No. 07-952

In the Supreme Court of the United States

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON, PETITIONER

v.

ANDREW A. HYMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTIONS PRESENTED

1. Whether the exception to discharge in bankruptcy established by 11 U.S.C. 523(a)(4), which applies to debts "for fraud or defalcation while acting in a fiduciary capacity," requires proof that the fiduciary either engaged in deliberate misbehavior or acted with extreme recklessness.

2. Whether, by virtue of collateral estoppel, the finding of the Surrogate's Court of New York that respondent breached his fiduciary duty and misappropriated assets compelled the bankruptcy court to hold that the debt created by the state court's judgment was for a "defalcation" within the meaning of Section 523(a)(4).

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Cases—Continued: Page

Statutes: Page

Miscellaneous:

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This brief is filed in response to the order of this Court inviting the Solicitor General to express the views of the United States. In the view of the United States, the petition for a writ of certiorari should be denied.

STATEMENT

1. In 1987, respondent and George W. Denton formed an insurance agency, the Denton-Hyman Agency (Denton-Hyman), together with their own pension administration company, National Pension Service (NPS), and a third company, National Pension Actuaries (NPA). Pet. App. 3a-4a. Respondent and Denton each owned 50% of the companies, and each served as a director and executive officer. *Id.* at 4a.

Guardian Life Insurance Company (Guardian) designated Denton-Hyman as the company's agent for

Westchester County to market life insurance products through pension plans, with the proviso that the agency would terminate upon the departure of either from the business. Pet. App. 3a-4a. In starting their businesses, Denton and respondent had incurred debts in excess of $1.6 million, which they guaranteed jointly and severally. *Id.* at 4a. NPS channeled business to Denton-Hyman and operated at a loss. *Ibid.*

In 1989, G.W. Denton died and was succeeded by respondent as president and sole director of the three corporations. Denton's death terminated the agency relationship between Guardian and Denton-Hyman. Under Guardian's regulations, neither Denton's estate nor Denton-Hyman was eligible to be a shareholder in the new general agency. Pet. App. 4a.

Respondent thereafter became Guardian's agent, formed the Andrew A. Hyman Agency (Hyman Agency), and continued as before to operate NPS. Pet. App. 5a, 86a. As of 1994, when respondent's relationship with Guardian terminated, he had liquidated, with the estate's consent, the $1.6 million debt by using the residual jointly-owned Denton-Hyman commissions and the earnings of the Hyman Agency. *Id.* at 5a. At the same time, respondent conducted prolonged and difficult negotiations with the executor of the G.W. Denton estate, petitioner G. Hallet Denton, in an effort to purchase the estate's 50% interest in Denton-Hyman, NPS, and NPA. *Ibid.* The negotiations failed because the parties could not agree on what portion of the income that respondent generated belonged to him as opposed to the estate. *Ibid.*

Petitioner subsequently sued respondent in the Surrogate's Court of New York, asserting a shareholder derivative claim on behalf of Denton-Hyman. See Pet.

App. 5a, 84a. On December 31, 2002, the state court issued its decision. The court held that respondent owed a fiduciary duty to Denton-Hyman, NPS, and NPA arising out of his role as a 50% shareholder, officer, and director of the corporations. *Id.* at 92a. The court further held that respondent had breached that duty by "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment," and that "[h]is actions constituted a misappropriation of the tangible assets and goodwill" of the three corporations. *Id.* at 92a-93a. The Surrogate's Court entered judgment in favor of the estate for $2,734,832, which reflected the net profits realized by respondent during the period that he operated the overall enterprise. *Id.* at 5a, 93a. The New York Supreme Court, Appellate Division, affirmed the judgment of the Surrogate's Court, *id.* at 47a, 106a-107a, and the New York Court of Appeals dismissed respondent's appeal as unripe, *id.* at 110a.

2. In February 2003, respondent filed for bankruptcy relief under chapter 11 of the Bankruptcy Code, 11 U.S.C. 1101 *et seq.* Pet. App. 6a, 47a. In July 2004, after the Surrogate Court's judgment in the state-court proceedings was affirmed by the Appellate Division, the bankruptcy case was converted to chapter 7, 11 U.S.C. 701 *et seq.* Pet. App. 47a.

Petitioner filed an adversary proceeding in the bankruptcy court, asserting a claim in the amount of the judgment of the Surrogate's Court. Pet. App. 6a, 47a. Petitioner contended that the debt created by that judgment was non-dischargeable because it arose from respondent's "defalcation while acting in a fiduciary capacity." *Id.* at 6a-7a; see 11 U.S.C. 523(a)(4) (establishing exception to bankruptcy discharge for any debt "for

fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny"). Petitioner waived his right to present evidence showing that the conduct on which the state court's judgment was premised constituted a "defalcation" within the meaning of Section 523(a)(4). Pet. App. 7a, 49a. Rather, petitioner relied on the doctrine of collateral estoppel to argue that the state court judgment established that respondent had engaged in a "defalcation." *Id.* at 7a, 42a-43a, 49a.

The bankruptcy court dismissed petitioner's claim. Pet. App. 39a-81a. The court held that "the Surrogate's Court Decision does not contain findings of fact and conclusions of law necessary to support denial of dischargability * * * under the doctrine of collateral estoppel." *Id.* at 81a. The court expressed the view that "[t]he word 'defalcation' used in subsection (4) * * * is far narrower than the concept of 'misappropriation' under state law," which includes "acts or omissions * * * done innocently or in good faith based upon mistake or negligence or simply disagreement between the parties as to their rights and obligations, with no conscious knowledge of or intent to do wrong." *Id.* at 61a. The court concluded that, "[g]iven the material differences between the meaning of 'defalcation' under federal bankruptcy law and the concepts of misappropriation and breach of fiduciary duty under state law, it simply cannot be said that the federal question at issue * * * was considered and decided in the Surrogate's Court proceeding." *Id.* at 67a-68a.

3. The district court affirmed the decision of the bankruptcy court. Pet. App. 20a-38a. The court held that "[d]efalcation requires more than mere negligence and cannot be a completely innocent act." *Id.* at 34a (quoting *Zohlman* v. *Zoldan*, 226 B.R. 767, 777

(S.D.N.Y. 1998)). The district court concluded that the "[c]reditor's reliance on the state court's characterization of Debtor's conduct as 'co-option,' 'misappropriation' and 'exploitation' of corporate assets does not persuade this Court that the issue of 'defalcation,' as that term is interpreted under the Bankruptcy Code, was previously decided." *Id.* at 29a.

4. The court of appeals affirmed. Pet. App. 1a-19a. In deciding whether the findings of the state court should be given preclusive effect, the court observed that "[t]he first critical question is whether a 'defalcation while acting in a fiduciary capacity' under [Section] 523(a)(4) of the Bankruptcy Code is identical to the factual and legal determinations necessarily decided in the prior Surrogate's Court action." *Id.* at 9a-10a. The court further noted that "[t]here has been much debate among the Circuits over whether a 'defalcation' under § 523(a)(4) includes all misappropriations or failures to account or only those that evince some wrongful conduct." *Id.* at 10a-11a. The court "align[ed] [itself] with the First Circuit * * * in holding that defalcation * * * requires a showing of conscious misbehavior or extreme recklessness—a showing akin to the showing required for scienter in the security law context." *Id.* at 15a (citing *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002)). The court rejected the decisions of other courts of appeals holding that a fiduciary's innocent mistake can sometimes constitute a "defalcation." *Id.* at 13a. The court explained that, under the standard it adopted, Section 523(a)(4) "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." *Id.* at 16a.

The court of appeals held that the doctrine of collateral estoppel was inapplicable in this case because the decision of the Surrogate's Court did not establish the elements of "defalcation" under Section 523(a)(4). Pet. App. 16a-18a. The court explained that the state court had "made no express findings with regard to [respondent's] state of mind," and that "the record contain[ed] evidence of [respondent's] good faith." *Id.* at 16a, 17a. Noting that "[t]he Surrogate had neither the ability nor the incentive to apply the standard we announce," *id.* at 17a, the court of appeals stated that it was "loath to conclude that an identical issue was necessarily decided or that [respondent] had a full and fair opportunity to contest his state of mind," *id.* at 18a.

DISCUSSION

Questions concerning the state of mind required for "defalcation" under 11 U.S.C. 523(a)(4) have arisen frequently and have divided the court of appeals. By categorically holding that Section 523(a)(4) "requires a showing of conscious behavior or extreme recklessness," Pet. App. 15a, the court of appeals construed the term "defalcation" in a way that conflicts with its common usage at the time that Section 523(a)(4)'s statutory predecessors were enacted, and with the holdings of other circuits. At least in circumstances where the relevant breach of duty is a wrongful diversion of trust assets to the fiduciary's own use or to another unauthorized purpose, the breach is properly regarded as a "defalcation" within the meaning of Section 523(a)(4), regardless of whether the fiduciary acts with ill intent.

This case, however, is not an attractive vehicle for the Court to clarify the precise meaning of the term "defalcation" or the proper application of Section 523(a)(4)

to the most frequently recurring factual scenarios. Petitioner did not seek to introduce evidence of respondent's wrongdoing in the bankruptcy court, but rather relied solely on the purported collateral estoppel effect of a state-court decision that contained no findings as to respondent's intent. If this Court granted certiorari and rejected petitioner's contention that *no* showing of scienter is needed to establish a "defalcation" within the meaning of Section 523(a)(4), the Court would have no occasion to decide what level of scienter *is* required. Moreover, under a proper understanding of Section 523(a)(4), the level of scienter needed to establish a "defalcation" will vary depending on the nature of the fiduciary breach involved. Because the circumstances of this case are unusual, the Court's application of Section 523(a)(4) to these facts is unlikely to provide guidance as to the statute's proper application to more common fact patterns.

On balance, while the question presented is important and subject to a circuit split, the Court should wait and address the meaning of the term "defalcation" and the proper application of Section 523(a)(4) in a case that would permit the Court fully to expound on what standard of scienter is required and how it applies in more common fact patterns. Accordingly, the petition should be denied.

A. The Court Of Appeals Erred In Categorically Holding That Proof Of Deliberate Misbehavior Or Extreme Recklessness Is Required To Establish A "Defalcation" Within The Meaning Of 11 U.S.C. 523(a)(4)

1. Section 523(a)(4) of the Bankruptcy Code provides in pertinent part:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> * * * * *
>
> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

11 U.S.C. 523(a)(4).[1] The term "defalcation" is not defined in the Code but has a long history of pre-Code use in the bankruptcy laws.

The 1841 Bankruptcy Act established a system of bankruptcy applicable to "[a]ll persons whatsoever * * * owing debts, which shall not have been created in consequence of defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity." Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441; see *Central Hanover Bank & Trust Co.* v. *Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) (L. Hand, J.). At that time, the ordinary dictionary definition of the term "defalcation" contained no scienter requirement. See, *e.g.*, Samuel Johnson, *A Dictionary of the English Language* 6L (1755) ("diminution; abatement; excision of any part of a customary allowance"); Noah Webster, *An American Dictionary of the English Language* 56 (1828) ("The act of cutting off, or deducting a part; deduction; diminution; abatement; as, let him have the amount of his rent without *defalcation*."). Legal dictionaries from the nineteenth century and early-

[1] Section 523(a)(11) of the Bankruptcy Code similarly exempts from discharge debts created by certain judgments, orders, or settlements "arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. 523(a)(11).

twentieth century similarly embraced a meaning of defalcation that was not limited to a fiduciary's intentional wrongdoing.[2]

Judicial decisions issued during the relevant period likewise did not suggest that any particular mental state was an essential prerequisite to a "defalcation." Before 1841, courts used the term "defalcation" in several contexts. A public officer's failure to account for and pay over to the government funds he received was described as a "defalcation," often without discussing whether the officer acted with a bad intention.[3] The term was also commonly used to describe a fiduciary, such as an executor of an estate, a guardian, or a trustee, who appropriated funds for his own use rather than protecting them

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[2] One meaning was simply "the act of a defaulter." John Bouvier, *A Law Dictionary* 388 (6th ed. 1856). In turn, a "defaulter" could be "[o]ne who is deficient in his accounts, or fails in making his accounts correct." *Ibid.*; Stewart Rapalje & Robert L. Lawrence, *A Dictionary of American and English Law* 362 (1888) (A "defaulter" is "[o]ne who makes a default," which is "[t]he neglect or non-performance of a duty.").

[3] See, *e.g.*, *Smith* v. *United States*, 30 U.S. (5 Pet.) 292, 298-299 (1831) (paymaster who failed to pay over funds upon his retirement found by jury to be liable for "defalcation" even though he claimed to have paid over all funds); see *Thompson* v. *Ross*, 24 Ky. (1 J.J. Marsh.) 600, 602 (1829); see also *Duncan's Heirs* v. *United States*, 32 U.S. (7 Pet.) 435, 446-447 (1833); *United States* v. *Nicholl*, 25 U.S. (12 Wheat.) 505, 508 (1827); *Postmaster Gen.* v. *Norvell*, 19 F. Cas. 1103 (E.D. Pa. 1829) (No. 11,310); *Salling* v. *M'Kinney*, 28 Va. (1 Leigh) 42 (1829). Some decisions made clear that the officer had failed to pay over the funds precisely because he had embezzled them. *E.g.*, *Baker* v. *Preston*, 21 Va. (Gilmer) 235, 287 (1821) (describing state treasurer's embezzlement as "defalcation"), overruled in part, *United States Fid. & Guar. Co.* v. *Jordan*, 58 S.E. 567 (Va. 1907). Those decisions did not hold, however, that an intent to make wrongful use of trust assets was essential to a finding that a "defalcation" had occurred.

for the estate, ward, or trust.[4] The word "defalcation" was also used in the early 1800's to describe garden variety acts of embezzlement, typically by a bank cashier.[5]

Consistent with those decisions, this Court remarked, shortly after the passage of the 1841 Act, that the "defalcation" exception to the rule of dischargeability covers "[a] misapplication of trust funds" and "fiduciary debts." *Chapman* v. *Forsyth*, 43 U.S. (2 How.) 202, 207-208 (1844).[6] Lower courts likewise understood the term "defalcation" under the 1841 Act to encompass a fiduciary's use of funds for an unauthorized

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[4] *E.g.*, *Bunting* v. *Ricks*, 22 N.C. (2 Dev. & Bat. Eq.) 130 (1838) (use of entrusted security for own purposes); *Deaderick* v. *Cantrell*, 18 Tenn. (10 Yer.) 263 (1837) (executor's use of estate funds for own purposes). But see *Brazer* v. *Clark*, 22 Mass. (5 Pick.) 96, 108 (1827) (Executor's liability for late sale of stock resulting in obtaining less than half of earlier price described as a "defalcation," and implied that it could result from "negligence or fraud.").

[5] *Taylor* v. *Bank of Ky.*, 25 Ky. (2 J.J. Marsh.) 564 (1829); *Henderson* v. *Morgan*, 4 Mart. (n.s.) 649 (La. 1826) (bank cashier's embezzlement a "defalcation"); *President of Dedham Bank* v. *Chickering*, 21 Mass. (4 Pick.) 314, 352 (1826) (bank clerk absconded with funds, described as "defalcation").

[6] In *Chapman*, this Court held that, under Section 1 of the 1841 Act, a debtor could obtain discharge of non-fiduciary debts even though he also owed debts that were non-dischargeable because they were incurred through a defalcation as a public officer or trustee. 43 U.S. (2 How.) at 207-208. The Court explained that the exception to dischargeability stated in Section 1 "applies to the debts and not to the person, if he owe other debts." *Id.* at 207. The Court contrasted Section 1 of the 1841 Act with Section 4, which provided that discharge in bankruptcy was not available to "any person who, after the passing of this act, shall apply trust funds to his own use." 5 Stat. 444. The Court explained that, "whilst the first section only withholds from the jurisdiction of the bankrupt court fiduciary debts, the fourth declares that if such debts have been contracted subsequent to the law, the individuals shall not be discharged." *Chapman*, 43 U.S. (2 How.) at 208.

purpose, without regard to the fiduciary's subjective intentions in making the expenditure. See, *e.g.*, *Pinkston* v. *Brewster, Solomon & Co.*, 14 Ala. 315, 322-323 (1848) (trustee commits a defalcation when he pays only one creditor contrary to his obligation to pay creditors pro rata); *Flagg* v. *Ely*, 1 Edm. Sel. Cas. 206, 208-209 (N.Y. Sup. Ct. 1846) (following *Chapman* and stating "that good faith forbid[s] the appropriation of the [trust] money to any other than the specified purpose"). Judicial precedent thus strongly suggests that proof of a "defalcation" within the meaning of the 1841 Act did not categorically require the "showing of conscious misbehavior or extreme recklessness," Pet. App. 15a, that the court of appeals held is essential under current law.

That conclusion is reinforced by Section 4 of the 1841 Act, which rendered ineligible for discharge in bankruptcy "any person who, after the passing of this act, shall apply trust funds to his own use." 5 Stat. 444. Section 4 contained no express scienter requirement but rather applied by its terms to an individual who made personal use of trust assets based on a sincere but incorrect belief that he was entitled to the money. Section 4, moreover, entailed more onerous consequences than did Section 1, since individuals covered by Section 4 were wholly ineligible for discharge in bankruptcy even with respect to non-fiduciary debts. See note 6, *supra*. The natural reading of the two provisions taken together is that a trustee's diversion of trust funds to his own use was a Section 1 "defalcation" without regard to the trustee's intent. Consistent with that reading, the Court in *Chapman* noted that "[a] misapplication of trust-

funds * * * covers the enumerated cases in the first section." 43 U.S. (2 How.) at 207-208.[7]

2. In 1867, Congress enacted a bankruptcy law that rendered non-dischargeable any "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." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533; see *Herbst*, 93 F.2d at 511. Courts continued to recognize that a public officer's failure to pay over taxes that he received was a defalcation under the bankruptcy laws. *Grantham* v. *Clark*, 62 N.H. 426, 427 (1882); *Councill* v. *Horton*, 88 N.C. 222, 223 (1883). One court concluded that a "defalcation" does not occur when a public officer fails to pay over tax money because of a purportedly negligent failure to collect the funds. *Courtney* v. *Beale*, 5 S.E. 708, 709-710 (Va. 1888). The court in that case explained that a "defalcation" requires "*mala fides*," and that the term has been defined as "the failure of one who *has received money* in trust or in a fiduciary capacity to account and pay over as he ought." *Ibid.* The court concluded "that the liability of a public officer created by his negligence merely,—as, for exam-

[7] In explaining the relationship between Sections 1 and 4 of the 1841 Act, the Court in *Chapman* also stated that, "whilst the first section only withholds from the jurisdiction of the bankrupt court fiduciary debts, the fourth declares that if such debts have been contracted subsequent to the law, the individuals shall not be discharged." 43 U.S. (2 How.) at 208. That statement strongly suggests that all debts identified in Section 4 (*i.e.*, debts arising out of a fiduciary's application of trust funds to his own use) were also encompassed by Section 1—a proposition that would not be true if proof of "defalcation" required evidence of wrongful intent.

ple, in failing to use due diligence in collecting and paying over money,—is not a defalcation." *Id.* at 710.[8]

In 1898, Congress rendered non-dischargeable debts "created by [the bankrupt's] 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. 550-551. Some courts concluded that any failure of a fiduciary to account for trust funds is a defalcation. See, *e.g.*, *First Citizens Bank & Trust Co.* v. *Parker*, 35 S.E.2d 489, 492 (N.C. 1945); *Citizens Mut. Auto. Ins. Co.* v. *Gardner*, 24 N.W.2d 410, 413 (Mich. 1946); *Orndorff* v. *State*, 108 S.W.2d 206, 212 (Tex. Civ. App. 1937); *England Loan Co.* v. *Campbell*, 35 S.W.2d 75, 78 (Ark. 1931); cf. *National Sur. Co.* v. *Wittich*, 240 N.W. 888, 889 (Minn. 1932) (failure to account for and pay over funds coming into bankrupt's control is prima facie defalcation or misappropriation). Other courts stated or suggested that some form of misconduct was required. See, *e.g.*, *Aetna Cas. & Sur. Co.* v. *Lauerman*, 107 N.W.2d 605, 609 (Wis. 1961); *Western Sur. Co.* v. *Reed*, 447 P.2d 672, 673 (N.M. 1968). Some of the cases requiring misconduct appeared to recognize, however, that a failure to account for funds received as a fiduciary is itself misconduct. *Indemnity Ins. Co. of N. Am.* v.

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[8] Read in isolation, the court's references in *Courtney* to the need for "*mala fides*" and the insufficiency of negligence standing alone might suggest that proof of heightened scienter is necessary to establish a "defalcation." The court's decision ultimately appears to rest, however, on the distinction between (a) wrongful payment of (or failure to account for) monies *actually received*, and (b) negligent failure to collect funds that ought to have been paid into the relevant account. The court in *Councill*, by contrast, held that an officer charged with collecting taxes had committed a "defalcation" based on proof that the taxes were "either not collected or collected and not paid over by him." 88 N.C. at 223.

Leibrock, 55 N.Y.S.2d 3, 4 (Sup. Ct. 1945); *Western Sur. Co.*, 447 P.2d at 673.

3. In 1978, Congress replaced the 1898 provision with 11 U.S.C. 523(a)(4). The legislative history of the 1978 Bankruptcy Code revision does not indicate an intent to change the meaning of the term "defalcation." *In re Hayes*, 183 F.3d 162, 168 (2d Cir. 1999); *Meyer* v. *Rigdon*, 36 F.3d 1375, 1382-1383 (7th Cir. 1994); *In re Cross*, 666 F.2d 873, 882 n.14 (5th Cir. 1982). There similarly is no indication that the 1898 law was intended to change the meaning of "defalcation" as that term was used in earlier bankruptcy laws. *Crawford* v. *Burke*, 195 U.S. 176, 192 (1904). Accordingly, the meaning of the term as it appeared in pre-Code bankruptcy laws is a significant factor in determining Congress's intent. *Cohen* v. *de la Cruz*, 523 U.S. 213, 221 (1998); see *Director, OWCP* v. *Greenwich Colleries*, 512 U.S. 267, 275 (1994); *Nationwide Mut. Ins. Co.* v. *Darden*, 503 U.S. 318, 322 (1992).

In light of the history described above, the term "defalcation" in current Section 523(a)(4) is properly understood to encompass *all* cases in which a fiduciary diverts trust assets to his personal use or to another unauthorized purpose, even if the trustee acts without wrongful intent and sincerely believes that his conduct is proper. That view is consistent with the common understanding of the term "defalcation" in 1841 and at the time of subsequent bankruptcy laws. It also strikes an appropriate balance between the "fresh start" policy that animates the bankruptcy laws generally, see *Marrama* v. *Citizens Bank*, 127 S. Ct. 1105, 1107 (2007), and the recognition (reflected in Section 523(a)'s exceptions) that some debts by their nature are unsuitable for discharge.

Even if a fiduciary does not engage in fraud or intentional wrongdoing, his use of trust property for other than its intended purpose constitutes serious misconduct. The equitable arguments against discharge in this setting are particularly compelling if the fiduciary diverts trust assets to his *own* use, thereby enriching himself even as the trust is diminished. As explained, under Section 4 of the 1841 Act, trustees who engaged in such conduct were categorically ineligible for discharge in bankruptcy even as to their non-fiduciary debts.

This does not mean that *every* breach of fiduciary duty constitutes a "defalcation" or that Section 523(a)(4) never requires proof of scienter. Many fiduciary breaches, such as a failure to exercise due care in selecting prudent investments or in managing income-producing properties, do not involve a diversion of trust assets to unauthorized purposes. Such breaches are not obviously encompassed by 1841-era dictionary definitions of the term "defalcation" (see p. 8, *supra*), and they are relatively far afield from the core breach of trust (application of trust assets to the fiduciary's personal use) described in Section 4 of the 1841 Act. Under Section 523(a)(4), proof of wrongful intent or recklessness may therefore be necessary to preclude discharge of debts arising from breaches of that character.

The approach described above is consistent with Judge Learned Hand's opinion for the Second Circuit in *Herbst*, which has been described as "the most authoritative explication" of the term "defalcation" as it appears in the bankruptcy laws. *In re Hayes*, 183 F.3d at 171. In *Herbst*, an individual was appointed receiver of real property in a foreclosure suit and was awarded $5,674.54 by the trial court after the property was sold. 93 F.2d at 511. He spent the money without attempting

to ascertain whether the award would be appealed, and he declared bankruptcy after the state appellate court disallowed the award. *Ibid.* Without purporting to decide the scope of the term "defalcation" in other circumstances, the Second Circuit held 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.* at 512. The court in *Herbst* did not hold that the receiver (who had received the funds pursuant to the state trial court's order) had acted recklessly or with wrongful intent; rather, the court found it sufficient that the receiver had taken and spent the money with actual or constructive knowledge that the award was subject to possible reversal on appeal. See *ibid.* That decision supports the view that, at least where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized, a Section 523(a)(4) "defalcation" occurs regardless of the fiduciary's state of mind.

B. The Courts Of Appeals Are Divided Over The Meaning Of The Term "Defalcation"

As the court of appeals recognized, the circuits are divided over the level of intent required by the term "defalcation" under Section 523(a)(4). Pet. App. 11a-14a. Other courts similarly have recognized the split in the circuits on the issue. *In re Baylis*, 313 F.3d at 18; *Meyer*, 36 F.3d at 1383. "Roughly, three interpretive camps have been established as to the standard for measuring defalcation." *In re Baylis*, 313 F.3d at 18.

The Second Circuit in this case aligned itself with the First Circuit, which has "set the highest bar," requiring

a showing of conscious misbehavior or extreme recklessness, "akin to the level of recklessness required for scienter [in securities law]." Pet. App. 14a (quoting *In re Baylis*, 313 F.3d at 20). By contrast, the Fourth, Eighth, and Ninth Circuits have rejected the view that Section 523(a)(4)'s "defalcation" exception to dischargeability always requires proof of intentional wrongdoing. Consistent with the position set forth above, pp. 14-15, *supra*, those courts have held that the term covers innocent or negligent actions of a fiduciary where those actions result in misappropriation or failure to account for assets held in trust. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Hemmeter*, 242 F.3d 1186, 1190 (9th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997), cert. denied, 522 U.S. 1112 (1998).

Finally, the Sixth and Seventh Circuits have held that, although a breach of duty resulting from the fiduciary's negligence or mistake *of fact* is not encompassed by Section 523(a)(4), a "defalcation" does occur if the fiduciary knowingly uses trust funds for a purpose that is in fact unauthorized, even if he does not intend to violate a known fiduciary duty (*i.e.*, if the fiduciary's mistake of law leads him to believe that an unauthorized purpose is authorized). *Meyer*, 36 F.3d at 1384-1385; *In re Johnson*, 691 F.2d 249, 257 (6th Cir. 1982).

C. This Case Is Not An Attractive Vehicle For This Court To Decide The Level Of Intent Required For A Defalcation

As explained above, the Second Circuit erred in categorically holding that "defalcation under § 523(a)(4) requires a showing of conscious misbehavior or extreme recklessness." Pet. App. 15a. Questions concerning the meaning of the term "defalcation" have arisen fre-

quently and have divided the courts of appeals, and their proper resolution is important to the administration of the bankruptcy laws. The issues are accordingly worthy of this Court's review in an appropriate case. For three related reasons, however, this case does not present an attractive vehicle for this Court to clarify the proof required to establish a Section 523(a)(4) "defalcation."

1. In the bankruptcy court, petitioner waived his right to present evidence showing that respondent's debt to him arose from a "defalcation" within the meaning of Section 523(a)(4). Rather, petitioner relied on the doctrine of collateral estoppel, arguing that the *findings* of the Surrogate's Court in the prior proceeding encompassed all findings necessary to establish that a "defalcation" had occurred. See Pet. App. 42a-43a, 49a. The question actually before the Surrogate's Court, however, was not whether respondent had committed a Section 523(a)(4) "defalcation," but whether he had committed a state-law breach of fiduciary duty. Thus, in neither the federal nor the state proceedings did the parties create an evidentiary record focused upon the bankruptcy-law question presented in this case.

2. As the court of appeals emphasized, the Surrogate's Court "made no express findings with respect to [respondent's] state of mind." Pet. App. 16a. If this Court granted certiorari and ultimately held that proof of a Section 523(a)(4) "defalcation" requires *some* level of scienter under the circumstances of this case, the Court therefore would have no occasion to identify the precise mental state that is required. The courts of appeals that have recognized a scienter requirement in this context have divided as to the contours of that requirement, see *id.* at 13a-14a; see pp. 16-17, *supra*, and that circuit conflict might remain even if this Court granted

certiorari here. It would be preferable for the Court to grant certiorari in a case where the Court could resolve that disagreement on a concrete record, if the Court concludes that some level of scienter is required.

3. Perhaps most significantly, the Surrogate's Court's finding of a fiduciary breach arose out of very idiosyncratic circumstances, and this Court's application of Section 523(a)(4) in this case might ultimately shed little light on the meaning of "defalcation" in more typical factual settings. Although the Surrogate's Court described respondent's conduct as a "misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS, and NPA," Pet. App. 92a-93a, no finding was made that respondent divested those corporations of their property. See *id.* at 68a (Bankruptcy court observes that "[t]here is no finding of fact by the Surrogate, and no claim by [petitioner] in this adversary proceeding, that [respondent] took money or property of the Denton-Hyman Agency, NPS or NPA without accounting for it.") (emphasis omitted).

The Surrogate's Court's finding that corporate assets were "misappropriat[ed]" rests on respondent's decision to operate the overall enterprise in a way that predictably resulted in profits for the Hyman Agency and losses for NPS. See Pet. App. 87a, 92a-93a. That mode of operation was fully consistent, however, with the manner in which the business had previously been conducted. See *id.* at 86a (Surrogate's Court observes that, "[i]n effect, nothing changed, with the singular exception that premiums earned on the sale of Guardian products were paid to the Hyman Agency, not to Denton-Hyman"); *id.* at 89a (explaining that, even before G.W. Denton's death, "NPS and NPA were not profit centers" and "both consistently lost money" in order "to provide

revenue for the general agency"). The Surrogate's Court apparently concluded that this longstanding practice became improper after Denton-Hyman was replaced by the Hyman Agency and the various components of the enterprise ceased to be under common ownership.[9]

Under principles of collateral estoppel, the state court's decision is binding on the question whether respondent's conduct constituted a breach of fiduciary duty under New York law. But if the level of scienter required to establish a Section 523(a)(4) "defalcation" varies depending on the nature of the fiduciary breach involved (see pp. 14-16, *supra*), the Surrogate's Court's mere use of the term "misappropriation" cannot control the bankruptcy-law inquiry. The breach found by the state court in this case is both difficult to categorize and relatively far afield from the typical diversion of trust assets to unauthorized purposes. Thus, this case does not offer an opportunity to provide guidance on the ap-

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[9] The Surrogate's Court suggested that the manner in which respondent operated the overall enterprise might have been lawful if a portion of the Hyman Agency's commissions had been shared with or assigned to the G.W. Denton estate. See Pet. App. 90a-91a; *id.* at 93a ("The use of NPS and NPA as feeders of new business for the Hyman Agency *without compensation* constitutes a breach of fiduciary duty to the corporations.") (emphasis added). Respondent did, however, engage in prolonged negotiations to purchase the estate's 50% interest in Denton-Hyman, NPS, and NPA. See *id.* at 5a. The Surrogate's Court did not find that respondent failed to negotiate in good faith or that the price he offered was unreasonably low. And, to the extent that the state-law breach found by the Surrogate's Court lay in respondent's failure to compensate the estate, there is a significant question whether respondent committed that breach "while acting in a fiduciary capacity" within the meaning of Section 523(a)(4). See *id.* at 78a-79a (bankruptcy court opinion); Br. in Opp. 10.

plication of Section 523(a)(4) and the meaning of "defalcation" in more usual cases.

Accordingly, while the proper application of Section 523(a)(4) and meaning of "defalcation" is important and has divided the courts of apples, on balance this case does not provide an attractive vehicle for the Court to resolve that circuit split and provide needed guidance on that issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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