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Chapter 7 Trustee Elections…

A Bankruptcy Tool for Greater Creditor Accountability

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Making the Chapter 7 trustee accountable to unsecured creditors will instill more confidence in the post-bankruptcy process where unsecured creditors are often left with the perception that bankruptcy courts operate solely for the benefit of professionals. Jeffrey Wurst and Michael Amato, both of Ruskin Moscou Faltischek, say that by making the trustee more accountable, the process will also move at a quicker pace.

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Congress vested with the creditors the fundamental right to elect a bankruptcy trustee in a Chapter 7 bankruptcy case. Although this right is rarely exercised, Congress clearly wished to encourage creditor participation in the case, while at the same time preventing domination by creditors that held small claims or may have interests adverse to the general creditor body.

Panel trustees play an important role in Chapter 7 cases and, to a great extent, take on cases for *de minimus* compensation. Promptly following the commencement of a Chapter 7 bankruptcy case, the Office of the United States Trustee appoints an interim trustee from a panel that it maintains. Trustees are paid a statutory fee of $60 for each Chapter 7 case they administer. If there are assets available to distribute to creditors, the trustee also will receive: 25% of the first $5,000 distributed, 10% of the next $45,000 distributed, 5% of the next $950,000 distributed and 3% of all amounts over $1 million distributed. However, Chapter 7 trustees often find themselves in a thankless and unrewarding position, because the vast majority of Chapter 7 cases require some amount of work for which the trustee cannot be compensated as the bankruptcy estate has little or no assets.

Thus, the business of being a bankruptcy trustee is dependent upon being assigned a sufficient number of cases with assets to balance the trustee's efforts on "no asset" cases. However, there is no assurance that once a panel trustee is appointed to an "asset" case, that creditors will not seek to exercise their right to elect a "permanent trustee" of their choice. The interim trustee does not possess a property right to the asset cases to which he or she has been assigned.

Creditors rarely exercise their right to elect a trustee. There are a number of reasons for this, both practical and

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procedural. Unlike Chapter 11 cases, where the Office of the United States Trustee plays an active role in soliciting participation from unsecured creditors to serve on the Official Committee of Unsecured Creditors and selects the members of such committee from those creditors seeking to serve, in Chapter 7 cases the Office of the United States Trustee merely appoints an interim trustee and provides oversight of that trustee's activities. It never solicits active participation from creditors as it does in Chapter 11 cases.

Another reason that trustee elections are rare is that without someone driving the process for creditor participation, most creditors are unaware of their rights in the process. The Office of the United States Trustee takes an active role and supervises elections of trustees in Chapter 7 cases, perhaps to better assure that it will retain an active panel of trustees to handle no asset cases.

The Bankruptcy Code provides that a creditor may vote for a trustee if such creditor holds a valid unsecured claim, does not have an interest materially adverse to the interests of creditors and is not an insider of the debtor. However, a creditor is entitled to vote in a Chapter 7 proceeding only if it files a proof of claim or other writing setting forth facts evidencing its claim.

An election for a permanent trustee is held if creditors holding at least 20% of the amount of allowed unsecured claims in the case request an election at or prior to the §341 meeting of creditors. A permanent trustee (other than the interim trustee) is elected if a majority in number of the claims voting, vote in favor of the permanent trustee.

While the procedures outlined in the Bankruptcy Code appear to be straightforward, the election process may prove difficult. Debtors often file bankruptcy petitions without filing complete schedules. In involuntary cases, schedules may not have been filed prior to the meeting of creditors. Accordingly, it may be difficult or impossible to determine the total amount of unsecured claims outstanding in the case in order to determine the 20% threshold.

It is common in bankruptcy elections for one or more individuals to hold proxies for creditors. The form, solicitation and voting of proxies require the holder of proxies to navigate multiple procedural hurdles in order to affect a vote for the permanent trustee.

All proxies must be in writing in the form of a power of attorney, authorizing the holder to vote the claim or otherwise act as the owner's attorney-in-fact in connection with the administration of the bankruptcy estate. A proxy may be solicited only by a creditor holding a valid unsecured claim, a proper committee of creditors or a *bona fide* trade or credit association, but such association may only solicit creditors that were members holding valid unsecured claims.

Any holder of two or more proxies is required, prior to the election, to file with the bankruptcy court and transmit to the United States Trustee a verified list of the proxies to be voted. Also required is a verified statement of the pertinent facts and circumstances in connection with the execution and delivery of each proxy, including copies of the solicitations for proxies, identification of the solicitor, representations that no consideration has been paid or promised by the proxy holder for the proxy, and whether there is any agreement between the proxy holder and any other person for the payment of any consideration in connection with voting the proxy or for sharing compensation with any entity for the proxy.

In most jurisdictions there is no requirement that the trustee be accountable to the creditors, although they must provide regular reports to the Office of the United States Trustee. Accordingly, creditors tend to be kept in the dark until the end of the case (which may take years) when a distribution is made and a final report is filed by the trustee.

These requirements exist to protect the integrity of the trustee system; however, they may be (and often are) used as a shield to protect the interim trustee's property interest in his or her interim appointment. The Advisory Committee Note to Bankruptcy Rule 2006 provides: "Creditor control was a basic feature . . . Creditor democracy is perverted and the congressional objective frustrated, however, if control of administration falls into the hands of persons whose principal interest is not what the estate can be made to yield to the unsecured creditors but in what it can yield to those involved in its administration or in other ulterior objectives."

The Advisory Committee expressed its concern of the potential for professionals to seize opportunities at the expense of the creditors. Although the initial concern may have been directed against those seeking election, it may also be read in the context of the interim trustee who may not share the views of the creditor body in how to proceed with maximizing the estate.

Notwithstanding these requirements, courts have held that procedural errors that do not affect the outcome of the election or conflict with the purpose of the Bankruptcy Code and Rules are insufficient to overrule the vote of the creditors. In the case *In re Ben Franklin Retail Stores, Inc.,*[1] the interim trustee objected to *inter alia*, the form of the proxies, the form of the

1 *In re Ben Franklin Retail Stores, Inc.,* 214 B.R. at 861 – 862.

solicitation letter and the proofs of claim filed by the creditors in the case. The bankruptcy court upheld the election, citing the infrequency of Chapter 7 elections and the relative paucity of procedural rules and case law. The court also noted that elections generally occur on truncated timetables, with little time for preparation. The *Ben Franklin* court stated: "Achieving the goal of the law may, therefore, require looking to the substance rather than the form of the process. Technical deficiencies that do not, under the circumstances, create a realistic prospect of substantive deficiencies should not be allowed to defeat the fairly expressed will of creditors."

Similarly, in the case *In re Metro Shippers, Inc.*, 63 B.R. 593 (Bankr. E.D. Penn. 1986), the holder of multiple proxies failed to file its verified statement prior to the first meeting of creditors pursuant to FRBP 2006(e). In addition, the interim trustee alleged that the proxy holder violated the solicitation rules pursuant to FRBP 2006(b)(1). The bankruptcy court granted the creditors' motion to approve the election, holding that it had discretion in handling disputes involving proxies, that the rules are not intended to restrict the scope of the court's discretion in the handling of proxy disputes and that absent bad faith, the "harmless" deviations were insufficient to invalidate the election of the trustee.[2]

Although creditors rarely exercise this right, more sophisticated creditors may raise the issue of an election. Institutional creditors, for example, that have been through the process and are familiar with the practices and procedures of bankruptcy courts may prefer to elect a trustee, especially where they have had a negative experience with either the appointed trustee or another panel trustee.

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Panel trustees may be better served if they were to establish regular communications with their constituents (the unsecured creditors) and provide them with periodic reports of their activities and the status of the case. Certainly, these reports should not contain any privileged information or specific strategies. Of course, members of the unsecured creditor body will likely find themselves as defendants in avoidance actions, and the trustee should not be disclosing any information that might compromise those efforts. At the same time, basic generic reports on the trustee's progress would do much to instill confidence in the process.

It has been suggested that the bankruptcy court would better serve unsecured creditors by having the clerk provide information regarding the creditors' rights in the bankruptcy process, together with its notice of the commencement of the case and the scheduling of the initial meeting of creditors. These rights include the right to elect a committee under §705 of the Bankruptcy Code — a provision very rarely exercised, contrary to Chapter 11 cases where committees are the norm. Making the Chapter 7 trustee accountable to the unsecured creditors will instill more confidence in the process where too often unsecured creditors are left with nothing but the perception that the bankruptcy courts operate solely for the benefit of the professionals. It is also likely that by making the trustee more accountable, the process will move at a quicker pace. Trustees who resist accounting to their constituents, the unsecured creditors, should be replaced by an elected trustee who agrees to responsibly account to the creditors. abfj

2 *In re Metro Shippers, Inc.*, 63 B.R. at 599.

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