

OCT 25 2006

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U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT**

ORDERED PUBLISHED

**UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT**

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|---------------------------|---|-----------------------------|
| In re: |) | BAP No. CC-05-1247-MaPaK |
| |) | |
| AFI HOLDING, INC., |) | Bk. No. LA 01-41567-VZ |
| |) | |
| Debtor. |) | |
| _____ |) | |
| CAROLYN A. DYE, Chapter 7 |) | |
| Trustee, |) | |
| |) | |
| Appellant, |) | |
| v. |) | <u>O P I N I O N</u> |
| |) | |
| J. GREGORY BROWN; CECILIA |) | |
| A. BROWN, et al, |) | |
| |) | |
| Appellees.) |) | |
| _____ |) | |

Argued and Submitted on March 23, 2006
at Pasadena, California

Filed - October 25, 2006

Appeal from the United States Bankruptcy Court
for the Central District of California

Honorable Vincent P. Zurzolo, Bankruptcy Judge, Presiding.

Before: MARLAR, PAPPAS and KLEIN, Bankruptcy Judges.

1 MARLAR, Bankruptcy Judge:

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INTRODUCTION

4

5 The chapter 7¹ trustee has appealed the bankruptcy court's
6 order of removal, which found that she was not disinterested due
7 to a material conflict of interest. She contends that the
8 bankruptcy court applied an incorrect legal standard under § 324,
9 and challenges the court's findings.

10 We hold that the bankruptcy court properly applied a
11 totality-of-circumstances test in making its determination that
12 the trustee's prior connections with insiders negatively impacted
13 the administration of the estate. Since disinterestedness is a
14 requirement for service as an appointed trustee, see §§ 321(a)(1)
15 and 701(a)(1), the court's determination that lack of such
16 disinterestedness was a "cause" for her removal was a proper
17 exercise of its broad discretion under § 324. In addition, the
18 evidence of an "appearance of impropriety," as well as the
19 trustee's failure to disclose all of her connections, were factors
20 contributing to a lack of creditor confidence and, thus, supported
21 the bankruptcy court's conclusion that cause for removal existed
22 under § 324. Therefore, we AFFIRM.

23

24

25

26 ¹ Unless otherwise indicated, all code, section, and chapter
27 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330 prior
28 to its amendment by the Bankruptcy Abuse Prevention and Consumer
Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (2005).
"Rule" references are to the Federal Rules of Bankruptcy Procedure
("Fed. R. Bankr. P."), Rules 1001-9036.

1 **FACTS**

2
3 This case was commenced on October 21, 2001, by the
4 simultaneous filing of six chapter 11 bankruptcy petitions.
5 Advance Finance, Inc. and AFI Holding, Inc. were the general
6 partners (together "AFI") of four limited partnerships (together
7 "AFI Entities"). The bankruptcy cases were consolidated, with AFI
8 Holding as the consolidated debtor.

9 Richard Cohen ("Cohen") was AFI's president from 1994 to
10 1996. In July of 1996, Gary A. Eisenberg ("Eisenberg") was
11 chairman of AFI and formed AFI Holding. The AFI Entities had been
12 involved in a "Ponzi" scheme, specifically a "factoring" business
13 whereby they would make loans to clients (borrowers) using the
14 clients' accounts receivable as collateral. Then, instead of
15 paying the investors with the profits, they paid the old investors
16 purported interest payments using the new investors' money. Cohen
17 left AFI in 1996, was criminally prosecuted, and went to prison.
18 After filing the chapter 11 petitions, Eisenberg relinquished
19 control of the AFI Entities and was convicted of securities
20 violations.

21 The bankruptcy court ordered that a chapter 11 trustee be
22 appointed for each case, and the U. S. Trustee selected Carolyn A.
23 Dye ("Dye"). Since 1998, Dye had been "Of Counsel" to Weinstein,
24 Eisen & Weiss, P.C. Some of Dye's prepetition services are
25 pertinent to this appeal, including her representation of and
26 acquaintance with James Meister ("Meister") and Allan Eriksen
27 ("Eriksen").

28

1 Dye's Representation of Meister

2
3 In 1995, while Meister was employed as the controller of AFI,
4 he hired Dye to represent him in a personal bankruptcy case.
5 After that, Meister and Dye occasionally saw each other at social
6 events but were not "close friends." Dep. of Dye 89, Feb. 11,
7 2005.

8 When Eisenberg formed AFI Holding, Meister was named its
9 chief financial officer, secretary, and director, but he was never
10 an investor, creditor or equity shareholder in any AFI Entity.
11 During Meister's employment with AFI, his domestic partner,
12 Eriksen, invested money in an AFI entity.

13 Between 1996 and 1997, Meister became aware of fraudulent
14 activities by Cohen and the complicity of Eisenberg.
15 Specifically, he realized that his financial statements were
16 inaccurate because they were based on forged documents, that money
17 was being embezzled by Cohen, that Cohen was directing him to
18 prepare false reports under threat of loss of his job, and that
19 Eisenberg was requiring him to participate in new investment
20 activities--"new money to pay repay the old money." Dep. of
21 Meister 56, Feb. 24, 2005.

22 Eisenberg, on the other hand, believed that Meister was
23 intentionally engaged in corporate misconduct. See Dep. of
24 Eisenberg 24, Feb. 15, 2005. In a 1998 state court action against
25 it, AFI filed a cross-complaint against Meister, which was
26 subsequently dismissed. See Decl. of Loeb ¶ 3-4, Apr. 14, 2005.

27 Meister testified that his next communication with Dye,
28 following his bankruptcy case, was in 1997 when he sought her

1 advice concerning his decision to resign from AFI. However, he
2 rescinded that testimony in a declaration dated April 13, 2005, in
3 which he averred that his discussion with Dye had actually taken
4 place in 1999, and concerned a termination notice which he had
5 received from his subsequent employer, Tri-Capital Finance Corp.
6 ("Tri-Capital").² Meister resigned from AFI in June, 1997, but
7 remained in a consulting role for another month.

8 In mid-1998, Meister referred Eriksen to Dye to represent him
9 in seeking a withdrawal of his investment monies from AFI. Both
10 Meister and Dye testified that they did not speak to each other
11 about either Eriksen's legal matters or AFI.

12 Then, in September, 1999, Meister sought Dye's legal advice
13 regarding the Tri-Capital termination notice. Dye testified that
14 she "looked [the notice] over only briefly, found it unremarkable,
15 and had no other involvement with Meister." Decl. of Dye 27, ¶ 9,
16 Apr. 13, 2005.

17 18 **Dye's Representation of Eriksen** 19

20 As a result of his investment, Eriksen was a limited partner
21 in an AFI entity. Eriksen was privy to the misconduct at AFI
22 because Meister had told him about it. See Dep. of Meister 63,
23 Feb. 24, 2005. (Eriksen's deposition testimony was stricken by
24

25 ² This change was interesting in that Meister's deposition
26 contained two and one-half pages of testimony concerning his
27 alleged 1997 contact with Dye, and the new declaration was filed
28 along with Dye's declaration in opposition to the motion to remove
her as trustee, in which she denied having advised Meister
concerning his termination from AFI. See Decl. of Dye 27, ¶ 8,
Apr. 13, 2005.

1 the bankruptcy court as untimely, and that ruling has not been
2 challenged in this appeal.)

3 In June, 1998, Eriksen hired Dye to assist him in his efforts
4 to withdraw his investment monies. Eisenberg allegedly had told
5 Eriksen that AFI needed to obtain new investor money in order to
6 pay him. See Dep. of Meister 57-60. Eisenberg also testified
7 that he told Dye that Meister's alleged misconduct was a reason
8 not to pay Eriksen. Dep. of Eisenberg 40-41.

9 However, when Dye was questioned as to whether Eisenberg had
10 ever implicated Meister to her in regards to operational
11 misconduct, she stated that "he never mentioned Mr. Meister as
12 being involved." Dep. of Dye 94. And, when Dye was asked whether
13 Eriksen had said anything to her "indicating that he thought there
14 was financial misconduct" at AFI, Dye gave a cautious response:

15 Mr. Eriksen was a limited partner. He had no
16 knowledge of what was going on in the office,
17 particularly as it related to Mr. Eisenberg's
18 dealings with limited partners.

17 Id.

18 Dye then negotiated a deal with Eisenberg to convert
19 Eriksen's equity to debt,³ and Eriksen was given a promissory
20 note, dated August 31, 1998, for \$52,327.29 payable from AFI.
21 This amount was compromised and satisfied in May 1999, at which
22 time a "Release Agreement" was purportedly signed. (Dye provided
23 a copy of an unsigned, undated "release agreement" but the signed
24 document was never produced.) However, a letter from Dye to
25 Eisenberg, dated May 18, 1999, was admitted into evidence, in
26 which she stated:

27

28 ³ Nonetheless, in the subsequent compromise negotiations,
Dye insisted that Eriksen had a partner's right to inspect the
partnership's tax return. See Letter from Dye to Eisenberg, May
4, 1999, Exh. 5 to Reply to Trustee's Opposition to Motion for
Removal.

1 Mr. Eriksen will accept your settlement figure.
2 However, he has asked that you issue two checks, one to
3 his IRA Trustee for \$12,697.66 and the second to my law
4 firm for \$1,250.

5 Dye has not disputed the fact that those monies were paid, as
6 indicated. See also Dye's Dep. Tr. Corr. [to p. 121], Feb. 28,
7 2005 (stating that the lump-sum payoff was performed).

8 **Dye's Declaration of Disinterestedness in Chapter 11**

9
10 In connection with her unopposed appointment as trustee in
11 the consolidated chapter 11 case, Dye filed her "Declaration of
12 Disinterestedness." She stated:

- 13 4. There is one other matter which I must disclose, not
14 because I believe it presents a conflict, but for
15 informational purposes.
- 16 5. In mid-June, 1998, I was engaged to represent an
17 individual who had made an investment in an entity
18 called Advance Finance Partnership. In that capacity
19 I negotiated a settlement for my client for the
20 withdrawal of his capital contribution. (The
21 settlement reached resulted in a compromised payment
22 and mutual releases.) That matter has been concluded
23 since mid-1999 and I do not have any continuing
24 client relationship with the individual I
25 represented.
- 26 6. I was in an adverse relationship with the Debtor
27 entities and did not learn anything as a result of my
28 own client relationship which would place me in a
present conflict. I do not believe this would
present any issue in my appointment in this case.

Decl. of Disinterestedness of Dye 2-3, Nov. 14, 2001.

Dye's declaration did not mention her representation of
Meister, identify Eriksen, or explain the connection between
Meister and Eriksen.

1 **The Chapter 7 Case and Dye's Supplemental Declaration**

2
3 The consolidated chapter 11 case was converted to chapter 7
4 on July 29, 2002, and Dye was appointed its trustee without
5 objection.

6 In July, 2003, Dye initiated litigation to recover about \$10
7 million from more than 150 potential defendants, including
8 investors and parties-in-interest who had received payments under
9 the Ponzi scheme, in an effort to liquidate Debtor's equity. Dye
10 did not sue Eriksen, based on her decision that his claim against
11 the estate had been settled and released and that he was judgment-
12 proof. Nor did she sue Meister for any alleged wrongdoing,
13 indicating that any claims of AFI against him were time-barred and
14 had expired prepetition.

15 Discovery proceeded in the adversary actions, including the
16 taking of depositions of Eisenberg, Meister, Eriksen, and Dye.
17 Being aware of Meister's testimony, Dye filed a "Supplement to
18 Declaration of Disinterestedness," on March 14, 2005, in which she
19 belatedly disclosed her relationship with Meister and his
20 relationship to both Eriksen and AFI. She stated that her failure
21 to disclose these facts sooner was due to inadvertence.

22 At the same time, AFI investors, including the appellees
23 herein ("Appellees"), filed a motion to remove Dye as trustee,
24 pursuant to § 324. They alleged, among other things, that she was
25 not disinterested, had failed to disclose material facts revealing
26 a conflict of interest, and had injured the estate by failing to
27 bring adversary proceedings against either Meister or Eriksen.⁴

28

⁴ Appellees also alleged that Dye had blocked and frustrated discovery. However, the bankruptcy court found no improprieties, and Appellees have not filed a cross-appeal. Therefore, we will not address the issue.

1 Dye and the U.S. Trustee opposed the motion. Dye maintained
2 that Appellees failed to show that she was not disinterested
3 because: (1) "disinterestedness" is defined as having an adverse
4 interest, not as "representing" an adverse interest; and (2) her
5 representation of Meister and Eriksen was not materially adverse
6 to the estate or a class of creditors.

7 The U.S. Trustee maintained that there was insufficient
8 evidence to support removal in light of a trustee's discretion to
9 make business judgments. He further stated that Dye's inadvertent
10 failure to disclose her representation of Meister was not cause
11 for removal.

12 Appellees replied with accusations that Dye's nondisclosure
13 was intentional, and that she gave false and misleading testimony
14 regarding the extent of her relationship with Meister and Eriksen,
15 as well as failing to produce Erickson's release agreement.
16 Moreover, Appellees argued that Dye's letter instruction to
17 Eisenberg to pay her \$1,250 in attorney's fees made her a direct
18 transferee of payments from AFI, in 1999.

19
20 **The Bankruptcy Court's Ruling**

21
22 On May 3, 2005, the bankruptcy court heard argument on the
23 motion for removal of Dye. Considering the standard for removal
24 under § 324, the court held that lack of disinterestedness,
25 standing alone, sufficed as "cause" for removal.

26 It then looked at all of the events and circumstances to
27 determine that Dye was not disinterested. It found that Meister
28 was an insider of the AFI Entities at the time Dye represented

1 him; that Dye then represented Ericksen, who was referred to her
2 by Meister and who was an investor in the AFI Entities. It found
3 that Dye had reached a settlement for Ericksen with AFI which
4 included payment of her attorney's fees, and such payment "could
5 possibly be materially adverse to the interest of the bankruptcy
6 estate." It found and concluded that

7 Carolyn Dye indeed had an interest that was materially
8 adverse to the interest of the estate. Why? Because
9 when you know when you have represented someone who had
10 claims against that entity and you represented, albeit
11 in an unrelated context, an individual who was an
insider of that entity and that insider referred an
investor to you to represent [its] claims against that
entity, you are representing an interest -- you
represent an interest which was adverse to this estate.

12 Tr. of Proceeding 72:10-18, May 5, 2005.

13 The court described this adverse interest in terms of a
14 potential⁵ conflict of interest, when it ruled:

15 Whether or not, ultimately we'll never know, the
16 estate would have had any claims against Meister and
17 against Eriksen or - in the form of a claim to undue
[sic] or attack the agreement and the release as in and
18 of itself an avoidable transfer or to pursue claims
19 against Meister for his role in the conduct of business
20 by the AFI entities, the fiduciary of the bankruptcy
21 estate who has to make business decisions about whether
22 of not to pursue those claims and - investigate those
claims should be completely free of any possible
influence with regard to making decisions against
parties that she represented as counsel pre-petition,
and that was not the case here. Both clients had a
direct interest in the debtor and this indeed created a
material conflict of interest for Dye.

23 On a subsidiary level there was also a direction
24 made by her apparently at . . . her client's insistence,
25 that a transfer of money as part of the Ericksen
26 settlement be made directly to her law offices which
creates an interest in herself directly that is material
- that could possibly be materially adverse to the
interest of the bankruptcy estate.

27
28 Id. at 72:19-25 to 73:1-12.

⁵ There is a trend to make no distinction between potential and actual conflicts. See generally 1 Norton Bankr. L. & Prac. 2d § 25:5 (2006). That topic is beyond the scope of our decision.

1 In addition to lack of disinterestedness, the court also
2 found that Dye had failed "to disclose a material conflict of
3 interest in a timely manner," albeit inadvertently. Id. at 73:25
4 to 74:1. In Dye's favor, the bankruptcy court found that she had
5 not interfered with discovery, nor acted, except for the
6 nondisclosure, in any way "other than doing her best with regards
7 to being a fiduciary of the estate" Id. at 73:23-24.

8 The order granting removal was entered on May 20, 2005, and Dye
9 timely appealed.⁶

10
11 **ISSUE**

12
13 The sole issue is whether the bankruptcy court erred in
14 removing Trustee Dye for "cause."

15
16 **STANDARD OF REVIEW**

17
18 Removal of a trustee under § 324 is left to the sound
19 discretion of the bankruptcy court. BH & P, Inc., 949 F.2d at
20 1313; Miller v. Miller (In re Miller), 302 B.R. 705, 709 (10th
21 Cir. BAP 2003). A bankruptcy court necessarily abuses its
22 discretion if it bases its decision on an erroneous view of the
23 law or on clearly erroneous factual findings. Warrick v. Birdsell
24 (In re Warrick), 278 B.R. 182, 184 (9th Cir. BAP 2002). It also

25
26
27 ⁶ Dye's counsel informed the Panel at oral argument that she
28 will not return as trustee no matter the outcome of this appeal.
The matter is not moot, however, because her standing is an issue
for her compensation. Additionally, this order is final and
appealable. See Matter of Schultz Mfg. Fabricating Co., 956 F.2d
686, 691-92 (7th Cir. 1992); In re BH & P, Inc., 949 F.2d 1300,
1306 (3rd Cir. 1991) (order removing chapter 7 trustee was final);
cf. Richman v. Straley, 48 F.3d 1139, 1143 (10th Cir. 1995) (court
assumed that appeal from an order which claimed to be a de facto
removal of a chapter 13 trustee was a final order).

1 abuses its discretion if it applies an incorrect legal rule.
2 Simantob v. Claims Prosecutor, LLC (In re Lahijani), 325 B.R. 282,
3 287 (9th Cir. BAP 2005).

4 5 DISCUSSION

6 7 A. Trustee Lack of Disinterestedness as § 324 "Cause"

8
9 A chapter 7 panel trustee is appointed by the U.S. Trustee.
10 Section 321 provides that a person is eligible to serve as a
11 bankruptcy trustee if such individual "is competent to perform the
12 duties of trustee." 11 U.S.C. § 321(a)(1). In regards to chapter
13 7, § 701(a)(1) provides that the U.S. Trustee "shall appoint *one*
14 *disinterested person* . . . to serve as interim trustee in the
15 case." 11 U.S.C. § 701(a)(1) (emphasis added). If creditors do
16 not elect a chapter 7 trustee pursuant to § 702, then the interim
17 trustee continues to serve as trustee in the case. See § 702(d).
18 The plain language of the statute requires that the appointed
19 interim trustee be "disinterested" in order to be eligible to
20 serve. See United States v. Ron Pair Enters., Inc., 489 U.S. 235,
21 241 (1989). Dye was the appointed chapter 7 trustee and thus was
22 required to be disinterested.⁷

23 A trustee is the "legal representative" and "fiduciary" of
24 the estate. See U.S. Trustee v. Joseph (In re Joseph), 208 B.R.
25 55, 60 (9th Cir. BAP 1997); United States ex rel. Block v. Aldrich
26 (In re Rigden), 795 F.2d 727, 730 (9th Cir. 1986); In re Mehr, 153
27 B.R. 430, 439 (Bankr. D.N.J. 1993); 11 U.S.C. §§ 323 (providing
28 that the trustee is the representative of the estate).

⁷ We do not decide whether an elected chapter 7 trustee must also be disinterested. See § 702(a) (silent on topic of disinterestedness).

1 The title "trustee" has "fiduciary significance in the equity
2 sense," and thus the trustee "may not be the representative of any
3 particular creditor, but must represent all creditors without
4 partiality." Gross v. Russo (Matter of Russo), 18 B.R. 257, 270-
5 71 (Bankr. E.D.N.Y. 1982) (under Bankruptcy Act) (citing 2
6 Remington on Bankruptcy § 1117, at 580 (1956)). "Equity tolerates
7 in bankruptcy trustees no interest adverse to the trust." Mosser
8 v. Darrow, 341 U.S. 267, 271 (1951). The chapter 7 trustee's role
9 facilitates one of the Bankruptcy Code's fundamental concepts of
10 "equitable distribution." Sherwood Partners, Inc. v. Lycos, Inc.,
11 394 F.3d 1198, 1203 (9th Cir. 2005), cert. denied, ___ U.S. ___
12 (October 3, 2005). See generally, Dept. of Justice, U.S. Trustee
13 Program, Annual Report of Significant Accomplishments, Fiscal Year
14 2004, ch. 6: Trustee Oversight, at 39 (bankruptcy trustees have
15 "the legal duty to act in the best interest of creditors and the
16 estate").

17 It follows that a bankruptcy trustee must have no interest
18 adverse to the estate, nor profit from her handling of the estate.
19 She "is an independent person with no prior connection to either
20 the debtor or the creditors. [Her] primary job is to marshal and
21 sell assets, so that those assets can be distributed to the
22 estate's creditors and then close the estate." Joseph, 208 B.R.
23 at 60 (quoting In re Reed, 178 B.R. 817, 821 (Bankr. D. Ariz.
24 1995)); see also 11 U.S.C. § 704 (duties of trustee).

25 Once assigned to a particular case, a panel trustee can be
26 removed from a pending case only if the bankruptcy court finds
27 "cause" after notice and a hearing. Brooks v. United States, 127
28 F.3d 1192, 1193 (9th Cir. 1997); 11 U.S.C. § 324(a). "[A]lthough

1 sufficient cause is not defined in the Bankruptcy Code, it is left
2 for the courts to determine on a case by case basis." 3 Collier
3 on Bankruptcy ¶ 324.02, at 324-3 (Alan N. Resnick & Henry J.
4 Sommer eds., 15th ed. rev. 2006).

5 It is well established that "cause" may include trustee
6 incompetence, violation of the trustee's fiduciary duties,
7 misconduct or failure to perform the trustee's duties, or lack of
8 disinterestedness or holding an interest adverse to the estate.
9 Id. at 324-3 to 324-4. Such cause must be supported by specific
10 facts, Schultz Mfg. Fabricating Co., 956 F.2d at 692, and the
11 party seeking removal has the burden to prove them. Alexander v.
12 Jensen-Carter (In re Alexander), 289 B.R. 711, 714 (8th Cir. BAP),
13 aff'd, 80 Fed. Appx. 540 (8th Cir. 2003). This listing is
14 illustrative, but not exhaustive.

15 In relevant part, the Code defines a "disinterested person"
16 as one that:

17 (E) does not have an interest materially adverse to the
18 interest of the estate or of any class of creditors
19 or equity security holders, by reason of any direct
20 or indirect relationship to, connection with, or
21 interest in, the debtor . . . , or for any other
22 reason.

21 11 U.S.C. § 101(14)(E).⁸ (Emphasis supplied.)

23 ⁸ Section 101(14) also provides that a "disinterested
24 person":

24 (A) is not a creditor, an equity security holder, or an
25 insider;

26 (B) is not and was not an investment banker for any
27 outstanding security of the debtor;

27 (C) has not been, within three years before the date of
28 the filing of the petition, an investment banker for
a security of the debtor, or an attorney for such an
investment banker in connection with the offer, sale,
or issuance of a security of the debtor;

(continued...)

1 A generally accepted definition of "adverse interest" is the
2 (1) possession or assertion of an economic interest that would
3 tend to lessen the value of the bankruptcy estate; or (2)
4 possession or assertion of an economic interest that would create
5 either an actual or potential dispute in which the estate is a
6 rival claimant; or (3) possession of a predisposition under
7 circumstances that create a bias against the estate. See Rome v.
8 Braunstein, 19 F.3d 54, 58 n. 1 (1st Cir. 1994); In re Roberts, 46
9 B.R. 815, 826-27 (Bankr. D. Utah 1985), aff'd in part, rev'd and
10 remanded in part on other grounds, 75 B.R. 402 (D. Utah 1987).⁹

11 Such an adverse interest is "material" if it exists "by
12 reason of any direct or indirect relationship to, connection with,
13 or interest in, the debtor . . . , or for any other reason." 11
14 U.S.C. § 101(14)(E). See also Black's Law Dictionary 998 (8th

15
16 ⁸(...continued)

17 (D) is not and was not, within two years before the date
18 of the filing of the petition, a director, officer,
19 or employee of the debtor or of an investment banker
specified in subparagraph (B) or (C) of this
paragraph; . . .

20 11 U.S.C. § 101(14).

21 ⁹ It is also well established that professionals employed by
22 the estate and approved by the bankruptcy court must be
disinterested. Section 327(a) provides:

23 Except as otherwise provided in this section the trustee,
24 with the court's approval, may employ one or more
25 attorneys, accountants, appraisers, auctioneers, or other
26 professional persons, that do not hold or represent an
interest adverse to the estate, and that are disinterested
persons, to represent or assist the trustee in carrying
out the trustee's duties under this title.

27 11 U.S.C. § 327(a).

28 It would be an odd rule, indeed, if a trustee's professional
must be disinterested, while the trustee need not.

1 ed. 2004) (defining "material" as "[h]aving some logical
2 connection with the consequential facts" or being "[o]f such a
3 nature that knowledge of the item would affect a person's
4 decision-making; significant; essential").

5 This so-called "catch all" provision is broad enough to
6 exclude a trustee with some interest or relationship that "would
7 even faintly color the independence and impartial attitude
8 required by the Code." Kravit, Gass & Weber, S.C. v. Michel (In
9 re Crivello), 134 F.3d 831, 835 (7th Cir. 1998) (citation
10 omitted); 3 Collier, supra, ¶ 327.04[2][a][E], at 327-41.

11 A frequent setting for disputes over trustee removal (as it
12 also is for attorney disqualification) is an alleged conflict of
13 interest, and the instant case is no exception. The bankruptcy
14 court found that Dye had a potential conflict of interest or lack
15 of disinterestedness due to her connections with insiders Meister
16 and Eriksen.

17 Dye counters that her former representation of Meister and
18 Eriksen, in unrelated matters, did not present an actual conflict
19 of interest, let alone injury or fraud, which she maintains is the
20 required standard for her removal under § 324. Dye maintains that
21 the bankruptcy court applied a punitive "per se" rule improperly
22 based on either an appearance of impropriety or a potential
23 conflict of interest.

24 25 **B. The Legal Standard for Removal of Trustees**

26
27 The standard for removal of a trustee due to a conflict of
28 interest under § 324 has not been formalized in the Ninth Circuit.

1 Nationally, there are three approaches in the case law to which we
2 will look for guidance. As noted, some of these cases involve
3 attorneys and other professionals, not trustees.

4 Some courts will not remove the trustee unless there is
5 actual injury to the estate or fraud. See In re Freeport Italian
6 Bakery, Inc., 340 F.2d 50, 54 (2d Cir. 1965) (actual conflict of
7 interest and fraud). Such harm may simply be the loss of creditor
8 confidence to the point that "discord threatens the estate."
9 3 Collier, supra, ¶ 324.02, at 324-5. Thus, these courts will
10 consider the best interests of the bankruptcy estate. If it
11 "would suffer more from the discord created by the present trustee
12 than would be suffered from a change of administration, the
13 removal of the trustee is necessarily the better solution." Baker
14 v. Seeber (In re Baker), 38 B.R. 705, 708 (D. Md. 1983) (quoting
15 Freeport Italian Bakery, 340 F.2d at 55); see also In re
16 Microdisk, Inc., 33 B.R. 817, 819 (D. Nev. 1983).

17 Another approach is per se disqualification if an individual
18 is determined to be not disinterested, typically under the plain
19 terms of §§ 101(14)(A)-(D), without analyzing the effect of any
20 such conflict on the estate. The majority of courts applying this
21 standard do so on the theory that the court cannot use its
22 equitable powers to disregard unambiguous statutory language.
23 See, e.g., Michel v. Fed'd Dep't Stores, Inc. (In re Fed'd Dep't
24 Stores, Inc.), 44 F.3d 1310, 1318-19 (6th Cir. 1995). Cf. Movitz
25 v. Baker (In re Triple Star Welding, Inc.), 324 B.R. 778, 790 (9th
26 Cir. BAP 2005) (noting, in a case involving the attorney for the
27 estate, that the court cannot approve employment of a person who
28 is not disinterested); First Interstate Bank of Nev., N.A. v. CIC

1 Inv. Corp. (In re CIC Inv. Corp.), 175 B.R. 52, 56 & n.4 (9th Cir.
2 BAP 1994) (holding, in a case involving professionals but not a
3 trustee, that a court must follow the unambiguous language of
4 §§ 327(a) and 101(14), but reserving judgment in regards to an
5 attorney with a claim arising solely from services rendered in the
6 bankruptcy case). The Fourth, Sixth and Eighth Circuits have
7 adopted a per se rule in disqualifying attorneys who are not
8 disinterested. See Harold & Williams Dev. Co. v. U.S. Trustee (In
9 re Harold & Williams Dev. Co.), 977 F.2d 906, 909-10 (4th Cir.
10 1992) (but holding that the congressionally established per se
11 rules are "carefully delineated and narrowly tailored"); Childress
12 v. Middleton Arms, L.P. (In re Middleton Arms, L.P.), 934 F.2d
13 723, 725 (6th Cir. 1991); and Pierce v. Aetna Life Ins. Co. (In re
14 Pierce), 809 F.2d 1356, 1362-63 (8th Cir. 1987).

15 The last approach, formulated by the First and Third
16 Circuits, holds that there is no bright-line rule, but that each
17 case "must be judged in the perspective of the particular case and
18 the facts presented." 3 Collier, supra, ¶ 327.04[2][a][I], at
19 327-35. These courts apply a nonexhaustive list of factors to
20 determine whether a conflict of interest, even if it arises under
21 § 101(14), is sufficient for removal or disqualification because
22 of a potential for a materially adverse effect upon the estate.
23 See In re Martin, 817 F.2d 175, 182 (1st Cir. 1987) and BH & P
24 Inc., 949 F.2d at 1313, as clarified in In re Marvel Entm't Group,
25 Inc., 140 F.3d 463, 476-77 (3d Cir. 1998). Both of these cases,
26 which are relied upon by Dye, deserve closer scrutiny.

27 Martin involved a debtor's attorney who duly disclosed that
28 he had taken a mortgage in the chapter 11 debtor's real property,

1 prepetition, in order to secure his fees. The case was then
2 converted to chapter 7 and the attorney sought to enforce the
3 mortgage. The bankruptcy court denied his motion because,
4 according to the plain language of § 101(14) (A) and the
5 disinterested requirement of § 327(a), the attorney was a
6 "creditor," and therefore not disinterested. Id. at 177.

7 On appeal, the First Circuit rejected this per se approach as
8 "a literalistic reading [which] defies common sense and must be
9 discarded as grossly overbroad." Martin, 817 F.2d at 180. It
10 adopted a "full panoply of events and elements" test to determine
11 whether such conflict of interest was materially adverse to the
12 estate and creditors, and elucidated a nonexhaustive list of
13 factors to consider. Id. at 182. The First Circuit then remanded
14 the case for such an analysis.

15 Some of those factors, which are relevant to our case,
16 include the likelihood that a potential conflict might turn into
17 an actual one, the influence the conflict might have in subsequent
18 decisionmaking, and how the matter is perceived by creditors and
19 other parties in interest. Id.

20 In a 1991 case, the Third Circuit was similarly faced with
21 making a per se decision, viz., the removal of a trustee because
22 he represented multiple debtors and therefore was a "creditor,"
23 under § 101(14) (A), by virtue of having filed claims against the
24 related estates. See BH & P, 949 F.2d at 1310. It opined that it
25 would be unfair and unsound from a standpoint of administrative
26 efficiency and economy to disqualify a trustee on that basis
27 alone, and that such an interpretation of the Code was
28 "overbroad." Id. at 1310.

1 First, the Third Circuit correctly reasoned that § 101(14) (A)
2 was inapplicable because it was intended to disqualify only
3 creditors with personal claims and those "holding" prepetition
4 adverse interests, not trustees having claims against the estate
5 solely in a representative capacity. See Levis v. Wilde, Floury,
6 Hayfield, Gould & Barney, LP (In re Levis), 347 B.R. 679, 688 (9th
7 Cir. BAP 2006) ("To represent an adverse interest means to serve
8 as an attorney for an entity holding such an adverse interest.")

9 Second, it adopted Martin and held that the inquiry as to
10 whether the "single trustee in jointly administered estates with
11 interdebtor claims" had a materially adverse interest should be
12 "evaluated prospectively on a case-by-case basis," by an
13 examination of "the full panoply of events and elements." BH & P,
14 949 F.2d at 1312-13. The Third Circuit concluded that the
15 disputed nature of the proofs of claim and the need for advocacy
16 of the competing interests was a materially adverse potential or
17 actual conflict of interest. Id. at 1313. It therefore affirmed
18 the bankruptcy court's removal of the trustee and his attorneys.
19 Id. at 1313-14.

20 Appellees concede, in their responsive brief, that the proper
21 analysis for our case is the Martin "full panoply of events and
22 elements" or totality-of-circumstances test. In addition, Dye
23 encourages the panel to adopt BH & P's approach, and suggests the
24 use of several additional factors which she has gleaned from the
25 case law.¹⁰

26
27 ¹⁰ Dye recommends an 11-point test including the following
28 factors: (1) the seriousness of a potential adverse interest; (2)
whether the potential conflict ever ripened into a materially
adverse interest; (3) whether the estate suffered injury as a
consequence of any materially adverse interest; (4) the extent to
which, if at all, the potentially adverse interest was disclosed
and when it was disclosed; (5) the extent that the potential
conflict was not disclosed for some period of time, the extent to
(continued...)

1 We agree with this approach to the extent that the question
2 of materiality is addressed in the disinterestedness
3 determination. Whether an interest is "materially adverse"
4 necessarily requires an objective and fact-driven inquiry. See
5 Rus, Miliband & Smith, APC v. Yoo (In re Dick Cepek, Inc.), 339
6 B.R. 730, 739-40 & n.10 (9th Cir. BAP 2006) (holding that where no
7 per se disqualification exists, "the inquiry into whether the
8 professional holds interests adverse to the estate, is
9 disinterested or otherwise is impaired by conflict of interest
10 (actual or potential) is necessarily case- and fact-specific.");
11 In re Guy Apple Masonry Contr'r, Inc., 45 B.R. 160, 166 (Bankr. D.
12 Ariz. 1984) (analyzing all the evidence to decide whether an
13 actual conflict of interest due to dual representation was
14 materially adverse).¹¹ We also generally agree that a court should

15 _____
16 ¹⁰(...continued)
17 which, if at all, the trustee was culpable with regard to the
18 nondisclosure; (6) the extent to which, if at all, the trustee's
19 conduct "was suggestive of irregularity"; (7) the extent to which,
20 if at all, the moving party was dilatory in seeking removal; (8)
21 the effect of removal on estate administration, including a
22 consideration of whether the movant is adverse to the trustee in
litigation and may be motivated by litigation tactics; (9) whether
a prophylactic purpose could be served by removing the trustee;
(10) the position of the U.S. Trustee regarding the motion; and
(11) the fairness of removal to the trustee under the
circumstances.

23 ¹¹ Moreover, because our facts only implicate the "catch-all"
24 provision of § 101(14) (E), we do not need to "throw out the baby
25 with the bath water." In other words, we do not need to decide
26 whether or not a per se rule should be applied to a lack of
27 disinterestedness based on §§ 101(14) (A)-(D).

28 In fact, the Third Circuit later circumscribed its holding in
BH & P in a case where the professional was clearly a creditor of
the debtor and thus not disinterested under the plain terms of
§ 101(14) (A). It stated:

We similarly reject the argument that our decision in
In re BH & P authorizes bankruptcy courts to take a
"flexible approach" in determining whether a professional
who is not 'disinterested' under the statutory definition
may nevertheless be employed pursuant to Section 327(a).
In In re BH & P, we were required to interpret the phrase
(continued...)

1 apply a totality-of-circumstances analysis in determining other
2 "causes" for removal under § 324. We do not subscribe to a rigid
3 application of factors, however, but view them as aids for the
4 court's discretionary review.

5 6 **C. Application to Our Facts**

7
8 Having adopted the totality-of-circumstances approach to
9 determine lack of disinterestedness under § 101(14)(E) as cause
10 under § 324, we now examine the facts and procedure in our case.

11 Indeed, the bankruptcy court made the precise analysis. It
12 found that Dye had certain social connections with Meister, whom
13 she had represented when he was an insider of Debtor, and a past
14 professional connection with Eriksen (Meister's domestic partner),
15 who was an investor and limited partner in the AFI Entities (Dye
16 described him as a "partner" in her letter to Eisenberg during the
17 settlement negotiations). Both individuals had a direct interest
18 in, or adverse interest to, Debtor at the time she represented
19 them.

20 However, Dye argues that insider status must be a "present"
21 one and maintains that such individuals were no longer affiliated
22 with AFI at the time of the bankruptcy petition. Dye urges that
23 whether circumstances exist as would create a conflict of interest

24
25 ¹¹(...continued)

26 "actual conflict of interest" in Section 327(c). We found
27 this phrase to be ambiguous and thus held that a
28 bankruptcy court should have discretion "in determining
whether an actual conflict exists 'in light of the
particular facts of each case.'" In re BH & P, 949 F.2d
at 1315 (citations omitted). In the current case, we must
interpret and apply Section 327(a), not Section 327(c),
and as we have explained, we find no ambiguity in the
relevant language of Section 327(a).

U.S. Trustee v. Price Waterhouse, 19 F.3d 138, 142 (3d Cir. 1994).
The court then reversed the order of employment.

1 must be considered as of the time of appointment. In re Lee Way
2 Holding Co., 102 B.R. 616 (S.D. Ohio 1988).

3 The facts and law support the bankruptcy court's ruling and
4 make practical sense. The definition of "insider" is open-ended
5 because the term is not precise." 3 Collier, supra, ¶ 327.04
6 [2][a][iii][C], at 327-36 to 327-37. "[I]nsider status may be
7 based on a professional or business relationship with the debtor,
8 in addition to the Code's per se classifications,^[12] where such
9 relationship compels the conclusion that the individual or entity
10 has a relationship with the debtor, close enough to gain an
11 advantage attributable simply to affinity rather than to the
12 course of business dealings between the parties." Friedman v.
13 Sheila Plotsky Brokers, Inc. (In re Friedman), 126 B.R. 63, 70
14 (9th Cir. BAP 1991).

15 The bankruptcy court properly considered the larger picture
16 of these interrelationships in order to determine their
17 materiality. At the time Dye formed business and social
18 relationships with Meister and Eriksen, they were insiders. Dye
19 claimed that she did not know about Meister's problems with AFI,
20 but there was colorable evidence that she knew that Eriksen's
21 reasons for wanting to withdraw his investment were closely tied
22 to the fallout from the Ponzi scheme. Dye was in an adversarial
23 position with AFI in representing Eriksen and negotiated a

24 _____
25 ¹² Section 101(31)(B) provides that insiders of a corporate
debtor include:

- 26 (i) director of the debtor;
27 (ii) officer of the debtor;
28 (iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or
person in control of the debtor.

11 U.S.C. § 101(31)(B).

1 settlement for him which she could have believed would withstand
2 scrutiny by any future bankruptcy trustee. As fate had it, she
3 was that trustee.

4 In addition, the court correctly found that these
5 associations could conceivably have influenced Dye's decision not
6 to assert a recovery action against Eriksen¹³ or litigation against
7 Meister. Then, Dye received payment from AFI as part of the
8 settlement. These relationships created suspicion and discord
9 between Dye and the estate's creditors which was detrimental to
10 the administration of the estate.¹⁴

11 A trustee/fiduciary must be free from any hint of bias. All
12 of this evidence fits within the parameters of a materially
13 adverse interest based on either an appearance of impropriety or a
14 potential conflict of interest. Either is a viable cause for
15 removal.

16 The Code's definition of disinterestedness "covers not only
17 actual impropriety, but the appearance of impropriety as well."
18 In re Paolino, 80 B.R. 341, 345 (Bankr. E.D. Pa. 1987); see also
19 Martin, 817 F.2d at 180-81 ("Section 327 is intended, however, to
20 address the appearance of impropriety as much as its substance, to
21

22 ¹³ Dye maintains that the release made Eriksen judgment
23 proof. However, the court found that no signed release had been
24 put into evidence. Nor does the record reflect that any judgment
against Eriksen would be uncollectible.

25 ¹⁴ Dye further argues that "adverse interest" in § 101(14)(E)
26 only refers to personally adverse interests and does not encompass
her past representational interests. She misapplies BH & P,
27 which opined that § 327(a) prohibits conflicts created by
concurrent adverse legal representation. See § 327(a)
28 (authorizing employment of professionals "that do not hold or
represent an interest adverse to the estate, and that are
disinterested persons") (emphasis added).

Dye was not an employed professional, but an appointed trustee. Her interests were past personal as well as professional relationships which could have predisposed her under circumstances that created a bias against the estate in her present trusteeship. See Roberts, 46 B.R. at 827.

1 remove the temptation and opportunity to do less than duty
2 demands."); In re Vebeliunas, 231 B.R. 181, 191-92 (Bankr.
3 S.D.N.Y. 1999) ("[t]o be disinterested is 'to prevent even the
4 appearance of a conflict'" and a disinterested person "'should be
5 divested of any scintilla of personal interest which might be
6 reflected in his decision concerning estate matters.'") (citations
7 omitted).¹⁵

8 Even if an appearance of impropriety is not an adequate basis
9 upon which to disqualify an employed professional, see Tevis, 347
10 B.R. at 688 (stating that what constitutes material adversity for
11 a lawyer is defined by neither bankruptcy law nor other federal
12 law, but by California state law), it can be "cause" for a
13 trustee's removal under § 324. Such a condition tends to create
14 disharmony and lack of confidence among the creditor body.

15 Furthermore, courts which eschew the appearance of
16 impropriety standard will authorize the bankruptcy court to remove

18 ¹⁵ Historically, in view of the strict impartiality
19 requirement, some courts presumptively disqualified trustees based
20 on any "prejudicial association" with interests adverse to those
21 of the estate. 6 Collier, supra, ¶ 702.08[1], at 702-18 to 702-
22 19. This strict standard was reinforced in state ethics rules,
23 particularly Canon 9 of the American Bar Association ("ABA") Model
24 Code of Professional Responsibility ("A lawyer should avoid even
25 the appearance of professional impropriety.")

26 Although the ABA Code has been replaced by the ABA Rules of
27 Professional Conduct, which expressly eliminates the "appearance
28 of impropriety" standard (see ABA Rule 1.9, comment [5]), and
although California has neither adopted the ABA Code or Rules nor
has its own such standard, the Code and case law illustrates that
federal courts have the inherent power to apply it. See In re
Glenn Elec. Sales Corp., 99 B.R. 596, 598-99 (D.N.J. 1988); In re
Snyder, 472 U.S. 634, 645 n.6 (1985) (holding that the state code
of professional responsibility did not by its own terms apply to
attorney sanctions in the federal courts, but that federal courts
in exercising their inherent power under the standards imposed by
federal law may charge attorneys with the knowledge of, and
conformity to, the state codes); see also U.S. Trustee v. S.S.
Retail Stores Corp. (In re S.S. Retail Stores Corp.), 211 B.R.
699, 703 (9th Cir. BAP 1997) (although California law provides for
a waiver of a conflict, the Bankruptcy Code does not allow for
such waiver under §§ 101(14) or 327(a)); In re Granite Partners,
L.P., 219 B.R. 22, 34 (Bankr. S.D.N.Y. 1998) (same).

1 a trustee or attorney with a potential conflict. The Third
2 Circuit, with respect to attorney representation, held:

3 (1) Section 327(a), as well as § 327(c), imposes a
4 per se disqualification as trustee's counsel of any
5 attorney who has an actual conflict of interest; (2) the
6 district court may within its discretion - pursuant to
7 § 327(a) and consistent with § 327(c) - disqualify an
8 attorney who has a potential conflict of interest and (3)
9 the district court may not disqualify an attorney on the
10 appearance of conflict alone.

11 Marvel Entm't Group, 140 F.3d at 476 (emphasis supplied).

12 The Ninth Circuit has held that disqualification is
13 appropriate where trustee's counsel previously represented an
14 electric company and had a potential conflict of interest in
15 pursuing a cause of action against such company on behalf of the
16 estate. Chugach Elec. Ass'n v. U. S. Dist. Ct., 370 F.2d 441,
17 442-43 (9th Cir. 1966). The court concluded:

18 A likelihood here exists which cannot be disregarded
19 that [counsel's] knowledge of private matters gained in
20 confidence would provide him with greater insight and
21 understanding

22 Where conflict of interest or abuse of professional
23 confidence is asserted, the right of an attorney freely to
24 practice his profession must, in the public interest, give
25 way in cases of doubt.

26 Id. at 443-44.

27 Here, the loss of Appellees' confidence in Trustee Dye was
28 not simply tactical, but was based on perceptions of partiality
due to her prior connections with Meister and Eriksen and her
receipt of the AFI payment.

The bankruptcy court also considered the factor of Dye's
nondisclosure regarding a material conflict of interest. At the
time of her appointment as chapter 11 trustee, Dye's Declaration
of Disinterestedness merely referred to her previous

1 representation of an unnamed investor. Dye did not mention her
2 representation of Meister, identify Eriksen, nor either explain
3 the connection between Meister and Eriksen or Mister's connection
4 to AFI.¹⁶ She did not make full disclosure until four years later,
5 prompted by the litigation with Appellees, after she had been
6 appointed the chapter 7 trustee.

7 It is axiomatic that a fiduciary has a duty to disclose any
8 connections with the debtor, creditors, or any other party in
9 interest. See In re Haldeman Pipe & Supply Co., 417 F.2d 1302,
10 1304 (9th Cir. 1969); Triple Star Welding, 324 B.R. at 789.
11 Failure to do so, even if inadvertent, can be a relevant factor
12 for the bankruptcy court's consideration of "cause" for a panel
13 trustee's removal. Such nondisclosure could serve as a basis for
14 the creditors to lose confidence in the trustee, which is
15 precisely what the court found had occurred in this case.
16 Therefore, the bankruptcy court did not abuse its discretion in
17 finding that such nondisclosure supported the "cause" necessary to
18 require removal under § 324.

19 Based on the foregoing analysis, we conclude that the
20 bankruptcy court did not err in its determination that Dye was not
21 disinterested because she had a materially adverse interest which
22 created ongoing disharmony in the administration of the estate.
23 Thus, these factors were sufficient to constitute cause for her
24 removal under § 324.

25
26
27
28 ¹⁶ Section 1104 provides that the chapter 11 trustee must be
a "disinterested person." See 11 U.S.C. § 1104(b) and (d);
7 Collier, supra, ¶ 1104.02[7][a] at 1104-27.

