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Creditors Unite! Electing a Chapter 11 Trustee

Creditors' Committees Can Help Creditors Elect Trustees in Their Chapter 11s

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Chapter 11 practitioners are well aware of the statutory bases for appointment of a trustee "for cause," including fraud, incompetence or gross mismanagement, or in the interests of creditors as set forth in 11 U.S.C.§1104(a). You may not be aware that the same procedures that allow unsecured creditors to elect trustees in chapter 7 cases also apply in chapter 11. Indeed, it is patently possible for unsecured creditors to elect a chapter 11 trustee of their own choosing, and the procedures for doing so are fairly straightforward, though seldom used. Creditors' committees can be instrumental in this process, and in many cases, the ability of a creditors' committee to help creditors select their own chapter 11 trustees makes the utmost sense. Chapter 11 trustees are often selected by U.S. Trustee's offices nationwide from a local panel of chapter 7 trustees. While many of these trustees are eminently qualified to serve as chapter 11 trustees, in certain cases, there may be a better choice. Since chapter 11 cases run the gambit of industries, sizes, levels of complexity, litigiousness and so on, one size does not fit all. There is sometimes a need for a particular industry or legal specialization or expertise, or the case may demand a specific personality or even a specific individual. Here's how it is done.

Step 1: Request for Election

Under 11 U.S.C. §1104(b)(1), "on the request of a party in interest made not later than 30 days after the court orders the appointment of a trustee...the United States trustee *shall* convene a meeting of creditors for the purpose of electing one disinterested person to serve as trustee in the case." (emphasis added). A pleading called "Request for Election" can be as simple as one or two sentences asking that an election to elect a chapter 11 trustee be held. It's that easy. The request must be made within 30 days after the court orders the appointment of a trustee.

After a party-in-interest requests an election, the U.S. Trustee's office arranges a meeting of creditors for the purpose of electing a trustee and must give notice of the meeting at least 21 days prior to the date of the meeting. Fed. R. Bankr. P. 2002(a)(1). Notice must be given to all creditors by mail, by the clerk or by some other person as the court directs. *Id*.

Step 2: Manner of the Election

Section 1104(b) provides that the election of a chapter 11 trustee should be conducted in the same manner as a chapter 7 trustee election or "in the manner provided in subsections (a), (b) and (c) of section 702 of this title." Even so, some of the provisions governing chapter 7 elections are somewhat inconsistent with the structure of a chapter 11 election, and secondary sources advise that the procedures should be implemented in a manner consistent with chapter 11. *See* 7 *Collier on Bankruptcy* §1104.02[8][b][v] (Lawrence P. King ed., 15th ed. 2009) (advising that it may be necessary for U.S. Trustee overseeing election or court resolving disputed election to evaluate each requirement and modify, interpret or, if necessary, disregard those requirements that are inconsistent with chapter 11). It is clear that the U.S. Trustee must preside over the meeting and the election. Fed. R. Bankr. P. 2007.1(b)(2).

Step 3: Who Can Vote?

Must Hold One of the Following Claims

Under §702(a), only the parties holding the following kinds of claims may vote for a trustee: (1) an unsecured claim that is undisputed, fixed, liquidated and timely filed under §501 of the Bankruptcy Code and Bankruptcy Rules 3002, 3003, 3004 or 3005; (2) a claim tardily filed if the holder did not have notice or knowledge of the case in time to timely file and proof is filed in time to permit payment; (3) other tardily filed claims; and (4) claims for fines, penalties, forfeitures or multiple, exemplary or punitive damages if the fine, penalty, etc. arose before the order for relief. 11 U.S.C. §702(a)(1) .

Thus, only unsecured creditors are allowed to vote for a trustee. 7 *Collier on Bankruptcy* §1104.02[8][b][iv]. Further,

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only unsecured creditors with claims that are allowable, undisputed, fixed and liquidated may vote. 11 U.S.C. §702(a)(1). A secured party, however, would be entitled to vote its deficiency claim. *Id*. However, holders of contingent and unliquidated claims are not eligible. *Id*.

Must Not Have Materially Adverse Interests

A creditor with an interest that is "materially adverse" to that of other creditors eligible to vote is not permitted to vote. 11 U.S.C. §702(a)(2). The only exception is for a creditor who holds an equity interest if that interest is not substantial in relation to its claim as a creditor. *Id*. While the Bankruptcy Code provides no definition of the phrase "adverse interest," courts have held that creditors who have the prospective ability to enhance their recoveries at the estate's expense hold a materially adverse interest to the estate within the meaning of §702(a). *See In re Klein*, 119 B.R. 971, 983 (N.D. Ill. 1990). The House Report submitted to Congress prior to the enactment of the Code states:

> The phrase "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), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5963, 6334.

As stated by one court, the object of §702 "is 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). For example, a Florida district court refused to let a secured party vote since it was "primarily concerned for their secured claims, a potential super-priority claim and with protecting such claims with regards to all of the Debtor's assets." *In re Jotan Inc.,* 236 B.R. 79, 84 (Bankr. M.D. Fla. 1999). In *Jotan*, the secured creditor sought to be secured in all of the debtor's assets while the unsecured creditors were challenging the secured party's interests so that the unsecured creditors could receive a distribution. *Id*. Looking at the totality of the circumstances and balancing various factors (such as the nature and size of the secured party's adverse interest and the degree to which it was adverse), the court found that the secured party's interests were materially adverse to the interests of the other creditors. *Id*. Accordingly, it was ineligible to vote. *Id*.

Obviously, whether or not a particular creditor is eligible to vote may be the basis for a dispute regarding the propriety of an election and its outcome. Presumably, the U.S. Trustee will note for the record the objections of creditors to an adverse party's vote. If anticipated, such adversity might be the basis for a motion to disqualify the adverse creditor from voting or to disqualify its vote after a disputed election.

No Insiders Allowed

A creditor may not vote if it is an "insider."11 U.S.C. §702(a)(3). The term "insider" includes: "(i) a director of the debtor; (ii) an officer of the debtor; (iii) a person in control of the debtor; (iv) a partnership in which the debtor is a general partner; (v) a general partner of the debtor; or (vi) a relative of a general partner, director, officer or person in control of the debtor." 11 U.S.C. §101(31)(B).

Proofs of Claim Are Sufficient to Be Eligible to Vote, but Are Not Required

Bankruptcy Rule 2003 applies to the election of a trustee in a chapter 11 proceeding. *See* Bankruptcy Rule 2007.1(b)(2). Rule 2003 provides that, unless an objection to the claim is made or the claim is facially insufficient, 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 under §702(a). Fed. R. Bankr. P. 2003(b)(3). Furthermore, pursuant to Bankruptcy Rule 3003(b), the schedules 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. " Fed. R. Bankr. P. 3003(b)(1). Accordingly, it is not necessary for a creditor to file a proof of claim to vote in a trustee election if that creditor's claim is scheduled, provided such claim is not scheduled as "disputed, contingent or unliquidated."

Step 4: The Vote

Section 702(c) provides that a trustee may be elected only if creditors holding at least 20 percent in amount of the eligible claims participate and vote. The candidate must then receive the votes of creditors holding a majority of the amount of claims held by creditors voting in the election. 11 U.S.C. §702(c). Bankruptcy Rule 2007.1(b)(2) regulates the use of proxies in an election of a trustee. It incorporates by reference Rule 2006, which governs the use of proxies in a case under chapter 7.

Solicitation of Proxies

Rule 2007.1(b)(2) authorizes a committee of creditors to solicit proxies. "The solicitation of a proxy is any communication, other than one from an attorney to a regular client who owns a claim…by which a creditor is asked, directly or indirectly, to give a proxy." Fed. R. Bankr. P. 2006(b)(2). Importantly, it is in the solicitation of votes by proxy that a creditors' committee can play a vital role in the selection of a trustee. If the committee determines that a particular individual is best qualified to act as a chapter 11 trustee in a specific case, the committee may be able to solicit votes in the form of proxies as a way to rally votes for its candidate. Proxies must be solicited in writing. Fed. R. Bankr. P. 2006(c)(2). A creditor who obtains a proxy should use Official Form 11A (general power of attorney) or 11B (special power of attorney) to authorize another party to vote on its behalf.

Solicitation is not permitted (1) in any interest other than that of general creditors, (2) by or on behalf of any custodians, (3) by the interim trustee or by or on behalf of any entity not qualified to vote under §702(a), (4) by or on behalf of an attorney at law or (5) by or on behalf of a transferee of a claim for collection. Fed. R. Bankr. P. 2006(d).

Verified List of Proxies

If the committee or any party receives two or more proxies, it 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." Fed. R. Bankr. P. 2006(e). In order to meet the "pertinent facts and circumstances" requirement, the holder of the proxies must include several things in its verified statement.

First, the proxy holder must include a copy of the solicitation. Fed. R. Bankr. P. 2006(e)(1). Second, the verified statement must identify the solicitor, the forwarder (in the event that the forwarder is neither the solicitor nor the claimant) and the proxyholder. Fed. R. Bankr. P. 2006(e)(2). In identifying the parties, the proxyholder must also include their connections with the debtor and creditor. *Id*. If it is the creditors' committee that holds or solicited the proxies, the statement must set forth: (1) the date and place the committee was organized; (2) that the committee was organized in accordance with Fed. R. Bankr. P. 2006(c)(1)(B) or (C); and (3) the members of the committee, the amount

of their claims, when the claims were acquired, the amounts paid therefore and the extent to which committee members' claims are secured or entitled to priority. *Id.* Third, the verified statement must include a statement that no consideration was paid or promised by the proxyholder for the proxy and whether there is an agreement between the proxyholder and any other entity for the payment of consideration, or for the sharing of compensation, in connection with voting the proxy. Fed. R. Bankr. P. 2006(e)(3), (4). If such an agreement exists, the proxyholder must provide the particulars of the agreement. *Id.* Fourth, if the proxy was solicited by an entity other than the proxyholder, it must include a signed and verified statement by the solicitor that no consideration has been paid or promised for the proxy and whether there is an agreement between the solicitor and any other entity for the payment of consideration in connection with the proxy. Fed. R. Bankr. P. 2006(e)(5). Finally, if the committee is the proxyholder, it must contain a signed and verified statement by each member as to the amount and source of any consideration paid (or to be paid) to such member in connection with the case, excluding any dividend on the member's claim. Fed. R. Bankr. P. 2006(e)(6).

In practicality, the verified statement seems to serve two purposes. First, it is clear from the requirements that the verified statement is 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." Fed. R. Bankr. P. 2006, Advisory Committee's Note to subdivision (e). Second, and possibly less apparent, the U.S. Trustee may refer to the verified statement (rather than the individual proxies) throughout the meeting of creditors to ensure accuracy in its computation of votes and also to determine whether other parties, who are present at the meeting, have objections to the proxies submitted. If the solicitation rules set forth in Bankruptcy Rule 2006 are not satisfied, the court may reject any proxy for cause, may vacate any order entered in consequence of the voting of any proxy that should have been rejected, or take any other appropriate action. Fed. R. Bankr. P. 2006(f).

Step 5: Certifying the Election

If an eligible, disinterested person is elected at the creditors' meeting and the election is undisputed, the U.S. Trustee must file a report with the court certifying the election. 11 U.S.C. §1104(b)(2). The report is treated effectively as the U.S. Trustee's selection and appointment of a trustee. *Id.* If the election is undisputed, the U.S. Trustee files an application with the court for approval of the appointment, which includes a statement setting forth the trustee elect's connections with parties in interest and a verified statement from the trustee elect describing any such connections. Fed. R. Bankr. P. 2007.1(b). The report constitutes the appointment of the elected person, subject to court approval. 7 *Collier on Bankruptcy* §1104.02[8][b][vi].

However, if a dispute arises from the election, the U.S. Trustee will file a report describing the dispute without an application for approval of the appointment. Fed. R. Bankr. P. 2007.1(b)(3)(B). The report should be accompanied by the candidates' verified statements of disinterestedness. *Id.* The court must resolve any dispute arising out of the election. 11 U.S.C. §1104(b)(2)(C). Once the court resolves the dispute and approves the successful candidate, the U.S. Trustee's report constitutes the appointment of the elected person to serve, as of the date of entry of the court's order. 7 *Collier on Bankruptcy* §1104.02[8][b][vi].

Conclusion

Though the applicable rules are relatively clear, provisions in the Bankruptcy Code permitting creditors to elect their own trustees are underutilized and perhaps even unknown to many bankruptcy practitioners. A creditors' committee can play a pivotal role, making it possible for just the right trustee to be elected. By instigating an election and soliciting proxies, creditors may be able to choose the estate representative they believe will best help them to maximize their returns in chapter 11. ■

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