

# Seventh Circuit Slams Bankruptcy Trustee for Asserting Frivolous Claims

By Brian S. Fraser and H. Rowan Gaither

We have written in the past about the risks to investors in troubled companies from trustees in bankruptcy seeking recoveries for the estate on theories such as insider trading, breaches of duty and conflicts of interest. While those risks remain real, a recent decision from the Seventh Circuit Court of Appeals should provide some restraint on bankruptcy trustees.

In *Maxwell v. KPMG LLP*, No. 07-2819, 2008 WL 746849 (7th Cir. Mar. 21, 2008) (attached), Judge Richard Posner (a founder of the law and economics movement at the University of Chicago), joined by Chief Judge Frank Easterbrook (another pillar of law and economics) and Judge Diane Pamela Wood, affirmed the district court's grant of summary judgment in favor of KPMG on negligence claims brought by a Chapter 7 bankruptcy trustee against the accounting firm, holding that the claims were frivolous, and invited KPMG to file a motion for sanctions in the district court to be paid personally by the trustee.

The decision is characteristically erudite. In this passage, Judge Posner observes that many of the natural checks on litigation do not apply in the case of bankruptcy trustees, who are paid to pursue claims:

The extreme weakness of the trustee's case, both on liability and on damages, invites consideration of the exercise of litigation judgment by a Chapter 7 trustee. The filing of lawsuits by a going concern is properly inhibited by concern for future relations with suppliers, customers, creditors, and other persons with whom the firm

deals (including government) and by the cost of litigation. The trustee of a defunct enterprise does not have the same inhibitions. A related point is that while the management of a going concern has many other duties besides bringing lawsuits, the trustee of a defunct business has little to do besides filing claims that if resisted he may decide to sue to enforce. Judges must therefore be vigilant in policing the litigation judgment exercised by trustees in bankruptcy, and in an appropriate case must give consideration to imposing sanctions for the filing of a frivolous suit. The Bankruptcy Code forbids reimbursing trustees for expenses incurred in actions not "reasonably likely to benefit the debtor's estate," 11 U.S.C. § 330(a)(4)(A)(ii)(I), and authorizes an "appropriate sanction" against parties who file such a claim. Bankruptcy Rule 9011(b)(2), (c)(1)(B); *In re Bryson*, 131 F.3d 601, 603-04 (7th Cir. 1997); *In re Cohoes Industrial Terminal, Inc.*, 931 F.2d 222, 227 (2d Cir. 1991). Not "reasonably likely to benefit the debtor's estate" may well be a correct description of this suit.

*Maxwell*, 2008 WL 746849, \*4.

Judge Posner reminds us and the lower courts, including the bankruptcy courts, that bankruptcy removes the usual careful balancing of the risks and rewards of litigation (which non-bankrupt litigants must always weigh) and may create incentives for behavior by bankruptcy trustees (filing frivolous claims) that wastes resources and

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inhibits desirable allocations of capital. Judge Posner further reminds the federal courts, which have historically been somewhat deferential to bankruptcy trustees in their pursuit of claims for the benefit of creditors, that the Bankruptcy Code, the Bankruptcy Rules and relevant authorities provide the necessary checks on bankruptcy trustees who are freed from the normal commercial considerations faced by non-bankrupt litigants and that it is the court's duty to review and police judgments made by bankruptcy trustees.

Trustees and other bankruptcy constituencies will still be on the hunt for deep pockets. *Maxwell*, however, should provide at least some protection against frivolous or extortionate claims.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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