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Chapter 7 Trustee Elections

Intricacies of § 702 in Battle for Control of a Liquidating Estate

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The overall concept of electing a chapter 7 trustee is simple: At the initial 341 meeting, 20 percent of unsecured creditors can call an election and elect a new trustee by majority vote.[1] However, Congress was concerned with any potential surreptitious motives and "gotcha" tactics of the electing creditors, and therefore enacted several complex disclosure and threshold-voting requirements. The result is § 702 of the Bankruptcy Code.

There are two primary catalysts for trustee elections in large chapter 7 cases. The first is the creditors' desire for control. In large chapter 7 cases, the stakes could be high for the creditors; the larger the claims against the estate, the more exposure for avoidance actions and otherwise greater impact on a creditor's business. From a creditor's perspective, a chapter 7 case can seem like a black box, an opaque process over which creditors have no influence. In larger chapter 7 cases, the creditors might want greater control and accountability.

The second driver of elections in large chapter 7 cases is the trustee's compensation. In a chapter 7, the larger the disbursements, the larger the trustee's commission[2] because there is no ceiling on a chapter 7 trustee's commission. In small "no-asset" cases, the chapter 7 trustee receives only a nominal fee, but in large cases, the trustee's compensation can be significant. For example, in a case filed as a chapter 11 in 2001 and converted in 2002, the chapter 7 trustee made more than $465 million in disbursements and received a commission of more than $12 million. Since the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), unlike other estate-compensated professionals, there is now no statutory requirement that the trustee's compensation be "reasonable."[3]

In addition, there is potential value from a trustee's perspective in hiring his/her own firm as counsel or accountant to the trustee. In large chapter 7 cases where the stakes are already high for the unsecured creditors, the prospect of a sizeable commission can be the spark that ignites a battle for control of the chapter 7 estate.

Chapter 7 Trustees and Election of Trustees, Generally

In each district, the U.S. Trustee establishes a panel of private trustees to serve in chapter 7 cases. The appointed trustee in a chapter 7 case is known as the "interim trustee."[4] In the vast majority of chapter 7 cases, the interim trustee becomes the permanent trustee after the initial 341 meeting.[5]

However, if creditors are not satisfied with the interim trustee, they can seek to elect a trustee of their choosing. First, in order for an election to be called, creditors holding at least 20 percent of the claims described in § 702(a) must request an election.[6] Second, creditors holding at least 20 percent of the total § 702(a) claims must actually vote.[7] Both requirements must be satisfied.[8]

Eligibility to Vote

Section 702 contains several thresholds to voting: The creditor's claim must be "allowable," "undisputed," "fixed," "liquidated" and "unsecured," and the creditor must not have a "materially adverse" interest to the other unsecured creditors. Based on published opinions, most disputes

1 *See* 11 U.S.C. § 702.
2 A chapter 7 trustee is entitled to a commission of 25 percent on the first $5,000 distributed, 10 percent on the next $45,000 distributed (up to $50,000), 5 percent on the next $945,000 (up to $1 million) and 3 percent of funds distributed in excess of $1 million. *See* 11 U.S.C. § 326(a).
3 *See* 11 U.S.C. § 330(a)(3) (specifying "an examiner, trustee under chapter 11, or professional person"); 11 U.S.C. § 330(a)(7) ("In determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on section 326."); *see generally* 3 *Collier on Bankruptcy* ¶ 330.LH[6] (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).
4 *See* 11 U.S.C. § 701.
5 *See* 11 U.S.C. § 702(d).
6 11 U.S.C. § 702(b).
7 11 U.S.C. § 702(c)(1).
8 *See Berg v. Esposito (In re Oxborrow)*, 913 F.2d 751, 754 (9th Cir. 1990).

are focused on the "allowable" and the not-materially-adverse element.

A claim evidenced by a properly filed proof of claim is deemed "allowed" unless an objection is made,[9] but § 702 uses the term "allowable," not "allowed," suggesting that Congress intended a different requirement. It makes sense that the Bankruptcy Code drafters would not simply port the § 502 concepts of allowance and disallowance to creditor elections: The trustee election is to occur during the first 341 meeting in the chapter 7 case,[10] and by that time, few creditors will have filed their proofs of claim, and the rules allow a creditor to submit an informal "writing" evidencing a right to vote.[11]

In determining the universe of claims that are entitled to vote, two approaches have developed: one expansive, and one restrictive.[12] The expansive approach would include the scheduled claims, plus any additional claims asserted in proofs of claim or informal writings.[13] Under this approach, the § 702(a) claims pool would include undisputed, liquidated, noncontingent scheduled claims, *and* any claims evidenced by proofs of claim or other writings. The restrictive approach only considers the proofs of claim on file as of the 341 meeting.[14] Courts applying the restrictive approach have focused on the requirements of § 502[15] and have held, in effect, that the terms "allowed" and "allowable" are synonymous.[16] In contrast, courts favoring the expansive approach have held that "allowable" means something broader than "allowed."[17] The expansive approach appears to be the clear majority rule.[18]

Material adversity is determined by reference to the interests of other similar creditors. Examples would include the receipt of a pre-petition avoidable transfer,[19] rights to funds held in trust by the debtor,[20] or other activity that reduces the amount available to other creditors.[21] Some courts have allowed a voting creditor with a purportedly adverse interest to disclaim the disabling interest prior to the election, therefore preserving its right to vote.[22]

In determining the universe of claims in a disputed election, the following process will be employed. If the court follows the expansive approach, it will first look to the debtor's schedules[23] and generally adjust that universe by considering timely filed proofs of claim or other writings that evidence claims. Next, the court subtracts claims that are not "allowable" or do not meet the other requirements of § 702(a)(1), then subtracts the claims of creditors that have "materially adverse" interests and the claims of insiders. From that process, the court arrives at the § 702(a) claims pool. If the voting creditors represent 20 percent of the § 702(a) claims pool, a new trustee can be elected by majority vote.

Election of a trustee is a big gun for unsecured creditors to use to exert their will, but creditors and their counsel should not wander unprepared into an election fight expecting an interim trustee to ignore the pecuniary impact of replacement.

Proxy Requirements

In addition to the rules applicable to all proxies,[24] there are intricate proxy requirements that are specific to trustee elections. Only written proxy solicitations are valid.[25] The rules also narrowly limit those who may solicit proxies. Practically speaking,[26] the only proper party to solicit votes from creditors is another creditor holding a § 702(a) claim.[27] Rule 2006(d) lists a host of other parties that are barred from soliciting proxies: secured creditors, priority creditors, equity security-holders,[28] a "custodian,"[29] an entity not qualified to vote under § 702(a), the interim trustee, "a transferee of a claim for collection only,"[30] and — most significantly — an attorney.[31] For custodians, disqualified creditors, transferees and attorneys, the rules prohibit not only direct solicitation by those parties, but also solicitation *on their behalf*.[32] However, the rule does not prohibit solicitations on the *interim trustee's* behalf,[33] meaning that while a disqualified creditor could not use an agent to solicit proxies (even if that agent was a § 702(a)-qualified creditor), there is no prohibition on the interim trustee using a friendly, qualified creditor to solicit proxies supporting the interim trustee.

9 *See* 11 U.S.C. § 502(a); Fed. R. Bankr. P. 3002(a) and 1019(3).
10 *See* 11 U.S.C. § 702(b).
11 *See* Fed. R. Bankr. P. 2003(b)(3) ("[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.*" (emphasis added)).
12 As a matter of tactics, a larger § 702(a) claims pool usually favors the incumbent trustee, while a smaller pool favors the advocating creditors. *Compare In re Sandhurst Secs. Inc.*, 96 B.R. 451, 453 (S.D.N.Y. 1989), *with In re San Diego Symphony Orchestra Ass'n*, 201 B.R. 978, 981 (Bankr. S.D. Cal. 1996).
13 *See, e.g., In re Michelex Ltd.*, 195 B.R. 993 (Bankr. W.D. Mich. 1996).
14 *See, e.g., In re Lake States Commodities Inc.*, 173 B.R. 642 (Bankr. N.D. Ill. 1994).
15 *Id.* at 646 ("Section 702 states [that] a creditor must hold a claim [that] is 'allowable.' A prerequisite to the allowability of a claim is the filing of a written proof of claim." (citing, *inter alia*, 11 U.S.C. § 502)).
16 *See, e.g., In re Michelex*, 195 B.R. at 1000-02 (criticizing *Lake States Commodities* as conflating "allowable" and "allowed").
17 *Id.* at 1000 ("If Congress intended that a proof of claim must be filed before, or at, the § 341 meeting in order for the claim to be within the § 702(a)(1) universe of claims, why does § 702(a)(1) use the term 'allowable' instead of 'allowed' or 'deemed allowed'?").
18 *See, e.g., id.* at 1002 (applying expansive rule).
19 *See, e.g., In re Lang Cartage Corp.*, 20 B.R. 534, 535-36 (Bankr. E.D. Wis. 1982).
20 *See, e.g., In re N.Y. Produce Am. & Korean Auction Corp.*, 106 B.R. 42, 48 (Bankr. S.D.N.Y. 1989) (holding that claimants' rights as trust beneficiaries under Perishable Agricultural Commodities Act were sufficient to disqualify vote).
21 *In re Klein*, 119 B.R. 971, 974-75 (Bankr. N.D. Ill. 1990).
22 *Id.* at 981 ("Strong policy reasons favor permitting a creditor to eradicate its material adverse interest prior to a hearing if the creditor desires to regain its right to vote.").
23 Electing creditors face a conundrum if the schedules are not filed, are incomplete or are somehow lacking good faith. *See, e.g., In re Blanchard Mgmt. Corp.*, 10 B.R. 186, 188 (Bankr. S.D.N.Y. 1981) (because no schedules were ever filed, it was not possible to determine whether 20 percent requirement was met to request election; since there was no election, interim trustee continued to serve). A party disadvantaged by this situation may seek to require the debtor to amend the schedules. Any party can request that the court order the debtor to file amended schedules. *See* Bankr. R. Civ. P. 1009(a).
24 *See* Fed. Rule Bankr. P. 9010(a) and (c) (validity of proxy and powers of attorney), 9011 (signing and verification) and 9012 (persons qualified to administer oaths).
25 Fed. R. Bankr. P. 2006(c)(2). As to permissible content of proxies, the Bankruptcy Rules are completely silent.
26 Under the Bankruptcy Rules, certain nonattorney representatives of a creditor may also solicit, but these are either very unlikely or are so overly complex that it makes them impractical; a creditors' committee elected under 11 U.S.C. § 705 (such committee is exceedingly rare), a trade or credit association (the association must be "bona fide," and may only solicit from creditors holding pre-petition, allowable and unsecured claims who are members "in good standing" of the association), and an informal committee. *See* Fed. R. Bankr. P. 2006(c)(1). The "informal committee" solicitation rules are particularly byzantine. *See* Fed. R. Bankr. P. 2006(c)(1)(C).
27 A trap for the unwary in a multi-debtor case: Even where the creditors are voting a single trustee to administer multiple debtors, it is only proper for a creditor to solicit a creditor of the same debtor. *See, e.g., In re Ben Franklin Retail Stores Inc.*, 214 B.R. 852, 862 (Bankr. N.D. Ill. 1997) (holding that creditor of one debtor subsidiary could not solicit proxies from creditors of different debtor subsidiary).
28 The foregoing three classes of parties would clearly have an "interest other than that of general creditors" within the meaning of Bankruptcy Rule 2006(d)(1). *See, e.g., In re Phillips*, 24 B.R. 715, 718 (Bankr. E.D. Cal. 1982) (prohibiting secured creditor from soliciting proxies under Rule 208 of 1973 Bankruptcy Rules).
29 This includes pre-petition receivers, trustees and assignees for the benefit of creditors. *See* 11 U.S.C. § 101(11).
30 The Advisory Committee notes that the drafters were focused on collection agencies, *see* 1983 Advisory Committee Note to Fed. R. Bankr. P. 2006, *reprinted in* Colliers App. 2006[1], but the plain language of this rule would seem to apply to professional claims traders.
31 Fed. R. Bankr. P. 2006(d).
32 *Id.*
33 *Id.*

Disputed Elections and the Incumbent Trustee's Defensive Measures

The U.S. Trustee does not resolve disputed elections but instead informs the court of the dispute. If no motion is filed within 10 days of the report, the interim trustee becomes the permanent trustee.[34] If the proposed trustee loses, he/she may not have standing to contest the election.[35] Conversely, if the proposed trustee prevails, the deposed interim trustee clearly has standing.[36]

Nothing in the Bankruptcy Code or Rules requires a creditor to notify the U.S. Trustee or the interim trustee of a creditor's intent to request an election. Under the Code, the U.S. Trustee is to preside at the meeting of creditors,[37] but the U.S. Trustee as a matter of course designates the interim trustee to conduct the meeting.[38] If the interim trustee anticipates a request for an election, the U.S. Trustee requires the interim trustee to notify the U.S. Trustee so that the U.S. Trustee can preside over the election.[39] However, it is not uncommon for an interim trustee to continue the 341 meeting when he/she catches wind of an election.[40] If the interim trustee anticipates an election, he/she could use the time before the 341 meeting to drum up support from creditors. A common defensive measure is the interim trustee filing claim objections or preference complaints on the eve of the election.[41]

Conclusion

Election of a trustee is a big gun for unsecured creditors to use to exert their will, but creditors and their counsel should not wander unprepared into an election fight expecting an interim trustee to ignore the pecuniary impact of replacement. Creditors should pay strict attention to the details of the solicitation and election process. Conversely, an interim trustee can take advantage of the time between filing or conversion and the first 341 meeting, either to prepare a defense or to become familiarized with the creditors and their goals for the case and, perhaps, mollify the activist creditors. Failing that, the process might devolve into a disputed election to be determined by the court. In the battle between the incumbent interim trustee vs. the electing creditors, both firmly entrenched in their respective positions, the court will be forced to consider the following paradox: What happens when an irresistible cannonball hits an immovable post? abi

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34 Fed. R. Bankr. P. 2003(d).
35 *See In re Sandhurst Secs. Inc.*, 96 B.R. 451, 457 (S.D.N.Y. 1989).
36 *See, e.g., In re Metro Shippers Inc.*, 63 B.R. 593, 598 (Bankr. E.D. Pa. 1986).
37 *See* 11 U.S.C. § 341(b).
38 *See* Fed. R. Bankr. P. 9001(12); *see generally* Richard C. Friedman, "A Guide to Trustee Elections," 1, *available at* www.justice.gov/ust/eo/public_affairs/articles/docs/trusteeelect02-00.pdf; Executive Office for U.S. Trustees, *Handbook for Chapter 7 Trustees*, 7-1, *available at* www.justice.gov/ust/eo/private_trustee/library/chapter07/docs/forms/ch7hb0702-2005_amended0306.pdf (hereinafter "*Trustee Handbook*").
39 *Trustee Handbook* 4-1.
40 *But see In re Michelex*, 195 B.R. at 1009-10 (Bankr. W.D. Mich. 1996) (dismissing interim trustee's adjournment of 341 meeting, purportedly to "obtain guidance" from U.S. Trustee, as merely attempt to get time to find other votes after interim trustee received no votes in election).
41 Filing preference complaints so early in the chapter 7 case may be difficult for interim trustees in courts that require more detail in preference complaints. *Gellert v. The Lenick Co. (In re Crucible Materials Corp.)*, No. 10-55178, 2011 WL 2669113, at *4 (Bankr. D. Del. July 6, 2011) (requiring plaintiff to allege, *inter alia*, details of underlying transaction between debtor and transferee).