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 *AMICUS CURIAE* G. ERIC BRUNSTAD, JR. IN SUPPORT OF PETITIONER

G. Eric Brunstad, Jr.
Counsel of Record
Collin O'Connor Udell
Matthew J. Delude
DECHERT LLP
90 State House Square
Hartford, Connecticut 06103
(860) 524-3999
eric.brunstad@dechert.com

Counsel for Amicus Curiae

TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES
(continued)

Page

TABLE OF AUTHORITIES
(continued)

Page

TABLE OF AUTHORITIES
(continued)

Page

STATUTES

TABLE OF AUTHORITIES
(continued)

Page

OTHER AUTHORITIES

INTEREST OF THE *AMICUS CURIAE*[1]

The undersigned *amicus curiae* is an Adjunct Professor of Law at New York University School of Law and a frequent Visiting Lecturer in Law at the Yale Law School where he teaches courses on bankruptcy law, domestic and international business reorganizations, commercial transactions, secured transactions, federal courts, and argument and reason. He began teaching at Yale in 1990, began teaching at NYU in 2012, and has also taught at the Harvard Law School. In addition to his teaching, the undersigned is a contributing author to Collier on Bankruptcy, responsible for writing several chapters of the Treatise. He is also a partner at the law firm of Dechert LLP; a prior Chair of the ABA Business Bankruptcy Committee; a former member of the Judicial Conference Advisory Committee on the Federal Bankruptcy Rules; and a Fellow of the American College of Bankruptcy.

---

[1] No counsel for any party has authored this brief in whole or in part, and no party or counsel for a party has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. All parties have been timely notified of the undersigned's intent to file this brief; both petitioner and respondent have consented to the filing of this brief. Copies of petitioner's and respondent's consents are filed herewith.

The undersigned has briefed and argued numerous bankruptcy matters before the Court, including *Schwab v. Reilly*, 130 S. Ct. 2652 (2010); *Milavetz, Gallop & Milavetz, P.A. v. United States*, 130 S. Ct. 1324 (2010); *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008); *Travelers Cas. & Sur. Co. v. Pacific Gas & Elec. Co.*, 549 U.S. 443 (2007); *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007); *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004); and *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000). He has otherwise participated as counsel for one of the parties in numerous other bankruptcy matters before the Court, including *Stern v. Marshall*, 131 S. Ct. 2594 (2011); *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010); *Central Virginia Cmty. College v. Katz*, 546 U.S. 356 (2006); *Rousey v. Jacoway*, 544 U.S. 320 (2005); *Kontrick v. Ryan*, 540 U.S. 443 (2004); *Lamie v. United States Trustee*, 540 U.S. 526 (2004); *FCC v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293 (2003); and *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249 (1992). In addition, he has prepared and filed with the Court several amicus briefs in bankruptcy cases, including *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012); *Hall v. United States*, 132 S. Ct. 1882 (2012); *Ransom v. FIA Card Servs.*, 131 S. Ct. 716 (2011); *United Student Aid Funds, Inc. v. Espinosa*, 130 S. Ct. 1367 (2010); *Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 547

U.S. 651 (2006); *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004); *Archer v. Warner*, 538 U.S. 314 (2003); and *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124 (1995).

The undersigned is deeply interested in the subject of bankruptcy law and has written, taught, and lectured on the subject of the bankruptcy discharge, including the exceptions to discharge contained in section 523 of the Bankruptcy Code, 11 U.S.C. § 523. The purpose of this brief is to address matters that bear on the Court's determination of an important bankruptcy issue: what degree of debtor misconduct constitutes a "defalcation" under section 523(a)(4) of the Bankruptcy Code such that the debtor may be denied a discharge in bankruptcy from a debt arising from the misconduct, and specifically, does it include actions that resulted in no loss of trust property? In particular, this brief explains why the debt at issue here should not have been excepted from Petitioner's discharge in light of the text of the governing statutory provision, relevant principles of statutory construction, and the historical use and interpretation in the bankruptcy setting of the term "defalcation." The undersigned argues that the decision of the court below should be reversed and that the correct standard is the "extreme recklessness" standard applied by the Court of Appeals for the Second Circuit in *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 68 (2d Cir. 2007) and the

Court of Appeals for the First Circuit in *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 19-20 (1st Cir. 2002).[2]

STATEMENT

In 1978, Curt Bullock, Petitioner's father, created a family trust for the benefit of Petitioner and his siblings. Pet. App. 2a, 17a. The trust's sole asset was Curt's life insurance policy, which had a $1 million death benefit and accumulated cash value. Pet. App. 17a. Petitioner was named as trustee of the trust, though he was unaware of its existence at that time. Pet. App. 45a.

In 1981, Curt informed his son, Petitioner, of his role as trustee of the trust and requested a loan in the amount of $117,545.96 to be taken against the cash value of the life insurance policy. Pet. App. 17a. The loan was used to repay debts owed by Petitioner's mother, Imogene Bullock. Pet. App. 2a, 17a. In 1984, Petitioner and his mother obtained an additional loan from the trust in the amount of $80,257.04 for the ultimate purpose of purchasing business property. Pet. App. 17a. In 1990, Petitioner and his mother obtained a final loan of $66,223.96 for the pur-

[2] The undersigned was counsel of record for the debtor/respondent in *Denton v. Hyman*, no. 07-952 (2009) (cert. denied).

chase of additional business property. Pet. App. 2a, 17a. All of the loans were ultimately repaid in full with six percent interest. Pet. App. 17a, 45a, 50a.

The terms of the trust permitted the trustee to borrow against the policy to provide funds to pay the premiums or to satisfy any request of a beneficiary for withdrawal of funds. Pet. App. 17a. Petitioner acknowledged that the money borrowed from the trust at issue here was not used in either of those two ways. Pet. App. 54a.

In 2001, Petitioner's two brothers filed an action in Illinois state court, claiming Petitioner had breached his fiduciary duty as trustee. Pet. App. 17a. The brothers sought to have any profits earned by Petitioner and his mother as a result of the loans remitted to the trust. Pet. App. 17a, 47a. The Illinois court ultimately granted summary judgment in favor of the brothers because the loans were deemed to be self-dealing transactions and therefore breaches of fiduciary duty under Illinois law, despite the fact that the court found that Petitioner did "not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a, 57a. The court awarded the trust $250,000 in damages, which it estimated to be the benefit Petitioner obtained from the breaches of duty, as well as attorneys' fees to Petitioner's brothers. Pet. App. 17a, 46a.

On October 21, 2009, Petitioner filed for bankruptcy under Chapter 7 of the Bankruptcy Code. Pet. App. 30a. Respondent, as successor trustee of the trust, filed an adversary proceeding seeking, pursuant to 11 U.S.C. § 523(a)(4), to except the Illinois judgment from Petitioner's bankruptcy discharge. Pet. App. 30a. The bankruptcy court ultimately excepted the debt from Petitioner's discharge and the district court and Eleventh Circuit affirmed. Pet. App. 1a-44a.

SUMMARY OF THE ARGUMENT

The bankruptcy discharge is a foundational aspect of bankruptcy law that vindicates the fundamental bankruptcy policy of the "fresh start"—the idea that an insolvent debtor may be released from preexisting civil liabilities in order to start over in life free from the burden of oppressive indebtedness. Because of the pivotal role of the "fresh start" in advancing Congress's objectives in adopting the various bankruptcy statutes enacted over the past two centuries, Congress has promoted, expanded, and protected the discharge time and again through a variety of legislative means. Recognizing the central role that the discharge plays in the administration of our bankruptcy system, together with the fundamental policy that it serves, this Court has generally interpreted the scope of the discharge generously and has correspondingly interpreted its *exceptions* narrowly to promote Congress's ambition of affording broad fresh start relief to

insolvent individuals. This is important to the nation as a whole because it helps avoid the perpetuation of a class of individuals perennially saddled with oppressive indebtedness. As a general rule, only debts that either (1) arise from *serious* forms of wrongdoing or (2) are treated specially for distinct policy reasons not relevant here are excepted from the discharge.

In order to further the ends of Congress's fresh start policy, this Court has deployed a special canon of construction in cases such as this involving the interpretation of the bankruptcy discharge provisions. That canon directs courts to interpret narrowly the statutory exceptions to discharge relief. That approach is closely analogous to a second canon the Court has adopted with respect to another fundamental policy of bankruptcy law—the goal of "equality of distribution" among a debtor's creditors. In order to advance the policy of equality of distribution, this Court construes narrowly provisions of the Code that give preference (or priority) to one creditor over others. Just as the Court construes narrowly the priority provisions of the Code to advance the policy of equality of distribution, the Court construes narrowly the exceptions to the bankruptcy discharge to advance the policy of the fresh start. Application of that canon here supports the conclusion that Petitioner's debt should not have been excepted from discharge.

Petitioner's cause is likewise advanced by the text of section 523(a)(4) and the historical interpretation of the term "defalcation." In context, the language and history of section 523(a)(4) demonstrate that Congress intended to limit "defalcation" to debts arising from a debtor's serious malfeasance resulting in a diminution of trust property, not simply inadvertent neglect or dereliction of duty. The text of the statute, which places "defalcation" between the terms "fraud," "embezzlement," and "larceny," reflects Congress's intent to limit the application of section 523(a)(4) to debts that arise from a debtor's serious wrongdoing. That interpretation is bolstered by reference to the serious nature of the other "fault" exceptions to the discharge. *See, e.g.,* 11 U.S.C. § 523(a)(9) (debt arising from personal injury caused by the debtor's operation of a motor vehicle or other vessel while intoxicated excepted from discharge). It is further supported by early decisions recognizing that the term "defalcation" as used in an early statutory predecessor to section 523(a)(4) was directed at conduct that "involve[d] moral turpitude or intentional wrong." *Keime v. Graff*, 14 F. Cas. 218, 219-20 (C.C.W.D. Pa. 1878).

In light of the relevant statutory text and the historical treatment of the "defalcation" exception, the interpretation of section 523(a)(4) that the First and Second Circuits have adopted is correct. *See Denton v. Hyman (In re Hyman)*,

502 F.3d 61, 68 (2d Cir. 2007); *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 19-20 (1st Cir. 2002). These decisions properly hold that the defalcation exception applies only when the debtor's behavior rises to the level of extreme recklessness—something much more akin to fraud, embezzlement, or larceny than negligence or dereliction of office. That approach also properly aligns with the overarching "fresh start" policy of the Bankruptcy Code and Congress's general ambition of promoting it broadly.

It is clear from the facts of this case that Petitioner's conduct does not rise to the level necessary under the defalcation exception to strip him of his discharge and leave him indebted beyond his means, perhaps for life. The state court in this case recognized that although Petitioner had technically engaged in a "self-dealing" transaction under Illinois law, he did not have a malicious motive in doing so. At bottom, he simply made a mistake. He apparently thought that it would be permissible to borrow from a trust of which he was also a beneficiary so long as he repaid the money at the same rate of return that the trust was already receiving from the relevant insurance company (which he did). It turns out that he was incorrect, but that mistake is insufficient to deprive him of the important benefit of his discharge because it simply does not rise to the level necessary to invoke the sanction of non-dischargeability which, for many,

would equate to perpetual insolvency. The decision below should be reversed.

ARGUMENT

A. The Court Should Construe the "Defalcation" Exception Narrowly.

Section 523(a)(4) generally excepts from the scope of a debtor's discharge any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). The question presented involves the proper interpretation of the term "defalcation." Although the terms "fraud," "embezzlement," and "larceny" are fairly well-worn, the term "defalcation" is arcane, arising so rarely in common conversation and usage that it is difficult to conclude that it has a "plain" or "fixed" independent meaning, at least in any lay sense. It apparently derives from the archaic term "defalk," with connotations (according to some authorities) of liability for fraudulent activity resulting in the depletion of funds entrusted to the care of a fiduciary. *See Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 17-18 (1st Cir. 2002) (canvassing various dictionary definitions and the origins of the term). Of course, there was no fraud in this case, nor any ultimate deficiency in the funds entrusted: all of the loans were repaid with interest. Here there was merely Petitioner's unfortunate lapse of appropriate judgment. His conduct

would thus appear to fall outside the traditional scope of the term.

Consistent with the fundamental "fresh start" policy underlying the discharge provisions of the Bankruptcy Code and this Court's practice of construing the discharge exceptions narrowly, the Court should construe the term "defalcation" narrowly to encompass only financial misdealing by a fiduciary rising to the level of extreme recklessness that results in the depletion of entrusted funds. Doing so has several virtues. First, it avoids infringing upon the discharge through an overbroad construction of an unusual and ambiguous term. Second, it aligns the concept of "defalcation" with its companions in section 523(a)(4)—"fraud," "embezzlement," and "larceny"—all of which also connote some form of financial loss. Third, it avoids rendering any of these other terms superfluous because it is distinct: the concept of extremely reckless behavior by a fiduciary that results in financial loss covers conduct that the more technical concepts of "fraud," "embezzlement," and "larceny" omit (because, as discussed below, each of these requires evidence of specific intent or its equivalent, whereas extreme recklessness would suffice for defalcation). Fourth, it aligns with historical interpretations of the term. Because the court below construed "defalcation" to encompass more than this narrow interpretation allows, its decision should be reversed.

1. The Court Should Construe the Exceptions to the Discharge Narrowly to Effectuate the Bankruptcy Code's Fresh Start Policy.

The discharge is a critical aspect of bankruptcy law, perhaps even *the* most critical of its features. It has long provided much needed relief from oppressive indebtedness to millions of American debtors. Congress has repeatedly acknowledged the benefits of the debtor's discharge, allowing even certain debts owed to the federal government, as well as other governmental entities, to be dischargeable. *See* 11 U.S.C. § 523; *FCC v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293, 303 (2003).

So important is the discharge that the Bankruptcy Code prevents individuals from waiving it *ex ante* at the time they incur debt, *see id.* § 524(a), and likewise places substantial *ex post* restrictions on the ability of debtors to waive the discharge with respect to particular debts through "reaffirmation" after filing for bankruptcy relief, *see id.* § 524(c). *See* 8B C.J.S. *Bankruptcy* § 1093 (2012) ("A 'reaffirmation agreement,' . . . is an agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under the Bankruptcy Code. Reaffirmation represents the only vehicle through which an otherwise dischargea-

ble debt can survive the successful completion of Chapter 7 proceedings, and an enforceable reaffirmation agreement makes a debtor remain personally obligated after discharge for a debt which is otherwise dischargeable."). In fact, even when a debtor wishes to waive his right to a discharge through reaffirmation, the bankruptcy court must essentially ratify the reaffirmation by ensuring that it does not impose an undue hardship on either the debtor or the debtor's dependents. *See id.* § 524(c)(3)(B); *Renwick v. Bennett (In re Bennett)*, 298 F.3d 1059, 1066-67 (9th Cir. 2002).

These protections did not arise by accident. They were enacted to curtail attempts to limit the discharge because the discharge serves as the primary vehicle through which the Bankruptcy Code's "fresh start" policy is achieved. As this Court has long recognized, one of the primary purposes of bankruptcy law is to excuse an insolvent debtor "from the weight of oppressive indebtedness, and permit him to start afresh . . . ." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554-55 (1915)). Indeed, "[t]his purpose . . . has been again and again emphasized by the courts as being of public as well as private interest" by giving insolvent debtors "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt." *Id.*

In light of the importance of the fresh start policy under the Bankruptcy Code, this Court has also long recognized that any "exceptions to the operation of a discharge thereunder should be confined to those plainly expressed." *Gleason v. Thaw*, 236 U.S. 558, 562 (1915). Accordingly, this Court has narrowly construed exceptions to the discharge in an effort to effectuate the Bankruptcy Code's "fresh start" goal. *See Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998). Consistent with that narrowing canon, Petitioner's obligations related to the Illinois court judgment should not be excepted from the scope of his discharge. That result is all the more appropriate here, given that Congress's use of the arcane term "defalcation" in section 523(a)(4) is hardly a "plain" expression of substantive meaning.

2. The Court's Approach of Interpreting Narrowly the Exceptions to Discharge Parallels Its Approach of Interpreting Narrowly the Exceptions to the Code's Priority Provisions.

The history of the Court's approach of interpreting the discharge exceptions narrowly parallels its companion approach of interpreting narrowly the Code's priority provisions. In addition to the fresh start policy, bankruptcy law also embodies the fundamental policy of equality of

distribution among the creditors of insolvent debtors. *See, e.g., Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) (discussing "the prime bankruptcy policy of equality of distribution" to creditors); *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945) ("historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets"); *Buchanan v. Smith*, 83 U.S. 277, 301 (1872) (noting the main bankruptcy policy of "[e]qual distribution of property of the bankrupt, *pro rata*"). Of course, the Bankruptcy Code actually honors this policy in the breach: although the Code *generally* requires ratable distribution among creditors, it specifically elevates certain debts above others by affording them priority treatment. *See, e.g.*, 11 U.S.C. § 507. Nonetheless, the policy of equality of distribution endures as a foundational baseline.

Because the Code's priority provisions have a corrosive effect on the general policy of equality of distribution, the Court has adopted a mediating canon that the priority provisions should be construed narrowly. *See Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 547 U.S. 651, 667 (2006). For example, relying specifically on the Code's aim "to secure equal distribution among creditors," the Court declined in *Howard Delivery* to afford priority status to premiums paid for workers' compensation insurance. *Id.* at 655. The Court explained that the

equal distribution objective directs the "corollary principle that provisions allowing preferences must be tightly construed." *Id.* at 667.

The Court's decision in *Howard Delivery* did not break new ground—the Court has often employed the same narrowing canon to other provisions allowing preferences in bankruptcy. *See, e.g., Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930) ("The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt's estate . . . [and] [a]ny agreement which tends to defeat that beneficent design must be regarded with disfavor."); *see also Nathanson v. NLRB*, 344 U.S. 25, 29 (1952) ("The theme of the Bankruptcy Act is 'equality of distribution' . . . and if one claimant is to be preferred over others, the purpose should be clear from the statute.") (quoting *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (explaining that in light of the bankruptcy theme of equality of distribution "an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice.")). Thus, the canon has become a well-recognized feature of the bankruptcy jurisprudential landscape. *See* 4 COLLIER ON BANKRUPTCY ¶ 507.01 (16th ed. 2012) ("Because priorities grant special rights to the holders of priority claims, priorities under the Code are to be narrowly construed.").

As this Court has also long recognized, "[t]he discharge of the debtor has come to be an object of no less concern than the distribution of his property." *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 588 (1935). Indeed, as the Court similarly explained in an early case under the Bankruptcy Act of 1898,

> The federal system of bankruptcy is designed not only to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors, but as a main purpose of the act, intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors. Our decisions lay great stress upon this feature of the law . . . .

Stellwagen v. Clum, 245 U.S. 605, 617 (1918).

Because (1) the Code's general fresh start policy is no less important than its general policy of equality of distribution, and (2) the Code's fresh start policy is eroded no less by the exceptions to discharge than the Code's policy of equality of distribution is eroded by the priority provisions, it follows that the same mediating principle applies in both settings: the exceptions to discharge *and* the priority provisions should

both be construed narrowly. As summarized above, the Court has long taken the path of construing the exceptions to discharge tightly, *see, e.g., Gleason*, 236 U.S. at 562, and the canon requiring narrow construction of the discharge exceptions is no less a familiar feature of the bankruptcy jurisprudential landscape than the canon requiring narrow construction of the priority provisions. *See* 4 COLLIER ON BANKRUPTCY ¶ 523.05 (16th ed. 2012) ("In determining whether a particular debt falls within one of the exceptions of section 523, the statute should be strictly construed against the objecting creditor and liberally in favor of the debtor."). Keeping with this tradition, the Court should construe narrowly the "defalcation" exception set forth in section 523(a)(4).

B. Congress Intended to Limit the Term "Defalcation" in Section 523(a)(4) to Debts Arising from a Debtor's Serious Malfeasance.

It is axiomatic that questions regarding the meaning of statutory text must "begin[] with the language of the statute itself." *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989). In this case, however, that exercise does not take us very far—at least without the assistance of several extrinsic aids, four of which are particularly important here: (1) the canon discussed above requiring the narrow construction of the excep-

tions to discharge relief, (2) the canon *noscitur a sociis*, (3) the whole act canon requiring consideration of section 523(a)(4) in context with the entirety of section 523(a), and (4) consideration of the historical interpretation of the "defalcation" concept as used in a succession of bankruptcy laws.

Dictionary definitions of the term "defalcation" are not particularly helpful. *See, e.g.*, WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 332 (1988) ("1. *Archaic*: deduction 2: the act or an instance of embezzling 3: a failure to meet a promise or an expectation") (hereinafter WEBSTER'S); *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 17-18 (1st Cir. 2002) (canvassing various dictionary definitions covering a broad variety of definitional possibilities and describing the origins of the term). Where, as here, the various dictionary definitions lead to no easy answer and the word at issue is nested in a list, courts routinely rely on the doctrine *noscitur a sociis* as a guide to interpretation—"a word is known by the company it keeps." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 575 (1995). In this way, courts "avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words, thus giving 'unintended breadth to the Acts of Congress.'" *Id.* (quoting *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961)). That is particularly appropriate here, given the impact that the

exceptions to discharge have on the general fresh start policy.

In this case, then, the term "defalcation" must be "read in context to refer to writings that, from a functional standpoint, are similar to" the terms "fraud," "embezzlement," and "larceny." *Id.* at 576; *see also Beecham v. United States*, 511 U.S. 368, 371 (1994) ("That several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well."); *Jarecki*, 367 U.S. at 307 (the term at issue "does not stand alone, but gathers meaning from the words around it."). Importantly, "[f]raud, embezzlement and larceny are all serious crimes requiring specific intent." *Baylis*, 313 F.3d at 20. Similarly, to the extent that section 523(a)(4) "covers civil actions for fraud, such as a fraudulent misrepresentation, the maker of the statement must know or believe the statement is untrue or that he has no basis to make the statement." *Id.* (citing RESTATEMENT (SECOND) OF TORTS § 526 (1976)).

According to WEBSTER'S, the term "fraud" means "deceit, trickery . . . intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right . . . an act of deceiving or misrepresenting." WEBSTER'S 490. The term "embezzle" means "to appropriate (as property entrusted to one's care) fraudulently to one's own use." WEBSTER'S 406.

The term "larceny" means "the unlawful taking of personal property with intent to deprive the rightful owner of it permanently: theft." WEBSTER'S 674. All of these terms indisputably involve serious and intentional wrongdoing as opposed to mere negligence or dereliction of office. Thus, the inclusion of "defalcation" in section 523(a)(4) together with the terms listed above strongly indicates Congress's intention to limit the application of that term to debts arising from a debtor's serious malfeasance. *Cf. Hickman v. Texas*, 260 F.3d 400, 403-04 (5th Cir. 2001) (using the *noscitur a sociis* doctrine to conclude that Congress intended to limit application of 11 U.S.C. § 523(a)(7) to forfeitures imposed upon a wrongdoing debtor).

This makes sense when one views section 523(a)(4) against the backdrop of section 523(a) as a whole. The exceptions to discharge in section 523(a) exist for one of two reasons. First, discharge may not be used to avoid the repayment of certain debts that are of special importance for distinct policy reasons (*e.g.*, certain taxes or customs duties (§ 523(a)(1)); debts incurred to pay certain taxes (§ 523(a)(14)); alimony and child support obligations (§ 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, except in cases of undue hardship (§ 523(a)(8)); restitution orders (§ 523(a)(13)); court fees (§

523(a)(17)); and support owed under state law and enforceable under the social Security Act (§ 523(a)(18)). *See Baylis*, 313 F.3d at 19. This first category of discharge exceptions are driven by the type of debt rather than the level of fault of the debtor. *Id.* Critically, the defalcation exception is not contained within any of these sections.

The second category includes exceptions based on the type of *fault* that caused the debt rather than the type of debt. These include debts based on 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)); and the exception at issue in this case: "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny" (§ 523(a)(4)). *See Baylis*, 313 F.3d at 19. The exception to discharge set forth in section 523(a)(12), "for malicious or reckless failure" to maintain capital of an insured depository institution to the extent required by federal regulatory agencies, combines both categories—a level of fault together with a type of debt important for policy reasons. *See Baylis*, 313 F.3d at 19.

The "type of fault" exceptions concern "extremely serious actions done knowingly or with great risk of harm to others." *Id.* Because the defalcation exception falls within this second

camp, the Court should conclude that, based on the structure of section 523(a) as a whole, "for an act to fall under the 'defalcation' exception to discharge, it must be a serious one indeed, and some fault must be involved." *Id.*

This approach is consistent with the historical interpretation of the word "defalcation" in the statutory predecessor to section 523(a)(4). This history is relevant because, as the Court has explained, it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Hamilton v. Lanning*, 130 S. Ct. 2464, 2473-74 (2010); *see also Travelers Cas. & Surety Co. of America v. Pacific Gas & Elec. Co.*, 549 U.S. 443, 454 (2007); *Lamie v. U.S. Trustee*, 540 U.S. 526, 539 (2004). In this instance, there is no indication that when Congress included section 523(a)(4) as part of the Bankruptcy Code in 1978, it intended the term "defalcation" to be broader than its historical interpretation.

In recognizable form, the statutory provision at issue here has been part of the nation's bankruptcy law since at least the Bankruptcy Act of 1867, and traces its roots even farther to the Bankruptcy Act of 1841. *Baylis*, 313 F.3d at 17 (citing An act to establish a uniform system of bankruptcy through the United States, ch. CLXXVI, § 33, 14 Stat. 517, 533 (1867) (repealed 1878) and An act to establish a uniform system

of bankruptcy throughout the United States, ch. IX, § 1, 5 Stat. 440, 441 (1841) (repealed 1843) (excepting only debts arising from "defalcation as a public officer")).

An older case on point is *Keime v. Graff*, where the court considered the meaning of "the thirty-third section of the bankrupt law [Act of 1867], which enacts that '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 by proceedings in bankruptcy.'" 14 F. Cas. 218, 218 (C.C.W.D. Pa. 1878). The court held that,

> applying the rule *noscitur a sociis* to the interpretation of this language, its meaning is clearly the same as that employed in the act of 1841. . . . [T]he term, 'defalcation,' which must be read in connection with the phrase in question, to make it intelligible, imports a greater degree of culpability than that which attaches to a refusal or failure to pay a debt, even though it is attended by a breach of confidence. It involves 'moral turpitude or intentional wrong,' hence it is associated with liabilities of like moral character and imports a classification of kindred subjects.

Id. at 220.

Analogously, in *Neal v. Clark*, this Court considered the same provision, this time with respect to the term "fraud," stating that "[i]n the construction of statutes, . . . the rule *noscitur a sociis* is very frequently applied; the meaning of a word, and, consequently, the intention of the legislature, being ascertained by reference to the context, and by considering whether the word in question and the surrounding words are, in fact, *ejusdem generis*, and referable to the same subject-matter." 95 U.S. 704, 709 (1877). The Court concluded that,

> in the section of the law of 1867 which sets forth the classes of debts which are exempted from the operation of a discharge in bankruptcy, debts created by 'fraud' are associated directly with debts created by 'embezzlement.' Such association justifies, if it does not imperatively require, the conclusion that the 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality.

Id.; *see also* 124 CONG. REC. H11095-96 (daily ed. Sept. 28, 1978); S17412 (daily ed. Oct. 6, 1978) (statements of Rep Edwards and Sen. DeConcini)

("Subparagraph (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.'"); *Tsurukawa v. Nikon Precision, Inc. (In re Tsurukawa)*, 258 B.R. 192, 197 (B.A.P. 9th Cir. 2001).

Thus, based on (1) application of the bankruptcy canon that the exceptions to the discharge should be construed narrowly; (2) application of the general canon *noscitur a sociis* to align the meaning of the term "defalcation" with its companion terms "fraud," "embezzlement," and "larceny"; (3) consideration of section 523(a)(4) in context with section 523(a) as a whole; and (4) the historically narrow construction of the term "defalcation" and other terms in section 523(a)(4), this Court should conclude that Congress intended to limit the application of the section to debts arising from a debtor's serious malfeasance, and specifically to defalcations by a debtor engaged in the most serious wrongdoing resulting in actual loss.

C. The First and Second Circuits' Conclusion that "Defalcation" Exists Only When the Debtor's Behavior Rises to the Level of Extreme Recklessness Is the Most Faithful to the Language, Structure, and History of Section 523(a)(4).

As discussed above, the "defalcation" provision has been part of the bankruptcy statutes since 1841, and since that time, many courts have weighed in concerning the degree of misconduct that is necessary to satisfy its requirements. Petitioner's brief discusses the relevant circuit split, Pet. Br. 12-15, which is not repeated here. It is worth reiterating, however, that the Court's post-1867 decisions consistently rejected an expansionary reading of section 523(a)(4)'s statutory predecessor. *See, e.g., Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) (Cardozo, J.) (interpreting Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1978)); *Crawford v. Burke*, 195 U.S. 176, 189-90 (1904) (same).

The current text of section 523(a)(4) was enacted as part of the 1978 Bankruptcy Reform Act. That Act deleted the term "misappropriation" appearing in section 17 of the Act of 1898, and revised the statutory language so that embezzlement and larceny were not limited to debtors acting in a fiduciary capacity, and fraud was limited to fiduciary situations because a separate

provision, section 523(a)(2) covers other kinds of fraud. *See Angelle v. Reed (In re Angelle)*, 610 F.2d 1335, 1341 n.12 (5th Cir. 1980) (discussing section 523(a)(4) of the Bankruptcy Reform Act, 11 U.S.C. § 523(a)(4)).[3] The limited legislative history that is available indicates that section 523(a)(4) was intended to reach debts incurred through a debtor's malfeasance: "Paragraph (4) excepts debts for embezzlement or larceny. The deletion of willful and malicious conversion from Sec. 17a(2) of the Bankruptcy Act is not intended to effect a substantive change. The intent is to include in the category of non-dischargeable debts a conversion under which the debtor *willfully and maliciously intends* to borrow property for a short period of time with no intent to inflict injury but on which injury is in fact inflicted." 1978 H. REP. NO. 95-595, 2d Sess., at 364 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6320 (emphasis added). In this instance, of course, the state court found that Petitioner acted without malicious intent. Further, there was no actual injury because the loans were repaid. Consistent with

---

[3] Section 17(4) excepted from the debtor's discharge debts that "were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1978). If anything, Congress's removal of the term "misappropriation" when it codified this provision in revised form as part of the new section 523(a)(4) demonstrates that Congress intended to narrow further the scope of the exception.

the legislative history, Petitioner's conduct in this case falls outside the purview of the kind of malfeasance Congress indicated it was targeting when it revised the fault provisions of section 523(a).

In *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937) (Learned Hand, J.), the Second Circuit took a different approach, issuing a "carefully equivocal opinion," *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18 (1st Cir. 2012); *see also Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 67 (2d Cir. 2007) ("In *Herbst*, Judge Learned Hand wrestled with this problem without resolving it."). The Second Circuit's analysis in *Herbst* departed significantly from this Court's approach to the interpretation of section 523(a)'s statutory predecessor in *Neal* and other decisions like *Keime v. Graff*, holding that defalcation could exist even in the absence of deliberate wrongdoing. *Baylis*, 313 F.3d at 18; *see also Hyman*, 502 F.3d at 67. Specifically, the Second Circuit stated in *Herbst*: "[c]olloquially perhaps the word, 'defalcation,' ordinarily implies some moral dereliction, but in this context [the reference to defalcation in section 17 of the Act of 1898], it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts." *Herbst*, 93 F.2d at 511.

Thus, rather than employ the canon *noscitur a sociis* (as this Court had in *Neale*) to find common attributes and similar ground between the word "defalcation" and its companions and then construe them all in like fashion, the Second Circuit in *Herbst* focused on finding *difference*: "[w]hatever was the original meaning of 'defalcation,' it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'" *Herbst*, 93 F.2d at 511; *see also Hyman*, 502 F.3d at 67. Indeed, the Second Circuit essentially rejected this Court's *noscitur a sociis* method, stating: "[i]t does not seem to us . . . that [the] linkage of 'fraud' and 'embezzlement' to 'defalcation' need change its meaning . . . . We must give the words different meanings so far as we can." *Herbst*, 93 F.2d at 511-12. In the end, the court concluded that "[a]ll we decide is 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.'" *Id.* Respectfully, the analysis in *Herbst* is wrong, and the Second Circuit properly repudiated it in its subsequent decision in *Hyman*.

Since *Herbst*, courts (including prominently the Second Circuit itself) have expressed different views on the proper interpretation of section 523(a)(4), giving rise to the current conflict

among the courts of appeals, with some courts holding that an innocent mistake can constitute defalcation, others requiring negligence but no more, and still others, including the First Circuit in *Baylis* and the Second Circuit in *Hyman*, departing from *Herbst* after looking carefully at the language and history of the statute, and requiring at least extreme recklessness. *See Hyman*, 502 F.3d at 66 ("This Circuit, although previously having suggested that "some portion of misconduct" may be required to establish a 'defalcation" under § 523(a)(4), has yet to squarely address this issue.") (citing *Herbst*, 93 F.2d at 512).

In *Hyman*, after discussing the circuit split in some detail, the Second Circuit decided to follow the First Circuit's decision in *Baylis*, which set the "highest bar, requiring a showing of extreme recklessness, 'akin to the level of recklessness required for scienter [in securities law].'" *Hyman*, 502 F.3d at 68 (quoting *Baylis*, 313 F.3d at 20)). In *Baylis*, the First Circuit described this form of recklessness as "'an extreme departure from the standards of ordinary care.' The mental state required for defalcation is akin to the level of recklessness required for scienter. It is more than the mere conscious taking of risk associated with the usual torts standard of recklessness. Instead, defalcation requires something close to a showing of extreme recklessness." 313 F.3d at 20 (citations omitted).

Both circuits thus interpret "defalcation" as "requiring a degree of fault, 'closer to fraud, without the necessity of meeting a strict specific intent requirement.'" *Hyman*, 502 F.3d at 68. Of all the standards for measuring defalcation embraced by the various courts, the extreme recklessness standard hews most closely to the language of section 523(a)(4), the provisions contained in section 523(a) as a whole, and the historical treatment (other than in *Herbst*) of the term "defalcation" and of other terms in section 523(a)(4) discussed above.

As a policy matter, this approach makes sense because "the harsh sanction of non-dischargeability is reserved for those who exhibit 'some portion of misconduct,' . . . [but] does not reach fiduciaries who may have failed to account for funds or property for which they were responsible only as a consequence of negligence, inadvertence or similar conduct not shown to be sufficiently culpable." *Hyman*, 502 F.3d at 68-69 (citation omitted). In the circumstances of this case, Petitioner's acts, one of which was done at the express behest of the Settlor of the trust, his father, to benefit his mother, and the other two of which were loans to himself and his mother (all of which were repaid in full with interest), do not come close to reaching the level of extreme recklessness that would trigger application of section 523(a)(4). *See, e.g.,* Pet. App. 45a (Order of the Circuit Court for the Fifth Judicial Circuit

of Illinois) (Dec. 23, 2002) ("*The Defendant in this case does not appear to have had a malicious motive in borrowing funds from the trust*. Up until the time the first loan was made by the Trust, the evidence shows that the Defendant was unaware of the existence of the Trust or of his position as trustee. The first loan was taken at the request of the Defendant's father, who was also the settlor of the Trust, for the benefit of the Defendant's mother. . . . The Defendant has shown his willingness to make the Trust whole by a pattern of payments he has made to repay the loans from the Trust. *The evidence shows the loans have been, in fact, repaid in full*.") (emphasis added); *see also* Pet. App. 18a-19a (United States District Court opinion) (March 22, 2011) ("Bullock's two sisters both asked the Bankruptcy Court to release Bullock from the debt because the litigation has been going on for fourteen years and needed to stop."). The decision of the court below should be reversed.

CONCLUSION

For the foregoing reasons, as well as those offered by Petitioner, the decision of the court below should be reversed.

Respectfully submitted,

G. Eric Brunstad, Jr.
Counsel of Record
Collin O'Connor Udell
Matthew J. Delude
DECHERT LLP
90 State House Square
Hartford, Connecticut 06103
(860) 524-3999
eric.brunstad@dechert.com

December 20, 2012 *Counsel for Amicus Curiae*