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Trying to Remove the Trustee? A Tough Road Ahead!

The entire Chapter 7 bankruptcy system is predicated on the orderly gathering and distribution of a debtor's assets to long-suffering creditors. The Chapter 7 trustee is thrown into this frequently adversarial—and often emotionally charged—process. Promptly after a voluntary Chapter 7 case is filed and the order for relief is entered by the bankruptcy court, the U.S. trustee, under Bankruptcy Code § 701(a), appoints the trustee, whose many duties are spelled out in § 702 of the code. In sum, the duties revolve around marshaling and distributing the assets of the debtor's estate created by the bankruptcy filing in accordance with the distribution scheme prescribed by the Bankruptcy Code.

In gathering the assets of the estate that will be distributed, the trustee has many valuable statutory tools at his or her disposal. Among these are the so-called § 341 meeting, named after the Bankruptcy Code section that created it, in which the trustee is allowed to question the debtor or the debtor's representative about the assets of the estate. From a review of the bankruptcy schedules filed by the debtor and the information gathered at the § 341 meeting, the trustee learns more about what assets are in the estate that needs to be administered. Assets not only includes tangible and intangible property that remains in the estate but also often consists of potential causes of action undertaken against insiders and third parties to recover an estate's assets.

The trustee's actions to recover fraudulent transfers, preferential payments, and other funds that rightfully belong to the estate—in an attempt to liquidate and return them to creditors—can frequently lead to contentious litigation. It is in this acrimonious atmosphere that those being pursued by the trustee may try to forestall recovery against them by seeking removal of the trustee, or creditors who are not targets of litigation may disagree with the business judgment of the trustee and seek his or her removal. In either instance—or in the enumerable chasm of possibilities in between—barring actual fraud or self-dealing on the part of the trustee, the road to removal is almost always impassable.

Section 324(a) of the Bankruptcy Code provides the sole statutory ground for removal of a trustee, stating the following: "The court, after notice and a hearing, may remove a trustee … for cause." Removal of a bankruptcy trustee is one of the most serious actions that a bankruptcy judge can decide. Under § 324(b), if a trustee is removed for "cause," then that trustee is removed from all other cases in which the trustee is then serving. Because of the serious nature of a motion to remove, courts generally will not remove a trustee absent an actual fraud or injury. *See In re Martin*, 817 F.2d 175 (1st Cir. 1987).

Courts generally give a trustee a wide degree of latitude in deciding how to handle and administer an estate. This "substantial degree of discretion in deciding how to administer the bankruptcy estate … [is] governed by a business judgment standard." *In re Beery*, 2007 Bankr. LEXIS 1868 at 17 (Bankr. N.M. May 30, 2007). Therefore, a trustee will not be removed for mistakes in judgment when the judgment is discretionary and reasonable under the circumstances. *See In re Cult Awareness Network, Inc.*, 205 B.R. 575 (Bankr. N.D. Ill. 1997).

Furthermore, a trustee is not required to prosecute every cause of action belonging to the estate. *See In re Olympia Holding Corp.*, 305 B.R. 586 (Bankr. M.D. Fla. 2004). Therefore, even when a creditor alleges that the trustee's actions are damaging to the creditor individually, courts still generally consider the best interests of the entire estate, rather than those of a single creditor who issues a complaint. *See Baker v. Seeber*, 38 B.R. 705, 708 (Bankr. D. Md. 1983). Because of this high standard and wide discretion given to the trustee, "[i]t is clear that removal of a trustee is an extreme remedy even where a trustee has acted negligently." *In re Cee Jay Discount Stores, Inc.*, 171 B.R. 173, 175 (Bankr. E.D.N.Y. 1994).

Because of the high standard set for imposing removal and the harsh ramifications if removal is granted, some circuits require a clear and convincing evidence standard of proof to be established rather than just a mere preponderance of evidence. *See In re Walker*, 2004 Bankr. LEXIS 2187 (Bankr. S.D. Fla. Dec. 1, 2004), *aff'd, Walden v. Walker (In re Walker)*, 515 F.3d 1204 (11th Cir. Fla. 2008).

Generally a trustee is removed only when there are egregious facts present. Situations in which a court has deemed the removal of a trustee necessary include an explicit conflict of interest,[1] embezzlement by the trustee,[2] and actual fraud on the creditors of the estate perpetrated by the trustee.[3] A removal motion is not taken lightly and is granted only when a court is faced with clear and convincing evidence that the trustee's continued representation of the estate is no longer appropriate, and, as a consequence of that behavior, under § 324(b), the trustee should be removed for all of his or her other cases as well. Therefore, because the consequences of removal are so drastic, trustees obviously launch a vigorous defense against removal

motions.

When a trustee is faced with a removal motion not only is the "trustee generally … entitled to defend himself from allegations of malfeasance by a party in interest," but the estate will also incur the cost of that defense. *In re NWFX, Inc.*, 267 B.R. 118, 249 (Bankr. W.D. Ark. 2001). The court in *In re Yellow Cab Company*, 212 B.R. 154 (Bankr.S.D.Cal.1997), explained the rationale for having the estate bear the cost of defending a trustee, stating the following:

> Bankruptcy Code § 323(b) expressly recognizes that a trustee may be sued. The trustee may or may not prevail. If the trustee is determined to be negligent in the administration of the estate, the trustee is personally liable. *See In re Cochise College Park, Inc.*, 703 F.2d 1339 (9th Cir.1983). Obviously, if the trustee is determined to have properly exercised his judgment, no liability results. The difficulty with adopting [the creditor/plaintiff's] position is that even where a trustee properly exercises his business judgment, but is nonetheless sued, the trustee's defense could not be funded by the estate. By definition, where the trustee is a defendant, settlement of the action will not result in the recovery of assets. …
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> Trustees are an integral part of the successful operation of the bankruptcy laws. If this Court required the trustee to pay for his or her own representation, given the relatively modest compensation the Code provides for trustees, the practical effect would be that few trustees would be willing to serve.… A representative of the bankruptcy estate in otherwise good standing is entitled to defend him or herself from allegations of malfeasance by a creditor, and, unless malfeasance is established, the estate shall bear the reasonable costs of such defense.[4]

Thus, not only is the trustee entitled to have the estate bear the cost of successful litigation in defense of a motion to remove the trustee, but he or she may also seek sanctions against the party bringing the motion to remove. If the motion to remove is a baseless or vindictive action or simply a litigation tactic without underlying merit, the trustee can seek sanctions in an amount sufficient to fully compensate the estate for the expenses incurred in defending a motion to remove the trustee. *See In re JIK Industries, Inc.*, 155 B.R. 321 (Bankr. W.D.N.Y. 1993).

Because of the drastic implications on the trustee, the motion to remove the trustee is generally granted only in extreme situations that are based on facts. In most instances, the trustee's business judgment provides him or her with a functional shield from the accusations contained in a removal motion. With the estate bearing the burden of defending a removal motion and with the potential imposition of sanctions, a motion to remove a trustee should be used only in factual circumstances evidencing the obvious need for removal. **TFL**

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Endnotes

[1]*See In re Morgan*, 375 B.R. 838 (8th Cir. BAP 2007) (finding a Chapter 13 trustee's negotiation of a settlement to relieve herself of personal liability at the expense of unsecured creditors was sufficient cause for removal of the trustee).

[2]*See Scofield v. U.S.*, 174 F. 1 (6th Cir. 1909).

[3]*See In re Freeport Italian Bakery Inc.*, 340 F.2d 50 (2d Cir. 1965)(holding that, where the trustee was a close relative of the principals of the bankrupt company and of its major creditors, had participated in defrauding other creditors by concealing his own claims, and had filed an exaggerated claim on his own behalf and on behalf of his mother-in-law removal, was appropriate).

[4]*In re Yellow Cab Company*, 212 B.R. 154, 159 (Bankr. S.D. Cal. 1997).