No. 07-952

IN THE

Supreme Court of the United States

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON,

Petitioner,

—v.—

ANDREW A. HYMAN,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF FOR PETITIONER

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STATEMENT

This Supplemental Brief is submitted in response to the Solicitor General's recommendation that certiorari be denied, notwithstanding his concurrence that (a) the Second Circuit **"Erred in Categorically Holding That Proof Of Deliberate Misbehavior Or Extreme Recklessness Is Required To Establish A 'Defalcation' Within The Meaning of 11 U.S.C. 523(a)(4)"** (Solicitor General's Brief, hereinafter "SGB", p. 7) (emphasis in original), and (b) his recognition that the circuit courts are now divided into "'three interpretive camps'" (*Id.*, p. 16)[1] regarding the level of wrongdoing, i.e., "scienter", required to render non-dischargeable a debt resulting from a "defalcation while acting in a fiduciary capacity" under the Bankruptcy Code.

The Solicitor General's recommendation, we submit, is based on misconceptions of the underlying state court litigation, a failure to distinguish between the applicability of collateral estoppel to factual as opposed to legal issues, and the same critical deficiency which has contributed to the ongoing morass of irreconcilable circuit court decisions, i.e., the failure to distinguish fiduciary self-dealing from all other fiduciary failings. The latter are characterized by detriment to the cestui without gain to the fiduciary; these do not necessarily constitute defalcations for § 523(a)(4) purposes. With respect to the self-dealing fiduciary, the law has favored an absolute bar, regardless of subjective considerations.

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[1] More accurately described by the Second Circuit as "persistent confusion." (15a); Numbers followed by "a" refer to the indicated page of the Appendix annexed to the Petition.

As recognized by the Solicitor General:

> At least in circumstances where the relevant breach of duty is a wrongful diversion of trust assets to the fiduciary's own use . . . the breach is properly regarded as a "defalcation" within the meaning of Section 523(a)(4), regardless of whether the fiduciary acts with ill intent.

(SGB, p. 6)

In these latter circumstances, a core value is at stake, i.e., that one cannot serve two masters; when self is juxtaposed to duty, duty must prevail. Whether the result of accident, design or otherwise—and because we can never know which—the self-dealing fiduciary's enrichment to the detriment of his cestui is always a "defalcation." Properly interpreted, § 523(a)(4) reflects that core value.

THE STATE COURT LITIGATION

The underlying state court litigation presented garden variety corporate fiduciary self-dealing issues for adjudication. As summarized in the trial court's decision, the petitioner [Denton Estate] "as a 50% shareholder of three corporations" sought to "recover . . . (i) profits earned by [respondent; the surviving 50% shareholder, officer and director] and the Hyman Agency [his 100% owned corporation] in exploiting the assets of [the jointly-owned] corporations; [and] (ii) damages suffered as a result of the diversion of corporate assets . . . ."; respondent "asserted a number of defenses, including statute of limitations, ratification and estoppel." (84a-85a)

After a nine-day trial, the trial court found that:

(a) the decedent and respondent were 50% shareholders of a three corporation enterprise (85a);

(b) respondent, as "a 50% shareholder, officer and director . . . owed a fiduciary duty to those corporations" (92a);

(c) immediately following the decedent's death, respondent "breached that duty by co-opting the . . . enterprise for the benefit of [his newly-formed, 100% owned] . . . Hyman Agency and for his own personal enrichment" (92a);[2]

(d) "Hyman [respondent] exploited the assets of NPS and NPA [two of the jointly-owned corporations] to obtain profits for himself" (90a); and

(e) "[h]is actions constituted a misappropriation of the tangible assets and goodwill of [the jointly-owned corporations]." (92a-93a)

The trial court rejected respondent's counterclaim and affirmative defenses and "dismissed [them] . . . in their entirety." (98a)

These findings were unanimously affirmed on appeal and further appeals were twice rejected by New York's Court of Appeals. (106a-113a)

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[2] The Solicitor General recognized that the respondent continued "to operate the overall enterprise in a way that predictably resulted in profits for the Hyman Agency and losses for NPS" (SGB, p. 19-20), but failed to comprehend that the losses borne by the 50% owned entity were now being incurred for the benefit of the respondent's newly-formed 100% owned entity. In other words, the losses were left to be shared 50/50, but 100% of the profits diverted to respondent.

Self-dealing by a corporate fiduciary is hardly "idiosyncratic" (SGB, p. 19), except, perhaps, in the details. In view of the trial court's explicit findings regarding the respondent's fiduciary status, his "co-opting" of the parties' jointly-owned corporate enterprise "for his own personal enrichment" (92a), his "exploit[ation]" of that enterprise "to obtain profits for himself" (90a), and his "misappropriation of the tangible assets and goodwill" of that enterprise (92a-93a), it would appear difficult to contend that "no finding was made that respondent divested those corporations of their property." (SGB, p. 19)

The Solicitor General's suggestion that this case "does not provide an attractive vehicle" (SGB, p. 21) to resolve an issue which "is important to the administration of the bankruptcy laws" (*Id.*, p. 18), an issue which has "arisen frequently" and has divided the courts of appeals (*Id.*, pp. 17-18) is based, *inter alia*, on the erroneous view that these factual findings are not binding because the trial court (a) was not presented with the "question . . . whether respondent had committed a Section 523(a)(4) 'defalcation,' but whether he had committed a state-law breach of fiduciary duty," and (b) " 'made no express findings with respect to [respondent's] state of mind' " (quoting from the Second Circuit's decision). (16a)[3] (SGB, p. 18)

It is self-evident that bankruptcy law issues regarding dischargeability are never presented to

[3] The Second Circuit, having concluded that a "defalcation" under Section 523(a)(4) requires "culpable" conduct, declined to accord the trial court's findings preclusive effect based on the theory that since good faith or innocent motives are not defenses to a corporate fiduciary self-dealing claim, the state court was not required to, and thus did not necessarily find that respondent acted with culpable intent. (16a-18a).

state courts, certainly not prior to the adjudication resulting in the debt subsequently sought to be discharged. The test for the application of collateral estoppel, is not whether the legal issue of "defalcation" was determined by the trial court, but whether the facts necessarily determined by that court constitute a "defalcation" under § 523(a)(4). Indeed, were the Solicitor General's contentions to be adopted, collateral estoppel could never be applied in fiduciary self-dealing cases, since "state of mind" is not an issue under state law, rendering any such finding unnecessary, and therefore not a basis for collateral estoppel, which only accords preclusive effect to necessary findings. "Taking [the Solicitor General's] argument to its logical conclusion, collateral estoppel would never apply in bankruptcy because the precise bankruptcy issue would never have been litigated in a court action prior to the filing of the petition in bankruptcy. Such a conclusion defies common sense and reason and is at odds with the Supreme Court's holding in *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654 (1991)." *In re Docteroff*, 133 F.3d 210, 215 (3d Cir. 1997).

Here, under the Solicitor General's own analysis of the law, the facts found by the trial court—that respondent "co-opt[ed]" the parties' jointly-owned corporate enterprise "for his own personal enrichment" (92a), that he "exploited" that enterprise "to obtain profits for himself" (90a), and that he "misappropriat[ed] [its] tangible assets and goodwill" demonstrate a "defalcation"—i.e., unquestionably constitute a "wrongful diversion of trust assets to the fiduciary's own use" (SGB p. 6), and is the one category of fiduciary misconduct which is clearly a "defalcation" under § 523(a)(4), regardless of the

fiduciary's protestations of good faith or intentions. (SGB, p. 14)

These determinations are binding on the parties in all subsequent litigation involving the same factual issues and the courts in which those issues are litigated. *Kremer v. Chemical Construction Corp.*, 456 U.S. 461, 102 S. Ct. 1883 (1982). The Full Faith and Credit clause of the U.S. Constitution, Article IV, § 1, as implemented by 28 U.S.C. § 1738, "requires federal courts to give the same preclusive effect to State court judgments that those judgments would be given in the courts of the state from which the judgments emerged." 456 U.S. at 466, 102 S.Ct. at 1889; *accord Parsons Steel, Inc.* v. *First Alabama Bank*, 474 U.S. 518, 523, 106 S. Ct. 768, 771 (1986). That "statute has long been understood to encompass the doctrines of res judicata, or 'claim preclusion,' and collateral estoppel, or 'issue preclusion.'" *San Remo Hotel, L.P. v. City and County of San Francisco*, 545 U.S. 323, 336, 125 S. Ct. 2491, 2500 (2005), citing *Allen v. McCurry*, 449 U.S. 90, 94-96, 101 S. Ct. 411 (1980). Without question, under New York law, New York courts would be bound by the trial court's factual findings in any subsequent litigation between the same parties involving the same facts, regardless of the legal issues then in contention. *Hinchey v. Sellers*, 7 N.Y.2d 287, 197 N.Y.S.2d 129 (1959) ("It is of course well-settled law that a fact, once decided in an earlier suit, is conclusively established between the parties [or their privies] in any later suit, provided it was necessary to the result in the first suit.") *Id.* at 293, 197 N.Y.S.2d at 133, *quoting* Judge Learned Hand in *The Evergreens v. Nunan*, 141 F.2d 927, 928 (2d Cir.), *cert. denied, Evergreens v. Commissioner of Internal Revenue*, 323 U. S. 720, 65 S.Ct. 49 (1944).

Neither the Bankruptcy Court nor the Solicitor General is empowered to alter the trial court's factual findings. The only issue presented to the Bankruptcy Court was a legal issue, that is, whether respondent's "co-opting [of the 50% owned corporate enterprise] for the benefit of the Hyman Agency [his 100% owned agency and] for his own personal enrichment" (92a), his exploitation of "the assets of NPS and NPA to obtain profits for himself" (90a) and his "misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA" (92a-93a), constituted a "defalcation" under Section 523(a)(4) of the Bankruptcy Code. No additional "evidentiary record" was required to determine this legal issue.

Finally, the notion that the state court proceeding was really about the respondent's failure to purchase the petitioner's 50% interest, as opposed to respondent's self-dealing, was first promoted in the Bankruptcy Court and seems to have gained limited currency with the Solicitor General. (SCB, p. 20, n. 9). As acknowledged by the Solicitor General, the trial court "did not find that respondent failed to negotiate in good faith or that the price he offered was unreasonably low." (*Id.*) Nor did the trial court find that he negotiated in good faith or that the offered price, if any, was adequate or excessive. The simple fact is that "failure to agree" was not in issue; it was never pleaded, briefed or argued in the state court proceeding, at trial or on appeal. To state the obvious, every civil trial, whether involving a pedestrian knock down or anti-trust violation, can be said to have resulted from the parties "failure to agree." Absent an obligation to do so, there is no such "cause of action" or "claim upon which relief may be granted." In the case at bar, neither party was under

an obligation to buy or to sell, and neither has ever contended otherwise. The contention is specious.

CONCLUSION

As the Solicitor General authoritatively demonstrates, "the term 'defalcation' in current Section 523(a)(4) is properly understood to encompass *all* cases in which a fiduciary diverts trust assets to his personal use . . . , even if the trustee acts without wrongful intent and sincerely believes that his conduct is proper." (SGB, p. 14) (emphasis in original)

The object of this appeal is to obtain a definitive ruling by this Court to that effect and obviate further conflicting and irreconcilable decisions among the circuit courts. If, notwithstanding the authorities cited by the Solicitor General, this Court were to conclude that "defalcation" does require "*some* level of scienter" (SGB, p. 18) (emphasis in original), we lose. The debate among the circuit courts regarding "the contours of that requirement" (*Id.*) can then proceed apace. In our view, the rule of *In re Hammond*, 98 F.2d 703 (2d Cir.) *cert. denied*, 305 U.S. 646, 59 S.Ct. 149 (1938), that no "conscious wrongdoing" is required in corporate fiduciary self-dealing cases would substantially end the ongoing "debate" and "confusion" which has existed for decades. To await the next petition for certiorari in this area, which may not come for decades more, would leave unresolved "issues . . . worthy of this Court's review" (SGB, p. 18) in an area "important to the administration of the bankruptcy laws." (*Id.*)

We urge the granting of our petition.

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Respectfully submitted,

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