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IN THE SUPREME COURT OF THE UNITED STATES

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RANDY CURTIS BULLOCK, :

Petitioner : No. 11-1518

v. :

BANK CHAMPAIGN, N.A. :

- - - - - x

Washington, D.C.

Monday, March 18, 2013

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:10 a.m.

APPEARANCES:

THOMAS M. BYRNE, ESQ., Atlanta, Georgia; on behalf of Petitioner.

BILL D. BENSINGER, ESQ., Birmingham, Alabama; on behalf of Respondent.

CURTIS E. GANNON, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; for United States, as amicus curiae, supporting Respondent.

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P R O C E E D I N G S

(11:10 a.m.)

CHIEF JUSTICE ROBERTS: We'll hear argument next in case 11-1518, Bullock v. Bank Champaign.

Mr. Byrne?

ORAL ARGUMENT OF THOMAS M. BYRNE

ON BEHALF OF THE PETITIONER

MR. BYRNE: Mr. Chief Justice, and may it please the Court:

This case presents one of the most confounding questions of bankruptcy law, and that is the meaning of defalcation, which is found currently in Section 523(a)(4) of the Code. It is an undefined term in a Bankruptcy Code with more than 100 defined terms and it has been in the Bankruptcy Code -- Bankruptcy Act, excuse me, since 1841 and in every version of it since then. There is no plain contemporary, ordinary meaning that we can resort to, with respect to interpretation of the word because it is not in common use.

This case presents both the question of the action required to establish defalcation and the mental state that most -- that must accompany it. And on the mental state issue, the circuits have split in probably three ways, at least.

1 The Eleventh Circuit here held that
2 Petitioner committed defalcation by acting recklessly
3 and affirmed on summary judgment -- a summary judgment
4 order that was granted for the petitioning creditor.

5 JUSTICE ALITO: Well, before we get to the
6 various candidates for applicable mental state, if there
7 is one, could you tell me what this mental state applies
8 to? Does it apply to facts or does it apply to law?

9 MR. BYRNE: Your Honor, it should apply to
10 both, but it applies -- the act must be accompanied by a
11 culpable mental state. We will argue that -- and have
12 argued that mistake of law can be relevant to the
13 knowledge that the actor has when he commits the act,
14 and we have argued that in this particular circumstance
15 particularly involving dischargeability, that a mistake
16 of law ought to be permissible in responding to the
17 claim of defalcation.

18 JUSTICE GINSBURG: Well, what we have here
19 is, I think everybody agrees, that these transactions
20 were not authorized and they were self-dealing to the
21 extent that there was a benefit to Mr. Bullock from the
22 investments that were made. So what, in addition to
23 being unauthorized and self-dealing, which the
24 government tells us should be enough to make
25 defalcation, what else other than that it was not

1 authorized and it was self-dealing?

2 MR. BYRNE: Your Honor, we believe that a
3 showing of extreme recklessness at least is required as
4 to the self-dealing, and so we have advocated for the
5 First and Second Circuit standard, which requires either
6 extreme recklessness or conscious misbehavior by the
7 actor.

8 JUSTICE GINSBURG: But is a trustee who is
9 taking -- borrowing against the cash value of the life
10 insurance making an investment for the benefit of
11 himself and his mother getting profit from that
12 investment and not sharing it with the other siblings
13 who are also. So what more than -- I mean, he did that
14 all advertently.

15 MR. BYRNE: Well, Your Honor, let me go back
16 to the question, first were -- were the loans
17 authorized. Now, this case -- the finding of
18 defalcation here is based entirely on the two Illinois
19 court orders in collateral estoppel. And the Illinois
20 courts specifically reserved the question of whether the
21 loans were authorized. But let me put that aside,
22 please, and answer your second question.

23 And what -- what sets this case apart and
24 what -- what at least creates a factual question on
25 whether Mr. Bullock committed defalcation was what was

1 his -- what was the overall transaction. This is a
2 family trust, it was created by his father, involving
3 his father's life insurance policy. There is
4 uncontradicted evidence that he did not know that making
5 a loan to his mother at his father's request would
6 somehow run afoul of the law more than a decade later
7 when this all came -- when this all came to court.

8 So we say, Your Honor, that there is at
9 least a factual question that would have entitled him --
10 should have entitled him to a trial on the question of
11 the mental state that accompanied his actions.

12 JUSTICE GINSBURG: But what about the two
13 other transactions which were not done at the bidding of
14 the father?

15 MR. BYRNE: Well, Your Honor, they were done
16 at the bidding of the mother and also they were -- they
17 went into the family business. These are two loans that
18 went into the business created by the father and the
19 mother, the garage building business. That's where the
20 proceeds went. And so it would have been a surprise, we
21 say, to the average person to learn that there was a
22 legal problem with those loans.

23 CHIEF JUSTICE ROBERTS: Well, I mean, it's
24 often the case that -- that children don't want to go
25 into the family business and it's often the case that

1 some of them do and some of them don't and the idea that
2 one of the children who wants to put the money back in
3 the family business is -- you know, you wouldn't think
4 that was wrong when the other children want to take the
5 money out or put it somewhere else. That's not at all
6 unusual.

7 MR. BYRNE: Well, it's not unusual to have
8 some sort of conflict about that, Your Honor. But the
9 record is very limited in this case as to what the
10 preferences of the others were. It is -- it seems clear
11 that --

12 JUSTICE SOTOMAYOR: Their preference is that
13 they wanted a piece of the action. They still do. They
14 want the profits from that investment. Whether they're
15 entitled to it is a different issue, but --

16 MR. BYRNE: That -- that position seems
17 clear now, Your Honor, that -- that background, these
18 loans were made, please, recall, in the '80s.

19 JUSTICE KENNEDY: I -- I assume the other
20 children did not have an interest in the business, but
21 just the trustee and the mother did. Or is that clear
22 from the record.

23 MR. BYRNE: That is not clear from the
24 record, Your Honor. I think I know the answer to that
25 question, but it is not in the record in the case, so --

1 JUSTICE BREYER: Could -- could you go back,
2 please, to Justice Alito's question? I -- I don't
3 understand the answer to that. That is, I don't
4 understand, and it's just something I don't understand.
5 I'm not saying it facetiously. I don't understand the
6 relationship of mental state to the issue.

7 I mean, I didn't think there is any doubt
8 here that the individual, your client, knew what he was
9 doing. He knew for a fact that he was taking money from
10 the trust. He knew he was giving it to his mother. And
11 he knows where it's going. And he knows it was later
12 paid back with 6 percent interest. So you don't have to
13 assume extreme recklessness. He knew it.

14 Now, what he didn't know was that that was
15 unlawful. And therefore, if I look at the accompanying
16 things, embezzlement, larceny, fraud in the trust, I
17 don't think any of them require a knowledge that what
18 you're doing is unlawful.

19 So if I -- or do they? I don't think -- you
20 can be convicted of embezzlement while misunderstanding
21 the law of embezzlement.

22 You can be convicted of larceny, it's
23 saying. And as far as I know, a person to commit fraud
24 lies, knows it's material, knows, et cetera, but he
25 doesn't have to know there's a law against it. And --

1 and so -- if I do what Justice Harlan was doing and
2 comparing it to the other three, it looks as if you
3 don't need to know that what you're doing is against the
4 law, where you commit defalcation.

5 Now, that I think is what Justice Alito was
6 driving at. And I'd like to hear an absolutely clear
7 answer on that.

8 MR. BYRNE: Your Honor, let me -- let me
9 try -- let me try to give such an answer. The first,
10 with respect to larceny, embezzlement and fraud, a
11 mistake of law is admissible where it negates the
12 scienter or the mental state.

13 JUSTICE BREYER: But I didn't think there's
14 any respect here in which missing -- mistake of law,
15 would negate the mental state as to having taken money
16 from the trust, used it in the family business and then
17 paid it back, which I take it are, we assume, which is a
18 different question I have, but for present purposes, we
19 are assuming that that's sufficient for defalcation.

20 Is that right? Where is it and where does
21 it negative the intent in respect to what happened?

22 MR. BYRNE: Well, Your Honor, the knowledge
23 of the law, knowledge of wrongdoing I think is what --
24 what you're asking, where does that come into this? And
25 it comes into the question A, if you didn't have it; and

1 B, the question becomes was it extremely reckless under
2 the scienter standard that the First and Second
3 Circuits -- the First and Second Circuits follow --

4 JUSTICE BREYER: No, it had nothing to do
5 with recklessness. He did these three things knowingly.
6 That is a stronger mental state than recklessness, not a
7 weaker one.

8 MR. BYRNE: Well, Your Honor, but he did it
9 without knowing that they --

10 JUSTICE BREYER: Were unlawful. So we're
11 back at the same question, and I'm now assuming you have
12 no answer to the question because there is none.

13 MR. BYRNE: Well, Your Honor, the -- in many
14 instances, not many, but in some instances, the Court
15 has held that not knowing that a practice is unlawful is
16 a defense to a charge of the crime.

17 JUSTICE SOTOMAYOR: My problem is the
18 following, which is let's assume he had taken the money
19 and lost it and he never repaid it. What does it matter
20 whether he thought he could take the money or not? I
21 thought the very basic definition of defalcation in
22 every dictionary of the time and forever, one of the
23 three definitions has always been that you cause a loss
24 to the -- to the trust. Why does mental state matter at
25 all, is my bottom line?

1 I think that your stronger argument is that
2 loss to the estate, or the one that you have to -- can
3 direct your attention to, is what is the loss to the
4 trust? But what does it matter whether I intended to
5 lose it or not if I wasn't entitled to lose it?

6 MR. BYRNE: Well, Your Honor, the question
7 would be whether or not on the mental state and then
8 I'll get to the actus reus element of this quickly, but
9 as to the mental state, if the mental state is not
10 culpable, then it seems entirely inconsistent --

11 JUSTICE SOTOMAYOR: Well, that's Justice
12 Breyer's point, which is if you took the money and lost
13 it, what does it matter? You took it. Unless -- unless
14 you were drugged and didn't know that you were taking
15 the money and somebody else forced you to in some --
16 under some sort of duress defense, some outrageous
17 question, isn't the issue the one that Justice Breyer
18 came to? If you're a fiduciary, why should an excuse of
19 ignorance of the law ever save you when you are required
20 to exercise the highest protection of the trust?

21 MR. BYRNE: Well, Your Honor, of course, it
22 does not save you from liability. Our issue here is
23 dischargeability, which is a --

24 JUSTICE SOTOMAYOR: Why should you be
25 discharged if you took -- if you knowingly did an act,

1 the actus reus --

2 MR. BYRNE: Because --

3 JUSTICE SOTOMAYOR: -- with its concomitant
4 mental state. You intended to take the money.

5 MR. BYRNE: Well, Your Honor, because for
6 dischargeability purposes, because of Gleason v. Thaw,
7 and the rule that -- that bankruptcy discharge
8 exceptions are confined to those plainly expressed
9 doubts are resolved in favor of the debtor. And if you
10 look at the other requirements for exceptions to
11 discharge in Section 523(a) you see a high level of
12 culpable conduct. For example, in Geiger the Court held
13 that reckless torts do not amount --

14 JUSTICE BREYER: Yes, but you see -- should
15 I have to write the opinion in this case, I would have
16 to deal with this issue and I'd have to say something
17 about it. And as soon as I look at the other words,
18 those are words like "embezzlement," "larceny," and
19 "fraud." Now, elsewhere in the U.S. Code where those
20 are crimes ignorance of the law is not an excuse. It
21 often is an excuse where in fact it's a tax violation or
22 some other technical violation.

23 So I would have to explain why the word
24 "defalcation" when linked to those three is being
25 treated differently. Or I'd have to say Congress used

1 words which never have ignorance of the law as an excuse
2 and meant them differently. Each of those is pretty
3 hard to say.

4 MR. BYRNE: Well, Your Honor, you're
5 alluding to Cheek v. United States and Rasco v. United
6 States, cases in which ignorance of the law, as an
7 exception to the general rule, was found to be a defense
8 in those cases. And what you had in those cases was a
9 complex legal regime. You had the tax laws and then you
10 had the -- anti-structuring statute.

11 And here, we say that trust law in and of
12 itself is a complex enough legal regime that a mistake
13 of law at least ought to be admissible, not for
14 liability, but for establishing bankruptcy --

15 JUSTICE BREYER: I have one other question
16 on a different subject that may be more helpful to you
17 or not. I think of defalcation as the individual who
18 has defalcated shows up in Rio with two suitcases full
19 of money, and it seems to me if you look at the root of
20 the word, it consists of diminishing, taking a sickle
21 and cutting something down, and therefore it did seem to
22 refer to an instance where you take the corpus or money
23 belonging to the trust, now it becomes ambiguous, and
24 you run off with it.

25 Is there anything you would like to say

1 about that?

2 MR. BYRNE: Yes, Your Honor. I would like
3 to say that defalcation requires a shortage in accounts
4 at the end of the day. And so there must be -- in the
5 trust, there must be some res missing when the trustee
6 is called to account.

7 CHIEF JUSTICE ROBERTS: But there is a
8 shortage of accounts at the end of the day. It's just a
9 question of what day it is. When he takes -- takes the
10 stuff and it's a lost -- it's either viewed as a lost
11 opportunity or an increase in the risk to the
12 beneficiary, and that's a loss to them at that point.
13 The fact -- it's like a bank robber giving back the
14 money. There is no loss to the bank, but it's still
15 crime.

16 MR. BYRNE: Well, Your Honor, the deletion
17 of the word "misappropriation" in 1978 from the
18 Bankruptcy Code by Congress suggests that
19 misappropriations that are on an interim basis that
20 cause -- that do not cause a loss to the trust and
21 are -- are never accounted for is not the kind of action
22 or act that should result in an exception to discharge.

23 But if you look with respect to defalcation
24 at the definitions at the time, the definitions that
25 were available in 1841 as I believe Justice Breyer has

1 done, the -- the definitions you get are, for example in
2 Webster's 1828 dictionary, the act of cutting off or
3 deducting a part.

4 And the origin of the defalcation exception,
5 and I believe the amici for Respondent are correct in
6 this respect, was the Swartwout scandal in 1838, when
7 one Samuel Swartwout, who was the -- in charge of
8 collections for the New York Customs House, which was a
9 substantial part of the Federal budget at that time, was
10 found after he departed the country to have \$1.2 million
11 missing from his accounts. And that was referred to as
12 a defalcation at the time and it's quite reasonable to
13 assume that's how it ended up in the statute.

14 So the loss of res there -- the loss of
15 funds to which the fiduciary is responsible for
16 collecting at the time of -- that he turns over his
17 office because this really originated with public
18 officials, is the relevant time.

19 JUSTICE KAGAN: But I guess the question is
20 how do you measure this loss? I mean, if you take money
21 away and then you give it back, or even if you give it
22 back with 2 percent interest or something, I mean, maybe
23 if that money had remained in the trust and I realize
24 that this is a strange trust, but we have to think about
25 other kinds of trusts, if that money had remained in the

1 trust, there would have been a profit to be made from
2 that money.

3 And -- you know, it's not -- if you say,
4 well, I gave it back, well, yes, but if you had just
5 left it there, you would have had that money plus all
6 the money that that money earned.

7 MR. BYRNE: Correct, Justice Kagan. But
8 here, there was never any money taken from the trust
9 that didn't wind up with the trust at the end of the
10 day. The evidence is that the net policy value on the
11 day Mr. Bullock unwittingly became a trustee in 1978 was
12 the same as when he, at the end of his tenure --

13 JUSTICE GINSBURG: But what -- what about
14 the profit from the transactions, the profit that he
15 made? Yes, he paid back everything with interest, but
16 in addition to that, according to the Illinois court
17 judgment, there was a profit that he made that he didn't
18 put back in the trust -- he didn't put in the trust.

19 MR. BYRNE: He was -- he was charged with
20 having profited with respect to one or more of the
21 loans, Your Honor.

22 JUSTICE SCALIA: A quarter of a million
23 dollars in loans.

24 MR. BYRNE: That's correct, Your Honor.

25 JUSTICE SCALIA: And that did not go back

1 into the trust.

2 MR. BYRNE: It did not.

3 JUSTICE SCALIA: As it should. Doesn't the
4 trustee have to disgorge whatever he makes by improper
5 use of the trust funds?

6 MR. BYRNE: He -- he does for liability
7 purposes, of course, Justice Scalia. But here the
8 question is whether there is a bankruptcy defalcation.
9 And that's a question of Federal law.

10 JUSTICE GINSBURG: May I ask you question
11 that is not a technical bankruptcy question, but he --
12 the objective of filing for bankruptcy was to get rid of
13 this judgment debt, this Illinois judgment debt, right?

14 MR. BYRNE: Yes, Your Honor.

15 JUSTICE GINSBURG: And the Eleventh Circuit
16 said -- you know, we're really sympathetic to that, but
17 the problem is that the bank would not let you sell the
18 collateral. If you could sell the collateral, then you
19 could pay off the loan and you wouldn't need to declare
20 bankruptcy.

21 Did you bring such a suit, the suit that
22 suggests that the bank was the culpable party here by
23 not letting you sell the property which would have
24 enabled you to pay the debt?

25 MR. BYRNE: That -- that action has not been

1 brought, Your Honor. And in that action, let's say it
2 were brought today, it could do nothing to relieve
3 Petitioner of the judgment of the Eleventh Circuit and
4 the lower courts here that he has a debt that is -- a
5 substantial debt that is excepted from discharge. He
6 could continue litigating perhaps if he has the
7 resources in -- in Illinois for many more years perhaps,
8 but --

9 JUSTICE SOTOMAYOR: Counsel, give me your
10 best answer to the rule that we should write, okay?
11 Forgetting that I don't accept that you need a mental
12 state, okay? Let's go to just the loss issue.

13 If I agree with you that you need to prove
14 the loss, this is a very unusual trust because the
15 measure of what the trust's res should be is fixed. It
16 was the amount of the trust plus the fixed interest,
17 essentially. This is a very unusual trust. In the
18 norm, the trust just says to the trustee invest
19 prudently. And the trustee self-deals by taking the res
20 out, puts the investment in his or her own name and
21 takes the profit.

22 In that situation, how would you measure the
23 loss? In the normal self-dealing where the trustee just
24 has to invest prudently and is depriving the trust of
25 that investment value, would you say in that situation

1 that the loss is measured by the lost opportunity?

2 MR. BYRNE: Your Honor --

3 JUSTICE SOTOMAYOR: Because there is a
4 difference between what the trust loses and the gain
5 that the trustee makes, which under normal trust
6 principles the gain has to be disgorged.

7 Are you separating out those two things and
8 how are you separating them out and how would I -- how
9 would we write -- the Court write this opinion to give
10 loss meaning? What's the -- what's the meaning you want
11 to give it?

12 MR. BYRNE: Your Honor, the -- the loss to
13 the trust should be measured by the economic loss to the
14 trust between points A and point B. And -- and it's --
15 it's as simple as that, and of course here there wasn't
16 loss to the trust. As you point out, it's an unusual
17 situation perhaps, but of course life insurance trusts
18 and other kinds of trusts that present this situation
19 are --

20 JUSTICE SOTOMAYOR: So under your theory,
21 the profit to the trustee is never a measurement.

22 MR. BYRNE: The profit to the trustee would
23 not come into play. It could come into play for fraud.
24 It could come into play for embezzlement. It could come
25 into play if the mental state that we argue for is

1 otherwise met.

2 JUSTICE SOTOMAYOR: Assume that that is
3 distasteful because for all the reasons the government
4 argues in its amicus brief, the idea that a trustee
5 could self-deal is the height of a breach of fiduciary
6 duty.

7 So give me something that -- that would win
8 your case without upsetting the fact that defalcation
9 somehow should, in the norm, include something as
10 egregious as self-dealing. You don't think your guy did
11 because he didn't know, but let's assume the worst case,
12 the guy knew.

13 MR. BYRNE: Well, for the -- for that worst
14 case, Your Honor, there is embezzlement in the statute.
15 So if a -- if someone comes into possession of property
16 and misuses it and does so with fraudulent intent, it
17 sounds like here, then there is a -- then embezzlement
18 can be established under the statute.

19 JUSTICE GINSBURG: Mr. Byrne, I -- I wasn't
20 finished asking you about the background of this. It --
21 it seems the simplest thing, if the bank is the culprit,
22 then why not go after the bank and then get the money
23 which would make the Chapter 7 unnecessary?

24 MR. BYRNE: Your Honor, there is a good bit
25 not in the record on that, and I presume you want me to

1 stick to the record in responding and there is no real
2 explanation for that. There is in the record a
3 consistent track of Petitioner trying to get the bank to
4 sell the collateral in order to pay the debt off over
5 time and with an urgency to it because the collateral
6 was deteriorating in value. But beyond that, there's
7 not anything else in the record about the practicality
8 or availability of the remedies in the Illinois court.

9 JUSTICE GINSBURG: But it was what the
10 Eleventh Circuit thought was a solution to this problem.

11 MR. BYRNE: It was, Your Honor.

12 JUSTICE GINSBURG: And were they wrong in --

13 MR. BYRNE: As a practical matter, Your
14 Honor, yes, and also as a legal matter because the
15 Illinois courts cannot set aside the order here
16 excepting the debt from discharge.

17 The only -- the only agenda potentially left
18 for Petitioner would be litigation in the -- in the
19 Illinois courts against the trustee to create some sort
20 of a judgment that might be used in some way to
21 ameliorate the effect of the bankruptcy court's
22 judgment, but he still has -- basically, he's been
23 consigned to permanent insolvency the way that this
24 judgment now sits.

25 JUSTICE KENNEDY: The briefs -- the briefs

1 on your side of the case say, well -- you know, there is
2 a series of words here: Fraud, defalcation,
3 embezzlement, larceny.

4 But really, fraud and defalcation are
5 defined in a further way where embezzlement and larceny
6 are not. Fraud and defalcation, while acting in a
7 fiduciary capacity, then embezzlement and larceny.

8 So I'm not quite sure it's there to say that
9 all four words must be consulted for the use of
10 generous because fraud and defalcation are qualified by
11 "in a fiduciary capacity" and then a comma.

12 MR. BYRNE: Well, that is correct, Your
13 Honor, that -- that that's the way that this particular
14 version of the Bankruptcy Act is set up.

15 In the past however, in Neal v. Clark, in an
16 important decision by this Court in 1878, the Court held
17 that fraud should be construed to require fraud with
18 moral turpitude because of the presence of embezzlement
19 in the 18 --

20 JUSTICE KENNEDY: Yes. In that respect, I
21 think the word "fraud" gives you some assistance in
22 arguing your case.

23 MR. BYRNE: Thank you, Your Honor. Unless
24 there are further questions, I'll reserve the remainder
25 of my time for rebuttal.

1 CHIEF JUSTICE ROBERTS: Thank you, counsel.
2 Mr. Bensinger?

3 ORAL ARGUMENT OF BILL D. BENSINGER

4 ON BEHALF OF THE RESPONDENT

5 MR. BENSINGER: Mr. Chief Justice, and may
6 it please the Court:

7 The Petitioner's act of self-dealing was a
8 reckless breach of his fiduciary duty of loyalty and was
9 therefore a defalcation.

10 JUSTICE KENNEDY: Was there a finding of
11 recklessness in the State court?

12 MR. BENSINGER: No, Your Honor. There was
13 not a finding of recklessness. The State court simply
14 found that the debtor engaged in self-dealing. That he
15 used trust assets for his own purposes and, thereby,
16 created a split, a conflict of interest between his
17 interest and the interest of the trust.

18 The moment that he made those loans, there
19 is an absolute certainty that there would be a conflict
20 of interest and a reasonable person -- a reasonable
21 trustee in the Petitioner's position would not have made
22 those loans because the risk was so high, nigh on an
23 absolute certainly, that there would be this conflict of
24 interest, and that has been the harm incurred at the
25 moment he made the loans, Your Honor.

1 JUSTICE KENNEDY: Is the crime of
2 embezzlement proven if you show recklessness? Or do you
3 need a further criminal intent?

4 MR. BENSINGER: Generally speaking, Your
5 Honor, embezzlement does require some sort of specific
6 mental intent, an intent to deceive or to defraud. But
7 defalcation does not require that same mental intent and
8 that's borne out by the history.

9 JUSTICE KENNEDY: Well, of course, that's
10 one of the things we are arguing about here. I don't
11 think that's conceded.

12 MR. BENSINGER: No, Your Honor, it's
13 certainly not conceded, but it's borne out in the
14 history of the Bankruptcy Act. Defalcation was first
15 added to the Bankruptcy Act in 1841 and it was simply an
16 exception to discharge for defalcation. There was no
17 mention of fraud, there was no mention of embezzlement,
18 there was no mention of larceny. It wasn't until 1867
19 that Congress, in the Bankruptcy Act of 1867, that
20 Congress added an exception to discharge for
21 embezzlement and for fraud.

22 JUSTICE ALITO: You think recklessness is
23 required?

24 MR. BENSINGER: I'm sorry, Your Honor?

25 JUSTICE ALITO: You think recklessness is

1 required?

2 MR. BENSINGER: Yes, Your Honor.

3 Recklessness is required as to the objective act.

4 JUSTICE ALITO: Recklessness as to the law,
5 as to what the law requires of the trustee.

6 MR. BENSINGER: Recklessness as to the law,
7 correct, Your Honor, but also as to the act. This was a
8 reckless act.

9 JUSTICE BREYER: Oh, yes. Wait, wait. You
10 say -- you mean either, both? I mean, there is no doubt
11 here, I agree with you, as far as the act is concerned.
12 It wasn't just reckless, it was intentional. So you
13 don't have to worry about that one.

14 Thus Justice Kennedy's basic question I'd
15 like to hear your answer to. I thought it might have
16 come from the other side, but you -- you concede, I take
17 it, that there has to be an element in which the person
18 not only knows what he has done, but that he does it
19 with an element of moral turpitude; i.e. he knows that
20 the law forbids it or -- or are you conceding this and
21 then fill in the blanks, or?

22 MR. BENSINGER: No, Your Honor, and I
23 apologize if I misspoke. All that is required is an
24 intent to do the act and that's what --

25 JUSTICE BREYER: All right. Then if that's

1 your position, what do you say to what Justice Kennedy
2 said, add in Justice Harlan's comment that embezzlement
3 and larceny are set off. These two concern fraud and
4 defalcation in respect to the trust. There is a case of
5 this Court that says fraud in respect to the trust
6 requires an element of moral turpitude.

7 That suggests a knowledge that what you are
8 doing violates the law. And if we read in pari materia,
9 we get the same kind of requirement for this, indeed
10 more so. Indeed, you just conceded it existed even in
11 respect to embezzlement, which is outside the
12 parenthesis.

13 MR. BENSINGER: Your Honor, fraud, like
14 embezzlement, does require a specific mental intent, but
15 defalcation does not. Defalcation --

16 JUSTICE BREYER: Why? Defalcation on your
17 definition would seem to be more likely to be thought
18 innocent by someone who commits it in some circumstances
19 than would fraud.

20 MR. BENSINGER: Your Honor, defalcation must
21 mean something other than fraud. The statute says
22 that --

23 JUSTICE BREYER: No. It may mean, for
24 example here, fine, okay, no fraud, but what you did was
25 you took some money that belonged to the trust given by

1 your father to help your mother. And your mother says,
2 help me, and the brothers and sisters will benefit well
3 too. And so you go to your insurance guy and he says,
4 sure, no problem. And then, lo and behold, they did it.
5 I mean, innocence just radiates from what the conduct
6 was as described.

7 (Laughter.)

8 MR. BENSINGER: When it's described like
9 that, maybe, Your Honor.

10 (Laughter.)

11 MR. BENSINGER: However, it was still a
12 reckless act, Your Honor, in that a reasonable
13 trustee --

14 JUSTICE SCALIA: I don't understand. Where
15 does this reckless act come from? Where do you get
16 reckless act out of either fraud or defalcation?

17 MR. BENSINGER: Your Honor, the courts have
18 traditionally ascribed -- most courts have said that
19 defalcation does require some form of reckless --

20 JUSTICE SCALIA: Perhaps so. Where did they
21 get it from?

22 (Laughter.)

23 MR. BENSINGER: Your Honor, that's the
24 genesis of this case.

25 JUSTICE SOTOMAYOR: What does it matter if

1 the money is missing? What does it matter the reason
2 why in terms of recklessness or intent? You took the
3 money. Justice Breyer and I both agree you intended to
4 take the money. So why are you adopting the need for
5 recklessness, unless you're trying to avoid the second
6 component that the other side's talking about, which is
7 that you caused a loss to the trust? Because that's
8 where you have a problem here, where you have a problem
9 because there really is no loss to the trust in a
10 traditional sense.

11 MR. BENSINGER: Possibly in the traditional
12 sense there might not have been a loss, but there was a
13 loss in the context of trust law, Your Honor. The
14 Petitioner in this case used trust funds for his own
15 benefit.

16 JUSTICE SOTOMAYOR: Well, the problem is
17 that, yes, there was a breach of the trust. But in
18 terms of the terms of the trust, the trust got every
19 penny that it would have earned if the money had not
20 been taken. It got the trust plus the fixed 6 percent
21 that the trust was entitled to. So it suffered no loss
22 in its traditional sense.

23 MR. BENSINGER: Maybe not in the traditional
24 sense, but in the context of a fiduciary obligation a
25 trustee is not allowed to benefit from his position as

1 trustee.

2 JUSTICE SCALIA: Well, the -- why are you
3 giving away that it's not in the traditional sense? I
4 think it's a loss in the traditional sense. The trust
5 was entitled to whatever profit was made from the use of
6 its funds, right?

7 MR. BENSINGER: Correct, Your Honor.

8 JUSTICE SCALIA: And he made a quarter
9 million dollars that should have belonged to the trust.
10 It's not enough to say, well -- you know, I'll pay you 2
11 percent interest or whatever the going rate of interest
12 was. He made \$250,000 which should have been given to
13 the trust.

14 MR. BENSINGER: That's correct, Your Honor.
15 And that is what the Illinois State court found, and
16 that is borne out also by the other exceptions to
17 discharge in Section 523(a)(4). If a fraudster commits
18 fraud, he doesn't just remedy that by paying back what
19 he took. He has to return all of the profits that he
20 has obtained.

21 JUSTICE ALITO: But the question here -- the
22 question here is not whether the trustee is liable.
23 Yes, the trustee is liable. The question is whether
24 it's dischargeable.

25 MR. BENSINGER: Correct, Your Honor.

1 JUSTICE ALITO: And if you look at the
2 other, the other words in this list, fraud,
3 embezzlement, larceny, those are -- those are bad acts.
4 There is a degree of moral culpability involved and
5 maybe there are people who commit fraud, embezzlement
6 and larceny and don't realize that it's illegal, but
7 there are not many. It's commonly understood that those
8 are bad.

9 So in a very impressionistic sense, there is
10 a difference between that and the kind of conduct that's
11 presented to us here. But you think that's irrelevant.

12 MR BENSINGER: It is irrelevant, Your Honor,
13 because a reasonable trustee would not act this way. A
14 reasonable trustee would know that the moment he makes
15 loans to himself he has created a conflict of interest
16 between himself and his trust.

17 JUSTICE ALITO: Well, what about a
18 reasonable trustee who just invests very imprudently, an
19 unreasonable trustee who invests very imprudently? Any
20 reasonable trustee would realize that investing
21 in -- you know, the widget factory totally unrelated to
22 him is a really bad idea and money is lost there.

23 What about that trustee? Is that a
24 defalcation.

25 MR. BENSINGER: If it's unreasonable, it

1 would be, Your Honor.

2 JUSTICE BREYER: Is it -- before we leave
3 this conduct, I mean, I understand I was painting you a
4 picture of they're being innocent. But we are in a
5 court that this Court has described as a court of equity
6 or akin thereto.

7 MR. BENSINGER: Yes, sir.

8 JUSTICE BREYER: One principle I used to
9 learn was he who has clean hands can come into equity,
10 but not anybody else.

11 Now, we have two lower courts that are
12 saying your client has pretty dirty hands or at least
13 they don't understand it. That this, the other client
14 tried to get him to sell the property, but they write
15 the properties are abandoned and uninsurable. Even
16 though Mr. Bullock produced a buyer, they won't sell it.
17 And so do you have clean hands? Not you yourself. You
18 didn't take the money and you do not have dirty hands,
19 all right?

20 But did your client here, does he lack clean
21 hands because two courts have said he should have just
22 sold his collateral and he would have gotten the money
23 and saved everybody a lot of trouble?

24 MR. BENSINGER: No, Your Honor.

25 JUSTICE BREYER: Because?

1 MR. BENSINGER: Because, first of all, the
2 bankruptcy court never made any specific finding of
3 facts. Those were allegations that were included in --
4 in the record of the district court --

5 JUSTICE BREYER: Did we remand it so they
6 could?

7 MR. BENSINGER: No, Your Honor, because the
8 Petitioner had every opportunity to bring those facts
9 into -- into evidence at the bankruptcy court and he did
10 not. There are facts outside the record as there are on
11 both sides with regard to this issue, why the trust
12 would not allow subsequent sales.

13 But it does go back to an important point,
14 and that's that the Petitioner did have, and retains
15 today, an opportunity to go back to State court and seek
16 a reduction in this judgment should he so desire.

17 A reduction in the judgment would reduce the
18 debt, and if there is no debt, then there is nothing for
19 the trust to collect subsequent to this discharge or
20 subsequent to the lack of discharge, as Respondent is
21 requesting.

22 JUSTICE GINSBURG: So there's nothing in the
23 record that shows why the bank refused to release any of
24 the collateral?

25 MR. BENSINGER: No, Your Honor, there is

1 not. That was not an issue that ultimately came before
2 the bankruptcy court. The bankruptcy court made no
3 finding of facts. There were only allegations on appeal
4 to the district court and to the Eleventh Circuit, Your
5 Honor.

6 However, to return back to the point
7 concerning that the required mental intent or the mens
8 rea, both in the petition and here this morning, the
9 Petitioner has not been able to articulate exactly what
10 mens rea is required, that is, what mental intent is
11 required. But the mental intent that he asked is that
12 it be something greater than extreme recklessness, in
13 effect.

14 However, that cannot work in the code
15 because it would make other code sections superfluous.
16 Specifically, if the mental intent required were an
17 intent to cause an injury, Section 523(a)(6) of the
18 Bankruptcy Code already accepts from discharge debts for
19 willful and malicious injury.

20 JUSTICE KENNEDY: Well, a number of
21 embezzlers -- not all of them -- many embezzlers fully
22 intend to pay everything back once things turn out all
23 right. But there's still an embezzlement. But there is
24 also a criminal intent at the time, or a wrongful
25 intent, even if -- even if you plan to pay it back.

1 And it -- it seems to me that you're
2 standing very firm on the fact that defalcation means
3 something different than fraud in the first clause, or
4 embezzlement and larceny in -- in the following clause.

5 MR. BENSINGER: It does, Your Honor.
6 Defalcation when it was first introduced into the
7 Bankruptcy Act of 1841 had a known meaning, and that
8 known meaning, at least according to the Oxford English
9 Dictionary, is a monetary deficiency through breach of
10 trust.

11 That was when the --

12 JUSTICE KENNEDY: And the problem is, as
13 the -- your friend on the other side points out, that
14 there's two problems with this. Number one, it's not
15 consistent with these -- with the meaning of the other
16 three terms in the -- in the statute; and two, it's not
17 consistent with the idea that discharges should be
18 freely given so that debtors can begin again.

19 MR. BENSINGER: But, Your Honor, the
20 subsequent inclusion of the terms fraud, embezzlement
21 and larceny cannot retroactively modify or change the
22 known definition of the word defalcation. This Court in
23 *Schwager v. Northern Burlington* considered two sections
24 of -- or two statutes in the Securities and Exchange
25 Act, Section 14(e) and Section 10(b). Section 10(b) was

1 the first enacted statute. Section 14(e) was
2 subsequently enacted.

3 Both statutes prohibited a manipulative type
4 of transaction with regard to securities. Section 14(e)
5 also prohibited a fraudulent act with regard to
6 securities. This Court stated in that case -- while it
7 wasn't central to its holding -- the Court did state
8 that the inclusion of the term "fraudulent" in Section
9 14(e) could not modify the understanding of the term
10 "manipulative."

11 And the same logic applies here. The
12 subsequent inclusion of the terms "fraudulent" and
13 "embezzlement" and "larceny" cannot modify the known
14 meaning, even if that known meaning has been lost, the
15 meaning of the word "defalcation."

16 JUSTICE KAGAN: Mr. Bensinger, if I heard
17 you correctly, you said that the definition was a
18 monetary deficiency arising from a breach of trust. Is
19 that -- does that mean that you're conceding that there
20 has to be a loss of monetary deficiency?

21 MR. BENSINGER: Your Honor, there was a
22 monetary deficiency in this case when the --

23 JUSTICE KAGAN: Whether there was or was not
24 in this case, but you're conceding that there has to be
25 a monetary deficiency according to the traditional

1 definitions.

2 MR. BENSINGER: Yes, Your Honor. For there
3 to be even a debt, which is what the Bankruptcy Code
4 discharges, there must be a monetary deficiency in this
5 case, or in the case of a defalcation.

6 And that is what this Court --

7 JUSTICE SOTOMAYOR: So are we fighting about
8 the meaning of loss? That's really the question.

9 MR. BENSINGER: I'm sorry, Your Honor?

10 JUSTICE SOTOMAYOR: Are we fighting about
11 what loss means?

12 MR. BENSINGER: Your Honor, that is
13 certainly an issue that the parties have contested in
14 the briefs before this Court and in the courts below,
15 whether there was a loss. And there was a loss. The
16 State court recognized that there was a loss in the
17 amount of \$250,000.

18 That judgment of \$250,000 creates a claim.
19 The Bankruptcy Code at Section 101-5 defines a claim as
20 a right to payment.

21 CHIEF JUSTICE ROBERTS: So if he made
22 nothing on the deal, and it just turns out he got
23 whatever the -- the trust was getting under its interest
24 rate and gave it back, there'd be no defalcation because
25 there'd be no loss in the sense of a lost opportunity?

1 MR. BENSINGER: There would be a
2 defalcation, Your Honor, but there would be no debt in
3 that case. And that -- there would be nothing --

4 CHIEF JUSTICE ROBERTS: I'm sorry. I
5 understood your answer to Justice Kagan to be that
6 you -- there must be a loss, right?

7 MR. BENSINGER: Your Honor, there -- there
8 needs to be a loss for there to be a debt.

9 CHIEF JUSTICE ROBERTS: Right. Does there
10 have to be a loss for there to be a defalcation?

11 MR. BENSINGER: No, Your Honor.
12 Inconsistent in that answer, I apologize. I did not
13 intend to be. There must be a loss for there to be a
14 debt. For there to be a defalcation, that merely goes
15 to the bad act. The act of, in this case, self-dealing.

16 CHIEF JUSTICE ROBERTS: So taking the money
17 out is sufficient for defalcation even if it's brought
18 back in full and even if there is no lost opportunity.

19 MR. BENSINGER: Correct, Your Honor.

20 JUSTICE SCALIA: That's not consistent with
21 the original meaning of defalcation to which you were
22 appealing. It's pretty clear to me that the original
23 meaning of -- is a cutting off, a failure to turn over
24 money that was due. So you -- are you appealing the
25 original meaning or not?

1 MR. BENSINGER: Your Honor --

2 JUSTICE SCALIA: You're saying defalcation
3 just means breach of trust. That's it.

4 MR. BENSINGER: No, Your Honor. We're
5 saying that in this case, the breach of trust, the
6 self-dealing, was that cutting off of the --

7 JUSTICE SCALIA: And that's what made it a
8 defalcation, no?

9 MR. BENSINGER: Correct, Your Honor.

10 JUSTICE SCALIA: Well, so then you say there
11 has to be a cutting off. There has to be a loss, for
12 defalcation. Not just for -- for a debt, but also for
13 the defalcation.

14 MR. BENSINGER: Your Honor, at that point,
15 there was a --

16 JUSTICE SCALIA: Why are you fighting that?
17 You're going to have to prove the loss anyway. You say
18 there is a loss.

19 MR. BENSINGER: Your Honor, the loss in that
20 case occurs -- Your Honor is absolutely right -- at the
21 time that there is that cutting off, at the time in this
22 case the Petitioner used the trust assets for his own
23 benefit.

24 JUSTICE BREYER: And then what's the loss?

25 I mean, let's assume the trust was worth \$1 million plus

1 6 percent, and every year, they have in their coffer \$1
2 million plus 6 percent.

3 MR. BENSINGER: Your Honor --

4 JUSTICE BREYER: The only part they don't
5 have is the extra money that the trustee made, that
6 there is no cutting down of the size of the trust. At
7 least that's an argument. Now, what's the answer?

8 MR. BENSINGER: Because, Your Honor, the
9 loss occurred. There was a loss in the amount of the
10 loans that he took out. And that loss was compounded,
11 if you will, Your Honor, by the Petitioner's failure to
12 return those -- the proceeds of those loans --

13 JUSTICE SOTOMAYOR: But he did. This is the
14 unusual part of this trust, which is that by the terms
15 of this trust, it was only going to grow at principal
16 plus a fixed interest. Most trusts are not written this
17 way.

18 This is the highly unusual trust, where it
19 never -- should have made more money because taking the
20 Chief Justice's hypothetical, which is he had invested
21 it and just gotten the interest due, why would there be
22 a defalcation?

23 What's the loss opportunity or the loss that
24 you would have suffered?

25 MR. BENSINGER: Your Honor, the loss that

1 the trust suffered was that its principal was taken
2 away, was it invested by the trustee for his own
3 benefit --

4 JUSTICE SOTOMAYOR: Yes. But let's assume a
5 different fact scenario, that he didn't make \$250,000,
6 that he happened to make just the amount of the interest
7 required, and he paid all of that back just as he did
8 here, what would have been the defalcation under the
9 Chief Justice's hypothetical?

10 MR. BENSINGER: The defalcation there, Your
11 Honor, would be that the trustee has split his interest,
12 has created a conflict of interest, and that causes a
13 loss. There might not be a monetary -- a straight
14 monetary loss at that time.

15 JUSTICE SOTOMAYOR: I've never heard of a
16 defalcation that didn't result in some monetary loss.
17 What would have been the monetary loss in the Chief's
18 hypothetical?

19 MR. BENSINGER: In that case, Your Honor,
20 there would not have been a strict monetary loss in that
21 hypothetical had the -- all the proceeds -- had there
22 not been any benefit that the trustee obtained from the
23 investment and use of those funds.

24 CHIEF JUSTICE ROBERTS: But there is still a
25 loss. I mean, when you're investing obviously the

1 return is part of it, but also the question is what risk
2 you assume. And the trust would have suffered because
3 during that period they were incurring a greater risk.
4 That's one reason you set up a trust, so you don't --
5 you protect people from that risk.

6 MR. BENSINGER: That's correct, Your Honor.
7 Thank you.

8 CHIEF JUSTICE ROBERTS: Mr. Gannon?

9 ORAL ARGUMENT OF CURTIS E. GANNON

10 ON BEHALF OF THE UNITED STATES,

11 AS AMICUS CURIAE, SUPPORTING RESPONDENT

12 MR. GANNON: Mr. Chief Justice, and may it
13 please the Court:

14 No particular mens rea is inherent in the
15 term "defalcation" or the structure of Section
16 523(a)(4).

17 JUSTICE KENNEDY: Unlike fraud -- fraud,
18 larceny and embezzlement?

19 MR. GANNON: Each of those terms does have
20 some mens rea associated with it. It is not, however,
21 the willfulness requirement that my friend was invoking
22 on the other side. There is no obligation under any of
23 those that there be an intentional violation of a known
24 legal duty.

25 There are specific intents to defraud, but I

1 think we know that this can't be -- it can't have that
2 mens rea because that would make it superfluous. That's
3 what Judge Hand said in the Herbst decision, and that's
4 what even the Second Circuit and the First Circuit
5 recognized here, that they could not adopt the same mens
6 rea that belongs with the other terms here and I --

7 JUSTICE BREYER: Because?

8 MR. GANNON: Pardon?

9 JUSTICE BREYER: Because? I mean, I thought
10 defalcation is -- supposes that the person does pack his
11 suitcases with the money and he goes and shows up in
12 Rio. I take it that would be defalcation. That isn't
13 fraud.

14 MR. GANNON: That would probably be
15 embezzlement and it would be superfluous in that sense.
16 I think that the dictionary definitions, if you look at
17 the dictionary definitions of defalcation that we quote
18 on pages 10 and 11 of our brief, both the English
19 dictionary definitions and the legal dictionary
20 definitions, they basically --

21 JUSTICE BREYER: But you didn't cite to the
22 Latin, did you?

23 MR. GANNON: Pardon?

24 JUSTICE BREYER: But you didn't have the
25 Latin definition, which I take it from my colleague and

1 it was confirmed by my law clerks, it comes from
2 medieval Latin, starting with a sickle and meant to cut
3 down, to cut down, and that suggested reduction.

4 MR. GANNON: We did quote the Samuel Johnson
5 dictionary and the Webster's 1828 dictionary that have
6 that meaning. If you look at the Oxford English
7 Dictionary definition, that was an obsolete meaning.

8 And I think that it's quite clear that the
9 meaning that Congress was invoking here is what is dealt
10 with under heading five in the Oxford English
11 Dictionary. And my friend quoted it earlier, there is
12 either a monetary deficiency through a breach of trust
13 by one who has the management or charge of funds --

14 JUSTICE KAGAN: Well, monetary deficiency,
15 again, isn't that a loss? But I thought that your
16 position was that there didn't need to be a loss.

17 MR. GANNON: Well, there are two questions
18 there and I think that one of the illustrative
19 quotations that the OED uses for that very definition
20 doesn't actually refer to a monetary deficiency, and
21 neither do most of the other dictionary definitions. So
22 I do think that there's probably an open question about
23 what the purest meaning of the term defalcation, whether
24 it requires a loss.

25 Here, we do think that there is a loss.

1 There is a loss in a very real and traditional sense.
2 There is no doubt about it that because the Petitioner
3 took -- engaged in self-dealing and made a profit with
4 that, with the money that he had taken out of the trust
5 corpus and refused to return those profits to the trust,
6 that is a loss to the trust, just as it would be had he
7 taken the money and invested it in some great investment
8 scheme and -- or he decided to bet it at the track --

9 JUSTICE KAGAN: Well, that's certainly
10 true --

11 MR. GANNON: -- and he decided --

12 JUSTICE KAGAN: -- in an ordinary trust, but
13 isn't there a real question as to this trust because if
14 this trust would -- the trustee shouldn't have been
15 investing this in the first place. All that this trust
16 was going to get was the principal plus a fixed income.

17 MR. GANNON: I don't think that's a fair
18 statement of the way this trust operates. It's not
19 consistent with Petitioner's own arguments.
20 Petitioner's argument in the State court and in the
21 Bankruptcy Court, the argument that he says is the
22 reason why there is no -- no determination about whether
23 this was an authorized use of the money under the trust
24 instrument is that -- that he was allowed to invest the
25 assets of the trust.

1 And so the way the courts -- and the parties
2 have offered to lodge the trust instrument with the
3 Court. As I understand it it's not otherwise in the
4 record. But the point here is that he did --

5 JUSTICE SOTOMAYOR: Would you just repeat
6 what you said? Your voice turned.

7 MR. GANNON: The last part I said, that the
8 parties have offered to lodge the trust instrument with
9 the Court, but my understanding is that it's not in the
10 record. But I don't think anybody has taken the
11 position that the only thing that could ever be in the
12 trust was the life insurance policy plus 6 percent.

13 JUSTICE SOTOMAYOR: That's what I
14 understood. So you're saying that that is not the case?

15 MR. GANNON: I believe that that is not the
16 case and that is not even consistent with Petitioner's
17 own position in the State court, where he said he was
18 taking this money and investing it in some alternative
19 thing because he thought that would be safer than
20 leaving the money with the life insurance company.

21 And I think if I can go back to explaining
22 why I think that this is a loss and so I think that this
23 trust is not as unusual or unique as you think it is, in
24 part because we don't have the language of it in front
25 of us.

1 But secondly, I was trying to say that had
2 he taken this money for an authorized purpose or not and
3 decided he was going to go invest it, he had some boffo
4 scheme, he had some friend who had a great stock tip, or
5 he had a tip at the races and he was going to go down to
6 the track and bet this money, he made 1,000 percent.

7 And he decided, well, you know what, had I
8 not taken the money out of the trust all I would have to
9 do is return, all I have to do is make it whole in the
10 sense of having the 6 percent that it otherwise would
11 have had. That everybody would understand, that's a
12 breach of his duty of loyalty. That's a defalcation.
13 It is an injury to the trust. It is a loss in every
14 relevant sense.

15 And in addition here, the \$35,000 that the
16 State court awarded for attorney's fees and costs is
17 also another concrete loss to the estate. And this
18 Court's decision in Cohen v. De la Cruz, which was about
19 nondischargeability of a fraud judgment, of a debt for
20 fraud, said that that debt for fraud included all of the
21 legal liability associated with the underlying fraud --

22 JUSTICE SOTOMAYOR: But there is two
23 components of the award, the attorney's fees plus the
24 \$250,000 profit. And you're representing to me right
25 now that, as a trustee, he was entitled to invest that

1 fund for the trust? And so there was a lost opportunity
2 here as well?

3 MR. GANNON: It's not that there -- it's not
4 the opportunity loss. It's not the fact that the trust
5 wasn't already earning the interest in the -- vis-à-vis
6 the insurance company as it otherwise would.
7 Petitioner's position is if he already gave back the
8 money that it would have earned in interest vis-à-vis
9 the insurance company, my position, the government's
10 position, is that the loss here is that he failed to
11 disgorge the profits that he made by self-dealing in the
12 assets of the trust corpus. That is a --

13 JUSTICE BREYER: What about the other
14 argument? I just don't want you to leave without
15 addressing the other argument.

16 MR. GANNON: The other argument --

17 JUSTICE BREYER: In your brief you talk
18 about and quote "Learned Hand" and say it means -- "If
19 it doesn't mean a deliberate malversation," said Learned
20 Hand --

21 JUSTICE SCALIA: "Malversation."

22 JUSTICE BREYER: -- then it must be the same
23 as fraud or embezzlement. So I will go look up
24 "malversation" as soon as I return to my office, and I
25 will get that.

1 Now, the other argument was, yes, fine, a
2 loss. Two, done deliberately, but with an innocent
3 state of mind because he didn't understand the law.
4 Justice Kennedy quoted, fraud -- from this Court, that
5 fraud in bankruptcy for purposes of this provision
6 requires some degree of moral turpitude. Well, that
7 suggests that you aren't innocent in respect to
8 knowledge that it's against the law. What about that?

9 MR. GANNON: My response to that is that the
10 Neal v. Clark decision that's being discussed here is --
11 and we discuss this in our brief -- is distinguishable
12 in part because its current descendent is not this
13 provision. It is not this reference to fraud. It is
14 the exception from discharge in paragraph (a)(2)(A).

15 And what makes this different is that this
16 is fraud in a fiduciary capacity which was not true in
17 the context of Neal v. Clark, and that's something that
18 the Court said at the time, that because it did not
19 actually have the limitations of the fiduciary context,
20 they needed to infer some type of limitation. They
21 inferred it, the Court inferred it, from embezzlement.

22 And so going back to Justice Kennedy's
23 question, the way Congress has dealt with that is that
24 it has put actual fraud in (a)(2)(A), and here it has
25 grouped fraud with defalcation in a fiduciary capacity

1 and therefore it includes the type of limitation that
2 the Court was trying to impose in Neal v. Clark.

3 We don't think that there is any inherent
4 mens rea in defalcation and --

5 JUSTICE ALITO: Could you explain what you
6 mean, before your time expires, in footnote 18? I
7 understood your argument until I got there, but then you
8 said that there was no particular mental state required.
9 And then in footnote 18 you said, well, there may be
10 cases where a particular mental state is required.

11 MR. GANNON: Well, I think when it gets
12 further away from the heartland definition of
13 defalcation, which does -- which, as was discussed in
14 this Court's 1844 decision in Chapman and in the 1841
15 bankruptcy law, the defalcation was equated with
16 self-dealing in trust assets. And so we think that's
17 the heart of defalcation.

18 As you move away from that particular type
19 of fiduciary breach, and if you move away from there it
20 may become more relevant whether there is --

21 JUSTICE ALITO: Where are courts supposed to
22 look to find out what is the border between the
23 heartland of defalcation and the badlands of defalcation
24 and whatever else?

25 MR. GANNON: Well, to be fair, the

1 dictionary definitions are broad enough to include other
2 types of fiduciary breaches, but it's not clear that
3 that means that defalcation needs to be doing all the
4 work here of potentially putting limits on the scope of
5 the exception.

6 And so if you look at the Ninth Circuit, for
7 instance, the way it has handled this is it has
8 recognized, as we do, that defalcation can be innocent
9 and -- but it has, it has concluded that the essence of
10 defalcation is the failure to account for or to produce
11 funds, and therefore it wouldn't be something that would
12 just be garden variety mismanagement of the assets.

13 JUSTICE SCALIA: Well, why not? I mean,
14 it's a -- it's a violation of the trustee's
15 responsibility when he makes a negligent investment of
16 the funds, right?

17 And so he doesn't turn over as much money as
18 should be turned over. It's a defalcation.

19 MR. GANNON: Well, we certainly do think
20 that that may well be the ultimate answer. We think
21 that would be further away from the core of defalcation,
22 but it's not this case, so we would urge the Court to
23 affirm.

24 CHIEF JUSTICE ROBERTS: Thank you, counsel.
25 Mr. Byrne, you have five minutes left.

1 REBUTTAL ARGUMENT OF THOMAS M. BYRNE

2 ON BEHALF OF THE PETITIONER

3 MR. BYRNE: Thank you, Your Honor.

4 JUSTICE SOTOMAYOR: Is it your position that
5 he couldn't have invested this? Let's assume that he
6 knew -- that he knew.

7 MR. BYRNE: Assuming he knew, Your Honor, he
8 could -- his position is and it was -- it was true his
9 position in the State court was that he could have
10 invested it, but --

11 JUSTICE SOTOMAYOR: As a trustee for the
12 trust.

13 MR. BYRNE: As a trustee for the trust.

14 JUSTICE SOTOMAYOR: Okay. Then you may be
15 losing this case.

16 MR. BYRNE: Well, Your Honor, that is --

17 JUSTICE SOTOMAYOR: Because if he could
18 invest it for the trust, why isn't the loss -- isn't it
19 a loss for the trust that he took this opportunity away
20 from the trust?

21 MR. BYRNE: Well, Your Honor, the -- of
22 course, the Illinois court never decided whether he was
23 right about whether he could actually invest the money
24 other than as -- as specified.

25 JUSTICE SOTOMAYOR: Let's assume he could

1 have.

2 MR. BYRNE: If you assume he could have --

3 JUSTICE SOTOMAYOR: Then why isn't the loss
4 of opportunity?

5 MR. BYRNE: Well, Your Honor, the -- the --
6 the trust instrument, I think you'll see does not
7 expressly authorize him to do that. He's making -- he
8 was making an argument --

9 JUSTICE SOTOMAYOR: Let's assume his
10 argument that he could.

11 MR. BYRNE: If the argument is or if the
12 trust provided that he could invest in other things and
13 it made him prudent investments, then there could be a
14 loss to the trust. Then his mental state would -- would
15 be poor.

16 JUSTICE SOTOMAYOR: Then we have to go back
17 to -- to the first issue, whether a mental state is
18 required or not.

19 MR. BYRNE: That's correct, Your Honor.
20 Now, to respond to a few things said by Respondent and
21 by the solicitor, the Petitioner actually did put into
22 the record when he opposed summary judgment pro se in
23 the bankruptcy court all of his evidence about what
24 he -- what should have been done with the money that was
25 in the constructive trust, what should have been done

1 with the property that was in the constructive trust
2 during that period.

3 He put that in -- in evidence, it's in the
4 record and his repeated pleas that the assets be sold to
5 pay the judgment are reflected by that.

6 The Respondent relied entirely on the two
7 Illinois court orders and put in no evidence other than
8 the original pleadings, if they are evidence, in the --
9 in the Illinois case. So there is that question about
10 the record, and Petitioner did track what -- what his
11 efforts were to try to persuade the trustee to consent
12 to the sale of the property.

13 And it's interesting, the constructive
14 trust, of course, was imposed on the properties that
15 were acquired with loans two and three. So if there are
16 any profit from the loans, they would have been caught
17 in those properties. And eventually, of course, they
18 were not sold.

19 But to determine the amount of the loss
20 here, a trial would be needed. And that's really why we
21 were hoping the Court will give us -- give Mr. Bullock a
22 day in court here to establish under the proper legal
23 standard what any loss really was, if there was one.

24 And it was said earlier that a conflict of
25 interest itself is a defalcation, but not if there's no

1 loss. That's just -- that's entirely inconsistent with
2 the other exceptions to discharge in the Code.

3 Mr. Gannon read the -- noted that the
4 dictionary definitions evolved over time, but the 1856
5 definition of defalcation from Bouvier's Law Dictionary
6 that's quoted in the government's brief actually still
7 reflects the -- the idea that -- or the definition that
8 defalcation is the act of a defaulter. And a defaulter
9 is defined as, "one who fails in making his accounts
10 correct."

11 So by 1856, years after the first enactment
12 of defalcation, that was still the definition that was
13 prevailing in the day, at least according to that
14 dictionary, and according to the others that -- that we
15 cite earlier.

16 Petitioner here made a mistake in judgment.
17 There was never any finding of dishonesty on his part.
18 There was never any finding that he acted with a
19 malicious intent. In fact, there was a finding that he
20 acted with no apparent malicious intent in the Illinois
21 courts. This question is one of dischargeability, and
22 his debt is really what bankruptcy is for. It's for a
23 fresh start for an honest, but unfortunate debtor.

24 Unless the Court has any further questions,
25 that concludes my argument.

1 CHIEF JUSTICE ROBERTS: Thank you, counsel.

2 The case is submitted.

3 (Whereupon, at 12:10 p.m., the case in the

4 above-entitled matter was submitted.)

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