Confusion and Solution: Chapter 11 Bankruptcy Trustee's Standard of Care for Personal Liability

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Repository Citation
David P. Primack, Confusion and Solution: Chapter 11 Bankruptcy Trustee's Standard of Care for Personal Liability, 43 Wm. & Mary L. Rev. 1297 (2002), https://scholarship.law.wm.edu/wmlr/vol43/iss3/8
CONFUSION AND SOLUTION: CHAPTER 11 BANKRUPTCY
TRUSTEE'S STANDARD OF CARE FOR PERSONAL
LIABILITY

In Chapter 11 of the Bankruptcy Code, a debtor is given a chance to reorganize his troubled estate rather than to liquidate it outright. Normally, the debtor remains in possession of the assets of the estate and continues to operate the business. In extraordinary situations, however, the court must appoint a trustee to take over the duties of the debtor and run the estate. The trustee is guided by the duties enumerated in the Code, but, unfortunately, one duty was not specifically spelled out: the personal liability standard for trustees.

The National Bankruptcy Review Commission (NBRC) recently recommended that the Code define this standard of care. This particular recommendation has been influential. As Brady Williamson stated:

Perhaps the most tangible jurisprudential effect of the [National Bankruptcy Review] Commission's work to date has come in cases involving the liability of trustees. The Bankruptcy Code ... does not provide a personal liability standard, and a long line of court decisions has led to varying conclusions—requiring a standard of care ranging from simple negligence to virtual immunity. The Commission recommended a “gross negligence” standard that balanced too little protection (and the resulting disincentive to serve) with too much protection (and the resulting disincentive to care). [In May 2000], the U.S. Court of

2. See 7 COLLIER ON BANKRUPTCY § 1104.02 (Lawrence P. King et al. eds., 15th ed. 2000).
3. See id.
4. The NBRC is a commission formed by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), whose purpose is to study and investigate issues related to the bankruptcy system and devise proposals to deal with these issues. For detailed analysis of the proposal relating to personal liability for trustees see infra notes 115-134 and accompanying text.
Appeals for the Fifth Circuit expressly adopted the Commission’s recommendations ....

Mr. Williamson, former chairman of the NBRC, was referring to the recent case of *Dodson v. Huff* (In re *Smyth*) where the Fifth Circuit Court of Appeals held that a Chapter 11 bankruptcy trustee should not be subjected to personal liability for damages to the bankruptcy estate unless the trustee acted grossly negligent in performance of their duties. What is most curious about the above quotation, particularly because it was delivered by the former chairman of the NBRC, is that the court in *Dodson* did not explicitly follow the Commission’s recommendations. In fact, Huff was appointed as a Chapter 11 trustee, and according to the proposal adopted by the NRBC, a Chapter 11 trustee ought to be personally liable for damages to the bankruptcy estate if they breach “the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.” As will be shown later in this Note, the Fifth Circuit clearly rejected the recommendation of the NBRC in relation to Chapter 11 trustees, and decided that the standard of gross negligence that the NRBC suggested for Chapter 7 trustees will suffice.

Confusion has always surrounded the standard of care for bankruptcy trustees. This Note will attempt to explain the source of this confusion among the courts, stemming from a misreading of one Supreme Court decision, and ultimately provide a solution that differs from both the Fifth Circuit and the NBRC recommendations. Specifically, the first section describes the trustee duties that are delineated by the Bankruptcy Code. The next section outlines the confusion of the courts, beginning with a misunderstanding of the “willful and deliberate” standard of *Mosser v. Darrow* and leading

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6. 207 F.3d 758 (5th Cir. 2000).
7. Id. at 762.
8. Id. at 760.
10. See infra notes 56-114 and accompanying text.
to the "gross negligence" standard as spelled out in the recent *Dodson v. Huff* case. The third section analyzes and criticizes the recommendations of the NBRC. Finally, the last section proposes that Chapter 11 trustees have a national, uniform standard of care that is akin to the standard of care for corporate directors.

**The Bankruptcy Code and Enumerated Duties of a Trustee**

Before delving into the Code's lack of specificity about the personal liability standard for Chapter 11 trustees, it is important to know what duties the Code actually delineates. "Section 1106(a) [of the Code] specifies six duties of a trustee in a reorganization case and incorporates by reference five duties of a trustee in a liquidation case."12 The five duties imposed on Chapter 7 trustees, applying also to Chapter 11 trustees, are that the trustee shall: (i) be accountable for all property received;13 (ii) examine and object to proofs of claims;14 (iii) furnish information about the estate and its administration upon request of a party in interest;15 (iv) file any required reports or summaries of the operations of the business to the court or governmental unit;16 and (v) make and file a final report and account of the estate with the court.17 It is clear that these common duties require both Chapter 7 and Chapter 11 trustees to examine the estate with which they are entrusted and to disclose information about it to the appropriate entities.

In addition to these five trustee duties common between Chapter 7 and 11, the Chapter 11 trustee must meet six duties specific to Chapter 11. The trustee must further disclose a list of creditors, a schedule of assets and liabilities, a schedule of income and expenditures, and a statement of the financial affairs of the debtor.18 Unless the court orders otherwise, the trustee must investigate all of the operations of the debtor and the debtor's business.19 As soon as practicable after this examination of the

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12. *7 Collier on Bankruptcy*, supra note 2, § 1106.02.
14. *Id.* § 704(5).
15. *Id.* § 704(7).
16. *Id.* § 704(8).
17. *Id.* § 704(9).
18. *Id.* § 1106(a)(2) (cross-referencing the duties delineated in 11 U.S.C. § 521(1)).
19. *Id.* § 1106(a)(3).
debtor, the trustee must disclose and file, with the court and appropriate creditors, any findings of "fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor." Thus, the Code forces not only disclosure from the trustee, but also an affirmative duty of investigation of the debtor's activities. In line with the purpose of Chapter 11, a plan for reorganization or recommendations for conversion to another Code chapter should be made by the trustee "as soon as practicable." Finally, the trustee is given limited immunity ("without personal liability") to provide information, if there is any available, to the appropriate governmental agency for missing tax information that the estate failed to file.

There are other important Code duties that apply to this trustee. He is the representative of the estate, and as such, has the "capacity to sue and be sued." Taxes must be appropriately filed. In addition to his own disinterested fiduciary duties, he must employ only disinterested professionals to help him in administration of the estate. Finally, in the duty most important to the Chapter 11 trustee, "the trustee may operate the debtor's business." The Code does not delineate the standard of care, but court decisions have applied the duties of corporate directors to this situation.

The duties enumerated by the Code "support the notion of a trustee as an independent third party whose role is to represent the

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20. Id. § 1106(a)(4).
21. Id. § 1106(a)(5).
22. Id. § 1106(a)(6).
23. Id. § 323(a),(b).
24. Id. §§ 346(b), 505.
25. Id. § 101(14)(E) (defining "disinterested person" as someone who "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to ... the debtor, or ... for any other reason").
26. Id. § 327. For an example of a court holding a trustee personally liable for the actions of their disinterested agents, see infra notes 32-55 and accompanying text.
27. Id. § 1108; see also 7 COLLIER ON BANKRUPTCY, supra note 2, § 1106.03(1)(d) ("Although section 1108 is ... not mandatory, the trustee is nonetheless under an affirmative duty to operate the business if such operation is necessary to preserve the value of the estate.").
28. See, e.g., Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982) ("The measure of care, diligence and skill required of a trustee is that of 'an ordinarily prudent man ....'") (quoting In re Johnson, 518 F.2d 246, 251 (10th Cir. 1977)).
estate for the benefit of the various parties in interest.” The result of this is that the trustee is under a duty to investigate and disclose the affairs of the estate so that the parties in interest will be able to protect their interests in the estate. Although the Code never defines the standard for when the Chapter 11 trustee will become personally liable for breaching these fiduciary duties, the duties delineated by the Code echo much the same duties as corporate directors: duty of care, duty of loyalty, and duty of disclosure. Whereas the duties of loyalty and disclosure are well spelled out by the Code as shown above, it is the duty of care, and the standard that goes along with it, that has caused the most problems for the courts.

**Mosser’s “Willful and Deliberate” Standard**

The first and only Supreme Court case to address the issue of the standard of care for a reorganization trustee is *Mosser v. Darrow.* Because this case was decided in 1951, the original Bankruptcy Act of 1898, not the current Code, governed its decision. Hence, Darrow was referred to as a “reorganization” trustee rather than a Chapter 11 trustee. The facts of the case are as follows: in 1935, Paul Darrow was appointed as reorganization trustee for two common law trusts that functioned as holding companies, with their principle assets being securities of twenty-seven companies. These two trusts and subsidiary companies had been promoted by Jacob Kulp and Myrtle Johnson and, given the financial woes of these business entities, Darrow thought it necessary to employ them to assist in the trusteeship. Kulp and Johnson were employed with the express agreement that they could continue to trade in securities of the debtors’ subsidiaries. These two assistants traded extensively in the bonds of the subsidiary companies, on occasion acquired bonds for themselves, and then sold them to Darrow at a

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29. 7 COLLIER ON BANKRUPTCY, supra note 2, § 1106.01.
30. Id.
31. See infra notes 159-64 and accompanying text.
33. Id. at 268.
34. Id. at 268-69.
35. Id. at 269.
profit for themselves.\textsuperscript{36} Substantial profits were made unbeknownst to Darrow.\textsuperscript{37} In the eight years of the trusteeship, Darrow filed only one account for one of the debtor-corporations and none for the other.\textsuperscript{38} At this point, the Securities and Exchange Commission intervened, and a special master was appointed who, after much investigation, recommended to surcharge Darrow.\textsuperscript{39} Upon this recommendation, the District Court surcharged the trustee, but on appeal, the Court of Appeals reversed the decision saying that a trustee could not be surcharged unless guilty of supine negligence.\textsuperscript{40} The Supreme Court reversed the Court of Appeals decision finding that Darrow should be held personally liable for the indiscrete actions of Kulp and Johnson.\textsuperscript{41}

Writing for the majority, Justice Jackson provided what seemed to be a clear and narrow ruling. Justice Jackson first noted that the issue was not that Darrow knowingly allowed Kulp and Johnson to make a profit by buying and selling securities, because to do so would definitely result in personal liability for violation of his fiduciary duties to the estate. Rather, the extent of Darrow's responsibility for profits gained unawares was the true issue in the case.\textsuperscript{42} The Court explained:

Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interests are always corrupt but because they are always corrupting. By its exclusion of the

\begin{footnotesize}
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\item \textsuperscript{36} Id.
\item \textsuperscript{37} Id. at 270.
\item \textsuperscript{38} Id.
\item \textsuperscript{39} Id. By "surcharge" the special master meant to find Darrow personally liable for his and his employees' actions. According to Black's Law Dictionary, "surcharge" means the "imposition of personal liability on a fiduciary for willful or negligent misconduct in the administration of his fiduciary duties." \textsc{Black's Law Dictionary} 1441 (6th ed. 1990).
\item \textsuperscript{40} \textit{Mosser}, 341 U.S. at 272 ("It is argued here, and appears to have been the view of the Court of Appeals, that principles of negligence applied and that a trustee could not be surcharged under many decisions unless guilty of 'supine negligence.'"). The terms "supine negligence" and "gross negligence" are synonymous. \textsc{See} E. Allan Tiller, \textit{Personal Liability of Trustees and Receivers in Bankruptcy}, 53 \textsc{Am. Bankr. L.J.} 75, 96 (noting that "some courts have emphasized the good faith of the trustee ... and have required a greater degree of negligence, i.e., 'gross' or 'supine' negligence").
\item \textsuperscript{41} \textit{Mosser}, 341 U.S. at 270.
\item \textsuperscript{42} Id. at 271 ("A reorganization trustee is the representative of the court and it is not contended ... that if he had engaged for his own advantage in the same transactions that he authorized on the part of his subordinates he should not be surcharged.").
\end{itemize}
\end{footnotesize}
trustee from any personal interest, it seeks to avoid such
delicate inquiries as we have here into the conduct of its own
appointees by exacting from them forbearance of all
opportunities to advance self-interest that might bring the
disinterestedness of their administration into question.43

There cannot be authorization for others to do what a trustee
himself may not do.44 The Court of Appeals thought that in this
particular case, the principles of negligence ought to apply and that
the trustee should not be surcharged for any acts of mere
negligence, i.e., not monitoring the actions of his employees.45 The
Supreme Court correctly saw that "[t]he liability here is not created
by a failure to detect defalcations, in which case negligence might
be required to surcharge the trustee, but is a case of willful and
deliberate setting up of an interest in employees adverse to that of
the trust."46 A trustee's disregard, whether it be reckless or not, for
the actions of his own employees, is immaterial in this instance.
Darrow willfully and deliberately authorized these transactions by
writing it into the employment contracts.47 "[E]quity... preclud[es]
such transactions for the reason that their effect is often difficult to
trace, and the prohibition is not merely against injuring the
estate—it is against profiting out of the position of trust."48 Later
court decisions have failed to understand this narrow ruling.49

Rather than leaving future courts with this narrow ruling, the
Court went on, albeit in dicta, to provide some guidance in judging
the duties of a reorganization trustee. First, it is clear that a
trustee, like any principal, is responsible for his employees.50 The
Court implied that there needs to be detailed inquiries into the
operations of employees.51 Second, the Court understood that

43. Id.
44. Id.
45. Id. at 272.
46. Id.
47. Id. at 267, 272.
48. Id. at 273.
49. See infra notes 56-79 and accompanying text (discussing Tenth, Seventh, and Sixth
Circuit decisions misinterpreting the Mosser holding).
51. See Mosser, 341 U.S. at 272 ("The question whether he was negligent in not making
detailed inquiries into their operations is unimportant, because he had given a blanket
authority for the operations.").
trustees by reason of sanction may become fearful of making business judgments if these decisions can later be “open to serious criticism by obstreperous creditors aided by hindsight.”\textsuperscript{52} The Court remarked that “[c]ourts are quite likely to protect trustees against heavy liabilities for disinterested mistakes in business judgment.”\textsuperscript{53} It appears that the Court would approve of judicial protection for trustees, much in the same way it does for corporate directors, by employing the business judgement rule.\textsuperscript{54} Finally, the Court implied that disclosure will limit, if not foreclose, personal liability for the trustee. This disclosure can be in the form of requests for instruction from the court on “difficult questions of judgment,” or regular accounting of the business given to the court and parties in interest.\textsuperscript{55}

On careful examination, \textit{Mosser} should have provided great guidance for later courts. The Court stated that willful and deliberative acts of the trustee or his employees against the interest of the trust will incur personal liability. The Court implied that when disinterested trustees have made mistakes, courts are likely to employ the business judgment rule to protect them from merely negligent actions. The trustee can utilize the business judgment rule to limit or avoid personal liability by prompt disclosure of the accounts of the business and by seeking instruction from the court when making very difficult judgments. Unfortunately, the Tenth Circuit, and the courts that followed their decision, failed to correctly interpret \textit{Mosser}. This has led to unnecessary confusion.

52. \textit{Id.} at 273-74.
53. \textit{Id.} at 274.
54. The business judgment rule is a common law principle that protects corporate directors from personal liability for any mistakes made in the course of the business so long as the decision was made in good faith and in the best interest of the business, from the perspective of an ordinarily prudent person. \textit{See, e.g.}, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating that where there is no evidence of bad faith, directors will not be liable for mistaken judgment unless having acted in an uninformed and reckless manner).
55. \textit{Mosser}, 341 U.S. at 274.
CONFUSION AND SOLUTION

MISCONSTRUING MOSSER

In *Sherr v. Winkler*, the plaintiffs brought a tort action for conversion against Winkler, the reorganization trustee of the Sierra Company. In the course of his duties, Winkler had obtained a Turnover Order from the court which brought the funds of certain gas and oil interests to the trust. Unbeknownst to Winkler, the Sherrys had an interest in these leases and thus were prevented by the court order from realizing these funds. According to the court, "[i]t is uncontradicted that Winkler did not check for any recorded interests ... prior to the Reorganization Court Turnover Order hearing...." Nevertheless, the trial court found that Winkler had not violated any of his fiduciary duties; he had acted in good faith and "no personal liability can be imposed in respect to his efforts, which were not a sham, evil or without legal justification."

The Tenth Circuit agreed with the trial court's conclusion that Winkler did not violate his fiduciary duties, but the court's reasoning is as confusing as it is unhelpful. The court first noted that "[a] trustee appointed and serving in a reorganization proceeding is a fiduciary who has an obligation to treat all parties fairly. The standard applicable to the surcharge of a bankruptcy trustee is negligence." The court then seemingly backed off from this mere negligence standard to a more generous negligence standard, stating that the question of personal liability of a trustee from loss resulting from negligence is essentially one of good faith, and that "acts of the fiduciary are to be treated with indulgence and mistaken judgment is not enough to impose liability."

Then, inexplicably, the court opined:

*Mosser v. Darrow* established the rules that a trustee or receiver in bankruptcy is (a) not liable, in any manner, for mistake in

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56. 552 F.2d 1367 (10th Cir. 1977)
57. As with *Mosser, Sherr* was decided before the adoption of the Code, and therefore, Winkler is known as a reorganization trustee.
58. *Sherr*, 552 F.2d at 1369.
59. *Id.*
60. *Id.* at 1371.
61. *Id.* at 1374 (citations omitted) (citing *Mosser v. Darrow*, 341 U.S. 267 (1951), without specific pinpoint, for support that negligence is the applicable standard).
62. *Id.* at 1375 (citing *Kaufman v. Kaufman*, 166 S.W.2d 860 (Ky. Ct. App. 1942)).
judgment where discretion is allowed, (b) liable personally only for acts determined to be willful and deliberate in violation of his duties and (c) liable, in his official capacity, for acts of negligence.63

In no way did the Mosser decision establish these three rules.64 As stated previously, Mosser merely held that a trustee may be held personally liable when willfully and deliberately acting against the trust.65 Certainly, Mosser established no distinctions between a trustee in an official capacity versus at other times. Furthermore, the Tenth Circuit failed to grasp that the plaintiffs in Sherr were not beneficiaries of the estate, so that a trustee would in fact owe no fiduciary obligations to them. Thus the trustee can be sued in his official capacity (i.e., as a representative of the estate) but the monies would come from the estate itself, unless the trustee acted outside the scope of his authority.66

Unfortunately, the confusion of Mosser by the Sherr court went unnoticed by the Seventh and Sixth Circuits. In the case of In re Chicago Pacific Corp.,67 the Seventh Circuit reaffirmed the Sherr decision by claiming that “[a] trustee may be held personally liable only for a willful and deliberate violation of his fiduciary duties.”68 In one sense, this court, unlike the Tenth Circuit, understood the difference between the trustee’s fiduciary duties to parties in interest and to third parties to which there are no fiduciary duties owed. In Chicago Pacific, minority vendors who had brought a class action against several railroads sought proof of claim against a debtor railroad in a reorganization meeting.69 Due to various procedural difficulties, the proof of claim was rejected.70 Because this claim was rejected, the court correctly deduced that the trustee owed no fiduciary duties to these minority vendors.71 Unfortunately,

63. Id. (citation omitted).
64. See supra notes 32-55 and accompanying text.
66. See infra notes 135-58 and accompanying text (discussing Daniel Bogart’s criticism of the NBRC’s recommendations).
67. 773 F.2d 909 (7th Cir. 1985).
68. Id. at 915 (citing Mosser and Sherr in support of this standard).
69. Id. at 910.
70. Id. at 912-13.
71. Id. at 915 ("Our examination of the complaint ... reveals not even the slightest indication that the Trustee was sued in his personal capacity. Indeed, we think it safe to say
the court accepted without any further discussion that Mosser required a willful breach for the trustee to be held personally liable.

In Ford Motor Credit Co. v. Weaver, the Sixth Circuit perpetuated the Sherr misunderstanding. Weaver was appointed the debtor in possession of Weaver Farms, a business which had filed for Chapter 11 protection. Due to an incorrect address, Ford Motor Credit Co. (FMCC) was not able to claim an interest on equipment that it had lent to Weaver Farms. FMCC sued and, among other claims, stated that Weaver "willfully and deliberately violated his fiduciary duties as debtor in possession by failing to safeguard the assets of Weaver Farms." The Sixth Circuit responded:

A trustee in bankruptcy may be liable for violations of his fiduciary duties. A trustee in bankruptcy can be liable in his official capacity or individually. A bankruptcy trustee is liable in his official capacity for acts of negligence ... personally only for acts willfully and deliberately in violation of his fiduciary duties.

The court remanded this case to determine whether Weaver had acted either negligently in his official capacity, or willfully and deliberately in his personal capacity, neither of which are found in the language of Mosser at all.

This distinction between official capacity and personal capacity has been completely misunderstood by these circuit courts. Official capacity exists when the trustee is sued as the representative of the estate. The estate pays for any damages, unless the trustee acted outside the scope of his authority. This occurs most frequently when a third party nonbeneficiary sues the trustee as representative of the estate. The trustees, who have no fiduciary duties

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72. 680 F.2d 451 (6th Cir. 1982).
73. Id. at 462 ("The principles governing the liability of a bankruptcy trustee are applicable to a debtor in possession.").
74. Id. at 461.
75. Id. at 461-62 (citing Mosser v. Darrow, 341 U.S. 267 (1951) and Sherr v. Winkler, 552 F.2d 1367 (10th Cir. 1977)).
76. Id. at 462.
77. See supra notes 46-48 and accompanying text.
to these third parties, should be insulated by a derived judicial immunity, provided they were within the scope of their authority. The circuit courts claim that negligence is the standard applicable for this situation. To charge a trustee with this low standard while they are trying to reorganize a business, however, would have a chilling effect on those who may decide to assume the tasks of a trustee.

NEGLIGENCE AS THE STANDARD OF CARE

The Ninth Circuit departed from the Tenth, Seventh, and Sixth Circuits' interpretations of Mosser in Hall v. Perry (In re Cochise College Park, Inc.). In this case, a class of beneficiaries sued Perry, the trustee, for breach of his fiduciary duties, claiming that Perry withheld payments on promissory notes that they owned and that he made actionable misrepresentations on certain contracts concerning land deals. The trial court granted summary judgment for the trustee on these issues, but the Court of Appeals reversed, deciding that there were indeed genuine issues of fact to be decided by the trial court. More specifically, the beneficiaries argued that for any payments not covered by the estate's assets, the trustee should be held personally liable. The beneficiaries reasoned that the trustee induced them, by misrepresentations, to continue to make payments on promissory notes even though he knew that reorganization of this business was impossible. The

78. See, e.g., Schechter v. Illinois Dep't of Revenue (In re Markos Gurnee P'ship), 182 B.R. 211, 220 (Bankr. N.D. Ill. 1995) ("The general personal immunity of bankruptcy trustees—which applies to claims other than for breach of bankruptcy-related fiduciary duties, arising out of the operation of the estate—renders the estate rather than the trustee liable . . . .”).
79. See, e.g., Tennsco Corp. v. Estley Metal Prods., Inc., 200 B.R. 542, 545 (D.N.J. 1996) (noting "there is a strong public policy in protecting bankruptcy trustees, since the imposition of personal liability . . . for unintentional tortious acts to non-parties to the bankruptcy proceeding would create a significant disincentive to trustee service").
80. Sherr v. Winkler, 552 F.2d 1367, 1375 (10th Cir. 1977).
82. Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982).
83. 703 F.2d 1339 (9th Cir. 1983).
84. Id. at 1346-47.
85. Id.
86. Id. at 1357.
87. Id.
Ninth Circuit correctly divided the case into two issues, the duty owed to the creditors for not rejecting executory contracts in a timely fashion and the duty owed for making misrepresentations.\(^8\)

As to the first issue, the Ninth Circuit laid out the correct foundation that "[a] bankruptcy or reorganization trustee is a fiduciary of each creditor .... As such, he has a duty to treat all creditors fairly and to exercise that measure of care and diligence that an ordinarily prudent person under similar circumstances would exercise."\(^9\) Then, in an important footnote, this court rejected the Tenth and Sixth Circuits' "apparent misreading" of Mosser and decided that "'[a]lthough a trustee is not liable in any manner for mistakes in judgment where discretion is allowed, he is subject to personal liability for not only intentional but also negligent violation of duties imposed upon him by law.'\(^9\) According to the court, Mosser is properly construed to mean that "the sort of personal liability which may be imposed on a trustee for the acts of his employees is not strict liability but rather liability depending at least on a showing of the trustee's own negligence."\(^9\) Whereas this interpretation is correct in that the Supreme Court only decided that willful and deliberate acts will make a trustee personally liable,\(^9\) the Mosser decision did not weigh in on what standard of negligence is needed. Indeed, the court specifically avoided this question altogether.\(^9\) Nevertheless, the Ninth Circuit held that negligence is the standard where there is a breach of the duty of care.

More importantly, the Ninth Circuit overturned the trial court's determination that misstatements to beneficiaries, unless willful and deliberate, are not actionable because the trustee's communications are protected by the Bankruptcy Act.\(^9\) This is plainly

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88. *Id.* at 1357-58.
89. *Id.* at 1357 (citations omitted).
90. *Id.* at 1357 & n.26 (citations omitted) (citing Mosser in support).
91. *Id.* at 1357 n.26.
93. See *id.* (declining to answer where acts of supine negligence are necessary for surcharging the trustee).
94. Note that the proceedings in this case were begun before the adoption of the Code. The Bankruptcy Act shielded the trustee from liability for "a 'communication' to a creditor .... where the communication is uttered 'in good faith and with reasonable grounds for belief in its truth.'" *Hall*, 703 F.2d at 1359 (quoting from the Bankruptcy Act § 21i, 11 U.S.C. § 44(i).
false because the fiduciary duty of care requires, at the very least, one to act in good faith. An intentional misstatement would not be acting in good faith under any reasonable construction of good faith. Thus the Ninth Circuit was correct in that Mosser had been misunderstood by the other circuits, but it failed to provide any reasoning for applying a negligence rather than gross negligence standard. Given the danger of creating disincentives for trustees to take up positions in bankruptcy reorganization cases, mere negligence may not be the right answer.

THE MIDDLE ROAD: GROSS NEGLIGENCE

In its cogent analysis, a Massachusetts bankruptcy court decided that gross negligence ought to be the standard of care for a Chapter 11 bankruptcy trustee. In DiStefano v. Stern (In re J.F.D. Enterprises, Inc.), the plaintiffs sued the trustee for breaching his fiduciary duties based on his mismanagement and failure to preserve the assets of the estate.

After determining whether the plaintiffs had standing to sue, the court turned to the issue of the standard of care for a trustee. The issue of the personal liability of bankruptcy trustees arises in two contexts: (a) acts or omissions of the trustee in operating the debtor's business ... which cause[s] injury to the plaintiff(s), and (b) the trustee's violation of his or her fiduciary duties to the estate, the creditors, or the shareholders. The court determined that there is no question that a trustee enjoys judicial immunity whenever he acts within the scope of his duties under a "properly noticed court order." After analyzing Mosser, the court noted that "[Mosser] makes clear that trustees are personally liable for willful, or

(1976)).

96. As fraud is intentional, a negligence standard would not even apply. See BLACK'S, supra note 39, at 660.
98. Id. at 617-19.
99. Id. at 624-25 ("Far more complicated is the standard of care owed by Stern as trustee, and to that morass the Court now turns.").
100. Id. at 625.
101. Id.
intentional, violations of their fiduciary duties. However, the question of whether a less than intentional violation of a fiduciary duty will subject a trustee to personal liability has divided the Circuits.\textsuperscript{102}

After citing Sherr,\textsuperscript{103} and Hall,\textsuperscript{104} this court dismissed the willful and deliberate standard as not applicable,\textsuperscript{105} and the negligence standard as insufficient, in favor of a gross negligence standard.\textsuperscript{106} When the bankruptcy trustee enters the reorganization process, he is bombarded with numerous problems. For example, the trustee generally has little prior knowledge of the business he has been appointed to oversee, the debtor usually resents someone else taking over the stewardship of his business, secured creditors are made statutorily adversarial to the trustee, and unsecured creditors are unhappy that their recovery is diluted by the trustee's involvement and compensation.\textsuperscript{107} Given this precarious situation, the court held that "trustees should not be deemed to have violated their fiduciary duty and become subject to personal liability unless they are found to have acted with gross negligence."\textsuperscript{108} According to the court, this standard "strikes the proper balance between the difficulties of the task assumed by trustees and the need to protect the interest of creditors and other parties in the bankruptcy case."\textsuperscript{109}

Agreeing with the logic of this decision, the Fifth Circuit similarly held that "trustees should not be subjected to personal liability .

\begin{itemize}
\item \textsuperscript{102} Id. at 625-26 (citations omitted).
\item \textsuperscript{103} 552 F.2d 1367 (10th Cir. 1977).
\item \textsuperscript{104} 703 F.2d 1339 (9th Cir. 1983).
\item \textsuperscript{105} DiStefano, 223 B.R. at 626 ("It appears to this Court that the holding of Mosser cannot be extended any further than the proposition that trustees are personally liable for intentional violations of their fiduciary duties.").
\item \textsuperscript{106} Id. at 627-28.
\item \textsuperscript{107} See id. at 628.
\item \textsuperscript{108} Id.
\item \textsuperscript{109} Id.
\end{itemize}
unless they are found to have acted with gross negligence." In *Dodson v. Huff*, a creditor sued the trustee of the Smyth estate because of alleged errors in the filing of the estate's tax returns. The trial court decided that simple negligence was not enough to find a trustee personally liable. The Fifth Circuit agreed. Relying heavily on *DiStefano* and the recommendations from the NBRC, the court noticed that there are conflicting policy considerations between having too little protection, and hence a disincentive to serve as trustee, and too much protection, which might result in mismanagement of the estate. Gross negligence, as defined by *Black's Law Dictionary*, is the proper intermediate standard. Although gross negligence correctly conforms to the *Mosser* decision and achieves policy goals more effectively than either the willful and deliberate or simple negligence standards, it is not what the NBRC recommended for Chapter 11 trustees.

**THE NBRC RECOMMENDATIONS**

By way of background, Congress created the NBRC in 1994 to review the entire bankruptcy system. The NBRC was given the enormous task of devising recommendations to improve the Code, while at the same time not disturbing the fundamental tenets of the existing bankruptcy law. Remarkably, in 1997, the NBRC submitted its report with over 170 individual recommendations on time and under budget. These recommendations were immediately influential on the current debate surrounding the bankruptcy system. The issue of personal liability for trustees was important enough that the NBRC felt it necessary to make a

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111. *Id.* at 760.
112. *Id.*
113. *Id.* at 761-62.
114. "The intentional failure to perform a manifest duty in reckless disregard of the consequences as affecting the life or property of another." *BLACK'S, supra* note 39, at 1033.
115. *NAT'L BANKR. REV. COMM'N FINAL REPORT, supra* note 9, Preface, at iv.
116. *Id.*, Preface, at i.
117. See Williamson, *supra* note 5 ("More than 40 federal courts have cited the Commission's work. And it's already been discussed in more than 250 law review articles. Several of the decisions, including two by the U.S. Court of Appeals, have turned on the Commission's recommendations.").
recommendation for its improvement in the Code.\textsuperscript{118} This recommendation has already influenced the analyses and decisions of other courts.\textsuperscript{119}

The NBRC recommendation is fourfold. First, any bankruptcy trustee has immunity for any acts taken within the scope of their duties as defined by the Code or any acts ordered by a court with proper notice given to parties in interest.\textsuperscript{120} Second, Chapter 7, 12, and 13 trustees should only be subject to suit in their representative or personal capacities for acts done with gross negligence.\textsuperscript{121} Third, Chapter 11 trustees should only be subject to suit in their representative and personal capacities for acts done in violation of the standard of care for corporate directors for the state in which the bankruptcy case is pending.\textsuperscript{122} Finally, the debtor in possession should remain subject to suit in exactly the same manner as in the current law.\textsuperscript{123}

\begin{itemize}
\item \textsuperscript{118} See NAT'L BANKR. REV. COMM'N FINAL REPORT, supra note 9, § 3.3.2.
\item \textsuperscript{120} NAT'L BANKR. REVIEW COMM'N FINAL REPORT, supra note 9, § 3.3.2 states that:

Trustees appointed in cases under Chapter 7, 11, 12 or 13 of the Bankruptcy Code should not be subject to suit in their individual capacity for acts taken within the scope of their duties as delineated in the Bankruptcy Code or by order of the court, as long as the applicable order was issued on notice to interested parties and there was full disclosure to the court.

\item \textsuperscript{121} Id. The Code continues:

Chapter 7, 12 and 13 trustees only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee acted with gross negligence in the performance of the trustee's fiduciary duties. Gross negligence should be defined as reckless indifference or deliberate disregard of the trustee's fiduciary duty.

\item \textsuperscript{122} Specifically, the Code says:

A Chapter 11 trustee for a corporate debtor only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee has violated the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.

\item \textsuperscript{123} Id. ("Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.").
\end{itemize}
In its reasoning for these recommendations the NBRC noted:

The Bankruptcy Code does not provide a personal liability standard for bankruptcy trustees. Since 1978, the courts that have addressed this issue have come to contrary conclusions. Under what has been described as a "crazy quilt" of decisions, trustees are held to standards of care ranging from personal liability for negligence to personal liability for willful and intentional acts in violation of the trustee's duties. Some courts also find that trustees have derived judicial immunity for acts taken within the scope of their authority.\textsuperscript{124}

Given this universe of choices, the report sought a balance "to protect trustees from personal liability where warranted while encouraging responsible administration of estate assets."\textsuperscript{125} This need for a balance led the NBRC to decide that any trustee should be protected when acting within the scope of his duties.\textsuperscript{126} Astutely, the NBRC explained that "[o]ften times, a party that is dissatisfied with the result of a court order ... will attempt to collaterally attack the order by suing the trustee personally."\textsuperscript{127} Additionally, there needs to be disclosure to the court and parties in interest.\textsuperscript{128} This recommendation squares with the \textit{Mosser} decision\textsuperscript{129} and makes good sense given the policy goals of the NBRC.\textsuperscript{130}

Outside of acts pursuant to statute or court order, the recommendation was a gross negligence standard for Chapter 7, 12, and 13 trustees. There was disagreement from the National Association of Bankruptcy Trustees (NABT) who, not surprisingly, lobbied to establish the willful and deliberate standard.\textsuperscript{131} The NBRC decided that this standard was too protective and "would not encourage trustees to seek court approval of difficult estate

\begin{itemize}
\item \textsuperscript{124} \textit{Id.} at 859-60 (citations omitted).
\item \textsuperscript{125} \textit{Id.} at 861.
\item \textsuperscript{126} \textit{Id.} at 862 ("The scope of a trustee's duties includes any action (including an exercise of business judgment) taken pursuant to statute or court order.").
\item \textsuperscript{127} \textit{Id.}
\item \textsuperscript{128} \textit{Id.} at 862-63.
\item \textsuperscript{129} \textit{See Mosser v. Darrow}, 341 U.S. 267, 272 (1951).
\item \textsuperscript{130} \textit{See NAT'L BANKR. REV. COMM'N FINAL REPORT}, supra note 9, Preface, at i-iv.
\item \textsuperscript{131} \textit{See id.} at 867 (citing that the NABT "recommended a 'willful and intentional' standard for personal trustee liability").
\end{itemize}
Unfortunately, the NBRC failed to give any in-depth explanation for why Chapter 11 trustees should be treated differently than Chapter 7 or 13 trustees. They merely mentioned that “[w]hen a trustee is appointed [to] a Chapter 11 case, the trustee acts in place of the debtor in possession and should be subject to the standard of care for officers and directors set forth by the state where the Chapter 11 case is pending.” This is an unsatisfying explanation and one that has been open to criticism.

CRITICISM OF THE NBRC RECOMMENDATIONS

Daniel Bogart clearly delineates the problems with the NBRC’s recommendations. Bogart is not subtle with his criticism about the NBRC’s proposal: “The provision ultimately drafted by the Commission suggests that the Commission ignored or misunderstood basic legal doctrine. If adopted, the provision would undermine the doctrinal integrity of the Bankruptcy Code.” His comments are worth investigating not only to understand the NBRC proposal but also to summarize the current state of the standard of care argument.

The first criticism that Bogart levies is that the NBRC missed the opportunity to clarify the case law that relies on the Mosser decision and instead codified its misunderstanding. Mosser is a “duty of loyalty,” not a duty of care situation, because this was a case of self-dealing. The Sherr court misunderstood this distinction and complicated matters by concluding that negligent actions will never result in personal liability because only deliberate actions can produce this result. According to Sherr, a negligent action will subject the trustee only to official liability—meaning that the estate will pay for the indiscretion. As Bogart suggests, this is

132. Id.
133. Id. at 869.
134. See, e.g., infra note 153 and accompanying text.
136. Id. at 707.
137. Id. at 711 (“Mosser is correct and should be applied and maintained.”).
138. Id. at 712.
139. Id. at 713.
140. Id. at 714.
manifestly wrong because whenever a trustee breaches a fiduciary duty, whether deliberately or negligently, he should run the risk of personal liability.141

Furthermore, according to Bogart, the Sherr court misapplied the concept of derived judicial immunity. Whenever a nonbeneficiary sues a trustee, derived judicial immunity, not fiduciary analysis, is necessary.142 The only issue in the Sherr case is whether the trustee is acting in the scope of his duties; if so, he is immune personally from liability.143 However, a trustee always has a duty to the parties in interest. "Trustees are simply not 'immune' from suits brought by their beneficiaries."144 Unfortunately, courts have confused these concepts. Bogart offers this advice: "[I]ssues of negligence and disloyalty are all that matters in cases where beneficiaries bring complaints. Similarly ... one can only be disloyal or incompetent vis-a-vis persons to whom one owes these duties. ... [T]his is, unfortunately, an error that the Commission makes."145 These misunderstandings of duty of loyalty versus duty of care and applications of judicial immunity are reflected in the NBRC's recommendations.

Turning to the proposal itself, Bogart noted the sloppy use of the language, as evidenced by the words "representative," "individual," and "personal."146 It is clear that when the trustee is acting in his representative capacity, he is immune from suit unless acting outside the scope of his activities, but the difference between individual and personal capacity is unclear on its face and could lead in the future to more misunderstandings by the courts, "a la Sherr v. Winkler."147 This sloppy terminology undermines the NBRC proposal because the first paragraph provides protection for all bankruptcy trustees in their individual (personal?) capacities for acts done in the scope of their duties, but the second paragraph says that certain bankruptcy trustees are subject to suit in their representative and personal (individual?) capacities for acts done

141. Id. at 715 ("A breach is a breach is a breach.").
142. Id. at 717.
143. Id.
144. Id. at 720.
145. Id. at 723.
146. See id. at 729-30.
147. Id.
with gross negligence. Furthermore, Chapter 11 trustees are held to the same standard of care as state corporate directors in their representative and personal capacities. As Bogart suggests, this mess of language creates the result that "personal liability would only arise if such grossly negligent actions were also outside the scope of the trustee's authority. Thus, the trustee would be judicially immune from the actions of beneficiaries." This is clearly not the result one wants. The NBRC should have made it clear that with respect to nonbeneficiaries, trustees are judicially immune for acts within the scope of their duties; and with respect to beneficiaries, the Chapter 7, 11, or 12 trustees will be personally liable for actions done with gross negligence.

Furthermore, these duties to beneficiaries are twofold, the duty of care and the duty of loyalty. The proposal fails to delineate either duty. Bogart suggests that "[n]o policy reason ... warrants treating the fiduciary duties of care and loyalty differently for the purpose of determining a trustee's personal liability." As has been previously mentioned in this Note, however, and noticed by the Supreme Court in Mosser, a breach of the duty of loyalty is often the result of a willful and deliberate act, whereas a breach of the duty of care may result from simple negligence. Thus, each duty should be analyzed accordingly.

Finally, Bogart correctly admonishes the NBRC for its recommendation for Chapter 11 trustees. To impose the duties of state corporate directors on Chapter 11 trustees "would create fifty different fiduciary standards for Chapter 11 trustees reflecting the corporate law of the fifty states of the Union." This result seems to undermine the purpose of the Code to provide uniform standards for the country as mandated by the U.S. Constitution.

148. See id. at 732-33; NAT'L BANKR. REV. COMM'N FINAL REPORT, supra note 9, § 3.3.2.
149. Id.
150. Bogart, supra note 135, at 733.
151. Id. at 714 (quoting Daniel B. Bogart, Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back, Something May Be Gaining on You", 68 AM. BANKR. L.J. 155, 211 (1994)).
154. See U.S. CONST. art. I, § 8, cl.4 ("To establish ... uniform Laws on the subject of Bankruptcies throughout the United States ... ").
differences between a trustee's duty of care and that of a typical corporate director. Similarly, although the differences may be less evident, there are real differences between a trustee's duty of loyalty and those of a corporate fiduciary.\textsuperscript{155} According to Bogart, the bankruptcy courts, although granting wide discretion, typically require something greater for a trustee than adherence to the business judgment rule standard.\textsuperscript{156} Corporate directors are only liable for irrational and uninformed mistakes, whereas trustees are held to a higher standard of reasonable care. Furthermore, state exculpatory statutes protect corporate directors from any breach of the duty of care, unlike trustees.\textsuperscript{157} Moreover, corporate directors only owe a duty of loyalty to their shareholders, whereas trustees' loyalties are to shareholders, creditors, and any other party in interest. Finally, Bogart suggests that as long as the language of the recommendation is made clear, Chapter 11 trustees, like their brethren, should be held in their personal capacity to the gross negligence standard.\textsuperscript{158}

Bogart makes very good arguments why the NBRC recommendations fail to provide much guidance. He is correct that the trustee's acts to nonbeneficiaries ought to be protected by derived judicial immunity as long as the acts are taken within the scope of the trustee's duties. The trustee's duties to beneficiaries ought to be delineated into a duty of care and duty of loyalty, but here Bogart is wrong with respect to his analysis of a Chapter 11 trustee. They should be governed by a uniform standard modeled on the duties of a corporate director.

156. Id. at 741.
157. Id.
158. See id. at 726-27.

[You will see that there is good reason not to place into statute even these modest differences between Chapter 7 and Chapter 11 standards of care. The reason is simple: Chapter 7 trustees are occasionally forced to run ongoing business in hopes of selling them whole during bankruptcy, and conversely, Chapter 11 trustees often liquidate parts, and perhaps even all, of the debtor's estate.... It should not matter what Chapter the trustee finds himself in. Rather, it is the nature of the debtor's estate and business that determines what we mean by "care."

Although trustees in Chapter 7 or 11 can be involved in the aspects of both liquidating and running a company, this fact blurs the distinction between the two Chapters of the Code. Chapter 11, as the title explicitly states, is about “reorganization,” not “liquidation.” Because the purpose of the trustee is different, at least in theory, between Chapter 11 and any other chapter, it behooves one to view the standard of care in light of the principles of reorganizing and running a business. Contrary to the opinions of Bogart and others, this Note asserts that having the Chapter 11 trustees governed by the same standards of care as a corporate director would be the best way to effectuate the policy goals of not creating disincentives to serve as trustee but also not allowing the trustee to mismanage the estate. The drafters of the NBRC proposal might have had this in mind when they declined to assign Chapter 11 trustees the same standard of care as the other bankruptcy trustees. The NBRC, however, failed to create a viable solution, as Bogart aptly points out.

The general standard for directors as set out by the Model Business Corporation Act provides excellent guidance for crafting a uniform, national standard for Chapter 11 trustees. The duty of care for a corporate director under this Act is defined as acting “(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.” Bogart worried that a directive like this would not make trustees accountable enough as a trustee, but this is not true. When a trustee does not act in good faith, it is tantamount to a breach of the duty of loyalty. As in corporate law, a breach of loyalty is never protected by the business judgment rule because this is not an act of negligence but of deliberate, intentional self-interest.

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159. See Bogart, supra note 135, at 726-27.
161. See Bogart, supra note 135.
163. See, e.g., Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944) (“The ‘business judgment rule,’ however, yields to the rule of undivided loyalty. This great rule of law is designed ‘to avoid the possibility of fraud and to avoid the temptation of self-interest.’”) (citation omitted).
Furthermore, by asking the trustee to make decisions like any other prudent trustee would make in similar circumstances, the trustee would have the freedom under the business judgment rule to make tough decisions without the repercussions of being personally sued. Because the Chapter 11 trustee is attempting to resurrect a troubled business, the courts should give great latitude to the trustee as long as he serves the dual interests of managing the estate and protecting the assets for the parties in interest. The business judgment rule, as modified for a Chapter 11 bankruptcy trustee, best achieves this purpose. Because there is no exculpatory clause written into this standard, trustees still will be obligated to make informed, reasonable decisions.\textsuperscript{164}

**CONCLUSION**

The standard of care for a Chapter 11 trustee has been misunderstood and misapplied. Bankruptcy trustees have only fiduciary duties to the beneficiaries of the estate, and thus, should be personally protected by derived judicial immunity for any suits brought by nonbeneficiaries. As for beneficiaries, like any other fiduciary, the Chapter 11 trustee owes the duties of care and loyalty. Rather than the "gross negligence" and "willful and deliberate" standards, the same duties as a "model" corporate director should be used. The business judgment rule will insulate the trustee enough so that there will not be a disincentive to run a business, but the necessity of an informed and reasonably prudent trustee will make sure that the interests of the estate are adequately served.

> David P. Primack

\textsuperscript{164} See, e.g., Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).