

A Chapter 7 Trustee's Qualified Right of Immunity May Be No Shield for Intentional, Negligent, or Grossly Negligent Conduct: Analyzing and Applying the Three-Way Circuit Split

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Quasi-judicial immunity is best understood as a blessing and a curse. A bankruptcy trustee is appointed to act as trustee through an order of the bankruptcy court. In *Antoine v. Byers & Anderson*, the Supreme Court provided a two-part test to analyze how far judicial immunity extends to persons who perform quasi-judicial functions in connection with their appointment.¹ This test explains whether a judicial appointee is absolutely immune from personal liability to the estate or others. Under the test, a court (1) must decide whether the functions of the individual were historically adjudicative in nature, and (2) must then evaluate whether the actions which are the basis for suit are discretionary adjudicative functions that are fundamentally the equivalent of those that would have been made or undertaken by the judge.² If both prongs are met, the officer is immune from personal liability for their discretionary actions.³

Presently, the Bankruptcy Code fails to provide any guidance on the immunity or personal liability of a trustee. Guidance from the courts regarding the liability of a trustee

¹ See *Antoine v. Byers & Anderson, Inc.*, 508 U.S. 429, 436 (1993).

² See *id.*

³ See *Mullis v. U.S. Bankr. Court for Dist. of Nevada*, 828 F.2d 1385, 1389 (9th Cir. 1987); *In re Jackson*, 105 B.R. 542, 546 (B.A.P. 9th Cir. 1989).

remains inconsistent. Currently, there are three viewpoints on this issue imposing liability for (1) intentional breach of a trustee's fiduciary duties, (2) negligent breach of a trustee's fiduciary duties, and (3) grossly negligent breach of a trustee's fiduciary duties. Accordingly, this Article will explain the doctrine of quasi-judicial immunity and will analyze a Chapter 7 trustee's potential personal liability to suit, by application of the various standards used by the federal appellate courts to permit such liability.

Part I of this Article will briefly discuss the roles and responsibilities of the bankruptcy trustee. These roles provide the guidelines of the expectation of a trustee and will help examine a trustee's immunity or personal liability. Part II of this Article will address the doctrine of quasi-judicial immunity as a defense to a personal liability claim. Part III will analyze the three different standards bankruptcy courts now use to decide whether to permit personal liability on trustees.

I. The Role of the Chapter 7 Bankruptcy Trustee

A bankruptcy trustee plays a vital role in a chapter 7 bankruptcy case. Section 323 of the Bankruptcy Code defines a trustee's role as the "representative of the estate."⁴ The trustee has two main obligations: (1) "fiduciary" obligations owed to the "bankruptcy court and the parties in cases in which the trustee serves," and (2) "institutional" obligations, owed "to the bankruptcy process itself."⁵ Section 704 of the Bankruptcy Code provides the "institutional obligations" the chapter 7 trustee owes to the debtor and creditor, both of whom are the "beneficiaries" of the estate.⁶ Pursuant to Section 704 of the Bankruptcy Code, all trustees must be accountable for the property they receive and manage that property, must examine statements of claim filed in their

⁴ 11 U.S.C. § 323.

⁵ See Steven W. Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 AM. BANKR. L.J. 147, 147-48 (2006).

⁶ See *In re Heinsohn*, 231 B.R. 48, 65 (Bankr. E.D. Tenn. 1999).

cases and object to a claim that is improper, must furnish information concerning the estates and their administration to parties in interest, and must make and file reports with the court and the United States trustee.⁷ Trustees also conduct meetings where testimony is given and resolve the rights of parties with respect to estate property. Additionally, they are charged with the important task of collecting and reducing to money property of the debtor's estates and closing the estates as fast as possible.⁸

Furthermore, aside from the statutory duties, trustees have certain fiduciary duties that they must abide by, as “the legal representative and fiduciary of the estate.”⁹ The Bankruptcy Code is silent on the fiduciary aspect of a trustee. Importantly, a trustee has a fiduciary relationship only with the beneficiaries of the estate, which are the debtors and creditors. Actions brought by third-parties, not by beneficiaries of the estate, do not result in any loss to the trustee, as the trustee is protected by a limited *McNulta* rule, which protects trustees from any personal liability from third-party suits where the trustee was acting in his “official capacity.”¹⁰ As a fiduciary, a trustee is charged with the duty of care and duty of loyalty.¹¹ If there is a breach of either fiduciary duty, the trustee opens the door for potential liability. Therefore, to avoid litigation, it is cautioned that a trustee act with the proper care and diligence and act entirely disinterested from the position of trust.

When a trustee fails to adhere to either the statutory or fiduciary duties on behalf of the estate, there may be a cause of action against the trustee under a theory of personal liability. The injured creditor will chase after the trustee for his poor performance. The most common

⁷ See *id.* § 704(a)(2)–(a)(9).

⁸ See *id.* § 704(a)(1).

⁹ *In re AFI Holding, Inc.*, 530 F.3d 832, 844 (9th Cir. 2008); see *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1357 (9th Cir. 1983) (discussing that a bankruptcy trustee is a fiduciary of each creditor or beneficiary of the estate).

¹⁰ *McNulta v. Lochridge*, 141 U.S. 327, 332 (1891).

¹¹ *In re AFI Holding, Inc.*, 530 F.3d at 844.

allegation against a trustee is the failure to collect and reduce to money property of the estate as expeditiously as possible.¹² Additionally, cause of action may be brought when the trustee fails to protect assets of the estate, fails to properly invest funds held by the estate, to bring and defend lawsuits in a timely manner, to protect the environment and pay claims according to the law, or to notice properly those matters which must be brought to the attention of parties in interest to the estate.¹³ These duties seem complex for the trustee trying to balance the interests of all competing interests, especially the unhappy creditors, in the bankruptcy proceeding. The Supreme Court has acknowledged these unhappy creditors and has concluded that “courts are quite likely to protect trustees against heavy liabilities for disinterested mistakes of business judgment.”¹⁴ However, since there are various jurisdictional standards of care, there are limitations to this rule, which will be covered in Part III below. Accordingly, the correct understanding is that if the trustee breaches the standards of care, there *might* be personal liability and the immunity discussed in Part II will not be available.

II. The Defense of Quasi-Judicial Immunity for Personal Liability

Section 323 of the Bankruptcy Code states that trustees have the “capacity to sue and be sued.”¹⁵ This section pertains to lawsuits against trustees acting in their official capacity.¹⁶ In this instance, if the trustee acted with the required standard of care detailed above, any harm their actions caused will be charged against them in their “official capacity.” This is an action against the estate. Thus, when a creditor is successful in this action, he gets to dip into the funds of the estate as damages, as opposed to getting a judgment against the trustee himself.¹⁷ As an initial

¹² See Elizabeth H. McCullough, *Bankruptcy Trustee Liability: Is there a Method in the Madness?* 15 LEWIS AND CLARK L. REV. 153, 158 (2011).

¹³ See *id.*

¹⁴ *Mosser v. Darrow*, 341 U.S. 267, 273 (1951).

¹⁵ 11 U.S.C. § 323.

¹⁶ See *id.*

¹⁷ See *In re Markos Gurnee P’Ship*, 182 B.R. 211, 214–16 (Bankr. N.D. Ill. 1995).

matter separate from personal liability, lawsuits against the trustee acting in his official capacity face a jurisdictional challenge called the *Barton* rule. In *Barton v. Barbour*, the Supreme Court established that suits against trustees in connection with estate administration require the appointing court's leave.¹⁸ There, a state court tort action against the trustee acting in his official capacity had to be dismissed absent the receiver court's leave.¹⁹ Accordingly, as a pleading matter, most plaintiff creditors sue the trustee in their personal capacities.²⁰

Even if sued personally, quasi-judicial immunity serves as a protective doctrine for trustees against personal liability. This immunity is derived from the trustee's appointing judge. The general rule is that when the trustee is acting "within the discretionary bounds of his authority, it is settled that the trustee may not be held liable for any mistake of judgment."²¹

The two-part test from *Anderson* discussed above emphasizes this immunity. In short, it immunizes the trustee from suit when the trustee is acting within the scope of his official capacities.²² "A trustee will enjoy absolute immunity so long as he does not act in the clear absence of all jurisdiction, or at least acts under the supervision of the bankruptcy judge."²³ If the trustee received approval of his actions by the judge, acting pursuant to an order, the immunity is triggered and the trustee does not have any liability.²⁴ The idea is that the trustee is following the judge's explicit orders. "Allowing suits against trustees for executing explicit court orders would create counterproductive tension between bankruptcy judges and trustees."²⁵ This immunity applies to all discretionary judicial-like functions, as well as the administrative functions that are essential to the authoritative adjudication of private rights with respect to the bankruptcy estate.

¹⁸ See *Barton v. Barbour*, 104 U.S. 126, 136 (1881).

¹⁹ See *id.*

²⁰ See *id.* at 138.

²¹ *In re S. Found Corp.*, 641 F.2d 182, 184–85 (4th Cir. 1981).

²² See *Mullis*, 828 F.2d at 1390.

²³ *Gonzalez v. Musso*, No. 08-CV-3026, 2008 WL 3194179, at *2 (E.D.N.Y. Aug. 6, 2008).

²⁴ See *In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1, 8 (1st Cir. 1999).

²⁵ *Id.*

In essence, a trustee has absolute immunity for at least some of his actions taken in connection with the administration of the estate.

There is an important policy purpose behind the doctrine, namely to prevent an avalanche of litigation and to protect trustees' independence by shielding them from litigants that they might anger or disappoint while carrying out their duties. Just as the Court made clear in *Forrester v. White*, the threat of liability or litigation can create “perverse incentives that operate to inhibit officials in the proper performance of their duties.”²⁶ Accordingly, litigants cannot generally sue trustees for monetary damages resulting from unfavorable results. While it is true that the immunity protects trustees from monetary suits, the doctrine does not provide absolute immunity from actions taken outside of a trustee's official capacity. Overall, the doctrine of judicial immunity allows judges and trustees protection when they are acting in conformity with their duties.

III. The Exceptions to the Defense of Quasi-Judicial Immunity: Standards of Care for Breach of a Fiduciary Duty

For a trustee to be sued in his personal capacity, there must be a breach of his fiduciary duty. Importantly, this suit is only available to the beneficiaries of the estate to whom the trustee owes the fiduciary obligations. Since the Supreme Court's decision in *Mosser v. Darrow*, courts have taken split positions on the degree of misconduct permitting a finding of trustee personal liability. In *Mosser*, the Supreme Court began the confusion when it held the trustee personally liable for willfully and deliberately permitting his agents to profit at the expense of the estate.²⁷ In its reasoning, the Court explained “we see no room for the operation of principles of negligence in a case in which conduct has been knowingly authorized.”²⁸ Thus, the question

²⁶ 484 U.S. 219, 223 (1988).

²⁷ See *Mosser*, 341 U.S. at 271.

²⁸ *Id.* at 272.

remained, would the trustee have been liable if he were acting negligently, a lower standard than willfully and deliberately? The Court provided no answer on this issue.

Accordingly, the case caused a three-way circuit split to emerge to try and understand trustee personal liability. The following three points outline the different positions the courts have taken to address trustee personal liability. Each Circuit Court attempts to draw on *Mosser*'s misunderstood opinion, with some courts seeing that case as requiring (1) knowing and intentional wrongful conduct to establish trustee personal liability for breach of fiduciary duty, (2) some requiring ordinary negligence in the discharge of fiduciary duties, and (3) others requiring gross negligence.²⁹

The willful and deliberate standard is the most protective for trustees, since it is a high bar to prove. Below is a break-down of all three standards of care for breach, along with the rationale and policy purposes for each standard.

1. Intentional and Deliberate Breach of a Trustee's Fiduciary Duties

A few circuits find that a trustee can be held personally liable only if there was a willful and deliberate violation of duties to the estate. This standard protects a trustee from any negligent conduct. Intention is very important under this standard and a trustee must, therefore, intend to mismanage the assets of the creditors of the estate.³⁰

The intentional and deliberate standard was best articulated by the Tenth Circuit in *Sherr*. The Tenth Circuit interpreted *Mosser* to hold "that a trustee would not be liable personally

²⁹ See, e.g., *In re Chicago Pacific Corp.*, 773 F.2d 909, 915 (7th Cir. 1985) (intentional breach); *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461–62 (6th Cir. 1982) (same); *Sherr v. Winkler*, 552 F.2d 1367, 1375 (10th Cir. 1977) (same); see *In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1, 7 (1st Cir. 1999) (negligent breach); *In re Gorski*, 766 F.2d 723, 727 (2d Cir. 1985) (same); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1357–58 (9th Cir. 1983) (same); *Red Carpet Corp. v. Miller*, 708 F.2d 1576, 1576 (11th Cir. 1983) (same); see *In re Smyth*, 207 F.3d 758, 761–62 (5th Cir. 2000) (grossly negligent breach).

³⁰ See, e.g., *In re Chicago Pacific Corp.*, 773 F.2d 909, 915 (7th Cir. 1985); *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461–62 (6th Cir. 1982); *Sherr v. Winkler*, 552 F.2d 1367, 1375 (10th Cir. 1977).

except for willful and deliberate acts.”³¹ The court explained that a trustee may be held liable in “his *official capacity* and thus *surcharged* if he fails to exercise that degree of care required of an ordinarily prudent person serving in such capacity, taking into account the discretion allowed.”³² The word “surcharge” here means that the damages resulting from trustees’ negligence would be paid only from the funds of the estate, and not from the trustee’s own personal bank account.³³ The trustee is liable in his official capacity for acts of negligence.³⁴ However, as the court in *Sherr* emphasized, a mistake in judgment cannot be the basis of a trustee’s liability “in any manner.”³⁵ The Second Circuit has echoed this view.³⁶ Accordingly, if the trustee’s conduct falls below the “knowing” standard, there would be no personal liability and the estate would pay off any damages to creditors for the trustee’s negligence.

The Tenth Circuit’s use of the term “surcharge” has caused differing interpretations among courts. For example, the Ninth Circuit in *Cochise Park* interpreted “surcharge” to permit “personal liability on a fiduciary for willful *or negligent* misconduct in the administration of *his fiduciary duties*.”³⁷ Accordingly, the Ninth Circuit believes that negligence could be the standard of care for personal liability purposes.

Other Circuit Courts are in accord with *Sherr*’s interpretation.³⁸ Accordingly, a trustee in these jurisdictions will not be personally liable for any conduct that is not willful and deliberate.

³¹ *Sherr*, 552 F.2d at 1375.

³² *Id.* (emphasis added).

³³ *Id.*

³⁴ See *In re S. Found Corp.*, 641 F.2d at 184.

³⁵ *Sherr*, 552 F.2d at 1375.

³⁶ See *In re Smith*, 645 F.3d 186, 189 (2d. Cir. 2011) (protecting trustee from personal liability for exercising business judgment).

³⁷ *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1341 (9th Cir. 1983) (emphasis added).

³⁸ See *In re S. Found Corp.*, 641 F.2d at 184 (4th Cir. 1981) (holding that trustee is not liable because there was no intentional or deliberate conduct) (discussing personal liability as “only for acts determined to be willful and deliberate in violation of his duties”); see *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461–62 (6th Cir. 1982) (finding that trustee could not be held personally liable for negligence and could only be liable to creditor for intentional and deliberate conduct in violation of his fiduciary duties); see also *In re Chicago Pacific Corp.*, 773 F.2d

In *Weaver*, the court examined whether the trustee was personally liable to the creditors for a willful and deliberate breach of his fiduciary duty to safeguard the assets of the debtor, Weaver Farms.³⁹ There, the court adopted the holding in *Sherr*, and held that it could find the trustee liable in his personal capacity only if he was willful and deliberate in violating his fiduciary duties towards the creditors of the Weaver Farms' estate.⁴⁰

The policy purpose behind the knowing standard is to attract good trustees to serve in the bankruptcy system.⁴¹ Immunizing trustees from suit is a strong positive for the system. If there is good protection and limited liability available, then there will be a better incentive to participate as trustee of an estate in a chapter 7 bankruptcy. Better protection will also foster communication between creditors who want their money now and trustees who are looking to find and liquidate assets.⁴²

2. Ordinary Negligent Breach of a Trustee's Fiduciary Duties

The negligence standard is the least protective of the trustee. Ordinary negligence is the failure to act the way a reasonable prudent person would act under similar circumstances. Finding trustees personally liable for negligent acts or omissions with respect to the bankruptcy estate and its beneficiaries has been applied by the First, Second, and Ninth Circuits.⁴³

909, 915 (7th Cir. 1985) (discussing that a "trustee may be held personally liable only for a willful and deliberate violation of his fiduciary duties").

³⁹ *Weaver*, 680 F.2d at 461.

⁴⁰ *See id.* at 462.

⁴¹ *See* Theresa J. Pulley Radwan, *Trustees in Trouble: Holding Bankruptcy Trustees Personally Liable for Professional Negligence*, 35 CONN L. REV. 525, 543 (2003).

⁴² *See id.*

⁴³ *See In re Mailman Steam Carpet Cleaning Corp.*, 196 F.3d 1, 7 (1st Cir. 1999) (holding that negligence suffices for personal liability "surcharge"); *In re Gorski*, 766 F.2d 723, 727 (2d Cir. 1985) (explaining that personal liability attaches "as the result of negligent" breaches of trustees' fiduciary duties); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1357–58 (9th Cir. 1983) (holding that a trustee "is subject to personal liability for not only intentional but also negligent violations of duties imposed upon him by law"); *Red Carpet Corp. v. Miller*, 708 F.2d 1576, 1576 (11th Cir. 1983) (finding that negligence is the standard for trustee behavior and surcharge is allowed).

In *U.S. v. Hemmen*, the Internal Revenue Service (IRS) brought action against Chapter 7 trustee contending that trustee was personally liable after trustee failed to honor notice of levy.⁴⁴ There, the IRS alerted the trustee of the consequences, but trustee did not respond.⁴⁵ The Ninth Circuit held that the trustee, who was the recipient of an IRS notice of levy at a time when the estate had assets which were not liquidated, was personally liable under 26 C.F.R. §301.6332(c)(1) for failure to honor the levy.⁴⁶ The court concluded that the action of the trustee was negligent and violated the trustee's fiduciary duty to honor the levy. Accordingly, the quasi-judicial immunity doctrine did not shield trustee because he acted negligently in not honoring the levy.⁴⁷ The court stated further that it was aware of the added burden on bankruptcy trustees, but that a contrary conclusion would impose an additional burden on the IRS' ability to expeditiously collect delinquent taxes.⁴⁸

Furthermore, the Ninth Circuit explained that a trustee is protected by reasonable business judgment for any mistakes made.⁴⁹ Although the negligence standard is low and hard on the trustees, it has its benefits.⁵⁰ For example, one bankruptcy commentator suggests that a fine line exists between negligence and intentional activities.⁵¹ She explains:

The use of a reasonableness standard, so long as reasonableness is properly defined as the actions of a reasonably prudent, similarly-situated trustee, serves as a balance between protection of creditors and protection of the trustee. It creates some measure of responsibility on the part of the trustee for mistakes made, without making the trustee an insurer for all creditors.⁵²

⁴⁴ See 51 F.3d 883, 891 (9th Cir. 1995).

⁴⁵ See *id.*

⁴⁶ See *id.*

⁴⁷ See *id.* at 892.

⁴⁸ See *id.*

⁴⁹ *In re Cochise College Park, Inc.*, 703 F.2d at 1357.

⁵⁰ See *In re J.F.D. Enterprises, Inc.*, 223 B.R. 610, 627 (Bankr. D. Mass. 1998) (emphasizing that the negligence standard "underestimates the role of a trustee under the Bankruptcy Code and the difficulty associated with the trustee's duties).

⁵¹ Theresa J. Pulley Radwan, *Trustees in Trouble: Holding Bankruptcy Trustees Personally Liable for Professional Negligence*, 35 CONN L. REV. at 551.

⁵² *Id.* at 555-56.

However, this standard has its weaknesses. Some capable trustees may choose not to serve for fear of liability and the risk of lawsuits.⁵³ As a practical matter, some trustees may spin what should be negligence into a “reasonable” action under the circumstances, thus escaping liability.⁵⁴

3. Grossly Negligent Breach of a Trustee’s Fiduciary Duties

This is the middle ground, one step higher in protection from acting negligently, and probably the best standard to use. It has only been adopted by the Fifth Circuit as the appropriate level of trustee misconduct to warrant a finding of personal liability for a breach of a fiduciary duty.⁵⁵ In that case, the Fifth Circuit explained that trustees need sufficient protection to persuade them to serve but not too much protection that might jeopardize the objective of efficient case management.⁵⁶ The *Smyth* court defined gross negligence as:

the intentional failure to perform a manifest duty in reckless disregard of the consequences. It is an act or omission respecting legal duty of an aggravated character as distinguished from a mere failure to exercise ordinary care. It amounts to indifference to present legal duty and to utter forgetfulness of legal obligations so far as other persons may be affected.⁵⁷

This is a high level of negligence. The court reasoned that “this standard of care strikes the proper balance between the difficulties of the task assumed by trustees and the need to protect the interest of creditors and other parties in the bankruptcy case.”⁵⁸ In short, it protects good enough protection not to be dissuaded to serve as a trustee.

⁵³ *See id.*

⁵⁴ *Id.*

⁵⁵ *See In re Smyth*, 207 F.3d 758, 761–62 (5th Cir. 2000).

⁵⁶ *See id.*

⁵⁷ *Id.* at 762 (quoting Black's Law Dictionary 1033 (6th ed. 1990)).

⁵⁸ *Id.*

For example, in *In re Wilson*, a chapter 7 trustee asserted claims against the defendants, alleging that the defendants had stolen the debtor's baseball training academy business.⁵⁹ There, the court dismissed trustee's claim against defendants and did not award the defendant with attorney's fees, even though it was requested in defendants' answer.⁶⁰ The court reasoned that, since the defendants were going after the trustee for attorney's fees in his personal capacity, the defendants had to properly assert a claim against the trustee by *alleging* gross negligence.⁶¹ Since the defendants did not allege gross negligence by the trustee, the defendants did not receive their attorney's fees.

Unlike with negligence, a trustee operating under a gross negligence jurisdiction will not be subjected to excessive personal liability. Accordingly, in finding a trustee personally liable, the grossly negligent standard is a more measured approach than mere negligent conduct or for intentional and deliberate acts.

Conclusion

The role of the chapter 7 bankruptcy trustee is an integral part to the proceeding and can be subject to lawsuits from disgruntled creditors. Courts recognize this role and immunize trustees with quasi-judicial and derived immunity. Nevertheless, trustees may be subject to personal liability, if they are in breach of their fiduciary duties to the beneficiaries of the estate. The law on trustee liability is, however, inconsistent. As it stands now, trustee liability depends upon the jurisdiction in which the trustee is appointed. Trustees should be cognizant of the jurisdiction that they are in and be aware of the standards that they will be held accountable.

⁵⁹ See No. 05-81190, 2007 WL 1040565, at *1 (Bankr. S.D. Tex. Mar. 30, 2007).

⁶⁰ See *id.* at *1.

⁶¹ See *id.* at *4 (emphasis added).