conduct is objectively reckless in light of Bullock's high obligations to the Trust. Thus, under an "objectively reckless" standard, Bullock's obligations to BankChampaign are not dischargeable under § 523(a)(4).

3. Breaching the Duty of Loyalty by Self-Dealing Is Always Greater Misconduct Than Negligence; Therefore, Bullock's Conduct Is Non-Dischargeable Even Under a Negligence Standard.

Even under a negligence standard for determining defalcation Bullock's debt should be non-dischargeable. When adopting a negligence standard for determining defalcation, some courts have held that all breaches of a fiduciary obligation constitute a defalcation. *Woodworking Enter v. Baird (In re Baird)*, 114 Bankr. 198, 204 (9th Cir. BAP 1990) ("In the

context of section 523(a)(4), the term 'defalcation' includes innocent, as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts."). Under this standard, Bullock's conduct is non-dischargeable as well.

Breach of the duty of loyalty by self-dealing is more than negligent conduct. *See, e.g., Wolf v. Fried*, 373 A.2d 734 (1977). In *Wolf*, the Supreme Court of Pennsylvania considered a corporate director's negligence to be a breach of his fiduciary duty. *Wolf*, 373 A.2d at 735. The court recognized, however, that negligence was a lesser standard than self-dealing, stating "[e]ven in the absence of fraud, self-dealing, or proof of personal profit or wanton acts of omission or commission, the directors of a corporation may be held personally liable where they have been imprudent, wasteful, careless and negligent and such actions have resulted in corporate losses." *Id*. Likewise, while not directly addressing self-dealing or breach of the duty of loyalty, in *Meyer v. Rigdon*, the Seventh Circuit concluded that "a knowing breach of fiduciary duty is more culpable than a mere negligent breach of fiduciary duty." *Meyer v. Rigdon (In re Rigdon)*, 36 F.3d 1375, 1385 (7th Cir. 1994).

In this case, Bullock's conduct constituted more than negligence as it was a willful breach of the duty of loyalty. Bullock willfully made loans from the Trust to himself. Pet. App., 50a ("The Defendant borrowed against the cash value of the life insurance policy on three occasions. He then loaned the proceeds to his mother and to business entities he had an interest

in."). Because Bullock's act of making a self-dealing loan was willful, it was more than negligent. *Rigdon*, 36 F.3d at 1385. Accordingly, the Court should affirm that Bullock's obligations to BankChampaign are non-dischargeable even if the standard for determining defalcation is mere negligence.

II. Bullock Incorrectly Argues That "Failure to Account" Is a Necessary Element of Defalcation Under Section 523(a)(4).

A. The Statute Does Not Contain Any Requirement of a Failure to Account in Order to Commit a Defalcation.

Bullock, through a strained grammatical construction, posits that a defalcation requires both (a) a misappropriation of trust funds, and (b) a failure to properly account for trust funds. Pet. Br., 26-27. In fact, the term defalcation includes either a misappropriation or a failure to account, but does not require both. The Black's Law Dictionary on which Bullock relies defines defalcation as "misappropriation of trust funds or money held in any fiduciary capacity; failure to properly account for such funds." Black's Law Dictionary 417 (6th ed. 1990).[2]

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[2] Petitioner cites *Corse v. Hemmeter (In re Hemmeter)*, 242 F.3d 1186 (9th Cir. 2001), for a definition of defalcation. *Hemmeter*, in turn, cites *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1185 (9th Cir. 1996), which relies on Black's Law Dictionary 417 (6th ed. 1990) as defining defalcation as "misappropriation of trust

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The Court should read the two provisions as alternative definitions, not as multiple elements of a single definition. *See generally NDSL, Inc. v. Patnoude*, 1:12-CV-1161, 2012 U.S. Dist. LEXIS 173694 at *10 n.2 (W.D. Mich. Dec. 7, 2012) (construing multiple definition entries separated by semicolons). *See also Stevens v. Briles (In re Briles)*, 16 Fed. Appx. 698 (9th Cir. 2001) (finding that a single act "constitutes defalcation *either* as a failure to account for property *or* as a misappropriation of property.") (emphasis added). By making self-dealing loans Bullock committed defalcation by misappropriation of the Trust corpus.

Most importantly, even if failure to account were a necessary element for committing a defalcation, Bullock did fail to account for the Trust assets in this case. A failure to account is not, as Bullock implies, simply a failure to maintain control of the assets, but includes a failure to report to beneficiaries concerning the financial performance of the trust. 760 Ill. Comp. Stat. 5/11(a) ("Every trustee at least annually shall furnish to the beneficiaries . . . a current account showing the receipts, disbursements and inventory of the trust estate."). In this case, Bullock failed to report profits that rightfully belonged to the Trust. The Illinois court found that Bullock failed to account for the trust assets. Pet. App., 58a. Accordingly, Bullock committed a defalcation by failing to account for

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funds or money held in any fiduciary capacity; failure to properly account for such funds."

the Trust assets. His debts on account of this defalcation are therefore non-dischargeable.

B. Bullock Failed to Account to the Trust by Failing to Turn Over the Profits That He Earned.

Even if, as Bullock argues, defalcation requires an element of "resulting loss" (Pet. Br., 20), Bullock caused a loss to the Trust by retaining the benefits of his own self-dealing. Courts of equity universally recognize that a trustee who breaches a fiduciary duty is "accountable for any profit accruing to the trust through a breach of trust." Restatement (Third) of Trusts § 205 (2012). *See also* Restatement (Second) of Trusts § 205 (1959) ("if the trustee commits a breach of trust, he is chargeable with . . . (b) any profit made by him through the breach of trust."). As the comment to the Restatement explains:

> The trustee is chargeable with any profit made by him through the improper disposition or use of trust property. Thus, if the trustee makes an unauthorized investment with trust money which results in a profit, he is chargeable with the profit.

Restatement (Third) of Trusts § 205 (2012); G. Bogert, G. Bogert & A. Hess, THE LAW OF TRUSTS AND TRUSTEES § 862 (3d ed. 2012) ("Another rule of damages provides that a trustee is liable for any profit he has made through his breach of trust even though the trust has suffered no loss. Thus the trustee will be

held liable for profits made through a prohibited dealing with trust property even though the trust received or paid fair market value for the property."). Courts have therefore held that one measure of making a trust whole for a trustee's breach of duty is the profits that the trustee obtains on account of the breach. *See Magruder v. Drury*, 235 U.S. 106 (1914); *Mosser v. Darrow*, 341 U.S. 267 (1951) (finding a trustee liable for profits earned by his employees).

In *Magruder*, this Court addressed the propriety of a trustee earning a profit from the use of trust assets. In *Magruder*, Drury was a trustee of a decedent's estate and a trust created under the decedent's will. *Id*. at 111. Drury was likewise an owner of a real estate brokerage firm, Arms & Drury. *Id*. at 118. As trustee of the trust, Drury directed the trust to make certain commercial loans to various borrowers. *Id*. Drury collected a commission from the borrowers. *Id*.

This Court held that Drury could not retain the commission and should pay the commission to the trust. *Id*. at 119-20. The Court reasoned that "It is a well settled rule that a trustee can make no profit out of his trust." *Id.* at 119. The Court based its reasoning on the inviolable duty of loyalty, stating:

> This rule in such cases springs from his duty to protect the interests of the estate, and not to permit his personal interest to in any wise conflict with his duty in that respect. The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful

> discharge of the duty which is owing in a fiduciary capacity.
>
> * * *
>
> It is the relation of the trustee to the estate which prevents his dealing in such way as to make a personal profit for himself.

Id. at 119-20.

In this case, Bullock derived a profit in the amount of $250,000 from the self-dealing loans and caused the trust to incur litigation costs in the amount of $35,000. Pet. App., 47a. It is this profit that courts recognize as a loss to the Trust. Bullock must pay this profit to the Trust for the Trust to be whole. The Court should not condone Bullock's self-dealing simply because Bullock was ultimately able to repay the loans. Rather, the Court should find that the debt is non-dischargeable, thus requiring Bullock to make the Trust whole by turning over the profits that he earned by wrongfully diverting trust assets. *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937) (finding that debtor committed defalcation by retaining trustee's expenses that a court subsequently determined the debtor owed to the trust).

III. Protection of the Trust's Beneficiaries Takes Precedence Over Bullock's Fresh Start.

Bullock's privilege of discharging his debts is subordinate to the rights of the Trust beneficiaries to

be protected. Discharge is available only to the "honest but unfortunate debtor." *Grogan*, 498 U.S. at 287 (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)). Thus, Congress determined that certain acts by a debtor will prevent the debtor from obtaining a discharge. *Id*. at 287 (stating that § 523(a) "reflect[s] a congressional decision to exclude from the general policy of discharge certain categories of debts."). Bullock's defalcation by self-dealing is such an act.

Nonetheless, Bullock argues that the fresh start policy takes precedence over all other policies. Pet. Br., 9. However, such a construction would thwart congressional intent to protect beneficiaries and maintain the high standards of loyalty expected from fiduciaries. *Cazenovia College v. Renshaw (In re Renshaw)*, 222 F.3d 82, 86 (2d Cir. 2000) ("there are circumstances where giving a debtor a fresh start in life is not the paramount concern and *protection of the creditor becomes more important*. For that reason, Congress in the Bankruptcy Code created several exceptions to the general rule that debts may be discharged in bankruptcy.") (emphasis added); *Forsdick v. Turgeon*, 812 F.2d 801, 802 (2d Cir. 1987) ("While the code therefore reflects a strong public policy of providing debtors with fresh starts, congress has also determined that *certain competing public policy interests shall take precedence*. These competing concerns are reflected in exceptions that congress has enacted to the general rule that debts are dischargeable in bankruptcy.") (emphasis added).

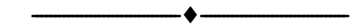
IV. Contrary to Bullock's Contention, BankChampaign Neither Urges Nor Requires Any Expansion of the Defalcation Exception to Discharge.

Despite Bullock's arguments otherwise, finding Bullock's debts to the Trust non-dischargeable will not require an "expansion" of the defalcation exception under § 523(a)(4). Bullock invokes *Chapman v. Forsyth*, 43 U.S. 202 (1844), for the idea that this Court "has repeatedly resisted expansion of the defalcation exception." Pet. Br., 11. *Chapman*'s central holding was that, under the statute then in existence, fiduciary defalcations were non-dischargeable only where the fiduciary acted under an express or technical trust. *Chapman* fully supports that Bullock's conduct in this case should be held non-dischargeable. Whether *Chapman* stands for "resisting" some "expansion" of the meaning of § 523(a)(4) is beside the point because no expansion of § 523(a)(4) is needed to uphold the non-dischargeability of Bullock's debt. The current statute could be squarely limited to *Chapman*'s requirement of an express trust, and Bullock's conduct would still be non-dischargeable.

Likewise, Bullock's arguments from *Neal v. Clark*, 95 U.S. 701 (1877) and *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) do not support a finding that Bullock's debts by self-dealing are dischargeable. In *Neal*, the Court determined that the fiduciary fraud section required actual fraud; not constructive fraud. *Neal*, 95 U.S. at 709. *Neal* is inapplicable because the instant case deals with

fiduciary defalcation, not fraud. In *Davis*, this Court refused to impose fiduciary status on a debtor *ex maleficio*. *Davis*, 293 U.S. at 333. *Davis* is irrelevant because this case does not include imposition of fiduciary status "*ex maleficio*"; rather Bullock's fiduciary status derives from expressly assuming the duties of a trustee.

BankChampaign is not arguing that the Court should expand the meaning of the term defalcation. Rather, BankChampaign encourages the Court to simply apply the term as understood in its context of § 523(a). *Grogan*, 498 U.S. at 287, n.13 ("In determining the meaning of the statute, we look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy") (internal citations omitted). Congress included the fiduciary defalcation exception to discharge for just this type of situation: to protect innocent beneficiaries from the disloyalty of their trustee by preserving their claims against the trustee. Bullock breached his duty of loyalty by self-dealing and should not be able to discharge his obligations to the Trust.



CONCLUSION

The exception to discharge on account of a fiduciary's defalcation protects innocent beneficiaries from the disloyalty of their trustees. Bullock breached the inviolable duty of loyalty by self-dealing with the Trust assets. Accordingly, the Court should hold that

Bullock's debts to the Trust are non-dischargeable and affirm the ruling of the Circuit Court.

Respectfully submitted,

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