An Obscure Revolution: The Liability of Professionals in Bankruptcy

Bradley M. Elbein

University of Texas School of Law

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I. INTRODUCTION

Bankruptcy law has undergone an obscure but startling revolution. Recent cases have overturned a century and a half of interpretation regarding one very critical section of the Bankruptcy Code. In the past, professionals with malpractice liability could use bankruptcy protection to shield themselves. Today, professionals can depend on no such protection. The Code no longer allows professionals to avoid the consequences of their malpractice. Oddly enough, this revolution has occurred with little fanfare or comment.

From 1841 to 1994, professionals who sought bankruptcy protection...
could safely presume an ability to discharge any malpractice liability they might incur. Such a presumption was no further afield than the prospect of discharging consumer or commercial debt. Any attorney, physician, or corporate director who abused a client’s trust could shield himself by seeking refuge in bankruptcy. Ironically, bankruptcy, the equitable remedy, became the protector of inequitable conduct. This intolerable situation could not continue forever. By the mid-1980s, a smattering of courts had begun to explore ways to deny the discharge of professional liability claims. Indeed, by the summer of 1994, a pattern of holdings in the bankruptcy courts revealed that a revolution was in progress. Taken together, two 1986 cases and a recent 1994 opinion have profoundly changed the bankruptcy world for professionals.

Part I of this article analyzes the liabilities that professionals face in bankruptcy that do not involve malpractice. To provide background for the analysis that follows, part II explores the traditional bankruptcy rules that practically assured a professional discharge for liability incurred through negligence or malpractice. Finally, part III considers the cases that heralded the change in treatment of professionals in bankruptcy and argues that these cases amount to a revolution.

II. THE NON-PROFESSIONAL LIABILITY OF PROFESSIONALS

Until the advent of the cases that form the basis for this article, a professional who sought protection in bankruptcy was treated the same as every other debtor in bankruptcy. Early on, the courts did not distinguish professionals from tradesmen. Perhaps for this reason, bankruptcy jurisprudence paid little attention to the origins of the liability from which debtors sought bankruptcy protection. Courts assumed that the debtor-professional

corporate officers or directors, i.e., “those who undertake any work calling for special skill, [who are] required not only to exercise reasonable care in what they do, but also to possess a standard minimum of special knowledge and ability.” W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 32, at 185 (5th ed. 1984).
7. Some distinctions were made, but generally these differentiated only between the respective rights of creditors and debtors. The distinction between secured and unsecured creditors, for

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needed protection (and for the most part was entitled to protection) from the
same two kinds of liability as all other debtors. These two basic types of
liability arose from either ordinary commercial, trade, or consumer debt, or
from intentional tort claims.

For the most part, the Bankruptcy Code states a general rule about the
treatment of both these categories. More precisely, the Code's treatment of
the dischargeability of ordinary debt on the one hand and liability for
intentional torts on the other comes as close to a promulgation of bright-line
tests as anything in the Code ever does. Ordinary commercial, trade, and
consumer debt are either completely discharged or discharged after a series
of payments pursuant to a payment plan. Thus, debtor-professionals will
discover that the vast majority of their "trade" and consumer debt is
completely discharged under Chapters 7, 11, and 13.

Example, reflected the rights for which the creditor bargained. These early cases evidence an
assumption that claims against the bankruptcy estate were the products of debts which arose in
the normal course of business or life; therefore, the factual circumstances or background
supporting a particular claim did not matter. This article argues that claims for professional
malpractice present unique problems precisely because of the circumstances that spawn them.

8. This class of claims is absent from the exceptions to discharge set forth in § 523. 11 U.S.C. § 523 (1994). Therefore, the practitioner is left to define this class by what it does not include.

9. The Bankruptcy Code may be unique in American jurisprudence in its failure to state
general rules. Other complex statutes (such as the Commercial Codes and the Internal Revenue
Code) first state general principles and then catalogue voluminous exceptions. In contrast, the
Bankruptcy Code consists of a thick volume of exceptions to a set of general rules never
explicitly and positively expressed by the statute itself but implicitly understood by practitioners.

10. This article uses the technically incorrect terms "dischargeable" and "nondischargeable"
to refer to two kinds of claims discussed throughout. More accurately, there are unexceptional
claims and exceptional claims. That is, there are claims that do not arise above the undifferentiated
mass of other debts from which the debtor seeks protection. These are discharged along with
other debt under the general rule that all unexceptional liabilities are discharged. The article refers
to these unexceptional claims as "dischargeable," although technically it is the corpus of claims
which are dischargeable, not any one claim. In contrast, exceptional claims either rise up out of
the mass of other claims to receive an exception to discharge under § 523 or § 727(b), or form
the basis for an objection to discharge under § 727(c)(1). The article refers to these exceptional
claims as "nondischargeable" or as "surviving bankruptcy," although this status only arises when
a party in interest seeks denial of the debtor's discharge by filing an adversary proceeding. Rather
than using the technically correct but indigestible terms "not excepted from discharge" and
"subject to exception from discharge" or "forming the basis for an objection to discharge," this
author opts for readability and the simpler terms.

12. See id. §§ 1141(d)(1)(A), 1328(a).
13. Under § 727(b), a discharge under Chapter 7 discharges "all debts," subject to exceptions enumerated in § 727(a) and § 523. Id. § 727(b).
14. Under § 1141(d)(1)(A), the confirmation of a plan "discharges the debtor from any debt," except for those debts set out in § 523 and § 727(a). Id. § 1141(d)(1)(A).
15. Under Chapter 13 discharge is subject to contingency and limitation. Section 1328(a)
There is also a simply stated rule for intentional torts, but with significant exceptions. In general, the Code does not favor the discharge of intentional torts. Section 523(a) of the Code excepts most species of intentional torts from discharge, including a broad category of actions that are "willful and malicious," fraud in a fiduciary capacity, embezzlement or larceny, and various kinds of claims for fraudulent misrepresentation and false pretense. The Code's prejudice against intentional torts is so broad that even conduct which is not intentional, but only grossly negligent, may survive the bankruptcy discharge. For example, § 523(a) excepts from discharge any personal injury claim arising from driving under the influence of intoxicants—an act which, at worst, constitutes only gross negligence.

As previously mentioned, the Code contains exceptions to the general rule of nondischargeability for intentional torts. The greatest of these exceptions is found in Chapter 13. Specifically, all of the intentional torts catalogued above receive a discharge if a Chapter 13 plan is confirmed. This is so despite the fact that certain acts of gross neglect are not discharged. In an odd twist,
however, if a hardship discharge is granted, Chapter 13 reverts to a smaller scope of dischargeability by incorporating the provisions of § 523(a)—negating the exception altogether.  

Thus, professionals in bankruptcy can generally count on discharge of their commercial and consumer debt but no protection for their intentional torts, unless the professional completes a plan under Chapter 13. Because bankruptcy law distinguished neither professionals from tradesmen or other debtors nor liability for malpractice from other types of debt, malpractice claims were formerly discharged like any other commercial or consumer debt. This situation was particularly distressing to those creditors who entrusted their intimate personal and financial affairs to a professional, only to find that bankruptcy law shielded the professional from malpractice liability.  

III. THE OLD RULES: NEGLIGENCE AND MALPRACTICE OF PROFESSIONALS  

In the no-man’s-land between dischargeable debt and nondischargeable intentional torts stretches a minefield of negligence and malpractice. In past years, the Code (and the Acts that preceded it) ignored any claim arising from negligence liabilities, making any claim resulting from the negligent acts of the debtor dischargeable.  

Because most malpractice claims are negligence claims, the Code’s silence meant that malpractice claims were not excepted from the general discharge. New cases have begun to erode this general rule, but for some professionals

25. Under § 1328(b) a Chapter 13 debtor may receive a discharge without full payment under the plan, if the debtor cannot complete payments due to circumstances beyond the debtor’s control. In that case, the discharge provisions of § 1328(c) come in to play. This latter section provides that where a hardship discharge is granted, it “discharges the debtor from all unsecured debts provided for by the plan or disallowed . . . except any debt . . . of a kind specified in § 523(a) of this title.” 11 U.S.C. § 1328(c). It is unclear why the scope of § 523(a) claims that survive discharge is greater for the hardship discharge debtor than for the debtor who manages to complete his plan. Two reasons are usually given. First, the hardship discharge is just the Chapter 7 discharge in another guise; second, a Chapter 13 plan must pay out more than a Chapter 7 liquidation. Whether these reasons are persuasive is a matter of individual judgment. Paraphrasing “Hamlet,” if this be method, there is madness in it.  

26. Predecessor statutes were the Bankruptcy Acts of 1800, 1841, 1867, 1898, and 1938 (the so called “Chandler Act”).  

27. In the Bankruptcy Act of 1898, only provable claims were dischargeable. In theory, some negligent claims were not provable and therefore not dischargeable, although it is not clear why any debtor would worry about the non-discharge of an unprovable claims.
the old rules clearly still apply. The disparity of treatment has led to inconsistent results for different professions.

A. Physicians

A debtor physician need only refer to one section of the Code when considering whether his malpractice claims will survive the bankruptcy discharge. Only § 523(a)(6) exposes the debtor physician to nondischargeable professional liability claims.\(^{28}\) The threat posed by this section results from the peculiar nature of medical practice and the history of malpractice law.

Unlike any other field of expertise, the medical profession inevitably commits innumerable acts of near-battery.\(^ {29} \) Battery is, of course, an intentional tort that occurs when an act of non-consensual, harmful or offensive touching causes injury.\(^ {30} \) Only the timely consent of the patient keeps these harmful and offensive touchings from becoming consummated battery.\(^ {31} \) Even if the consent barrier is somehow circumvented and battery charged, the malpractice claim may fall squarely within the terms of § 523(a)(6).

Section 523(a)(6) excepts from discharge any “willful and malicious injury by the debtor.”\(^ {32} \) At a glance, the elements of “willfulness” and “maliciousness” would seem to exclude all but the most egregious acts of medical malfeasance. In practice, the line is quite hard to draw because, especially in context, the meaning of these words is unclear.\(^ {33} \) For example, some courts

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\(^ {28} \) 11 U.S.C. § 523(a)(6) (1994). Section 523(a)(6) reads: “A discharge under § 727, 1141 . . . or 1328(b) of this title does not discharge an individual debtor from any debt . . . for willful and malicious injury by the debtor to another entity or to the property of another entity.” \textit{Id.}

\(^ {29} \) “A battery is the unlawful touching . . . of the person of another . . . with the intention of bringing about a harmful or offensive contact . . . .” 6 AM. JUR. 2D Assault and Battery § 5 (1963). Moreover, “a battery, in the legal sense of the term, may be committed although no physical harm resulted from the act.” \textit{Id.} The fact that surgery begins with a violation of the integrity of the skin indicates that medical treatment may be harmful in the short term. “[An] operation is battery [unless there is] . . . consent.” 6A C.J.S Assault and Battery § 16, n.91 (1975).

\(^ {30} \) Under archaic definitions of battery, a necessary element was the intention to harm. As American Jurisprudence notes, “This requirement appears to have been relaxed to a certain extent.” 6 AM. JUR. 2D Assault and Battery § 6 (1963). In fact, it is more accurate to say that modern definitions of battery tend to require only that the tortfeasor intend the act, not the offense or harm.

\(^ {31} \) “Consent of a patient to medical treatment may preclude liability for assault and battery based on such treatment.” 6A C.J.S Assault and Battery § 16, n. 86 (1975). “[A]n act done without the consent of the person affected . . . constitutes an assault and battery, as for example, an unauthorized surgical operation . . . .” 6 AM. JUR. Assault and Battery § 147 (1963).

\(^ {32} \) 11 U.S.C. § 523(a)(6).

\(^ {33} \) See James L. Rigelhaupt, Jr., Annotation, \textit{When Does Medical Practitioner’s Treatment of Patient Constitute “Willful and Malicious Injury” so as To Make Practitioner’s Debt Arising}
have held that intentional acts that result in injury satisfy the willful and malicious standard,\textsuperscript{34} while others have held that the phrase requires an act committed with intent to cause an injury.\textsuperscript{35} Recent cases suggest that if a physician has reason to know facts that should put him on notice of a defect in consent or if he has not taken reasonable precautions to protect the patient, he may well be considered to be acting with the willful and malicious intent that invokes an exception to discharge under § 523(a)(6).\textsuperscript{36} These rules hold true even though the physician’s subjective intent may have been to assist the patient, not to commit an intentional tort, and certainly not to act willfully or maliciously.

For almost a century, injured malpractice plaintiffs who are also creditors in their physician’s bankruptcy proceedings have pressured the bankruptcy courts to interpret § 523(a)(6) as a \textit{de facto} gross negligence standard. This campaign has been somewhat effective. In 1904, the United States Supreme Court held that an act characterized as “willful disregard” was nondischargeable under § 523’s precursor.\textsuperscript{37} In drafting § 523(a)(6), the House Judiciary Committee announced that it intended specifically to exterminate the looser standard set forth by the Supreme Court.\textsuperscript{38} Nevertheless, because the wording of this section is so similar to the gross negligence formulation used in many states, a gross negligence standard will likely continue to apply to medical malpractice claims in bankruptcy.

This should give physician-debtors pause for two reasons. First, a thin line separates “mere negligence” from gross negligence.\textsuperscript{39} Often, only a jury’s anger moves negligence into the gross negligence area. At times, larger cultural factors determine whether an act is gross or mere negligence; for example, consider “driving while intoxicated” law. Just a few years ago, most jurisdictions considered this conduct to be mere negligence. Today, it is considered an act of negligence gross enough to receive its own exception to discharge under the starched and staid Bankruptcy Code. Whatever it is that

\textit{from Such Treatment Nondischargeable Under § 523(a)(6) of Bankruptcy Act (11 USC § 523(a)(6)), 77 A.L.R. Fed. 918 (1986).}

34. See, e.g., Impulsora del Territorio Sur, S.A. v. Cecchini (\textit{In re} Cecchini, 772 F.2d 1493 (9th Cir. 1985)).

35. See, e.g., Barclays Am./Bus. Credit, Inc. v. Long (\textit{In re} Long), 774 F.2d 875 (8th Cir. 1985).


39. Discussing the distinction, Prosser notes that the prevailing view is that “gross negligence is merely the same thing as ordinary negligence, ‘with the addition,’ as Baron Rolfe once put it, ‘of a vituperative epithet.’” \textit{WILLIAM L. PROSSER, LAW OF TORTS} § 34, at 182 (4th ed. 1971).
separates gross from simple negligence, it is surely not defined with a degree of accuracy that would serve physicians in the already complex world of medical malpractice. Second, the Code subjects physicians to heightened scrutiny and less protection because of their greater knowledge and control.40

In short, physicians contemplating bankruptcy cannot be absolutely certain their malpractice claims will be discharged—except under the mainstream discharge of Chapter 13.41 This is no easy task, however. To qualify for Chapter 13, the physician must fit within the restrictive requirements of § 109(e).42 Although recent amendments raised the maximum debt limitations, some physician debtors may yet not qualify. Adding to the obstacle, the only debts which are included within the limits of § 109(e) are those which are both "noncontingent" and "liquidated."43 Courts have debated at great length the precise meaning of these two terms.44 For the purpose of this discussion, a debt is liquidated if the amount of the debt can be readily ascertained by reference to an agreement or by simple computation.45 Likewise, contingent debts are "those claims which depend either as to their existence or their amount on some future event which may not occur at all of may not occur until some uncertain time."46

Significantly for physician-debtors faced with malpractice liability, "when the debtor's liability is of a tortious nature, courts have been reluctant to find the debt noncontingent where the liability itself has not been fixed prior to the bankruptcy filing."47 In very broad terms, any pending tort claim is contingent.48 Whether the debtor disputes the claim (as physicians are likely to do when faced with malpractice claims) is not relevant to the issue.49 Thus, a physician who can beat his malpractice claims to the courthouse (no simple task given the complexity of the bankruptcy process) and who does not admit

40. See discussion infra Part V.
42. 11 U.S.C. § 109(e) (1994). The physician must owe, on the date of filing, less than $250,000 of non-contingent, liquidated and unsecured debt, and less than $750,000 of non-contingent, liquidated and secured debt. Id.
43. Id.
44. See generally 2 COLLIER ON BANKRUPTCY ¶ 109.05, (Lawrence P. King et al. eds., 15th ed. 1996) (reviewing cases that define "noncontingent" and "liquidated").
48. See 2 COLLIER ON BANKRUPTCY, supra note 44, at n.12 (interpreting Belt, 106 B.R. at 558).
49. In re Jerome, 112 B.R. 563, 566 (Bankr. S.D.N.Y. 1990). In determining Chapter 13 eligibility, a dispute regarding liability or amount of claim does not cause debt to be regarded as unliquidated. Id.
readily ascertainable claims,50 may be able to discharge his malpractice liability under Chapter 13.

Not surprisingly, there are two significant caveats to this statement. First, it is critical to remember that if the physician-debtor seeks a hardship discharge under § 1328(b)51 and (c),52 the § 523(a)(6) claims will not be discharged.53 Second, and more important, Chapter 13 contains a "good faith" requirement that comes into play when a court decides whether or not to confirm a plan.54 Specifically, the court can consider pre-filing conduct,55 including the circumstances under which a debt was incurred,56 the type of debt and whether any portion of it is nondischargeable under other sections of the Code,57 and the legal and equitable effects of the proposed plan.58 This judicial inquiry is so broad that the court can even consider the state of mind of the debtor.59 Curiously, the good faith requirement applies only to the filing of the plan, not the bankruptcy itself.60 Abuse of the "purposes or spirit" of Chapter 13, however, may be considered bad faith sufficient to deny confirmation.61 In any case, a physician-debtors can count on discharge of their malpractice liabilities only if they can survive either the "willful and malicious" standard of § 523(a)(6) or the restrictions of Chapter 13.

B. Accountants

Accountants' work broadly encompasses the rather separate tasks of auditing, tax return preparation, and management consulting.62 Errors in any of these roles may cause injury to the client. Fortunately for accountants,

50. See Ramus, 37 B.R. at 726 (stating that there is an exception to noncontingency where the debtor admits the tort and the amount is ascertainable).
51. Section 1328(b) defines the hardship discharge.
52. Section 1328(c) sets out the debts discharged, including § 523(a) claims.
53. See supra note 25.
54. 11 U.S.C. § 1325(a)(3) (1994). "[T]he court shall confirm a plan if . . . the plan has been proposed in good faith and not by any means forbidden by law . . . ." Id.
55. See generally 5 COLLIER ON BANKRUPTCY, supra note 44, ¶ 1325.04 (reviewing cases that have considered pre-filing conduct in the determination of good faith).
57. See United States v. Estus (In re Estus), 695 F.2d 311, 317 (8th Cir. 1982).
however, the Bankruptcy Code and courts would probably grant a discharge for claims stemming from such errors.63

Historically, courts have been wary of holding accountants liable for much more than breach of contract.64 Yet, with some understandable disregard for its potential impact on this time-tested limitation, the Bankruptcy Code fails to distinguish liability for breach of contract from any other "right to payment."65 In essence, the claim arising from an accountant’s breach might as well be ordinary consumer debt; breach of contract claims are discharged under all chapters in the Code. As one commentator put it, "A simple breach of contract does not cause an injury which may be excepted from discharge under Code § 523(a)(6)."66

Recently, courts have expressed a willingness to hear negligence claims against accountants.67 This development has been helpful to a plaintiff seeking recompense for an accountant’s malpractice outside of bankruptcy, but it does not save the injured client under the Code. In bankruptcy, claims for negligence still are discharged along with other claims.68 Thus, independent of whether the potential accounting malpractice claim sounds in negligence or breach of contract, the accountant can count on a discharge—at least under the old rules.

C. Attorneys and Other Professionals

A long history of cases decided under the Bankruptcy Code and its predecessor acts protected professionals from malpractice liability in a bankruptcy proceeding. The Code traditionally ignored negligence and, by not

63. DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS spends an entire chapter discussing "Risk Management," but it mentions bankruptcy protection in only one small paragraph. The writers characterize the idea of professionals seeking protection in bankruptcy as "distasteful." Id. at 534. They then assert that "[s]ection 523(a)(4) . . . prevents the discharge of claims for fraud or defalcations of a fiduciary," although they do not analyze how accountant malpractice claims qualify within that section. Id.

64. See Leeds Estate, Bldg. & Inv. Co. v. Shepherd, 36 Ch. D. 787, 809 (1887); City of East Grand Forks v. Steele, 141 N.W. 181, 182 (Minn. 1913). See also CAUSEY, supra note 62, at 55.


66. WILLIAM L. NORTON, NORTON BANKRUPTCY LAW AND PRACTICE § 47:41 (2d ed. 1994). Of course, what for a commentator is a "simple breach" can for the client be a financial disaster.

67. In 1913, the court dismissed the negligent failure of an auditor to discover fraud as outside the contemplation of the parties, that is outside of the contract. East Grand Forks, 141 N.W. at 181. By 1939, negligence was a question for the jury. National Sur. Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (1939). By the mid-1980s, the liability of accountants was well-enough established to sustain a comparative negligence defense, as in Devco Premium Fin. Co. v. North River Ins. Co., 450 So.2d 1216, 1220 (Fla. Dist. Ct. App. 1984). Of course, negligence litigation against accountants exploded with the savings and loan disasters of the mid-1980s.

68. See discussion infra Part III.C.
excepting it from discharge, allowed professionals who were also tortfeasors to discharge the results of their negligence. 69 Without doubt, bankruptcy’s origin in the “law merchant” 70 helps to explain this easy treatment of professionals. Bankruptcy jurisprudence evolved insensitive to issues common in professional practice. When faced with claims arising from professional malpractice, the courts simply deferred to the language of the Code and found no reason to except those claims from the general discharge of debts. 71

Section 523(a)(4) is the only section of the Code that comes close to addressing professional malpractice claims. 72 The current wording of this section provides an exception to discharge for “fraud or defalcation while acting in a fiduciary capacity.” 73 The various preceding acts used similar language, 74 and the courts have consistently chosen a strict interpretation. In the middle of the 19th century, courts began to require three elements in order to justify this particular exception to discharge. First, an express trust had to exist between the debtor and the claimant. 75 Second, the debtor must have acted in a fiduciary capacity. 76 Third, the debtor-fiduciary must have committed fraud or defalcation. 77


70. The inclusion of non-merchants in the class of those who could seek bankruptcy protection was an innovation. “Bankruptcy law evolved from the English bankruptcy legislation, which in turn traces its roots to the Italian law-merchant,” which applied only to merchants, not those practicing the learned professions. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART I, H.R. DOC. NO. 93-137, at 63 (1st Sess. 1973). One commentator notes that although the first English Bankruptcy statute was not restricted on its face to traders, the second, in 1570, was. “The bankruptcy law only applied to ‘traders,’ i.e., to merchant debtors. Non-merchants were relegated to the separate ‘insolvency’ laws . . . .” Charles Jordan Tabb, The History of the Bankruptcy Laws in the United States, 3 AM. BANKR. INST. L. REV. 5, 9 (1995). This restriction continued in America through the Bankruptcy Act of 1800, until the Bankruptcy Act of 1841. That act for the first time extended the protection of the bankruptcy laws to non-merchants. Id. at 17.

71. “Damages from mere negligence or lack of skill . . . do not rise to the level of ‘willful or malicious injury’ [to be rendered non-dischargeable under § 523] without a further showing.” Norton, supra note 66, § 47:43.

72. Section 523(a)(4) of the Bankruptcy Code reads: “A discharge under § 727, 1141 . . . or 1328(b) . . . does not discharge an individual debtor from any debt . . . for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . .” 11 U.S.C. § 523(a)(4) (1994).

73. Id.

74. For example, § 523(a)(4) is characterized as “substantially the same as § 17a(4) of the Bankruptcy Act.” Norton, supra note 66, § 47:19.


77. See Central Hanover Bank & Trust Co. v. Herbst, 93 F.2d 510, 511 (2nd Cir. 1937).
1. Existence of an Express Trust

Establishing the existence of an express trust became a threshold issue in claims against the professional.78 In the leading case, Davis v. Aetna Acceptance Co.,79 the Court construed the 1841 Bankruptcy Act to require that a "technical trust" exist before going forward with the dischargeability analysis.80 Davis was not a case of first impression: It relied upon the hoary authority of Chapman v. Forsyth, decided in 1844.81 These opinions apparently reasoned that, without a trust, there could be no fiduciary and therefore no actions in a fiduciary capacity.82

2. Fiduciary Capacity

Having established the existence of an express trust, the claimant seeking an exception to discharge was required to show that the debtor also acted as fiduciary. Merely acting in a fiduciary capacity was not enough—despite the wording of the statute.83 Indeed, the courts went beyond the language of the statute and required that the fraud or defalcation be caused by a fiduciary par excellence.

In bankruptcy settings, the term "fiduciary" has been narrowly construed to apply only to relationships involving technical or express trusts. An express or technical trust may be either one in which a formal document is executed which establishes the rights and duties of the parties, or one in which trust-type obligations are imposed pursuant to statute or common law. As a rule, the general fiduciary duty created by a power of attorney gives rise to an agency relationship, but does not give rise to the fiduciary capacity required by section 523(a)(4).84

78. Note that neither § 523(a)(4) nor its predecessors state this requirement.
79. 293 U.S. 328 (1934).
80. Id. at 333.
81. 43 U.S. 202 (1844).
82. For example, Chapman discusses the statutory requirement for what the opinion calls "special" or "technical" trusts, and seems to derive from that discussion the necessity for the bankrupt to have acted in a fiduciary capacity. Id. at 208. Davis discusses the necessity of a true trust, and follows this discussion with the requirement for the bankrupt "to have been a trustee before the wrong and without reference thereto." Davis, 293 U.S. at 333.
83. Section 523(a)(4) specifies the requirement of acting "in a fiduciary capacity." 11 U.S.C. § 523(a)(4) (1994). However, even under the old Act, courts took great care to narrow the meanings of this phrase. Justice McLean argued in Chapman that, "in almost all the commercial transactions of the country, confidence is reposed...and a violation of these is, in a commercial sense, a disregard of a trust. But this is not the relation spoken of in the first section of the act." Chapman, 43 U.S. at 208.
Being construed as a fiduciary under non-bankruptcy law likewise was not sufficient. In order to qualify as "fiduciary capacity" for purposes of § 523(a)(4), an express trust agreement, an identifiable res, and fiduciary duties arising from the agreement must have existed. Agents, attorneys in fact and attorneys at law might have been considered fiduciaries in other areas of the law, but not in bankruptcy.

3. Fraud or Defalcation

While § 523(a)(4) encompasses a debtor who has either defrauded or defalcated, the bulk of the revolution in professional liability claims falls squarely on the interpretation of "defalcation." "Fraud" does appear as an alternative ground in § 523(a)(4), but it has no relevance in the context of malpractice litigation. After all, intentional torts like fraud lead to either nondischargeable criminal liability or nondischargeable intentional tort liability. Moreover, the definition of fraud is clear, and the elements for fraud are well established.

85. Agents, such as those in Chapman, were not considered fiduciaries in the bankruptcy context. The court provided two reasons for this conclusion: First, the trust imposed upon an agent is an ordinary commercial trust. Second, any other construction "would have left but few debts on which the [bankruptcy] law could operate." Chapman, 43 U.S. at 208.

86. The Code of Professional Responsibility defines the attorney-client relationship in terms of a fiduciary relationship, although without naming it as such. "The professional judgment of a lawyer should be exercised . . . solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client." Model Code of Professional Responsibility, EC 5-1 (1979). Some states drew the obvious conclusion and labeled the relationship as fiduciary. See Georgia Code of Professional Responsibility, EC 4-1 (1997). The courts had long been referring to the attorney-client relationship as a fiduciary relationship. See, e.g., In re Czachorski, 244 N.E.2d 164, 166 (III. 1969); Smoot v. Lund, 369 P.2d 933, 936 (Utah 1962).


88. With the exceptions noted for chapter 13. See supra note 23-25 and accompanying text.

89. The elements are generally agreed to be: "(1) a representation of an existing fact; (2) its materiality; (3) its falsity; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) his intent that it should be acted on by the person to whom it is made; (6) ignorance of its falsity on the part of the person to whom it is made; (7) the latter's reliance on the truth of the representation; (8) his right to rely upon it; (9) his consequent damage." Swanson v. Solomon, 314 P.2d 655, 657 (Wash. 1957). See also Ardis v. Cox, 314 S.C. 512, 513, 431 S.E.2d 267, 269 (Ct. App. 1993).
Defalcation is a vague, ill-defined term ripe for creative interpretation. It has almost no currency outside the fiduciary context. The word's curious lack of definition predisposed it to revolutionary use.

The Code does not define defalcation. The word smacks of archaic English, but the Oxford English Dictionary provides little assistance. Black's Law Dictionary provides little more in the way of elucidation. Neither of the dictionaries addresses the questions of greatest significance to practitioners (and debtors): Whether the act of defalcation which excepts a debt from discharge must be intentional (as in misappropriation) or merely negligent (as with failure to account)? Whether the actor must be a public agent or merely a fiduciary? Whether defalcation requires malfeasance?

The few bankruptcy cases which do define defalcation are not of much assistance either. In Central Hanover Bank & Trust Co. v. Herbst, the court attempted an interpretation of § 17a(4) of the former Bankruptcy Act, the predecessor of § 523(a)(4). In its efforts, the Herbst court traced the term defalcation from its first appearance in the Bankruptcy Act of 1841, through the former Bankruptcy Act of 1867 and then through colloquial usage. The court eventually threw up its rhetorical hands: "Whatever was the original meaning of ‘defalcation,’ it must here [in § 17a(4) of the Bankruptcy Act] have covered other defaults than deliberate malversations, else it added nothing to the words, ‘fraud or embezzlement.’" The court concluded that the scope of defalcation reaches beyond acts of fraud, embezzlement, or misappropriation. At about the same time as the Herbst decision, the Second Circuit, in In re Bernard, held that "misappropriation must be due to a known breach of the duty, and not to mere negligence or mistake." A reasonable synthesis of these cases might be that defalcation was the general, nonspecific

91. The word has seen something of a rebirth in recent years in the environmental law context. Cases and articles in professional journals are replete with references to "environmental defalcation."

92. The Oxford English Dictionary defines defalcation as: "A monetary deficiency through breach of trust by one who has the management or charge of funds; a fraudulent deficiency in money matters; also . . . a breach of trust by one who has charge or management of money." Oxford English Dictionary 369 (2d ed. 1989).

93. Black's Law Dictionary defines defalcation as, "[u]sually spoken of officers of corporations or public officials. . . . Colloquially, perhaps, the word 'defalcation' ordinarily implies some moral dereliction. As used in the Bankruptcy Act, it may demand some portion of misconduct, but it is not synonymous with 'embezzlement.'" Black's Law Dictionary 504 (4th ed. rev. 1986).

94. 93 F.2d 510 (2nd Cir. 1937) (J. Learned Hand).
95. Id. at 511.
96. Id.
97. Id. at 512.
98. 87 F.2d 705 (2nd Cir. 1937) (J. Augustus Hand).
99. Id. at 707.
description of any act, by an agent, causing monetary loss to the principal, and which implied some hint of malfeasance floating unsubstantially about the usage.

Bringing together the rather vague definition of defalcation and the very narrow meaning attributed to fiduciary, § 523(a)(4) seemed to require both an identifiable fund of money and an express trust relationship to render a malpractice claim nondischargeable. These are not the characteristics of typical professional liability claims.100

Puzzling as it may seem, it was not until the late twentieth century that bankruptcy courts began to recognize that their reading of § 523(a)(4) protected unjust and inequitable behavior that was not protected outside of bankruptcy. When courts finally began to refuse to discharge professional malpractice claims, they turned to the words “defalcation” and “fiduciary capacity” in § 523(a)(4). The historical readings of the these two terms did not long delay the courts in their desire to make professional liability nondischargeable.

IV. THE REVOLUTION: PROFESSIONALS AS FIDUCIARIES

As noted above, § 523(a)(4) of the Code has served as the professional-debtor’s chief shield from the results of malpractice.101 By necessity, § 523(a)(4) has also served as the primary offensive weapon for attacking a professional’s attempt to discharge malpractice liability. The professional-debtor is allied with more than a century of decisional law, but the strength of his precedent is weakening. Across the country, bankruptcy courts are increasingly willing to bar discharge of professional liability claims, and they are accomplishing their objective by reading the fiduciary requirement of § 523(a)(4) without the restrictive gloss of the old cases.

A. Attorneys

Legal malpractice claims in bankruptcy have spearheaded the revolution. This may be because of the suspicious regard in which the public holds attorneys,102 but more likely, it is because attorneys are considered fiducia-
ries in almost every context outside of bankruptcy. To treat attorneys as non-fiduciaries upon initiation of bankruptcy proceedings—with the inequitable result of shielding them from the results of their own malpractice—might simply have been too much for the courts to swallow. For whatever reason, attorneys were the first group of professionals to find that their bankruptcy haven was no longer secure.

During the summer of 1986, two cases in different jurisdictions (Massachusetts and Illinois) signaled the bankruptcy judiciary's initial willingness to change. These two cases are stark reversals of § 523(a)(4) interpretation. Several more courts jumped on the bandwagon in the ensuing decade. Any of these cases taken separately might be a mere aberration, but taken together with an opinion on directors’ and officers’ liability, they signal a revolution.

In 1986, a Massachusetts attorney named Kwiat filed for bankruptcy relief under Chapter 7. Among his liabilities was a two-year-old judgment arising from a malpractice claim. In a pre-bankruptcy judgment, a state court had found that Kwiat had violated a state statute limiting the fees allowed for a particular class of conduct by an attorney. After two years of appeals that affirmed the judgement against him, Kwiat filed for bankruptcy relief. The plaintiff, unwilling to have his judgment discharged, filed an adversary proceeding to bar discharge under § 523(a)(4) and § 523(a)(6). The court had little difficulty in determining that the attorney’s conduct violated both elements of § 523(a)(4). Although the opinion runs several...
pages, the relevant analysis of § 523(a)(4) occupies less than a quarter of a printed page. The first step of the court’s short analysis is a bald assertion: “Clearly, an attorney holds a fiduciary capacity to this client . . . .” This proposition, in the context of an attorney malpractice claim, is so obvious as to be trivial. Most states have both Codes of Professional Responsibility for attorneys and case law that hold attorneys to be fiduciaries. Yet, the statement is a revolutionary one in the context of § 523(a)(4) requirements.

Two sentences further along, the court added the second step in its analysis, again by stating a naked assertion: “The wrong committed by Kwiat in his fiduciary capacity was a defalcation.” The court reached this conclusion largely because the trial court had already determined (prior to the bankruptcy filing) that Kwiat had taken the excess fees without his client’s permission and from a sum held in trust for settlement. The Kwiat fact pattern satisfied all of the traditional requirements of defalcation: (1) an identifiable res, (2) plaintiff’s financial interest in it, (3) a formal trust relationship, and (4) a malfeasant taking by the trustee. These criteria being met, debtor Kwiat’s situation could easily be seen as a traditional fiduciary defalcation case. Yet, because the defalcator was an attorney, the court assumed that he was also a fiduciary and proceeded under § 523(a)(4).

In reaching its blunt ends, Kwiat cites the other 1986 case that barred discharge of attorney malpractice liability, In re Janikowski. Janikowski was decided a few weeks before Kwiat and reached a similar result, but there is no other similarity between the two cases. While the Kwiat court faced an easy fact pattern, the Janikowski court struggled against well-established precedent and wrestled with an unruly factual situation in order to avoid an inequitable result. Of course, it is the Janikowski decision that has the broadest potential for impact on developments under § 523(a)(4) because the court stretched the statute further beyond its historical boundaries.

113. Id.
114. See supra note 86.
115. It is ironic that this revolutionary statement is actually a return to a literal reading discarded by the earlier cases. The bankruptcy statutes have never on their face required a formal fiduciary relationship, only that actions be undertaken in a fiduciary capacity. The early courts read this general term very narrowly, as if the statute required a fiduciary officer and a formal trust. The Kwiat court’s literal reading of the statute comes from its rejection of the gloss that years of usage had built on the phrase “fiduciary capacity”.
117. Id.
118. Id. at 822 (referring to the debtor’s “fiduciary duty as [an] attorney”).
Waclaw Janikowski and his partner practiced law in the northern district of Illinois.\textsuperscript{120} While representing sellers (eventually the plaintiffs) in a real estate transfer, the attorneys managed to violate most of the standards of practice for attorneys handling real estate transactions.\textsuperscript{121} The attorneys recommended the use an improper form of conveyance,\textsuperscript{122} failed to record the deed, and then induced the seller not to foreclose on the defaulting buyer.\textsuperscript{123} Worst of all, the attorneys failed to reveal to the sellers that the buyer who benefited from their errors was also their client.\textsuperscript{124} The plaintiffs sustained a substantial loss and sued;\textsuperscript{125} the attorneys filed for bankruptcy protection under Chapter 7.\textsuperscript{126} Plaintiffs instituted an adversary proceeding to bar discharge, alleging that the attorney-debtors' conduct fit within § 523(a)(4).\textsuperscript{127}

The length and detail of the Janikowski opinion reveals the court's intense desire to bar discharge of the malpractice claim. Yet, the court could not avoid conceding that "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 and not under a trust imposed ex-maleficio."\textsuperscript{128} To bar discharge, therefore, the court had to go beyond a constructive or resulting trust and find a bona fide trust relationship.

The court asserted that attorneys occupied the position of fiduciaries under state law.\textsuperscript{129} In discussing whether an attorney's status under non-bankruptcy law satisfied the Code requirements, the court made apparent its intention to stretch the law and create a way to bar discharge:

Although the courts in interpreting § 523(a)(4) have held the fiduciary relationship must arise from an express or "technical" trust, the outer limits of what may constitute the "trust" have never been clearly defined. Generally, an express trust is created by agreement between the parties to impose a trust relationship. The usual elements of an express trust traditionally have included an explicit declaration of trust, a clearly defined trust res, and an intent to create a trust relationship.\textsuperscript{130}

\textsuperscript{120} Id. at 785.
\textsuperscript{121} Id. at 786-87.
\textsuperscript{122} Id.
\textsuperscript{123} Id. at 787.
\textsuperscript{124} Id.
\textsuperscript{125} Id. at 785, 788.
\textsuperscript{126} Id. at 785.
\textsuperscript{127} Id. at 788.
\textsuperscript{128} Id. (citing Davis v. Aetna Acceptance Co., 293 U.S. 328, 333 (1934); Carlisle Cashway, Inc. v. Johnson (In re Johnson), 691 F.2d 249, 251 (6th Cir. 1982); Bankers Trust Co. v. Lichstrahl (In re Lichstrahl), 27 B.R. 46, 47 (Bankr. S.D. Fla. 1983)).
\textsuperscript{129} Id.
\textsuperscript{130} Id. at 788-89 (citing Congress Fin. Corp. v. Levitan (In re Levitan), 46 B.R. 380, 384
Without question, none of these "usual elements" were present in the malpractice claim against Janikowski and his partner.

The court found support for its desired result in a contemporary line of cases holding that "a technical express trust may also be created by a statute that expressly imposes fiduciary obligations on a party." The court reasoned with some precision:

A fiduciary relationship for dischargeability purposes may exist where a state statute has defined a particular relationship as a fiduciary. The state statute creating the fiduciary relationship must, however, have imposed a trust on the property and set forth the fiduciary duties. Further, the debt alleged to be nondischargeable must arise from a breach of the trust obligations imposed by law and not from any breach of contract. Therefore, the trustee's duties must be independent of the parties' contractual relationship.

To hold the attorneys liable, then, the court in Janikowski needed to find a statute that imposed a trust on the property and defined the attorney's fiduciary duties.

What statute supplied the necessary relationship? In this case, none did. Without explanation and with little rhetorical transition, the court simply held that "a fiduciary relationship under Code § 523(a)(4) may be established by [State Bar] disciplinary rules adopted by a state's highest court rather than by statute." The lengthy and detailed opinion explained neither how a code of administrative rules could substitute for a statute nor how this disciplinary code satisfied the traditional requirements of a fiduciary relationship. Unable to find an appropriate statute, the Court substituted the disciplinary rules, even though they did not have the full force and effect of law.

There remained for the Janikowski court only the issue of whether the attorneys' actions constituted defalcation. Typically, defalcation is defined as the reduction of some fund held by the trustee without permission of the trustor. The court did not even pretend to assert that Janikowski and his partner held the plaintiffs' money; it merely noted in passing that "there is no reason why [defalcation] should not be applied to the improper handling of any


131. Id. at 789 (citing Johnson, 691 F.2d at 252; Allen v. Romero (In re Romero), 535 F.2d 618, 621-22 (10th Cir. 1976); Kawczynski, 442 F. Supp. at 415-16).

132. Id. at 788 (citing Johnson, 691 F.2d at 253; Teamsters Local 533 v. Schultz (In re Schultz), 46 B.R. 880, 884 (Bankr. Nev. 1985); Reliance Ins. Co. v. Gagliano (In re Gagliano), 44 B.R. 259, 261 (Bankr. N.D. Ill. 1984)).

133. Id. at 789.
property." The court ultimately ruled that the malpractice claims against Janikowski and his partner satisfied § 523(a)(4).

Although Kwiat and Janikowski holdings are superficially similar, their differences are vast. Kwiat dealt with an exceptional malpractice case—one that fell neatly into the formal trust requirements of § 523(a)(4). In contrast, the Janikowski court had difficulty in finding a trust to satisfy the fiduciary requirement. The court did not identify an express or technical trust nor did it point to a statute that would establish a trust in lieu of the express or technical variety. Finally, the Janikowski court did not explain how a Bar Code of Ethics might satisfy a rule that expressly called for a statutory pronouncement. In essence, the court announced and then ignored its own rule. At least the Janikowski court made shorter work of § 523(a)(4)’s defalcation requirement, nakedly asserting that defalcation might as well include malpractice.

As unsatisfying as Janikowski’s reasoning was, it nevertheless signals a willingness on the part of courts to except a debtor-attorney’s malpractice from discharge. Kwiat opened the door by recognizing attorneys as fiduciaries, and Janikowski burst in to show other courts the way toward a liberal reading of § 523(a)(4).

By the mid-1990s, more courts began to ignore the historically established, formal hurdles of § 523(a)(4) with barely a sideways glance. Courts even began to sidestep other elements of the older construction, such as the requirement of an identifiable trust fund. The Fifth Circuit, in \textit{In re Ben-}

134. Id.

135. Id. at 790. Actually, since the matter came before the court on the debtors’ motion to dismiss the plaintiffs’ adversary proceeding, it is more accurate to say that the court found the complaint to be sufficient to bar discharge; the issue of dischargeability itself was not before the court. The court denied the motion to dismiss because the malpractice claims were “far beyond a mere allegation of attorney negligence or malpractice which could not, standing alone, bar discharge under § 523(a)(4).” Id.

136. The court never explicitly found that an express trust existed. After discussing the three elements required for dischargeability under § 523(a)(4), and noting in particular that “there must either be an express or technical trust,” Doucette v. Kwiat (\textit{In re Kwiat}), 62 B.R. 818, 821 (Bankr. D. Mass 1986), aff’d \textit{in part and vacated in part on other grounds}, 81 B.R. 184 (D. Mass. 1987), the court skips on to the issue of fiduciary capacity. Nevertheless, since Kwiat was an attorney holding settlement proceeds in trust for his client, it is clear that these funds were held in trust. Id. at 820-21.

137. The court in Janikowski rather apologetically explained that “several courts have held that a technical express trust may also be created by a statute which expressly imposes fiduciary obligations on a party.” Janikowski, 60 B.R. at 789. This seems to confuse the requirement of fiduciary capacity with existence of a trust, but the court was obviously not going to be sidetracked by details.

138. Id.

139. Id at 789-90.
stated that "the trust obligations necessary under section 523(a)(4) can arise pursuant to a statute, common law or a formal trust agreement." The Seventh Circuit jumped even further in *In re Marchiando*. The *Marchiando* court pointed to the attorney-client relationship as a patent example of "the conventional trust or fiduciary setting" that satisfied § 523(a)(4), in contrast to a statutorily created trust that did not. By 1994, attorneys were so well accepted as § 523(a)(4) fiduciaries that a court handling an unrelated case used the attorney’s role as an analogy to justify extending fiduciary status to directors and officers.

Although it would have been unthinkable twenty years ago, attorneys can no longer count on a discharge for their malpractice liability. They are not the only professionals to suffer this fate. Even corporate directors and officers, whom the law has been otherwise reluctant to touch, are now threatened.

**B. Directors and Officers**

In the revolution of professional liability claims, directors’ and officers’ cases now occupy the front lines. When faced with adversary proceedings involving creditors seeking to bar the discharge of claims against corporate directors and officers (Ds&Os), courts have split wildly. Some courts have maintained a strict adherence to the traditional reading of § 523(a)(4), holding that even Ds&Os who allegedly falsify corporate books and records are entitled to discharge. One of these courts—a neighbor of the *Janikowski* court—expressly and rather stiffly “declined . . . to depart from the narrower

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140. Bennett v. LSP Inv. Partnership (In re Bennett), 989 F.2d. 779 (5th Cir. 1993).
141. *Id.* at 785.
142. *In re Marchiando*, 13 F.3d 1111 (7th Cir. 1994).
143. *Id.* at 1116. “So a lawyer is deemed the fiduciary of his client, even if he does not manage a fund entrusted to him by the client.” *Id.* at 1115 (citing Maksym v. Loesch, 937 F.2d 1237, 1241-42 (7th Cir. 1991)).
144. *See id.* at 1115-16. *Marchiando* held a license to sell lottery tickets for the State of Illinois. *Id.* at 1113. As such, she was statutorily deemed a trustee, and the proceeds she collected constituted the trust res. *Id.*. Ms. *Marchiando* breached her statutory duties to the state by commingling and pilfering the ticket sales fund. *Id.*. The matter came to a head when Marchiando filed for bankruptcy. The significance of the case is again the ease with which the court refers to an attorney as the patent example of a fiduciary for purposes of § 523(a)(4).
146. Directors and officers enjoy the shield of the business judgment rule. This rule, in one of its earliest formulations, holds that “[directors who] act in good faith within the limits of power conferred, using proper prudence and diligence . . . are not responsible for mere mistakes or errors of judgment.” Hun v. Cary, 82 N.Y. 65, 70 (1880).
interpretation of § 523(a)(4), which requires proof of a technical or express trust.”¹⁴⁸ These traditionalist courts cling to a crumbling foothold. A majority has recently emerged; the dominant thinking seems to be that Ds&Os are § 523(a)(4) fiduciaries, at least upon the insolvency of the corporation.¹⁴⁹

One case which evidences the majority perspective, In re Reuscher,¹⁵⁰ defines both the field and the probable shape of future developments in the area.¹⁵¹ Reuscher and Sheible were directors and principals of a corporation which dissolved involuntarily when it failed to pay its franchise fee.¹⁵² During insolvency, a creditor brought an action against Reuscher and Sheible, alleging conversion and misappropriation of corporate funds.¹⁵³ Reuscher and Sheible filed separate petitions for personal bankruptcy, and the creditor commenced adversary proceedings in both bankruptcy cases to bar discharge.¹⁵⁴ The bankruptcy court dismissed the adversary proceedings summarily, holding that “the plaintiffs must establish that an express or technical trust existed, that the debt was caused by fraud or defalcation, and that the debtor acted as a fiduciary to the creditor at the time the debt was created.”¹⁵⁵

On appeal, the district court carefully recapitulated both the traditional interpretations of § 523(a)(4) and the new developments.¹⁵⁶ The opinion catalogues the cases that set out the old standard¹⁵⁷ and the newer cases that utilize a “broader interpretation” of § 523(a)(4).¹⁵⁸ The Reuscher court quotes Marchiando’s attempt to synthesize the two lines of cases:

¹⁴⁸. Martin, 162 B.R. at 714.
¹⁴⁹. See, e.g., John P. Maguire & Co. v. Herzog, 421 F.2d 419, 422 (5th Cir. 1970); Berres v. Bruning (In re Bruning), 143 B.R. 253 (D. Colo. 1992); United States v. Bagel (In re Bagel), 1992 WL 477052 (Bankr. E.D. Pa. 1992) (mem.). See also Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613, *34 n.55 (Del. Ch. 1991) (mem.) (a non-bankruptcy case holding that “directors will recognize that . . . in the vicinity of insolvency . . . the right . . . course to follow for the corporation may diverge from the choice that the stockholders (or the creditors . . . ) would make if given the opportunity to act.”).
¹⁵¹. Id.
¹⁵². Id. at 399.
¹⁵³. Id. The exact nature of the original complaints filed personally against Reuscher and Sheible was somewhat unclear at the time of the appeal.
¹⁵⁴. Id.
¹⁵⁵. Id. at 399.
¹⁵⁶. Id. at 400-02.
¹⁵⁷. Id. at 400 (citing Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934); Chapman v. Forsyth, 43 U.S. 202 (1844); Klingman v. Levinson, 831 F.2d 1292 (7th Cir. 1987); CRL, Inc. v. Holmes (In re Holmes), 117 B.R. 848 (Bankr. D. Md. 1990)).
¹⁵⁸. Id. at 400-01 (citing In re Marchiando, 13 F.3d 1111 (7th Cir. 1994); Bennett v. LSP Inv. Partnership (In re Bennett), 989 F.2d. 779 (5th Cir. 1993)).
The key to knitting the cases into a harmonious whole is the distinction stressed in *Davis* and other cases between a trust or other fiduciary relation that has an existence independent of the debtor’s wrong and a trust or other fiduciary relation that has no existence before the wrong is committed. A lawyer’s fiduciary duty to his client, or a director’s duty to his corporation’s shareholders, pre-exists any breach of that duty, while in the case of a constructive or resulting trust there is no fiduciary duty until a wrong is committed. The intermediate case, but closer we think to the constructive or resulting trust pole, is that of a trust that has a purely nominal existence until the wrong is committed.159

Ultimately, the *Reuscher* court adopted the *Marchiando* reasoning and further determined that the Seventh Circuit would include both statutory and common law trust relationships as eligible for the § 523(a)(4) bar to discharge.160

The *Reuscher* court faced a high hurdle: no statute defined corporate officers and directors as fiduciaries. For this reason the court was forced to hold that common law trust relationships, in addition to express and statutory trusts, qualified for the § 523(a)(4) exception to discharge.161

The *Reuscher* court noted that, at common law, corporate Ds&Os were not necessarily trustees for their corporations’ creditors.162 The court, however, also noted that other courts had held that Ds&Os were trustees—when their corporations became insolvent.163 By embracing this distinction, the court was able to avoid the problem of trusts *ex maleficio*:

Up to the point of insolvency, corporate officers or directors owe no duty to the corporation’s creditors. Therefore, the officers and directors are not liable for the corporation’s debts to such creditors. But when the corporation becomes insolvent or is dissolved, the officers and directors then assume fiduciary obligations to preserve and protect the corporation’s assets for the creditors. . . . [I]f they breach their fiduciary duties—e.g., if they misappropriate corporate assets for their own personal gain—they will incur a nondischargeable liability.

When viewed in this context, it is clear that the officer/director’s wrongful conduct does not create the fiduciary duty. Rather, the duty arose upon the corporation’s insolvency or dissolution and the officer/director’s subsequent breach of that duty creates an obligation or debt.164

159. *Id.* at 401 (quoting *Marchiando*, 13 F.3d at 1115-16).
160. *Id.* at 402.
161. *Id.* at 402.
162. *Id.* at 402 (citing *Beach v. Miller*, 22 N.E. 464, 466 (Ill. 1889)).
164. *Id.*
Having identified a qualifying fiduciary relationship and a trust, the court had only to find that the Ds&Os committed a defalcation in order to bar discharge of the debt.165

Fundamentally, Reuscher stands for the proposition that directors and officers are § 523(a)(4) fiduciaries who cannot depend on the discharge of their professional malpractice liabilities.166 Its significance is even greater, though, because it appeals to common law rather than parochial bankruptcy jurisprudence to interpret § 523(a)(4).

V. CONCLUSION: REVOLUTION AND ITS AFTERMATH

It can be argued that Reuscher is simply one rogue opinion. Only time will tell. It is, however, more likely that the Reuscher case signifies the culmination of a revolutionary change in the corpus of bankruptcy law. Three particular points reveal the progression.

First, consider the court’s rush through the traditional analysis. The opinion barely touches upon the formal hurdles set up by cases which preceded Reuscher.167 The Kwiat court visibly struggled to squeeze its holding into the old paradigms.168 The Janikowski court mentioned the paradigms before fully ignoring them.169 In its turn, the Reuscher court wrote without even a pretense of struggle. The Reuscher court serves notice that the traditional approach of Chapman and Davis no longer holds relevance. More to the point, the progression from Kwiat and Janikowski to Reuscher and Marchiando suggests an inexorable movement toward preventing professionals from escaping their malpractice liability through bankruptcy protection.

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165. Reuscher dealt with the bankruptcy court’s dismissal of the creditors’ adversary proceeding to determine dischargeability. The issue of whether the directors’ and officers’ actions were defalcations under § 523(a)(4) was not before the court. However, the court noted that the breach of their fiduciary duties as directors and officers would result in a nondischargeable liability. Id. at 404. Therefore, the court must have determined that the breach was defalcation under § 523(a)(4).

166. Again, the threat of an exception to discharge for professional liability claims exists in chapters 7, 11, and hardship discharge under chapter 13. The chapter 13 debtor can count on a discharge if he completes payments under a plan.

167. The opinion mentions Chapman, Davis, and Klingman. Reuscher, 169 B.R. at 400 (citing Davis v. Aetna Acceptance Co., 293 U.S. 328 (1934); Chapman v. Forsyth, 43 U.S. 202 (1844); Klingman v. Levinson, 831 F.2d 1292 (7th Cir. 1987)). However, it jumps quickly to the “much broader interpretation” of cases like In re Bennett. Id. at 400-01 (citing Bennett v. LSP Inv. Partnership (In re Bennett), 989 F.2d. 779 (5th Cir. 1993)).


The second telling feature is the Reuscher court’s offhand acceptance of the proposition that attorneys are § 523(a)(4) fiduciaries. Professionals could, in the past, count on the Code’s overprotective reading of the term fiduciary. In the summer of 1994, however, the fight over the meaning of fiduciary capacity was no longer being contested; the revolution had moved on to other fronts. Another crucial step in the old paradigm was discarded.

The third and most important point is the Reuscher court’s quiet application of common law in the § 523(a)(4) context. In the Chapman and Davis line of cases, courts had steadfastly refused to budge from the narrow and parochial bankruptcy definition of fiduciary, even for those debtors who were otherwise universally accepted as fiduciaries. The Janikowski court, by giving mere lip service to the concept of a statutory trust, took a huge step toward abandoning the formal requirements of Chapman and other pre-1986 cases. This step becomes a quantum leap, however, as Reuscher relies on the common law for its definition of fiduciary. If Reuscher represents a move to use the common law to understand § 523(a)(4), then it is revolutionary indeed.

Standing at the edge of a revolution, it is difficult to predict the direction of developments to come. Still, a few cases have hinted at what the future may hold. In re Marchiando, a case which does not superficially appear to support the thesis of this paper, points to the most likely future for professional liability claims in bankruptcy. Ms. Marchiando owned a convenience store and was licensed to sell lottery tickets for the state. When her store began to fail, Marchiando applied proceeds from the lottery ticket sales to her daily business expenses. A state statute explicitly defined the

170. "Assuming [that the debtor corporation was declared insolvent and allowed its corporate charter to lapse], the Court finds that the debtors then acquired a fiduciary obligation to preserve and protect the corporation’s assets for the appellants and other creditors." Reuscher, 169 B.R. at 403. The court then tackles the question of whether this is the kind of fiduciary obligation which may create a nondischargeable debt under § 523(a)(4). After a short discussion, it concludes that “when the corporation becomes insolvent or is dissolved, the officers and directors then assume fiduciary obligations to preserve and protect the corporation’s assets for the creditors. . . . [I]f they breach their fiduciary duties—e.g., if they misappropriate corporate assets for their own personal gain—they will incur a nondischargeable liability.” Id. at 403. Nowhere does the opinion attempt a rigorous analysis of how these common law fiduciary duties satisfy § 523(a)(4).
171. Id. at 402.
172. In re Marchiando, 13 F.3d 1111 (7th Cir. 1994).
173. Even if Marchiando was an exception to the analysis laid out here, “the exception proves the rule.” John Wilson, The Cheats (1664), cited in DICTIONARY OF QUOTATIONS 211 (Bergen Evans, ed. 1969). The term “prove” meant “test” and not “support.” Marchiando by arguing against the thesis of this paper, tests the thesis and in the modern sense, proves it.
174. Marchiando, 13 F.3d at 1113.
175. Id.
proceeds from lottery tickets sales as a "trust fund,"176 and therefore, Marchiando appeared to be a trustee177 and a fiduciary,178 at least under state law. When conversion of the trust funds could no longer keep Marchiando’s convenience store solvent, she filed for bankruptcy protection.179 The state filed an adversary proceeding to except its $17,000 in uncollected trust funds from discharge.180

Throughout the proceedings in the bankruptcy court and the district court, the parties fought over the meaning of § 523(a)(4) and its terms. For the Seventh Circuit, the key question became the definition of fiduciary under § 523(a)(4). The court carefully reviewed the cases and discovered three different treatments of the issue in the case law. First were the cases upon which this article has focused—cases holding that defalcations by professionals were nondischargeable, even where a fiduciary status was created by non-bankruptcy statutes or through the actions of the debtor.181 The court identified a second line of cases holding that fiduciary status is conferred only by the bankruptcy code.182 Finally, the court noted that a third line of cases "divided over the question [of] whether a statute that . . . deems a debtor a fiduciary . . . makes the debtor a 'fiduciary' for purposes of § 523(a)(4)."183 The Marchiando court ultimately decided that the status of fiduciary under the Code section requires something more than the liberal usage of the state statute.

Whether the Marchiando court reached the right decision is not relevant here. In wrestling with the issue, the Seventh Circuit produced a thoughtful analysis. This analysis in turn lead the court to derive an implicit factor not acknowledged in prior cases. The court noted that some cases have found an actor to be a § 523(a)(4) fiduciary when the fiduciary duties were created in advance of the breach complained of in the adversary proceeding. "[These] cases involve a difference in knowledge or power between fiduciary and principal which . . . gives the former a position of ascendancy over the

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176. Id.
177. Id. at 1116.
178. Id. at 1115.
179. Id. at 1113.
180. Id.

181. Id. at 1115 (citing as examples, Bennett v. LSP Inv. Partnership (In re Bennett), 989 F.2d. 779 (5th Cir. 1993); Sheerin v. Davis (In re Davis), 3 F.3d 113 (5th Cir. 1993); Lewis v. Short (In re Short), 818 F.2d 693 (9th Cir. 1987)).

182. Id. (citing, among others, Davis v. Aetna Acceptance Corp., 293 U.S. 328 (1934)).

183. Id. The court cites a number of cases not reviewed here: For one side of the proposition, see Quaif v. Johnson, 4 F.3d 950 (11th Cir. 1993); Carey Lumber Co. v. Bell, 615 F.2d 370 (5th Cir. 1980). For the other side, see Coburn Co. v. Nicholas (In re Nicholas), 956 F.2d 110 (5th Cir. 1992); In re Thomas, 729 F.2d 502 (7th Cir. 1984); Angelle v. Reid (In re Angelle), 610 F.2d 1335 (5th Cir. 1980).
The disparity in knowledge becomes the key issue in the analysis of dischargeability:

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

Marchiando implies that when the party with more knowledge uses that knowledge to take advantage of the ignorant party, the bankruptcy courts should be more willing to find the debtor to be acting in a fiduciary capacity for purposes of §523(a)(4).

Again, it can be argued that Marchiando is only one case and certainly not illustrative of the case law in general. Recall, however, that Reuscher cites the above language from Marchiando with approval. Moreover, the disparity of knowledge issue appears fleetingly in many of the professional liability cases cited in this article and in much of the modern malpractice law.

A focus on the disparity of knowledge between debtor and creditor makes a great deal of sense. As several cases note, every debtor is to some extent a fiduciary of the money and goods provided by the creditor. To go further, however, and hold that every debtor is a fiduciary under §523(a)(4) would be absurd. Nevertheless, there are situations where the creditor cannot protect himself from the debtor, "lacking not only knowledge but also the power to act upon it." As the Seventh Circuit points out, this lack of knowledge and power may exist between clients and lawyers, limited partners and general partners, corporate shareholders and the corporation's officers and directors. In all of these cases, and in all professional liability claims in bankruptcy, it makes sense to avoid the metaphysical debates over defalcation and fiduciary and instead to ask a relatively simple question: Did the debtor use his superior knowledge and power to take advantage of the creditor? If the

184. Id. at 1116 (citing Maksym v. Loesch, 937 F.2d 1237 (7th Cir. 1991)).
185. Id.
187. See Marchiando, 13 F.3d at 1116. The court discusses how, on these terms, a state could define any of the parties with whom it contracts as fiduciaries and thus earn for itself a preferred position over other creditors in the event of bankruptcy. Id.
188. Id.
189. Id.
answer to this question is yes, then the debtor’s discharge of resulting claims under § 523(a)(4) should be barred. That is the direction of cases like Kwiat, Janikowski and Reuscher, and it is the direction in which the law should continue to develop if professionals guilty of malpractice are to be denied the safe harbor of bankruptcy.

Of course, some courts still refuse to look beyond the traditional requirements of § 523(a)(4). As the conflict in the cases plays out, the victory will not necessarily go to the swiftly moving groundswell of judicial opinion favoring nondischarge of professional liability claims, nor will the triumph necessarily go to the new liberal interpretation of § 523(a)(4)’s requirements. But to paraphrase Damon Runyan, that’s the way to bet. 191

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190. See First Options, Inc. v. Kaplan (In re Kaplan), 162 B.R. 684, 705 (Bankr. E.D. Pa. 1993), aff’d, 189 B.R. 882 (E.D. Pa. 1995) (citing Chapman v. Forsyth, 42 U.S. 202 (1844), for the proposition that “[i]t has long been the law that a creditor must prove more than just the presence of a fiduciary relationship before grounds to deny a debtor a discharge on the ground of defalcation [are] present. In addition, the creditor must prove that an express trust has been created on behalf of the beneficiary in the relationship.”); Barber v. Martin (In re Martin) 162 B.R. 710 (Bankr. C.D. Ill. 1993).

191. “The race is not always to the swift, nor the battle to the strong—but that’s the way to bet.” THE MODERN HANDBOOK OF HUMOR 218 (Ralph L. Woods, ed. 1967).