

# Taking the Mystery Out of the Chapter 11 Trustee Appointment Process

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Every debtor under chapter 11 of the United States Bankruptcy Code becomes a debtor in possession, vested with most of the powers and duties of a trustee. In a careful compromise when adopting the Code in 1978, Congress provided an alternative in cases where a debtor cannot or should not be vested with those trustee powers and duties—a chapter 11 trustee.<sup>1</sup> Although the Senate originally proposed that chapter 11 trustees be mandatory for all large cases, § 1104(a) of the Code reflects the congressional compromise that bankruptcy courts must direct the United States Trustee to appoint a chapter 11 trustee if the court finds “cause” or that a trustee is in the interest of stakeholders.<sup>2</sup> In keeping with the Code’s animating principle to separate the adjudication function from the enforcement and administration functions, the appointment itself is left to the impartial U.S. Trustee after “consultation with parties in interest.”

Some commentators, including these authors, believe that greater use of the chapter 11 trustee mechanism to supplant management that cannot or will not act as fiduciaries on behalf of all stakeholders in the case would enhance sound corporate governance in bankruptcy.<sup>3</sup> Nevertheless, the appointment of a trustee should not be routine and requires great care.<sup>4</sup> This article will explain how U.S. Trustees approach this task through a comprehensive consultation and selection process to fulfill our statutory obligation to select qualified and independent fiduciaries to represent the interests of all stakeholders in the chapter 11 case.<sup>5</sup>

## Consultation and Candidate Identification

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<sup>1</sup> 11 U.S.C. § 1104(a). For additional information on Congressional deliberations leading to the adoption of the Bankruptcy Code, see our article at Clifford J. White III and Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners after BAPCPA*, 80 Am. Bankr. L.J. 289, 293-97 (2006) (“*White-Theus*”).

<sup>2</sup> 11 U.S.C. § 1104(a).

<sup>3</sup> Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. Rev. 791, 857 (1992-1993) (“Under the Code, trustees are almost never appointed. . . . Courts announce and apply a very strong presumption against the appointment of a trustee. The norm is that the debtor continues in possession. This . . . is a perversion of what virtually everyone involved in the 1970s reforms intended.”)

<sup>4</sup> There are many reasons for the reluctance of parties to seek chapter 11 trustees. These include historical reluctance to oust entrenched management that pre-dates the changes to the Code conferring the authority on the U.S. Trustee to make the appointment. Some courts apply an arguably unjustified burden of proof (“clear and convincing evidence” vs. “preponderance of the evidence”) before granting a chapter 11 trustee motion. Creditors may wish to avoid possible retaliation by the incumbent management and its creditor allies. And some of the more powerful players in the case may be concerned that they will lose control of the case and risk possible investigation into estate claims against them.

<sup>5</sup> In contrast, conversion of a case from chapter 11 to a chapter 7 liquidation with a trustee appointed from the U.S. Trustee’s statutory panel of chapter 7 trustees is not rare. The U.S. Trustee files a motion to convert or dismiss in about 40 percent of all chapter 11 cases. The motions typically are filed in smaller cases and on grounds such as negative cash flow diminishing the value of the estate, the failure to maintain insurance or the failure to file required financial reports. See 11 U.S.C. § 1112(b)(4).

Once the court orders the appointment of a chapter 11 trustee, the U.S. Trustee, after consultation with parties in interest, appoints a disinterested person. That trustee appointment is subject to court approval.<sup>6</sup>

U.S. Trustees approach the consultation and appointment process seriously. The Program has developed thorough and rigorous processes, scaled to the needs of the case, to ensure a comprehensive search for and evaluation of the best candidates. Although a U.S. Trustee will never enter into an agreement to appoint a particular candidate, U.S. Trustees often encourage parties to begin considering skills and candidates before the court orders the appointment. Once the court enters the order, the U.S. Trustee expeditiously consults with major creditors, the creditors' committee, the debtor and other interested parties. This consultation might be in person, by telephone or by email. U.S. Trustees take seriously and place a high value on the input provided by parties in interest.

During these consultations, parties occasionally recommend more than one candidate to the U.S. Trustee and may advise the U.S. Trustee of their first choice. An unsuccessful candidate may think that the U.S. Trustee has rejected the creditor's recommendation, wrongly believing that he or she was the creditor's first or only choice.

In addition to names of particular individuals, the U.S. Trustee seeks the interested parties' views of the "skill set" that the trustee should possess. In some cases, a businessperson with expertise in dealing with distressed companies in the relevant industry might be the best choice. In others, an attorney with significant experience handling complex financial litigation might be better suited. In still others, a person with a background in the investigation of financial fraud might be ideal.<sup>7</sup>

The U.S. Trustee also brings independent judgment to bear on what type of trustee the case needs and what person is best qualified to serve as trustee. The U.S. Trustee encourages and considers self-nominations to expand the pool of qualified and independent candidates. And, unlike in chapter 7,<sup>8</sup> the U.S. Trustee can conduct a nationwide search for a chapter 11 trustee. In the most complex cases, the U.S. Trustee often reaches beyond the district in which the case was filed to identify candidates with unquestioned independence and the optimum skill set to best meet the needs of the case.

Professionals occasionally request meetings with senior U.S. Trustee Program officials to discuss their qualifications and interest in future appointments. Such meetings, which are held at headquarters or in regional offices, are welcomed and valuable. They are often scheduled to permit the attendance of multiple U.S. Trustees in person or by video or telephone conference. These prior meetings provide a good source of candidates to whom the U.S. Trustee may reach out even if the candidate was not recommended by a creditor in the case at bar. The U.S. Trustee Program urges bankruptcy and other professionals to request such meetings to strengthen the

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<sup>6</sup> 11 U.S.C. § 1104(d); *see also* Fed. R. Bankr. P. 2007.1.

<sup>7</sup> In smaller cases or cases where an immediate liquidation appears likely, parties frequently suggest that the U.S. Trustee appoint members of the chapter 7 panel of trustees to serve as chapter 11 trustees, recognizing the expertise of those persons in bankruptcy matters.

<sup>8</sup> 11 U.S.C. § 321(a)(1) (chapter 7 trustee must reside or have an office in the judicial district where the case is pending or in an adjacent district).

bench of potential candidates for future appointments, particularly in cases in which the need for a speedy appointment is most acute.

### **The Appointment Decision**

In considering whom to appoint, U.S. Trustees look first for independence. A candidate cannot be beholden to the party that recommended him or her or to any other party in the case. The trustee must protect all interests and be prepared to “bite the hand that fed him” if required. For example, an attorney for a major creditor recently complained about the selection of a chapter 11 trustee who aggressively pursued causes of action against his client, notwithstanding the irony that his client had recommended the trustee to the U.S. Trustee. That trustee displayed admirable independence. The U.S. Trustee’s impartiality in appointing trustees enhances trustees’ ability to exercise this type of independence.

Beyond independence, the U.S. Trustee will consider a candidate’s experience, qualifications and ability to muster necessary bankruptcy, financial and business expertise. The U.S. Trustee may have an informed view about the ideal skill set for the engagement. For example, a debtor might be an operating business and the U.S. Trustee and parties might agree that a turnaround specialist would be ideal for the position. The U.S. Trustee will seek to ensure that the specialist will engage proper professionals and take appropriate steps to manage the costs of case administration.

So how is this information gathered? The U.S. Trustee seeks CVs or résumés from recommended and self-nominated candidates. The U.S. Trustee may also request that candidates complete a preliminary conflicts analysis and submit preliminary statements of their connections with the debtor, its insiders and creditors before a final, more rigorous review. In many cases, and certainly in every complex one, the U.S. Trustee will interview candidates before making the appointment. Candidates are interviewed by phone or in person and may be interviewed more than once. The U.S. Trustee and others from the U.S. Trustee Program will question the candidate about a broad range of topics, such as the candidate’s expertise and amount of time available to devote to the job. In particular, the questions often focus on the candidate’s prior experience in similar matters; how the candidate would economically assemble a team to address the multi-faceted aspect of a case; the candidate’s knowledge of the case, including how that knowledge was obtained; and the candidate’s initial plan to marshal assets and secure information to guide the case to a successful conclusion.

In-person interviews are strongly preferred, but the urgency of an appointment sometimes requires that interviews be conducted by videoconference or by telephone. In major cases, it is not unusual for a multi-regional team, including Executive Office officials, to interview the candidates along with the selecting U.S. Trustee. This enhances the thoroughness of the evaluation process in the particular case and helps acquaint a wider swath of U.S. Trustee Program officials who are involved in the trustee appointment process with an array of candidates for consideration in future cases.

Reviewing conflicts and connections is often the most important and painstaking stage of the appointment process. Additional disclosures are often requested, and assessing connections, particularly in larger cases with candidates from large professional firms, can be difficult. Disqualifying conflicts are not always obvious. Often a candidate who was tentatively selected is

not appointed after a full review of the candidate's connections with the case and stakeholders. Although "conflicts counsel" may sometimes be countenanced to deal with limited attorney conflicts, "conflicts trustees" never can. A trustee must be "disinterested," but that is not the end of the inquiry. We seek to appoint trustees whose objectivity and independence is beyond question. For example, a candidate from a law firm, although technically disinterested and legally eligible to serve personally, may nevertheless be deemed unsuitable for appointment as a fiduciary because of the firm's representations or relationships in unrelated matters.<sup>9</sup>

Once the U.S. Trustee decides whom to appoint, the appointment and approval process is relatively straightforward. The U.S. Trustee formally appoints the candidate and then files an application seeking approval of the appointment. Pursuant to Rule 2007.1,<sup>10</sup> the application must name the trustee and the trustee's connections with parties in interest, their attorneys and accountants, the U.S. Trustee and persons employed by the U.S. Trustee. The application must also list the parties with whom the U.S. Trustee consulted in connection with the appointment. A statement of connections verified by the appointee will be attached to the application. The court's approval of the appointment should be limited to a review of whether the person is statutorily qualified to serve; the court should not substitute its judgment for that of the U.S. Trustee.

The final check on the trustee appointment process is the right of creditors to seek a trustee election.<sup>11</sup> Creditors rarely invoke this right. The U.S. Trustee will not delay appointing a trustee until the time for an election request has expired, because the circumstances justifying the removal of management generally call for quick action.

## **Conclusion**

The appointment of chapter 11 trustees need not be rare or mysterious. The Bankruptcy Code provides a straightforward mechanism to supplant management who are unsuitable to serve in a fiduciary capacity for all stakeholders. The Code also provides standards and procedures that are assiduously followed by U.S. Trustees in selecting qualified and independent candidates. U.S. Trustees have appointed highly qualified individuals to serve as trustees and examiners<sup>12</sup> in chapter 11 cases, including top bankruptcy partners in major law firms, nationally known workout and turnaround professionals, financial professionals, retired bankruptcy judges, and a former director of the FBI and other former high-ranking law enforcement officials. Perhaps more discussion of the need for chapter 11 trustees and less mystery surrounding the selection process can lead to more diligent use of this important tool for sound corporate governance in bankruptcy cases.

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<sup>9</sup> Chapter 11 trustees are also subject to a government background investigation, similar to the process conducted for federal employment. This formal investigation generally involves filling out a detailed background questionnaire and is followed by a public records search and field investigation. The background investigation process is usually completed after the appointment is effective. In rare cases it has been necessary to withdraw the selection of a candidate due to information revealed on the background questionnaire or to seek the removal of a trustee after appointment.

<sup>10</sup> Fed. R. Bankr. P. 2007.1.

<sup>11</sup> 11 U.S.C. § 1104(b).

<sup>12</sup> The process for appointing examiners is identical to that for appointing trustees. 11 U.S.C. § 1104(d).