American Bankruptcy Institute
Central States Bankruptcy Workshop

Construction: Theft by Contractor Issues

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CONCURRENT SESSION
2026

ABI · CENTRAL STATES BANKRUPTCY WORKSHOP · 2026

Theft by Contractor.

Where trust funds, statutes & § 523(a)(4) collide.

PANEL

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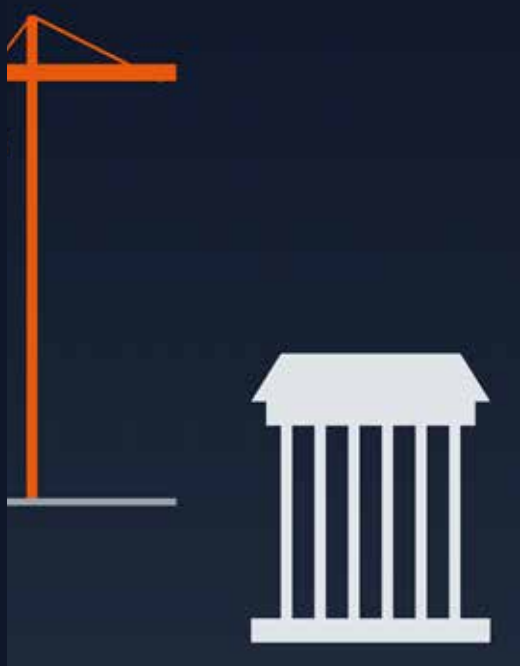


WHY THIS PANEL ISN'T BORING

"Defalcation—a word that only lawyers and judges could love."

— Judge Posner, In re Jahrling, 816 F.3d 921 (7th Cir. 2016)

7

Midwest jurisdictions

Three statutory schemes, three lien regimes

2

Filters to fiduciary capacity

State-law trust · Federal trust-character

60

Days after § 341 mtg.

Rule 4007(c). Jurisdictional. Unforgiving.

THE ANALYTICAL SPINE

State Law Sets It Up. Federal Law Decides.

Two filters establish fiduciary capacity. Only then does the defalcation mental-state question arise.

1

FILTER 1 — STATE LAW

Does a statutory trust exist?

Who is the trustee? When does it attach? IL, WI, MI, MN — yes (with caveats). IN, OH, IA — no statutory trust.

2

FILTER 2 — FEDERAL TRUST-CHARACTER

Does the trust impose real duties in advance of breach?

Davis v. Aetna (1934) · Marchiando (7th Cir. 1994) · Thompson (8th Cir. 2012). A remedial label slapped on a debtor ex maleficio doesn't count.

→

THEN — PROVING DEFALCATION

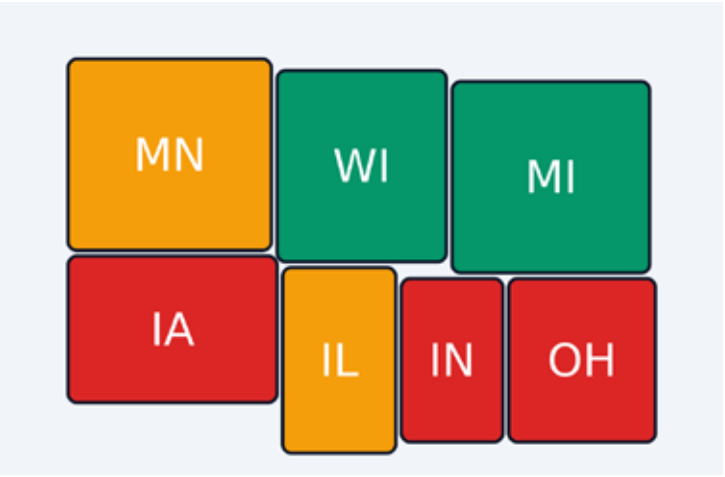
Once fiduciary capacity is established, what mental state?

Bullock v. BankChampaign, 569 U.S. 267 (2013). A culpable state of mind — actual knowledge or gross recklessness as to the fiduciary breach. Not a filter; it is the next question.

SEVEN-STATE SNAPSHOT

Where the Trust Statutes Clear Both Filters

Clears both filters / reliable hook (green) · Statute exists but fails Filter 2 (yellow) · No statutory trust (red).



LEGEND

Clears both filters
Wisconsin · Michigan

Fails Filter 2
Illinois (Hivon) · Minnesota (Reshetar)

No statutory trust
Iowa · Indiana · Ohio

> *"A state cannot magically transform contractors into fiduciaries by the simple incantation of the terms 'trust' or 'fiduciary.'"*
>
> *— In re Thompson, 686 F.3d 940, 945 (8th Cir. 2012)*

SIDE-BY-SIDE

The Seven-State Matrix

Eight issues that drive practice. The row that matters most: the § 523(a)(4) hook.

Issue	IL	WI	MI	MN	IN	OH	IA
Statute	770 ILCS 60/21.02	§ 779.02(5)	MBTFA § 570.151	§ 514.02	None	None	None
Trust trigger	Lien waiver	Receipt (auto)	Receipt (auto)	Receipt (auto)	—	—	—
Civil scienter	Knowing diversion	Strict / intent for treble	Intent (presumed)	Knowing failure	—	—	—
Treble / fees	No	§ 895.446	via § 600.2919a	via § 604.14	Crime Victims Act	via § 2307.61	No
Officer liability	Not automatic	Responsible	Brown / Patel	Residential only	No	No	No
Criminal	Misdemeanor	Up to Class G fel.	Felony	Felony > $1k	General theft	General theft	General theft
§ 523(a)(4) hook	No (Hivon)	Sveum	Patel/Johnson	Reshetar	No	No	No
SOL	5 yrs	6 yrs	6 yrs	6 yrs	Lien-driven	Lien-driven	Lien-driven

FILTER 1

Does the State Recognize a Trust?

Different statutes, very different mechanics.

Statutes That Create a Trust

Wisconsin — *Wis. Stat. § 779.02(5) / § 779.16*

Express trust; receipt of funds is the trigger; officers personally liable if 'responsible for' the diversion.

Michigan — *MCL § 570.151 (MBTFA)*

Trust attaches the moment funds are paid; corporate officer is the statutory contractor (People v. Brown).

Illinois — *770 ILCS 60/21.02*

Trust triggers on lien waiver for payment — but lacks express-trust hallmarks, so it fails Filter 2 (Hivon).

Minnesota — *Minn. Stat. § 514.02*

Statute says trust — but expressly disclaims fiduciary liability. Federal § 523 hook breaks at Filter 2.

No Statutory Trust

Iowa — —

No theft-by-contractor statute. Build the case on lien, contract, and conversion.

Indiana — *Crime Victims Relief Act § 34-24-3-1*

No statutory trust; treble damages still available via the CVRA.

Ohio — *ORC § 2913.02 (general theft)*

No dedicated statute; use general theft + civil-theft trebling under § 2307.61.

FILTER 2

Federal Trust-Character

The Marchiando / Thompson question — does the trust have substance before any wrong? IL and MN fail here.

Traditional Hallmarks of a Trust

7th Circuit (McGee / Marchiando)

Segregation of funds · management by financial intermediaries · entity holds at most 'bare' legal title.

6th Circuit (Patel)

(1) Intent to create a trust · (2) trustee · (3) trust res · (4) definite beneficiary.

8th Circuit (Thompson)

(1) Definable res · (2) imposes 'trust-like' duties (separate accounts, detailed records).

Where the Statutes Break

Illinois — In re Hivon / Schumacker

N.D. Ill. holds 770 ILCS 60/21.02 creates no fiduciary relationship: no duty to segregate, only 'bare' title, and no fiduciary duty until a sub goes unpaid.

Minnesota — In re Thompson

2000 amendment expressly disclaims fiduciary liability; no segregation required; past-tense beneficiary language means the trust didn't exist before the wrong.

Kentucky · Tennessee · Iowa · Indiana

Courts find no trust within the technical meaning required by § 523(a)(4).

PROVING DEFALCATION · THE MENTAL STATE

Bullock v. BankChampaign

569 U.S. 267 (2013) — once fiduciary capacity is established, this is the culpability ladder.

TIER A

Actual Knowledge

Debtor knew the conduct violated a fiduciary duty.

TIER B

Willful Blindness

Conscious disregard of a substantial and unjustifiable risk that conduct will violate a fiduciary duty. (Model Penal Code § 2.02(2)(c).)

TIER C

Mere Negligence

Not defalcation. Patel: 'no such thing as defalcation per se.'

"Gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation."

— Bullock, applying Model Penal Code § 2.02(2)(c). Post-Bullock, every § 523(a)(4) case must address the contractor's state of mind.

CIRCUIT TOUR · 7TH

Wisconsin Builds the Playbook

How E.D./W.D. Wis. courts apply Bullock to theft-by-contractor cases.

Sveum v. Stoughton Lumber — NON-DISCH.

534 B.R. 771 (W.D. Wis. 2015) · 787 F.3d 1174 (7th Cir. 2015)

Officer pooled draws in one account, knowing the statute — willfully blind. On appeal: segregation isn't required; failing to preserve the trust funds was the violation.

In re St. Antoine — DISCHARGED

533 B.R. 743 (Bankr. E.D. Wis. 2015)

Debtors never knew of trust requirements — high-school educated, no formal business training. Bullock standard not met.

In re Hall — NON-DISCH.

581 B.R. 864 (Bankr. W.D. Wis. 2018)

Practical framework: knowledge of the statute · circumstances of the violation · degree of self-interest. Commingling + no accounting = defalcation.

In re Olson — CURRENT

2026 Bankr. LEXIS 93 (Bankr. E.D. Wis. Jan. 15, 2026)

Latest reaffirmation — § 779.02(5) is a sufficient fiduciary basis for § 523(a)(4); Bullock willful-blindness applies.

CIRCUIT TOUR · 6TH

Michigan — Objective Recklessness

Johnson, Patel, Poynter — the MBTFA line.

In re Johnson — FOUNDATION

691 F.2d 249 (6th Cir. 1982)

Foundational MBTFA case. Objective standard: using funds for any non-project purpose first = defalcation, regardless of subjective intent. Contractor charged with knowledge of the statute.

In re Patel — NON-DISCH.

565 F.3d 963 (6th Cir. 2009)

Corporate officer paid his own payroll, utilities, taxes before subs — 'woefully inadequate' accounting. 'No defalcation per se' — but objective recklessness suffices.

In re Poynter — NON-DISCH.

535 F. App'x 479 (6th Cir. 2013)

Commingling bond contract funds with other project funds = defalcation. Physical commingling, even without theft, is enough when express trust governs.

In re Piercy — STANDARD

21 F.4th 909 (6th Cir. 2021)

Sharpens the line: defalcation needs only gross recklessness, while embezzlement under the second prong demands fraudulent intent. Lower bar for the trust-fund creditor.

CIRCUIT TOUR · 8TH

Minnesota — Where the Statute Goes to Die

The disclaimer in § 514.02 collapses Filter 2.

In re Thompson

686 F.3d 940 (8th Cir. 2012)

Minn. Stat. § 514.02 'shall be held in trust' — but the statute says 'nothing . . . shall require money to be placed in a separate account . . . or create a fiduciary liability.' Past-tense beneficiary language means the trust did not exist before the wrong.

NO § 523(a)(4) HOOK

In re Harris

898 F.3d 834 (8th Cir. 2018)

Not a contractor case — but the controlling 8th Cir. Bullock application. CEO diverted employee health plan contributions knowing the plan would be cancelled. Reckless disregard of substantial and unjustifiable risk = defalcation.

NON-DISCHARGEABLE

WHEN THE TRUST STATUTE FAILS

The Embezzlement Back Door

Embezzlement & larceny do not require a fiduciary capacity.

§ 523(a)(4) Embezzlement Elements

1. Fraudulent appropriation
Of property entrusted or lawfully come into debtor's hands.

2. Deposit in a debtor-only account
Funds placed where only the debtor can access.

3. Disbursal without explanation
Use of funds with no business reason or accounting.

Larceny is the same — but the taking is unlawful at the start. Rarely fits a contractor who was hired.

Who Can Use the Back Door?

Subs in MN, IL, TN *Funds contractually belonged to the GC.*	NO
Owners / lenders in IN *Yant — loan proceeds used outside agreed purpose.*	YES
Owners / lenders in IA *Mortensen — funds entrusted only for build.*	YES
Owners / lenders in OH *Keirns — false photos of materials.*	YES
Owners / lenders in TN *Batson — retainer used for other purposes.*	YES

PIERCING THE VEIL

Brown vs. Sveum — Two Routes, Same Result

How Michigan and Wisconsin reach the principal personally.

MICHIGAN *People v. Brown · In re Patel*	WISCONSIN *Burmeister · Stoughton Lumber v. Sveum*
Who is the trustee? The officer herself — statutory 'contractor.'	**Who is the trustee?** The entity. Officer's diversion is 'deemed theft by' her personally.
Required nexus Office + participation in the misapplication.	**Required nexus** Officer/member status + 'responsible for' the misapplication.
Benefit relevant? No — participation is the inquiry.	**Benefit relevant?** No — Burmeister rejects benefit as an element.
Treble damages Via § 600.2919a statutory conversion.	**Treble damages** Yes, direct — Wis. Stat. § 895.446 (Sobkowiak intent).
Bankruptcy state of mind Patel objective recklessness, harmonized post-Bullock.	**Bankruptcy state of mind** Bullock willful blindness — easily met (Sveum).
Best defense Passive officer; delegated bookkeeping; did not direct disbursements.	**Best defense** Not 'responsible for' diversion; bona fide dispute over claim amount.

THE DISCHARGE-FIGHT MULTIPLIER

Collateral Estoppel ≠ Res Judicata

The state-court record you build today is the § 523(a)(4) record tomorrow.

Res Judicata — DOESN'T APPLY

Claim preclusion

A § 523 action is never the same cause as the underlying state claim. Dischargeability is within the bankruptcy court's exclusive jurisdiction.

Brown v. Felsen, 442 U.S. 127 (1979) · In re Piercy (6th Cir. 2021)

Collateral Estoppel — APPLIES

Issue preclusion

Issues actually litigated and necessarily decided are conclusive. Look to the preclusion law of the rendering state (28 U.S.C. § 1738).

Marrese (1985) · § 523(a) discharge proceedings

The settlement trap — Archer v. Warner

A settlement that releases all claims and swaps the fraud debt for a promissory note does NOT launder it. Courts examine the underlying character of the debt — if it arose from fraud or defalcation, it stays nondischargeable. Sveum applied exactly this to a defaulted theft-by-contractor settlement.

PRECLUSION IN PRACTICE

What a State Judgment Actually Locks In

Bare damages judgments aren't preclusion material. Win findings on each disputed element.

6TH CIRCUIT

In re Piercy

Res judicata never applies to dischargeability; collateral estoppel does.

In re Calvert

Default judgments get preclusive effect if the rendering state would give it.

In re Phillips

Liability & damages precluded — but willful injury still tried.

7TH CIRCUIT

First Weber v. Horsfall

§ 523(a)(6): judgment bound injury & malice, not intent to injure.

Gerard v. Gerard

Statutory words needn't appear — ask if the findings meet the standard.

In re Davis

Porch case: contract scope precluded; fraud/intent was not.

8TH CIRCUIT

In re Luebbert

§ 523(a)(6): collateral estoppel on the injury element from a contract judgment.

In re Riehm

Bar-fight stabbing: criminal stipulated facts not 'actually litigated'; civil verdict used a different intent standard.

PROCEDURE

Pleading & Burdens

What you have to plead, what you have to prove, and who has to prove it.

Rule 9(b) — Heightened Pleading

FRAUD: yes. EMBEZZLEMENT / LARCENY: yes (fraud is an element). DEFALCATION: split — most courts say no; Wells-Lucas (Bankr. N.D. Ga. 2021) says yes.

Underlying Debt (State Law)

Wis. JI-Civil 2722: (1) improvement agreement; (2) receipt of funds; (3) intentional non-project use; (4) without consent; (5) monetary loss.

Nondischargeability (Federal)

Preponderance (Grogan v. Garner). Strictly construed against the creditor, liberally in favor of the debtor (Scarlata).

Burden-Shifting on Accounting

In re Hall · In re Little: once plaintiff shows the trust res and no accounting, burden shifts to contractor to explain. Collier disapproves — debate is live.

PRACTICE POINTERS

Three Chairs, Three Playbooks

The same fund flow looks different from each side of the table.

PLAINTIFF

Sub / supplier counsel

- Pick the forum: WI/MI trust statute; IL § 21.02 + lien; MN § 514.02 + § 604.14.
- Build the § 523 record in civil discovery — depose on statute awareness & check-signing.
- Demand specific findings, not bare judgments — issue preclusion is the multiplier.
- Calendar Rule 4007(c): 60 days after the § 341 meeting. Jurisdictional.
- Plead in the alternative: (a)(2)(A), (a)(4) embezzlement, (a)(6).

DEFENDANT

Contractor / principal counsel

- Trust-fund accounting from day one — the single best defense.
- Document bona fide disputes contemporaneously, not on the eve of suit.
- Watch the IL lien-waiver flow; false 'paid' reps compound to § 523(a)(2)(A).
- Segregate before petition — trust funds aren't estate property (§ 541(d)).
- Corporate Ch. 11 cleanses the entity; passive-officer defense has real content.

BANK / LENDER

Secured-creditor counsel

- Know your collateral: trust money in receipts isn't yours to sweep.
- Workouts: require segregated accounts + sub-payment certifications.
- DIP orders should carve trust funds out of the collateral package.
- Multistate: same borrower is a trustee on some projects, not others.
- Ohio § 1311.14: the mortgagee itself takes on disbursement duties.

CLOSING

Six Takeaways

1. **State law sets it up. Federal law decides whether it counts.**
2. **Two filters establish fiduciary capacity; Bullock's mental-state test comes after.**
3. **Only Wisconsin and Michigan reliably clear both filters.**
4. **Illinois and Minnesota fail Filter 2; Iowa, Indiana, and Ohio fail Filter 1.**
5. **Build detailed state-court findings — collateral estoppel is the discharge-fight multiplier.**
6. **Calendar Rule 4007(c) on the petition date. It's the most common cause of death.**

Questions & Panel Discussion

CONSTRUCTION – THEFT BY CONTRACTOR ISSUES

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CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

I. State Theft-by-Contractor Statute Comparison Matrix

The matrix below summarizes seven Midwest jurisdictions on the eight issues that drive practice: whether a statutory trust exists, what triggers it, the civil scienter requirement, whether treble damages are available, whether officers face personal liability, whether those officers face criminal exposure, whether the statute reliably supports a federal § 523(a)(4) defalcation claim, and the statute of limitations. The most important row is the second-to-last — the § 523(a)(4) hook—or whether the state law trust establishes the requisite "fiduciary capacity" under federal law.

Issue	Illinois	Wisconsin	Michigan	Minnesota	Indiana	Ohio	Iowa
Statute	770 ILCS 60/21.02	Wis. Stat. §§ 779.02(5), 779.16	MCL 570.151–.153	Minn. Stat. § 514.02	None	None	None
Trust trigger	Lien waiver for payment	Receipt of funds (auto)	Receipt of funds (auto)	Receipt of funds (auto)	N/A	N/A	N/A
Civil scienter	Knowing diversion	Strict liability (basic); intent for trebling	Intent to defraud (presumed)	Knowing failure to apply	N/A	N/A	N/A
Treble / fees	No	Yes (§ 895.446)	Via stat. conversion (§ 600.2919a)	Via civil theft (§ 604.14)	Via Crime Victims Act	Via civil theft (§ 2307.61)	No
Officer liability	Not automatic	Yes (responsible)	Yes (*Brown* / *Patel*)	Residential only	No	No	No
Criminal exposure	Misdemeanor	Up to Class G felony	Felony	Felony (over $1k)	General theft	General theft	General theft
Reliable § 523(a)(4) hook	No. (*Hivon*)	Yes (*Sveum*)	Yes (*Patel* / *Johnson*)	No (*Reshetar*)	No	No	No
Statute of limitations	5 yrs	6 yrs	6 yrs	6 yrs	Lien-driven	Lien-driven	Lien-driven

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

770 ILCS 60/21.02 Construction Trust Funds.

(a) Money held in trust; trustees. Any owner, contractor, subcontractor, or supplier of any tier who requests or requires the execution and delivery of a waiver of mechanics lien by any person who furnishes labor, services, material, fixtures, apparatus or machinery, forms or form work for the improvement of a lot or a tract of land in exchange for payment or the promise of payment, shall hold in trust the sums received by such person as the result of the waiver of mechanics lien, as trustee for the person who furnished the labor, services, material, fixtures, apparatus or machinery, forms or form work or the person otherwise entitled to payment in exchange for such waiver.

(b) How trust moneys held; commingling. Nothing contained in this Section shall be construed as requiring moneys held in trust by an owner, contractor, subcontractor, or material supplier under this Section to be placed in a separate account. If an owner, contractor, subcontractor, or material supplier commingles moneys held in trust under this Section with other moneys, the mere commingling of the moneys does not constitute a violation of this Section.

(c) Violation of this Section. Any owner, contractor, subcontractor, or material supplier who knowingly retains or used the moneys held in trust under this Section or any part thereof, for any purpose other than to pay those for whom the moneys are held in trust, shall be liable to any person who successfully enforces his or her rights under this Section for all damages sustained by that person.

Wis. Stat. § 779.02(5):
Theft by contractors. The proceeds of any mortgage on land paid to any prime contractor or any subcontractor for improvements upon the mortgaged premises, and all moneys paid to any prime contractor or subcontractor by any owner for improvements, constitute a trust fund only in the hands of the prime contractor or subcontractor to the amount of all claims due or to become due or owing from the prime contractor or subcontractor for labor, services, materials, plans, and specifications used for the improvements, until all the claims have been paid, and shall not be a trust fund in the hands of any other person. The use of any such moneys by any prime contractor or subcontractor for any other purpose until all claims, except those which are the subject of a bona fide dispute and then only to the extent of the amount actually in dispute, have been paid in full or proportionally in cases of a deficiency, is theft by the prime contractor or subcontractor of moneys so misappropriated and is punishable under s. 943.20. If the prime contractor or subcontractor is a corporation, limited liability company, or other legal entity other than a sole proprietorship, such misappropriation also shall be deemed theft by any officers, directors, members, partners, or agents responsible for

the misappropriation. Any of such misappropriated moneys which have been received as salary, dividend, loan repayment, capital distribution or otherwise by any shareholder, member, or partner not responsible for the misappropriation shall be a civil liability of that person and may be recovered and restored to the trust fund specified in this subsection by action brought by any interested party for that purpose. Except as provided in this subsection, this section does not create a civil cause of action against any person other than the prime contractor or subcontractor to whom such moneys are paid. Until all claims are paid in full, have matured by notice and filing or have expired, such proceeds and moneys shall not be subject to garnishment, execution, levy or attachment.

Wis. Stat. § 779.16:

Theft by contractors. All moneys, bonds or warrants paid or to become due to any prime contractor or subcontractor for public improvements are a trust fund only in the hands of the prime contractor or subcontractor to the amount of all claims due or to become due or owing from the prime contractor or subcontractor for labor, services, materials, plans, and specifications performed, furnished, or procured for the improvements, until all the claims have been paid, and shall not be a trust fund in the hands of any other person. The use of any such moneys by any prime contractor or subcontractor for any other purpose until all claims, except those which are the subject of a bona fide dispute and then only to the extent of the amount actually in dispute, have been paid in full or proportionally in cases of a deficiency, is theft by the prime contractor or subcontractor of moneys so misappropriated and is punishable under s. 943.20. If the prime contractor or subcontractor is a corporation, limited liability company, or other legal entity other than a sole proprietorship, such misappropriation also shall be deemed theft by any officers, directors, members, partners, or agents responsible for the misappropriation. Any of such misappropriated moneys which have been received as salary, dividend, loan repayment, capital distribution or otherwise by any shareholder, member, or partner not responsible for the misappropriation shall be a civil liability of that person and may be recovered and restored to the trust fund specified in this subsection by action brought by any interested party for that purpose. Except as provided in this subsection, this section shall not create a civil cause of action against any person other than the prime contractor or subcontractor to whom such moneys are paid or become due. Until all claims are paid in full, have matured by notice and filing or have expired, such money, bonds and warrants shall not be subject to garnishment, execution, levy or attachment.

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

Mich. Comp. Laws § 570.151 Building contract fund; status as a trust fund.

Sec. 1.

In the building construction industry, the building contract fund paid by any person to a contractor, or by such person or contractor to a subcontractor, shall be considered by this act to be a trust fund, for the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen, and the contractor or subcontractor shall be considered the trustee of all funds so paid to him for building construction purposes.

Mich. Comp. Laws Ann. § 570.152 Building contract fund; fraudulent detention or use by contractor or subcontractor, penalty.

Sec. 2.

Any contractor or subcontractor engaged in the building construction business, who, with intent to defraud, shall retain or use the proceeds or any part therefor, of any payment made to him, for any other purpose than to first pay laborers, subcontractors and materialmen, engaged by him to perform labor or furnish material for the specific improvement, shall be guilty of a felony in appropriating such funds to his own use while any amount for which he may be liable or become liable under the terms of his contract for such labor or material remains unpaid, and may be prosecuted upon the complaint of any persons so defrauded, and, upon conviction, shall be punished by a fine of not less than 100 dollars or more than 5,000 dollars and/or not less than 6 months nor more than 3 years imprisonment in a state prison at the discretion of the court.

Mich. Comp. Laws Ann. § 570.153 Building contract fund; evidence of fraudulent detention or use.

Sec. 3.

The appropriation by a contractor, or any subcontractor, of any moneys paid to him for building operations before the payment by him of all moneys due or so to become due laborers, subcontractors, materialmen or others entitled to payment, shall be evidence of intent to defraud.

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

Minn. Stat. § 514.02:
Subdivision 1.Proceeds of payments; acts constituting theft.

(a) Proceeds of payments received by a person contributing to an improvement to real estate within the meaning of section 514.01 shall be held in trust by that person for the benefit of those persons who furnished the labor, skill, material, or machinery contributing to the improvement. Proceeds of the payment are not subject to garnishment, execution, levy, or attachment. Nothing contained in this subdivision shall require money to be placed in a separate account and not commingled with other money of the person receiving payment or create a fiduciary liability or tort liability on the part of any person receiving payment or entitle any person to an award of punitive damages among persons contributing to an improvement to real estate under section 514.01 for a violation of this subdivision.
. . .

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

A. The Two Filters — Can a Trust Established by State Law be a Predicate to § 523(a)(4)?

Yes, but only as a necessary condition. State law establishes the trust; federal law decides whether that trust counts.[1] A creditor pursuing a § 523(a)(4) defalcation claim must clear two filters in order to establish the requisite fiduciary relationship:

- **Filter 1 — State law.** Does the state recognize a trust over project funds? Who is the trustee? When does it attach?

- **Filter 2 — Federal trust-character.** Does the state-law trust impose real duties in advance of breach? *Davis v. Aetna*, 293 U.S. 328 (1934); *In re Marchiando*, 13 F.3d 1111 (7th Cir. 1994). A remedial label slapped on a debtor *ex maleficio* (arising from wrongdoing) doesn't count.

WI and MI clear both filters reliably. IL and MN fail at Filter 2. Bankruptcy courts in the Northern District of Illinois have held 770 ILCS 60/21.02 does not create the requisite fiduciary relationship for purposes of § 523(a)(4) because "critical hallmarks of an express trust are absent" such as a requirement to segregate funds or vesting the contractor with "nominal ownership or title to the purported 'trust' funds" and because, under the statute, "a contractor has no duties of a fiduciary character until a subcontractor is not paid."[2]

In *In re Thompson*, the Eighth Circuit held Minn. Stat. § 514.02 did not create the requisite fiduciary relationship for § 523(a)(4).[3] The Court agreed with the Bankruptcy Appellate Panel that the statute did not create an express trust because the Minnesota statute itself expressly disclaimed a fiduciary relationship via a 2000 amendment reading "[n]othing contained in this subdivision shall . . . create a fiduciary liability or tort liability on the part of any person receiving payment."[4] But the Court went further, finding that "[e]ven construing [the statute] as creating an express trust would not change our conclusion that the statute did not create a fiduciary relationship in the 'strict and narrow sense' that § 523(a)(4) requires" because the statute did not require segregation of funds, or other trust like duties

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[1] *Long v. Piercy (In re Piercy)*, 21 F.4th 909, 926 (6th Cir. 2021); *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 766 (7th Cir. 2011); *In re Thompson*, 686 F.3d 940, 945 (8th Cir. 2012).

[2] *Stair One, Inc. v. Hivon (In re Hivon)*, Nos. 14 B 26441, 14 A 710, 2015 Bankr. LEXIS 485, at *13–14 (Bankr. N.D. Ill. Feb. 13, 2015) (citing *In re Marchiando*, 13 F.3d 1111, 1113, 116 (7th Cir. 1994)); *Imperial Roofing, Inc. v. Schumacker (In re Schumacker)*, Nos. 18bk33669, 19ap00125, 2021 Bankr. LEXIS 2030, at *10-11 (Bankr. N.D. Ill. July 15, 2021)

[3] *In re Thompson*, 686 F.3d 940, 945 (8th Cir. 2012).

[4] *Id.*

such as record keeping. [5] Even more importantly, the statute applied only for the benefit of contractors "who *furnished*" labor, so the trust was not created until the subcontractor had a "contractual right to be paid."[6]

IN, OH, and IA fail at Filter 1 — no statutory trust to anchor the analysis. Plaintiffs in those four states must therefore route through § 523(a)(2)(A) (false pretenses), the (a)(4) embezzlement / larceny prongs (no fiduciary required), or § 523(a)(6) (willful injury).

B. Officer Liability

Wisconsin and Michigan are the two Midwest states that most aggressively pierce the corporate veil for construction trust-fund violations. They get to the same place — personal liability for the principal who controls the cash flow — by different doctrinal routes. Understanding the difference matters for pleading, discovery, and discharge strategy.

i. Michigan — People v. Brown and In re Patel

People v. Brown, , holds that a corporate officer is herself a statutory "contractor" under the Michigan Builders' Trust Fund Act — directly liable, criminally and civilly — if she (i) was a corporate officer and (ii) participated in the misappropriation.[7] The Sixth Circuit applied *Brown* to nondischargeability in *Patel v. Shamrock Floorcovering*, holding that the MBTFA creates a technical trust attaching at the moment funds are paid, with corporate-officer trustee status arising contemporaneously by operation of statute.[8]

Michigan elements:

(1) Defendant held corporate office — formal title or de facto control

(2) Defendant participated in the misappropriation — not merely held office

(3) Project funds were used for a non-project purpose

(4) Subs / materialmen were unpaid at the time of the diversion

[5] *Id.* at 945–46.

[6] *Id.* at 946 (emphasis in original) (quoting Minn. Stat. § 514.02).

[7] 239 Mich. App. 735, 740 (2000).

[8] *Patel v. Shamrock Floorcovering Servs., (In re Patel)*, 565 F.3d 963, 969 (6th Cir. 2009).

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

ii. Wisconsin — Burmeister

Wisconsin reaches officers through different statutory language. Wis. Stat. §§ 779.02(5) and 779.16 expressly provide that misappropriation by a corporate or LLC contractor "shall be deemed theft by any officers, directors, members, partners, or agents responsible for the misappropriation." The officer's personal benefit is irrelevant; the test is whether she was "responsible for" the diversion.[9]

Wisconsin elements:

(1) Defendant was an officer, director, member, partner, or responsible agent

(2) Defendant was responsible for the misappropriation — control inquiry, not benefit inquiry

(3) Project funds were used for non-project purposes

(4) Subs / materialmen had unpaid claims on the same project

(5) Treble Damages (§ 895.446): "intent to use moneys subject to a trust for purposes inconsistent with the trust."[10]

[9] *Burmeister Woodwork Co. v. Friedel*, 65 Wis. 2d 293, 298, 222 N.W.2d 647, 650 (1974).

[10] *State v. Sobkowiak*, 173 Wis. 2d 327, 339, 496 N.W.2d 620, 626 (Ct. App. 1992).

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

Side-by-Side

Issue	Michigan (*Brown* / *Patel*)	Wisconsin (*Burmeister*)
Who is the trustee?	The corporate officer herself — by statutory definition of "contractor"	The corporate entity; the officer's misappropriation is "deemed theft by" her personally
Required nexus	Officer status + participation in the misappropriation	Officer/member/director status + responsibility for the misappropriation
Benefit to officer relevant?	No — participation is the inquiry	No — *Burmeister* rejects benefit as an element
Recipient liability	Limited to participation theory	Yes — separate provision reaches anyone who received misappropriated funds as salary, dividend, loan repayment, or capital distribution, regardless of responsibility
Mental state for criminal liability	Intent to defraud (per MCL 570.152), but § 153 presumption shifts the burden	Intent under § 943.20(1)(b) and *Sobkowiak* — intent to use trust funds inconsistently with the trust
Treble damages?	Not directly under MBTFA; via statutory conversion (MCL 600.2919a)	Yes, directly under Wis. Stat. § 895.446 if criminal-theft intent is shown
Best defense	Officer was passive; delegated bookkeeping; did not direct disbursements	Officer was not 'responsible for' misappropriation; bona fide dispute over claim amount

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

C. Practice Pointers

For Plaintiffs (Sub / Supplier Counsel)

- **Choose the forum carefully.** WI or MI: home-state trust statute is the optimal vehicle. IL: layer § 21.02 with the lien claim if a waiver was given. MN: § 514.02 plus § 604.14 civil theft (the disclaimer kills fiduciary liability). IN: Crime Victims Relief Act (§ 34-24-3-1) for treble damages. OH: civil-theft treble damages (§ 2307.61). IA: no treble — build on lien, contract, and conversion.

- **Build the bankruptcy case during civil discovery.** Depose the principal on what he knew about the trust statute, when he knew it, who reviewed cash flow, who signed checks, what he did when subs went unpaid. Lock in admissions that map to *Bullock's* willful-blindness, gross recklessness, or conscious disregard elements (more on this below). The state-court record built today is the § 523(a)(4) record tomorrow.

- **Push for detailed findings, not just a judgment.** Bare damages judgments are not collateral-estoppel material (more on this below). Move for specific findings on knowledge, control, and disbursement decisions. WI: *Sobkowiak* intent findings. MI: *Brown* participation findings. IL: § 21.02(c) "knowing" findings. Issue preclusion is the discharge-fight multiplier.

- **Joint and several pleading.** WI: name the entity, every responsible officer/director/member, and every shareholder/member who received misappropriated funds as salary, dividend, loan repayment, or distribution. MI: name the entity and every officer who controlled day-to-day finances or participated in disbursement decisions.

- **Calendar Fed. R. Bankr. P. 4007(c) on the petition date.** Sixty days after the first § 341 meeting date. This deadline is jurisdictional and unforgiving. Most failed nondischargeability cases die here, not on the merits.

- **Plead alternative § 523 theories.** Even in trust-fund states, plead (a)(2)(A) false pretenses (lien-waiver fraud), (a)(4) embezzlement/larceny (no fiduciary required), and (a)(6) willful and malicious injury. One may survive when another fails.

For Defendants (Contractor / Principal Counsel)

- **Trust-fund accounting from day one.** Contemporaneous job-cost accounting is the single best defensive measure. Separate trust accounts — even where not legally required — are highly probative on willful blindness and substantially undermine Sveum-style nondischargeability claims.

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

- **Document bona fide disputes contemporaneously.** WI's safe harbor protects only amounts genuinely in dispute. Defective-work notice, withhold letters, backcharge documentation, and correspondence challenging the sub's entitlement — all written at the time, not on the eve of suit. Reconstructed disputes look like litigation cover and get treated as such.

- **Watch the lien-waiver flow in Illinois.** Section 21.02 triggers only when a waiver was given for payment. If progress payments are structured on sworn statements without contemporaneous waivers, the case stays in contract territory. If waivers are necessary, ensure no false representations about which subs have been paid — the exposure compounds to § 21.01 and § 523(a)(2)(A).

- **Segregate trust funds before petition; protect the trust corpus.** Trust funds are not estate property under *In re Marrs-Winn*[11] and § 541(d). Commingled funds may be lost in the lowest-intermediate-balance analysis. Segregation immediately before filing preserves the corpus for beneficiaries and reduces personal exposure.

- **Use corporate Chapter 11 to cleanse the entity.** Section 523(a)(4) does not apply to corporate debtors — only individuals. The corporate Chapter 11 plan can release entity liability while the principal addresses personal exposure separately.

- **Take the passive-officer defense seriously where it exists.** *Brown's* "participation" and Wisconsin's "responsible for" both have content. An officer who genuinely delegated bookkeeping, didn't sign checks, and didn't direct disbursements has a viable defense. Build the record early.

For Bank / Lender Counsel

- **Know your collateral in trust-fund states.** In IL, WI, and MI, a meaningful portion of incoming contractor receipts is trust money the bank does not own. Cash sweeps that scoop up trust funds expose the bank to suit by unpaid subs and aiding-and-abetting theories. Underwriting must identify the trust portion — not just the total.

- **Workout structure for troubled contractors.** Forbearance agreements should require segregated trust accounts, regular sub-payment certifications, lien-waiver tracking, and project-by-project cash-flow reporting. A bank that tightens the borrowing base without addressing trust-fund flow creates its own exposure.

- **DIP financing in contractor cases.** DIP orders should expressly carve out trust funds from the lender's collateral package and budget for sub-payment

[11] *Marrs-Winn Co. v. Giberson Elec. (In re Marrs-Winn Co.)*, 103 F.3d 584, 589 (7th Cir. 1996).

obligations. Otherwise the order is vulnerable to challenge by sub committees and the U.S. Trustee.

- **Multistate exposure.** A contractor licensed across the seven states has different fund-flow obligations on each project. The IL project goes under § 21.02, the WI project under § 779.02(5), the MI project under MBTFA, the MN project under § 514.02, IN/OH/IA under their lien regimes only. A single borrower can be a trustee on some receivables and not others. Monitoring must reflect that.
- **Ohio § 1311.14 is a bank-specific trap.** On Ohio construction loans, the mortgagee (not the contractor) takes on trust-like duties to disburse loan proceeds for project payees as a condition of maintaining lien priority. Failure subordinates the mortgage to mechanics' liens to the extent of misapplication. Ohio loan administration must track this specifically.

II. Collateral Estoppel and Res Judicata in Bankruptcy Court

The doctrine of collateral estoppel, or as it is sometimes called, "issue preclusion," dictates that once an issue of law or fact is actually and necessarily determined, that determination is conclusive in subsequent suits involving the same party.[12]

This is different from the doctrine of res judicata, or as it is sometimes called, "claim preclusion." Under res judicata, a "final judgment on the merits bars further claims by parties or their privies based on the same cause of action" and "prevents litigation of all grounds for, or defenses to, recovery that were previously available to the parties, regardless of whether they were asserted or determined in the prior proceeding."[13]

A. General Principles

i. Federal law instructs federal courts to give "full faith and credit" to judgments from state courts:

28 U.S.C. § 1738 - State and Territorial statutes and judicial proceedings; full faith and credit

> The records and judicial proceedings of any court of any such State, Territory or Possession, or copies thereof, . . . so authenticated, shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken.

ii. Federal courts must refer to the preclusion law of the state in which the judgment was entered.

"Section 1738 embodies concerns of comity and federalism that allow the States to determine, subject to the requirements of the statute and the Due Process Clause,

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[12] *Havoco of Am. v. Freeman, Atkins & Coleman*, 58 F.3d 303, 307 (7th Cir. 1995) ("Collateral estoppel refers to a judgment's effect of foreclosing relitigation in a subsequent action of an issue of law or fact that has been actually litigated and decided in the initial action.") (quotation omitted); *Long v. Piercy (In re Piercy)*, 21 F.4th 909, 918 (6th Cir. 2021) ("[C]ollateral estoppel, also known as issue preclusion, . . . precludes relitigation of issues of fact or law actually litigated and decided in a prior action between the same parties and necessary to the judgment.") (quotation omitted).

[13] *Brown v. Felsen*, 442 U.S. 127, 131 (1979) (quotations and citations omitted) (debtor may not use claim preclusion to prevent creditor with stipulated judgment from pursuing nondischargeability claim in subsequent bankruptcy).

the preclusive effect of judgments in their own courts."[14] "Only if state law indicates that a particular claim or issue would be barred, is it necessary to determine if an exception to § 1738 should apply. . . . Resolution of this question will depend on the particular federal statute as well as the nature of the claim or issue involved in the subsequent federal action."[15]

iii. There is an exception to § 1738 for some purposes in nondischargeability actions.

In *Brown v. Felsen*, the creditor (Brown) guaranteed a car dealership debt of the debtor (Felson).[16] The lender filed suit against both, and the creditor filed a cross claim alleging that the debtor induced the guaranty by misrepresentation.[17] The suit was settled by stipulation.[18] The creditor and debtor were jointly and severally liable to the lender, but the creditor would have a judgment against the debtor.[19] Neither the stipulation nor the resulting judgment mentioned the misrepresentation claim.[20] In the ensuing nondischargeability case under § 523(a)(2)(A), the debtor argued that the creditor was bound by the state court judgment that said nothing about fraud, and that the creditor was barred from litigating matters that could have been included in the consent judgment.[21]

The Supreme Court held that res judicata did not apply. The Court noted that "[c]onsiderations material to discharge are irrelevant to the ordinary collection proceeding" and that parties have "little incentive" to litigate those issues when bankruptcy is merely "hypothetical."[22] Therefore, "the bankruptcy court is not confined to a review of the judgment and record in the prior state-court proceedings when considering the dischargeability of respondent's debt."[23]

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[14] *Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 380 (1985).

[15] *Id.* at 386.

[16] 442 U.S. 127 (1979).

[17] *Id.* at 128.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.* at 129.

[22] *Id.* at 134–36.

[23] *Id.* at 138–39.

The rule in *Brown v. Felson* applies even when the settlement stipulation purports to release all claims and replaces the underlying debt for fraud with a promissory note.[24]

"Under [*Brown*] the correct preclusion principle in a § 523 case is collateral estoppel, and not res judicata, because a § 523 action cannot be the same cause as an underlying state court cause of action."[25]

iv. Prior litigation of the underlying issues may be dispositive under principles of collateral estoppel.

"[C]ollateral estoppel principles . . . apply in discharge exception proceedings pursuant to § 523(a)."[26] Courts generally examine whether there is an identity of factual or legal issues between the prior judgment and the requirements for nondischargeability, applying the collateral estoppel law of the forum (federal or state) that issued the relevant judgment.[27]

B. Sixth Circuit Case Law

i. In re Piercy, 21 F.4th 909 (6th Cir. 2021)

The Sixth Circuit addressed the "critical" difference between res judicata and collateral estoppel "as applied to dischargeability proceedings in bankruptcy."[28] The court said that res judicata will never apply in nondischargeability cases because whether a debt is dischargeable is "a matter separate from the merits of the debt itself."[29] "Res judicata applies to the existence of a debt, but not to the question of

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[24] *Archer v. Warner*, 538 U.S. 314, 323 (2003) ("We conclude that the Archers' settlement agreement and releases may have worked a kind of novation, but that fact does not bar the Archers from showing that the settlement debt arose out of 'false pretenses, a false representation, or actual fraud,' and consequently is nondischargeable, 11 U.S.C. § 523(a)(2)(A).").

[25].*Stoughton Lumber Co. v. Sveum (In re Sveum)*, Nos. 12-15483, 13-2, 2013 Bankr. LEXIS 2761, at *8 (Bankr. W.D. Wis. July 8, 2013) (quotations omitted) (citing *In re Webb*, 2009 Bankr. LEXIS 591, 2009 WL 1139548, at *3 (Bankr.N.D. W. Va. Mar. 31, 2009), which, in turn, cites *Grogan v. Garner*, 498 U.S. 279 (1991)).

[26] *See Grogan v. Garner*, 498 U.S. 279, 284 n. 11 (1991).

[27] *Fischer v. Scarborough (In re Scarborough)*, 171 F.3d 638, 641 (8th Cir. 1999). *Johnson v. Porter (In re Porter)*, 2007 Bankr. LEXIS 5006, at *9 (Bankr. D.S.D. Sep. 28, 2007); *William R. Lee Irrevocable Tr. v. Lee (In re Lee)*, 2015 Bankr. LEXIS 4547, at *19 (Bankr. S.D. Ind. Dec. 2, 2015); *Ronk v. Maresh (In re Maresh)*, 277 B.R. 339, 345 (Bankr. N.D. Ohio 2001) (bankruptcy courts apply issue preclusion law of the forum where original proceeding took place whether state or federal court) (citations omitted).

[28] *Long v. Piercy (In re Piercy)*, 21 F.4th 909, 918 (6th Cir. 2021).

[29] *Id.*

whether that debt is dischargeable in bankruptcy because dischargeability is a legal conclusion within the exclusive jurisdiction of the bankruptcy courts."[30]

"Principles of collateral estoppel, on the other hand, do apply to the determination of dischargeability."[31] "The bankruptcy court, when asked to determine the potential application of collateral estoppel, must review the record of the state-court proceeding to determine if any factual issues relevant to dischargeability have been actually and necessarily determined by the state court. If not so determined, the bankruptcy court must independently make the necessary factual findings."[32]

ii. In re Calvert, 105 F.3d 315 (6th Cir. 1997)

State law applies to determine whether a default judgment renders issues barred by collateral estoppel, regardless of whether the default judgment arises from a failure to respond or as a sanction for litigation conduct.[33]

"In the absence of any indication in the Bankruptcy Code or legislative history suggesting that Congress intended an exception to § 1738 apply to true default judgments and with no principled distinction between cases where a defendant participates in part in defense of the state court suit and cases where the defendant does not respond at all, we conclude that collateral estoppel applies to true default judgments in bankruptcy dischargeability proceedings in those states which would give such judgments that effect."[34]

iii. In re Phillips, 434 B.R. 475, 487 (B.A.P. 6th Cir. 2010)

Debtors defaulted in state court after failing to respond to the complaint and a state court judgment was entered.[35] Plaintiffs brought a nondischargeability action under § 523(a)(6).[36] Bankruptcy court and BAP determined that the issues of liability and damages were determined by judgment and entitled to collateral estoppel

[30] *Id.* (citing *Brown*, 442 U.S. at 136-39).

[31] *Id.* (citing *Grogan*, 498 U.S. at 284 n. 11).

[32] *Id.* at 919.

[33] *Bay Area Factors v. Calvert (In re Calvert)*, 105 F.3d 315, 322 (6th Cir. 1997).

[34] *Id.*

[35] *Phillips v. Weissert (In re Phillips)*, 434 B.R. 475, 482 (B.A.P. 6th Cir. 2010).

[36] *Id.*

effect.[37] Issue of willful injury was not entitled to collateral estoppel effect under Michigan law, so bankruptcy court was right to proceed to trial on that issue.[38]

C. Seventh Circuit Case Law

i. First Weber Grp., Inc. v. Horsfall, 738 F.3d 767 (7th Cir. 2013)

First Weber sued Horsfall in state court alleging claims based on breach of contract, tortious interference, and unjust enrichment based on a real estate commission Horsfall collected.[39] The state court granted summary judgment to First Weber.[40] In its ruling, the state court stated that Horsfall had "converted" funds owed to First Weber.[41]

Horsfall then filed bankruptcy.[42] In the nondischargeability case under § 523(a)(6), First Weber argued that Horsfall was barred from relitigating the issues relevant to proof of the elements of the nondischargeability claim.[43] The Seventh Circuit determined that there were three elements of a claim under § 523(a)(6):
(1) injury caused by the debtor,
(2) willfully, and
(3) maliciously.[44]
The court held that the state court judgment was binding on elements 1 and 3; it was not binding on element 2.[45] The judgment included a finding of an intentional act, but not a finding of intent to injure.[46]

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[37] *Id.* at 485–86.

[38] Under Michigan law, default judgments are not necessarily given collateral estoppel effect. The issue is whether "there is sufficient participation by the parties to meet the *actually litigated* requirement." *Id. at* 486 (emphasis added)_ (citing cases).

[39] *First Weber Grp., Inc. v. Horsfall*, 738 F.3d 767, 771-72 (7th Cir. 2013).

[40] *Id.* at 772.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.* at 774.

[45] *Id.* at 775.

[46] *Id.*

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

ii. Gerard v. Gerard, 780 F.3d 806, 810 (7th Cir. 2015)

"[T]he failure of the statutory text of § 523(a)(6) to appear in the state court proceedings does not bar the application of issue preclusion. Thus, that the jury in the underlying state court proceedings did not find that [the debtor] had acted 'willfully and maliciously' does not bar issue preclusion. Rather, we must assess whether the jury's findings satisfy the 'willful and malicious' standard within the meaning of § 523(a)(6)."[47]

iii. In re Davis, 638 F.3d 549 (7th Cir. 2011)

Reeves contracted with Davis to make home renovations, including to build a covered porch.[48] Davis quit work on the job, and a state court entered judgment against Davis after finding that the contract did include the porch, that Davis stopped work without justification or excuse, and that much of the work was defective.[49]

The Seventh Circuit held that the bankruptcy court should have applied collateral estoppel to the issue whether the parties' contract included the porch.[50] But "[t]he fact that the porch was part of the contract and that Davis did not build it establishes only breach of contract, not fraud."[51] The state court made no determination as to Davis's intent, and the evidence supported the bankruptcy court's finding that Davis did not make an intentional misrepresentation.[52]

iv. Sveum v. Stoughton Lumber Co., No. 13-CV-00789-WMC, 2014 U.S. Dist. LEXIS 133252, (W.D. Wis. Sept. 23, 2014), aff'd, 787 F.3d 1174 (7th Cir. 2015)

Creditor sued the debtor for breach of contract and theft by contractor.[53] The parties settled, and the debtor defaulted on the settlement agreement.[54] The creditor obtained a default judgment for breach of the settlement agreement, and the debtor filed bankruptcy.[55] In the nondischargeability action, the creditor argued that

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[47] *Gerard v. Gerard*, 780 F.3d 806, 810 (7th Cir. 2015).

[48] *Reeves v. Davis (In re Davis)*, 638 F.3d 549, 552 (7th Cir. 2011).

[49] *Id.*

[50] *Id.* at 554.

[51] *Id.*

[52] *Id.*

[53] *Sveum v. Stoughton Lumber Co.*, No. 13-cv-789-wmc, 2014 U.S. Dist. LEXIS 133252, at *2 (W.D. Wis. Sep. 23, 2014).

[54] *Id.* at *3.

[55] *Id.*

judgment on the settlement agreement included sums that would not be nondischargeable under § 523(a)(4).[56] The bankruptcy court and the district court applied *Archer v. Warner* to conclude that the entire debt was nondischargeable.[57] "*Archer* simply mandates that the court examine the underlying character of a debt to determine if, on a fundamental level, it arose from fraud or defalcation."[58]

D. Eighth Circuit Case Law

i. In re Luebbert, 987 F.3d 771 (8th Cir. 2021)

The debtor signed a noncompete with his employer.[59] He breached the noncompete, and the parties entered into a settlement agreement.[60] He later breached the terms of the settlement agreement.[61] A judgment was entered against the debtor for breach of contract.[62] The employer filed a nondischargeability action under § 523(a)(6) after the debtor filed bankruptcy.[63] The Eighth Circuit held that there were three elements of the claim:
(1) injury caused by the debtor;
(2) willfully inflicted; and
(3) debtor's actions were malicious.[64]
The court applied collateral estoppel as to the first element.[65] An injury is a legal injury, and the right to damages for breach of contract is a legal injury.[66]

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[56] *Id.* at *4.

[57] *Id.* at *7.

[58] *Id.*

[59] *Luebbert v. Glob. Control Sys. (In re Luebbert)*, 987 F.3d 771, 776 (8th Cir. 2021).

[60] *Id.*

[61] *Id.* at 777.

[62] *Id.* at 778.

[63] *Id.*

[64] *Id.*

[65] *Id.* at 779–80.

[66] *Id.*

ii. In re Riehm, 615 B.R. 850 (Bankr. D. Minn. 2020)

The debtor stabbed the creditor during a bar fight.[67] The debtor was convicted of assault in state court, and the creditor also obtained a civil judgment for intentional battery.[68] In the nondischargeability action under § 523(a)(6), the bankruptcy court held that collateral estoppel did not apply on the elements of willful injury and malice.[69] The criminal case was tried to the bench based on stipulated facts, so the facts were not "actually litigated."[70] For the civil judgment, the special verdict form did not apply the same standard for intent as required under § 523(a)(6).[71]

III. Dischargeability of Theft by Contractor Debts Under 523(a)(4) – Fraud or defalcation while acting in a fiduciary capacity or embezzlement

11 U.S.C. § 523 - Exceptions to discharge

(a) A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

. . .

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

First requirement: existence of a debt in the first instance, *i.e.*, that the creditor has a claim against the Debtor under nonbankruptcy law. The debt does not have to be liquidated or reduced to judgment.[72]

Second requirement: the debt must be for fraud or defalcation while acting in a fiduciary capacity, or embezzlement or larceny.

A. Fiduciary capacity.

[67] *Kerkinni v. Riehm (In re Riehm)*, 615 B.R. 850, 854 (Bankr. D. Minn. 2020).

[68] *Id.* at 857.

[69] *Id.* at 859–61.

[70] *Id.* at 860.

[71] *Id.* at 860, 860 n.2.

[72] 11 U.S.C. §§ 101(12), (5). Because debt means "liability on a claim" and because a "claim" is a "right to payment, whether or not such right is reduced to judgment, liquidated [or] unliquidated." 11 U.S.C. §§ 101(12), (5).

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

To adequately plead a 523(a)(4) claim arising from fraud or defalcation, the debtor must have "acted as a fiduciary to the creditor at the time the debt was created" and the fiduciary relationship must predate and exist independently of the act from which the indebtedness arose.[73] "It is not enough that by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee ex maleficio. He must have been a trustee before the wrong and without reference thereto."[74] While certain state statutes purport to create trusts, and while federal courts certainly consider those statutes, the scope of the term "fiduciary capacity" is ultimately a question of federal law.[75]

Additionally, in order for a state statute to create the requisite fiduciary relationship, courts within the Seventh Circuit look to see if the statute possesses the traditional hallmarks of trust, such as "[s]egregation of funds, management by financial intermediaries, and recognition that the entity in control of the assets has at most 'bare' legal title to them."[76] The Sixth Circuit looks to see whether the statute demonstrates:

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[73] *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 766 (7th Cir. 2011). *In re Marchiando*, 13 F.3d 1111, 1115 (7th Cir. 1994) ("The key . . . is the distinction stressed in *Davis* [*v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934)] . . . between a trust or other fiduciary relation that has an existence independent of the debtor's wrong [qualifying fiduciary relation] and a trust or other fiduciary relation that has no existence before the wrong is committed [insufficient fiduciary relation]"); *Bd. of Trs. v. Bucci (In re Bucci)*, 493 F.3d 635, 642 (6th Cir. 2007) (quotation omitted) ("[R]equisite trust relationship must exist prior to the act creating the debt and without reference to it."); *Arvest Mortg. Co. v. Nail (In re Nail)*, 680 F.3d 1036, 1041 (8th Cir. 2012).

[74] *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934).

[75] "Not all persons treated as fiduciaries under state law are considered to "act in a fiduciary capacity" for purposes of federal bankruptcy law." *Follett Higher Educ. Grp., Inc. v. Berman (In re Berman)*, 629 F.3d 761, 767 (7th Cir. 2011). *See, e.g., In re Thompson*, 686 F.3d 940, 945 (8th Cir. 2012) ("It is not enough that a statute purports to create a trust: A state cannot magically transform . . . contractors, . . . into fiduciaries by the simple incantation of the terms 'trust' or 'fiduciary.' Rather, to meet the requirements of § 523(a)(4), a statutory trust must (1) include a definable res and (2) impose 'trust-like' duties."); *In re Marchiando*, 13 F.3d 1111, 1116 (7th Cir. 1994) (Posner, J.) (disapproving of the notion that "[i]f, . . . , a fiduciary is anyone whom a state calls a fiduciary . . . states will have it in their power to deny a fresh start to their debtors by declaring all contractual relations fiduciary"); *Johnson v. Woldman*, 158 B.R. 992, 996 (N.D. Ill. 1993) ("Illinois law does not clearly and expressly impose trust-like obligations on general partners, and the court will not assume that such duties exist.").

[76] *In re McGee*, 353 F.3d 537, 540-41 (7th Cir. 2003) (municipal code provision requiring landlords to deposit tenants' security deposits in an insured account, that the deposits remain the tenants property while on deposit, and that the deposits not be commingled with other assets created the requisite fiduciary relationship). *But see In re Marchiando*, 13 F.3d at 1115-16 (IL statute providing lottery ticket sale proceeds "shall constitute a trust fund until paid to the Department" and forbidding commingling of trust funds did not create requisite fiduciary relationship because "[r]ealistically, the trust did not begin until she failed to remit ticket receipts. For until then she had no duties of a fiduciary character toward the Department of Lottery or anything or anyone else.").

"(1) an intent to create a trust;
(2) a trustee;
(3) a trust res; and
(4) a definite beneficiary."[77]
The Eighth Circuit looks to see whether the statute "(1) include[s] a definable res and (2) impose[s] trust-like duties."[78]

So, which states impose fiduciary relationships on contractors sufficient to qualify under § 523(a)(4)?

In Wisconsin, Wis. Stat. § 779.02(5) imposes a fiduciary relationship via an express trust between the general contractor and owner and general contractor and subcontractor for purposes of Section 523(a)(4).[79]

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[77] *Patel v. Shamrock Floorcovering Servs., (In re Patel)*, 565 F.3d 963, 968–69 (6th Cir. 2009) (quotation omitted) (finding that the Michigan Builders Trust Fund Act created the necessary fiduciary relationship for 523(a)(4) purposes because the act created a fiduciary relationship "at the time any monies are paid to the contractor or subcontractor whether or not there are any beneficiaries of the trust at that time and continues until all the trust beneficiaries have been paid"). But see *In re Thompson*, 686 F.3d 940, 945–46 (8th Cir. 2012) (finding that Minnesota's nonpayment for improvement's statute did not create requisite fiduciary relationship between general and subcontractors because the statute did not require trust-like duties of contractor—*i.e.*, segregating accounts and keeping detailed records—and did not create a fiduciary relationship until the subcontractors had a contractual right to be paid).

[78] *In re Thompson*, 686 F.3d 940, 945 (8th Cir. 2012); *Arvest Mortg. Co. v. Nail (In re Nail)*, 680 F.3d 1036, 1040 (8th Cir. 2012).

[79] *Lenfant v. Hall (In re Hall)*, 581 B.R. 864, 868 (Bankr. W.D. Wis. 2018); *Stoughton Lumber Co. v. Sveum*, 787 F.3d 1174, 1177 (7th Cir. 2015); *Ganther Constr., Inc. v. Ward (In re Ward)*, 417 B.R. 582, 589 (Bankr. E.D. Wis. 2009) (Wis. Stat. § 779.02(5) "creates an express fiduciary relationship" for purposes of § 523(a)(4) (quoting *Chase Lumber & Fuel Co. v. Koch (In re Koch)*, 197 B.R. 654, 658 (Bankr. W.D. Wis. 1996)).

This author submits neither the Seventh Circuit, nor lower Wisconsin federal courts, have engaged in the depth of analysis characteristic of *Marchiando*, *McGee, Berman, Patel and Thompson* to explain why Wisconsin's theft-by-contractor law creates a requisite fiduciary duty under federal law. Many decisions so holding cite decisions that simply take the statute at face value. For example, in *Moodie v. Olson (In re Olson)*, the Court simply said: "precedent holds that the fiduciary obligation imposed by Wis. Stat. §779.02(5) affords a sufficient basis for finding that the debtor acted as a fiduciary for purposes of §523(a)(4)." 2026 Bankr. LEXIS 93, at *13 (Bankr. E.D. Wis. Jan. 15, 2026) (citing *Stoughton Lumber Co., Inc. v. Sveum*, 787 F.3d 1174, 1177 (7th Cir. 2015)).

Stoughton Lumber was penned by Circuit Judge Posner two decades after he wrote *Marchiando*, 13 F.3d 1111 (7th Cir. 1994). And yet instead of considering, as *Marchiando* did—such factors as (1) whether the trust created by Wis. Stat. 779.02(5) "is that of a trust that has a purely nominal existence until the wrong is committed" by the debtor (13 F.3d at 1116) (2) whether there is "a difference in knowledge or power between fiduciary and principal" (*id.* at 1116) or (3)—it seems *Stoughton Lumber* simply took the Wisconsin Legislature's word that general contractors are fiduciaries under federal law, a result *Marchiando* warned against. Compare *Stoughton Lumber*, 787 F. 3d at 1176–77 ("A portion of the money received for those sales became by operation of the Wisconsin

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In Michigan, the Michigan Builder's Trust Fund Act, (M.C.L.A. § 570.151 et seq.) establishes the fiduciary relationship.[80] The statute provides:

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statute . . . a trust fund . . . Segregation of the trust funds was not required either by the statute or, as far as we're aware, the case law; but while [general contractor] was therefore free to commingle the funds with other moneys, it had to preserve intact the assets of the trust fund for [subcontractor]. . . . [T]he Wisconsin legislature provides subcontractors with the substitute protection of a trust.") with *Marchiando*, 13 F.3d at 1116 ("If, . . . , a fiduciary is anyone whom a state calls a fiduciary . . . states will have it in their power to deny a fresh start to their debtors by declaring all contractual relations fiduciary.").

It's also unclear whether *Stoughton Lumber's* indication that Wis. Stat. § 779.02(5) creates a fiduciary relationship is dicta or whether the parties conceded this issue. *Marchiando* itself recognized earlier dicta from the Seventh Circuit's decision in *In re Thomas*, which indicated Section 779(16)—the "public projects" analog to 779.02(5)—established a fiduciary relation. *Marchiando*, 13 F.3d at 1115 ("Our own *In re Thomas*, 729 F.2d 502, 504-05 (7th Cir. 1984), contains the briefest of dicta supporting the affirmative position; it is our only brush with the issue."); *In re Thomas*, 729 F.2d 502, 504-05 (7th Cir. 1984) ("[D]efendants no longer contest the applicability of the "defalcation while acting in a fiduciary capacity" exception in 11 U.S.C. § 523(a)(4) to discharge when tied to a state statute such as Wis. Stat. § 779.16."). *Stair One, Inc. v. Hivon (In re Hivon)*, Nos. 14 B 26441, 14 A 710, 2015 Bankr. LEXIS 485, at *14 n.5 (Bankr. N.D. Ill. Feb. 13, 2015) "To the extent *Thomas* suggests that a statute declaring the debtor a trustee automatically makes him a fiduciary under section 524(a)(4), that suggestion is dictum").

Another group of decisions seemingly take the Wisconsin Legislature's word on the subject. One such decision simply provides Wis. Stat. § 779.02(5) "creates an 'express trust' within the scope of 11 U.S.C. § 523(a)(4)" citing only to the statute itself. *Lenfant v. Hall (In re Hall)*, 581 B.R. 864, 868 (Bankr. W.D. Wis. 2018). *See also Baytherm Insulation, Inc. v. Carlson (In re Carlson)*, 456 B.R. 391, 395 (Bankr. E.D. Wis. 2011) ("The bankruptcy court must look to state law to determine whether the requisite trust relationship exists. . . . Wisconsin's theft by contractor statute establishes the type of express statutory trust contemplated by section 523(a)(4) of the Bankruptcy Code.") (citing *Thomas*); *Hellenbrand Glass, LLC v. Pulvermacher (In re Pulvermacher)*, 567 B.R. 881, 888 (Bankr. W.D. Wis. 2017) ("Section 779.02(5) contemplates that when an owner pays money to a prime or subcontractor for improvements, that money creates a trust in the hands of that prime or subcontractor.") *In re Polus*, 455 B.R. 705, 708 (Bankr. W.D. Wis. 2011) ("It is generally recognized that the language in the statute creates an "express trust" within the scope of § 523(a)(4).").

The bankruptcy court in *Ward*—held Wis. Stat. § 779.02(5) "creates an express fiduciary relationship" for purposes of § 523(a)(4), and cited *Chase Lumber & Fuel Co.* for support.–417 B.R. at 589 (quoting 197 B.R. at 658). *Chase Lumber* found Wis .Stat. § 779.02(5) and § 779.16 "create[] an express fiduciary relationship and delineate[] clear duties," but does not outline those duties. 197 B.R. at 658. Is the contractor required to segregate funds? No, "[s]egregation of the trust funds was not required either by the statute or, as far as we're aware, the case law." *Stoughton Lumber*, 787 F.3d at 1176. Is the contractor required to deposit the funds in an insured account at a financial institution and are the funds the payor's property while on deposit not to be commingled? *In re McGee*, 353 F.3d at 540 (analyzing such questions). The author submits an analysis of these questions is required to determine whether the Wisconsin Legislature's judgment truly creates a fiduciary relation under federal law.

[80] *Micco Constr. Co. v. Brunett (In re Brunett)*, 394 B.R. 425, 428 (Bankr. E.D. Mich. 2008) ("[T]he Michigan Builders' Trust Fund Act makes the contractor a fiduciary with respect to the funds paid to him by the owner so as to render the debt arising from the contractor's misapplication of those funds a defalcation under section 523(a)(4)."); *In re Johnson*, 691 F.2d 249, 253 (6th Cir. 1982) (finding

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> In the building construction industry, the building contract fund paid by any person to a contractor, or by such person or contractor to a subcontractor, shall be considered by this act to be a trust fund, for the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen, and the contractor or subcontractor shall be considered the trustee of all funds so paid to him for building construction purposes.[81]

Minnesota law does not create the requisite fiduciary relationship between general contractor and subcontractor. In *In re Thompson*, the Eighth Circuit found that a Minnesota Statute did not create the requisite fiduciary relationship.[82] The statute provided:

> [P]ayments received by a person contributing to an improvement to real estate *shall be held in trust* by that person for the benefit of those persons who *furnished* the labor, skill, material, or machinery contributing to the improvement
>
> . . .
>
> *Nothing . . . shall require money to be placed in a separate account and not commingled with other money of the person receiving payment or create a fiduciary liability*.[83]

The Eighth Circuit noted that in order to meet the requirements of Section 523(a)(4) and create a fiduciary relationship, the statutory trust must (1) include a definable res and (2) impose "trust-like' duties such as "plac[ing] funds received . . . into separate accounts" or "detailed record keeping."[84] Because the statute did not require trust-like duties of the general contractor and because the statute provided for the "benefit of those persons who *furnished* the labor" (past tense), the trust was not created until the subcontractor had the contractual right to be paid, violating the

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that "[t]he fiduciary relationship established by the [Michigan statute] arises at the time any monies are paid to the contractor or subcontractor whether or not there are any beneficiaries of the trust at that time and continues until all of the trust beneficiaries have been paid"); *Patel v. Shamrock Floorcovering Servs., (In re Patel)*, 565 F.3d 963, 968–69 (6th Cir. 2009) (same).

[81] Mich. Comp. Laws Ann. § 570.151.

[82] 686 F.3d 940 (8th Cir. 2012).

[83] *Id.* at 945–46 (quoting Minn. Stat. § 514.02) (emphases in original).

[84] *Id.* at 945–46 (citing *Arvest Mortg. Co. v. Nail (In re Nail)*, 680 F.3d 1036, 1040 (8th Cir. 2012)); *Matter of Tran*, 151 F.3d 339, 342-43 (5th Cir. 1998).

requirement that the debtor "must have been a trustee before the wrong and without reference thereto."[85]

Not the case in Ohio, which does not have a single, dedicated statute explicitly titled "Theft by Contractor," but instead utilizes the general criminal theft statute (Ohio Revised Code 2913.02) to prosecute contractors who knowingly take funds without performing agreed-upon services.

Not the case in Kentucky as between owners and general contractors.[86]

Not the case in Tennessee as between owners and general contractors.[87]

Not the case in Illinois as between general and subcontractors.[88]

Not the case in Iowa. as between general and subcontractors or owners and general contractors.[89]

Not the case in Indiana as between owners and general contractors.[90]

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[85] *Id.* at 946 (quoting *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934)).

[86] *Riden v. Sigler (In re Sigler)*, 196 B.R. 762, 765 (Bankr. W.D. Ky. 1996) ("K.R.S. 376.070 does not contain language which creates such a trust fund.").

[87] *In re Wilson*, 30 B.R. 91, 94 n.5 (Bankr. E.D. Tenn. 1983) (citations omitted) ("The payment of construction proceeds to a contractor by an owner does not create a trust within the technical meaning of the term 'trust' necessary to establish a fiducial relationship for the purpose of 11 U.S.C.A. § 523(a)(4) (1979).").

[88] *Stair One, Inc. v. Hivon (In re Hivon)*, Nos. 14 B 26441, 14 A 710, 2015 Bankr. LEXIS 485, at *11 (Bankr. N.D. Ill. Feb. 13, 2015) (Illinois Mechanics Lien Act does not create contractor-subcontractor fiduciary relationship because, although the statute "requires a contractor to 'hold in trust' a payment the contractor receives . . . critical hallmarks of an express trust are absent"); *Imperial Roofing, Inc. v. Schumacker (In re Schumacker)*, Nos. 18bk33669, 19ap00125, 2021 Bankr. LEXIS 2030, at *10 (Bankr. N.D. Ill. July 15, 2021).

[89] *Indus. Refrigeration Servs. v. Ramos (In re Ramos)*, Nos. 11-02642, 12-09019, 2012 Bankr. LEXIS 3351, at *16 (Bankr. N.D. Iowa July 20, 2012) (Iowa theft of services statute does not create the fiduciary relationship); *See also Zio Johnos, Inc. v. Ziadeh (In re Ziadeh)*, 284 B.R. 893, 900 (Bankr. N.D. Iowa 2002) (Plaintiff could point to no express agreement or Iowa statute establishing fiduciary relationship between debtor roofing contractor and owner).

[90] *Prough v. Prough (In re Case No. 23-11665)*, No. 24-1018, 2024 Bankr. LEXIS 2931, at *7 (Bankr. N.D. Ind. Nov. 13, 2024) (Plaintiff "fail[ed] to cite any legal authority for the proposition that a contractor is a fiduciary for a homeowner or that a contractor has some kind of fiduciary duty to a homeowner.").

B. Defalcation.

"'[D]efalcation,' a word that only lawyers and judges could love."[91] Defalcation is the "misappropriation of funds entrusted to one—a form of embezzlement. It differs from fraud in not requiring a false statement."[92] It also includes the "failure to properly account" for trust funds.[93]

The central dispute is often the level of culpability required to establish "defalcation." So the question for any litigator then is: how do I prove "defalcation?"

Before the United States Supreme Court decision in *Bullock v. BankChampaign, N.A.*,[94] some bankruptcy courts applied a *per se* approach when determining if theft by contractor debts were dischargeable.[95] That is, if the debtor's conduct met the state statute's requirements, then the debt was nondischargeable.

Bullock held that defalcation requires a "culpable state of mind," defined as one "involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior."[96] The Court held that where actual knowledge of wrongdoing is lacking, conduct is equivalent to an intentional wrong if the fiduciary "consciously disregards (or is willfully blind to) a substantial and unjustifiable risk" that the conduct will violate a fiduciary duty—a standard drawn from Model Penal Code § 2.02(2)(c). The risk "must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation."

After *Bullock*, courts must make a determination regarding the debtor's state of mind while acting in a fiduciary capacity.[97]

iii. 7th Circuit

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[91] *Estate of Cora v. Jahrling (In re Jahrling)*, 816 F.3d 921, 925 (7th Cir. 2016).

[92] *Stoughton Lumber Co. v. Sveum,* 787 F.3d 1174, 1176 (7th Cir.2015) (citing *Bullock,* 133 S.Ct. at 1754).

[93] *Tudor Oaks Limited Partnership v. Cochrane (In re Cochrane)*, 124 F.3d 978, 984 (8th Cir. 1997).

[94] 569 U.S. 267 (2013).

[95] *K&D Masonry LLC v. Vieaux (In re Vieaux)*, Nos. 12-36663, 13-2196, 2013 Bankr. LEXIS 4635, at *6 (Bankr. E.D. Wis. Nov. 5, 2013).

[96] *Bullock v. BankChampaign, N.A.*, 569 U.S. 267 (2013).

[97] *In re Vieaux*, 2013 Bankr. LEXIS 4635, at *7.

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Courts within the 7th Circuit have developed a substantial body of law addressing what constitutes "defalcation while acting in a fiduciary capacity" under 11 U.S.C. § 523(a)(4) in the context of theft by contractor claims. Defalcation requires more than mere negligence; after *Bullock*, courts require a showing of:

1. actual knowledge of wrongdoing; or
2. conscious disregard of (or willful blindness to) a substantial and unjustifiable risk; and
3. a fiduciary duty violation.[98]

The Seventh Circuit Court of Appeals recently explained that " 'Defalcation' refers to the misappropriation of funds entrusted to one—a form of embezzlement. It differs from fraud in not requiring a false statement."[99]

In *In re St. Antoine*, the bankruptcy court for the Eastern District of Wisconsin addressed debtors who were principals of a failed remodeling business and sought to discharge debts owed to suppliers under Wisconsin's theft-by-contractor statute.[100] The court held that the debtors did not have actual knowledge of their duties as trustees and were not willfully blind to facts that would have caused them to learn of those duties and therefore did not meet the *Bullock* standard for defalcation—resulting in the debt being dischargeable.[101] Here, the court relied on the fact that the debtors—having only high school educations and no formal business education—never knew of the trust fund requirements of the statute.[102]

By contrast, in *Sveum v. Stoughton Lumber Co.*, the Western District of Wisconsin affirmed a bankruptcy court's finding of defalcation where an officer/shareholder of a corporate contractor failed to take any action to ensure the company complied with its trust obligations under Wis. Stat. § 779.02(5), despite being aware of those obligations and aware that the company's practice was to pool construction draws in a general operating account rather than segregate them.[103] The court held that—even if not actually aware of his brother's wrongdoing, the officer/shareholder had consciously disregarded the substantial and unjustified risk

[98] *Bullock*, 569 U.S. at 1759–60.

[99] *Stoughton Lumber Co. v. Sveum,* 787 F.3d 1174, 1176 (7th Cir.2015) (citing *Bullock,* 133 S.Ct. at 1754).

[100] 533 B.R. 743 (Bankr. E.D. Wis. 2015).

[101] *Id.* at 749–50.

[102] *Id.* at 749.

[103] 534 B.R. 771, 776 (W.D. Wis. 2015).

that his conduct was violating his fiduciary duty, thereby meeting the standard of willful blindness articulated in *Bullock*.[104] Notably, upon appeal of this decision, the 7th Circuit noted that segregation of the trust funds was not required—and so comingling on its face was not the issue—rather the lack of preservation of the funds in trust was the violation.[105]

In *In re Hall*, the bankruptcy court for the Western District of Wisconsin articulated a practical framework for evaluating culpability in theft-by-contractor defalcation cases: courts look at the debtor's knowledge of the statute, the circumstances surrounding the violation, and the degree to which the debtor acted in his own self-interest as relevant evidence from which inferences of culpability can be drawn.[106] There, a contractor who commingled funds from two remodeling projects and failed to provide any adequate accounting was found to have committed defalcation, given that he acknowledged the money was a trust fund and repeatedly failed to render a proper accounting despite requests.[107]

iv. 6th Circuit

In *In re Piercy*, the Sixth Circuit cited *Bullock* and explained that "embezzlement or larceny under the second prong of § 523(a)(4) requires demonstrating a debtor's fraudulent intent, whereas defalcation under the first prong requires only a showing of gross recklessness." *In re Piercy*, 21 F.4th 909, 919 (6th Cir. 2021). Thus, this court's reference to *Bullock* was used to distinguish that a creditor pursuing a defalcation claim need only prove that the debtor acted with gross recklessness, rather than the higher bar of fraudulent intent required for embezzlement.

The foundational Sixth Circuit case on contractor defalcation pre-*Bullock* is *In re Johnson*.[108] There, a pole barn contractor received funds from property owners but used them for personal and general business expenses rather than first paying his materialman.[109]

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[104] *Id.* at 775.

[105] *Stoughton Lumber Co. v. Sveum*, 787 F.3d 1174, 1176 (7th Cir. 2015).

[106] 581 B.R. 864, 868 (Bankr. W.D. Wis. 2018).

[107] *Id.*

[108] 691 F.2d 249 (6th Cir. 1982).

[109] *Id.* at 250.

On the definition of defalcation, the court established an objective standard: "the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first is sufficient to constitute a defalcation under section [523(a)(4)] so long as the use was not the result of mere negligence or a mistake of fact; subjective intent to violate a known fiduciary duty or bad faith is irrelevant."[110] The court further held that a contractor is charged with knowledge of the law and his status as a trustee under the state rules, regardless of whether he actually knew of the statute.[111]

The most significant post-*Johnson* appellate contractor case is *In re Patel*.[112]. In *Patel*, a corporate officer and 50% shareholder of a general contractor used construction funds to pay his own operating expenses—payroll, utilities, taxes, and wages to himself—before paying subcontractors and maintained a "woefully inadequate" accounting of project funds.[113] On the defalcation standard, the court clarified there is "no such thing as 'defalcation per se'"—innocent or merely negligent defalcation is not cognizable—and held that the debtor must have been objectively reckless in failing to properly account for or allocate trust funds.[114] Paying one's own expenses before subcontractors, combined with an inadequate accounting, satisfied this objective recklessness standard.[115]

In *In re Poynter*, the Sixth Circuit held that a general contractor's commingling of bond contract funds with funds from other construction projects constituted defalcation under § 523(a)(4).[116] The court, applying the agreement of indemnity's express trust provision, found that the failure to "segregate the funds from bonded construction contracts from funds received through other construction projects" was a "misappropriation of trust funds."[117] This case confirms that physical commingling of funds—even absent outright theft—may constitute defalcation when the plaintiff establishes the existence of a trust that requires segregation of those funds.[118]

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[110] *Id.* at 257.

[111] *Id. But see In re St. Antoine*, 533 B.R. 743 (Bankr. E.D. Wis. 2015).

[112] 565 F.3d 963 (6th Cir. 2009).

[113] *Id.* at 971.

[114] *Id.* at 970.

[115] *Id.* at 971.

[116] 535 F. App'x 479, 483–84 (6th Cir. 2013).

[117] *Id.* at 484.

[118] *Id.* at 483–84.

v. Eighth Circuit

The governing Eighth Circuit definition of defalcation was established in *Tudor Oaks Limited Partnership v. Cochrane (In re Cochrane).*[119] There, the court defined defalcation as "the misappropriation of trust funds or money held in any fiduciary capacity; [the] failure to properly account for such funds."[120] Pre-*Bullock*, the Eighth Circuit's standard was notably broad.

There are few post-*Bullock* Eighth Circuit cases that specifically involve theft by contractor issues. The most significant post-*Bullock* case is *In re Harris*, decided by both the Eighth Circuit BAP in 2017 and affirmed by the Eighth Circuit Court of Appeals in 2018.[121] While not a traditional contractor case, *Harris* involved trust fund misappropriation and directly applied *Bullock*'s intentional wrong standard. The BAP held that defalcation requires either intentional misappropriation of trust funds or misappropriation undertaken with conscious disregard of a substantial and unjustifiable risk of breaching fiduciary duty.[122] In *Harris*, the debtor, as CEO, knowingly diverted employee health plan contributions to pay corporate expenses after being aware the plan would be cancelled without payment, which satisfied *Bullock*'s recklessness standard.

In *In re Lewis*, the Bankruptcy Court for the Western District of Arkansas applied the *Bullock* standard to a corporate officer who misappropriated funds from an insurance company through a fraudulent breach of fiduciary duty.[123] The court cited *Harris* for the definition of defalcation—"the misappropriation of trust funds or money held in any fiduciary capacity; [and the] failure to properly account for such funds"—and quoted *Bullock*'s requirement of an intentional wrong, including the provision that reckless disregard of a substantial and unjustifiable risk qualifies as the equivalent of knowing misconduct.[124] The court found the debtors' conduct satisfied both the fraud and the lesser defalcation standards under § 523(a)(4).[125] The court also noted, consistent with *Bullock*, that "'defalcation,' unlike 'fraud,' may be

[119] 124 F.3d 978 (8th Cir. 1997).

[120] *Id.* at 984.

[121] 898 F.3d 834 (8th Cir. 2018).

[122] *Id.* at 845.

[123] 637 B.R. 832 (Bankr. W.D. Ark. 2022).

[124] *Id.* at 860.

[125] *Id.*

used to refer to *nonfraudulent* breaches of fiduciary duty," confirming that theft by contractor claims need not reach full fraud to result in nondischargeability.[126]

C. Embezzlement or Larceny

Embezzlement or larceny need not be committed while acting in a fiduciary capacity.[127]

"Embezzlement, for purposes of section 523(a)(4), is the fraudulent appropriation of property of another by a person to whom such property has been entrusted or into whose hands it has lawfully come."[128] The "required elements of embezzlement are: (1) appropriation of funds for the debtor's own benefit by fraudulent intent or deceit; (2) the deposit of the resulting funds in an account accessible only to the debtor; and (3) the disbursal or use of those funds without explanation of reason or purpose."[129]

"Larceny is proven for § 523(a)(4) purposes if the debtor has wrongfully and with fraudulent intent taken property from its owner."[130] "The only difference between embezzlement and larceny under this subsection is that embezzled property comes into the debtor's hands lawfully, while larceny requires that the debtor obtain the property unlawfully."[131] Larceny is likely not applicable in theft-by-contractor conduct because larceny involves a wrongful taking in the first instance. It is difficult to imagine a situation where this would happen in construction projects because contractors are hired and given funds lawfully.

Can embezzlement form a basis to recover for theft-by-contractor conduct that in states that do not recognize the requisite fiduciary relationship?

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[126] *Id.* (emphasis in original).

[127] *Werner v. Hofmann*, 144 B.R. 459, 464 (Bankr. D.N.D. 1992).

[128] *In re Thompson*, 686 F.3d 940, 947 (8th Cir. 2012) (quotation omitted). See also *Brady v. McAllister (In re Brady)*, 101 F.3d 1165, 1173 (6th Cir. 1996) (same); *In re Weber*, 892 F.2d 534, 538 (7th Cir. 1989) (same).

[129] 4 Collier on Bankruptcy P 523.10 (16th 2026) (citing *First State Ins. Co. v. Bryant*, 147 B.R. 507, 512 (Bankr. W.D. Mo. 1992)).

[130] *In re Rose*, 934 F.2d 901, 903 (7th Cir. 1991) (citation omitted).

[131] *Long v. Piercy (In re Piercy)*, 21 F.4th 909, 919 (6th Cir. 2021) (quotation omitted). *Reshetar Sys. v. Thompson (In re Thompson)*, 458 B.R. 504, 510 (B.A.P. 8th Cir. 2011) (citation omitted).

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Not by subcontractors in Minnesota.[132]

Not by subcontractors in Illinois.[133]

Not by subcontractors in Tennessee.[134]

Owners/lenders in Indiana,[135] Iowa,[136] Ohio,[137] and Tennessee[138] may do so.

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[132] *In re Thompson*, 686 F.3d 940, 947 (8th Cir. 2012) (because nothing in the Minnesota statute, contract, or subcontract gave the subcontractor property rights over monies paid by the owner to the general contractor, embezzlement fails because "one cannot embezzle one's own property") (quoting *In re Belfry*, 862 F.2d 661, 662 (8th Cir. 1988)).

[133] *Imperial Roofing, Inc. v. Schumacker (In re Schumacker)*, Nos. 18bk33669, 19ap00125, 2021 Bankr. LEXIS 2030, at *14 (Bankr. N.D. Ill. July 15, 2021) (rejecting embezzlement argument that owner's payments to general contractor were meant to compensate subcontractor because "it was up to [the general contractor] to distribute funds according to his own agreements with subcontractors . . . the homeowners owed [the general contractor], and [the general contractor] owed [the subcontractor]. Because funds paid to [the general contractor]contractually belonged to [him], he could not have committed embezzlement.").

[134] *Sherrick v. HST Corp. Interiors, LLC (In re Sherrick)*, No. 3:17-cv-01086, 2018 U.S. Dist. LEXIS 75195, *11, at *11 (M.D. Tenn. May 3, 2018) (reversing bankruptcy court's finding of embezzlement because general contractor owned the funds placed into its account and subcontractor did not have ownership rights to the funds over and above rights to them under an agreement—subcontractor did not entrust its funds to the general contractor, it was merely owed money).

[135] *Hineman v. Yant (In re Yant)*, Nos. 08-15515-AJM-13, 09-50222, 2011 Bankr. LEXIS 2084, at *13 (Bankr. S.D. Ind. May 26, 2011) (use of loan proceeds by contractor to construct a bank when contractor knew loan proceeds were to be used exclusively for constructing pole barns constituted nondischargeable embezzlement).

[136] *Little Family Farms Corp. v. Mortensen (In re Mortensen)*, 415 B.R. 383, 386, 390–91 (Bankr. S.D. Iowa 2009) (finding embezzlement where debtor knew that funds were to be used only for construction of the houses and where "oral agreement between the parties was that the money was a construction loan to be used only for building houses," contract did not permit contractor to take draws for salary).

[137] *Stoner v. Keirns (In re Keirns)*, 628 B.R. 911, 919-20 (Bankr. S.D. Ohio 2021) (denying motion to dismiss where plaintiffs alleged they paid debtor for construction at multiple office buildings, that debtor did not use the money for that purpose, and that debtor continued to mislead by providing false photos of materials purchased).

[138] *Poole v. Batson (In re Batson)*, 568 B.R. 281, 290 (Bankr. M.D. Tenn. 2017) (finding, in dicta, that where an owner entrusted a retainer to the general contractor to construct a home, relied on the assurances of the contractor that the retainer would be so used, where funds were used for other purposes, and where contractor knew of its cash problems when they took the money, the debt was also dischargeable under 523(a)(4) for embezzlement, in addition to 523(a)(2)(A)).

CONSTRUCTION- THEFT BY CONTRACTOR ISSUES

D. Heightened Pleading Requirements?

Defalcation (as opposed to fraud, larceny, and embezzlement) is not subject to the heightened pleading requirements of Fed. R. Civ. P. 9(b); Fed. R. Bankr. P. 7009?[139] Fraud is different from defalcation because fraud "typically requires a false statement or omission," whereas defalcation "can encompass a breach of fiduciary obligation that involves neither conversion, nor taking and carrying away another's property, nor falsity."[140]

Fraud in a fiduciary capacity and embezzlement/larceny are subject to the heightened pleading requirements of Fed R. Civ. P. 9(b), because fraud is a necessary part of each category of conduct.

E. Evidentiary Burdens

vi. Nonbankruptcy law burdens

The burden of proof to prove a debt exists against the debtor (before proving whether such debt is nondischargeable) rests with the party under nonbankruptcy law.[141] But federal law provides the standard of proof on whether those debts are nondischargeable.[142]

Wisconsin

Under Wisconsin's theft-by-contractor law, Plaintiff bears the burden of proving the following elements by a preponderance of the evidence:

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[139] Pleadings alleging fraud must "state with particularity the circumstances constituting fraud", though "[m]alice, intent, knowledge, and other conditions of a person's mind may be alleged generally." Fed. R. Civ. P. 9(b); Fed. R. Bankr. P. 7009.

[140] *Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 268, 133 S. Ct. 1754, 1756 (2013). See also *Moodie v. Olson (In re Olson)*, Nos. 25-21293-gmh, 25-02090-gmh, 2026 Bankr. LEXIS 93, at *10-11 (Bankr. E.D. Wis. Jan. 15, 2026) (owner's "claim for relief under §523(a)(4) is based on allegations that [contractor] took her funds to construct a house for her—used [owner's] funds in violation of the trust imposed by Wis. Stat. §779.02(5) knowing that [contractor] was prohibited from doing so or willfully blind to the statutory prohibition on that use, ***not*** that he made false statements while acting as a fiduciary") (emphasis in original). *See also Rude v. Hood (In re Hood)*, Nos. 11-11922-FJO-7, 12-50002, 2013 Bankr. LEXIS 4478, at *30 (Bankr. S.D. Ind. Oct. 25, 2013) (citing *In Re Moran*, 152 B.R. 493, 495 (Bank.S.D.Ohio 1993))("[A]llegations of defalcation under Section 523(a)(4) do not need to meet the particularity requirements of Rule 9(b)."). But see *Young v. Wells-Lucas (In re Wells-Lucas)*, Nos. 20-68333-JWC, 20-06196-JWC, 2021 Bankr. LEXIS 836, at *4 (Bankr. N.D. Ga. Mar. 31, 2021) "claims of fraud or defalcation while acting as a fiduciary under § 523(a)(4) are governed by the heightened pleading standards of Rule 9").

[141] *Raleigh v. Ill. Dept. of Revenue*, 530 U.S. 15, 21-26, 120 S. Ct. 1951, 147 L. Ed. 2d 13 (2000) (burdens of proof follow the non-bankruptcy law giving rise to claims against the debtor).

[142] *Grogan v. Garner*, 498 U.S. 279, 288–89 (1991) (preponderance of the evidence).

(1) debtor entered into an agreement for improvement of land;
(2) debtor received money from owner (or owner's agent) for improvement of land;
(3) debtor intentionally used part or all of the money for purposes other than the payment of bona fide claims due or to become due for labor or materials used in the improvements;
(4) the use of the money was without the consent of the owner of the land and contrary to the debtor's authority; and
(5) the owner suffered a monetary loss as a result of the debtor's use of the money.[143]

If seeking treble damages, the Plaintiff must also prove the criminal level of intent by a preponderance of the evidence: that "defendant knowingly retained, concealed, or used contractor trust funds without the owner's consent, contrary to his authority, and with intent to convert such funds to his own use or the use of another."[144]

Michigan

"[P]laintiff must show:
(1) that the defendant is a contractor or subcontractor engaged in the building construction industry,
(2) that the defendant was paid for labor or materials provided on a construction project,
(3) that the defendant retained or used those funds, or any part of those funds,
(4) that the funds were retained for any purpose other than to first pay laborers, subcontractors, and materialmen, and
(5) that the laborers, subcontractors and materialmen were engaged by the defendant to perform labor or furnish material for the specific construction project."[145]

Michigan law is unclear whether these elements must be met via a preponderance of the evidence standard.

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[143] *Ruck v. McGill (In re McGill)*, 653 B.R. 904, 907 (Bankr. E.D. Wis. 2023) (citing *Soria v. Classic Custom Homes of Waunakee, Inc.*, 2019 WI App 48, ¶39, 388 Wis. 2d 474, 934 N.W.2d 570 (2019) (unpublished decision) (which, in turn, cites to WIS JI-CIVIL 2722)).

[144] *Id.* at 915 (quoting *Tri-Tech Corp. of Am. v. Americomp Servs.*, 2002 WI 88, 254 Wis. 2d 418, 431-32, 646 N.W.2d 822, 829).

[145] *Livonia Bldg. Materials Co. v. Harrison Constr. Co.*, 742 N.W.2d 140, 144 (2007).

vii. Federal Burden

Then, Plaintiff has the burden of proof by a preponderance of the evidence to prove that the claim or debt is nondischargeable under Section 523(a)(4).[146] Exceptions to discharge must "be constructed strictly against a creditor and liberally in favor of the debtor."[147]

However, even though nearly all courts recite the noncontroversial rule that a plaintiff-creditor bears the burden to prove nondischargeability of debts, there is law requiring debtor-contractors to show that defalcation has *not* occurred.[148]

Collier disapproves of this burden shifting framework: "The Supreme Court has held that the 'clear and convincing evidence' standard prevailing in many states does not apply under section 523(a)(2)(A). *Grogan v. Garner*, 498 U.S. 279 . . . (1991). . . . Thus, it cannot be assumed that section 523(a)(4) of the Code incorporates the burden-shifting doctrine existing under state law in defalcation actions against fiduciaries. Also, [such decisions are] inconsistent with the principle that the Code should be strictly construed against the objecting creditor and in favor of the debtor." 4 Collier on Bankruptcy P 523.10 (16th 2026).

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[146] *Sonnentag v. Swinehart (In re Swinehart)*, Nos. 18-25585-kmp, 18-2198, 2019 Bankr. LEXIS 3266, at *4 (Bankr. E.D. Wis. Oct. 15, 2019) (citing *Estate of Cora v. Jahrling (In re Jahrling)*, 816 F.3d 921, 925 (7th Cir. 2016)); *R.E. Am., Inc. v. Garver (In re Garver)*, 116 F.3d 176, 178 (6th Cir. 1997); *In re Juve*, 761 F.3d 847, 851 (8th Cir. 2014).

[147] *In re Scarlata*, 979 F.2d 521, 524 (7th Cir. 1992) (quoting *In re Zarzynski*, 771 F.2d 304, 306 (7th Cir. 1985)); *Pazdzierz v. First Am. Title Ins. Co. (In re Pazdzierz)*, 718 F.3d 582, 586 (6th Cir. 2013); *In re Van Horne*, 823 F.2d 1285, 1287 (8th Cir. 1987).

[148] *Lenfant v. Hall (In re Hall)*, 581 B.R. 864, 869-70 (Bankr. W.D. Wis. 2018) ("Where . . . detail necessary to establish the disbursement of the trust funds was solely and exclusively under the control of Defendant, Plaintiffs can be expected to do no more than establish the amount of the trust res and that they received no accounting to establish a prima facie case [of defalcation]. The burden . . . then shifts to Defendant to present some explanation and accounting in order to rebut that prima facie case."; defalcation found in part because contractor possessed knowledge of improper nature of his relevant fiduciary behavior because he failed to provide accounting of project funds before or at trial, despite testifying that an account existed); *Cappella v. Little (In re Little)*, 163 B.R. 497, 500, 503 (Bankr. E.D. Mich. 1994) (because Michigan law requires trustees to account for funds, and because "it would likely be easier for the Debtor to prove that the funds were properly spent than for the Plaintiff to prove that they were not" the "Debtor had to prove that defalcation did not occur"); *H.A. Smith Lumber & Hardware Co. v. Decina*, 258 Mich. App. 419, 426, 670 N.W.2d 729, 734 (2003) (quotation omitted). ("A reasonable inference of appropriation arises from the payment of construction funds to a contractor and the subsequent failure of the contractor to pay laborers, subcontractors, materialmen, or others entitled to payment." See also *Otto v. Niles (In re Niles)*, 106 F.3d 1456, 1458 (9th Cir. 1997) (Adhering to common law and California state law and holding that the fiduciary bore the burden of proof in showing that defalcation had not occurred: "Basic principles of the law of fiduciaries therefore place the burden to render an accounting on the fiduciary once the principal has shown that funds have been entrusted to the fiduciary and not paid over or otherwise accounted for.").

Faculty

Hon. Rachel M. Blise is a U.S. Bankruptcy Judge for the Eastern District of Wisconsin in Milwaukee, appointed to the bench in 2021. She also presides over cases in the Western District of Wisconsin. Before her appointment, Judge Blise was senior counsel at Foley & Lardner LLP, where she represented financial institutions, commercial mortgage lenders and loan servicers, and other creditors in collection, foreclosure, receivership proceedings, bankruptcy cases and lender-liability cases. She also represented a wide variety of clients in other complex commercial litigation. Judge Blise received her Bachelor's degree from Carthage College and her J.D. *summa cum laude* from Marquette University Law School. After law school, she clerked for the Hon. Carolyn Dineen King of the U.S. Court of Appeals for the Fifth Circuit.

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