United States Trustee Program's
Agenda on Chapter 11 Corporate Reorganization Issues[1]

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The great economist Joseph Schumpeter wrote about the importance of economic dynamism and the entrepreneurial spirit. He knew the personal sting of bankruptcy, but remained convinced that change and the "wild spirits" of entrepreneurs were the key to economic growth.

An effective bankruptcy system is an essential element of every developed national economy. It encourages entrepreneurship by accounting for failure. Bankruptcy provides individual debtors with a "fresh start" and business debtors with a "breathing spell" during which the business can be reorganized or sold. Importantly, bankruptcy also provides a mechanism for the efficient distribution of assets in the event of business failure.

Role of the United States Trustee in Chapter 11 Cases

Regardless of whether a case is consumer or business, liquidation or reorganization, a core responsibility of the United States Trustee Program (USTP) is to help ensure that all participants in the bankruptcy system comply with the Bankruptcy Code.

The Limits of Discretion in a Code-Based Bankruptcy System

In the Bankruptcy Code, Congress established the rules and the public policies that bind all participants in the bankruptcy system. Neither judges exercising their discretion nor the parties reaching an agreement can contravene the law or substitute their preferences for those of the Congress as expressed in statute.

One of the best examples of this arose in *Czyzewski v. Jevic Holding Corporation*, which was decided in March by the Supreme Court. The essential facts in the case were that the debtor laid off employees on the eve of bankruptcy and later sought approval of a settlement to dismiss the case that provided for a final distribution of available assets. The problem was that the distribution excluded the WARN Act claims of the laid off truck drivers and instead favored lower priority creditors who would be paid in return for the creditors' committees dropping a fraudulent conveyance lawsuit against the creditors who bought the company in a leveraged buy-out. Fortunately and appropriately, the Supreme Court said "no."

The USTP sided with the truck drivers in objecting to the settlement in bankruptcy court. We lost. We then unsuccessfully argued for reversal in the Court of Appeals for the Third Circuit. Ultimately, we were signatories on the Solicitor General's brief in the Supreme Court where we prevailed. The Supreme Court made clear that the bankruptcy court does not possess

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discretion to approve a final distribution through a structured dismissal that violates the priority of creditors – at least not without the affirmative consent of the harmed stakeholders.

The rationale of the *Jevic* decision may have major implications, not only in protecting the chapter 11 plan confirmation and priority of distribution process, but also in many other contexts where parties seek to circumvent statutory mandates.

Significant USTP Actions in Chapter 11 Cases

In carrying out our responsibilities, the USTP sometimes takes positions that are adverse to those of debtors and major creditors. This tension is consistent with the adversarial nature of any legal process and is particularly present in bankruptcy where there is a multiplicity of interests.

In the USTP's chapter 11 practice, our responsibility to uphold the Bankruptcy Code is reflected in our day-to-day practice of reviewing and, where necessary, objecting to proposed actions that we believe do not meet statutory standards. For example, the USTP continues to see applications for bonuses that require unexceptional efforts by insiders, such as realizing a sales price which already was offered by a stalking horse bidder. We also see motions seeking to assume pre-petition employment agreements that contain buried retention bonus provisions, even though section 503(c) clearly applies to agreements made pre-petition. In many cases, the USTP is the lone voice in objecting. Although in most cases we succeed in obtaining at least a modification of the initial bonus plan, we are disappointed that we have not succeeded more in improving compliance with the bonus restrictions that Congress has imposed.

Similarly, the USTP stands alone regarding non-consensual, non-debtor third party releases. Consider this scenario. The debtor and large creditors who seek to control the post-confirmation entity place a provision in the plan releasing non-bankruptcy claims of non-debtors against other non-debtors without the consent of the releasing parties. It is important to note that a creditor's vote in favor of a plan does not in and of itself constitute consent to the release of that creditor's right to sue on its non-bankruptcy claims against non-debtors. And even in Circuits that are more lenient in approving non-debtor releases, the scope of proposed releases is often beyond the pale. The proponent's justification often boils down to two arguments having little to do with the merits: (1) the USTP has no financial interest in the case; and (2) without the agreement, the whole deal will fall part. The court, understandably trying to bring the case to a conclusion, sometimes expresses skepticism about the objection as well. Lost in the argument though, are the facts that: (1) the USTP was created as a neutral "watchdog" to allow it the freedom to enforce the law as Congress has written and to protect the rights of smaller creditors who cannot afford to participate actively in the case; and (2) often there is scant evidence that the benefitting parties will withdraw from the deal absent the releases. More often than not, we prevail, at a minimum, in obtaining substantial modifications to the proposed terms of the releases. But there is little doubt that, in many cases, the rights of non-consenting creditors would be unprotected but for the watchful eye of the USTP.

New Initiatives

The USTP has two new initiatives underway that may be of special interest to insolvency and restructuring professionals: professional fee guidelines for financial advisors and investment bankers and a protocol on the retention of Chief Restructuring Officers (CROs). Similar to the process we followed in the development of the large case attorney fee guidelines issued in 2013, for both initiatives, we will conduct outreach to stakeholders, publish a draft for comment, conduct a public meeting at which stakeholders can make statements and answer questions from USTP representatives, and then publish the final guidance. This process not only provides the USTP with valuable insights and information from experts on the front end, but also provides transparency on the back end by allowing parties to understand the information the USTP will consider in deciding whether to object.

Professional Fees of Financial Advisors and Investment Bankers

This is a propitious time to develop fee guidelines for financial advisors and investment bankers. The fees charged by financial advisors in bankruptcy cases today sometimes exceed legal fees. And the scope of services goes far beyond the accountancy that used to be the main service provided. Both financial advisors and investment bankers are essential actors in analyzing the core financial problems of the debtor's business, valuing assets, devising strategies for reorganization or sale, and identifying investors and buyers. Nonetheless, standardized disclosures of services and time spent often are vague and insufficient. In the case of investment bankers especially, there need to be more meaningful disclosures of services and metrics for evaluating success.

More frequently for financial professionals than attorneys, retention agreements provide for a fee arrangement under section 328 of the Code. Instead of using the section 330 lodestar approach of average hourly rate times reasonable time spent delivering agreed upon services, a basic sum is agreed to at the beginning of a case. Although the USTP agrees that alternative fee arrangements can provide a more efficient mechanism for charging for professional services than the lodestar method, they certainly should not be used to evade basic disclosures required under the Bankruptcy Code and Bankruptcy Rule 2016.

Investment bankers, probably more than any other professionals, have used section 328 in their retention agreements. Under the so-called "Blackstone Protocol," USTP offices concur with the section 328 term with a proviso that fees at the end of the case still can be reviewed by the USTP under the more expansive factors set forth in section 330. Some say that this defeats the purpose of having a pre-approved compensation term. The USTP understands that point of view. But these retention applications often are submitted for approval while the proverbial "ice cube" is melting and efforts are intensely focused on trying to salvage the business or arrange a sale. As a result, the applications may lack the necessary evidentiary support and the parties and the court may not be in the best position to conduct the rigorous review required of the pre-approved compensation terms. With the new guidelines, parties will have more information so that fees can be awarded with greater assurance that they were earned under the reasonableness standards set forth in the Code.

Employment Terms for Chief Restructuring Officers

It is well established that the CRO industry has grown markedly in the bankruptcy world over the past two decades. Just as CROs play an integral role in turning around distressed enterprises outside of bankruptcy, increasingly they have navigated companies through the shoals of chapter 11 and helped manage corporate debtors back to financial health.

CROs Are Not a Substitute for a Chapter 11 Trustee

While CROs can play a constructive role, they cannot fill the shoes of a chapter 11 trustee when cause exists warranting the appointment of an independent fiduciary under section 1104. Sometimes businesses have engaged in pre- or post-petition activity that disqualifies current management and the board of directors from serving as the debtor-in-possession.

Upon the filing of a bankruptcy petition, by operation of law, management transforms into a fiduciary that is bound to act for the benefit all stakeholders, including creditors. A recent history of financial irregularities, egregious mismanagement, or indifference by the board, along with other facts, may render the company's management unfit for service as a fiduciary. In such circumstances, the Bankruptcy Code and principles of sound corporate governance dictate that the court authorize the USTP to appoint an independent chapter 11 trustee. Unsurprisingly, management usually resists, and is often joined in opposition to our motion for a trustee by controlling creditors or the official committee.

Sometimes management seeks to defeat a trustee by appointing a CRO who reports to the same board that failed to detect or remedy prior management's malfeasance or nonfeasance. Predictable arguments we hear are that continuity is needed, a trustee will result in additional costs to the estate and delay in the ultimate resolution of the case, creditors will not contribute funds to a plan with unknown trustee management, or some other argument designed to thwart a trustee.

As much as the USTP may respect the integrity and qualifications of a particular CRO, we do not accept those arguments. There are numerous cases in which the selection of a CRO by the culpable corporation has simply preserved management's prerogatives and led to no benefit to the estate. And the lack of independence in and of itself diminishes the integrity of the process.

In the USTP's view, too few chapter 11 trustees are appointed in the modern bankruptcy system. In many districts, case law sets the burden of proof at the heightened "clear and convincing" evidence standard, rather than the typical "preponderance" of the evidence standard. The fact is that it is easier to deny a discharge to a consumer debtor – known as the death penalty of bankruptcy – than it is to obtain an order ousting incumbent management in favor of an independent trustee. That is both unfair and contrary to the statute.

While we appreciate the role CROs should play in the bankruptcy system, the USTP will persist in our position that, if grounds exist to appoint a trustee, the appointment of a CRO does not provide a substitute cure. Of course, sometimes the USTP appoints a member of the CRO community as trustee who can provide the expertise needed, but it does so free from tainted management's control and influence.

USTP Protocol on Scope of CRO Retention

In recognition of the important role CROs can play in many bankruptcy reorganizations, almost 20 years ago we developed a protocol governing USTP consideration of the scope of a CRO engagement that became known as the "J. Alix Protocol." The protocol provides that the USTP will not object to employment of a CRO if the debtor applies for retention under section 363 pertaining to the use of estate funds out of the ordinary course of business and also agrees to other protections against conflicts that would apply to a professional employment application under section 327. For many years, this solution has properly harmonized the demands of the Bankruptcy Code with the debtor's practical need for CRO services.

Over the two decades since the protocol was adopted, however, there have been many changes in the CRO industry that warrant a fresh look at it. The USTP has reached out to participants in the restructuring business and other stakeholders for information on how the protocol should be updated to better reflect modern practice while remaining faithful to the conflict of interest provisions of the Code. Among the issues to be considered are: whether the "one hat" rule limiting the CRO to a single role as either manager or financial advisor can be more flexible; whether there should be a reduction in the post-engagement period of time during which the CRO or members of the CRO firm are prohibited from investing in the securities of the reorganized company; and whether the indemnification of the CRO should be aligned with the indemnification of officers outside of bankruptcy.

Conclusion

As Professor Schumpeter said, "economic progress, in capitalist society, means turmoil." And bankruptcy surely displays a good bit of turmoil. But insolvency and restructuring advisors are there to help manage that turmoil. And the USTP is there to help ensure that the reorganization process goes forward in accord with the rule of law as written by the Congress. If we all do our jobs, then the result at least will reflect the democratic process and hopefully result in economic growth and prosperity that benefits all citizens.