

February 2011

"Some Portion of Misconduct": The Argument for a Negligence Standard for Expecting Discharge of Debts Incurred Through Defalcation

Alyssa Miller

Follow this and additional works at: <https://scholarship.law.wm.edu/wmblr>



Part of the [Bankruptcy Law Commons](#)

Repository Citation

Alyssa Miller, *"Some Portion of Misconduct": The Argument for a Negligence Standard for Expecting Discharge of Debts Incurred Through Defalcation*, 2 Wm. & Mary Bus. L. Rev. 185 (2011), <https://scholarship.law.wm.edu/wmblr/vol2/iss1/7>

Copyright c 2011 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/wmblr>

“SOME PORTION OF MISCONDUCT”: THE
ARGUMENT FOR A NEGLIGENCE STANDARD FOR
EXCEPTING DISCHARGE OF DEBTS INCURRED
THROUGH DEFALCATION

ABSTRACT

The United States Circuit Courts are currently split on the correct standard for defalcation: that is, they are split on what level of mental culpability a fiduciary must possess before bankruptcy courts exclude debts incurred through misconduct from discharge. The First, Fifth, Sixth, and Seventh Circuits apply a recklessness standard. The Fourth, Eighth, and Ninth Circuits apply a negligence standard. The time has come to resolve the circuit split because the inter-jurisdictional nature of business in the twenty-first century creates a danger that fiduciaries will not have notice of potential liability if standards for liability vary from jurisdiction to jurisdiction. Based on original intent and current policy interests, the correct resolution of the circuit split is for all of the circuits to apply a negligence standard.

TABLE OF CONTENTS

INTRODUCTION	187
I. DEFALCATION: PERVASIVE CONFUSION	189
II. ORIGINAL INTENT: THE MEANING OF THE WORD DEFALCATION AND HAND'S INTERPRETATION IN <i>CENTRAL HANOVER BANK</i> <i>AND TRUST CO. v. HERBST</i>	191
III. HEIGHTENED MENTAL STATE IS NECESSARY: THE FIRST, FIFTH, SIXTH, AND SEVENTH CIRCUITS.....	193
IV. <i>HYMAN</i> : THE SECOND CIRCUIT WEIGHS IN	198
V. A NEGLIGENCE STANDARD: THE PROPER RESOLUTION OF THE CIRCUIT SPLIT.....	200
VI. THE BUSINESS JUDGMENT RULE AS APPLIED TO THE CIRCUIT SPLIT.....	202
CONCLUSION.....	204

INTRODUCTION

Imagine that you have entrusted your personal funds to an agent with the instructions that the agent is to hold the funds in an account for you and disburse them to manage your affairs when asked to do so. The agent assures you that he will handle your money with competence and care. You go about your business, confident that your money lies in good hands. Several years later, you discover that your agent has declared bankruptcy. In addition, he did not keep your funds in a separate account, but rather he commingled them with funds in his personal account. For that reason, the agent owes you money from his personal funds. He claims he had commingled funds throughout his years of working as a trustee and had never experienced problems before. Thus, he had no reason to think that he was failing to comply with his duties by handling your funds in the way he did. Nevertheless, you want him to repay his debt to you, notwithstanding his bankruptcy declaration. The issue is whether the agent, even though failing to act as an upstanding fiduciary, can discharge his debt to you because he did not know that his behavior was inappropriate.

A current circuit split in the nation’s bankruptcy law jurisprudence demonstrates prevalent tensions in the United States’ legal system, namely, the tension between states’ rights and legal uniformity, as well as the tension between accountability and leniency towards the honest debtor.¹ Though these countervailing interests are pervasive throughout the legal system of the United States, as it relates to this circuit split, they arise in a very narrow context. The question is this: When a fiduciary declares bankruptcy and attempts to discharge his debts in order to obtain a fresh start, to what extent must he misbehave before a court can choose to exclude some of those debts from discharge?

When an individual debtor declares bankruptcy, section 523(a)(4) of the Bankruptcy Code provides both relief to the bankrupt debtor and several exceptions to the discharge of debts.² One of these exceptions

¹ See *Davis v. Davis (In re Davis)*, 170 F.3d 475, 478 (5th Cir. 1999) (noting that the interests of states’-rights advocates to tailor exemptions from discharge to local conditions runs counter to the federal interest in uniformity); Andrea Johnson, Note, *The Defalcation Exception to Discharge: Should a Fiduciary’s Mistake Prohibit a Discharge from Debt?*, 27 W. NEW ENG. L. REV. 93, 95 (2005) (stating that the confusion between the circuits is increased by the goals of the Bankruptcy Code, which seeks to give a fresh start to “honest” debtors while attempting to repay “similarly situated” creditors).

² See 11 U.S.C. § 523(a)(4) (2006) (“(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt ... for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or

applies to debtors who commit defalcation³ while acting in a fiduciary capacity.⁴ The financial crises of recent years have drawn attention to a circuit split regarding the state of mind required to exempt a debt from discharge due to defalcation.⁵ Scholarship on the issue recognizes two major competing policy concerns: bankruptcy's interest in providing the honest but unfortunate debtor with a fresh start and the desire to hold fiduciaries accountable to their victims.⁶

This Note will argue that the latter interest, of holding fiduciaries accountable to their victims, must ultimately outweigh the former; it will also examine the circuit split from an originalist⁷ perspective. Those considerations will lead to the conclusion that courts should uniformly apply a negligence standard to defalcation cases. First, as a matter of providing background information, this Note will describe the recent case that brought renewed attention to defalcation, *Denton v. Hyman (In re Hyman)*.⁸ Having established the import of the circuit split, the Note will then turn to an examination of original intent under *Central Hanover Bank and Trust Co. v. Herbst*.⁹ Next it will proceed into an examination of the various perspectives proffered by the circuit courts;¹⁰ the First, Second,

larceny"); *see also* 11 U.S.C. § 727(a)(7) (2006) ("The court shall grant the debtor a discharge, unless ... the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection.").

³ BLACK'S LAW DICTIONARY 479 (9th ed. 2009) (defining defalcation as "embezzlement" or "[l]oosely, the failure to meet an obligation; a nonfraudulent default" and the archaic definition given is "[a] deduction; a setoff").

⁴ *See* 11 U.S.C. § 523(a)(4) (2006).

⁵ *See* Johnson, *supra* note 1, at 93 (stating that courts have disagreed over the necessary level of intent required to find defalcation); Matthew W. Knox, Note, *Persistent Confusion: The Circuit Split Over the Exception to Discharge for Defalcation Under 11 U.S.C. § 523(a)(4)*, 34 COLUM. BUS. L. REV. 1078, 1080-81 (2008) (finding the circuits employ three varying standards for the mental state required for defalcation).

⁶ Knox, *supra* note 5, at 1079-80 (arguing that §523(a)(4) is designed to balance the interests of the victim of defalcation with the goal of allowing an honest debtor to emerge from bankruptcy with a fresh start).

⁷ *See* Cent. Hanover Bank and Trust Co. v. Herbst, 93 F.2d 510, 511 (2d Cir. 1937) (finding that the original meaning of defalcation was not limited solely to cases of "deliberate malversations").

⁸ 502 F.3d 61, 68-69 (2d Cir. 2007).

⁹ *See* Cent. Hanover Bank, 93 F.2d at 511 (finding that the original intent of defalcation was not limited to cases of intentional malfeasance, but included other defaults as well).

¹⁰ *See* Patel v. Shamrock Floorcovering Serv. (*In re* Patel), 565 F.3d 963, 970-71 (6th Cir. 2009); *In re* Hyman, 502 F.3d at 68-69; Oklahoma Grocers Ass'n, Inc. v. Millikan (*In re* Millikan), 188 Fed. App'x. 699, 701-02 (10th Cir. 2006); Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 18 (1st Cir. 2002); Republic of Rwanda v. Uwimana (*In re*

Fifth, Sixth and Seventh Circuits require a heightened mental state of willful neglect or recklessness.¹¹ This Note will explain that these four circuits support a standard that will ultimately prove contradictory and unworkable. It will then point to the negligence standard utilized by the Fourth, Eighth, Ninth, and Tenth Circuits as the standard that would properly resolve the circuit split.¹² Finally, this Note will address the argument that circuit courts should apply a willful neglect or recklessness standard in order to promulgate norms established under the business judgment rule¹³ and conclude that norms of corporate law, as demonstrated through the business judgment rule, in fact support a negligence standard. Ultimately, this Note will show that a negligence standard is the most workable standard because it is consistent with original intent, is practical to apply, and is the most appropriate standard in light of the current economic climate, which has demonstrated the import of accountability.

I. DEFALCATION: PERVASIVE CONFUSION

On January 12, 2009, the Supreme Court of the United States denied G. Hallett Denton’s petition for writ of certiorari.¹⁴ Denton petitioned the Court to reconsider the Second Circuit’s ruling that defalcation requires a conscious or extremely reckless state of mind, and thus Hyman, a fiduciary in default, had not committed defalcation¹⁵ and therefore would not be liable for debts he had mishandled.¹⁶ With their holding in the underlying case, the Second Circuit aligned itself with the Fifth, Sixth, and Seventh Circuits by requiring extreme recklessness on the part of the defalcator before debts would be excepted from discharge.¹⁷

Uwimana), 274 F.3d 806, 811 (4th Cir. 2001); *Office of Thrift Supervision v. Felt* (*In re Felt*), 255 F.3d 220, 226 (5th Cir. 2001); *Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1186-87 (9th Cir. 1996); *Meyer v. Rigdon* (*In re Rigdon*), 36 F.3d 1375, 1384-85 (7th Cir. 1994).

¹¹ See *In re Patel*, 565 F.3d at 970-71; *In re Hyman*, 502 F.3d at 68-69; *In re Felt*, 255 F.3d at 226; *In re Rigdon*, 36 F.3d at 1384-85.

¹² See *In re Uwimana*, 274 F.3d at 811; *Tudor Oaks Ltd. P’ship v. Cochrane* (*In re Cochrane*), 124 F.3d 978, 984 (8th Cir. 1997); *In re Lewis*, 97 F.3d at 1186-87.

¹³ *Knox*, *supra* note 5, at 1108.

¹⁴ *In re Hyman*, 502 F.3d 61 (2d Cir. 2007), *cert. denied*, 129 S.Ct. 895 (2009).

¹⁵ BLACK’S LAW DICTIONARY, *supra* note 3, at 479.

¹⁶ See *In re Hyman*, 502 F.3d at 68-69.

¹⁷ See *Current Circuit Splits*, 4 SETON HALL CIR. REV. 129, 143 (2007). This journal provides an overview of circuit splits rather than analyses. *Id.* at 129. The Article notes the breakdown of the circuits regarding the level of intent necessary for defalcation. *Id.* at 143. It points out that the Second Circuit chose to adopt the most stringent standard for

By denying cert to the petitioner in *Denton*,¹⁸ the Supreme Court effectively chose not to resolve a persistent split among the circuit courts regarding the state of mind required for defalcation. Defalcation is one of the several exceptions to the discharge of debts available to an individual debtor upon declaring bankruptcy,¹⁹ and as a result of the Supreme Court's denial of certiorari, the exception will continue to vary between the circuits. To this point, the circuits have been "laboratories for experimentation"²⁰ regarding the mental state required for defalcation, and although this would be acceptable and even beneficial in certain contexts from a federalist perspective,²¹ the nature of business in the twenty-first century renders unjust the circuit split regarding defalcation. Individuals, as well as corporations, conduct business across jurisdictions and, by extension, across various circuits. Based on broad theories of personal jurisdiction that can place an individual in federal court²² and the application of state law in certain federal court cases,²³ this results in an individual's liability for debts to vary across circuits. Fiduciaries, as well as those who entrust funds to them, have a reasonable expectation of being

intent necessary to commit defalcation and that it is in a minority of the circuits in doing so. *Id.* The Fifth, Sixth, and Seventh Circuits require some level of fault above negligence. *Id.*; see also *supra* note 1 and accompanying text.

¹⁸ *In re Hyman*, 502 F.3d 61 (2d Cir. 2007), cert. denied, 129 S.Ct. 895 (2009).

¹⁹ See 11 U.S.C. § 523(a)(4) (2006).

²⁰ *United States v. Lopez (In re Lopez)*, 514 U.S. 548, 581 (1995) (Kennedy, J., concurring) ("[T]he States may perform their role as laboratories for experimentation to devise various solutions where the best solution is far from clear.").

²¹ See *New State Ice Co. v. Liebmann (In re Liebmann)*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (arguing that the experimentation of the various states allows for the meeting of changing needs, which can then ultimately be adopted by the majority for the improvement of society).

²² See *Asahi Metal Indus. Co. v. Superior Court*, 480 U.S. 102, 112 (1987) (finding an individual can be subject to personal jurisdiction in a given state if that individual either has minimum contacts in the state or if he has availed himself of the state, even if only by putting a product in the stream of commerce that is likely to end in the state); see also *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 295, 297-98 (1980) (requiring purposeful availment of the benefits of a forum state for personal jurisdiction to be exercised, while rejecting the idea that isolated contacts arising from unilateral actions of consumers within the forum state can establish personal jurisdiction).

²³ See *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938) (holding that except in cases where the Constitution or Congress has pre-empted state law, the law applied in a case is the law of the state); see also *Butner v. United States*, 440 U.S. 48, 54-56 (1979) (federal courts sitting in diversity jurisdiction or bankruptcy jurisdiction must apply state common substantive law); *United Mine Workers v. Gibbs*, 383 U.S. 715, 725 (1966) (requiring in a case of mixed state and federal jurisdiction that the federal claim giving rise to federal jurisdiction share a "common nucleus of operative fact" with the state claims in an action for the federal court to hear the state claim).

put on notice about their liability for debts after bankruptcy. Because business may be conducted across various circuits, the time has come for a uniform standard of liability.

II. ORIGINAL INTENT: THE MEANING OF THE WORD DEFALCATION AND
HAND’S INTERPRETATION IN *CENTRAL HANOVER BANK
AND TRUST CO. V. HERBST*

Confusion surrounding the concept of defalcation has plagued courts in recent years on a very practical level, but the confusion stems at least partly from linguistic development. A literal translation of defalcation from its Latin roots yields the phrases “‘a chopping off’ or ‘cutting down.’”²⁴ Those phrases have little to do with modern understandings of the term, which largely include “‘a taking away’ or ‘failure to meet an obligation [or] non-fraudulent default.’”²⁵ Black’s Law Dictionary also provides the archaic alternate definition, “[a] deduction; a set-off.”²⁶ Finding common ground among these various definitions proves difficult. They boil down to an action of taking away, although there is considerable variation between chopping off and failing to meet an obligation. In the bankruptcy context, this amounts to an action of wrongfully depriving another of funds, but nowhere does the meaning of the word articulate any practical standard for an analysis of the requisite intent. Understanding the meaning of defalcation could shed light on the intent required for defalcation.

Central Hanover Bank and Trust Co. v. Herbst is the seminal case circuits look to in order to determine the meaning of defalcation.²⁷ In *Central Hanover Bank*, the debtor in question received an award for funds in a real property suit.²⁸ This debtor spent his award without waiting to learn whether the opposing creditor would appeal the decision, and because he spent his money prematurely, the debtor did not have funds remaining when the high court ultimately reversed the decision.²⁹ Shortly thereafter, the debtor declared bankruptcy.³⁰ The bankruptcy court was faced with whether the debt incurred through the prior suit should be

²⁴ NORTON BANKRUPTCY LAW AND PRACTICE 57-85-86, § 57:29 (Honorable William L. Norton, Jr. & William L. Norton III eds., West) (3d ed. 2010).

²⁵ *Id.* (citing BLACK’S LAW DICTIONARY 448 (8th ed. 2004)).

²⁶ BLACK’S LAW DICTIONARY, *supra* note 3, at 479.

²⁷ *See* Cent. Hanover Bank and Trust Co. v. Herbst, 93 F.2d 510 (2d Cir. 1937).

²⁸ *Id.* at 511.

²⁹ *Id.*

³⁰ *Id.*

discharged under section 17(a)(4) of the Bankruptcy Act.³¹ In its determination, the court analyzed the word defalcation as it appeared in nineteenth century bankruptcy legislation and unsurprisingly was unable to definitively interpret the plain meaning of the word.³² The court concluded that regardless of the “original meaning of ‘defalcation,’ it must ... have covered other defaults than deliberate malversations, else it add[s] nothing to the words, ‘fraud or embezzlement.’”³³ The court went on to distinguish defalcation from misappropriation, which would require more than mere negligence or mistake.³⁴ The court determined that defalcation required “some portion of misconduct” but not more than “mere negligence or mistake,” as would be required by misappropriation.³⁵

Since 1937, courts and circuits have interpreted the phrase “some portion of misconduct”³⁶ in a variety of ways. As subsequent discussions will show, Justice Hand’s statement in *Central Hanover Bank* has turned into a quagmire within bankruptcy law. Throughout the twentieth century, courts have chosen to latch on to the ambiguous language in the opinion, rather than recognize that the *Central Hanover Bank* court deliberately distinguished defalcation from wrongdoing that would require a higher mental state than mere negligence or mistake.³⁷ The Second Circuit is the circuit most recently guilty of this in its *In re Hyman* decision.³⁸ Unfortunately, modern circuits have hijacked Judge Hand’s use of the phrase “some portion of misconduct”³⁹ and taken it to support a recklessness standard, thus requiring conscious conduct.⁴⁰ Read in a

³¹ *Id.* (The relevant questions are whether the debtor incurred his debt through “‘fraud, embezzlement misappropriation, or defalcation while acting as an officer or in any fiduciary capacity’; and whether, having been discharged, he was acting ‘in any fiduciary capacity,’ when he took the money.”).

³² *Id.* (finding that regardless of what the original meaning of “defalcation” was, it included something beyond deliberate malfeasance).

³³ *Id.*

³⁴ *Id.* at 512.

³⁵ *Id.* at 510.

³⁶ *Id.*

³⁷ *Id.*

³⁸ See *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 66-67 (2d Cir. 2007) (focusing on the language in *Central Hanover Bank* that some misconduct might be required to establish defalcation).

³⁹ See, e.g., *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417, 421 (5th Cir. 1990) (arguing that a “defalcation is a willful neglect of duty,” regardless of fraud or embezzlement).

⁴⁰ Recklessness is the lowest mental state that requires conscious conduct, with the implication of an element of willfulness. See BLACK’S LAW DICTIONARY, *supra* note 3, at 1385 (defining “reckless” as being “[c]haracterized by the creation of a substantial and

vacuum, the phrase might support a recklessness standard, but read in context with the surrounding language, it is clear that Justice Hand intended that innocent mistakes suffice to constitute defalcation.⁴¹

III. HEIGHTENED MENTAL STATE IS NECESSARY: THE FIRST, FIFTH, SIXTH, AND SEVENTH CIRCUITS

Several circuits have attempted to resolve the circuit split by requiring the defalcator to have more than a negligent state of mind.⁴² These circuits have required anything in the range of willful neglect, recklessness, and even actual knowledge.

The First Circuit has gone beyond adopting a blanket standard and articulated factors to consider in determining whether a debtor should be required to except certain debts from discharge. The First Circuit noted the exception to discharge applies to fiduciaries only when they are acting in a fiduciary capacity, that defalcation requires a breach of a fiduciary duty, and that defalcation must mean something other than fraud and is different from “willful and malicious injury.”⁴³ Although this *Baylis* test may prove helpful as far as giving notice, the factors do nothing to clear up the debate about the intent required for defalcation. Instead, they bring attention to the fact that defalcation requires a breach of fiduciary duty.⁴⁴ The First Circuit’s emphasis on the breach element of a negligence cause of action evades the issue in need of clarification—the intent required for defalcation. Although the circuit settles on a heightened recklessness standard as to intent, falling somewhere short of specific intent,⁴⁵ the

unjustifiable risk of harm to others and by a conscious (and sometimes deliberate) disregard for or indifference to that risk; heedless; rash. Reckless conduct is much more than mere negligence: it is a gross deviation from what a reasonable person would do.”)

⁴¹ Cent. Hanover Bank and Trust Co. v. Herbst, 93 F.2d 510, 511 (2d Cir. 1937) (finding that the use of defalcation in the Act of 1841 probably included innocent defaults).

⁴² See Meyer v. Rigdon (*In re Rigdon*), 36 F.3d 1375, 1384-85 (7th Cir. 1994) (rejecting the view that negligent acts may constitute defalcation); Carlisle Cashway, Inc. v. Johnson (*In re Johnson*), 691 F.2d 249, 257 (6th Cir. 1982) (adopting an objective knowledge test and finding actual knowledge of the law or subjective intent to violate a fiduciary duty or bad faith irrelevant to the question of whether a defalcation has occurred).

⁴³ Rutanen v. Baylis (*In re Baylis*), 313 F.3d 9, 17 (1st Cir. 2002).

⁴⁴ *Id.* at 20 (“Defalcation may be presumed from breach of the duty of loyalty, the duty not to act in the fiduciary’s own interest when that interest comes or may come into conflict with the beneficiaries’ interest . . .”).

⁴⁵ *In re Baylis*, 313 F.3d at 20 (“To show defalcation, a creditor need not prove that a debtor acted knowingly or willfully, in the sense of specific intent. However, a creditor

court's application of the standard focuses on the breach of a fiduciary duty of loyalty, rather than any actual intent.⁴⁶

The Seventh Circuit has stated that negligence is not enough for defalcation,⁴⁷ and the Sixth Circuit agrees that negligence is not enough,⁴⁸ but the court goes further and essentially finds that intent is irrelevant for determining whether an individual is liable for defalcation, resulting in the Sixth Circuit imposing the highest standard.⁴⁹ The court states that "creating a debt by breaching a fiduciary duty is a sufficiently bad act to invoke the ... [defalcation] exception even without a subjective mental state evidencing intent to breach a known fiduciary duty or bad faith in doing so."⁵⁰ To determine if defalcation exists, the court employs an objective knowledge standard.⁵¹ This principle at least provides a bright line standard, but it is inconsistent with other United States jurisprudence, and thus provides no clarity as to a uniform standard to be used across jurisdictions.⁵²

The Fifth Circuit presents a tempting standard, one of willful neglect or recklessness. This circuit has stated that "[t]he defalcation determination turns on ... whether ... [a debtor's] breaches were 'willful,'" and that "willfulness is measured objectively by reference to what a reasonable person in the debtor's position knew or reasonably

must be able to show that a debtor's actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny.").

⁴⁶ *In re Baylis*, 313 F.3d at 22 ("Given this combination of the fiduciary breach which caused the lawsuit and the self-dealing to defend against it, we find that Baylis's actions here constitute defalcation under 11 U.S.C. § 523(a)(4)."). Although the *Baylis* factors are somewhat redundant when coupled with the language from *Central Hanover Bank*, *In re Baylis* does appropriately draw attention to the fiduciary role. The first and second *Baylis* factors serve to emphasize that a fiduciary is a person different from the typical everyday debtor and should be held to a different standard than the run of the mill unlucky debtor. *Id.* "The 'badness' related to defalcation by a fiduciary is supplied 'by an individual's special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching those duties.'" *Id.* The First Circuit argues that it is this breach of such a significant duty, that of a fiduciary's duty of loyalty, that makes defalcation an appropriate reason to except discharge for a person assuming that role. *Id.*

⁴⁷ See *Meyer v. Rigdon (In re Rigdon)*, 36 F.3d 1375, 1385 (7th Cir. 1994) ("we cannot say that Congress intended for a debt arising from a mere negligent breach of fiduciary duty to be excepted from discharge under section 523(a)(11)").

⁴⁸ See *In re Johnson*, 691 F.2d at 249, 257 (6th Cir. 1982).

⁴⁹ See *id.* (adopting an objective knowledge standard).

⁵⁰ *Id.* at 256.

⁵¹ *Id.* at 255.

⁵² See discussion *supra* Part II; discussion *infra* Parts IV, V.

should have known.”⁵³ Although the willful neglect standard is attractive, because it seems to retain the negligence standard while requiring a higher level of awareness, it can be less than workable. Neglect,⁵⁴ and by extension negligent behavior, is distinct from recklessness,⁵⁵ therefore, the willful neglect standard the Fifth Circuit has articulated⁵⁶ is essentially contradictory and meaningless.

The willful neglect standard begets confusion. Commentators who argue for the willful neglect standard desire a standard higher than negligence but lower than recklessness.⁵⁷ In theory, this standard would satisfy two competing policy interests; honest but unfortunate debtors would get a fresh start because defalcation would require behavior worse than negligence⁵⁸ and at the same time, fiduciaries would be held accountable for their behavior even without it rising to the level of reckless or conscious action.⁵⁹ But what is willful neglect? It is willful, or intentional, which takes the conscious disregard element from the recklessness standard. The neglect part of the phrase obviously refers to the negligence standard. Put together, it is as meaningless a phrase as *Central Hanover Bank’s* “some portion of misconduct.”⁶⁰

⁵³ *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001).

⁵⁴ BLACK’S LAW DICTIONARY, *supra* note 3, at 1132 (defining “neglect” as “[t]he omission of proper attention to a person or thing, whether inadvertent, negligent, or willful; the act or condition of disregarding ... failure to give proper attention, supervision, or necessities, ... to such an extent that harm results or is likely to result”).

⁵⁵ *Id.* at 1385 (Defining “recklessness” as “[c]onduct whereby the actor does not desire harmful consequence but nonetheless foresees the possibility and consciously takes the risk. Recklessness involves a greater degree of fault than negligence but a lesser degree of fault than intentional wrongdoing.”).

⁵⁶ *See, e.g., In re Felt*, 255 F.3d at 226 (requiring a willful mental state).

⁵⁷ *See Meyer v. Rigdon (In re Rigdon)*, 36 F.3d 1375, 1384-85 (7th Cir. 1994) (stating that mere negligence will not suffice); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 257 (6th Cir. 1982) (finding that even though negligence will not establish defalcation, the debtor had objective knowledge of the wrongdoing, thus constituting defalcation); *see also Knox, supra* note 5, at 1081 (arguing for the willful neglect/recklessness standard to be applied for an act to constitute defalcation); *Johnson, supra* note 1, at 97 (arguing that “a standard of intent similar to willful neglect should be used to determine whether a fiduciary has committed defalcation”).

⁵⁸ *Knox, supra* note 5, at 1109-10 (explaining how the honest but unfortunate debtor is protected because his debts are not barred from being discharged by the mere negligence of a fiduciary under a willful neglect standard).

⁵⁹ *Johnson, supra* note 1, at 128 (explaining how a fiduciary who intended to commit an act, but not the bad outcome to the debtor, would be held liable for defalcation).

⁶⁰ *Cent. Hanover Bank and Trust Co. v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937).

Several commentators have argued for the application of this willful neglect or recklessness standard.⁶¹ These commentators focus on balancing policy issues: weighing the need to hold a fiduciary accountable with the countervailing interest of providing the honest but unfortunate debtor with a fresh start.⁶² Although it is noble to offer sympathy to the unfortunate debtor, given the recent financial turmoil in the United States,⁶³ attributable in part to lack of fiduciary accountability,⁶⁴ it makes more sense to focus on the irresponsible debtor.⁶⁵ The irresponsible debtor should not be given a clean slate. “The narrow reading of the word ‘fiduciary’ and the broad reach of defalcation in section 523(a)(4) of the Bankruptcy Code cannot easily be reconciled with the concept of a fresh start for the ‘honest but unfortunate’ debtor.”⁶⁶ Although a potentially harsh result, this debtor seems far from honest and should be held to the standard of the fiduciary that he has held himself out to be.

The Knox and Johnson Notes previously referenced pose an identical hypothetical.⁶⁷ An attorney is the trustee for a client’s trust.⁶⁸ “The trustee deposits the funds in a bank, which appears on all accounts to be federally insured, but later goes bankrupt”⁶⁹ Although the bank represented

⁶¹ Knox, *supra* note 5, at 1081; Johnson, *supra* note 1, at 97.

⁶² Knox, *supra* note 5, at 1079-80; *see Grogan v. Garner*, 498 U.S. 279, 286-87 (1991) (recognizing that there are and must be limitations to a completely fresh start for an honest but unfortunate debtor).

⁶³ *See* Knox, *supra* note 5, at 1079 (arguing that in light of recent economic downturn and financial scandals, regulations that protect beneficiaries provide an important remedy).

⁶⁴ Shareholder Bill of Rights Act of 2009, S.1074, 111th Cong. § 2(1) (2009) (stating that “among the central causes of the financial and economic crisis that the United States faces today has been a widespread failure of corporate governance”).

⁶⁵ *See Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 256 (6th Cir. 1982) (“Although the ‘badness’ of fraud, embezzlement or misappropriation is readily apparent, creating a debt by breaching a fiduciary duty is a sufficiently bad act to invoke the section 17(a)(4) exception even without a subjective mental state evidencing intent to breach a known fiduciary duty or bad faith in doing so. This is because the requisite ‘badness,’ to conform with the spirit of the bankruptcy laws, is supplied by an individual’s special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching these duties.”); *see also* Knox, *supra* note 5, at 1090 (“§ 523(a)(4) may be intended to hold fiduciaries accountable for their actions”); Johnson, *supra* note 1, at 95 (“Those courts that favor a standard requiring a lower level of intent ... agree that the need to hold fiduciaries accountable in their special legal roles outweighs the desire for a fresh start policy.”)

⁶⁶ NORTON BANKRUPTCY LAW AND PRACTICE, *supra* note 24, at 57-87, § 57:29.

⁶⁷ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94-95.

⁶⁸ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

⁶⁹ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

itself as federally insured, in reality it had no such insurance.⁷⁰ The trust wins in an action against the attorney trustee and⁷¹ the attorney trustee files for bankruptcy.⁷² The Knox and Johnson Notes pose the question, “[s]hould the trustee be denied discharge for committing defalcation while acting in a fiduciary capacity?”⁷³ Both Notes conclude that the fiduciary should not be denied discharge because otherwise he would be less likely to serve as a fiduciary in the future and, in addition, imposing liability on this fiduciary will deter others from taking on fiduciary positions.⁷⁴

The bankruptcy system cannot coddle fiduciaries in such a manner. The fiduciary in the hypothetical obtained clients’ trust based on his representations that he was an expert. He should be responsible for investigating the persons and agencies with whom he chooses to work. Again, the policy consideration of encouraging fiduciary responsibility must outweigh the bankruptcy courts’ desire to give the honest but unfortunate debtor a fresh start.⁷⁵

Even worse, the willful neglect standard would work against the policy consideration of putting creditors, debtors, and fiduciaries on notice. Because the willful neglect standard comes close to make believe,⁷⁶ courts will only be able to apply it on an inconsistent basis; the court will look at behavior that supposedly falls somewhere between negligence and recklessness and slap the label of willful neglect on it.⁷⁷ But behavior cannot be willful and negligent at the same time.⁷⁸ Just so, courts cannot ease their burden of resolving the issue of the appropriate standard for defalcation by applying a hybrid of both a negligence and willful standard.

⁷⁰ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

⁷¹ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

⁷² Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

⁷³ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 94.

⁷⁴ Knox, *supra* note 5, at 1090; Johnson, *supra* note 1, at 128.

⁷⁵ Knox, *supra* note 5, at 1080 (holding debtors accountable for defalcation can have a “profound impact on the efforts of an individual debtor to organize his financial affairs and emerge from bankruptcy with clean slate”).

⁷⁶ See *supra* note 57 and accompanying text.

⁷⁷ See, e.g., *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226-27 (5th Cir. 2001) (finding that behavior constituted willful neglect); *Meyer v. Rigdon (In re Meyer)*, 36 F.3d 1375, 1385 (7th Cir. 1994) (finding that defendant knowingly breached his fiduciary duty, which was “more culpable than a mere negligent breach of duty”).

⁷⁸ BLACK’S LAW DICTIONARY, *supra* note 3, at 1133 (defining “negligence” as “[t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, *except for conduct that is intentionally, wantonly, or willfully* disregarding of others’ rights”) (emphasis added).

IV. *HYMAN*: THE SECOND CIRCUIT WEIGHS IN

In re Hyman, a Second Circuit case, gave the Supreme Court the opportunity to choose to allow the circuit split to remain unresolved.⁷⁹ With its decision in *In re Hyman*,⁸⁰ the Second Circuit aligned itself with the Fifth, Sixth, and Seventh circuits and chose to put the interests of the fiduciaries above the interests of their beneficiaries.⁸¹ The court ultimately decided that defalcation “requires a showing of conscious misbehavior or extreme recklessness.”⁸² The court first and foremost articulated bankruptcy law’s general interest in affording the “‘honest but unfortunate’ debtor a fresh start.”⁸³ Having articulated this interest, the court did not choose to address whether a fiduciary deserves the same consideration as the typical debtor.⁸⁴ As previously discussed, fiduciaries should arguably be held to a higher standard than the typical unfortunate debtor because the nature of the fiduciary position requires that the fiduciary hold himself or herself out as an authority, worthy of trust and capable of responsible behavior.⁸⁵

The *Hyman* court offered three justifications for their decision: first, to ensure “that the term ‘defalcation’ complements but does not dilute the other terms of the [bankruptcy code] provision ... all of which require a showing of actual wrongful intent,” second, to “[ensure] that the harsh sanction of nondischargeability is reserved for those who exhibit ‘some portion of misconduct,’” and finally, to ensure that the standard “has the

⁷⁹ Denton v. Hyman (*In re Hyman*), 502 F.3d 61, 68-69 (2d Cir. 2007), *cert. denied*, 129 S.Ct. 895 (2009).

⁸⁰ *Id.*

⁸¹ *Id.* See *In re Felt*, 255 F.3d at 226 (finding that defalcation is dependent on willfulness and thus a finding of negligence will not suffice to constitute defalcation); *In re Meyer*, 36 F.3d at 1385 (finding “a well recognized principle in bankruptcy law” is to provide the debtor with a fresh start); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 257 (6th Cir. 1982) (finding that negligence does not constitute defalcation).

⁸² *In re Hyman*, 502 F.3d at 68.

⁸³ *Id.* at 66 (citations omitted).

⁸⁴ See generally *id.* at 66-70.

⁸⁵ See *supra* note 46 and accompanying text; BLACK’S LAW DICTIONARY, *supra* note 3, at 702 (defining “fiduciary” as “[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor ... [o]ne who must exercise a high standard of care in managing another’s money or property”); *Johnson*, *supra* note 1, at 104 (defining fiduciary capacity as one involving one person entrusting his property to another in the form of an express special or technical trust).

virtue of ease of application since [sic] the courts and litigants have reference to a robust body of securities law”⁸⁶

As to the first concern, a negligence standard would also be distinct from, but in line with, the other terms of section 523(a)(4).⁸⁷ Although negligent behavior is wrongful to a lesser degree than the other evils enumerated in section 523(a)(4), its wrongfulness is exacerbated when committed by a fiduciary.⁸⁸ Thus, a negligence standard could comport with the Second Circuit’s first goal in the same way that a recklessness standard would. As for the second reason, negligent acts by a fiduciary do involve some portion of misconduct, as numerous circuits have recognized.⁸⁹

The only legitimate consideration enumerated by the *Hyman* court is the ease of application concern. Although consistency and uniformity are legitimate goals, the *Hyman* court’s ease of application only applies within the Second Circuit, and the need for consistency and uniformity applies throughout the United States.⁹⁰ Additionally, consistently applying an ill-formed standard is arguably worse than inconsistently applying the more appropriate standard at least part of the time.

The *Hyman* court also misinterpreted Judge Hand’s opinion from *Central Hanover Bank*, in which he wrote, “[a]lthough [misappropriation] probably carries a larger implication of misconduct than ‘defalcation,’ ‘defalcation’ may demand some portion of misconduct; we will assume arguendo that it does.”⁹¹ The *Hyman* court wrongly aligned the standard that Justice Hand articulated for misappropriation with the standard for defalcation.⁹² Justice Hand explicitly stated that misappropriation requires

⁸⁶ *In re Hyman*, 502 F.3d at 68-69.

⁸⁷ See 11 U.S.C. § 523(a)(4) (2006); *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 256 (6th Cir. 1982) (“Although the ‘badness’ of fraud, embezzlement or misappropriation is readily apparent, creating a debt by breaching a fiduciary duty is a sufficiently bad act to invoke the section 17(a)(4) exception even without a subjective mental state evidencing intent to breach a known fiduciary duty or bad faith in doing so.”).

⁸⁸ NORTON BANKRUPTCY LAW AND PRACTICE, *supra* note 24, at 57-87, § 57:29. (citing *In re Johnson*, 691 F.2d 249 (6th Cir. 1982)).

⁸⁹ See *Cent. Hanover Bank and Trust Co. v. Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) (stating that a fiduciary’s wrongdoing may include “innocent defaults”); *Tudor Oaks Ltd. P’ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997) (referring to innocent or negligent defaults as “misdeeds”).

⁹⁰ See *In re Hyman*, 502 F.3d at 69.

⁹¹ *Id.* at 67 (citing *Cent. Hanover Bank*, 93 F.2d at 511-12).

⁹² *Id.* at 67-70 (requiring conscious misbehavior or extreme recklessness for defalcation and applying that to actions described as misappropriation despite having just cited Justice Hand’s distinction between misappropriation and defalcation in which he

more misconduct than defalcation.⁹³ He stated that defalcation only requires “some portion of misconduct.”⁹⁴ An honest reading of the text cannot take that paragraph to support a recklessness standard. Justice Hand meant only that the defalcator must have done something wrong—elsewhere in his same opinion, he stated that such wrongdoing could include innocent mistake.⁹⁵

V. A NEGLIGENCE STANDARD: THE PROPER RESOLUTION OF THE CIRCUIT SPLIT

The decisions of three circuits, the Fourth, Eighth, and Ninth circuits, have differed from the holdings of the previously discussed circuits. The Fourth Circuit has focused on the agent-principal relationship and held that mistake, even innocent mistake, constitutes defalcation and is therefore not dischargeable.⁹⁶ The Tenth Circuit has similarly held that the talismanic phrase “some portion of misconduct” can mean anything from negligence on up to reckless, willful, or intentional misbehavior.⁹⁷ The Eighth Circuit has articulated a two-step approach: first, the court must determine whether the debtor occupied a fiduciary capacity; and second, whether the act of defalcation occurred while the debtor was acting in the fiduciary capacity.⁹⁸

The Fourth, Eighth, and Tenth circuits have properly focused their attention on the most important part of defalcation, the fiduciary relationship.⁹⁹ They recognize that he who holds himself out as a fiduciary and expert should bear the risk of loss if he acts negligently. Alternatively, if the fiduciary is wholly innocent, he should not bear such risk.¹⁰⁰ For that

stated that misappropriation involved more misconduct than defalcation).

⁹³ *Id.* at 67.

⁹⁴ *Id.*

⁹⁵ See *Cent. Hanover Bank*, 93 F.2d at 511 (“Colloquially perhaps the word, ‘defalcation,’ ordinarily implies some moral dereliction, but in this context it may have included innocent defaults.”).

⁹⁶ *Republic of Rwanda v. Uwimana (In re Uwimana)*, 274 F.3d 806, 811 (4th Cir. 2001).

⁹⁷ *Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 288 (B.A.P. 10th Cir. 1997).

⁹⁸ *Tudor Oaks Ltd. P’ship v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997) (citing *Lewis v. Scott*, 97 F.3d 1182, 1185 (9th Cir. 2006)).

⁹⁹ See *In re Uwimana*, 274 F.3d at 811; *In re Cochrane*, 124 F.3d at 984; *Oklahoma Grocers Ass’n, Inc. v. Millikan (In re Millikan)*, 188 Fed. App’x. 699, 702 (10th Cir. 2006).

¹⁰⁰ See *In re Uwimana*, 274 F.3d at 811 (requiring mistake for defalcation, although that mistake may be innocent); *In re Cochrane*, 124 F.3d at 984 (requiring default for

reason, the proper resolution of the circuit split is a negligence standard. More specifically, courts should employ the Eighth Circuit’s two-part test which consists of looking to see if a fiduciary relationship existed, and then determining whether the mistake occurred while acting in this fiduciary capacity.¹⁰¹ The courts should continue to focus on the fiduciary relationship, as that relationship is ultimately the defining characteristic of defalcation.

Of course, the two-part test is somewhat redundant. It merely echoes the inherent truth that in order for an individual to be held liable for defalcation, that individual must be a fiduciary; this is true because section 523(a)(4) requires fiduciary status for defalcation.¹⁰² However, the Eighth Circuit two part test is useful in that it draws attention away from the picture of the supposedly pitiful honest but unfortunate debtor and back to the reality of the misbehaving fiduciary.¹⁰³

The Ninth Circuit in *In re Lewis* has also explicitly held that the intent to defraud is not required to make the individual liable for defalcation.¹⁰⁴ In *Woodworking Enterprises, Inc. v. Baird (In re Baird)*, the Ninth Circuit stated that “[i]n the context of section 523(a)(4), the term ‘defalcation’ includes innocent, as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts.”¹⁰⁵ In *In re Baird*, the Ninth Circuit recognized the often overlooked policy interest of holding fiduciaries accountable for all of their conduct.¹⁰⁶

Yet the Ninth Circuit recognized conflicting precedent within its own jurisdiction in the case of *Martin v. Fidelity and Deposit Co. of Maryland (In re Martin)*.¹⁰⁷ That case calls for an ambiguous element of “bad faith

defalcation, although intent is unnecessary).

¹⁰¹ See *In re Cochrane*, 124 F.3d at 984.

¹⁰² See 11 U.S.C. § 523(a)(4) (2006).

¹⁰³ See *In re Cochrane*, 124 F.3d at 984 (describing defalcation as a misappropriation or failure by fiduciary).

¹⁰⁴ *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1187 (9th Cir. 1996). Business partner of debtors incurred debt arising from investment in partnership’s craft stores. *Id.* Bankruptcy court granted summary judgment for partner, finding the debt nondischargeable. *Id.* Bankruptcy appellate panel affirmed. *Id.* Court of appeals held that debtors owed trustees of partner a fiduciary duty within the meaning of defalcation under Arizona law and that that duty had been breached by commingling partner’s investment with other funds and not producing complete account for handling of funds. *Id.*

¹⁰⁵ *Woodworking Enter., Inc. v. Baird (In re Baird)*, 114 B.R. 198, 204 (B.A.P. 9th Cir. 1990).

¹⁰⁶ *Id.*

¹⁰⁷ *Martin v. Fidelity & Deposit Co. of Maryland (In re Martin)*, 161 B.R. 672, 678 (B.A.P. 9th Cir. 1993).

or reprehensible conduct” for a finding of defalcation.¹⁰⁸ Unfortunately, that standard is as unworkable as *Central Hanover Bank’s* “some portion of misconduct.”¹⁰⁹ *In re Martin* searches wistfully for some workable standard between neglect and willful neglect or recklessness.¹¹⁰ Between the lines, the opinion reads that the court will know defalcation when it sees it.¹¹¹ But a court’s *ad hoc* recognition of bad conduct cannot serve to put fiduciaries on notice about their potential liability for defalcation. For that reason, the Ninth Circuit overruled *In re Martin*, ridding itself of such ambiguous and unworkable language.¹¹²

With the aforementioned analysis, the Ninth Circuit has correctly recognized that the policy consideration of fiduciary accountability overrides the policy of giving the honest but unfortunate debtor a fresh start.¹¹³ Ultimately, an unfortunate debtor and a negligent debtor-fiduciary are not the same, and a fiduciary must be held to a higher standard than the lay debtor.¹¹⁴ Attempts to equate them will only allow, and even encourage, less than diligent behavior on the part of debtor-fiduciaries.¹¹⁵ In fact, although debated within scholarship, even the familiar deference of the business judgment rule comports with the application of a negligence standard in a debtor fiduciary context.

VI. THE BUSINESS JUDGMENT RULE AS APPLIED TO THE CIRCUIT SPLIT

Commentators have argued that the willful neglect or recklessness standard is the appropriate one for defalcation because it is the equivalent of the business judgment rule,¹¹⁶ but this logic misapplies the business

¹⁰⁸ *Id.*

¹⁰⁹ *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937).

¹¹⁰ *See In re Martin*, 161 B.R. at 677-78 (discussing varying standards of culpability required for defalcation).

¹¹¹ *Id.* at 678.

¹¹² *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1186-87 (9th Cir. 1996).

¹¹³ *See id.* at 1185-86 (stating that although the purpose of bankruptcy is to discharge all debts, the exception of defalcation does not require purposeful wrongdoing).

¹¹⁴ *See id.* at 1186 (stating that a fiduciary relationship imposes the highest duty of good faith).

¹¹⁵ *Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 287 (B.A.P. 10th Cir. 1997) (stating that holding fiduciaries to an objective standard encourages them to act carefully).

¹¹⁶ *See Knox supra* note 5, at 1081; *see also* BLACK’S LAW DICTIONARY, *supra* note 3, at 226 (defining the “business-judgment rule” as “[t]he presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief their actions are in the corporation’s best interest”). “The rule shields directors and officers from liability for

judgment rule. The business judgment rule exists to protect those working in a fiduciary capacity who make reasoned decisions that later prove incorrect.¹¹⁷ The business judgment rule is not meant to protect those fiduciaries that act negligently when managing funds on behalf of their beneficiaries.¹¹⁸

Some make the argument that the business judgment rule exists to protect corporate fiduciaries from the equivalent of honest mistake,¹¹⁹ but honest mistake and neglect do not mean the same thing. Honest mistake results from reasoned judgment that later proves to be false.¹²⁰ Neglect results from a breach of a duty, and a person can “neglect’ his duty either intentionally or negligently”¹²¹ Therefore, if section 523(a)(4) were to be construed to shield fiduciaries from liability in the same way that the business judgment rule does, it should only protect him from honest mistakes rather than a negligent breach of duty.¹²²

Proponents of the recklessness standard also latch on to the business judgment rule as a way of promulgating “a familiar and understandable norm of conduct for those acting in a fiduciary capacity” when those people find themselves faced with bankruptcy.¹²³ Though fiduciaries will typically be familiar with the business judgment rule, they will similarly be familiar with standards of negligence.¹²⁴ That is not to say that bankruptcy courts should take away all deference from fiduciaries. If a fiduciary makes a business decision that later proves harmful, he or she should be shielded from liability under the business judgment rule, as

unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors’ or officers’ authority.” *Id.* at 226-27.

¹¹⁷ BLACK’S LAW DICTIONARY, *supra* note 3, at 227 (shielding from “unprofitable” decisions if they “were made in good faith ...”).

¹¹⁸ *See Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (“[t]hus, a director’s duty to exercise an informed business judgment is in the nature of a duty of care”).

¹¹⁹ *Knox*, *supra* note 5, at 1108.

¹²⁰ *See Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964) (holding that “the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made”).

¹²¹ *See* BLACK’S LAW DICTIONARY, *supra* note 3, at 1132-33 (citation omitted).

¹²² *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.”).

¹²³ *Knox*, *supra* note 5, at 1108.

¹²⁴ *Antlers Roof-Truss & Builders Supply v. Storie (In re Storie)*, 216 B.R. 283, 287 (B.A.P. 10th Cir. 1997) (stating that fiduciaries are charged with knowledge of the applicable law).

norms of business practice in the United States demand.¹²⁵ But if the fiduciary acts negligently while making decisions, the shield should come down, and those debts should not be dischargeable.¹²⁶

This standard would not deviate from norms in any harmful way. The business judgment rule grants deference to corporate fiduciaries ““unless a challenger produces evidence establishing that the directors acted fraudulently, in bad faith, or with gross or culpable negligence...; [o]ther terms that have been used to describe the type of conduct not protected... include...willful abuse of discretionary power or neglect of duty, and recklessness.””¹²⁷ The commentator in question cited that statement to support a recklessness standard, but the language actually cuts the other way. Although recklessness does not enjoy business judgment rule protection, neither does “neglect of duty,” and neither should neglect of duty protect a bankrupt fiduciary.¹²⁸ Therefore, imposing a negligence standard for defalcation would not deviate from any norms, as it would not violate fiduciaries’ expectations under established principles of corporate law.

CONCLUSION

After examining the original intent and policy considerations surrounding the debate over the proper mental standard for defalcation under section 523(a)(4) of the Bankruptcy Code, it becomes clear that the only correct standard must be negligence. Courts have hesitated to adopt this standard across the board¹²⁹ and continue to search for that nonexistent level of culpability that fits their individual interpretations of the talismanic phrase “some portion of misconduct.”¹³⁰ But such searching is not necessary. *Central Hanover Bank* made it clear from the outset of defalcation jurisprudence that innocent mistake on the part of fiduciary suffices to except discharge.¹³¹

Subsequent case law does offer negligent fiduciaries hope that they can still wipe their slate clean so long as their actions do not rise to a

¹²⁵ See *Aronson*, 473 A.2d at 812 (stating that the business judgment rule provides an assumption of the good faith of directors, absent an abuse of discretion).

¹²⁶ See *id.* at 812 (noting that the business judgment rule is based on gross negligence concepts).

¹²⁷ Knox, *supra* note 5, at 1109 (citations omitted).

¹²⁸ *Id.*

¹²⁹ See *supra* Parts III and IV.

¹³⁰ See *supra* Part IV.

¹³¹ See *supra* Part II.

reckless level,¹³² but the Supreme Court must take on the task of overruling that erroneous body of case law. In the choice between negligence and recklessness, original intent of courts and the nature of the fiduciary position both support negligence. In addition, the financial crises of the past decade should make it clear to courts that extending near-absolute forgiveness to negligent fiduciaries is not a valid policy concern.¹³³ Under the recklessness standard, only intentional acts, such as fraud, would hold fiduciaries accountable.¹³⁴ The nature of the fiduciary role demands more accountability. Such accountability can be found in applying a negligence standard to defalcation.

*Alyssa Miller**

¹³² *See supra* Part III.

¹³³ *See supra* notes 63-65 and accompanying text.

¹³⁴ *See supra* note 40 and accompanying text.

* J.D. Candidate, Marshall-Wythe School of Law at the College of William & Mary.