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I. Introduction

This article will examine section 3.3.2 of the Report of the National Bankruptcy Review Commission (the "Commission"). That section attempts to clarify and improve the present state of law governing liability and fiduciary obligations of trustees in bankruptcy. However, as I will explain, the Commission's proposal is dramatically flawed and represents a grand failure to untangle a variety of legal doctrines confused by bankruptcy courts since the adoption of the Code.

However, before evaluating this recommendation in earnest, I would like to interject some good, "old time" religion. Fear not: I do not want to convert anyone to any religious persuasion. I know the reader may not be expecting this digression, but bear with me. There is a very real connection between the message of this story and the lesson it teaches and what other scholars and I have been asked to do in this symposium edition of the *Dickinson Law Review*.

There is a famous story in the Bible of how the prophet Elijah (with obvious help from above) destroyed the prophets of a then powerful cult, the cult of Ba'al. Jez'bel, who was queen of Israel, was a follower of Ba'al and had previously killed all the other prophets of God but Elijah. According to the story, God gave

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Elijah an unenviable task: to cause the people to repent and return to God, to reject their own enchantment with the cult in the face of a powerful and violent queen. But how was Elijah to do so? How was he to persuade the multitude of Israel to turn away from what seemed an inexorable and self destructive path?

Elijah chose pyrotechnics. Elijah proposed a test: his God versus Ba'al, before all the people. Elijah laid out an alter and offering before the assembled multitude of Israel. The prophets of Ba'al did likewise. Then, rather than setting fire to the offerings in the traditional way, the prophets, false and real, called on their respective gods to light up the offerings. Elijah called Fire from Heaven and destroyed his offering, proving his God real and Ba'al false.

Elijah did not stop there, however. In the power of the moment, Elijah commanded the multitude to seize the prophets of Ba'al and kill them.

Elijah was a powerful man, used to giving commands and proving his word with dramatic deeds. He used pyrotechnics in an attempt to bring his people to a better path. But did he really change the *hearts* of his people? True, they saw the results with their own eyes and they respected the power of all that happened, but had they been truly *persuaded*?

After conquering the prophets of Ba'al Elijah fled, knowing that Jezebel would not be happy with the outcome. Elijah retreated to a cave and God found him there. It is then that Elijah expressed his despondency. He admitted that he failed to really teach his people anything and had, instead, resorted to violence to make his ultimate point. He went so far as to tell God that he wanted to die, for "I am no better than my fathers."[1]

This story is dramatic, surely. But so far, at least, it has no connection with anything we might do or say at this symposium. It is what happened next that has importance for us here today, and why I repeat this story; Elijah learns a lesson in persuasion.

The Bible then says:

> And God said, "Go forth, and stand upon the mount before the Lord." And behold, the Lord passed by, and a great and strong wind rent the mountains, and broke in pieces the rocks before the Lord, but the Lord was not in the wind; and after the wind, an earthquake, but the Lord was not in the

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1. 1 *Kings* 19:4.

> Earthquake; and after the Earthquake, a fire, but the Lord was not in the fire; and after the fire, a still, small voice. And when Elijah heard it, he wrapped his face in his mantle and went out and stood at the entrance of the cave. And behold, there came a voice to him, and said, "What are you doing here, Elijah?"[2]

The problem, as Elijah learned, is that earthquakes and storms do not persuade. We have all felt this at times. When we argue over an emotional point with colleagues and friends, we lose any hope for persuasion when we begin yelling. The other person more often than not yells even louder back or retreats stonefaced from the barrage. It is the still small voice that destroyed Elijah's will, or perhaps, opened his eyes. It is the "still small voice" that forces *introspection and reflection.*

This is one of my favorite passages, and one that we might think about now. This article reflects on the work and recommendations of the National Bankruptcy Review Commission. The year preceding the Commission Report of October 22, 1997, has been marked by incredible propaganda and publicity campaigns. Lives and livelihoods, businesses and reputations are at stake: bankruptcy law touches debtors and families, employees of debtors, creditors, who may be individuals or entities, and countless others. And in the last year, there has been an endless succession of earthquakes, floods (of information), and storms (of protest). And yet, I would ask of the reader, were you persuaded, or even forced to rethink and verify your position, when confronted with shrill, caustic protests?

This last year and a half has been characterized by direct and indirect attempts to influence the Commission—direct at hearings and in correspondence and indirect in the attempts of different organizations and interested parties to influence public opinion. Editorial writers decried the state of the American debtor and the huge number of personal filings. Even electronically there was a din and chorus, for a massive amount of information is available online. Academics have sometimes also been shrill and loud and cannot always claim greater dignity throughout this process.

But I think that here, as a part of this symposium, we have been asked to provide the "still small voice." I believe that this is just what my colleagues on this panel have done in their presenta-

2. 1 *Kings* 19:11-13.

tions and in their articles. They have sliced through the cacophony of conflicting protests to allow for meaningful reflection.

The "still small voice" may mean many things, and certainly different things to different people. Social scientists might calmly proffer statistical evidence for one position or another (that, for example, the huge volume of consumer bankruptcies may be traced to a particular root cause). Behavioral scientists might quietly explain the effects (or lack thereof) of the "bankruptcy stigma" and its deterrent effect on filing. But this symposium is a panel of law professors, and, although we might effectively comment on these and other issues, legal doctrine is our stock and trade. We deal, and are expected to deal, with doctrine, terminology, and statutory structure better than any other group. I will, therefore, limit my attention to legal doctrine; it is here where I best find my "still small voice."

For all of its faults, I like the Bankruptcy Code. I teach it every year. I have grown fond of its language and its structure. I know that others will be somewhat surprised, and even cynical, about this. The original 1978 Code was neither so precise as to eliminate flexibility of courts and parties nor so vague as to lack guidance.[3] I would like to see this Code survive a bit longer, and with some dignity.

Law professors and other wonderful, competent, and creative lawyers were involved in the Commission activity at all levels and at all times. It is therefore disappointing that doctrine and terminology received such poor attention at times.[4] In particular, section 3.3.2 of the Report, which modifies, and supposedly clarifies personal liability and performance standards for bankruptcy trustees, represents a failure to incorporate different and important legal doctrines. This is frustrating for many reasons, perhaps mostly because careful scholarship dating back to 1979 effectively explains these doctrines and was available to the drafters.

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3. The Code is in this way much different from the Internal Revenue Code which has a seemingly endless and comprehensive set of regulations.

4. I do not intend my criticism to show any lack of respect for the individuals who worked so hard to put this Report together; just my thoughtful concerns. The drafters of this report expect careful evaluation of their work, and they expect disagreement. I do not for a moment doubt the extraordinary talent, good faith and well meaning efforts of the drafters. But I do believe that in the heated, give-and-take of the hearing, drafting, and voting process, the language of the Code and its metaphors and doctrinal consistency suffered.

This failure has broader implications than might first appear. On its own, the uncertain liability of trustees in bankruptcy is an important issue. As the Commission makes clear, the Code will not operate effectively unless qualified and honest people are willing to serve as trustees. But, 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. Furthermore, the provision would effect a major and unacknowledged change in the nature of the fiduciary obligations of the Debtor in Possession (hereinafter the "DIP") in Chapter 11 bankruptcies.

Yet, despite the limited focus of this review, I do have a general point that I hope to address at different times throughout: codes, and this includes the Bankruptcy Code, derive much of their legitimacy, and certainly their workability, from some significant degree of underlying consistency—consistency in terminology, doctrinal basis, and policy goals. On the last count, the Bankruptcy Code has been subject to both criticism and bewilderment. Is there a constant policy explanation for what the Bankruptcy Code does, or is there irreconcilable tension between provisions attempting to achieve a host of sometimes contradictory goals? Is the Code a vehicle for debt collection, or more?[5] But even if this last issue remains unresolved, the Code should benefit from the consistent use of terms and doctrinal sources. And any code riddled with terminological inconsistencies and doctrinal confusion must ultimately fail. Indeed, it is just this kind of confusion that will one day in the future lead to yet another commission, one with the express purpose of not just modifying the Bankruptcy Code but replacing it.

Part II of this article explains the doctrinal bases of a bankruptcy trustee's personal and representative liability to creditors and others. There is considerable misunderstanding in the law, in

5. *See* FRANK H. EASTERBROOK & DANIEL H. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 6-7 (1991) (presenting a recent and influential description of corporate structure as a contract). The view that relations among shareholders and officers and directors can be described in contractual terms has been stridently criticized. *See* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985). *See also* 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, 164-68 (1994).

case opinions particularly, about both the doctrinal bases for holding a trustee liable for his or her acts and the terminology to ascribe to these situations. Simply put, a bankruptcy trustee is a unique person, holding fiduciary obligations to a discrete set of "beneficiaries," and liable to these persons for a failure to live up to necessary standards, while simultaneously serving as a functionary of the bankruptcy court entitled to a judge's judicial immunity from suit. But, as we shall see, these are two discrete doctrines and should apply at different times and in response to different suits.

Only with the legal foundation set does it make sense to repeat and evaluate the recommendation of the Commission. Therefore, Part III of this article will analyze the section 3.3.2 of the Commission's proposal. There are several very obvious problems in the proposal that have to do with word choice as much as anything else. But, as we shall see, the primary problems with this proposal, and there are many, result from doctrinal errors.

The doctrinal (and perhaps simply drafting) errors fall into several categories. These include, but are not limited to (1) a failure to distinguish properly between fact sets calling for judicial immunity analysis and those calling for fiduciary analysis; (2) a fully circular definition of fiduciary obligations for all trustees, except Chapter 11 trustees and; (3) the establishment of a Chapter 11 trustee's obligations that stands the meaning and direction of the Code on its head. This latter error results from the longstanding failure of scholars and courts to apply and take seriously the Supreme Court's two-time directive that the DIP derives its standards and liability from the trustee and not the other way around.[6] Yet, the recommendation of the Commission reverses the correct application of the trustee/debtor in possession relationship. Even more bizarre, the Report contains the statement that it does not alter the obligations of the DIP when it does so radically.

Throughout this article, I will pinpoint the failure of the drafter to correctly appraise basic bankruptcy law doctrine and the unfortunate consequences.

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6. *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) (noting that directors of the DIP "have essentially the same fiduciary obligations to creditors and shareholders as would the trustee for a debtor out of possession"). *See also* Wolf v. Weinstein, 372 U.S. 633, 649-50 (1963).

II. A Bankruptcy Trustee's Liability

A. *The Nature of the Bankruptcy Trustee*

It would be impossible to evaluate properly the Commission's proposal regarding trustee liability without first getting a handle on trustee liability law as it presently exists. We ought to begin by thinking about the trustee in bankruptcy and what a trustee is meant to be.

A bankruptcy trustee is one of the most peculiar of statutory creatures. He is simultaneously a fiduciary and a court appointed officer, and therein lies the problem. Where do the limits of liability in one role end and the liabilities, and limitations on liability for the other, begin? This is a daunting question and has been problematic for courts. This confusion dates from the Bankruptcy Act and, unfortunately, has been carried through to cases falling under the current Bankruptcy Code. Underlying this confusion is a simple but pervasive misunderstanding of trust law and trust law terminology among academics, lawyers, and judges.

An understanding of trust law is paramount because this is the terminology upon which the drafter of the Code relied. A "trustee" is appointed in Chapters 7 and 13, and possibly appointed in Chapter 11. No specific definition of trust law or package of trust law duties and liabilities is specified by the Code. In the absence of a fixed set of trust law definitions and duties, bankruptcy courts have fashioned a common law of trusts for use in bankruptcy cases. This common law draws upon a host of sources.[7]

7. *See generally* Bogart, *supra* note 5. These sources often include the *Restatement (Second) of Trusts* and state law trust cases. For a good recent example of how federal courts create and apply the common law of trusts to bankruptcy trustees, see *Walsh v. Northwestern Nat'l Ins. Co. of Milwaukee* (*In re* Ferrante), 51 F.3d 1473, 1478 (9th Cir. 1995). The court in Ferrante permitted a Chapter 11 trustee to sue a surety (bond company) for the acts of a prior Chapter 11 trustee in the same case who embezzled from the estate and then disappeared. The court stated:

> When a trustee receives funds as a trustee, he holds them as a fiduciary and is accountable for them. *See* Restatement (Second) of Trusts § 170(1) (1959) (trustee must administer trust *solely* in beneficiary's interest); *id.* § 172 (trustee must render clear and accurate accounts). We would have thought that proposition ineluctable. Judges have been saying as much for centuries. Yet attempts by faithless trustees to avoid their obligations continue, and new excuses are regularly erumpent.

In re Ferrante, 51 F.3d at 1479-80.

A variety of issues complicate this task. A trustee is limited by standards of care, loyalty, and impartiality, and these standards take on a somewhat different cast in bankruptcy practice. Identifying a bankruptcy trustee's beneficiaries is often difficult. The trust document, the Code, is not written consistently with an eye towards explaining the trustee's obligations. This is the opposite of what a personal trustee's trust document should aim to achieve. There is also a policy problem underlying a discussion of trustee liability in bankruptcy. Given the potentially huge array of potential beneficiaries in some cases, particularly Chapter 11 cases, there is a great and legitimate fear that trustees will be sued for mistakes in judgment or for allegations of disloyal behavior. The Report of the Commission identifies this policy concern explicitly as driving their proposal.[8]

The Commission's proposal is not yet law and may never become so. The question therefore must be: what is the best understanding of the present state of the law of trustee liability, and where has it in fact gone awry? The Commission correctly calls the present state of the law "a crazy quilt" of decisions.[9] In its explanation, the Commission focuses on the famous Supreme Court case of *Mosser v. Darrow*[10] to help define the liability of trustees. According to the Commission:

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8. *See Report of the National Bankruptcy Commission*, Oct. 20, 1997, at 860-61 [hereinafter *Report*].

> Any attempt to codify a standard for personal trustee liability runs the risk that some measures would provide too little protection and some measures would provide too much protection. Too little protection might expose a trustee to excessive personal liability and dissuade capable people from becoming trustees.

Id. (footnote omitted). Since the Report adopts a proposal that would change current law, one can presume that the drafter found the present balance deficient. Given that the new rules would give greater protection to trustees, it is fair to infer that the Commission believed that too little protection is now afforded trustees.

9. *Report*, *supra* note 8, at 859-60 (quoting memorandum from David W. Allard on behalf of the National Association of Bankruptcy Trustees, *Bankruptcy Trustees Should Be Provided a Uniform Standard of Care Governing Personal Liability—Support for a Revision of the United States Bankruptcy Code*, April 1997).

10. 341 U.S. 267 (1951). Professor Ralph C. McCullough of the University of South Carolina School of Law, published an article on the liability of bankruptcy trustees immediately prior to publication of this article. *See* Ralph C. McCullough, *Trustee Liability: Is There Enough Protection in These "Arms of the Court?"* 103 COMM. L.J. 123 (1998). I therefore did not have the opportunity to address Professor McCullough's work and contribution to the degree to which he would have otherwise been entitled. Professor McCullough discusses the confusion surrounding the personal liability of bankruptcy trustees, and then argues that these individuals should not be liable for acts of mere negligence. I encourage the reader to consult Professor McCullough's article directly.

> 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. . . . [T]rustees 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. The only Supreme Court decision in this area, *Mosser v. Darrow*, held a trustee personally liable for allowing his agents to profit at the estate's expense. Unfortunately, *Mosser* has not provided much guidance to subsequent courts and has been cited for a broad range of positions.[11]

The Commission's quotation is instructive. The Commission is entirely correct that courts have reached a wide variety of conclusions when evaluating trustee conduct and liability. And, the Commission is similarly correct that the Supreme Court's *Mosser* decision has resulted in much confusion. But, the Commission is wrong to suggest that *Mosser* did not provide useful guidance. As we shall see in a minute, *Mosser* has been incorrectly interpreted and implemented by a variety of courts. The Supreme Court's mistake was not in reaching the wrong result, but simply in a sloppy use of trust law terminology. What is frustrating is that the Commission had the opportunity to reflect upon and then to clarify case law that relies upon *Mosser*, but failed to do so. Although the law that emerged in the wake of *Mosser* is confusing, a thoughtful explanation of legal doctrine eliminates this confusion: *Mosser* is correct and should be applied and maintained. Not only does the Commission miss this opportunity, but it actually repeats the worst of the doctrinal errors and perpetuates and (if successful) codifies a doctrinally unsound and confusing statement of trustee liability.

1. *Two Cases*: Mosser v. Darrow *and* Sherr v. Winkler.—To understand the state of the common law of bankruptcy trustee liability now and the mistakes of the Commission, we must look at two very important cases in the area. As it happens, both predate the Code. One is the just mentioned Supreme Court case of *Mosser v. Darrow*, and the other is the Tenth Circuit Court of

11. *Report*, *supra* note 8, at 860-61 (citations omitted).

Appeals case *Sherr v. Winkler*.[12] The former opinion can rightly be accused of imprecision in the use of trust language, but *not* of outright error. The latter opinion seizes upon this imprecision and inserts into the law blatant errors which manifest themselves to this day. The end result has been unfortunate: many bankruptcy courts protect trustees from personal liability on the basis of derived judicial immunity in cases when that doctrine is inappropriate. Courts also distinguish between a trustee's breach of the duty of care and breach of the duty loyalty, refusing to impose liability for the latter. And, because the duties and liabilities of the DIP derive from those of the trustee in bankruptcy, the DIPs will presumably be similarly treated.

a. Mosser v. Darrow.—Much of the confusion surrounding the trustee's liability may be traced to the 1951 Supreme Court decision, *Mosser v. Darrow*.[13] In that case, a bankruptcy trustee was held personally liable for the self-dealing of his employees.[14] The employees were founders of two common law trusts in reorganization.[15] The trustee permitted these individuals to trade securities in the trusts during the reorganizations.[16]

Now, as the reader no doubt already knows, a trustee that trades in a debtor's securities engages in self-dealing, a breach of the duty of loyalty rather than care. Indeed, the Court specifically stated that "principles of negligence" were not involved in *Mosser*.[17] The Court recognized that negligence principles would be appropriate in other instances, specifically where a trustee failed to "detect defalcations."[18] (This latter language is classic "duty of care" terminology, identifying a trustee as negligent for failing to use the care of a reasonable and prudent trustee to discover diversions from the trust). Instead, the Court identified the trustee's failure as the "willful and deliberate setting up of an

12. 552 F.2d 1367 (10th Cir. 1977).
13. 341 U.S. at 267.
14. *See id.* at 272.
15. *See id.*
16. *See id. See generally* Bogart, *supra* note 5, at 208-10; E. Allan Tiller, *Personal Liability of Trustees and Receivers in Bankruptcy*, 53 AM. BANKR. L.J. 75, 94-96 (1979). Tiller's article and his important, if too often ignored, contributions are discussed in detail, *infra* Part II.B. *See also* McCullough, *supra* note 10 (citing Tiller throughout his piece).
17. *Mosser*, 341 U.S. at 272.
18. *Id.*

interest in [the trustee's] employees adverse to that of the trust."[19] The following paragraph is the culprit and caused this terrible confusion:

> We see no room for the operation of the principles of negligence in a case in which conduct has been knowingly authorized . . . . The 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 [the trustee's] employees adverse to that of the trust.[20]

Unfortunately, the Supreme Court did not approach *Mosser* with a forthright use of trust law terminology. This might have nipped the problem in the bud. The Court could have referred to a breach of the "duty of care" instead of "principles of negligence" and the "failure to detect defalcations." Similarly, the Court could have discussed whether the trustee breached his "duty of loyalty" rather than asking whether he willfully and deliberately set up an interest adverse to that of the trust. The Supreme Court is not known for using trust law language well, and its choice of words in *Mosser* is, therefore, unsurprising.[21]

b. Sherr v. Winkler: *The One-Two Punch.*—Debate and differing judicial opinion has arisen from the "willful and deliberate" language the Court used in *Mosser.* The misreading of *Mosser* found its most important voice in the Tenth Circuit opinion *Sherr v. Winkler.*[22] As we shall see, this misreading is just one mistake the Tenth Circuit made.

i. A Breach of the Duty of Loyalty Begets Personal Liability; A Breach of the Duty of Care Does Not.—The Sherr court determined, based on *Mosser*, that a trustee would only be held personally liable for a breach of his duties to the extent that the breach was "willful and deliberate."[23] When a person acts deliberately, and makes decisions that he knows to be stupid or

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19. *Id.*
20. *Id.*
21. I made this point in my prior article. *See* Bogart, *supra* note 5. *See* John H. Langbein, *The Supreme Court Trusts,* 1990 SUP. CT. REV. 207 (cited in Bogart, *supra* note 5, at 202 n.260).
22. 552 F.2d 1367 (10th Cir. 1977).
23. *See id.* at 1375.

unwise, then that person acts *disloyally*. Think about a trustee's duty to protect and preserve property. If a trustee fails to leave the warm water dripping in the faucets of a commercial, but unoccupied building during the winter, and the pipes burst as a result, we would say that he is negligent. But, if he *deliberately* leaves the water off, hoping that the pipes will burst, we would not say that he is negligent. By doing so deliberately, he transforms his behavior from a breach of the duty of care into a breach of the duty of loyalty.

Under the rubric of *Sherr*, however, negligent actions never result in personal liability. Only actions that are deliberate would, as a matter of course, result in personal liability. Negligent actions of a trustee would result in "official" liability only. In other words, the trust estate would cover the damage resulting from the breach of care; the trustee would not pay out of his own pocket.

I have previously written:

> No policy reason in either trust or bankruptcy warrants treating the fiduciary duties of care and loyalty differently for the purpose of determining a trustee's personal liability. The purpose of fiduciary obligations is to deter a trustee from engaging in sloppy or disloyal behavior. These devices are necessary because the cost of monitoring a trustee's behavior is high, and because the beneficiaries are vulnerable to the trustee's misbehavior. Fiduciary obligations are meaningless if a trustee cannot be held liable for a breach. It makes no sense then to say that a trustee who breaches an obligation of care does not incur liability. If courts are concerned that trustees are too easily exposed to liability, the remedy is to grant trustees wider discretion in the performance of his or her duties—that is, to make the determination of a breach more unlikely.[24]

Yet, this is precisely what the Tenth Circuit, and those circuits and courts following that court, have done. Where a trustee is held to have acted negligently, even by the very generous (if somewhat different) standards applied to bankruptcy trustees in Chapters 7 and 11 cases, these courts do not surcharge the trustee.[25] In other

24. Bogart, *supra* note 5, at 211.

25. With time and inclination, this article might be used as a springboard for a comprehensive discussion of a trustee's fiduciary obligations in bankruptcy. However, my 1994 article attempted just such a treatment, therefore, it is not my goal to rehash that article here beyond what is necessary to evaluate the Commission's proposal. Interested readers

words, the estate, not the trustee himself, picks up the tab for the trustee's negligent acts.

It would have been better, and made the error of the *Sherr* court more obvious, if that court had spoken clearly in trust law terms. According to the *Sherr* court, a trustee will not be liable for his breach of the duty of care, but he will be liable for his disloyal conduct.[26] One then must ask: what policy or legal analysis supports this odd result? The *Sherr* court's decision is contrary to normal trust law because the only question typically asked is whether the trustee breached *any* fiduciary duty. It does not matter which duty is breached. A breach is a breach is a breach. As noted, the Supreme Court did not require this result in *Sherr*, and, therefore, the most important precedent does not support this difference in result.

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are encouraged to digress to that earlier piece. *See* Bogart, *supra* note 5, at 186-204. Still, some elucidation would be useful. According to the *Restatement*, a trustee must possess "such care and skill as a man of ordinary prudence would exercise in dealing with his own property." RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). Bankruptcy courts have largely adopted this formulation of a trustee's duty of care in the collection and preservation of the assets of the estate. *See* George Benz & Sons v. Lovett (*In re* Scwen's, Inc.), 20 B.R. 638, 641 (Bankr. D. Minn. 1982) (adopting as the standard of care "that of an ordinarily prudent person in the conduct of his or her private business under similar circumstances"). *See also In re* Rollins, 175 B.R. 69, 73 (Bankr. E.D. Cal. 1994) (quoting section 170 of the *Restatement (Second) of Trusts*). Where a trustee operates an ongoing business (as is often the case), courts grant trustees wide discretion; care has, therefore, come to mean something a bit more generous in this context. *See In re* Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) ("[D]isagreements over business policy are not amenable to judicial resolution."). The meaning of loyalty for personal trustees, as for bankruptcy trustees, has largely the same meaning. The *Restatement* rather broadly states that a trustee acts under the "duty to the beneficiary to administer the trust solely in the interest of the beneficiary with such care and skill as a man of ordinary prudence would exercise in dealing with his own property." RESTATEMENT (SECOND) OF TRUSTS § 170.

Courts often react spiritedly to evidence of self dealing, conflicts of interest, or appearances of impropriety on the part of bankruptcy trustees. For a particularly noteworthy example, see *Stubb v. Estrada (In re San Juan Hotel Corp.)*, 71 B.R. 413 (D. P.R. 1987), where a trustee was surcharged for prolonging the life of a Chapter 11 case for the sole purpose of receiving a salary in connection with the case and taking advantage of the extensive amenities of a hotel during the reorganization. *See also*, Walsh v. Northwestern Nat'l. Ins. Co. (*In re* Ferrante), 51 F.3d 1473 (9th Cir. 1995) (permitting a successor Chapter 11 trustee to bring suit against the surety of the original trustee to recover funds embezzled by the original trustee).

The Commission notes briefly that trustees are subject to fiduciary obligations, although it does not explain the sources of these obligations in any serious manner. *See Report*, *supra* note 8, at 859-60. The Commission states only that "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 . . . ." *Id.* (footnotes omitted).

26. *See Sherr*, 552 F.2d at 1375.

Courts may be concerned that trustees will be unwilling to serve if hit too often and too hard with allegations of incompetence. But if this is so, it would make more sense to address this concern within the confines of intelligible doctrine and trust law rather than rejecting the basic operative elements of that doctrine. For example, (and the Commission's proposal would do this as well) the standard of care for a bankruptcy trustee may be lowered to such a degree that incompetent behavior is difficult to find but in the most rare of cases. But, if this kind of behavior is ultimately found, why should trust beneficiaries (creditors) be in a worse position than if disloyal behavior were uncovered?

Careful doctrinal analysis and a deliberate use of trust law terminology unwind the *Sherr* court's mistake. The Tenth Circuit correctly noted that the trustee in *Mosser* was held personally liable for his wrongdoing (a breach of loyalty).[27] The Tenth Circuit then manifested a very basic but nevertheless very important misunderstanding of trust law terminology. Apparently, it read the Supreme Court's statement that a trustee might be "surcharged" for negligent failure to "detect defalcations" to indicate that a surcharge represents something *other* than personal liability.[28] In trust law, and as applied by the Supreme Court in Mosser, surcharge and personal liability are one and the same.[29]

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27. *See id.*

28. *See id.* This error again results from a sloppy and simple misreading. The Tenth Circuit read *Mosser* to mean (1) only disloyal activities result in personal liability, and (2) surcharges apply to negligent actions. *See id.* The *Sherr* court was apparently troubled by the fact that the word "surcharge" appears in the same phrase as "negligence" and reasoned that the two words belong inextricably together. But since the Court did not suggest negligent actions do not result in personal liability, the second reading—that surcharges apply only to negligent actions—also fails.

29. "The language of Sherr is questionable, in that it tries to distinguish the surcharge of a trustee from personal liability . . . . Mosser made no such distinction." Tiller, *supra* note 17, at 99. Quickly on the heels of the *Sherr* court, other courts rejected the *Sherr* court's misapplication of *Mosser*. *See, e.g.*, Hall v. Perry (*In re* Cochise Park, Inc.), 703 F.2d 1339, 1357 n.26 (9th Cir. 1981) (noting that surcharge and personal liability are one and the same). *See generally* Bogart, *supra* note 5, at 210-11. It is not entirely possible to determine exactly where each circuit stands on the issue of personal liability of trustees. The Ninth Circuit rejects the *Sherr* court's reading in *United States v. Aldrich* (*In re Ridgen*), 795 F.2d 727 (9th Cir. 1986) and the Second Circuit does so in *In re Kirchenbaum*, 766 F.2d 723 (2d Cir. 1985). The other prime culprit in perpetuating this misreading of *Mosser* is the Sixth Circuit. *See* Ford Motor Credit v. Weaver, 680 F.2d 451 (6th Cir. 1982). *See also* Yadkin Valley Bank & Trust Co. v. McGee, 819 F.2d 74 (4th Cir. 1987). *See generally* Bogart, *supra* note 5, at 209 n.303. Courts in other jurisdictions continue to criticize these opinions. A good recent example would be a case out of the New Hampshire Bankruptcy Court, which falls under the jurisdiction of the First Circuit. *See In re* Barrows, 171 B.R. 455, 457 (Bankr.

ii. Derived Judicial Immunity Versus Fiduciary Doctrine.—The court in *Sherr* made another even more destructive error.[30] That court mingled two absolutely distinct legal doctrines: fiduciary analysis and derived judicial immunity. Indeed, the court's entire analysis of a trustee's personal liability for negligent as opposed to disloyal activity may have been *unnecessary*. The trustee in *Sherr* was sued by a non-beneficiary of the debtor's estate for a tort, not by a beneficiary for breach of fiduciary obligations. The only analysis called for is that of derived judicial immunity. And that analysis is simple: so long as a trustee was acting within the scope of his authority, a trustee, like a judge, cannot incur personal liability.

In *Sherr*, the plaintiffs alleged that the Chapter X trustee procured a Turnover Order of "funds realized from production of oil belonging to plaintiffs."[31] Trustees in bankruptcy reorganizations and liquidations, (both under the Act and today under the Code) may use and dispose of "property of the estate." Property belonging to a person other than the debtor, or property in which the debtor has no rights, is not property of the estate. The plaintiffs in *Sherr* were not creditors of the debtor. Their only interest in the bankruptcy was the return of their funds, and these funds were not rightfully in the hands of the trustee. The trustee did not act maliciously by taking the funds, nor even negligently. This was simply a very difficult and complex reorganization, and determining which funds from which production assets belonged to

D. N.H. 1994) ("We reject the approach of the Tenth and Sixth Circuits which, in an apparent misreading of the seminal case of *Mosser v. Darrow*, have concluded that a bankruptcy or reorganization trustee may be held personally liable only for damages only for injuries arising from intentional—as opposed to negligent—conduct.") (citations omitted). Similarly, recent scholarly opinion continues to view the *Sherr* opinion as a misreading of *Mosser v. Darrow* and to argue that bankruptcy trustees must be held personally liable for negligent behavior. *See* Carlos J. Cuevas, *The Myth of Fiduciary Duties in Corporate Reorganization Cases*, 73 NOTRE DAME L. REV. 385, 392-93 (1998). Professor Cuevas states:

> With all due deference, the Tenth and Sixth Circuits misconstrued *Mosser v. Darrow*. The Supreme Court never discussed the issue of what was the standard for imposing liability on a trustee for breach of fiduciary duty. Thus, as a matter of law, these courts have misinterpreted the law, and made the enforcement of fiduciary duties against a debtor-in-possession more difficult.

Id. at 392.

30. The error was destructive in the sense that any hope for a doctrinally consistent and satisfying analysis was placed beyond reach.

31. *Sherr*, 552 F.2d at 1369.

the debtor was an unusually daunting task. The trustee was proven wrong in due course, but he was not proven to be foolish.[32]

Unfortunately, the *Sherr* court ignored the correct and basic analysis of the problem. It should have identified the case as one in which a plaintiff, to whom no fiduciary duties were owed by the trustee, was suing for the return of his property. In this case, the only issue is whether the trustee acted within the scope of his authority. If so, even if the trustee was wrong (as he was in *Sherr*), he would not be any more liable to the plaintiff than a bankruptcy judge whose ruling is, by appeal or academic discourse, later proven to be wrong. Them's just the breaks: we all take the chance in a society driven and controlled by the rule of law that the judge may be wrong.

As is so often the case, baseball may be the best metaphor (thus, I digress from one religious metaphor into another). The umpire may be wrong and call a player "out" when trying to steal second; the player may show his displeasure, but he cannot *sue*. Vis-a-vis non-beneficiaries of the debtor's estate, the trustee is an umpire, nothing more.[33]

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32. "The trial court found that Winkler [the trustee] acted 'in a fair and proper way in marshalling the assets' of the estate located in numerous states and that following the hearing on October 9, 1970, Winkler acted properly, in good faith, and without negligence in connection with the turnover proceedings." *Id.* at 1371 (citations omitted). The Tenth Circuit evaluated the factual record and then determined that the trial court's conclusions were not "clearly erroneous." *Id.* at 1376.

33. The trustee has the capacity to sue and be sued as representative of the estate. *See* 11 U.S.C. § 323(b) (1994). Rule 6009 of the Federal Bankruptcy Rules of Civil Procedure further provides the trustee of the DIP the right to prosecute cases, appear and defend those cases in front of any tribunal. *See* FED. BANKR. R. CIV. P. 6009. *See generally* WILLIAM MILLER COLLIER, COLLIER ON BANKRUPTCY § 323.03 (15th ed. 1997). The concept of qualified immunity from suit for governmental officials and persons operating under the auspices of a court is not limited to bankruptcy trustees. This is an important concept with broad application. For a nice statement of this general idea, see *Bush v. Rauch*, 38 F.3d 842, 847 (6th Cir. 1994). In that case, the Sixth Circuit held a former probate court administrator immune from suit. *See id.* The court officer assessed the stability and maturity of a minor and incorrectly labeled the child as nonviolent. *See id.* The operators of a non-secure "juvenile detention home" with whom the child was placed suffered at the child's hands and brought suit against the officer in both the officer's official and individual capacities. *See id.* at 842-43. The court's language immunizing the probate officer describes generally the concept of derived judicial immunity and applies equally well to bankruptcy trustees who act under the specific instructions of a bankruptcy court. The court stated:

> It is well established that judges are entitled to absolute judicial immunity from suits for money damages for all actions taken in the judge's judicial capacity, unless these actions are taken in the complete absence of any jurisdiction. Moreover, absolute judicial immunity has been extended to non-judicial officers who perform "quasi-judicial" duties. Quasi-judicial immunity extends to those

There is an easy way to answer the question of whether a trustee is entitled to derived judicial immunity. If the trustee in bankruptcy enters a contract and breaches it, or if the trustee is alleged to have committed a tort, then the trustee ought to be able to defend himself on the grounds that he was acting within the scope of his authority and thereby assert the defense of derived judicial immunity. A trustee may, in fact, breach a contract or, by his actions, commit a tort. The aggrieved parties will then file suit, often outside of bankruptcy court, for damages.

But when any party sues a trustee in bankruptcy alleging that the trustee breached some duty of care or loyalty owed to the plaintiff, and therefore a fiduciary duty, there is no basis for protecting the trustee pursuant to his derived judicial immunity.[34]

> persons performing tasks so integral or intertwined with the judicial process that these persons are considered an arm of the judicial officer who is immune. The Supreme Court has endorsed a "functional" approach in determining whether an official is entitled to absolute immunity. Under this approach, a court "looks to" "the nature of the function performed, not the identity of the actor who performed it."

Id. at 847 (citations and footnotes omitted). Individuals serving in the Office of the United States Trustee therefore receive this official judicial immunity. *See In re* Swift, 185 B.R. 963, 969-70 (Bankr. N.D. Ga. 1995) ("Under this established reasoning, case law has firmly established that, as an arm of the bankruptcy court, the Trustee merits such quasi-judicial immunity. Accordingly, the law will absolutely immunize the Trustee for his conduct, unless he has acted in the clear absence of any authority regarding this matter.") (footnotes omitted). In *Swift*, the United States Trustee was sued for slander and libel in response to the Trustee's motion demanding that lawyers for the Chapter 11 debtor disgorge fees. *See id.*

Bankruptcy trustees who act on specific instructions of the court after disclosing all material information are, in reality, "an arm of the court." To this extent, they deserve the same immunity a judge would receive for enforcing the orders on his own. *See In re* Kashani, 190 B.R. 875, 884 (B.A.P. 9th Cir. 1995) ("It has long been established that a bankruptcy trustee is an officer of the appointing court. As an officer of the court, the trustee is entitled to a form of derivative judicial immunity from liability for actions carried out within the scope of the trustee's official duties."). However, bankruptcy trustees do not usually obtain this discrete guidance from bankruptcy courts when dealing with estate property for the benefit of creditors, and, therefore, as between the trustee and his beneficiaries, the policy of granting absolute immunity from suit by creditors and the debtor does not ordinarily exist.

34. Although the *Sherr* court and its progeny confuse these two doctrines, other courts do not. For example, the court in the recent case of *Tennsco Corp. v. Estley Metal Products, Inc.*, 200 B.R. 542 (D. N.J. 1996) correctly separates immunity and fiduciary law analyses. *Tennesco* epitomizes the correct use of judicial immunity. In *Tennsco*, the plaintiff purchased property from the debtor during a Chapter 11 case. *See id.* at 543. The trustee in bankruptcy issued the deed. *See id.* The plaintiff later determined, to its chagrin, that the property was contaminated by environmental waste. *See id.* at 544. Plaintiff sued the trustee demanding that the trustee be held personally liable. *See id.* at 543. The court noted that the plaintiff was a "non-party" to the bankruptcy—that is, it had a contractual relationship

Trustees are simply not "immune" from suits brought by their beneficiaries.

There is only one instance in which it might be appropriate to say that a bankruptcy trustee is immune from suit against allegations that he acted negligently or disloyally. Such a situation may arise when the trustee receives specific instructions from the bankruptcy court to follow some course of action. If the trustee revealed all material information to the court and interested parties had notice and hearing, then the trustee, at worst, was following the specific instructions of the court and should be immune from suit, even as against beneficiaries of the trust.[35] In practice, such

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with the debtor but was not a creditor. Instead, the plaintiff sought to sue the debtor and trustee to establish their liability under both state environmental law and the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). *See id.* at 544.

This is similar to suing a trustee for his breach of a contract, or commission of a tort, post-petition. (Forcing liability under environmental laws would seem to be a combination of the two, and perhaps something more). In any event, the question remains whether the trustee was acting within the scope of his authority when issuing the deed and when making any representation about the property. In this case, the court determined that the trustee acted within his authority and should be immune from suit. *See id.* at 544-45. The court noted that "there is a strong public policy in protecting bankruptcy trustees, since the imposition of personal liability on bankruptcy trustees for unintentional tortious acts to non-parties to the bankruptcy proceeding would create a significant disincentive to trustee service." *Id.* at 545 (footnote omitted). Yet, the court also explicitly and correctly noted that this policy would not operate where a trustee is sued by beneficiaries of the bankruptcy trust for alleged breaches of fiduciary obligation. The court stated:

> Moreover, no breach of fiduciary duty by [the trustee] occurred. The sale of the property by [the trustee] took place as a part of the bankruptcy proceedings, with [the trustee] acting within the scope of his authority as the bankruptcy trustee for [the Debtor's estate]. Therefore, since no breach of fiduciary duty occurred, the negligence standard [otherwise applicable to trustees in the Third Circuit] is irrelevant to the issue at hand.

Id. *See also* Illinois Dep't of Revenue v. Schechter, 195 B.R. 380, 384 (N.D. Ill. 1996) ("[I]t is well settled that a trustee cannot be held personally liable unless he acted outside the scope of his authority as trustee, i.e., acted ultra vires, or breached a fiduciary duty that he owed as the trustee to some claimant."). *Cf.* Walsh v. Northwestern Nat'l Ins. Co. of Milwaukee (*In re* Ferrante), 51 F.3d 1473, 1478 (9th Cir. 1995) (Trustees may be held personally liable for breach of fiduciary duties; the embezzlement of funds from the estate is a clear violation of the duty of loyalty to creditors.).

35. *See In re* Markos Gurnee Partnership, 182 B.R. 211, 218 (Bankr. N.D. Ill. 1995); *In re* Rollins, 175 B.R. 69 (Bankr. E.D. Cal. 1994) (holding that the trustee was not immune from personal liability in a suit by a creditor of the estate where the trustee did not reveal all material information of the court when obtaining a court order to abandon property). *See also* Bogart, *supra* note 5, at 208 (noting that it would be "an unlikely event" for a bankruptcy trustee to receive instructions of this sort). *See also* McCullough, *supra* note 10, at 140-41.

instructions are not that common.[36] Bankruptcy courts would be unable to function if they constantly entertained trustees' requests to review the decisions that the trustee was hired to make.

Given this analysis, the job of the *Sherr* court was easy. The court should have noted only that the trustee was acting within the scope of its authority when it incorrectly identified some of the oil well proceeds as the debtor's. The court noted the inexperience of the trustee, but also the necessity that the trustee complete the difficult business of collecting all of the property of the estate. Indeed, the larger the debtor's business the more likely that a mistake will be made. Instead, the court embarked on the rocky road of fiduciary analysis, even though no beneficiaries were present.[37] The court confused these two distinct, but important, doctrines.[38]

Other courts have followed the lead of the Tenth Circuit and incorrectly evaluated trustee behavior under fiduciary guidelines

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36. This is not to say that trustees never seek and receive guidance. For example, see *Holywell Corp. v. Bank of N.Y. (In re* Holywell Corp.), 177 B.R. 991 (S.D.N.Y. 1995). In *Holywell*, the trustee sought and received instructions from the bankruptcy court to sell encumbered property and to pay taxes out of proceeds of the sale. After a series of appeals, the Supreme Court reversed the bankruptcy court. The debtors filed suit against the trustee in both his representational and individual capacity for "breach of fiduciary duty, gross negligence, and conspiracy to injure another in the trade, practice or profession." *Id.* at 991. The bankruptcy and district courts disagreed with the debtors, however, and determined that the trustee was immune from the suit of these beneficiaries of the bankruptcy trust because the trustee had been following lawful and correctly obtained instructions. *See id.* at 998-99 (affirming the bankruptcy court's determination that "the Trustee complied with each court order governing the tax issues [and] [u]pon the trustee being acquired to file returns and pay taxes") (citations omitted).

37. *See Sherr*, 552 F.2d at 1375-76. The court in *Markos Gurnee Partnership* correctly states the rule as follows: "A bankruptcy trustee is personally liable for breach of a duty to the estate or to creditors of the estate, but may protect against such liability by obtaining a court order authorizing contemplated action." *In re* Markos Gurnee Partnership, 182 B.R. at 218. The *Markos* court distinguished properly between judicial immunity afforded trustees as against non-beneficiaries of the estate and the limited immunity granted to trustees as fiduciaries upon a lawfully obtained court order. The court stated:

> It is important to recognize that the "immunity" flowing from a court order directing trustee action is distinct from the personal immunity discussed above. Court orders protect trustees from surcharge for action potentially violative of their bankruptcy-related fiduciary duties; this immunity requires notice to affected parties and disclosure of relevant facts. 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 without the need for notice or a court order of any kind.

Id. at 220.

38. *See* Tiller, *supra* note 16, at 99-102; Bogart, *supra* note 5, at 206-08.

when the only issue should have been the trustee's derived judicial immunity—that is, whether the trustee functioned properly as the "umpire."[39]

Yet, there are times when it is not enough for a trustee to say, "I acted within the scope of my authority." A trustee cannot hide behind this mantle when responding to complaints of the beneficiaries of the trust. The very nature and rationale of trust law relationships is that one party (the trustee) holds the property or wealth of another (the beneficiary) for the other's benefit. In the case of bankruptcy law, the assets of the debtor (property of the estate) are held for the benefit of the debtor and creditors. Why then should it matter that the trustee acted within the scope of his authority if he damaged the beneficiary?

For example, turn around the facts of *Sherr.* Assume that a creditor brings a complaint against the trustee alleging that the trustee either negligently or disloyally failed to collect all of the assets of the estate.[40] The trustee would surely be acting within the scope of his authority when deciding, under the gun, to pursue some assets and forego others. A creditor, examining the trustee's behavior, may nevertheless see, or at least allege, facts supporting a claim of negligence. Would, and should, the trustee's answer that he was acting "within the scope of his authority" form a valid shield?

There is an inherent moral hazard in these types of relationships. The beneficiaries suffer a loss of value when a trustee negligently handles or disloyally misuses trust property. Trust law, therefore, creates a set of fiduciary duties for the express purpose of forcing the trustee to internalize risks that normally fall on the beneficiaries. Not only does the rationale for judicial immunity fail to apply here, imposing this doctrine actively interferes with the regulation of the trust relationship.

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39. *See, e.g.,* Weisman v. Hassett, 47 B.R. 462, 465-66 (S.D.N.Y. 1985); Searles v. Dye (*In re* Noakes), 104 B.R. 323, 326-27 (Bankr. D. Mont. 1989). In truth, these are the same cases that I cited in 1994. *See* Bogart, *supra* note 5, at 207, n.294. As I said in my prior article, courts more typically (and incorrectly) inject immunity language into cases calling for fiduciary analysis. *See id.* I have not discovered any more recent cases making the identical mistake to *Sherr,* that is, injecting fiduciary analysis into cases calling solely for fiduciary analysis.

40. Or, as where the trustee had a pre-existing relationship with another creditor and chose to forego a preference action.

Unfortunately, some courts apply immunity language and doctrine where fiduciary relationships exist.[41] One might say simply that negligent behavior is never within the scope of the trustee's authority. Courts say much the same thing about disloyal behavior. But this would permit the continued confusion of the two doctrines. I suggest a more direct approach: issues of negligence and disloyalty are all that matters in cases where beneficiaries bring complaints. Similarly, although facts leading to a determination of negligence and disloyalty might be adduced in a trial by a non-beneficiary against the trustee, one can only be disloyal or incompetent vis-a-vis persons to whom one owes these duties. As I note below, this is, unfortunately, an error that the Commission makes.

I have previously written that the *Sherr* court, and other courts that evaluate the behavior of trustees in bankruptcy, could avoid these basic errors in doctrine by simply asking the "foundational" question: is the person who brings this suit in a fiduciary relationship with the trustee? In other words, the bankruptcy court's first job is simply to carefully parse through the facts and classify the party wronged by the trustee's actions.

B. *Tiller, Bogart, and Thoughtful Case Opinions*

I evaluated and wrote about this doctrinal confusion in 1994.[42] That section of my article in the *American Bankruptcy Law Journal* was largely an update of what E. Allan Tiller wrote in the *American Bankruptcy Law Journal* in 1979. This scholarly record was available for the drafters to read.

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41. For example, see *Dana Commercial Credit v. Nisselson (In re Center Teleproductions, Inc.)*, 112 B.R. 567, 576 (Bankr. S.D.N.Y. 1990). *See generally* Bogart, *supra* note 5, at 207.

42. *See* Bogart, *supra* note 5, at 202-12. That article carefully evaluated the differences between fiduciary and immunity analysis and the occasional mistaken confused application of these doctrines by bankruptcy courts. However, that article attempted more than an analysis of whether trustees may be held personally liable and under what circumstances. The largest portion of that article examined the nature of fiduciary obligations in Chapter 11. Specifically that portion of the article examined (1) the rationale of subjecting directors of the DIP to duties of care and loyalty; (2) whether a business judgment rule truly operates in Chapter 11 and; (3) the meaning of a duty of "impartiality" in Chapter 11. Finally, the article presented a focused examination of two specific cases, *Fulton State Bank v. Schipper (In re Schipper)*, 109 B.R. 832 (Bankr. N.D. Ill. 1989), *aff'd*, 112 B.R. 917 (N.D. Ill. 1990), *aff'd*, 933 F.2d 513 (7th Cir. 1991); and *In re Integrated Resources, Inc.*, 135 B.R. 746 (Bankr. S.D.N.Y. 1992), *aff'd*, 147 B.R. 650 (S.D.N.Y. 1992).

In fairness, there are a multitude of articles on bankruptcy law on law library shelves. Every law professor and lawyer who has published an article that addresses some issue that is dealt with by the Commission in its report might, with puffed up self-importance, say, "If they had just read my article, they would not have made this mistake." In my case, I buried my discussion of trustee liability fifty-five pages into a one hundred and ten page article (and thereby committed an error traditional to younger law professors on the tenure track).

However, Mr. Tiller's piece was out there, on point, and also in a journal devoted entirely to bankruptcy issues. It appeared in 1979, just after the enactment of the 1978 Bankruptcy Code, and it followed the decision that it specifically criticized, *Sherr v. Winkler*. It nailed the doctrinal errors committed by the *Sherr* court.

Careful legal analysis and citations accompanied each of the Commission's proposals. The Report was not intended just to list proposals, but to persuade. And each proposal was discrete and reflected independent and thorough work. Mr. Tiller's article should have been noted, if only to be rebutted.

But even without spotting scholarship directly on point, the doctrinal error the Commission committed is one courts have grappled with, and one that, however inelegantly, the Commission recognized by noting the confusion in the area. Instead of resolving the problem, the Commission proposes to make it part of the statute itself.[43]

Well then, one wonders if anything has happened in the law of trusts, in bankruptcy law, or in the conventional understanding of derived judicial immunity, to change Mr. Tiller's (and my) conclusions since we published our respective views on the subject. The answer is, unsurprisingly, no. Courts have not become more sophisticated, at least on this set of issues, and both academics and courts continue to make the same mistakes.[44]

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43. Indeed, this raises a serious question about what law professors do and whether what we do matters. Law professors played important roles in the Commission process. Why write if we are not read? With a significant rewriting of the Code in progress, one expects that the drafters would look to the efforts of legal scholars over the last twenty years. Now, it would be impossible to read everything, or even a large portion of all that was written on bankruptcy issues in that time. But once particular aspects of the operation of the Code were identified as "subject to rewrite," it would have been possible to create a list or bibliography of articles directly on point.

44. The Commission's Report is itself an academic document (no pun intended, it may or may not be rendered "academic") and is, therefore, an example of the continuing failure

Still, not all circuits and bankruptcy courts make this error. For example, in the case of *In re Rollins*,[45] Judge Michael S. McManus, of the Eastern District of California, recognized the distinction between immunity doctrine and fiduciary doctrine. *In re Rollins* was a Chapter 7 case. The trustee made the foolish decision to rely entirely on the word of the debtor for information about an inheritance that should have been property of the estate.[46] As the court correctly noted, the trustee in a Chapter 7 filing has a non-discretionary duty to promptly investigate assets of the estate and then collect those assets. The United States Trustee filed a motion to surcharge the trustee, that is, to hold the trustee personally liable.[47] The trustee had an obviously difficult time arguing that his behavior was reasonable. Instead, the trustee suggested that his failure to investigate was the *court's* fault because the bankruptcy court, on the trustee's motion, ruled that the trustee should abandon the inheritance. Unfortunately, the trustee filed this motion after the debtor "had [already] disappeared" with the money.[48]

Judge McManus identified the correct rule and surcharged the trustee. According to the judge, "[w]hen sued by someone other than a debtor or a creditor, the trustee may also claim a limited immunity."[49] This immunity, according to Judge McManus, may be incurred on the basis of tort or contract law but not fiduciary law. According to the judge, the only time a trustee may claim derived judicial immunity when sued by a beneficiary is "[i]f a trustee, prior to taking action, and after making a full disclosure of all relevant facts, obtains a court order . . . ."[50] In *Rollins*, the trustee failed to make one critical disclosure: the fact that the debtor absconded with the money. Judge McManus is to be commended for untangling a doctrinal knot that eluded the Commission.

As noted, *Rollins* was a Chapter 7 case. But there is nothing in the Code to indicate that the fiduciary obligations of Chapter 7

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of scholars and courts to make sense of judicial immunity and trustees' duties.

45. 175 B.R. 69 (Bankr. E.D. Cal. 1994).

46. *See generally id.*

47. *See id.* at 73.

48. *Id.* at 77.

49. *Id.* at 77, n.7.

50. *In re Rollins*, 175 B.R. at 77. *See also In re* Markos Gurnee Partnership, 182 B.R. 211, 218 (Bankr. N.D. Ill. 1995).

trustees differ from those of Chapter 11 trustees. True, Chapter 7 trustees and Chapter 11 trustees have somewhat different responsibilities under sections 704 and 1106, but nowhere in these sections do the drafters deign to tell us the extent of the trustee's personal liability or explain the trustee's duties of "honesty," "loyalty" and "care." I suppose there may be reasons to apply different standards of care at different times in Chapters 7 and 11. But, do we really want "loyalty," "deceit," and "self dealing" to mean different things in different chapters? No case suggests this is warranted, and no philosophy supports it.

As to the duty of care, there is a rationale for a difference in obligation and, therefore, in personal liability of the trustee. A trustee managing a massive Chapter 11 bailout and facing innumerable business decisions demands wide discretion. His goal is to resuscitate the business. On the other hand, the prototypical Chapter 7 requires the trustee to collect property of the estate and then to distribute it. In Chapter 7 cases, the goal of the trustee is to "preserve" the estate; let the creditors waste the property if that is to happen. Chapter 11 trustees, and their debtor in possession predecessors, may have to do more than simply preserve the estate. The business continues, competition continues, markets change, and choices must be made. Discretion is necessary and case opinion provides this to trustees.[51] Yet, the Code does not actually hint at different standards of care or liability.

But if you think about it for more than a moment, 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.[52] The reason is simple: Chapter 7 trustees are occasionally forced to run ongoing businesses in the hopes of selling them whole during bankruptcy, and, conversely, Chapter 11 trustees often liquidate parts, and perhaps even all, of the debtor's estate.[53] A Chapter 7 trustee running an ongoing business will be faced with

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51. In my article in the *American Bankruptcy Law Journal*, I argued that, while this discretion is wide, it is not truly equivalent to that afforded by the "business judgment rule." Bogart, *supra* note 5, at 222-24. Other scholars and certainly courts have described Chapter 11 care requirements in this way, but careful analysis of what bankruptcy courts actually do indicates that courts always consider the substance of the trustee's decision even where an obviously rational basis existed for that action. *See id.*

52. That is, I do not want Congress to amend the Code to institute these standards.

53. Chapter 11 explicitly recognizes the possibility of a liquidating plan in section 1141(d)(3) which denies the debtor a discharge if the debtor is liquidated and ceases business as a result of the plan.

all of the same worries and choices as a Chapter 11 trustee running the same business. Moreover, a Chapter 11 trustee liquidating the debtor's estate pursuant to the plan should have as his primary responsibility the collection and preservation of the debtor's estate prior to the distribution to creditors. 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."

It should come as no surprise that "preservation of the estate" language appears in Chapter 7 cases and "business judgment rule" language appears in Chapter 11 cases. But this is not because the Code preordains a specific fiduciary obligation; instead, the *typical* Chapter 7 and 11 cases necessitate this.

To summarize, the 1978 Code did not spell out the fiduciary obligations or the extent of personal liability of trustees in bankruptcy. Instead, the Code imported the concept of the trustee generically leaving the details to courts and lawyers. In this vacuum, courts struggle and trustees remain uncertain. Disparities in the treatment of trustees have resulted. Some courts incorrectly distinguish between breaches of the duty of loyalty and the duty of care when determining whether to hold trustees personally liable by focusing on "willful and deliberate" behavior as opposed to "negligent" behavior. Similarly, courts confuse two distinct legal doctrines: a trustee's derived judicial immunity and a trustee's fiduciary obligations to beneficiaries of the bankruptcy trust. These areas of confusion exist independently of policy objectives. Whether you think trustees should be virtually immune from suit and owe no substantial fiduciary obligations to creditors or anyone else, or if you believe that trustees need to be monitored closely, your view is not really served by this uncertainty. Moreover, this uncertainty and confusion arises from a misunderstanding of doctrine and a sloppy use of trust law language.

III. The Commission's Proposals: Confusion Written into Law

With this lesson in legal doctrine and the history of trustee liability behind us, the question naturally arises: What does the Commission propose to do about it? Will the doctrines of judicial immunity and fiduciary obligation be appropriately described in the Code so that courts apply the right doctrine to the right facts? Will the Code be clarified so that we see "willful and deliberate" behavior for what it is, a breach of the duty of loyalty equal to a breach of the duty of care? If we alter the Code appropriately in this manner, the policy debate itself will be in focus: what do we want these standards to be?

Unfortunately, the Commission proposal would codify the very confusion that thoughtful analysis suggests should be eliminated. Worse still, the proposal actually adds two additional errors that will mar and render doctrinally inconsistent Code provisions describing trustee and DIP obligations and liability. The proposals formally distinguish a trustee's liabilities in Chapter 7 from a trustee's liabilities in Chapter 11. Perhaps worst of all, the proposal, if adopted, would fundamentally alter the duties of the Debtor in Possession even though the notes of the Commission explicitly state this is not the drafters' intention.

The Commission's proposal reads as follows:

> 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.
>
> 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.
>
> A Chapter 11 trustee for a corporate debtor[[54]] 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.
>
> Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.[55]

54. What of a trustee for a non-corporate Chapter 11 debtor? The Commission proposal does not address this possibility. Wealthy individuals may file in Chapter 11, and, if they grossly mismanage their own affairs, a trustee may be appointed.

55. *Report*, *supra* note 8, § 3.3.2.

A. *Word Choice—Simple Criticisms*

I think before plumbing the Commission's proposal substantively to see how the drafters handled the issues I just raised, it would be best to examine the language for more basic errors. The proposal, which is comprised of four unnumbered paragraphs, speaks of three, not two, capacities in which a trustee may be held liable for breach of fiduciary obligations:

- The first paragraph applies specifically to all filing chapters (except Chapter 9) and limits a trustee's liability in his "individual" capacity to acts outside the scope of his authority;
- The second paragraph, which applies to Chapters 7, 12, and 13, subjects trustees to liability in their "representative" and "personal" capacities for acts of gross negligence (which is, as we shall see a very generous standard); and
- The third paragraph subjects Chapter 11 trustees to liability in both their "representative" and "personal" capacities only for a violation of the standard of care of officers and directors of corporations in which the case is pending.

The meaning of a trustee's "representative" capacity seems clear. The trustee is not "surcharged," that is, he will not be held liable out of his salary and fees for a breach of obligation. Instead, the trustee's failure will cost the estate of the debtor and, ultimately, the creditors. But what is the difference between a trustee's "individual" capacity and the trustee's "personal" capacity? There is a reason for this word choice, but it is not made clear in the proposal. This failure opens the door to significant misunderstanding, *a la Sherr v. Winkler.*

There is a wonderful scene in the movie, *The Blues Brothers*, starring Dan Ackroyd and John Belushi. With their blues band in tow, "Jake" and "Elwood" drive aimlessly through rural Illinois in search of a "gig." They spot an obviously cowboy-themed bar and, posing as a band called the "Good Old Boys," con their way into a job. At one point, they ask the woman tending bar, "What kind of music you got here?" The bartender responds genially, "We got Country and we got Western; we got both kinds."

Well, there are two kinds of liability for a trustee within the framework of a bankruptcy case and as imposed by a bankruptcy judge: the kind that forces the trustee to pay out of his own pocket and the kind that lets the trustee look to the assets of the debtor's estate. Somehow, the proposal would seem to find three. A casual reading of the proposal might suggest that the terms "personal" and "individual" mean the same thing, but this is not, I believe, the intent of the drafters. Given the tendency of courts to draw meaning from sloppy trust law terminology (as the *Sherr* court did in its reading of *Mosser*), the language of the proposal should be tighter. Indeed, at least one of the commissioners specifically complained that the provision, on its face, was unclear.[56]

This sloppiness is especially disheartening since this proposal was intended to clarify the present law. "Individual" immunity applies to trustees who act within the scope of their authority and should not be applied to trustees when beneficiaries of the bankruptcy trust (creditors) allege a breach of fiduciary obligation. The proposal does not make this distinction clear. In fact, the report and explanation accompanying section 3.3.2 explicitly suggest the opposite.[57]

B. Judicial Immunity as a Statutory Shield to Allegations of Breach of Fiduciary Obligations

As you might guess, however, I am not concerned solely about word choice, troubling as this language may be. I am concerned about the substantive aspects of this proposal. My initial review of the law in Part II suggests that a trustee's liability should be evaluated against two discrete doctrines: judicial immunity and a fiduciary's obligations to his beneficiary. Confusion in the law as it now exists arises, to some degree, because the present Code does not acknowledge this distinction and because courts fail to apply it. The proposal does not merely mirror this confusion; it codifies it.

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56. *See* Letter from James I. Shepard to Brady C. Williamson (Sept. 3, 1997) (on file with author) [hereinafter Shepard Letter]. Commissioner Shepard voiced his opposition to section 3.3.2 of the proposed changes on several occasions and articulated various defects in that section, all to no avail. I would like to thank Commissioner Shepard for providing me copies of this letter and other materials, as well as for spending a portion of his valuable time discussing the issue raised in this article.

57. The Commission explains that

> to hold a trustee personally liable for a breach of fiduciary duty, a plaintiff would have to show (1) that the trustee was not acting within the scope of judicial authority granted under the Bankruptcy Code or by court order; and (2) that the trustee was grossly negligent in the performance of the trustee's fiduciary duties.

Report, *supra* note 8, at 867.

One of my primary criticisms of the law as it has developed is simply this: courts, as well as drafters of codes, do not identify doctrines as they deal with them. Often, just taking the step to correctly name a rule or doctrine would force the judicial or statutory lawmaker to recognize the dividing line between doctrines (i.e. the line between the duties of care and loyalty and between immunity and fiduciary law).

This is absolutely true of proposed section 3.3.2. Paragraph one of the proposal describes the judicial immunity of trustees in bankruptcy. It is a largely correct statement of the doctrine of judicial immunity. I suspect this is the real reason that paragraph one speaks of a trustee's liability in his "individual" capacity where the other paragraphs speak of a trustee's liability in his "personal" capacity. And yet, nowhere does paragraph one use the phrase "derived judicial immunity." In this context, "individual" makes sense. Either the trustee is an officer of the court acting within the scope of his authority, in which case he is not liable to parties harmed by his actions, or he is an "individual." The other paragraphs deal not with judicial immunity, but with fiduciary obligation.

Except for one glaring omission, paragraph one correctly states the rule of derived judicial immunity. According to the drafter, trustees "should not be subject to suit in their individual capacity for acts taken within the scope of their duties."[58] According to the drafters, the scope of a trustee's duties in any of the bankruptcy chapters is defined both by the Code and by an order of the court where notice was given to all interested parties after full disclosure of material information by such parties.[59] This makes sense and follows established doctrine. If a trustee follows a court's instructions he should not be held liable for unforeseen and unfortunate consequences no matter how terrible, even as against beneficiaries of the trust. Similarly, where the Code permits, and perhaps even requires, the trustee to take some action, *or in a reasonable trustee's judgment, the Code permits such action*, then the trustee should not be later forced to pay damages out of his own pocket for taking such action. This is not to say that persons harmed by the bankruptcy process may not be made whole; it is just that under

58. *Report, supra* note 8, at 862.
59. *Id.* at 863-64.

these circumstances it should not be the trustee's assets doing the healing.

The drafters' language is good, but only so far as it goes. The problem, for lack of better words, is that the "to whom" is missing from the provision. Paragraph one does not state *to whom* the trustee shall be liable in his individual capacity. The error—the omission—is the failure of the Commission to limit the protection of this proposal to *non-beneficiaries* of the debtor's estate. Recall that there is ample justification for protecting judges and persons who act for the court if they reasonably believe themselves to be following the dictates of the Code or a court order. No one would agree to serve in a bankruptcy case without this level of protection. In this sense, although persons operating the debtor's business or controlling its assets are called trustees, it is enough to consider them merely officers of the court. Simple issues of fairness require this result.

Not so, with respect to the obligations of trustees to beneficiaries. Trust law assumes that persons serving as trustees do so accepting their obligations to beneficiaries.[60] That trustees are subject to liability is necessary to forestall problems of moral hazard.

I suppose that the "whom" might be implied. After all, the drafters use the word "individual," as opposed to "personal," to describe the liability a trustee faces when acting outside his authority. But this is a slim reed. As pointed out previously in this article, courts routinely confuse scenarios requiring judicial immunity analysis. Why would we expect such a subtle reading of this language? This provision should be modified, at the least, to insert language limiting protection to non-beneficiaries of the bankruptcy trust.

Worse is the fact that a reasonable reading of the entirety of section 3.3.2 suggests that the protection afforded by paragraph one of that section would apply in cases where the complaining party was a beneficiary of the debtor's estate (i.e., a creditor). This is exactly the wrong result and, as in case law, mixes two independent legal doctrines. Paragraph one applies to Chapter 7, 11, 12, and 13 trustees with no exceptions for suits by creditors. For example, the second paragraph of the proposal creates personal liability for

60. We might make standards generous, but standards of behavior always exist, violation of which should always subject trustees to personal liability.

trustees acting in a grossly negligent fashion. Applying paragraph one first suggests that this 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. Many of the actions that courts might term grossly negligent, and certainly actions that reasonable persons would describe as simply negligent, are typically within the scope of the trustee's duties. The trustee merely performed these actions in such a poor manner, and with such a lack of insight and foresight, that we call these actions negligent. Moreover, much of what we term "negligent" and even "grossly negligent" amounts to *failures to act and omissions.* I suspect many courts would stumble if forced to identify a *failure to act* as an *action* outside the scope of authority. Again, at least one commissioner identified and objected to this aspect of section 3.3.2, but to no avail.[61]

The explanation following section 3.3.2 reinforces this reading. It states that "liability for a breach of fiduciary duty would attach only to the extent that a trustee acted with gross negligence outside the scope of the trustee's Bankruptcy Code or court ordered authority."[62] The drafters thus clearly intended to limit creditors by the immunity doctrine—the wrong result.

Similarly, Chapter 11 creditors would be unable to sue the trustee "individually" even though the trustee is available "personally" under paragraph three if courts read the judicial immunity section as applying to motions raised against the trustee in bankruptcy court. This is the error of the Tenth Circuit in *Sherr* and the Commission's language virtually codifies this mistake.

C. *Failure to Clarify the Real Content of a Bankruptcy Trustee's "Care" and "Loyalty"*

Part II of this article notes that, in addition to confusing immunity doctrine with fiduciary doctrine, courts routinely misapply and confuse the meaning of the basic fiduciary obligations of care

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61. *See* James I. Shepard, Memorandum, Sept. 12, 1997 ("[T]here seems to be considerable confusion in the area because of the attempt to apply fiduciary liability concepts to actions by third parties, where no fiduciary duty exists."). Commissioner Shepard thus identifies the correct doctrinal application of judicial immunity doctrine. Unfortunately, his understanding of trustee liability and fiduciary duties was not fully incorporated into the final proposal.

62. *Report*, *supra* note 8, at 867.

and loyalty. This error is at least partly excusable because of the lack of guidance provided by the present Code. Nowhere does the Code explain the duties of loyalty and care. This confusion has significantly impacted courts' willingness to "sock" trustees with personal liability for breaches of their fiduciary duties. Unfortunately, instead of clarifying the law, the Commission's proposal extends and reinforces this confusion. We see this when we examine the second and third paragraphs of the proposal. Paragraph Two treats the fiduciary obligations of all trustees, except Chapter 11 trustees. Paragraph three of the proposal treats the fiduciary obligations of Chapter 11 trustees. I will analyze Paragraph two first.

1. Paragraph Two.—The first thing I noticed when reading this section is not what is there and wrong, but what is missing—the duty of loyalty. This is surprising. Although fiduciary obligations of trustees and the DIP continue to be subject to debate[63] and misunderstanding, one would have at least expected the drafters to distinguish between and explain the two major fiduciary obligations of a trustee.

Paragraph two would hold the trustee personally liable (or at least subject him to suit in his personal capacity) for acts that constitute "gross negligence in the performance" of his "fiduciary duties."[64] "Gross negligence" is then defined as "reckless indifference or deliberate disregard of the trustee's fiduciary duty."[65]

This definition of the trustee's duty of care is circular.[66] A trustee's fiduciary duties are composed of the duty of care and the duty of loyalty.[67] The duty of care is correctly couched in terms

63. For a recent serious treatment of the fiduciary obligations of the DIP, see Cuevas, *supra* note 29.

64. *Report*, *supra* note 8, § 3.3.2. Recall that personal liability under the Commission proposal would be limited to the trustee's acts outside the scope of his authority.

65. *Id.*

66. Commissioner Shepard similarly failed to find substantive content within this paragraph. For example, Commissioner Shepard voted against the Service and Ethics Working Group Proposal # 7 which dealt with the liability of trustees and contained language that ultimately became section 3.3.2. He states in a letter to Brady Williamson, Chair of the Commission that "I have a great deal of difficulty reading the second paragraph of the proposal to state its apparent intention. I don't mean to be so presumptuous, as to believe that my suggested language is a paradigm of clarity, but I do believe that the proposal should be restated." Shepard Letter, *supra* note 56.

67. A trustee also has the duty to remain impartial among beneficiaries. What "impartial" means in the context of Chapter 11 has been subject to significant debate. *See*

of negligence, that is, mistakes that the trustee made accidentally and not deliberate behavior. In turn, negligence is itself a definable term and relates to an objective standard of behavior against which a trustee may compare himself. For example, in the world of personal trustees, the standard against which the trustee may compare himself might be "the reasonable and prudent trustee" under similar circumstances and operating pursuant to the same trust language. The common law has developed a fairly comprehensive series of cases, supplemented by treatises, that describe what is "reasonable and prudent" in connection with investment practices, business operations, etc.

If the drafters want the standard of a bankruptcy trustee to be "gross negligence," then so be it. But this term must be defined, as it is in the operation of personal trusts, with a standard against which the trustee may compare his own behavior. *Instead, the drafters define gross negligence in terms of a breach of the trustee's fiduciary duty, when the duty to avoid negligent actions (the duty of care) is itself a fiduciary duty.* This is, therefore, a totally meaningless definition. A trustee is to avoid gross negligence, which is a breach of its fiduciary duty, which is, among other things, the duty of care, which is the obligation to avoid negligence, and so it goes, around and around.

It is hard to see how the drafters made this mistake when they themselves cite, as support for their proposed standard, Prosser and Keeton's definition of gross negligence. According to these two giants of tort law, gross negligence is "a failure to exercise that care which a careless person would use."[68] This is a real, if somewhat vague, standard and one that provides trustees a benchmark against which to compare their own behavior. By contrast, a standard that references only a trustee's "breach of fiduciary duty" does not provide such a benchmark. Why the drafters failed to actually define the most important term is a mystery to me; although, it certainly comports with the "tradition" of the Code, which originally failed to define the trustee's fiduciary duties.

Bogart, *supra* note 5, at 241-53.

68. *See* Report, *supra* note 8, at 861 n.2198 (quoting W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 209, 212 (5th ed. 1984). The drafters display their sophistication by quoting other possible standards for "gross negligence." Citing a federal district case from Rhode Island, they note that gross negligence may be "reckless or shockingly unjustified and unreasonable action." *Id.* at 861 n.2198 (quoting Leite v. City of Providence, 463 F. Supp. 585, 591 (D.R.I. 1978)).

Fortunately, the drafters have not, at least explicitly, incorporated the rule of the Tenth Circuit, announced in *Sherr v. Winkler*, that personal liability follows only "willful and deliberate" behavior. According to the Commission, a trustee will be liable in representative and personal capacities when acting with "reckless indifference or deliberate disregard" for his fiduciary duties.[69] Recall that, under the prescription of *Sherr v. Winkler*, personal liability would follow the trustee *only* for "willful and deliberate" acts.[70] As I said earlier, this is a loose way of describing breaches of the duty of loyalty. Although the Commission would retain personal liability for deliberate behavior, it would also permit personal liability for reckless behavior—behavior that is at least a step below "willful and deliberate" and can be characterized as a breach of the duty of care.

Thus, for example, a trustee must act to collect and preserve assets of the estate.[71] The failure to insure property adequately would be a violation of the duty of care. Under Prosser's definition of "gross negligence," this would be a violation only if, in failing to insure the property, the trustee failed to exercise the care that even a careless person would use under the same circumstances. Assuming that the drafter intended the "fiduciary duty" mentioned in paragraph two of their proposal to include the duty to preserve the estate, then the trustee would violate this duty by acting recklessly.[72]

2. *Paragraph Three.*—The final two paragraphs of the Commission proposal deal with Chapter 11 trustees and the DIP. These paragraphs turn the traditional understanding of fiduciary obligations of the trustee, and hence the DIP, on their head. The provision provides that a trustee may be subject to suit in his representative capacity and personal capacity to the extent the

69. The drafters borrow this language from corporate governance law, not tort or trust law. *See id.* at 861 n.2199 (citing Potter v. Pohlad, 560 N.W.2d 389, 392 (Minn. Ct. App. 1997)).

70. *See supra* notes 22-24 and accompanying text.

71. *See, e.g.*, Reich v. Burke (*In re* Reich), 54 B.R. 995 (Bankr. E.D. Mich. 1985), *as modified*, Bankr. Proc. Docket, No. 84-9041, Entry No. 33 (Bankr. E.D. Mich. July 3, 1986) (trustee has an obligation to keep a building that was estate property clear of snow; roof of building caved in). One court stated that "[c]ollecting and preserving the estate's property is the primary duty of the trustee, and is not discretionary." *In re* Rollins, 175 B.R. 69, 75 (Bankr. E.D. Cal. 1994).

72. The trustee may also violate his fiduciary duty if his actions, although close to deliberate behavior, are nevertheless not quite as culpable (i.e. reckless).

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."[73] Existing Supreme Court opinions, commentary, and other case law indicate a basic doctrine: that the DIP derives its fiduciary obligations from the trustee in bankruptcy. The Commission's proposal would reverse this rule. Since the Commission explicitly states that it is not modifying the law governing the DIP, when it clearly does, the Commission once again seems to misunderstand basic bankruptcy law doctrine.

Paragraph three of the Commission's provision would effect a major change in the Code and in the case law. That provision would create fifty different fiduciary standards for Chapter 11 trustees reflecting the corporate law of the fifty states of the Union. This would engender an unnecessary disuniformity in Chapter 11 bankruptcy law and does not reasonably reflect the expectations of the creditors. This proposal is especially surprising since one primary goal of the Commission appears to have been to alleviate some of the disuniformities that are part and parcel of bankruptcy law as it exists today. For example, the Commission proposed significant changes to the exemptions provision of Chapter 7 to eliminate the differences in treatment among debtors from different states.

Subjecting Chapter 11 trustees to the fiduciary obligations of directors in states where Chapter 11 cases are filed does not make sense in theory or in fact. Corporate law theorists have adopted a "contractual" explanation of corporate governance. Creditors contract for the return of their investment but not fiduciary rights. Absent a later insolvency, creditors cannot sue directors alleging breach of care or loyalty. Therefore, creditors do not typically care what regimen of fiduciary obligations exists in any particular state. Instead, creditors examine the credit worthiness of debtors by looking to balance sheets, assets, etc.

By contrast, shareholders contract for equity in the company and for the fiduciary obligations of directors and officers.[74] This is the primary modern theoretical and doctrinal justification for saddling equity owners in the fifty states to different corporate

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73. *See Report*, *supra* note 8, § 3.3.2.

74. This view, particularly that shareholders bargain for any specific package of fiduciary obligations, has been criticized as unconnected to the real motives and decisions of equity investors. *See generally* Bogart, *supra* note 5, at 164-68.

governance regimes. Indeed, some corporate law theorists argue that corporations ought to be able to "bargain out" of fiduciary obligations altogether. After all, they say, the inability to sue directors will be known to reasonable investors and reflected in share prices.[75]

It is undeniably true, however, that *creditors do not* bargain or typically care what regime of fiduciary obligations govern corporations that owe them money since they typically have no involvement in corporate governance. And yet, the expectation that a particular regime of corporate governance mechanisms govern a particular debtor, expectations that only shareholders typically have, is the only basis I can see for imposing different state statutes and case law on different Chapter 11 trustees.[76]

Thus, there is no good reason to subject creditors in Chapter 11 cases to varying sets of fiduciary obligations, whether the managers at the time are trustees or the DIP. Instead, creditors from any particular state and concerned with any particular debtor, "reasonably expect the terms 'honesty,' 'prudence,' and 'competence,' as such terms apply to trustee behavior, to mean the same whether the bankruptcy occurs in Massachusetts or Florida."[77] This is the present rule, and it ought not be changed by statute.

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75. *See id.*

76. I have previously written:

> Critics of the contract theory of corporations might be surprised by the reorganization process in Chapter 11. The contract achieved by creditors and the debtor in that process is not metaphorical, it is the real thing. However, the observations of these critics retain their validity when applied to the description of the corporate environment of the DIP outside the process of negotiating the plan of reorganization. In fact, their criticisms—that owners of the corporate entity do not bargain with directors and managers for any particular set of fiduciary obligations—are even more legitimate in this context. Where shareholders may meet and force the election of new directors, or force unplanned meetings in order to cause management and the board to address their concerns, these rights may be limited in Chapter 11. The ultimate stakeholders of the reorganized debtor in many Chapter 11 cases—the creditors—do not have the right during the Chapter 11 case to vote at such meetings even if such meetings do take place. The normal mechanisms of corporate governance are severely undermined in Chapter 11. *The argument that the articles of incorporation, as modified by state corporate governance law, reflect an agreement among the stakeholders and management carries even less force following the filing of the bankruptcy petition.* The elimination of traditional mechanisms of corporate governance therefore creates a valid rationale for the imposition of fiduciary duties upon the DIP that are more rigorous than those typically imposed on the prepetition corporate fiduciary.

See id. at 184-85 (emphasis added) (citations omitted).

77. *See id.* at 220.

Chapter 11 cases are often cross-jurisdictional with, perhaps, the exception of some single asset cases. Creditors come from many states and sometimes from beyond the borders of the United States. Why should Delaware law, as opposed to New York law or Georgia law, govern the standard of care and loyalty followed by the trustee assigned to oversee the reorganization? Again, the only possible reason would be the expectation of the creditors. Yet, there is nothing in a creditor's typical decision to lend money or sell goods on credit to a debtor that indicates any such expectation.

Indeed, there is just as little reason to believe that creditors expect different sets of fiduciary duties to apply to the DIP depending on whether the corporation was incorporated in one state or another. The reasons for this are essentially the same; creditors expect duties of loyalty and care for trustees to be the same regardless of where the case is filed or where the corporation is incorporated. As just stated, creditors do not bargain for any specific set of fiduciary obligations when lending money to the debtor corporation. They have only the right to sue if the debtor breaches the loan contract; fiduciary obligations are not part of the bargain, at least absent insolvency.

Even if creditors expect fiduciary duties of the states in which debtors incorporate to follow trustees in Chapter 11, why in the world would creditors, or anyone else for that matter, expect the duties of *states in which cases are filed* to follow trustees? Debtors do not necessarily file in those states where they incorporate. There is absolutely no theoretical basis for making corporate governance issues dependent upon the states in the which cases are pending.

The Code does not prescribe the nature of the DIP's fiduciary obligations any more than it does for the trustee. The only hint the Code gives is section 1107(a) which states that the DIP shall "perform all the functions and duties . . . of a trustee."[78] Interpreting this language, the Supreme Court twice stated that the DIP inherits the fiduciary obligations of the trustee in bankruptcy.[79] The federal bankruptcy judiciary essentially responded by creating a federal common law of trusts which is applied first to trustees and derivatively to the DIP.[80] Many bankruptcy courts have taken the

78. 11 U.S.C. § 1107(a) (1994).

79. *See supra* note 6 and accompanying text.

80. *See generally* Bogart, *supra* note 5.

Supreme Court at its word and simply applied this common law of trusts to the DIP. Even those courts that spout corporate governance terminology when evaluating the DIP (i.e., by referring to the business judgment rule) really apply something more strenuous to directors and officers of Chapter 11 companies.

There are striking 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. As we shall see, however, the Commission's proposal saddles trustees with the standards of a corporate fiduciary and, in so doing, alters the required behavior of the DIP as well.

I suspect the reader is well aware of what is meant by the "business judgment rule." The business judgment rule is a layer of protection afforded corporate directors and officers of solvent companies prior to the filing of the petition. The rule protects these individuals from suits by shareholders alleging that directors made decisions that ultimately harm the company. The business judgment rule may be formulated in a number of ways, but, usually, it states that directors and officers will not be held liable for their decisions affecting the company so long as they were rational and informed when the decisions were made and they were not otherwise acting in a disloyal manner.[81] This standard allows

81. The American Law Institute's formulation of the business judgment rule protects directors if they acted loyally and in good faith, in an informed manner, and "rationally believe[d] that the business judgment is in the best interests of the corporation." PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) (1994). A review of cases and scholarly articles discussing a corporate director's duty of care and the correct application of the business judgment rule is beyond the scope of this short article. Primary judicial statements of the rule may be found in such well known cases as *Joy v. North*, 692 F.2d 880 (2d Cir. 1982) and *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The business judgment rule insulates directors from liability for their poor decisions; it may even protect them from negligent behavior. One well known court opinion explains the rule as follows:

> The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under [Delaware business statutes] . . . . It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.

Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted). The business judgment rule is the subject of much scholarly discussion and debate. For example, see Andrew G.T. Moore, II, *The 1980's—Did We Save the Stockholders While the Corporation Burned*, 70 WASH. U. Q. 277 (1992); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984). I discuss the business judgment rule and its various formulations in Bogart, *supra* note 5, 168-73. In that article, directors to act in a painfully stupid manner and escape liability for their acts. This protection has been deemed necessary because without it, so goes the argument, individuals would not agree to serve as directors.

However, bankruptcy courts require something greater than the rational person standard when evaluating the behavior of Chapter 11 directors, which is a minimal level of care. Even where courts suggest that the business judgment rule exists in Chapter 11, these same courts routinely examine the reasonableness of a corporate director's decisions.[82] Bankruptcy courts may grant wide discretion, but they do not really technically apply the standard corporate rule. This is not surprising since the duty of care for a trustee outside of bankruptcy is that of a prudent person.[83] Bankruptcy courts have looked to the *Restatement* and other treatises, as well as state court opinions, to flesh out what a trustee's care ought to be. Trustees, while often granted wide discretion in the operation of a beneficiary's business, do not have the benefit of the corporate business judgment rule.

The duty of care as applied in the world of solvent, non-bankrupt companies is, thus, quite different from that actually applied in the world of Chapter 11, notwithstanding the suggestions that the business judgment rule lives in bankruptcy. Unsurprisingly, there are also differences between the duty of loyalty as actually applied by bankruptcy courts and as it exists in a normal corporate context, but these are more subtle. The actual wording of a court's prohibitions on disloyalty is the same regardless of one's status as a trustee or corporate fiduciary. The primary difference is that corporate fiduciaries typically exculpate themselves from liability under state law by having a board of disinterested and independent directors vote to ratify the disloyal acts. These state laws do not apply to trustees. And no bankruptcy court, at least that I know of, has entertained (or has been asked to entertain) arguments that directors are shielded from liability for disloyal conduct by state exculpatory statutes.[84] This could change

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I also examine and reject the notion that the business judgment rule, as it is traditionally understood, is truly effective in Chapter 11 cases. *Id.* at 220-27.

82. *See* Bogart, *supra* note 5, at 222-23.

83. *See* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) (providing that a trustee owes a duty of "such care and skill as a man of ordinary prudence would exercise in dealing with his own property"). *See also* Bogart, *supra* note 5, at 235-38.

84. *See generally* Bogart, *supra* note 5, at 239-40.

if Congress adopts the Commission's proposal. After all, if the standards of corporate fiduciaries govern trustees, then the business judgment rule and exculpatory statutes are essential parts of those standards.

There may simply be a difference in the tone of courts when dealing with allegations that a trustee has been disloyal, as opposed to a corporate director.[85] Trustees are expected to deal with the wealth of their charges in the utmost good faith. True, other fiduciaries, including real estate agents and corporate directors are subject to these strictures. Yet, to be a "trustee" is to incur special and significant expectations of honesty and good faith.

Thus, there is a single overriding characteristic of fiduciary obligations in Chapter 11. Whether the manager of the reorganized debtor is a trustee or DIP, the standards are those of the trustee in bankruptcy and the DIP's fiduciary obligations flow from these standards. Previously, if you wanted to know what "care" and "loyalty" meant as applied to the behavior of the DIP, you would first look at the meaning of those terms in the context of the trustee's behavior.

Now, look at the Commission proposal. The trustee's standards are rendered by statute to be the standards of corporate fiduciaries, abrogating much of the case law developed from the time of the Bankruptcy Act and on. If the DIP's duties are derivative of the trustee's, then, under the Commission's proposal, the DIP's obligations are returned back to state corporate governance law. However, unlike normal state law corporate governance, the debtor will be governed by the standards of the state in which the case is pending. This is a bizarre twist.

In short, the drafters have turned the basic premise of fiduciary obligations in Chapter 11 upside down. Since a DIP's fiduciary standards are based on those of the trustee, the DIP's obligations will simply be the standard corporate fiduciary obligations of directors and officers. For example, where I previously concluded that the business judgment rule does not technically exist in

85. *See* Nancy B. Rapoport & C.R. Bowles, Jr., *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47, 56 (1997) ("The standard of care under the 'common law trustee' line of cases isn't that much different from the standard of care under the 'corporate fiduciary' standard,—it's just more stringent.").

Chapter 11 under the present Code,[86] it most certainly will exist following the adoption of the Commission's proposal. There will be fifty different standards and rules with slightly, and sometimes not so slightly, varying language.

The wording of the duties vary subtly from jurisdiction to jurisdiction. Presumably, since the statutes are state laws, trustees will be forced to look at the case law in each jurisdiction to determine what these statutes mean. Bankruptcy courts could interpret the state statutes without reference to what state courts have done, but I think this is very unlikely. I predict that when and if this proposal is passed by Congress and signed into law by the President, there will be a rush by the major law publishers to create new "handbooks" for trustees describing their duties. These handbooks will necessarily provide state law sections covering the law of all of the states and explaining the nuances of corporate fiduciary law in each of the states. Similarly, creditors' committees and their counsel will be forced to learn and apply a huge array of differently worded corporate fiduciary standards.

3. Paragraph Four.—Before concluding, I would ask the reader to look at the last paragraph of proposed section 3.3.2. This paragraph suggests that the standards governing the DIP remain unaltered by the proposal. I have suggested throughout this article that the failure of the Commission to take doctrine seriously—as worthy of consideration apart from policy ends—damages the proposal and will result in a poorly fashioned law. Paragraph four brings me back to this point.

How is it possible for the drafters to make such a point in the first place? There is really only one answer. They did not understand the impact of their own statutory modification on the Code. The reason for this is their failure to understand the doctrinal impact of placing the DIP in the shoes of the trustee. The Code says now that the DIP has the duties of the trustee. While arguing that this remains unchanged, the proposal reverses this present state of affairs.

Paragraph four states that the Commission proposal will not alter the status quo regarding the DIP. And yet, I am worried that,

86. As previously noted, Chapter 11 trustees are granted very wide discretion in the operation of an ongoing business, and justifiably so. But this is still a long way from the rational-but-stupid standard one finds in the business judgment rule.

in an almost Orwellian way, courts and commentators will forget how the law was understood to operate prior to adoption of the proposal and conclude that the blanket incorporation of the different states corporate fiduciary law into Chapter 11 was *always* the regimen of Chapter 11, when it certainly was not.

If this provision is adopted, I suspect that later courts and commentators will focus upon the rationale of the Commission, as evidenced by its report and the language of the proposal. In a sense then, the explanation the Commission gives for its proposal is a kind of quasi-legislative history. The Commission, however, cannot rightfully tell us what the original drafters of the Code intended, *only what they mean to do today*. Unfortunately, the dramatic modification of the standards governing the DIP, accompanied by the Commission's statement that the rules governing DIP have not changed, does just that; it suggests that this most recent Commission's reading of the rules governing the DIP is the true and correct understanding.

IV. Conclusion

The Commission's Proposal 3.3.2 is doctrinally confused and ought not to be placed into law, at least as is. It incorporates into the fiduciary standards governing Chapter 11 trustees, and hence the DIP, the doctrine of derived judicial immunity. This is a terrible error from several vantage points. The Commission has successfully ignored an opportunity to correct what thoughtful commentary and many courts believe to be a misreading of Supreme Court directive. The law permitting the DIP, trustees, and creditors relying on the Code to plan their behavior will be cluttered even further. Worst of all, beneficiaries of the estate—the creditors—may well find their actions against trustees for breach of fiduciary duties stymied by courts convinced that the trustee's careless acts were within the scope of the trustee's authority.

The Commission distinguishes between Chapter 11 and the other chapters for purposes of defining the liability and fiduciary obligations of trustees in a way previously not seen in bankruptcy law.

The Commission successfully avoids an opportunity to explain what "care" and "loyalty" mean in bankruptcy. This would have been hard but valuable work and would have done more to aid courts and trustees than just about anything else the Commission might have attempted. The Commission might have carefully used trust law terminology.

The Commission also proposes to stand upside down the present understanding of the DIP's fiduciary obligations. Instead of looking to the nature of a trustee to discern the obligations of directors of a Chapter 11 company, following adoption of the Commission's proposal, trustees will be forced to look to state law corporate fiduciary obligations. And departing from any reasonable expectation, trustees will be bound by the judiciary obligations imposed on corporate directors in the state where the bankruptcy case is filed. The Commission would impose this change while suggesting that the standards of the DIP remain untouched.

Despite my criticisms, I am not despondent. I take the state of bankruptcy law seriously and recognize its impact on the lives of others. But I cannot control the decisions of the Commission, let alone Congress, and I will (and must) accept and work with what Congress actually adopts. Yet, this brings me full circle, back to the "still small voice." My father began law practice nearly forty years ago. One of the lawyers who hired him was a man known affectionately as "Mr. Max."[87]

When Mr. Max would leave for home at the end of the day, so my father says, he was fond of telling younger lawyers still working in the library or at their desks, "Save some work for tomorrow." This was a still small voice that intense young lawyers probably easily ignored, but they should not have. I cannot imagine that Mr. Max really wanted lawyers who had trials or transactions to prepare to leave for the day before their work was complete. Instead, Mr. Max saw young lawyers working on projects that were not immediately due and letters that could wait until morning; in other words, the inexhaustible supply of work that is always on a lawyer's desk and is never really finished. As to this, Mr. Max's advice was to "save some work for tomorrow." He knew, I think, that a busy lawyer's sanity and ability to reflect on a client's problems necessarily required the knowledge of when to quit and go home for the day.

So too with us and with our review of the proposals of the National Bankruptcy Review Commission. No Code will ever be

87. This was in Atlanta, Georgia, and a common and old southern practice was to show formality and respect for older persons, as well as affection, by addressing that person by title and first name.

perfect; and even in the best of statutory projects such as this, there are bound to be serious flaws—problems that later Commissions and Congresses will have to address. This is true of the work of the National Bankruptcy Review Commission. It is unclear whether and how much of this Commission's report will be adopted by Congress and what changes to the Commission's proposals Congress will make. But even if Congress adopts and the President signs into law a bill containing provision 3.3.2, I will remember Mr. Max's admonition. Like the young lawyers who both frustrated and amused Mr. Max, we simply will not be able to correct all that is wrong or improve that which can be made better, either in the original Code or in the Commission's proposal. The Commission has saved us all work for tomorrow. Mr. Max's voice was the voice of reason and reflection then and now: it is time to go home for the day.