

# What Happens When Unsecured Creditors Exercise Their Right to Elect a Trustee?

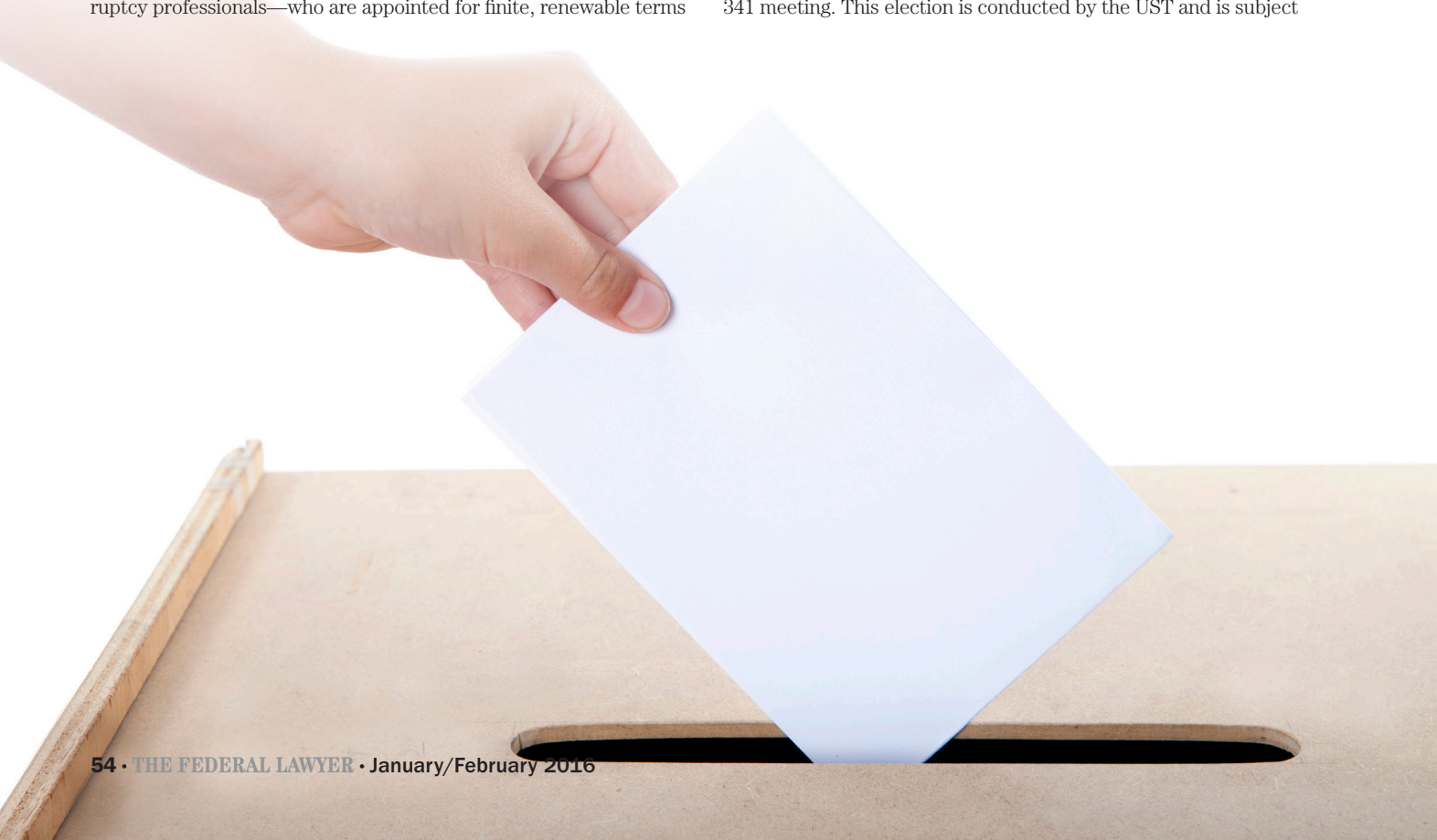
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In every Chapter 7 bankruptcy case—whether the filing is by an individual, a partnership, or a corporate entity—a trustee is assigned to serve as the creditors’ representative and is responsible for locating and liquidating assets for the benefit of creditors.

A trustee’s duties include investigating the debtor’s financial affairs, bringing lawsuits to recover assets, and reviewing and objecting to claims when advisable.<sup>2</sup> The trustee is appointed by the U.S. Trustee (UST) promptly after the order for relief.<sup>3</sup> He or she must be a disinterested person<sup>4</sup> and must be selected from a panel of private trustees that is established, maintained, and supervised by the UST.<sup>5</sup> The panel is composed of individuals—ordinarily experienced bankruptcy professionals—who are appointed for finite, renewable terms

and are subject to periodic performance reviews.<sup>6</sup>

The trustee appointed by the UST, however, is only an interim trustee. He or she only serves as the case trustee until the § 341 meeting of creditors, when creditors may vote her out. If there is no ouster, then the interim trustee automatically becomes the permanent case trustee by operation of law. While a statistically rare event, unsecured creditors have the right to elect the case trustee at the § 341 meeting. This election is conducted by the UST and is subject



to a number of complex statutes and rules. If an election is held and is then contested, the court will become involved in deciding the propriety and result of the election.

The focus of this article is an overview of the statutory and rules-based framework for the election of a Chapter 7 trustee and the role that the UST is to play. As later discussed, this role is essentially the same as in the election of a Chapter 11 trustee.

### Why Invoke a Trustee Election?

A trustee election is largely driven by a creditor's financial incentive to demand one. In the majority of Chapter 7 cases, there are little to no assets available for the trustee to recover and distribute to creditors, and relatively few unsecured creditors. Because a trustee and his or her professionals are paid their reasonable fees and expenses from any assets of the estate, unsecured creditors holding small unsecured debts have little economic incentive to spend the time and money to request an election where there is little prospect for a distribution to them; they get the same money regardless of who the trustee is. However, in Chapter 7 cases involving creditors with large claims and thus a larger financial stake in the outcome of the case, creditors may wish to have greater input into the administration of the case<sup>7</sup> and may have developed a comfort level with having a certain person running the case as opposed to the person selected by the UST.

### What Is the Voting Process?

When a Chapter 7 case is filed, the clerk of the court sends out the notice of commencement of the case to advise creditors of the time and date for the § 341 meeting of creditors and, unless the case is filed as a no asset case, the date to file claims.<sup>8</sup> The UST is the entity responsible to "convene and preside at" the meeting of creditors.<sup>9</sup> The § 341 meeting will be held well before the bar date has run; the bar date in a Chapter 7 case is fixed by Rule 3002(c) at 90 days after the first date set for the § 341 meeting, with the creditors meeting to be held between 21 and 40 days after the order for relief. The Bankruptcy Code and Rules do not explicitly require any advance notice be given by a creditor of the intention to exercise its right to request a trustee election, nor is there any formal method by which a creditor is required to ask for an election. Further, while Section 702 and Rule 2003 address who may vote and how the outcome of an election is to be determined, there is no trustee election ballot or form—unlike the official proof of claim form<sup>10</sup> or the official plan ballot.<sup>11</sup>

If any creditor seeks to elect the permanent trustee, the voting threshold is relatively low; that is, only 20 percent of eligible unsecured creditors must actually seek an election at the § 341 meeting in order to initiate a trustee election.<sup>12</sup> However, there are several restrictions on who is entitled to vote. First, the creditor who wishes to vote must have either filed a proof of claim before the meeting or "a writing setting forth facts evidencing a right to vote pursuant to § 702(a) of the Code." Second, the right to vote can be nullified if an "objection is made to the claim or the proof of claim is insufficient on its face."<sup>13</sup> Third, an insider cannot vote.<sup>14</sup> Once the election has been spurred, the trustee candidate who receives the majority of eligible votes becomes the elected trustee. There is no specific limit on the number of candidates to be voted upon,<sup>15</sup> and the candidate for permanent trustee does not need to be on the panel of trustees that is established, maintained, and supervised by the UST.

### Counting to 20 — Isn't That Simple?

Courts have developed various methods for determining what claims are eligible to reach the 20 percent threshold and initiate the election. Counting to 20 is not as simple as one might think. One method, often referred to as the expansive view, looks at the debtor's list of unsecured creditors identified on Schedule F in addition to the proofs of claims filed with the court before the election is sought.<sup>16</sup> Another more restrictive approach refers only to Schedule F without any reference to proofs of claim.<sup>17</sup> Yet another approach considers only proofs of claim that are facially valid and have not been objected to or other writings that clearly demonstrate a right to vote.<sup>18</sup> These eligibility requirements are designed to maintain the legitimacy of the election process. As one court has noted, the intent of § 702 would be corrupted if claimants who may not hold legitimate claims were essentially able to "choose their opponent."<sup>19</sup>

As for actual mechanics, eligible creditors can vote by appearing in person at the § 341 meeting or by proxy. However, the solicitation and voting of proxies are strictly regulated by the Bankruptcy Rules so as to "ensure that creditors' control is not subverted through improper solicitation of granting of proxies" and to discourage creditors' attorneys, rather than creditors themselves, from engineering an election.<sup>20</sup> In fact, the solicitation of proxies by or on behalf of an attorney who is not acting as an agent for a legitimate creditor is strictly prohibited.<sup>21</sup>

### What Is the Role of the UST?

The role of the UST in a contested election is somewhat perfunctory; that is, the office is charged with presiding over the election. This merely involves tabulating the votes for each candidate and preparing a report of the results of the election for the court.<sup>22</sup> The nature of the report turns on whether the election is disputed or not—a disputed election can be either one in which creditors disagree over whether the requisite percentage of eligible creditors initiated the election in the first instance, or over whether a trustee candidate received sufficient votes from eligible creditors to become the permanent trustee. In an undisputed election, the UST simply files a statement identifying the elected trustee, noting that the election was undisputed. In a disputed election, the UST must file a report that delineates the nature of the dispute and explains which candidate would be elected under each alternative presented by the dispute. However, the UST is not authorized to resolve any disputes or offer any opinions on how the dispute should be resolved.<sup>23</sup>

Thus, the UST's role in the Chapter 7 election process is expressly limited and varies from other functions delegated to the UST by Congress. For example, the UST is expressly charged with selecting the members of a Chapter 11 creditors' committee from a qualified universe; the UST solicits membership to the committee from the debtor's list of 20 largest unsecured creditors and then selects from that list the holders of the seven largest unsecured claims willing to serve on the committee.<sup>24</sup> The court may then be called upon to review the UST's selections, but the level of review by the court is not de novo.<sup>25</sup> The UST is also charged by statute with the selection of a Chapter 11 trustee or Chapter 11 examiner once the court has ordered the appointment of the same. Finally, although the UST is a party-in-interest which may be heard on any issue in a case,<sup>26</sup> it does not appear that the UST has the right to be heard at a hearing to determine the outcome of a disputed election.

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The role the UST plays in a Chapter 7 trustee election is similar to other election settings. In the case of a Chapter 11 trustee appointment, a party in interest may request the UST convene a creditors' meeting for purposes of electing a trustee. That election process is conducted in substantially the same manner as a permanent trustee would be selected under § 702.<sup>27</sup> Finally, creditors in a Chapter 7 case who are eligible to vote for a Chapter 7 trustee may also elect a creditors' committee.<sup>28</sup> In the event of a Chapter 7 creditors' committee election, the UST will follow essentially the same protocol as in the election of a permanent trustee.<sup>29</sup>

### After All the Voting Has Occurred, What Happens?

Once the UST has filed its report of election, the court will resolve any disputes over who was allowed to vote and in what amounts. The permanent trustee will have been elected if (1) at least 20 percent of the eligible voting creditors actually vote and (2) the candidate received a majority of those votes.<sup>30</sup> A more in-depth discussion of the resolution of voting disputes is beyond the scope of this article.<sup>31</sup> Before commencing his or her official duties as the permanent trustee, the ultimate victor must "qualify" for the appointment by posting a bond in favor of the United States conditioned on the faithful service of the trustee's official duties.<sup>32</sup>

### Conclusion

While a disputed Chapter 7 trustee election may be a rare event, understanding the complex statutes and rules that govern the Chapter 7 trustee electoral process can be a useful tool in navigating not just the permanent trustee election but also the election of a Chapter 11 trustee. ☉

### Endnotes

<sup>1</sup> DISCLAIMER: None of the statements contained in this paper constitutes official policy of any judge, court, agency, or government official or quasi-governmental agency.  
<sup>2</sup> See 11 U.S.C. § 704(a).  
<sup>3</sup> 11 U.S.C. § 701(a)(1).  
<sup>4</sup> *Id.*; see 11 U.S.C. § 101(14).  
<sup>5</sup> See 11 U.S.C. § 701(a)(1); 28 U.S.C. § 586(a).  
<sup>6</sup> See 28 C.F.R. § 58.3 (setting forth the qual-

ifications necessary for membership on a panel of private trustees); 11 U.S.C. § 321 (setting forth the eligibility requirements for a person to serve as a trustee in a case under any chapter of the Bankruptcy Code).

<sup>7</sup> See Gavin and Murley, *Chapter 7 Trustee Elections: Intricacies of § 702 in Battle for Control of a Liquidating Estate*, XXXIII ABI JOURNAL 5, 14-15, 104-05, May 2014; see also Amato and Wurst, *Chapter 7 Trustee Elections, A Bankruptcy Tool for Greater Creditor Accountability*, 11 ABF JOURNAL 8, November 2013.

<sup>8</sup> "Rule 2002(e) allows the clerk to issue what has become known as the 'no asset' notice. In a Chapter 7 case when there appear to be no distributable assets, the notice of the meeting of creditors may contain a statement to that effect. Creditors are requested not to file proofs of claim and are informed that, should assets later become available, notice of such assets and notice of the bar date for filing proofs of claim will be mailed." 8 COLLIER ON BANKRUPTCY P. 2002.06 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.); see FED. R. BANKR. P. 2002(e), 3002(c)(5).

<sup>9</sup> 11 U.S.C. § 341(a).

<sup>10</sup> See Official Form B10.

<sup>11</sup> See Official Form B14.

<sup>12</sup> 11 U.S.C. § 702(b); FED. R. BANKR. P. 2003.

<sup>13</sup> See FED. R. BANKR. P. 2003(b)(3).

<sup>14</sup> Section 702(a) provides that a creditor is eligible to vote only if it (1) "holds an allowable, undisputed, fixed, liquidated, unsecured claim of a kind entitled to distribution under sections 726(a)(2), 726(a)(3), 726(a)(4), 752(a), 766(h) or 766(i)" of the Code; (2) does not have an interest materially adverse to the interest of creditors entitled to such distribution; and (3) is not an insider. 11 U.S.C. § 702(a).

<sup>15</sup> See 11 U.S.C. § 702(c); FED. R. BANKR. P. 2003(b)(3).

<sup>16</sup> See *In re Michelex*, 195 B.R. 993, 1003 (Bankr. W.D. Mich. 1996).

<sup>17</sup> See *In re Lindell Drop Forge Co.*, 11 B.R. 137, 144 (Bankr. W.D. Mich. 1990).

<sup>18</sup> See *In re TBR USA, Inc.*, 429 B.R. 599, 616-17 (Bankr. N.D. Ind. 2010); *In re Lake State Commodities, Inc.*, 173 B.R. 642, 645 (Bankr. N.D. Ill. 1994); see FED. R. BANKR. P. 2003(b)(3).

<sup>19</sup> *In re San Diego Symphony Orchestra Ass'n*, 201 B.R. 978, 985 (Bankr. S.D. Cal. 1996); see 8 COLLIER ON BANKRUPTCY P. 702.03 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

<sup>20</sup> *In re Eddie Haggard Ltd.*, 190 B.R. 281, 284 (Bankr. N.D. Tex. 1995).

<sup>21</sup> FED. R. BANKR. P. 2006(d); *Eddie Haggard Ltd.*, 190 B.R. at 285.

<sup>22</sup> FED. R. BANKR. P. 2003(b)(3), (c).

<sup>23</sup> See FED. R. BANKR. P. 2003 (Advisory Committee Note to the 1991 Amendment); see U.S. Department of Justice, Handbook for Chapter 7 Trustees, Chapter 4-C, July 2002 (as amended on May 1, 2010).

<sup>24</sup> 11 U.S.C. § 1102(a)(1), (b)(1).

<sup>25</sup> *In re JNL Funding Corp.*, 438 B.R. 356, 362 (Bankr. E.D.N.Y. 2010).

<sup>26</sup> See Section 307 of the Bankruptcy Code, which authorizes the Trustee to "raise and [ ] appear and be heard on any issue in any case or proceeding under this title." 11 U.S.C. § 307; *Adams v. Zarnel (In re Zarnel)*, 619 F.3d 156, 161-62 (2d Cir. 2010).

<sup>27</sup> See 11 U.S.C. § 1104(b), (c); FED. R. BANKR. P. 2007.1. This article does not address the specific differences between a Chapter 7 and Chapter 11 trustee election. Compare 11 U.S.C. § 702(a) and FED. R. BANKR. P. 2003 with 11 U.S.C. § 1104 and FED. R. BANKR. P. 2007.1.

<sup>28</sup> 11 U.S.C. § 705.

<sup>29</sup> See FED. R. BANKR. P. 2003(d).

<sup>30</sup> 11 U.S.C. § 702(c); see also FED. R. BANKR. P. 2020 (which provides that any proceeding to contest acts or failures to act of the UST are contested matters governed by Bankruptcy Rule 9014).

<sup>31</sup> This article also does not address whether or not the elected Chapter 7 permanent trustee needs to be disinterested. Compare 11 U.S.C. § 701(a)(1) with 11 U.S.C. § 702(c).

<sup>32</sup> 11 U.S.C. § 322. Ordinarily, a panel trustee is covered by a regional or district blanket bond and does not need to post a separate bond in each case. FED. R. BANKR. P. 2010; 8 COLLIER ON BANKRUPTCY P. 322.02 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.).