Trustees and Joint Administration

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INTRODUCTION

Bankruptcy Rule 1015(b) permits the joint administration of two or more related bankruptcy estates if the debtors are affiliates, spouses, or general partners of one another. While typically a consideration in chapter 11 cases, joint administration is no stranger to chapter 7. Bankruptcy Rule 2009 specifically provides for the appointment and election[1] of chapter 7 trustees in jointly-administered estates. But what happens when estates hold claims against one another ("inter-estate claims")? Unfortunately, the Bankruptcy Code does not provide a conclusive solution. Nevertheless, after conducting an analysis of the relevant authorities, there appears to be a framework under which trustees may jointly-administer estates with inter-estate claims.

ELIGIBILITY TO SERVE AS TRUSTEE

One of the hallmarks of trustees is their independence from the estates to which they are appointed, *i.e.* "disinterestedness." 11 U.S.C. § 701(a)(1).[2] The Bankruptcy Code defines a disinterested person as someone who:

> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not, within 2 years before the date of filing of the petition, a director, officer, or employee of the debtor; and
>
> (C) does not have an interest materially adverse to the interest of the estate or any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.

11 U.S.C. § 101(14)(C). A trustee must remain disinterested throughout a case. Furthermore, the disclosure of any material facts relating to a trustee's disinterestedness must be immediately and thoroughly disclosed to the Court. *See, e.g., In re Bennett Funding Group, Inc.*, 226 B.R. 331, 334 (Bankr. N.D. N.Y. 1998).

Trustees of jointly-administered estates must satisfy an additional layer of scrutiny. Courts may order the appointment of separate trustees "[o]n a showing that creditors or equity se-

KEY POINTS

1. While the Bankruptcy Code specifically permits the appointment of a single trustee in jointly-administered cases, the inherent connection between related estates may jeopardize a trustee's status as a "disinterested" person.
2. Some courts believe that a trustee whose jointly-administered estates have claims against one another is rendered disinterested as a "creditor." A more common approach, however, is to examine whether the trustee's claim belongs to him or her *personally*, rather than through the trustee's *representative* capacity.
3. Substantive consolidation may eliminate the need for a "disinterestedness" analysis, but trustees can expect to receive opposition from creditors whose claims may be diluted by merging the estates.
4. To preserve one's disinterestedness and protect against the loss of fees or the risk of removal, trustees should routinely disclose potential conflicts of interest.

curity holders of the different estates will be prejudiced by conflicts of interest of a common trustee who has been elected or appointed." Bankruptcy Rule 2009(d).[3]

In short, trustees of jointly-administered estates are held to high standards and cannot possess relationships with their estates that compromise their impartiality. Trustees who possesses (or later obtain) an interest that might color their independence, may lose their ability to earn a fee, or worse, be required to resign. *See, e.g., In re BH & P, Inc.*, 103 B.R. 556, 573 (Bankr. D. N.J. 1989).

DISINTERESTEDNESS AND INTER-ESTATE CLAIMS: CAN THEY COEXIST?

Trustees may find it challenging to satisfy the disinterestedness requirements when appointed in jointly-administered cases. After all, jointly-administered cases are by definition related, and it is common for the estates to possess inter-estate claims. Given the lack of clarity in the Bankruptcy Code, it is unsurprising that courts apply different approaches to these cases.

Some courts have chosen to adopt complicated tests that are seemingly impossible to satisfy because they presume a conflict. *See, e.g., In re Parkway Calabasas Ltd.*, 89 B.R. 832, 834 n. 3 (Bankr. C.D. Cal. 1988). Other Courts have focused on fraud or damage to the estates. *See, e.g., In re Freeport Italian Baker, Inc.*, 340 F.2d 50, 54 (2nd Cir. 1965).

Perhaps the most reasoned approach is that taken by the First Circuit in *In re BH & P , Inc.*, 949 F.2d 1300(3d Cir. 1991), where the court recognized "the advantages of joint administration and the place for single trustees in that process" and was "not prepared to say that inter-debtor claims mandate disqualification of the trustee in every instance." *Id*. at 1312. The *BH & P* Court noted that:

> It is important that each case involving a single trustee in jointly administered estates with inter-debtor claims be evaluated prospectively on a case-by-case basis. The retention of a trustee should not be upheld simply because, after the fact, no harm appears to have been done. In some circumstances, the potential for conflict and the appearance of conflict *may,* without more, justify removing a trustee from service. At the same time, however, it must be made clear that horrible imaginings alone cannot be allowed to carry the day. Not every conceivable conflict must result in sending the trustee away to lick his wounds. And, when all is said and done, doubts are to be resolved in favor of invalidation.

Id. at 1313 (citing *In re Martin,* 817 F.2d 175, 181-83 (1st Cir.1987)). S*ee also In re Petters Co., Inc.*, 401 B.R. 391, 405–06 (Bankr. D. Minn. 2009), *aff'd sub nom. Ritchie Special Credit Investments, Ltd. v. U.S. Tr.*, 415 B.R. 391 (D. Minn. 2009), *aff'd,* 620 F.3d 847 (8th Cir. 2010).

INTER-ESTATE CLAIMS SHOULD NOT BAR THE APPOINTMENT OF A SINGLE TRUSTEE IN JOINTLY-ADMINISTERED CASES

Although factual differences exist in every case, the typical fact-pattern involves a trustee appointed under Bankruptcy Rule 2009, who later learns that the jointly-administered estates possess inter-estate claims. These claims may be based on several factors, including inter-company transfers, cross-pledge agreements, or competing claims against assets. The following cases provide insight into how courts evaluate disinterestedness, and balance it against the goal of efficiently administering estates in ways that reduce administrative costs and increase distributions to creditors.

For example, in *In the Matter of International Oil Company*, 427 F.2d 186 (2nd Cir. 1970),[4] the debtor and three wholly-owned subsidiaries filed for relief under the Bankruptcy Act. A creditor objected to the appointment of a single trustee alleging that the trustee represented a pre-petition creditor and asserting the existence of inter-estate claims. The court found that the objection was insufficient to disqualify the trustee, especially considering that the creditor's pre-petition claim was unsecured. The court went on to find that "such a showing is [in]sufficient to saddle these estates with the expense of separate trustees and trustees' attorneys at the present time." *Id*. at 187.

About the Authors

Ross Hartog is a resident in our Fort Lauderdale office. Ross has focused his law practice in bankruptcy and insolvency since 1998. He represents parties in all aspects of the bankruptcy process including trustees, assignees for the benefit of creditors, receivers, creditors, debtors, committees, and purchasers of assets. Ross is a member of the Panel of Bankruptcy Trustees for the Southern District of Florida where he is routinely appointed as a chapter 7 and chapter 11 trustee. He also serves as a receiver and assignee for the benefit of creditors.

Alan Rosenberg represents bankruptcy trustees, creditors, debtors, and other parties-in-interest, in all aspects of insolvency proceedings and bankruptcy-related litigation, including, but not limited to, the sale of bankruptcy estate assets and the pursuit and defense of avoidance actions and other litigation claims. In addition to his bankruptcy practice, Alan also represents individual and corporate clients in a wide variety of commercial litigation claims and real estate transactions. In his free time, Alan enjoys learning about cryptocurrency and blockchain technology and has been published several times on the subject.

Additionally, in *In re Lyons Transportation Lines, Inc.*, 144 B.R. 32 (Bankr. W.D. Pa. 1992), defendants in lawsuits commenced by a trustee in jointly-administered cases moved to disqualify the trustee. The defendants alleged that the trustee was not disinterested because inter-estate claims made the trustee a creditor of one of the jointly-administered estates. The court refused to disqualify the trustee, finding that an inter-estate claim was not determinative on the issue of disinterestedness because the trustee held "no claim *personally* as a creditor… and hence, has no personal interest." *Id*. at 34 [emphasis added]. The court concluded that the trustee's role as a creditor solely in his *representative capacity* did not create a material adverse interest requiring the trustee's disqualification. *Id*. at 35.

Furthermore, in *In re Smartt*, 132 B.R. 765 (Bankr. D. Colo. 1990), the court focused not only on the nature of the conflict, *i.e.*, personal vs. representative, but on the timing of the conflict, *i.e.*, present vs. future.[5] There, a trustee was appointed in a corporate case and in the related case of the corporation's principal. The trustee, who served as his own counsel, filed fee applications. Upon review of a memorandum submitted by the trustee in connection with his fee applications, the court became concerned about possible conflicts of interest resulting from inter-estate claims. The court, however, ultimately found that the trustee's joint approach to administration of the estates "saved an enormous amount of duplication of effort and expense to both estates." *Id*. at 767. The court recognized that the inter-estate claims may create conflicts in the future, but found that the trustee's administration of the estate did not presently prejudice the creditors. Accordingly, the trustee was entitled to compensation and was not subject to removal. *Id*. at 768. The Court also noted that "while the trustee must be free of any scintilla of personal interest, the trustee does not become interested by reason of his appointment as trustee in two related estates." *Id*. at 768 (citing *In re Realty Associates Securities Corp.*, 56 F.Supp. 1007 (E.D. N.Y. 1944)).

It should also be noted that mere allegations of an alleged adverse interest or conflict are insufficient. *In re PL Liquidation Corp.*, 305 B.R. 629 (Bank. Del. 2004) demonstrates this point. In *In re PL Liquidation Corp,* the creditors elected a common trustee for seven jointly-administered estates. The ousted interim trustee and one of the creditors objected to the election, arguing, among other things, that inter-company claims, as well as the acquisition of one debtor by another, could create an adverse interest or give rise to a conflict. The court overruled the objection because the mere assertions of potential conflicts or adverse interests were insufficient. *Id*. at 634. The court required an actual showing, which the objectors did not do. Accordingly, the court approved the election of the trustee. *Id.* at 635.

The holdings in these cases make practical sense. Moreover, "[i]t has long been recognized that joint administration, and the appointment of a common trustee, are favored means to save expense." *In re Ben Franklin Retail Stores, Inc.*, 214 B.R. 852, 858 (Bankr. N.D. Ill. 1997). "The election of a common trustee for jointly administered cases carries out [the] goal of 'economical and expeditious administration.'" *Id*.

SUBSTANTIVE CONSOLIDATION – A POSSIBLE SOLUTION

Substantive consolidation may resolve potential conflicts arising from inter-estate claims. The primary advantage to substantive consolidation is the elimination of inter-estate conflicts by merging the estates into one. Unfortunately, the merger of two estates is also its largest drawback. Indeed, trustees will likely encounter objections by creditors who believe a consolidated estate will dilute their claim. Substantive consolidation is a multi-faceted issue and the subject of an article in the Spring 2020 issue of the *NABT American Bankruptcy Trustee Journal* entitled "*Unscrambling the Egg with Substantive Consolidation of Assets*." It is highly recommended reading.

CONCLUSION

A trustee considering acceptance of an appointment in jointly-administered cases should be prepared to conduct extensive due diligence. Not only must the trustee examine the general relationship between the estates, but the trustee should also be prepared to fully disclose any conflicts, making clear to distinguish those that are personal to the trustee and those that arise in their representative capacity. Even among those courts that adopt the criteria outlined in the BH & P case, no bright-line rule governs a trustee's eligibility to serve jointly-administered cases and when irreconcilable conflicts exist. Courts will make case-by-case and fact-specific analyses balancing a trustee's personal and present conflicts, and the efficiencies resulting from the trustee's administration.[6] Disclosure of conflicts (even potential ones) was the key to protecting the trustee in the *Smartt* case and is a best practice. The failure to adequately disclose may lead to denial of fees or even removal, which is a result that favors no one.

ENDNOTES:

1 Chapter 7 trustees may be appointed or elected. For purposes of this article, all references will be made to a trustee's appointment unless otherwise noted.

3 Disinterestedness is a requirement of successor trustees appointed by the U.S. Trustee, but may not necessarily apply to trustees elected by creditors. *Compare* 11 U.S.C. § 703(c) to 11 U.S.C. §§ 702(a) and 703(a). *But see In re Jack Greenberg, Inc.*, 189 B.R. 906, 909 n. 6 (Bankr. E.D. Pa. 1995) (disinterestedness requirement for elected trustee may be implicit and was a component of the election of trustee provisions of the Bankruptcy Act of 1898).

4 Bankruptcy Rule 1015 includes similar language instructing the bankruptcy court to "give consideration to protecting creditors of different estates against potential conflicts of interest."

5 The *International Oil* case is cited in the Advisory Notes for Bankruptcy Rule 2009.

5 Section 101(14) requires a trustee to "have" an adverse interest making the timing of an alleged adverse interest relevant.

7 A court must make a conflict of interest analysis when considering joint administration under Bankruptcy Rule 1015. One interesting note is whether a second conflict of interest analysis is required to appoint a trustee under Bankruptcy Rule 2009. *See Ben Franklin*, 214 B.R. at 860.