

May the Trustee's Personal Debt to the Trust Owed as a Result of a Breach of Trust be Discharged in Bankruptcy?

The U.S. Bankruptcy Code provides that a personal debt is not dischargeable if the debt had been occasioned by the debtor's defalcation while acting in a fiduciary capacity. Courts of appeals had long disagreed about the mental state that must accompany the bankruptcy-related definition of "defalcation," particularly in the trust context. The U.S. Supreme Court has recently settled the matter. Charles E. Rounds, Jr. explains in an updated version of Section 7.4 of *Loring and Rounds: A Trustee's Handbook* (2013).

§7.4 Discharge in Bankruptcy of Trustee's Personal Debt to Trust Owed as a Result of a Breach of Trust

[Updated excerpt from *Loring and Rounds: A Trustee's Handbook* (2013)]

*Of course, the personal creditors of the trustee cannot reach the trust property, because the trustee, as trustee, has no beneficial interest in either the trust or the trust property.*¹

Because the assets of a trust are supposed to be segregated from the personal assets of the trustee, the personal bankruptcy of the trustee should be a nonevent insofar as the equitable interests of the beneficiaries are concerned.² "Although a bona fide purchaser for some purposes, the trustee in bankruptcy holds trust property subject to the trust."³ Moreover, any claims *for money damages* for fraud, embezzlement, defalcation,⁴ or other such acts of willful and malicious injury to a formal express trust by the trustee are not dischargeable, as per Section 523(a)(4) of the Federal Bankruptcy Code.⁵ Surcharges occasioned by the trustee's ordinary negligence generally are.⁶

In 2013, the U.S. Supreme Court clarified the scope of the term "defalcation" as it is employed in Section 523(a)(4): "We hold that it includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase. We describe the state of mind as one involving knowledge of, or gross recklessness in respect to, the

¹3 Scott & Ascher §14.11. For a discussion of ways to limit the trustee in bankruptcy's access to the equitable interest in the event of the *beneficiary's* bankruptcy, the reader is referred to §5.3.3.3 of this handbook, as well as its sub-sections.

²See generally 4 Scott & Ascher §24.26.

³4 Scott & Ascher §24.26. See also 5 Scott & Ascher §29.3.10 (Trustee in Bankruptcy). See generally §§8.3.1 of this handbook (the trustee's personal creditors and the trustee's spouse) and 8.15.63 of this handbook (doctrine of bona fide purchase; the BFP) and.

⁴See *In re Baylis*, 313 F.3d 9 (2002); 4 Scott & Ascher §24.26 (wrestling with the meaning of "defalcation" in the context of bankruptcy law).

⁵4 Scott & Ascher §24.26; 3 Scott on Trusts §221. Here is the statutory language verbatim: "An individual cannot obtain a bankruptcy discharge from a debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4).

⁶4 Scott & Ascher §24.26.

improper nature of the relevant fiduciary behavior.”¹ With respect to *the trust property* itself, if it can be traced, the trustee in bankruptcy (not to be confused with the bankrupt trustee) will hold the property subject to the trust.⁷ The beneficiary then will have priority over the general creditors with respect to that property.⁸ An exception is land, subject to an oral trust that is unenforceable because of the statute of frauds.⁹ Title to the land passes from the bankrupt trustee to the trustee in bankruptcy, even if the latter has notice of the oral trust and becomes available to the general creditors.¹⁰ Likewise with most properties that are the subject of implied trusts, constructive trusts, agencies, and the like.¹¹

To summarize: A trustee in bankruptcy of another trustee’s personal estate is generally not a good-faith purchaser for value (BFP) of the property which the other trustee had been holding in trust.¹² That property the trustee in bankruptcy holds “subject to the trust or other equity.”¹³ On the other hand, “although the beneficiary retains his or her equitable interest in the trust property, some claims for damages against a trustee or one who has assisted or participated in a breach of trust may be discharged in bankruptcy.”¹⁴

¹ Bullock v. BankChampaign, N.A., 2013 WL 1942393 (U.S.).

⁷4 Scott & Ascher §24.26; 3 Scott on Trusts. §221.1 (U.S.); Lewin on Trusts ¶22-50 (England).

⁸4 Scott & Ascher §24.26; 3 Scott on Trusts §221.1.

⁹See generally §8.15.5 of this handbook (statute of frauds).

¹⁰1 Scott & Ascher §6.14. See, e.g., 4 Scott & Ascher §24.26 n.16.

¹¹See 4 Scott & Ascher §24.26 n.16.

¹²5 Scott & Ascher §29.3.10 (Trustee in Bankruptcy). See generally §§8.3.1 of this handbook (the trustee’s personal creditors and the trustee’s spouse) and 8.15.63 of this handbook (doctrine of bona fide purchase in the trust context).

¹³5 Scott & Ascher §29.3.10 (Trustee in Bankruptcy).

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