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Consumer Counterpoint

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Since When Have We Complained of Equal Treatment?



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The level of culpability required to prove “defalcation while acting in a fiduciary capacity” under § 523(a)(4) of the Bankruptcy Code has to be the same as its statutory neighbors (fraud, embezzlement and larceny), or else the lower standard becomes the only standard that disgruntled creditors would attempt to satisfy. The “reluctance to treat statutory terms as surplusage” advocated by the U.S. Supreme Court in *Bullock v. BankChampaign NA*¹ is nonsensical.

These statutory terms each relate to a different form of the same improper conduct: fraud — the same fraud found in § 523(a)(2), the same fraud that must be plead with particularity, and the same fraud used in the legal definitions of embezzlement and larceny. Courts should not assess whether a debtor acted “recklessly” to prove defalcation and a different standard for its statutory neighbors. The culpability level required to find a debt nondischargeable under § 523(a)(4) should be the same across the subsection.

The Model Penal Code Creates a Square Peg/Round Hole Issue

Bullock cites the Model Penal Code’s definition of “reckless conduct” as the appropriate level of culpability.² The Model Penal Code was promulgated by the American Law Institute to provide a comprehensive and cohesive model for states “that would clarify some aspects of the [criminal] law and improve upon aspects that were irrational or unwise.”³ Under the Model Penal

Code, there are four types of mental states (or *scienter*) to address culpability: purposely, knowingly, recklessly and negligently.⁴

Much like the definition in § 101 of the Bankruptcy Code, the mental state definitions in the Model Penal Code were designed to be used with other operational provisions of the Model Penal Code.⁵ Unlike the Model Penal Code (where elements are described and defined mental states are expressly used in the descriptions of the offenses), the descriptions of fiduciary capacities are not connected to the mental states referred to in the Bankruptcy Code. There are numerous fiduciary capacities of debtors under § 523(a)(4), and these fiduciary duties must be analyzed on a case-by-case basis because they cannot be articulated in terms of elements.

The facts in *Bullock* and the recent opinion by Hon. **Frank J. Bailey**⁶ both arise out of improper actions taken by a trustee to a trust. The trust instruments defined the permitted uses of the trust assets. These fiduciary duties lack the structure of using “reckless” to modify the elements of an offense. Unless the laws are revised to implement mental states into fiduciary duties, the Model Penal Code’s “reckless” mental standard cannot align with the source of a debtor’s fiduciary duties.

Objective Standard, Subjective Standard: It's All *Bullock(s)* to Us

Bankruptcy courts generally are in agreement that the *Bullock* standard has subjective and objective elements. *Bullock* requires evidence that the

¹ 569 U.S. 267, 274; 133 S. Ct. 1754, 1760 (2013) (“*Bullock*”).

² 569 U.S. at 272, 133 S. Ct. at 1759; Model Penal Code § 2.02(2)(5) (“When recklessness suffices to establish an element, such element also is established if a person acts purposely or knowingly.”).

³ Kent Greenawalt, “The Cultural Defense: Reflections in Light of the Model Penal Code and The Religious Freedom Restoration Act,” 6 *Ohio St. J. Crim. L.* 299, 305 (2008) (Prof. Greenawalt served as chief reporter for the American Law Institute in created explanatory comments to Model Penal Code).

⁴ Model Penal Code § 2.02 (1962).

⁵ The Model Penal Code’s definition of the crime of “entrapment” includes “making knowingly false representations,” just like the definition of “allowance of claims” in § 502 includes the defined term “claim.”

⁶ *Benjamin H. Whittaker III, et. al. v. James B. Whittaker* (In re James B. Whittaker), Adv. Pro. No. 14-1017; Case No. 13-15310 (Bankr. D. Mass. Jan. 17, 2017) [Docket No. 132].

debtor was aware that the debtor's conduct might violate a fiduciary duty, or be so "willfully blind" to a substantial and unjustifiable risk that the debtor's conduct would violate a fiduciary duty, along with an objective assessment by the court of whether the debtor's conduct involved a "gross deviation from the standard of conduct that a law-abiding person would observe in the [debtor's] situation."⁷ Almost 20 years earlier in *Farmer v. Brennan*,⁸ the Supreme Court provided the structure for the objective and subjective standards to evaluate risk.

In *Farmer*, an objective standard is a legal norm based on what a "reasonable person would have known" or what the "litigant should have known," rather than what the litigant consciously thought, believed or understood. Conversely, a subjective standard is based on what the litigant was actually aware of and might be satisfied by circumstantial evidence showing that the "litigant must have known."⁹

When reviewing the subjective risk components of a § 523(a)(4) claim that a debtor's "conduct will turn out to violate a fiduciary duty," bankruptcy courts should consider the significance or magnitude of the pertinent fiduciary duty. In other words, the analysis should focus on the nature and degree of the risk, and whether it was justifiable.¹⁰ Similarly, when reviewing whether the debtor's conduct involved a gross deviation from the standard of conduct that a law-abiding person would observe, bankruptcy courts must make a comparison against the civil law of fiduciaries — not the criminal law where knowledge of the law is constructively imposed. It is possible that a fiduciary debtor having civil fiduciary duties might not be deemed to know those duties and might be unaware of the entire scope of such duties.

Bullock's standard requiring the debtor to have subjective awareness of the risk changes the law and would preclude the imposition of constructive knowledge of fiduciary duties resulting in a "should have known" standard rather than reckless standard. Moreover, what is a law-abiding person in a fiduciary capacity? Is it the perfect fiduciary? The conservative fiduciary? How can you apply a reckless standard measuring gross deviation when the standard of care might vary based on the trust document governing the situation?

If It Walks Like a Fraud and Talks Like a Fraud...

Each of the statutory terms of fraud, embezzlement, larceny and defalcation should be interchangeable, or else they should be split into separate Code subsections for purposes of § 523. For example, the legal definition of "embezzlement" contains fraud as an element. Embezzlement in § 523(a)(4) is "the fraudulent conversion of the property of another by one who is already in lawful possession of it."¹¹ In addition, "to amount to embezzlement, conversion must be committed by a perpetrator with fraudulent intent."¹² Next, embezzlement

"requires proof that (i) property in the perpetrator's lawful possession but (ii) belonging to another, (iii) was appropriated by the perpetrator in a manner inconsistent with the property rights of the other and the scope of his or her authorization to deal with the property (iv) with fraudulent intent."¹³ Lastly, "[i]t is knowledge that the use is devoid of authorization, scienter for short ... that make conversion fraudulent and thus embezzlement."¹⁴ Likewise, the legal definition of "larceny" requires felonious intent.

Rather than create different tests (objective and/or subjective) for each bad act listed in § 523(a)(4), it would be more streamlined to use a universal standard — one that already is embedded in the underlying legal principle of each act — of fraud. Otherwise, at the end of the day, it is simply the bankruptcy court's judgment call. Thus, perhaps Justice Potter Stewart's colloquial threshold test for obscenity in *Jacobellis v. Ohio*¹⁵ has it right: "I know it when I see it." **abi**

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7 569 U.S. 267, 133 S. Ct. 1754, 1760.

8 511 U.S. 825 (1994).

9 *Id.* at 836-37.

10 The Model Penal Code contains many examples of justifiable risks, such as necessity, use of force in self-protection, use of force in law enforcement and consent.

11 *Sherman v. Potapov* (*In re Sherman*), 603 F.3d 11, 13 (1st Cir. 201) (defining "embezzlement" as used in § 523(a)(4)).

12 *Id.*

13 *Reiss v. McQuillan* (*In re McQuillan*), 509 B.R. 733, 785 (Bankr. D. Mass. 2014); *Zacharikas v. Melo* (*In re Melo*), 558 B.R. 521, 558 (Bankr. D. Mass. 2016).

14 *In re Sherman*, 603 F.3d at 13.

15 378 U.S. 184.