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NOT FOR PUBLICATION

SUSAN M SPRAUL, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:) BAP No. CC-12-1430-TaPaMk
)
 MARTIN PEMSTEIN and DIANA) Bk. No. 2:12-bk-15900-RK
 PEMSTEIN,)
)
 Debtors.) Adv. No. 2:12-ap-01291-RK
)
 HAROLD PEMSTEIN,)
)
 Appellant,)
)
 v.) MEMORANDUM*
)
 MARTIN PEMSTEIN; DIANA)
 PEMSTEIN,)
)
 Appellees.)
)

Argued and Submitted on May 16, 2013
at Pasadena, California

Filed - June 5, 2013

Appeal from the United States Bankruptcy Court
for the Central District of California

Honorable Robert N. Kwan, Bankruptcy Judge, Presiding

Appearances: Christopher L. Blank for Appellant Harold
Pemstein; Alan Wayne Forsley of Fredman Knupfer
Lieberman LLP for Appellees Martin Pemstein and
Diana Pemstein

Before: TAYLOR, PAPPAS, and MARKELL, Bankruptcy Judges.

* This disposition is not appropriate for publication.
Although it may be cited for whatever persuasive value it may
have (see Fed. R. App. P. 32.1), it has no precedential value.
See 9th Cir. BAP Rule 8013-1.

1 further findings with respect to the applicability of issue
2 preclusion for defalcation under § 523(a)(4) consistent with this
3 Memorandum or, if the bankruptcy court does not enter a judgment
4 based on issue preclusion, for reconsideration by the bankruptcy
5 court of its conclusions after trial.

6 On remand, the bankruptcy court also should be mindful of
7 the Supreme Court's recent decision in Bullock v. BankChampaign,
8 N.A., 2013 U.S. Lexis 3521 (U.S. May 13, 2013).⁵ In Bullock,
9 the Supreme Court resolved the split among the circuits regarding
10 the mental state that must accompany defalcation under
11 § 523(a)(4) (in doing so, it considered and spoke to the meaning
12 of § 523(a)(4) "defalcation"). Although we reverse here based on
13 the bankruptcy court's application of an incorrect legal
14 interpretation of defalcation, and not based on the scienter
15 standard articulated in Bullock, on remand the bankruptcy court
16 should consider reopening evidence regarding intent, given that
17 Bullock requires a heightened standard not previously required in
18 the Ninth Circuit.

19 **FACTS**

20 Harold and Martin are brothers and were partners in a
21 California general partnership, as well as directors of and
22 shareholders in a small, closely-held family corporation. The
23 partnership owned industrial real property that it leased to the

24
25 ⁴(...continued)
26 conclusion here solely pertains to the bankruptcy court's ruling
regarding defalcation.

27 ⁵ The Supreme Court granted certiorari after the bankruptcy
28 court here rendered its decision, but while this appeal was
pending.

1 corporation and from which the corporation ran the family
2 business. Harold filed lawsuits against Martin in state court
3 based on disputes that arose between them regarding the
4 corporation and the partnership (the "State Court Action").

5 During the course of the litigation, the state court filed a
6 Statement of Decision and Judgment in the State Court Action on
7 June 30, 2005 (the "2005 Decision"). The 2005 Decision primarily
8 ordered dissolution of the corporation and the partnership. On
9 January 5, 2010,⁶ Harold obtained a money judgment in the State
10 Court Action against Martin in the amount of \$696,218.03 (the
11 "2010 Judgment").⁷ The state court did not issue a statement of
12 decision in connection with the 2010 Judgment, as neither party
13 requested it.⁸ The 2010 Judgment states as follows:

14 The Court finds for the Plaintiff Harold
15 Pemstein against Martin Pemstein finding that
16 Martin Pemstein breached his duty of care to
17 Harold Pemstein in the collection of rent on
18 behalf of HMS Properties. The Court finds
19 that the breach caused Harold Pemstein
20 damages of \$295,871.00 in principal and
21 \$400,347.03 in interest.

22 The State Court Complaint, in particular the fifth cause of
23 action for breach of fiduciary duty against Martin as partner of

24 ⁶ The gap in time between the 2005 Decision and the 2010
25 Judgment was, at least in part, attributable to intervening
26 bankruptcy petitions filed by both the corporation and the
27 partnership.

28 ⁷ The bankruptcy court admitted the 2010 Judgment into
evidence at the trial as Plaintiff's Trial Exhibit 2.

⁸ The bankruptcy court admitted, at Martin's request, a
copy of Plaintiff's Second Amended Complaint in the State Court
Action dated December 1, 2001 ("State Court Complaint"). At
trial the parties agreed that the State Court Complaint was the
operative complaint on which the state court based the 2010
Judgment.

1 the partnership, cited statutory authority that would support
2 findings that Martin had breached the duty of loyalty to Harold
3 in the management and winding up of the partnership.⁹ It also
4 alleged facts that would support findings that Martin had
5 breached both the duty of loyalty and the duty of care owed to
6 Harold, although it did not include a citation to the statute
7 defining the duty of care.¹⁰ The 2010 Judgment was based on the
8 finding that Martin had breached his duty of care to Harold.
9 Under California law, this finding necessarily means that the
10 state court found that Martin had engaged in "grossly negligent
11 or reckless conduct, intentional misconduct, or a knowing
12 violation of law" while acting as a trustee over partnership
13 assets. Cal. Corp. Code § 16404(c). And, as specifically stated
14 in the 2010 Judgment, that conduct related to the "collection of
15 rent on behalf of" the partnership.

16 Harold, but apparently not Martin,¹¹ appealed from the 2010
17 Judgment.¹² The Court of Appeal resolved Harold's appeal by

18
19 ⁹ Specifically, California Corporations Code § 16404(b).

20 ¹⁰ Cal. Corp. Code § 16404(c).

21 ¹¹ At the trial before the bankruptcy court, Martin
22 testified that he filed bankruptcy because he was financially
unable to obtain an appellate bond.

23 ¹² Harold's appeal from the 2010 Judgment is not directly
24 relevant to the issue on appeal here. Harold asserted that the
25 trial court erred by refusing to allow him to amend his complaint
26 to conform to evidence by adding a cause of action for breach of
27 fiduciary duty. As discussed later in this Memorandum, Martin
28 argues that the DCA Opinion confirms that the 2010 Judgment did
not include a finding that Martin breached any fiduciary duty.
We disagree. The DCA Opinion addresses Harold's attempt to add a
breach of fiduciary duty claim in connection with Harold's
argument and alleged evidence proving that Martin had, at one

(continued...)

1 affirming the 2010 Judgment in an unpublished opinion on May 16,
2 2011 ("DCA Opinion").¹³

3 Martin and his wife Diana Pemstein filed their joint
4 petition under chapter 11 on April 28, 2010, and Harold filed his
5 complaint objecting to discharge and dischargeability thereafter
6 ("Adversary Complaint"). Pemstein v. Pemstein (In re Pemstein),
7 476 B.R. 254, 256 (Bankr. C.D. Cal. 2012). The Adversary
8 Complaint incorporated the 2010 Judgment. Pursuant to the first
9 cause of action, Harold sought an exception to discharge under
10 § 523(a)(4), solely as to Martin, on multiple alleged factual
11 grounds. All such grounds were based on alleged breaches of
12 fiduciary duties Martin owed to Harold as his partner in the
13 partnership. The Adversary Complaint also asserted that Martin
14 was liable to Harold based on larceny and conversion of rental
15 income and based on fraud or defalcation by Martin's violation of
16 his duty of loyalty and the duty of care owed to Harold as his
17 partner. At paragraphs 23 and 24 of the Adversary Complaint,
18 Harold virtually quoted, without citation, § 16404(b) & (c) of
19 the California Corporations Code:

21 ¹²(...continued)
22 point in time, put the partnership into bankruptcy to avoid the
23 state court's dissolution order and, by doing so without Harold's
24 consent, had breached his fiduciary duty and harmed Harold. The
25 DCA Opinion does not address the state court's finding that
26 Martin breached his duty of care to Harold, a fiduciary duty owed
27 by partners to one another in a California partnership. See,
28 Cal. Corp. Code § 16404(a).

26 ¹³ The record is silent as to if or when the bankruptcy
27 court granted relief from the stay to allow Harold's appeal to go
28 forward post-petition. The bankruptcy court admitted a copy of
the DCA Opinion into evidence at trial and, thus, was apparently
aware of the prosecution of the appeal, at least after the fact.

1 23. A partner's duty of loyalty to the partnership and
2 the other partners includes all of the following:

3 (A) To account to the partnership and hold as
4 trustee for it any property, profit, or benefit derived
5 by the partner in the conduct and winding up of the
6 partnership business or derived from a use by the
7 partner of partnership property or information,
8 including the appropriation of a partnership
9 opportunity.

10 (B) To refrain from dealing with the partnership
11 in the conduct or winding up of the partnership
12 business as or on behalf of a party having an interest
13 adverse to the partnership.

14 (C) To refrain from competing with the
15 partnership in the conduct of the partnership business
16 before the dissolution of the partnership.

17 24. A partner's duty of care to the partnership and
18 the other partners in the conduct and winding up of the
19 partnership business is limited to refraining from
20 engaging in grossly negligent or reckless conduct,
21 intentional misconduct, or a knowing violation of law.
22

23
24 The bankruptcy court conducted a trial on November 30,
25 2011.¹⁴ It requested or allowed three rounds of post-trial
26 briefs on specifically identified legal questions regarding
27 defalcation under § 523(a) (4).¹⁵ The bankruptcy court twice
28 heard post-trial oral arguments. Thereafter, it issued its
Memorandum Decision denying all claims under the Adversary
Complaint and entered judgment in favor of both Debtors on
August 2, 2012. Harold timely filed his notice of appeal.
Harold appeals only from the bankruptcy court's denial of his

24 ¹⁴ Although Harold was represented by counsel when he filed
25 the Adversary Complaint and for all post-trial briefing and
26 argument, he presented his direct testimony at trial by
27 declaration filed pro se and participated in the trial in pro
28 per.

24 ¹⁵ The record indicates that at least twice the bankruptcy
25 court stated or issued tentative rulings in Harold's favor on the
26 § 523(a) (4) defalcation cause of action.
27
28

1 § 523(a) (4) claim;¹⁶ he primarily challenges the bankruptcy
2 court's interpretation and application of the standard for
3 defalcation, its refusal to apply issue preclusion, and its
4 conclusion that Harold failed to carry his burden of proof at
5 trial.

6 JURISDICTION

7 The bankruptcy court had jurisdiction pursuant to 28 U.S.C.
8 §§ 1334 and 157(b) (2) (I) & (J). We have jurisdiction under
9 28 U.S.C. § 158.

10 ISSUES

11 Did the bankruptcy court err in determining that Harold's
12 § 523(a) (4) defalcation claim fails because neither the 2010
13 Judgment nor evidence admitted at trial established that Martin
14 actually received rents for which he failed to account?

15 STANDARD OF REVIEW

16 In reviewing a bankruptcy court's dischargeability
17 determination, we review its findings of fact for clear error and
18 its conclusions of law de novo. Oney v. Weinberg

19
20 ¹⁶ In Harold's Notice of Appeal he appealed broadly from
21 all orders and rulings adverse to him, including denial of his
22 motion for summary judgment ("MSJ"), and all adverse evidentiary
23 rulings made in connection with the MSJ and at trial. Harold's
24 Statement of Issues on Appeal identified thirteen issues that
25 pertain to rulings on the MSJ or at or after trial regarding
26 § 523(a) (4) and § 523(a) (6), but no issues regarding the § 727
27 rulings. In Harold's Opening Brief here, he further reduces the
28 issues and now appeals only trial rulings on his § 523(a) (4)
claim. On appeal, both parties address only the bankruptcy
court's rulings regarding defalcation by a fiduciary. We
therefore consider all other issues identified in the Notice of
Appeal and the Statement of Issues on Appeal as waived by Harold.
Padgett v. Wright, 587 F.3d 983, 986 n.2 (9th Cir. 2009) (per
curium) (appellate courts "will not ordinarily consider matters on
appeal that are not specifically and distinctly raised and argued
in appellant's opening brief.").

1 (In re Weinberg), 410 B.R. 19, 28 (9th Cir. BAP 2009). The
2 availability of issue preclusion is a question of law, which we
3 review de novo. Wolfe v. Jacobson (In re Jacobson), 676 F.3d
4 1193, 1198 (9th Cir. 2012). If issue preclusion is available,
5 the decision to apply it is reviewed for abuse of discretion.
6 Lopez v. Emergency Serv. Restoration, Inc. (In re Lopez),
7 367 B.R. 99, 103 (9th Cir. BAP 2007). A bankruptcy court abuses
8 its discretion if it bases a decision on an incorrect legal rule,
9 or if its application of the law was illogical, implausible, or
10 without support in inferences that may be drawn from the facts in
11 the record. United States v. Hinkson, 585 F.3d 1247, 1261-62 &
12 n.21 (9th Cir. 2009) (en banc).

13 **DISCUSSION**

14 A creditor objecting to the dischargeability of its claim
15 bears the burden of proving, by a preponderance of the evidence,
16 that the particular debt falls within one of the exceptions to
17 discharge enumerated in section 523(a). Grogan v. Garner,
18 498 U.S. 279, 286-91 (1991). The bankruptcy court here correctly
19 allocated to Harold the burden to prove that Martin was acting in
20 a fiduciary capacity and that, while doing so, he committed
21 defalcation. In re Pemstein, 476 B.R. at 257.

22 Harold cites as error the bankruptcy court's placement of
23 the burden of proof on him at trial.¹⁷ Harold's argument on this
24 point consists entirely of quotations from case authority with no

25
26 ¹⁷ Harold also argues on appeal that the bankruptcy court
27 denied him due process by ruling that he could not re-try facts
28 from the State Court Action. Nothing in the record indicates
that the bankruptcy court made such a ruling. Nor did Harold
present any argument directed to his due process issue. We,
thus, consider the issue waived.

1 discussion. As confirmed during oral argument, Harold argues
2 that the burden of proof should have shifted to Martin at some
3 point to show that he had properly accounted. See Otto v. Niles
4 (In re Niles), 106 F.3d 1456, 1462 (9th Cir. 1997) (burden is
5 placed on the fiduciary to render an accounting, "once the
6 principal has shown that funds have been entrusted to the
7 fiduciary and not paid over or otherwise accounted for"). The
8 burden never shifted here because the bankruptcy court too
9 narrowly defined defalcation.

10 Harold also bears the burden of proof for application of
11 issue preclusion. Honkanen v. Hopper (In re Honkanen), 446 B.R.
12 373, 382 (9th Cir. BAP 2011). To meet this burden, Harold was
13 required to pinpoint "the exact issues litigated in the prior
14 action and introduce[] a record revealing the controlling facts."
15 Id. As a pro se litigant at trial, Harold provided the 2005
16 Decision, the 2010 Judgment, and his direct testimony by
17 declaration. Martin offered the State Court Complaint and the
18 DCA Opinion, as well as his direct testimony by declaration.
19 Harold testified that the dispute between Martin and him in the
20 state court concerned how much rent was due him from Martin for
21 the period of time Martin was in sole possession of partnership
22 properties. In effect, the bankruptcy court found that Harold
23 did not meet this burden. The bankruptcy court, however, did not
24 perform a complete issue preclusion analysis, given its view of
25 defalcation.

26 **Issue preclusion.**

27 Federal courts must give "full faith and credit" to
28 judgments of state courts. 28 U.S.C. § 1738. As a matter of

1 full faith and credit, the federal court must apply the forum
2 state's law of issue preclusion. Bugna v. McArthur
3 (In re Bugna), 33 F.3d 1054, 1057 (9th Cir. 1994). These
4 principles of issue preclusion apply equally in § 523(a)
5 proceedings. Grogan v. Garner, 498 U.S. at 286-291.

6 California courts will apply issue preclusion only if
7 certain threshold requirements are met, and then only if
8 application of preclusion furthers the public policies underlying
9 the doctrine. There are five threshold requirements:

10 First, the issue sought to be precluded from
11 relitigation must be identical to that decided in a
12 former proceeding. Second, this issue must have been
13 actually litigated in the former proceeding. Third, it
14 must have been necessarily decided in the former
15 proceeding. Fourth, the decision in the former
16 proceeding must be final and on the merits. Finally,
17 the party against whom preclusion is sought must be the
18 same as, or in privity with, the party to the former
19 proceeding.

20 Id. (internal citations omitted).

21 Here, the bankruptcy court decided it could not apply issue
22 preclusion in connection with the defalcation claim because it
23 determined that the issue decided in the State Court Action was
24 not identical to the question of whether Martin committed
25 defalcation while acting in a fiduciary capacity. Pemstein,
26 476 B.R. at 258. In making this determination, the bankruptcy
27 court utilized an inappropriately narrow definition of
28 defalcation.

Section 523(a)(4) defalcation by a fiduciary.

As relevant here, section 523(a)(4) excepts from discharge
debts incurred by fiduciaries as a result of their defalcations.
It also excepts debts incurred through embezzlement, or larceny

1 regardless of who embezzled or committed larceny. Case law makes
2 clear that the broad, general definition of fiduciary – a
3 relationship involving confidence, trust and good faith – is
4 inapplicable in the dischargeability context. Ragsdale v.
5 Haller, 780 F.2d 794, 796 (9th Cir. 1986). Instead, § 523(a)(4)
6 nondischargeability results only where, among other things, the
7 fiduciary relationship between the debtor and the creditor arises
8 in relation to an express or technical trust that pre-dates the
9 alleged defalcation. Lewis v. Scott (In re Lewis), 97 F.3d 1182,
10 1185 (9th Cir. 1996); Runnion v. Pedrazzini (In re Pedrazzini),
11 644 F.2d 756, 758 (9th Cir. 1981). In short, under
12 section 523(a)(4), it "is not enough that, by the very act of
13 wrongdoing out of which the contested debt arose, the bankrupt
14 has become chargeable as a trustee ex maleficio." Davis v. Aetna
15 Acceptance Co., 293 U.S. 328, 333 (1934); In re Honkanen,
16 446 B.R. at 378-379. Thus, section 523(a)(4) does not render a
17 claim nondischargeable when the fiduciary duty pre-dates the
18 defalcation, and the only trust is a constructive, resulting, or
19 implied trust that arises only after the defalcation. Blyler v.
20 Hemmeter (In re Hemmeter), 242 F.3d 1186, 1189-90 (9th Cir.
21 2001). Whether the debtor was acting in a fiduciary capacity
22 within the meaning of § 523(a)(4) is a question of federal law.
23 Lewis, 97 F.3d at 1185. State law, however, determines whether
24 the requisite trust relationship exists. Id.

25 Under California law, "all partners [are] trustees over the
26 assets of the partnership." Ragsdale, 780 F.2d at 796; and see
27 Cal. Corp. Code § 16404(b)(1) (partner has a duty to hold as
28 trustee any "property, profit, or benefit derived" from

1 partnership business or use of partnership property). And
2 accordingly, "California partners are fiduciaries within the
3 meaning of § 523(a)(4)." Ragsdale 780 F.2d at 796-97. The
4 bankruptcy court here found "no factual dispute that Martin was
5 acting in a fiduciary capacity as a partner of Harold in
6 HMS Properties, a family business." In re Pemstein, 476 B.R. at
7 257. And for purposes of issue preclusion, on its face the 2010
8 Judgment was based on Martin's breach of his duty of care to
9 Harold in Martin's actions in connection with partnership
10 business.

11 The critical question here is whether the 2010 Judgment was
12 based on Martin's defalcation. The bankruptcy court based its
13 negative answer to this question on the omission from the 2010
14 Judgment of any statement that "Martin had failed to account for
15 rents *he received*." Id. (emphasis in original). Our analysis of
16 existing court decisions, supported by the Supreme Court's
17 discussion in the recent Bullock decision, leads us to conclude
18 that actual receipt of funds subject to a trust is not necessary
19 to establish defalcation.

20 The bankruptcy court relied on a definition of defalcation
21 articulated by the Ninth Circuit, quoting Black's Law Dictionary,
22 in In re Lewis: "Defalcation is defined as the 'misappropriation
23 of trust funds or money held in any fiduciary capacity; [t]he
24 failure to properly account for such funds.'" 97 F.3d at 1186
25 (citation omitted). From this definition, the bankruptcy court
26 focused largely on the words "misappropriation" and "funds."

27 In effect, the bankruptcy court's focus negates any
28 difference between defalcation and embezzlement under

1 § 523(a)(4). Embezzlement, however, is nondischargeable under
2 § 523(a)(4) whether or not committed by someone acting in a
3 fiduciary capacity. To equate defalcation with embezzlement,
4 thus, would improperly render part of § 523(a)(4) mere
5 surplusage. See Bullock v. BankChampaign, N.A., 2013 U.S. Lexis
6 3521 at *14. Moreover, defalcation does not require conversion,
7 whereas embezzlement does. Id. (“‘Defalcation,’ as commonly used
8 (hence as Congress might have understood it), can encompass a
9 breach of fiduciary obligation that involves neither conversion,
10 nor taking and carrying away another’s property [i.e. larceny],
11 nor falsity [i.e. fraud]”).

12 And, the bankruptcy court missed the broader meaning of
13 defalcation actually applied in Lewis, where the Ninth Circuit
14 held that the debtors’ failure to “provide a complete accounting
15 of the funds [plaintiff] invested in the partnership, or of the
16 partnerships [sic] assets generally, and commingl[ing] [of] his
17 investment with their other funds” fit within the legal
18 definition of defalcation. Id. at 1187 (emphasis added).
19 Defalcation, therefore, is broader than the misappropriation of
20 funds or mere bookkeeping malfeasance. Defalcation includes the
21 failure by a fiduciary to account for money or property that has
22 been entrusted to him. Woodworking Enter., Inc. v Baird
23 (In re Baird), 114 B.R. 198, 204 (9th Cir. BAP 1990); and see
24 In re Hemmeter, 242 F.3d at 1191 (the Ninth Circuit has “as yet
25 not fully defined the contours of defalcation under
26 § 523(a)(4)”); In re Niles, 106 F.3d at 1462 (an agent who comes
27 into possession of money or other thing for the principal must
28 account for it).

1 Whether the 2010 Judgment was based on Martin's receipt of
2 rents and a failure to account for those rents or was based on
3 rents from partnership property that he should have received but
4 failed to collect, the state court determined that Martin caused
5 his partner, Harold, damages of \$295,871.00 in principal and
6 \$400,347.03 in interest. Based on our review of the record,¹⁸ we
7 can infer, at a minimum, that the state court found that Martin
8 breached a fiduciary duty to Harold that negatively impacted
9 Harold's right to receive rents from the partnership's property.
10 The right to receive rents was part of the bundle of rights in
11 the real property owned by the partnership. See Black's Law
12 Dictionary 1335 (9th ed. 2009) (property is the "right to possess,
13 use, and enjoy a determinate thing. . .; the right of ownership
14 Also termed bundle of rights.") This breach of fiduciary
15 duty may constitute defalcation under § 523(a)(4).¹⁹

16 The 2010 Judgment specifically states the finding that
17 Martin "breached his duty of care to Harold Pemstein in the
18 collection of rent on behalf of HMS Properties." We may infer
19 that in making this finding, the state court necessarily decided
20 against Martin on the fifth cause of action in the operative
21 complaint, the only claim in the State Court Complaint against

22
23 ¹⁸ At trial, the bankruptcy court admitted into evidence
24 the State Court Complaint (Defendant's Trial Ex. B), the 2005
25 Decision (Plaintiff's Trial Ex. 1), the 2010 Judgment
(Plaintiff's Trial Ex. 2), and the DCA Opinion (Defendant's Trial
Ex. A). See Hr'g Tr. (November 30, 2011) at iii.

26 ¹⁹ See Brown v. Kenney (In re Kenney), 2012 Bankr. LEXIS
27 4127 *11-12 (Bankr. N.D. Cal. 2012) (use of the term
28 "defalcation" is not required for issue preclusion purposes,
"[i]t is necessary only that the prior decision establish facts
necessary to except the debt from discharge under section 523")
(emphasis in original).

1 Martin for breach of fiduciary duty as Harold's partner. The
2 wrongful conduct alleged there includes failing to account to the
3 partnership and to "hold as trustee the properties, profits, and
4 benefits" derived therefrom (State Court Complaint at 12-13,
5 para. f); dealing with partnership properties in a manner adverse
6 to Harold (Id. at 13, para. g); and "refusing to set market
7 rents" for partnership properties rented to the family
8 corporation, from which Harold had been excluded (Id. at 13.
9 para. k).

10 This inference is supported by our review of the
11 DCA Opinion. In the DCA Opinion, the Court of Appeal recited the
12 history of the litigation between these parties, and in summary
13 stated that after the 2005 Decision, "[t]he only issue remaining
14 was the equitable accounting for rents Harold claimed Martin owed
15 him." DCA Opinion at 3. It then quoted the state court's minute
16 order dated December 14, 2009, wherein the state court prefaced
17 its oral ruling after the multi-day trial on the State Court
18 Complaint by stating that the only issue then remaining was
19 "Harold's . . . equitable claims for RENT between himself and
20 Martin . . . regarding Martin['s] stewardship of HMS on behalf of
21 the partnership . . ." Id. at 3-4. Thus, as the 2010 Judgment
22 was the result of Martin's failure to account for partnership
23 property entrusted to him, the bankruptcy court utilized an
24 incorrect legal rule when it denied the 2010 Judgment issue
25 preclusive effect, based on the assumption that defalcation
26 resulted only when the fiduciary fails to account for cash
27 actually received.

28

1 **Section 523(a) (4)'s scienter requirement.**

2 In its decision, the bankruptcy court opined that the 2010
3 Judgment may have been based on a finding of "negligence," which
4 the bankruptcy court thought insufficient to establish
5 defalcation. In re Pemstein, 476 B.R. at 259. We find no
6 support in the record for a finding of simple negligence. The
7 State Court Complaint contained no negligence cause of action.
8 And, at the time the bankruptcy court rendered its decision, at
9 least in the Ninth Circuit, "the term 'defalcation' include[d]
10 innocent, as well as intentional or negligent defaults."
11 In re Lewis, 97 F.3d at 1186 (citation omitted). Thus, the
12 bankruptcy court's concern that Martin may have been found only
13 negligent, even if true, did not support the bankruptcy court's
14 ruling under the standard in effect at that time in the Ninth
15 Circuit.

16 We acknowledge, however, that the Bullock decision abrogates
17 the Ninth Circuit's previous standard that omitted a scienter
18 element for § 523(a) (4) defalcation, and the bankruptcy court's
19 analysis on remand must reflect the change. In brief, Bullock
20 instructs us that the necessary state of mind for § 532(a) (4)
21 defalcation is "one involving knowledge of, or gross recklessness
22 in respect to, the improper nature of the relevant fiduciary
23 behavior." Bullock v. BankChampaign, N.A., 2013 U.S. Lexis 3521,
24 *5.

25 In the 2010 Judgment, the term "duty of care" applies to one
26 of the two statutory fiduciary duties of partners to one another
27 and the partnership as enunciated in the California Corporations
28 Code. See Cal. Corp. Code § 16404(c). This duty required Martin

1 to refrain from "engaging in grossly negligent or reckless
2 conduct, intentional misconduct, or a knowing violation of law"
3 in the conduct and winding up of the partnership business. Thus,
4 in light of this statutory provision, the state court necessarily
5 found that Martin's collection of rents was no less than "grossly
6 negligent or reckless conduct," "intentional misconduct," or "a
7 knowing violation of law." Id. Whether such findings, made in
8 the context of the civil litigation and tort concepts that were
9 before the state court, satisfy the heightened standard
10 established in Bullock is not for this Panel to determine for the
11 first time as a reviewing court and must be determined by the
12 bankruptcy court on remand.

13 **CONCLUSION**

14 Based on the foregoing, we conclude that the bankruptcy
15 court erred when it ruled that Harold's § 523(a)(4) claim failed
16 because Harold did not prove that Martin actually received funds
17 for which he failed to account. We determine that this error was
18 not harmless. We, therefore, REVERSE the bankruptcy court's
19 narrow application of § 523(a)(4) defalcation, we VACATE the
20 denial of Harold's § 523(a)(4) claim, and we REMAND for further
21 findings regarding issue preclusion or, if found to be otherwise
22 not applicable, for determinations of the sufficiency of evidence
23 at trial in light of our conclusions herein, or for further
24 consideration of evidence as the bankruptcy court deems necessary
25 in light of the intervening Supreme Court decision in Bullock.