The U.S. Trustee Program’s Appellate Practice: Clarifying the Law and Enforcing the Bankruptcy Code

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The U.S. Trustee Program works to protect the integrity and efficiency of the bankruptcy system. Through its appellate practice, the Program strives to clarify unsettled law and to ensure the system works fairly for all stakeholders. To promote consistency and predictability in the bankruptcy system, the Program identifies important emerging issues, develops uniform legal positions and then advocates them as a party and as amicus. To see that the law is followed and justice is done, the Program participates in appeals to enforce the Bankruptcy Code, so that all stakeholders in the bankruptcy system — trustees, creditors, debtors, and professionals — fulfill their responsibilities.

The Program’s appellate practice benefits from a nationwide team of attorneys who help litigate Program appeals at every appellate level, including bankruptcy appellate panels, district courts, courts of appeals and the Supreme Court. A group of appellate attorneys in the Executive Office for U.S. Trustees in Washington, D.C., oversees the Program’s appeals and coordinates with attorneys in the Program’s 95 field offices in briefing and arguing them. The Program also works closely with the Appellate Staff of the Department of Justice’s Civil Division and, typically whenever the United States appears before the Supreme Court in a bankruptcy case, with the Office of the Solicitor General by performing tasks such as drafting the initial version of the government’s Supreme Court brief, participating at moot courts, and providing guidance on bankruptcy law issues. Program attorneys appeared among the government’s counsel of record in four of the five bankruptcy cases decided by the Supreme Court between March 2010 and January 2011, and prevailed in all four cases.¹

On average, the Program is involved in approximately 100 appeals per year. During fiscal year 2011, the Program acted as a party or amicus in more than 125 appeals. Those appeals involved a broad spectrum of chapter 7, 11, 12 and 13 issues, including case conversions and dismissals, denials of discharge, the appointment and compensation of professionals, the

activities of bankruptcy petition preparers, and the conduct of mortgage servicers and other creditors. The following are examples of the Program’s recent appeals, highlighting the aspects of the bankruptcy system upon which the Program has recently focused.

Promoting Consistency in Individual Bankruptcies

A widely disputed question of statutory interpretation after the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) involved the vehicle ownership expense deduction and BAPCPA’s means test. When debtors perform means test calculations in chapter 7 cases under 11 U.S.C. § 707(b)(2), and in chapter 13 cases under 11 U.S.C. § 1325(b), they are allowed under BAPCPA to claim a deduction for “applicable monthly expense amounts specified under the National Standards and Local Standards.” Courts across the country were divided on whether this language allowed debtors to claim the deduction without actually incurring a relevant expense, such as a loan or lease payment. The Program argued that debtors must incur such an expense to claim the deduction.

To help clarify the law and eliminate the uncertainty about how to apply the means test, the Program briefed the issue as a party or amicus before the Fifth, Sixth, Seventh, Eighth, Ninth and Tenth Circuits. In one of those cases, Ransom v. MBNA, America Bank, the Program participated as an amicus and helped convince the Ninth Circuit to adopt the government’s interpretation. On appeal before the Supreme Court, the government participated as amicus in support of the respondent. The Program actively assisted the Solicitor General with the case and prepared the initial draft of the government’s amicus brief.

The Supreme Court agreed with the government’s position and affirmed the Ninth Circuit’s decision. The Program was thus able to help definitively resolve a widely contested issue of law.

Clarifying Bankruptcy Court Jurisdiction

In Stern v. Marshall, the Supreme Court considered whether bankruptcy courts have statutory and constitutional authority to decide state-law counterclaims brought by the estate against persons filing claims against the estate. The government participated as amicus before the

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2 Tate v. Bolen (In re Tate), 571 F.3d 423 (5th Cir. 2009); Hildebrand v. Kimbro (In re Kimbro), 409 F. App’x 930 (6th Cir. 2011); Ross-Tousey v. Neary (In re Ross-Tousey), 549 F.3d 1148 (7th Cir. 2008); Babin v. Washburn (In re Washburn), 579 F.3d 934 (8th Cir. 2009); Ransom v. MBNA, Am. Bank, 577 F.3d 1026 (9th Cir. 2009), aff’d sub nom., Ransom v. FIA Card Servs., 131 S. Ct. 716 (2011); Skehen v. Soos (In re Soos), 422 F. App’x 728 (10th Cir. 2011).


Supreme Court, arguing that Congress had the constitutional authority to authorize bankruptcy courts to adjudicate state-law counterclaims and that bankruptcy courts could decide such counterclaims as core proceedings under the Bankruptcy Code.\(^6\) The Program worked with the Solicitor General’s office in developing and presenting the government’s views to the Supreme Court.

The Supreme Court, however, held that bankruptcy courts lacked constitutional authority to adjudicate a state-law counterclaim. Following its earlier decision in Northern Pipeline,\(^7\) which held that a bankruptcy court could adjudicate a state-law claim brought against a third party only if the claim fell within the public rights exception to Article III, the Supreme Court determined that a state-law counterclaim did not fall within that exception. As a multitude of interpretative issues have developed in Stern’s wake, the Program will continue its efforts to help clarify the scope of the bankruptcy courts’ post-Stern authority.

**Clarifying the Standard of Proof for Chapter 11 Trustee Appointments**

The Bankruptcy Code requires that a debtor in possession be replaced by a neutral trustee when, for example, the debtor lacks honesty or cannot manage the estate’s affairs.\(^8\) But the Second and Third Circuits have required proof by clear and convincing evidence to demonstrate cause for the appointment of a chapter 11 trustee.\(^9\) The Program has long believed that this heightened standard of proof cannot be reconciled with the plain text of the Bankruptcy Code and the Supreme Court’s decision in Grogan v. Garner,\(^10\) which held that the preponderance standard applies in a civil action unless constitutional or fundamental rights are at stake.

In Keeley and Grabanski Land Partnership v. Keeley,\(^11\) the Program defended an order requiring the appointment of a chapter 11 trustee before the Bankruptcy Appellate Panel for the Eighth Circuit. On appeal, the debtor argued that the record did not establish clear and convincing evidence of cause for the appointment of the trustee. The appellate panel, however, rejected the Second and Third Circuits’ clear and convincing evidence requirement. Instead, it agreed with the Program and held that Grogan required the preponderance standard be applied because a debtor in possession does not have a constitutional or fundamental right to remain in

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\(^8\) 11 U.S.C. § 1104(a).

\(^9\) Adams v. Marwil (In re Bayou Group, LLC), 564 F.3d 541, 546 (2d Cir. 2009); In re Sharon Steel Corp., 871 F.2d 1217, 1226 (3d Cir. 1989).


control of a chapter 11 estate. This decision will help ensure that parties in interest will not face an unnecessary evidentiary burden when an experienced and honest trustee is necessary to protect creditors and the estate.

Protecting the Integrity of the Bankruptcy System from Creditor Misconduct

Even before the mortgage meltdown, the Program was concerned that secured creditors and mortgage servicers were abusing the bankruptcy system by filing inflated and inaccurate proofs of claim, and motions for relief from stay based upon faulty accounting and misrepresentations to the bankruptcy courts. In 2008, a U.S. Trustee filed a complaint against Countrywide Home Loans, Inc., seeking to hold Countrywide accountable for its misdeeds. The bankruptcy court dismissed the complaint for failure to state a claim upon which relief could be granted, necessitating an appeal to the district court. In Walton v. Countrywide Home Loans, Inc., the Program prevailed on appeal and the district court reinstated the U.S. Trustee’s lawsuit. That suit ultimately formed part of the Program and the Federal Trade Commission’s $108 million settlement with Countrywide and its affiliate BAC Home Loans Servicing LLP for improper default servicing practices.

When U.S. Trustees determined that many other mortgage servicers were also filing improper proofs of claim and stay relief motions, they began to investigate that conduct by scheduling Rule 2004 examinations. Some servicers refused to submit to examination, appealing roughly two dozen Rule 2004 examination orders and related subpoenas across the country. After the Program convinced district courts to dismiss those appeals, the servicers filed appeals and petitions for writs of mandamus before the Sixth, Eighth and Ninth Circuits. The Program convinced the circuit courts to dismiss the appeals and deny the mandamus requests. That allowed U.S. Trustees to conduct the Rule 2004 examinations necessary to determine whether debtors in their jurisdictions were being victimized by improper proofs of claims and stay relief motions.

Protecting the Integrity of the Bankruptcy System from Debtor Misconduct

The Program also acts to protect creditors from debtors who want to discharge their debts under 11 U.S.C. § 727, despite having engaged in fraud or other misconduct. Indeed, two recent circuit court decisions underscore the Program’s commitment to defending orders that prevent the improper discharge of debt.

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13 BAC Home Loans Serv. v. McDermott (In re Donovan), No. 11-3433 (6th Cir. June 28, 2011); BAC Home Loans Serv. v. McDermott (In re Santiago), No. 11-3386 (6th Cir. June 28, 2011); Wells Fargo Bank, NA v. McDermott (In re Gray), No. 11-1495 (6th Cir. June 27, 2011); BAC Home Loans Serv. v. Gargula (In re Heavenly Dawn Morris), No. 11-2281 (8th Cir. July 29, 2011); Bank of Am., N.A. v. DeAngelis, No. 11-56496 (9th Cir. Dec. 7, 2011).
In *Stamat v. Neary*, the Seventh Circuit agreed with the Program and affirmed a bankruptcy court order denying the debtors’ discharge under 11 U.S.C. § 727(a)(4)(A) for making false oaths. The debtors — a doctor and an accountant — failed to report ownership interests in various business assets, $90,000 they had received from refinancing their home, and a payment under a litigation settlement. They also overstated income received from their businesses. On appeal, the debtors argued that they were not required to disclose such information in their statement of financial affairs, and that over-reporting income was not evidence of intent to defraud. The Seventh Circuit rejected all of the debtors’ arguments, thereby enabling creditors to seek the repayment of their debts.

In *Standiferd v. U.S. Trustee*, the Tenth Circuit agreed with the Program and affirmed a bankruptcy court order denying the chapter 7 debtors’ discharge under 11 U.S.C. § 727(a)(6)(A) for refusal to obey a lawful order of the court while the case was proceeding under chapter 13. The debtors formed and operated a construction company after their chapter 13 repayment plan was confirmed, but never reported their new earnings to the chapter 13 trustee as required by the confirmation order. When the debtors’ misconduct was discovered, they voluntarily converted their case to one under chapter 7.

The Tenth Circuit held that § 727(a)(6)(A)’s requirement that the disobedience occur “in the case” included preconversion chapter 13 proceedings because conversion does not effect a change in the commencement of the case under 11 U.S.C. § 348(a). Moreover, the Tenth Circuit explained that § 727(a)(6)(A) was not designed to allow a debtor to engage in willful misconduct and, upon discovery of that misconduct, convert the case to avoid the consequences for that misconduct. By successfully defending the bankruptcy court’s preconversion order, the Program was able to ensure that debtors cannot ignore court orders with impunity.

**Protecting the Integrity of the Bankruptcy System from Professional Misconduct**

The bankruptcy system expects professionals and their clients to conduct an adequate investigation before filing pleadings. When they do not, the Program seeks to hold professionals accountable under Bankruptcy Rule 9011 to remedy and deter misconduct. In *In re Taylor*, the Third Circuit agreed with the position of the U.S. Trustee and affirmed a bankruptcy court order imposing sanctions against HSBC, its local law firm and the head of the firm’s bankruptcy practice under Fed. R. Bankr. P. 9011 for filing two erroneous pleadings.

All of the information in the pleadings was computer-generated by HSBC and given to counsel without any human oversight through the NewTrak system provided and maintained by HSBC’s third party vendor, Lender Processing Services. The law firm failed to investigate any of the information before filing the pleadings. The bankruptcy court required HSBC to circulate a copy of the decision to its other outside counsel; the firm to conduct training on the computer

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14 *Stamat v. Neary*, 635 F.3d 974 (7th Cir. 2011).

15 *Standiferd v. U.S. Trustee (In re Standiferd)*, 641 F.3d 1209 (10th Cir. 2011).

16 *In re Taylor*, 655 F.3d 274 (3d Cir. 2011).
On appeal, the Third Circuit affirmed these sanctions and explained that an attorney “cannot simply settle for the information her client determines in advance — by means of an automated system, no less — that she should be provided with . . .” and the appellees had “ignored clear warning signs as to the accuracy of the data . . .” the law firm received. The court also stated it was proper for the bankruptcy court to consider the “effect of the sanctions on the future conduct of other attorneys appearing before her . . . After all, the prime goal of Rule 11 sanctions should be deterrence of repetition of improper conduct.”

Conclusion

As these cases demonstrate, the Program’s appellate practice strives to promote clear and consistent case law and to foster justice for all participants and stakeholders in the bankruptcy system. The Program’s national perspective and mission to safeguard the public interest in the integrity of the bankruptcy system make it a unique and significant participant in the bankruptcy appellate process.

17 Id. at 285.

18 Id. at 288 (internal quotations omitted).