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### Fiduciary Capacity and the Bankruptcy Discharge

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# FIDUCIARY CAPACITY AND THE BANKRUPTCY DISCHARGE\*

JONATHON S. BYINGTON\*\*

## ABSTRACT

Bankruptcy law has fiercely competing policies. A primary one is the debtor's fresh start. Another is that discharge of debt is a selectively conferred privilege rather than an unlimited right. This latter policy is manifested in part by the Bankruptcy Code's exceptions to discharge. One exception involves a debt "for . . . defalcation while acting in a fiduciary capacity."<sup>1</sup> In 2013, the Supreme Court addressed the meaning of the term "defalcation" and established a new, heightened mental standard based on the Model Penal Code's definition of recklessly.<sup>2</sup> The meaning of the term "fiduciary capacity" is not clear.

This Article makes three contributions. First, it compiles and evaluates the Supreme Court's jurisprudence on the meaning of fiduciary capacity in the bankruptcy setting. The most recent opinion on that term was issued in 1934 and provided limited guidance that was obscure and primarily in a negative form.<sup>3</sup> Since the time of that decision, circuit and bankruptcy courts throughout the country have struggled to apply a consistent framework for determining whether modern legal relationships amount to a fiduciary capacity. The second contribution is the categorization of the circuit split into four separate approaches. The final contribution is an assessment of the adequacy of the current judicial approaches and the proposal of a new framework for determining if a relationship is a fiduciary capacity for purposes of the exception to discharge. This is done by exploring the methods used to identify a fiduciary relationship under non-bankruptcy law, examining the problems with using those methods in a bankruptcy context, and suggesting the Supreme Court's 2013 opinion on defalcation justifies a rebalancing of the judicial construction of the statutory terms "defalcation" and "fiduciary capacity."<sup>4</sup>

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<sup>1</sup> 11 U.S.C. § 523(a)(4) (2012).

<sup>2</sup> See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1759 (2013) ("We include as intentional not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. Thus, we include reckless conduct of the kind set forth in the Model Penal Code.").

<sup>3</sup> See *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (providing that a fiduciary capacity cannot come from a debtor becoming chargeable *ex maleficio*).

<sup>4</sup> See *Bullock*, 133 S. Ct. at 1759–61 (construing "defalcation" to entail intentional or reckless conduct).

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## INTRODUCTION

Bankruptcy law has fiercely competing policies. A primary one is the debtor's fresh start.<sup>5</sup> The fresh start is sacrosanct. It is accomplished through the discharge of debt and an injunction preventing creditor efforts to collect debts that have been discharged.<sup>6</sup> A rival policy is that discharge of debt is a selectively conferred privilege rather than an unlimited right.<sup>7</sup> This policy is manifested through two types of discharge restrictions. First, a discharge may be denied globally rendering all of a debtor's debts nondischargeable.<sup>8</sup> Second, a debtor's specific, individual debt may be excepted from discharge either because the nature of the debt itself is important to society or the debt relates to a debtor's wrongful conduct.<sup>9</sup> The tension between the fresh start policy and the discharge restrictions is a backdrop for every performance on the exception to discharge stage. The featured shows are constantly changing because not all debts or debtors are the same.

One of the exceptions to discharge, section 523(a)(4), relates to debts for "defalcation while acting in a fiduciary capacity."<sup>10</sup> The exception has two parts, a "defalcation" by a debtor who is acting in a "fiduciary capacity."<sup>11</sup> In 2013, the Supreme Court resolved a long-standing three-way circuit split regarding the defalcation part of the test in *Bullock v. BankChampaign* ("*Bullock*").<sup>12</sup> *Bullock* resolved the circuit split on the definition of defalcation by establishing a new,

<sup>5</sup> See *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367 (2007) (noting "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor'" (quoting *Grogan v. Garner*, 498 U.S. 279, 286–87 (1991)); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (stating the fresh start policy is a "public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt").

<sup>6</sup> See 11 U.S.C. § 524 (enumerating effects of discharge of debt); *id.* § 727(a) (granting debtor discharge of debt, unless certain conditions exist); *id.* § 944(b) (governing discharge in the adjustment of municipalities' debts); *id.* § 1141(d) (governing discharge of debtor in certain reorganizations); *id.* § 1228(a) (providing for discharge of debt for family farmers or family fishermen with regular annual income); *id.* § 1328(a) (providing for discharge of debt for individuals with regular income).

<sup>7</sup> See *Grogan*, 498 U.S. at 286 (noting "a debtor has no constitutional or 'fundamental' right to a discharge in bankruptcy") (citing *United States v. Kras*, 409 U.S. 434, 445–46 (1973)); *In re McNamara*, 310 B.R. 664, 668 (Bankr. D. Conn. 2004) (stating "[b]ankruptcy is a privilege, not a right").

<sup>8</sup> See 11 U.S.C. § 727(a) (listing situations where court may deny discharge of debt).

<sup>9</sup> See *id.* § 523(a)(2)(A) (providing denial of discharge of debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition"); see also *Cohen v. De La Cruz*, 523 U.S. 213, 222 (1998) (stating that "[t]he various exceptions to discharge in §523(a) reflect a conclusion on the part of Congress that the creditors' interest in recovering full payment of debts in these categories outweigh[s] the debtors' interest in a complete fresh start") (quoting *Grogan*, 498 U.S. at 287); *Bruning v. United States*, 376 U.S. 358, 361 (1964) (noting predecessor to section 523(a) "[was] not a compassionate section for debtors" because "it demonstrate[d] congressional judgment that certain problems . . . override the value of giving the debtor a wholly fresh start").

<sup>10</sup> 11 U.S.C. § 523(a)(4).

<sup>11</sup> *Id.*

<sup>12</sup> 133 S. Ct. 1754 (2013).

elevated standard based on the Model Penal Code's definition of recklessly.<sup>13</sup> *Bullock's* new definition significantly elevated the meaning of defalcation by imposing a mental standard requirement.<sup>14</sup> It also raised the importance of what the term fiduciary capacity means and how *Bullock's* new defalcation standard affects competing bankruptcy policies.<sup>15</sup>

The meaning of fiduciary capacity in section 523(a)(4) is not clear. The Bankruptcy Code does not define it. The current judicial framework for determining if a relationship amounts to a fiduciary capacity under section 523(a)(4) is inadequate. Supreme Court guidance on the term is limited, obscure, and primarily in a negative form. It is also old. Circuit and bankruptcy courts throughout the country have struggled to apply a consistent framework for determining whether modern legal relationships amount to a fiduciary capacity. It is time to re-evaluate what a fiduciary capacity means, especially since the last Supreme Court opinion on it was issued in 1934<sup>16</sup> and society has changed significantly since that time. The limited amount of scholarship in this area is either restricted to specific, individual relationships<sup>17</sup> or primarily focuses on the term defalcation.<sup>18</sup> To date, no scholarship has undertaken a comprehensive analysis of

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<sup>13</sup> *Id.* at 1759 ("Where actual knowledge of wrongdoing is lacking, we consider conduct as equivalent if the fiduciary 'consciously disregards' (or is willfully blind to) 'a substantial and unjustifiable risk' that his conduct will turn out to violate a fiduciary duty.").

<sup>14</sup> *Id.* at 1761 (remanding the case "to permit the court to determine whether further proceedings are needed and, if so, to apply the heightened standard that we have set forth").

<sup>15</sup> *Id.* (stressing importance of uniformity within federal courts).

<sup>16</sup> See *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) ("[A] factor does not act in a fiduciary capacity; the statute 'speaks of technical trusts, and not those which the law implies from the contract.'") (quoting *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844)).

<sup>17</sup> See Bradley M. Elbein, *An Obscure Revolution: The Liability of Professionals in Bankruptcy*, 48 S.C. L. REV. 743, 769 (1997) (focusing on professional fiduciaries and stating "it makes sense to avoid the metaphysical debates over defalcation and fiduciary and instead to ask a relatively simple question: Did the debtor use his superior knowledge and power to take advantage of the creditor?"); see also Jennifer Liotta, *ERISA Fiduciaries in Bankruptcy: Preserving Individual Liability for Defalcation and Fraud Debts Under 11 U.S.C. § 523(a)(4)*, 22 EMORY BANKR. DEV. J. 725, 758 (2006) (arguing an ERISA fiduciary should be a fiduciary capacity for purposes of section 523(a)(4)); Michael D. Sousa, *Are You Your Produce Vendor's Keeper? The Perishable Agricultural Commodities Act and § 523(a)(4) of the Code*, 15 J. BANKR. L. & PRAC. 6 ART. 3 (Dec. 2006) (stating "an expansion of the meaning of 'fiduciary capacity' to encompass trusts created by statute offends the admonitions of the United States Supreme Court to strictly limit this provision of the Bankruptcy Code"); Michael D. Sousa, *The Nondischargeability of Partners' Debts Under § 523(a)(4): The Unresolved Collision Between the Bankruptcy Code and Partnership Law*, 14 J. BANKR. L. & PRAC. 3 ART. 2 (2005) (asserting the "proper approach is to follow those courts which conclude that co-partners do not act in a fiduciary capacity for purposes of determining the dischargeability of debts in bankruptcy").

<sup>18</sup> See Jonathon S. Byington, *The Challenges of the New Defalcation Standard*, 88 AM. BANKR. L.J. 3 (2014) (focusing on the challenges of applying the *Bullock* Court's new meaning of the term defalcation); Elbein, *supra* note 17, at 743 (claiming "[r]ecent cases have overturned a century and a half of interpretation . . ."); Andrea Johnson, *The Defalcation Exception to Discharge: Should a Fiduciary's Mistake Prohibit a Discharge from Debt?*, 27 W. NEW ENG. L. REV. 93, 131 (2005) (recommending a "willful neglect" standard of intent); Matthew W. Knox, *Persistent Confusion: The Circuit Split over the Exception to Discharge for Defalcation Under 11 U.S.C. § 523(a)(4)*, 2008 COLUM. BUS. L. REV. 1078, 1110 (2008) (claiming a "willful neglect or recklessness" standard would be best); Bradley Kendall Mahanay, *An Analysis of the Matter of Bennett and Its Effect on Non-Dischargeability of Debt for Defalcation While Acting In a*

the term fiduciary capacity or developed a reliable framework for determining what it means. This Article seeks to do so by making three contributions. First, it compiles and evaluates the Supreme Court's jurisprudence on the meaning of fiduciary capacity. Second, it analyzes the circuit split on the meaning of fiduciary capacity and identifies four separate approaches that have developed. Finally, it questions the adequacy of the current judicial approaches and proposes a new framework for determining if a relationship is a fiduciary capacity. It does so by exploring the methods used to identify a fiduciary relationship under non-bankruptcy law, examining the problems with using those methods in a bankruptcy context, and suggesting *Bullock's* opinion on defalcation justifies a rebalancing of the judicial construction of the statutory terms defalcation and fiduciary capacity.

### I. HISTORICAL DEVELOPMENT: A NEGATIVE AND OBSCURE DESCRIPTION OF A FIDUCIARY CAPACITY

Supreme Court guidance on the meaning of the term fiduciary capacity is limited, obscure, and primarily in a negative form.<sup>19</sup> It is limited because there are only seven opinions that address whether a particular relationship is one where the debtor is acting in a fiduciary capacity.<sup>20</sup> Not one of those opinions found a debtor

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*Fiduciary Capacity*, 46 BAYLOR L. REV. 281, 292 (1994) (arguing a general partner should not be in a fiduciary capacity to limited partners for purposes of section 523(a)(4)); Alyssa Miller, "Some Portion of Misconduct": The Argument for a Negligence Standard for Excepting Discharge of Debts Incurred Through Defalcation, 2 WM. & MARY BUS. L. REV. 185, 204 (2011) (arguing a "negligence" standard should be applied); Peter M. Reinhardt and William G. Horlbeck, *Defalcation While Acting In a Fiduciary Capacity: What Does It Mean?*, 79 COLO. LAW. 1773 (Aug. 1995) (analyzing Tenth Circuit law on both defalcation and fiduciary capacity); Zvi S. Rosen, *Discharging Fiduciary Debts*, 87 AM. BANKR. L.J. 51 (2013) (examining the evolution and historical meaning of the term "defalcation").

<sup>19</sup> In addition to the opinions addressed in this Article, four other Supreme Court opinions reference the relevant statutes but do not address the meaning of a fiduciary capacity. See *Tindle v. Birkett*, 205 U.S. 183, 186 (1907); *Bayly v. Washington and Lee Univ.*, 106 U.S. 11, 12–13 (1882); *Neal v. Clark*, 95 U.S. 704, 709 (1877); *Wilmot v. Mudge*, 103 U.S. 217, 218 (1880).

<sup>20</sup> See *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844) (holding a factor who received the money of his principal was not a fiduciary); see also *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 330 (1934) (holding that an auto dealer who obtained a loan and was a chattel mortgagor in possession of an automobile, and bound by covenant not to sell the automobile without the mortgagee's written consent, was not acting as a fiduciary when the dealer sold the automobile and failed to make prompt remittance of payment to the lender); *Crawford v. Burke*, 195 U.S. 176, 194 (1904) (holding there was no evidence that frauds perpetrated by defendants were committed by them in a fiduciary capacity when defendants purchased, under instructions of plaintiff, certain stocks, and opened an account with him, charged him with commission and interest, and credited him with amounts received as margins and then subsequently sold the stocks and converted them to their own use); *Upshur v. Briscoe*, 138 U.S. 365, 375 (1891) (holding that a debtor was not acting in a fiduciary capacity when he received delivery of \$10,000 and signed an instrument under circumstances in which trust or confidence was reposed in him, but merely created a contract between a debtor and creditor); *Noble v. Hammond*, 129 U.S. 65, 67–68 (1889) (holding a produce dealer who had been requested by parties to collect money for them as an accommodation without compensation and to keep it until they called for it, proceeded to make such collection, and then deposited the proceeds to his own credit with his own funds and who before he paid it over was unexpectedly forced into bankruptcy, was not acting in a fiduciary character); *Liebke v. Thomas*, 116 U.S. 605, 608 (1886) (holding in a composition case an agreement to take care of and pay a promissory note when it became due and hold original maker

was acting in a fiduciary capacity. The guidance is obscure because the Court has not explained what it means.<sup>21</sup> It is negative because it consists of, or is characterized by, the absence rather than the presence of distinguishing features. The Court has said more about what a fiduciary capacity is not than what it is. It has principally given indications through negative implication—describing something by what it is not. This section explores the historical development of the term fiduciary capacity throughout the bankruptcy acts and the Court's jurisprudence on its meaning.<sup>22</sup>

#### A. 1841 Bankruptcy Act and Related Decisions

The Bankruptcy Act of 1841<sup>23</sup> contained the terms defalcation and fiduciary capacity, but they were located in the section that described who may be declared a bankrupt instead of the section that addressed when a bankrupt was not entitled to a discharge.<sup>24</sup> Section 1 of the 1841 Act stated:

All persons whatsoever . . . owing debts, which shall not have been created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any

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harmless was not one of a fiduciary character); *Hennequin v. Clews*, 111 U.S. 676, 678 (1884) (holding a bankrupt's appropriating to his own use collateral securities deposited with him as security for payment of money or the performance of a duty, and his failure or refusal to return the same after the money had been paid or the duty performed, was not acting in a fiduciary character).

<sup>21</sup> See *In re Turner*, 134 B.R. 646, 651 (Bankr. N.D. Okla. 1991) (surveying some of the U.S. Supreme Court decisions and stating that "[t]he Court did not say just what 'special trusts' or 'technical trusts' are . . . What a 'technical trust' is does not readily appear. Courts of Appeal would later assume that a 'technical' trust is an 'express' trust . . . The assumption is plausible enough; but what the U.S. Supreme Court really meant by the term is open to question").

<sup>22</sup> The first federal bankruptcy statute, the Bankruptcy Act of 1800, did not mention the terms defalcation or fiduciary capacity. Bankruptcy Act of 1800, ch. 19, § 1, 2 Stat. 19 (1800) (repealed in 1803). This act was primarily a creditor remedy against merchant debtors. See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 14 (1995).

<sup>23</sup> The 1841 Act was modeled after the Massachusetts Insolvency Law of 1838. CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 70 (1935); Tabb, *supra* note 22, at 17. The Massachusetts Supreme Judicial Court interpreted the phrase to include "only technical trusts, and not trusts implied by law from contracts of agency or bailment." *Woodward v. Towne*, 127 Mass. 41, 42 (1879) (holding that an attorney that creates a debt is not acting as a fiduciary within the meaning of the Bankruptcy Acts of 1841 or 1867).

<sup>24</sup> Compare Bankruptcy Act of 1841, ch. 9, § 1, 5 Stat. 440, 441 (1841) ("All persons . . . owing debts, which shall not have been created in consequences of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity, who shall, by petition, . . . shall be deemed bankrupts within the purview of this act . . ."), with Bankruptcy Act of 1841, ch. 9, § 4, 5 Stat. 440, 443–44 (1841) ("That every bankrupt . . . shall . . . be entitled to a full discharge from all his debts . . . And if any such bankrupt shall be guilty of any fraud or wilful concealment of his property . . . he shall not be entitled to any such discharge or certificate; nor shall any person, being a merchant, banker, factor, broker, underwriter, or marine insurer, be entitled to any such discharge or certificate, who shall become bankrupt, and who shall not have kept proper books of account, after the passing of this act; nor any person who, after the passing of this act, shall apply trust funds to his own use.").

other fiduciary capacity, . . . shall be deemed bankrupts within the purview of this act . . .<sup>25</sup>

The Supreme Court viewed this section as excepting certain debts "from the operation of the act,"<sup>26</sup> although it later characterized it as "exempt[ing] from discharge"<sup>27</sup> the debts described.

The most commonly-known feature of a fiduciary capacity comes from the 1844 case of *Chapman v. Forsyth*.<sup>28</sup> This feature is that a fiduciary capacity may derive from a special or technical trust.<sup>29</sup> In *Chapman*, the Court held that "a factor who owes his principal money received on the sale of his goods," was not acting in a fiduciary capacity and therefore not within the Bankruptcy Act.<sup>30</sup> During that time period, a factor was a professional middleman or consignee.<sup>31</sup> The Court explained that Section 1 described relationships such as the defalcation of a public officer, executor, administrator, guardian, or trustee, and that these were "not cases of implied but special trusts, and the 'other fiduciary capacity' mentioned, must mean the same class of trusts. The act speaks of technical trusts, and not those which the law implies from the contract."<sup>32</sup>

The concern identified by the *Chapman* Court was that if the Bankruptcy Act embraced a debt owed by a factor, "it [would] be difficult to limit its application" and "[s]uch a construction would have left but few debts on which the law could operate."<sup>33</sup> In other words, the exception would swallow the rule. The Court explained that "[i]n almost all the commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and a violation of these is, in a commercial sense, a disregard of a trust. But that is not the relation spoken of in the first section of the act."<sup>34</sup> Interestingly, the *Chapman* Court was addressing Section 1, which defined the scope of who could be a debtor, by identifying certain debts that were not within the scope of the 1841 Bankruptcy

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<sup>25</sup> *Id.* §1, 5 Stat. at 441.

<sup>26</sup> *Chapman v. Forsyth*, 43 U.S. 202, 207 (1844).

<sup>27</sup> *Neal v. Clark*, 95 U.S. 704, 708 (1877) (interpreting the term "fraud" under the Bankruptcy Act of 1867).

<sup>28</sup> *Chapman*, 43 U.S. at 208.

<sup>29</sup> *See id.* at 208 (interpreting Bankruptcy Act of 184 section 1 to mean a fiduciary capacity may derive from technical trusts, and not from implied contractual trusts like that of a factor).

<sup>30</sup> *Id.* (describing how Bankruptcy Act of 1841 section 4 excludes factor as fiduciary debtor).

<sup>31</sup> *See In re Turner*, 134 B.R. 646, 651 (Bankr. N.D. Okla. 1991) (defining factor as "a professional middleman or cosignee").

<sup>32</sup> *Chapman*, 43 U.S. at 208 (determining Bankruptcy Act of 1841's language intended to include only technical trusts, not implied contractual trusts like that of a factor, within Act's definition of fiduciary debtor).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*



Act.<sup>35</sup> It was not addressing what type of debts were excepted from discharge. Subsequent case law however, caused this distinction to lose its significance.<sup>36</sup>

*B. 1867 Bankruptcy Act and Related Decisions*

The Bankruptcy Act of 1867 was the first bankruptcy statute to contain the terms defalcation and fiduciary in a section addressing exceptions to discharge.<sup>37</sup> Section 33 of the 1867 Act stated "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 under this act."<sup>38</sup>

In *Hennequin v. Clews*,<sup>39</sup> the Court held a bankrupt was not acting in a fiduciary character when the bankrupt held bonds as collateral on a line of credit it had extended as a lender and subsequently deposited the bonds with third parties to raise money for the bankrupt's own purposes.<sup>40</sup> The *Hennequin* Court explained:

The creditor who holds a collateral, holds it for his own benefit under contract. He is in no sense a trustee. His contract binds him to return it when its purpose as security is fulfilled; but if he fails to do so it is only a breach of contract, and not a breach of trust. A mortgagee in possession is bound by contract, implied if not expressed, to deliver up possession of the mortgaged premises when his debt is satisfied; but he is not regarded as guilty of breach of trust if he neglects or refuses to do so, but only of a breach of contract.<sup>41</sup>

The *Hennequin* Court noted that English courts regarded "many transactions" as breaches of trust and observed that the "liberal construction made in favor of the certificate of discharge in this country is due to the peculiar modes and habits of business prevailing among our people."<sup>42</sup> The concern in *Hennequin* was that a broad construction of the excepting clause would make it "include debts arising from agencies and the like," and "would leave but few debts upon which the law

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<sup>35</sup> See *id.* (examining relationship between section 1 and fiduciary debtor).

<sup>36</sup> At a later time when interpreting the term fraud under the Bankruptcy Act of 1867, the Supreme Court glossed over the distinction when it summarized the 1841 Act as follows: "The Bankruptcy Act of 1841 exempted from discharge debts 'created in consequence of a defalcation as a public officer, or as executor, administrator, guardian, or trustee, or while acting in any fiduciary capacity.'" *Neal v. Clark*, 95 U.S. 704, 708 (1877) (quoting *Chapman*, 43 U.S. at 208).

<sup>37</sup> See Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 517, 533 (1867) (repealed 1878).

<sup>38</sup> *Id.*

<sup>39</sup> 111 U.S. 676 (1884).

<sup>40</sup> *Id.* at 682 (holding "[a] creditor who holds collateral . . . for his own benefit . . . is in no sense a trustee").

<sup>41</sup> *Id.* at 682.

<sup>42</sup> *Id.* at 683.

could operate."<sup>43</sup> Thus, the desire to preserve the fresh start policy was having an influential impact on the early construction of this exception to discharge. However, the discharge restrictions policy was also recognized by the Court at that time when, two years later, the Court acknowledged that not all debts were entitled to be discharged:

It is of the essence of the bankrupt law that when the bankrupt has complied with all the conditions of the statute, and surrendered his property, he should be released from all his debts, except those of a fiduciary character or founded in fraud....<sup>44</sup>

A negative feature of a fiduciary capacity is that it cannot come from a trust the law implies from a contract, such as trusts which form an element in every agency and in nearly all commercial transactions in the country. In *Noble v. Hammond*,<sup>45</sup> the Court summarized *Chapman's* holding and noted that the provision containing the term "fiduciary character" in the 1867 act was "substantially a re-enactment of the provision of the act of 1841."<sup>46</sup> The *Noble* Court described *Chapman* as follows:

[*Chapman*] held that the cases enumerated in the act are cases not of implied but special trusts; that the phrase, 'in any other fiduciary capacity,' referred, not to those trusts which the law implies from the contract, and which form an element in every agency, and in nearly all the commercial transactions in the country, but to technical trusts; and hence that a factor who had sold the property of his principal, and had failed to pay over to him the proceeds, did not owe to him a debt created in a fiduciary capacity within the meaning of the act.<sup>47</sup>

The Court later explained in *Upshur v. Briscoe*<sup>48</sup> that the substance of the transaction governs over form.<sup>49</sup> In *Upshur*, the Court held a relationship that "was merely the usual one of contract between debtor and creditor" was not within the scope of a "fiduciary character."<sup>50</sup> The *Upshur* Court focused on substance over form and noted that even though the signed instrument in the case used the words "trust," "trustee," and "mandate," it did "not create a 'trust' in its technical sense, or make the debt of [the bankrupt] one created by him while acting in a 'fiduciary

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<sup>43</sup> *Id.* (citing *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844)).

<sup>44</sup> *Liebke v. Thomas*, 116 U.S. 605, 607–08 (1886).

<sup>45</sup> 129 U.S. 65 (1889).

<sup>46</sup> *Id.* at 69.

<sup>47</sup> *Id.*

<sup>48</sup> 138 U.S. 365 (1891).

<sup>49</sup> *See id.* at 375.

<sup>50</sup> *Id.*

character."<sup>51</sup> The *Upshur* Court also addressed the importance of the timing of the debt creation and the fiduciary relationship by holding that "debts created by the bankrupt 'while acting in any fiduciary character,' . . . apply only to a debt created by a person who was already a fiduciary when the debt was created."<sup>52</sup> This timing concept was developed further by the Court in a subsequent case.<sup>53</sup>

### C. 1898 Bankruptcy Act and Related Decisions

Section 17 of the Bankruptcy Act of 1898 stated, "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as . . . (4) were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity."<sup>54</sup>

In *Crawford v. Burke*, the Court compared the 1898 Act language with the 1867 Act language and stated that:

[A] change in phraseology creates a presumption of a change in intent, and . . . Congress would not have used such different language in § 17 from that used in § 33 of the act of 1867, without thereby intending a change of meaning. The view generally taken by the bankruptcy courts has been the terms "officer" and "fiduciary capacity" extend to all the claims mentioned in paragraph 4, and are not confined to cases of defalcation.<sup>55</sup>

Thus, *Crawford* considered a debtor acting either as an "officer" or "in any fiduciary capacity" as a required element in addition to a debtor's fraud, embezzlement, misappropriation, or defalcation.<sup>56</sup> The *Crawford* Court continued:

The intent of Congress in changing the language of the act of 1867 seems to have been to restore the act of 1841, which, as already observed, extended the benefits of the law to every debtor who had not been guilty of defalcation as a public officer or in a fiduciary

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<sup>51</sup> *Id.* (noting that the bankrupt has "[t]he right to use [the money] any way he thought proper was repugnant to the idea of any fiduciary relation to the money, for there was no obligation upon him to keep it separate from his own money, or to put upon it any marks of identification, or to invest it in any particular securities").

<sup>52</sup> *Id.* at 378.

<sup>53</sup> See *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (stressing the importance of the debtor's trustee status arising before the act of wrongdoing out of which the debt arose).

<sup>54</sup> Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 544, 550 (1898) (repealed 1978).

<sup>55</sup> *Crawford v. Burke*, 195 U.S. 176, 190 (1904).

<sup>56</sup> See *id.* at 194 (holding "as there is no evidence that the frauds perpetrated by the defendants were committed by them in an official or fiduciary capacity, plaintiff's claim against them was discharged by the proceedings in bankruptcy").

capacity, the act of 1898 adding, however, to the excepted class those against whom a judgment for fraud had been obtained.<sup>57</sup>

In the 1934 case of *Davis v. Aetna Acceptance Co.*,<sup>58</sup> the Court addressed the timing concept from *Upshur* and stated that a fiduciary capacity cannot come from the debtor becoming chargeable as a fiduciary *ex maleficio* (meaning, by some wrongdoing or malfeasance).<sup>59</sup> The debtor must already be a fiduciary when the debt was created.<sup>60</sup> In *Davis*, the Court relied upon its previous decision in *Chapman* to interpret the term fiduciary capacity under the 1898 Act:

The meaning of these words has been fixed by judicial construction for very nearly a century. [*Chapman*], decided in 1844, is a decision to the effect that, within the meaning of a like provision in the Act of 1841, a factor does not act in a fiduciary capacity; the statute 'speaks of technical trusts, and not those which the law implies from the contract.' The scope of the exception was to be limited accordingly. Through the intervening years that precept has been applied by this court in varied situations with unbroken continuity.<sup>61</sup>

The *Davis* Court also focused on the timing, explaining that "[i]t is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee ex maleficio."<sup>62</sup> He must have been a trustee before the wrong and without reference thereto."<sup>63</sup> The Court also reconfirmed that the substance of the relationship governs over its form.<sup>64</sup>

*D. Bankruptcy Law Reform Act of 1978 and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*

The Bankruptcy Law Reform Act of 1978 dropped the language relating to "an officer" and stated the following in section 523(a)(4): "A discharge . . . does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while

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<sup>57</sup> *Id.* at 192.

<sup>58</sup> 293 U.S. 328 (1934) (holding petitioner was not a trustee in a strict and narrow sense).

<sup>59</sup> *Id.* at 333 (finding "it is not enough that the act of wrongdoing from which the contested debt arose, the bankrupt is chargeable as a trustee ex maleficio").

<sup>60</sup> *Id.* (citing *Upshur v. Briscoe*, 138 U.S. 365, 378 (1891)) ("The language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created.").

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 334 ("The substance of the transaction is this, and nothing more, that the mortgagor, a debtor, has bound himself by covenant not to sell the mortgaged chattel without the mortgagee's approval. The resulting obligation is not turned into one arising from a trust because the parties to one of the documents have chosen to speak of it as a trust.").

acting in a fiduciary capacity, embezzlement, or larceny."<sup>65</sup> In 1979 in *Brown v. Felsen*, the Court noted that "[d]ischarge provisions substantially similar to § 17 of the [1898 Act] appear in § 523 of the new law."<sup>66</sup> The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 retained the identical language of the 1978 Act in section 523(a)(4).<sup>67</sup> In 2013 in *Bullock*, the Court focused on the term defalcation in section 523(a)(4) and did not address the meaning of fiduciary capacity.<sup>68</sup>

To recap, the Court has provided the following guidance on the meaning of the term fiduciary capacity:

- The cases enumerated in the statute, the defalcation of a public officer, executor, administrator, guardian, or trustee, are not cases of implied but special trusts, and the "other fiduciary capacity" mentioned must mean the same class of trusts.<sup>69</sup>
- A factor does not act in a fiduciary capacity; the statute speaks of technical trusts, and not those which the law implies from the contract.<sup>70</sup>
- A fiduciary capacity cannot come from a relationship where a debtor is holding or possessing an item and the refusal to return the item is only a breach of contract.<sup>71</sup>
- A fiduciary capacity cannot come from a trust the law implies from a contract,<sup>72</sup> such as trusts which form an element in every agency and in nearly all commercial transactions in the country.<sup>73</sup>

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<sup>65</sup> Bankruptcy Law Reform Act of 1978, Pub. L. No. 95-598, § 523, 92 Stat. 2549 (codified at 11 U.S.C. § 523(a)(4)).

<sup>66</sup> *Brown v. Felsen*, 442 U.S. 127, 129 n.1 (1979) (addressing res judicata principles).

<sup>67</sup> See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 523, 119 Stat. 54 (codified at 11 U.S.C. § 523(a)(4)).

<sup>68</sup> See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013) (involving a debtor who was a non-professional trustee of an irrevocable living trust). In *Bullock*, the Court remanded the case for further proceedings without addressing whether the debtor was acting in a fiduciary capacity. See also *Bullock v. BankChampaign, N.A.*, (*In re Bullock*), 670 F.3d 1160, 1164 (11th Cir. 2012) (stating "[t]he parties do not dispute that the judgment debt arose from conduct that occurred while Bullock was acting in a fiduciary capacity (*i.e.*, while he was the trustee of his father's trust)").

<sup>69</sup> See *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844) (interpreting the term fiduciary capacity to include special or technical trusts, but not implied trusts).

<sup>70</sup> See *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (excluding implied trusts from fiduciary capacity).

<sup>71</sup> See *Chapman*, 43 U.S. at 208 (holding "a factor who owes his principal money received on the sale of his goods, is not a fiduciary debtor within the meaning of the act"); *Hennequin v. Clews*, 111 U.S. 676, 682 (1884) (finding mortgagee in refusal to follow express or implied contract to give up premises is not guilty of breach of trusts, but breach of contract).

<sup>72</sup> See *Chapman*, 43 U.S. at 208 (observing how "[t]he act speaks of technical trusts, and not those which the law implies from the contract").

<sup>73</sup> See *Noble v. Hammond*, 129 U.S. 65, 69 (1889).

- Using the term "trust" or "trustee" in a contract with a debtor does not create a fiduciary capacity.<sup>74</sup> The substance of a transaction "is not turned into one arising from a trust because the parties to one of the documents have chosen to speak of it as a trust."<sup>75</sup>
- A fiduciary capacity cannot come from the debtor becoming chargeable as a fiduciary *ex maleficio* (meaning, by some wrongdoing or malfeasance).<sup>76</sup> The debtor must already be a fiduciary when the debt was created.<sup>77</sup>
- A fiduciary capacity cannot come from the usual contractual relationship between a debtor and creditor, even if it was created under circumstances in which trust or confidence was reposed in the debtor.<sup>78</sup>

The Court has never explained exactly what a special or technical trust is. Nor has it issued an opinion in which it determined that the facts of the case amounted to a fiduciary capacity. From a purely textualist perspective, it is odd that the terms "*any* fiduciary character"<sup>79</sup> in the Bankruptcy Act of 1867 and "*any* fiduciary capacity"<sup>80</sup> in the Bankruptcy Act of 1898 were construed in a manner that ignores the unspecified adjective "*any*." There is a legitimate concern that the exception to discharge should not be construed so broadly that the exception swallows the rule. However, the fresh start policy should not be overemphasized in a way that ignores

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<sup>74</sup> See *Upshur v. Briscoe*, 138 U.S. 365, 375 (1891) (explaining that "[t]he statement in the paper signed by Andrews that Briscoe accepts the 'trust,' . . . and the statement in the paper signed by Annie M. Andrews that she accepts the appointment of Briscoe 'as her trustee,' do not create a 'trust' in its technical sense, or make the debt of Briscoe one created by him while acting in a 'fiduciary character'").

<sup>75</sup> *Davis*, 293 U.S. at 334.

<sup>76</sup> See *id.* at 333 (holding "[i]t is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong and without reference thereto").

<sup>77</sup> See *Upshur*, 138 U.S. at 378 (stating "the language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created"). This suggests the term fiduciary capacity would exclude trusts created *ex post* as a remedial measure, such as constructive trusts and resulting trusts.

<sup>78</sup> See *id.* at 375 (holding "[t]he relation created was merely the usual one of contract between debtor and creditor. Within the meaning of the exception in the bankruptcy act, a debt is not created by a person while acting in a 'fiduciary character' merely because it is created under circumstances in which trust or confidence is reposed in the debtor, in the popular sense of those terms").

<sup>79</sup> Bankruptcy Act of 1867, ch. 176, § 33, 14 Stat. 517, 533 (1867) (repealed 1878) (stating in section 33 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 under this act").

<sup>80</sup> Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 544, 550–51 (1898) (repealed 1978) (stating in section 17 that "[a] discharge in bankruptcy shall release a bankrupt from all of his provable debts, except such as . . . (4) were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity").

the discharge restriction text promulgated by Congress under the bankruptcy clause of the Constitution.<sup>81</sup>

The Court has construed the words "fiduciary capacity" to have some type of connection to a trust. Interestingly, non-bankruptcy scholarship has observed that under old English law, the word "fiduciary" historically described situations that fell short of a trust relationship, meaning "those situations which are in some respects trust-like but are not, strictly speaking, trusts."<sup>82</sup>

The Court's jurisprudence indicates that a usual debtor-creditor relationship is insufficient to create a fiduciary capacity.<sup>83</sup> If all relationships were lined up on a spectrum with a commonplace debtor-creditor relationship on one end and the Court's nebulous special or technical trust on the other, there would be a large number of multifarious relationships located in between. The Court's seven opinions on the meaning of fiduciary capacity were issued between 1844 and 1934. Since that time, significant changes have occurred to the economy, credit, and the types of relationships that debtors have with others. All sorts of new relationships have developed since the year 1934.<sup>84</sup> Circuit courts have struggled with both the application and translation of what a fiduciary capacity means to new relationships that involve those who eventually become a debtor under bankruptcy law.

## II. ANALYSIS OF THE CIRCUIT COURTS ON THE MEANING OF FIDUCIARY CAPACITY

The Supreme Court's guidance on the meaning of a fiduciary capacity has proven inadequate for the circuit courts to apply consistently to the ever-growing universe of debtor relationships. This Section identifies areas in which the circuit courts are in substantial agreement on the meaning of a fiduciary capacity in section 523(a)(4). It then evaluates the circuit court split on the meaning of a fiduciary capacity and identifies four separate approaches that have developed.

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<sup>81</sup> See U.S. CONST. art. I, § 8, cl. 4 (empowering Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States").

<sup>82</sup> L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 71-72 n.11 (1962) (noting that an early instance of the use of the word by a judge was in *Bishop of Winchester v. Knight* (1717) 1 P. Wms. 406, 407 per Cowper L.C., involving a proceeding by a landlord for an account of ore dug by a tenant: "it is stronger in this case by reason that the tenant is a sort of fiduciary to the lord, and it is a breach of the trust which the law reposes in the tenant, for him to take away the property of the lord").

<sup>83</sup> See *Upshur*, 138 U.S. at 375 (holding "[t]he relation created was merely the usual one of contract between debtor and creditor. Within the meaning of the exception in the bankruptcy act, a debt is not created by a person while acting in a 'fiduciary character,' merely because it is created under circumstances in which trust or confidence is reposed in the debtor, in the popular sense of those terms").

<sup>84</sup> Consider for example the Revised Uniform Partnership Act, the Uniform Limited Partnership Act, the Revised Uniform Limited Partnership Act, the Uniform Prudent Investor Act, the Model Business Corporation Act, the Revised Model Business Corporation Act, the Uniform Limited Liability Company Act, the Revised Uniform Limited Liability Company Act, and the Employee Retirement Income Security Act of 1974.

### A. The Circuit Similarities

#### 1. Judicial Construction of Exceptions to Discharge

Even though the burden of proof is on the creditor to prove exceptions to discharge by "the ordinary preponderance-of-the-evidence standard,"<sup>85</sup> the Supreme Court has established a "well-known guide"<sup>86</sup> and "long-standing principle"<sup>87</sup> that exceptions to discharge "should be confined to those plainly expressed."<sup>88</sup>

Many circuit courts have gone a step further and required a pro-debtor/anti-creditor construction. For example, in the Fifth Circuit, exceptions to discharge "are generally to be 'narrowly construed . . . against the creditor and in favor of the bankrupt.'"<sup>89</sup> In the Second Circuit, "exceptions to discharge are to be narrowly construed and genuine doubts should be resolved in favor of the debtor."<sup>90</sup> The Eleventh Circuit noted "courts generally construe the statutory exceptions to discharge in bankruptcy liberally in favor of the debtor and recognize that the reasons for denying a discharge must be real and substantial, not merely technical and conjectural."<sup>91</sup> The Seventh Circuit construes exceptions to discharge "strictly against the objecting creditor and liberally in favor of the debtor."<sup>92</sup> Thus, many of the circuits take similar approaches and construe exceptions to discharge in favor of the debtor.

#### 2. Scope of Fiduciary Capacity is a Question of Federal Law

Unfortunately, the Bankruptcy Code does not define the term "fiduciary capacity" as used in section 523(a)(4). The circuits that have addressed the issue uniformly agree that the meaning of "fiduciary capacity" in section 523(a)(4) is a question of federal law.<sup>93</sup> But the circuits look to state law to determine the nature

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<sup>85</sup> *Grogan v. Garner*, 498 U.S. 279, 290 (1991) (holding "[w]e are unpersuaded by the argument that the clear-and-convincing standard is required to effectuate the 'fresh start' policy of the Bankruptcy Code").

<sup>86</sup> *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998).

<sup>87</sup> *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1760 (2013).

<sup>88</sup> *Gleason v. Thaw*, 236 U.S. 558, 562 (1915).

<sup>89</sup> *Boyle v. Abilene Lumber, Inc. (In re Boyle)*, 819 F.2d 583, 588 (5th Cir. 1987) (quoting *Murphy & Robinson Inv. Co. v. Cross (In re Cross)*, 666 F.2d 873, 879–80 (5th Cir. 1982)); see also *Century 21 Balfour Real Estate v. Menna (In re Menna)*, 16 F.3d 7, 9 (1st Cir. 1994) ("Exceptions to discharge are narrowly construed in furtherance of the Bankruptcy Code's 'fresh start' policy."); *Caspers v. Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987) ("[E]vidence presented must be viewed consistent with congressional intent that exceptions to discharge be narrowly construed against the creditor and liberally against the debtor, thus effectuating the fresh start policy of the Code.")

<sup>90</sup> *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 66 (2d Cir. 2006).

<sup>91</sup> *Equitable Bank v. Miller (In re Miller)*, 39 F.3d 301, 304 (11th Cir. 1994).

<sup>92</sup> *Crosswhite v. Ginter (In re Crosswhite)*, 148 F.3d 879, 881 (7th Cir. 1998).

<sup>93</sup> See, e.g., *In re Fahey*, 482 B.R. 678, 688 (B.A.P. 1st Cir. 2012) (stating "[t]he fiduciary relationship necessary for a denial of discharge under § 523(a)(4) is determined by federal law"); *Fowler & Peth, Inc. v. Regan (In re Regan)*, 477 F.3d 1209, 1211 n.1 (10th Cir. 2007) (quoting *Mangum v. Siegfried (In re*



of the relationship involving the debtor, including for example, whether a trust was established.<sup>94</sup> The Second Circuit explained the interplay between federal and state law as follows:

Although the precise scope of the defalcation exception is a question of federal law, its application frequently turns upon obligations attendant to relationships governed by state law. For example, state law can be an important factor in determining whether someone acted in a fiduciary capacity under Section 523(a)(4). [citations omitted] On the other hand, there are federal limits on the ability of state law to expand the effects of this provision. See, e.g., *In re Marchiando*, 13 F.3d 1111, 1116 (7th Cir. 1994) ("If . . . a fiduciary is anyone whom a state calls a fiduciary . . . states will have it in their power to deny a fresh start to their

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Siegfried), 5 Fed. Appx. 856, 859 (10th Cir. 2001)) (stating "[w]hile 'the existence of a fiduciary relationship under § 523(a)(4) is determined under federal law,' state law is relevant to this inquiry"); *Guerra v. Fernandez-Rocha (In re Fernandez-Rocha)*, 451 F.3d 813, 816 (11th Cir. 2006) (looking first to federal cases for the meaning of fiduciary capacity); *Gupta v. E. Idaho Tumor Inst., Inc. (In re Gupta)*, 394 F.3d 347, 349 (5th Cir. 2004) (quoting *LSP Inv. P'ship v. Bennett (In re Bennett)*, 989 F.2d 779, 784 (5th Cir. 1993)) (stating "[t]he scope of the concept of fiduciary under 11 U.S.C. § 523(a)(4) is a question of federal law"); *In re Frain*, 230 F.3d 1014, 1017 (7th Cir. 2000) (stating "[t]he existence of a 'fiduciary relationship' is a matter of federal law. It bears emphasis that not all fiduciary relationships qualify under the Bankruptcy Code."); *Andy Warhol Found. for Visual Arts, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162, 166 (2d Cir. 1999) (stating "the precise scope of the defalcation exception is a question of federal law"); *Harrell v. Merch.'s Express Money Order Co.*, 173 F.3d 850 (4th Cir. 1999) (per curiam) (recognizing "[t]he definition of 'fiduciary' for purposes of § 523(a)(4) is controlled by federal common law"); *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997) (quoting *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1185 (9th Cir. 1996)) (stating "[w]hether a relationship is a 'fiduciary' one within the meaning of section 523(a)(4) is a question of federal law"); *In re Lewis*, 97 F.3d at 1185 (referencing *Runnion v. Pedrazzini (In re Pedrazzini)*, 644 F.2d 756, 758 (9th Cir. 1981) (stating "[w]hether a relationship is a 'fiduciary' one within the meaning of section 523(a)(4) is a question of federal law"); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 251 n.2 (6th Cir. 1982) (stating the question of who is a fiduciary "is one of federal law").

<sup>94</sup> See, e.g., *In re Fahey*, 482 B.R. at 688 ("The content of federal law is informed by principles articulated in state law, including those that define essential attributes of a trust relationship."); *Arvest Mort. Co. v. Nail (In re Nail)*, 680 F.3d 1036, 1040 (8th Cir. 2012) (holding "[i]t is now well settled that a state statute may create the fiduciary relationship required by § 523(a)(4)"); *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 767 (7th Cir. 2011) ("Not all persons treated as fiduciaries under state law are considered to 'act in a fiduciary capacity' for purposes of federal bankruptcy law."); *Kubota Tractor Corp. v. Strack (In re Strack)*, 524 F.3d 493, 498 (4th Cir. 2008) (looking to state law for guidance to determine whether a trust was established); *In re Regan*, 477 F.3d at 1211 n.1 ("While 'the existence of a fiduciary relationship under § 523(a)(4) is determined under federal law,' state law is relevant to this inquiry.") (quoting *In re Siegfried*, 5 Fed. Appx. at 859); *In re Gupta*, 394 F.3d at 350 ("The scope of the concept of fiduciary under 11 U.S.C. § 523(a)(4) is a question of federal law; however, state law is important in determining whether or not a trust obligation exists.") (quoting *In re Bennett*, 989 F.2d at 784); *In re Hayes*, 183 F.3d at 166–67 ("Although the precise scope of the defalcation exception is a question of federal law, its application frequently turns upon obligations attendant to relationships governed by state law."); *In re Lewis*, 97 F.3d at 1185 ("Whether a fiduciary is a 'trustee in that strict and narrow sense,' is determined in part by reference to state law.") (citations omitted); *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993) (analyzing a Georgia statute to determine if there was a statutory fiduciary duty); *In re Johnson*, 691 F.2d at 251 n.2 ("State law is merely a factor in the equation used to determine whether the fiduciary capacity requirement is satisfied as a matter of federal law, using federal standards.").

debtors by declaring all contractual relations fiduciary"). As a general matter, therefore, federal law sets the outer boundaries of the defalcation exception, while state law may, through lesser or greater regulation of fiduciary obligations, affect the application of the provision.<sup>95</sup>

Thus, the circuit courts have found that even though state law is commonly essential to the analysis, state law is not conclusive. The circuits have generally agreed that many relationships that are characterized as fiduciary in nature under state law will not automatically amount to a fiduciary capacity under section 523. One reason for this different treatment is that bankruptcy policies differ from those under state law.

### 3. An Express Trust Gives Rise to a Fiduciary Capacity

Under non-bankruptcy law, an express trust is a fiduciary relationship with respect to property, arising as a result of a manifestation of an intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of another.<sup>96</sup> The person who holds property in trust is the trustee and the person for whose benefit property is held in trust is the beneficiary.<sup>97</sup> According to the Restatements, a trust involves three elements: (i) a trustee (ii) one or more beneficiaries, and (iii) trust property.<sup>98</sup> Under the Uniform Trust Code,

[a] trust may be created by: (1) transfer of property to another person as trustee during the settlor's lifetime or by will or other disposition taking effect upon the settlor's death; (2) declaration by the owner of property that the owner holds identifiable property as trustee; or (3) exercise of a power of appointment in favor of a trustee.<sup>99</sup>

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<sup>95</sup> *In re Hayes*, 183 F.3d at 166–67. See also *Texas Lottery Comm'n v. Tran (In re Tran)*, 151 F.3d 339, 343 (5th Cir. 1998) ("The question whether a state statute creates the type of fiduciary relationship required under § 523(a)(4) is one of federal law. To make this determination a federal court must nevertheless look to state law—here, to the statute purporting to create a fiduciary relationship and to any regulations promulgated in regard thereto—to discern whether the supposed fiduciary relationship possesses the attributes required under § 523(a)(4), which brings us to the case at hand.").

<sup>96</sup> See RESTATEMENT (SECOND) OF TRUSTS § 2 (AM. LAW INST. 1959) (defining "trust"); RESTATEMENT (THIRD) OF TRUSTS § 2 (AM. LAW INST., Tentative Draft No. 1, 1996) (same).

<sup>97</sup> See RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. h (AM. LAW INST. 1959) (listing elements of a trust); RESTATEMENT (THIRD) OF TRUSTS § 3 cmt. f (AM. LAW INST., Tentative Draft No. 1, 1996) (same).

<sup>98</sup> See RESTATEMENT (SECOND) OF TRUSTS § 2 cmt. h (AM. LAW INST. 1959); RESTATEMENT (THIRD) OF TRUSTS § 3 cmt. f (AM. LAW INST., Tentative Draft No. 1, 1996).

<sup>99</sup> UNIF. TRUST CODE § 401 (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2000) (amended 2010).

Except for the trustee's duty to keep the beneficiaries informed of administration and the trustee's obligation to act in good faith, a trustee's fiduciary duties arise from the terms of the trust.<sup>100</sup>

Every circuit<sup>101</sup> has recognized that a debtor acting as a trustee under an express trust is a fiduciary capacity under section 523(a)(4).<sup>102</sup> Although there are minor variations arising from applying different state law, there is significant agreement among the circuits on the requirements to establish an express trust.<sup>103</sup>

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<sup>100</sup> See UNIF. TRUST CODE art. 8, gen. cmt. (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2000) (amended 2010) (explaining all elements of article 8 may be "[o]verridden in the terms of the trust" except for trustee's duty to act in good faith and to inform beneficiaries of administration).

<sup>101</sup> Except the District of Columbia Circuit and Federal Circuit.

<sup>102</sup> See *Follett Higher Educ. Grp., Inc. v. Berman* (*In re Berman*), 629 F.3d 761, 769 (7th Cir. 2011) (stating its threshold inquiry was whether a fiduciary obligation was owed through the presence of an "express trust"); *Kubota Tractor Corp. v. Strack*, (*In re Strack*), 524 F.3d 493, 497 n.6 (4th Cir. 2008) ("Here, the dispute concerns only whether an express trust was created, which, as both parties acknowledge, is clearly sufficient to establish a fiduciary relationship for the purposes of § 523(a)(4)."); *Eberhart v. First Am. Title Ins. Co.* (*In re Eberhart*), 124 Fed. Appx. 672, 674 (2d Cir. 2005) (concluding that a relationship "created an express trust" by failing to act in his fiduciary capacity owed to trust beneficiaries as a trustee); *Hunter v. Philpott*, 373 F.3d 873, 875 (8th Cir. 2004) ("We have interpreted the term 'fiduciary' in § 523(a)(4) to refer only to trustees of 'express trusts.'"); *Rutanen v. Baylis* (*In re Baylis*), 313 F.3d 9, 17 n.3 (1st Cir. 2002) (deciding a case where a debtor was an attorney and co-trustee of an express trust and stating "[i]t is undisputed that [the debtor] is a fiduciary for purposes of § 523(a)(4)"); *Andy Warhol Found. for Visual Arts, Inc. v. Hayes* (*In re Hayes*), 183 F.3d 162, 167 (2d Cir. 1999) (stating "the defalcation exception is not limited to express trusts"); *Texas Lottery Comm'n v. Tran* (*In re Tran*), 151 F.3d 339, 343 (5th Cir. 1998) (holding "[u]nder § 523(a)(4), 'fiduciary' is limited to instances involving express or technical trusts"); *R.E. America, Inc. v. Garver* (*In re Garver*), 116 F.3d 176, 179 (6th Cir. 1997) (holding "[w]e believe that this definition . . . necessarily implies the existence of an express or technical trust relationship"); *Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1185 (9th Cir. 1996) (stating "the fiduciary relationship must be one arising from an express or technical trust"); *Fowler Bros. v. Young* (*In re Young*), 91 F.3d 1367, 1371 (10th Cir. 1996) (stating "an express or technical trust must be present for a fiduciary relationship to exist under § 523(a)(4)"); *Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993) (noting "[i]n the early judicial interpretation of the predecessors to § 523(a)(4), the courts seemed to include the voluntary, 'express' trust within the scope of 'fiduciary capacity'"); *Bloemecke v. Applegate*, 271 F. 595, 599 (3d Cir. 1921) (comparing different versions of the bankruptcy act and concluding that "Congress doubtless had in mind that the courts had construed the term 'fiduciary' as meaning an express, technical trust, and by omitting those words from the act of 1898 it must have intended to extend the class coming within the meaning of 'fiduciary capacity'").

<sup>103</sup> See *In re Fahey*, 482 B.R. 678, 688 (B.A.P. 1st Cir. 2012) (finding an express trust requires "an explicit declaration of trust, a clearly defined trust *res*, and an intent to create a trust relationship") (quoting *In re Olinger*, 160 B.R. 1004, 1014 (Bankr. S.D. Ind. 1993)); *In re Thompson*, 458 B.R. 504, 508 (B.A.P. 8th Cir. 2011) (providing "[a]n express trust is one 'created with the settlor's express intent, usually declared in writing'" (quoting BLACK'S LAW DICTIONARY 1650 (9th ed. 2009))); *In re Sawaged*, Nos. 10–058, 08–10344, 08–01304, 2011 WL 880464, at \*3 (B.A.P. 10th Cir. Mar. 15, 2011) (explaining that "[e]xpress trusts are those trust relationships which are intentionally entered into by the parties. An express trust may involve a formal declaration of trust or a situation where the intention of the parties to form a trust relationship may be inferred by the surrounding facts and circumstances") (quoting *In re Steele*, 292 B.R. 422, 427 (Bankr. D. Colo. 2003)); *In re Strack*, 524 F.3d at 498–99 (applying Virginia law and finding "'an express trust is based on the declared intention of the trustor,' manifested either in writing or through the parties' actions" and that "[a]ll that is necessary is the 'unequivocal' intent 'that the legal estate [be] vested in one person, to be held in some manner or for some purpose on behalf of another'" (quoting *Old Republic Nat'l Title Ins. Co.* (*In re Dameron*), 155 F.3d 718, 722 (4th Cir. 1998)); *Commonwealth Land Title Co. v. Blaszak* (*In re Blaszak*), 397 F.3d 386, 391–92 (6th Cir. 2005) (holding an express trust has four requirements: "(1) an intent to create a trust; (2) a trustee; (3) a trust *res*; and (4) a definite beneficiary") (citing *In re Grim*, 293 B.R. 156, 166 (Bankr. N.D. Ohio 2003)); *Quaif*, 4 F.3d at 953 (describing an express trust as "a voluntary trust, created by

#### 4. A Technical Trust May Come From Many Different Sources

Under non-bankruptcy law, fiduciary duties may come from many different sources such as the agreement of the parties via express or implied contractual terms or through some type of legislative or judicial decree.<sup>104</sup> These sources commonly confer power to, or impose obligations upon, the fiduciary.

Most circuits have held that a fiduciary capacity requires an "express or technical trust."<sup>105</sup> The circuits have looked to many different sources to find a technical trust. For example, in the Eighth Circuit, "[t]rusts satisfying § 523(a)(4) can be created by state statute or by common law, as well as by contract."<sup>106</sup> In the Ninth Circuit, a "trust within the meaning of § 523(a)(4) may arise by virtue of state case law."<sup>107</sup> The First Circuit recognized that "in analyzing common law technical trusts, courts typically examine state law to determine if it imposes fiduciary obligations on the relevant party."<sup>108</sup>

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contract") (citing *In re Turner*, 134 B.R. 646, 650 (Bankr. N.D. Okl. 1991)); *E.A. Schlecht v. Thornton* (*In re Thornton*), 544 F.2d 1005, 1007 (9th Cir. 1976) (finding "[t]he general characteristics of an express trust are 1) sufficient words to create a trust; 2) a definite subject; and 3) a certain and ascertained object or res").

<sup>104</sup> See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON 425 (1993); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995); Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039 (2011).

<sup>105</sup> See *In re Fahey*, 482 B.R. at 687 (B.A.P. 1st Cir. 2012) (holding "the debt must result from a fiduciary's defalcation under an 'express or technical trust'") (quoting *In re Duncan*, 331 B.R. 70, 77 (Bankr. E.D.N.Y. 2005)); see also *Guerra v. Fernandez-Rocha* (*In re Fernandez-Rocha*), 451 F.3d 813, 816 (11th Cir. 2006) (recognizing the term fiduciary refers to technical trusts and that courts seemed to include the voluntary, express trust created by contract within the scope of 'fiduciary capacity') (citing *Quaif*, 4 F.3d at 953); *Andy Warhol Found. for Visual Arts, Inc. v. Hayes* (*In re Hayes*), 183 F.3d 162, 168 (2d Cir. 1999) (stating "the attorney-client relationship, although usually not involving a technical trustee or express trust, has long been understood to be a fiduciary relationship within the meaning of the defalcation exception"); *Harrell v. Merch.'s Express Money Order Co.* (*In re Harrell*), 173 F.3d 850 (4th Cir. 1999) (per curiam) (holding that "under [§ 523(a)(4)], a fiduciary is limited to instances involving express or technical trusts"); *In re Tran*, 151 F.3d at 343 (holding that "[u]nder § 523(a)(4), 'fiduciary' is limited to instances involving express or technical trusts"); *In re Garver*, 116 F.3d at 179 (holding that "[w]e believe that this definition . . . necessarily implies the existence of an express or technical trust relationship"); *Tudor Oaks Ltd. P'ship v. Cochrane* (*In re Cochrane*), 124 F.3d 978, 984 (8th Cir. 1997) (quoting *Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1185 (9th Cir. 1996)) (stating "[t]he fiduciary relationship must be one arising from an express or technical trust"); *In re Lewis*, 97 F.3d at 1185 (stating "the fiduciary relationship must be one arising from an express or technical trust") (citing *Ragsdale v. Haller*, 780 F.2d 794, 795 (9th Cir. 1986)); *In re Young*, 91 F.3d at 1371 (stating "an express or technical trust must be present for a fiduciary relationship to exist under § 523(a)(4)").

<sup>106</sup> *Rechetar Sys., Inc. v. Thompson* (*In re Thompson*), 686 F.3d 940, 944 (8th Cir. 2012) (citing *Barclays Am./Bus. Credit, Inc. v. Long* (*In re Long*), 774 F.2d 875, 878 (8th Cir. 1985)).

<sup>107</sup> *In re Stanifer*, 236 B.R. 709, 718 (B.A.P. 9th Cir. 1999) (stating California case law gives rise to the "core requirements of a trust and to the type of fiduciary relationship contemplated within the meaning of § 523(a)(4)"). See also *Ragsdale v. Haller* (*In re Ragsdale*), 780 F.2d 794, 796–97 (9th Cir. 1986) (concluding that "[i]f state law makes clear that a partner necessarily is a trustee over partnership assets for all purposes, then that partner is a fiduciary within the narrow meaning of § 523(a)(4)").

<sup>108</sup> *In re Fahey*, 482 B.R. at 688 (quoting *In re Sullivan*, 217 B.R. 670, 675 (Bankr. D. Mass. 1998)) (noting a technical trust may arise under statute or common law).

When relying upon a statute to create the trust, the circuits have developed similar but slightly different tests. Some of these tests incorporate aspects of the Supreme Court's guidance. For example, the First Circuit has found that "[w]here the basis for the existence of a technical trust is statutory, the statute must '(1) define the trust res, (2) spell out the trustee's fiduciary duties, and (3) impose a trust prior to and without references to the wrong that created the debt.'"<sup>109</sup> In the Fifth Circuit, "[s]tatutory trusts . . . can satisfy the dictates of § 523(a)(4). It is not enough, however, that a statute purports to create a trust . . . to meet the requirements of § 523(a)(4), a statutory trust must (1) include a definable res and (2) impose 'trust-like' duties."<sup>110</sup> The Eighth Circuit adopted the Fifth Circuit's requirements noting "[i]t is now well settled that a state statute may create the fiduciary relationship required by § 523(a)(4)."<sup>111</sup> In the Sixth Circuit, "a statute may create a trust for purposes of § 523(a)(4) if that statute defines the trust res, imposes duties on the trustee, and those duties exist prior to any act of wrongdoing."<sup>112</sup> The Ninth Circuit has found fiduciary relationships imposed by statute may cause a debtor to be considered a fiduciary under section 523(a)(4) "if the statute: (1) defines the trust res; (2) identifies the fiduciary's fund management duties; and (3) imposes obligations on the fiduciary prior to the alleged wrongdoing."<sup>113</sup> Thus, there is significant agreement among the circuits that fiduciary capacities under section 523(a)(4) may come from many different sources.

### B. *The Circuit Split*

Despite their agreement on trusts, the circuits have struggled to consistently apply the Supreme Court's description of a fiduciary capacity. One bankruptcy court observed that "[r]educing these varied precedents to an intelligible rule is not easy"<sup>114</sup> and another concluded it was an issue that "[m]uch judicial ink has been spilled on" and the reported case law "is hopelessly divided."<sup>115</sup> There are multiple

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<sup>109</sup> *Id.* at 688 (quoting *In re Bologna*, 206 B.R. 628, 632 (Bankr. D. Mass. 1997)).

<sup>110</sup> *In re Tran*, 151 F.3d at 342–43 (noting that one trust-like duty was that "a trustee refrain from spending trust funds for non-trust purposes").

<sup>111</sup> *Arvest Mortgage Co. v. Nail (In re Nail)*, 680 F.3d 1036, 1040 (8th Cir. 2012).

<sup>112</sup> *Bd. of Trustees of the Ohio Carpenters' Pension Fund v. Bucci (In re Bucci)*, 493 F.3d 635, 641 (6th Cir. 2007) (highlighting Michigan's Building Contract Fund Act established a fiduciary obligation on a contractor when a payment is paid to the contractor, not when a contractor misappropriates the funds).

<sup>113</sup> *Blyler v. Hemmeter (In re Hemmeter)*, 242 F.3d 1186, 1190 (9th Cir. 2001) (considering whether fiduciaries under ERISA also constitute fiduciaries under section 523(a)(4)).

<sup>114</sup> *In re Turner*, 134 B.R. 646, 656 (Bankr. N.D. Okla. 1991) (discussing difference in opinions among Court of Appeals and lower courts on topic of express trusts).

<sup>115</sup> *In re Bayer*, 521 B.R. 491, 509 (Bankr. E.D. Penn. 2014) (acknowledging Georgia case law has held that a debtor's status as a director or officer does not, by itself, create a fiduciary relationship between the director or officer and the corporation, whereas Illinois case law is still unclear on the issue as "it is not possible to describe definitively the state of § 523(a)(4)"). See also *In re Heilman*, 241 B.R. 137, 160 (Bankr. D. Md. 1999) ("It is an understatement to say that the courts are divided on the meaning of 'fiduciary capacity' for purposes of nondischargeability of debts for fraud or defalcation while acting in a fiduciary capacity under 11 U.S.C. § 523(a)(4).").

levels of splits throughout the circuits on what type of relationships are a fiduciary capacity under section 523(a)(4).

The circuits disagree on the treatment of distinct, individual relationships. For example, the Ninth Circuit has found the Employee Retirement Income Security Act of 1974 ("ERISA") plan fiduciaries are fiduciaries for purposes of section 523(a)(4) because the ERISA statute "(1) defines the trust res; (2) identifies the fiduciary's fund management duties; and (3) imposes obligations on the fiduciary prior to the alleged wrongdoing."<sup>116</sup> But the Sixth Circuit has held the definition of fiduciary capacity in section 523(a)(4) "does not match the definition of an ERISA fiduciary."<sup>117</sup> Another example is an attorney-client relationship where the debtor is an attorney and the creditor is a client. The Tenth Circuit has held that a fiduciary capacity under section 523(a)(4) requires more than a general attorney-client relationship.<sup>118</sup> But the Second Circuit has determined that the attorney-client relationship, without more, constitutes a fiduciary relationship under section 523(a)(4).<sup>119</sup>

The disagreement among the circuits goes beyond pairings of opposite views on individual relationships. The circuits are divided on the meaning of a special or technical trust. There is not a commonly-known meaning of the term "technical trust." Black's Law Dictionary, which contains entries for over 117 different types of trusts, contains a single cross-reference to the term "passive trust" but does not independently define the term technical trust.<sup>120</sup> Neither the Second nor Third Restatements of Trust contain the term technical trust.<sup>121</sup> It is absent from the Uniform Trust Code.<sup>122</sup> In addition to there being no uniform understanding on the meaning of a technical trust, the circuits also disagree on what aspect of a fiduciary relationship is the most important. Many of the circuits agree that they are looking for "trust-type obligations," but they disagree on what those obligations look like.<sup>123</sup>

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<sup>116</sup> *In re Hemmeter*, 242 F.3d at 1190 (considering whether fiduciaries under ERISA also constitute fiduciaries under section 523(a)(4)).

<sup>117</sup> *In re Bucchi*, 493 F.3d at 641 (stating definition of a fiduciary under ERISA is "broader than the common-law definition, and does not turn on formal designations, such as who is the trustee").

<sup>118</sup> *See Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1372 (10th Cir. 1996) ("[T]he majority of courts that have considered the issue have applied the above principles to require more than attorney-client relationship alone to establish a fiduciary relationship for purposes of § 523(a)(4)"). *See also* R.E. America, Inc. v. Garver (*In re Garver*), 116 F.3d 176, 179 (6th Cir. 1997) (holding "[t]he attorney-client relationship, without more, is insufficient to establish the necessary fiduciary relationship for defalcation under § 523(a)(4)").

<sup>119</sup> *See Andy Warhol Found. for Visual Arts, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162, 170 (2d Cir. 1999) (holding "the attorney-client relationship, without more, constitutes a fiduciary relationship within the meaning of Section 523(a)(4)").

<sup>120</sup> *See* BLACK'S LAW DICTIONARY 1747 (10th ed. 2014) (defining the term passive trust as "[a] trust in which the trustee has no duty other than to transfer the property to the beneficiary").

<sup>121</sup> *See* RESTATEMENT (SECOND) OF TRUSTS § 2 (AM. LAW INST. 1959); RESTATEMENT (THIRD) OF TRUSTS § 5 cmt. e (AM. LAW INST., Tentative Draft No. 1, 1996).

<sup>122</sup> *See* UNIF. TRUST CODE (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2000) (amended 2010).

<sup>123</sup> *See, e.g., LSP Inv. P'ship v. Bennett (In re Bennett)*, 989 F.2d 779, 784–85 (5th Cir. 1993) (stating "the 'technical' or 'express' trust requirement is not limited to trusts that arise by virtue of a formal trust

The circuits have split into at least four separate approaches for determining if a relationship is a fiduciary capacity under section 523(a)(4).

### 1. Restrictive Approach Requiring Traditional Express Trust Elements Such As a Trust Res and Trustee

The most restrictive approach focuses on traditional express trust elements such as requiring the relationship to have a trust res, a trustee, and an appropriate timing of when the fiduciary obligations were created. The Ninth and Tenth Circuits are good examples of this approach. These courts are flexible on the source of where these elements come from, but nonetheless still require some of the traditional trust elements. For example, these courts have analyzed whether the trustee requirement was met in a variety of different contexts, such as when the debtor was a corporate officer,<sup>124</sup> partner,<sup>125</sup> joint venturer,<sup>126</sup> attorney,<sup>127</sup> licensed real estate broker,<sup>128</sup> former spouse,<sup>129</sup> or insurance agent.<sup>130</sup> They have looked to whether there was a trust res arising from a California contractor statute,<sup>131</sup> a fee an attorney received,<sup>132</sup>

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agreement, but includes relationships in which trust-type obligations are imposed pursuant to statute or common law"); *see also In re Stanifer*, 236 B.R. 709, 714 (B.A.P. 9th Cir. 1999) (finding that the technical trust requirement "includes relationships in which trust-type obligations are imposed pursuant to statute or common law").

<sup>124</sup> *See Cal-Micro, Inc. v. Cantrell (In re Cantrell)*, 329 F.3d 1119, 1126–27 (9th Cir. 2003) (noting that "California case law has consistently held that while officers possess the fiduciary duties of an agent, they are not trustees with respect to corporate assets").

<sup>125</sup> *See Ragsdale v. Haller (In re Ragsdale)*, 780 F.2d 794, 796 (9th Cir. 1986) (finding "California has made all partners trustees over the assets of the partnership"); *see also Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1185 n.1 (9th Cir. 1996) (determining if state law imposed trust obligations on partners that were substantially similar to those imposed on trustees).

<sup>126</sup> *See Lewis v. Short (In re Short)*, 818 F.2d 693, 696 (9th Cir. 1987) (stating "[s]hort had a duty to act as trustee for the affairs of the joint venture").

<sup>127</sup> *See Banks v. Gill Distrib. Ctrs., Inc. (In re Banks)*, 263 F.3d 862, 870 (9th Cir. 2001) (finding "[w]hen he placed his client's funds into his trust account, he became his client's fiduciary"); *Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1372 (10th Cir. 1996) (finding a New Mexico Rule of Professional Conduct "does not place an attorney in the position of a trustee" even though it applies to the instant case); *In re White*, 271 B.R. 213 (B.A.P. 10th Cir. 2001) (holding a Kansas Rule of Professional Conduct "puts the attorney in the position of a trustee").

<sup>128</sup> *See Otto v. Niles (In re Niles)*, 106 F.3d 1456, 1459 (9th Cir. 1997) (stating that "[b]ecause Niles collected rents for the Ottos in her capacity as a licensed real estate broker . . . and was required either to pay those funds directly to the Ottos or to hold them in a trust fund account in accordance with the Ottos' instructions, she was the trustee of an express trust").

<sup>129</sup> *See Teichman v. Teichman (In re Teichman)*, 774 F.2d 1395, 1399 (9th Cir. 1985) (finding "no estate was conveyed to the husband as a trustee").

<sup>130</sup> *See In re Kelley*, 215 B.R. 468, 474 (B.A.P. 10th Cir. 1997) (evaluating an Oklahoma statute and concluding it "identifies as a trust res all the insurance charges or premiums that an administrator collects for an insurer").

<sup>131</sup> *See Runnion v. Pedrazzini (In re Pedrazzini)*, 644 F.2d 756, 758 (9th Cir. 1981) (determining "[t]he California statutes do not create the basic elements of a trust. No res is defined . . .").

<sup>132</sup> *See In re Bigelow*, 271 B.R. 178, 188 (B.A.P. 9th Cir. 2001) (concluding that "[s]ince there were no trust funds involved in Bigelow's attorney-client relationship with Stephens, theirs was not a 'fiduciary' relationship within the narrow meaning of § 523(a)(4)").

a Texas construction fund statute,<sup>133</sup> a transaction involving a real estate broker,<sup>134</sup> a Colorado construction lien statute,<sup>135</sup> Oklahoma common law,<sup>136</sup> a commercial relationship,<sup>137</sup> and an Oklahoma general corporation act.<sup>138</sup> Finally, the timing of when the alleged trust arose was decisive in a situation where a limited liability company was not formed and an operating agreement was not signed,<sup>139</sup> where a California contractor statute was at issue,<sup>140</sup> a case involving withdrawal liability under ERISA,<sup>141</sup> and obligations of a former spouse came from a property settlement agreement.<sup>142</sup> This approach of requiring traditional express trust elements is the most restrictive view.

## 2. Broad Approach Abandoning Trust Concepts

The broadest approach completely ignores trust concepts. The Second Circuit has construed the Supreme Court's requirement that there be a "special trust" as not requiring a trust "in the modern sense of a legal relationship where a party (the trustee) is the legal owner of property beneficially held on behalf of others, but more generally of the class of relationships in which special trust is bestowed upon a party."<sup>143</sup> The Second Circuit found "certain relationships not constituting actual

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<sup>133</sup> See *In re Munton*, 352 B.R. 707, 715 (B.A.P. 9th Cir. 2006) (finding "[t]he Texas statute clearly defines the trust res, i.e. construction payments made to a contractor 'under a construction contract for the improvement of specific real property'").

<sup>134</sup> See *In re Honkanen*, 446 B.R. 373, 381 (B.A.P. 9th Cir. 2011) (finding Honkanen did not hold any property in trust and "[i]n the absence of a trust res, a fundamental requirement to form a trust, there was no express, technical or statutory trust formed" and thus no fiduciary capacity).

<sup>135</sup> See *Mangum v. Siegfried (In re Siegfried)*, 5 Fed. Appx. 856, 859 (10th Cir. 2001) (stating the statute "expressly designates the funds received by the contractor as trust funds to be held for payment to subcontractors") (opinion adopted and published by *Fowler & Peth, Inc. v. Regan (In re Regan)*, 477 F.3d 1209, 1211 n.1 (10th Cir. 2007)).

<sup>136</sup> See *In re Seay*, 215 B.R. 780, 787 (B.A.P. 10th Cir. 1997) (finding that in addition to failing to prove the existence of an express or technical trust, Holaday failed to establish the existence of a trust res).

<sup>137</sup> See *In re Burton*, No. 09-15177, 2010 WL 3422584, at \*5-6 (B.A.P. 10th Cir. Aug. 31, 2010) (highlighting that the alleged trust res was not titled in the debtor's name).

<sup>138</sup> See *In re Hill*, 390 B.R. 407, 412 (B.A.P. 10th Cir. 2008) (finding "the Corporation Act does not sufficiently and explicitly create a trust or define a trust res").

<sup>139</sup> See *In re Utmehmer*, 499 B.R. 705, 717 (B.A.P. 9th Cir. 2013) (questioning "how a fiduciary duty that may arise in an LLC that does not come into existence until sometime in the future" satisfies the requirement that the fiduciary duty arise before any alleged wrongdoing takes place).

<sup>140</sup> See *Runnion v. Pedrazzini (In re Pedrazzini)*, 644 F.2d 756, 758 (9th Cir. 1981) (noting that the statutes in question "operate only after an act of wrongdoing has occurred").

<sup>141</sup> See *Carpenters Pension Trust Fund for N. Cal. v. Moxley*, 734 F.3d 864, 869 (9th Cir. 2013) (reasoning that "[b]ecause withdrawal liability does not arise until the employer ceases to have an obligation to contribute to the plan, it cannot be considered an unpaid contribution under the collective bargaining agreement").

<sup>142</sup> See *Teichman v. Teichman (In re Teichman)*, 774 F.2d 1395, 1399 (9th Cir. 1985) (holding that "[a]lthough the debtor husband in this case may now be classified as a constructive trustee pursuant to [California statutes], a constructive trust would be imposed only after the defendant has defaulted. This is not sufficient to render the debt non-dischargeable under section 523(a)(4)").

<sup>143</sup> *Andy Warhol Found. for Visual Arts, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162, 169 (2d Cir. 1999).



trusts are within the defalcation exception."<sup>144</sup> It held an attorney-client relationship, without more, is a fiduciary capacity under section 523(a)(4).<sup>145</sup> Although it refused to "disaggregat[e] the fiduciary relation into component pieces," it noted "the attorney-client relationship entails one of the highest fiduciary duties imposed by law" and explained "[t]he fiduciary obligation owed by an attorney to his client extends to all aspects of the attorney-client relationship, including the means by which the relationship is created, as evidenced from the extensive regulation of attorney-client fee arrangements."<sup>146</sup> Thus, this broad view does not require a trustee or trust res.

### 3. Fiduciary Capacity Based On Control

Another approach has been to look for "trust-like" duties with a special focus on control. In the Fourth Circuit, debtors who were in control of the supervision and handling of the day-to-day operations of a corporation were deemed to be acting in a fiduciary capacity.<sup>147</sup> The Fifth Circuit looks at "whether the alleged fiduciary exercises actual control over the alleged beneficiary's money or property."<sup>148</sup> In a different case, the Fifth Circuit focused on a managing partner's control over a partnership as creating a greater duty of loyalty than is normally required and noted that "the issue of control has always been the critical fact looked to by the courts in imposing this high level of responsibility."<sup>149</sup> On another occasion, the Fifth Circuit concluded that an officer of a corporate general partner who was entrusted with the management of a limited partnership, and who exercised control over the limited partnership, owed a fiduciary duty to the partnership under section 523(a)(4).<sup>150</sup> The Fifth Circuit explained that "it is not only the control that the officer actually exerts over the partnership, but also the confidence and trust placed in the hands of the controlling officer, that leads us to find that a fiduciary relationship exists."<sup>151</sup> The court focused on the debtor's "near-complete control over both tiers of the entity" and that the board had entrusted him "with the sole and plenary authority over the day-to-day management of the partnership" including controlling "the hiring,

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<sup>144</sup> *Id.*

<sup>145</sup> *See id.* at 170 (rejecting "the view that the attorney-client relationship is of a fiduciary nature for purposes of Section 523(a)(4)").

<sup>146</sup> *Id.* at 168–70.

<sup>147</sup> *See Airlines Reporting Corp. v. Ellison (In re Ellison)*, 296 F.3d 266, 269 (4th Cir. 2002) (holding where one party, by their personal decisions, failed to make required payments for trustee corporation while running its day-to-day operations, party had breached its fiduciary duty).

<sup>148</sup> *Texas Lottery Comm'n v. Tran (In re Tran)*, 151 F.3d 339, 345 (5th Cir. 1998) (noting that the statute in question "fails to entrust the ticket sales agent with the state's money for safekeeping").

<sup>149</sup> *LSP Inv. P'ship v. Bennett (In re Bennett)*, 989 F.2d 779, 789 (5th Cir. 1993) (finding the requirements of section 523(a)(4) were met because under Texas law, a managing partner owed limited partners the highest fiduciary duty recognized by law).

<sup>150</sup> *See FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615, 622 (5th Cir. 2011).

<sup>151</sup> *Id.*

evaluation, promotion, and termination of [partnership] employees."<sup>152</sup> Thus, the alleged fiduciary's control has been the primary focus of one approach.

#### 4. Fiduciary Capacity Based On Ascendancy from Knowledge or Power

The final approach looks at whether the debtor was put in an ascendant position based on the debtor's knowledge or power. The Seventh Circuit<sup>153</sup> has held a fiduciary capacity may come from "a difference in knowledge or power between the fiduciary and principal which . . . gives the former a position of ascendancy over the latter."<sup>154</sup> The rationale is that this inequality of relation "justif[ies] the imposition on the fiduciary of a special duty, basically to treat his principal's affairs with all the solicitude that he would accord to his own affairs."<sup>155</sup> The court explained that there are several reasons a fiduciary may have more knowledge:

The fiduciary may know much more by reason of professional status, or the relation may be one that requires the principal to repose a special confidence in the fiduciary; both factors are present in the case of a lawyer-client relation and also the relation between director and shareholder or managing partner and limited partner. Or the principal may be a child, lacking not only knowledge but also the power to act upon it. These are all situations in which one party to the relation is incapable of monitoring the other's performance of his undertaking, and therefore the law does not treat the relation as a relation at arm's length between equals.<sup>156</sup>

Having substantially more power than another may give rise to a fiduciary capacity in the Seventh Circuit.<sup>157</sup> In one case, the Seventh Circuit found a debtor who was a chief operating officer holding 50% of the shares and who could not be removed for cause without his consent possessed a position of considerable ascendancy over the other shareholders.<sup>158</sup> The court focused on the debtor's

<sup>152</sup> *Id.* at 523.

<sup>153</sup> The Seventh Circuit has recognized additional grounds for finding a fiduciary relationship under section 523(a)(4) even where there is no substantial inequality in knowledge or power. *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 770–71 (7th Cir. 2011).

<sup>154</sup> *In re Marchiando*, 13 F.3d 1111, 1116 (7th Cir. 1994) (distinguishing fiduciary relation imposing duty prior to breach and fiduciary relation which does not); *see also In re Frain*, 230 F.3d 1014, 1018 (7th Cir. 2000) (holding the source of a debtor's fiduciary relationship was his "substantial ascendancy" over two shareholders).

<sup>155</sup> *In re Marchiando*, 13 F.3d at 1116 (indicating nondischargeable debts under section 523(a)(4) have typically included conventional trusts or relationships of ascendancy).

<sup>156</sup> *Id.*

<sup>157</sup> *See In re Frain*, 230 F.3d at 1018 (determining inequality of power was a source of fiduciary relationship).

<sup>158</sup> *See id.* at 1017 (noting, however, that the natural advantage a debtor may have over other shareholders in terms of knowledge of a corporation's finances from being responsible for the day-to-day business decisions of a corporation is "not sufficient in itself to establish a position of ascendancy").

"significant freedom to run the corporation as he saw fit, including oversight of such items as salary and distributions of corporate cash flow" as well as the lack of a system of "checks and balances."<sup>159</sup> The court later explained that it was a "substantial concentration of power under the corporation's internal structure [that] created a fiduciary duty."<sup>160</sup> In another case, the Seventh Circuit found that the disparity in power governing segregated funds created an "economic relation" that was fiduciary in nature.<sup>161</sup> Hence, this approach considers the alleged fiduciary's ascendancy from knowledge or power as the source of a fiduciary capacity under section 523(a)(4).

### III. REFORMING THE MEANING OF FIDUCIARY CAPACITY

The four-way circuit split is an indication that the Supreme Court's guidance on the meaning of fiduciary capacity is inadequate. It also demonstrates the broad variety of relationships that are alleged to be fiduciary in nature. A usable framework to provide guidance to courts is needed. This Section seeks to provide that framework. It does so by examining the definition of a fiduciary relationship under non-bankruptcy law and two methods used to recognize one. It identifies problems with using those methods in a bankruptcy context to determine if a relationship is a fiduciary capacity under section 523(a)(4). It then develops a framework that provides a principled and consistent basis for determining if a relationship is a fiduciary capacity in a bankruptcy context. It concludes by suggesting the *Bullock* Court's opinion on defalcation justifies a rebalancing of the judicial construction of the statutory terms "defalcation" and "fiduciary capacity."

#### A. *Non-Bankruptcy Law's Elusive Definition of a Fiduciary Relationship and the Two Methods Used To Identify One*

Fiduciary relationships are pervasively entwined throughout modern social and economic systems.<sup>162</sup> Fiduciary duties are imposed by non-bankruptcy law in a

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<sup>159</sup> *Id.* at 1018 (determining debtor's power was crucial to establishing a fiduciary relationship).

<sup>160</sup> *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 770 (7th Cir. 2011) (finding a fiduciary relationship from the effects of the internal corporate structure).

<sup>161</sup> *See Nelson v. McGee (In re McGee)*, 353 F.3d 537, 541 (7th Cir. 2003) (comparing formal separation and ownership rules in economic relation to management of a client's funds by a lawyer).

<sup>162</sup> *See Paul B. Miller, Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 971 (2013) (explaining the pervasiveness as follows: "Lawyers, doctors, investment advisors, and other professionals are fiduciaries of their clients. Trustees, executors, and agents are fiduciaries of their beneficiaries, testators, and principals. Directors, officers, and trustees of corporations, hospitals, universities, and charities are fiduciaries of the legal entities under their charge. Parents and guardians are fiduciaries of their children and wards"); *see also* Robert Cooter and Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046 (1991) (noting "[f]amiliar forms of fiduciary relationships include trustee-beneficiary, agent-principal, corporate director/officer-corporation, and partner-partnership, although courts have emphasized that these categories are not exclusive"); Robert A. Kutcher, *Breach of Fiduciary Duties*, in *BUSINESS TORTS LITIGATION 1* (David A. Soley, et al. eds., 2d ed. 2005); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1400 (2002) (observing

wide variety of relationships, including those involving trustees,<sup>163</sup> agents,<sup>164</sup> estate representatives,<sup>165</sup> partners,<sup>166</sup> corporate officers, directors, and majority shareholders,<sup>167</sup> members of limited liability companies,<sup>168</sup> stock brokers or

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that "[c]ourts routinely impose fiduciary duties in myriad relationships, including trustee-beneficiary, employee-employer, director-shareholder, attorney-client, and physician-patient . . . . In addition, courts regularly impose fiduciary obligations ad hoc in relationships where one person trusts another and becomes vulnerable to harm as a result"; Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 159–60 (2013) (explaining that "[f]iduciary law is not generally considered to be a separate and distinct body of law in the United States. Rather, many different areas of law employ fiduciary law principles. Among the most common are agency law, trust law, corporate law (and the law of other business entities), the Employee Retirement Income Security Act, and professional practice. Each implements the principles of fiduciary law in different ways. Thus, it is difficult to make very many claims about fiduciary law in general").

<sup>163</sup> See RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b (AM. LAW INST., Tentative Draft No. 1, 1996) (defining trust as "a fiduciary relationship with respect to property"); *Himel v. Cont'l Ill. Bank & Trust Co. of Chi.*, 596 F.2d 205 (11th Cir. 1979) (noting plaintiff's claim was founded on the premise "the Bank had mismanaged the trust estate and breached its fiduciary duty"); *IAM Stock Ownership Inv. Trust Fund v. E. Air Lines, Inc.*, 639 F. Supp. 1027 (D. Del. 1986) (holding that a "[t]rustee has an affirmative—indeed, a high fiduciary—duty"); *Busby v. Worthen Bank & Trust Co., N.A.*, 484 F. Supp. 647 (D. Ark. 1979) ("[The trustee of an express trust] is subject to what is probably the highest standard of fiduciary duty known to the law."); *First Sec. Bank of Utah, N.A. v. Banberry Cross*, 780 P.2d 1253 (Utah 1989) (citing *Blodgett v. Martsch*, 590 P.2d 298, 301–03 (Utah 1978) (noting "the trustee is bound by a fiduciary duty to act in the interest of the trustor").

<sup>164</sup> See RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (defining agency as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act"); *Wilcox v. St. Croix Labor Union Mut. Homes, Inc.*, 567 F. Supp. 924 (D.V.I. 1983) (citing RESTATEMENT (SECOND) OF AGENCY §§ 399(g), 400, 401) (noting an agent is liable to his principal for damages if he breaches his fiduciary duty); *Sierra Pac. Indus. v. Carter*, 163 Cal. Rptr. 764, 766 (Cal. Ct. App. 1980) (reasoning that "[a]n agent bears a fiduciary relationship to his or her principal which requires . . . disclosure of all information in the agent's possession relevant to the subject matter of the agency").

<sup>165</sup> See *Alford v. Thibault*, 83 Mass. App. Ct. 822, 829 n.2 (2013) ("An executor owes a fiduciary duty to the beneficiaries of an estate."); *Probate Court of City of Warwick ex rel. Lawton v. Bank of Am., N.A.*, 813 F. Supp. 2d 277, 301 (R.I. 2011) (citing *Estate of Wickes v. Stein*, 107 R.I. 260 (1970)) ("An executor owes a fiduciary duty to the beneficiaries under a will, . . . his fiduciary duty requires that the executor act at all times in the best interests of the beneficiaries as a whole."); *In re Tomlin*, 266 B.R. 350, 354 (N.D. Tex. 2001) (holding that an executor owes a fiduciary duty to pay taxes to the IRS).

<sup>166</sup> See UNIF. P'SHIP ACT § 21 (1914) (stating a partner is accountable as a fiduciary for "any transaction connected with the formation, conduct, or liquidation of the partnership"); *id.* § 404 (1997) (defining fiduciary duties a partner owes to the partnership as duty of loyalty and duty of care); *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC*, 376 F. Supp. 2d 385, 408 (S.D.N.Y. 2005), (indicating that general partners owe a fiduciary duty to limited partners); *Credentials Plus, LLC v. Calderone*, 230 F. Supp. 2d 890, 898–99 (N.D. Ind. 2002) (noting that Indiana courts impose a fiduciary duty on partners in accordance with "traditional partnership principles"); *Georgou v. Fritzhall*, No. 93 C 997, 1995 WL 692019, at \*2 (N.D. Ill. Nov. 20, 1995) ("It is well settled that partners owe a fiduciary duty to one another.").

<sup>167</sup> See MODEL BUS. CORP. ACT §§ 8.30 and 8.60 (1984) (noting board of director members have a duty to corporation to act in good faith and in corporation's best interest); *Mukamal v. Bakes*, 383 B.R. 798, 822–23 (S.D. Fla. 2007) (citing *Matter of Reading Co.*, 711 F. 2d 509, 517 (3d Cir. 1983) ("Delaware law recognizes that not only do directors and officers 'stand in a fiduciary relationship to their corporation and stockholders[,] but 'a majority shareholder, or a group of shareholders who combine to form a majority, has a fiduciary duty to the corporation and to its minority shareholders.'"); *see also* *Casden v. Burns*, 306 Fed. Appx. 966, 969 (6th Cir. 2009); *In re Greater S.E. Cmty. Hosp. Corp. I.*, 353 B.R. 324, 344 (D.D.C. 2006); *In re United States Sugar, Corp. Lit.*, 669 F. Supp. 2d 1301, 1326 (S.D. Fla. 2009); *Levin v. Kozlowski*, 846 N.Y.S.2d 37, 3 (App. Div. 1st Dep't. 2001).

investment advisors,<sup>169</sup> accountants,<sup>170</sup> physicians,<sup>171</sup> real estate agents and brokers,<sup>172</sup> auctioneers,<sup>173</sup> and actors with discretionary authority under ERISA.<sup>174</sup> Fiduciary duties often relate to property or power that has been entrusted to a fiduciary or the performance of services by a fiduciary.<sup>175</sup> Non-bankruptcy law is helpful in understanding what a fiduciary relationship is and how it is different than other types of relationships.

### 1. The Definition of a Fiduciary Relationship under Non-Bankruptcy Law

Black's Law Dictionary defines a fiduciary relationship as "[a] relationship in which one person is under a duty to act for the benefit of another on matters within the scope of the relationship."<sup>176</sup> Some non-bankruptcy scholars have taken the position that a generic explanation of a fiduciary relationship is simply undefinable.<sup>177</sup> Others have attempted to define it. For example, one scholar simply

<sup>168</sup> See *Zimmerman v. Crothall*, 62 A.3d 676, 702 n.145 (Del. Ch. 2013) (citing *Feeley v. NHAOCG, LLC*, No. 7304-VCL, 2012 WL 5949209, at \*8–10 (Del. Ch. Nov. 28, 2012)) (holding "managers and managing members of an LLC do owe fiduciary duties as a default matter"); *Kyle v. Apollomax, LLC*, 987 F. Supp. 2d 519, 523 (D. Del. 2013) (stating "the fiduciary duties of any person bound by an LLC agreement 'may be expanded or restricted or eliminated by provisions in the limited liability agreement'"); *In re D'Amore*, 472 B.R. 679, 687 (Bankr. D.N.J. 2012); *Purcell v. S. Hills Invs., LLC*, 847 N.E.2d 991, 996 (Ind. App. 2006); *McLinden v. Coco*, 765 N.E.2d 606, 615 (Ind. App. 2002); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 16 (1995).

<sup>169</sup> See *Nathanson v. Polycom, Inc.*, 87 F. Supp. 3d 966, 973 (N.D. Cal. 2015); *Gallier v. Woodbury Fin. Servs.*, 2015 U.S. Dist. LEXIS 67448 (S.D. Tex. May 26, 2015); *Siegal v. Gamble*, 2015 U.S. Dist. LEXIS 104702 (N.D. Cal. Aug. 10, 2015); *Groom v. Bank of Am.*, 2012 U.S. Dist. LEXIS 2374, at \*10 (M.D. Fla. Jan. 9, 2012); *Pipino v. Onuska*, No. 4:11CV00129, 2011 WL 1603134, at \*4 (N.D. Ohio 2011); *Escalon v. World Grp. Secs, Inc.*, 2008 U.S. Dist. LEXIS 107196, at \*16–17 (N.D. Tex. Nov. 14, 2008); *First Am. Disc. Corp. v. Jacobs*, 324 Ill. App. 3d 997, 1012 (2001); *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 741–52 (Cal. Ct. App. 1989) (stating that, because stockbrokers "act as agents for buyers and seller of securities," stockbrokers owe a fiduciary duty to clients).

<sup>170</sup> See *Iacurci v. Sax*, 139 Conn. App. 386, 409 (2012) (citing *Peterson v. H & R Block Tax Servs.*, 971 F. Supp. 1204, 1215 (N.D. Ill. 1997) (holding relationship between accountant and client is not fiduciary in nature)).

<sup>171</sup> See *Mays v. Marshall Univ. Bd. of Governors*, No. 14-0788, 2015 WL 6181508, at \*9 (W. Va. Oct. 20, 2015) (extending fiduciary duty to physicians); *Jameson v. Desta*, 215 Cal. App. 1144, 1164 (2013) (same).

<sup>172</sup> See *FV 1 Inc. v. Goodspeed*, 974 N.E.2d 664, 671 (Ohio 7th Dist. 2012) (extending fiduciary duty to real estate agents); see also *Dube-Forman v. D'Agostino*, 61 A.D.3d 1255, 1257–58 (N.Y. 2009) (same); *Saiz v. Horn*, 668 N.W.2d 332, 336 (S.D. 2003) (stating real estate agents have fiduciary duties); *Barfield v. Hall Realty, Inc.*, 232 P.3d 286, 291 (Colo. App. 2010) (same).

<sup>173</sup> See *United Feature Syndicate, Inc. v. Miller Features Syndicate, Inc.*, 216 F. Supp. 2d 198, 217 (S.D.N.Y. 2002) (holding auctioneers have fiduciary duties).

<sup>174</sup> See 29 U.S.C. §§ 1002(21)(A) and 1104(a)(1) (1988); *Edmonson v. Lincoln Nat. Life Ins. Co.*, 725 F.3d 406, 426 (3d Cir. 2013), *cert. denied*, 134 S. Ct. 2291 (2014); *Johnson v. Couturier*, 572 F.3d 1067, 1080 (9th Cir. 2009); *Sonoco Products Co. v. Physicians Health Plan, Inc.*, 338 F.3d 366, 372–74 (4th Cir. 2003).

<sup>175</sup> See TAMAR FRANKEL, *FIDUCIARY LAW 107* (Oxford University Press 2011) [hereinafter FRANKEL, *FIDUCIARY LAW*] (stating fiduciary duties aim at reducing entrustors' risks in two main areas).

<sup>176</sup> BLACK'S LAW DICTIONARY 744 (10th ed. 2014); see RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979).

<sup>177</sup> See *Sealy*, *supra* note 82, at 78 (stating "[t]he word 'fiduciary,' we find, is *not* definitive of a single class of relationships to which a fixed set of rules and principles apply. . . . It is obvious that we cannot proceed any

described a fiduciary as "a person who undertakes to act in the interest of another person."<sup>178</sup> Another defined a fiduciary relationship as one "in which one party (the fiduciary) exercises discretionary power over the significant practical interests of another (the beneficiary)."<sup>179</sup> A different scholar observed that "while the definitions of fiduciaries are not identical, all definitions share three main elements: (1) entrustment of property or power, (2) entrustors' trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment."<sup>180</sup> Others have observed that "[t]hree indicia mark the fiduciary relationship: discretion, vulnerability, and trust."<sup>181</sup> One scholar explained: "[w]hat is a fiduciary duty? It is not so much a special type of duty as it is a duty imposed in a special kind of relationship."<sup>182</sup>

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further in our search for a *general* definition of fiduciary relationships"); *see also* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 908 (1988) [hereinafter DeMott, *Beyond Metaphor*] (observing "[l]egal commentators have made several attempts to develop general justifications for fiduciary obligation; that is, to describe in a comprehensive and analytic fashion those aspects of relationships that justify imposition of fiduciary constraints . . . In part, fiduciary obligation eludes theoretical capture because it arises in diverse types of relationships . . . The scope of the fiduciary's obligation, as well as the obligation's precise formulation, necessarily varies with the context of the relationship"); Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. L. REV. 925, 935–36 (2006) [hereinafter DeMott, *Breach of Fiduciary Duty*] (observing that "[t]he difficulty is that the characteristics of even the standard or conventional fiduciary relationships—these include trustee-beneficiary, agent-principal, lawyer-client, guardian-ward, director-corporation, and partner-fellow partner and partnership—are too varied to enable one to distill a single essence or property that unifies all in any analytically satisfactory way"); Easterbrook & Fischel, *supra* note 104, at 438 (claiming there is nothing "special about fiduciary relations" and that "[s]earching for the right definition of a fiduciary duty is not a special puzzle . . . there is no subject here, and efforts to unify it on a ground that presumes its distinctiveness are doomed"); Leonard I. Rotman, *Fiduciary Law's "Holy Grail": Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921, 941 (2011) ("Rather than defining fiduciary law by the more rigid and rule-oriented scheme of contract law or other common law schemes giving rise to civil obligation, fiduciary law ought to be understood by reference to the broad postulates that underlie it and give it meaning."); Andrew Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478, 482 n.22 (2005) (noting that under the Commonwealth, "[t]he fiduciary relationship has been said to defy definition" and "the features or indicia giving rise to a fiduciary relationship are nowhere exhaustively defined").

<sup>178</sup> Austin W. Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 540 (1949); *see also* Paul D. Finn, *Contract and the Fiduciary Principle*, 12 U. NEW SOUTH WALES L.J. 76, 84 (1989) (stating "[t]he true nature of the fiduciary principle is revealed in this. It originates, self-evidently, in public policy. To maintain the integrity and utility of relationships in which the (or a) role of one party is perceived to be the service of the interest of the other, it insists upon a fine loyalty in that service. The fiduciary is not to use his position or the power or opportunity it gives him to serve an interest other than his beneficiary's—be this his own or a third party's").

<sup>179</sup> Miller, *supra* note 162, at 1011; *see also* Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 4 (1975) (stating the two core elements of a fiduciary relationship are "[f]irst, the fiduciary must have scope for the exercise of discretion, and, second, this discretion must be capable of affecting the legal position of the principal").

<sup>180</sup> FRANKEL, FIDUCIARY LAW, *supra* note 175, at 4.

<sup>181</sup> Ethan J. Leib, et al., *A Fiduciary Theory of Judging*, 101 CALIF. L. REV. 699, 706–08 (2013) (explaining that "although the three indicia noted above define the fiduciary relationship and consequent fiduciary liability, the quantum of discretion, trust, and vulnerability used to trigger fiduciary obligation varies according to type of relationship").

<sup>182</sup> Velasco, *supra* note 162, at 159; *see also* Miller, *supra* note 162, at 978 (stating "[t]he conventional position is that fiduciary duties arise upon the establishment of a fiduciary relationship").

Another scholar described fiduciary obligations as "a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of characteristics of that person's relationship with another."<sup>183</sup> Another proposed that "[t]he defining or determining criterion should be whether the plaintiff (or claimed beneficiary of a fiduciary duty) would be justified in expecting loyal conduct on the part of an actor and whether the actor's conduct contravened that expectation."<sup>184</sup> Yet, another described a fiduciary duty as "an obligation to refrain from self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources."<sup>185</sup>

Although there may be no clear, universally-accepted definition of a fiduciary relationship, there are two generally established ways fiduciary relationships are identified: the status-based method and the context-based method. Many courts start with the status-based method to see if a relationship is one that is routinely treated as fiduciary and if it is not, will then turn to the context-based method to determine if fiduciary status is warranted in the particular case. The circuit split on the meaning of fiduciary capacity in a bankruptcy context illustrates how both methods of identification are used. Each will be addressed in turn.

## 2. The Status-Based Method

The status-based method recognizes fiduciary relationships based on the position of a person in relation to another depending on conventionally recognized categorical forms—meaning those that are in a form generally accepted and prescribed, such as trustee-beneficiary, attorney-client, and principal-agent.<sup>186</sup>

The Ninth Circuit uses a status-based approach to determine if a relationship amounts to a fiduciary capacity under section 523(a)(4). It takes a new relationship and compares it to an express trust to see if the new relationship fits within this same conventionally-recognized category. That is why the Ninth Circuit's decisions focus on the elements of an express trust such as whether the party was in the position of a trustee or if the relationship involved some type of property that could be categorized as trust res.

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<sup>183</sup> DeMott, *Beyond Metaphor*, *supra* note 177, at 915.

<sup>184</sup> DeMott, *Breach of Fiduciary Duty*, *supra* note 177, at 936.

<sup>185</sup> Smith, *supra* note 162, at 1407; *see also* D. Gordon Smith and Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 613 (2014) (explaining both legal and non-legal constraints on discretion and observing non-legal constraints include "market forces, reputational concerns, industry customs, social norms, and moral values").

<sup>186</sup> *See Fiduciary Relationship*, BLACK'S LAW DICTIONARY 744 (10th ed. 2014). For example, the Uniform Fiduciaries Act defines the term "fiduciary" to include "a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust or estate." Uniform Fiduciaries Act § 1(1) (1922).

### 3. The Context-Based Method

The context-based method recognizes fiduciary relationships based on attributes of the relationship—meaning those that arise from a factual context that indicates fiduciary characteristics, such as the placement of trust or confidence in another, vulnerability or dependence on another, substantial disparity in knowledge, and the ability to exert influence.<sup>187</sup>

The Fifth and Seventh Circuits both use a context-based approach to determine if a relationship amounts to a fiduciary capacity under section 523(a)(4). These courts look at the factual characteristics of the particular relationship instead of the status to determine if it equates to a fiduciary capacity. The Fifth Circuit has focused on whether the alleged fiduciary had the characteristic of control. The Seventh Circuit targets the alleged fiduciary's ascendancy over another with a focus on the attributes of knowledge and power. Although the characteristics differ (control or ascendancy), the analysis under this approach determines if a relationship is fiduciary in nature by evaluating whether it has certain types of characteristics.

Both the status and context-based methods have shortcomings when used to determine if a relationship is a fiduciary capacity under section 523(a)(4). As explained below, the status-based method is flawed and should not be used. The context-based method is too broad because it can effectively identify every fiduciary relationship but is unable to distinguish among degrees of fiduciarity. The problems with each method will be addressed in turn.

#### *B. The Problem With Using The Status-Based Method To Determine Fiduciary Capacity in Section 523(a)(4)*

The status-based method is inflexible, distinguishes relationships on a basis that is not justified, and goes against the underlying policy of section 523(a)(4). Other than identifying the significant concern of preventing the discharge exception from applying to all debts, the Supreme Court has not explained why it selected a special or technical trust as the point of comparison for meeting the fiduciary capacity requirement. Presumably, the Supreme Court was itself using a status-based method to separate various relationships. During the time period between 1844 and 1934, an express trust with a trustee and beneficiary was a historic and generally accepted form of a fiduciary relationship.<sup>188</sup> It was the prototypical fiduciary

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<sup>187</sup> See *Fiduciary Relationship*, BLACK'S LAW DICTIONARY 744 (10th ed. 2014).

<sup>188</sup> See AUSTIN WAKEMAN SCOTT et al., SCOTT AND ASCHER ON TRUSTS 24 (5th ed. 2006) (stating "the trust was already present in America in colonial times"); GEORGE GLEASON BOGERT et al., THE LAW OF TRUSTS AND TRUSTEES 31 (3d ed. 2007) (stating "[by] the end of the eighteenth century, when trusts came into more common use in America, the English system had been well developed, and was adopted in substantial entirety by the American colonial and early state chancellors. The first state reports show that



relationship. Choosing an express trust as the litmus test category would be natural. However, the only justification given by the Supreme Court did not relate to why trusts were selected instead of a different category. Instead, it was a concern that the term fiduciary capacity be construed to prevent the exception's application to all debts.<sup>189</sup> Although that reasoning makes sense, it is not a valid justification to continue exclusive use of the trust category as the only accepted status if other categories also effectively prevent the section 523(a)(4) discharge exception from applying to all debts.

Another problem with the status-based method is that it undermines the reason section 523(a)(4) exists. This concern is more subtle. A narrow, status-based approach requires any alleged fiduciary relationship to fit within the same category as a prototypical, express trust. Such an approach would eliminate altogether the "technical" trust concept and other expansive doctrines like control, ascendancy, and the bestowal of trust. Construing the statutory term "fiduciary capacity" in this narrow manner would drastically reduce the number of circumstances in which the defalcation exception under section 523(a)(4) would apply. A construction that is too narrow would "eviscerate § 523(a)'s purpose of preventing debtors . . . from avoiding, through bankruptcy, the consequences of their wrongful conduct."<sup>190</sup>

Using a narrow status-based method in this manner goes against one of the philosophies behind the exceptions to discharge in the Bankruptcy Code. The exceptions to discharge in section 523 demonstrate a Congressional decision that the interests of certain creditors in recovering debt payment outweigh the interests of debtors in obtaining a fresh start.<sup>191</sup> The exceptions to discharge can be divided into two categories: those based on the type of debt and those based on a debtor's bad conduct. Examples of exceptions that are based on the type of debt are those relating to taxes,<sup>192</sup> domestic-support obligations,<sup>193</sup> government fines,<sup>194</sup>

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despite the relative poverty and newness of America trusts were involved in litigation with a fair measure of frequency").

<sup>189</sup> See *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844) (stating "[i]f the act embrace such a debt, it will be difficult to limit its application. It must include all debts arising from agencies; and indeed all cases where the law implies an obligation from the trust reposed in the debtor. Such a construction would have left but few debts on which the law could operate"); see also *Hennequin v. Clews*, 111 U.S. 676, 683–84 (1884) (stating "[i]t is, no doubt, true, as said in *Chapman v. Forsyth*, that a construction of the excepting clauses which would make them include debts arising from agencies and the like, would leave but few debts upon which the law could operate. At all events, we think that the previous decisions of this court, and of the state courts in the same direction, accord with the true spirit and meaning of the act of congress, and with the necessities of our business conditions and arrangements").

<sup>190</sup> *Ellison v. Ellison (In re Ellison)*, 296 F.3d 266, 271 (4th Cir. 2002) (stating that caution should be taken to "avoid a construction so narrow as to eviscerate § 523(a)'s purpose of preventing debtors such as the [debtor in that case], from avoiding, through bankruptcy, the consequences of their wrongful conduct").

<sup>191</sup> *Cohen v. De La Cruz*, 523 U.S. 213, 222 (1998) (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)) (stating that "[t]he various exceptions to discharge in § 523(a) reflect a conclusion on the part of Congress that the creditors' interest in recovering full payment of debts in these categories outweigh[s] the debtors' interest in a complete fresh start"); *Bruning v. United States*, 376 U.S. 358, 361 (1964) (noting predecessor to section 523(a) "[was] not a compassionate section for debtors" because "it demonstrate[d] congressional judgment that certain problems . . . override the value of giving the debtor a wholly fresh start").

<sup>192</sup> See 11 U.S.C. § 523(a)(1) (2012) (certain taxes cannot be discharged debts).

educational loans,<sup>195</sup> and orders of restitution in criminal cases.<sup>196</sup> The very nature of these debts is significant enough to outweigh both the public and private interest in providing debtors a fresh start.<sup>197</sup> Examples of exceptions that arise from certain types of reprehensible conduct by a debtor include debts obtained by false pretenses or actual fraud,<sup>198</sup> embezzlement,<sup>199</sup> larceny,<sup>200</sup> willful and malicious injury by the debtor to another,<sup>201</sup> or death or injury caused by the debtor's operation of a vehicle while being intoxicated.<sup>202</sup>

Historically, it was not clear if the discharge exception for "defalcation while acting in a fiduciary capacity" should be characterized as falling in the "type of debt" or "bad conduct" category. Before *Bullock*, one circuit court ultimately concluded that defalcation by a fiduciary was a "bad conduct" discharge exception, but noted that "[i]t is arguable that defalcation by a fiduciary fits into [the] 'type of debt' category."<sup>203</sup> Scholars took both sides of the issue.<sup>204</sup> *Bullock's* imposition of a mental state clearly placed the section 523(a)(4) exception in the "bad conduct" category.<sup>205</sup> *Bullock* emphasized "the improper nature of the relevant fiduciary behavior"<sup>206</sup> instead of the existence of a debt arising from a fiduciary relationship. In addition, when explaining the considerations that led to requiring a mental standard for defalcation, the *Bullock* Court stated that its interpretation was "consistent with a set of statutory exceptions that Congress normally confines to circumstances where strong, special policy considerations, *such as the presence of*

<sup>193</sup> See *id.* § 523 (a)(5) (certain domestic support obligations cannot be discharged debts).

<sup>194</sup> See *id.* § 523 (a)(7) (certain government fines cannot be discharged debts).

<sup>195</sup> See *id.* § 523 (a)(8)(a)(i) (certain educational loans cannot be discharged debts).

<sup>196</sup> See *id.* § 523 (a)(13) (certain orders of restitution cannot be discharged debts).

<sup>197</sup> See John M. Czarnetzky, *The Individual and Failure: A Theory of The Bankruptcy Discharge*, 32 ARIZ. ST. L.J. 393, 405 (2000) (discussing an entrepreneurial theory behind the bankruptcy discharge); Adam Feibelman, *Defining The Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129 (2005) (discussing the function of bankruptcy as social insurance).

<sup>198</sup> See 11 U.S.C. § 523(a)(2) (stating "a discharge . . . does not discharge an individual debtor from any debt . . . for money, property, services . . . to the extent obtained by false pretenses, a false representation, or actual fraud").

<sup>199</sup> See *id.* § 523(a)(4) (stating "a discharge . . . does not discharge an individual debtor from any debt . . . for . . . embezzlement").

<sup>200</sup> See *id.* (stating "a discharge . . . does not discharge an individual debtor from any debt . . . for . . . larceny").

<sup>201</sup> See *id.* § 523(a)(6) (stating "a discharge . . . does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity").

<sup>202</sup> See *id.* § 523(a)(9) (stating "a discharge . . . does not discharge an individual debtor from any debt . . . for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated").

<sup>203</sup> *Rutanen v. Baylis (In re Baylis)* 313 F.3d 9, 19 (1st Cir. 2002).

<sup>204</sup> See Johnson, *supra* note 18, at 119 ("Section 523(a)(4) is probably more like fault-based exceptions, in that it contains language that suggests dishonesty on the part of the debtor."); Rosen, *supra* note 18, at 87 (asserting the defalcation exception applies only when there is a failure to remit or account for funds or property held in an express or technical trust and that the debtor's type of mental state does not matter).

<sup>205</sup> See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013) (holding that "[defalcation] includes a culpable state of mind requirement . . . involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior").

<sup>206</sup> *Id.* at 1757 (emphasis added).

*fault*, argue for preserving the debt, thereby benefiting, for example, a typically more honest creditor."<sup>207</sup> Thus, the exception to discharge in section 523(a)(4) is one based on the bad conduct of the debtor.<sup>208</sup> This conclusion should affect how the term fiduciary capacity in section 523(a)(4) is construed and the appropriate method to be used to identify it. If courts only use a narrow status-based method to identify fiduciary relationships, it creates the unintended and unwanted consequence of similar bad conduct by a debtor being treated differently. In other words, the same bad conduct by a debtor is discharged in certain circumstances but excepted from discharge in others. The following three hypotheticals are instructive.

The first hypothetical involves a trust. Assume a woman named Tina is a trustee of a prototypical express trust. The trust res is \$100,000 in cash. At the time the trust was created, the cash was placed in a deposit account and Tina, as trustee, was named as the customer with respect to the deposit account. Under the trust instrument, Tina was required to use the trust res only for education and living expenses of Ben, the sole beneficiary of the trust. Instead, Tina spent the money on herself to pay for an extravagant vacation. Assume Tina's violation of the trust instrument and applicable duties as trustee amounted to a defalcation under *Bullock*.<sup>209</sup> Assume further that Tina subsequently filed bankruptcy and Ben sought to have his claim for \$100,000 against Tina excepted from discharge under section 523(a)(4). Under the current judicial framework, courts in every circuit would conclude that Tina's debt to Ben was excepted from discharge because it is settled law in every circuit that a trustee of an express trust acts in a fiduciary capacity under section 523(a)(4).

The second hypothetical involves an agency relationship between an attorney and a client. Assume a woman named Anna is an attorney. Carl is Anna's client. Anna is representing Carl in connection with the sale of Carl's real estate. Carl granted Anna a written power of attorney to sell Carl's real estate to a purchaser for a purchase price that reflects the property's fair market value. At the time, the fair market value of the property was approximately \$100,000. In violation of these instructions, Anna decided to convey the real estate to her brother. In exchange for the deed, Anna's brother took her on an extravagant vacation. Assume Anna's conveyance of the property to her brother amounted to a defalcation under *Bullock*.<sup>210</sup> Assume further that Anna subsequently filed bankruptcy and Carl sought to have his claim for \$100,000 against Anna excepted from discharge under section 523(a)(4). Under the current judicial framework, the circuits would be split on this issue. Some would identify Anna's relationship with Carl as a fiduciary capacity

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<sup>207</sup> *Id.* at 1761 (emphasis added).

<sup>208</sup> *See id.* at 1759 (noting that bad conduct includes acts involving "bad faith, moral turpitude, other immoral conduct . . . [and] intentional wrongs set forth in the Model Penal Code").

<sup>209</sup> *See id.* at 1757 (describing state of mind required for defalcation as "one involving knowledge of, or gross recklessness in respect to, the proper nature of the relevant fiduciary behavior").

<sup>210</sup> *See id.*

because of the inherent characteristics of an attorney-client relationship.<sup>211</sup> Others would highlight the nature of the relationship as being a mere agency, note that Anna never took title (legal or equitable) to the real property and was not acting as a trustee, and consider the relationship to not be a fiduciary capacity under section 523(a)(4).<sup>212</sup>

The third hypothetical involves a lending relationship between a secured party and a borrower. Assume a person named Luke is a lender. Bob borrowed \$100,000 from Luke with interest accruing at an agreed upon rate. Bob used the loan proceeds to buy equipment. The loan was secured by a security interest in favor of Luke in Bob's equipment. The security agreement between Luke and Bob allowed Bob to retain possession of and use the equipment and prohibited Bob from selling it unless the loan was fully paid. In violation of the security agreement, Bob sold the equipment to a buyer who took possession of the equipment and fled the country. Bob spent the sale proceeds on himself to pay for an extravagant vacation. Bob did not repay any of the loan to Luke. Assume Bob's sale of the equipment and use of the sale proceeds was a defalcation under *Bullock*.<sup>213</sup> Assume further that Bob subsequently filed bankruptcy and Luke sought to have his claim for \$100,000 against Bob excepted from discharge under section 523(a)(4). Under the current judicial framework, the circuits would hold that a typical lending relationship between a lender and borrower is not a fiduciary capacity under section 523(a)(4).<sup>214</sup>

Even though the wrongful conduct of the debtors in all three hypotheticals was similar, courts using a narrow status-based method for identifying a fiduciary capacity would hold that the debt in the trust hypothetical was excepted from discharge and a few might find the attorney-client relationship sufficient to except the debt from discharge in the agency hypothetical. This result goes against the philosophy of the exceptions to discharge that are based on the bad conduct of the

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<sup>211</sup> See *Andy Warhol Found. for Visual Arts, Inc. v. Hayes (In re Hayes)*, 183 F.3d 162, 170 (2d Cir. 1999) (holding "the attorney-client relationship, without more, constitutes a fiduciary relationship within the meaning of Section 523(a)(4)"); *Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997) (stating "an attorney-client relationship is the type of relationship for which the attorney's breach of fiduciary duties to the client may give rise to a finding of a 'defalcation' within the meaning of §523(a)(4)").

<sup>212</sup> See *Cal-Micro, Inc. v. Cantrell (In re Cantrell)*, 329 F.3d 1119, 1126–27 (9th Cir. 2003) (holding a debtor was not a fiduciary under section 523(a)(4) because "California case law has consistently held that while officers possess the fiduciary duties of an agent, they are not trustees with respect to corporate assets"); *In re Honkanen*, 446 B.R. 373, 381 (B.A.P. 9th Cir. 2011) (finding Honkanen did not hold any property in trust and "[i]n the absence of a trust res, a fundamental requirement to form a trust, there was no express, technical or statutory trust formed" and thus no fiduciary capacity).

<sup>213</sup> See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013).

<sup>214</sup> See *Upshur v. Briscoe*, 138 U.S. 365, 375 (1891) (noting "[t]he relation created was merely the usual one of contract between debtor and creditor" and was not created by a person while acting in a fiduciary character); *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 767 (7th Cir. 2011) (holding "an ordinary principal-agent or buyer-seller relationship, without more, is not a fiduciary relationship under section 523(a)(4)").

debtor. Based solely on the wrongdoing, which section 523(a)(4) is supposed to be about, there is no justifiable difference between the hypotheticals.

A narrow status-based method requires an express trust relationship, which means there must be title to the trust res vested in a trustee. Yet, there are numerous fiduciary relationships, like the second hypothetical, where it is not property but power that is conveyed to the fiduciary. If the exception to discharge is supposed to be based on a debtor's bad conduct, then requiring title to be vested in the debtor seems irrelevant. One modern-day example is directors of a corporation. Directors occupy a trustee-like position.<sup>215</sup> But unlike trustees, directors do not themselves have legal ownership interests in property beneficially owned by another. But like trustees, directors are entrusted with power to use in the interest of another. The current judicial framework creates the potential for non-trustee debtors who have engaged in sufficiently bad conduct (defalcation) to discharge debts that Congress has identified should be excepted from discharge. In a bankruptcy context, the status-based method of requiring an express trust should not be followed because it is inflexible and results in inconsistent treatment of similar bad conduct by debtors.

*C. The Problem With Using The Context-Based Method To Determine Fiduciary Capacity in Section 523(a)(4)*

The context-based method is too flexible and, depending on the fiduciary characteristics that are used, results in every relationship containing any fiduciary aspect as being classified as fiduciary in nature. The hallmark of the context-based method is a factual context that indicates fiduciary characteristics. One problem with the context-based method is selecting the appropriate fiduciary characteristics. For the present purpose of examining the context-based method, this Article will assume the following broad array of fiduciary characteristics: (i) the entrustment of power or property to the fiduciary,<sup>216</sup> (ii) the fiduciary has authority or discretionary ability to exercise, control, or use the entrusted power or property,<sup>217</sup> (iii)

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<sup>215</sup> See DeMott, *Beyond Metaphor*, *supra* note 177, at 880–81 (stating "the corporate form of business organization proved to be fertile ground for application and development of fiduciary principles").

<sup>216</sup> FRANKEL, *FIDUCIARY LAW*, *supra* note 175, at 4.

<sup>217</sup> This often arises from a fiduciary's skill, training, knowledge, or abilities.

vulnerability of a person other than the fiduciary arising from the entrustment,<sup>218</sup> and (iv) obligations of the fiduciary to another that relate to the entrustment.<sup>219</sup>

A context-based method using the above characteristics will identify more fiduciary relationships than a status-based method because the attributes being evaluated are broader than conventionally-recognized categorical forms such as those of a principal-agent or trustee-beneficiary. The focus of the context-based method is on the attributes of the relationship and whether it is fiduciary in nature. The failing of the context-based method is that it is overly-inclusive for purposes of section 523(a)(4). The hypotheticals illustrate its virtue and weakness.

Under a context-based method, courts would conclude that the trust hypothetical involves a fiduciary relationship because (i) the \$100,000 in cash was an entrustment of property to Tina, (ii) Tina had the ability to use the cash (and did so), (iii) Ben was vulnerable because his transfer of the cash to Tina exposed him to risk, and (iv) Tina was obligated to only use the cash for Ben's education and living expenses. In the trust hypothetical, the conclusion is the same under both the status-based and context-based methods. Tina would be deemed to have been acting in a fiduciary capacity under section 523(a)(4).

The agency hypothetical has a different result under the context-based method. Under this method, courts would conclude that the agency relationship is a fiduciary relationship because (i) the power of attorney to convey the real property was an entrustment of power to Anna, (ii) Anna had the ability to exercise the power of attorney and convey the real property (and did so), (iii) Carl was vulnerable because his transfer of a power to convey to Anna exposed him to risk, and (iv) Anna was obligated to convey the property in exchange for payment of the fair market value. In the agency hypothetical, the conclusion under the context-based method is different than under the status-based method because the context-based method avoids the requirement that the debtor have title to the real property.

Depending on how broadly the characteristics are construed, the lending hypothetical may also be considered a fiduciary relationship under the context-based method because (i) Bob the borrower was entrusted with property (the \$100,000 in loan proceeds and possession of the equipment that was subject to

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<sup>218</sup> Vulnerability includes exposure to risk or susceptibility to harm. This would include the dependence of a party on the fiduciary. See Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 810 (1983) (stating a fiduciary relationship "may expose the entrustor to risk even if he is sophisticated, informed, and able to bargain effectively. Rather, the entrustor's vulnerability stems from the structure and nature of the fiduciary relation. The delegated power that enables the fiduciary to benefit the entrustor also enables him to injure the entrustor, because the purpose for which the fiduciary is allowed to use his delegated power is narrower than the purposes for which he is capable of using that power"). See also Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 735 (1994); Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 284 (2011) (stating "[t]he distinctive quality of the vulnerability is a matter of degree, not kind"); Smith & Lee, *supra* note 185, at 620 (explaining how a fiduciary's discretion places the other party in a vulnerable position).

<sup>219</sup> The paramount duty is that of loyalty—the fiduciary's obligation to pursue the interests of another when executing a fiduciary mandate. See Miller, *supra* note 162, at 977 (stating "[t]he boundaries of fiduciary obligation are poorly defined, but there is consensus on its essence. At the core lies the cardinal fiduciary duty of loyalty").

Luke's security interest), (ii) Bob had the discretionary ability to use and control the equipment (and did so), (iii) Luke was vulnerable because of his delivery of the loaned money and Bob's possession of the equipment, and (iv) Bob was obligated to not sell the equipment and to repay the loan. In the lending hypothetical, a liberal application of the context-based method could result in Bob being treated as a fiduciary in his relationship with Luke.<sup>220</sup>

As shown by these hypotheticals, the context-based method treats similar fiduciary characteristics equally, regardless of whether the form of the relationship is a prototypical trust or something else. But the context-method has two shortcomings. First, there is no distinct and exclusive list of the "correct" fiduciary characteristics to use when analyzing a relationship.<sup>221</sup> Second, even if such a list existed, taken alone, those characteristics would be unable to distinguish among varying fiducial degrees. In other words, if all relationships were ordered on a continuum, one end would have relationships that are completely fiduciary while the other end would be those that have no fiduciary aspect. The utility of the context-based method is limited to identifying whether a relationship has any fiduciary aspect, whether small or great. It is not able to accurately sort fiduciary relationships by degree on a principled basis. It cannot be used to separate two fiduciary relationships where one is completely fiduciary and the other has only limited aspects that are fiduciary.

The problem with applying the context-based method using an all-encompassing list of fiduciary characteristics is just that—the method becomes all-encompassing. In the context of a section 523(a)(4) analysis in bankruptcy, using

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<sup>220</sup> This result would be contrary to existing law. See *Buxcel v. First Fidelity Bank*, 601 N.W. 2d 593, 603 (S.D. 1999) (Konenkamp, J., dissenting) (stating "[i]n the ordinary lender-borrower relations, therefore, no fiduciary duty exists"); *United Jersey Bank v. Kensey*, 704 A.2d 38, 44 (N.J. Super. Ct. App. Div. 1997) (observing "[t]he virtually unanimous rule is that creditor-debtor relationships rarely give rise to a fiduciary duty"). *But cf.* Hunt, *supra* note 218, at 768 (proposing fiduciary obligations be recognized in the servicing stages of lender-borrower relationships, but excluded from the arm's-length negotiation stage).

<sup>221</sup> See Sealy, *supra* note 82, at 78 (stating "[t]he word 'fiduciary,' we find, is *not* definitive of a single class of relationships to which a fixed set of rules and principles apply . . . It is obvious that we cannot proceed any further in our search for a *general* definition of fiduciary relationships"); see also DeMott, *Beyond Metaphor*, *supra* note 177, at 908 (observing that "[l]egal commentators have made several attempts to develop general justifications for fiduciary obligation; that is, to describe in a comprehensive and analytic fashion those aspects of relationships that justify imposition of fiduciary constraints. . . . In part, fiduciary obligation eludes theoretical capture because it arises in diverse types of relationships. . . . The scope of the fiduciary's obligation, as well as the obligation's precise formulation, necessarily varies with the context of the relationship"); DeMott, *Breach of Fiduciary Duty*, *supra* note 177, at 935–36 (explaining that "[t]he difficulty is that the characteristics of even the standard or conventional fiduciary relationships—these include trustee-beneficiary, agent-principal, lawyer-client, guardian-ward, director-corporation, and partner-fellow partner and partnership—are too varied to enable one to distill a single essence or property that unifies all in any analytically satisfactory way"); Easterbrook & Fischel, *supra* note 104, at 438 (claiming there is nothing "special about fiduciary relations" and that "[s]earching for the right definition of a fiduciary duty is not a special puzzle . . . there is no subject here, and efforts to unify it on a ground that presumes its distinctiveness are doomed"); Rotman, *supra* note 177, at 941 (stating "[r]ather than defining fiduciary law by the more rigid and rule-oriented scheme of contract law or other common law schemes giving rise to civil obligation, fiduciary law ought to be understood by reference to the broad postulates that underlie it and give it meaning").

an all-encompassing context-based method would be over-inclusive and encompass every possible fiduciary relationship under state law. This creates the very situation the Supreme Court in *Chapman* was concerned about—a situation where the exception threatens to swallow the rule.<sup>222</sup> The competing bankruptcy policies would become out of balance and the discharge restrictions would absorb the fresh start. In an un-modified state using broad characteristics, the context-based method should not be used to determine if a relationship is a fiduciary capacity under section 523(a)(4).

*D. Modifying the Context-Based Method to Require Both Ascendancy and Loyalty is a Better Approach*

The status-based method is inflexible, distinguishes relationships on a basis that is not justified, and goes against the underlying policy of section 523(a)(4). Courts should stop interpreting the term "fiduciary capacity" in section 523(a)(4) to require the debtor to be acting as a trustee. The context-based method is too flexible and, depending on the fiduciary characteristics that are used, is overly-inclusive, resulting in every relationship containing any fiduciary aspect as being classified as fiduciary in nature.

The proper framework should be flexible enough to avoid the categorical constraints of the status-based method but not so loose that it encompasses relationships that possess a trivial amount of fiduciary characteristics. A better approach is to take the focus on fiduciary characteristics from the context-based method and combine it with criteria that ensures the relationship is genuinely fiduciary in nature. Accordingly, I propose a fiduciary capacity under section 523(a)(4) requires a relationship in which the debtor (the fiduciary) has a substantial degree of ascendancy in relation to another (the beneficiary), who reasonably expects the debtor's loyalty as a primary purpose of the relationship. Ascendancy and loyalty are indispensable elements of a genuine fiduciary relationship.

1. A Substantial Degree of Ascendancy

Ascendancy requires the debtor to have had a superior, influential or dominating position over another at the time of defalcation. Of course, a fiduciary usually does not literally have an ascendant position over the person of the beneficiary, but rather over something belonging to the beneficiary, such as power or property.<sup>223</sup> A debtor's position of ascendancy may arise from a debtor being entrusted with power or property. It may also come from other sources such as

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<sup>222</sup> See *Chapman v. Forsyth*, 43 U.S. 202, 208–09 (1844) (discussing implications of interpreting the statute in an overly-broad manner).

<sup>223</sup> In the context of a physician-patient relationship such as a surgeon, an ascendant position may be literally over the physical body of the beneficiary.



control, knowledge, vulnerability, influence, training, skill, or ability.<sup>224</sup> Requiring ascendancy avoids the narrowness of the status-based method's traditional categories and provides flexibility to enable a court to analyze the true characteristics of a new relationship that is being alleged to be a fiduciary capacity. The reason for requiring a substantial degree of ascendancy is to exclude relationships that only involve a minimal amount of ascendancy. The substantiality requirement helps avoid the all-encompassing feature that is the weakness of the unmodified context-based method.

## 2. Reasonable Expectations of Loyalty

Although it is commonly thought of as a duty, loyalty is the other essential characteristic of a fiduciary relationship.<sup>225</sup> There should be a reasonable and justifiable expectation that the debtor will act in the interests of another in and for the purposes of the relationship.<sup>226</sup> An assessment of reasonableness includes

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<sup>224</sup> Section 815(b) of the Uniform Trust Code provides:

[t]he exercise of a power is subject to the fiduciary duties prescribed by this [Article] . . . [Interestingly, the Comment states:] A power differs from a duty. A duty imposes an obligation or a mandatory prohibition. A power, on the other hand, is a discretion, the exercise of which is not obligatory. The existence of a power, however created or granted, does not speak to the question of whether it is prudent under the circumstances to exercise the power.

UNIFORM TRUST CODE § 815 cmt. b (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2000) (amended 2010); *Follett Higher Educ. Grp., Inc. v. Berman* (*In re Berman*), 629 F.3d 761, 769 (7th Cir. 2011) (stating the non-dischargeability standard could be met where a fiduciary relationship "involved a difference in knowledge or power giving one party a position of ascendancy over another"); *Texas Lottery Comm'n v. Tran* (*In re Tran*), 151 F.3d 339, 343 (5th Cir. 1998) (quoting *In re Marchiando*, 13 F.3d at 1116 (stating "a true fiduciary relationship involves a difference in knowledge and power between the fiduciary and beneficiary, in which the former assumes 'a position of ascendancy over the latter'"); *In re Marchiando*, 13 F.3d 1111, 1116 (7th Cir. 1994) (stating that "[i]f we probe more deeply the distinction between the fiduciary relation that imposes real duties in advance of the breach and the fiduciary relation that does not we find that the first group of cases involve a difference in knowledge or power between fiduciary and principal which, . . . gives the former a position of ascendancy over the latter").

<sup>225</sup> See RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b (AM. LAW INST., Tentative Draft No. 1, 1996) (explaining that "[d]espite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship"); Scott, *supra* note 178, at 541 (stating "[s]ome fiduciary relationships are undoubtedly more intense than others. The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty. Thus, a trustee is under a stricter duty of loyalty than is an agent upon whom limited authority is conferred or a corporate director who can act only as a member of the board of directors or a promoter acting for investors in a new corporation. All of these, however, are fiduciaries and are subject to the fiduciary principle of loyalty, although not to the same extent").

<sup>226</sup> See DeMott, *Breach of Fiduciary Duty*, *supra* note 177, at 938–39 (noting that "[a]ssessing whether a plaintiff's expectations of loyalty are justifiable is related to, but not identical to, assessing whether they are reasonable"); Finn, *supra* note 178, at 94 (stating that "[w]hat in the end one is seeking to identify is a relationship in which one party has in fact relaxed, or is justified in believing he can relax, his self-interested vigilance or independent judgment because, in the circumstances of the relationship, he reasonably believes

consideration of the specific circumstances of the relationship as well as industry customs and social norms. Loyalty requires a relationship in which the debtor puts the interests of another above his or her own.<sup>227</sup> To some extent, loyalty involves acting selflessly for the benefit of another, but it is not accurately described as purely selfless because the fiduciary often receives some benefit from the relationship.<sup>228</sup> One scholar explained that loyalty requires the fiduciary to "refrain from self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources."<sup>229</sup> Although it would be impractical to literally require the fiduciary to pursue the sole interests of the other person, it should require the fiduciary to act in their best interests.<sup>230</sup> Requiring the relationship to have loyalty as a primary purpose helps distinguish among varying degrees of fiduciary relationships and provides a method to consistently exclude relationships on a principled basis. The loyalty requirement helps identify relationships that seem fiduciary-like because of the presence of ascendancy—but in substance are not a true fiduciary species. A real fiduciary has the interests of another as primary.

The three hypotheticals illustrate the utility of defining a fiduciary capacity under section 523(a)(4) to require a relationship in which the debtor (the fiduciary) has a substantial degree of ascendancy in relation to another (the beneficiary), who reasonably expects the debtor's loyalty as a primary purpose of the relationship.

In the trust hypothetical, the trustee Tina had a substantial degree of ascendancy over the beneficiary Ben. Tina was named as the customer over the deposit account containing \$100,000. Tina, not Ben, had the ability to withdraw funds from the account. Tina had power and control over the funds and Ben was vulnerable as a result. Under the trust instrument and common law and statutory duties applicable to trustees, the primary purpose of the relationship was for Tina to act in the

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or is entitled to assume that the other is acting or will act in his (or in their joint) interests"); Paul D. Finn, *The Fiduciary Principle*, in EQUITY, FIDUCIARIES AND TRUSTS 6 (TG Youdan ed., 1989); Tuch, *supra* note 177, at 482 (stating features of a relationship as identifying fiduciary character include "a reasonable expectation that a person (the fiduciary) will act in the interests of another in and for the purposes of a relationship").

<sup>227</sup> See Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1067 (2007) ("An agent's duties of loyalty also operate with consequences not captured by contract law and tort law principles, consequences that both define and reinforce a principal's entitlement to faithful service from its agents."); Frankel, *supra* note 218, at 824.

<sup>228</sup> See John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 932 (2005) (arguing transaction in which there has been conflict or overlap of interest with trustee should be sustained); Smith & Lee, *supra* note 185, at 635 (explaining how courts use industry customs and social norms to determine the reasonable expectations of beneficiaries and distinguish the appropriate pursuit of self-interest from the inappropriate pursuit of self-interest).

<sup>229</sup> Smith, *supra* note 162, at 1407 (defining wrong as when fiduciary does something "inconsistent with the beneficiary's interest").

<sup>230</sup> See Langbein, *supra* note 228, at 932 ("[A] transaction prudently undertaken to advance the best interest of the beneficiaries best serves the purpose of the duty of loyalty, even if the trustee also does or might derive some benefit."). *Contra* HANOCH DAGAN & SHARON HANNES, PHIL. FOUND. OF FIDUCIARY L. 91, 97 (Andrew S. Gold & Paul B. Miller eds., Oxford University Press 2014) (defending the sole interest standard).

interests of Ben by using the \$100,000 only for Ben's education and living expenses. Even if Tina was entitled to be compensated for her services as trustee, the primary or predominant purpose of the relationship was to act in Ben's interests over her own. The conclusion under the ascendancy and loyalty elements is that Tina was acting in a fiduciary capacity under section 523(a)(4).

In the agency hypothetical, the attorney Anna had a substantial degree of ascendancy over her client Carl. Anna was granted a power of attorney to sell Carl's real estate. Although Anna did not own fee simple title to the real estate, she did have the power to convey it and Carl was vulnerable as a result. Under the terms of the written power of attorney and common law and statutory duties applicable to agents, Anna was required to sell the property only for a purchase price that reflected the property's fair market value. Even though Anna was likely charging a fee for her services, the primary purpose of Anna's relationship with Carl under the power of attorney was to follow Carl's directions with respect to exercising the power of attorney. The predominant purpose of the relationship was not for Anna to seek after her own interests.<sup>231</sup> The conclusion under the ascendancy and loyalty criteria is that Anna was acting in a fiduciary capacity under section 523(a)(4).

In the lending hypothetical, the result changes when the ascendancy and loyalty elements are applied. The lender Luke certainly had some degree of ascendancy over the borrower Bob. Luke held a security interest in his favor and also had contractual rights that prohibited Bob from engaging in certain conduct, like selling the equipment before the loan was fully paid. But Bob was not really vulnerable to Luke's security interest or contractual rights unless Bob failed to perform in a manner that constituted a default. From a practical perspective, Bob also had some degree of ascendancy over Luke because Bob was in possession of the equipment and also had the ability (although wrongful) to refuse to pay Luke. The relationship involved arms-length bargaining. The true nature of the lending relationship is manifested by evaluating the loyalty requirement. From Luke's perspective, the primary purpose of making the loan was not to achieve Bob's best interests. Luke extended the loan to receive the benefit of the interest rate and return on investment. From Bob's perspective, the predominant purpose of the loan was not to carry out Luke's best interests, but rather to use the loan proceeds for his own purposes of acquiring the equipment. Although each party may have had contractual obligations that benefitted the other party, the overall purpose of the relationship did not have the best interests of one party as primary. The conclusion under the ascendancy and loyalty criteria is that neither Luke nor Bob were acting in a fiduciary capacity under section 523(a)(4).

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<sup>231</sup> See Smith & Lee, *supra* note 185, at 620 ("The difference between independent contractors and fiduciaries is that the latter are subject to the additional constraint of the duty of loyalty, which regulates their self-interested actions, even when those actions are within the scope of the discretion granted by the contract.").

The utility of the ascendancy and loyalty criteria is that it can accurately sort among relationships and exclude relationships that are not genuinely fiduciary. But a debt is not automatically excepted from discharge simply because a court concludes a debtor was acting in a fiduciary capacity under section 523(a)(4). The statute also requires defalcation.<sup>232</sup>

#### E. *The Impact of the Bullock Court's Elevated Defalcation Standard*

In May 2013, in *Bullock*, the Supreme Court addressed the meaning of "defalcation" in section 523(a)(4) and established as a minimum floor the culpable state of mind requirement of "recklessly" under the Model Penal Code.<sup>233</sup> The challenges of implementing *Bullock's* new defalcation standard are addressed elsewhere.<sup>234</sup> Prior to *Bullock*, several courts and commentators had taken the position that defalcation was limited to the narrow situation where a fiduciary fails to produce entrusted funds.<sup>235</sup> *Bullock* clarified that defalcation "can encompass a breach of fiduciary obligation that involves neither conversion, nor taking and carrying away another's property, nor falsity."<sup>236</sup>

*Bullock* held that defalcation "includes a culpable state of mind requirement"<sup>237</sup> that involves "knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."<sup>238</sup> It can be satisfied through either (i) "conduct that the fiduciary knows is improper,"<sup>239</sup> or (ii) "reckless conduct of the kind that the criminal law often treats as the equivalent,"<sup>240</sup> meaning "the kind set forth in the Model Penal Code."<sup>241</sup>

Before *Bullock* established a new meaning of the term defalcation, many courts interpreted defalcation in a broad sense and fiduciary capacity in a narrow sense in order to comply with the circuit-level standard that exceptions to discharge should be construed narrowly.<sup>242</sup> Under *Bullock*, the statutory term "defalcation" is now an

<sup>232</sup> See 11 U.S.C. § 523(a)(4) (2012).

<sup>233</sup> See *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1757 (2013) (describing recklessly as involving "knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior").

<sup>234</sup> See Byington, *supra* note 18.

<sup>235</sup> See 4 COLLIER ON BANKRUPTCY § 523.10, at 523-71 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2015) (stating "[d]efalcation' refers to a failure to produce funds entrusted to a fiduciary"); Rosen, *supra* note 18, at 51 (arguing "this exception is intended to cover only the failure to remit or account for funds or property held in an express or technical trust. It does not cover other fiduciary relationships. It does not cover other actions or inactions.").

<sup>236</sup> *Bullock*, 133 S. Ct. at 1760.

<sup>237</sup> *Id.* at 1757.

<sup>238</sup> *Id.*

<sup>239</sup> *Id.* at 1759.

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*

<sup>242</sup> See *In re Storie*, 216 B.R. 283, 290 (B.A.P. 10th Cir. 1997) (noting that "[w]hile we agree that exceptions to discharge under section 523(a) are to be construed narrowly, our interpretation of 'defalcation' does not upset this policy in that the Tenth Circuit has interpreted 'fiduciary' narrowly to include only individuals operating under an 'express or technical trust'" (quoting *In re Fowler Bros. v. Young (In re Young)*, 91 F.3d 1367, 1371 (10th Cir. 1996)); *In re Failing*, 124 B.R. 340, 344 (W.D. Okla. 1989) (stating

elevated standard.<sup>243</sup> If the statutory term "fiduciary capacity" is construed narrowly, the combined construction of both defalcation and fiduciary capacity may nearly eliminate the application of this exception to discharge. As one bankruptcy judge insightfully observed in 1991:

The present interpretation of "defalcation while acting in a fiduciary capacity," which reads "fiduciary capacity" *narrowly* but "defalcation" *broadly*, does not further this basic purpose—it manages to allow discharge of some heinous abuses of confidence which do not happen to involve "technical" trusts, while impeding the "fresh start" of some honest but unfortunate (or merely negligent) fiduciaries. Bankruptcy purposes would actually be best served if "fiduciary capacity" were read *broadly* ... while "defalcation" were read *narrowly* . . . This would allow most confidential relationships the benefit of protection, but would limit such protection (and the corresponding penalty to debtors) to the more heinous breaches of such confidences. This would except from discharge most "dishonest" debts, and discharge most "honest" ones.<sup>244</sup>

Preservation of the debtor's fresh start is a firm-standing hallmark of bankruptcy law. But using an excessively narrow interpretation of the term "fiduciary capacity" in order to further the fresh start causes a disproportionate imbalance of the competing policy in favor of the discharge restrictions. Instead, as the Supreme Court requires, exceptions to discharge "should be confined to those plainly expressed."<sup>245</sup> The fresh start rationale should not be used to construe statutory language in a manner that "make[s] a mockery"<sup>246</sup> of the "defalcation while acting in a fiduciary capacity" exception to discharge.<sup>247</sup> If this exception to discharge is snuffed out of existence by an unreasonably narrow construction, debtors who are truly dishonest or have engaged in sufficiently wrongful conduct (defalcation) will have debts discharged that should not be.

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that although "defalcation" is defined broadly, "fiduciary capacity" is defined narrowly); *In re Frick*, 207 B.R. 731, 735 (Bankr. N.D. Fla. 1997) ("The narrow interpretation of fiduciary with the broad interpretation of defalcation ensures that the window of liability opens infrequently."); *In re Brown*, 131 B.R. 900, 904 (Bankr. D. Me. 1991) (recognizing that "defalcation" is defined broadly but "fiduciary capacity" is defined narrowly); *In re Gans*, 75 B.R. 474, 490 (Bankr. S.D.N.Y. 1987) (recognizing that "defalcation" is defined broadly while "fiduciary capacity" is defined narrowly).

<sup>243</sup> See *In re Pearl*, 502 B.R. 429, 432 (Bankr. E.D. Pa. 2013) (indicating *Bullock* had imposed a "heightened level of scienter" when defining defalcation under section 523(a)(4)).

<sup>244</sup> *In re Turner*, 134 B.R. 646, 659 (Bankr. N.D. Okla. 1991).

<sup>245</sup> *Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754, 1760 (2013) (quoting *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998)).

<sup>246</sup> *In re Kalinowski*, 482 B.R. 334, 344 (B.A.P. 10th Cir. 2012).

<sup>247</sup> 11 U.S.C. § 523(a)(4) (2012).

## CONCLUSION

Although the discharge of debt is a primary purpose of bankruptcy law, the discharge restrictions should be construed in a manner that recognizes both the fresh start and discharge restriction policies. The Supreme Court's guidance on the meaning of the term fiduciary capacity is inadequate and the circuit courts are hopelessly divided. Neither the status nor context-based methods identify fiduciary relationships in a manner that is consistent with bankruptcy policy.

The *Bullock* Court's recent elevation of the defalcation standard calls for a recalibration of the way the statutory terms "defalcation" and "fiduciary capacity" are construed in order to maintain an appropriate balance between competing bankruptcy policies. Now that *Bullock* has significantly elevated the term defalcation, courts should stop construing the term fiduciary capacity narrowly. The new framework proposed in this Article provides a way for courts to do so in a principled and consistent manner. Consequently, a fiduciary capacity under section 523(a)(4) should require a relationship in which the debtor (the fiduciary) has a substantial degree of ascendancy in relation to another (the beneficiary), who reasonably expects the debtor's loyalty as a primary purpose of the relationship.