After Brenda and Eddie Divorce, Eddie Files for Bankruptcy: The Unusual Life of Defalcation under BAPCPA

by
Shayna M. Steinfeld*
and
Dana E. Prescott**

In the 1970s, Billy Joel, cooed, in *Scenes from an Italian Restaurant*:

Brenda and Eddie were the popular steadies
And the king and the queen of the prom
Riding around with the car top down and the radio on
Nobody looked any finer
Or was more of a hit at the Parkway Diner
We never knew we could want more than that out of life
Surely Brenda and Eddie would always know how to survive.
Oh, oh, oh, oh . . .
Brenda and Eddie were still going steady in the summer of '75
When they decided the marriage would be at the end of July
Everyone said they were crazy
"Brenda you know that you're much too lazy
and Eddie could never afford to live that kind of life."
Oh, but there we were wavin' Brenda and Eddie goodbye.
Oh, oh, oh
Well they got an apartment with deep pile carpets
And a couple of paintings from Sears
A big waterbed that they bought with the bread
They had saved for a couple of years
but they started to fight when the money got tight
And they just didn't count on the tears.
Oh, oh, yeah rock 'n roll, Oh, oh, oh

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* Shayna M. Steinfeld practices with her husband, Bruce R. Steinfeld, a Fellow of the American Academy of Matrimonial Lawyers, in Atlanta, Georgia, in Steinfeld & Steinfeld, PC. Ms. Steinfeld would like to thank Alexandra Ragan, who as a third year law student at Emory University in Atlanta assisted her with the research for this article.

** Dana E. Prescott, Esq., LMSW, is a partner in Prescott, Jamieson, Nelson & Murphy, LLC, Saco, Maine.

Well, they lived for a while in a very nice style
But it's always the same in the end
They got a divorce as a matter of course . . . .

While the lyrics happily conclude with they "parted the closest of friends," in too many divorce cases, particularly those with unilateral bankruptcies that follow, that cheery outcome is rarely the case. Statistically, about 20% of all bankruptcies are caused by divorce and about the same percentage of divorces are caused by financial problems.[1] By the sheer volume of reported cases, bankruptcy often follows divorce in a chess match played between spouses to avoid obligations imposed by agreement or court order. The social and legal problems generated from this form of economic chaos do not even begin to account for the effect of recession or the perils of the unforeseen, such as illness, on family systems over the short-, medium-, and long-runs.

For decades, Congress has sought to balance public policy when divorce (a matter of state law) and bankruptcy (a matter of federal law) overlap. Throughout various reforms, debtors in a bankruptcy case have consistently been unable to discharge, or eliminate, "support-related" debt such as child support, alimony, or other obligations that are "in the nature of support." By now, most divorce lawyers are attuned to the fact that support debt is non-dischargeable and draft divorce agreements accordingly. In response to all the litigation generated by the structural tension inherent in federalism, federal courts have established about eighteen different elements that may be considered when determining if a particular obligation is really in the "nature of support" or not really "in the nature of support" under 11 U.S.C. sections 523(a)(5) and 523 (a)(15).[2] One of the authors of this article (the one from Atlanta) has a book published through the American Bar Association, *The Family Lawyers Guide to Bankruptcy*,[3] which contains a detailed analysis of the distinction between a support-related debts (acronymically known as a DSO or "domestic support obligation") and non-support-related debts.[4]

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1 *See generally* TERESA SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000).

2 All Code citations are to 11 U.S.C. unless stated otherwise.

3 SHAYNA STEINFELD & BRUCE STEINFELD, THE FAMILY LAWYER'S GUIDE TO BANKRUPTCY: FORMS, TIPS, AND STRATEGIES (2nd ed., 2007).

4 Under 11 U.S.C. §101(14A)

This book (and a robust body of literature in both specialties) also contains a detailed analysis of other bankruptcy ramifications of divorce-related issues. The specifics of these items are, however, beyond the scope of this article.[5]

Divorce attorneys may be much less familiar with other more complex exceptions to discharge, including a specific exception for debts incurred by an individual "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny" under section 523(a)(4). Hence, the specific focus of this article: the applicability of section 523(a)(4) to the divorce context. Although a seemingly unusual exception in divorce, this truth is probably more a function of clients being advised that an adversary proceeding is futile even when a lawyer may recognize the opportunity to challenge dischargeability under section 524(a)(4). Not so much. In the sections below, the authors briefly explore the history of support-related debts under the Code before explaining the process and substantive law that guide non-dischargeability objections. The confluence of more parties maintaining post-divorce property arrangements due to

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> The term '"domestic support obligation"' means a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law notwithstanding any other provision of this title, that is—
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> (A) owed to or recoverable by (i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative or (ii) a governmental unit;
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> (B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly so designated;
>
> (C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of– (i) a separation agreement, divorce decree, or property settlement agreement; (ii) an order of a court of record; or (iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and(D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative for the purpose of collecting the debt.

[5] For a brief but helpful survey, *see* David C. Hoskins & Ellen R. Welner, *Bankruptcy and Divorce: What Divorce Counsel should know about Bankruptcy*, 37 COLO.LAW. 35 (Oct. 2008).

economic turmoil and the 2005 changes to the Bankruptcy Code suggests closer consideration of other Code provisions than the (now) more mundane exceptions for DSOs.

I. "Waving Goodbye to the Past"

For many years, divorcing parties could eliminate the obligation to pay non-support-related debts. This policy dramatically changed in 1994, thereby increasing the frequency and scope of litigation between former spouses when one party declared bankruptcy. Euphemistically described as "legislative sausage," former spouses were required to litigate "disposable income" issues and a "balancing test" to determine the discharge of the non-support obligations under section 523(a)(15). Congress amended the law again in 2005, further strengthening ex-spouses' rights and remedies under the Bankruptcy Code. In bankruptcy lawyer vernacular, these amendments to the Code were called "BAPCPA," or otherwise dubbed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[6]

For the most part, BAPCPA took effect on October 17, 2005.[7] The primary consumer beneficiaries under the amendment were mothers and ex-spouses[8] because, among the most significant changes under BAPCPA, property settlement debts, as well as all other divorce-related debts, incurred before, during and after the bankruptcy case, are now *automatically* non-dischargeable in Chapter 7, 11 and 12 bankruptcy cases.[9] BAPCPA

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[6] Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

[7] Although a seemingly simple notion, make sure that the case law is post-2005 to avoid unnecessary embarrassment. These "reforms" have generated much scholarly debate. *See* John E. Matejkovic & Keith Rucinski, *Bankruptcy "Reform": The 21st Century's Debtors' Prison*, 12 AM. BANK. INST. L. REV. 473 (2004).

[8] For a prior discussion in this journal, see Shayna M. Steinfeld, *The Impact of Changes Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 on Family Obligations*, 20 J. AM. ACAD. MATRIM. LAW. 251 (2007). The use of gender to suggest an advantage or disadvantage at the intersection between bankruptcy and divorce raises its own controversy. *See* Peter C. Alexander, *Building A Doll's House: A Feminist Analysis of Marital Debt Dischargeability in Bankruptcy*, 48 VILL. L. REV. 381 (2003).

[9] Each form of bankruptcy has its unique requirements and consequences. *See generally* Steinfeld & Steinfeld, note 3.

eliminated the need for the "section 523(a)(15) balancing test" adopted in 1994 and the litigation it spawned and also elevated the priority of support-related debts, now more broadly defined under BAPCPA as "Domestic Support Order" ("DSO") debts as defined in section 101(14A).[10]

Accordingly, the only significant areas where the distinction between support and non-support-related debt still matters in a bankruptcy case (provided that Congress does not again change the law) is in Chapter 13 filings because section 1328 does not incorporate all of section 523(a), but only incorporates specific sub-parts of section 523(a), notably excluding section 523(a)(15)-non-DSOs. Assuming this exclusion is an intended omission by Congress from BAPCPA, non-support, divorce-related obligations remain dischargeable (subject to elimination) in Chapter 13, provided that the debtor is able to complete the Chapter 13 plan and obtain a discharge.[11] Therefore, if you represent a party with a non-support-related, divorce debt and the opposing party files a Chapter 13 case, you need to be aware of this possibility and take steps to protect your client if the facts warrant it. Notably, the distinction between support and non-support-related debts is still important as it relates to certain other provisions of the Bankruptcy Code, especially payment of past-due or future support-related debts and certain other provisions, which are beyond the scope of this paper.[12]

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10 *See supra* note 6.

11 The statistics for debtors actually completing Chapter 13 plans and making it to discharge are actually fairly low. As with many policy debates, there is more myth than actual reliance on empirical data. BABCPA is no different. *See* Thomas Evans & Paul B. Lewis, *An Empirical Analysis of the 2005 Bankruptcy Reforms*, 24 EMORY BANKR. DEV. J. 327 (2008).

12 Under BAPCPA, the term "Domestic Support Obligation" ("DSO") is used throughout the Bankruptcy Code and is incorporated into various other provisions such as in section 507 for priorities, in the discharge provisions for chapters 7, 11, 12 and 13, as a defense to the preference provisions of section 547, for certain exceptions to the automatic stay under section 362, requiring the trustees to give certain notices to the DSO creditor, provisions that require that all DSO payments must be current for confirmation of Chapter 11, 12 and 13 plans and for discharge under Chapters 12 and 13. Accordingly, the distinction drawn between support and non-support divorce-related obligations is still relevant for these other purposes under the Bankruptcy Code but these are beyond the scope of this article.

We have set forth the "gap" for non-DSO, divorce-related debts found in Chapter 13 and the changes contained in BAPCPA because post-BAPCPA it may be quite rare for an attorney to need to litigate an issue under section 523(a) (4) in a Chapter 7, 11 or 12 case. There may be isolated instances like domestic partners or long-term, live-in relationships, where there is no court order or divorce decree that meets the parameters of a DSO. In such a case, the aggrieved party who is owed money by the party filing bankruptcy may be looking for other ways to collect his or her debt and section 523(a) (4) may then be viable in one of the other bankruptcy chapters. The vast majority of divorce-related debts are automatically carved out of the discharge pursuant to section 523(a)(5) as a DSO or pursuant to section 523(a)(15) as a debt owed "to a spouse, former spouse, or child of the debtor." Because this article is being published for a divorce lawyer audience and post-BAPCPA, at a time when most every divorce-related obligation is automatically excepted from discharge under either section 523(a)(5) or 523(a)(15) pursuant to section 523(c) in Chapter 7, 11 and 12 cases, this article will focus on the criteria to file a complaint to determine dischargeability under sections 523(c) and Federal Rule 4007 in other circumstances, most likely arising in a non-DSO context in a Chapter 13 case.[13] With that caveat, we move to section 523(a)(4).

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[13] Rule 4007. Determination of Dischargeability of a Debt

(a) Persons entitled to file complaint.
A debtor or any creditor may file a complaint to obtain a determination of the dischargeability of any debt.

(b) Time for commencing proceeding other than under § 523(c) of the Code.
A complaint other than under § 523(c) may be filed at any time. A case may be reopened without payment of an additional filing fee for the purpose of filing a complaint to obtain a determination under this rule.

(c) Time for filing complaint under § 523(c) in a chapter 7 liquidation, chapter 11 reorganization, chapter 12 family farmer's debt adjustment case, or chapter 13 individual's debt adjustment case; notice of time fixed.
Except as otherwise provided in subdivision (d), a complaint to determine the dischargeability of a debt under § 523(c) shall be filed no later than 60 days after the first date set for the meeting of creditors under § 341(a). The court shall give all creditors no less

II. "Everyone Said They Were Crazy"

The brief discussion above has much that lawyers understand. But what of the crazy twist so common to the alternate universe of divorced couples? After entering a divorce decree, Brenda and Eddie sell their home but Eddie convinces Brenda to give her share of the settlement from their property division to buy another property in his name because they have kids and he can manage the rentals and pay the mortgage. Brenda decides to become his "partner" (for "the kids") and a few months later he evicts her from the home and declines to pay her for her contribution. Brenda sues in state court, which results in a decision after a trial that her claims that Eddie converted her property and breached her fiduciary duty were "subsumed in her claim for a partnership accounting." The state court then rules that Eddie breached his fiduciary duty[14] to Brenda and awards her damages and enters a judgment in favor of Brenda and against Eddie.

> than 30 days' notice of the time so fixed in the manner provided in Rule 2002. On motion of a party in interest, after hearing on notice, the court may for cause extend the time fixed under this subdivision. The motion shall be filed before the time has expired.
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> (d) Time for filing complaint under § 523(a)(6) in a chapter 13 individual's debt adjustment case; notice of time fixed.
> On motion by a debtor for a discharge under § 1328(b), the court shall enter an order fixing the time to file a complaint to determine the dischargeability of any debt under § 523(a)(6) and shall give no less than 30 days' notice of the time fixed to all creditors in the manner provided in Rule 2002. On motion of any party in interest, after hearing on notice, the court may for cause extend the time fixed under this subdivision. The motion shall be filed before the time has expired.
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> (e) Applicability of rules in Part VII.
> A proceeding commenced by a complaint filed under this rule is governed by Part VII of these rules.

[14] Under Maine law, for example, the confidential relationship between married partners requires good faith between them. *See* Smith v. Farrington, 139 Me. 241 (Me. 1943); Dennison v. Dawes, 121 Me. 402 (Me. 1922). In *Thomas v. Fales,* 577 A.2d 1181 (Me. 1990), the Law Court affirmed the imposition of constructive trust for the benefit of a wife on real estate held by the husband's brother which the husband had transferred and stated:

> A person can be found to stand in a fiduciary relation to another "When he has rights and duties that he is bound to exercise for the benefit of (another) person. . . . Whenever one person is placed in such a relation to another that it becomes interest for him . . . and any

Eddie naturally files a Chapter 7 bankruptcy to avoid the civil judgment. Several lawyers tell Brenda her situation is hopeless because the judgment was post-divorce and not in the nature of support. (As a caveat, we must mention that "success" in a bankruptcy adversary proceeding is a piece of paper that says "nondischargeable"—it is not "cash." The debt must still be collected.) Brenda, though, perseveres and eventually finds a lawyer who initiates an adversary proceeding on her behalf. The preliminary issue is whether Eddie's breach of fiduciary duty is an exception to dischargeability under section 523(a)(4). The answer requires a discussion in two parts. First, is the state court order subject to the doctrines of res judicata or collateral estoppel in the bankruptcy court? Second, if so, do the findings of fact and conclusions of law constitute an exception to the discharge provisions of the Code?

III. "But It Is Always the Same in the End"

Traditional elements of "preclusion" apply in bankruptcy court. Historically referred to as the doctrines of *res judicata* and *collateral estoppel*, these terms are known, respectively, in modern terminology as "claim preclusion" and "issue preclusion."[15] Under federal law, the bankruptcy court "retains jurisdiction to ultimately determine the dischargeability of the debt."[16] The preclusive effect of state court judgments may be a function of full faith and credit.[17] The doctrine of claim preclusion (res judicata) prevents the relitigation of claims that were previously brought and litigated, arising out of the same transaction and

> subject of property . . . he is prohibited from acquiring rights and that subject antagonistic to the person with those interests."

Id. at 1182-83.

15 *See* RESTATEMENT (SECOND) OF JUDGMENTS §27 (1982); *see also* Machias Sav. Bank v. Ramsdell, 689 A.2d 595, 599 (Me. 1997) ("Issue preclusion, also referred to as collateral estoppel, prevents the relitigation of factual issues already decided if 'the identical issue was determined by a prior final judgment, and . . . the party estopped had a fair opportunity and incentive to litigate the issue in a prior proceeding.'").

16 Matter of Schwager, 121 F.3d 177, 181 (5th Cir. 1997); *see also* Grogan v. Garner, 498 U.S. 279, 285 n.11 (1991); *In re* Ingeneri, 321 B.R. 601, 606 n.3 (Bankr. D. Me. 2005).

17 *Id.*

that could have been brought in the original transaction.[18] The U.S. Supreme Court has determined that the doctrine of claim preclusion (res judicata) does *not* apply in dischargeability litigation in bankruptcy cases.[19]

The doctrine of "issue preclusion" (collateral estoppel), however, prevents the re-litigation of specific issues that were previously litigated between identical parties, which issues were a necessary part of the prior litigation.[20] The U.S. Supreme Court has determined that issue preclusion (collateral estoppel) *does* apply to dischargeability proceedings and can be a useful tool for litigants.[21] A secondary matter with regard to issue preclusion is whether the bankruptcy court should apply state or federal issue preclusion law.[22] In most jurisdictions, however, modern doctrines of issue preclusion have evolved on parallel tracks so the distinction may be meaningless. In either case, the doctrine only applies to those material issues that were actually litigated and upon which a final judgment was entered.[23]

IV. "They Started to Fight"

A. *An Adversary Proceeding*

An adversary proceeding (complaint) must be initiated in the bankruptcy court by specifically setting forth the grounds for objecting to the dischargeability of a debt pursuant to section 523(a)(4). This complaint must be timely, i.e. within 60 days of the first scheduled meeting of creditors in the bankruptcy case.[24] In a Chapter 13 case, this is sometimes too early in the case, so it

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18 Christopher Klein et al., *Principles of Preclusion and Estoppel in Bankruptcy Cases*, 79 AMER. BANKR.L.J. 839, 842 (2005), *citing* 18 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & EDWARD H. COOOPER, FEDERAL PRACTICE AND PROCEDURE § 4402 (2d Ed. 2003).

19 *See* Brown v. Felsen, 442 U.S. 127 (1979).

20 *See* RESTATEMENT (SECOND) OF JUDGMENTS §27 (1982).

21 *See* Grogan v. Garner, 498 U.S. 279 (1991).

22 *See* Colorado West Trans. Co., Inc. v. McMahon (*In re* McMahon), 356 B.R. 286, 301 (Bankr. N.D. Ga. 2006), *rev'd*, 380 B.R. 911 (N.D.Ga. 2007). For an interesting discussion of this issue, *see* Pincus v. Long (*In re* Long), 2006 Bankr. LEXIS 2619 (Bankr. N.D. Ga. June 30, 2006)

23 *See* Penkul v. Matarazzo*,* 983 A.2d 375, 377-78 (Me. 2009); *see also In re* Gauvreau*,* 375 B.R. 14, 19 (Bankr. D. Me. 2007).

24 *See* 11 U.S.C.§523(c); *See* FED. R. BANKR. P. 4007(c).

is prudent to try and extend this date by motion and court order, which also must be timely.[25] This is particularly true if the Chapter 13 plan provides for a high payment on the underlying *non-DSO* claims or when the Chapter 13 plan may be modified before the claim is paid in full but after the bar date for the filing of the adversary proceeding complaint. Of particular practice interest, a proof of claim must be filed within 90 days after the first section 341 meeting of creditors for the creditor to be paid anything at all.[26]

B. *The Threshold Policy and Definition*

The tension between section 523(a)(4) and the policies that undergird the Code begin with this proposition: "The historic purpose of bankruptcy is for honest, but insolvent, debtors to get a fresh start in their financial lives."[27] At its core, the bankruptcy process seeks to provide debtors with a discharge from their debt obligations.[28] Because "the basic objectives underlying the hope of bankruptcy [is to] afford a bankrupt a new chance,"[29] bankruptcy courts generally construe discharge exceptions against the creditor and in favor of the debtor.[30] Accordingly, the spouse objecting to the discharge bears the burden of proving, by a preponderance of the evidence, that the debtor's discharge should be denied as to that particular state court judgment.[31]

Under section 523(a)(2), false pretenses, false representations or actual fraud may constitute the basis for nondis-

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25 *See, e.g.,* FED. R. BANKR. P. 9006(b).

26 *See* FED. R. BANKR. P. 3002.

27 Gamble v. Gamble (*In re* Gamble), 196 B.R. 54, 55 (Bankr. N.D. Tex. 1996)(citing Local Loan Co. v. Hunt, 292 U.S. 234 (1934)).

28 *See* Dilworth v. Boothe, 69 F.2d 621, 624 (5th Cir. 1934).

29 Hughes v. Lieberman (*In re* Hughes), 873 F.2d 262, 263 (11th Cir. 1989).

30 HSSM # 7 Ltd. Partnership v. Bilzerian (*In re* Bilzerian), 100 F.3d 886, 891 (11th Cir. 1996); *see also* Chauncey v. Dzikowski (*In re* Chauncey), 454 F.3d 1292, 1295 (11th Cir. 2006); Equitable Bank v. Miller (*In re* Miller), 39 F.3d 301, 304 (11th Cir. 1994).

31 *See* Grogan v. Garner, 498 U.S. 279, 285-91 (1991); Hawley v. Cement Indus., Inc., 51 F.3d 246, 249 (11th Cir.1995); Chalik v. Moorefield (*In re* Chalik), 748 F.2d 616, 619 (11th Cir. 1984); *In re* Murphy, 297 B.R. 332, 348 (Bkrptcy. D. Mass. 2003).

chargeability.[32] Unlike *defalcation* under section 523(a)(4), section 523(a)(2) specifically requires a showing of *scienter*.[33] Both "provisions codify a long-standing bankruptcy policy that any debt which is shown to have arisen from a dishonest or otherwise wrongful act committed by a debtor is not entitled to the benefits of a bankruptcy discharge."[34] To prevent discharge of a debt under section 523(a)(4), a creditor must demonstrate that: (1) the debtor was acting in a fiduciary capacity within the meaning of section 523(a)(4); (2) that the debtor's actions constituted a defalcation; and (3) the debtor's acts caused an actual loss to the creditor/plaintiff.

Although the term *fiduciary capacity* under section 523(a)(4) may not be as broad as state law in other circumstances, facts may be sufficient to establish such a relationship between husband and wife or the finding of a post-divorce partnership.[35] The U.S. Supreme Court has generally defined "fiduciary" narrowly under section 523(a)(4) "holding that the trust upon which the fiduciary relationship relies must be an express or technical trust."[36] As to the second prong, the meaning of defalcation under section 523(a)(4), there is a split in the federal courts of appeal concerning the scope (or definition) of defalcation.[37] The First Circuit has adopted a narrower test than other circuits but aptly summarizes the policy debate:

> A defalcation for purposes of §523(a)(4) necessarily means there has been a breach of fiduciary duty, but not all breaches of fiduciary duty constitute a defalcation. Courts are divided on the standard to be employed in determining which breaches of fiduciary duty reach the level of "defalcation" for purposes of nondischargeability under that Code

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32 *See In re* Anstead, Docket No. 10-3094 (Bankr. Ohio No. Dist. 2010).

33 *Id.* at 2.

34 *Id.* Applying a different part of the Code, the court in *In re Gauvreau,* 375 B.R. at 18, noted the tension between "the Code's twin policies of giving honest debtors a leg up and protecting the interests of creditors from debtors who would attempt to exploit them."

35 *See In re* Patel*,* 565 F.3d 963, 968 (6th Cir. 2009).

36 Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934)(decided under section 17(a)(4) of the Bankruptcy Act, which was transplanted virtually unchanged to §523(a)(4)). For an interesting discussion of this issue see *Dynaspan v. Evilsizer(In re Evilsizer), 2009 Bankr. LEXIS 942 (Bankr. N.D. Ga. Mar. 18, 2009)*

37 *See e.g.*, *In re* Hyman*,* 502 F.3d 61, 66-69 (2nd Cir. 2007) (reviewing case law).

> section. In this Circuit, however, the question is now conclusively decided. In *Baylis,* the First Circuit Court of Appeals defined "defalcation" for purposes of §523(a)(4) as an act "so egregious in nature that [it] come[s] close to the level that would be required to prove fraud, embezzlement, or larceny." *Baylis,* 313 F.3d 9 at 20.[38]

Even though defalcation is determined through an objective standard, proof still involves some degree of fault that is closer to fraud, without the necessity of meeting a strict specific intent requirement. The *Baylis* court analogized the requisite degree of fault to the "scienter" standard for securities fraud. "A form of recklessness can meet the requirement of scienter but it is 'more like a lesser form of intent." *Id.* at 20 (quoting *Rizek v. SEC,* 215 F.3d 157, 162 (1st Cir. 2000)).[39] Accordingly, mere acts of negligence or conscious risk taking do not constitute "defalcation" for the purposes of section 523(a)(4) but an act or omission tending to show such an extreme departure from the standards of ordinary care as to reach the level of extreme recklessness. The totality of the circumstances in each particular case "will provide the level of wrongdoing needed to constitute a defalcation."[40]

The process of distinguishing cases is often an interesting intellectual exercise (like Sudoku) but rarely does it actually matter when applying, in particular, principles of law to the factual matrix of each case. But – and it is an important but – none of the cases cited or derived from *Baylis* involved a husband and wife,[41] a divorce judgment, or a subsequent *express* – not implied – partnership or conversion of money within that partnership. As the court in *In re Murphy* summarized, defalcation is an objective standard that requires "some degree of fault" without the necessity of meeting a specific intent requirement. Indeed, in *Murphy,*

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38 In *re Murphy,* 297 B.R. 332 at 350.

39 *Id.*

40 *Id.*

41 In Maine, the "partnership theory of marriage" under section 953 is "a major guiding principal in the separation and division of property at divorce." Tibbetts v. Tibbetts, 406 A.2d 70, 76 (Me. 1979). Under general principles of partnership law, much less a marriage or intimate partnership with children, it is well-settled that a partner has a fiduciary responsibility that obliges him to account for disposition of partnership property. *See* Dalton v. Austin, 432 A.2d 114 (Me. 1981); *see also* Rosenthal v. Rosenthal, 543 A.2d 348 (Me.1980) (defining fiduciary responsibility in a complex family partnership, which entitles a party to restitution for breach of fiduciary duty, including recovery of money for lost value).

involving nonrelations to stock transactions, the bankruptcy court found the obligation nondischargeable under section 523(a)(4) because the debtor's acts went beyond an act of omission constituting mere negligence or conscious taking of a risk.[42] Objective facts, taken as a whole and in the context of a *spousal* relationship, may establish a record of misbehavior or recklessness that does reserve the "harsh sanction" of nondischargeability for a debtor who has exhibited "some portion of misconduct."[43]

C. *Grounds or Not?*

So, are there grounds to file a section 523(a)(4) complaint? There is very little case law following the enactment of BAPCPA exploring the divorce/section 523(a)(4) overlay. *Collier Family Law and the Bankruptcy Code*[44] notes that

> [g]enerally, courts have held that a debtor may be considered a fiduciary subject to this section [section 523(a)(4)] only when an express or technical trust exists, rather than when one is created by law due to the debtor's status or a constructive trust is created as a result of wrongful conduct. However, courts have held that state statutory provisions may create a fiduciary relationship when a marriage in a community property state is dissolved with the *res* of the trust being the community property under a spouse's control.[45]

Leaving aside the distinction between community property and equitable distribution states, when there has been an absence of a valid, technical, trust, arguments have been unsuccessful. The parties may, of course, affirmatively place a provision in a divorce decree that would create an express trust and fiduciary duties as was the case in *In re Eichelberger*[46] with regard to a pension plan.

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42 *Id.* at 352.

43 *In re* Hyman*,* 502 F.3d 61 at 69 (citation omitted) (declining to apply collateral estoppel on findings of a prior court judgment when adopting the *Baylis* standard for the first time in the Second Circuit).

44 DISCHARGEABILITY OF MARITAL OBLIGATIONS IN BANKRUPTCY ch. 6 at [5] (MB 2010).

45 *Id.*

46 *In re* Eichelberger, 100 B.R. 861 (Bankr. S.D. Tex. 1989); *see also In re* Dahlin, 94 BR. 79 (Bankr. E.D. Va. 1988). *Collier's* at [5] footnote 64.

In *Eichelberger*,[47] a pre-BAPCPA case, the court noted that under the Bankruptcy Act (prior to 1978) and the Bankruptcy Code (the current bankruptcy law), "courts have consistently held that to be a fiduciary for purposes of dischargeability, the debtor must be a trustee under either an express or technical trust rather than a trust imposed ex-maleficio."[48] A trust that is created "ex-maleficio" is one that is created by virtue of the act of the wrong doing and is applied by courts constructively as a remedy for wrongdoing to prevent unjust enrichment.[49] In *Eichelberger,* the wife did not seek to enforce the divorce decree but rather sought to have the bankruptcy court determine that any damages arising as a result of her ex-husband's breaches of fiduciary duties, while he was serving as her trustee under their divorce decree, were non-dischargeable under section 523(a)(4). In cases under section 523(a) (4), federal law controls whether a fiduciary relationship exists and the critical inquiry is whether the trust created between the parties is express, technical or ex-maleficia.[50] A "long line of case authority has held that an express or technical trust may be created by a statute which expressly imposes fiduciary obligations on a party, which explains why pension and ERISA conflicts between spouses arise more often under this scenario."[51]

The bankruptcy court held in the ex-wife's favor, finding that the state family court judge intended to create an express or technical trust to protect the ex-wife's community property interests in her share of the debtor's ERISA qualified pension plan. This was made clear by the divorce decree's express designation of the debtor as a "trustee" for the ex-wife with respect to the pension fund, coupled with the identification of the "res" – a specifically identifiable property for the trust – half of the pension fund. Finally, the divorce decree also identified specific duties that the debtor was to perform vis á vis the pension fund.

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47 100 BR 861 (Bankr. S.D. Tex. 1989); *see also* Eichelberger v. Eichelberger, 584 F. Supp. 899 (S.D. Tex. 1984).

48 *Eichelberger*, 100 BR at 863 (citations to various circuit court opinions omitted).

49 *Id.* at 864.

50 *Id.*

51 *Id.* at 864 (internal string citations omitted).

The bankruptcy court further found that the debtor committed a defalcation that would cause the debt to be non-dischargeable in the bankruptcy case, though the majority of cases in this arena are to the contrary, including the Ninth Circuit, which has held that "as a general rule, the exception to discharge in Section 523(a)(4) should not apply in connection with a property settlement agreement or divorce decree."[52] The *Eichelberger* court states in response that "the need for imposing an express or technical trust via a divorce decree will only arise when the beneficial and legal interest in a particular piece of community property cannot be vested immediately in the spouse awarded the property . . . [this] has all the characteristics of an express or technical trust."[53] To be non-dischargeable under section 523(a)(4), the court must determine that the debtor owed fiduciary obligations which were breached in a manner that rises to the level of a defalcation. "Defalcation" may be caused by misconduct, negligence or even just a failure to account.[54]

The Fifth Circuit, in a 1987 case, broadly defined defalcation as "an abuse of a fiduciary position." Therein lays the importance of the trial court's findings of fact and legal conclusions. The *Eichelberger* bankruptcy court found, by utilizing collateral estoppel of the district court's findings, that the debtor committed a defalcation that would be non-dischargeable in the bankruptcy case.

D. *Other Examples*

There is significant bankruptcy case law holding that QDROs and other provisions assigning rights in pension funds to former spouses actually transfers title to the party receiving that interest under the divorce decree. These cases incorporate various provisions of the Bankruptcy Code, as debtors have tried different ways to challenge the terms of their divorce decrees in a bankruptcy case to eliminate these obligations and keep their share of these funds. In a situation that addresses a breach of fiduciary duty argument, *In re Dahlin*,[55] the court determined

52 *Id.* at 865, *citing In re* Teichman, 774 F.2d 1395, 1400 (9th Cir. 1985).

53 *Id.*

54 *Id.* at 866 (internal citations omitted).

55 94 B.R. 79, 81 (Bankr. E.D. Va. 1988), *aff'd*, 911 F.2d 721 (4th Cir. 1990). In Bush v. Taylor, 912 F.2d 989 (8th Cir. 1990), although the debtor had

that the divorce decree created an express trust for pension benefits and found that the debtor's failure to hold the benefits in trust for his ex-wife's benefit and to turn them over to her, established grounds to deny discharge of the debt to her pursuant to section 523(a)(4). Similarly, in a California case, *Lovell v. Stanifer (In re Stanifer),*[56] the debtor's failure to account for lump sum distribution from an IRA, as community property during their marriage, gave rise to an express trust under California law, such that the debt would be excluded from discharge for the debtor's breach of fiduciary duty and defalcation under section 523(a)(4). These cases, though, are fact specific. For a contrasting ruling, the court in *In re Albert*[57] held that there was not a sufficient trust under state law to warrant non-dischargeabililty of the debt under section 523(a)(4).

In a Florida bankruptcy case from 1989, the court noted that the vast majority of cases determine that the defalcation issue will not generally arise in the divorce context. In *In re Pattie*,[58] the debtor-husband filed a complaint, prior to the 1994 changes to the Bankruptcy Code, asserting that his property settlement to his ex-wife was "in the nature of a property settlement" and, therefore, subject to discharge. The ex-wife defendant raised various affirmative defenses, including that the debtor had committed a defalcation in his capacity as a fiduciary regarding certain obligations due and owing to her under their divorce decree. After much litigation, including a series of appeals, she was ultimately unsuccessful. The court ruled:

> [A]s far as it appears, the divorce decree did not designate the Debtor as trustee and did not establish an express or technical trust which existed prior to any alleged breach of fiduciary duty. There is no allegation in the amended counterclaim that an express trust existed prior to any alleged defalcation or any breach of any duty on the party of the Debtor. For this reason, the [ex-wife] cannot establish a viable claim under Section 523(a) (4) of the Bankruptcy Code under any set of facts. Moreover, it is also well established as a general rule, that the exception to discharge in Section 523(a)(4) has no application to con-

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died the court determined that the ex-wife's share of the pension funds were held in constructive trust for her.

56 236 B.R. 709 (B.A.P. 9th Cir. 1999).

57 194 B.R. 907 (D. Kan. 1996).

58 Pattie v. Pattie (*In re* Pattie), 108 B.R. 791 (Bankr. M.D. Fla. 1989).

troversies relating to property settlement agreements arising out of a divorce proceeding.[59]

This case may have limited utility today because it was a Chapter 7 discharge that the debtor was seeking and under BAPCPA, as discussed above, all divorce-related debts are automatically non-dischargeable from all chapters except for property-settlement, non-DSOs, in Chapter 13.

In a more recent Chapter 13 case in 2009, *Berger v. Jacobson (In re Jacobson)*,[60] the Texas bankruptcy court ruled on a former wife's complaint seeking to except the debt due to her by the debtor, her former husband, on grounds that he committed a defalcation while acting in a fiduciary capacity. In *Jacobson*, the ex-wife asserted that she was due approximately $1.2 million in oil and gas lease revenue that she was awarded by the family court. The protracted litigation was over which oil and gas leases and wells belonged to the debtor, which should have been transferred to his ex-wife; and how the debtor was to pay his ex-wife her interest in the wells and reserves. The bankruptcy judge ruled in favor of the debtor, on the breach of fiduciary duty aspect of the case, declining to find that the Texas state law provisions, that facially appear to give a spouse awarded certain property fiduciary obligations to the other party, do not rise to the level of "fiduciariness" required under the Bankruptcy Code for defalcation under section 523(a)(4).

The Fifth Circuit has held that the threshold issues for a debt to be rendered non-dischargeable due to defalcation are: (1) the presence of a definable res, (2) the imposition of trust-like duties, and (3) the trust's existence prior to any claimed misappropria-

59 *Pattie*, 108 B.R. at 797, *citing Teichman*, 774 F.2d at 1400 and *In re* Wheeler, 101 B.R. 39 (Bankr. N.D. Ind. 1989). In *Wheeler* the court denied the debtor's discharge altogether under grounds that found that he intended to hinder, delay and defraud his ex-wife with his post-petition sale of a motorcycle. But the court did not find grounds to exclude the debt to her under section 523(a)(4) for breaches of fiduciary duty because no express or technical trust was established in the divorce decree establishing the debtor as a trustee on her behalf: "A trust in either real or personal property is enforceable only if there is written evidence of its terms bearing the signature of the settlor or his authorized agent."

60 433 B.R. 183 (S.D.Tex. 2010).

tion.[61] The court incorporates what has been stated in the other cases about express, technical and constructive trusts and goes on to state that a statutory trust may be sufficient for section 523(a)(4) but that the situation must also include the elements of a res and defined duties.[62] It is important to note that in *Jacobson*, the parties had been engaged in protracted litigation over fifteen years and the court appears more focused on the abuse of the fiduciary position. The court specifically held that the debtor did not commit a defalcation and reserved judgment on the alleged embezzlement issue. It is notable, that despite debt limitations to qualify for Chapter 13, the debt by the debtor to his ex-wife was "okay" in that it was found to be "unliquidated."[63]

In what would appear to be a post-BAPCPA case, but is not, the *In re Lewis*[64] Court determined that to exclude a debt from discharge pursuant to section 523(a)(4) for breach of fiduciary duty, a plaintiff must show that there is a fiduciary relationship between the parties and that the debtor committed a fraud or defalcation while performing his fiduciary duties.[65] The court found that there was no evidence of a trust, or even a contract, rising to the level necessary to create a "fiduciary relationship" necessary under section 523(a)(4). In this particular case, the understanding between the parties, that the debtor would re-convey title to the home back to the ex-wife after he refinanced, was oral and not even reduced to writing and, therefore, the court found in favor of the debtor.

In another pre-BAPCPA situation, where section 523(a)(4) has been utilized on the domestic front to allege that a debt was

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[61] "The trust created by Tex. Fam. Code Ann . . . does not suffice for purposes of the defalcation exception to discharge." *Jacobson,* 433 B.R. at 191.

[62] *Id.* at 192.

[63] *Id.* at 189.

[64] 359 B.R. 732 (E.D. Mo. 2007).

[65] *In re* Lewis, 359 B.R. 732 (E.D. Mo. 2007). The case was filed under Chapter 7 at the end of September 2005, just weeks before the law changed in October 2005 to provide that all divorce-related debts would be non-dischargeable from Chapters 7, 11 and 12. His ex-wife filed a complaint seeking to exclude debts due to her under the divorce decree as non-dischargeable, specifically relating to the marital home lost to foreclosure, which became caught up in a dispute over a refinance and reconveyances between the parties. The ex-wife filed her complaint under the 1994 amendments to the Code, specifically sections 523(a)(4), (5), (6) and (15).

obtained by fraud or defalcation while acting in a fiduciary capacity and should not be discharged, the court in *Law Firm of Wendy R. Morgan v. LeRoy*,[66] found that there was no fiduciary relationship between a law firm and/or ex-wife client and the debtor-attorney for the firm to successfully pursue a section 523(a)(4) complaint to except an assigned debt for attorney's fees from debtor's discharge as a breach of fiduciary duty. In *Sculler v. Rosen (In re Rosen)*,[67] the debtor's obligation to account for monies removed from daughter's bat mitzvah fund was not in the nature of an express trust for purposes of section 523(a)(4). In summary, section 523(a)(4) "has been at the root of much judicial debate because courts disagree as to whether a fiduciary must have intent to commit defalcation."[68]

V. "But It's Always the Same in the End"

Then the king and the queen went back to the green
But you can never go back there again.
Brenda and Eddie had had it already
By the summer of '75
From the high to the low to the end of the show
For the rest of their lives
They couldn't go back to the greasers
The best they could do was pick up the pieces
But we always knew they would both find a way to get by
Oh, that's all I heard about Brenda and Eddie
Can't tell you more cause I told you already
And here we are waving Brenda and Eddie goodbye.

Now you have tools to use if Brenda and Eddie's divorce decree creates a *res*, that can be construed as an express or technical trust, and assigns Eddie specific duties thereunder and Eddie breaches those duties, causing direct harm to Brenda. If the marital relationship creates a fiduciary duty recognized by federal law, then a defalcation objection to dischargeability remains a viable option. If Eddie files for bankruptcy then Brenda may not need to do anything under Chapter 7, 11 or 12 because any debt created pursuant to a divorce decree is automatically non-

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66 251 B.R. 490 (Bankr. N.D. Ill. 2000).

67 232 B.R. 284 (Bankr. E.D.N.Y. 1999).

68 Andrea Johnson, Note, *Bankruptcy – The Defalcation Exception to Discharge: Should a Fiduciary's Mistake Prohibit a Discharge from Debt?,* 27 W. New Eng. L. Rev. 93, 93 (2005).

dischargeable from the bankruptcy case in Chapters 7, 11 and 12. If, however, Eddie files for a Chapter 13, Brenda may file her adversary complaint pursuant to section 523(a)(4) within 60 days of the first set meeting of creditors (or succeed in getting that deadline extended). Whether or not the court allows the ex-spouses to "gesture goodbye" may hinge on technical distinctions between state and federal law. Of critical importance is that the Bankruptcy Code provides a forum for legitimate complaints against dischargeability arising from the divorce relationship.