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Statutory Construction Blog

January 31, 2009

Interesting BAPCA Split on "Defalcation" in Context of Fiduciary Capacity

From the District Court for New Jersey in In re Tamis, 398 BR 124 (Bankr. D.N.J. 2008), comes this:

Like the phrase “fiduciary capacity,” the meaning of the term “defalcation” is a matter of federal law. Carlisle Cashway, Inc. v. Johnson (In re Johnson), 691 F.2d 249, 254 (6th Cir.1982)(“Federal, not state law controls our determination because it is the intent of Congress in using the word ‘defalcation’ that we seek to discover.”) Unfortunately, ascertaining the meaning of defalcation in § 523(a)(4) is hampered by the fact that the term is not defined in the Bankruptcy Code and there is no legislative history that illuminates its intended meaning. As a result of this lack of statutory guidance, the courts, including the Circuit Courts of Appeal, are split on the mental state required to establish defalcation or whether wrongful conduct is a necessary element.

The Third Circuit Court of Appeals has not yet spoken on how to define defalcation. A number of other circuits have considered the issue and the decisions can be roughly grouped into three approaches. The Fourth, Eighth and Ninth Circuits hold that an innocent default or negligence which results in misappropriation or default is sufficient. Rwanda v. Uwimana (In re Uwimana), 274 F.3d 806, 811 (4th Cir.2001) citing Pahlavi v. Ansari (In re Ansari), 113 F.3d 17, 20 (4th Cir.1997); Tudor Oaks Limited Partnership v. Cochrane, (In re Cochrane), 124 F.3d 978, 984 (8th Cir.1997); Lewis v. Scott (In re Lewis), 97 F.3d 1182, 1186 (9th Cir.1996). The court in Lewis stated that:

Defalcation is defined as the “misappropriation of trust funds or money held in any fiduciary capacity; [the] failure to properly account for such funds.” Under section 523(a)(4), 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.

Lewis, 97 F.3d at 1186-87. Unsurprisingly, Chase asserts that we should follow this line of authority.

The Fifth and Seventh Circuits hold that at least reckless conduct is required for a finding of defalcation. The Fifth Circuit finds that a “willful neglect” of a fiduciary duty constitutes a defalcation and characterizes this conduct as “essentially a recklessness standard.” *131 Schwager v. Fallas (Matter of Schwager), 121 F.3d 177, 185 (5th Cir.1997). Recognizing a split among the circuits as to whether defalcation may result from negligence and that objections to discharge are strictly construed against the creditor and in favor of the debtor, the Seventh Circuit concludes that “we cannot say that Congress intended for a debt arising from a mere negligent breach of fiduciary duty to be excepted from discharge under section 523(a)(11).” Meyer v. Rigdon, 36 F.3d 1375, 1385 (7th Cir.1994).

The Sixth Circuit Court of Appeals seems to occupy a midpoint between the Fourth, Eighth and Ninth Circuits on the one hand, and the Fifth and Seventh Circuits on the other. In Johnson, the Sixth Circuit interpreted § 17(a)(4) of the 1898 Bankruptcy Act, the predecessor statute to § 523(a)(4). The court found that no intent or actual knowledge was needed for defalcation, but that the conduct must be more than “mere negligence.” 691 F.2d at 254-57. The Sixth Circuit announced that defalcation must be measured by an objective standard, stating that “[t]he character of the liability imposed upon a fiduciary for appropriating property held by him in trust is the same whether he has actual knowledge that the law imposes a duty or is merely charged with such knowledge.” Id. at 257. Thus, in In re Bucci, 493 F.3d 635, 639 (6th Cir.2007) it stated that a defalcation encompasses not only embezzlement and misappropriation by a fiduciary, but also the failure to account for funds.

The First Circuit imposes a higher threshold, requiring a showing of extreme recklessness, “akin to the level of recklessness required for scienter.” In re Baylis, 313 F.3d 9, 20 (1st Cir.2002). The Second Circuit recently announced its agreement with Baylis, stating that “defalcation under § 523(a)(4) 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 61, 68 (2d Cir.2007). Both courts relied in part on statutory analysis, finding that requiring conscious misbehavior is consistent with the other intentional misconduct (fraud, embezzlement, larceny) identified in § 523(a)(4). Baylis, 313 F.3d at 20; Hyman, 502 F.3d at 68.

This court is persuaded that Baylis and Hyman state a standard for defalcation that is most in harmony with the Bankruptcy Code generally, and § 523(a)(4) in particular. Baylis takes note of the structure of § 523, pointing out that the exceptions to discharge basically fall into two categories. 313 F.3d at 19. One category encompasses debts for which an individual, as a matter of public policy, should remain liable. Id. These obligations include such debts as those for certain taxes or custom duties (§ 523(a)(1)), alimony and child support (§ 523(a)(5)), and orders of restitution (§ 523(a)(13)). Id. “The level of fault of the debtor has no bearing on these exceptions; the exception turns on the type of debt.” Id. Baylis infers that the second category of exceptions is premised on fault and “[t]hese exceptions define not the type of debt itself, but the type of fault that caused the debt.” Id. These exceptions include debts arising from money, goods or services obtained by fraud, false pretenses or false representations (§ 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 fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny (§ 523(a)(4)). Id. From this review of the structure of § 523, the court in Baylis concluded that an act of defalcation by a fiduciary must be a serious one, and some fault must be involved. Id.

The court confirmed its interpretation by looking at the specific language of § 523(a)(4). Based on its analysis, it concluded that conduct constituting defalcation must be of a similar gravity as conduct that gives rises to a discharge exception for fraud, embezzlement or larceny. Id. But, recognizing that defalcation must mean something different from the other terms, it found that proof of specific intent is not required. Rather, “a creditor must be able to show that a debtor's actions were so egregious that they came close to the level that would be required to prove fraud, embezzlement or larceny.... 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.” Id. at 20. (citation omitted).

The court in Hyman was also persuaded that a showing of extreme recklessness is a proper measure of defalcation because it “ensures that the term ‘defalcation’ complements but does not dilute the other terms of the provision-‘fraud’, ‘embezzlement’, and ‘larceny’-all of which require a showing of actual wrongful intent.” 502 F.3d at 68. Hyman stated that such a standard for defalcation means that “the harsh sanction of dischargeability is reserved for those who exhibit ‘some portion of misconduct.’ ” Id. at 68-69 (quoting Cen. Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510, 512 (2d Cir.1937)). Moreover, it observed that use of this standard would 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.” Id. at 69. Finally, the Second Circuit also concluded that using the standard of extreme recklessness to define defalcation “has the virtue of ease of application since the courts and litigants have reference to a robust body of securities law examining what these terms mean.” Id.

This court agrees with both Baylis and Hyman that an extreme recklessness standard for measuring defalcation is the standard most consistent with the long held view that exceptions to discharge should be narrowly construed in favor of the Bankruptcy Code's “fresh start” policy. Baylis, 313 F.3d at 17 (quoting Century 21 Balfour Real Estate v. Menna (In re Menna), 16 F.3d 7, 9 (1st Cir.1994)). The Third Circuit has likewise stated that a strict construction furthers the purpose of the Bankruptcy Code “to relieve debtors from the weight of oppressive indebtedness and provide them with a fresh start.” Ins. Co. of Am. v. Cohn (In re Cohn), 54 F.3d 1108, 1113 (3d Cir.1995).

[5] If a lesser or more broadly defined standard for defalcation is employed, it runs the risk of encompassing ordinary mistakes of judgment. For example, the standard followed by the Fourth, Eighth and Ninth Circuits captures poor record-keeping, a common failure of many individuals and businesses that file for bankruptcy relief. Thus, this court further agrees with the court in Zohlman v. Zoldan (In re Zoldan), 226 B.R. 767, 777 (S.D.N.Y.1998) that a broad reading of defalcation should be avoided because of the ever-expanding definition of the term "fiduciary." Zoldan explains that:

When state courts and legislatures create express or technical trusts in a plethora of areas, from corporate officers, to joint ventures, attorneys, building contractors, real estate agents, insurance brokers, and executors, often without considering the substantial ramifications*133 such expansion could have in the bankruptcy context, each of these individuals becomes a "fiduciary" for purposes of the Bankruptcy Code. Given the ever expanding definition of what constitutes a "fiduciary," to couple this expansion with an equally expansive view of defalcation would defeat the fresh start objective of the bankruptcy law. (citation omitted)

Id.

The Third Circuit has long held that scienter is a "mental state embracing intent to deceive, manipulate or defraud." U.S. S.E.C. v. Infinity Group Co., et al, 212 F.3d 180, 192 (3d Cir.2000) quoting McLean v. Alexander, 599 F.2d 1190, 1196-97 (3d Cir.1979); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). See also, Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir.1977). Further, it agrees with the Seventh Circuit that the scienter required for securities fraud includes recklessness and finds recklessness to include:

[H]ighly unreasonable (conduct), involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

McLean, 599 F.2d at 1197 (citing Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.1977)).

However, the Third Circuit has also cautioned that "good faith, without more, does not necessarily preclude a finding of recklessness." Infinity Group Co., 212 F.3d. at 192. In Infinity, the SEC filed a civil securities fraud action against an investment trust and its principals. The individual defendants raised the defense that the SEC failed to establish scienter. The individuals claimed that they acted in good faith in that they believed the representations in Infinity Group's promotional literature to be true. 212 F.3d at 192. Among the representations made was the statement that investors were guaranteed to receive an annual rate of return ranging from 138% to 181% depending on the amount of the principal investment. Id. at 184-85. The Third Circuit's survey of the factual record before the district court led it to conclude that the district court had properly rejected the good faith argument advanced by the defendants. Id. at 193.FN4 It specifically pointed out that even if it assumed that the individuals actually believed the promotional representations, "[a] good faith belief is not a 'get out of jail free card.' " Id. A good faith belief "will not insulate the defendants from liability it is the result of reckless conduct." Id.

Accordingly, if Chase demonstrates an extreme departure from the standards of ordinary care, the defendants' claim of good faith does not save them. However, as set forth below, it is apparent that Chase has completely failed to prove its case. As the party objecting to dischargeability of the debt owed to it, Chase must establish its entitlement to such relief by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 287-88, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991). When preponderance of evidence is the standard of proof, "the plaintiff's burden is to convince [the fact finder] upon all the evidence before [it] that the facts asserted *134 by the plaintiff are more probably true than false." Applebaum v. Henderson (In re Henderson), 134 B.R. 147, 156 (Bankr.E.D.Pa.1991)(quoting Burch v. Reading Co., 240 F.2d 574, 579 (3d Cir.1957)).

I sometimes wonder if our fight over the meaning of words effects that many cases (at the margins, no doubt, but in the main?) and, more significantly given our economic downturn, whether the benefits of splits like this outweigh the social cost....

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