

Concurrent Session

“Broken Arrow” Chapter 11 Trustees and the New Sheriff Appointment, Job Description and Ethical Issues

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**The “Keeper”: The Trustee’s Role in
Individual Chapter 11s**

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I. Introduction¹

Individual Chapter 11 filings are quite rare as compared to other types of bankruptcies filed by individuals. In 2009, Chapter 11 accounted for only 0.11 percent of all consumer cases, while Chapter 7 accounted for 71% and Chapter 13 for 29%. As compared to business Chapter 11 bankruptcies, however, individual Chapter 11 bankruptcies are on the rise, accounting nationally for roughly 10% filed in 2009.² In the Western District of Washington, individual chapter 11 filings annually account for over 30% of the Chapter 11 filings since 2008, and a whopping 37.5% in the first ten months of 2010 (95 cases out of 253)³

Unfortunately, there is no statistical data on the appointment of trustees to individual Chapter 11 bankruptcy cases. Based on anecdotal evidence, however, the author is aware of seven such appointments in the Western District of Washington since the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was enacted in 2005. To the extent that one can draw conclusions from only seven cases, they will be discussed below in the section “Life of an Individual Chapter 11 Trustee Case.”

There is thus very little information – statutes, case law, or secondary literature – to guide the individual Chapter 11 trustee. This paper attempts to gather what little information is available to serve as a starting point for Chapter 11 trustees, their attorneys, and bankruptcy courts.

¹ The author gratefully acknowledges the assistance of Nathaniel S. Strauss, a legal intern at Karr Tuttle Campbell, numerous practitioners, and others from the judiciary and Bankruptcy Court Clerk’s Office of the Western District of Washington.

² See <http://www.abiworld.org/bkstats/index.html>.

³ Per communication with Bankruptcy Court Clerk’s Office, Western District of Washington. Between January - October 2010, a total of 253 Chapter 11s were filed, versus 123 in 2008. Overall, the appointment of trustees in Chapter 11 bankruptcies is rare, whether business or individual. From January 2008 through October 2010, in the Western District of Washington, there were 582 Chapter 11s filed; trustees were appointed in 11 of those: six in individual Chapter 11s, and five in business Chapter 11s. (In 2010, one trustee was appointed Trustee in nine related Meridian Fund cases, which were administratively consolidated. They are counted here as only one trustee appointment.)

II. Individual Chapter 11: A Background

As noted above, Chapter 11 is not the first choice of most individual debtors. Presumably, most debtors choose Chapter 7 because it is efficient and provides the discharge of debt that debtors seek. Chapter 13 is popular because it enables the debtor to discharge debts while protecting some of his or her assets from the bankruptcy. Prior to BAPCPA, Chapter 11 was desirable for some individuals because post-petition earnings were not property of the estate. Chapter 11 was less desirable for some debtors, however, because it required the bankruptcy to adhere to the “absolute priority rule,” which generally prohibited courts from confirming reorganization plans over the objections of a dissenting class of creditors unless either the dissenting creditors were to be paid in full or no junior creditor was to receive any payment.⁴ Although some courts have ruled that BAPCPA abolishes the absolute priority rule in individual Chapter 11 cases,⁵ there is a split of authority, as unpublished decisions reveal that courts within the Ninth Circuit differ on whether the absolute priority rule was abrogated.⁶ Nonetheless, Chapter 11 still appears to be a viable option for individuals with high debts, and, at least in some jurisdictions, it has opened the way to successfully confirm less than 100% plans.

The less-than-1 percent of individuals who file under Chapter 11 presumably do so because they do not qualify under either Chapter 7 or Chapter 13. When Congress passed BAPCPA in 2005, it intentionally tightened the rules for filing under those other chapters to encourage debtors to develop reorganization plans that would satisfy all creditors. Chapter 7 now imposes a means test to weed out “unworthy” debtors.⁷ Chapter 13 imposes a debt limit of

⁴ 11 U.S.C. § 1129(b)(2)(B).

⁵ *See, e.g., In re Tededer*, 369 B.R. 477 (Bankr. Neb. 2007).

⁶ Per conversation with Honorable Karen A. Overstreet, Chief Judge, U.S. Bankruptcy Court for the Western District of Washington.

⁷ 11 U.S.C. § 707(b)(2)(B).

\$360,475 in unsecured debt and \$1,081,400 in secured debt.⁸ Debtors who cannot meet either of those tests must resort to Chapter 11 if they are seeking bankruptcy relief.

In real-world terms, individual Chapter 11 bankruptcies tend to behave like hybrids between business Chapter 11s and individual Chapter 13s.⁹ The individuals who file under Chapter 11 are often wealthier than debtors under Chapter 13 and tend to have assets that the debtor believes can be retained and made solvent, such as extensive real estate holdings, sole proprietorships and other closely-held businesses. Some courts treat them as small businesses, allowing combined hearings on disclosure statements and reorganization plans under Section 1125(f), or, for bankruptcies whose the primary assets are real estate, as SAREs (single asset real estate bankruptcies), as defined in Section 101 (51B). The Honorable Bruce Markell, bankruptcy judge in Nevada, notes that individual Chapter 11s are not small in number and has suggested that they warrant their own subchapter in the Bankruptcy Code.¹⁰

III. Appointment of Individual Chapter 11 Trustees

Section 1104 provides for the appointment of a private trustee. Broadly speaking, it allows bankruptcy courts discretion to order the appointment of a private trustee (a) for cause, such as where there has been malfeasance such as fraud or gross mismanagement on the part of the debtor; or (b) appointment would be in the best interest of the creditor and the estate.¹¹

While there has been no comprehensive study on the subject, anecdotal evidence suggests that most trustee appointments fall into the first category. For example, in one case, a debtor was appointed a private trustee after a showing of cause, “to ensure that the Debtor [a physician]

⁸ 75 F.R. 8747, 8748 (Feb. 25, 2010).

⁹ For a comparison of the features of individual chapter 11s and 13s, see *High Income Individuals: Chapter 11 by and for the People*, ABI Hawai'i Bankruptcy Workshop, August 2010.

¹⁰ Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 after BAPCPA*, 2007 U. Ill. L. Rev. 67, 69-70 nn. 6-9 (2007).

¹¹ 11 U.S.C. § 1104. Technically speaking, it is the U.S. Trustee, rather than the bankruptcy court, who appoints the trustee. The court merely orders the appointment.

accurately accounted for and separated his personal finances from The Heart Centre,” a business that the debtor owned.¹² While there is no record that the doctor engaged in “dishonesty, incompetence, or gross mismanagement,” the bankruptcy court explained in a published opinion that the appointment came after creditors raised objections to his disclosure statement and his proposed reorganization plan.¹³

In a more egregious (pre-BAPCPA) case, the debtor, Catherine Duffy Petit, was forced into a Chapter 7 involuntary bankruptcy after engaging in a “multifarious” investment scheme that pivoted around her effort to finance a multi-million dollar lawsuit against her bank, the bank’s attorneys, and her own attorneys.¹⁴ The bankruptcy court eventually converted the case into Chapter 11 and also appointed a private trustee, whom Petit sued, harassed, and threatened.¹⁵ (Petit was eventually convicted on 78 counts of conspiracy, money laundering, and fraud – including bankruptcy fraud – for her actions both before and during her bankruptcy.¹⁶)

The Petit case is not unusual; many high-dollar investment fraud schemes end up in bankruptcy, and the Department of Justice, through the U.S. Trustee, often recommends the appointment of a private trustee. For example, in 2002, the D.O.J. sought and obtained the appointment of a private trustee in the Chapter 11 bankruptcy of Reed Slatkin, co-founder of Internet service provider Earthlink Inc.¹⁷ Mr. Slatkin had operated a Ponzi scheme and defrauded over 500 investors of more than \$230 million.¹⁸ Bankruptcy fraud is also not unusual as the basis for the appointment of a trustee; in at least one Chapter 11 case in 2005, the D.O.J.

¹² *In re Clemente*, 409 B.R. 288, 290 (Bankr. D. N.J. 2009).

¹³ *Id.*

¹⁴ *United States v. Richard*, 234 F.3d 763, 765 (1st Cir. 2000).

¹⁵ *Id.* at 765-66.

¹⁶ *Id.* at 766.

¹⁷ UNITED STATES TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS, FISCAL YEAR 2002 pp. 33-34, available at http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2002.pdf; *Earthlink Founder Sentenced in Fraud*, NEW YORK TIMES (September 3, 2003).

¹⁸ *Id.* at p. 34.

sought and obtained the appointment a private trustee after it discovered that the debtor had concealed real estate worth over \$1.3 million from his creditors.¹⁹

IV. Other Powers and Duties of the Appointed Trustee

As in business Chapter 11 bankruptcies, the responsibilities of a trustee appointed to an individual Chapter 11 bankruptcy case are detailed in section 1106 of the Bankruptcy Code. Among other duties, the trustee must investigate the debtor's financial condition²⁰; file an initial report listing the debtor's creditors, assets, liabilities, and income²¹; and develop a reorganization plan that will either lead to dismissal of the case or to conversion to Chapters 7 or 13.²²

Undoubtedly most court precedents that apply to business chapter 11 bankruptcy cases also apply to individual cases. This makes particular sense in light of the fact that most Chapter 11 individual debtors have significant business assets that must be managed similar to those of their business debtor counterparts. In all cases, then, a trustee has the power and duty to exercise his or her own business judgment to manage the estate's business affairs without giving prior notice to creditors or obtaining leave from the court.²³ The trustee must still seek court approval for the sale of assets not in the ordinary course of business. The trustee serves as a fiduciary to the estate, and is required to exercise a reasonable degree of care. While the trustee may be sued for willful and deliberate breach of her fiduciary duties,²⁴ courts have generally held

¹⁹ UNITED STATES TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS, FISCAL YEAR 2005 p. 20, available at http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2005.pdf.

²⁰ 11 U.S.C. § 1106(a)(3).

²¹ 11 U.S.C. § 1106(a)(2).

²² 11 U.S.C. § 1106(a)(5).

²³ See *In re Lowry Graphics, Inc.*, 86 B.R. 74 (Bankr. S.D. Tex. 1988).

²⁴ See *Sherr v. Winkler*, 552 F.2d 1367 (10th Cir. 1977).

that Chapter 11 trustees are entitled to quasi-judicial immunity and may not be sued for conduct arising from their appointed duties without leave of the bankruptcy court.²⁵

Once the trustee is appointed, the trustee may need to grapple with issues concerning non-debtor business entities in which the individual debtor has an interest, especially if these are operating entities. The trustee must first assess the status of the business(es), such as ensuring that there is adequate insurance for potential liabilities. The trustee may want to seek from the court an order authorizing the trustee to manage those entities in the ordinary course and granting the trustee sole authority to perform certain “trustee actions” on behalf of those entities, including, for example, acting as and/or appointing officers and directors, authorizing bankruptcy filings, and selling or liquidating any assets of the entities. The trustee may allow the debtor to continue the day-to-day operation of the non-debtor entities, but the trustee could reserve the right to remove the debtor from such capacity in the trustee’s discretion. The trustee needs to be mindful with operating companies to ensure that trust fund taxes are paid so that the estate does not become burdened with responsible person tax claims. The trustee may further want to seek protections, such as asking the court in a “comfort order” to find that the trustee should not be considered a responsible person for any payroll tax purposes.

One notable duty of trustees is to investigate suspected fraud or other mismanagement by the debtor and to report any findings to the creditors and to “such other entity as the court designates.”²⁶ Since trustees are often appointed based upon a suspicion of debtor malfeasance, this aspect of a trustee’s duty can become quite significant. While no available data indicates

²⁵ See *In re Cedar Funding, Inc.*, 419 B.R. 807, 821-23 (B.A.P. 9th Cir. 2009) (citing *Antoine v. Byers & Anderson, Inc.*, 508 U.S. 429 (1993)).

²⁶ 11 U.S.C. § 1106(a)(4).

how often Chapter 11 trustees discover new fraud or mismanagement under this provision, personal experience would indicate that it is not uncommon.

My experience and others' demonstrate that the individual Chapter 11 trustee often acts not only as a business administrator of a private estate, but also as a watchdog and an adjunct to white-collar criminal law enforcement, coordinating with various state and federal agencies. As discussed above, many Chapter 11 bankruptcies would not receive appointed trustees in the absence of prior criminal wrongdoing; and the appointment of a trustee in such a case will likely increase the chance that more criminal acts will be uncovered.

Individual Chapter 11 trusteeships implicate other issues aside from debtor malfeasance. For example, individual debtors may be less likely to cooperate with trustees and courts than their business counterparts. This is true for multiple reasons, not the least of which is that business debtors often have a strong desire to proceed expeditiously in the hopes of exiting bankruptcy and attracting new investors. Individuals, on the other hand, are often in Chapter 11 to stave off creditors and preserve personal assets. An individual debtor is more likely to be personally and emotionally attached to his or her assets, especially when the bankruptcy estate includes the debtor's home, automobiles, and other possessions such as art or wine collections.

Thus, there appears to be a greater potential for conflict between the individual debtor and the appointed trustee. At one point during the lengthy Chapter 11 proceedings for the estate of litigation investment fraud mogul Catherine Duffy Petit, Ms. Petit challenged the appointed trustee's power to convene an initial creditor meeting under 11 U.S.C. § 341.²⁷ That section expressly authorizes the "U.S. trustee" to convene a creditor meeting, but does not reference

²⁷ *In re Petit*, 172 B.R. 706 (Bankr. D. Maine 1994).

private trustees.²⁸ However, the bankruptcy court held that the authority of the private trustee was implied in *Taylor v. Freeland & Kronz*,²⁹ in which the Supreme Court had stated that “performing his duty as a trustee, Taylor held the required initial meeting of creditors in January 1985. See 11 U.S.C. § 341; Bkrcty. Rule 2003(a).”³⁰

In a surprising twist, the *Petit* bankruptcy court continued by pointing to 11 U.S.C. § 102(9), which states that the definition of a “United States trustee” “includes a designee of the United States trustee.”³¹ The court held that the appointed trustee was a designee of the United States trustee, so he assumed the same authority under section 341. What is troubling about this line of reasoning, however, is that, taken to its extreme, it would apply to the *entire* bankruptcy code, effectively giving an appointed trustee all of the powers of a U.S. trustee. Common sense and experience practicing bankruptcy law seem to indicate that this was not Congress’s intent.

A legal dispute over trustees’ statutory powers was not the worst of the conflict that arose in the *Petit* bankruptcy between the debtor and the appointed trustee. After “aggressively performing his statutory duties,” the trustee abruptly quit after receiving threats such as “we’ll take your house” from the lawyer of the debtor’s friend and main co-conspirator in pending criminal charges.³² Consider yourself forewarned: the life of the individual Chapter 11 trustee is fraught with numerous challenges, often from the debtor him or herself, and a trustee is well advised to keep detailed records of all dealings with the debtor, and actions taken. It is not unknown for debtors to file complaints with the Court, the U.S. Trustee’s Office, and even their congressional representatives regarding the actions of the trustee.

²⁸ 11 U.S.C. § 341(a), (b), (e).

²⁹ 503 U.S. 638 (1992).

³⁰ *Petit*, 172 B.R. at 706 (quoting *Taylor*, 503 U.S. at 640).

³¹ *Petit*, 172 B.R. at 706.

³² *In re Petit*, 291 B.R. 582, 584-85 (Bankr. D. Maine 2003).

These challenges are complicated even more when there are non-debtor business assets that must be administered. Where those business assets are themselves in financial jeopardy, the trustee may find himself or herself faced with creditor collection actions (foreclosures, evictions, utility shutoffs, etc.) for which there is no automatic stay in effect, unless those entities themselves are then placed into bankruptcy protection.

V. Individual Debtors and Their Personal Expenses

One particularly vexing and unsettled issue in trustee-appointed Chapter 11 cases is the status and management of the debtor's personal expenses. Under Section 1115, post-petition income becomes the property of the bankruptcy estate. Under Section 503, the estate may pay "administrative expenses" with the court's permission. Under Section 547, a trustee is obligated to honor transfers incurred by the debtor in the ordinary course of business.³³ Are an individual debtor's personal expenses such as rent payments and grocery bills "administrative expenses" or "transfers incurred in the ordinary course of business?" And where a trustee is appointed to manage the estate, what duties and powers does he or she have to monitor or control those expenses? In other words, must the trustee track and approve of the debtor's grocery bills and movie tickets? In this regard, the bankruptcy code is notoriously unhelpful.

One bankruptcy court has held, in a non-trustee case, that personal expenses are effectively the individual's equivalent of a business's transfers incurred in ordinary course of course of business.³⁴ As a result, the court "declined to fix [the debtor's] allowance and decide what amounts he could and could not spend and for what purposes."³⁵ However, the court also noted that if the debtor's personal spending was sufficiently "eroding property of the state" in the

³³ 11 U.S.C. § 547(c)(2).

³⁴ *In re Bradley*, 185 B.R. 7,8 (Bankr. W.D. N.Y. 1995) (referring to a previous decision by the same court).

³⁵ *Id.*

future, then the court would consider appointing a trustee or consider converting the case to Chapter 7.³⁶

Applying the same logic in cases that already have trustee appointments, then trustees would presumably have the duty to monitor the debtor's personal expenses, but would not be obligated to manage them actively. The trustee might still be entitled to approve or deny the debtor's personal budget. One group of practitioners has noted that courts often leave such budgeting issues to the discretion of oversight of the U.S. Trustee's office.³⁷ By extension, it would only make sense that courts would grant similar discretion to an appointed trustee.

In the Western District of Washington at Seattle, one bankruptcy court judge conducts Section 105 status conferences at the beginning of each individual Chapter 11 case and requires the debtor to present a budget for review by the court. It is not clear, however, under what standards the court is reviewing that budget, nor the mechanism for imposing a budget on the debtor.

A related issue is monthly reporting. While this is arguably the trustee's responsibility, it is not clear exactly how this report is to be prepared. Anecdotally, some trustees report their own estate income and disbursements, merely attaching copies of any debtor bank statements, while other trustees provide an additional narrative and require debtors to fill out extensive monthly reports and file their bank statements. Thus it seems to be a case-by-case situation, presumably in coordination with the U.S. Trustee's Office.

³⁶ *Id.*

³⁷ WILSON MUHLHEIM ET AL., INDIVIDUAL CHAPTER 11 BANKRUPTCY CASES 3, <http://www.mb-lawoffice.com/Idividualchap11BkyCases.pdf>.

VI. The Specter of Involuntary Servitude

Modifications to Chapter 11 under BAPCPA have created the possibility of unconstitutionality in certain circumstances. In particular, some commentators have argued forcefully that, where an individual debtor enters Chapter 11 involuntarily, courts could violate the Thirteenth Amendment's prohibition against involuntary servitude.³⁸ The contours of that argument are that, prior to BAPCPA's enactment in 2005, courts had rejected similar challenges to Chapter 13 by reasoning that Chapter 13 is voluntary and that a Chapter 13 debtor has a right to dismiss his case with no minimum time limit.³⁹ Under post-BAPCPA Chapter 11, on the other hand, a debtor may be forced into Chapter 11 involuntarily⁴⁰; the debtor's post-petition earnings from services automatically become part of the bankruptcy estate⁴¹; and, if a single unsecured creditor objects to the reorganization plan, the debtor must repay the debt in full or devote all of his projected disposable income for the longer of five years or the length of the plan.⁴² The debtor is generally only discharged upon completion of plan payments. As a result, under Chapter 11, a creditor-turned-employer could potentially put a debtor into bankruptcy and keep him there against his will until he works off his debt. In a case, therefore, where a trustee is appointed in an involuntary individual chapter 11, the chapter 11 trustee is directly affected by this argument.

³⁸ Robert J. Keach, *Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?*, 13 AM. BANKR. INST. L. REV. 483 (2005); Erwin Chemerinsky, *Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 571, 583-590 (2005); *but see* Margaret Howard, *Bankruptcy Bondage*, 2009 U. ILL. L. REV. 191 (2009) (submitting that bankruptcy courts can comply with the Thirteenth Amendment by not issuing coercive orders)

³⁹ *See* Keach at 490-91.

⁴⁰ 11 U.S.C. § 303.

⁴¹ 11 U.S.C. § 1115(a).

⁴² 11 U.S.C. § 1129(a)(1).

The Thirteenth Amendment may be implicated in voluntary Chapter 11 bankruptcies as well as involuntary bankruptcies. In *In re Clemente*,⁴³ the debtor filed for Chapter 11 relief voluntarily, and the court ultimately appointed a Chapter 11 trustee.⁴⁴ Later, upon rejection of his reorganization plan by multiple creditors, the debtor moved to convert his case to Chapter 7.⁴⁵ At that point, however, he “hit a statutory roadblock”⁴⁶: because he was no longer a debtor in possession as a result of the trustee appointment, he had lost his power to convert.⁴⁷ At that point, he argued that his bankruptcy was “keeping him captive” in Chapter 11 as an indentured servant.⁴⁸

The court first discussed, but did not decide, the constitutionality of individual Chapter 11, and noted that a Thirteenth Amendment question existed even where a debtor enters Chapter 11 voluntarily.⁴⁹ However, the court then explicitly sidestepped the dilemma under the doctrine of constitutional avoidance and held that it could reasonably interpret the debtor’s motion to convert to Chapter 7 as including a request to terminate the appointment of his trustee.⁵⁰ The court then granted that implicit request, invoking its “equitable power under § 105(a) ‘to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.’”⁵¹

The upshot of the *Clemente* decision is that, if it is followed by other courts, individual debtors effectively have the power in some circumstances to unilaterally “force” courts to terminate trustee appointments. Of course, if a court feels that a debtor is abusing this power, or

⁴³ 409 B.R. 288 (Bankr. D. N.J. 2009).

⁴⁴ *Id.* at 290.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ See 11 U.S.C. § 1112(a)(1).

⁴⁸ *Clemente*, 409 B.R. at 290-91.

⁴⁹ *Id.* at 293.

⁵⁰ *Id.* at 295.

⁵¹ *Id.* (quoting 11 U.S.C. § 105(a)).

if for whatever reason the court wishes to keep an appointed trustee on a case, then it could choose not to follow *Clemente* and to address the debtor's constitutional challenge head-on.

One court in the Western District of Washington, when faced with a debtor's motion to convert his Chapter 11 case to a Chapter 7 (presumably to retain his post-petition earnings), juxtaposed with a motion by numerous creditors to appoint a Chapter 11 trustee, authorized entry of a order appointing a Chapter 11 trustee but authorizing the debtor, from entry of the appointment, to retain his post-petition earnings.⁵²

VII. The Life of an Individual Chapter 11 Trustee Case

The following is an effort to distill common facts, differences and possibly trends from a review of the seven (7) Chapter 11 Individual trustee cases filed in the Western District of Washington since BAPCPA.

- A. Debtors. These include a number of professionals (a fine art dealer and an engineer), business owners (pizza stores, investment funds,⁵³ and an advertising company) and two realtors/property developers.
- B. Initiation. Five were initiated by secured creditors, one by an ex-wife (in the middle of dissolution dispute), and the seventh was initiated by the U.S. Trustee's Office.
- C. Reasons for Initiating. The primary reasons appear to be mismanagement, including irregularities in Chapter 11 reporting and operations, paying prepetition debts without authorization, failure to adhere to court orders, loss or diminution to estate, and failure to file and/or pursue a confirmable plan. In two cases, known

⁵² *In re Berg*, Case no.10-18668.(Bankr. W.D. Wash. 2010)

⁵³ The individual Chapter 11 debtor filed for protection after investors in his alleged Ponzi scheme sought to impose personal liability on the individual fund owner/manager. The majority of the investment Funds are in separate Chapter 11s with a different court-appointed Chapter 11 trustee.

pre-petition fraud and mismanagement of business affairs by the debtors was invoked as a reason for the appointment. The time period for appointment ranged from one month of the petition date, to one year, with the average appearing to be four to six months.

- D. Trustee Appointments. There were three Chapter 7 panel trustees (two of which are attorneys), three bankruptcy attorneys, and one non-trustee/non-attorney (an accountant/turnaround professional). Most appointed outside counsel to represent them, although two retained their own law firms to represent them, and the turnaround professional (individual) retained his own firm to provide services. Official committees of creditors had been appointed in two of the seven cases.
- E. Case Disposition. One was dismissed after the Debtor borrowed money to pay creditors in full (which funds the Chapter 11 trustee administered), three are ongoing, two were converted to Chapter 7 (and thus the debtors received a discharge), and one was dismissed without a plan after all of the assets were administered (and thus without a discharge of the debtor). None of these cases to date has had a Chapter 11 plan confirmed.

The take-away from reviewing these dockets and talking to affected parties is that courts tend to appoint trustees in individual Chapter 11s when they sense either that the debtor is blatantly untrustworthy (fraud/mismanagement is almost a “given”), or that the debtors are concerned more about their *own* properties and rights than ensuring that their creditors get paid (by, for example, failing to list “favorite” assets for sale, despite the fact that such sales would generate funds for creditors). It is the appointed trustee’s task then to determine what is the most expeditious and efficient way to ensure the maximum recovery to creditors, and whether

remaining in Chapter 11 is the best route. It is the trustee's role to figure out what is impeding progress – be it settling contentious matters between the debtor and creditors, or listing property for sale – and then taking action to accomplish those objectives.

VIII. Conclusion

There are many unsettled legal and practical issues in the individual Chapter 11 arena -- and with the role of appointed trustees in such cases in particular. Many of those issues are outside the purview of this paper, such as how is the trustee to be paid, payment for counsel of debtors, and what elements need to be in a Chapter 11 plan to ensure confirmability.

At the end of the day, appointed trustees and their attorneys will have to “wing” it by incorporating the law of Chapters 7 and 13, as well as the law of Chapter 11 for business debtors. They will have to decide whether and how the existing law should apply in the individual Chapter 11 context. Specifically, because the bankruptcy code was not originally designed with individual Chapter 11s and their appointed trustees in mind, trustees, attorneys, and courts must divine Congress's general intent using a healthy dose of common sense. While this may be daunting to some, it provides great opportunity for courts and trustees alike to put their stamp on the future of high-asset individual bankruptcy law.

“Broken Arrow”

CHAPTER 11 TRUSTEES
AND OTHER ETHICAL ISSUES

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The less-than-1 percent of individuals who file under Chapter 11 presumably do so because they do not qualify under either Chapter 7 or Chapter 13. When Congress passed BAPCPA in 2005, it intentionally tightened the rules for filing under those other chapters to encourage debtors to develop reorganization plans that would satisfy all creditors. Chapter 7 now imposes a means test to weed out “unworthy” debtors.⁷ Chapter 13 imposes a debt limit of

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⁷ 11 U.S.C. § 707(b)(2)(B).

\$360,475 in unsecured debt and \$1,081,400 in secured debt.⁸ Debtors who cannot meet either of those tests must resort to Chapter 11 if they are seeking bankruptcy relief.

In real-world terms, individual Chapter 11 bankruptcies tend to behave like hybrids between business Chapter 11s and individual Chapter 13s.⁹ The individuals who file under Chapter 11 are often wealthier than debtors under Chapter 13 and tend to have assets that the debtor believes can be retained and made solvent, such as extensive real estate holdings, sole proprietorships and other closely-held businesses. Some courts treat them as small businesses, allowing combined hearings on disclosure statements and reorganization plans under Section 1125(f), or, for bankruptcies whose the primary assets are real estate, as SAREs (single asset real estate bankruptcies), as defined in Section 101 (51B). The Honorable Bruce Markell, bankruptcy judge in Nevada, notes that individual Chapter 11s are not small in number and has suggested that they warrant their own subchapter in the Bankruptcy Code.¹⁰

III. Appointment of Individual Chapter 11 Trustees

Section 1104 provides for the appointment of a private trustee. Broadly speaking, it allows bankruptcy courts discretion to order the appointment of a private trustee (a) for cause, such as where there has been malfeasance such as fraud or gross mismanagement on the part of the debtor; or (b) appointment would be in the best interest of the creditor and the estate.¹¹

While there has been no comprehensive study on the subject, anecdotal evidence suggests that most trustee appointments fall into the first category. For example, in one case, a debtor was appointed a private trustee after a showing of cause, “to ensure that the Debtor [a physician]

⁸ 75 F.R. 8747, 8748 (Feb. 25, 2010).

⁹ For a comparison of the features of individual chapter 11s and 13s, see *High Income Individuals: Chapter 11 by and for the People*, ABI Hawai'i Bankruptcy Workshop, August 2010.

¹⁰ Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 after BAPCPA*, 2007 U. Ill. L. Rev. 67, 69-70 nn. 6-9 (2007).

¹¹ 11 U.S.C. § 1104. Technically speaking, it is the U.S. Trustee, rather than the bankruptcy court, who appoints the trustee. The court merely orders the appointment.

accurately accounted for and separated his personal finances from The Heart Centre,” a business that the debtor owned.¹² While there is no record that the doctor engaged in “dishonesty, incompetence, or gross mismanagement,” the bankruptcy court explained in a published opinion that the appointment came after creditors raised objections to his disclosure statement and his proposed reorganization plan.¹³

In a more egregious (pre-BAPCPA) case, the debtor, Catherine Duffy Petit, was forced into a Chapter 7 involuntary bankruptcy after engaging in a “multifarious” investment scheme that pivoted around her effort to finance a multi-million dollar lawsuit against her bank, the bank’s attorneys, and her own attorneys.¹⁴ The bankruptcy court eventually converted the case into Chapter 11 and also appointed a private trustee, whom Petit sued, harassed, and threatened.¹⁵ (Petit was eventually convicted on 78 counts of conspiracy, money laundering, and fraud – including bankruptcy fraud – for her actions both before and during her bankruptcy.¹⁶)

The Petit case is not unusual; many high-dollar investment fraud schemes end up in bankruptcy, and the Department of Justice, through the U.S. Trustee, often recommends the appointment of a private trustee. For example, in 2002, the D.O.J. sought and obtained the appointment of a private trustee in the Chapter 11 bankruptcy of Reed Slatkin, co-founder of Internet service provider Earthlink Inc.¹⁷ Mr. Slatkin had operated a Ponzi scheme and defrauded over 500 investors of more than \$230 million.¹⁸ Bankruptcy fraud is also not unusual as the basis for the appointment of a trustee; in at least one Chapter 11 case in 2005, the D.O.J.

¹² *In re Clemente*, 409 B.R. 288, 290 (Bankr. D. N.J. 2009).

¹³ *Id.*

¹⁴ *United States v. Richard*, 234 F.3d 763, 765 (1st Cir. 2000).

¹⁵ *Id.* at 765-66.

¹⁶ *Id.* at 766.

¹⁷ UNITED STATES TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS, FISCAL YEAR 2002 pp. 33-34, available at http://www.justice.gov/ust/ea/public_affairs/annualreport/docs/ar2002.pdf; *Earthlink Founder Sentenced in Fraud*, NEW YORK TIMES (September 3, 2003).

¹⁸ *Id.* at p. 34.

sought and obtained the appointment a private trustee after it discovered that the debtor had concealed real estate worth over \$1.3 million from his creditors.¹⁹

IV. Other Powers and Duties of the Appointed Trustee

As in business Chapter 11 bankruptcies, the responsibilities of a trustee appointed to an individual Chapter 11 bankruptcy case are detailed in section 1106 of the Bankruptcy Code. Among other duties, the trustee must investigate the debtor's financial condition²⁰; file an initial report listing the debtor's creditors, assets, liabilities, and income²¹; and develop a reorganization plan that will either lead to dismissal of the case or to conversion to Chapters 7 or 13.²²

Undoubtedly most court precedents that apply to business chapter 11 bankruptcy cases also apply to individual cases. This makes particular sense in light of the fact that most Chapter 11 individual debtors have significant business assets that must be managed similar to those of their business debtor counterparts. In all cases, then, a trustee has the power and duty to exercise his or her own business judgment to manage the estate's business affairs without giving prior notice to creditors or obtaining leave from the court.²³ The trustee must still seek court approval for the sale of assets not in the ordinary course of business. The trustee serves as a fiduciary to the estate, and is required to exercise a reasonable degree of care. While the trustee may be sued for willful and deliberate breach of her fiduciary duties,²⁴ courts have generally held

¹⁹ UNITED STATES TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS, FISCAL YEAR 2005 p. 20, available at http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2005.pdf.

²⁰ 11 U.S.C. § 1106(a)(3).

²¹ 11 U.S.C. § 1106(a)(2).

²² 11 U.S.C. § 1106(a)(5).

²³ See *In re Lowry Graphics, Inc.*, 86 B.R. 74 (Bankr. S.D. Tex. 1988).

²⁴ See *Sherr v. Winkler*, 552 F.2d 1367 (10th Cir. 1977).

that Chapter 11 trustees are entitled to quasi-judicial immunity and may not be sued for conduct arising from their appointed duties without leave of the bankruptcy court.²⁵

Once the trustee is appointed, the trustee may need to grapple with issues concerning non-debtor business entities in which the individual debtor has an interest, especially if these are operating entities. The trustee must first assess the status of the business(es), such as ensuring that there is adequate insurance for potential liabilities. The trustee may want to seek from the court an order authorizing the trustee to manage those entities in the ordinary course and granting the trustee sole authority to perform certain “trustee actions” on behalf of those entities, including, for example, acting as and/or appointing officers and directors, authorizing bankruptcy filings, and selling or liquidating any assets of the entities. The trustee may allow the debtor to continue the day-to-day operation of the non-debtor entities, but the trustee could reserve the right to remove the debtor from such capacity in the trustee’s discretion. The trustee needs to be mindful with operating companies to ensure that trust fund taxes are paid so that the estate does not become burdened with responsible person tax claims. The trustee may further want to seek protections, such as asking the court in a “comfort order” to find that the trustee should not be considered a responsible person for any payroll tax purposes.

One notable duty of trustees is to investigate suspected fraud or other mismanagement by the debtor and to report any findings to the creditors and to “such other entity as the court designates.”²⁶ Since trustees are often appointed based upon a suspicion of debtor malfeasance, this aspect of a trustee’s duty can become quite significant. While no available data indicates

²⁵ See *In re Cedar Funding, Inc.*, 419 B.R. 807, 821-23 (B.A.P. 9th Cir. 2009) (citing *Antoine v. Byers & Anderson, Inc.*, 508 U.S. 429 (1993)).

²⁶ 11 U.S.C. § 1106(a)(4).

how often Chapter 11 trustees discover new fraud or mismanagement under this provision, personal experience would indicate that it is not uncommon.

My experience and others' demonstrate that the individual Chapter 11 trustee often acts not only as a business administrator of a private estate, but also as a watchdog and an adjunct to white-collar criminal law enforcement, coordinating with various state and federal agencies. As discussed above, many Chapter 11 bankruptcies would not receive appointed trustees in the absence of prior criminal wrongdoing; and the appointment of a trustee in such a case will likely increase the chance that more criminal acts will be uncovered.

Individual Chapter 11 trusteeships implicate other issues aside from debtor malfeasance. For example, individual debtors may be less likely to cooperate with trustees and courts than their business counterparts. This is true for multiple reasons, not the least of which is that business debtors often have a strong desire to proceed expeditiously in the hopes of exiting bankruptcy and attracting new investors. Individuals, on the other hand, are often in Chapter 11 to stave off creditors and preserve personal assets. An individual debtor is more likely to be personally and emotionally attached to his or her assets, especially when the bankruptcy estate includes the debtor's home, automobiles, and other possessions such as art or wine collections.

Thus, there appears to be a greater potential for conflict between the individual debtor and the appointed trustee. At one point during the lengthy Chapter 11 proceedings for the estate of litigation investment fraud mogul Catherine Duffy Petit, Ms. Petit challenged the appointed trustee's power to convene an initial creditor meeting under 11 U.S.C. § 341.²⁷ That section expressly authorizes the "U.S. trustee" to convene a creditor meeting, but does not reference

²⁷ *In re Petit*, 172 B.R. 706 (Bankr. D. Maine 1994).

private trustees.²⁸ However, the bankruptcy court held that the authority of the private trustee was implied in *Taylor v. Freeland & Kronz*,²⁹ in which the Supreme Court had stated that “performing his duty as a trustee, Taylor held the required initial meeting of creditors in January 1985. See 11 U.S.C. § 341; Bkrtcy. Rule 2003(a).”³⁰

In a surprising twist, the *Petit* bankruptcy court continued by pointing to 11 U.S.C. § 102(9), which states that the definition of a “United States trustee” “includes a designee of the United States trustee.”³¹ The court held that the appointed trustee was a designee of the United States trustee, so he assumed the same authority under section 341. What is troubling about this line of reasoning, however, is that, taken to its extreme, it would apply to the *entire* bankruptcy code, effectively giving an appointed trustee all of the powers of a U.S. trustee. Common sense and experience practicing bankruptcy law seem to indicate that this was not Congress’s intent.

A legal dispute over trustees’ statutory powers was not the worst of the conflict that arose in the *Petit* bankruptcy between the debtor and the appointed trustee. After “aggressively performing his statutory duties,” the trustee abruptly quit after receiving threats such as “we’ll take your house” from the lawyer of the debtor’s friend and main co-conspirator in pending criminal charges.³² Consider yourself forewarned: the life of the individual Chapter 11 trustee is fraught with numerous challenges, often from the debtor him or herself, and a trustee is well advised to keep detailed records of all dealings with the debtor, and actions taken. It is not unknown for debtors to file complaints with the Court, the U.S. Trustee’s Office, and even their congressional representatives regarding the actions of the trustee.

²⁸ 11 U.S.C. § 341(a), (b), (e).

²⁹ 503 U.S. 638 (1992).

³⁰ *Petit*, 172 B.R. at 706 (quoting *Taylor*, 503 U.S. at 640).

³¹ *Petit*, 172 B.R. at 706.

³² *In re Petit*, 291 B.R. 582, 584-85 (Bankr. D. Maine 2003).

These challenges are complicated even more when there are non-debtor business assets that must be administered. Where those business assets are themselves in financial jeopardy, the trustee may find himself or herself faced with creditor collection actions (foreclosures, evictions, utility shutoffs, etc.) for which there is no automatic stay in effect, unless those entities themselves are then placed into bankruptcy protection.

V. Individual Debtors and Their Personal Expenses

One particularly vexing and unsettled issue in trustee-appointed Chapter 11 cases is the status and management of the debtor's personal expenses. Under Section 1115, post-petition income becomes the property of the bankruptcy estate. Under Section 503, the estate may pay "administrative expenses" with the court's permission. Under Section 547, a trustee is obligated to honor transfers incurred by the debtor in the ordinary course of business.³³ Are an individual debtor's personal expenses such as rent payments and grocery bills "administrative expenses" or "transfers incurred in the ordinary course of business?" And where a trustee is appointed to manage the estate, what duties and powers does he or she have to monitor or control those expenses? In other words, must the trustee track and approve of the debtor's grocery bills and movie tickets? In this regard, the bankruptcy code is notoriously unhelpful.

One bankruptcy court has held, in a non-trustee case, that personal expenses are effectively the individual's equivalent of a business's transfers incurred in ordinary course of course of business.³⁴ As a result, the court "declined to fix [the debtor's] allowance and decide what amounts he could and could not spend and for what purposes."³⁵ However, the court also noted that if the debtor's personal spending was sufficiently "eroding property of the state" in the

³³ 11 U.S.C. § 547(c)(2).

³⁴ *In re Bradley*, 185 B.R. 7,8 (Bankr. W.D. N.Y. 1995) (referring to a previous decision by the same court).

³⁵ *Id.*

future, then the court would consider appointing a trustee or consider converting the case to Chapter 7.³⁶

Applying the same logic in cases that already have trustee appointments, then trustees would presumably have the duty to monitor the debtor's personal expenses, but would not be obligated to manage them actively. The trustee might still be entitled to approve or deny the debtor's personal budget. One group of practitioners has noted that courts often leave such budgeting issues to the discretion of oversight of the U.S. Trustee's office.³⁷ By extension, it would only make sense that courts would grant similar discretion to an appointed trustee.

In the Western District of Washington at Seattle, one bankruptcy court judge conducts Section 105 status conferences at the beginning of each individual Chapter 11 case and requires the debtor to present a budget for review by the court. It is not clear, however, under what standards the court is reviewing that budget, nor the mechanism for imposing a budget on the debtor.

A related issue is monthly reporting. While this is arguably the trustee's responsibility, it is not clear exactly how this report is to be prepared. Anecdotally, some trustees report their own estate income and disbursements, merely attaching copies of any debtor bank statements, while other trustees provide an additional narrative and require debtors to fill out extensive monthly reports and file their bank statements. Thus it seems to be a case-by-case situation, presumably in coordination with the U.S. Trustee's Office.

³⁶ *Id.*

³⁷ WILSON MUHLHEIM ET AL., INDIVIDUAL CHAPTER 11 BANKRUPTCY CASES 3, <http://www.mb-lawoffice.com/Individualchap11BkyCases.pdf>.

VI. The Specter of Involuntary Servitude

Modifications to Chapter 11 under BAPCPA have created the possibility of unconstitutionality in certain circumstances. In particular, some commentators have argued forcefully that, where an individual debtor enters Chapter 11 involuntarily, courts could violate the Thirteenth Amendment's prohibition against involuntary servitude.³⁸ The contours of that argument are that, prior to BAPCPA's enactment in 2005, courts had rejected similar challenges to Chapter 13 by reasoning that Chapter 13 is voluntary and that a Chapter 13 debtor has a right to dismiss his case with no minimum time limit.³⁹ Under post-BAPCPA Chapter 11, on the other hand, a debtor may be forced into Chapter 11 involuntarily⁴⁰; the debtor's post-petition earnings from services automatically become part of the bankruptcy estate⁴¹; and, if a single unsecured creditor objects to the reorganization plan, the debtor must repay the debt in full or devote all of his projected disposable income for the longer of five years or the length of the plan.⁴² The debtor is generally only discharged upon completion of plan payments. As a result, under Chapter 11, a creditor-turned-employer could potentially put a debtor into bankruptcy and keep him there against his will until he works off his debt. In a case, therefore, where a trustee is appointed in an involuntary individual chapter 11, the chapter 11 trustee is directly affected by this argument.

³⁸ Robert J. Keach, *Dead Man Filing Redux: Is the New Individual Chapter Eleven Unconstitutional?*, 13 AM. BANKR. INST. L. REV. 483 (2005); Erwin Chemerinsky, *Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 571, 583-590 (2005); but see Margaret Howard, *Bankruptcy Bondage*, 2009 U. ILL. L. REV. 191 (2009) (submitting that bankruptcy courts can comply with the Thirteenth Amendment by not issuing coercive orders)

³⁹ See Keach at 490-91.

⁴⁰ 11 U.S.C. § 303.

⁴¹ 11 U.S.C. § 1115(a).

⁴² 11 U.S.C. § 1129(a)(1).

The Thirteenth Amendment may be implicated in voluntary Chapter 11 bankruptcies as well as involuntary bankruptcies. In *In re Clemente*,⁴³ the debtor filed for Chapter 11 relief voluntarily, and the court ultimately appointed a Chapter 11 trustee.⁴⁴ Later, upon rejection of his reorganization plan by multiple creditors, the debtor moved to convert his case to Chapter 7.⁴⁵ At that point, however, he “hit a statutory roadblock”⁴⁶: because he was no longer a debtor in possession as a result of the trustee appointment, he had lost his power to convert.⁴⁷ At that point, he argued that his bankruptcy was “keeping him captive” in Chapter 11 as an indentured servant.⁴⁸

The court first discussed, but did not decide, the constitutionality of individual Chapter 11, and noted that a Thirteenth Amendment question existed even where a debtor enters Chapter 11 voluntarily.⁴⁹ However, the court then explicitly sidestepped the dilemma under the doctrine of constitutional avoidance and held that it could reasonably interpret the debtor’s motion to convert to Chapter 7 as including a request to terminate the appointment of his trustee.⁵⁰ The court then granted that implicit request, invoking its “equitable power under § 105(a) ‘to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.’”⁵¹

The upshot of the *Clemente* decision is that, if it is followed by other courts, individual debtors effectively have the power in some circumstances to unilaterally “force” courts to terminate trustee appointments. Of course, if a court feels that a debtor is abusing this power, or

⁴³ 409 B.R. 288 (Bankr. D. N.J. 2009).

⁴⁴ *Id.* at 290.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ See 11 U.S.C. § 1112(a)(1).

⁴⁸ *Clemente*, 409 B.R. at 290-91.

⁴⁹ *Id.* at 293.

⁵⁰ *Id.* at 295.

⁵¹ *Id.* (quoting 11 U.S.C. § 105(a)).

if for whatever reason the court wishes to keep an appointed trustee on a case, then it could choose not to follow *Clemente* and to address the debtor's constitutional challenge head-on.

One court in the Western District of Washington, when faced with a debtor's motion to convert his Chapter 11 case to a Chapter 7 (presumably to retain his post-petition earnings), juxtaposed with a motion by numerous creditors to appoint a Chapter 11 trustee, authorized entry of a order appointing a Chapter 11 trustee but authorizing the debtor, from entry of the appointment, to retain his post-petition earnings.⁵²

VII. The Life of an Individual Chapter 11 Trustee Case

The following is an effort to distill common facts, differences and possibly trends from a review of the seven (7) Chapter 11 Individual trustee cases filed in the Western District of Washington since BAPCPA.

- A. Debtors. These include a number of professionals (a fine art dealer and an engineer), business owners (pizza stores, investment funds,⁵³ and an advertising company) and two realtors/property developers.
- B. Initiation. Five were initiated by secured creditors, one by an ex-wife (in the middle of dissolution dispute), and the seventh was initiated by the U.S. Trustee's Office.
- C. Reasons for Initiating. The primary reasons appear to be mismanagement, including irregularities in Chapter 11 reporting and operations, paying prepetition debts without authorization, failure to adhere to court orders, loss or diminution to estate, and failure to file and/or pursue a confirmable plan. In two cases, known

⁵² *In re Berg*, Case no.10-18668.(Bankr. W.D. Wash. 2010)

⁵³ The individual Chapter 11 debtor filed for protection after investors in his alleged Ponzi scheme sought to impose personal liability on the individual fund owner/manager. The majority of the investment Funds are in separate Chapter 11s with a different court-appointed Chapter 11 trustee.

pre-petition fraud and mismanagement of business affairs by the debtors was invoked as a reason for the appointment. The time period for appointment ranged from one month of the petition date, to one year, with the average appearing to be four to six months.

- D. Trustee Appointments. There were three Chapter 7 panel trustees (two of which are attorneys), three bankruptcy attorneys, and one non-trustee/non-attorney (an accountant/turnaround professional). Most appointed outside counsel to represent them, although two retained their own law firms to represent them, and the turnaround professional (individual) retained his own firm to provide services. Official committees of creditors had been appointed in two of the seven cases.
- E. Case Disposition. One was dismissed after the Debtor borrowed money to pay creditors in full (which funds the Chapter 11 trustee administered), three are ongoing, two were converted to Chapter 7 (and thus the debtors received a discharge), and one was dismissed without a plan after all of the assets were administered (and thus without a discharge of the debtor). None of these cases to date has had a Chapter 11 plan confirmed.

The take-away from reviewing these dockets and talking to affected parties is that courts tend to appoint trustees in individual Chapter 11s when they sense either that the debtor is blatantly untrustworthy (fraud/mismanagement is almost a “given”), or that the debtors are concerned more about their *own* properties and rights than ensuring that their creditors get paid (by, for example, failing to list “favorite” assets for sale, despite the fact that such sales would generate funds for creditors). It is the appointed trustee’s task then to determine what is the most expeditious and efficient way to ensure the maximum recovery to creditors, and whether

remaining in Chapter 11 is the best route. It is the trustee's role to figure out what is impeding progress – be it settling contentious matters between the debtor and creditors, or listing property for sale – and then taking action to accomplish those objectives.

VIII. Conclusion

There are many unsettled legal and practical issues in the individual Chapter 11 arena -- and with the role of appointed trustees in such cases in particular. Many of those issues are outside the purview of this paper, such as how is the trustee to be paid, payment for counsel of debtors, and what elements need to be in a Chapter 11 plan to ensure confirmability.

At the end of the day, appointed trustees and their attorneys will have to “wing” it by incorporating the law of Chapters 7 and 13, as well as the law of Chapter 11 for business debtors. They will have to decide whether and how the existing law should apply in the individual Chapter 11 context. Specifically, because the bankruptcy code was not originally designed with individual Chapter 11s and their appointed trustees in mind, trustees, attorneys, and courts must divine Congress's general intent using a healthy dose of common sense. While this may be daunting to some, it provides great opportunity for courts and trustees alike to put their stamp on the future of high-asset individual bankruptcy law.

**CHAPTER 11 TRUSTEES AND THE NEW SHERIFF
APPOINTMENT: JOB DESCRIPTION AND
ETHICAL ISSUES**

[select issues]

American Bankruptcy Institute
Rocky Mountain Bankruptcy Conference

January 27, 2011
Neal H. Levin, Esq.
Freeborn & Peters LLP

Freeborn & Peters LLP



Are The Estate And The Debtor Separate?

- Estate – “all legal or equitable interests of the debtor in property as of the commencement of the case”
 - 11 U.S.C. § 541(a)(1)
- Debtor – the “person or municipality concerning which a case under this title has been commenced.”
 - 11 U.S.C. § 101(13)

Chapter 11 Trustee: Grounds For Appointment

- 11 U.S.C. §1104(a): Appointment of Trustee
 - Upon request of a party in interest
 - After commencement of case but before confirmation of plan
 - Movant must demonstrate grounds for appointment
 - (1) For cause
 - (2) Best interests of parties in interest
 - (3) Grounds to convert or dismiss
 - (4) Reasonable suspicion of wrongdoing

Chapter 11 Trustee: Grounds For Appointment

- For Cause
 - “for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor”
 - 11 U.S.C. §1104(a)(1)
 - *In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1986)
 - “For Cause” under BAPCPA
 - Mandatory if cause proven

Chapter 11 Trustee: Grounds For Appointment

- Best Interests Test
 - “if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor”
 - 11 U.S.C. §1104(a)(2)
- Balancing of Competing Factors
 - Trustworthiness of the Debtor
 - Debtor’s past performance and prospects for rehabilitation
 - Confidence of business community in current management
 - Cost/benefit analysis
 - *In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1986)
- Clear and Convincing Evidence Standard
- Discretionary

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Chapter 11 Trustee: Grounds For Appointment

- Best Interests Test (Cont.)
 - Liquidating Chapter 11
 - No need to balance chapter 11 trustee with present management's ability to run company
 - *In re PRS Ins. Group, Inc.*, 274 B.R. 381 (Bankr. D. Del. 2001)
 - Look for acrimony between management and creditors
 - *In re Cohoes Ind. Terminal, Inc.*, 65 B.R. 918 (Bankr. S.D.N.Y. 1986)

Chapter 11 Trustee: Grounds For Appointment

- Grounds to Convert or Dismiss
 - “if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.”
 - 11 U.S.C. § 1104(a)(3)
 - Must show cause
 - Provides courts with choice besides conversion/dissmissal
 - Added by BAPCPA

Chapter 11 Trustee: Grounds For Appointment

- Reasonable Suspicion
 - “The United States trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor’s chief executive or chief financial officer, or members of the governing body who selected the debtor’s chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor’s public financial reporting.”
 - 11 U.S.C. §1104(e)
 - Response to *Worldcom* and *Adelphia* bankruptcies
 - Courts have been reluctant to interpret
 - *In re The 1031 Tax Group, LLC*, 374 B.R. 78 (Bankr. S.D.N.Y. 2007)

Role Of The Chapter 11 Trustee:

- Principal Trustee duties defined under 11 U.S.C. 1106(a); including:
 - (1) Duties specified under 11 U.S.C. § 704
 - (2) File list, schedule, statement required under 11 U.S.C. § 521(1)
 - (3) Investigate acts, conduct, assets, liabilities, financial condition, business operation, desirability of continuance of business, matters relevant to formation of plan
 - (4) File a statement of investigation
 - (5) File a plan under 11 U.S.C. § 1121
 - (6) File a tax return for any year the debtor failed to
 - (7) After confirmation of the Plan, file reports with court

Role Of The Chapter 11 Trustee:

- Additional Powers of Trustee:
 - Avoid certain transfers under §§ 544 – 550
 - Reject executory contracts under § 365
 - Power to obtain credit under § 364
 - Power to use, sell, or lease property under § 363
 - Power to retain professionals under § 327
 - Authority to operate debtor's business under § 1108
- Courts have authority to limit Trustee's authority (§§ 1107, 1108)



Role Of The Chapter 11 Trustee: Fiduciary Duties

- Same Fiduciary Duties as CEO of Corporate Debtor
 - Refrain from self-dealing
 - Considerable discretion under business judgment rule
 - Duty of loyalty
 - Protect and conserve interests/assets
 - Refrain from damaging estate and hindering successful reorganization
 - May conduct a Rule 2004 Investigation
 - Review fee applications and object if necessary

Role Of The Chapter 11 Trustee: Reliance On Employees

- Dependency on employees is contextual
 - Familiarity with industry, business relationships, etc.
 - *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226-27 (3rd Cir. 1989)
- BAPCPA and KERPS
 - Pre-BAPCPA: Business Judgment Rule
 - Post-BAPCPA: Limited by 11 U.S.C. §503(c)
 - Disguised performance-based KERPS prohibited
 - *In re Dana Corp.*, 351 B.R. 96 (Bankr. S.D.N.Y. 2006)



Role Of The Chapter 11 Trustee: Investigating Current Management

- Trustee essentially replaces Debtor's management
 - *In re W.R. Grace*, 285 B.R. 148 (Bankr. D. Del. 2002)
 - Although, Court can appoint trustee with limited authority
- Trustee must investigate affairs of debtor and status of case
 - 11 U.S.C. §1106(a)(3)


Role Of The Chapter 11 Trustee: If Fraud Is Detected


- **Duty to Report Criminal Conduct**
 - Trustee must report suspected violations of federal criminal law
 - Must investigate for a bankruptcy crime
 - 18 U.S.C. §3057

Role Of The Chapter 11 Trustee: If There Is No Money In The Estate

- Avoidance of fraudulent or preferential transfers
 - 11 U.S.C. §§544-549

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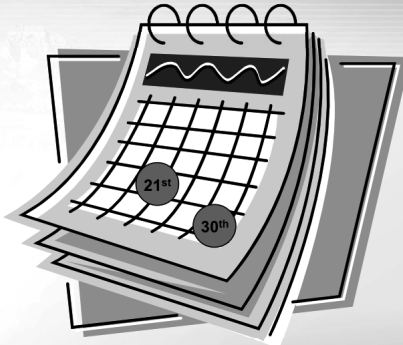
**There's A New Sheriff In Town:
Electing A Chapter 11 Trustee**




HOLLAND & HART 




- **Must Request Within 30 days after Court Orders Appointment**
- **21 Days Notice of Election**



11 U.S.C. § 1104(b)(1)
Bank. R. 2002(a)(1)


HOLLAND & HART 



The Request

- Orally at 341 Meeting
- Pleading filed with Court and transmitted to U.S. Trustee's Office

Bankr. R. 2007.1

HOLLAND & HART 

Who Can Vote?




Only unsecured creditors with claims that are:

1. FULA;
2. Not Materially Adverse; and
3. Not Owned by an Insider




11 U.S.C. § 702(a).

HOLLAND & HART 

FULA?



- Fixed
- Undisputed
- Liquidated
- Allowable

HOLLAND & HART 


Satisfying FULA



Proof of Claim

“a creditor is entitled to vote at a meeting if, at or before the meeting, the creditor has filed a proof of claim or a writing setting forth facts evidencing a right to vote pursuant to § 701(a) of the Code unless objection is made to the claim or the proof of claim is insufficient on its face.”

Bankr. R. 2003(b)(3).

HOLLAND & HART 


Satisfying FULA



Scheduled Claim


The schedule of liabilities filed by the debtor “constitute *prima facie* evidence of the validity and amount of the claims of creditors, unless they are scheduled as disputed, contingent, or unliquidated.”

Bankr. R. 3003(b)(1).

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Not Materially Adverse



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Not Materially Adverse



The Purpose?

“to permit the general unsecured creditors to provide for the administration of the Chapter 7 estate by a trustee of their own choosing.”

In re Nanvarok Inc., 148 B.R. 86, 87 (Bankr. D.D.C. 1992).

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Not Materially Adverse



What Is It?

Creditors are materially adverse if they have the prospective ability to enhance their recoveries at the estate's expense.

See *In re Klein*, 119 B.R. 971, 983 (N.D. Ill. 1990).

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Not Materially Adverse



How Do We Evaluate It?


Evaluating “materially adverse” requires a balancing of various factors, such as the nature of the adverse interest, the size of the adverse interest, the degree to which it is adverse, and so on.”

H.R. Rep. No. 595, 95th Cong., 1st Sess. 378 (1977).

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Not An Insider



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Calculating the Votes



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The Critical Number: 20/51



- At Least 20% percent in amount of the eligible claims participate and vote.
- Trustee candidate must receive 51% of votes cast.


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Proxies



Must Be Solicited In Writing!!!!

Bankr. R. 2006(c)(2).

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Proxies



Who Can Solicit?

- Creditors' Committee
- Unsecured FULA
- Bona fide trade or credit association*

Bankr. R. 2007(b)(2).
Bankr R. 2006(c)(1).

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Proxies



Who Cannot Solicit?

- Any interest other than of general creditors
- By or on behalf of custodian
- Interim trustee
- By or on behalf of attorney
- By or on behalf of transferee of a claim for collection only

Bankr R. 2006(d).


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Proxy Form



Recommended That You Use:

- Official Forms 11A (General Power of Attorney) or
- Official Forms 11B (Special Power of Attorney)

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Proxy Power



If obtain two or more proxies?

You must, “file and transmit to the United States trustee a verified list of the proxies to be voted and a verified statement of the pertinent facts and circumstances in connection with the execution and delivery of each proxy” before voting begins at the meeting of creditors “or at any other time as the court may direct.”

Bankr. R. 2006(e).

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Verified List of Proxies



Purpose?

Designed to prevent fraud and corruption in the solicitation and voting of proxies by parties who are attempting to “acquire control of the administration of the estate for an ulterior purpose.”

Bankr. R. 2006, Advisory Committee’s Note to subdivision (e).


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Verified List of Proxies



1. Copy of solicitation
2. Identify the solicitor and the proxyholder (including connections with debtor and creditor).
3. No consideration, no agreement.
4. Add’l requirements for proxies solicited by creditors’ committee.
5. Add’l requirements if solicited by an entity other than the proxyholder.

Bankr. R. 2006(e).

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Verified List of Proxies




If failed to comply with Rule 2006(e)?

Court may:

1. Reject proxy for cause,
2. May vacate any order entered in consequence of the voting of any proxy that should have been rejected, or
3. Take any other appropriate action.

Bankr. R. 2006(f).

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Post-Election




Undisputed

- U.S. Trustee files an application with the Court for approval of the appointment
- U.S. Trustee must disclose trustee elect's connections with parties in interest
- Verified statement from trustee elect describing any such connections.

11 U.S.C. § 1104(b)(2).

Bankr. R. 2007.1(b).

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Post-Election



Disputed

- U.S. Trustee will file report describing dispute and candidate(s).
- File candidates' verified statement of disinterestedness.
- Court will resolve dispute.


11 U.S.C. § 1104(b)(2).
Bankr. R. 2007.1(b).

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Cheat Sheet: Want a Vote




- Surprise attack at 341 meeting?
- File proofs of claim
- File objections to other claims
- Solicit proxies
- Prepare verified statement

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Cheat Sheet: Not Want a Vote



- File objections to proofs of claim.
 - Have friend sitting at the Court
 - Bring your Blackberry
- Solicit proxies to vote “no.”
- Throw fit about notice.

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The Keeper: The Trustee's Role in Individual Chapter 11s

Diana K. Carey

Karr Tuttle Campbell, Seattle, WA

ABI Rocky Mountain 2011



The Setting

- *Individual* chapter 11 filings rare ($\leq 1\%$) vis-à-vis all filings by individuals
- Within chapter 11s, individual filings are on the rise
 - 10% nationwide
 - Pockets of increase – e.g., California
 - Western District of Washington – 30% of chapter 11 filings since 2008 are individuals
 - Unknown how many have trustees – “RARE”

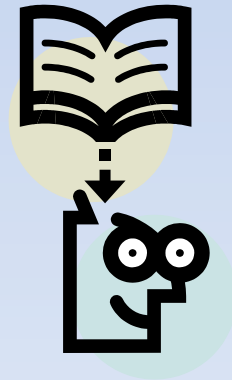


Individual 11 filings

- Why more individuals filing 11s?
 - “Means test” in chapter 7 a deterrent
 - Debt limits in chapter 13 a deterrent
 - High net worth individuals
- Absolute priority rule abolished?
 - Since BAPCPA, allows confirming less than 100% plans
 - Split of authority

Treatment of individual 11s

- Hybrid of business chapter 11s and individual chapter 13s – without the framework
- Some treat as small businesses
- SAREs?
- Warrant own subchapter of Code?



Appointment of Trustees



- For cause: malfeasance, fraud, gross mismanagement
- Best interest of creditors and the estate
- Typical:
 - ponzi schemes
 - Concealment of assets
 - Incomplete or inaccurate accounting

Powers and Duties of Trustee

- Investigate Debtor's financial condition, fraud, mismanagement
- Initial report – assets/liabilities
- Reorganization plan (. . . *really?*)
- Adjunct to criminal enforcement activity
- Fiduciary of estate – reasonable degree of care

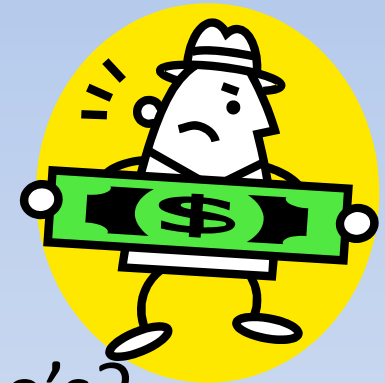


Trustee challenges



- Debtor cooperation
- Debtor resistance to liquidation
- Running debtor's businesses "in ordinary course"
- Seizure of assets by government under forfeiture powers – vs. liquidation by Trustee

Debtor's personal expenses



- Guidelines and standards?
- Court's role? Trustee's? U.S. Trustee's?
 - Set budget? Or just monitor?
 - Section 105 status conferences
 - Filing of monthly reports with Office of US Trustee
- Are the expenditures equivalent to “Ordinary course” business expenses?

Involuntary Servitude?



- Debtor's post-petition earnings are part of the estate
- Does an involuntary bankruptcy filing place a person in debtor's prison" against his/her will?
- What about a voluntary individual 11 where a Trustee is later appointed (or proposed)?
 - Affects ability to dismiss case
 - Conversion to 7 vs. Appointment of trustee?

Life of an Individual chapter 11 trustee case

- 7 W.D. Washington cases since 2005
- Professionals/property developers/business owners
- Initiated by secured creditors, ex-wife, and office of U.S. Trustee
- Why? Mismanagement, failure to follow rules (paying debts without authorization), failure to liquidate or pursue plan, inadequate reporting

Take-aways

- Appointments where debtor especially untrustworthy, fail to honor creditors' rights
- Trustee's role to figure out route to maximize recovery
 - Liquidate?
 - File plan? Or convert to 7?
 - Put related entities into bankruptcy?
- Lots of common sense required

