TOP 10 WAYS TO HAVE A TRUSTEE APPOINTED IN A CASE

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2014 Northern District of Texas
Bankruptcy Bench/Bar Conference
June 20, 2014
Dallas, TX

Statutory Guidance

Appointment of a Trustee is governed by Section 1104 of the United States Bankruptcy Code.

§ 1104. Appointment of trustee or examiner

(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—

(1) 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; or

(2) If such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regarding to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

(b)(1) Except as provided in section 1163 of this title, on the request of a part in interest made not later than 30 days after the court orders the appointment of a trustee under subsection (a), 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. The election of a trustee shall be conducted in the manner provided n subsections (a), (b) and (c) of section 702 of this title.

(2)(A) If an eligible, disinterested trustee is elected at a meeting of creditors under paragraph (1), the United States trustee shall file a report certifying that election.

(B) Upon the filing of a report under subparagraph (A)--

(i) the trustee elected under paragraph (1) shall be considered to have been selected and appointed for purposes of this section; and

(ii) the service of any trustee appointed under subsection (a) shall terminate.

(C) The court shall resolve any dispute arising out of an election described n subparagraph (A).

> (c) If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest or the United states trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if—
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> (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
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> (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.
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> (d) If the court orders the appointment of a trustee or an examiner, if a trustee or an examiner dies or resigns during the case or is removed under section 324 of this title, or if a trustee fails to qualify under section 322 of this title, then the United States trustee, after consultation with parties in interests, shall appoint, subject to the court's approval, one disinterested person other than the United States trustee to serve as trustee or examiner, as the case may be, in the case.
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> (e) 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.

That section is divided into three parts:

The first section relates to appointment of a Trustee for cause. Cause includes fraud, dishonesty, incompetence or gross mismanagement of the debtor. §1104(a)(1). The second ground for appointment is if appointment is in the best interests of the creditors, equity security holders and other interests of the estate. §1104(a)(2). The third ground to appoint a Trustee is that the court concludes there is a basis for dismissal or conversion, but determines that it is in the best interests of creditors to appoint a Trustee. §1104(a)(3). Also, note §1104(e) Added in 2005 to require the United States Trustee to move for appointment of a Trustee, if there are

grounds to believe that the Board or certain high ranking officers participated in actual fraud, dishonest or crimes in managing the debtor or debtor's public accounting.

In addition to the reasons set out in § 1104 to appoint a Trustee, practitioners should be mindful that courts look for guidance from § 1112 of the Code governing conversion or dismissal. If the debtor has committed one or more of the actions described in § 1104(b)(4), there is high likelihood that a Trustee will assume control.

> § 1112(b)(4). For purposes of this subsection, the term "cause" includes –
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> (A) Substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
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> (B) Gross mismanagement of the estate;
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> (C) Failure to maintain appropriate insurance that poses a risk to the estate or to the public;
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> (D) Unauthorized use of cash collateral substantially harmful to 1 or more creditors;
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> (E) Failure to comply with an order of the court;
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> (F) Unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
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> (G) Failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal rules of Bankruptcy Procedure without good cause shown by the debtor;
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> (H) Failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
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> (I) Failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;
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> (J) Failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;
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> (K) Failure to pay any fees or charges required under chapter 123 of title 28;
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> (L) Revocation of an order of confirmation under section 1144;

(M) Inability to effectuate substantial consummation of a confirmed plan;

(N) Material default by the debtor with respect to a confirmed plan;

(O) Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and

(P) Failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

Case Law Interpretation in the Fifth Circuit

The remedy of appointing a Trustee is meant to be used sparingly. *See Louisiana Electric Company, Inc., et al., (In the Matter of Cajun Electric Power Cooperative, Inc.),* 69 F.3d 746 (5th Cir. 1995). In *Cajun Electric,* the 5th Circuit explained that "[t]he appointment of a trustee pursuant to Section 1104(a)(1) is an extraordinary remedy, and there is a strong presumption that the debtor should be permitted to remain in possession absent a showing of need for the appointment of a trustee." *Id.* at 749. In that case, the lower court's justification for appointing a trustee stemmed from a single conflict of interest: "Cajun's inherent conflict between the interests of its member-customers, who want low rates, and those of its creditors, who want to raise rates." *See id.* Initially, the Fifth Circuit noted that this inherent conflict—the result of Congress encouraging the debtor to structure its business as an electric cooperative—was insufficient to support the appointment of a trustee, as such a rule would result in an unintended *per se* rule without evidence of legislative intent to establish such a rule. *See id.* at 750. On rehearing *en banc*, the Fifth Circuit ultimately affirmed the appointment of the trustee, recognizing that "this is a large and messy bankruptcy that promises to get worse without a disinterested administrator at the helm." *Id.* at 751 (Garza, J., dissenting) (dissenting opinion adopted after *en banc* review, *see* 74 F.3d 599 (5th Cir. 1996) (en banc)). From this decision, we take away the following lessons:

(1) Appointment of a Trustee is an "extraordinary remedy" and the party seeking such appointment has a high burden of proof, showing such cause by "clear and convincing evidence."

(2) The appointment of a Trustee was "a decision of a significant and discrete dispute" that was appealable.

(3) A court's decision to appoint a trustee is reviewed for abuse of discretion.

Synthesizing the Jurisprudence

In reviewing cases for our top 10 list, we found that most of the case law fit under one of the following categories: (i) the debtor failed to comply with fundamental bankruptcy requirements – for example – did not file monthly operating reports, did not keep collateral insured; (ii) the debtor concealed critical information; (iii) the debtor's management was defrauding creditors or equity security holders, or both, (iv) the debtor acted incompetently, and finally, (v) the debtor simply is unable to avoid continuing losses.

Often courts have to make difficult judgment calls. The consequences of appointing a Trustee can be devastating to all parties, not just old management. The appointment of a Trustee signals that a liquidation will occur (although not always). Moreover, appointing a Trustee means that a new set of professionals will be hired by the Estate, putting another layer of expenses in front of the unsecured creditors. Not only does this add to costs, it often puts the Trustee into a business with which he or she may not be familiar. There are a number of potential negatives with a Trustee. Why, then, do Courts use them so often?

One theory is that the Trustee's independence is valuable. The Courts often feel more comfortable with the Trustee as eyes and ears of the Court, rather than the debtor's principals, who often have some conflicting interest (for example, in small businesses, the principal is often a guarantor, sometimes a lender, and usually an owner, creating a stew of potential ethical and financial conflicts).

While a search of cases exclusively in the Northern District yields many examples of instances where the Court appointed a Trustee, we have often avoided Trustees by using other means. For example, Courts commonly are asked to appoint chief restructuring officers (See Senior Living Properties, LLC, Debtor, Case No. 02-34243, in the United States Bankruptcy

Court for the Northern District of Texas, Dallas Division and Mason Coppell OP, LLC, et al., Debtors, Case No. 14-31327, in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division). The use of CROs is widely viewed as the antidote to the sins of old management. However, if the CRO reports to a Board comprised of old debtor principals, how much deference should the court and the parties give to such an arrangement? Additionally, Courts have entertained the use of examiners, examiners with expanded powers See Mirant Corporation, Case No. 03-46590-dml-11, United States Bankruptcy Court for the Northern District of Texas, Fort Worth Division.

Notwithstanding the strategies used to avoid the appointment of a Trustee, here is the Panel's list of reasons you have a Trustee appointed:

PANEL'S TOP 10 REASONS YOU HAVE A TRUSTEE APPOINTED

NO. 10 **Failure to file schedules and statements and/or failure to file monthly operating reports.** *See In re Syndor,* 431 BR 584 (Bankr. D. MD 2010). In that case, the debtors failed to file monthly operating reports until days before a hearing on a motion to dismiss, convert or appoint a Trustee. There was also evidence that the debtors (Syndor was a debtor and a related case involved Clarkson) were seriously delinquent on their payment of U.S. Trustee fees. The court evaluated cause under § 1104 and employed § 1112(b)(4) as a tool to evaluate whether to dismiss or convert the case. The court noted that § 1112(b)(4)(H) and (K) both were violated and had little trouble appointing a Chapter 11 Trustee.

NO. 9 **Failure to pay U.S. Trustee fees.** As discussed above in the *Syndor* case, the failure to pay U.S. Trustee fees is grounds to convert a case under § 1112(b)(4)(K). Courts have used this as one element of determining whether conduct warrants appointment of a Trustee.

NO. 8 **Gross mismanagement of the Estate.** We should begin by recognizing, as do most of the commentators, that some mismanagement exists in almost every chapter 11. (See *Colliers* discussion at § 1104). However, the statutes require gross mismanagement. What evidence is likely to constitute gross mismanagement? One example is a failure to file tax returns. In *In re Evans*, 48 B.K. 46 (Bankr. W.D. Tex. 1985), the court found that the debtor had failed to file tax returns for 3 years and that this constituted cause. There have been many other cases involving failure to pay taxes to the IRS and property taxes where the court has considered it grounds for appointment of a Trustee. *See* In re Euro American Lodging Corp., 365 B.R. 421 (Bankr. S.D.N.Y. 2007). Other than failure to pay taxes, courts have examined failure of a business to operate profitably over long periods of time when peers are profitable, and courts have looked at business practices, especially record keeping. The standard, however, appears to be flexible and fact intensive.

NO. 7 **Unauthorized use of cash collateral.** Cash collateral is famously governed by 11 U.S.C. § 363. A fundamental requirement of staying in chapter 11 is only using cash collateral with consent from the party having an interest in cash collateral and usually an order from the Bankruptcy Court. Like many of the issues set out above, misuse of cash collateral, resulting in substantial harm to one or more creditors, is grounds for conversion of a case. *See 11 U.S.C. 1112(b)(4)(D).* This obligation is taken seriously. At least one court has held that a $3,000 unauthorized expense was grounds to appoint a Trustee. *See SI Grand Traverse LLC,* Bankr. W.D. Michigan 2011).

NO. 6 **Best interests of creditors, equity holders.** While this one may seem vague at first or duplicative of 1104(a)(1), there are circumstances when it fits. In a case called *Pacific Plains,* Judge Jernigan heard a motion from the holder of about 1/3 of equity and also a creditor who complained that management was not looking out for the interests of creditors or equity security holders. The evidence presented over several days was that management and the creditors seeking a Trustee had once been friends and had jointly acquired over 100 acres on the north shore of Hawaii. The land sat unused and unsold for more than 20 years. There was a dispute among the owners over plans to develop the property, as well as allowing debt incurred to grow without any effort to sell or work the property. There was evidence of continuing losses and a suggestion that the dominant owners now were trying to freeze out the minority. While the court found that none of the evidence quite met the fraud standard or the gross mismanagement standard under 1104(a)(1), the Court found that disputes over control, disagreement over direction of any development and an unwillingness to consider selling the property favored appointing a Trustee. *See Pacific Plains Company, LLC,* Case No. 12-31653-sgj-7, in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division.

NO. 5 **Continuing Losses.** In another case decided by Judge Jernigan, *Patman Drilling International, Inc., Debtor;* Case No. 07-34622-sgj-11, the Court was presented with a motion by two secured creditors seeking a Trustee. The facts were these. The debtor was managed by two brothers. The company leased rigs to oil companies and was unable to keep them leased. The company had losses of at least $300,000 a month. Moreover, the debtor did business with a company in which the brothers owned a significant percentage. Finally, the two brothers were drawing large salaries. One of the brothers was taking out $385,000 a year – the other over $200,000 a year.

The Court looked at the losses, the evident conflicts and appointed a Trustee. An interesting note – the Committee, in the face of all that evidence, opposed the appointment. Their concern was that appointment of a Trustee would be expensive and would trigger a liquidation.

NO. 4 **Conflicts of Interest.** While *Patman Drilling* is one example of an evident conflict of interest, numerous other examples exist. In *In re Embrace Systems Corp.,* Bankr. W.D. Mich. 1995), the court found that the principal of the debtor had an irreconcilable conflict through an interest in another enterprise that was trying to buy technology owned by the debtor. There was evidence that the principal of the debtor was more concerned about the enterprise trying to buy technology from the debtor than in keeping the debtor alive.

NO. 3 **Acrimony between the debtor and creditors.** This is a factor that when used tells you that everyone has grown tired of the debtor's antics, including the judge. The lead case on this is probably *In re Marvel Entertainment Group*, 140 F.3d 463, 472-474 (3rd Cir. 1998), but also see *Celeritas Technologies, LLC,* 446 B.R. 54 (Bankr. D. Kan 2011). In both of those cases, there is an element that I think fuels most of the "acrimony" fact situations. The case is less like an ordinary bankruptcy and more like pure litigation.

NO. 2 **Failure to Confirm a Plan.** Many times a Trustee is appointed because the debtor simply cannot confirm a plan. The circumstances may be a result of economics, not enough money to pay key voting constituencies, failure to meet key requirements of § 1129, for example, not enough money to pay admin claims or not enough distributions to pay more than a liquidation. Examples of trustee appointments in cases when there has been no progress include:

NO. 1 **Taking the Fifth.** In general, a debtor and its principals have a duty of candor and disclosure to the bankruptcy court and creditors. While the Fifth Amendment to the United States Constitution may protect individuals from self-incrimination, that protection may come with a cost. In *In re Ondova Limited Co.,* Case No. 09-34784-sgj-11 (Bankr. N.D. Tex. Sept. 11, 2009) [Doc. No. 85], the principal invoked the Fifth Amendment in response to all questions during a show cause hearing. Judge Jernigan found that the principal's invocation of the Fifth Amendment, coupled with his mismanagement of the debtor, demonstrated sufficient cause to appoint a trustee.

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Mark Andrews is a shareholder with Cox Smith Matthews Incorporated. He has represented lenders, business debtors and committees throughout his over twenty-five years of bankruptcy practice. Mark joined Cox Smith in 2006 after a number of years practicing as a partner in a business bankruptcy boutique firm in Dallas. Among recent significant engagements, Mark has represented debtors in connection with construction, energy, healthcare, real estate and retail businesses. He has also defended lawyers and law firms in connection with legal malpractice claims. Finally, he has recently served as a Chapter 11 Trustee. In addition to his practice, Mark currently serves on the firm's Management Advisory Committee.

Mark is a member of the John C. Ford Inns of Court. He is a frequent speaker at state and local seminars. He is also a member of the American College of Bankruptcy. Mark has a J.D. from Tulane University School of Law and a B.A. from Georgetown University.

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Mr. Faulkner has more than 30 years of accounting and management experience in bankruptcy and litigation services. He has also advised troubled companies on strategic, financial and operational matters. Mr. Faulkner demonstrates great finesse in addressing complex financial and accounting issues arising in bankruptcy, dispute resolution and litigation support engagements by gathering and analyzing data, relating key findings to client needs, explaining conclusions clearly and concisely and, when appropriate, facilitating solutions.

Mr. Faulkner has assisted in the formulation and review of reorganization plans, preparation of financial projections, asset liquidation, administration and analysis of claims, and forensic accounting, including the tracing of assets. He has individually served as examiner, receiver, chief restructuring officer, both Chapter 11 and Chapter 7 trustee, and as post-confirmation trustee in a variety of engagements. His work in litigation services encompasses accounting investigations and expert witness testimony. As a business advisor, Mr. Faulkner has performed strategic planning, crisis management, operational reviews, and day-to-day operations administration.

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Served as Trustee, Operating Receiver and Receiver under the Bankruptcy Act, as well as Counsel to both Debtors and Creditors under the Bankruptcy Act, and served as Trustee and Counsel for Trustees, Debtors, Creditors and Creditors' Committees under the Bankruptcy Code

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1996 & 1999 Urban Attorney of the Year - West Texas Legal Services Private Attorney Involvement Program

2003 Outstanding Small Lawfirm Of The Year - Legal Aid of Northwest Texas

Adjunct Professor of Law - Texas Wesleyan Law School -
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