There’s a New Trustee in Town
Examining the Role of Reorganization Trustees in Light of the New Subchapter V Standing Trustee

On Aug. 23, 2019, the Small Business Reorganization Act of 2019 (SBRA) became law. Referred to as “subchapter V,” it seeks to help small business debtors for whom chapter 11 is too expensive and cumbersome. One of the notable features of subchapter V is that, unlike in chapter 11 cases, a trustee is appointed in all cases and districts might decide to appoint standing trustees. The choice to require a trustee for business reorganizations is a significant departure from current and historical chapter 11 practice. In addition, although the trustee’s role appears fairly straightforward, the picture becomes more complicated upon closer inspection.

Early Trustees

Trustees played a role in bankruptcy proceedings even before the country’s founding. Debtors seeking relief from their debts sought the appointment of someone “who [would] not only do Justice to the Creditors but Treat my Character in a Friendly and not in an III natured manner.” An early law in Connecticut provided — after a debtor was imprisoned, of course — that the debtor could petition a court for relief to negotiate his debts, and for release from prison. If relief was granted, the debtor would submit an inventory of assets and debts and swear that he had not committed any fraud. After a hearing where creditors could object, the “estate” would be assigned to a trustee, who would liquidate assets and review creditors’ claims, then distribute the proceeds. Exceeding the imprisonment aspect, this is similar to a chapter 7 trustee’s role today.

Chapter 11 Trustees

The legal birth of the chapter 11 trustee can be traced to the financial reforms of the 1930s. Prior to the passage of the first federal reorganization statute, section 77 in 1934, the state court equity receivership was the only option for reorganization. Receiverships developed thanks to creative investment lawyers representing railroad bondholders.

Railroad bonds were secured by a physical portion of the railroad — collateral of little resale value if the railroad was not operating as a whole. Law firms representing the investment banks said that the bank would make more money if there was a mechanism for selling a failing railroad as a whole. Eventually, they convinced state courts to get on board with the process.

These receiverships were the subject of much suspicion from financial reformers, so when the process was incorporated into federal law, the law also tasked the newly created Securities and Exchange Commission to study receiverships. This study confirmed the worst of the reformers’ suspicions: The receiverships were predominantly run by a small, elite network of bankers and lawyers, primarily to line their own pockets, with little benefit to smaller creditors. Furthermore, due to the prior relationships among the lawyers, bankers and a debtor’s management, no party pursued litigation against the debtor’s managers for fraud, mismanagement or waste.

In an effort to curb this corruption, the Chandler Act, passed in 1938, required courts to appoint a “disinterested” trustee in every case where the debtor’s liquidated, noncontingent debts exceeded $250,000. The trustee — who could not have had any prior connection to the debtor or creditors in order to be appointed — ousted management, operated the business and proposed a bankruptcy plan. Partially due to this change, corporate reorganizations fell dramatically from approximately 570 cases in 1930 to around 100 cases in 1943. In the 1960s, when a sharp increase in consumer bankruptcy filings prompted Congress to re-examine existing bankruptcy laws, bankruptcy professionals used that opportunity to vociferously lobby Congress to remove the mandatory-trustee requirement.

2 Id. at 64.
3 Id. Once the process was complete, the debtor would be released from prison and receive a discharge.
4 id. at 56-60; 64. The receivership process developed due to railroad reorganizations, and for a long period of time was limited to only railroads.
5 Id. at 62.
Chapter 11 is the result of this advocacy and presumes that the debtor remains in possession.16 Section 1104 allows for the appointment of a trustee in solely two instances—first, “for cause, including fraud, dishonesty, incompetence, or gross mismanagement,”17 which case law limits to clear, unrepentant post-petition conduct by the chapter 11 debtor in possession (DIP),18 and second, § 1104(a)(2) allows appointment “if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate.”19 Trustee appointment under this section is appropriate, for example, when there is a clear conflict of interest between a debtor’s management and creditors.20

Under either standard, an appointment of a chapter 11 trustee is rare.21 Once appointed, however, a chapter 11 trustee, like the pre-1978 trustee, operates the business and proposes a chapter 11 plan.22 Existing management is out. Although § 1105 provides for the termination of the trustee’s services, and thus contemplates that the debtor could regain possession, cases where that has happened are rare to nonexistent.23

**Trustees in Chapters 12 and 13**

Unlike in chapter 11, there was no debate over whether a trustee should be appointed in chapter 12 and 13 cases. Presumably, the drafters believed that an objective party would help facilitate these smaller types of reorganizations. Also likely is the presumption that these smaller, individual or mom-and-pop reorganizations needed the helping hand of a trustee.

Both trustees play a role in a bankruptcy case that is neither complete control nor solely as a collector and disbursers of payments. The most notable limitation, as compared to chapter 11, is that in no instance is either type of trustee permitted to propose a bankruptcy plan.24 Both trustees have many duties similar to those of a chapter 11 trustee with the exception of liquidating the estate.25 Both play the role of a disbursment agent: collecting plan payments, making disbursements, and taking action to dismiss if the debtor is not making payments.26 However, this is where their similarities end.

Chapter 13 trustees investigate the financial affairs of the debtor, advise the debtor (except in legal matters) and aid the debtor in performance of the plan.27 This includes helping debtors create a bankruptcy plan and ensuring that it is feasible; in fact (rumor has it), in some districts, chapter 13 trustees are known to draft bankruptcy plans for debtors and ensure that the debtor commences payments.28 Chapter 13 trustees also assist debtors by making payment arrangements.29 This role is consistent for chapter 13 trustees in every case.

Initially, the chapter 12 trustee’s role is more limited; it does not investigate, advise or assist the debtor.30 However, a chapter 12 trustee’s role can change. First, it can be ordered to investigate the debtor’s financial affairs if parties in the case initiate a request.31 Second, a chapter 12 debtor might be removed as the DIP by virtue of § 1204 for the same cause as a chapter 11 DIP.32 Such removal would trigger a chapter 12 trustee’s duty to run the business—a role that is never performed by chapter 13 trustees.33

**The Subchapter V Trustee**

The foregoing discussion suggests that reorganizational trusteeships can be viewed on a spectrum. On one hand, a chapter 11 has no automatic trustee; existing management, with knowledge of the complexities of its own business, is thought to be best suited to guide the debtor through reorganization. Chapter 12 and 13 trustees are closer to disbursing agents, although the chapter 13 trustee is expected to take a more active role in helping the debtor succeed. Chapters 11 and 12 have a “fire alarm” mechanism that creditors can use to seek a more active trusteeship when a debtor is behaving badly. In those situations, chapter 11 permits a trustee to take control of the case, while in chapter 12, the trustee is limited to investigating and acting as caretaker of the estate.

Where on this spectrum does the new subchapter V trustee lie? Section 1183 provides that a trustee shall be appointed in every case and/or that the U.S. Trustee shall appoint a standing trustee.34 The trustee’s duties are identical to those of a chapter 12 trustee.35 The trustee is required to appear and be heard on the same matters as a chapter 12 trustee and ensure that the debtor commences payments.36 However, the trustee has a new, special duty to “facilitate the development of a consensual plan of reorganization.”37 This language appears nowhere else in the Bankruptcy Code but perhaps is meant to be akin to the chapter 13 duty to advise and assist the debtor in the creation and completion of a plan.

The court can order the expansion of the subchapter V trustee’s role in an identical progression to chapter 12. First, for cause or upon the request of a party in interest, the court may order a trustee to investigate the debtor’s affairs and file reports.38 Second, § 1185 provides for DIP removal for the same reasons as in chapter 12.39 Should that happen, the subchapter V debtor is removed from management and from operating the business, and the trustee is inserted in its place.
Similar to chapter 12, the subchapter V trustee is not authorized to file a plan. Thus, the main difference between the chapter 12 and subchapter V trustee is in how active the trustee is in facilitating the reorganization.

Unclear is the role that a subchapter V trustee will play in collecting and disbursing payments, and when that role terminates. Subchapter V has language similar to chapter 12 regarding the plan requirement that the debtor pay the trustee and the trustee disburse payments. However, the termination of the trustee’s role changes based on what type of plan is confirmed. If a plan is confirmed consensually, the trustee’s services are terminated upon substantial consummation — the same standard that is used to complete a chapter 11 case. If the plan is not consensually confirmed, “the trustee shall make payments to creditors under the plan.”

Despite these differences, the trustee is always tasked with collecting and disbursing plan payments. So what happens if a plan is confirmed consensually and the parties move for substantial confirmation prior to the completion of plan payments? The statute envisions reappointment, but specifically states that reappointment is for taking over the duties of the DIP or to be heard on a post-confirmation modification — not for collecting and disbursing payments. Creditors might oppose any motion for termination based on substantial consummation, as it is frequently in their best interests for the trustee to continue monitoring the debtor’s efforts. Herein lies an area where certainly the courts, or local rules, will need to fill in the gaps.

Conclusion

The new trustee’s role appears to be a hybrid of the roles of chapter 12 and 13 trustees, and is far more limited than the role of a chapter 11 trustee. This compromise reflects Congress’s viewpoint that small business debtors need heightened scrutiny in the bankruptcy process, but it also allows, like in chapter 11, the management of the small business debtor to control the reorganization.

Although subchapter V provides for the termination of the trustee’s services prior to plan completion, practically speaking it is unclear why a debtor and creditors would agree to let that happen. After all, the trustee’s role as a facilitator between debtors and creditors goes back to early American history: The trustee is to be a trusted, middle party that will work with the debtor while protecting creditors’ interests.

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41 Compare 11 U.S.C. § 1189(a), providing that only a debtor may propose a plan, with § 1121(c), which provides for other parties to file plans after the expiration of the exclusivity period.
44 11 U.S.C. § 1183(c).
47 The House Judiciary Report states that “[t]he trustee’s service terminates upon substantial consummation of the plan” and notes the plan requirement regarding payments to the trustee. It gives no explanation of how to wed these two provisions. See H.R. Rep 116-171 116th Congress, 1st Sess. (2019), at 14.

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