

Why U.S. Trustee Enforcement Should Not Yield to Debtor and Creditor Preferences

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Introduction

This year marks the 25th anniversary of the nationwide expansion of the United States Trustee Program (USTP or Program). From its inception as a pilot project established in the Bankruptcy Reform Act of 1978 through numerous Congressional amendments that expanded the role of the USTP, the Program has served, in the words of our legislative history, as the “watchdog” of the bankruptcy system. Although USTP duties have expanded over the years, our essential mission has remained constant: to promote the integrity and efficiency of the bankruptcy system by enforcing the law as Congress has written it—and to do so with prudence, discretion and sound judgment.

Stakeholders in the bankruptcy system often have differing views on when and how the U.S. Trustees should assert their broad authorities in a particular case. Indeed, U.S. Trustees exercise civil prosecutorial discretion every day. These decisions are designed to achieve our legislative purpose by reflecting both national Program priorities and district-by-district needs of the bankruptcy system. This article describes some of the basic principles and objectives that guide our prosecutorial discretion.¹

Legislative Background

The statutory basis for the USTP’s role in bankruptcy cases starts, but does not end, with the Bankruptcy Reform Act of 1978. The USTP was initially established as a pilot program in 18 judicial districts. Many of the U.S. Trustees’ current duties and authorities were expressly added in later amendments. Importantly, 11 U.S.C. § 307, which allows the U.S. Trustee to appear and be heard on nearly any issue in any case or proceeding under Title 11, was enacted in 1986. In the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the USTP was given new substantive authorities such as supervising the means test and approving pre-bankruptcy credit counseling agencies. Congress also directed U.S. Trustees to seek the appointment of chapter 11 trustees in cases where there are reasonable grounds to believe that certain types of misconduct has occurred. These additional duties and authorities reflect Congress’s desire for the U.S. Trustee to play an increasingly active role in policing the bankruptcy system.

Prosecutorial Discretion

The U.S. Trustees recognize the importance of exercising prosecutorial discretion, and they do so every day. Not every variation from strict legal requirements mandates an enforcement action or a remedy. An enforcement agency must look both at the facts and circumstances of each case, as well as the broader system-wide impact of the conduct or

¹ In November 2012, I participated in the American Bankruptcy Institute’s Winter Leadership Conference “Great Debates” session on the topic of “Should the U.S. Trustee’s enforcement role in chapter 11 cases yield to creditor preferences?” This article is an adaptation of the remarks I prepared for that Debate. I extend my deepest appreciation to my colleague, Walter Theus, for his work on this article.

violation. USTP enforcement decisions are driven by the fact that Congress designed the bankruptcy system to operate for the benefit of all stakeholders—the debtor, its employees, large creditors, small creditors and the general public. For instance, U.S. Trustees generally should not participate in true two-party disputes. In deciding whether to object to a motion or to take an enforcement action, U.S. Trustees ask many questions, including: Will the resolution of the matter implicate rights of other parties or of any institutional interest of the bankruptcy system? If the parties propose a settlement, does the statute allow the court to approve the agreed-upon relief? Might the court’s adjudication set a troubling precedent?

In determining when to become involved in an issue or a dispute, U.S. Trustees bear in mind their essential mission to promote compliance with the law. The bankruptcy laws are more than a default set of rules that parties can choose whether to follow. In so many areas Congress has made public policy choices that may not be contravened by agreement. The public interest is served by consistent application of the Bankruptcy Code as written, rather than by a system where anything goes as long as the biggest economic interests in the case agree and no one else notices or can afford to complain.

The U.S. Trustees will not seek to substitute their business judgment for that of the debtor and creditors. But corporate debtors and large creditors do not have a license to rewrite the laws passed by Congress and signed by the President. A U.S. Trustee’s prudential decision not to contest an apparent violation of the Bankruptcy Code or Rules in a particular case does not mean that this violation is immune from objection in future cases.

Prudential considerations are part and parcel of the decision-making process of every enforcement agency. Once an enforcement agency decides to exercise its discretion to bring an action or to take a position on a legal or factual issue, the court should promptly adjudicate the issue regardless of whether the court disagrees with the agency’s decision to act. The court’s responsibility is to decide the dispute before it on the facts and the law, without regard to the identity or economic stake of the parties to the dispute.

Protecting All Stakeholders

Enforcing the law and advancing economic interests in a case are not inconsistent unless the efforts to advance the economic interests contravene the law. This false dichotomy is most frequently suggested when strict application of the law would upset an agreement between powerful constituencies in the case, such as the debtor’s entrenched management and major institutional creditors. But unlike many other areas of the law, bankruptcy implicates a multiplicity of interests. The interests of management of the debtor company and its largest creditors are often aligned against the interests of other parties in the case—sometimes against employees, sometimes against small creditors and sometimes against other major parties such as privately managed investment funds. The public also has an interest in compliance with the law.

The multiplicity of interests in bankruptcy is one of the major reasons Congress established the U.S. Trustee as a neutral party to protect all interests—including less powerful economic interests and the public interest. The USTP’s independence is at the core of its existence and justifies its unique role in the system. The USTP is the only party in a case that acts as a disinterested party to protect the integrity of the bankruptcy system. We recognize that other parties have interests they understandably want to vindicate. But, when the solutions

crafted by those parties are outside the law or require the court to enter an order beyond its powers, it is the USTP's responsibility to object.

If the USTP were to limit its involvement to issues that had been joined by economic stakeholders, it would not police a wide variety of important areas. The following are examples of the types of enforcement actions that the USTP may undertake, even in the absence of economic stakeholder involvement.²

Venue

U.S. Trustees may seek the transfer of venue when appropriate under the statutory scheme. In one fact pattern, the debtor manufactures venue by creating a non-operating affiliate with few, if any, assets on the eve of bankruptcy. No creditor objects. But to ensure that the court has an opportunity to exercise its statutory discretion under the "interests of justice" test, the U.S. Trustee does object. If the USTP were powerless to act in this case, debtors would be able to forum shop and to ignore the venue parameters set by Congress.³ Congress did not write venue laws with an exception permitting debtors to file anywhere as long as the economic interests agree. And Congress did not create a watchdog that cannot act independently to enforce the law as written. There is no better standard for the USTP to uphold than the "interests of justice"—and we will continue to do that even if it means we must act alone.

Appointment of a Trustee

Another USTP enforcement action that is often held up for scrutiny is the motion to appoint a chapter 11 trustee. Debtors sometimes claim that the appointment of a trustee will destroy the business or that any change in control will interfere with a sale or otherwise result in catastrophe. These arguments should be closely examined. The trustee's appointment might be catastrophic for top management, but not for the creditors, the employees and the public.

Examine this fact pattern: The debtor and the largest creditor file a motion to authorize a quick sale even though management of the company is guilty of pre-petition wrongdoing. Then, to defeat the U.S. Trustee's motion for a trustee, the company board and largest lender install a chief restructuring officer (CRO) to manage the quick sale. The U.S. Trustee opposes the CRO because the board is tainted by pre-petition conduct and the CRO cannot be independent of the board. The only cure is the appointment of an independent chapter 11 trustee to look out for the interests of all stakeholders.

Consider one more fact pattern: The debtor successfully installs a CRO to defeat a motion for a trustee. Ultimately, the debtor's business cannot be sold as a going concern, and all employees are laid off. In such a case, it is difficult to see how deference to incumbent management benefited stakeholders.

² Unless otherwise noted, the following are composite examples and do not necessarily mirror the facts of any particular case.

³ Some commentators have highlighted the court's dictum in *In re Patriot Coal Corp.*, 428 B.R. 718, 744 (Bankr. S.D.N.Y. 2012), that the decision to grant the U.S. Trustee's motion might have been different had no party with an economic interest also challenged venue. Such a result, however, would clearly have been inconsistent with the ruling itself which stated that the debtor's steps to manufacture venue were an "affront to . . . the integrity of the bankruptcy system"—as well as with the decision in *In re Winn-Dixie Stores, Inc.*, Case No. 05-11063 (RDD) (Bankr. S.D.N.Y. Apr. 12, 2005), that the "interests of justice" trump the "convenience of the parties."

Executive Bonuses

U.S. Trustees frequently object to executive bonuses that do not comply with 11 U.S.C. § 503(c). Examine this common fact pattern: The debtor proposes to pay bonuses to keep executives and insiders on board during the sale or reorganization of the company. Only the U.S. Trustee objects. In response, the debtor recharacterizes the retention bonus as an easy-to-reach incentive bonus, and the U.S. Trustee objects to enforce the bonus restrictions in § 503(c).

Congress made the policy choice to strictly limit retention bonuses, and that choice should not be contravened by private interests. As case law holds, an incentive plan cannot be a “lay-up” but must be a “stretch” to qualify under § 503(c). The statute is a clear statement of Congressional intent to rein in abusive bonus programs in bankruptcy, yet parties treat it as an inconvenient obstacle to overcome.

In one recent case, the court heard an executive bonus motion and objections. While the matter was under advisement, the press reported that the debtor sent notices to employees under the Worker Adjustment and Retraining Notification (WARN) Act. Simple arithmetic showed that the total executive bonus amount sought by the debtor was the equivalent of more than \$31,000 for each employee reportedly facing layoff. Even though the press report was not part of the court record or a basis for the court’s decision, it was troublesome.⁴

Professional Compensation

In yet another major area, review and approval of compensation requested by bankruptcy professionals, the U.S. Trustee often is the only party to object. Assume that the U.S. Trustee discovers that the debtor’s law firm routinely discounted its fees billed to the debtor before the bankruptcy filing, but the law firm neither discounted its fees for the bankruptcy engagement nor disclosed the pre-petition discount. Under 11 U.S.C. § 330, Congress requires that compensation be reasonable “based on the customary compensation charged by comparably skilled practitioners in cases other than cases under [Title 11].” If the U.S. Trustee does not raise this important issue, it is likely that no party will.

Consider one more fact pattern relating to professional compensation: To break an impasse and settle all contested issues, the debtor proposes that, if certain creditors will withdraw their objections to the reorganization plan, the debtor will amend the plan to pay the attorneys’ fees of these creditors. The U.S. Trustee objects to enforce § 503’s requirements that limit when creditors can have their attorneys’ fees paid by the estate. That section binds creditors and debtors alike; neither the court nor the parties by agreement have the authority to alter that statutory scheme.

Consumer Bankruptcy

The previous examples were drawn from chapter 11 fact patterns. The USTP intervenes to protect the integrity of the bankruptcy system in consumer cases as well. For instance, in seeking to retain their homes, individual debtor homeowners are most often outmatched by large banks and their big law firms, even in situations where the banks and/or their attorneys have engaged in questionable lending, collection or foreclosure practices. In many of these cases, the

⁴ *In re Hawker Beechcraft, Inc.*, 479 B.R. 308 (Bankr. S.D.N.Y. 2012)(order denying the executive motion bonus).

banks will quickly settle with the homeowners and then combat U.S. Trustee efforts to remedy systemic problems by arguing that there is nothing left for the U.S. Trustee to investigate or remedy. The USTP has rejected this “no harm no foul” defense against the investigation of potentially systemic violations and has actively participated in the negotiation of several major nationwide settlements designed to remedy collection abuses. Needless to say, the USTP had no economic interest, but the USTP has investigated or taken court action in thousands of such cases.

Conclusion

The USTP will act in cases when parties seek to fundamentally contravene the law. In those cases, the USTP is obliged to police the system and to act as a “watchdog” over the integrity of the bankruptcy system. The Bankruptcy Code is not a set of suggestions to be followed when adherence is convenient. We are all well-advised to respect the Code and thereby enhance public confidence in the system that we serve.