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To Fraud or Not to Fraud, That Is the Question

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In 2013, the U.S. Supreme Court resolved a circuit split regarding whether the dischargeability exception set forth in § 523(a)(4) requires any level of intent or *scienter*, and if so, to what scale. In *Bullock v. BankChampaign NA*, the Supreme Court held that when a fiduciary's conduct "does not involve bad faith, moral turpitude, or other immoral conduct," defalcation still requires "an intentional wrong."[2] Defalcation requires "a culpable state-of-mind requirement, "and one that involves "knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."[3]

In early 2017, the U.S. Bankruptcy Court for the District of Massachusetts issued a lengthy opinion regarding this standard. Post-*Bullock*, courts have analyzed various subjective and objective elements to apply the *Bullock* test to determine whether the nondischargeability standard was met. This article vets the opposing views regarding whether the "reckless" standard is, in fact, the appropriate standard.

It is a basic tenet of American jurisprudence that Congress enacts the law and that the judiciary interprets the law. The rules of statutory interpretation dictate, *inter alia*, that (1) an interpretation must not render another statutory provision superfluous[4] and (2) the specific overrides the general.[5] With these concepts in mind, it is clear that the Supreme Court correctly interpreted § 523(a)(4) when rendering its decision in *Bullock v. BankChampaign NA*.[6]

Relying largely on the precedent set in *Bullock*, Hon. **Frank J. Bailey** correctly held in *Benjamin H. Whittaker III, et al. v. James B. Whittaker (In re James B. Whittaker)*[7] that § 523(a)(4) does not require the same level of culpability for defalcation as embezzlement, larceny and actual fraud. To do so would render other subsections of § 523(a) superfluous and ignore the specificity utilized by Congress in drafting the phrase "fraud or defalcation in a fiduciary capacity."

The Supreme Court in *Bullock* recognized that the Model Penal Code requires an intentional wrong to provide defalcation. The Court then properly applied the canons of statutory interpretation to conclude that reckless conduct may give rise to defalcation in a fiduciary capacity. Specifically, the Supreme Court held:

> Where the conduct at issue does not involve bad faith, moral turpitude or other immoral conduct, [defalcation] requires an intentional wrong. 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 Modal Penal Code. 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.[8]

Although "fraud or defalcation while acting in a fiduciary capacity" precedes embezzlement and larceny in § 523(a)(4), to impute a specific intent requirement would render other portions

1 With contributions from Daniel R. Schimizzi, an associate with Bernstein-Burkley, PC.
2 133 S.Ct. 1754.
3 *Id.* at 1757.
4 *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, 566 U.S. 639, 645, 132 S. Ct. 2065, 2070-71 (2012) (citing *Kawaauhau v. Geiger*, 523 U.S. 57, 62, 118 S. Ct. 974, 140 L. Ed. 2d 90 (1998), for its proposition that the Supreme Court is hesitant to adopt an interpretation of a congressional enactment that renders superfluous another portion of the same law).
5 *Hamilton v. Lanning*, 560 U.S. 505, 518, 130 S. Ct. 2464, 2474 (2010) (discussing canon of statutory interpretation that specific governs general) (other citations omitted).
6 569 U.S. 267, 133 S. Ct. 1754 (2013) ("*Bullock*").
7 Doc. No. 132 Adv. Pro. No. 14-1017, Bankr. No. 13-15310 (Bankr. D. Mass. Jan. 17, 2017).
8 *Bullock*, 133 S. Ct. at 1759.

of § 523 — namely, § 523(a)(2)(A) — superfluous. Section 523(a)(2)(A) includes "actual fraud" as one of the grounds for declaring a debt nondischargeable. For a debt resulting from actual fraud to be nondischargeable, the underlying conduct must involve moral turpitude or an intentional wrong,[9] which is why most courts have refused to recognize constructive fraud as a ground for denying discharge of a debt.

If Congress had intended for the same level of culpability for actual fraud to apply to fraud or defalcation while acting in a fiduciary capacity, why would it have drafted both §§ 523(a)(2)(A) and 523(a)(4)? The simple answer is that it would not have because both sections would lead to the same end: The actor must have the specific intent to defraud a creditor, whether or not the actor was in a fiduciary relationship with the creditor. Imputing the same culpability requirement for actual fraud and fraud or defalcation ignores the qualification in § 523(a)(4), which is that the fraud or defalcation must occur "while acting in a fiduciary capacity."

A fiduciary is 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 another the duties of good faith, trust, confidence and candor.[10] Fiduciaries are often vested with broad powers and entrusted to make sound decisions that will benefit the constituents. It is clear that Congress intended to hold fiduciaries to a higher standard because of this special status. It would be nonsensical for Congress to have intended the phrase "fraud or defalcation" to require the same culpability as actual fraud. This would be akin to suggesting that a surgeon who recklessly injures a patient while attempting to perform a complex surgery while impaired is not responsible for the injury, because the surgeon never intended to injure the patient. Since debts incurred through larceny or embezzlement (*i.e.*, actual fraud) are nondischargeable regardless of whether a fiduciary relationship existed, it would serve no real purpose for Congress to require the same culpability requirement in § 523(a)(4).

When reading § 523 in its entirety, it is readily apparent that Congress did not intend for the same level of culpability to apply for §§ 523(a)(2)(A) and 523(a)(4). Had that been its intent, Congress would not have separated "actual fraud" in § 523(a)(2)(A) from "fraud or defalcation while acting in a fiduciary capacity" in § 523(a)(4). These are the exact reasons why the Supreme Court and Judge Bailey got it right when rendering their decisions in *Bullock* and *Whittaker, et al. v. Whittaker*, respectively, and other courts should follow suit when faced with similar facts. abi

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9 *Husky Int'l Elecs. Inc. v. Ritz*, 136 S. Ct. 1581, 1586 (2016) (citation omitted).
10 *See Black's Law Dictionary* 524 (8th ed. abridged 2005).