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USTP Focuses on Professional Fees, Corporate Governance, and Predictability and Transparency in Chapter 11

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I had the opportunity to speak at the ABI's Bankruptcy Battleground West in Los Angeles in March. In those remarks, I provided an update on major U.S. Trustee Program (USTP) consumer and chapter 11 priorities. This article is an adaptation of the portions of that speech that addressed issues arising in business reorganization cases.

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The mission of the USTP in consumer and business cases alike is to advocate for the most faithful reading of the Bankruptcy Code to ensure that policy preferences embodied in statute are respected. Not surprisingly and quite properly, private lawyers often make arguments to advance the economic interests of their clients. In contrast, the role of the USTP is fulfilled every time we stand up for the integrity of the Code and ensure that issues are properly and completely presented for court resolution.

As the USTP advances our chapter 11 agenda and confronts emerging issues, we often consult the Report of the ABI Commission to Study the Reform of Chapter 11. The Commission, ably led by co-chairs Robert Keach and Al Togut with the indefatigable assistance of Reporter Michelle Harner, stands as a work of scholarship and vital reference for all practitioners, regardless of whether they agree with the conclusions of the Commissioners.[1] In the course of explaining various USTP priorities in this article, I make several references to ABI Commission findings.

Professional Compensation

USTP Fee Guidelines

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[1] As USTP Director, I served as a non-voting, *ex officio* member of the Commission. Neither I nor the USTP adopted or opposed any specific recommendations.

One of the major chapter 11 initiatives of the USTP continues to be implementation of the USTP's Guidelines for Attorney Compensation in Large Chapter 11 Cases (Guidelines). The Guidelines call for additional disclosures in attorney retention and applications, and lay out the criteria used by the USTP in deciding whether to object to those applications.

Last year, the Government Accountability Office (GAO) studied the Guidelines. Notably, in its final report, the GAO made no recommendations for changes in the content or implementation of the Guidelines.[2] Additionally, in our experience most law firms have sought to comply with the Guidelines instead of provoking litigation. This has been a welcome development, because the USTP's goal has been to encourage compliance and to avoid conflict.

Even though we are pleased with the efforts of major law firms to comply, the additional disclosures have uncovered instances of non-compliance with statutory requirements, including the standard that allows compensation comparable to non-bankruptcy practice areas. To date, these matters have been resolved by the consensual modification of the retention or fee application. For example, some firms that provided pre-petition fee discounts to the debtor had to amend their retention applications to provide the same discounts after the debtor filed for chapter 11 protection.

As familiarity with the Guidelines grows, the USTP will increasingly expect firms to provide more complete and responsive information, especially regarding comparable billing data. As law firms put compliance systems into effect, USTP offices will more closely scrutinize, for example, proffered explanations for why firms charge higher hourly rates for bankruptcy engagements than for non-bankruptcy work. The USTP has intentionally avoided litigation, and hopes to continue to do so. But, to avoid future objections to their fee applications, law firms will be expected to provide more substantive explanations of apparent rate disparities.

Asarco and its Progeny

The major substantive development on the professional compensation front this past year was the Supreme Court's decision in *Baker Botts v. Asarco*.[3] In its

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[2] GAO Report 15-839, *Stakeholders Have Mixed Views on Attorneys' Fee Guidelines and Venue Selection for Large Chapter 11 Cases*, http://www.gao.gov/products/GAO-15-839.

[3] *Baker Botts LLP v. ASARCO LLC*, __ U.S. __, 135 S. Ct. 2158 (2015).

decision, the Court, taking a stricter position than what the government had urged, held that law firms cannot recover fees for defending objections to their fee applications in bankruptcy court. The high Court found that the American Rule governs. Each side pays its own legal fees absent an express statutory or contractual exception.

Soon after the decision, the USTP posted on its public Web site a series of questions and answers on the *Asarco* decision so that firms would be aware of the USTP's likely response to anticipated issues and situations.[4] Among other things, the USTP made it clear that the USTP will not object to fees for reasonable time spent negotiating fee issues, so long as those negotiations occur before an objection is filed with the court.

The most significant issue that arose after *Asarco* was whether § 328 permits professional firms to contract with the debtor or committee for the payment of fees on fees. Even before the issue arose, the USTP made clear in its Q&A that it viewed such agreements as contrary to the Supreme Court ruling. The lead case to test that position was *Boomerang Tube* in the District of Delaware.[5] About 25 other cases raising the same issue quickly piled up, nearly two-thirds of which were in Delaware.

In late January 2016, Bankruptcy Judge Walrath ended the suspense. In an opinion largely tracking the analysis in the USTP's briefs, the court found that § 328 does not create an exception to the American Rule that governs in § 330.[6] In *Asarco*, the Supreme Court held that fees on fees are not allowed. Therefore, the court may not approve § 328 agreements that violate that Rule.

Soon thereafter, Professor Stephen Lubben published an article on the *Boomerang Tube* decision on the *New York Times* Web site.[7] He suggested several possible effects of the decision, including that the decision could cause attorneys to file more cases in the Southern District of New York in search of a more fee-friendly venue. He also said that professionals may simply raise their rates to make up for the prohibition on fees on fees. He speculated that there could be less transparency in the fee award process because professionals could simply hide

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[4] https://www.justice.gov/ust/Prof_Comp/FAQ_Prof_Comp.
[5] *In re Boomerang Tube, LLC*, et al., No. 15-11247 (MFW), Bankr. D. Del.
[6] *In re Boomerang Tube, Inc.*, 2016 WL 385933 (Bankr. D. Del. 2016).
[7] Stephen J. Lubben, *Decision May Prolong Dearth of Bankruptcy Cases in New York*, February 12, 2016, http://www.nytimes.com/2016/02/13/business/dealbook/decision-may-prolong-dearth-of-bankruptcy-cases-in-new-york.html.

their true compensation. Professor Lubben concluded that "the United States Trustee has won the battle, but the result may be that professional fees become even less transparent than they were before. . . ."

Professor Lubben's views reflect cynicism about bankruptcy lawyers and the system. To some extent, he is merely agreeing with the 18 out of 25 judges interviewed by the GAO who believe that professional fees are a factor influencing venue selection.[8] But he goes beyond that. Professor Lubben incorrectly suggests that firms may appropriately raise their bankruptcy rates in response to *Asarco* regardless of their customary rates for non-bankruptcy engagements. Such a disparity would violate the "comparability" standard of § 330(b)(3)(F), which Professor Lubben does not even mention. And, most alarmingly, he says that bankruptcy professionals will intentionally hide their real billing rates.

Let us hope Professor Lubben is wrong on all counts. Even though the USTP does not acknowledge the validity of Professor Lubben's cynicism about the bankruptcy system, the USTP will be alert and will object to any further attempts to eviscerate the Supreme Court's decision.

Corporate Governance

The ABI Commission recommended a statutory amendment to clarify that the burden of proof for ordering the appointment of a trustee under § 1104 be clearly established as "preponderance of the evidence."[9] The ABI Commission position is consistent with the USTP's view that "preponderance" is the correct standard under current law. However, courts in many districts apply the higher "clear and convincing" standard.

It is often extraordinarily difficult to oust management in favor of an independent trustee. At one ABI event a few years ago, the late Harvey Miller acknowledged that more trustees should be appointed. Without a viable option to replace management with an independent fiduciary, entrenched management or the most powerful lenders can control a case to the detriment of other stakeholders and interests.

Many common arguments are routinely advanced against the appointment of a trustee. Often, the debtor in possession (DIP) says that it dismissed bad

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[8] GAO Report, *supra* n. 2, at 24.
[9] ABI Commission Report at 26.

management immediately before or just after the bankruptcy filing, so all is well. That argument has prevailed even in cases in which senior officers hand-picked by the discredited prior management are in control of the company. In other cases, the DIP asserts that a sale or other pivotal transaction is imminent. And in many cases, the DIP negotiates dubious loan covenants that imperil the financial condition of the company if entrenched management is replaced.

Multiple examples could be provided. Here are just a few:

- In one case several years ago, a chief executive remained on the board for months after he was arrested for financial crimes and defrauding the company's creditors.
- In another case, a top corporate officer pled the Fifth Amendment and declined to respond to questions about the debtor's financial transactions. The USTP's trustee motion was nevertheless denied because a chief restructuring officer had just been hired and the debtor made the predictable assertion that a sale was imminent.
- Finally, a company whose chief executive was arrested, was dismissed from the company, and then pled the Fifth Amendment defeated a motion for a trustee. In that case, a board member who was selected during the tenure of the chief executive was joined by two new directors, but only after the chapter 11 filing. Once again, the assertion that the debtor's fragile business would be imperiled if new management were installed prevailed over corporate governance arguments.

Not surprisingly, in many of these cases, the "imminent" sale never materializes and there is further diminution of the estate. Incumbent management and their professionals stay in power longer and get paid handsomely for their services while creditors often suffer.

Despite the obstacles placed in its way, the USTP will continue to seek the appointment of chapter 11 trustees where incumbent management committed or is tainted by egregious prior acts or misconduct.

Predictability and Transparency in Bankruptcy Proceedings

The understandable urgency of bankruptcy cases sometimes leads to processes that are inconsistent with the fundamental legal principles of predictability and transparency. Everyone agrees that transparency and predictability are the linchpins of the bankruptcy system. All legal systems require these attributes, but they are especially important in bankruptcy because bankruptcy litigation is almost never a two-party dispute. A bankruptcy case involves a multiplicity of interests. The Code carefully balances the rights of all parties and the Bankruptcy Rules guarantee openness in court procedures.

A major reason for the creation of the USTP was to provide a neutral party without a financial interest in the outcome of a case to ensure consistent application of the law. Often, the USTP is the only party to ask the court to "turn on the lights" so all stakeholders, including the public, can see what is transpiring and can have access to critical information.

Some commentators have suggested that predictability and transparency in bankruptcy are yielding to other objectives such as putative efficiency and results-oriented procedures. In offering a few examples to consider, the USTP does not suggest that lawyers should be faulted for trying to gain an advantage for their clients or that courts should not take into account countervailing legal principles. They are offered merely to demonstrate that all bankruptcy professionals ought to be concerned whenever predictability and transparency are compromised.

Statutory Standards

When substantial rights and financial interests of creditors large and small are at stake, then the clearer the standards and the law, the better for stakeholders – not only in the case at hand but in the larger marketplace as well. Predictability is good, both in law and in business.

The value of predictability and the need for flexibility are sometimes in conflict. Parties with an economic interest frequently advance creative statutory constructions to enhance their recoveries. It is not always easy for courts and parties to know precisely where the boundary lines are drawn. It is not always easy to determine how to respond when Congressional commands bump up against what appears to be the most economical result in the case at bar. And it is not always easy to know when efficiency of result in one case will undermine the fairness of result in future cases. The role of the USTP is to identify those possible conflicts, to advance the most faithful reading of the law and to promote predictability.

The USTP approach has often met resistance. Unsurprisingly, sometimes we prevail and sometimes we do not. For example, in *Lehman Brothers*, we prevailed on appeal when creditors' committee members sought payment of their own legal fees even though Congress had amended the law specifically to clarify that they had no right to receive such fees for committee-related services.[10] Similarly, in the *Boomerang Tube* case discussed above, our reading of the Code prevailed over more creative interpretations of the law.

As of the time this is written, the Supreme Court is considering whether to review the Third Circuit's decision in *Jevic Holding Corp*.[11] In that case, the USTP lost on the issue of whether a settlement and structured dismissal may be used to distribute funds without following the Code's priority scheme. In *Jevic*, the USTP sided with employees whose unpaid priority claims were skipped in favor of non-priority creditors. The ABI Commission took a dim view of structured dismissals and suggested a statutory amendment to clarify the law.[12]

Of course, statutory standards have been at issue in many cases in which the USTP was not directly involved. Many commentators point to a recent case involving the confirmation standard of "unfair discrimination" among classes of creditors. In that case, the bankruptcy court held that the statutory standard was met as long as the plan satisfied the judicial conscience. Without regard to whether it is legally correct, such a subjective test demonstrates the tensions that may exist between the twin imperatives of flexibility in the case at bar and predictability of outcome in future cases.

Sealing and Proceedings Off the Record

a. Sealing Documents

On the issue of transparency, anecdotal evidence from USTP offices as well as from private practitioners suggests that the number of motions to seal documents is increasing. The USTP interprets the sealing provisions of § 107 and Bankruptcy Rule 9037 to set a very high bar that must be reached for the court to deviate from the presumption in favor of open court records and proceedings.

For example, we often object to executive bonus motions that either do not provide or seek to seal information about the nature, amounts and possible recipients of bonuses. While it might sometimes be appropriate to withhold the names of executives, it is not good practice to withhold other information that is

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[10] *In re Lehman Bros. Holdings Inc.*, 508 B.R. 283 (S.D.N.Y. 2014).
[11] *In re Jevic Holding Corp.*, 787 F. 3d 173 (3rd Cir. 2015).
[12] ABI Commission Report at 269.

needed to reasonably evaluate a bonus motion. Disclosure of the organizational level of an executive and the precise benchmarks that the executive must achieve to receive the bonus are essential for parties to make informed decisions on whether to object to the compensation.

We also disfavor sealing examiner reports. The exception here is a brief temporary seal so that parties, and the court if necessary, can resolve any objections to the public disclosure of privileged or otherwise protected information. In one well-known case, however, the entire report was sealed for some period for the acknowledged purpose of incentivizing a settlement. Although that court's determination to seal the report might have made sense in the context of that particular case, such procedures could raise broader policy issues for bankruptcy practice.

b. Sealing the Courtroom and Off-the-Record Chambers Conferences

Another example that illustrates the transparency issue is the sealing of courtrooms. Occasionally, courtrooms must be sealed. But it seems to the USTP that such requests are becoming more common. In numerous cases, chapter 11 debtors seek to discuss their financial condition in proceedings in which smaller creditors cannot participate. The USTP generally will oppose these requests.

In a few courts, parties seek off-the-record chambers conferences to discuss substantive matters. Traditionally, chambers conferences have been used to address administrative matters. In some cases, the conferences properly may be used for broader purposes. But both USTP attorneys and private practitioners have complained that chambers conferences may involve more precise judicial directions to parties, including arguments to be made and motions to be filed, and are conducted without any transcription. I have been told that the overuse of chambers conferences has engendered confusion among litigants in certain cases. There may be reasons to keep certain discussions off the public record, but practitioners and courts ought to consider the appropriate circumstances justifying such conferences.

Mediation

Another practice we are seeing increasingly is mediation. Mediation is universally acclaimed as a means of reducing costs and producing speedier outcomes. Certainly, it can be a constructive tool in a judge's toolbox to bring about efficient resolution. And, encouraging the consensual resolution of issues is sound public policy. But mediation should not be used at the expense of due process, protecting the rights of all stakeholders, and ensuring public confidence in public proceedings.

Given its role as an administrator, regulator and enforcement agency, the USTP is not frequently involved in mediation. So, the USTP seldom opines in court on this issue.

In an upcoming article in the *Yale Journal on Regulation*, Professor Melissa Jacoby raises the important question of whether mediation has been used to excess.[13] If mediation does more than facilitate negotiations, and if it is used to pressure parties to reach a settlement on terms favored by the mediators, then most would agree that it has gone too far and denies due process.

Mediation by a judge sitting in the same district where a case is being heard may, under certain circumstances, put undue pressure on professionals who may have to face the mediator-judge in other cases involving other clients. Furthermore, some uses of mediation may interfere with the mandate of access to court proceedings by all parties and the public. No matter what position one might take on these issues, they are worthy of debate and consideration within the bankruptcy community.

Post-Confirmation Trusts

The ABI Commission noted that transparency has been compromised by the increasing use of post-confirmation trusts to resolve core economic issues affecting both debtor and creditor rights. These post-confirmation trusts are often thinly described in the disclosure statement and plan of reorganization. The Commission made several recommendations for changes in the law, which included requiring more detailed disclosure of the corporate governance of trusts, of standards for resolving claims and distributing proceeds and of mechanisms for creditors to object to trust administration and to seek court relief.[14] The USTP believes that such disclosures should be required under existing law. The USTP will accordingly object to disclosure statements that contain inadequate information about post-confirmation trusts and similar entities.

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[13] Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 Yale J. on Reg. 55 (2016).
[14] ABI Commission Report at 240.

Other practices are developing that may be reducing predictability and transparency. None of this, though, is to say that the courts do not have discretion, that chambers conferences are not a valuable vehicle for moving cases along, that sealing documents according to statutory criteria is not sometimes essential, that mediation is not immensely valuable and conserves resources or that post-confirmation trusts are not often essential. But all professionals who are committed to advancing the ideals of the bankruptcy system should carefully consider whether the system is becoming unpredictable and opaque. Competing considerations always exist, but all participants in the system should be wary whenever the preeminent goals of predictability and transparency yield to other considerations.

Conclusion

The USTP plays a unique role in bankruptcy. Our statutory mandate as the "watchdog" of the bankruptcy system often causes us to clash with all other parties in a case. This article addresses a number of our initiatives and concerns about chapter 11 practice, but our mandate causes us to engage in many routine tasks in business cases as well. The USTP does not always prevail in our positions; our primary goal is to ensure that important issues are raised and adjudicated, regardless of the outcome. That does not always make us the most popular advocate in the courtroom, but it does ensure that we are fulfilling our statutory mission.