Contents

VOLUME 3: CHAPTER 11 CASE ADMINISTRATION 1

CHAPTER 3.1.0: KEY TERMS 1

CHAPTER 3-1: GENERAL POLICY CONSIDERATIONS 1

CHAPTER 3-2: VOLUNTARY CASE ADMINISTRATION 2

3-2.1 FILING REQUIREMENTS 2
3-2.2 CASE FILING NOTIFICATION AND DOCUMENT RECEIPT 3
3-2.3 INITIAL REVIEW 3
3-2.3.1 Signature Requirements 3
3-2.3.2 Authorization for Filing 3
3-2.3.3 Debtor Eligibility 4
3-2.4 REPRESENTATION OF DEBTOR BY COUNSEL 5
3-2.5 CASES COMMENCED BY RECEIVER 5
3-2.6 GENERAL CASE REVIEW 6
3-2.7 MONITORING BANK ACCOUNTS 6
3-2.8 REVIEW OF INITIAL PLEADINGS 6
3-2.8.1 Bankruptcy Rule 6003; Relief that Cannot be Granted within 21 Days 7
3-2.8.2 Employment of Professionals 7
3-2.8.3 Employment of Other Professionals 8
3-2.8.4 Limitation on Executive Compensation 9
3-2.8.5 Cash Collateral Use and Financing Orders 13
3-2.8.6 Early Payments to Pre-Petition Creditors 22
3-2.8.7 Requests for Approval of Responsible Persons 27
3-2.8.8 Joint Administration and Substantive Consolidation 29
3-2.8.9 Small Business Chapter 11 Cases 29

CHAPTER 3-3: INITIAL DEBTOR INTERVIEWS, OPERATING GUIDELINES, AND MONTHLY OPERATING REPORTS 30

3-3.1 INITIAL DEBTOR INTERVIEWS (IDIs) 30
3-3.1.1 Procedure for Setting Up the IDI 30
3-3.1.2 United States Trustee's Initial Assessment of the Case 31

3-3.1.3 FAMILIARIZING THE DEBTOR WITH ITS NEW FIDUCIARY OBLIGATIONS 32
3-3.2 OPERATING GUIDELINES 33
3-3.2.1 GENERAL PROVISIONS 33
3-3.2.2 BANK ACCOUNTS 33
3-3.2.3 INSURANCE 34
3-3.3 FINANCIAL REPORTS 34
3-3.3.1 SMALL BUSINESS CASES 35
3-3.3.2 OTHER CASES 35
3-3.3.3 CASH RECEIPTS AND DISBURSEMENTS STATEMENT 35
3-3.3.4 STATEMENT OF OPERATIONS 36
3-3.3.5 BALANCE SHEET 36
3-3.3.6 SCHEDULE OF POST-PETITION LIABILITIES 36
3-3.3.7 POST-PETITION TAXES PAYABLE (TAX RECONCILIATION) STATEMENT 37
3-3.3.8 ADDITIONAL REPORTING REQUIREMENTS 37

CHAPTER 3-4: COMMITTEES 37

3-4.1 STATUTORY BASIS: 11 U.S.C. § 1102 AND 1103 37
3-4.2 THE SOLICITATION OF, AND NOTICE TO, CREDITORS 38
3-4.2.1 THE SOLICITATION PACKAGE 38
3-4.2.2 TIMING 40
3-4.3 SIZE AND COMPOSITION OF THE COMMITTEE 40
3-4.3.1 SIZE 40
3-4.3.2 COMPOSITION 40
3-4.4 MEMBERSHIP ISSUES 42
3-4.4.1 UNIONS 42
3-4.4.2 LANDLORDS 43
3-4.4.3 SECURED CREDITORS 43
3-4.4.4 COMPETITORS 44
3-4.4.5 PROFESSIONALS FORMERLY EMPLOYED BY THE DEBTOR 44
3-4.4.6 GOVERNMENTAL UNITS 44
3-4.4.7 INSIDERS 45
3-4.4.8 CONTINGENT, UNLIQUIDATED, OR DISPUTED CLAIMS 45
3-4.4.9 INDENTURE TRUSTEES 46
3-4.4.10 EQUITY SECURITY HOLDERS 47
3-4.4.11 PRIORITY RECLAMATION CLAIMS UNDER SECTION 503(B)(9) 47
3-4.4.12 CRITICAL VENDORS 47
3-4.5 CONDUCTING A FORMATION MEETING 47
3-4.5.1 TIMING 47
3-4.5.2 CONDUCTING THE FORMATION MEETING 48
3-4.5.3 PROXIES 49
3-4.5.4 CONCLUSION OF THE FORMATION MEETING 50
3-4.6 NOTICE OF THE COMMITTEE APPOINTMENT 51
3-4.7 INITIAL COMMITTEE MEETING AND COMMITTEE DUTIES, POWER, AND RESTRICTIONS 51

3-4.7.1 ORGANIZATION 51
3-4.7.2 POWERS AND DUTIES 51
3-4.7.3 RESTRICTIONS ON TRADING 52
3-4.8 CERTIFICATIONS OF CLAIMS HELD 53
3-4.9 PRE-PETITION COMMITTEES 54
3-4.10 ATTEMPTS TO PRE-EMPT THE SELECTION PROCESS 55
3-4.11 SMALL BUSINESSES - REQUESTS NOT TO FORM A CREDITORS'COMMITTEE 55
3-4.12 INVOLUNTARY CASES 55
3-4.13 NUMBER OF COMMITTEES 55
3-4.14 EQUITY SECURITY HOLDERS' COMMITTEE 58
3-4.15 MODIFICATION OF COMMITTEE MEMBERSHIP 59
3-4.15.1 CONSIDERATIONS 59
3-4.15.2 SUBSTITUTIONS 61
3-4.15.3 REMOVAL OF MEMBERS 61
3-4.16 RULE 2019: AD HOC COMMITTEE AND OTHER CREDITOR GROUP DISCLOSURES 61
3-4.16.1 BACKGROUND AND SUMMARY OF CHANGES 61
3-4.16.2 WHO IS COVERED 62
3-4.16.3 WHAT MUST BE DISCLOSED 63
3-4.16.4 TIMING OF DISCLOSURE 64
3-4.16.5 REMEDIES AND CONSEQUENCES OF NON-DISCLOSURE 64

CHAPTER 3-5: MEETINGS OF CREDITORS 64

3-5.1 INTRODUCTION 64
3-5.2 SCHEDULING 65
3-5.3 NOTICE 65
3-5.4 SCOPE OF EXAMINATION 65
3-5.5 CONDUCTING THE MEETING 66
3-5.6 QUESTIONING THE DEBTOR 67
3-5.7 ATTENDANCE BY CREDITORS, THE MEDIA, AND THE PUBLIC 69
3-5.8 IMMUNITY, SELF-INCRIMINATION, AND REFUSAL TO ANSWER QUESTIONS 69
3-5.9 PROOFS OF CLAIM 70
3-5.10 CONTINUANCES AND ADJOURNMENTS 70
3-5.11 SPECIAL MEETINGS 71
3-5.12 CONDUCT OF SECTION 341 MEETINGS FOR HEARING-IMPAIRED DEBTORS 71
3-5.13 FOREIGN LANGUAGE INTERPRETERS 72
3-5.14 SECURITY AT MEETINGS OF CREDITORS 72
3-5.14.1 GENERAL 72
3-5.14.2 ACQUIRING MEETING ROOMS AND/OR SECURITY ON A ONE-TIME BASIS 72

CHAPTER 3-6: APPOINTMENT OF CHAPTER 11 TRUSTEES AND EXAMINERS 73

3-6.1 GROUNDS FOR APPOINTMENT 73
3-6.1.1 STATUTORY BASIS: 11 U.S.C. § 1104 73
3-6.1.2 SECTION 1104(E) CONSIDERATIONS 73
3-6.2 CHOICE OF REMEDY – TRUSTEE OR EXAMINER 74
3-6.3 THE SELECTION PROCESS 76
3-6.3.1 TIMING 77
3-6.3.2 DUTY TO CONSULT 77
3-6.3.3 THE CONSULTATION PROCESS 78
3-6.3.4 CONSIDERATION OF ADDITIONAL CANDIDATES AND CONSULTATION WITH OTHER UNITED STATES TRUSTEES 78
3-6.3.5 ELIGIBILITY AND DISINTERESTEDNESS 79
3-6.3.6 THE SELECTION 79
3-6.4 THE NOTICE OF AND APPLICATION TO APPROVE APPOINTMENT 80
3-6.4.1 NOTICE OF APPOINTMENT 80
3-6.4.2 APPLICATION TO APPROVE APPOINTMENT 80
3-6.4.3 SECURITY CLEARANCE 81
3-6.4.4 ACCEPTANCE OF APPOINTMENT AND POSTING OF BOND 81
3-6.5 TERMINATION OF A TRUSTEE'S APPOINTMENT 82
3-6.6 REMOVAL OF A TRUSTEE OR EXAMINER 83
3-6.7 ELECTION OF A TRUSTEE 84
3-6.7.1 REQUESTS FOR ELECTION 84
3-6.7.2 ELECTION PROCEDURES 86
3-6.7.3 ELIGIBLE VOTERS 87
3-6.7.4 DETERMINING ELECTION RESULTS 88
3-6.7.5 SOLICITATION OF PROXIES 88
3-6.7.6 QUALIFICATIONS OF AN ELECTED TRUSTEE 91

CHAPTER 3-7: EMPLOYMENT OF PROFESSIONALS 91

3-7.1 STATUTORY FRAMEWORK: 11 U.S.C. § 327 AND FED. R. BANKR. P. 2014 91
3-7.1.1 RETENTION OF CRISIS MANAGERS UNDER 11 U.S.C. § 363 94
3-7.1.2 11 U.S.C. § 329 AND FED. R. BANKR. P. 2016(B) AND 2017 95
3-7.1.3 DEFINITION OF PROFESSIONAL PERSON 95
3-7.1.4 AUCTIONEERS AND APPRAISERS 96
3-7.1.5 11 U.S.C. § 327(E) 96
3-7.2 THE DISINTERESTED PERSON REQUIREMENT FOR EMPLOYMENT OF PROFESSIONALS AND APPOINTMENT OF TRUSTEES AND EXAMINERS 97
3-7.2.1 STATUTORY FRAMEWORK: 11 U.S.C. § 101(14) AND 327(A) 97
3-7.2.2 U.S.C. § 101(14) (A)-(B) 97
3-7.2.3 OVERLAP OF 11 U.S.C. § 101(14) (C) AND 11 U.S.C. § 327(A) 98
3-7.3 SPECIAL PROBLEMS IN RELATED CASES 102
3-7.3.1 APPOINTMENT OF A TRUSTEE 102
3-7.3.2 RETENTION OF PROFESSIONALS 103

CHAPTER 3-8: COMPENSATION OF PROFESSIONALS 104

3-8.1 DETERMINATION OF REASONABLE COMPENSATION, 11 U.S.C. § 330 AND FED. R. BANKR. P. 2016(A) 104
3-8.1.1 FEE GUIDELINES 107
3-8.1.2 FEE GUIDELINES FOR ATTORNEYS IN LARGER CHAPTER 11 CASES 108
3-8.2 RETAINERS 109
3-8.2.1 SUCCESS FEE 112
3-8.2.2 FEE ENHANCEMENT 113
3-8.3 INTERIM COMPENSATION, 11 U.S.C. § 331 115
3-8.4 RESPONSIBILITY OF PARTIES TO CONTROL COSTS 116
3-8.5 FEE PROCEDURE ORDERS 117
3-8.6 TRUSTEE COMPENSATION 118

CHAPTER 3-9: QUARTERLY FEES 119

3-9.1 INTRODUCTION 119
3-9.2 INFORMING PARTIES OF THE FEE REQUIREMENT 119
3-9.3 FEE AMOUNT AND DUE DATE 120
3-9.3.1 CALCULATION OF THE FEE 120
3-9.4 FEE DUE DATES AND PERIODS COVERED 121
3-9.5 FEES IN JOINTLY ADMINISTERED 121
3-9.6 BILLING AND COLLECTION PROCEDURES 122
3-9.6.1 BILL GENERATION PROCESS 122
3-9.6.2 FEE PAYMENTS AND REFUNDS 122
3-9.6.3 PAYMENT ADEQUACY REVIEW 123
3-9.6.4 DELINQUENT PAYMENT REVIEW AND COLLECTION EFFORTS 124
3-9.6.5 ENCOURAGING VOLUNTARY COMPLIANCE 125
3-9.6.6 LEGAL ACTION 125
3-9.7 WRITE-OFF AND REFERRAL PROCEDURES 127
3-9.7.1 CONFIRMED CHAPTER 11 CASES 127
3-9.7.2 DISMISSED CHAPTER 11 CASES 128
3-9.7.3 CONVERTED CHAPTER 11 CASES 128
3-9.7.4 STANDARDS 128
3-9.7.5 DEBT COLLECTION BY THE TREASURY DEPARTMENT 129
3-9.7.6 DOCUMENTATION 129

CHAPTER 3-10: MONITORING THE CASE 129

3-10.1 CASE ADMINISTRATION 129
3-10.2 STANDING 129
3-10.3 OBTAINING EVIDENCE 130

3-10.3.1 SECTION 341(A) MEETING 130
3-10.3.2 FED. R. BANKR. P. 2004 EXAMINATION 130
3-10.3.3 OTHER DISCOVERY DEVICES AND ORDERS TO COMPEL ATTENDANCE FOR EXAMINATION 131
3-10.4 PROBLEMS AND RESPONSES 131
3-10.4.2 FAILURE TO ATTEND SECTION 341(A) MEETING 132
3-10.4.3 FAILURE TO DESIGNATE CORPORATE OFFICIAL 132
3-10.4.4 FAILURE TO FILE OPERATING REPORTS 132
3-10.4.5 FAILURE TO MAINTAIN INSURANCE OR PAY ADMINISTRATIVE TAXES 133
3-10.4.6 FAILURE TO FILE REORGANIZATION PLAN AND/OR DISCLOSURE STATEMENT 133
3-10.4.7 FAILURE TO GIVE PROPER NOTICE OF SETTLEMENT AGREEMENT, DISPOSITION OF PROPERTY, OR CASH COLLATERAL/ADEQUATE PROTECTION AGREEMENT 134
3-10.4.8 FAILURE TO DEPOSIT OR INVEST FUNDS AS REQUIRED BY 11 U.S.C. § 345 134
3-10.4.9 CONTINUING LOSSES OR OTHER DIMINUTION OF THE ESTATE 135
3-10.4.10 IMPROPER POST-PETITION TRANSFERS 135
3-10.4.11 FAILURE TO COMPLY WITH COURT ORDER 136
3-10.4.12 UNAUTHORIZED POST-PETITION PAYMENTS TO PROFESSIONALS 136
3-10.4.13 ONGOING INSOLVENCY PROCEEDINGS IN ANOTHER FORUM 136
3-10.4.14 SALE OF SUBSTANTIALLY ALL OF A DEBTOR'S ASSETS 137
3-10.4.15 FAILURE TO PAY QUARTERLY FEES AND POST-CONFIRMATION PERFORMANCE 139
3-10.4.16 ENVIRONMENTAL PROBLEMS 140
3-10.5 CHOICE OF REMEDY – DISMISSAL OR CONVERSION 141
3-10.5.1 STATUTORY BASIS: 11 U.S.C. § 1112 141
3-10.5.3 CONVERSION 142

CHAPTER 3-11: REVIEW OF DISCLOSURE STATEMENTS AND PLANS 144

3-11.1 INTRODUCTION 144
3-11.2 THE CONCEPTUAL FRAMEWORK 146
3-11.2.1 ITEMS TO INCLUDE 146
3-11.2.2 "SAFE HARBOR," 11 U.S.C. § 1125(E) 146
3-11.2.3 FACTORS AFFECTING ADEQUACY OF DISCLOSURE 146
3-11.3 CONDUCTING THE REVIEW 147
3-11.3.1 STANDARD LANGUAGE 147
3-11.3.2 DESCRIPTION OF THE DEBTOR'S BUSINESS 147
3-11.3.3 REASONS FOR FINANCIAL DIFFICULTIES AND CORRECTION OF THOSE FACTORS 148
3-11.3.4 HISTORICAL AND CURRENT FINANCIAL INFORMATION 148
3-11.3.5 MATERIAL POST-PETITION EVENTS 149
3-11.3.6 OUTLINE OF THE PLAN 149
3-11.3.7 MEANS OF EFFECTUATING THE PLAN 150
3-11.3.8 SECURITIES TO BE ISSUED 151
3-11.3.9 PROJECTIONS 152
3-11.3.10 MANAGEMENT, 11 U.S.C. § 1129(A)(5) 153
3-11.3.11 CONTROLLING PERSONS 153
3-11.3.12 INSIDER CLAIMS 154

3-11.3.13 Transactions with Insiders 154
3-11.3.14 Disputed Claims 154
3-11.3.15 Legal Proceedings 155
3-11.3.16 Tax Consequences 155
3-11.3.17 Trustee or Examiner 155
3-11.3.18 Creditors' Committees and Equity Security Holders' Committees 156
3-11.3.19 Information Regarding Plan Proponent 156
3-11.3.20 Liquidation Analysis 156
3-11.3.21 Vote Required for Acceptance 157
3-11.3.22 Cram Down 158
3-11.3.23 Miscellaneous Matters 159
3-11.3.24 Summary and Table of Contents 159
3-11.3.25 Notice 159
3-11.4 PLAN MODIFICATION 159
3-11.5 REVIEW OF PLAN AND CONFIRMATION 160
3-11.6 POST-CONFIRMATION MONITORING 161
3-11.7 CASE CLOSURE UNDER SECTION 350(a) AND RULE 3022 162

CHAPTER 3-12: CHAPTER 11 CASES FILED BY INDIVIDUALS 163

3-12.1 SPECIAL CONSIDERATIONS FOR CASES FILED BY INDIVIDUALS 163
3-12.1.1 Property of the Estate Includes After-Acquired Wages and Property 163
3-12.1.2 Funding a Plan with Post-Petition Earnings 163
3-12.1.3 Plan Confirmation Requires Debtor to Pay All Post-Petition Domestic Support Obligations in Full 163
3-12.1.4 Debtors Must Meet Disposable Income Test if Unsecured Creditor Objects to Confirmation ... 164
3-12.1.5 Modification of Cram Down Standards for Individual Chapter Debtors 166
3-12.1.6 An Individual Chapter 11 Debtor Does Not Receive a Discharge until after All Plan Payments Have Been Completed 167
3-12.1.7 The Plan Can Be Modified Post-Confirmation 167
3-12.1.8 Individual Debtor Can Be a Small Business Debtor at the Same Time 167
3-12.2 PRE-CONFIRMATION MONITORING OF CHAPTER 11 CASE FILED BY AN INDIVIDUAL 167
3-12.3 CLOSURE OF CHAPTER 11 CASE FILED BY AN INDIVIDUAL 169

CHAPTER 3-13: PRE-PETITION ACCEPTANCE OR REJECTION OF THE PLAN 172

3-13.1 STATUTORY FRAMEWORK: 11 U.S.C. § 1126(b) AND BANKR. RULE 3018(b) 172
3-13.2: SECTION 341 MEETINGS IN PRE-PACKAGED CHAPTER 11 CASES 174
3-13.3 CREDITORS' COMMITTEES IN PRE-PACKAGED CHAPTER 11 CASES 176
3-13.4 POST-PETITION DISCLOSURE AND SOLICITATION 176

CHAPTER 3-14: SMALL BUSINESS CHAPTER 11 CASES 177

3-14.1 STATUTORY FRAMEWORK 177
3-14.2 DEFINITION OF A SMALL BUSINESS 178
3-14.3 SMALL BUSINESS DEBTOR DESIGNATION 179
3-14.4 CREDITORS' COMMITTEE FORMATION 179
3-14.5 INITIAL FILING REQUIREMENTS AND DEBTOR REQUIREMENTS 179
3-14.6 EXCLUSIVITY PERIODS, AND THE PLAN AND DISCLOSURE STATEMENT 180

CHAPTER 3-15: INVOLUNTARY CHAPTER 11 CASE ADMINISTRATION 182

3-15.1 INTRODUCTION 182
3-15.2 STATUTORY AND BANKRUPTCY RULE PROVISIONS 183
3-15.3 APPOINTMENT OF TRUSTEE PRIOR TO ENTRY OF ORDER FOR RELIEF 184
3-15.4 PROFESSIONAL FEES DURING THE GAP PERIOD 184
3-15.5 DISMISSAL 185

CHAPTER 3-16: RAILROAD REORGANIZATIONS 185

3-16.1 INTRODUCTION 185
3-16.2 APPOINTMENT OF A TRUSTEE 186
3-16.3 OPERATIONS DURING THE GAP PERIOD 187
3-16.4 OTHER PROVISIONS APPLICABLE ONLY TO RAILROAD REORGANIZATIONS 187

CHAPTER 3-17: SUBCHAPTER V CHAPTER 11 CASES 188

3-17.1 INTRODUCTION 188
3-17.1.1 STATUTORY FRAMEWORK 188
3-17.1.2 ROLE OF THE UNITED STATES TRUSTEE IN GENERAL 189
3-17.2 SUBCHAPTER V ELECTION BY THE DEBTOR 189
3-17.3 ROLE OF THE SUBCHAPTER V TRUSTEE 190
3-17.4 CREDITORS' COMMITTEE ONLY ON ORDER OF COURT 192
3-17.5 SUBCHAPTER V DEBTOR'S DUTIES 192
3-17.6 UNITED STATES TRUSTEE'S OVERSIGHT OF SUBCHAPTER V CASES 193
3-17.7 SUBCHAPTER V EXCLUSIVITY PERIODS AND DISCLOSURE REQUIREMENTS 195
3-17.8 SUBCHAPTER V PLAN REQUIREMENTS 196
3-17.9 SUBCHAPTER V PLAN CONFIRMATION 196
3-17.9.1 CONSENSUAL PLANS 197
3-17.9.2 NON-CONSENSUAL PLANS 197
3-17.10 SUBCHAPTER V POST-CONFIRMATION 199

3-17.10.1 Final Decree and Case Closing 200
3-17.11 MODIFICATION OF SUBCHAPTER V PLANS 200
3-17.11.1 Modification before Confirmation 200
3-17.11.2 Modification after Confirmation 201
3-17.11.3 Reappointing a Subchapter V Trustee Post-confirmation 201
3-17.12 TRANSACTIONS WITH PROFESSIONALS IN SUBCHAPTER V CASES 201
3-17.13 SUBCHAPTER V TRUSTEE QUALIFICATIONS FOR APPOINTMENT 202
3-17.13.1 Qualifications and Acceptance 202
3-17.13.2 A Trustee Must Not Have Conflicts of Interest 202
3-17.13.3 Background Investigation 203
3-17.14 SUBCHAPTER V TRUSTEE RECRUITMENT 203
3-17.15 TRUSTEE COMPENSATION AND BENEFITS 204
3-17.15.1 Effect of Disposition of the Case 204
3-17.15.2 Case-by-Case Trustee Compensation 205
3-17.15.3 Standing Trustee Compensation 205
3-17.16 SUPERVISION OF SUBCHAPTER V TRUSTEES 206
3-17.16.1 Banking 207
3-17.16.2 Bonding 209
3-17.16.3 Reporting 210
3-17.16.4 [Reserved] 211
3-17.16.5 Audits, Periodic Reviews, and Evaluations 211
3-17.16.6 Enforcement Actions Against Subchapter V Trustees 213

VOLUME 3: CHAPTER 11 CASE ADMINISTRATION

CHAPTER 3.1.0: KEY TERMS

"BAPCPA" means the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

"Department" means Department of Justice, unless otherwise indicated.

"EOUST" means Executive Office for U.S. Trustees in Washington, D.C.

"IDI" means initial debtor interview.

"KERP" means key employee retention program.

"PBGC" means Pension Benefit Guaranty Corporation.

"Program" means U.S. Trustee Program.

"SEC" means Securities and Exchange Commission.

"USTP" means U.S. Trustee Program.

CHAPTER 3-1: GENERAL POLICY CONSIDERATIONS

The United States Trustee is charged with responsibility for supervising the administration of chapter 11 cases. Chapter 11 cases present a wide array of issues and challenges, and the statutes accord the United States Trustee broad discretionary authority to act in these cases. Responsible and efficient use of the U.S. Trustee Program (USTP or Program) resources requires that priorities be established and maintained. The following basic principles can serve to guide Program employees in the reasoned exercise of their discretion in chapter 11 cases.

One of the most important functions of the United States Trustee in a chapter 11 case is to ensure the integrity of the chapter 11 process. This can be accomplished by both monitoring and, when warranted, commenting on the actions of parties to the case, as well as by ensuring that the bankruptcy system itself functions effectively and efficiently. The integrity of the process depends on the involvement of all parties with an interest in the case. The United States Trustee should strive to facilitate creditor involvement. A creditors' committee must be formed promptly, if possible.

During the initial stages of a case, the United States Trustee should focus on certain principal administrative responsibilities. The debtor and its counsel should be contacted and provided with guidance and instruction regarding their statutory responsibilities and fiduciary obligations. The first meeting of

creditors must be scheduled within the time limits established by the Federal Rules of Bankruptcy Procedure.

The United States Trustee may, at his or her discretion, limit his or her involvement in those chapter 11 cases with significant creditor interest and activity. In many instances, the presence of competing interests will serve to ensure that significant issues in a case are raised and resolved by the parties themselves, and will assist in moving the case forward without significant involvement by the United States Trustee. The United States Trustee should not seek to substitute his or her business judgment for that of creditors or other parties in interest. For example, creditors vote on plans of reorganization. They have the right to make their determinations as to what constitutes an acceptable return under the terms of the plan.

Regardless of the level of creditor activity, however, the United States Trustee has a statutorily defined role in chapter 11 cases. When the United States Trustee deems it appropriate, he or she shall monitor applications for compensation and reimbursement, plans and disclosure statements, and applications for the retention of professionals. See 28 U.S.C. § 586(a)(3)(A), (B), and (H). The United States Trustee should take the necessary steps to ensure that the office receives copies of all significant pleadings and orders in order to meet its statutory duties.

Chapter 11 cases often present circumstances requiring the United States Trustee to take a more active role. For example, creditor involvement may be limited or non-existent. Issues involving the fundamental integrity of the bankruptcy system, such as conflicts of interest or allegations of criminal misconduct, must be addressed quickly and thoroughly by the United States Trustee. Issues of national significance or designated as priorities for the United States Trustee Program must be addressed. The United States Trustee should exercise good judgment and appropriate discretion in the optimum allocation of resources to meet these needs.

Decisions regarding the degree of involvement necessary in a particular chapter 11 case ultimately are committed to the sound discretion of the Program's managers and professionals. The exercise of that discretion should be guided by the principles enunciated in this manual, as well as by consideration of available resources and priorities in other areas.

CHAPTER 3-2: VOLUNTARY CASE ADMINISTRATION

3-2.1 FILING REQUIREMENTS

To commence a voluntary chapter 11 case, the debtor must file a bankruptcy petition, as well as items set forth in Fed. R. Bankr. P. 1007, which items include a list of creditors and, if the debtor is a corporation, a corporate ownership statement. Schedules and statement of financial affairs, as well as a list of any equity security holders, must be filed within 14 days of filing the petition. In an

individual chapter 11 case, the debtor must also file a statement of current monthly income (Fed. R. Bankr. P. 1007(b)(5)) within 14 days of filing the petition. The official forms prescribe the content of many of these documents. Local bankruptcy court rules or procedures may require additional information or otherwise change the official requirements. The United States Trustee should ensure that the required documents are filed in a timely manner.

3-2.2 CASE FILING NOTIFICATION AND DOCUMENT RECEIPT

The clerk of the court shall transmit a copy of the bankruptcy petition to the United States Trustee. Fed. R. Bankr. P. 1002(b). The clerk also shall transmit copies of lists, schedules, and statements to the United States Trustee, Fed. R. Bankr. P. 1007(l), as well as amendments. Fed. R. Bankr. P. 1009(d). The United States Trustee should establish a procedure with the clerk to ensure that copies of these documents are transmitted promptly.

3-2.3 INITIAL REVIEW

3-2.3.1 Signature Requirements

The United States Trustee should review the petition and related documents to ensure that they have been signed. In districts with electronic case filing, the United States Trustee should review the court docket to ensure that the debtor has filed a declaration regarding electronic filing. Ensuring that all documents are signed is important in the event of a subsequent perjury investigation

3-2.3.2 Authorization for Filing

State law is pertinent to the issue of the appropriate authority for filing bankruptcy. The Supreme Court has held in the corporate context that applicable nonbankruptcy law determines whether authority exists for a particular debtor to commence a bankruptcy case. *See* Price v. Gurney, 324 U.S. 100 (1945). Courts have followed this rule in the partnership context as well. *See e.g., Jolly v. Pittore*, 170 B.R. 793 (S.D.N.Y. 1994); *In re Century/ML Cable Venture*, 294 B.R. 9 (Bankr. S.D.N.Y. 2003). The law of some states may require the consent of all general partners for a voluntary partnership bankruptcy filing. In these states, if fewer than all of the partners consent, the filing is an involuntary petition against the partnership. 11 U.S.C. § 303(b)(3)(A).

State law often requires a board of directors' resolution as authorization for a corporate bankruptcy case, and, in these cases, the United States Trustee should ensure that a resolution has been adopted. If an appropriate resolution has not been passed, the United States Trustee should file a motion to dismiss the case. Case law supports dismissal under these circumstances. *In re Moni-Stat, Inc.*, 84 B.R. 756, 757 (Bankr. D. Kan. 1988); *In re Farner, Boring & Tunneling, Inc.*, 26

B.R. 29 (Bankr. E.D. Tenn. 1982); *In re Autumn Press, Inc.*, 20 B.R. 60 (Bankr. D. Mass. 1982).

Challenges to proper authorization should be made promptly. Local bankruptcy rules in some jurisdictions establish short deadlines for filing such challenges.

3-2.3.3 Debtor Eligibility

The United States Trustee should ensure that each chapter 11 debtor satisfies the eligibility requirements for filing a case as set forth in 11 U.S.C. § 109. This includes ensuring in an individual chapter 11 case that such individual has, during the 180-day period preceding the date of the filing of the petition, received credit counseling from an approved agency. See 11 U.S.C. § 109(h)(1).

Certain entities are not eligible for relief. Stockbrokers and commodity brokers specifically are precluded from filing a chapter 11 petition. 11 U.S.C. § 109(d). Certain foreign, federal, or state regulated businesses, including insurance companies, banks, savings banks, cooperative banks, savings and loan associations, and credit unions, also are not eligible for chapter 11 relief. 11 U.S.C. § 109(b) and (d). Railroads, however, expressly are authorized to file for chapter 11 relief. 11 U.S.C. § 109(d). Certain provisions of chapter 11 apply only to railroads. 11 U.S.C. § 103(g); 11 U.S.C. § 1161. *See* Manual 3-16.

Trusts present special eligibility questions. With one exception, a trust is not eligible for relief under title 11. *In re Medallion Realty Trust*, 103 B.R. 8, 10 (Bankr. D. Mass. 1989), *aff'd*, 120 B.R. 245 (D. Mass. 1990). A business trust is included within the definition of a corporation set forth in section 101(9)(A)(v), and it therefore is eligible for relief. *See generally*, *In re Secured Equip. Trust of Eastern Airlines*, 38 F.3d 86 (2d Cir. 1994); *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009). A variety of tests have been applied to determine whether an entity is a business trust. *See discussion in General Growth*, 409 B.R. at 70-72. In general, a business trust is one "created for the purpose of carrying on some kind of business, whereas the purpose of a non-business trust is to protect and preserve the trust res." *In re Secured Equip.*, 38 F.3d at 89. It is not necessary for debtors to engage in business to qualify for relief. *Toibb v. Radloff*, 501 U.S. 157 (1991).

The United States Trustee should review cases to ensure that all joint petitions are properly filed. A joint petition is filed appropriately only by an individual that

may be a debtor and that individual's spouse.[1] 11 U.S.C. § 302(a). Cases naming an individual and a corporation as debtors, cases naming two or more corporations as debtors, cases naming a partnership and one or more individuals as debtors, or cases naming two or more unmarried individuals, as defined by state law, as debtors are not authorized. The United States Trustee should promptly move to dismiss these cases.

3-2.4 REPRESENTATION OF DEBTOR BY COUNSEL

A corporate debtor involved in proceedings before a court must be represented by licensed counsel and may not appear *pro se.* *See Osborn v. Bank of U.S.*, 22 U.S. 738 (1824). This rule applies to bankruptcy cases. *See* Fed. R. Bankr. P. 9010; *In re Dick Tracy Ins. Agency, Inc.*, 204 B.R. 38, 39 (Bankr. W.D. Mo. 1997). The United States Trustee should promptly move to dismiss cases involving a corporate debtor appearing *pro se.* *But see In re IFC Credit Corp.*, 420 B.R. 471 (Bankr. N.D. Ill. 2009), *appeal dism'd*, 2010 WL 1337142 (N.D. Ill., Mar. 31, 2010) (where the court found that an amended petition filed the next day and signed by an attorney was valid). Challenges to proper authorization should be made promptly. Local bankruptcy rules in some jurisdictions establish short deadlines for filing such challenges.

3-2.5 CASES COMMENCED BY RECEIVER

A custodian, such as a state court receiver, may file a voluntary bankruptcy case if applicable nonbankruptcy law, including his or her order of appointment, authorizes the receiver to do so and the filing is not prohibited by bankruptcy law. *See In re Milestone Educ. Inst., Inc.*, 167 B.R. 716, 720-21, 724 (Bankr. D. Mass. 1994) (suspending bankruptcy proceedings to permit appeal to state court regarding receiver's authority under state law to file bankruptcy); *In re Monterey Equities-Hillside*, 73 B.R. 749 (Bankr. N.D. Cal. 1987) (state law authorized partnership bankruptcy filing, but filing prohibited by Fed. R. Bankr. P. 1004(a) because general partner did not consent). Cases commenced by receivers trigger certain rights and responsibilities including the turnover of property, filing of an accounting, and the potential right to payment of reasonable compensation as set forth under 11 U.S.C. § 543. In administering cases commenced by a receiver, the United States Trustee may encounter motions to excuse compliance with certain turnover requirements of Section 543. Even if a court grants a motion to

---

[1]The USTP interprets the terms "spouse," "marriage," and "husband and wife" in the Bankruptcy Code and Bankruptcy Rules to include same-sex married couples. The USTP also interprets these terms to refer to individuals who are lawfully married under any state law, including individuals married to a person of the same sex who were legally married in a state that recognizes such marriages, but who are domiciled in a state that does not recognize such marriages. Thus, the USTP will apply the relevant Bankruptcy Code and Bankruptcy Rule provisions to same-sex spouses just as it would apply them to opposite-sex spouses.

excuse the turnover requirements, a receiver may not exercise the rights of a trustee or debtor-in-possession. The court is not permitted to appoint a receiver to control the estate. See 11 U.S.C. § 105(b). Instead, United States Trustees should consider whether a motion to convert, dismiss or appoint a chapter 11 trustee may be proper when the court has excused turnover.

3-2.6 GENERAL CASE REVIEW

As soon as case documents are received, the United States Trustee should review the documents to become generally familiar with the debtor and its business, as well as to identify any problems requiring immediate attention. The schedules and statement of financial affairs should be reviewed to determine the nature of the debtor's business and the extent of its assets and liabilities. The United States Trustee should determine whether the debtor controls or owns at least 20 percent interest of any entity, and, if so, a periodic report as required by Fed. R. Bankr. P. 2015.3 must be filed. The first periodic report must be filed no later than seven days before the first date set for the meeting of creditors under 11 U.S.C. § 341. Potential problems relating to insiders, such as loans or related entity control, should be identified. The attorney disclosure statements filed pursuant to Fed. R. Bankr. P. 2014 and 2016 should be reviewed and any apparent or potential problems regarding disinterestedness, conflicts of interest, or the terms of any retainer agreement noted.

3-2.7 MONITORING BANK ACCOUNTS

United States Trustees should establish procedures to ensure that all trustees and debtors comply with all requirements of 11 U.S.C. § 345 to safeguard estate funds from loss. *See* Manual Volume 7.

3-2.8 REVIEW OF INITIAL PLEADINGS

The chapter 11 debtor frequently files a variety of pleadings either with the petition or shortly after the case is commenced. These pleadings often request an expedited hearing, affording interested parties little notice or opportunity for review. Such a request may be appropriate and interim relief for a limited period may be necessary in order to guarantee the debtor's uninterrupted operations. The United States Trustee should seek to ensure that parties in interest are provided the best notice possible in these circumstances and are not precluded from raising and litigating these issues at a later date. The United States Trustee should be familiar with local rules, administrative orders and specific procedures for the filing, noticing, and hearing of initial requests for relief. Often these procedures embody specific guidance on the content and handling of such motions.

Initial requests typically include applications to employ attorneys, accountants, and other professionals, applications regarding payments to officers and

employees, applications for cash collateral, applications for financing, and applications to allow payments to pre-petition creditors. Administrative requests typically include applications to jointly administer or procedurally consolidate two or more cases and applications to continue cash management systems.

3-2.8.1 Bankruptcy Rule 6003; Relief that Cannot be Granted within 21 Days

Bankruptcy Rule 6003 provides that three enumerated types of relief cannot be granted within 21 days after the filing of the petition, except to the extent that relief is necessary to avoid immediate and irreparable harm. This rule was designed to prevent creditors from being prejudiced to creditors by actions taken in the first days of a case, before a creditors' committee has been formed and before important parties in interest are informed about the filing of the case and have had time to react to it. As a result, the United States Trustee should object when relief is sought contrary to Rule 6003.

The three types of relief that are not to be granted within 21 days of the filing of the petition are:

1. retention of professionals;

2. the use, sale, lease or incurrence of an obligation of property of the estate, including payment of part or all of a pre-petition claim; and,

3. the assumption or assignment of an executory contract or unexpired lease.

The rule does not prevent rejection of executory contracts or unexpired leases. The rule provides no guidance as to whether such motions should be granted once the 21 days has expired. Other principles of bankruptcy law guide the court in those decisions. Rule 6003 does not prohibit filing first-day motions as to various matters described in the rule; rather, it only prohibits the court from granting the relief until after 21 days has passed.

The Committee Note indicates that the language "except to the extent that relief is necessary to avoid immediate and irreparable harm" was taken from Rules 4001(b)(2) and (c)(3) governing the use of cash collateral and financing orders. Decisions under those rules provide guidance on how a court should interpret this provision. When a claim is made that an emergency requires relief on matters covered by Rule 6003, the United States Trustee should ensure that the relief is necessary and argue for the narrowest form of relief possible during the 21-day period to avoid the harm. For example, relief could be requested on an interim basis, with the final hearing to take place after the 21-day period.

3-2.8.2 Employment of Professionals

Applications to employ professionals, typically attorneys and financial advisors, are often presented for court approval shortly after a case is filed. 11 U.S.C.

§ 1107(a) and 327. As stated above, these applications should not be granted during the first 21 days of the case. Fed. R. Bankr. P. 6003. The employment applications, at a minimum, must specify the name of the professional to be employed; the reason for selection; the services to be performed; the proposed compensation terms; and the professional's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed by the Office of the United States Trustee. Fed. R. Bankr. P. 2014(a). The application must be accompanied by a verified statement of the person to be employed setting forth the connections with the parties listed above. Fed. R. Bankr. P. 2014(a).

The United States Trustee should examine the application and verified statement, as well as the disclosures required by Fed. R. Bankr. P. 2016 and question 9 of the statement of financial affairs, which relates to contact with and payments to attorneys, to determine whether the applicant is precluded from employment by virtue of the Bankruptcy Code or applicable ethical rules. Any concerns should be addressed at the first opportunity.

In appropriate cases, the United States Trustee also may wish to initiate or participate in a fee-budgeting process for professionals. If the court is amenable, appointment orders may be drafted to provide that fees may not exceed a specific amount absent further court order.

See below at Manual 3-7 and 3-8 for further discussion of issues regarding the employment and compensation of professionals.

3-2.8.3 Employment of Other Professionals

Debtors may seek to employ a range of other professionals. Several issues warrant United States Trustee examination.

3-2.8.3.1 Classification as a Professional

There may be an issue as to whether the person to be employed is a professional and thus subject to the employment and compensation requirements of the Bankruptcy Code. If the persons to be employed will be actively involved in case administration, the United States Trustee should assert that they are professionals. *See, e.g.*, *In re North Star Management, LP*, 308 B.R. 906, 911 (8th Cir BAP 2004); *In re Bartley Lindsay Co.*, 120 B.R. 507 (Bankr. D. Minn. 1990), *aff'd*, 137 B.R. 305 (D. Minn. 1991) (management consultant is a professional); *In re Grimes*, 115 B.R. 639 (Bankr. D.S.D. 1990) (farm consultant denied compensation and required to disgorge amounts paid); *In re WFDR, Inc.*, 22 B.R. 266 (Bankr. N.D. Ga. 1982) (management consultant denied compensation when employment not approved). *See also U.S. ex rel. Kraft v. Aetna Cas. and Sur. Co.*, 43 B.R. 119 (M.D. Tenn. 1984) (appraiser); *In re Neidig Corp.*, 117 B.R. 625 (Bankr. D. Colo. 1990) (operator of radio station was a professional person – the operator provided specialized services and acted with

relatively unfettered autonomy and discretion); and *In re Providence Television Ltd. Partnership*, 113 B.R. 446 (Bankr. N.D. Ill. 1990) (media broker). If a business regularly has employed a professional person on salary, that person may be compensated and may be retained or replaced without court approval if the employment is necessary to the operation of the business. *See* 11 U.S.C. § 327(b); *Park Terrace v. Wilds*, 852 F.2d 1019 1022-23 (7th Cir. 1988).

United States Trustees should comply with the *Jay Alix Protocol*, which allows for the retention of a crisis manager under 11 U.S.C. § 363, rather than 327. *See* Manual 3-8.1.1.

3-2.8.3.2 Duties and Compensation

If other professionals are to be employed by the debtor, the United States Trustee should request a specific delineation of duties and, where appropriate, an automatically executing termination date. To ensure no duplication of services, all professionals should be required to keep detailed time records documenting their services. Monthly or total caps on compensation also may be advisable. When the person or firm to be employed is essentially performing the functions of management, the United States Trustee should oppose any compensation package that exceeds those typical in the industry. The United States Trustee should ensure that all professionals are aware of the requirements of the Bankruptcy Code regarding compensation and reimbursement of expenses. See 11 U.S.C. § 330 and 331. *See* Manual 3.8.1 *et seq*.

3-2.8.4 Limitation on Executive Compensation

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (Apr. 20, 2005) (BAPCPA) amended the Bankruptcy Code to add new section 11 U.S.C. § 503(c), which restricts the allowance and payment of administrative expenses to a debtor's officers, managers, and consultants. The addition of section 503(c) to the Code was spurred by public concern that excessive compensation, particularly bonus compensation, was being paid to management of chapter 11 debtors in possession. In drafting the BAPCPA, Congress sought to limit a debtor's use of a particular bonus program known as a "key employee retention program" (KERP) in chapter 11 cases – a plan that paid bonuses to management for remaining in the employ of the debtor.

In contrast to prior practice when KERP and similar programs generally were approved under a relaxed "business judgment" standard, section 503(c) establishes a series of objective restrictions on the persons who may receive the benefit of a KERP or severance benefits, places a cap on the amount of certain payments, and, in the case of retention bonuses, establishes a stringent test that must be satisfied before the debtor can make payments to its insiders. United States Trustees must raise appropriate objections to ensure compliance with these provisions.

Section 503(c) significantly alters pre-BAPCPA management compensation practices. Subsection (c)(1) restricts "transfer[s] made to, or obligation[s] incurred for the benefit of, an insider of the debtor." Subsection (c)(2) addresses "severance payment[s] to an insider of the debtor." Subsection (c)(3) applies to "transfers or obligations [other than those referenced in subsections (c)(1) and (c)(2)] that are outside the ordinary course of business and not justified by the facts and circumstances of the case." In light of these significant alterations to the Bankruptcy Code, the United States Trustee should closely scrutinize any request for approval of bonus, severance or compensation plans, or employment agreements to determine whether such request complies with the new limitations set forth in the Bankruptcy Code.

3-2.8.4.1 Informational Deficiencies

Motions filed by debtors in possession seeking authority to make payments or incur obligations under section 503(c) often may raise more questions than they answer. Occasionally, debtors in possession will file motions seeking approval of executive compensation or severance plans with nothing more than a "broad brush" overview of the plan that omits critical information necessary to evaluate the plan's merits, such as who is covered by the plan, whether the covered persons are "insiders," the performance criteria for receiving a bonus, and the specific amounts proposed to be paid to each employee. The proposed plans may seek to pay amounts to "insiders" which, upon initial review, appear to be excessive. In addition, prior to bankruptcy filings, debtors may make questionable retention payments or incur questionable severance obligations to insiders. The review of these payments or transfers often will require the United States Trustee to engage in formal or informal discovery to elicit sufficient information to properly evaluate the merits of the proposed payments. To evaluate the debtor's proposal, the United States Trustee may elect to request a range of documents, such as spreadsheets detailing performance versus projections on a quarterly basis, board of directors meeting minutes, board compensation committee minutes, historical compensation and salary information and compensation expert reports.

3-2.8.4.2 Transfers to Insiders

Given that sections 503(c)(1) and (2) restrict debtors in possession from making certain payments and incurring certain obligations to "insiders," some debtors in possession may propose a narrow construction of the term "insider" to avoid the limitations set forth in subsections (c)(1) and (2). The term "insider" is defined in 11 U.S.C. § 101(31). If the debtor is a corporation, the term "insider" includes, among other entities, a "director," an "officer," a "person in control" and a "managing agent" of the debtor. The United States Trustee should be generally aware that the term "insider" may include management employees other than "by-law" officers, depending on the facts of a particular case. A person performing the functions of an officer may be found to be an "insider" even though the person was not formally appointed as a corporate officer pursuant to the by-laws. *See*

Official Committee of Unsecured Creditors v. ABC Capital Markets Group (In re Capital Metals Co., Inc.), 228 B.R. 724, 727 (B.A.P. 9th Cir. 1998) (the person who functioned as the Chief Financial Officer was the Chief Financial Officer, even without a corporate resolution to that effect).

In cases that involve pre-petition transfers to insiders, 11 U.S.C. § 548(a)(1)(B)(ii)(IV) was added to clarify that transfers to or for the benefit of insiders under employment contracts outside of the ordinary course of business are avoidable as fraudulent transfers provided that the statutory elements are satisfied.

3-2.8.4.3 Disguised Retention Plans

The United States Trustee must closely scrutinize proposed bonus plans to determine whether such plans have a retentive purpose. Debtors will frequently seek approval of compensation plans that are designated incentive plans but in reality are veiled retention plans. These plans generally take two forms:

1. Debtors in possession may frame events along the time line of a chapter 11 case as benchmarks or payment "triggers" under an "incentive program." *See In re Dana Corp.*, 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) ("Completion Bonus" that was payable upon the debtors' emergence from bankruptcy protection was an impermissible "retention bonus" under section 503(c)(1)); and

2. Debtors in possession may attempt to evade application of the restrictive statutory standard by setting benchmarks or payment "triggers" at a level such that meeting the benchmarks is not an achievement. (Essentially, all that an employee has to do to collect the incentive payment is to be employed at the end of the relevant measuring period.) The case law that has developed under section 503(c)(1) suggests that, for a debtor to avoid running afoul of section 503(c)(1)'s restriction on retention pay, the debtor must demonstrate that its bonus plan is tied to significant hurdles that are difficult to achieve. *See In re Dana Corp*., 358 B.R. 567, 582 (Bankr. S.D.N.Y. 2006) (court found that benchmarks for the debtors' long-term incentive plan "are difficult targets to reach and are clearly no 'lay-ups'"). United States Trustees should carefully review proposed incentive programs to determine whether the benchmarks or payment triggers are true hurdles as opposed to a *fait accompli*.

3-2.8.4.4 Severance Plans

All proposed severance payments made to "insiders" are governed by section 503(c)(2). The United States Trustee must be vigilant in reviewing all severance programs, employment contracts, and first-day wage motions to evaluate whether a request for severance payable to insiders contained in any of the above violates section 503(c)(2). Moreover, United States Trustees should strongly oppose any attempts to circumvent section 503(c)(2) through the inclusion of an improper term in a chapter 11 plan. *See In re AMR Corp.*, 497 B.R. 690, 696-99 (Bankr. S.D.N.Y. 2013) (sustaining objection of United States

Trustee and refusing to approve $19.8 million severance payment to departing chief executive officer based upon a finding that the debtors could not circumvent section 503(c)(2) through a chapter 11 plan).

Compliance with section 503(c)(2) requires that the court find the existence of a severance program generally applicable to all full-time employees, and find that the amount of any payments to the person designated as an "insider" is not greater than 10 times the amount of severance pay given to non-management employees during the calendar year in which the payment is made. Severance payments to "insiders" are limited based upon the mean severance pay given to non-management employees during the calendar year in which the payment is made. The precise amount of the severance benefit is contingent upon the calendar year in which the severance payment is made and the amount of severance pay given to non-management employees during the calendar year in which the payment is made. Accordingly, assuming that the proposed severance payment to an insider is "part of a program that is generally applicable to all full-time employees," the calculation of the benefit must wait until the termination event so the calculation can be completed. The language in the plan or order approving the severance payment should mirror the text of section 503(b)(2)(B).

3-2.8.4.5 Other Compensation outside the Ordinary Course of Business

Section 503(c) serves as an additional restriction on a court's ability to approve certain transfers and obligations as administrative expenses. Section 503(c)(3) applies to compensation and bonus payments made outside the ordinary course of business to which subsections (c)(1) and (2) are not applicable. Section 503(c)(3) states that "notwithstanding subsection (b), there shall neither be allowed nor paid . . . other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition." It should be noted that section 503(c)(3) applies to transfers by way of compensation to all employees of the debtor, whether insiders or not. Section 503(c)(3) is not properly read to apply only to officers, managers, or consultants hired after the filing of the case. It applies only to transfers made or obligations "incurred outside of the ordinary course of business." If, therefore, a debtor had a standing severance plan applicable to all employees, non-insider employee severance payments would not be subject to section 503(c)(3).

If section 503(c)(3) is applicable, the transfer or obligation must be "justified by the facts and circumstances of the case." The evaluation of whether a transfer or obligation is prohibited under section 503(c)(3) involves the making of specific factual findings by the court related to the justification for the proposed plan or agreement. Approval of any such compensation plan requires specific findings by the court that such plan is justified by the facts and circumstances of the case. In making its determination, the court should evaluate the debtor's historical compensation practices, the work performed by the individual, the proposed

metrics under the plan, and compensation practices of other similarly situated companies. The court's determinations should not rest solely on the exercise of the debtor's business judgment, or lack thereof, in making the transfer or incurring the obligation at issue; the appropriate exercise of that judgment may not be sufficient justification for the transfer or obligation. *See GT Advanced Technologies Inc. v. Harrington,* 2015 WL 4459502, at *7 (D.N.H. July 21, 2015) ("§ 503(c)(3) directs courts to give plans such as the KERP in this case more scrutiny than is required by the § 363(b)(1) business judgment test"); *see also In re Pilgrim's Pride Corp.,* 401 B.R. 229, 237 (Bankr.N.D .Tex. 2009) ("Section 503(c)(3) is intended to give the judge a greater role: even if a good business reason can be articulated for a transaction, the court must still determine that the proposed transfer or obligation is justified in the case before it"); *but see In re Global Home Prods., LLC,* 369 B.R. 778, 783 (Bankr. D. Del. 2007) ("If the proposed plans are intended to incentivize management, the analysis utilizes the more liberal business judgment review under § 363").

3-2.8.5 Cash Collateral Use and Financing Orders

Motions addressing the use of cash collateral and other financing issues frequently are heard by the court within the first week after a petition is filed. These motions can have a substantial impact on the interests of unsecured creditors. It is virtually impossible, however, to form a creditors' committee prior to the interim hearings on these motions. The United States Trustee should raise and attempt to preserve issues that will likely be of concern to a committee once it is formed. Specifically, the United States Trustee should:

1. determine whether the transaction properly is characterized as use of cash collateral as opposed to post-petition financing;
2. insist on adequate notice and opportunity for interested parties to be heard;
3. alert the court to substantive issues that should be preserved until interested parties are able to be heard; and
4. where necessary, take substantive positions to prevent overreaching.

To avoid the high standard for paying bonuses to executives during bankruptcy, some debtors have paid significant bonuses to executives shortly before filing bankruptcy. These payments may be avoidable under section 548 of the Bankruptcy Code, which could provide some recovery to general unsecured creditors if the committee is granted derivative standing to pursue claims that only a debtor in possession or trustee may assert but which the debtor in possession is unlikely to assert. But debtors often seek authorization to grant liens over avoidance actions as interim relief before a committee is formed. The United States Trustee should object to this request to preserve the cause of action.

3-2.8.5.1 Cash Collateral Versus Post-Petition Financing

Like the use of cash collateral, post-petition borrowing provides a source of operating funds to a debtor in possession. Post-petition financing, however, involves the infusion of new money into the estate, while cash collateral is defined in the Bankruptcy Code as "cash . . . or other cash equivalents" in which the estate has an interest but which is subject to a security interest. 11 U.S.C. § 363(a). While the distinction between the two seems straightforward, in practice it can blur, particularly where the entity providing the post-petition financing is an existing secured creditor. It is important to distinguish between cash collateral use and obtaining new financing in a proposed financing order since they have very different consequences for the bankruptcy estate.

Section 363 deals with the use of cash collateral, while 11 U.S.C. § 364 addresses obtaining new credit. Under section 363, the court can order that cash collateral be used, over a creditor's objection, so long as the debtor provides "adequate protection," as defined in 11 U.S.C. § 361. By contrast, since a potential lender cannot be ordered to extend funds, section 364 affords "an escalating series of inducements that the debtor in possession may offer while attempting to obtain credit for use in the reorganization." *In re Photo Promotion Assocs., Inc.*, 87 B.R. 835, 839 (Bankr. S.D.N.Y. 1988) (providing overview of provisions of 11 U.S.C. § 364), *aff'd*, 881 F.2d 6 (2d Cir. 1989). Among the inducements of section 364 are super-priority status (giving priority over 11 U.S.C. § 503(b) and 507(b) administrative expenses); granting a lien on unencumbered property or a junior lien on encumbered property; and granting a priming lien. 11 U.S.C. § 364(c) and (d). *See also In re Defenders Drug Stores, Inc.*, 145 B.R. 312, 316-18 (B.A.P. 9th Cir. 1992) (upholding payment of enhancement fee under section 364); *In re Southern Soya Corp.*, 251 B.R. 302 (Bankr. D.S.C. 2000). Section 364(e) also provides a "safe harbor" on appeal, assuring lenders that even if the authorization to obtain credit under section 364 is reversed or modified on appeal, the validity of the debt to a good faith lender, as well as any priority or lien granted to secure the debt, is not affected.

Because of the enhanced protections available for post-petition financing, creditors often attempt to characterize their financing arrangement as post-petition financing. For example, a typical situation might involve a pre-petition lender who has a lien on inventory to secure the debt. The debtor may agree to pay down the secured interest from the sale of the inventory in exchange for the lender extending "new credit" that is secured by a lien on the debtor in possession's post-petition inventory. Functionally, this arrangement is indistinguishable from an agreement to use cash collateral with adequate protection in the form of a lien on post-petition assets. However, if the transaction is characterized as post-petition financing rather than the use of cash collateral, the lender may be entitled to a super-priority, as well as the "safe harbor" on appeal. The parties' characterization of the arrangement should not end the inquiry regarding the actual nature of the relationship. For a more complete discussion of this issue,

see Warfield, *Is It Use of Cash Collateral or Post-Petition Borrowing: How Much Protection Does the Creditor Deserve*, 94 Commercial L. J. 369 (1989).

3-2.8.5.2 Notice and Hearing Requirements

In addition to determining whether the motion is for use of cash collateral or for post-petition financing, the United States Trustee must consider whether the appropriate parties have received adequate notice of the proceedings. Local bankruptcy court rules or procedures may address notice and hearing requirements, including requirements that certain provisions of an order are highlighted to the court. The United States Trustee should ensure that the local rules are followed.

1. General Requirements

The rules governing the scope and timing of notice for cash collateral motions, Fed. R. Bankr. P. 4001(b), and post-petition financing motions, Fed. R. Bankr. P. 4001(c), are virtually identical. Both require at least 14 days notice to any appointed or elected committees or their authorized agents, or, if there is no committee, to the 20 largest unsecured creditors, and to such other entities as the court may direct. The United States Trustee also must receive notice. Fed. R. Bankr. P. 9034. The only difference is that for cash collateral motions, the entity with an interest in the cash collateral also must be served.

Where there has been agreement to use cash collateral or where the debtor and a secured creditor have agreed to the creation of new liens to facilitate post-petition financing, the Code does not require a hearing. Instead, there must be notice of the motion and a 14-day period for the served parties to object (Fed. R. Bankr. P. 4001(d)(1), (2), and (3)). If no objection is filed, the court can approve or disapprove the agreement without conducting a hearing. If there is objection and the court determines that a hearing is appropriate, then a hearing may be held with no less than seven days notice to the appropriate parties. Fed. R. Bankr. P. 4001(d)(3).

2. Interim Relief

If requested, the court can conduct a preliminary hearing with less than 14 days' notice, but it may only authorize the use of that amount of cash collateral or credit as is necessary "to avoid immediate and irreparable harm" to the estate pending a final, adequately noticed hearing. Fed. R. Bankr. P. 4001(b)(2) and 4001(c)(2); *see also* In re Colad Group, Inc., 324 B.R. 208, 218 (Bankr. W.D.N.Y. 2005) (rejecting financing agreement where the "order failed to reflect any effort to limit the conditions of credit only to those which would be absolutely necessary to avoid immediate and irreparable harm"). Occasionally a debtor, arguing exigent circumstances, will seek approval of a financing order on the day the case is filed. The question then becomes whether it is necessary to conduct a hearing at all and how much, if any, notice is required.

Under sections 363 and 364, the court can issue an interim order only "after notice and a hearing." However, 11 U.S.C. § 102(1), which defines the phrase "after notice and a hearing," provides that there need not be an actual hearing if there is notice and if "there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act." The section also states that notice means "such notice as is appropriate in the particular circumstances."

In *In re Blumer*, 66 B.R. 109, 113-14 (9th Cir. BAP 1986), *aff'd*, 826 F.2d 1069 (9th Cir. 1987), the court held that, whether or not a hearing takes place, notice is always required. The court noted that while the Bankruptcy Code permits shortened notice "as is appropriate in the particular circumstances," it does not permit dispensing with notice altogether, as is expressly allowed for relief from stay requests or motions to prohibit or condition the use, sale, or lease of property in Fed. R. Bankr. P. 4001. *See also In re Monarch Circuit Industries, Inc.*, 41 B.R. 859, 861 (Bankr. E.D. Pa. 1984).

In *Blumer*, the court held that notice is not only a statutory requirement, but also is dictated by the due process clause of the Fifth Amendment. Relying on Supreme Court holdings that the bankruptcy power is subject to the Fifth Amendment, *United States v. Security Indus. Bank*, 459 U.S. 70, 75 (1982), and that the right to due process before property is taken is meaningless without notice, *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950), the court concluded that the United States Constitution requires at least some notice before a court can order even interim relief on a cash collateral or financing motion.

The amount of notice required will depend on the circumstances. In *Blumer*, the court noted "in an emergency situation, telephonic notice may suffice." 66 B.R. at 113; *In re Ellingsen Maclean Oil Co.*, 65 B.R. 358 (W.D. Mich. 1986), *aff'd*, 834 F.2d 599 (6th Cir 1987). *But see In re Center Wholesale, Inc.*, 759 F.2d 1440 (9th Cir. 1985) (holding that one day's notice was inadequate in light of the facts and circumstances present). The determination of whether a hearing is necessary and what constitutes adequate notice – whether or not there is a hearing – is a matter of balancing the asserted need for emergency relief against the necessity of preserving the due process rights of the parties involved.

3. Notice Issues

The United States Trustee should review the proof of service to determine whether notice of cash collateral and financing motions is appropriate. Any deficiencies should be brought to the court's attention.

A proposed interim order may fail to specify that a final hearing will be held or that appropriate parties will have an opportunity to object. A final hearing, or at least an opportunity to object, is always required even when all parties received appropriate notice of the interim hearing. At the interim hearing, the United States Trustee should ensure that the order approving financing or use of cash

collateral is not final and that appropriate notice of a final hearing is served in accordance with the Federal Rules of Bankruptcy Procedure.

4. Scheduling of the Final Hearing

Although Fed. R. Bankr. P. 4001(b) and (c) establish a 14-day requirement before a final hearing can be held, this is a minimum rather than a maximum time for holding the hearing. In many cases, the creditors' committee will have been recently appointed. To assure that the unsecured creditors are able to participate, the United States Trustee should request that the final hearing not be set until after the duly appointed unsecured creditors' committee has had an opportunity to review the terms of the proposed cash collateral or financing order.

In the alternative, the United States Trustee may request that the unsecured creditors' committee, when appointed, be permitted to request reconsideration within a reasonable time of court rulings on such issues as super-priorities, cross-collateralization, and the validity of the secured creditors' liens. Such an arrangement also would provide the committee an opportunity to express its viewpoint.

3-2.8.5.3 United States Trustee's Role on Substantive Issues

1. Overview

The United States Trustee is principally concerned with preserving the right of the unsecured creditors to review and comment on the early financing motions that can have a substantial impact on the future conduct of the case. Assuring adequate notice and the opportunity for creditors' committee input before a final ruling are essential in this regard, but these generic concerns may not be enough to convince the court to burden the debtor with the delay that such considerations may necessitate. Thus, whenever possible, the United States Trustee should highlight those specific issues that are likely to raise concerns for unsecured creditors at the interim hearing, thereby bolstering the argument for preserving the creditors' opportunity for review. Once the interested parties have responded, the United States Trustee generally should refrain from asserting positions.

The situation is more complex when, in a given case, it is apparent that it will not be possible to appoint a committee and no creditors are actively involved in the case. In such circumstances, the United States Trustee must determine whether the terms of the financing arrangement raise concerns significant enough to justify taking a substantive position.

2. Relevant Substantive Issues

A. Review by the United States Trustee to Prevent Overreaching

In reviewing whether the substantive provisions of a proposed financing order are objectionable, the United States Trustee should focus on the effect that the order will have on the general creditor body. This usually involves balancing the benefit to the estate from obtaining the financing against the detriment to the

creditor body of providing special benefits to a particular creditor. This is inherent in the requirement established in sections 364(c) and (d)(1)(A) that the trustee must be unable to obtain the credit otherwise.

The need for financing may be so desperate that the debtor in possession will agree to almost any terms the creditor demands, which can lead to overreaching by the creditor. *See e.g.*, *In re Tenney Village Co.*, 104 B.R. 562 (Bankr. D.N.H. 1989). In *Tenney* the debtor agreed to a provision waiving pre-petition fraudulent conveyance and preference claims against a secured creditor, as well as to automatic relief from stay upon "termination events," cross-collateralization, limitations on compensation of debtor's counsel, and the right to designate the debtor's counsel and Chief Executive Officer. The court determined that such sweeping concessions evidenced a breach of the debtor's fiduciary duty to the estate, as well as overreaching by the secured creditor.

While it is difficult to establish a formula for determining when a particular arrangement constitutes overreaching, the following discussion of considerations related to various substantive provisions should provide some guidance.

B. Adequate Protection – Cash Payments

Many interim cash collateral and financing orders contain some provision for adequately protecting the secured creditor by making "a cash payment or periodic cash payments" under 361(1). The United States Trustee should consider whether a cash payment is even appropriate. Is the creditor under-secured? If so, the creditor is not entitled to interest payments. Some courts have held that where a creditor is over-secured, the equity cushion is sufficient protection. The United States Trustee may want to argue that any payment should be provisional pending a determination of the value of the collateral.

The United States Trustee should also consider whether the proposed amount is appropriate in light of the debtor's ability to pay based on the projections of operations during the interim period. It may be appropriate to request that the debtor and secured creditor be required to present evidence on these issues. If the evidence indicates that the size of the payments will inhibit the debtor's ability to operate, the United States Trustee should consider objecting.

C. Cross-Collateralization

The most contentious issue in many financing orders is whether an existing creditor can, post-petition, secure its existing debt with additional security. The United States Trustee should be concerned when a pre-petition creditor who is under-secured attempts to "bootstrap" its status by acquiring liens on either unencumbered assets or post-petition assets, such as avoidance actions, to secure its pre-petition debt. Because this increased security would come at the expense of other unsecured creditors, it is unlikely to be in the best interests of the general creditor body.

Some courts have taken the position that cross-collateralization is impermissible. *In re Saybrook Mfg. Co.*, 963 F.2d 1490 (11th Cir. 1992); *In re Monach Circuit Indus., Inc.*, 41 B.R. 859 (Bankr. E.D. Pa. 1984) (cross-collateralization constitutes an illegal preference); *cf. In re Ellingsen MacLean Oil Co.*, 834 F.2d 599, 601 (6th Cir. 1987), *cert. denied*, 448 U.S. 817 (1988) (section 364 priority appears limited to newly incurred debt).

However, the majority view seems to find cross-collateralization provisions acceptable under certain limited circumstances. In *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983), the court established a four-part test that has met with general acceptance:

1. the business will not survive without the financing;
2. the debtor cannot obtain alternate financing on acceptable terms;
3. the lender will not accept less favorable terms; and
4. the proposed financing is in the best interest of the general creditors.

See also In re Adams Apple, Inc., 829 F.2d 1484, 1490 (9th Cir. 1987) (cross-collateralization may provide only means of saving debtor); *In re Mid-State Raceway, Inc.*, 323 B.R. 40 (Bankr. N.D.N.Y. 2005); *In re Ames Dept. Stores, Inc.*, 115 B.R. 34, 39-40 (Bankr. S.D.N.Y. 1990) (where debtor demonstrated that unsecured financing was unavailable, cross-collateralization was permitted).

Even among courts that accept cross-collateralization, it is a disfavored means of financing. *See Vanguard Diversified*, 31 B.R. at 366 (cross-collateralization is a disfavored means of financing and is to be authorized only after hearing with notice to creditors). It is important to ensure that creditors have adequate notice and opportunity to object to the financing order. At a minimum, the United States Trustee should emphasize the disfavored status of such financing provisions and seek to have the court apply the four-part test set forth in *Vanguard*.

D. Super-Priority Provisions

The granting of "super-priority" status pursuant to 11 U.S.C. § 364(c)(1), which gives the unsecured creditor priority over most other administrative expenses, raises many of the same concerns as cross-collateralization. Accordingly, it is appropriate to consider the *Vanguard* factors in determining whether super-priorities should be approved.

It may be consistent with the interests of the general creditor body to consider carving out certain classes of claims from a grant of super-priority status. For example, provisions should be made for the payment of fees for debtor's counsel and for counsel to the creditors' committee. If a financing order is entered before any official committees are appointed, the United States Trustee should object to any carve-out for professional fees that does not include fees for

committee professionals. If these professionals cannot be paid, the interests of general unsecured creditors and other parties in interest may go unrepresented.

Under 11 U.S.C. § 1129(a) (12), the United States Trustee's quarterly fees must be paid on or before the effective date of any plan as a condition of confirmation. The United States Trustee should insist that a carve-out be provided for quarterly fees from any super-priorities or liens. If the case converts to chapter 7, the United States Trustee's quarterly fees and chapter 7 administrative expenses take priority over chapter 11 administrative expenses. 11 U.S.C. § 726(b). *In re Endy*, 104 F.3d 1154, 1157 (9th Cir. 1997); *In re Juhl Enterprises*, 921 F.2d 800, 803 (8th Cir. 1990).

E. Validation of Pre-Petition Liens and Waiver of Claims

Other provisions that frequently appear in proposed financing orders are the validation of pre-petition liens and the waiver of claims against a pre-petition creditor. The United States Trustee should argue that such provisions should become effective only after other parties in interest have been provided with notice and an opportunity to object. This is consistent with the policy of preserving issues for the creditors' review and would obviate due process concerns.

F. Priming of Liens

The interim order may provide for priming the new lender's liens over existing liens. 11 U.S.C. § 364(d). It is particularly important to ensure that junior lienholders receive adequate notice of such priming. The junior lienholders are in the best position to address the issue of whether they are adequately protected.

G. Roll-Ups

Because of their dire need for funding to continue operations and pay expenses related to the chapter 11 filing, potential post-petition lenders are able to exact broad concessions from debtors in possession that often are injurious to efforts to reorganize and compromise provisions of the Bankruptcy Code. In larger chapter 11 cases, a secured lender at times may seek to convert the entirety of its prepetition claim into post-petition debt protected by a super priority claim and priming liens. This is referred to as a "roll-up." Most simply, a roll-up involves the payment of prepetition debt with proceeds from a post-petition loan. *In re Capmark Financial Group, Inc.,* 438 B.R. 471, 511 (Bankr. D. Del. 2010).

In the motion for interim and final post-petition financing under 11 U.S.C. § 364, there may be a provision that seeks to permit the debtor in possession to borrow money that not only will fund post-petition operations but will be used to fully repay all prepetition claims owed to the secured lender either at once or over time. In this way, the lender's prepetition secured claim is fully converted to post-petition debt and enjoys the post-petition protections of 11 U.S.C. § 364(c) and/or (d) as well as the terms of the DIP order. *Id. at 511.*

Some bankruptcy courts have local rules or procedures that require a debtor to highlight the existence of a roll-up provision in its post-petition borrowing motion and forbid the inclusion of such provision in an interim request for relief. *See* LBR 4001-2(a)(7) (Bankr. S.D. N.Y. August 1, 2013); LBR 4001-2(a)(i)(E) (Bankr. D. Del. February 1, 2014). The United States Trustee should verify that any motion for relief under 11 U.S.C. § 364 follows applicable local rules in this regard.

The United States Trustee should object to any attempt to achieve a roll-up through an interim order for financing under 11 U.S.C. § 364 and preserve all rights to object to the roll-up when the final hearing is conducted. Also, the United States Trustee should ensure that parties in interest, including the official committee of unsecured creditors, retain the right to review and object to the validity and priority of any prepetition debt that is ultimately paid off through post-petition borrowing.

H. Default Provisions with Automatic Remedies

The United States Trustee should carefully review any provision in a proposed financing order that purports to grant an automatic remedy in the event of default. For example, a requirement that the case be automatically dismissed or converted to chapter 7, without the notice required under Fed. R. Bankr. P. 2002(a)(4), is not appropriate. Likewise, relief from stay should not be permitted without notice as required by Fed. R. Bankr. P. 4001(a). *See In re Tenney Village Co.*, 104 B.R. 562, 569 (Bankr. D.N.H. 1989) (finding that agreement to provisions containing automatic remedies may constitute a breach of the debtor's fiduciary duties). Similarly, a provision that all terms of a financing order will be binding on any subsequently appointed trustee may impair a chapter 7 Trustee's administration of the estate.

I. Conclusion

The primary role of the United States Trustee with respect to interim cash collateral and financing orders is to ensure that creditors have an opportunity to review the issues and present their views to the court. The United States Trustee should raise objections if adequate notice is not given and should attempt to preserve as many issues as possible until a creditors' committee is in a position to participate.

It will, at times, be appropriate for the United States Trustee to take steps to preserve issues so that others are not later prevented from objecting to interim orders. On occasion, the United States Trustee may be called upon to take a position on the substance of a cash collateral or financing order. In these circumstances, the guiding concern should be what is in the best interests of the estate. *See generally* Stripp, *Balancing of Interests in Orders Authorizing the Use of Cash Collateral in Chapter 11*, 21 Seton Hall L. Rev. 562 (1991).

3-2.8.6 Early Payments to Pre-Petition Creditors

One of the matters that frequently arises immediately after the filing of a case is a request by the debtor to pay certain pre-petition creditors. The debtor often seeks authority to pay these creditors on an emergency basis with shortened notice to a limited number of creditors. The nature of the requests vary from payment of employee wages to payment of unsecured supplier creditors. Most requests are accompanied by a representation that the payments are essential for the continued existence and/or viability of the debtor's business. While payment to unsecured creditors may seemingly be beyond the scope of the provisions of the Bankruptcy Code, several courts authorize such payments by invoking the necessity of payment doctrine.

3-2.8.6.1 Background of the Doctrine of Necessity

The doctrine of necessity is an equitable principle that evolved originally from two related common law rules applied in railroad reorganizations – i.e., the necessity of payment rule and the six-month rule. *See* Eisenberg & Gecker, *The Doctrine of Necessity and Its Parameters*, 73 Marq. L. Rev. 1, 2-5 (1989). The necessity of payment rule allows a court to authorize the payment of certain pre-existing claims, if such payments are essential to the railroad's continued existence. *See In re Boston and Maine Corp.*, 634 F.2d 1359 (1st Cir. 1980), *cert. denied*, 450 U.S. 982 (1981); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989). The six-month rule authorizes administrative expense priority treatment to creditors supplying services and goods to railroads within the six- month period prior to case filing. *In re B&W Enters., Inc.*, 713 F.2d 534, 536 (9th Cir. 1983) (six month rule now codified at 11 U.S.C. § 1171(d)).

In the chapter 11 reorganization field, the doctrine of necessity is now used in non-railroad cases, though its use is generally restricted to instances where the payments of pre-petition claims are essential and necessary to the debtor's continued existence. Compare *In re EqualNet Comm'ns Corp.*, 258 B.R. 368 (Bankr. S.D. Tex. 2000) (permitting payments to customers with billing credits arising from pre-petition billing and service errors) with *In re Zenus is Jewelry, Inc.*, 378 B.R. 432, 433-34 (Bankr. D.N.H. 2007) (denying critical vendor motion in light of alternative feasible vendor sources).

The doctrine of necessity attempts to reconcile two otherwise opposing objectives of chapter 11– i.e., the reorganization of business entities (with attendant creditor recoveries and job preservation) vis–a-vis the equal treatment of creditors. *In re United American, Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005). The pre-confirmation payment of select creditors violates the equal treatment principle. *Id.* Thus, some courts have refused to apply the doctrine on the grounds that payments would constitute preferential treatment over similarly classified creditors, and that the equitable powers granted to the bankruptcy court under section 105 confer the court with the power to override the Bankruptcy Code's priority scheme. *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004) (stating that

the doctrine of necessity is just a fancy name for power to depart from the Bankruptcy Code, and holding that section 105 does not grant bankruptcy court the power to override the Code's rules regarding priority and distribution).

Bankruptcy courts have recognized that the doctrine of necessity "should only be invoked in extraordinary circumstances and it is a device to be used only in rare cases." *Zenus*, 378 B.R. at 433 (internal quotes omitted). In recent years, reported decisions have focused on setting standards governing critical vendor motions. See *Kmart*, 359 F.3d at 873 (the debtor must show that disfavored creditors will be as well off with reorganization as with liquidation, and that favored creditors would have ceased providing goods and services if their old debts were left unpaid during the pendency of pre-petition litigation; and *In re United American, Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005) (the vendor must be necessary for the debtor's successful reorganization, the payment must be in the debtors' sound business judgment, and payment of the critical vendor must not prejudice other unsecured creditors).

Federal Rule of Bankruptcy Procedure 6003, which became effective in 2007, also regulates requests for the early payment of pre-petition creditors. The rule provides, in relevant part, that "except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 21 days after the filing of the petition, grant relief regarding – (b) a motion to incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition." Fed. R. Bankr. P. 6003(b). The rule is intended to prevent the court from rendering pivotal rulings without complete consideration and to provide all parties in interest with a meaningful opportunity to be heard. Debtors seeking the entry of a critical vendor order within the first 21 days of the case must comply with Rule 6003(b).

3-2.8.6.2 Statutory References

1. 11 U.S.C. § 105(a)

The statute most frequently cited to support application of the doctrine of necessity is 11 U.S.C. § 105(a), which empowers a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The courts invoking section 105(a) for this purpose rationalize that since the fundamental purpose of chapter 11 is to allow a debtor to reorganize, section 105 may be used to avert the consequences of a failed reorganization that may result if the payment to pre-petition creditors is not allowed. *See, e.g.*, *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175-177 (Bankr. S.D.N.Y. 1989). Some courts have reasoned that section 105(a) must be used in conjunction with another provision of the Code (e.g., section 363 or 507) that at least impliedly authorizes critical vendor payments. *In re CEI Roofing, Inc.*, 315 B.R. 50, 59 (Bankr. N.D. Tex. 2004).

Courts refusing to apply section 105(a) rely upon limitations imposed by concepts of the Bankruptcy Code. These courts usually rule that pre-petition creditor

payments upset the priority scheme of section 507 and/or the principle, embodied in 11 U.S.C. § 1122-1129, that similarly situated creditors be similarly treated. *See, e.g.*, *Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 302 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988) (clear language of Bankruptcy Code and Rules does not authorize payment or advance of monies to or for the benefit of unsecured creditors prior to approval of plan). Courts using section 105(a) counter that sections 507 and 1122-1129 are not inflexible, and that the latter statutes apply only in the plan confirmation context. *See, e.g.*, *In re Chateaugay Corp.*, 80 B.R. 279, 287 (S.D.N.Y. 1987) (rigid application of section 507 would be inconsistent with fundamental purpose of reorganization, which is to permit the debtor's survival and payment to creditors).

2. 11 U.S.C. § 363

Some courts cite 11 U.S.C. § 363(b) or 363(c)(1), which permit the debtor to use property of the estate in the operation of the business, as a basis for application of the doctrine of necessity. By viewing the debtor's application to pay certain pre-petition claims as a request for authority to expend funds outside of the ordinary course of business pursuant to section 363, some early courts have required that the debtor articulate a sound business reason for the decision to do so. *See, e.g.*, *In re Ionosphere Clubs, Inc.*, 98 B.R. at 175-176. To the extent a critical vendor order is desired within 21 days of the commencement of the case, the invocation of section 363 as the basis for a critical vendor motion is governed by Rule 6003. *See infra*.

3. 11 U.S.C. § 507

Courts may approve payments to pre-petition creditors on the theory that 11 U.S.C. § 507(a), which defines administrative expenses, provides priority status to the requested payments. *See In re Structurlite Plastics Corp.*, 86 B.R. 922, 933 (Bankr. S.D. Ohio 1988). While section 507 does not authorize immediate payment of priority claims, these courts apparently rationalize that the claims will ultimately be paid in full and that no one is harmed by early payment. *See also* section 503(b)(9) (granting administrative expense priority for the value of goods received by the debtor within 20 days before the commencement of the case when the goods have been sold to the debtor in the ordinary course of the debtor's business).

3-2.8.6.3 Types of Requests

1. Employees (Non-Management)

The most common use of the doctrine of necessity concerns pre-petition employee payroll and benefits claims. Typical requests include seeking authorization to pay pre-petition payroll and work benefits and to reimburse employee expenses. These types of requests are often granted, particularly if the payments requested fall within the section 507(a) priority parameters. *See* Eisenberg & Gecker, *supra*, at 12-15; *see also In re The Colad Group*, 324 B.R.

208, 214 (Bankr. W.D.N.Y. 2005) (granting first-day order for payment of pre-petition wages and benefits not to exceed priority limits of sections 507(a)(3) and (a)(4); and *CEI Roofing*, 315 B.R. at 60 (granting authority for debtors to pay, prior to plan confirmation, pre-petition employee wage claims, to the extent that such individual claims qualify as priority wage claims under section 503(a)(3).

An issue may arise, however, as to whether payments must be made to all creditors within a specific priority classification. *See In re Chateaugay Corp.*, 80 B.R. 279 (S.D.N.Y. 1987) (debtor that received authorization to pay employee and workers' compensation claims was not required to pay workers' compensation claims in all states); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (debtor that received authorization to pay pre-petition claims of active employees was not required to pay claims of non-active striking employees whose claims enjoyed same priority status).

Some debtors request authorization for payment of terminated employee wages and benefits on the grounds that nonpayment of these claims would adversely affect current employee morale and/or the public image of the debtor. *See, e.g.*, *In re Structurlite Plastics Corp.*, 86 B.R. at 924.

2. Management

Requests for authorization to pay pre-petition wages sometimes include requests to pay management salaries, expenses, or benefits. Occasionally, authorization for payments to pre-petition creditors is sought on the ground that payment of these creditors will allow management to focus its attention on the debtor's reorganization. Payments to creditors to whom management may be personally liable, such as taxing entities or holders of guaranteed debt, may be requested under this theory. *See, e.g.*, *In re Revco D.S., Inc.*, 91 B.R. 777 (Bankr. N.D. Ohio 1988) (denying request to pay only pre-petition trust fund taxes but no other taxes entitled to section 507(a)(7) priority so that principals could avert threat of personal assessment). Payments of the claims of pre-petition insiders should be evaluated for conformity with section 503(c). *See* Manual 3-2.8.4.

3. Customers

Courts that allow use of the doctrine of necessity generally approve requests that preserve customer good will. The doctrine may be used to authorize payment of warranty claims, return of customer deposits, honoring customer gift certificates, or payment of customer referral commissions. *See EqualNet*, 258 B.R. at 368 (permitting payments to customers with billing credits arising from pre-petition billing and service errors).

4. Suppliers

Some courts authorize payments to critical suppliers or service providers. *See, e.g.*, *Eagle-Picher Indus., Inc.*, 124 B.R. at 1021, 1023 (Bankr. S.D. Ohio 1991) (payments to pre-petition unsecured toolmakers authorized). Payments may be sought for several reasons. The debtor may allege that a creditor will not supply

essential supplies, will go out of business to the debtor's economic detriment, or will ruin the debtor's reputation if the pre-petition debt is not paid. With increasing frequency, the bankruptcy courts are requiring that, in exchange for the payment of their pre-petition claims, the favored suppliers must agree to continue providing goods and services to the debtors for a specified period. *See, e.g.*, *In re CoServ, LLC*, 273 B.R. 487, 500 (Bankr. N.D. Tex. 2002).

5. Foreign Creditors

The doctrine of necessity may be used to justify payments to foreign creditors. Eisenberg & Gecker, *supra* at 16-17. Utilization of the doctrine may avoid expensive legal proceedings and preserve the debtor's image abroad where perceptions of bankruptcy may differ. Application of the doctrine also avoids testing the validity of the automatic stay in other countries and the initiation of self-help or other legal remedies available in the foreign creditor's country.

6. Sales and Use Taxes

Payroll taxes, sales and use taxes collected from the debtor's customers, and other "trust fund" taxes entitled to priority pursuant to section 507(a)(8) may also be the subject of motions made under the doctrine of necessity. The bankruptcy courts have granted such motions on the grounds that the payments are otherwise entitled to priority status. *See Colad*, 324 B.R. at 214.

3-2.8.6.4 United States Trustee's Position on Doctrine of Necessity Requests

The United States Trustee should endeavor to ensure the broadest possible notice of doctrine of necessity requests. The scope and length of the notice urged should generally be evaluated in the context of the case, and should specifically be tailored in light of the time sensitivities involved, the nature and amounts of the payments requested, the costs of notice, and the existence of effective creditor advocates, such as an active creditors' committee. Fed. R. Bankr. P. 4001 and Fed. R. Bankr. P. 6003 offer general guidance on the minimal length of notice appropriate for emergency and non-emergency situations.

The United States Trustee should also endeavor to ensure that debtors fulfill the evidentiary burdens associated with the extraordinary relief requested in first-day motions, particularly Rule 6003. This will help ensure compliance with established precedent, and as applicable, Congressional intent, in this regard. Specifically, the United States Trustee should make sure debtors disclose specific amounts to be paid and identify the recipients. Also, debtors should not receive blanket approval to pick and choose recipients and payment amounts based solely on their discretion. Finally, the United States Trustee should consider requiring debtors to report on all payments made pursuant to doctrine of necessity requests on their post-petition monthly operating reports.

Discretion, however, should be exercised in determining substantive positions on case-specific doctrine of necessity requests. Factors that may suggest decreased scrutiny by the United States Trustee include active creditor participation, the

consent of parties in interest (which may include the creditors' committee and secured creditors whose collateral may be used for the payments), full notice with an adequate objection period, requests involving minimal expenditures in comparison with case size, requests to pay creditors entitled to priority pursuant to section 507 (which are likely to be paid in full in any event), and payments that are obviously essential to the debtor's continued existence. On the other hand, factors that may suggest increased United States Trustee scrutiny include requests favorable to the debtor's management, requests for payments where there is an absence of evidence that the payments are essential, and requests for payments to creditors whose class is not likely to be paid in full through the bankruptcy process.

United States Trustees should also consider the difficulty of evaluating the economic consequences of nonpayment and the probability of uncontroverted testimony from the debtor's management. Unless presented with egregious or obviously overreaching requests, such as when insider or creditor intimidation is indicated, the United States Trustee should rely on pecuniarily-affected parties to challenge doctrine of necessity requests on substantive grounds.

3-2.8.7 Requests for Approval of Responsible Persons

One of the major controversies during the legislative debates leading to the enactment of the Bankruptcy Code in 1978 was how debtors reorganizing under the new chapter 11 would be governed. Some argued that an independent trustee should be appointed in every case involving a public company. Others believed that chapter 11 debtors should generally be permitted to remain in possession and to control their own reorganization destinies. As enacted, the Bankruptcy Code reflected a compromise between these two views. By default, a chapter 11 debtor is a "debtor in possession," 11 U.S.C. § 1101(1), and has virtually all the rights, powers and duties of a trustee. 11 U.S.C. § 1107(a). If, however, the court finds that "cause" exists for the appointment of a trustee, or that such an appointment is in the interests of creditors, equity security holders, and other interests of the estate, the court is directed to order the appointment of a trustee. 11 U.S.C. § 1104(a)(1), (2). *See* Manual 3-6 for a full discussion of chapter 11 trustee appointments.

Nowhere in the Bankruptcy Code does a "responsible person" appear as an alternative to a debtor in possession or chapter 11 trustee. Consequently, United States Trustees should object to motions brought to the bankruptcy court for approval of appointment of a "responsible person." The Bankruptcy Code is conspicuously silent on who has the power to govern a non-individual debtor in possession. For instance, while a corporation can be a debtor under chapter 11, the definition of a "corporation" in 11 U.S.C. § 101(9) provides no hint regarding who controls a corporate debtor in possession. This is by design. With very few exceptions, corporations and other artificial entities are creatures of state statutory law.

Whether a corporate debtor may irrevocably turn its affairs over to a responsible person must therefore be determined under state law. If such a permanent devolution of corporate management authority to an individual is permissible under state law, the bankruptcy court need not be involved in the selection or approval process. Because, however, few if any state statutes permit such a management structure, parties seeking the appointment of a responsible person to ward off a trustee appointment must enlist the aid of the bankruptcy court.

The typical factual scenario is that a company, usually either a corporation or limited liability company, has serious problems and there may be allegations of wrongdoing. Investors and others may have commenced lawsuits against the company and its principals, alleging widespread financial misdeeds and abuse. State and federal securities regulators may have commenced enforcement actions and taken steps to seek the appointment of receivers. Usually as part of the first-day motions, the debtor asks the court to approve the appointment of a named individual as the "responsible person" for the debtor in possession. The responsible person will have all of the rights, powers, and duties of a chapter 11 trustee and will be subject to removal only by court order. United States Trustees should be alert to these situations and should object to such relief, because the Bankruptcy Code only provides for the appointment of a chapter 11 trustee. Pursuant to section 1104(d), if the court orders the appointment of a trustee, then the United States Trustee shall appoint a disinterested person to serve in that capacity.

Parties seeking responsible person appointments advance a variety of practical rationales for why such an appointment is preferable to a trustee appointment: the suggested candidate is above reproach; a responsible person will cost less than a trustee; a trustee appointment would terminate the debtor's exclusivity rights. These concerns are almost always overstated. U.S. Trustees are obligated to consult with parties in interest in selecting persons to appoint as chapter 11 trustee, and creditors may elect a trustee of their choice if they are unhappy with an appointment. 11 U.S.C. § 1104(b). A chapter 11 trustee's compensation must be reasonable, and must be determined under the same standards that govern compensation of professional persons. 11 U.S.C. § 330(a)(3). Although a trustee appointment will terminate the debtor's exclusive right to file a plan, 11 U.S.C. § 1121(c)(1), there is no reason for exclusivity to continue when a responsible person with no prior relationship with the debtor assumes complete control of the debtor's affairs. That person is a trustee in all but name, and the Congressional intent to enable creditors and other parties to file plans to protect their interests upon the appointment of a trustee should not be so easily circumvented.

Chapter 11 governance provisions have remained largely unchanged since the 1986 reform act assigned the trustee appointment duty to United States Trustees. The provisions dealing with the appointment of trustees are not discretionary. If grounds exist for the appointment of a trustee, then a trustee must be appointed, and United States Trustees should not consent otherwise.

See Walter W. Theus, Jr, "*Who's Responsible Here? 'Responsible Persons' in Chapter 11 Cases,"* Am. Bankr. Inst. J., May 2008, at 12 for a more detailed exposition of the arguments and case law that may be cited in support of United States Trustee opposition to the appointment or continuation of a responsible person as a substitute for a trustee.

3-2.8.8 Joint Administration and Substantive Consolidation

Fed. R. Bankr. P. 1015(b) allows the court to order the joint administration of two or more related cases. Joint administration is a procedural device meant to simplify case administration, and affects procedural matters only. *See In re Reider*, 31 F.3d 1102, 1109 (11th Cir. 1994). A joint administration order may be entered if it enables the estates to be administered more efficiently, expeditiously, and/or with less cost. It allows hearings, pleadings, notices, or other matters involving several distinct cases to be combined. *See Unsecured Creditors Comm. v. Leavit Structural Tubing Co.*, 55 B.R. 710, 712 (N.D.Ill. 1985), *aff'd*, 796 F.2d 477 (7th Cir. 1986). One of the most common advantages of joint administration is the procedural combination of the estates with a single docket number. This facilitates the filing of proofs of claims, the combining of notices to creditors of different estates, the joint handling of administrative matters, and calendaring.

Joint administration must be distinguished from substantive consolidation of cases. Unlike joint administration, substantive consolidation is an "extreme and unusual remedy" that results in asset and liability pooling and may substantially affect the rights of creditors. *See In re Pacific Lumber Co.*, 584 F.3d 229, 249 (5th Cir. 2009); *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *cert. denied* 547 U.S. 1123 (2006). The United States Trustee should oppose substantive consolidation if it is requested on limited or shortened notice. *See, e.g.*, *In re Auto Train Corp.*, 810 F.2d 270, 278 (D.C. Cir. 1987) (consolidation motion required reasonable notice and opportunity for hearing). Complete and appropriate notice of any such request should be provided to all creditors. In certain situations, United States Trustees may consider opposing substantive consolidation on substantive grounds, particularly where the movant has failed to meet the controlling legal standard in a given jurisdiction and when the request is used to circumvent other Bankruptcy Code provisions (including any restrictions on the representation of multiple estates by a single professional firm).

3-2.8.9 Small Business Chapter 11 Cases

Chapter 11 contains a number of provisions applicable only to small business debtors. *See* Manual 3-14 for a discussion of those provisions.

CHAPTER 3-3: INITIAL DEBTOR INTERVIEWS, OPERATING GUIDELINES, AND MONTHLY OPERATING REPORTS

3-3.1 INITIAL DEBTOR INTERVIEWS (IDIs)

Immediately following the entry of an order for relief, the United States Trustee should schedule an initial debtor interview (IDI) with the principals of the debtor and debtor's counsel. Section 1116 of the Bankruptcy Code specifically provides that debtors in small business cases, through their senior management and counsel, shall attend IDIs. *See* Manual 3-14.5 below concerning initial case requirements for small business debtors in chapter 11 cases.

The general purpose of the IDI is two-fold:

1. to provide the United States Trustee with vital information so that an early assessment can be made of the accuracy of the debtor's schedules and statements and of the debtor's financial ability to confirm a plan; and

2. to ensure that the debtor is aware of its new fiduciary obligations and of the United States Trustee's role in the administration of chapter 11 cases.

Generally speaking, IDIs should be conducted at the United States Trustee's office. However, the United States Trustee may sometimes choose to conduct an IDI at the debtor's place of business when it might help the United States Trustee understand the debtor's operations and chances for reorganization. Under section 1121(7), a small business debtor is required to allow a United States Trustee representative to inspect the debtor's premises after reasonable prior notice.

3-3.1.1 Procedure for Setting Up the IDI

The United States Trustee should advise the debtor's principals and debtor's counsel, in writing, that an IDI has been set at a tentative date and time. Reasonable effort should be made to accommodate the various individuals' schedules. While a personal meeting is preferable, factors such as the small size or lack of complexity of a case, as well as the resources available in the local office, may warrant alternative arrangements. For example, a telephone conference with the debtor can be conducted. Regardless of the method employed, it is vital that contact with representatives of the debtor be promptly initiated and that the IDI be held before the section 341 meeting.

Before the IDI, the United States Trustee should make a written request for certain financial and other information pertaining to the debtor's business or affairs. The request can vary depending on the nature or size of the business. Typically, financial statements, pre-petition bank statements and cancelled checks, federal tax returns, material lawsuits, and executory contracts should be requested. In small business cases, debtors are required to file their most recent balance sheet, statement of operations, cash flow statement, and federal income

tax return with the court or a statement that those documents do not exist. 11 U.S.C. § 1116(1). The debtor should also be asked to provide documentation such as proof of a debtor in possession account and evidence of insurance to ensure the case is in administrative compliance. Regardless of the debtor's complete compliance, the IDI should proceed. The debtor's failure to timely provide information or to attend the IDI constitutes cause for dismissal or conversion of the case to chapter 7. 11 U.S.C. § 1112(b)(4)(H).

Because of restrictions covering contact between attorneys and represented clients, the United States Trustee should inquire from debtor's counsel whether United States Trustee staff may communicate directly with the debtor or its employees regarding administrative matters such as insurance coverage, bank account information, monthly operating reports, quarterly fees, and post-confirmation reporting. Any approval for direct communication should be in writing.

3-3.1.2 United States Trustee's Initial Assessment of the Case

The primary focus of the IDI is to gather key financial and background information on the debtor's business, focusing on the past, the present, and the future. The debtor should be encouraged to provide a historical background of the business, its principals, and its products or services. Key customers, primary creditors, major contracts, and significant lawsuits, if any, should be identified and discussed. The immediate and underlying reason(s) for the filing of the chapter 11 bankruptcy case should be fully addressed. The debtor and debtor's counsel should be asked to identify the immediate hurdles that must be overcome to stabilize the business. Questions about how the debtor plans to proceed through chapter 11 and, ultimately, resolve the case, including a tentative timetable, should be raised.

The United States Trustee may also discuss the debtor's accounting controls. The debtor's schedules and statements should be reviewed carefully with the debtor and debtor's counsel to identify any inconsistencies or omissions based upon the information disclosed during the IDI.

The United States Trustee should also consider and inquire about, in appropriate cases, whether the debtor is a health care business under 11 U.S.C. § 101(27A) or a small business debtor under 11 U.S.C. § 101(51C)-(51D). The United States Trustee should also inquire, as appropriate, about whether the debtor has a retirement plan for its employees and the status of that retirement plan, and whether the debtor is considering selling or leasing personally identifiable information about individuals to persons not affiliated with the debtor. 11 U.S.C. § 363(b)(1).

If the debtor is an individual, the United States Trustee should ascertain whether the debtor received a briefing from an approved nonprofit budget and credit counseling agency pursuant to 11 U.S.C. § 109(h) before filing the case, is subject

to a domestic support obligation, and filed the Form 22B, Statement of Current Monthly Income.

The United States Trustee should also inform the debtor about the requirement to file, seven days before the first date set for the section 341 meeting, a Report of Financial Information on Entities in Which a Chapter 11 Estate Holds a Controlling or Substantial Interest for any entity in which the debtor controls or owns at least a 20 percent interest. Fed. R. Bankr. P. 2015.3. The report must be submitted on Official Form B26 (12/08).

At the conclusion of the IDI, the United States Trustee should make an initial assessment of the accuracy of the debtor's schedules and statements, whether financial reorganization is a viable option for this debtor, and what case management tools and alternatives should be considered given the circumstances of the case. The key information gathered at the IDI and the initial assessment should be set forth in a written report so that it can be more readily used by the United States Trustee case attorney for reference during the section 341 meeting and for general case management purposes.

3-3.1.3 Familiarizing the Debtor with its New Fiduciary Obligations

At the IDI, the United States Trustee should set forth the statutory duties and obligations of a debtor in possession. The debtor's representatives should be provided with a copy of the United States Trustee Program's chapter 11 operating guidelines and monthly report forms, which should be explained and discussed. The procedures for calculating and paying the quarterly fee assessed pursuant to 28 U.S.C. § 1930(a)(6) should be explained. The United States Trustee should ensure that the debtor has closed its former bank accounts and established separate debtor in possession bank accounts. The debtor should be required to provide proof that appropriate insurance coverage is being maintained. The United States Trustee should inform the debtor that it may not, without court authority:

1. use, sell, or lease property of the estate outside the ordinary course of business (section 363(b));
2. use cash collateral without consent from the creditor with an interest in the cash collateral (section 363(c)(2); or
3. incur secured debt (section 364).

The role of the United States Trustee in the administration of chapter 11 cases should be explained to the debtor. The debtor should be advised that the United States Trustee will take appropriate measures to protect creditors' interests and be advised of the circumstances under which the United States Trustee will take such action.

Information and commitments regarding either compliance matters or document requests that are obtained from the debtor's representatives at the IDI should be

documented and retained in the case file. A specific time frame within which any outstanding deficiencies or issues will be resolved should be established before the conclusion of the IDI. The debtor's failure to adhere to any such agreement should result in prompt action by the United States Trustee.

3-3.2 OPERATING GUIDELINES

The operating guidelines for chapter 11 debtors are an important facet of the United States Trustee's efforts to monitor the administration of chapter 11 cases. They address the subject areas discussed in the following subsections.

3-3.2.1 General Provisions

The debtor should be advised of its obligation to comply with the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, local rules, and any court order, and that post-petition debts must remain current and pre-petition unsecured debts may not be paid, unless otherwise ordered by the court. The debtor should be instructed to close its books and records as of the date of filing and to open new post-petition books and records. Finally, the debtor should be advised of the consequences of failing to comply with the operating guidelines and reporting requirements. The United States Trustee should explain to the debtor how to determine the amount of fees owed to the United States Trustee for each quarter the debtor is in chapter 11 and where the debtor should send each payment.

3-3.2.2 Bank Accounts

The operating guidelines contain a requirement that the debtor close its pre-petition bank accounts and open new debtor in possession accounts. Absent court authorization, the accounts may be maintained only in depositories that agree to post a bond or pledge securities for all deposits not insured or guaranteed by the United States or by a department, agency, or instrumentality of the United States, or backed by the full faith and credit of the United States. 11 U.S.C. § 345(b). The debtor should establish a separate general account for the purpose of paying bills incurred during the administration of the case. The debtor should, where appropriate, also establish a separate tax trust account so that it may escrow the necessary funds for the payment of post-petition taxes including, for example, payroll and sales or excise taxes, when such liabilities are incurred.

The debtor may also be required to establish separate accounts for such items as payroll and payments to secured creditors. Savings accounts and certificates of deposit may be maintained as well, pursuant to the statutory obligation to obtain a safe, yet reasonable, return on estate funds for the benefit of creditors. *See* 11 U.S.C. § 345(a).

3-3.2.3 Insurance

A debtor must maintain appropriate insurance coverage, and documentation regarding the existence of the coverage must be provided to the United States Trustee as early in the case as possible.

The dollar amount of the insurance coverage must be sufficient to cover the fair market value of the estate's property. Information about the fair market value of the property can be derived from such sources as the testimony of the debtor's principal, the schedules and statement of financial affairs, and appraisals prepared in connection with financing or valuation hearings.

The extent of coverage must be adequate, given the circumstances of the case. Depending on the case, the debtor may be required to maintain all or a combination of fire and extended liability insurance, general liability insurance, worker's compensation and unemployment insurance, employee health insurance (especially if pursuant to a collective bargaining agreement or retirement plan; *see* 11 U.S.C. § 1113 and 1114), malpractice insurance, product liability insurance, and liquor or dramshop insurance. The debtor should instruct its insurance companies and agents to include the Office of the United States Trustee as a notice party on any insurance policies so that the United States Trustee receives prior notification regarding any change, cancellation, or expiration of a debtor's insurance policy. A debtor should also be required to provide separate notice to the United States Trustee regarding any change in insurance coverage.

3-3.3 FINANCIAL REPORTS

The debtor in possession should file operating reports each month throughout the pendency of the case. The timely filing of reports of operations is crucial to the efficient administration of chapter 11 cases. These reports are designed to provide the United States Trustee, the court, creditors, and other parties in interest with reliable information regarding the current status of a case. The United States Trustee should use the information contained in the reports to identify cases lacking a realistic prospect of reorganization and to evaluate the feasibility of a proposed plan of reorganization.

The United States Trustee retains the discretion to waive or modify the reporting requirements. The rationale underlying any such decision, however, should be documented in writing and maintained in the file. Moreover, this discretion should be exercised sparingly, given the importance of timely and accurate financial information in the reorganization process, as well as the need to avoid the appearance that a debtor is receiving disparate treatment. The debtor's obligation to file monthly operating reports ends when a case is converted or dismissed. Post-confirmation, the United States Trustee should require submission and filing of reports pursuant to 11 U.S.C. § 1106(a)(7). *See* Manual 3-9.7.

3-3.3.1 Small Business Cases

Chapter 11 debtors designated as small businesses have a separate form Monthly Operating Report. This form should be required by the United States Trustee in all small business cases. Additional information about the small business debtor's ongoing financial condition should be required only as made necessary by the particular circumstances of the case.

3-3.3.2 Other Cases

Different reporting formats may be used for different types of cases. For example, the operating report form used for a case involving an ongoing manufacturing concern may be different from the form more suitable for use in a real estate case. Generally, the debtor's operating reports should be premised on the accrual basis of accounting. Under this method, revenue is considered earned in the period in which sales are made or services are rendered regardless of when payment is collected, and expenses are considered in the period in which they are incurred regardless of when they are paid.

The operating report form used in a standard business reorganization under chapter 11 should generally encompass the elements described in the following subsections.

3-3.3.3 Cash Receipts and Disbursements Statement

The United States Trustee should require the submission of a schedule of cash receipts and disbursements of the debtor, as well as a separate bank account reconciliation statement for each of its bank accounts, e.g., general account, tax escrow account, and payroll account. The information contained in these statements will reflect whether the debtor's operations are generating a positive cash flow. The information should be analyzed with appropriate consideration given to the seasonality of the debtor's business and any historical information that is relevant.

Aside from the income and other items comprising cash receipts, the schedule of cash receipts and disbursements should contain the debtor's expenditures for inventory, salaries, taxes, and so forth. The United States Trustee can use the information to discover:

1. whether the debtor is making unauthorized payments to professionals;
2. whether the debtor is improperly paying pre-petition debts;
3. whether the debtor has sufficient cash flow to effectively reorganize;
4. whether inordinate payments are being made for travel, entertainment, or other employee benefits; and
5. whether improper payments are being made by the debtor that will hamper its ability to reorganize.

3-3.3.4 Statement of Operations

The debtor should provide a monthly statement of operations (income statement) that indicates whether the debtor is generating sufficient funds to reorganize. The statement of operations form is a comparative statement designed to allow the United States Trustee to review all the information from a particular debtor on one spreadsheet.

A detailed review and analysis of this statement is important, as it provides a different picture of a debtor's operations than does the schedule of cash receipts and disbursements. Many expenses are paid less frequently than on a monthly basis. In addition, there are non-cash accounts (e.g., depreciation and amortization) that do not appear on a cash statement, yet must be taken into account in analyzing the ongoing viability of the debtor. For example, although depreciation is a non-cash item, the debtor will eventually need to buy new machinery and equipment or pay for other capital improvements.

The accrual income statement is also important since it indicates the cost of goods sold. This requires a beginning inventory figure based upon a physical or perpetual inventory. The beginning inventory figure is critical since it is only after purchases have been added and ending inventory deducted that one arrives at the cost of goods sold. This will determine the debtor's gross profit margin.

3-3.3.5 Balance Sheet

The debtor is required to provide a balance sheet on a monthly basis to allow the United States Trustee to review the debtor's changing assets and debts.

Careful analysis of the balance sheet is required, as it can uncover whether the debtor is making payments on pre-petition debts, whether assets are being dissipated, and whether the debtor is accumulating unpaid post-petition liabilities and uncollected post-petition accounts receivable. If any of these occur, the United States Trustee should take appropriate action.

3-3.3.6 Schedule of Post-Petition Liabilities

The debtor should provide an accounting of the amount of obligations unpaid since the commencement of the case, as well as an aging schedule for these sums. If the total amount of unpaid obligations increases and the amounts owed are becoming further past due, it may indicate a negative cash flow and/or administrative insolvency. However, there will almost always be certain post-petition obligations that have not been paid simply because they have not become due in the ordinary course of business or because their payment is not yet authorized, such as payment of attorney or accountant fees.

3-3.3.7 Post-Petition Taxes Payable (Tax Reconciliation) Statement

The taxes payable or tax reconciliation statement provides a means for monitoring and verifying that a debtor is current with its post-petition tax obligations. Aging information about these obligations should be provided. Close scrutiny of this form is critical and prompt remedial action should be undertaken by the United States Trustee if unpaid post-petition obligations accumulate.

3-3.3.8 Additional Reporting Requirements

In addition to the five standard forms previously discussed, the United States Trustee retains the discretion to request the debtor to submit to the United States Trustee or file with the court additional reports necessary to ensure that a case is properly monitored and administered. Examples include:

1. A list of inventory;
2. A list of employees and their current salaries;
3. Aging statements regarding accounts receivable;
4. A rent roll in a real estate case; and
5. A check register.

CHAPTER 3-4: COMMITTEES

3-4.1 STATUTORY BASIS: 11 U.S.C. § 1102 AND 1103

Section 1102 of the Bankruptcy Code directs and authorizes the United States Trustee to appoint an official unsecured creditors' committee and provides the United States Trustee with the discretion to appoint additional committees, including equity security holders' committees. Each of section 1102's three subsections addresses a specific function of the United States Trustee with regard to committee formation.

In all chapter 11 cases, the United States Trustee **must** endeavor to appoint a committee of creditors holding unsecured claims "as soon as practicable after the order for relief. . . and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate." 11 U.S.C. § 1102(a)(1) (emphasis added). "On request of a party in interest, the court may order the appointment of additional committees . . . if necessary to assure adequate representation of creditors or of equity security holders." 11 U.S.C. § 1102(a)(2). With respect to small business cases, "on request of a party in interest in a case in which the debtor is a small business as defined in section 101(51C)] and for cause, the court may order that a committee of creditors not be appointed." 11 U.S.C. § 1102(a)(3).

It has been held that a court could not use its equitable powers to override the United States Trustee's decision to appoint an additional committee. *In re Caesars Entm't Operating Co., Inc.,* 526 B.R. 265, 269 (Bankr. N.D. Ill. 2015) (*citing In re New Life Fellowship, Inc.,* 202 B.R. 994, 996 (Bankr. W.D. Okla. 1996)).

Section 1102(b)(1) provides that "a committee of creditors . . . shall **ordinarily consist** of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee . . . ." (emphasis added). The legislative history, as well as the context of the statute itself, makes clear that this is precatory language. H.R. Rep. No. 595, 95th Cong., 1st Sess. 401 (1977).

On request of a party in interest, the court may order the appointment of additional committees or may order a change in an already appointed committee's membership if either is necessary to assure "adequate representation" of creditors or equity security holders. 11 U.S.C. § 1102(a)(2) and (4). The United States Trustee will not appoint a creditors' committee in a small business case unless the court directs such an appointment for cause. 11 U.S.C. § 1102(a)(3) (as amended by the SBRA).

The powers and duties of a creditors' committee are set forth in 11 U.S.C. § 1103(c). As part of those powers and duties, the committee may:

1. review and investigate the acts, conduct, and financial condition of the debtor;
2. consult with the debtor concerning the administration of the case; and
3. participate in the formulation of the plan of reorganization. 11 U.S.C. § 1103.

As part of their obligation to represent creditor interests as a whole, members of a committee have fiduciary obligations. *See Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 268-269 (1941), *reh'g denied*, 312 U.S. 715 (1941).

Forms exist for use in soliciting creditor interest and forming official committees of unsecured creditors.

3-4.2 THE SOLICITATION OF, AND NOTICE TO, CREDITORS

3-4.2.1 The Solicitation Package

The notice used to solicit creditor interest in serving on a committee will vary slightly based on whether a formation meeting will be held. In large cases (where a large number of creditors may be interested in serving), the United States Trustee will generally appoint a committee after holding a formation meeting. In smaller cases (where fewer creditors may be interested in serving), the United States Trustee will usually appoint a committee without holding a

formation meeting. But the solicitation package for creditors should always include the following:

(1) Notice to creditors regarding the United States Trustee's interest in forming a committee, including a deadline for the creditor to act if it wants to be considered for committee membership. If a formation meeting will be held, the package should include notice of where and when the meeting will be held. If a committee will be formed without a meeting, the solicitation letter should state the deadline for returning the completed package.

(2) A questionnaire seeking information about the creditor, its claim, and its connections with the debtor. The questionnaire should elicit enough information so that the United States Trustee can evaluate a creditor's eligibility to serve and can appoint a committee that adequately represents the unsecured creditor constituencies in the case, such as trade creditors and unsecured bondholders, for example. In designing the questionnaire, the United States Trustee should consider what information will assist in appointing a representative committee and avoiding appointments of those unsuited or unqualified for service. See discussion below, Composition of the Committee.

(3) An information sheet about the purpose, powers, duties, role, and governance of, and restrictions on, the committee and its members. This information sheet should also include information regarding the committee's employment of professional persons and the prohibition and consequences of trading in the debtor's securities or claims absent an order of the bankruptcy court.

The solicitation package should typically be sent to all creditors on the List of Creditors Holding 20 Largest Unsecured Claims. However, there is no restriction on soliciting unsecured creditors beyond those 20 largest identified by the debtor, and many cases may require solicitation of a larger pool if the United States Trustee has the information to do so. For example, debtors in large cases frequently identify more than 20 creditors, notwithstanding the official form's requirement to identify only 20. Unsolicited creditor applications may also be considered, and the United States Trustee should obtain the information elicited through the questionnaire upon receiving an unsolicited expression of interest to serve on a committee.

The solicitation package should not represent or imply that returning the completed questionnaire results in automatic appointment to the committee. Rather, the form should be clear that the United States Trustee will determine the membership of the committee only after reviewing the information provided.

During the solicitation process the United States Trustee may be contacted by professionals who are interested in representing the committee. The United States Trustee should not ask to receive or accept advertising or promotional material from professionals seeking to be retained by the committee. The United States Trustee should not serve as a conduit for this information to committee

members. It is not the role of the United States Trustee to recommend particular professionals to the committee or its members.

To assist United States Trustees in their statutory duties to appoint and monitor official committees, template forms A through F are available on the Program's Web site.

3-4.2.2 Timing

Because the statute requires appointment "as soon as practicable after the order for relief," the United States Trustee should act as quickly as possible after filing to contact creditors and appoint a committee. This can include phone calls as well as e-mailing, faxing or mailing the solicitation package. Many critical issues arise early in the case, and it is important that a committee be formed as soon as the United States Trustee is reasonably able to do so. In most instances, particularly larger cases, the committee should be formed before the section 341 meeting of creditors. Case circumstances, however, may often require more expedited formation, particularly if significant "first day" (or even "second day") motions will be heard early in the case. Ideally, a committee should be formed within the first 10 to 14 days of a case if there are creditors willing to serve.

3-4.3 SIZE AND COMPOSITION OF THE COMMITTEE

3-4.3.1 Size

Although section 1102(b)(1) suggests a committee should "ordinarily" consist of seven members, it is certainly not a statutory or Program requirement. Rather, a committee of only three members is often adequately representative. Rarely, a large and complex case may warrant a committee with more than seven members, but larger committees can be unwieldy and increase costs to the estate. It is not at all unusual to have committees of three or five members.

3-4.3.2 Composition

When determining the composition of the committee, the relative size of the potential committee members' claims is one factor, but it is certainly not the dispositive factor, as discussed below. Nevertheless, the value of a creditor's claim is a starting point. Appointing only those with the largest claims will not necessarily result in a representative committee, and the statute's "ordinarily" language recognizes the United States Trustee's need for flexibility in the appointment process. Conversely, appointing too many members with relatively small claims may result in an unbalanced committee. Valuing the creditors' claims may be challenging early in the case, particularly if there is a dispute between the debtor and creditor on the claim's value or if the claim results from a complex transaction.

Appointing an adequately representative committee also requires understanding the nature of the creditor constituencies present in a case. Thus, the United States Trustee needs to become familiar with the debtor's financial structure and the various kinds of unsecured claims, such as trade creditors, unsecured bondholders (including different tranches among the bondholders), employees, pension funds, or utilities, for example. In addition, the United States Trustee should consider appointing a small business concern in appropriate circumstances, consistent with section 1102(a)(4).

It is also important to know whether a potential committee member has a potentially disqualifying conflict or status. Thus, in addition to the size and kind of the creditor's claim, the United States Trustee should also determine whether a potential committee member:

- also has an administrative, reclamation, or section 503(b)(9) claim
- is under-secured rather than unsecured, or holds both a secured and unsecured claim
- will be paid as a critical vendor
- has an executory contract, such as a lease, that the debtor has already decided to assume and cure
- is or was an "insider"
- holds equity in the debtor
- is a governmental entity that may not serve or is a governmental entity within the exceptions that may serve in some circumstances (such as PBGC or FDIC)
- is a competitor of the debtor
- has purchased its claim post-petition or has purchased it at a significant discount
- is a potential purchaser of some or all of the debtor's assets
- is a vendor that wants to continue doing business with the debtor
- has an ongoing business relationship with the debtor
- is an indenture trustee or agent of a creditor with authority to act rather than the creditor itself
- has credit insurance or other hedges that limit its exposure and may affect the true holder of the claim
- executed any agreement limiting its ability to act as a fiduciary or to consider more than one plan, such as an inter-creditor or "lock-up" agreement with the debtor
- voted for any plan solicited pre-petition
- intends to trade in claims against the debtor or the debtor's securities

Not all of these are disqualifying per se, and the United States Trustee should request additional information from any creditor who has one or more of these issues before appointing it to a committee.

The Code defines a "creditor" as an entity that holds a "claim," and a "claim" includes a contingent, unliquidated, or disputed claim. 11 U.S.C. § 101(5),

101(10). Accordingly, holders of disputed, unliquidated, and contingent claims may serve on a committee, as may those in litigation with the debtor or even those hostile to reorganization. Any rule otherwise could give the debtor control of committee membership by simply labeling a claim as disputed.

The United States Trustee should then use this information to appoint an adequately representative and properly balanced committee. Most of this information should be sought in the questionnaire, but information can also be obtained at a formation meeting, if one is held, in a telephone call to the creditor, and in consultations with the debtor. *See* § 3-4.4 *infra* (Membership Issues).

The same considerations apply when the United States Trustee appoints committees in cases having multiple, related debtors. Debtors having jointly administered cases may have consolidated financial affairs, the debtors may confront many common issues during the case, and their cases may ultimately be resolved through the confirmation of one, joint chapter 11 plan. Just as such debtors may often be represented by a single law firm, in many instances it may be appropriate to appoint one committee to represent the diverse interests of the unsecured creditors in the various cases. While the United States Trustee may determine that it is appropriate to form one committee in such circumstances, that committee must nonetheless still provide adequate representation of the various kinds of claims that are present in the cases. *See generally*, *In re Enron Corp.*, 279 B.R. 671 (Bankr. S.D.N.Y. 2002), *aff'd sub nom. Mirant Americas Energy Marketing, L.P. v. Official Committee of Unsecured Creditors of Enron Corp.*, No. 02 Civ. 6274, 2003 WL 22327118 (S.D.N.Y. Oct. 10, 2003). Regardless of whether the United States Trustee appoints one or multiple committees in jointly administered cases, care must be taken in reviewing the overall structure of the corporate enterprise, including its debt structure. It may also be necessary to solicit creditors beyond those listed on the debtors' twenty largest creditors list, particularly if that list is filed on a consolidated basis.

3-4.4 MEMBERSHIP ISSUES

3-4.4.1 Unions

Unions are eligible for appointment to creditors' committees. *See In re Altair Airlines, Inc.*, 727 F.2d 88 (3d Cir. 1984); *In re Barney_s Inc.*, 197 B.R. 431 (Bankr. S.D. N.Y, 1996). If the union's entire claim is entitled to priority treatment pursuant to sections 507(a)(3) and (4), however, then the union should not be appointed to the unsecured creditors' committee, as its interest is fundamentally different from that of the general unsecured creditors. *But see In re Plabell Rubber Prods.*, 140 B.R. 179 (Bankr. N.D. Ohio 1992) (United States Trustee ordered under section 105 to add union to committee, where none of the extant members represented a similar claim).

When considering the appointment of labor representatives to the committee, the United States Trustee must consider the impact of any "first day orders" that may permit the debtor in possession to pay pre-petition wages in the ordinary course of the debtor's post-petition operations and that may permit the debtor in possession to honor pre-petition obligations for employee benefits in the ordinary course. In *In re Barney_s, Inc.*, 197 B.R. 431 (Bankr. S.D.N.Y. 1996), a benefit fund representative was appointed. *See* Manual 3-4.41.6 for a discussion of the participation of the Pension Benefit Guarantee Corporation (PBGC) on creditors' committees.

3-4.4.2 Landlords

The claims of landlords for unpaid rent may be substantial in certain cases, such as that of a department store chain. These claims may increase if leases are rejected pursuant to section 365. To the extent the debtor intends to reject a number of its leases in the bankruptcy proceeding, the presence of a landlord will be helpful to the committee in analyzing particular dispositions. If, however, the particular landlord's lease is assumed and all defaults are cured, the landlord is no longer a creditor. The landlord should be informed by the United States Trustee that if the landlord's lease is assumed, the landlord should resign from the committee. This analysis is equally applicable when dealing with franchisers, licensors, and other parties to executory contracts. The United States Trustee may consult with the debtor prior to the committee formation to determine if it has made a determination regarding assumption or rejection of leases.

When analyzing the candidacy of landlords for committee membership, the United States Trustee may wish to consider three distinct types of landlord claims: claims for rent that is actually delinquent as of the petition date; claims for items other than base rent, such as Common Area Maintenance payments or percentage rents, which are actually delinquent as of the petition date; and possible claims of the particular candidate for rejection damages later in the case.

3-4.4.3 Secured Creditors

Fully secured creditors should, of course, not be appointed to a committee of unsecured creditors. *Accord In re America West Airlines*, 142 B.R. 901, 903 (Bankr. D. Ariz. 1992) (United States Trustee acted properly in removing a creditor from the creditors' committee after it extended post-petition financing on terms that effectively secured most of its pre-petition claim. The creditor's motion for reinstatement was denied because the creditor no longer represented an unsecured claim). Creditors holding claims that are only partially secured, however, are eligible. *In re Walat Farms, Inc.*, 64 B.R. 65 (Bankr. E.D. Mich. 1986).

3-4.4.4 Competitors

The fact that a creditor is a competitor of the debtor does not disqualify the creditor from membership on the creditors' committee, but the better part of wisdom may be not to make such an appointment. *In re MAP Int'l., Inc.*, 105 B.R. 5 (Bankr. E.D. Pa. 1989); *In re Plant Specialties, Inc.*, 59 B.R. 1 (Bankr. W.D. La. 1986). But see *In re Wilson Foods Corp.*, 31 B.R. 272 (Bankr. W.D. Okla. 1983). If the debtor expresses concern about such an appointment, the United States Trustee should emphasize the fiduciary obligations of committee members and highlight that information received at committee meetings is generally confidential and may not be used for an individual's pecuniary gain. The party seeking to exclude a creditor from serving on the creditors' committee bears the burden of proving that the creditor's appointment will be detrimental to the debtor's reorganization. *See In re MAP Int'l, Inc.*, 105 B.R. at 6. A violation of this standard of conduct may subject the creditor to sanctions similar to the damages awarded plaintiffs in cases involving violations of the "insider trading" provisions of the securities laws. To guard against this problem, the committee bylaws can allow for particular members to be excluded from certain deliberations.

3-4.4.5 Professionals Formerly Employed by the Debtor

Former counsel to a debtor may be a significant creditor in a case. If such counsel is one of the largest creditors and wishes to serve on the creditors' committee, the United States Trustee should caution counsel concerning certain issues that may arise. For example, the attorney may have information that is subject to the attorney-client privilege. This places the attorney in an awkward position vis-a-vis meeting his or her fiduciary obligation as a member of the creditors' committee. Of course, the debtor may waive the privilege. This same analysis is applicable to accountants, even though no accountant-client privilege exists under federal law.

3-4.4.6 Governmental Units

A governmental unit is generally ineligible to serve on a creditors' committee unless it qualifies as a "person." Only persons are eligible to serve pursuant to section 1102(b)(1), and the term "person" is defined to exclude governmental units, except to the extent that a governmental unit:

1. has acquired an asset from a person as a result of a loan guarantee agreement or as a receiver or liquidating agent of a person;
2. is a guarantor of a pension benefit payable by or on behalf of a debtor or an affiliate of the debtor; or
3. is the legal or beneficial owner of an asset of an employee pension benefit plan that is a governmental plan as defined by the Internal Revenue Code or

an eligible deferred compensation plan as defined in the Internal Revenue Code. 11 U.S.C. § 101(41). *See also Matter of Gates Engineering Co., Inc.*, 104 B.R. 453 (Bankr. D. Del. 1989); *In re Mansfield Tire & Rubber Co.*, 39 B.R. 974 (N.D. Ohio 1983); *In re VTN, Inc.*, 65 B.R. 278 (Bankr. S.D. Fla. 1986); *In re Baldwin-United Corp.*, 38 B.R. 802, 806 (Bankr. S.D. Ohio 1984).

As a practical matter, this exception usually comes into play with regard to the participation of the PBGC on unsecured creditors' committees. The claims of the PBGC and certain analogous state agencies are often of two types. The first is a pre-petition claim for actual underfunding of a benefit plan, i.e., pre-petition arrearages. The second is for termination liability, i.e., the long-term exposure suffered by the PBGC should the benefit plan be terminated in the bankruptcy case. Since this sum represents a long- term stream of payments to a group of beneficiaries, the amount of the claim oftentimes dwarfs other claims against the estate. When analyzing the candidacy of this type of entity, the United States Trustee may wish to consider the probability of plan termination.

Unless there is current underfunding, the debtor in possession may not identify the PBGC as one of the 20 largest unsecured creditors at the commencement of the case. The policy of the United States Trustee Program is that United States Trustees should carefully consider any PBGC request for membership. Further, United States Trustees should not decline to place the PBGC on a committee based upon the debtor's bare assertion that it has no unfunded pension liability and no present intention to terminate an extant plan. The United States Trustees must consult with the Office of the General Counsel (OGC) regarding any PBGC request for membership on the unsecured creditors' committee.

3-4.4.7 Insiders

The claims of insiders are not required to be listed among the 20 largest unsecured creditors (Fed. R. Bankr. P. 1007(d)) because insider claims are generally not representative of the kinds found on the committee. In considering the formation and role of committees, Congress considered the natural tension that exists between the debtor and its creditors, a tension absent if the creditor is an insider. The presence of insiders on the committee would permit the debtor, in effect, to negotiate a plan with itself. *In re Swolsky*, 55 B.R. 144 (Bankr. N.D. Ohio 1985); *In re Glendale Woods Apartments, Ltd.*, 25 B.R. 414 (Bankr. D. Md. 1982). But see *In re Vermont Real Estate Inv. Trust*, 20 B.R. 33 (Bankr. D. Vt. 1982).

3-4.4.8 Contingent, Unliquidated, or Disputed Claims

The mere fact that a creditor holds a claim that is contingent, unliquidated, or disputed does not disqualify the creditor from appointment to the committee. This is clear from the definitions of "claim" and "creditor" set forth in the Code.

11 U.S.C. § 101(5), (10). *See generally In re Barney's, Inc.*, 197 B.R. 431 (Bankr. S.D.N.Y. 1996).

3-4.4.9 Indenture Trustees

The Trust Indenture Act of 1939, 15 U.S.C. § 77aaa-77bbbb, defines an "indenture" as any mortgage, deed of trust, trust, or other indenture under which securities are outstanding or are to be issued, whether or not any property, real or personal, is or is to be pledged, mortgaged, assigned, or conveyed thereunder. 15 U.S.C. § 77ccc (7). The Bankruptcy Code defines an indenture similarly at section 101(28). The indenture defines the relationship between an issuer of securities, often a debtor in bankruptcy, and the indenture trustee, typically a financial institution that has agreed to serve for the equal and ratable benefit of the holders of the securities. In the event of a default by the issuing company under the indenture, the indenture trustee typically undertakes to exercise the rights given it by contract with the same degree of care and skill as a prudent person in the conduct of his or her own affairs. The failure to exercise this degree of care on behalf of the holders can subject the indenture trustee to liability for negligence.

The indenture trustee rarely has a direct claim of any consequence against the debtor at the time the case is commenced, except perhaps for certain expenses incurred incident to its trusteeship. However, given the indenture trustee's potential exposure to liability, the indenture trustee is typically one of the first volunteers to serve on an unsecured creditors' committee. The Bankruptcy Code recognizes that an indenture trustee may often make a substantial contribution to a chapter 11 case. *See* 11 U.S.C. § 503(b)(3)(D) and (b)(5). It may be useful to communicate with the indenture trustee in connection with the committee formation process to determine the amounts outstanding under the given indenture, the relative priority of the debt, whether there is any collateral securing repayment of the issue, and the identity of the beneficial holders of the bonds. Frequently, it will be difficult to penetrate beyond the "street name" holders of record to the real beneficial owners of the securities. If beneficial owners of significant amounts of the outstanding debt can be identified, the participation of the indenture trustee as a voting member of the creditors' committee may not be necessary. The United States Trustee may wish to attempt to place actual holders of the securities on the committee given the precatory language of section 1102(b)(1).

On the other hand, the appointment of an indenture trustee as a voting member may be the only way to assure adequate representation of the public debt holders where large institutional investors cannot be identified or do not exist. (The United States Trustee does not appoint non-voting (*ex officio*) members to a committee.) Accordingly, the policy with respect to the appointment of indenture trustees to unsecured creditors' committees as members cannot be expressed as a *per se* rule, but rather must depend on the circumstances of the case and the need

to include or exclude indenture trustees in order to assure adequate representation. *See In re Value Merchants, Inc.*, 202 B.R. 280, 290 (E.D. Wis. 1990) (district court affirmed bankruptcy court's finding that United States Trustee acted arbitrarily and capriciously in excluding indenture trustees from voting membership on unsecured creditors' committee).

3-4.4.10 Equity Security Holders

In certain cases, large unsecured creditors who also hold stock of the debtor will seek membership on the committee. In this type of situation, the United States Trustee may wish to undertake an analysis akin to that utilized for undersecured creditor candidates and discussed in *In re Walat Farms, Inc.*, 64 B.R. 65 (Bankr. E.D. Mich. 1986). Factors that may be relevant include, but are not limited to, the type of stock held, e.g., preferred or common; voting or non-voting; the size of the shareholding relative to all issued and outstanding shares; the value of the shares; and the length of time held.

3-4.4.11 Priority Reclamation Claims under Section 503(b)(9)

Under section 503(b)(9), an administrative claim priority is given to claims for the value of any goods received by the debtor within 20 days before the date of commencement of a case where goods were sold to a debtor in the ordinary course of business. Such claimants should not be included on the committee of general unsecured creditors.

3-4.4.12 Critical Vendors

Parties who obtain orders and are to be paid as "Critical Vendors" should not be included on the committee of general unsecured creditors. *See* Manual 3-2.8.6. *et seq. supra*.

3-4.5 CONDUCTING A FORMATION MEETING

3-4.5.1 Timing

If a formation meeting will be held, the United States Trustee should generally seek to conduct the meeting within approximately 10 to 14 days after the commencement of the case. However, often, the circumstances of the case require more expedited formation, particularly if significant "first day" motions will be heard early in the case. If the formation meeting notice is served with less than 10 days' notice, then the United States Trustee should consider serving the notice by e-mail or facsimile to the extent practicable. The United States Trustee may request that the debtor's counsel provide e-mail addresses and facsimile numbers for the creditors to be solicited, particularly with "first day" binders.

3-4.5.2 Conducting the Formation Meeting

The formation meeting will be attended by the debtor, its creditors, and various professionals. The debtor should attend to give a short presentation to the creditors. Creditors will attend because they want to serve on the committee, although attendance at the meeting is not required for appointment. Because the committee typically holds its first meeting immediately following the formation meeting, professionals often attend, seeking to represent the committee once appointed.

The representative of the United States Trustee should announce the case and then introduce the United States Trustee personnel and the debtor's representative. Any creditor questionnaires not received before the meeting should be collected. The Program attorney conducting the meeting should explain the role of the United States Trustee and the creditor's committee in the bankruptcy process, including the committee members' fiduciary obligation to the entire unsecured creditor body and the committee's powers and duties set forth in section 1103(c). Creditors should also be reminded that they will not be appointed to the committee absent an agreement not to trade in claims or securities of the debtor without court authorization.

The debtor should then make a short presentation to the creditors regarding the events that led to filing the case and respond to limited inquiries by creditors. This presentation generally covers matters publicly revealed in the early days of the case. This is not an occasion for extensive questioning, and the debtor's representative is not placed under oath.

After the debtor makes its initial presentation, the United States Trustee should meet privately with the individual creditors (and their counsel) seeking appointment to the committee to discuss their particular claims or interests and any other relevant information. The United States Trustee's consultations with individual creditors should be private so that the parties can speak openly without fearing public disclosure of sensitive or confidential information. Such information may be very useful in evaluating the case and ensuring a representative committee. In addition, if the United States Trustee has not already done so, she should consult with the debtor regarding its debt structure and any other information pertinent to appointing a balanced and representative committee.

Although the consultations with individual creditors and the deliberation process should be conducted privately, the United States Trustee should, absent unusual circumstances, allow the public and press to attend the remaining portions of the formation meeting, including her representative's introduction and announcement of committee appointments (discussed below), as well as the debtor's presentation. The United States Trustee's representative should monitor attendance at the formation meeting and may wish to use separate sign-in sheets for creditors and professionals. In addition, recording devices should not be permitted in any part of the formation meeting.

3-4.5.3 Proxies

Creditors seeking committee membership may authorize someone else to appear on their behalf at the formation meeting. Bankruptcy Rule 9010 specifically permits the use of proxies. Fed. R. Bankr. P. 9010.[2] Thus, there is no per se prohibition on a proxy holder appearing at a creditors' committee formation meeting. Anyone appearing for an absent creditor must have a valid proxy granting authority to act on behalf of the absent creditor at the meeting, which the United States Trustee should carefully scrutinize both for the appropriate grant of authority and the extent of that authority. Rule 9010 requires that a proxy be in writing, conform substantially to the appropriate official form, and be acknowledged before a state or federal official authorized to administer oaths. Although a creditor may participate in the committee formation meeting by proxy, the creditor itself is appointed to the committee, not the proxy holder. This is important because the United States Trustee seeks creditor members who will actively participate and not defer to proxy holders or "professional committee sitters."

The circumstances surrounding the proxy's execution and solicitation require further inquiry to ensure the integrity of the committee formation process. Determining the legitimacy of the creditor's and proxy holder's motives is difficult but critical. Sometimes creditors and proxy holders seek to influence the selection of committee counsel or other committee professionals for an undisclosed quid pro quo arrangement. *See generally In re Universal Building Products*, No. 10-12453, 2010 WL 4642046, at *1 (Bankr. D. Del. Nov. 4, 2010). Proxy holders themselves may also seek to be retained by the committee. If the proxy holder seeks to be retained by the committee and its creditor has been selected for committee membership, then the proxy holder should not participate in the interviews of professionals and any retention decisions. *See generally In re ABC Automotive Products Corp.*, 210 B.R. 437 (Bankr. E.D. Pa. 1997).

Accordingly, when presented with a proxy, the United States Trustee should inquire about and determine the following:

(1) the nature and extent of the proxy holder's relationship with the creditor;

(2) whether a proxy holder who is a professional will seek to be retained by the committee;

---

[2]Bankruptcy Rule 2006, Solicitation and Voting of Proxies in Chapter 7 Liquidation Cases, does not generally apply in chapter 11 cases. Rule 2006's limits on proxy use and solicitation apply in chapter 11 cases only when the court reviews an official committee consisting of members of a committee organized by creditors before the commencement of the case, Fed. R. Bankr. P. 2007(b)(2), or creditors seek to elect a trustee. Fed. R. Bankr. P. 2007.1(b)(2).

(3) whether the proxy holder has committed to vote for a particular professional's retention by the committee;

(4) whether the proxy was obtained by improper solicitation, including:
   a. whether it was solicited by the proxy holder rather than sought by the creditor;
   b. whether it was solicited for the purpose of being retained as a committee professional; and
   c. if an attorney solicited the proxy, whether the attorney has a prior family, personal, or professional relationship with the creditor;[3]

(5) whether the proxy holder is familiar with the creditor and its claim, and is able to answer any questions about them;

(6) any agreements regarding compensation, retention, or employment between the creditor and proxy holder; and

(7) the creditor's interest in serving and actively participating on the committee.

If it appears that a proxy holder obtained the proxy improperly or for an improper purpose, or that the creditor is not genuinely interested in serving, those facts should be considered in the committee appointment process.

3-4.5.4 Conclusion of the Formation Meeting

After considering the information contained in the questionnaire and gathered at the formation meeting from the debtor and creditors, the Office of the United States Trustee typically announces the creditors being appointed to the committee and concludes the formation meeting. The deliberation process should be conducted privately, following the conclusion of which the United States Trustee's representative should rejoin the formation meeting to publicly announce the appointments. The United States Trustee or Assistant United States Trustee (if specifically authorized by the United States Trustee) must approve all creditor committee appointments before they are announced.

The conclusion of the formation meeting, in turn, can serve as a transition to the first meeting of the committee itself (discussed below). Professionals who hope to be retained by the committee often remain available nearby because the committee may interview professionals during its initial meeting.

[3]United States Trustees should also be aware of applicable ethics rules on attorney solicitation, which can vary by jurisdiction. Many jurisdictions ban attorneys from soliciting prospective clients unless the attorney and prospective client have a prior family, close personal, or professional relationship. *See* Rule 7.3 of the Model Rules of Professional Conduct.

3-4.6 NOTICE OF THE COMMITTEE APPOINTMENT

Regardless of whether a committee is appointed after a formation meeting or after written solicitation and phone calls, the United States Trustee must prepare and file a Notice of Appointment with the bankruptcy court and send a copy to the debtor and each committee member. The notice should include each committee member's name, address, telephone number, facsimile number, and e-mail address, except that an individual creditor should generally be listed by name only.

If a committee cannot be appointed because of a lack of eligible or interested creditors, it may be good practice to file a notice with the court regarding the inability to appoint after the United States Trustee makes that determination. In addition to demonstrating the effort to comply with the statutory duty to appoint, the notice of no appointment may result in previously reluctant creditors agreeing to serve.

3-4.7 INITIAL COMMITTEE MEETING AND COMMITTEE DUTIES, POWER, AND RESTRICTIONS

3-4.7.1 Organization

If a committee is appointed after a formation meeting, the committee usually holds its first meeting immediately thereafter. If a committee is formed by other means, the United States Trustee should consider convening the first meeting by telephone conference. In either event, the United States Trustee needs to discuss with the committee members their need to select a chairperson and adopt committee by-laws or procedural rules for their governance (e.g., quorum, voting, recusal, and claims trading and information sharing restrictions).

3-4.7.2 Powers and Duties

The United States Trustee must also reiterate to the committee members their powers and duties set forth in 11 U.S.C. § 1103(a) and (c), including their fiduciary duties to the entire unsecured creditor body, and the disclosures that must be filed under Federal Rule of Bankruptcy Procedure 2019. The committee has authority to:

- retain attorneys, accountants, and other professionals to represent the committee
- consult with the debtor in possession (or trustee) concerning the administration of the case
- investigate the acts, conduct, assets, liabilities, and financial condition of the debtor
- investigate the operation of the debtor's business and the desirability of the continuance of such business

- investigate any matters relevant to the formulation of a plan
- participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan
- request the appointment of a trustee or examiner

In addition, the committee may perform such other services as are in the interest of those represented, which may include:

- reviewing and possibly objecting to any applications for administrative expense, including but not limited to professional fees
- negotiating executive compensation issues
- negotiating bid procedures in a proposed sale of substantially all the assets of the estate
- acquiring the right to pursue avoidance and other chapter 5 claims or other claims on behalf of the estate
- investigating the bona fides of pre-petition secured debt

Effective December 1, 2011, some, but not all, of revised Bankruptcy Rule 2019 applies to official committees. Fed. R. Bankr. P. 2019. Rule 2019, as amended, requires each member of an official committee to file a verified statement disclosing its name, its address, and the nature and amount of each "disclosable economic interest" held in relation to the debtor on the date the committee was formed. If information previously disclosed materially changes, the committee must file a verified supplemental statement updating the earlier information when taking a position before the court or soliciting votes on a plan.

Further guidance concerning amended Rule 2019 and its application to other groups is located in section 3-4.16.

3-4.7.3 Restrictions on Trading

In addition to whatever duties may be imposed on a creditor engaging in trading activities under applicable federal and state law, the United States Trustee must ensure that a creditor engaging in trading activity is not appointed to the committee without securing from the creditor its agreement not to trade while on the committee (unless the creditor obtains court approval for such trading). The United States Trustee must ensure that the committee members can and will fulfill their fiduciary duties to the unsecured creditor body. Committee members should be advised that they will likely have access to material, non-public information ("inside information") about the debtor, and any transactions they or their businesses engage in during the case related to the debtor may raise allegations of a breach of fiduciary duty or at least an appearance of improper conduct.[4] Accordingly, committee members must agree prior to accepting a

[4]These concerns about the sharing of a debtor's confidential information also suggest caution when a debtor's competitor seeks committee membership. Nevertheless, the creditor's status as a competitor is not, *per se*, disqualifying.

position on the committee that they will not engage in trading activities absent bankruptcy court authorization. Absent court approval of a trade or transfer, this trading prohibition applies so long as the creditor remains a member of the committee. The United States Trustee may also require certifications of claim holdings by committee members (described in the following section of this manual).

Sometimes a committee member, or the committee itself, may file a "blocking motion" or other motion that permits some trading in the debtor's claims or securities. Blocking motions typically establish specific screening walls or blocking procedures to prohibit a committee member's trading personnel from contacting the member's personnel who serve on the committee. If such an order is entered, the order's procedures should be specific, but it should not insulate the creditor from liability for any breach of fiduciary duty simply because of compliance with the blocking order's procedures.

3-4.8 CERTIFICATIONS OF CLAIMS HELD

The United States Trustee may require committee members to agree to provide certifications with respect to the claims that they hold. In addition to an initial certification regarding claims, the United States Trustee may require each committee member to certify quarterly all its claims against, or interests in, the debtor. The certification requirement seeks, among other things, to ensure that a committee member remains a creditor of the debtor and that the creditor is not using material non-public information obtained through committee membership for personal gain. Creditors who fail to satisfy such requirements may be removed from the committee. If the United States Trustee requires quarterly certifications, they should be provided until the earlier of (1) the effective date of a confirmed plan, (2) dismissal, (3) conversion, (4) the members' resignation from the committee, or (5) disbandment of the committee.[5]

Irrespective of whether an ongoing quarterly certification procedure is used, the United States Trustee may also require that committee members notify the United States Trustee immediately (the same day) in writing of any material changes in the amount of total debt owned or managed by the committee member. The written notice may specify the amount of debt involved and the reason for the change (for example, a transfer of claim, or consummation of any type of credit protection transaction). Upon receipt, the United States Trustee may evaluate the information to determine whether the trade or assignment of the claim violates a

[5]Even after the committee ceases to exist or the creditor resigns, the creditor might nonetheless continue to face restrictions on trading under applicable state or federal law, based on its possession of inside information.

trading order or the committee by-laws or sufficiently reduces the creditor's interest in the case, any of which may require removal from the committee.

3-4.9 PRE-PETITION COMMITTEES

Creditors may form a committee prior to the commencement of a case. If such a committee was fairly chosen and is representative of the various kinds of claims presented, the United States Trustee must give strong consideration to appointing the members of the pre-petition committee to the committee of unsecured creditors in the case. 11 U.S.C. § 1102(b)(1). The standards for determining whether a pre-petition committee was fairly chosen are set forth in Fed. R. Bankr. P. 2007(b) and require consideration of additional factors including:

1. whether a meeting was called;
2. who called the meeting;
3. who was invited to the meeting;
4. what creditors were told regarding the purpose of the meeting;
5. who attended the meeting;
6. what transpired at the meeting;
7. who expressed a desire to serve on the creditors_ committee; and
8. who was selected and why.

As a practical matter, the "safe harbor" provisions of Fed. R. Bankr. P. 2007(b) are so difficult for the creditors to satisfy – and for the United States Trustee to verify – that it is appropriate for the United States Trustee to schedule a formation meeting following the standard procedures and to invite the pre-petition committee members to declare themselves as candidates. Care should be exercised to ensure that creditors who did not participate on the pre-petition *ad hoc* committee are not dissuaded from becoming candidates for the official committee.

The information set out above should be supplied to the United States Trustee in affidavit form by member(s) of the pre-petition committee. Other documentation may be relied upon; for example, a copy of the sign-in sheet for the meeting may be used to determine who was in attendance.

The appointment of a pre-petition committee as the official committee of unsecured creditors can greatly facilitate efficient case administration during the period immediately following the filing of a petition. The members of the committee are already familiar with the circumstances confronting the debtor and can immediately apply their knowledge and expertise to the reorganization effort. Conversely, if a pre-petition committee was not fairly chosen or is not adequately representative, its appointment as the official committee may significantly impede early case administration efforts.

If the United States Trustee appoints the pre-petition committee and an objection is raised, the court, after notice and hearing, may determine whether the requirements of section 1102(b)(1) have been met. Fed. R. Bankr. P. 2007(a). If a determination is made that the requirements of section 1102(b)(1) have not been met, the court will direct the United States Trustee to vacate the appointment of the committee and may order other appropriate action. Fed. R. Bankr. P. 2007(c).

3-4.10 ATTEMPTS TO PRE-EMPT THE SELECTION PROCESS

Creditor attempts to preempt the United States Trustee's role in the appointment process following the entry of an order for relief in a voluntary case should be closely scrutinized. These attempts are often organized by attorneys seeking employment as committee counsel and, as a result, are not entitled to great deference by the United States Trustee.

3-4.11 SMALL BUSINESS CASES - CREDITORS'COMMITTEE NOT APPOINTED ABSENT COURT ORDER

11 U.S.C. § 1102(a)(3) provides:

> Unless the court for cause orders otherwise, a committee of creditors may not be appointed in a small business case or a case under subchapter V of this chapter.

The SBRA amended section 1102(a)(3) to effectively eliminate committees in small business cases. The USTP should request committees sparingly, given the congressional intent to effectuate cost savings. Creditors and other parties in interest will have a better grasp of the facts that might warrant a court finding of "cause."

3-4.12 INVOLUNTARY CASES

Creditors may organize meetings after the commencement of an involuntary case, but before the entry of an order for relief. The United States Trustee's authority to appoint an official committee is operative only after the entry of an order for relief. 11 U.S.C. § 1102(a)(1).

3-4.13 NUMBER OF COMMITTEES

The Bankruptcy Code mandates that the United States Trustee form a committee of unsecured creditors in all chapter 11 cases and permits the United States Trustee to appoint additional committees of creditors or equity security holders as appropriate. *See* 11 U.S.C. § 1102(a)(1). Usually, one committee will be sufficient. But other committees can be appointed to represent varieties of or significantly different interests. *See* 11 U.S.C. § 1102(a)(2). *See also In re Wang Labs., Inc.*, 149 B.R. 1 (Bankr. D. Mass. 1992).

Section 1102(a)(1) authorizes the appointment by the United States Trustee of additional committees, including a committee of equity security holders. The United States Trustee is authorized to appoint such additional committees as the United States Trustee "deems appropriate." This language signifies that the United States Trustee has considerable discretion in deciding whether to appoint additional committees.

The court may order the appointment of such a committee by the United States Trustee. 11 U.S.C. §1102(a)(2). While there is no statutory requirement that they do so, practitioners should be encouraged to submit requests for additional committees first to the United States Trustee prior to moving for relief from the court, as this may achieve the desired result without the need for litigation and its associated costs to the parties and the estate.

If a party in interest moves the court for an order directing the appointment of an additional committee, the court can grant the relief only upon a finding that the appointment of the additional committee is "necessary to assure adequate representation" of the movant's interests. 11 U.S.C. § 1102(a)(2); *see also In re Edison Bros. Stores, Inc.*, 1996 WL 534853 (D. Del. Sept. 17, 1996); *In re Johns-Manville*, 68 B.R. 155 (S.D.N.Y. 1986), *appeal dismissed,* 824 F.2d 176 (2nd Cir. 1989). The requirement of "necessity" is a high standard "that is far more onerous than if the statute merely provided that a committee be 'useful'." *In re Kasper A.S.L., Ltd.*, Oral Opinion, Case No. 02-10497 (LAG) (Bankr. S.D.N.Y. July 15, 2003) as cited in *In re Oneida, LTD.*, 2006 WL 1288576 (Bankr. S.D.N.Y. 2006).

As noted, tension among creditors is inherent in all cases and is necessary for the case to move forward. *See In re Baldwin-United Corp.*, 45 B.R. 375, 376 (Bankr. S.D. Ohio 1983). The mere presence of a potential conflict of interest among creditors does not automatically require the appointment of separate committees. *See In re McLean Indus., Inc.*, 70 B.R. 852, 861 (Bankr. S.D.N.Y. 1987). *See also In re Salant Corp.*, 53 B.R. 158 (Bankr. S.D.N.Y. 1985); *In re Baldwin-United Corp.*, 45 B.R. at 376.

The appointment of several separate committees can lead to posturing among the creditor groups that might not otherwise arise. Moreover, counsel for a single committee may be more apt to encourage creditors to resolve their differences, as opposed to counsel for separate committees who may be inclined to litigate such matters. The proliferation of committees to serve special interests has an adverse impact on the efficient administration of a case. *See In re Baldwin-United Corp.*, 45 B.R. at 376. Rather than striving to resolve creditor differences, separate committees tend to prolong the process of reconciling differences into a consensus in support of a plan of reorganization. Compelling creditors with diverse interests to serve on the same committee may create opportunities for creditors to resolve their differences consensually.

Another important factor militating against appointing separate committees is the cost factor. The appointment of additional committees inevitably means the retention of additional attorneys, accountants, and other professionals. *See In re*

Saxon Indus., Inc., 39 B.R. 945, 947 (Bankr. S.D.N.Y. 1984). With the increase in the number of professionals comes a concomitant decrease in the accountability and delineation of responsibility. Courts have denied requests for additional committees based in large part upon their concern for escalating administrative costs. *See In re Sharon Steel Corp.*, 100 B.R. 767, 778 (Bankr. W.D. Pa. 1989); *In re Texaco, Inc.*, 79 B.R. 560, 567 (Bankr. S.D.N.Y. 1987); *In re Baldwin-United Corp.*, 45 B.R. at 376. *But see In re Beker Indus. Corp.*, 55 B.R. 945, 949 (Bankr. S.D.N.Y. 1985).

The appointment of a separate committee may be appropriate, however, if conflicts among creditors are of such a magnitude as to impair the ability of a committee to function effectively. *In re McLean Indus., Inc.*, 70 B.R. 852, 861 (Bankr. S.D.N.Y. 1987). *See also In re Johns-Manville Corp.*, 38 B.R. 331 (Bankr. S.D.N.Y. 1983). This is especially true in a large, complex case in which the debtor's business is extremely unstable. As such a case progresses, the interests of creditors may diverge and they may take more extreme positions than would otherwise be expected. For example, in the *Beker Indus. Corp.* case, the debtor's survival depended upon obtaining additional financing. 55 B.R. at 949. The financing agreement would have affected various creditor groups in materially different ways. The court, therefore, directed the appointment of an additional committee of debenture holders due to the unstable nature of the case and the need for the active participation of the debenture holders to protect their interests. *Accord In re Dow Corning Corp.*, 194 B.R. 121, 143-45 (Bankr. E.D. Mich. 1996) (a case involving trade creditors, tort claimants, and insurance and indemnity claims relating to breast implants merited appointment of multiple committees because no single committee could adequately represent all of their conflicting interests). *Cf. In re Hills Stores Co.*, 137 B.R. 4 (Bankr. S.D.N.Y. 1992) (court denied a request to appoint a separate committee of subordinated bondholders absent evidence that a conflict among creditors would impede the extant committee's ability to function).

If more than one committee is appointed, they should be advised that no two committees should retain the same counsel. *See In re Proof of the Pudding, Inc.*, 3 B.R. 645 (Bankr. S.D.N.Y. 1980). With regard to accountants, the United States Trustee might suggest that, if appropriate under the facts of the case, provisions be made for the free flow of information between the accountants for the separate committees.

If a party in interest challenges a decision by the United States Trustee to appoint an additional committee, the United States Trustee should emphasize the "deems appropriate" language of section 1102(a)(1). A court should not disband an additional committee appointed by a United States Trustee under section 1102(a)(1) because it would not have ordered the appointment of the committee under section 1102(a)(2).

In responding to a motion under section 1102(a)(4) to change the composition of a committee, the United States Trustee should generally focus on the representativeness issue and not on how the United States Trustee arrived at the

appointment decision. Accordingly, any response should analyze the kinds of creditors present in the case and show how the membership adequately represents those interests. Any further discussion of the appointment process runs the serious risk of waiving an important governmental privilege, the deliberative process privilege. A government official's pre-decision and deliberative processes are often shielded from disclosure, but the privilege can be waived. The Office of General Counsel should be consulted prior to taking any action that may waive the privilege.

3-4.14 EQUITY SECURITY HOLDERS' COMMITTEE

United States Trustees should appoint equity committees as a rare exception and not in every case. "Appointment of committees of equity holders is the rare exception rather than the rule in chapter 11 cases." *Exide Technologies v. State of Wisconsin Investment Board*, 2002 WL 32332000 (D.Del. 2002); *In re Williams Communications Group, Inc.*, 281 B.R. 216, 224 (Bankr. S.D.N.Y. 2002). *See also* 7 King, *Collier on Bankruptcy* ¶ 1102.03[2] at 1102-22 (15th ed. Rev. 2001). The appointment of an equity security holders' committee is an extraordinary remedy. *In re Dana Corp.*, 344 B.R. 35, 38 (Bankr. S.D.N.Y. 2006); *In re Winn-Dixie Stores, Inc.*, 326 B.R. 853, 857 (Bankr. M.D. Fla. 2005); *Enron Corp.*, 279 B.R. at 685. The movant has the burden of establishing that its class of equity security holders is not adequately represented. *Dana Corp.*, 344 B.R. at 38; *Winn-Dixie*, 326 B.R. at 857; *Enron Corp.*, 279 B.R. at 685. To meet its burden, the movant must "establish that (i) there is a substantial likelihood that they will receive a meaningful distribution in the case under a strict application of the absolute priority rule, and (ii) they are unable to represent their interests in the bankruptcy case without an official committee." *Williams Communications*, 281 B.R. at 223. Equity security holders' committees should not be appointed when the estate is "hopelessly insolvent." *In re Emons Indus., Inc.*, 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985). Inadequacy of representation is not demonstrated simply because the interests of equity security holders differ from those of unsecured creditors. There are many sources of adequate representation aside from the appointment of an official committee. *Johns-Manville*, 68 B.R. at 163; *In re Hill Stores Co.*, 137 B.R. 4 (Bankr. S.D.N.Y. 1992). Generally, the board of directors acts for the equity security holders. Once a company becomes insolvent or files for bankruptcy protection, the directors still owe a fiduciary duty to the equity security holders. *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 355 (1985). Upon commencement of a bankruptcy case, the board's fiduciary duty is extended to the creditors. *Commodity Futures Trading Commission*, *supra.* Pure speculation that a debtor's board and management will sacrifice the interests of the equity security holders to placate the creditors is insufficient to establish the need for an official equity security holders' committee. *Edison Bros. Stores, Inc.*, *supra.* At times, even the official creditors' committee has been found to represent the interests of the equity security holders when their interests are sufficiently aligned. *Williams Communications*, 281 B.R. at 222; *In re Leap Wireless Int_l, Inc.*, 295 B.R. 135,

139-140 (Bankr. S.D. Cal. 2003). Finally, even unofficial committees can provide adequate representation of the interests of equity security holders without burdening the estate with the costs of such a committee's professionals. *Johns-Manville*, 68 B.R. at 162-4.

The United States Trustee may consider all relevant factors in determining whether or not to appoint an equity security holders' committee. Factors to consider may include whether the debtor is hopelessly insolvent *(In re Emons Indus., Inc.*, *supra*); whether the stock is publicly traded and widely held (*In re Wang Labs, Inc.*, 149 B.R. 1 (Bankr. D. Mass. 1992) and *Johns-Manville*, 68 B.R. 155 (S.D.N.Y. 1986)); whether a case is financially complex (*In re Edison Bros. Stores, Inc.*, *supra*); timeliness of the request for the committee (*In re Kalvar Microfilm, Inc.*, 195 B.R. 599, 600 (Bankr. D. Del. 1996)); additional cost to the estate, *id*; and alternative sources of representation (*In re Edison Bros. Stores, Inc.*, *supra*; *In re Hill Stores Co.*, *supra*).

If an equity security holders' committee is to be appointed, the United States Trustee should seek to obtain a list of the largest beneficial holders of the debtor's securities. As a starting point, United States Trustees should consult the list of equity security holders that a chapter 11 debtor is required to file. *See* Fed.R.Bankr.P. 1007(a)(3). Large blocks of stock are often held in a "street name" by brokerage houses or "in trust" at financial institutions, making it difficult to determine the identity of the beneficial interest holders. The regional office of the SEC may be able to assist in this process. The list should contain the names of at least the 40 largest beneficial holders, as potential members often reside throughout the country and it may, therefore, be difficult to find equity security holders willing to serve.

Section 1102(b)(2) provides that committees of equity security holders will ordinarily consist of the persons holding the seven largest amounts of equity securities of the debtor. When appointing members to an equity security holders' committee, inquiry should be made whether the holders acquired their interest before or after the commencement of the case. If the interest was acquired post-petition, the holder may well be designated as a "speculator" and potentially afforded different treatment under a plan. *In re Four Seasons Nursing Ctrs., Inc.*, 472 F.2d 747 (10th Cir. 1973). Because the appointment of these members may distort the "representativeness" of the committee, this circumstance should be considered by the United States Trustee in making the appointment.

3-4.15 MODIFICATION OF COMMITTEE MEMBERSHIP

3-4.15.1 Considerations

Proper supervision of an estate requires a continuing review of its circumstances. A modification of a committee's structure may at some point become necessary. Nothing in the Code limits the power of the United States Trustee to alter committee appointments after they are initially made. Accordingly, the United States Trustee has the authority to remove committee members as well as to

appoint committee members and otherwise to alter the composition of the committee after it has been created. However, this authority is subject to the court's power under section 1102(a)(4).

Section 1102(a)(4) provides that the court may, on request of a party in interest and after notice and a hearing, order the United States Trustee to change the membership of a committee appointed under section 1102 if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders.

The court's authority to adjust committee membership is not unfettered. With the exception noted below, the court may order a change in the composition only if the court determines that doing so is necessary to ensure adequate representation of creditors or equity security holders. The court does not appoint any replacement members. The court can only order the United States Trustee to change membership on the committee, but appointment of replacement members is still a decision that will be made by the United States Trustee.

Section 1102(a)(4) also permits the court to order the United States Trustee to increase the number of members of a committee to include a creditor that is a small business concern as defined in the Small Business Act, 15 U.S.C. § 631 *et seq*. The court may only do so, however, if it determines that the creditor holds claims the aggregate amount of which is disproportionately large. The effect of this section is to allow a smaller creditor to serve on a committee if the amount owed to that creditor will have a significant impact on the creditor's business, even if the creditor is not the holder of a large claim. The matter is discretionary and a court may decline to order the expansion of a committee to include such a creditor, even if the case will have a severe impact on the creditor's business.

Creditors seeking to modify a committee should be urged to first request such modification from the United States Trustee. Indeed, absent an issue of adequacy of representation, it has been held that questions concerning committee membership must, in the first instance, be directed to the United States Trustee. *In re First RepublicBank Corp.*, 95 B.R. 58 (Bankr. N.D. Tex. 1988). When reviewing such requests, the United States Trustee should consider the same factors that are relevant to the initial appointment of the committee – for example, the representativeness of the committee, the ability of its members to cooperate effectively in pursuing a reorganization, the impact financially on the estate, and any disruption that may result. A paramount consideration is whether the committee structure is moving the case forward, e.g., the effect of a modification on the operation of the current committee and on the conduct of the case. Before reconstituting or adding a committee, a determination must be made that the change will move the case toward resolution.

Bankruptcy Rule 2020 provides that a proceeding to contest any act or failure to act by the United States Trustee is governed by Bankruptcy Rule 9014. The effect of this rule is to establish that challenges to decisions by the United States Trustee are determined by motion. Nothing in Bankruptcy Rule 2020 has an

impact on whether particular actions are subject to judicial review or who may seek review of such actions.

3-4.15.2 Substitutions

Being ever mindful of the statutory requirement that the official unsecured creditors' committee be representative of the entire body of unsecured creditors entitled to such representation, in those cases where a creditor resigns or no longer wishes to serve, the United States Trustee may substitute another creditor with a similar claim if doing so would preserve the necessary balance of the committee's membership. A creditor who resigns from the committee should notify the United States Trustee in writing of its resignation, so that the United States Trustee may undertake any actions that may be appropriate.

3-4.15.3 Removal of Members

The United States Trustee has the authority to remove, as well as to appoint, members of official committees. *In re America West Airlines*, 142 B.R. 901 (Bankr. D. Ariz. 1992). The decision to remove a member should be premised upon a change in status as a creditor, or a breach of or inability to perform fiduciary duties. Conflicts within a committee on issues of strategy or objectives ordinarily would not constitute cause for removal. These conflicts are intrinsic to the committee process and should be resolved within the committee.

The decision to remove or not to remove a committee member is committed to the discretion of the United States Trustee. No court approval of the removal is required. Unless that discretion is exercised arbitrarily or capriciously, the scope of judicial review of the United States Trustee's decisions in this area is extremely limited. *See* Campos-Guardado v. I.N.S. 809 F.2d 285, 289 (5th Cir. 1987), *reh'g denied*, 814 F.2d 658 (5th Cir. 1987), *cert. denied*, 484 U.S. 826 (1987).

3-4.16 RULE 2019: AD HOC COMMITTEE AND OTHER CREDITOR GROUP DISCLOSURES

3-4.16.1 Background and Summary of Changes

Before December 1, 2011, Bankruptcy Rule 2019 required "every entity or "unofficial" committee representing more than one creditor" in chapter 9 and chapter 11 cases to file a verified statement disclosing, among other things, the identities of all creditors represented and financial details about each creditor's holdings. But courts reached inconsistent results when enforcing this section, especially as applied to entities such as claims traders, hedge funds, and other distressed debt investors, who often form *ad hoc* committees to act in concert but who do not purport to represent any creditors other than themselves. Rule 2019, effective December 1, 2011, clarifies who must disclose what information and expands the disclosures required.

3-4.16.2 Who is Covered

Rule 2019 plainly applies to groups and committees that "consist of"—and not just those that "represent"—creditors and equity holders. Fed. R. Bankr. P. 2019(b)(1). The added "consists of" language clarifies that the Rule applies to *ad hoc* committees and groups acting only for themselves. The amended rule also adds a definition of "represent," which means "to take a position before the court or to solicit votes regarding the confirmation of a plan on behalf of another." Fed. R. Bankr. P. 2019(a)(2).

The discussion below explains those who are included in and excluded from the rule's requirements, along with certain limited exceptions.

Included, subject to the exceptions below: The rule applies to the following who work together ("in concert") to advance common interests:

(1) any group, committee, or entity *representing* more than one creditor or equity security holder, or

(2) any group or committee *consisting* of more than one creditor or equity security holder.

Thus, the rule applies to any group acting together regardless of whether the group calls itself a committee—official, unofficial, *ad hoc*, informal, or otherwise, making the amended rule broader than the prior rule. Because the rule also applies to entities that represent creditors and equity security holders, a law firm that represents multiple creditors or equity security holders must file Rule 2019 disclosures if: (1) its multiple clients are acting in concert; and (2) the firm is advocating for the clients in court or soliciting votes on a plan. Assuming that the Bankruptcy Code's definition of entity, which includes persons, applies equally to the Bankruptcy Rules, then Rule 2019 applies to attorneys and not just law firms if the other requirements of the rule are triggered.

A law firm that is merely consulted by a group of creditors but does not advocate for them in court or solicit votes on a plan need not file the Rule 2019 statement.

Included, but not subject to all of the rule's disclosure requirements: Official committees. *See* section 3-4.7.2 for official committee requirements.

Excluded: Groups composed entirely of affiliates and insiders of one another, such as related companies jointly represented.

Excluded, but with possible exceptions: "Unless the court orders otherwise," Rule 2019 does not apply "solely because" of one's status as an indenture trustee, credit agreement agent, class action representative, or governmental unit. Fed. R. Bankr. P. 2019(b)(2). Although the Advisory Committee note to subsection (b)(2) states that these entities are excluded, the language of the rule itself is not so absolute. Rule 2019 provides that indenture trustees do not file the statement unless ordered to do so. Before December 1, 2011, indenture trustees had to file the verified statement unless ordered *not* to do so.

3-4.16.3 What Must Be Disclosed

Rule 2019(b) requires every group, committee, or entity covered by the Rule to file a verified statement disclosing certain information. The information that must be disclosed varies depending on who is making the disclosure: (1) a group or committee acting only for the members; (2) a group or committee representing other parties in addition to the members; (3) an entity representing others; or (4) an official committee. In addition, creditors or equity security holders who are represented (but not by an official committee) must disclose certain information.

*a. Disclosures required of **all groups or committees** (except official committees):*

- pertinent facts and circumstances regarding the formation of the group or committee
- name of each entity at whose instance the group or committee was formed or each entity for whom the group or committee has agreed to act
- name and address of each member
- nature and amount of each member's disclosable economic interest held on the date the group or committee was formed
- copy of the instrument, if any, authorizing the group or committee to act for creditors or equity security holders

*b. Additional disclosures required of **all groups or committees representing others** (except official committees):*

- for each member of the group or committee, the year and quarter the member acquired each disclosable economic interest (unless acquired more than one year before the petition date)

*c. Disclosures required of **all entities representing others**:*

- pertinent facts and circumstances regarding the employment of the entity
- name of each creditor or equity security holder who arranged the entity's employment
- name and address of the entity
- copy of the instrument, if any, authorizing the entity to act for creditors or equity security holders

*d. Disclosures required of **each creditor or equity security holder represented by an entity, group, or committee** (except those represented by official committees):*

- name and address of the creditor or equity security holder

- nature and amount of each member's disclosable economic interest held on the date of the verified statement

The term "disclosable economic interest" is broadly defined in subdivision (a) to include not just claims or interests but all economic rights and interests that could affect the legal and strategic positions that a stakeholder takes in a case, including options, liens, pledges, participations, derivative instruments, or any economic interested affected by the value, acquisition, or disposition of a claim or interest. Moreover, each member of a group must disclose information on an individual basis, rather than reporting information in the aggregate for all members.

The rule reflects a deliberate decision not to require disclosure of the purchase price or specific date of acquisition for each disclosable economic interest. Nevertheless, Rule 2019 is not a bar to obtaining this information, if relevant, through discovery or a Rule 2004 examination.

3-4.16.4 Timing of Disclosure

The Rule sets no time for filing the initial verified statement, but it is reasonable to infer that it must be filed before appearing before the court or soliciting votes on a plan. Under Rule 2019(d), if any fact in a verified statement changes materially, the statement must be supplemented with the material changes before taking a position before the court or soliciting votes on the confirmation of a plan.

3-4.16.5 Remedies and Consequences of Non-Disclosure

Any party in interest may file a motion challenging compliance with the rule. The court may also find a failure to comply on its own motion. The court is authorized to grant any appropriate relief as a sanction, including refusing to permit the group, committee, or entity to be heard or holding invalid any authority, acceptance, rejection, or objection given, procured, or received by the sanctioned group, committee, or entity. Fed. R. Bankr. P. 2019(e).

CHAPTER 3-5: MEETINGS OF CREDITORS

3-5.1 INTRODUCTION

The United States Trustee shall convene and preside at a meeting of creditors within a reasonable time after the order for relief in a case. 11 U.S.C. § 341(a). The meeting of creditors is the statutory forum where the debtor must appear and answer questions under oath about the case unless the court orders otherwise. 11 U.S.C. § 343; Fed. R. Bankr. P. 2003(b).

3-5.2 SCHEDULING

The United States Trustee must schedule a meeting of creditors to be held not fewer than 21 nor more than 40 days after the order for relief. Fed. R. Bankr. P. 2003(a). However, if the United States Trustee designates a place for the meeting that is not regularly staffed by the United States Trustee, then the meeting may be scheduled not more than 60 days after the order for relief. The enlargement or reduction of these time periods is prohibited. Fed. R. Bankr. P. 9006(b)(2) and 9006(c)(2). If there is an appeal from or a motion to vacate the order for relief, or if there is a motion to dismiss the case, the United States Trustee may schedule a later date for the meeting. Fed. R. Bankr. P. 2003(a). The meeting may be held at a regular place for holding court or at any other place designated by the United States Trustee within the district convenient for the parties in interest. Fed. R. Bankr. P. 2003(c).

3-5.3 NOTICE

Notice of the meeting must be provided to all parties of interest and, unless the court orders otherwise, shall include the debtor's employer identification number, Social Security number, and any other federal taxpayer identification number. Fed. R. Bankr. P. 2002(a)(1). Notice of the meeting of creditors is given by the clerk of the court or some other person as the court may direct, such as the debtor or an outside service, pursuant to Fed. R. Bankr. P. 2002(a)(1). At least 21 days notice of the meeting by ordinary mail is required under Fed. R. Bankr. P. 2002(a). Notice can be given by publication if notice by mail is impracticable or is desirable to supplement the notice. Fed. R. Bankr. P. 2002(1). The 21-day notice period may be modified by order of the court. Fed. R. Bankr. P. 9006.

The United States Trustee should provide the clerk with the location, date, and time of the meeting well in advance of the noticing period to permit the clerk to notice the meeting in a timely fashion. The United States Trustee should ensure that committees, trustees, and examiners appointed after the noticing of the meeting or after the initial meeting are advised of the meeting or any adjourned meeting.

3-5.4 SCOPE OF EXAMINATION

The scope of examination of the debtor pursuant to section 343:

> may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. . . . The examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan. Fed. R. Bankr. P. 2004(b).

Questioning should not be allowed to deteriorate to a level constituting harassment or to focus on the dischargeability of a particular debt. Parties who wish to examine the debtor regarding dischargeability of particular debts or regarding other matters beyond the scope of the examination should be advised to consider alternate means of discovery. *In re Nixon Elec. Supply, Inc.*, 85 B.R. 988 (Bankr. W.D. Tex. 1988). A meeting of creditors is not a substitute for discovery in connection with an adversary proceeding.

3-5.5 CONDUCTING THE MEETING

The United States Trustee presides at the meeting. 11 U.S.C. § 341(a). The United States Trustee includes any designee of the United States Trustee. 11 U.S.C. § 102(9) and Fed. R. Bankr. P. 9001(11).

The meeting must be recorded electronically by the United States Trustee. Fed. R. Bankr. P. 2005(c). The record of the meeting must be preserved by the United States Trustee and be available for public access until two years after the conclusion of the meeting. At an entity's request, the United States Trustee shall certify and provide a copy or transcript of the recordings at the entity's expense. Fed. R. Bankr. P. 2003(c).

An individual debtor must present:

1. an original government-issued photo identification, or any other identifying information that establishes the debtor's identity; and
2. confirmation of the Social Security number listed on the section 341 meeting notice issued by the clerk of court and provided to the debtor and creditors in the case. Fed. R. Bankr. P. 4002(b)(1).

If the debtor fails to provide the required forms of identification or supporting documentation that is satisfactory to the United States Trustee, or provides an incorrect Social Security number, the presiding officer may proceed with the meeting, but, before concluding the meeting, should determine what corrective action should be required of the debtor.

Acceptable forms of picture identification (ID) include: driver's license, U.S. government ID, state ID, passport (and current U.S. visa, if not a U.S. citizen), military ID, resident alien card, and identity card issued by a national government authority (if authorized by the United States Trustee). Acceptable forms of proof of Social Security number include: Social Security card, medical insurance card, pay stub, W-2 Form, IRS Form 1099, and Social Security Administration (SSA) Statement. When debtors state that they are not eligible for a Social Security number, further inquiry is necessary to verify identity.

The presiding officer should make an introductory statement. A suggested introductory statement is:

> "My name is _____. I am an (attorney/analyst/etc.) in the Office of the United States Trustee, a component of the United States

> Department of Justice. The United States Trustee supervises the administration of bankruptcy cases under the Bankruptcy Code. The debtor is required to appear and to be examined under oath regarding the bankruptcy case. The examination will be recorded. All persons questioning the debtor must state their names and indicate who they represent. An appearance sheet will be circulated. If you wish to receive notice of any adjourned meeting, you must fill out the appearance sheet."

The presiding officer should state the case name and number and the date and time of the meeting, and should inform creditors that they will be given an opportunity to ask questions of the debtor.

Appearances should be noted on the record, particularly the appearance of counsel representing the debtor or other parties in the case. Debtors or debtors' representatives should be asked to raise their right hands so that the oath or affirmation can be administered as follows:

> "Do you swear or affirm to tell the truth, the whole truth, and nothing but the truth?"

The presiding officer has the authority to administer oaths or affirmations. There is no requirement that the presiding officer be a notary. 11 U.S.C. § 343; Fed. R. Bankr. P. 2003(b)(1) and 9012. After administering the oath, the presiding officer must ask the debtor to verify that the debtor signed an original petition and schedules, that the debtor reviewed the documents before signing them, that the debtor affirms that the documents are accurate, and that the debtor affirms that no changes need to be made to the documents.

The United States Trustee should respond only to inquiries regarding administrative or procedural matters. The United States Trustee should never give legal advice at the section 341 meeting, but should refer parties with legal questions to their attorneys.

3-5.6 QUESTIONING THE DEBTOR

The debtor or a designated representative of a partnership or corporation must attend the meeting of creditors and submit to examination under oath. 11 U.S.C. § 343; *In re Steinmetz Group, Ltd.*, 85 B.R. 633 (Bankr. S.D. Fla. 1988). The person appearing on behalf of the debtor should be prepared to respond effectively to the examination and to verify the accuracy of the schedules and statements. If the debtor is a corporation, the representative may include any or all of its officers, members of its board of directors or trustees, or similar controlling body, a controlling stockholder or member, or any other person in control. If the debtor is a partnership, the representative may include any or all of its general partners or, if designated by the court, any other person in control. Fed.R. Bankr. P. 9001(5). If a chapter 11 trustee has been appointed, the trustee may also give a report, but should not be sworn or subjected to examination.

When spouses have filed a joint petition, they must both be present. If only one debtor appears, the United States Trustee may elect to examine the attending debtor and continue the section 341 meeting for the examination of the other.

If the debtor or debtor's representative fails to appear at the meeting, the United States Trustee may either continue the meeting, file a motion for an order of the court designating a person to attend the meeting on behalf of the partnership or corporate debtor pursuant to Fed. R. Bankr. P. 9001(5), file a motion for the appointment of a trustee, or file a motion to convert or dismiss the case. The provisions of Fed. R. Bankr. P. 2005 may also be used to apprehend the debtor and compel his or her attendance at the meeting.

When a debtor's attorney fails to appear, the United States Trustee should generally seek to determine if counsel is delayed or unable to appear for some reason. If counsel is not readily available, the United States Trustee should consider continuing the meeting to a later date. The decision regarding whether to grant a continuance should be based upon a review of the following conditions:

1. whether the reason for non-attendance is one that rendered appearance impossible, e.g., illness or sudden emergency, or whether non-attendance merely involved a scheduling conflict;
2. whether the United States Trustee was notified in advance of the non-appearance;
3. whether creditors appearing at the section 341 meeting traveled a great distance, and how many were in attendance; and
4. whether the particular attorney has failed to attend previous creditors' meetings for other debtors.

The continued date should be announced to all parties in attendance.

The United States Trustee should review the debtor's schedules and statements and other documents in the file prior to the section 341 meeting of creditors. The person questioning the debtor should also confer with the person who conducted the IDI and review the information obtained and the IDI report. The United States Trustee may also request that the debtor bring specific documents to the meeting and follow up on information required and not produced at the IDI. The examination should be flexible, incisive, and responsive to the circumstances of the proceeding and the case. The examination should be sufficiently detailed so that the United States Trustee has an understanding of the debtor's business and its operations. The meeting also provides the opportunity to remind debtors of their duties and to question them regarding compliance with those duties, such as filing operating reports and paying United States Trustee quarterly fees. The United States Trustee should take notes of the meeting and maintain a written record either in the form of a minute report or a memo to the file in the case file. The United States Trustee should obtain the spelling of the names of parties in the event a transcript of the meeting is requested at a later date. Creditors and other

parties in interest must also be given an opportunity to ask questions and examine the debtor. *See In re Kincaid*, 146 B.R. 387 (Bankr. W.D. Tenn. 1992). The Federal Rules of Evidence do not apply to examinations conducted at a meeting of creditors and objections predicated upon those rules should not be entertained. However, the presiding officer must maintain control over the proceeding and preserve the professional atmosphere and decorum appropriate to the situation.

3-5.7 ATTENDANCE BY CREDITORS, THE MEDIA, AND THE PUBLIC

Meetings are open to the public, except that the court may not attend. 11 U.S.C. § 341(c). Representatives of the media are permitted to be present, but not to televise, record, or photograph the proceedings or to ask questions at the meeting. *See In re Astri Inv., Management and Sec. Corp.*, 88 B.R. 730 (D. Md. 1988). Only those entities identified in section 343, e.g., creditors, any indenture trustee, any trustee or examiner in the case, or the United States Trustee, may examine the debtor. Debtors, creditors, indenture trustees, equity security holders, committees, or other parties may be represented by an authorized agent, attorney in fact, or proxy. Fed. R. Bankr. P. 9010(a).

3-5.8 IMMUNITY, SELF-INCRIMINATION, AND REFUSAL TO ANSWER QUESTIONS

Immunity may be granted under part V of title 18 of the United States Code to persons required to submit to examination, to testify, or to provide information in a bankruptcy case. 11 U.S.C. § 344. The operative sections for granting immunity are 18 U.S.C. § 6002 and 6003. Pursuant to these sections, the debtor or other witness may refuse to testify based upon the privilege against self-incrimination, but may be compelled to do so under a grant of immunity from the United States Attorney. *Hoffman v. United States*, 341 U.S. 479 (1951); *In re Save More Foods, Inc.*, 96 B.R. 1 (D.D.C. 1989); *In re Hulon*, 92 B.R. 670 (Bankr. N.D. Tex. 1988). Under the Bankruptcy Code, if the debtor testifies without claiming the privilege, it may be waived. *See Melaragno v. Ciotti (In re Ciotti),* 442 B.R. 412 (Bankr. W.D. Pa. 2011); *In re Mudd*, 95 B.R. 426 (Bankr. N.D. Tex. 1989). Once the debtor or another witness has claimed the privilege against self-incrimination, immunity may be granted only by order of the district court upon the request of the United States Attorney for the district in which the case was filed. 18 U.S.C. § 6003.

If the debtor asserts the Fifth Amendment privilege against self-incrimination in response to a question, the United States Trustee should proceed with the meeting and continue to question the debtor. A "blanket" assertion of the privilege is inappropriate and the debtor should be compelled to assert the privilege in response to each question propounded. A debtor's discharge may not be denied for properly invoking the privilege against self-incrimination. 11 U.S.C. § 727(a)(6)(C). *United States v. Kras*, 409 U.S. 434 (1973); *In re Krohn*, 886 F.2d 123 (6th Cir. 1989); *In re French*, 127 B.R. 434 (Bankr. D. Minn. 1991).

See also *In re McCormick*, 49 F.3d 1524 (11th Cir. 1995) (confirmation of a chapter 11 debtor's plan of reorganization cannot be denied solely because the debtor invoked his Fifth Amendment privilege in an adversary proceeding). The failure to answer questions at a section 341 meeting, however, may be cause to dismiss or convert the case or to order the appointment of a trustee. *Cf. In re Connelly*, 59 B.R. 421 (Bankr. N.D. Ill. 1986). Alternatively, the United States Trustee may seek an order from the court compelling the debtor to testify.

If the debtor refuses to answer a question, the meeting should continue and, at the end of the meeting, the parties should seek a resolution from the court. The presiding officer may, however, state for the record an opinion on the propriety of the question and whether or not it appears to fall within the permissible scope of examination. In addition, the United States Trustee may subsequently wish to appear in court and state a position on this issue. This is especially so in a case where the United States Trustee asked or would have asked the question, and it has a direct bearing on the ability of the United States Trustee to supervise the case because the debtor is making insufficient disclosure.

If the debtor or other witness is granted immunity by the United States Attorney, he or she can be required to testify.

3-5.9 PROOFS OF CLAIM

A proof of claim must be filed with the clerk. However, if a creditor insists upon filing the proof of claim at the section 341 meeting, Fed. R. Bankr. P. 5005(c) establishes a procedure. The presiding officer should note on the claim the date of receipt and transmit it forthwith to the clerk of the bankruptcy court.

3-5.10 CONTINUANCES AND ADJOURNMENTS

After notice of the section 341 meeting has been given, continuances should rarely be granted. If a request for a continuance is made, the United States Trustee may allow the request and continue the meeting if the continuance could not have been avoided. The party requesting the continuance must provide the debtor, the trustee (if any), all creditors and indenture trustees, as well as the clerk of the court, with notice of the continued date and time and provide the United States Trustee with proof of service of such notice. The failure of the debtor to file schedules is not cause to continue the meeting. The initial meeting should be held and adjourned until some date after the filing of the schedules. *But see In re Vance*, 120 B.R. 181 (Bankr. N.D. Okla. 1990).

The United States Trustee may file a motion under 11 U.S.C. § 329(b) to compel turnover or refund of the fees received by an attorney who repeatedly fails to appear without justification.

Fed. R. Bankr. P. 2003(e) provides that "the meeting may be adjourned from time to time by announcement at the meeting of the adjourned date and time without

further written notice." If no further information is necessary, the meeting should be concluded. Any adjournment of the meeting and the length of time of any adjournment will be determined after taking into consideration such matters as the need to examine the debtor, the necessity to resolve matters that are still open at the conclusion of the prior meeting, and the need to monitor the particular case closely. At the conclusion of the section 341 meeting, an announcement should be made by the presiding officer regarding the date and time of the next meeting, unless later written notification will be made. Where no further notice will be given, the attendees should be so notified.

Fed. R. Bankr. P. 4003(b) provides that a trustee or creditor may file objections to claimed exemptions within 30 days after the conclusion of the meeting. Adjournment of the meeting may improperly impede an individual debtor's right to establish his or her exemptions, unless the court fixes a date certain to object to such claimed exemptions. *In re Vance*, 120 B.R. 181 (Bankr. N.D. Okla. 1990).

3-5.11 SPECIAL MEETINGS

The United States Trustee may call a special section 341 meeting on request of a party in interest or on the United States Trustee's own initiative pursuant to Fed. R. Bankr. P. 2003(f). Special meetings may be called to address a situation that has come to the United States Trustee's attention and requires close supervision. The United States Trustee should notify all appropriate parties in interest of the date, time, and location of the special meeting.

An example of a special meeting is a meeting of creditors to elect a chapter 11 trustee. 11 U.S.C. § 1104(b)(1). The election must be requested by a party in interest within 30 days after the court orders the appointment of a trustee under section 1104(a). The United States Trustee convenes the meeting for the purpose of electing one disinterested person to serve as a trustee in the case. The clerk or some other person as the court directs must give at least 21 days notice by mail of the meeting date, time, and location. The notice must include the debtor's employer identification number, Social Security number and any other federal taxpayer identification number. Fed. R. Bankr. P. 2002(a).

3-5.12 CONDUCT OF SECTION 341 MEETINGS FOR HEARING-IMPAIRED DEBTORS

The United States Trustee should have procedures in place to address the special needs of debtors. This includes making arrangements for sign interpreters for debtors or creditors. The cost of providing a sign interpreter is paid for by the Program.

3-5.13 FOREIGN LANGUAGE INTERPRETERS

The United States Trustee should follow Program policy when conducting a meeting for non-English speaking or Limited English Proficient debtors.

3-5.14 SECURITY AT MEETINGS OF CREDITORS

3-5.14.1 General

Each leased meeting of creditors site should meet minimum General Services Administration security requirements as determined by the Facilities Management Division of the EOUST when the property is leased. Duress alarms are generally provided, and all persons presiding at section 341 meetings of creditors should be trained in their use.

If the United States Trustee is made aware in advance that there may be security problems at a particular meeting, the United States Marshal's Service should be notified. It may also be possible to request that the debtor in possession hire security guards to be present at the meeting to deter potential security problems.

3-5.14.2 Acquiring Meeting Rooms and/or Security on a One-Time Basis

On occasion, offices have had a need for larger meeting room space, or additional security from the Federal Protective Service, on a one-time basis for a section 341 meeting. When such circumstances arise, offices should adhere to the following USTP Policy to secure funding approval:

1. Identify the requirement sufficiently in advance of the meeting so that arrangements can be made to handle larger than normal participation and/or potential security issues.
2. If after discussion with the United States Trustee it is determined that additional space or security is justified, check first with the bankruptcy court to determine if the meeting can be moved to court-controlled space. If the bankruptcy court is not an option, identify other possible free space that may be used on a one-time basis for the meeting.
3. Submit a UST-6 to the Assistant Director for Administration, signed by the United States Trustee, that justifies the request and provides sufficient detail concerning the issue(s) at least 72 hours in advance. The UST-6 should note that bankruptcy court space and other free space were pursued. It should also include rental costs for at least one alternative location, where practical, and/or an estimate from the Federal Protective Service for the additional security.
4. After review and approval, the EOUST will issue a purchase order for the meeting room or a work authorization for additional security.

CHAPTER 3-6: APPOINTMENT OF CHAPTER 11 TRUSTEES AND EXAMINERS

3-6.1 GROUNDS FOR APPOINTMENT

3-6.1.1 Statutory Basis: 11 U.S.C. § 1104

Section 1104 sets forth the statutory provisions regarding the appointment of a trustee or examiner. Section 1104(a)(1) requires the court, upon request by the United States Trustee or a party in interest, to order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause . . . ."

In the alternative, the court can order the appointment of a trustee pursuant to the provisions of section 1104(a)(2). This subsection provides that the court shall order the appointment of a trustee if such an appointment is determined to be in the interests of creditors, any equity security holders, and other interests of the estate.

Finally, the court may order the appointment of a trustee if grounds exist for conversion or dismissal of the case but the court determines that the appointment of a trustee is in the best interests of the creditors and the estate. 11 U.S.C. § 1104(a)(3).

If the court does not order the appointment of a trustee, section 1104(c) permits the court, on request of a party in interest or the United States Trustee, to order the appointment of an examiner. Such an appointment shall be ordered:

1. if it is determined to be in the interests of creditors, any equity security holders, and other interests of the estate; or

2. if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

If the court orders the appointment of a trustee or examiner, the United States Trustee shall, after consultation with parties in interest, select one disinterested person to serve in the position. 11 U.S.C. § 1104(d).

3-6.1.2 Section 1104(e) Considerations

Pursuant to section 1104(e), the U.S. Trustee shall move to appoint a trustee if there are reasonable grounds to believe current company officials participated in actual fraud, dishonesty, or criminal conduct in the "management of the debtor or the debtor's public financial reporting." This provision applies to chapter 11 cases commenced on or after April 20, 2005. It applies to all chapter 11 debtors, not just publicly held companies, and it applies to both pre-petition conduct and post-petition conduct. Note that section 1104(e) only provides for the *filing* of a

motion under certain circumstances; it does not change the grounds for granting the motion.

3-6.2 CHOICE OF REMEDY – TRUSTEE OR EXAMINER

Trustees and examiners perform distinct functions. A trustee displaces the debtor in possession and assumes responsibility for estate assets and for the operation of the business. An examiner reviews specific transactions or circumstances as directed by the order authorizing appointment. Accordingly, a determination of whether to request the appointment of a trustee or an examiner will depend on the results desired.

One factor the United States Trustee must take into account is if sufficient admissible evidence is available to establish grounds for the appointment of a trustee. Mere suspicion or allegations of wrongdoing are not sufficient. Admissions by the debtor or its agents in public filings, in schedules and statements of financial affairs, or at the section 341 meeting may be used to support a motion. Discovery is available. Third parties or whistle-blowers might also provide the United States Trustee with evidence.

Questions have arisen over the burden of proof that must be met to establish cause for the appointment of a trustee. Many courts have ruled that a trustee motion must be proven with "clear and convincing" evidence. *See, e.g.*, *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471 (3rd Cir. 1998). In the absence of controlling circuit authority, United States Trustees should contend that the appropriate burden of proof is "preponderance of the evidence." *See In re Keeley & Grabanski Land P'ship,* 455 B.R. 153, 163 (B.A.P. 8th Cir. 2011) ("If a preponderance of the evidence standard is a sufficient standard for the denial of discharge based on a debtor's fraud, it should likewise be sufficient for the appointment of a trustee based on allegations of the debtor's fraud or misconduct."); *see also Tradex Corp. v. Morse (In re Tradex Corp.)*, 339 B.R. 823 (D. Mass. 2006). United States Trustees faced with this issue should contact the Office of the General Counsel.

Section 1104(a)(1) enumerates several specific grounds, including fraud, dishonesty, and incompetence, which constitute cause and require the appointment of a trustee. This list of factors constituting cause is not exclusive. *See* 11 U.S.C. § 102(3). Other situations that may constitute cause include the debtor's violation of a court order or breach of fiduciary duties, failure of the debtor to cooperate with the United States Trustee's efforts to supervise the administration of the case, or internal dissension in the corporate hierarchy resulting in failure to operate properly. *See In re Colorado-Ute Elec. Ass_n, Inc.*, 120 B.R. 164, 175-76 (Bankr. D. Colo. 1990); *In re Sullivan*, 108 B.R. 555, 556 (Bankr. E.D. Pa. 1989); *In re St. Louis Globe-Democrat, Inc.*, 63 B.R. 131, 137-38 (Bankr. E.D. Mo. 1985).

It should be noted that the examples of "cause" included in section 1104(a)(1) all involve "current management." Generally speaking, if management that has

engaged in misconduct has been truly displaced by competent and honest management, the appointment of a trustee may not be warranted. The United States Trustee should, however, inquire into the relationships between ousted management and those currently operating the debtor. Former management may retain the right under state law to replace current management if former management controls the equity interests of the debtor. Furthermore, the debtor's board of directors or similar governing body may still be composed of persons on whose watch the misconduct occurred. Under these circumstances, the United States Trustee should consider seeking a trustee appointment.

Under section 1104(a)(2), a trustee may also be appointed if it is in the interest of creditors, equity security holders, and other interests of the estate. The language of the statute provides little guidance on how it is to be applied. It is clear, however, that the court is called upon to weigh the interests of all constituencies in the case, and not just those of creditors. Where the debtor's business affects such a large segment of the general public, consideration of the public interest becomes a greater factor in deciding whether to order the appointment of a trustee under section 1104(a)(2). *See In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1990). Courts have also considered factors such as the trustworthiness of the debtor, its past and present performance and prospects for rehabilitation, and the confidence, or lack thereof, of the business community and creditors in present management.

The United States Trustee should consider seeking the appointment of an examiner to investigate any questionable management activities or any unexplained irregularity in the debtor's financial history. *See In re Gilman Servs., Inc.*, 46 B.R. 322, 327-28 (Bankr. D. Mass. 1985).

Section 1104(c)(2) requires the court to order the appointment of an examiner if a request for the appointment is made by the United States Trustee or other party in interest, and the debtor's fixed, liquidated, unsecured debts (other than debts for goods, services, taxes, or owing to an insider) exceed $5 million. The appointment of an examiner is mandatory if the dollar threshold is met. *See In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990). The United States Trustee should not automatically request the appointment of an examiner in every case having the requisite amount of qualifying debt. In deciding whether to seek an examiner appointment, the United States Trustee should carefully consider all relevant factors, including whether pre-petition or post-petition events involving the debtor warrant an independent investigation and report.

Courts occasionally direct the appointment of a mandatory examiner under section 1104(c)(2) but severely constrain the scope of examination. Some courts have directed that an examiner perform no investigation at all. The United States Trustee should consult with OGC if either of these circumstances occurs or appears to be imminent. Furthermore, a party arguing or court finding that section 1104(c)(2) is not mandatory should immediately be brought to OGC's attention.

The United States Trustee may take a position on another party's motion for the appointment of a trustee or an examiner; the United States Trustee should not, however, file joint pleadings with other parties in interest. Nor should the United States Trustee adopt verbatim the allegations and arguments contained within the pleadings filed by other parties. A separate pleading setting forth the position advocated by the United States Trustee should be filed.

The statutory duties of both chapter 11 trustees and examiners are set out in section 1106. Section 1106(a)(3), which is made applicable to examiners by section 1106(b), requires an investigation into the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan. That subsection also grants the court the authority to restrict the scope of the investigation. Court-imposed limitations on the permissible scope of an examination are most frequently set forth in the same order that authorizes the appointment of the trustee or examiner. The United States Trustee should ensure that any restrictions and limitations contemplated by the court are clearly set forth in the order. This will avoid the delay and expense that would be engendered by having to return to the court for clarification of the original order.

Section 1106(b) also allows for the expansion of an examiner's duties to encompass any other duties of a trustee that the court orders the debtor in possession not to perform. Again, the United States Trustee should ensure that the precise scope of the expanded duties contemplated for the examiner is clearly set forth in the order of appointment.

3-6.3 THE SELECTION PROCESS

The procedures set forth below apply to the United States Trustee's appointment of a chapter 11 trustee or examiner in any chapter 11 case. In summary, in a chapter 11 case, once the court has determined that a trustee or examiner should be appointed, the authority to select and appoint the trustee or examiner is vested in the United States Trustee. 11 U.S.C. § 1104(d); *In re Plaza de Diego Shopping Center, Inc.*, 911 F.2d 820, 829 (1st Cir. 1990).

Section 1104 of the Bankruptcy Code lists four basic conditions that must be satisfied when the United States Trustee appoints a trustee or examiner:

- the United States Trustee must "consult with parties in interest;"
- the person appointed must be "disinterested;"
- the person appointed may not be the United States Trustee; and
- the appointment must be submitted to the Bankruptcy Court for approval.

11 U.S.C. § 1104(d).

In addition, Federal Rule of Bankruptcy Procedure 2007.1 provides that the order approving the appointment must be made on application of the United States

Trustee and lists certain information that must be included in that application. The application must also be accompanied by a verified statement by the person appointed listing his or her connections with other parties and participants in the bankruptcy case. Fed. R. Bankr. P. 2007.1(c).

3-6.3.1 Timing

The process of selecting a trustee or examiner should occur as promptly as possible once the court has ordered that a trustee or examiner be appointed. Before making the appointment, the United States Trustee must engage in a meaningful consultative and deliberative process, taking into consideration that in some cases timing of the appointment may be affected by the potential risk to estate assets from undue delay. In some larger and more complex cases, and when expediency may require it, the United States Trustee should begin identifying candidates even before the entry of the order directing the appointment if it is reasonably certain an appointment will be ordered. Although an order directing the appointment of a trustee creates a 30-day window in which any party in interest may request that a creditors' meeting be held to elect a trustee, 11 U.S.C. § 1104(b)(1), the United States Trustee is not required to–and should not– wait before appointing a trustee because of the prospect of an election. *See* 11 U.S.C. § 1104(b)(2)(B)(ii) (service of trustee appointed under subsection (d) terminates once election of different trustee under subsection (b) is certified). As a result, the United States Trustee should not delay the appointment process even if there is reason to believe that a request for election may be forthcoming.

3-6.3.2 Duty to Consult

The United States Trustee's first step in the selection of a trustee or examiner is to solicit the views of "parties in interest," as section 1104(d) requires. Although the Bankruptcy Code does not specify the parties the United States Trustee should consult, at a minimum, the United States Trustee should confer with the debtor, any official committees, the pre-petition and post-petition lenders, and any key creditors, including governmental authorities, who are expected to play an active role in the chapter 11 case. It is better to be over-inclusive than under-inclusive in the consultation process.

Because the duty to consult is an important statutory duty, the United States Trustee should never agree to appoint a particular candidate. Rather, during the consultation process parties in interest should be assured that their views and any suggested candidates will be duly considered. Despite the statutory requirement to consult with parties in interest, the decision to make the best appointment for the case ultimately rests within the discretion of the United States Trustee. Indeed, for this reason, it is inappropriate for any court order directing the appointment of a trustee or examiner to specify who should be appointed or to condition the order on the appointment of a particular person.

3-6.3.3 The Consultation Process

There is no required form that the section 1104(d) consultation should take. The United States Trustee should solicit both general input and specific nominations. Parties in interest should be asked to identify any specialized skills, experience, or qualifications that they believe the trustee or examiner should have. Parties should also be encouraged to submit the names and contact information for any individuals they believe would be well qualified to serve. During the consultation process, the United States Trustee should not ask the parties in interest to react to or express an opinion about particular candidates the United States Trustee may be considering for the appointment.

In smaller cases, informal methods of consultation are often preferable. In particular, if counsel for all major constituencies are present when the court directs the appointment of a trustee or examiner, it may be most effective to consult with parties orally in the courtroom immediately after the hearing. In more complex cases, or in cases where there are a large number of parties to consult, the United States Trustee may send a letter soliciting input from parties in interest.

3-6.3.4 Consideration of Additional Candidates and Consultation with Other United States Trustees

The United States Trustee is obligated to appoint the most qualified individual to serve in the particular case. Therefore, although the nominations of parties in interest are an important resource for identifying candidates, the United States Trustee has discretion to and should consider candidates from other sources as well.

In certain cases, one source for additional trustee candidates may be the local panel of chapter 7 trustees. Appointing a panel trustee, however, should not be the automatic or default choice, even if the case is not complex or involves a liquidation. Moreover, the determination that a panel trustee is appropriate for appointment as trustee in a particular case does not eliminate the United States Trustee's statutory duty to consult with parties in interest. During the consultation process, the United States Trustee should never take or voice the position that the choice of candidates is limited solely to panel trustees.

The Executive Office for United States Trustees also maintains a directory of trustee and examiner candidates. The trustee and examiner portal is a resource that United States Trustees can use to both identify other skilled, qualified candidates beyond local panel trustees and the bar and to determine whether potential candidates have been vetted by other United States Trustees. The searchable résumé database contains information on candidates in a variety of fields and geographic locations. It is not, and should not be viewed as, the sole source of information to consider, and it is not a list of approved candidates. However, United States Trustees should consult the portal any time he or she has an appointment decision, and if a preferred candidate is included in the portal, it is

imperative that United States Trustees consult with the United States Trustee who either appointed or considered that candidate in other cases to determine whether the candidate is appropriate for the appointment currently under consideration.

3-6.3.5 Eligibility and Disinterestedness

Although section 321 of the Bankruptcy Code arguably permits appointment of corporations and firms as well as individual persons to serve as trustee or examiner, the USTP's policy is to appoint individuals only and to avoid the appointment of professional firms or corporations. In addition, the Bankruptcy Code prohibits the United States Trustee from appointing multiple persons to serve as co-trustees or co-examiners. *See* 11 U.S.C. § 1104(d) (appoint "one disinterested person"). Anyone that has previously served as an examiner may not thereafter serve as a trustee in the same case. *See* 11 U.S.C. § 321(b). Unlike cases arising under chapters 7, 12, and 13, there is no statutory geographic limitation on who may be appointed as a chapter 11 trustee. *See* 11 U.S.C. § 321(a).

Under section 1104(d), the trustee or examiner must be a "disinterested person," as that term is defined in section 101(14) of the Bankruptcy Code. The test is the same one that applies to the debtor's professionals. That test disqualifies from service, among other persons, creditors, equity holders, former directors and officers (within the past two years), and persons in control, as well as any person who is directly or indirectly "materially adverse" to the debtor for any reason. *See* 11 U.S.C. § 101(14)(A), (B), (C) and 101(31)(B).

In some cases, parties may request that the United States Trustee appoint as trustee a person who has already been appointed as the receiver of the debtor in another proceeding. Any receiver, whether sought by a creditor or governmental entity such as the SEC, is a "custodian." *See* 11 U.S.C. § 101(11). Section 543 provides that, unless the court directs otherwise, any custodian holding the debtor's property must turn over that property to the debtor-in-possession or chapter 11 trustee. 11 U.S.C. § 543. In many cases, these receivers cannot be appointed as trustee because they do not meet the disinterestedness test of the Bankruptcy Code, either because they are currently acting as an officer of the debtor or are otherwise "in control" of the debtor, or because their fiduciary duties as receiver could conflict with their duties as trustee or examiner. While there is no per se rule disqualifying receivers from consideration as trustee or examiner, nominations of current or past receivers should be scrutinized carefully for conflicts issues. Before appointing any receiver as trustee, the United States Trustee should consult with OGC.

3-6.3.6 The Selection

Once a pool of qualified candidates has been identified, the United States Trustee should act quickly to contact each of the candidates to confirm their interest in serving, immediately identify any obvious disqualifying conflicts and instruct them to commence their preliminary conflict checks, and otherwise determine

their eligibility and suitability to serve. The United States Trustee should request from each candidate a recent and detailed curriculum vitae.

The United States Trustee, or her staff in appropriate cases, should interview the candidates who appear most qualified to serve, including those candidates with whom the United States Trustee is already familiar, to determine their suitability for appointment in the particular case. While the law requires consultation with the parties in interest, it does not require the United States Trustee to interview every recommended candidate, although this may be preferable in cases in which the number of candidates is few. The candidate ultimately chosen for appointment must be interviewed. Whether to conduct interviews in person or by telephone or video teleconference may be dictated by the exigencies of the case.

All appointees must conduct conflicts checks and complete and submit to the United States Trustee affidavits regarding their background, connections, and conflicts. These affidavits consist of: (1) the candidate's verified statement of connections pursuant to Rule 2007.1; and (2) a chapter 11 security affidavit.

The verified statement must "set forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Fed. R. Bankr. P. 2007.1(c). A verified statement is required even if the candidate is a panel or case trustee. The format and content of the verified statement should be identical to that of a Rule 2014 statement of a professional retained under 11 U.S.C. § 327. The candidate must also provide to the United States Trustee a chapter 11 security affidavit.

In addition, the United States Trustee should ask the selected trustee or examiner to make periodic informal reports to the United States Trustee in appropriate cases.

3-6.4 THE NOTICE OF AND APPLICATION TO APPROVE APPOINTMENT

3-6.4.1 Notice of Appointment

The appointment should not be made until the United States Trustee has received and reviewed the Rule 2007.1 verified statement and chapter 11 affidavit and confirms the candidate's eligibility and disinterestedness. Upon making a selection, the United States Trustee must serve a notice of appointment on the trustee or examiner.

3-6.4.2 Application to Approve Appointment

After making the appointment, the United States Trustee should immediately file with the court an application to approve the appointment. Fed. R. Bankr. P. 2007.1(c). The application should set forth the following information: (1) the name of the trustee or examiner; (2) a list of all parties in interest with whom the United States Trustee consulted; and (3) a statement that, to the best of the United States Trustee's knowledge, the proposed trustee or examiner is disinterested.

The application typically includes three documents: the United States Trustee's notice of appointment, the trustee or examiner's Rule 2007.1 verified statement, and a proposed order.

1. Notice of appointment

The notice of appointment is served on the trustee or examiner and is filed with the court as an exhibit to the application. If a trustee will be required to post a case-specific bond, see infra Section 3-6.4.4.2, the notice should also state the amount of the bond. Fed. R. Bankr. P. 2008.

2. Verified statement

The application must be accompanied by the appointee's verified statement "setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Fed. R. Bankr. P. 2007.1(c). *See supra* section 3-6.3.6.

3. Order

The order approving the appointment is typically limited to a statement that the United States Trustee's application is granted. It is not necessary for this order to incorporate any substantive terms from the order directing appointment.

3-6.4.3 Security Clearance

In addition, all persons appointed as chapter 11 trustees or examiners must undergo a security clearance. Full background checks are not required for any individual for whom a background investigation is already in progress or has been completed within the preceding five years in connection with another examiner or trustee appointment. The United States Trustee should contact the Office of Oversight in EOUST upon identifying a candidate for trustee or examiner in order to determine if the candidate has a full background check already on file. If a security clearance is required, the candidate must complete and submit to the United States Trustee a standard packet of background investigation forms. The United States Trustee should monitor the trustee or examiner to ensure that these forms are timely completed and, upon receipt and review, should forward the completed forms to the Office of Oversight in EOUST.

3-6.4.4 Acceptance of Appointment and Posting of Bond

3-6.4.4.1 Acceptance of Appointment

Under Federal Rule of Bankruptcy Procedure 2008, within seven days of the receipt of the notice of appointment, a trustee must provide written notice of acceptance to both the court and the United States Trustee. Fed. R. Bankr. P. 2008. A chapter 11 trustee who fails to provide such notice is deemed to reject the appointment. This is a critical distinction from trustee appointments in most cases under chapters 7, 12, and 13, where the failure to file a rejection (in most circumstances) is deemed acceptance of the trustee appointment. The letter

transmitting the notice of appointment to the trustee might include a reminder of this requirement and instructions of how to return the written acceptance. Rule 2008 does not apply to examiners.

3-6.4.4.2 Posting of Bond

To qualify as a chapter 11 trustee, the trustee must post a bond in favor of the United States of America and file it with the court no later than six days ("before seven days") after selection. 11 U.S.C. § 322(a). The United States Trustee must determine both the initial amount and sufficiency of the bond. 11 U.S.C. § 322(b)(2). The United States Trustee should evaluate the assets of the estate when initially setting the amount of the bond. The bond should be set at a level sufficient to ensure the confidence of the parties, while considering that the estate will bear the cost of the bond premium. *See* United States Trustee Program Policies and Practices Manual § 7-2.2.4 (Chapter 11 Trustees and Examiners). Thereafter, the chapter 11 trustee must monitor the amount of funds on hand and ensure that the bond is maintained in an adequate amount, generally at least one and one-half times (150%) of the average monthly balance of funds on hand.

The surety on any bond written in favor of the United States of America must be authorized by the Secretary of the Treasury. 31 U.S.C. § 9304 and 9308. The Treasury Department publishes Treasury Circular 570, a list of companies holding certificates of authority as acceptable sureties on federal bonds, every July 1 in the Federal Register. The Circular is also posted on the Internet, available at https://www.fiscal.treasury.gov/fsreports/ref/suretyBnd/c570.htm. The United States Trustee may only approve those companies appearing on this list as sureties on trustee bonds, and should consult the Circular before approving any trustee bond to ensure coverage falls within authorized underwriting limits, which are on a per-bond basis. If a bond exceeds authorized underwriting limits, it cannot be approved absent proper coinsurance or reinsurance. *See* United States Trustee Program Policies and Practices Manual § 7-2.1.2 (Sufficiency of the Surety).

An examiner ordinarily need not obtain a bond. But if the examiner is given expanded powers despite the United States Trustee's objection and has access to assets of the estate, the United States Trustee should request that a bond be posted. *Id.* at § 7-2.2.4 (Chapter 11 Trustees and Examiners).

This discussion is intended as a summary and is not exhaustive. United States Trustees should consult Volume 7 of the United States Trustee Program Policies and Practices Manual for additional information and guidance regarding bonding requirements and procedures governing fiduciaries of estate assets.

3-6.5 TERMINATION OF A TRUSTEE'S APPOINTMENT

Under 11 U.S.C. § 1105, the court, on request of the United States Trustee or a party in interest and after notice and a hearing, may terminate the trustee's appointment and restore the debtor to possession. That authority should be exercised carefully and sparingly. *See In re Taub,* 441 B.R. 211, 215 (Bankr. E.D.N.Y. 2010) ("But possessing the authority to terminate a trustee's

appointment does not mean that courts freely exercise that power. This is reflected in the careful and infrequent application of Section 1105."). Section 1105 is intended to address instances in which the debtor's situation has changed and the need for a trustee no longer exists. The removal of the trustee may reflect a change in the circumstances under which the appointment was made. *See In re Eastern Consol. Utils., Inc.*, 3 B.R. 591, 592-93 (Bankr. E.D. Pa. 1980). Disagreement with a trustee's business judgment is not sufficient evidence of an improvident appointment or changed circumstances. *Taub*, 441 B.R. at 216. While the result of this order would place the debtor in possession back in control of the operation of the business, the court may nevertheless order the operation of the business to cease under 11 U.S.C. § 1108.

3-6.6 REMOVAL OF A TRUSTEE OR EXAMINER

Pursuant to 11 U.S.C. § 324(a) the court may, for cause, remove a trustee or an examiner. Notice and a hearing regarding the matter must be provided as required by section 102(1).

The Bankruptcy Code does not list specific grounds constituting cause for removal. Determining whether circumstances warrant the removal of a trustee or examiner is necessarily left to the court on a case-by-case basis. Many of the reported decisions on the application of section 324 arise in the context of chapter 7 cases. As with chapter 7 trustees, the United States Trustee must ensure that chapter 11 trustees and examiners are appropriately supervised and held accountable for their actions. To the extent that these individuals are not filing reports or otherwise complying with their fiduciary obligations, a motion seeking their removal should be filed. Unless the court orders otherwise, the removal of a trustee or an examiner in any one bankruptcy case effects the trustee's or examiner's removal in all other cases in which the trustee or examiner is then serving. 11 U.S.C. § 324(b).

In the event of an allegation of loss of estate funds held by the chapter 11 trustee, the United States Trustee should follow guidance set forth in Manual Volume 2, on chapter 7 case administration.

A trustee who has been removed must still file a final report and account of the administration of the estate. *See* 11 U.S.C. § 704(a)(9) made applicable to chapter 11 trustees by 11 U.S.C. § 1106(a)(1). The removed trustee must also turn over all books, records, and other assets of the estate to a successor trustee, and indeed can be compelled to do so if necessary. *See* 11 U.S.C. § 542(a); *In re Grand Jury Proceedings*, 119 B.R. 945, 952-55 (E.D. Mich. 1990); *Matter of Jim's Garage*, 118 B.R. 949, 951-53 (Bankr. E.D. Mich. 1989). The successor trustee appointed in any such case must also file an accounting of the prior administration of the estate. Fed. R. Bankr. P. 2012(b)(2).

3-6.7 ELECTION OF A TRUSTEE

Section 1104 allows creditors to elect a trustee in chapter 11 cases. Pursuant to section 1104(b)(1), the election of the chapter 11 trustee is to be conducted in the same manner as the election of a chapter 7 trustee**.** *See* Fed. R. Bankr. P. 2007.1 for procedures for the election of a chapter 11 trustee.

3-6.7.1 Requests for Election

Any party in interest may request the election of a trustee after the court orders the appointment of a trustee under section 1104(a). The request must be made no later than 30 days after the court orders the appointment. *See* 11 U.S.C. § 1104(b)(1) and Fed. R. Bankr. P. 2007.1(b)(1).

If a timely request for election is made, the United States Trustee must convene a section 341 meeting. *See* 11 U.S.C. § 1104(b)(1). In the event that the section 341 meeting initially convened in the case has been concluded, section 1104(b)(1) and Rule 2003(f) (Special Meetings) provide authority for the United States Trustee to convene another meeting of creditors for the purpose of holding a trustee election. Notice should be given in the same manner as for any section 341 meeting. *See* Fed. R. Bankr. P. 2002(a)(1) and 2007.1(b)(2). Parties should be able to request the court to shorten the normal 21-day notice period. *See* Fed. R. Bankr. P. 9006(c)(1).

There appears to be a conflict in the statute regarding the determination of the number of creditors required to request an election. The first sentence of section 1104(b) indicates that an election shall be held "on the request of a party in interest." This would seem to indicate an election should be held even if only one eligible creditor requests the election. However, the second sentence of section 1104(b) further states, "the election of a trustee shall be conducted in the manner provided in subsections (a), (b), and (c) of section 702 of this title." 11 U.S.C. § 702(b) provides that:

> Creditors may elect one person to serve as trustee in the case if election of a trustee is requested by creditors that may vote under subsection (a) of this section, and that hold at least 20 percent in amount of the claims specified in subsection (a)(1) of this section that are held by creditors that may vote under subsection (a) of this section.
>
> *Id.*

As the language of section 1104(b) specifically refers to section 702(b), it would appear that Congress intended that eligible voters holding at least 20 percent in the amount of claims must request the election at the meeting convened upon the request of a party in interest. Therefore, although any single party in interest may request the United States Trustee to convene a meeting of creditors for the purpose of electing a trustee, the 20 percent "requesting" requirement of section 702(b) must also be met before the election may proceed. This interpretation comports with the policy underlying the enactment of section 702(b), namely, "to insure that a trustee is elected only in cases in which

there is true creditor interest, and to discourage election of a trustee by attorneys for creditors." H.R. Rep. No. 595, 95th Cong., 1st Sess. 102 (1977).

In chapter 11 cases, as in chapter 7 cases, the right to vote is determined pursuant to Fed. R. Bankr. P. 2003(b)(3). *See* Fed. R. Bankr. P. 2007.1(b)(2). Rule 2003(b)(3) provides that an unsecured creditor is only entitled to vote if, at or before the meeting, the creditor has filed a proof of claim or a writing setting forth facts evidencing a right to vote. An objection may be made to the claim at the election. If an objection is made to the amount or allowability of a claim for the purposes of voting, the United States Trustee shall tabulate the votes for each alternative presented by the dispute, and if resolution of such dispute is necessary to determine the result of the election, the tabulations for each alternative shall be reported to the court. *See* Fed. R. Bankr. P. 2003(b)(3).

A claim or interest is deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a). A proof of claim executed and filed in accordance with the Bankruptcy Rules constitutes *prima facie* evidence of the amount and validity of the claim. *See* Fed. R. Bankr. P. 3001(f). Accordingly, most courts have concluded that a claim that is *prima facie* valid may not be denied the right to vote because of a mere general assertion that the claim is invalid. *See, e.g.*, *In re Poage*, 92 B.R. 659, 664 (Bankr. N.D. Tex. 1988). The party objecting to the claim for voting purposes must go forward with the evidence to establish the invalidity of the claim. *See In re Metro Shippers, Inc.*, 63 B.R. 593, 599 (Bankr. E.D. Pa. 1986).

Unlike in chapter 7, a creditor in chapter 11 does not need to file a proof of claim unless the claim is disputed, contingent, or unliquidated. *See* Fed. R. Bankr. P. 3003(c)(2). The schedules constitute *prima facie* evidence of the validity and the amount of the claim. *See* Fed. R. Bankr. P. 3003(b)(1). Accordingly, an eligible unsecured creditor who holds a claim that is not disputed, contingent, or unliquidated should be deemed to have the right to vote.

The first step in determining whether a sufficient number of creditors has made a request for an election is to determine the proper "claims base" against which the 20 percent "requesting" requirement may be measured. The proper time to compute this universe of voting creditors is as of the time of an election. *In re Williams*, 277 B.R. 114, 117 (Bankr. C.D. Cal. 2002). From a review of Schedule F and filed proofs of claim, the total claims universe eligible to vote in the election should be calculated. This process, which reduces the total universe of claims asserted in the case, may involve:

1. eliminating all Schedule F claims that are superseded by filed proofs of claim;
2. eliminating all Schedule F claims listed in "unknown" amounts;
3. eliminating all Schedule F claims listed as "contingent," "unliquidated" or "disputed";

4. eliminating all filed claims that are superseded by duplicate or amended proofs of claim;
5. eliminating all claims (or portions thereof) filed as "secured" or "priority";
6. eliminating all filed claims listed as "contingent," "unliquidated" or "disputed";
7. eliminating all filed claims that have been paid and satisfied under bankruptcy court orders;
8. eliminating all filed claims as to which objections have been filed or made otherwise; and
9. eliminating all claims filed after the court-ordered bar date. *See In re American Eagle Mfg., Inc.*, 231 B.R. 320, 329-331 (Bankr. 9th Cir. 1999).

3-6.7.2 Election Procedures

The United States Trustee convenes and presides at the election. See 11 U.S.C. § 1104(b)(1) and Fed. R. Bankr. P. 2007.1(b)(2). The meeting should be recorded, as is done with the section 341 meeting. *See* Fed. R. Bankr. P. 2003(c). The following information should be obtained and recorded:

1. the case name and number;
2. the date of the meeting;
3. the names of all parties in attendance;
4. the name of the individual requesting the election and the claim represented, including the amount of the claim;
5. the name of the claimant requesting an election, a copy of the claim, and a copy of any proxy or power of attorney; and
6. if an attorney is voting a claim, a statement from the attorney that the claimant is a regular client of that attorney or a solicitation statement from the attorney.

If an eligible disinterested trustee is elected, the United States Trustee must file a report certifying that election. *See* 11 U.S.C. § 1104(b)(2)(A). Furthermore, upon completion of an undisputed election, the United States Trustee shall promptly file with the court a report of the election, including the name and address of any person elected as trustee and a statement that the election is undisputed. *See* Fed. R. Bankr. P. 2007.1(b)(3)(A). If creditors elect a trustee under section 1104(b)(1), the report filed by the United States Trustee effectively serves as the selection and appointment of such person by the United States Trustee under section 1104(d), and the service of the original chapter 11 trustee appointed by the United States Trustee terminates. *See* 11 U.S.C. § 1104(b)(2)(B).

If it is necessary to resolve a dispute regarding the election:

The United States Trustee shall promptly file a report stating that the election is disputed, informing the court of the nature of the dispute, and listing the name and address of any candidate elected under any alternative presented by the dispute. The report shall be accompanied by a verified statement by each candidate elected under each alternative presented by the dispute, setting forth the person_s connections with the debtor, creditors, any other party in interest, their respective attorneys, the United States Trustee, and any person employed in the office of the United States Trustee. Fed. R. Bankr. P. 2007.1(b)(3)(B).

The United States Trustee must deliver a copy of the report and each verified statement to all parties in interest who either have made a request to convene a meeting under section 1104(b), or requested a copy of the report. *Id.* All committees appointed under section 1102 also are to be served with the report and verified statement. *Id.*

A motion to resolve the dispute must be filed within 14 days after the date the United States Trustee files the report. *Id.* If such a motion is not filed within the 14-day period, the person appointed by the United States Trustee in accordance with section 1104(d) and approved in accordance with Fed. R. Bankr. P. 2007.1(c) shall serve as trustee. *Id.* If a motion to resolve the dispute is filed within the 14-day period, the court must resolve the dispute. *See* 11 U.S.C. § 1104(b)(2)(C). Rule 2007.1 does not provide procedures for judicial resolution of a disputed election in a chapter 11 case. *See* Fed. R. Bankr. P. 2001.1. However, the procedures applicable in disputed chapter 7 elections may be used as guidance. *See* Fed. R. Bankr. P. 2003(d)(2). To avoid a gap in service, pending disposition by the court of the disputed election, the interim trustee shall continue in office. *See* Fed. R. Bankr. P. 2007.1(b)(1).

3-6.7.3 Eligible Voters

Eligible voters are those unsecured creditors who have allowable, undisputed, fixed, liquidated claims that would be entitled to distribution under 11 U.S.C. § 726(a)(2), 726(a)(3), 726(a)(4), 752(a), 766(h), or 766(i). See 11 U.S.C. § 702(a)(1) and 1104(b)(1). Given that these provisions of chapter 7 are not applicable in chapter 11 cases, some confusion regarding this portion of section 702(a)(1) may arise. It would appear that Congress intends to allow unsecured, non-priority creditors to be eligible to vote.

Priority unsecured creditors and secured creditors clearly are not eligible to vote. *See In re Aspen Marine Group, Inc.*, 189 B.R. 859, 863 (Bankr. S.D. Fla. 1995); *In re USA Capital, LLC*, 251 B.R. 883, 889-90 (Bankr. D. Colo. 2000). An undersecured creditor should be allowed to vote the unsecured portion of its claim. *See* 7 *Collier on Bankruptcy*, ¶ 1104.02[8][b][iv], at 1104-29 (16th ed. 2009); *In re Tartan Constr. Co.*, 4 B.R. 655, 658 (Bankr. D. Neb. 1980); *but see In re Lindell Drop Forge Co.*, 111 B.R. 137 (Bankr. W.D. Mich. 1990).

An unsecured creditor with an interest materially adverse to the interests of other unsecured creditors may not vote in a trustee election. 11 U.S.C. § 702(a)(2). For example, an unsecured creditor has a material adverse interest when facts

indicate that the creditor has received a voidable preferential transfer. *See In re Lang Cartage Corp.*, 20 B.R. 534, 536 (Bankr. E.D. Wis. 1982). However, the suspicion of an avoidable preference is insufficient to prohibit a creditor from voting. *See In re Poage*, 92 B.R. 659, 665 (Bankr. N.D. Tex. 1988).

However, a creditor with a small equity position is not automatically excluded from voting solely because of the equity interest. 11 U.S.C. § 702(a)(2). The equity interest may be disregarded if it is *de minimus* when compared with the unsecured claim. *See* H.R. Rep. No. 595, 95th Cong., 2d Sess. 378 (1977). A creditor who is an insider of the debtor is not eligible to vote. *See* 11 U.S.C. § 702(a)(3).

3-6.7.4 Determining Election Results

The election is void unless creditors holding at least 20 percent in the amount of eligible claims actually vote. 11 U.S.C. § 702(c)(1). The successful candidate must receive votes from creditors holding a majority in the amount of claims that are held by creditors actually voting. 11 U.S.C. § 702(c)(2). The number of creditors voting for or against a candidate is irrelevant, as only the dollar amount of the claim is counted for voting purposes.

The 20 percent "requesting" requirement of section 702(b) is independent of the 20 percent "quorum" requirement of section 702(c)(1). *See In re Oxborrow*, 913 F.2d 751, 753-54 (9th Cir. 1990). At least 20 percent of eligible creditors must request an election regardless of the number of creditors who actually cast votes at an election. *Id.*

3-6.7.5 Solicitation of Proxies

In most cases, not all creditors who wish to vote for a trustee will be in attendance. It is likely that in cases with a significant number of creditors the election will be requested by one or more creditors holding proxies. A proxy is defined in Fed. R. Bankr. P. 2006(b)(1) as a "written power of attorney authorizing any entity to vote the claim or otherwise act as the owner's attorney in fact in connection with the administration of the estate." The validity of a proxy is determined under Fed. R. Bankr. P. 9010(c).

Proxy holders who have solicited proxies for voting at the election of a trustee must follow the rules set forth in Fed. R. Bankr. P. 2006. The court may reject any proxies, on motion of a party in interest or on its own motion, if there has been a failure to comply with this rule. Fed. R. Bankr. P. 2006 applies in chapter 11 trustee elections. *See* Fed. R. Bankr. P. 2007.1(b)(2).

The strict rules regulating the solicitation of proxies must be enforced to ensure that a trustee is elected only in cases where there is true creditor interest. The Advisory Committee Note to Fed. R. Bankr. P. 2006 states:

> Creditor control was a basic feature of the Act and is continued, in part, by the Code. Creditor democracy is perverted and the congressional objective frustrated, however, if control of administration falls into the hands of

> persons whose principal interest is not in what the estate can be made to yield to the unsecured creditors but in what it can yield to those involved in its administration or in other ulterior objectives.

Id.

Any communication concerning a proxy for electing a trustee is deemed solicitation unless the communication is between a creditor and an attorney acting for the creditor. Fed. R. Bankr. P. 2006(b)(2). A communication between an attorney and his/her regular client would not be a solicitation. *Id.*

The requirements for an authorized solicitation are set forth in Fed. R. Bankr. P. 2006(c). The solicitation must be in writing. Fed. R. Bankr. P. 2006(c)(2).

A proxy may be solicited only by the following individuals or committees:

(A) a creditor owning an allowable unsecured claim against the estate on the date of the filing of the petition; (B) a committee elected pursuant to § 705 of the Code which does not apply in chapter 11 cases; (C) a committee of creditors selected by a majority in number and amount of claims of creditors (i) whose claims are not contingent or unliquidated, (ii) who are not disqualified from voting under § 702(a) of the Code, and (iii) who were present or represented at a meeting of which all creditors having claims of over $500 or the 100 creditors having the largest claims had at least five days notice in writing and of which meeting written minutes were kept and are available reporting the names of the creditors present or represented and voting and the amounts of their claims; or (D) a bona fide trade or credit association, but such association may solicit only creditors who were its members or subscribers in good standing and had allowable unsecured claims on the date of the filing of the petition. Fed. R. Bankr. P. 2006(c)(1).

A committee of unsecured creditors appointed under section 1102 is also entitled to solicit a proxy for the purposes of the election of a chapter 11 trustee. See Fed. R. Bankr. P. 2007.1(b)(2).

The purpose of these restrictions is to protect creditors from the loss of control of the administration of the case to holders of proxies having interests different from the general unsecured creditors. This rule restricts solicitation to those who were creditors at the commencement of the case. Advisory Committee Note, Rule 2006(c).

Fed. R. Bankr. P. 2006(d) expressly prohibits solicitation by five types of persons. First, any entity holding any interest other than that of a general creditor is prohibited from soliciting proxies. Under this provision, secured and priority creditors and the debtor are prohibited from solicitation. Solicitations are prohibited by or on behalf of any custodian. Further, the interim trustee appointed under section 701 is prohibited from soliciting proxies. (Of course, this prohibition is not applicable in a chapter 11 case.) Under that same subdivision, any entity not entitled to vote under section 702 is prohibited from

solicitation. Solicitation is not permitted by or on behalf of a transferee of a claim for collection only.

In addition, the solicitation of proxies is not permitted by or on behalf of an attorney at law. Fed. R. Bankr. P. 2006(d). This rule does not regulate communications between an attorney and his or her regular client. Fed. R. Bankr. P. 2006(b)(2). Any other communication between an attorney and any other person or group requesting a proxy from a creditor, however, is a regulated solicitation.

The case of *In re Darland Co.*, 184 F. Supp. 760 (S.D. Iowa 1960), is cited in the Advisory Committee Note to Fed. R. Bankr. P. 2006. In that case, the district court stated that the solicitation of a proxy by an attorney from a creditor who was not a client may be objectionable as unethical conduct. *Id.* at 763-64. The Advisory Committee Note further states that solicitation by an attorney "carries a substantial risk that administration will fall into the hands of those whose interest is in obtaining fees from the estate rather than securing dividends for creditors."

Several bankruptcy courts have refused to recognize proxies that were solicited by attorneys at law. *See, e.g.*, *In re Oxborrow*, 104 B.R. 356, 362 (E.D. Wash. 1989), *aff'd*, 913 F.2d 751 (9th Cir. 1990). These courts recognize that the drafters of the Bankruptcy Rules made a conscious and deliberate decision to prohibit solicitation by attorneys. *But see In re Diva Jewelry Design, Inc.*, 367 B.R. 463, 475-76 (Bankr. S.D.N.Y. 2007) (attorney is not barred from assisting the solicitation efforts of a creditor or committee, provided it is clear that the attorney, in his or her personal capacity, is not the solicitor and that the solicitation is not on behalf of the attorney in that capacity).

A solicitation statement must be filed with the court and served upon the United States Trustee by a holder of two or more proxies prior to the time voting commences at any meeting of creditors. Fed. R. Bankr. P. 2006(e). Delivering the proxy statement to the presiding official at the meeting is not the equivalent of filing the statement with the clerk of the court. *See In re Brent Indus., Inc.*, 96 B.R. 193, 196 (Bankr. D. Iowa 1989). The solicitation statement must include the following:

1. a copy of the solicitation;
2. identification of the solicitor, the forwarder, . . . and the proxy holder. . . . If the solicitor, forwarder, or proxy holder is an association, there shall also be included a statement that the creditors whose claims have been solicited . . . were members in good standing and had allowable unsecured claims . . . ;
3. a statement that no consideration has been paid or promised by the proxy holder for the proxy;
4. a statement as to whether there is any agreement . . . for the payment of any consideration in connection with voting the proxy, or for the sharing of compensation with any entity, other than a member or regular associate of the proxy holder's law firm, which may be allowed the trustee . . . ;

5. if the proxy was solicited by an entity other than the proxy holder . . . . a statement signed and verified by the solicitor or forwarder that no consideration has been paid or promised . . . ;

6. if the solicitor, forwarder, or proxy holder is a committee, a statement signed and verified by each member as to the amount and source of any consideration paid or to be paid . . . .Fed. R. Bankr. P. 2006(e).

3-6.7.6 Qualifications of an Elected Trustee

An elected trustee must be "disinterested." 11 U.S.C. § 1104(b). In addition, the elected trustee must meet the qualifications of section 321. The person elected to be trustee must be competent to perform the duties. 11 U.S.C. § 321(a)(1). If the elected trustee is a corporation, the corporation must be authorized by the corporation's bylaws or charter to act as a trustee. 11 U.S.C. § 321(a)(2). Additionally, the person cannot have served as an examiner in the case. 11 U.S.C. § 321(b). The elected trustee must post a bond in favor of the United States. 11 U.S.C. § 322(a). The amount of the bond and sufficiency of the surety shall be determined by the United States Trustee. 11 U.S.C. § 322(b)(2).

If the elected trustee has provided no indication of his or her ability or intent to comply with the Bankruptcy Code and Rules and to adhere to fiduciary standards, the court may refuse to certify the election. *See In re Shubov*, 187 F.3d 648 (9th Cir. 1999) (upholding bankruptcy court's rejection of elected chapter 7 trustee, where individual elected lacked experience in chapter 7 cases, the estate was small relative to the resources needed to educate the individual, and the individual lacked financial resources and demonstrated financial irresponsibility).

CHAPTER 3-7: EMPLOYMENT OF PROFESSIONALS

3-7.1 STATUTORY FRAMEWORK: 11 U.S.C. § 327 and FED. R. BANKR. P. 2014

Sections 327, 1103, and 1107 govern the employment of professionals in connection with a chapter 11 case. For professionals employed by creditors' committees pursuant to section 1103, *see* Manual 3-4.2. The following discussion is primarily directed at the employment of professionals by debtors in possession and chapter 11 trustees. Unless the professional comes within the limited exception provided for by section 327(b), prior court approval of the employment of a professional person is necessary.

The retention process is designed to ensure public confidence in the bankruptcy system, prevent abuses, and achieve some degree of economy in the administration of the case by limiting the retention of professionals to only those instances where it can be demonstrated that the services are necessary. Furthermore, the requirements of section 327 "serve the important policy of ensuring that all professionals appointed pursuant to the section tender undivided

loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994). 28 U.S.C. § 586(a)(3)(I) specifically requires the United States Trustee to monitor employment applications and, when appropriate, to file with the court comments with respect to the approval of such applications.

Court approval of a professional person's employment is contingent upon a finding that the applicant has met a two-pronged test:

1. the professional must be disinterested, pursuant to section 327(a); and
2. the professional must not hold or represent an interest adverse to the estate.

The question of whether a professional meets the standards of the law is one for the court to adjudicate after a full disclosure of the facts. A failure to disclose constitutes an independent basis for disqualification.

A professional's conflict of interest may render him or her ineligible to serve as a professional under section 327(a). Despite the requirements of that section and the definition of a "disinterested person" that appears in section 101(14), a professional is not necessarily disqualified from employment because of representation of both the trustee and a creditor. Section 327(c) requires the presence of an actual conflict of interest; however, the statute does not define an actual conflict of interest. Whether the professional's representation is precluded is dependent on a detailed consideration of the relevant circumstances. Few *per se* rules exist in this area, but case law can provide some guidance regarding specific situations.

Some courts require an actual conflict of interest to render counsel not disinterested. Other courts find a potential conflict is disabling. Some courts find that there is no distinction between a potential or an actual conflict. Generally, a finding of actual conflict warrants disqualification of a professional under section 327(a). In addition, under the appropriate circumstance, the appearance of impropriety or an appearance of potential conflict can be grounds for disqualification of counsel.

Pursuant to section 328(c), the court may deny allowance of compensation for services and reimbursement of expenses to a professional employed pursuant to section § 327 or 1103 if the court finds that at any time during the employment the professional was not a disinterested person or held or represented an interest adverse to the estate.

The United States Trustee should promptly examine the application for employment and its accompanying verified statement not only to determine if the proposed professional service is necessary, but also to ascertain if any disclosures suggest questionable relationships, divided loyalties, or disqualifying adverse interests. Issues that may warrant closer scrutiny include multiple debtor representation, simultaneous representation of a limited partnership and a general partner, representation of a corporation and an affiliate or shareholder, receipt of a preference or unpaid fees, security interests taken to secure the payment of fees or other unusual arrangements for compensation, and prior or concurrent

representation of a major creditor. Where appropriate, the United States Trustee should require further disclosure or comment on any unusual aspects of the application. The United States Trustee should object to the employment when the services are unnecessary or duplicative, the applicant is not disinterested, or representation of adverse interests warrants disqualification.

Bankruptcy Rule 6003(a) provides that applications to employ professionals cannot be granted within 21 days of the filing of the petition, except to the extent that relief is necessary to avoid immediate and irreparable harm. The United States Trustee should object when relief is sought contrary to Rule 6003(a).

Fed. R. Bankr. P. 2014(a) requires that a copy of the employment application be transmitted to the United States Trustee, but it does not specify any additional parties that must be served. The issue of notice may be addressed by local rule or customary practice. When appropriate, however, the United States Trustee may suggest that only interim orders authorizing employment be entered *ex parte* pending notice and opportunity for objection by parties in interest before the order is permitted to become final.

The contents of an employment application are dictated by Fed. R. Bankr. P. 2014. It must contain all of the following elements:

1. specific facts showing the necessity of the employment;
2. the name of the person to be employed;
3. the reasons for the selection;
4. the professional services to be rendered;
5. any proposed arrangement for compensation; and
6. all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee.

Fed. R. Bankr. P. 2014 disclosure requirements are to be strictly construed. All facts that may have any bearing on the disinterestedness of a professional must be disclosed. It is the responsibility of the professional, not of the court, to ensure that all relevant connections have been brought to light. Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification.

The best practice is for the professional to file an application for employment as soon as possible after the petition date or retention, whichever comes first, even though Rule 6003 does not permit the court to enter the order approving the retention in the first 21 days of the case absent "immediate and irreparable harm." Rule 6003 bars entry of the order in the first 21 days, not the filing of the application. Once the court enters the order, it can be effective as of the date of the employment application.

Professionals perform services at their peril before they file an application for employment. Any approval of employment seeking an effective date before the

application was filed should be considered as a request for *nunc pro tunc* approval. Some circuits enforce a rule denying compensation to professionals for work done prior to the filing of an application for employment unless, as a matter of fundamental fairness, the court approves a *nunc pro tunc* application. Some courts limit entry of *nunc pro tunc* employment orders to extraordinary circumstances and not merely because the approval requirement was overlooked. Mere oversight and inadvertence of counsel are not extraordinary circumstances.

Courts permitting a liberal *nunc pro tunc* approach generally consider if:

1. the application would have been approved originally by the court;
2. evidence appears in the record that demonstrates that the court and other interested parties had actual knowledge of the services being rendered;
3. an application seeking an order *nunc pro tunc* has been filed as soon the matter is brought to the applicant's attention; and
4. a sustainable objection has not been filed to the application for fees.

The Supreme Court has criticized the use of a *nunc pro tunc* order as an "Orwellian vehicle for revisionist history" when reviewing a *nunc pro tunc* order in a non-employment setting. *Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano*, 140 S. Ct. 696, 701 (2020). Although the better interpretation of *Acevedo Feliciano* is that *nunc pro tunc* retention may be appropriate depending on the facts of the case, bankruptcy courts may apply the decision differently. For instance, one bankruptcy court has interpreted the reasoning of *Acevedo Feliciano* to preclude any *nunc pro tunc* relief for professional retention. *See In re Benitez*, No. 8-19-70230-REG, 2020 WL 1272258, at *2 (Bankr. E.D.N.Y. Mar. 13, 2020) ("[T]his Court will no longer require or grant nunc pro tunc retentions.")

The United States Trustee should enforce the requirement of prior court approval and object to the entry of *nunc pro tunc* orders, if appropriate.

3-7.1.1 Retention of Crisis Managers under 11 U.S.C. § 363

In some cases, the debtor may seek to retain a crisis manager, restructuring adviser, or chief restructuring officer (collectively, "crisis manager"). Although the specific terms of the retention and duties of these persons will vary from case to case, the hallmark of such engagements is that the crisis manager predominantly will assume duties that, outside of bankruptcy, typically would be performed by an officer or full-time employee of the debtor.

Because the nature of the crisis manager's duties arguably renders him or her non-disinterested, and therefore ineligible to be retained as a professional under section 327, debtors frequently seek to authorize the employment of such persons as a non-ordinary course transaction under section 363(b).

Although the USTP has never conceded that crisis managers fall outside the scope of section 327, which governs the retention of professionals, it has been the policy of the USTP not to object to applications to retain crisis managers under section 363(b) as long as certain conditions are observed. These conditions are memorialized in the *Jay Alix Protocol*, a 2003 stipulation between the United States Trustee for Region 3 and a crisis manager.

Among other key terms, the *Jay Alix Protocol* requires the crisis manager to limit itself to a single function in the bankruptcy case. The crisis manager may not fully supplant the debtor's existing management, but must remain answerable to the debtor's independent board of directors. In addition, the *Jay Alix Protocol* requires the crisis manager to file fee applications under procedures similar to those applicable to professionals under section 330 and limits the indemnification rights that the crisis manager's firm may receive. An individual crisis manager may be indemnified to the same extent as state law, the bylaws or other documents of corporate governance permit the indemnification of individual officers or directors, along with insurance coverage under the debtor's D&O policy. The firm or corporate entity for which the crisis manager works may not be indemnified. The *Jay Alix Protocol* does not have the force of law. Rather, it is a compromise that the USTP historically has offered to debtors and crisis managers. As a result, if the debtor or crisis manager rejects any term of the *Jay Alix Protocol*, the United States Trustee retains the right to object to all issues regarding the crisis manager's employment, including the request to be retained under section 363 rather than section 327.

3-7.1.2 11 U.S.C. § 329 and Fed. R. Bankr. P. 2016(b) and 2017

Every attorney for a debtor must file the statement required by section 329 within 14 days of the order for relief setting forth the compensation paid or agreed to be paid for services rendered or to be rendered in contemplation of or in connection with the bankruptcy case and the source of such compensation. Fed. R. Bankr. P. 2016(b) also requires disclosure of any agreement to share compensation with any other entity, other than a member or regular associate of the attorney's law firm. Fed. R. Bankr. P. 2017 permits the court on the motion of a party in interest or on its own initiative to determine whether any payment or transfer to an attorney is excessive. Pursuant to section 329(b), the court may order the return of any excessive payments to the estate or the entity that made the payment.

3-7.1.3 Definition of Professional Person

Professional persons employed pursuant to section 327 or 1103 may be awarded compensation pursuant to sections 330 and 331. Clearly, the statute recognizes that attorneys, accountants, appraisers, and auctioneers are professional persons for whom prior court approval of employment would be required. Occasionally, it is necessary for the trustee, debtor in possession, or committee to contract with outside firms or individuals who do not fall within these categories for assistance in the performance of their statutory duties. In these circumstances, the question sometimes arises whether an order of employment is required. The classic

definition of professional person for purposes of section 327(a) limits the term to "persons in those occupations which play a central role in the administration of the debtor proceeding." *In re Marion Carefree Ltd. Partnership*, 171 B.R 584 (Bankr. N.D. Ohio 1994); *In re Seatrain Lines, Inc.*, 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981). The degree of autonomy and discretion exercised by the firm or individual in question is also a relevant consideration in determining whether the requirements of section 327(a) apply. *In re Bicoastal Corp.*, 149 B.R. 216 (Bankr. M.D. Fla. 1993); *In re Park Ave. Partners Ltd. Partnership*, 95 B.R. 605 (Bankr. E.D. Wis. 1988).

3-7.1.4 Auctioneers and Appraisers

The court must approve the retention of appraisers and auctioneers who must meet the same statutory requirements as other professionals. 11 U.S.C. § 327(a). Fed. R. Bankr. P. 6005 requires that the order of retention fix the amount or rate of compensation. The rule further provides that no employee or officer of the judiciary or of the Department may act as an appraiser or auctioneer, and provides that no residence or licensing requirement is to be required, even though most states require an auctioneer to be licensed and bonded. It is not unusual for an appraiser to be compensated on a per diem basis and an auctioneer to be compensated at a percentage of the gross proceeds of sale. Local rules may govern the maximum allowable percentage to auctioneers. The appraiser and the auctioneer should not be the same person. An obvious conflict arises where the same person appraises items that he or she will be auctioning, and the United States Trustee should object if it is proposed that one person be employed in both capacities.

Auctioneers must be bonded since they handle significant amounts of cash belonging to estates. The amount may be set by local rules, but the United States Trustee should require a bond of an amount sufficient to protect the estate. The bonds are generally filed with the clerk of the court. All proceeds of an auction sale are to be delivered to the trustee or the attorney for the debtor in possession as soon as they are received.

All auction sales are to be noticed pursuant to Fed. R. Bankr. P. 6004(a), and the auctioneer must submit an itemized statement of the property sold, the name of each purchaser, and the price received. Fed. R. Bankr. P. 6004(f)(1).

3-7.1.5 11 U.S.C. § 327(e)

An attorney who may be ineligible for employment under section 327(a) because of the attorney's prior representation of the debtor may be hired under section 327(e) if the employment is for a specified special purpose, other than to "represent the trustee in conducting the case," provided that the employment is in the best interest of the estate and the attorney does not hold or represent an interest adverse to the estate with respect to the particular matter for which such attorney is employed. Note that section 327(e) applies only to attorneys. *See* 3 COLLIER ON BANKRUPTCY § 327.04[9][a] ("The exception for the retention of

special purpose services applies exclusively to attorneys"). Accountants and other professional persons are not eligible for employment pursuant to that section. *See In re Andover Togs, Inc.,* 2001 U.S. Dist. LEXIS 2690 (S.D.N.Y. Mar. 13, 2001).

An analysis of whether special counsel qualifies for employment under section 327(e) should begin with an understanding of applicable ethical regulations. Certain potential conflicts are capable of being waived after full disclosure and consent. Most often, the question will become whether the conflicting interest that makes counsel ineligible for employment under section 327(a) is such that counsel is rendered incapable of exercising independent professional judgment on behalf of the client. If the employment necessarily requires that one interest be served at the expense of the other, an adverse interest exists that should disqualify counsel for employment pursuant to section 327(e).

3-7.2 THE DISINTERESTED PERSON REQUIREMENT FOR EMPLOYMENT OF PROFESSIONALS AND APPOINTMENT OF TRUSTEES AND EXAMINERS

The disinterested person requirement of the Bankruptcy Code applies when professionals are employed pursuant to 11 U.S.C. § 327(a), and in the appointment of trustees and examiners, 11 U.S.C. § 701, 1104, 1202(a), and 1302(a).

3-7.2.1 Statutory Framework: 11 U.S.C. § 101(14) and 327(a)

Disinterested person" is defined at section 101(14) as a person that:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or for any other reason.

Section 327(a) of the Bankruptcy Code involves the application of a two-pronged test. First, the professional must be disinterested as defined in section 101(14). Second, the professional must not hold or represent an interest adverse to the estate. Failure to meet either condition of employment can result in disqualification.

3-7.2.2 U.S.C. § 101(14) (A)-(B)

The language of section 101(14) (A)-(B) mandates a literal approach to the disinterested person requirement and sets forth in detail a series of characteristics that disqualify a person from being "disinterested." These paragraphs do not call

for any "weighing" or "balancing" of the impact of disqualification. A judicial determination that a person's characteristics would pose problems for the administration of the bankruptcy estate is not a prerequisite for disqualification. Each paragraph refers to characteristics of a person that are either carefully defined within the Bankruptcy Code or are easily understood. *See, e.g.*, 11 U.S.C. § 101(10) ("creditor"), (17) ("equity security holder"), and (31) ("insider"). If a professional has the characteristic, then disqualification is automatic. The fact that the interest in question may arguably be considered *de minimus* is of no importance in the analysis. Since the language of the statute is clear, it must be applied as written.

An agreement to subordinate a claim to payment of all other claims in a case will not cure a disinterestedness problem. However, waiver of the claim will render an applicant disinterested and thus in compliance with the statute.

3-7.2.3 Overlap of 11 U.S.C. § 101(14) (C) and 11 U.S.C. § 327(a)

A more difficult inquiry must be undertaken to determine whether the professional meets the adverse interest standard of sections 101(14) (C) and 327(a). Subparagraph (C) of section 101(14), the so-called "catch-all" provision, provides that a person is disinterested if the person:

> does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or for any other reason.

Section 327(a) provides that the trustee may employ professionals "that do not hold or represent an interest adverse to the estate, and that are disinterested persons. . . ." There is thus some overlap between the no adverse interest requirement of section 327(a) and the materially adverse interest standard of section 101(14)(C). Viewed practically, persons failing one of the requirements will often fail the other as well.

The conclusion that retention is improper requires a careful consideration and weighing of the totality of the circumstances presented; it is not, however, a balance of impropriety against the alleged disruption disqualification will create. If the circumstances reveal a conflict impeding the exercise of independent judgment by the professional, an objection to the retention should be made.

There are differences between sections 327(a) and 101(14)(C). Section 327(a) refers merely to an interest that is "adverse," whereas section 101(14)(C) refers to a "materially adverse" interest. This would suggest that a somewhat broader standard is contained in section 327(a). Subparagraph (C) of section 101(14), however, appears to be more stringent than section 327(a) in one regard. The adverse interest clause of section 327(a) merely precludes the employment of persons holding or representing an interest adverse to the estate, whereas subparagraph (c) expands the proscription to include interests that are materially

adverse not only to the estate, but also to any class of creditors or equity security holders.

These statutory distinctions complicate the analysis that must be undertaken. Further complexity results from the provision of section 327(c) that states that a professional is not disqualified for employment "solely because of such person's employment by or representation of a creditor, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest." Thus, a professional is not ineligible for employment simply because he/she represents a creditor, absent an actual conflict. Furthermore, section 1107(b) provides that, notwithstanding the requirements of section 327(a), a person is not disqualified for employment by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case. Proper application of these varied statutory provisions demands a painstaking analysis of the unique facts and circumstances presented in each case.

3-7.2.4 2019 Disclosure Principles Memorandum

On December 4, 2019, the Director issued a memorandum setting forth four guiding principles for the USTP to follow when reviewing and objecting to professional employment applications. The contents of that memorandum are incorporated below.

Pursuant to 28 U.S.C. § 586(a)(3)(I), the USTP has an important responsibility to review applications in chapter 11 cases to employ law and other professional firms ("professional firms")[6] that will seek payment from the bankruptcy estate. Due to the multiplicity of interests in a case—from large to small creditors, from employees to other stakeholders—the Bankruptcy Code and Rules mandate that professional firms disclose their connections to other parties in the case and satisfy conflict of interest standards.

Although all parties in a case may object to the adequacy of a professional firm's disclosures and to a professional firm's retention because of potential or actual conflicts, it is usually only the USTP that makes inquiries or files objections. Our role as the "watchdog" of the bankruptcy system is to faithfully read and apply the Code and Rules and to raise issues that we have identified so that the court may make the ultimate determination on a professional firm's employment.

The organizational structure of many professional firms seeking to be retained in bankruptcy cases has grown more complex in recent years. Some professional firms are affiliates of larger businesses that provide a variety of services to clients, both inside and outside of the bankruptcy system. In addition, some professional firms (including parents and affiliates) sponsor funds that invest in their business clients, in distressed debt that may be at issue in a bankruptcy case, or in

[6] As used herein, this term also includes the individual professionals of the professional firm.

industries (including competitors of their business clients) to which they provide services.

The increasingly complex profile of professional firms subject to the disclosure and conflict provisions of 11 U.S.C §§ 327 and 1103 and Fed. R. Bankr. P. 2014 makes both our review of employment applications and the court's decision on such applications more challenging. Accordingly, set forth below are the general principles that should guide you, as USTP personnel, in reviewing applications to employ professional firms in bankruptcy cases.

1. **Enforce the Law**. The USTP's responsibilities start and stop with a textual reading and expert application of the Bankruptcy Code and Rules. Although professional firms may adopt internal protocols that guide their processes for compliance, these internal protocols cannot change substantive law. Nor can these protocols provide a safe harbor for a firm that does not meet the strict legal requirements governing disclosures and conflicts.

2. **Disclose Connections on the Public Record.** It is the USTP's position that relevant bankruptcy law requires professional firms to disclose on the public record their connections to a case, even if they have a contractual arrangement to keep client information, including client names, confidential. The USTP will argue that a professional firm required to disclose information must either publicly disclose on the record the withheld information or file a properly supported motion to seal under Bankruptcy Code section 107 for the court to adjudicate. Should the professional firm choose to file a motion to seal rather than publicly disclose the required information on the record, the USTP has a responsibility to object to any motion that does not satisfy the high bar for sealing.

3. **Disclose Affiliate Connections**. It is the USTP's position that a professional firm being employed must disclose the connections of all its affiliates. Every case is fact specific and, in some circumstances, a professional firm may be able to show that it is sufficiently separate from its affiliates to excuse affiliate disclosure.[7] The applicant seeking to employ the professional firm bears the burden of proof and only the court has authority to excuse affiliate disclosure.

4. **Disclose Connections Based on Investments**. Investments by the professional firm's investment affiliates or by their individual professionals may

[7]Separate incorporation may not be dispositive of whether affiliate disclosure may be excused. Professional firms routinely disclose connections of their separately incorporated affiliates when, for example, the separate legal entities belong to an international cooperative.

create conflicts, and depending on the circumstances, those conflicts can be just as serious as conflicts created by working for clients with adverse interests. It is the USTP's position that relevant bankruptcy law requires the professional firm to disclose connections that extend to investments in clients and other entities that may be a party in interest in the case, such as a stalking horse bidder, DIP lender, or other creditor. Investments include direct investments in such entity, as well as investments made through third parties.

In deciding whether investments must be disclosed, the USTP will analyze two key factors: (1) knowledge; and (2) control. If the professional firm knew or could have known about the investment in a particular entity that may be involved in the case or an investment in the debtor's industry, then it is the USTP's position that the investment should be disclosed. Or if the professional firm controlled or could have controlled the selection of the investment in a relevant entity or industry, then it is the USTP's position that the investment must be disclosed. Thus, for example, a typical investment in a diversified mutual fund that is managed by an independent outside advisor need not be disclosed. But a professional firm that sponsors pooled investments in clients who may be parties in interest in the case may be required to disclose those investments.

It is vital that the USTP acts consistently from district to district in this, as in other, legal matters. Please ensure that all staff who review chapter 11 retention applications are familiar with these general disclosure principles. Each case will have unique facts that should be considered in a manner consistent with these principles.

The Office of the General Counsel should be consulted if there are any questions regarding these principles or their application in specific cases.[8] These principles are internal directives to guide USTP personnel in carrying out their duties, but the ultimate determination on the obligations of professionals under sections 327 and 1103 and Fed. R. Bankr. P. 2014 resides solely with the court. Nothing in these disclosure principles has any force or effect of law, and nothing stated in them imposes on parties outside the USTP any obligations that go beyond those set forth in the Bankruptcy Code and Rules.

[8]Nothing in this internal guidance: (1) limits the USTP's discretion to request additional information necessary for the review of a particular application; (2) limits the USTP's discretion to file comments or objections to applications, including as to whether a professional firm is disinterested or otherwise satisfies the statutory standards for retention in the case; or (3) creates any private right of action on the part of any person enforceable against the USTP or the United States.

3-7.3 SPECIAL PROBLEMS IN RELATED CASES

3-7.3.1 Appointment of a Trustee

A trustee appointed in a chapter 11 case must meet the disinterested person requirement. 11 U.S.C. § 1104(d). Notwithstanding this requirement, when multi-debtor partnerships or related corporate debtors are involved, the responsibilities of the trustee to pursue assets and resist claims within the context of these entities may raise added concerns about potential conflicts. The determination of whether one or more trustees should be appointed in these circumstances rests upon a careful evaluation of the overall potential for conflict, i.e., the need for the varied interests involved in the cases to be separately administered.

The definition of a disinterested person proscribes various types of disqualifying interests. As a general matter, section 101(14) does not disqualify persons because of whom they represent, but rather because of the nature of their personal status – for example, because they personally are creditors of the debtor or they personally "have an interest" that is "materially adverse" under subparagraph (C). Therefore, the mere fact that a trustee may assert a claim against one estate in his or her representative capacity for another estate does not make him or her a "creditor" in an individual sense for purposes of applying 11 U.S.C. § 101(14)(A). *In re BH & P, Inc.*, 949 F.2d 1300 (3d Cir. 1991).

Moreover, the "materially adverse" requirement of section 101(14)(C) should not be read to prevent a single trustee from serving in related cases. A standard that automatically disqualifies a trustee from serving in jointly administered cases where there are inter-debtor claims is overbroad. Indeed, the provisions of Fed. R. Bankr. P. 2009 specifically allow the appointment of a single trustee for jointly administered cases. The United States Trustee must weigh a number of competing interests when deciding whether a single trustee can serve in such cases. A single trustee is often able to maximize the return to jointly administered estates through increased economy and efficiency. Moreover, jointly administered estates will virtually always have inter-debtor claims or potential claims. Were the use of a single trustee precluded in jointly administered estates, these cases would be exposed to increased costs and inefficiency. *In re BH & P, Inc.*, 949 F.2d 1300 (3d Cir. 1991).

However, there are circumstances where the appointment of one trustee in multiple cases may be inappropriate. Fulfilling fiduciary obligations to one estate may require that the trustee take actions that adversely impact the others. Genuine conflicts may arise. The presence and size of assets to pursue in the related estates, the disputed nature of the claims, and the relationship of the various classes of unsecured creditors must be examined. The issue to be resolved is whether the need for advocating competing interests among and between the estates is such that it interferes with the ability of the trustee to exercise independent judgment on behalf of one or more class of creditors. If creditors of the different estates will be prejudiced by conflicts of interest of a

common trustee, the court should order the appointment of separate trustees for jointly administered cases. See Fed. R. Bankr. P. 2009.

There are related corporate debtor circumstances where multiple representation by trustees is allowed. The case of *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932 (Bankr. S.D.N.Y. 1982), is illustrative. In *O.P.M.*, a single trustee was appointed for two related debtors, a parent company and its subsidiary, in reorganization cases under chapter 11. Notably, different trustees had been appointed for the individual owners of the parent company in their liquidation cases. Objections were made to the multiple representation at late points in the cases during contested adversary proceedings between the corporate debtors and individual stockholders. The bankruptcy court found that the corporate debtors possessed a decisive "unity of interest and singleness of purpose" in prevailing in the adversary proceedings against the individual shareholders, even though there was a potential conflict between the parent and the subsidiary as to their respective rights to share in proceeds of the litigation and even though there were other inter-corporate claims. *In re O.P.M.*, 16 B.R. at 938.

In cases involving multiple representation of related debtors, steps can be taken to cure conflicts. The *O.P.M.* court noted that the potential conflict regarding the debtors' respective rights to litigation proceeds did not require the appointment of different trustees because apparent conflicts of interest "might be resolved in a number of ways," including the appointment of special counsel. *In re O.P.M.*, 16 B.R. at 939 (quoting *In re General Economics Corp.*, 360 F.2d 762, 766 (2d Cir. 1966)). The appointment of separate or special counsel has been endorsed by several courts as an acceptable remedial measure.

O.P.M. illustrates the pragmatic approach of having a single trustee administer related debtor cases with inter-affiliate claims, particularly where an objection is raised late in the case. The issue is resolved by balancing the degree to which the circumstances interfere with the ability of the trustee to provide independent judgment against the impact that disqualification will have on the administration of the estate. The reality of the circumstances must be examined, not the hypothetical. Consideration must be given to the economic costs of appointing different trustees.

Finally, to the extent the United States Trustee decides to appoint one trustee, the trustee must be made aware of his or her own independent obligation to be on the lookout for any real or apparent conflicts and to make such disclosure or to take whatever steps are necessary and appropriate.

3-7.3.2 Retention of Professionals

In related cases, the professional's representation of all the debtors ultimately depends upon whether the professional's capacity for independent judgment and the vigorous pursuit of the interests of a particular debtor are infringed upon. As with the case of the multiple debtor trustee, the cost of obtaining different professionals, as well as the expense that accrues when a professional is employed late in a case, are significant factors. The nature of disclosure at the time of

retention, whether the interests of related estates are parallel or conflicting, and the type of the inter-debtor claims are also significant. The size and nature of inter-debtor claims, whether they are disputed or hold priority status, and whether the various debtor interests diverge in some material way must also be examined. Ultimately, the efficiency and economy that favors multiple representation must be weighed against the need that the interests of each of the estates be adequately represented.

CHAPTER 3-8: COMPENSATION OF PROFESSIONALS

3-8.1 DETERMINATION OF REASONABLE COMPENSATION, 11 U.S.C. § 330 AND FED. R. BANKR. P. 2016(a)

Section 330(a) authorizes the court, after notice and a hearing, to award to a trustee, an examiner, or other professional person employed under section 327 or 1103 –

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

The court is also authorized to award less than the amount of compensation requested. 11 U.S.C. § 330(a)(2).

Section 330(a)(3) provides:

In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including –

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and

(E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

Fed. R. Bankr. P. 2016(a) prescribes that any entity seeking interim or final compensation for services or reimbursement of expenses shall file a detailed statement of the services rendered, the time expended, the expenses incurred, and the total amount requested. If the amount requested exceeds $1,000, Fed. R.

Bankr. P. 2002(a)(6) requires at least 21 days notice to creditors and parties in interest of the hearing set to consider the application. This period may be reduced for cause pursuant to Fed. R. Bankr. P. 9006(c)(1).

Section 330(a)(4)(A) establishes limitations on the award of compensation:

Except as provided in subparagraph (B), the court shall not allow compensation for –

(i) unnecessary duplication of services; or

(ii) services that were not –

(I) reasonably likely to benefit the debtor's estate; or

(II) necessary to the administration of the case.

These guidelines grew out of court decisions beginning with *Johnson v. Georgia Highway Exp., Inc.*, 488 F.2d 714, 717-19 (5th Cir. 1974), a civil rights case. In that case, the court identified the following twelve factors to be considered in awarding reasonable compensation:

1. the time and labor required;
2. the novelty and difficulty of the questions;
3. the skill requisite to perform the legal service properly;
4. the preclusion of other employment by the attorney due to acceptance of the case;
5. the customary fee;
6. whether the fee is fixed or contingent;
7. time limitations imposed by the client or the circumstances;
8. the amount involved and the results obtained;
9. the experience, reputation, and ability of the attorneys;
10. the "undesirability" of the case;
11. the nature and length of the professional relationship with the client; and
12. awards in similar cases.

The *Johnson* factors were deemed applicable to bankruptcy cases in *In re First Colonial Corp. of America*, 544 F.2d 1291, 1299 (5th Cir. 1977), *cert. denied*, 431 U.S. 904 (1977), in which the Fifth Circuit stated as follows:

> Bankruptcy judges . . . may abuse their discretion either by failing to apply proper legal standards and follow proper procedures in making the determination . . . or by basing the award upon findings of fact that are clearly erroneous.

* * *

> In order to establish an objective basis for determining the amount of compensation that is reasonable for an attorney's services, and to make meaningful review of that determination possible on appeal, we held in *Johnson* . . . that a district court must consider. . . twelve factors in awarding attorneys' fees. . . . Although *Johnson* involved a suit brought under 42 U.S.C.A. § 2000e et seq., the guidelines we established there are equally useful whenever the award of reasonable attorneys' fee is authorized by statute. *Id.* at 1298-99 (citations omitted).

Courts generally apply the *Johnson* factors in conjunction with a "lodestar" analysis. The "lodestar" is obtained by multiplying the "reasonable" number of hours times a "reasonable" hourly rate. The resulting lodestar may then be adjusted up or down according to the special circumstances of the case. *See Lindy Bros. Builders, Inc. v. Am. Radiator & Sanitary Corp. (Lindy Bros. I)*, 487 F.2d 161, 168 (3d Cir. 1973); *Lindy Bros. Builders, Inc. v. Am. Radiator & Sanitary Corp. (Lindy Bros. II)*, 540 F.2d 102, 117 (3d Cir. 1976). In the context of federal fee-shifting statutes, the Supreme Court has held that there is "a strong presumption that the lodestar figure – the product of reasonable hours times a reasonable rate – represents a "reasonable" fee." *Pennsylvania v. Delaware Valley Citizens Council for Clean Air (Delaware Valley I)*, 478 U.S. 546, 565 (1986). The *Johnson* factors assist in determining the initial "reasonable" hourly rate, as well as the final adjustments to the lodestar. *See In re Manoa Fin. Co.*, 853 F.2d 687, 691 (9th Cir. 1988); *In re Casco Bay Lines, Inc.*, 25 B.R. 747, 755 (B.A.P. 1st Cir. 1982) (the lodestar theory serves to "provide an analytical framework for the trial court's application of the *Johnson* . . . criteria"). *See also Grant v. George Schumann Tire & Battery Co.*, 908 F.2d 874, 878-79 (11th Cir. 1990); *In re Peoples Sav. & Inv., Inc.*, 103 B.R. 264, 271 (Bankr. E.D. Okla. 1989); *In re Stable Mews Assocs.*, 49 B.R. 395, 398 (Bankr. S.D.N.Y. 1985). On recalculating the lodestar, *see In re Narragansett Clothing Co.*, 160 B.R. 477, 482-83 (Bankr. D.R.I. 1993).

What is a reasonable hourly rate? "Congress expressed its intent that there should be no distinction between fees set in bankruptcy cases and those set in non-bankruptcy cases." *Grant v. George Schumann Tire & Battery Co.*, 908 F.2d at 878. *See also In re UNR Indus., Inc.*, 986 F.2d 207, 209-10 (7th Cir. 1993). Therefore "the starting point for the calculation of fees is the applicant's 'normal billing rate'." "Generally, so long as the rates being charged are the applicant's normal rates charged in bankruptcy or non-bankruptcy matters alike, they will be afforded a presumption of reasonableness." *In re Jefsaba, Inc.*, 172 B.R. 787, 798 (Bankr. E.D. Pa. 1994) (citations omitted). As the rate must be reasonable "so must the time spent by the professionals on the various tasks to be performed." *Id.* Indeed,

> We review fee applications paying particular attention to the level of professional . . . billing time *viz-a-viz* the complexity of the task being

> performed. The nature, extent and complexity of the task . . . determines the level of professional . . . who should perform the task, and, consequently, the reasonableness of the fees charged . . . It is unreasonable for a senior attorney to perform routine tasks such as preparing a debtor_s schedules . . . . Consequently, fees charged at a senior attorney's hourly rate for such services are unreasonable.

Id. at 796-97 (citation omitted).

The determination of the reasonable hourly rate is a matter of proof of comparable rates charged to non-bankruptcy clients. *See, e.g.*, *In re Busy Beaver Bldg. Ctrs., Inc.*, 19 F.3d 833, 853 (3d Cir. 1994); *In re Jefsaba*, 172 B.R. at 798. *See also In re River Landings, Inc.*, 180 B.R. 701, 704 (Bankr. S.D. Ga. 1995), where the court noted that applying counsel "met her burden of showing comparable rates by presenting the testimony and affidavits of four local attorneys of comparable skill, experience, and reputation in bankruptcy and other commercial matters."

The United States Trustee faces an interesting challenge when presented with a fee application by non-local counsel who seek rates comparable to their home jurisdiction and usually well in excess of local rates. Rigid enforcement of a policy allowing only local rates is inappropriate, as each situation has its own facts and circumstances that must be taken into account. Some courts may require that reasonable rates for attorneys should be the rate for comparable competence and services in a comparable community. *See, e.g.*, *In re El Paso Refinery, L.P.*, 257 B.R. 809, 827 (Bankr. W.D. Tex. 2000). At a minimum, this may require billing rates comparable to those in the community where the attorneys and other timekeepers live and work, if circumstances require the use of professionals outside the community where the case has been filed. *See id.* at 832; *In re Western Co. of North America*, 123 B.R. 546, 549 (N.D. Tex. 1991). In determining reasonable compensation allowable to non-local counsel, the courts should begin with counsels' customary rates, and then make reductions based on other factors if necessary. *See Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc.*, 50 F.3d 253, 260-61 (3d Cir. 1995).

3-8.1.1 Fee Guidelines

Section 586(a)(3)(A) of title 28 was amended in 1994 to require review of applications for compensation and reimbursement under section 330 "in accordance with procedural guidelines adopted by the Executive Office of the United States trustee (which guidelines shall be applied uniformly by the United States trustee except when circumstances warrant different treatment) . . . ." The guidelines were promulgated and, after an opportunity for comment had passed, were published as Appendix A to 28 C.F.R.§ 58 (*see* http://www.justice.gov/ust/eo/rules_regulations). The guidelines established a policy favoring project billing that simplifies the review process. The guidelines do not take the place of local rules or precedent. However, many courts have

adopted the guidelines, in whole or in part, as a local rule. In addition, some United States Trustees have established exceptions to the guidelines for small fee applications.

The review of fee applications is time-consuming and complex. The Bankruptcy Code abandons the principle of economy and conservation of the estate that was the philosophy of the Bankruptcy Act, H.R. Rep. No. 595, 95th Cong., 1st Sess. 330 (1977), yet requires an analysis of benefit to the estate, not in hindsight but tested from the point of view at the time the service was rendered. The courts are obligated to review the applications yet have little time to do so. It is the role of the United States Trustee to assist in the fulfillment of their duty by identifying the problem areas, thus preventing abuse of the system.

The fee guidelines set out the elements that the United States Trustee should look for in evaluating an application for compensation. If the application is deficient such that the United States Trustee cannot analyze it efficiently and effectively, then the United States Trustee must decide whether to file a comment or an objection. The deficiencies usually fall into the following categories:

1. failure to obtain prior court approval of the employment;
2. inadequate disclosure of relationships or possible conflicts;
3. non-compliance with timing or format requirements;
4. inadequate descriptions of services rendered;
5. services performed outside the scope of employment;
6. inappropriate rounding or lumping of time;
7. duplication of effort, inefficient delegation, or excess time spent in performance of a given task;
8. services not reasonably likely to benefit the estate or not necessary to the administration of the case;
9. overhead items inappropriately billed or expensed;
10. inadequate documentation of expenses; and
11. excessive charges for preparing the fee application.

Before filing an objection or comment to a fee application, the United States Trustee should generally confer with the applicant not only to confirm the facts warranting objection, but also to determine if the deficiency can be remedied either by amendment of the application or by voluntary adjustment of the request.

3-8.1.2 Fee Guidelines for Attorneys in Larger Chapter 11 Cases

The United States Trustee Program has guidelines for reviewing attorney compensation in larger chapter 11 cases. These Guidelines are formally titled

"Appendix B–Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed Under 11 U.S.C. § 330 for Attorneys in Larger Chapter 11 Cases." Appendix B to 28 C.F.R.§ 58 (*see* http://www.justice.gov/ust/eo/rules_regulations). They are posted in the Federal Register at 78 FR 36248 and at 78 FR 40507 (date correction only). For purposes of these Appendix B Guidelines, a larger chapter 11 case is defined as a chapter 11 case with $50 million or more in assets and $50 million or more in liabilities, aggregated for jointly administered cases and excluding single asset real estate cases as defined in 11 U.S.C. § 101(51B). These Appendix B Guidelines are a statement of the USTP's policy governing its review of attorney fee applications in larger chapter 11 cases. They communicate to professionals and the general public the criteria used by United States Trustees in the review of fee applications, the USTP's expectations of professionals, and possible bases for USTP objections to the payment of fees and reimbursement of expenses. These Appendix B Guidelines do not supersede local rules, court orders, or other controlling authority.

Although the Appendix B Guidelines technically relate to the review of fee applications filed under sections 330 and 331 of the Bankruptcy Code, the United States Trustee's duties under the Appendix B Guidelines extend well beyond the fee application phase of the case. The Appendix B Guidelines will have an impact in connection with the retention and compensation of attorneys, and the Appendix B Guidelines consequently should be consulted throughout the case, from the petition date until the filing of the final fee applications. Reference should be made to the Appendix B Guidelines and accompanying step-by-step guide for full information. United States Trustees must notify the Executive Office, both the AGC for Chapter 11 and the Assistant Director for Planning and Evaluation, when a case is filed subject to the Appendix B Guidelines.

3-8.2 RETAINERS

A retainer has been defined as the fee that a client pays when he or she employs an attorney to act for him or her, thereby preventing that attorney from working for an adversary. *Black's Law Dictionary* 1183 (5th ed. 1979). Section 328(a) permits the court to authorize the employment of professional persons on any reasonable terms and conditions, including a retainer.

The United States Trustee must scrutinize retainers for several reasons:

1. to assure that the amount of a retainer is not so substantial as to drain a chapter 11 debtor of all of its working capital;
2. to prevent overreaching by counsel who might be taking advantage of a debtor who is not in a position to effectively negotiate the terms of its representation;

3. to review whether the amount of a retainer is likely to give one administrative claimant a preference over other administrative claims in the event of liquidation;
4. to assure that the retainer is paid from a proper source; and
5. to analyze any potential conflicts.

Of course, not all of these concerns will be present in each case. For example, in a large chapter 11 case, it is likely that the debtor will be able to negotiate an arms-length agreement for its legal representation. In small cases, however, the same equality of bargaining power may not exist. As a general rule, the United States Trustee should view retainer agreements as contractual agreements that have been negotiated at arm's length between parties with equal bargaining positions and, absent facts that tend to raise questions as described in a specific case, the United States Trustee should not object to retainers.

Pursuant to section 329 and Fed. R. Bankr. P. 2016(b) and 2017, the amount and source of pre-petition retainers must be disclosed. Post-petition retainers that are paid from the estate may result in an unauthorized transfer under section 549 unless they are paid after the 21-day notice requirements of Fed. R. Bankr. P. 2002(a)(6) or court order and authorized in compliance with the substantive provisions for compensation found in sections 330 and 331 and Fed. R. Bankr. P. 2016(a). Post-petition retainers paid from some source other than the estate must be disclosed as required by Fed. R. Bankr. P. 2016(b) and 2017. Post-petition retainers may implicate cash collateral. In those cases, sections 363 and 364 apply.

So-called "evergreen" retainers present special problems. These arrangements can take several forms. For example, counsel may propose that it receive a pre-petition retainer to hold throughout the pendency of a case, while any interim fee awards to counsel are paid from the debtor's operating funds. The retainer is, thus, held in reserve as a form of guarantee against the risk of nonpayment. Alternatively, counsel who has received and exhausted a pre-petition retainer may seek to replenish that fund by requesting an additional lump sum cash payment. Arguably, these arrangements place an additional strain on a debtor's already precarious cash position. While it has been held that the payment of an evergreen retainer is not objectionable *per se* (*In re Benjamin's-Arnolds, Inc.*, 123 B.R. 839, 840 (Bankr. D. Minn. 1990)), such retainers should be closely scrutinized by the United States Trustee to ensure that they are not improvident under the circumstances. *See In re Pan American Hosp. Corp.*, 312 B.R. 706, 709-11 (Bankr. S.D. Fla. 2004).

Payments may be made by debtors to their counsel or other professionals during the "gap" period following the filing of an involuntary proceeding and prior to entry of an order for relief pursuant to Section 303(f). Section 549(b) allows attorneys who provide services to a gap period putative debtor to be paid for

contemporaneous services during the gap period, without court order. There is no need for counsel to seek court authorization for employment until an order for relief is entered and the debtor becomes a debtor in possession.

From the practitioners' viewpoint, one of the most critical issues is whether retainers can be used by the professional without the necessity of obtaining a court order. The issue turns on whether the funds used to pay the retainer are considered to be property of the estate. Case law is sharply divided on this issue.

Perhaps the most thorough analysis holding that pre-petition retainers do not constitute property of the estate is set forth in *In re McDonald Brothers Constr., Inc.*, 114 B.R. 989, 998-1003 (Bankr. N.D. Ill. 1990). The *McDonald Brothers* court looked to state law to determine what type of retainer was negotiated by the parties. *Id.* If state law permits a pre-petition retainer to be fully earned at the time of payment, then those funds would not have been owned by the debtor at the time of its filing and, thus, would not become part of the debtor's estate. *Id.*

The reasoning of those cases holding that pre-petition retainers are property of the estate is set forth in *In re NBI, Inc.*, 129 B.R. 212 (Bankr. D. Colo. 1991). The *NBI, Inc.* court suggested that the *McDonald Brothers* decision was based on two erroneous assumptions – first, that the "reasonableness" of a contractual agreement between the debtor and its counsel is governed in a bankruptcy proceeding by the same factors applicable under state law that govern in non-bankruptcy settings, and second, that counsel and the debtor may, through a pre-petition retainer contract, remove funds from the estate and, in so doing, eliminate the requirement that counsel present formal fee applications. *In re NBI, Inc.*, 129 B.R. at 221-22. Taken to its logical conclusion, pre-petition retainers, as property of the estate, are simply held in trust by counsel and may not be taken into income absent compliance with the procedures and substantive requirements governing all fee requests. The rationale enunciated in *In re NBI, Inc.* is the better view and reflects the Program's position on this issue.

If a retainer is construed to be property of the estate, there are additional considerations. For example, a final fee application would be necessary even if the amount requested did not exceed the amount of the retainer. In a failed chapter 11 case that is converted to an administratively insolvent chapter 7 case, a professional who received a retainer could be required to repay the retainer into the estate due to the administrative priority accorded to chapter 7 expenses by section 726(b).

Questions have arisen concerning whether pre-petition retainer contracts that contain "fully earned upon receipt" clauses can be sustained in chapter 11 cases. The *NBI, Inc.* court held that such clauses are *per se* contrary to the Bankruptcy Code. *Id.* at 222-23. Even the *McDonald Brothers* court recognized the court's power to invalidate a "fully earned upon receipt" clause. *In re McDonald Bros. Constr.*, 114 B.R. at 995-96.

Pre-petition retainers also may trigger a preference analysis. Frequently, counsel may be owed money for pre-petition services not rendered in connection with the chapter 11 filing. Counsel who receives payment prior to a filing needs to determine how the funds will be applied. If counsel deems this payment as a retainer for future services, counsel will likely have to waive his or her pre-petition claim in order to be disinterested. If, on the other hand, counsel applies all or a portion of this payment to pre-petition services, counsel is subject to potential preference actions, as well as disqualification, since counsel arguably would be required to advise the debtor as to whether or not to pursue that potential preference. *In re Pillowtex*, 304 F.3d 246, 252-55 (3d Cir. 2002).

In some jurisdictions, counsel receives security interests in some or all of a debtor's assets as a retainer. The issue that arises in this situation is whether counsel can qualify as "disinterested," notwithstanding his or her security interest. In *In re Carter*, 116 B.R. 123, 126 (Bankr. E.D. Wis. 1990), the court noted the split in the two circuits that have addressed this issue. The Eighth Circuit (*In re Pierce*, 809 F.2d 1356, 1362-63 (8th Cir. 1987)) has adopted a *per se* rule that counsel cannot be disinterested in such circumstances, while the First Circuit (*In re Martin*, 817 F.2d 175, 183 (1st Cir. 1987)) provides a more flexible approach requiring the analysis of numerous factors. These cases are not as inapposite as they might first appear. *Pierce* involved a mortgage interest that was taken to secure the pre-petition claim of debtor's counsel, and it represents the traditional view that a creditor is disqualified to serve as a professional. *Martin* addresses the far more difficult situation that is presented when counsel acquires a security interest in consideration for its agreement to represent the debtor in a bankruptcy proceeding. This will most likely occur when debtors are cash poor and unable to pay a retainer. Assuming that only bankruptcy-related services are involved, counsel who receive security interests in property are not totally unlike those who receive a cash retainer insofar as both guarantee payment for services rendered or to be rendered in connection with the bankruptcy case.

Security interests in property are far more suspect than cash retainers. In the case of a security interest, counsel becomes a stakeholder in the reorganization process, and may be particularly concerned with negotiations and plans that involve its collateral. As a result, counsel may be unable to exercise independent judgment. Such arrangements also create the potential for overreaching by counsel. For these reasons, the taking of such security interests must be closely scrutinized.

3-8.2.1 Success Fee

Professionals, particularly investment bankers and financial advisors, may include a base fee based on hourly or flat rates plus a success fee that may also be referred to as a bonus, transaction fee, completion fee, or incentive fee. The employment order should specify that the success fee is subject to review under section 330

rather than pre-approved under section 328, and the success fee should be defined by measurable standards establishing that the professional added value to the case. *See Matter of Texas Securities, Inc.*, 218 F.3d 443, 445-446 (5th Cir. 2000), citing *Matter of National Gypsum*, 123 F.3d 861 (5th Cir. 1997). *See also In re Amberjack Interests, Inc.*, 326 B.R. 379, 386-87 (Bankr. S.D. Tex. 2004); *In re Nucentrix Broadband Networks*, *Inc.*, 314 B.R. 574, 578-80 (Bankr. N.D. Tex. 2004).

3-8.2.2 Fee Enhancement

Reasonable compensation in general and fee enhancement in particular are within the sound discretion of the court. In cases that have boasted rare or exceptional results, such as unexpected full payment plans following protracted and litigious chapter 11 cases, where the debtor initially appeared to be on the brink of administrative insolvency, professionals employed under section 327 have sought court approval under Section 330(a) for fee enhancements. Generally, courts have taken the view that such applications must be based on "rare and extraordinary" circumstances that justify increasing fees calculated pursuant to standard or market rates charged by the professionals for bankruptcy and non-bankruptcy work. The starting point for any enhancement request is the "lodestar" fee, discussed above. The basis for a court's granting an enhancement must be founded upon measurable standards establishing the extent to which an applicant's representation of the debtor or official committee was superior to that which one would reasonably expect in light of the fees charged during the bankruptcy case. *See El Paso Refinery L.P.*, 257 B.R. at 835-836. Work well done with excellent results, but which do not exceed the expectations from the professionals may not warrant a fee enhancement. *Id.* at 842.

Reasonable compensation in general and fee enhancements in particular are within the discretion of the court. However, as stated above, absent specific evidence to the contrary, there is a strong presumption that the lodestar constitutes reasonable compensation. *See Pennsylvania v. Delaware Valley Citizens_ Council For Clean Air*, 478 U.S. 546, 565 (1986); *In re Celotex Corp.*, 232 B.R. 484, 487 (M.D. Fla. 1998)(denial of fee enhancement to official committee due to foreseeability of complexity of litigation at the commencement of representation).

The United States Supreme Court has revisited the issue of fee enhancements in the context of a civil rights fee shifting case arising under 42 U.S.C. § 1988. In *Perdue v. Kenny A.*, 130 S. Ct. 1662, 559 U.S. 542 (April 21, 2010), the Supreme Court reversed an enhancement of 75 percent granted by the district court and affirmed by the Eleventh Circuit. The Supreme Court acknowledged that the lodestar has "achieved dominance in the federal courts" since 2002, and held that the calculation of an attorney's fee based on the lodestar may be increased due to superior performance, but only in rare and extraordinary circumstances. The

lodestar permits a meaningful judicial review that was not possible under the factors enumerated by the Fifth Circuit in *Johnson v Georgia Highway Express*, a civil rights case, discussed above at Manual 3-8.1. Like *Johnson*, bankruptcy courts should find *Perdue* to be equally useful to bankruptcy fee enhancement requests. *But see In re Pilgrim's Pride Corp.,* 690 F.3d 650, 662-63 (5th Cir. 2012) ("The Trustee argues that we should extend *Perdue* to the bankruptcy arena because the decision clarifies how to apply the lodestar method, cabins the discretion of bankruptcy judges, and leads to more uniform and predictable results. We decline this invitation because *Perdue* did not unequivocally, *sub silentio* overrule our legion of precedent in the field of bankruptcy.").

The Supreme Court set forth six important rules behind its decision in *Perdue*:

1. A "reasonable" fee is one that is sufficient to induce a capable attorney to undertake the case. Perdue, 130 S. Ct. at 1672-73;
2. There is a "strong" presumption that the lodestar fee is sufficient to achieve this goal. *Id.* at 1673;
3. Although the Supreme Court has never sustained an enhancement fee based on performance, there may still be rare and exceptional circumstances that support an enhancement. *See Id.*; and
4. The lodestar calculation includes most, if not all, relevant factors constituting a reasonable fee, and an enhancement should not be awarded based on a factor subsumed in the lodestar calculation. For example, novelty and complexity of a case are fully reflected in the number of billable hours while the special skills, experience, and quality of an attorney's performance are normally reflected in the reasonable hourly rate. *See Id.;*
5. The burden of proving the justification for an enhancement is borne by the applicant. *See Id.; and*
6. The applicant must produce "specific evidence" that supports the award requested. *See Id.*.

The Supreme Court also made clear that the quality of the attorney's performance should not be treated separately from any outstanding results obtained. The two elements are to be treated as a single factor for purposes of evaluating an enhancement request. Superior results are relevant only to the extent they are the product of superior attorney performance. Otherwise, the results have no relevance. *See Id.* at 1674.

Once the court determines that facts and circumstances warrant an enhancement, there is little guidance concerning the amount of the enhancement. Case law reflects awards from flat dollar amounts to percentages of fees charged during the bankruptcy case. Again, *Perdue* may be instructive as the Supreme Court addressed three examples of when an enhancement may be proper:

1. When the lodestar calculation does not adequately measure the attorney's true market value, e.g., when the hourly rate is determined by a formula that fails to consider anything other than the number of years since the attorney's admission to the bar. *See Id.*;
2. When the attorney's performance includes an extraordinary outlay of expenses during exceptionally protracted litigation. *See Id.*; and
3. When extraordinary circumstances dictate that the attorney's performance required exceptional delays in the payment of fees. *See Id.* at 1675.

Although the foregoing list of examples may not be exhaustive, it certainly limits rare and exceptional enhancement awards to adjusting hourly rates to compensate for the time value of money, and prevents enhancement request from serving as vehicles for financial windfalls to professionals in the chapter 11 case.

3-8.3 INTERIM COMPENSATION, 11 U.S.C. § 331

Section 331 provides that

> A trustee, an examiner, a debtor's attorney, or any professional person employed under Section 327 or 1103 of this title may apply to the court not more than once every 120 days after an order for relief . . . or more often if the court permits, for such compensation for services rendered before the date of such an application or reimbursement for expenses incurred before such date as is provided under Section 330 . . . .

This statute reflects Congressional acknowledgment that bankruptcy professionals should not be in the position of financing the reorganization effort by being required to defer payment of their fees. *In re UNR Indus., Inc.*, 30 B.R. 613, 617 (Bankr. N.D. Ill. 1983).

An interim application filed pursuant to section 331 must be evaluated on the same basis as a final application under section 330, i.e., the nature, extent, and value of the services, the time spent, and the cost of comparable services. The value of the services cannot be fully ascertained until the conclusion of the case when the overall results obtained are quantifiable. As a result, many courts impose a holdback on interim fees rather than allow interim compensation in the full amount sought. *See In re Bank of New England Corp.*, 134 B.R. 450, 458-59 (Bankr. D. Mass. 1991). A holdback serves several purposes. First, it is not always possible to predict administrative solvency at the conclusion of the case, particularly if super-priorities pursuant to section 364 have been granted in connection with post-petition financing. Interim fee allowances are always subject to reexamination and adjustment at the final hearing. 11 U.S.C. § 330(a)(5). However, interim payment percentages should be crafted to guard against the unpleasant task of seeking the disgorgement of fees already paid in the event of administrative insolvency. *See, e.g.*, *U.S. Trustee v. Johnston*, 189 B.R.

676, 677 (N.D. Miss. 1995); *In re Gherman*, 114 B.R. 305, 307 (Bankr. S.D. Fla. 1990). Second, although professionals need not finance the case, the allowed percentages should be balanced against the debtor's need for working capital. It may be that certain debtors simply cannot afford to reorganize and pay the fees associated with the effort at the same time. Third, the holdback may provide an incentive to the professional to pursue the case diligently to a conclusion so that the amounts held back can finally be awarded and paid.

Professionals are allowed to apply for interim compensation every 120 days pursuant to section 331. However, not all chapter 11 cases are appropriate candidates for use of this procedure. Where the hardship visited upon the professional by the deferral of fees is slight due to relatively little investment of time and other resources balanced against the debtor's dubious prospects for successful reorganization, lack of available cash, questionable interim results, or other reasons, it may be advisable to oppose any payment of interim fees.

Professionals engaged in a large reorganization case will generally seek at an early stage of the case court approval for interim payment procedures at intervals more frequent than once every 120 days. For example, in *In re Knudsen Corp.*, 84 B.R. 668, 671-72 (B.A.P. 9th Cir. 1988), professionals were allowed to receive monthly payments on account pending court approval at periodic formal fee hearings. In an instance where substantial professional time is devoted to a case on a monthly basis, it is consistent with the purpose and intent of section 331 for the United States Trustee to participate in the negotiation of an appropriate fee review procedure order. Any such order should provide for a United States Trustee review of invoices prior to payment and preserve the right of objection at all stages of the procedure. Formal court approval should be provided for at regular periodic intervals after notice and a hearing. Holdbacks on fees should be provided for in an appropriate case.

3-8.4 RESPONSIBILITY OF PARTIES TO CONTROL COSTS

The United States Trustee should seek to establish a structure that encourages the parties in a case to actively supervise the work of the professionals. The parties themselves are in the best position to control costs. *See, e.g.*, *In re S.T.N. Enters., Inc.*, 70 B.R. 823 (Bankr. D. Vt. 1987). To achieve this goal there must be an obligation placed on the debtor and the creditors' committees to review and evaluate the proposed actions of professionals. Similarly, the professionals should have a corresponding obligation to delineate their proposed actions and the prospective costs. Particular attention should be directed toward eliminating duplicate efforts. The point is to persuade both the professionals and the parties to make a judgment as to the potential costs and benefits a particular effort will entail.

Whether at the initial debtor interview, the initial organizational meeting of creditors, or at a specific meeting called by the United States Trustee to discuss fees, the United States Trustee should seek to have the parties structure a mechanism that will evaluate the work of the professionals before it is commenced. The debtor and creditors' committee should review the proposed actions of any professional, although there will be an exception for those matters where the need to maintain confidentiality with the client is such to limit the review to the client. Failing such an agreement, the United States Trustee should consider moving for the entry of an order requiring such a structure.

3-8.5 FEE PROCEDURE ORDERS

In larger reorganization cases, various bankruptcy courts have issued administrative orders that address procedural and, to some extent, substantive requirements for all fee applications in a given case. Fee procedure orders structured for a particular case serve the same function as the United States Trustee's guidelines. The orders set forth the law of the case and, to the extent the terms of the orders are inconsistent with the United States Trustee's guidelines, the terms of the order obviously control. The underlying rationale favoring these orders is that the orders promote judicial economy while providing the practitioners with a clearer understanding of the requirements pertaining to all fee applications. The common items addressed in these orders include the deadlines and scheduling for filing fee applications; the court's requirements as to the detail necessary for substantiating various expenses; the court's views as to certain recurring problems (e.g., inter-office conferences, lumping time entries, general legal research, etc.); the frequency or intervals at which the court will entertain fee applications; and the dates set aside for hearings on fee applications. In concept, the United States Trustee should support such orders as they fulfill the stated goals of judicial economy and reduction of costs to the estate.

These orders are also used as a vehicle for allowing interim compensation without the necessity of full hearings. Particularly in larger cases, orders tend to be entered that provide that interim fees can be awarded at various pre-determined percentages subject to the applicant periodically filing complete fee applications. Arguably, this assists both the fee applicant and the reviewer. The fee applicant is assured of prompt payment of his or her fee requests, subject to a later review, and the reviewer is encouraged to scrutinize the time entries on a more frequent basis.

"Automatic" payment procedures are arguably allowed by the "more often if the court permits" language of section 331. The United States Trustee should discourage the use of this procedure except in rare instances. To the extent that professionals insist on such procedures, the United States Trustee should request safeguards, which may include:

1. A holdback of a percentage of the fees requested, which could range from 20 percent to more than 50 percent depending on the projected solvency of the estate;
2. An opportunity to object and request hearings based on reviews of the "automatic" fee petitions;
3. A provision in the order directing debtor's counsel to review all interim fee requests and to file a written analysis of its review;
4. A provision in the order requiring all applicants to file formal applications periodically, and prohibiting the debtor from paying any applicant who is not in compliance with that provision of the order; and
5. Other safeguards as appear necessary.

3-8.6 TRUSTEE COMPENSATION

A trustee's compensation is determined under section 330 and the statutory cap set out in 11 U.S.C. § 326(a). That section provides that:

> In a case under chapter 7 or 11, the court may allow reasonable compensation under section 330 of this title to the trustee for the trustee's services, payable after the trustee renders such services, not to exceed 25 percent on the first $5,000 or less . . . and reasonable compensation not to exceed 3 percent of such moneys in excess of $1,000,000, upon all moneys disbursed or turned over in the case by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.

The United States Trustee must review a trustee's application to determine that the requested compensation does not exceed the statutory limitation and is reasonable. For example, in *In re H & S Motor Freight, Inc.*, 23 F.3d 1431 (8th Cir. 1994), the trustee attempted to charge the statutory rate increased by amendment although the case had been filed long before. The United States Trustee objected and prevailed on appeal.

Many trustees view the maximum fee as a minimum. But unlike chapter 7 trustees who are paid on commission based upon section 330(a)(7), chapter 11 trustees are explicitly included in section 330(a)(3), which requires that the court consider "the time spent on such services" and "the rates charged for such services" in determining reasonable compensation. Consequently, evidentiary support for any fee requested is required.

There are instances where a reasonable fee is clearly less than the maximum allowed. "The fact is that the Bankruptcy Code provides no formula for determining the minimum compensation that a trustee is entitled to be paid . . . . Nowhere has § 326 been construed to create an entitlement to the maximum amount provided for under that section . . . ." *In re Draina*, 191 B.R. 646, 648

(Bankr. D. Md. 1995). *See also In re Dorn*, 167 B.R. 860, 866 n.11 (Bankr. S.D. Ohio 1994).

A trustee may seek an interim payment of compensation and expenses pursuant to section 331, although there appears to be some statutory conflict with section 326 if there has not been a distribution. *See In re Heatherly*, 179 B.R. 872, 874-75 (Bankr. W.D. Tenn. 1995); *In re Tom Carter Enters*, 49 B.R. 243, 245-46 (Bankr. C.D. Cal. 1985). In *Heatherly*, the court read the distribution as modifying the limitation on the fee and not on eligibility for an interim allowance.

Fed. R. Bankr. P. 2016 applies to trustees. The trustee must file a detailed statement of the work performed, time expended, and expenses incurred and bears the burden of proving the application. *See In re Evangeline Refining Co.*, 890 F.2d 1312, 1326 (5th Cir. 1989). The United States Trustee guidelines are applicable to the trustee's request for fees. As a matter of practice, therefore, the trustee should maintain contemporaneous time records. *Id.*

Interim awards are interlocutory and subject to full review and adjustment at a later date. *See In re Hutter*, 45 Fed. Appx. 71 (2nd Cir. 2002), *citing In re Stable Mews Assocs.*, 778 F.2d 121, 123 n.3 (2d Cir. 1985).

CHAPTER 3-9: QUARTERLY FEES

3-9.1 INTRODUCTION

Pursuant to 28 U.S.C. § 1930(a)(6), every open case or every debtor in a case pending under chapter 11 must pay a fee each quarter to the United States Trustee. *See Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.),* 402 F.3d 416 (3d Cir. 2005); *United States Trustee v. CF & I Fabricators of Utah, Inc. (In re CF & I Fabricators of Utah, Inc.)*, 150 F.3d 1233 (10th Cir. 1998). The monies generated from quarterly fee payments represent a significant source of revenue for the United States Trustee System Fund. *See generally In re Prines*, 867 F.2d 478 (8th Cir. 1989). Consequently, the monitoring and collection of quarterly fees is an integral part of the United States Trustee's oversight of chapter 11 cases. Efforts to ensure the prompt payment of fees begin at the inception of the case and continue until the case is closed, or beyond. Offices are responsible for timely and accurately entering case data into ACMS, which is then read by the centralized accounts receivable system in the EOUST. In addition, the United States Trustee must take appropriate action when quarterly fees remain unpaid.

3-9.2 INFORMING PARTIES OF THE FEE REQUIREMENT

The United States Trustee should inform the debtor and the debtor's attorney of the obligation to pay quarterly fees as soon as practicable after the case is filed.

The initial debtor interview is usually the first opportunity to discuss these requirements. The debtor's obligation to pay quarterly fees, the schedule of fees, and the consequences of nonpayment should also be incorporated in any chapter 11 operating guidelines adopted by the United States Trustee. Debtors should also be told that if their payment is not timely, then interest will be added. Chapter 11 trustees must also be advised of the fee requirement shortly after their appointment.

3-9.3 FEE AMOUNT AND DUE DATE

3-9.3.1 Calculation of the Fee

Section 1930(a)(6) of title 28 sets forth a sliding schedule of fees based on the amount of money that is disbursed during a calendar quarter. If no disbursements are made in a quarter, the minimum fee must still be paid. *See Clippard v. Kentucky Processing Co. (In re Kentucky Processing Co.)*, 418 B.R. 217 (E.D. Ky. 2009).

The Program adheres to the plain meaning of the word "disbursement," but debtors have made numerous attempts to narrow the category of disbursements that are subject to quarterly fees. Before embarking on a disbursement definition battle, the United States Trustee should consider whether the dispute will actually affect the amount of fees owed. Since the disbursement ranges set forth in 28 U.S.C. § 1930(a)(6) that determine the amount of quarterly fee owed are quite broad, differences in definition may have no practical consequence. The United States Trustee must also consult with the Office of the General Counsel in deciding whether to undertake litigation in this area.

3-9.3.1.1 Operating Expenses

Disbursements encompass all expenses paid by or on behalf of the debtor. *See In re Cash Cow Servs. of Fla., LLC*, 296 F.3d 1261 (11th Cir. 2002); *In re Charter Behavioral Health Sys., LLC*, 292 B.R. 36 (Bankr. D. Del. 2003). Disbursements subject to quarterly fees are not limited to payments to pre-petition creditors. *See United States Trustee v. Pettibone Corp.*, 251 B.R. 335 (N.D. Ill. 2000).

3-9.3.1.2 Cash Collateral/Financing Order Payments

Payments to secured creditors pursuant to cash collateral or financing orders are disbursements upon which the quarterly fee is calculated. Debtors and secured creditors often structure financing orders that are designed to permit the continued use of cash collateral. Pursuant to these arrangements, the debtor usually pays the creditor the cash collateral, which the creditor then loans back to the debtor. Regardless of how the parties may choose to characterize the debtor_s payments, they are still considered disbursements for purposes of calculating quarterly fees. *See In re Wernerstruck, Inc.*, 130 B.R. 86 (D.S.D. 1991).

3-9.3.1.3 Payments Out of Escrow or by Third Parties

Disbursements include payments made on behalf of the debtor by any third party, including an escrow company or another debtor. *See Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.)*, 402 F.3d 416 (3d Cir. 2005); *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (9th Cir. 1994), *modified*, 46 F.3d 969 (9th Cir. 1995).

3-9.3.1.4 Non-Cash Transactions

Disbursements are calculated upon cash transfers, not transfers in kind. For example, when estate assets are sold and the purchaser assumes an obligation of the debtor as part of the sale consideration, the amount assumed is not considered a disbursement for purposes of calculating the quarterly fee.

3-9.4 FEE DUE DATES AND PERIODS COVERED

Quarterly fees are calculated on a calendar quarter basis. The fee for each quarter is payable on the last day of the month immediately following the end of the calendar quarter. 28 U.S.C. § 1930(a)(6). Every plan of reorganization must provide for payment of any unpaid fees on or before the effective date of the plan. 11 U.S.C. § 1129(a)(12).

The filing of a voluntary petition commences a case. 11 U.S.C. § 301. The obligation to pay quarterly fees commences on the date the chapter 11 case is filed. Although a case is commenced upon the filing of an involuntary petition (11 U.S.C. § 303(b)), the debtor will not be billed for quarterly fees until an order for relief is entered or a chapter 11 trustee is appointed, whichever occurs first. At that point, the fee will be assessed from the time the case was filed.

The obligation to pay quarterly fees ceases when the case is no longer pending under chapter 11, i.e., when a final decree closing the case is entered or the case is either converted, dismissed, or transferred to Alabama or North Carolina. The date the final decree or the order of dismissal, conversion, or transfer is docketed should be used as the ending date for the quarterly fee obligation, unless the decree or order contains a provision for an earlier date.

The commencement and termination of a chapter 11 case will occur at varying points within a quarter. The fee for partial quarters is calculated on disbursements that were made during the period of time the case was pending under chapter 11. The fee itself is not prorated.

3-9.5 FEES IN JOINTLY ADMINISTERED AND SUBSTANTIVELY CONSOLIDATED CASES

Jointly administered cases remain distinct. Each case must pay a quarterly fee based upon its respective disbursements. Substantively consolidated cases become one case and are subject to only one fee from the time the substantive

consolidation order is docketed. *See Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.)*, 402 F.3d 416 (3d Cir. 2005); *In re Charter Behavioral Health Sys., LLC*, 292 B.R. 36 (Bankr. D. Del. 2003).

3-9.6 BILLING AND COLLECTION PROCEDURES

3-9.6.1 Bill Generation Process

The United States Trustee is responsible for timely and accurate entry of case data into ACMS. The EOUST issues data call memoranda to field offices specifying the dates for the field office review of quarterly fee data. The FICS Help e-mail group assists offices with generic account problems and provides information regarding reports, forms, and procedures.

3-9.6.2 Fee Payments and Refunds

3-9.6.2.1 Payment Procedures

Every month, computer-generated statements are sent to billable chapter 11 debtors.

As of September 30, 2025, the United States Trustee Program no longer accepts checks or money orders as forms of payment for chapter 11 quarterly fees.[9] Any checks or money orders received on or after this date will be returned to the sender. All quarterly fee payments must be made electronically through the United States Trustee Program's Pay.gov site located here: https://www.pay.gov/public/form/start/672415208.

The party paying quarterly fees will need their ten-digit quarterly fee account number (xxx-xx-xxxxx) and bank account information (account and routing number) to remit quarterly fee payments via Pay.gov. You should follow the instructions on Pay.gov for remitting payment.[10] Please note that you will be required to complete the box requesting the debtor's Taxpayer ID on Pay.gov to

---

[9]On March 25, 2025, President Donald J. Trump signed Executive Order 14247 titled "Modernizing Payments to and From America's Bank Account" (EO 14247). This order aims to modernize the government's payment processes by mandating a transition from traditional paper-based payments to fast and secure electronic payments. In accordance with EO 14247, the United States Trustee Program will no longer accept checks or money orders as forms of payment for chapter 11 quarterly fees.

[10]Automatic debits to business or checking accounts may be blocked by a security feature called ACH Fraud Prevention Filters. ACH Fraud Prevention Filters works by having an allowed list of ACH Company ID's, thereby enabling debits. The agency identification for the United States Trustee Program is 1501000502. This will allow payments being presented for payment to process and not blocked by your banks ACH Fraud Prevention filters.

complete the payment. If a debtor does not have an EIN, you may enter all 9's in this box.

Pay.gov allows the use of PayPal as a payment method, thereby enabling parties to make payments without sharing bank account details directly with Pay.gov. However, PayPal has transaction limits, which vary based on account verification status and payment method. Parties wishing to use PayPal to pay quarterly fees should check with PayPal.com directly for more information regarding the monetary cap.

Failing to make acceptable electronic payments of quarterly fees through Pay.gov could result in delays in payment and the accrual of interest and other penalties, and legal action for failure to timely remit payment.

Anyone who has questions about the payment of chapter 11 quarterly fees, should be instructed to contact their local United States Trustee office.

Offices receiving cash, checks, or other negotiable instruments for the payment of quarterly fees must return the payment to the paying party and instruct the party to use the United States Trustee Program's Pay.gov site, located here: https://www.pay.gov/public/form/start/672415208 to pay quarterly fees. When returning the payment, the office should remind the paying party that failing to make acceptable electronic payments of quarterly fees through Pay.gov could result in delays in payment and the accrual of interest and other penalties, and legal action for failure to timely remit payment. 4.

3-9.6.2.2 Determination of Payments

An office can determine the quarterly fees paid and the amounts credited to each quarter by examining the case in the FICS report.

3-9.6.2.3 Payment Problems

An e-mail to FICS Help should be sent if assistance is needed with procedural payment problems and questions about payment allocation.

3-9.6.2.4 Payment Refunds

Payment refund procedures established by the EOUST should be followed in the event that overpayment of quarterly fees necessitates a refund. For further instructions as to completion of the appropriate forms, FICS Help should be contacted. Credits toward future fees should be encouraged in lieu of refunds.

3-9.6.3 Payment Adequacy Review

The United States Trustee must establish a plan to verify that payments made by debtors meet those established categories of disbursements. Sources for determining the amount of quarterly fees paid include the debtor's monthly operating reports as reviewed and entered into ACMS. The debtor is advised of the actual amount due based on disbursements reported during the applicable quarter.

The most complete review possible should be conducted. For some offices, this may include review of all payments in pending chapter 11 cases. For offices that cannot review every payment, this review can be conducted on a sampling basis.

Case review and follow-up must be documented. In addition, field offices must submit a quarterly memorandum to the regional office detailing fee adequacy review efforts. The memorandum should include:

1. the total number of chapter 11 cases billed for the quarter;
2. the number and percentage of fee payments actually reviewed for compliance with the fee schedule;
3. the number of payments found to be less than the debtor's obligation; and
4. a statement of the date on which corrective action was initiated or a date certain by which corrective action will be initiated.

3-9.6.4 Delinquent Payment Review and Collection Efforts

The United States Trustee should keep informed of quarterly fee delinquencies and attempt to obtain fee payment at every opportunity. Quarterly fee status should be specifically considered when:

1. Continued section 341 meetings are held. These meetings can be used to obtain an explanation for lack of payment and an agreement to a specific deadline for payment on the record.
2. The debtor fails to file operating reports. Failure to file reports is often indicative of other compliance deficiencies. Quarterly fee payment status should be examined.
3. Cash collateral use or financing is sought. The United States Trustee should ensure that any proposed order limiting operating budgets includes the payment of quarterly fees. Proposed orders should also be examined to ascertain whether super-priority is proposed pursuant to 11 U.S.C. § 364(c)(1). If such priority is sought, a quarterly fees exclusion should be requested.
4. A motion to transfer venue is filed. Payment of fees should be required prior to case transfer. *See In re 1606 New Hampshire Ave. Assocs.*, 85 B.R. 298, 312 (Bankr. E.D. Pa. 1988) (court conditioned transfer of venue upon payment of quarterly fees).
5. The exclusivity period terminates or a motion is filed to extend the exclusivity period. If quarterly fees are not current, the United States Trustee may oppose an exclusivity extension or request a short deadline for disclosure statement and plan submission.
6. A fee application is filed. The United States Trustee should consider opposing interim payments to professionals if there are delinquent quarterly fees.

7. A motion to use, sell, or lease property of the estate other than in the ordinary course of business is filed. Proposed transactions should be examined for the potential effect on quarterly fee liability and the availability of net proceeds to meet any such liability, particularly if voluntary case conversion or dismissal will likely be sought.

8. A motion to convert or dismiss or for the appointment of a trustee is contemplated or filed. *See* Manual 3-11.5 for an in-depth discussion of dismissal and conversion motions.

9. A plan and/or disclosure statement is filed. The United States Trustee must take affirmative action to ensure that any plan of reorganization meets the tests of section 1129(a)(12), which requires the debtor to be current on 28 U.S.C. § 1930 fees or that "the plan provides for the payment . . . on the effective date." The plan should provide for continuing payment of quarterly fees until the case is closed for quarterly fee purposes. The case must be reviewed for payment compliance by the time that confirmation objections are due. The plan's definition of the effective date should be reviewed to ensure that it is within a reasonable time after plan confirmation. The plan should also be reviewed for any other provisions affecting quarterly fees, such as a requirement to file claims and deadlines. Such requirements are generally objectionable. Otherwise, the United States Trustee must take all measures called for under the plan to ensure timely payment after confirmation.

10. A motion for entry of a final decree is filed. The United States Trustee should consider filing a motion under Fed. R. Bankr. P. 9013 asking the court to compel the debtor to comply with 28 U.S.C. § 1930(a)(6). Alternately, if local practice permits, the United States Trustee may respond to a motion for a final decree with a "response" or "statement" requesting that the court direct payment of the statutory fee. An objection should not be filed unless there are other substantive reasons to object to the closing of a case.

3-9.6.5 Encouraging Voluntary Compliance

Before filing any motion to enforce compliance with the debtor's obligation to pay quarterly fees, the U.S. Trustee should contact the debtor's counsel and seek the debtor's consensual agreement to pay the outstanding quarterly fees. Any agreement reached should be documented in a confirming letter or e-mail to the debtor's counsel, specifying when the debtor will pay and the consequences if the debtor does not.

3-9.6.6 Legal Action

If voluntary compliance with quarterly fee requirements cannot be obtained, legal action must be taken in the form of a motion to dismiss or convert although, as indicated above, other action may also be appropriate.

Failure to file monthly operating reports and nonpayment of fees are specifically enumerated grounds for dismissal or conversion pursuant to sections 1112(b)(4)(F) and (K), respectively. If operating reports are not timely filed or fees are unpaid, the case should be reviewed for other deficiencies, including failure to pay administrative creditors or lack of insurance. A motion to convert or dismiss for nonpayment of fees should include, as further grounds, all identified deficiencies.

Once a case is dismissed, unpaid quarterly fees lose their administrative priority status. Consequently, unpaid fees from an earlier case have the priority of a general unsecured claim in a later filed case. In some instances, a judgment for unpaid quarterly fees may be obtained prior to dismissal. Other remedies to collect unpaid fees can be explored, but contempt remedies or other sanctions are not favored. *See, e.g.*, *In re Patterson*, 111 B.R. 395, 399 (Bankr. N.D.N.Y. 1989) (court ordered that quarterly fees be paid prior to dismissal but denied imposition of daily fine, opining that no purpose would be served).

Offices of the United States Trustee are frequently presented with voluntary dismissal motions in cases with unpaid quarterly fees. Voluntary dismissal requests frequently accompany or follow a sale of substantial estate assets or resolution of a major dispute. When there are assets in such cases, it is appropriate to request the court to condition dismissal on the payment of quarterly fees. *See, e.g.*, *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525, 1528 (9th Cir. 1994), *modified*, 46 F.3d 969 (9th Cir. 1995); *In re Rose*, 86 B.R. 439, 442 (Bankr. E.D. Pa. 1988). Such requests must be timely made, however. *In re Jehle*, 72 B.R. 487, 488-89 (Bankr. D.R.I. 1987) (court denied United States Trustee's request to vacate dismissal order, where United States Trustee failed to timely object to initial dismissal motion). In these situations, thought should also be given to seeking dismissal, conditional on payment to other creditors who would be paid if the case were converted to chapter 7.

The United States Trustee should not oppose dismissal or entry of a final decree in cases where there is no money available to pay the quarterly fees and there is no reason to suggest conversion to chapter 7. *See In re Markhon Indus., Inc.*, 100 B.R. 432, 434-35 (Bankr. N.D. Ind. 1989); *In re Motorworks, Inc.*, 85 B.R. 661, 662 (Bankr. S.D. Ga. 1988).

If a case converts to another chapter, the United States Trustee must file a timely proof of claim for unpaid quarterly fees. Any claim filed in a chapter 7 case should clearly request chapter 7 administrative priority status pursuant to section 507(a)(2). The amount of the proof of claim should be calculated on the basis of disbursements during the unpaid quarters. If disbursements are not known, the Program's billing procedures should be used to estimate the fee. *See In re Flowers by Mike & Ray, Inc.*, 95 B.R. 31, 34-35 (Bankr. D. Md. 1988) (United States Trustee must make a good faith determination of the disbursements and cannot just claim maximum fee). If all delinquent quarters are noted on the

proof of claim, upward amendments to the claim can be submitted if further information develops. The time within which to file a chapter 11 claim in a subsequent chapter 7 case is governed by Fed. R. Bankr. P. 1019(6).

In chapter 7, unpaid quarterly fees have the same priority status as chapter 7 administrative claims. Section 726(a) calls for distribution first to section 507 claims, in the order of their priority. Section 507(a)(2) affords high priority to administrative expenses allowed under section 503(b) and fees and charges assessed under chapter 123 of title 28. Since the obligation to pay chapter 11 quarterly fees arises under chapter 123 of title 28, unpaid fees have priority status. Section 726(b), which subordinates section 503(b) expenses incurred during chapter 11 to section 503(b) expenses incurred during chapter 7, is inapplicable to fees arising under chapter 123 of title 28. *In re Endy*, 104 F.3d 1154, 1157-58 (9th Cir. 1997); *In re Juhl Enters., Inc.*, 921 F.2d 800, 802-03 (8th Cir. 1990); *In re Darmstadt Corp.*, 164 B.R. 465, 470-71 (D. Del. 1994); *In re Metro Transp. and Health Referral, Inc.*, 165 B.R. 832, 833-34 (Bankr. N.D. Ohio 1994); *In re K & M Printing & Lithographing, Inc.*, 135 B.R. 404, 406-07 (Bankr. D. Ore. 1992); *In re AM-PM Photo Camera Fashions, Inc.*, 116 B.R. 222 (Bankr. D. Idaho 1990). *Contra In re Wetmore*, 117 B.R. 201, 202 (Bankr. W.D. Pa. 1990). Compare *In re Rose Truck Brokers, Inc.*, 166 B.R. 179 (M.D. Fla. 1992), *rev_g* 122 B.R. 465 (Bankr. M.D. Fla. 1990) (bankruptcy court's ruling conflicts with the clear command of Congress; fees are due regardless of whether a plan is ever confirmed).

3-9.7 WRITE-OFF AND REFERRAL PROCEDURES

The United States Trustee is delegated write-off authority limited to $100,000 per case. If the debt is the subject of appellate litigation, the United States Trustee's write-off authority is further subject to the Director's approval. Permission to write off amounts in excess of $100,000 must be requested of the EOUST with submission to the Assistant Attorney General for Administration for action.

3-9.7.1 Confirmed Chapter 11 Cases

Under the provisions of section 1129(a)(12), the court shall confirm a plan in a chapter 11 case only if the pre-confirmation quarterly fees have been paid; otherwise, the plan must provide for their payment on the effective date of the plan. If pre- or post-confirmation fees remain unpaid after the effective date of a confirmed plan, the circumstances of the case are to be evaluated and a determination made as to whether to seek enforcement of the plan or pursue other remedies. The United States Trustee should first determine whether the account is uncollectible by Program personnel and whether it is appropriate for write-off according to the guidelines set forth at Manual 3-10.7.4.2. If an account is uncollectible by Program personnel, but not subject to write-off, Program policy requires that the amount owed must be referred to the Treasury Department for collection as set forth at Manual 3-9.7.5.

3-9.7.2 Dismissed Chapter 11 Cases

The court may convert or dismiss a chapter 11 case for cause, which may include the nonpayment of quarterly fees. 11 U.S.C. § 1112(b)(4)(K). The prospect of this remedy provides a strong incentive for debtors to pay quarterly fees in order to remain in chapter 11. However, if quarterly fees are not paid and the chapter 11 case is dismissed, appropriate collection action is to be undertaken or, if the fee account is uncollectible by Program personnel, it should be written off according to the guidelines set forth in at Manual 3-10.7.4.2. If not subject to write-off, the amount owed must be referred to the Treasury Department for additional collection efforts as set forth at Manual 3-9.7.5.

3-9.7.3 Converted Chapter 11 Cases

When quarterly fees remain unpaid in a chapter 11 case that has been converted to another chapter, the United States Trustee shall file a proof of claim in the converted case and/or take whatever steps are appropriate under the laws or rules applicable in the converted chapter. The balance owing after the filing of a no-asset report in the converted case or after a distribution to creditors in the converted case will ordinarily be treated as discharged under governing bankruptcy laws. Accordingly, the United States Trustee should recommend write-off of the debt as soon as practicable following conversion, but only after ensuring that the claim will be recognized and paid in the event of a distribution. If the debtor does not receive a discharge, then the outstanding amount owed for quarterly fees should be either written off pursuant to the guidelines in Manual 3-9.7.4.2, or referred to the Treasury Department pursuant to Manual 3-9.7.5.

3-9.7.4 Standards

3-9.7.4.1 Timing of Write-Off or Referral to the Treasury Department

Write-off or referral of the debt to the Treasury Department should occur when, after pursuing all reasonable collection efforts, the United States Trustee determines that an account is uncollectible by the Program, that active collection efforts should terminate, and that the obligation should be removed as a receivable from the records. All cases not eligible for write-off must be referred to Treasury.

3-9.7.4.2 Write-Off Guidelines

The following factors should be used in evaluating the collectability of unpaid quarterly fees.

1. When the balance due is less than $25, the Assistant U.S. Trustee or the Quarterly Fee Coordinator can approve the write-off. All other write-offs must contain the approval signature of the United States Trustee.

   A write-off request of less than $25 can be submitted via e-mail. The signature of the United States Trustee or Assistant U.S. Trustee is not necessary.

2. The debtor is documented to have no assets or appears to have no present or prospective ability to pay the debt, and the amount due is more than $25 but less than $600.
3. The debtor's case converted from chapter 11 to another chapter in which a discharge order was entered, or the debtor filed a new case in any chapter and a discharge order was entered that included unpaid fees in the previous case(s).

3-9.7.4.3 Effect of Write-Off

The write-off of a debt does not constitute a waiver of the United States Trustee's right to receive payments in the future; it merely signifies the termination of active collection efforts. Payments received after write-off will be treated as an offset of the amount written off. This includes payments received in the form of distributions following the conversion of a case to chapter 7, 12, or 13.

3-9.7.5 Debt Collection by the Treasury Department

Contact the Office of Administration in the EOUST for instructions on how to refer delinquent debts to the Treasury Department and how to complete Form UST 82.

3-9.7.6 Documentation

The United States Trustee is to report the write-off or referral to Treasury of all debts to FICS Help so that appropriate adjustments in the chapter 11 accounting system can be made. Standardized forms promulgated by the EOUST for these purposes shall be utilized. The write-off amount should be reconciled with quarterly disbursement and fee reports, listings, and so forth, and any discrepancies should be resolved prior to submission of the write-off.

CHAPTER 3-10: MONITORING THE CASE

3-10.1 CASE ADMINISTRATION

The United States Trustee is charged by statute with the responsibility of supervising the administration of chapter 11 cases. 28 U.S.C. § 586(a)(3). The administrative process should be designed to ensure that cases move through the system in an expeditious manner. Cases that lack a realistic prospect of reorganization within a reasonable period of time must be identified and appropriate action taken to seek the dismissal or conversion of such cases.

3-10.2 STANDING

Section 307 of the Bankruptcy Code grants the United States Trustee standing in bankruptcy cases, including those under chapter 11. Several cases have also

clarified the United States Trustee's standing. *See United Artists Theater Co v. Walton* 315 F.3d 217, 225 (3rd Cir. 2003). A challenge to the United States Trustee's standing in a chapter 11 case may be sanctionable. *Hayes and Son Body Shop, Inc. v. United States Trustee*, 124 B.R. 66, 68 (W.D. Tenn. 1990), *aff'd*, 958 F.2d 371 (6th Cir. 1992).

3-10.3 OBTAINING EVIDENCE

3-10.3.1 Section 341(a) Meeting

The efficacy of the United States Trustee's enforcement actions is dependent upon the compilation of a comprehensive evidentiary record. The foundation of that record most often consists of documents such as schedules and operating reports. In some instances, however, it may be necessary to obtain additional material for use at an evidentiary hearing. Section 341 requires that the United States Trustee convene a meeting of creditors in each case.

The business of the meeting includes the examination of the debtor under oath. *See* 11 U.S.C. § 343 and Fed. R. Bankr. P. 2003(b)(1). The scope of the examination that can be conducted at the meeting is very broad. Questioning that relates to the acts, conduct, property, liabilities, and financial condition of the debtor; the administration of the estate; or the debtor's right to a discharge is permissible. The examination may also relate to the operation of the debtor's business and issues relevant to the formulation of a plan. *See* Fed. R. Bankr. P. 2004(b). As a result, the examination of the debtor at the section 341 meeting is often a vital and productive source of information and has great importance as a discovery device. Because the United States Trustee schedules and presides over the meeting, he or she may continue the meeting from time to time to allow for additional questioning, and may even convene a special meeting if necessary. *See* Fed. R. Bankr. P. 2003(e) and (f). For a further discussion of section 341 meetings, *see* Manual 3-5.1.

3-10.3.2 Fed. R. Bankr. P. 2004 Examination

Fed. R. Bankr. P. 2004 provides that the court, on motion of any party in interest, may order the examination of any entity. If a Rule 2004 exam is of an entity other than the debtor, the United States Trustee, in addition to obtaining a court order, should issue a subpoena to the person sought for examination unless the examination is by agreement. The permissible scope of an examination under Fed. R. Bankr. P. 2004 is very broad. However, the examination must not stray into matters irrelevant to the basic inquiry and cannot be utilized for purposes of abuse or harassment. *See In re M4 Enters., Inc.*, 190 B.R. 471, 475 (Bankr. N.D. Ga. 1995).

If the United States Trustee wishes to participate in a Fed. R. Bankr. P. 2004 examination scheduled by another party in interest, a separate order from the court permitting such participation should be obtained unless all parties stipulate that the United States Trustee may participate.

A Fed. R. Bankr. P. 2004 examination may not be available if a contested matter has already been commenced. Some courts have ruled that a party to a contested matter has to use the procedures for taking a deposition rather than those for a Fed. R. Bankr. P. 2004 examination when that party seeks information after filing its motion. *See In re Ecam Publications, Inc.*, 131 B.R. 556, 559 (Bankr. S.D.N.Y. 1991). Accordingly, the United States Trustee should conduct appropriate Fed. R. Bankr. P. 2004 examinations prior to filing a motion or application.

3-10.3.3 Other Discovery Devices and Orders to Compel Attendance for Examination

Pursuant to Fed. R. Bankr. P. 9014, the discovery devices found in Fed. R. Bankr. P. 7028 through 7037 are available in all contested matters. A contested matter must have been commenced before these discovery tools can be used. However, the speed with which contested matters are set by many courts may preclude the effective use of discovery tools other than Fed. R. Bankr. P. 2004 examinations.

A debtor may attempt to avoid questioning by fleeing the jurisdiction or by evading service of a subpoena or order to appear for examination. Fed. R. Bankr. P. 2005 sets forth the procedures to be followed to obtain an order directing the apprehension and, if necessary, removal of the debtor to compel attendance at an examination.

3-10.4 PROBLEMS AND RESPONSES

This section contains a list of some of the most frequent problems encountered by the United States Trustee during the course of administering chapter 11 cases. The list is not exhaustive and the United States Trustee retains discretion to develop an appropriate response for any situation.

3-10.4.1 Failure to File Schedules

The schedules and statements contain significant information about the debtor and its financial condition as of the filing date. 11 U.S.C. § 521 and Fed. R. Bankr. P. 1007 require the debtor to file these documents within certain time frames. If the debtor fails to file timely, the United States Trustee should apply to the court for an order either fixing a date by which the schedules and statements must be filed, or dismissing or converting the case.

If the debtor seeks an extension of time within which to file schedules, the United States Trustee should assess whether an extension is justified in light of the size and complexity of the case. If the extension does not appear reasonable given the circumstances of the case, an objection should be filed.

The United States Trustee should seek to ensure that the schedules are on file prior to the first section 341 meeting. However, even if the schedules have not been filed by that date, the section 341 meeting must be conducted as scheduled. The meeting can then be continued to a later date to allow for further examination of the debtor regarding the content of the schedules.

3-10.4.2 Failure to Attend Section 341(a) Meeting

Section 343 requires the debtor to appear and be examined by creditors, the United States Trustee, and other parties in interest at the section 341 meeting. If the debtor fails to appear, cause exists for the dismissal or conversion of the case. 11 U.S.C. § 1112(b)(4)(G). The totality of the circumstances must be considered when determining the appropriate action to take.

3-10.4.3 Failure to Designate Corporate Official

A corporate or partnership debtor must designate an official to act on its behalf during bankruptcy proceedings, as, for example, by appearing at the first section 341 meeting or a Fed. R. Bankr. P. 2004 examination, or by signing appropriate documents as required by rule or order of the court. The failure to designate a corporate official occurs most frequently in involuntary cases.

Pursuant to Fed. R. Bankr. P. 9001(5), any one of the officers, a member of the board of directors, a controlling stockholder of a corporate debtor, or any person in control may be designated by court order to perform certain acts or to appear for examination. Such an order may help lay the groundwork for a motion to dismiss a case. For example, if an order is entered compelling a corporate officer to attend a section 341 meeting and the officer fails to attend, then cause may exist to dismiss the case.

Rather than obtaining an order directing an individual to appear on behalf of the debtor, the United States Trustee may immediately move for the conversion or dismissal of the case. The debtor's failure to designate an individual may indicate significant problems with the debtor and its operations that would constitute "cause" under section 1104 or 1112.

3-10.4.4 Failure to File Operating Reports

Pursuant to sections 704(a)(7) and (8) (made applicable in chapter 11 cases by sections 1106(a)(1) and 1107(a) and Fed. R. Bankr. P. 2015), the debtor is required to file financial reports on a periodic basis. If a debtor does not file these reports, then the ability of parties in interest and the United States Trustee to monitor the operations of the debtor is impaired. For example, the United States Trustee will not be able to determine if the debtor is current with post-petition obligations, is making improper payments to professionals, or has paid the correct United States Trustee quarterly fee.

If a debtor fails to file complete financial reports, the United States Trustee may seek an order compelling the filing of the reports or may request more drastic relief, such as the appointment of a trustee or examiner, conversion, or dismissal. If the United States Trustee elects to request an order compelling filing, that order should also direct the debtor to file all future reports timely. Violation of such an order may be cause for dismissal or conversion.

The failure to file complete financial reports may constitute cause for the appointment of a trustee or an examiner. 11 U.S.C. § 1104. The failure to file

reports may also constitute cause for the conversion or dismissal of a case. 11 U.S.C. § 1112(b)(4)(F).

3-10.4.5 Failure to Maintain Insurance or Pay Administrative Taxes

The chapter 11 debtor is authorized to continue to operate its business, unless the court orders otherwise. 11 U.S.C. § 1108. A debtor has all of the duties and responsibilities of a trustee, including the obligation to maintain insurance and pay taxes. 11 U.S.C. § 1107(a).

A debtor's failure to maintain proper insurance is a breach of its fiduciary obligations. The insurance required of a debtor extends beyond property insurance to protecting the tangible assets of the estate from loss. For example, if the debtor's business is open to the public and the debtor does not have liability insurance, the business should be closed until such time as insurance is obtained and written verification submitted to the United States Trustee. In order to minimize the risk to innocent third parties, any motion seeking to terminate the debtor's operations should also request an expedited hearing. If the debtor is unable to purchase insurance, then a motion to convert or dismiss is appropriate. 11 U.S.C. § 1112(b)(4)(C).

Failure to remit taxes is also a breach of the debtor's statutory obligations and fiduciary duties. See 11 U.S.C. § 346(f); 28 U.S.C. § 959 and 960. A debtor is presumed to be aware of the withholding requirements of federal and state law. *See In re WPAS, Inc.*, 6 B.R. 40, 44 (Bankr. M.D. Fla. 1980). Unpaid post-petition taxes are administrative claims, and failure to make payment prejudices the estate and creditors. A failure to remit taxes constitutes grounds for conversion or dismissal pursuant to section 1112(b)(4)(I).

3-10.4.6 Failure to File Reorganization Plan and/or Disclosure Statement

Section 1121(d) authorizes the court, for cause, to extend, shorten, or fix the time during which only the debtor may file a plan and disclosure statement. Sections 1121(b) and (e), which establish the exclusive period within which only the debtor may file a plan, do not impose any requirement that the debtor actually file a plan or suffer specific consequences. The bankruptcy court has the authority to set a deadline for the filing of a plan and disclosure statement.

In some districts, local rules or standing orders set deadlines for the filing of plans and disclosure statements. If no previous order or rule has established a deadline, then the United States Trustee may apply to the court for an order fixing a date for the debtor to file a plan and disclosure statement. Such a motion should be filed only after giving due consideration to the size and complexity of a case, as well as to the status of any outstanding litigation and ongoing negotiations. If an order is entered directing the debtor to file a plan and disclosure statement and those documents are not filed by the time set forth in the order, cause exists to convert or dismiss the case. 11 U.S.C. § 1112(b)(4)(J).

The United States Trustee may also object to an application of the debtor to extend the exclusivity period. A debtor seeking an extension of the exclusivity period must demonstrate that "cause" justifying the extension exists. *See In re*

Service Merchandise Co., 256 B.R. 744, 751 (Bankr. M.D. Tenn. 2000); *In re All Seasons Indus., Inc.*, 121 B.R. 1002 (Bankr. N.D. Ind. 1990). Cause might include an unusually large case or recalcitrance among creditors. The debtor must demonstrate some promise of probable success in the reorganization effort. S. Rep. No. 989, 95th Cong., 2d Sess. 118 (1978). A request for an extension must be made prior to the expiration of the exclusivity period. 11 U.S.C. § 1121(d). The United States Trustee should object to an untimely request for an extension. *See In re Congoleum Corp.*, 362 B.R. 198 (Bankr. D.N.J. 2007).

Section 158(a) of title 28, as amended by the Bankruptcy Reform Act of 1994, allows an immediate appeal as of right to the district court from a bankruptcy court's order extending or reducing the debtor's exclusivity period. Participation by the United States Trustee in such an appeal must be authorized by the EOUST.

3-10.4.7 Failure to Give Proper Notice of Settlement Agreement, Disposition of Property, or Cash Collateral/Adequate Protection Agreement

Fed. R. Bankr. P. 2002 and 4001 require specific notice of certain actions by the debtor. The technical requirements of these rules may be violated, intentionally or not, in three common situations: use, sale, or lease of property other than in the ordinary course of business; settlement of a controversy; or settlement of a cash collateral or adequate protection dispute.

If notice of a transaction has not been given, the United States Trustee should alert the parties involved. If these parties fail to remedy the notice problem, the United States Trustee should apply to the court for an appropriate remedy, such as setting aside the transaction. The fact that a sale may have been for full value or that the settlement is appropriate does not excuse failure to comply with Fed. R. Bankr. P. 2002 and 4001, but may influence the choice of remedial action.

3-10.4.8 Failure to Deposit or Invest Funds as Required by 11 U.S.C. § 345

Usually the debtor in possession is required to open new bank accounts in an authorized depository, which is a bank that agrees to post collateral or a bond to protect uninsured amounts or deposits and also to report on a debtor's bank activity on a monthly basis. Protection may also be provided by a deposit or investment "insured or guaranteed by the United States . . . or backed by the full faith and credit of the United States. . . ." 11 U.S.C. § 345(b). The court, for cause, may modify these requirements.

Each region should have in place an authorized depository program. Banks participating in the program must agree to pledge appropriate securities to the Federal Reserve Bank to protect any bankruptcy estate funds not covered by deposit insurance (any amount over $250,000 per debtor is not insured) or to post a bond. As required by section 345(b)(2), securities used as collateral must be of the kind specified in 31 U.S.C. § 9303. Section 9303 specifies that government obligations may be used as security. A "government obligation" in turn is defined in 31 U.S.C. § 9301(2) as a public debt obligation of the United States Government and an obligation whose principal and interest is unconditionally guaranteed by the government. In light of this definition, only United States

Treasury bills, bonds, or notes are deemed to constitute acceptable securities for purposes of the authorized depository system. *See In re Columbia Gas Sys., Inc.*, 33 F.3d 294 (3d Cir. 1994).

If a debtor fails to deposit funds in an insured account or otherwise fails to comply with section 345, the United States Trustee must take action. The United States Trustee should seek an order of the court directing the debtor to comply with the requirements of section 345. The debtor's failure to comply with such an order constitutes cause for the United States Trustee to seek conversion, dismissal, or the appointment of a trustee.

Foreign bank accounts present special problems and concerns. In cases requiring the maintenance of foreign accounts, consideration should be given to the development of investment guidelines. Such guidelines, in the form of a court order, can be utilized to establish maximum deposit levels for foreign accounts and minimum ratings for banks that the debtor proposes to utilize. The guidelines should also set forth any additional reporting or oversight procedures necessary for the United States Trustee to monitor the overseas accounts properly. *See In re Interco, Inc.*, 130 B.R. 301, 303 (Bankr. E.D. Mo. 1991).

If the depository elects to provide protection by posting a bond, the United States Trustee must ensure that the amount of the bond is adequate. It should exceed, by a healthy margin, the total of all deposits. The United States Trustee should also ensure that the surety has adequate reserves to make good on the bond. Before approving the surety, the United States Trustee should inquire as to the amount of other bonds issued for this purpose to be certain the surety is not overextended.

3-10.4.9 Continuing Losses or Other Diminution of the Estate

If the debtor is operating at a deficit during the case, the United States Trustee should consider filing a motion to convert the case. However, before filing such a motion, the United States Trustee must consider any special circumstances that exist in the case. For example, the debtor may possess assets that would return value over the long term but do not contribute much to cash flow or may possess intangible assets of value, such as tax benefits, or may be able to obtain an infusion of third party funds that would allow it to emerge successfully from chapter 11.

3-10.4.10 Improper Post-Petition Transfers

Generally, if a debtor transfers property of the estate after the commencement of the case outside the ordinary course of business and the transfer is not authorized pursuant to an order of the court or under the Bankruptcy Code, the debtor has entered into a voidable post-petition transaction. 11 U.S.C. § 549. For example, a debtor may pay all or part of its pre-petition obligations to its suppliers for fear that they might otherwise refuse to do business with the debtor. Such conduct "raises serious questions as to the ability and motivation of the debtor in possession. . . ." *See In re E. Paul Kovacs and Co.*, 16 B.R. 203, 205 (Bankr. D. Conn. 1981).

If the debtor fails to take any corrective action, the United States Trustee should seek the appointment of a trustee to review and pursue such post-petition payments. In the alternative, such complete disregard for the requirements of the Bankruptcy Code constitutes cause for conversion or dismissal of the case under section 1112.

3-10.4.11 Failure to Comply with Court Order

If an order has been entered directing the debtor to file operating reports, schedules, a plan, and so forth, and the debtor has failed to comply with such an order, the United States Trustee should move to convert or dismiss the case or seek the appointment of a trustee. Failure to comply with a court order may demonstrate both an inability to reorganize and a lack of adherence to fiduciary standards. Such a failure has been held to be cause justifying dismissal or conversion of a case. 11 U.S.C. § 1112(b)(4). Failure to pay post-petition taxes constitutes cause to convert or dismiss under section 1112(b)(4)(I).

3-10.4.12 Unauthorized Post-Petition Payments to Professionals

If a debtor pays any of its professionals subsequent to the commencement of the case and without court approval, the United States Trustee should first ask the professional to remit the amount received. If the professional ignores the request, the United States Trustee may apply to the bankruptcy court for an order directing disgorgement of the payments. The failure to obtain court authorization before making payments to estate professionals constitutes a breach of a debtor-in-possession's fiduciary duties and serves as a basis for dismissal or conversion pursuant to 11 U.S.C. § 1112(b). *In re Hampton Hotel Investors, L.P.,* 270 B.R. 346, 359 (Bankr. S.D.N.Y. 2001) (finding unauthorized payments to professionals as a form of "gross misconduct" and a basis for conversion to Chapter 7).

3-10.4.13 Ongoing Insolvency Proceedings in Another Forum

A chapter 11 case may be commenced for or against a debtor that is already subject to similar proceedings in another state or country, or against a partnership that is already winding up its affairs pursuant to state law. 11 U.S.C. § 305 permits the bankruptcy court to abstain from hearing such a case or to suspend the proceedings in the case for a period of time.

Section 305 can be invoked when the debtor is involved in a bankruptcy case in a foreign country, or the debtor is a partnership that has dissolved pursuant to state law and is "winding up" under applicable state statutes. *See In re AXL Indus., Inc.*, 127 B.R. 482, 485 (S.D. Fla. 1991), *aff'd in part dismissed in part*, 977 F.2d 598 (11th Cir. 1992); *In re Trina Assocs.*, 128 B.R. 858, 867-68 (Bankr. E.D.N.Y. 1991). Suspension of all proceedings in a case pursuant to section 305 also suspends the debtor's obligation to pay United States Trustee quarterly fees.

3-10.4.14 Sale of Substantially All of a Debtor's Assets

The sale of all or substantially all of a debtor's assets outside the ordinary course of business can be accomplished through a plan of reorganization. However, in some instances, debtors have sought court authority to consummate such a sale by motion outside of, or in advance of, a confirmed plan. Obviously, a motion to sell can be addressed and resolved more quickly and inexpensively than a plan can be brought to confirmation. Many courts do not find a sale of most or all of a debtor's assets by motion to be objectionable. *See Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 388-90 (6th Cir. 1986); *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983). Other courts, however, have found such sales objectionable on the grounds that they constitute a *sub rosa* plan, but short circuit the protections for creditors crafted into the plan confirmation requirements of the Bankruptcy Code. *See Motorola, Inc. v. Official Comm. Of Unsecured Creditors*, 478 F.3d 452 (2nd Cir. 2007); *In re Braniff Airways, Inc.*, 700 F.2d 935, 939-40 (5th Cir. 1983), *reh'g denied*, 705 F.2d 450 (5th Cir. 1983); *In re Gulf Coast Oil Corp.*, 404 B.R. 407 (Bankr. S.D. Tex. 2009) (discussion of history and changes to sales in chapter 11 since 1997). Criticism for such sales often point to: lack of due process; potential abuse by the primary secured creditors in the case, including the debtor in possession's lenders; debtors' efforts to append or integrate broad releases to the purchase agreement; and inadequate marketing efforts. *See Id.* Such sales outside of a plan may also impose significant tax consequences on the estate that must be considered. *See* 11 U.S.C. §1146; *Florida Dept. Of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008).

Business justification for a sale of assets early in the chapter 11 case may include: highly perishable goods; the debtor's inevitable operational losses or inability to obtain debtor in possession financing; and the accrual of interest on secured claims. Also, under Fed. R. Bankr. Proc. 6003, debtors need to prove that a sale within the first 21 days of the case is necessary to avoid immediate and irreparable harm.

The United States Trustee must become familiar with the prevailing case law regarding this issue in his or her district(s). If significant asset sales outside the context of a plan are allowed in a district, the United States Trustee must ensure that the sales are properly noticed with a reasonable opportunity for objections, competing bids, and compliance with applicable non-bankruptcy laws. If a previous order has been entered in the case limiting notice, consider whether notice of the proposed transaction should be expanded to include all creditors and parties in interest. If the sale is a private sale, consideration should be given as to how value was determined. The United States Trustee should assess whether an auction of the assets is likely to generate more for the estate. If the sale is to an insider, corporate approvals and valuation methods should be closely scrutinized to guard against the potential for fraud and/or criminal violations, as well as to ensure that full value is provided to the estate. Similarly, greater scrutiny by the United States Trustee of valuation methods is required in cases where there is no active creditors' committee.

The essential terms of the sale should be clearly set forth in the motion seeking approval of the sale. These terms can include: a fair description of the assets, including executory contracts; purchase price; conditions to closing such as sale subject to due diligence; identity and financial strength of the purchaser or "stalking horse," if any; prior and prospective efforts regarding marketing of the assets; timing and manner of qualified competing bids; form of the proposed or actual asset purchase agreement; auction or sales procedures, if applicable; projected closing date; and procedures related to identifying qualified back-up bids. Arm's length dealings between a debtor and potential purchaser and sound business justification for a sale outside of a plan are also critical. *See In re Enron Corp.*, 291 B.R. 39 (S.D.N.Y. 2003) (sound business justification); *In re Biderman Industries, U.S.A., Inc.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997) (arm's length dealings). *See also* 11 U.S.C §363(m) (good faith).

An auction sale of the debtor's assets can occur after a bidding and sale procedures hearing, and may take place at the offices of the debtor's counsel or, if there is sufficient interest, in a public venue such as the bankruptcy court. Courts should generally approve a sale of assets for the "highest and best offer" following an auction. Although such term is not defined in the Bankruptcy Code, local case decisions should provide some guidance. In particular, the court should evaluate competing bids that are similar, i.e. apples to apples. Thus, a stalking horse offer of a cash purchase with no contingencies may or may not be superior to a higher installment sale price with financing contingencies. Also, a sale to a single purchaser may or may not be superior to a piecemeal sale of the same assets divided among multiple purchasers. The court should make a finding that the ultimate sale is in the "best interest" of the bankruptcy estate and its creditors. Conversely, to justify a private sale, the debtor needs to show that an auction is not practicable, or would not be in the best interests of the estate, for example, because it is too costly. Where the proceeds of a sale of substantially all the assets will largely go to the secured creditors and the estate is administratively insolvent, consideration should be given to conversion of the case to chapter 7. Finally, sales to "insiders" require approval by independent directors, and must be evaluated for compliance with local laws regarding interested directors.

It is also worth noting the requirements of sections 363 (f)-(k), relating to the power to sell property in which the estate is a co-owner or that is subject to a valid lien or interest in favor of a third party. For example, pursuant to section 363(k), when a sale is outside of the debtor's ordinary course of business, a lienholder is entitled to credit bid at the sale.

The motion for sale, purchase agreement, and related documents may also discuss certain protection for the stalking horse. Requirements and procedures vary among courts, so familiarity with local rules and judges is paramount. For example, many purchase contracts discuss "breakup fees" or "topping fees." A breakup or topping fee is a specified amount paid to the stalking horse in the event that it is not the successful bidder for the assets, based on the premise that the stalking horse conducted due diligence and thus makes the stalking horse bid and any subsequent bids more valuable. Put another way, "the break-up fee

covers reimbursement of the disappointed purchaser's out-of-pocket expenses related to the proposed acquisition and/or compensation for the time, efforts, resources, lost opportunity costs and risks incurred by the disappointed purchaser." *In re APP Plus,* 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998). For example, the debtor may agree to pay 3 percent of the total consideration received on the sale of assets to the stalking horse. *See, e.g., AgriProcessors, Inc. v. Fokkena (In re Tama Beef Packing, Inc.),* 321 B.R. 496, 498 (B.A.P. 8th Cir. 2005) (noting that fees in the range of 1 to 4 percent of purchase price are generally upheld as reasonable). Left unchecked, break-up fees can chill bidding and depress the ultimate sale price for a debtor's assets, thereby harming the estate. Depending on how a break-up fee is structured, an alternative purchaser may be required to submit a higher bid for a debtor's assets and pay a separate fee to the stalking horse bidder. Even if the alternative purchaser was willing to submit a higher offer for the assets, payment of the separate break-up fee may be cost-prohibitive, causing the alternative purchaser to abandon their efforts. These fees must be evaluated in the context of other similar cases and should not be a vehicle to chill competing bids by other strategic or financial buyers. Breakup fees should not simply be evaluated under a business judgment standard, but should also pass muster under the section 503(b) administrative expense standard, i.e. provide some benefit to the estate. *See, e.g.*, *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3rd Cir. 1999) (adopting administrative expense standard); *AgriProcessors, Inc. v. Iowa Quality Beef Supply Network, L.L.C. (In re Tama Beef Packing, Inc.),* 290 B.R. 90, 97-98 (B.A.P. 8th Cir. 2003) (summarizing case law); *but see In re Integrated Resources,* 147 B.R. 650 (S.D.N.Y. 1992) (reviewing under modified business judgment standard). These fees may be either in addition to or in lieu of the debtor's obligations to reimburse the stalking horse bidder for its out-of-pocket expenses in the event it is not the successful bidder. In addition, there may be restrictive language regarding the debtor's ability to continue to market or shop the assets after selection of a stalking horse. These "no shop" or "window shop" provisions require great scrutiny to avoid abuses by unscrupulous purchasers. Likewise, minimum initial overbids and subsequent bidding increments should be reasonable under the circumstances.

In addition, the United States Trustee must ensure compliance with section 363(b) if the sale includes personally identifiable information. Under section 363(b)(1), sale of property of the estate that includes personally identifiable information cannot take place without the appointment of a consumer privacy ombudsman and the satisfaction of other conditions, if at the commencement of the case there was a policy in place prohibiting the transfer of personally identifiable information.

3-10.4.15 Failure to Pay Quarterly Fees and Post-Confirmation Performance

Prior to confirmation, if informal efforts to obtain payment of delinquent quarterly fees are not successful, the United States Trustee should consider filing a motion to convert or dismiss or seek an order of the court directing payment, depending on the circumstances. A debtor that is not paying quarterly fees most likely has other unpaid post-petition obligations. The motion to convert or dismiss should identify all the deficiencies. The United States Trustee should not favor

conversion over dismissal merely because quarterly fees have not been paid in full. A reorganization plan cannot be confirmed unless provision is made for the payment of all outstanding quarterly fees no later than the effective date of the plan. *See* 11 U.S.C. § 1129(a) (12).

The issue of performance by the reorganized debtor under the confirmed plan is complex. Very often creditors lose contact and are unaware that the reorganized entity is not doing what the plan requires. Creditors are also unsure as to how to remedy such a problem. Complaints to the United States Trustee may lead to temporary relief, but remedies are limited. Some courts will not entertain a motion compelling performance.

The issue of requesting conversion or dismissal as a remedy for nonperformance is more complex. The courts are split in their analysis of the effect of conversion upon a chapter 11 case with a confirmed plan. Some courts take the position that, upon conversion of a chapter 11 case post-confirmation, only those assets remaining that did not revest in the debtor become part of the chapter 7 estate. *See In re Lacy*, 304 B.R. 439, 445 (D. Colo. 2004); *In re Canal Street Ltd. P'ship.*, 260 B.R. 460, 462 (Bankr. D. Minn. 2001). In most cases, this would leave the chapter 7 trustee with nothing to administer.

Some courts, however, have found that assets in which "the Debtor had a cognizable legal or equitable ownership interest on the date of confirmation will be properties of the estate in a Chapter 7 case, but properties which are clearly acquired by the Debtor postconfirmation will not be subject to administration by the Chapter 7 trustee." *See In re Smith*, 201 B.R. 267, 273 (D. Nev. 1996), *aff'd, mem.*, 141 F.3d 1179 (9th Cir. 1998). *See also In re RJW Lumber Co.*, 262 B.R. 91, 93 (Bankr. N.D. Cal. 2001); *In re Calania Corp.*, 188 B.R. 41, 43 (Bankr. M.D. Fla. 1995).

Other cases appear to have gone even further and hold that assets acquired after confirmation but before conversion are also subject to chapter 7 administration. *See In re Midway, Inc.*, 166 B.R. 585, 590 (Bankr. D.N.J. 1994). In order to avoid this potential problem, the United States Trustee should consider language in the confirmation order that revests all property in the estate upon conversion.

In all likelihood, if a debtor is not paying post-confirmation quarterly fees, the debtor is not making payments under the confirmed plan. If, in fact, there is no money to pay anyone and there is no property for a chapter 7 estate, dismissal is most appropriate in those jurisdictions where case law would leave nothing in the estate of a converted debtor. *See In re Motorworks, Inc.*, 85 B.R. 661, 662 (Bankr. S.D. Ga. 1988).

3-10.4.16 Environmental Problems

State or federal regulatory agencies may be pursuing a debtor because the debtor's operations generate or have generated toxic waste. The debtor may be liable for cleanup costs of environmentally contaminated sites. *See generally* the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. § 9601 *et. seq*. If significant litigation regarding environmental problems is ongoing in another forum, parties may ask the

bankruptcy court to abstain from exercising jurisdiction in the case or to suspend all proceedings pursuant to the provisions of section 305(a). In most instances, the United States Trustee should not initiate such an action.

If the environmental problems present in a particular case are of such magnitude that the debtor has no realistic prospect of reorganization, the United States Trustee should seek dismissal of the case. Conversion would create significant problems and potential liability for a chapter 7 trustee.

3-10.5 CHOICE OF REMEDY – DISMISSAL OR CONVERSION

3-10.5.1 Statutory Basis: 11 U.S.C. § 1112

Section 1112 governs the conversion or dismissal of chapter 11 cases. Some courts have interpreted section 1112(a) to give the debtor the absolute right to convert a voluntary chapter 11 case in which the debtor remains in possession to a case under chapter 7. *In re Dieckhaus Stationers of King of Prussia, Inc.*, 73 B.R. 969, 971 (Bankr. E.D. Pa. 1987). Other courts find that the debtor's right to convert is not absolute. *See, e.g.*, *Monroe Bank & Trust v. Pinnock*, 349 B.R. 493, 496-97 (E.D. Mich. 2006); *In re Adler*, 329 B.R. 406, 408-09 (Bankr. S.D.N.Y. 2005). Section 1112(b) provides that the court, on request of a party in interest or the United States Trustee and after notice and a hearing, may dismiss or convert a chapter 11 case for "cause." The statute contains a list of 16 factors that may constitute cause, including the inability to effectuate a plan and unreasonable delay by the debtor. The list is not exclusive. Additional examples of "cause" include failure to comply with a court order, failure to timely satisfy filing or reporting requirements, failure to appear before the court or the United States Trustee for scheduled hearings or meetings, failure to pay post-petition taxes or file post-petition tax returns, and failure to act diligently in proposing a plan. The court is able to consider other factors as they arise and use its equitable powers to reach an appropriate result in a particular case. *See* H. Rep. No. 595, 95th Cong., 1st Sess. 405 (1977).

Once cause has been established, the decision whether to dismiss or convert a case is made by determining which of these remedies is in the best interest of creditors and the estate in the matter under consideration. In the event that cause is established after a plan is confirmed, additional considerations may apply. Section 1112(c) provides that the court may not convert a chapter 11 case to a case under chapter 7 if the debtor is a farmer or a corporation that is not a moneyed, business, or commercial corporation, unless the debtor requests such conversion. Section 1112(d) sets forth the conditions under which a chapter 11 case may be converted to a case under chapter 12 or chapter 13. Finally, Section 1112(f) provides that a chapter 11 case may not be converted to a case under any other chapter of the Bankruptcy Code unless the debtor is eligible to be a debtor under that chapter. *See* 11 U.S.C. § 109.

3-10.5.2 Dismissal

Dismissal of a chapter 11 case is preferable to conversion if no assets remain to be administered by a chapter 7 trustee. In addition, conversion of a case should be

avoided when such an action would subject a chapter 7 trustee to risk of liability, such as when the debtor holds property contaminated by toxic waste.

The effect of an order dismissing a bankruptcy case is governed by 11 U.S.C. § 349. Section 349(a) provides, in general, that the dismissal of a case is without prejudice. However, a dismissal with prejudice can be imposed if the court, for cause, so orders. A dismissal with prejudice bars the discharge in a later case of debts that were dischargeable in the case dismissed. Section 349(b) provides that an order of dismissal operates to undo the bankruptcy case, in so far as practicable, and restores the status quo regarding property rights that existed at the commencement of the case.

The United States Trustee should ensure that an order of dismissal is conditioned on payment of any unpaid quarterly fees. If the order conditions dismissal upon the filing of a report of all unpaid administrative expenses and the payment of those sums, the United States Trustee should ensure that those conditions are met.

3-10.5.3 Conversion

Conversion of a case from chapter 11 to chapter 7 may be appropriate if assets exist that can be liquidated for the benefit of creditors. Conversion is not appropriate if the debtor merely seeks to unburden itself of environmental problems and saddle a trustee with those liabilities.

The effect of an order converting a bankruptcy case is governed by 11 U.S.C. § 348. Section 348(a) provides that conversion constitutes an order for relief under the new chapter. However, except as provided in section 348(b) and (c), the conversion of a case does not effect a change in the filing date, the commencement of the case, or the date of the order for relief. Under section 348(d), a claim arising after the order for relief under chapter 11 but before conversion of the case under section 1112 (other than a claim specified in section 503(b)) "shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition."

Most claims arising in the chapter 11 case have a lower priority than those arising under the new chapter. An exception is United States Trustee quarterly fees. Conversion terminates the service of any trustee or examiner appointed in the chapter 11 case. *See* 11 U.S.C. § 348(e). However, that trustee may be reappointed as the chapter 7 trustee. *See* 11 U.S.C. § 701(a)(1).

Conversion does not negate all actions taken while the case was pending in chapter 11. The schedules, statement of financial affairs, and statement of executory contracts filed in the prior case are deemed to be filed in the converted case. If any of these documents were not filed, the debtor is required to comply with Fed. R. Bankr. P. 1007 as if an order for relief had been entered on the date of the order of conversion. *See* Fed. R. Bankr. P. 1019(1).

The conversion of a case to chapter 7 results in the immediate ouster of the debtor in possession and the appointment of an interim trustee as provided in section 701. Unless the interim chapter 7 trustee seeks a court order authorizing the continued operation of the business, the business operations of the debtor must

cease immediately upon conversion of the case. *See* 11 U.S.C. § 721. In the event the assets of a partnership debtor are insufficient to pay claims, a trustee may have a claim against the general partner to the extent of the general partner's personal liability under applicable nonbankruptcy law. *See* 11 U.S.C. § 723 and Fed. R. Bankr. P. 1007(g).

Conversion of a case to chapter 7 raises issues concerning the deadline for filing avoidance actions under section 546 and considerations for our offices in connection with the timing of motions to convert chapter 11 cases and the scheduling of chapter 7 meetings of creditors after courts enter orders converting chapter 11 cases to chapter 7. Section 546 provides:

> (a) An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of—
>
> (1) the later of—
>
> (A) 2 years after the entry of the order for relief; or
>
> (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
>
> (2) the time the case is closed or dismissed.

A problem may arise for the interim chapter 7 trustee when a chapter 11 case converts to chapter 7 before the two-year deadline in section 546(a)(1)(A) expires and the chapter 7 meeting of creditors is not scheduled and concluded until after the deadline. This is due to the reference in section 546(a)(1)(B) to section 702 rather than section 701. In this circumstance, the deadline may expire shortly after the interim trustee is appointed (i.e. without the extra one year). The Seventh Circuit's opinion in *Fogel v. Shabat (In re Draiman)*, 714 F.3d 462 (7th Cir. 2013) illustrates the problem. The Seventh Circuit held that the appointment of an interim trustee does not extend the deadline for avoidance actions even if the interim trustee eventually becomes the permanent trustee. The United States Trustee should be aware of the two-year deadline and, to the extent possible, seek conversion of a case in sufficient time for a chapter 7 meeting of creditors to be held and concluded before that date.

If a case is converted to one under chapter 7, 12, or 13 pursuant to section 1112, the debtor is required to file a schedule of unpaid obligations incurred after the commencement of the chapter 11 case. *See* Fed. R. Bankr. P. 1019(5). The United States Trustee should file a proof of claim for unpaid quarterly fees in the converted case. Pursuant to section 726(b), fees assessed under 28 U.S.C. § 1930, including United States Trustee quarterly fees, are not subordinated to chapter 7 administrative expenses. *See, e.g.*, *In re Juhl Enters., Inc.*, 921 F.2d 800, 803 (8th Cir. 1990); *In re Jonick Deli Corp.*, 263 B.R. 196, 199 (S.D.N.Y.

2001); *In re Mary James, Inc.*, 225 B.R. 635, 639-40 (E.D. Mich. 1998). *See also In re Endy*, 104 F.3d 1154, 1157-58 (9th Cir. 1997).

CHAPTER 3-11: REVIEW OF DISCLOSURE STATEMENTS AND PLANS

3-11.1 INTRODUCTION

Section 586(a)(3)(B) of title 28 provides that the United States Trustee shall, whenever the United States Trustee considers it to be appropriate, monitor plans and disclosure statements filed in cases under chapter 11 and file with the court comments with respect to such plans and disclosure statements. The disclosure process is the heart of the reorganization provisions of the Bankruptcy Code. Full disclosure is required before solicitation of acceptances of a plan of reorganization, thereby enabling creditors to make an informed judgment, whether to accept or reject a plan.

As stated in the legislative history of the Bankruptcy Code:

> The premise underlying the consolidated chapter 11 of this bill is the same as the premise of the securities law. If adequate disclosure is provided to all creditors and stockholders whose rights are to be affected, then they should be able to make an informed judgment of their own, rather than having the court or the Securities and Exchange Commission inform them in advance of whether the proposed plan is a good plan. Therefore, the key to the consolidated chapter is the disclosure section.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 226 (1977).

Pursuant to 11 U.S.C. § 1125(b), acceptance or rejection of a plan may not be solicited unless accompanied by a disclosure statement found by the court to contain "adequate information" regarding the plan. The practical approach to disclosure embodied in section 1125, however, is quite unlike the standardized approach to disclosure embodied in the federal securities laws. This is illustrated by section 1125(a)(1), which qualifies the sufficiency requirement with the following reasonableness standard:

> "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor and a hypothetical investor typical of the holders of claims or interests in the case, that would enable a such a hypothetical investor of the relevant class to make an informed judgment about the plan and ... the court shall consider the complexity of the case, the benefit of additional information ... and the cost of providing additional information ..."

11 U.S.C. § 1125(a)(1). Section 1125(d) elaborates by providing that "adequate information is not governed by any otherwise applicable nonbankruptcy law, rule, or regulation. . . ."

The United States Trustee's review of disclosure statements focuses on the adequacy of disclosure. The role of the United States Trustee in reviewing disclosure statements is critical to the protection of creditors who have not directly participated in the negotiations, or when committees are inactive or have not been appointed.

The Bankruptcy Code permits the court to "approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets." 11 U.S.C. § 1125(b). Congress recognized that the circumstances will vary widely from one chapter 11 case to the next and, therefore, the parameters of "adequate information" will also vary. The legislative history states:

> The Supreme Court's rulemaking power will not extend to rulemaking that will prescribe what constitutes adequate information. . . . Precisely what constitutes adequate information in any particular instance will develop on a case-by-case basis. Courts will take a practical approach as to what is necessary under the circumstances of each case, such as the cost of preparation of the statements, the need for relative speed in solicitation and confirmation, and, of course, the need for investor protection. There will be a balancing of interests in each case. In reorganization cases, there is frequently great uncertainty. Therefore, the need for flexibility is greatest.

H.R. Rep. No. 595 at 409.

A review of case law illustrates what courts consider "adequate information" based on the facts of each case. *See In re Adelphia Communications Corp.*, 352 B.R. 592 (Bankr. S.D.N.Y, 2006) (once adequate information "floor" is satisfied, additional information can be included as long as accurate and not misleading). Information may vary depending upon the sophistication of the class. *See In re Bloomingdale Partners*, 155 B.R. 961, 972 (Bankr. N.D. Ill. 1993). *But see In re Walker*, 198 B.R. 476, 479-80 (Bankr. E.D. Va. 1996) (court held that the information need only be the best prediction that the debtor can make based upon information available).

The process for obtaining approval of a disclosure statement and soliciting votes for a plan of reorganization has been simplified for small business debtors. In a small business case, the court may determine the plan itself provides adequate information and that a separate disclosure statement is not necessary; may approve a disclosure statement submitted on standard forms approved by the court or adopted under section 2075 of title 28; and may conditionally approve a disclosure statement subject to final approval after notice and hearing. The conditionally approved disclosure statement must be mailed not later than 25 days prior to the date of the hearing on confirmation of the plan. The court can then hold a single hearing to consider both final approval of the disclosure

statement and plan confirmation. 11 U.S.C. § 105(d)(2)(B)(vi) and 1125(f)(1), (2), and (3); Fed. R. Bankr. P. 3016 and 3017.1.

3-11.2 THE CONCEPTUAL FRAMEWORK

3-11.2.1 Items to Include

The United States Trustee should not advocate a "checklist" approach to the review of disclosure statements. The disclosure statement certainly should discuss the elements set out in 11 U.S.C. § 1123 insofar as they are in the plan filed. Reference to case law regarding information to be included is essential. *See, e.g.*, *Mabey v. S.W. Elec. Power Co. (In re Cajun Elec. Power Co)*, 150 F.3d 503, 518 (5th Cir. 1998); *Hall v. Vance*, 887 F.2d 1041, 1043 (10th Cir. 1989); *In re Metrocraft Publ'g Servs., Inc.*, 39 B.R. 567, 568-69 (Bankr. N.D. Ga. 1984); *In re Malek*, 35 B.R. 443, 443-44 (Bankr. E.D. Mich. 1983); *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982).

3-11.2.2 "Safe Harbor," 11 U.S.C. § 1125(e)

Under section 1125(e), a person who solicits acceptances or rejections of a plan in good faith and in compliance with the Bankruptcy Code is not liable on account of such solicitation for the violation of any applicable law, rule, or regulation governing the offer, issuance, sale, or purchase of securities. The purpose of this section is to protect creditors, creditors' committees, counsel for committees, and others involved in a case from potential liability for use of an approved disclosure statement.

This safe harbor rule was intended to codify the result of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), *reh'g denied*, 425 U.S. 986 (1976), which held that proof of *scienter* is a prerequisite to the imposition of civil liability under the antifraud provisions of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. It was also intended to extend the good faith safe harbor to the imposition of injunctive liability. *See* H.R. Rep. No. 595 at 229-31.

3-11.2.3 Factors Affecting Adequacy of Disclosure

Several factors can affect the appropriate quantity and quality of disclosure in a given case, including:

1. the nature of the proposed plan of reorganization or liquidation;
2. the sophistication of the various holders of claims and interests and their familiarity with the debtor and its business;
3. whether the expense of the disclosure would substantially outweigh its anticipated benefit to creditors and stockholders;
4. the peculiarities of the debtor's business or financial condition;
5. the need for an expeditious resolution; and

6. the access of a plan proponent, other than the debtor, to factual information regarding the debtor.

An inordinately long or complex disclosure statement may confuse rather than enlighten creditors. In such cases, the deletion of certain materials or the preparation of a summary may be suggested; care must be taken, however, to ensure that significant material is not deleted.

3-11.3 CONDUCTING THE REVIEW

3-11.3.1 Standard Language

The use of some standardized language in disclosure statements is appropriate. For example, all documents should indicate that any representations made in order to secure an acceptance of the plan that are not contained in the disclosure statement are to be reported to the debtor, the creditors' committee, the United States Trustee, and the bankruptcy court for such action as may be appropriate.

Similarly, there should be a statement that the plan represents a legally binding arrangement and should be read in its entirety; the reader should not rely on the summary in the disclosure statement. Accordingly, creditors may wish to consult with their own lawyers and the creditors' committee and its lawyer to understand the plan more fully. The disclosure statement should also refer to "the right to vote for acceptance or rejection" of the plan or "the right to vote upon" the plan.

While the disclosure statement may serve the parallel purpose of solicitation, the solicitation aspect of the statement should be clearly identified as such and kept distinct from the disclosure aspect. For example, the disclosure statement may state that "as a creditor, your acceptance is important" but such a statement should not be included in a paragraph describing voting procedures. It is permissible, however, for a discussion of the voting process to state that it is important for each creditor to vote.

The disclosure statement should indicate that bankruptcy court approval of the disclosure statement is not a ruling by the bankruptcy court on the merits of the plan. The disclosure statement should indicate which classes are impaired and are, therefore, entitled to vote on the plan and should define impairment in plain language. The voting requirements under 11 U.S.C. § 1126 for acceptance must be set forth in the disclosure statement. Voters should be told where the ballots must be sent and the deadline for voting. The ballots should not be sent to the United States Trustee.

3-11.3.2 Description of the Debtor's Business

The disclosure statement should describe the nature of the debtor's business. In cases in which the plan contemplates cash payments upon confirmation, a brief narrative description should suffice. If the plan contemplates deferred payments or the issuance of common or preferred stocks to creditors and, therefore, its

implementation depends upon the future course of the business, the description should be more detailed. Items to look for in the latter case are:

1. material factors peculiar to the specific business of the debtor, such as seasonality, limited sources of supply, limited number of potential customers, patents or licenses, special capital needs, regulatory problems, or backlog;
2. principal product and services present, contemplated, or under development;
3. competitive conditions in the applicable market; and
4. material contracts and leases, including important terms such as expiration dates. Of course, if detailed information would have a detrimental impact on the debtor_s competitive position, general terms may be permissible.

3-11.3.3 Reasons for Financial Difficulties and Correction of Those Factors

The disclosure statement should give a brief narrative description of the factors leading to the debtor's financial difficulties, together with a listing of the steps already taken or to be taken by the debtor to correct the problems. This description should be reviewed from the standpoint of the assistance it will provide the holders of claims and interests in assessing the likelihood of any recurrence of prior difficulties and, thus, the feasibility of the proposed plan. In cases in which the plan has neither deferred payments nor issuance of common or preferred stock, the reasons for the debtor's financial difficulties and the correction of those factors are less important and may be dealt with summarily.

3-11.3.4 Historical and Current Financial Information

Historical financial information, such as cash flow statements and profit and loss statements (statements of operation), should, where relevant, provide the holders of claims and interests some perspective regarding the debtor's financial situation and future prospects as reflected in any projections included in the disclosure statements. *See* "Projections" *infra*.

Current financial information, such as cash flow statements, profit and loss statements (statements of operations), and balance sheets, provides holders of claims and interests with important information about the debtor's performance during the chapter 11 case. Of particular importance is the comparison of the current balance sheet with the balance sheet as of the commencement of the case.

The disclosure statement should include, as an exhibit, a summary of the results of the operations during the chapter 11 case. *In re Merrimack Valley Oil Co.*, 32 B.R. 485, 488 (Bankr. D. Mass. 1983); *In re Western Management, Inc.*, 6 B.R. 438, 442-43 (Bankr. W.D. Ky. 1980). The summary should be in a format consistent with the projections so that creditors can make a meaningful comparison of the past with future projections. The format of the summary and

the projections should be consistent with regard to time and designation of income and expense items.

The disclosure statement should also include a projection of the financial condition of the debtor upon confirmation of the plan. This information enables the court and creditors to determine if the debtor will need further financial reorganization or if the plan will be followed by a liquidation. 11 U.S.C. § 1129(a) (11).

The extent to which financial statements are prepared in accordance with generally accepted accounting principles (GAAP) will vary. The period covered by historical financial information may vary based on the nature of the plan; the condition of the debtor's books and records (11 U.S.C. § 1125(a)(1) expressly recognizes this as a variable); and the nature of the debtor_s business. Any financial statements that have not been prepared in accordance with GAAP due to the condition of the debtor_s books and records should contain appropriate disclaimers and a brief explanation of the accounting methods employed.

The American Institute of Certified Public Accountants issued Statement of Position (SOP) 90-7, on November 19, 1990, as amended by FASB Staff Position Report FSP SOP 9-7-1 (April 24, 2008). The statement provides guidance for the financial reporting of entities currently in chapter 11 that expect to reorganize as going concerns.

3-11.3.5 Material Post-Petition Events

The disclosure statement should briefly describe all material post-petition events including:

1. borrowings;
2. issuance of securities;
3. sales or transfers of assets other than in the ordinary course of business;
4. necessary regulatory approvals; and
5. lease assumptions and/or assignments or rejections, along with other executory contracts.

3-11.3.6 Outline of the Plan

The degree of detail in which the proposed plan of reorganization should be outlined in the disclosure statement will vary greatly with the complexity of the plan. In some instances, cross-references in the disclosure statement to pertinent plan provisions will suffice. In other instances, complex features of the plan may need to be separately, but briefly, described in the disclosure statement. For example, if the plan contemplates deferred payments to unsecured creditors out of retained earnings in excess of a stated figure, look for some explanation of this feature in the disclosure statement. Similarly, complex plan provisions often involve definitional problems that should be clarified in the disclosure statement.

For example, the amount of deferred payments to a particular class of creditors may be expressed as a percentage of "net sales," a term that should be defined. Any default provisions or affirmative and negative covenants contained in the plan, such as dividend restrictions, limitations on further borrowing, and board memberships, should be explained. Information on the amount of claims in each class should be provided in tabular form in order to allow computations of the possible distribution to be made under the plan. The disclosure statement should also predict when confirmation will occur.

3-11.3.7 Means of Effectuating the Plan

Information relating to the source and application of funds to effectuate the proposed plan of reorganization should appear in the disclosure statement, including an estimate of the amounts necessary for the initial payments under the plan. This number should be compared to the cash on hand. If the amount needed to confirm is greater than the cash available, there should be an explanation concerning the source of the additional funds. There should also be a brief description of the structure of any transaction related to carrying out the plan, such as the sale of stock or of assets. There should be an indication as to whether there exists any avoidable transfers (preferences and/or fraudulent conveyances) and whether the debtor or acquiring entity intends to prosecute these claims. These potential causes of action should be factored into the estimated liquidation analysis. *Harstad v. First Am. Bank,* 39 F.3d 898, 903 (8th Cir. 1994) (Creditors have the right to know of any potential causes of action that might enlarge the estate--and that could be used to increase payment to the creditors.)

The disclosure statement should contain a brief description of the terms of any material agreements relating to the effectuation of the plan that the debtor has executed or proposes to execute, such as funding agreements, security agreements, guarantees, trust indentures, and agreements for the sale of stock or assets. For example, the plan may contemplate the use of a trust indenture in connection with deferred payments to creditors. In that event, the scope of discretionary authority lodged in the indenture trustee (e.g., the discretion to pledge assets to facilitate new financing or to subordinate the security interest granted to creditors) and the identity and affiliations of the indenture trustee should be disclosed. If there are to be guarantees for debtor's obligations under the plan, the guarantors should be identified and the nature and scope of guarantees described. In addition, the guarantor's ability to support the guarantee (e.g., a net worth statement in the case of an individual guarantor) should be discussed.

If a third party, including the debtor's principal, is to provide the necessary funds for confirmation, there should be some financial information with respect to the third party. If the third party does not want to be disclosed or does not want to disclose its financial condition, there are acceptable alternatives. For instance, if the funds are deposited in an identifiable escrow account for confirmation or by an irrevocable letter of credit, financial disclosure about the third party may not be

necessary. Terms of the advance loan or contribution to capital should also be set forth. This should also be reflected in a projection that assumes confirmation of the plan.

The disclosure statement should indicate if there are any conditions that have to be met by any party in order for the plan to be confirmed. The disclosure statement should also state the likelihood of the requisite events occurring as scheduled.

3-11.3.8 Securities to be Issued

In rare instances, a case will involve the issuance of securities. If such a case arises, the disclosure statement should provide information about any securities to be issued pursuant to the plan of reorganization, where applicable, as to:

1. dividend rights, management's dividend policies, and external constraints on the payment of dividends (e.g., a negative covenant in a loan agreement);
2. liquidation rights and preferences;
3. voting rights;
4. sinking fund payments;
5. conversion features;
6. preemptive rights;
7. redemption provisions;
8. provisions relating to interest, amortization, and maturity;
9. provisions restricting the issuance of additional securities; and
10. other special rights and preferences (e.g., the right to elect a majority of the board of directors in the event of defaults on payments in respect to debentures issued or the right to veto certain corporate changes, such as recapitalization, that could adversely affect the security holders' rights).

The disclosure statement should indicate whether the issuance of the securities in question is exempt from the registration requirements of federal and state securities laws by virtue of 11 U.S.C. § 1145(a) or a different exemption, or whether it is contemplated that the securities will be registered. United States Trustees should be aware that section 1145(a) generally permits the issuance of exempt securities to those who hold claims (including administrative expense claims) and interests in the debtor and affiliates only. *See U.S. S.E.C. v. Universal Exp., Inc.,* 475 F. Supp. 2d 412, 425 (S.D.N.Y. 2007) ("The section 1145(a) exemption is available only when the offerees are receiving the securities, at least in part, in exchange for claims against or interest in the debtor which they hold.") *aff'd sub nom. U.S. S.E.C. v. Altomare,* 300 F. App'x 70 (2d Cir. 2008) (citations omitted).

It may be appropriate for the disclosure statement to include information relating to the current and anticipated post-confirmation distribution of ownership of equity securities. This information could serve to inform the holders of claims and interests as to any dilution or changes in control likely to result from the issuance of securities contemplated by the plan of reorganization. Even in those cases where existing stockholders do not have preemptive rights, if the stock is being diluted, the existing stockholders are impaired. *Cf. In re Barrington Oaks General Partnership*, 15 B.R. 952 (Bankr. D. Utah 1981).

If there is a market for the securities to be issued (or the securities into which they are convertible), the disclosure statement should identify the principal markets involved. If the securities are traded on an exchange, information as to high and low sales prices in the recent past should be included. If the principal market for such securities is not an exchange, there should be included information as to high and low bid quotations in the recent past, with disclosure of the source of those quotations. If there is no market for such securities, the disclosure statement should so state, and should also state whether it is expected that a market will exist for securities distributed under the confirmed plan. If the securities are publicly held, but not traded because of past failure to disseminate public information, that fact should be disclosed *See* Securities Exchange Act Rule 15c2-11. If it is expected that the disclosure being made will cure the deficiency so that trading can resume, then that expectation should be noted.

Finally, the disclosure statement should briefly describe applicable law relating to the resale of the securities to be issued under the plan of reorganization. There is a limited exemption in section 1145(d) from the provisions of the Trust Indenture Act of 1939.

3-11.3.9 Projections

"The essence of disclosure in a reorganization case, and the essence of valuation of a business as a going concern, is a projection of future earnings of the business." H.R. Rep. No. 595 at 230-31. If the plan of reorganization does not contemplate any deferred payments or the issuance of any equity security, such projections are unnecessary. In all other cases, projections are critical to the creditors' and shareholders' ability to assess the viability of the plan and of the debtor. It should be noted that the Securities and Exchange Commission encourages the use of projections of future economic performance. *See* Securities Act Release No. 33-5992 (November 7, 1978), 43 F.R. 53246.

The projections should include both cash flow and earnings estimates. All payments contemplated under the plan should be factored into the cash flow projections. If earlier projections are available, they should be compared in the disclosure statement with actual results for the periods covered. Creditors will then be able to assess management's powers of projection.

There may be instances in which payments under the plan are tied to specific financial measures such as net sales, pre-tax profits, retained earnings, or other

measures. In such circumstances, the projections should set forth estimates in terms of the appropriate measure.

The United States Trustee should ensure that the underlying assumptions utilized by management in developing the projections are disclosed as specifically as possible. There may exist, however, legitimate reasons for a vague statement concerning such items as the introduction of a new product or the gearing down of operations. It should be understood that the disclosure of "adequate information" may conflict with the debtor's legitimate need to protect its competitive position. For example, the disclosure of market study results for a proposed new product, while of significant informational value to creditors, might not be appropriate. Where the assumptions made relate to the factors cited as reasons for the debtor's financial difficulties and are intended to correct those factors, the connection should be made clear.

Cases may arise in which alternative sets of projections, or at least ranges of projections, would be appropriate. For example, the plan of reorganization may offer creditors two or more payment options. Alternative sets of projections or ranges of projections may be desirable to reflect the different results that would flow from the election of each option. Similarly, alternative sets of projections or ranges of projections may be appropriate when there is a reasonable prospect of a change affecting the debtor's business, such as regulatory changes, introduction of a new product, or new market entrants.

3-11.3.10 Management, 11 U.S.C. § 1129(a)(5)

Even if the plan of reorganization contemplates exclusively cash payments upon confirmation, the disclosure statement must identify the anticipated post-confirmation directors and executive officers of the debtor, and indicate the extent to which this represents a change from pre-confirmation management. The disclosure statement should contain a brief account of the business experience of each director and executive director, together with their age, tenure, and possible retirement where relevant. Information as to compensation arrangements with the debtor's directors and executive officers should also be disclosed. The disclosure statement should also include any other information relevant to the integrity and competence of management – for example, criminal or regulatory proceedings and prior bankruptcies or receiverships.

3-11.3.11 Controlling Persons

In the case of a plan of reorganization that will be implemented over time, the disclosure statement should identify any "persons" (as defined in section 101(41)) that will "control" the debtor following confirmation of the proposed plan of reorganization.

With respect to any "person" that is to "control" the debtor, the disclosure statement should provide at least the following information:

1. the nature and extent of "control" to be exercised;
2. a brief narrative description of the business of the controlling person;

3. the identity of persons that control such controlling person;
4. the identity and experience of management of the controlling person;
5. the identity of affiliates of the controlling person;
6. an outline of the transaction whereby control is to be acquired;
7. if known, the business plans of the controlling person for the debtor; and
8. pertinent financial information regarding the controlling person, if available.

3-11.3.12 Insider Claims

The disclosure statement should list any claims held by "insiders" of the debtor as defined in section 101(31) and should include:

1. the identity of the claimant;
2. the claimant's affiliation with the debtor;
3. the circumstances giving rise to the claim;
4. the amount of the claim; and
5. the treatment to be afforded the claim in accordance with the plan.

3-11.3.13 Transactions with Insiders

The disclosure statement should contain a brief description of any present or proposed material transactions of the debtor in which "insiders" of the debtor (as defined in 11 U.S.C. §§ 101(31)) have any interest. The insider should be identified, the affiliation with the debtor described, and the nature of the interest in the transaction explained. For example, rentals paid by or to the debtor should be compared to existing market rates. If any transactions have given rise to claims either on behalf of or against the debtor in the chapter 11 case, they should be disclosed.

3-11.3.14 Disputed Claims

Any material claims that the debtor disputes or proposes to dispute, in whole or in part, should be listed and there should be a disclosure of:

1. the identity of the claimant;
2. the nature of the claim;
3. the full amount of the claim and the amount subject to dispute; and
4. the grounds of the debtor's challenge to the claim (e.g., voidable preference, fraudulent transfer, or lack of collateral value). It may also be appropriate for the disclosure statement to explain the effect upon the plan of reorganization (and the related projections, if any) of the allowance or disallowance of the disputed claim.

3-11.3.15 Legal Proceedings

The disclosure statement should give a brief description of any material legal proceedings to which the debtor is a party, that the debtor contemplates instituting, or that are threatened against the debtor. This disclosure should include information as to:

1. the identity of the parties to the litigation;
2. the nature of the claims;
3. the factual basis alleged to underlie the proceedings;
4. the court in which the litigation is pending;
5. the relief sought;
6. the status of the litigation; and
7. a statement as to whether a judgment adverse to the debtor might seriously affect the debtor's business or financial conditions or the debtor's ability to effectuate the plan of reorganization.

3-11.3.16 Tax Consequences

The definition of "adequate information" requires a "discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor and a hypothetical investor typical of the holders of claims or interest in the case, . . ." 11 U.S.C. § 1125(a)(1). In determining the adequacy of information, including tax consequences, "courts shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information..." *Id.* The larger and more complex the case, the more detailed the discussion of all required type of information, including material tax consequences, will have to be in order to be "adequate."

3-11.3.17 Trustee or Examiner

If a trustee or an examiner has been appointed in a chapter 11 case, the identity and the reasons for the appointment of the trustee or examiner should be disclosed. Similar information regarding an elected trustee should be provided. If the trustee or the examiner has prepared a report regarding the operations of the debtor, and if it is not too voluminous, a copy should be attached to the disclosure statement. If it is not attached, it should be summarized in the disclosure statement, with directions on how to obtain a copy of the report.

3-11.3.18 Creditors' Committees and Equity Security Holders' Committees

The disclosure statement should indicate whether there are any creditors' or equity security holders' committees, together with a list of the members of such committees, their addresses, and whether the proposed plan of reorganization has been negotiated with the committees. Any professionals retained by the committees should also be disclosed. The position of the committees on the plan and what role, if any, the committees will play after confirmation should be disclosed.

3-11.3.19 Information Regarding Plan Proponent

Occasionally, a plan and disclosure statement may be offered by a party other than the debtor, the trustee, or the creditors' committee. The proponent must be a "party in interest" under section 1121. In those situations, the disclosure statement should clearly describe the position of the proponent relative to the debtor – for example, a supplier holding an unsecured claim against the debtor in the amount of $20,000 – since it may affect the proponent's access to the information and, thus, the quality and quantity of disclosure. On the other hand, disclaimers by an "outside" plan proponent as to the absence of information regarding the debtor must also be scrutinized, since the formulation of a plan by the proponent necessarily involved certain assumptions, if not "hard" information, regarding the debtor. The standard of adequate information should not change depending upon the proponent of the plan. Any assumptions should be disclosed and the proponent should be compelled to obtain the necessary, existing information in order for the disclosure statement to be approved. *See In re Civitella*, 15 B.R. 206, 208 (Bankr. E.D. Pa. 1981) (disclosure statement for a plan proposed by three secured creditors denied approval because no factual information provided, only allegations and opinions). Where other plans have been proposed, their existence and the fact that they are on file with the court should be disclosed. These are potential alternatives to the plan that creditors/equity holders are being asked to vote upon.

3-11.3.20 Liquidation Analysis

A creditor cannot make an informed judgment regarding a proposed plan of reorganization without information as to the available alternatives. The most obvious alternative is liquidation of the debtor under chapter 7. Any reference to liquidation should be prefaced with the term "estimated," since liquidation has not occurred. *See In re Radco Properties, Inc.*, 401 B.R. 666, 682 (Bankr. E.D. N.C. 2009). These statements of alternatives should be neutral. If other alternatives, such as a competing plan of reorganization, have been considered by the proponent of the plan during the chapter 11 case, the disclosure statement could briefly describe the alternatives considered and the reasons for finding the proposed plan of reorganization preferable.

In most cases an elaborate liquidation analysis should not be necessary. A brief tabular presentation should suffice if it sets forth estimated administration expenses; estimated priority, secured, and unsecured claims; and estimated asset values; along with disclosure of the source of those estimates. The disclosure statement should indicate the percentage distribution, if any, to creditors on liquidation.

The disclosure statement should enable the reader to determine what assumptions were made in connection with the estimate of claims and asset values (e.g., the assumptions regarding disallowance of certain claims, recoverable transfers, the book figures upon which the liquidation values are based, and the method employed in computing the book figures or the discount applied to accounts receivable and how this discount relates to the debtor's actual pre-petition and post-petition collection experience). Certain assets, such as leases and real estate, may not be reflected accurately on the balance sheet, although quite valuable upon liquidation. Any adjustments that are made should be disclosed.

If liquidation will not be immediate, an estimate of the length of time that would be required to liquidate the assets of the debtor should be included. If relevant, the liquidation analysis should factor in available exemptions provided by the Bankruptcy Code. If claims incorporated in the liquidation analysis are held by "insiders" of the debtor, that fact should be mentioned. In the case of a partnership, the disclosure statement should include financial information about the general partners so that creditors can determine if the plan is in their "best interest." 11 U.S.C. § 1129(a)(7); *see also* 11 U.S.C. § 723 (partnership distributions in chapter 7).

Section 1125(b) of the Bankruptcy Code indicates that the court may approve a disclosure statement without a valuation of the debtor or an appraisal of its assets. Appraisals are, however, performed in most cases and their incorporation in the disclosure statement enhances the liquidation analysis. (Disclosure of information relating to an appraisal may be restricted.) If an appraisal is too voluminous, a summary and information on how to obtain a copy of the appraisal will generally suffice. In either event, the disclosure statement should identify the appraiser, identify the party who commissioned the appraisal, and disclose the purpose of the appraisal. The proponent of the plan of reorganization may want to argue that one of the appraisals is especially reliable and the reasons for this conclusion.

3-11.3.21 Vote Required for Acceptance

The disclosure statement should briefly describe the vote required for acceptance of the plan by the various classes of holders of claims and interests under section 1126, and should specifically identify which classes are impaired and voting on

the plan. The disclosure statement should also establish a record date for voting on the plan of reorganization by holders of equity securities.

3-11.3.22 Cram Down

Although the application of section 1129(b) is essentially a question for confirmation, the discussion in the disclosure statement of "cram down" raises a difficult problem. The term "cram down" is used to describe the power of the bankruptcy court to confirm a reorganization plan even though one or more impaired classes of creditors does not accept the plan. 7 *Collier on Bankruptcy* ¶ 1129.03 (Alan N. Resnick, Henry J. Sommer 16th ed. Rev. 2009). At a minimum, if the debtor intends to invoke the "cram down" provisions against a dissenting class, that intention should be disclosed. Moreover, if the invocation of "cram down" is intended, the disclosure statement should contain a brief summary of the operation of section 1129(b) as it would affect the class in question, as well as a brief outline of the "fair and equitable" standard that would be applied should "cram down" be invoked.

The disclosure problem is further complicated to the extent there may be, as a legal matter, significant doubt as to the availability of "cram down" in a given case. For example, although a plan of reorganization proposes that stockholders will receive cash payments in exchange for their shares, the disclosure statement may state, or at least suggest, that section 1129(b) "may be" invoked against unsecured creditors as a class. The availability of "cram down" in those circumstances may be questionable. It is misleading to even suggest to creditors that the debtor may invoke section 1129(b) without an explanation. Thus, in every case in which the debtor states or suggests that "cram down" is contemplated, the United States Trustee should analyze the legal issue and formulate a judgment as to the availability of "cram down" under the circumstances. If the United States Trustee questions the availability of "cram down," an objection to the disclosure statement should be made. The remedy may be deletion or the inclusion of an explanation of the legal issues involved.

Moreover, the disclosure statement should include a statement to the effect that, if a senior class of creditors rejects the plan, the court may find that the junior class (or classes) may not receive a distribution under the plan or retain its interests in the reorganized debtor unless it satisfies the "new value exception" which would require that the junior class (or classes) contribute value to the debtor that is new, substantial, money, or money's worth; necessary for a successful reorganization; and in an amount reasonably equivalent to the value of the interest or distribution that it is retaining or receiving. *Bank of America v. 203 N. LaSalle St. Partnership*, 526 U.S. 434, 143 L.Ed.2d 607, 119 S Ct. 1411, 1415 - 1424 (1999); *In re Brotby*, 303 B.R. 177, 194 (9th Cir. BAP 2003); *In re One Times Square Assocs. Ltd. Partnership*, 159 B.R. 695, 706-08 (Bankr. S.D.N.Y. 1993).

3-11.3.23 Miscellaneous Matters

The disclosure statement should identify the leases or executory contracts being assumed or rejected under the plan. To the extent a lease or executory contract is being rejected, a claim for damages may arise. An estimate of these damage claims should be set forth and factored into the estimated amount of claims in each class.

The disclosure statement should set forth any default provisions under the plan and the consequences attendant to a default. For example, a default could trigger an acceleration of the total future payments under the plan or an immediate conversion to chapter 7.

3-11.3.24 Summary and Table of Contents

If the disclosure statement is voluminous, the inclusion of a table of contents and a brief summary of the plan, of alternatives to the plan, and of the debtor's future prospects may be appropriate.

3-11.3.25 Notice

The notice of the hearing on a disclosure statement must be sent to all creditors. Fed. R. Bankr. P. 2002(b)(1). This may be only a one-page notice and need not include the proposed disclosure statement. The notice should indicate that copies are available, if requested, and that the original is on file with the court.

After a disclosure statement is approved, it must be sent to all creditors along with the plan, a ballot, and the order approving the disclosure statement. That order should indicate the date by which ballots must be received, the persons to whom they must be sent, the date of the confirmation hearing, and the date by which any objections to confirmation must be filed.

On the subject of notice, *see* Fed. R. Bankr. P. 3017(d) (giving the court discretion to direct that disclosure statements, plans, and notices of time for filing ballots not be sent to unimpaired classes of creditors or equity security holders); *In re Douglas Hereford Ranch, Inc.*, 76 B.R. 781, 783 (Bankr. D. Mont. 1987) (the affirmative vote of one impaired class was necessary to invoke cram down; deemed acceptance was not enough); *In re Russell*, 44 B.R. 452, 453 (Bankr. E.D.N.C. 1984) (the deemed acceptance of an unimpaired class is different from the affirmative acceptance of an impaired class required by section 1129(a) (10)). The United States Trustee should ensure that classes are described properly so that adequate notice is given.

3-11.4 PLAN MODIFICATION

The plan proponent may wish to modify the plan either prior to or after confirmation. 11 U.S.C. § 1127. To the extent that the change is not a

"material" modification, additional disclosure and a re-solicitation may not be necessary. *See* 11 U.S.C. § 1127(c) and the legislative history. Obviously, any downward change in the amount of distribution or the payment schedule would constitute a material modification requiring a re-solicitation. Such a procedure may be in the form of a "negative solicitation," i.e., members of the class may be given an opportunity to change their vote, vote if they had not already done so, or do nothing and have their vote counted as originally cast. The United States Trustee should review any modification and make such recommendation to the court as is appropriate.

3-11.5 REVIEW OF PLAN AND CONFIRMATION

The United States Trustee should review the plan to determine that it meets the requirements of section 1129. Confirmation issues that may concern the United States Trustee include: the inappropriate classification of claims and interests; administrative solvency or insolvency (whether the administrative and priority claims can be paid in full or properly deferred); a request for discharge in contravention of section 1141(d); inappropriate exculpatory clauses releasing professionals and disbursing agents from liability beyond the scope of section 1125(e); the bonding of escrow or disbursing agents where the absence of a bond casts doubt on whether the plan provides adequate means for its implementation; and ensuring that the plan includes a provision for payment of any outstanding quarterly fees on the effective date of the plan and for the payment of post-confirmation quarterly fees. Objections premised upon lack of feasibility should be filed in cases where a debtor's financial projections are totally unrealistic, as, for example, if unsupported by experience of the entity or the industry. The United States Trustee should also review the plan to determine if it contains provisions for the release of, or injunctions in favor of, guarantors, partners, or non-debtor entities in contravention of 11 U.S.C. § 524(e). *See In re Continental Airlines*, 203 F.3d 203 (3rd Cir. 2000) (plan_s broad release of claims against non-debtor shareholders violated section 524(e)); *In re PWS Holding Corp.*, 228 F.3d 224, 247 - 247 (3rd Cir. 2000) (release provisions in plan which purported to insulate committee members and professionals from any liability except willful misconduct or gross negligence did not violate section 524(e)); *In re Zenith Electronics Corp.*, 241 B.R. 92 (Bankr. D. Del. 1999), and *In re Genesis Health Ventures, Inc.*, 266 B.R. 591 (Bankr. D. Del. 2001).

While the United States Trustee has the discretion to file objections to confirmation, confirmation issues should generally be left to creditors after full and fair disclosure, absent exceptional circumstances. If creditors are not active or are unrepresented, as when a committee could not be appointed, the United States Trustee's role is more important. *In re South Beach Securities, Inc.*, 606 F.3d 366 (7th Cir. 2010).

On occasion, the plan proponent may seek to modify the plan or to change the ballot tabulation at the hearing on confirmation. Careful consideration should be given to such last-minute changes to ensure compliance with the requirements contained in the Bankruptcy Code and Rules.

3-11.6 POST-CONFIRMATION MONITORING

After confirmation of the plan, the reorganized debtor is required to "file such reports as are necessary or as the court orders." 11 U.S.C. § 1106(a)(7). If no such reports are required by local rule or guideline, the United States Trustee should require the reorganized debtor to file and serve post-confirmation reports on a periodic basis – monthly or quarterly – sufficient for the United States Trustee to determine the amount of the debtor's receipts and disbursements and to collect all post-confirmation quarterly fees that are owing. In addition, the reports should contain sufficient information for the United States Trustee to determine whether the reorganized debtor has substantially consummated the plan and whether the debtor is entitled to a final decree pursuant to 11 U.S.C. § 350 and Fed. R. Bankr. P. 3022. If necessary, the United States Trustee should interpose an objection to the plan of reorganization to require such reporting, along with appropriate language to confirm the reorganized debtor's continued obligation to pay quarterly fees until case dismissal, conversion, or closure.

The United States Trustee should review all final reports and motions for final decrees filed in chapter 11 cases and object if appropriate. In cases where no such pleadings have been submitted, the United States Trustee should monitor the progress of the case and initiate action to compel the filing of a final report once the case has been fully administered.

Often parties in interest may move to dismiss or convert a confirmed case. "Cause" sufficient to establish grounds for conversion or dismissal listed under 11 U.S.C. § 1112(b) includes the inability to effectuate substantial consummation of a confirmed plan (section 1112(b)(4)(M)) and material default by the debtor with respect to a confirmed plan (section 1112(b)(4(N)). It is clear that the courts retain jurisdiction to hear such motions post-confirmation. The United States Trustee may be requested to state his/her position at such hearings or file his or her own motion if the debtor has failed to progress toward completing the administration of the case.

The United States Trustee should review carefully the reported decisions within the applicable jurisdiction, if any, as the courts are divided over whether dismissal or conversion is the appropriate remedy in such situations. Some courts hold that, unless the plan or order of confirmation provides otherwise, the property permanently revests in the reorganized debtor and, absent revocation pursuant to 11 U.S.C. § 1144, dismissal is the appropriate remedy since a chapter 7 trustee would have no estate property to administer for the benefit of creditors.

Before taking a position, the United States Trustee also should review the plan and disclosure statement, order of confirmation, and the reorganized debtor's post-confirmation reports, if any. The United States Trustee also should determine whether any post-confirmation fees are owing and consider whether case closure is preferable to dismissal or conversion.

To the extent that the United States Trustee becomes aware of cause to revoke the order of confirmation pursuant to section 1144, the United States Trustee should pursue such action. For example, if there is a material misrepresentation in the disclosure statement discovered within six months after confirmation or there was a concealment of assets, the United States Trustee should move to revoke confirmation. Revocation of confirmation requires the filing of an adversary complaint and a specific showing of fraud. Special considerations for post-confirmation monitoring of chapter 11 cases filed by individuals are discussed in Manual 3-12.

3-11.7 CASE CLOSURE UNDER SECTION 350(a) AND RULE 3022

Section 350(a) provides that: "After an estate is fully administered and the court has discharged the trustee, the court shall close the case." Fed. R. Bankr. Proc. 3022 provides that "After an estate is fully administered in a chapter 11 reorganization case, the court, on its own motion or on motion of a party in interest, shall enter a final decree closing the case." The Advisory Committee Note to the Rule provides, in pertinent part: "Entry of a final decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been completed. Factors that the court should consider in determining whether the estate has been fully administered include (1) whether the order confirming the plan has become final, (2) whether deposits required by the plan have been distributed, (3) whether the property proposed by the plan to be transferred has been transferred, (4) whether the debtor or the successor of the debtor under the plan has assumed the business or the management of the property dealt with by the plan, (5) whether payments under the plan have commenced, and (6) whether all motions, contested matters, and adversary proceedings have been finally resolved." This is not the same as substantial consummation under section 1101(2). Entry of the final decree is an administrative event and does not determine substantive rights of parties in interest. *In re Greater Jacksonville Transp. Co.*, 169 B.R. 221 (Bankr. M.D. Fla. 1994).

United States Trustees should not oppose closing of cases once the factors listed above have been satisfied. On the other hand, United States Trustees should oppose efforts to close cases prematurely.

CHAPTER 3-12: CHAPTER 11 CASES FILED BY INDIVIDUALS

3-12.1 SPECIAL CONSIDERATIONS FOR CASES FILED BY INDIVIDUALS

The BAPCPA included a number of provisions that materially changed how chapter 11 applies to individual debtors. Note that the SBRA includes many provisions that change how a case of an individual under Subchapter V of chapter 11 will be administered. See Manual chapter 3-17 for a discussion of the relevant provisions of Subchapter V. Accordingly, the following chapter 3-12 should be applied only to chapter 11 cases of individuals who have not elected the application of Subchapter V.

3-12.1.1 Property of the Estate Includes After-Acquired Wages and Property

Property of the estate for individual chapter 11 debtors is different from property of the estate for individual chapter 7 debtors. Pursuant to 11 U.S.C. § 1115, property of the estate for an individual chapter 11 debtor includes, in addition to property described in 11 U.S.C. § 541, the debtor's post-petition income from personal services and other property obtained post-petition. The United States Trustee should be alert to this difference and make certain that all property is fully identified.

3-12.1.2 Funding a Plan with Post-Petition Earnings

Section 1123(a)(8) states that a plan that is filed in a case in which the debtor is an individual must "provide for the payment to creditors under the plan of all or such portion of earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan."

This section was added by the BAPCPA in 2005 to require that an individual debtor whose plan calls for periodic payments to creditors dedicate sufficient earning from personal services to enable the debtor to make those payments. In this regard, the section operates very similarly to 11 U.S.C. 1322 in chapter 13 cases. If an individual chapter 11 plan calls for periodic payments and does not comply with this requirement, the United States Trustee should object to the plan. *See* Manual 3-12.1.4 for further discussion of the disposable income test in individual chapter 11 cases.

3-12.1.3 Plan Confirmation Requires Debtor to Pay All Post-Petition Domestic Support Obligations in Full

Under § 1129(a) (14), as a condition of plan confirmation, individual chapter 11 debtors must have paid all post-petition amounts required by a judicial or administrative order, or by statute, for domestic support obligations. "Domestic support obligation" is defined in section 101(14A) to be "in the nature of alimony,

maintenance, or support...of [a] spouse, former spouse, or child of the debtor or such child's parent. . .," without regard to whether such debt is expressly so designated.

Section 1129(a) (14) thus requires that the individual debtor have paid all domestic support obligations that accrue post-petition. Pre-petition arrearages may be paid over the term of the plan in accordance with section 1129(a)(9)(B). Therefore, United States Trustees should object to confirmation if all post-petition domestic support obligations have not been paid in full.

3-12.1.4 Debtors Must Meet Disposable Income Test if Unsecured Creditor Objects to Confirmation

The BAPCPA imposed the "means test" on individuals in chapter 7 and chapter 13. Chapter 11 was amended to import a form of the means test into the requirements for the confirmation of a plan for an individual debtor. Section 1129(a) (15) provides that, if "the holder of an allowed unsecured claim objects to the confirmation of" an individual debtor's chapter 11 plan, the court cannot confirm the plan unless:

> "(A) the value, as of the effective date of the plan, of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
>
> (B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor (as defined in section 1325(b)(2)) to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer."

11 U.S.C. § 1129(a) (15).

Confirmation of a plan is conditioned upon compliance with section 1129(a) (15) only if the holder of an allowed unsecured claim objects to confirmation. In the absence of such an objection, the "means test" plainly will not be a barrier to confirmation.

Because the United States Trustee is not a "holder of an allowed unsecured claim," the United States Trustee does not have standing to object to confirmation of a plan based upon the means test. Moreover, the United States Trustee should not attempt to raise the means test objection indirectly by objecting under the good faith requirement of section 1129(a)(3).

Instead, the United States Trustee should consider objecting to the adequacy of the disclosure statement if it does not contain adequate information to enable unsecured creditors to determine whether to raise a means test objection. If the disclosure statement and plan are considered at the same hearing, the United

States Trustee should clearly indicate that the objection is to disclosure, not to confirmation.

Nevertheless, if a party with standing files an objection triggering the means test issue, the United States Trustee, pursuant to 11 U.S.C. § 307 and 28 U.S.C. § 586(a)(3)(B), may comment on and be heard on whether the debtor's plan meets the requirements of section 1129(a)(15) (B).

Section 1129(a) (15) (B) requires that the plan provide for distributions to creditors in an amount not less than the debtor's projected disposable income over the time period during which plan payments are to be made. See 11 U.S.C. § 1129(a)(15) (B). In considering whether a plan complies with the means test once a party with standing triggers section 1129(a) (15), the United States Trustee must bear in mind that the debtor is not required to make periodic payments to his unsecured creditors. Instead, the test requires that the value of the property to be distributed to the unsecured creditors equal at least the amount of the debtor's projected disposable income for the longer of five years or the period for which the plan provides payments. Thus, if the plan calls for unsecured creditors to receive assets from sources other than the debtor's income, such as the proceeds of a property sale, the value of those assets must be considered in determining whether the means test is met.

Section 1129(a) (15) (B) refers to the "projected disposable income of the debtor (as defined in section 1325(b)(2))."[11] Despite the BAPCPA's intent to treat individual chapter 11 and chapter 13 debtors similarly, the calculation of "disposable income" for purposes of determining the debtor's "projected disposable income" is different in a chapter 11 case than in a chapter 13 case. Section 1129(a) (15) (B) specifically refers to section 1325(b)(2), which defines "disposable income" as current monthly income less amounts reasonably necessary to be expended for the support and maintenance of the debtor and the debtor's dependents and charitable contributions. Section 1325(b)(3), which is not specifically referred to in section 1129(a) (15) (B), provides that the amounts reasonably necessary to be expended under section 1325(b)(2) will be determined in accordance with the means test provisions of section 707(b). Although section 1129(a) (15) (B)'s reference solely to section 1325(b)(2) could imply the application of section 1325(b)(3), an alternative reading of the Code prevailed in the rule-making process.

In particular, Bankruptcy Rule 1007(b)(5) states that "an individual debtor in a chapter 11 case shall file a statement of current monthly income, prepared as prescribed by the appropriate Official Form." Fed. R. Bankr. P. 1007(b)(5). This Rule reflects the drafters' interpretation that, although current monthly

---

[11]Section 1325(b)(2) refers to "disposable income." Section 1325(b)(1)(B), which is not included in section 1129(a)(15)(B), refers to "*projected* disposable income."

income is to be calculated in conformity with the chapter 13 means test, amounts reasonably necessary to be expended are to be determined by the court on a case-by-case basis. The United States Trustee should take no position if a party in interest questions the interpretation of these provisions reflected in Rule 1007(b)(5).

Notwithstanding the difference in the calculation of "disposable income," the phrase "projected disposable income" in chapter 11 should be interpreted consistently with the Program's position in the context of chapter 13 plan confirmation, as adopted by the Supreme Court. *See Hamilton v. Lanning*, 560 U.S. 505 (2010).

3-12.1.5 Modification of Cram Down Standards for Individual Chapter Debtors

In 2005, section 1129(b)(2)(B)(ii) was amended to allow individual debtors to retain property "included in the estate under section 1115" and still satisfy the "fair and equitable" requirement for cram down as long as the debtor's plan pays all post-petition domestic support obligations as required for confirmation by section 1129(a) (14). Although courts were initially divided on whether this provision abrogates the absolute priority rule in individual chapter 11 cases, the majority, including every circuit that has considered the issue, have held that this provision did not implicitly repeal the absolute priority rule for individual chapter 11 debtors. *Zachary v. Cal. Bank & Tr. (In re Zachary)*, 811 F.3d 1191 (9th Cir. 2016); *Ice House Am., LLC v. Cardin (In re Cardin)*, 751 F.3d 734 (6th Cir. 2014); *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *Dill Oil Co., LLC v. Stephens (In re Stephens)*, 704 F.3d 1279 (10th Cir. 2013); *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *contra SPCP Group, LLC v. Biggins*, 465 B.R. 316 (M.D. Fla. 2011); *In re Roedemeier*, 374 B.R. 264 (Bankr. D. Kan. 2007); In re Tegeder, 369 B.R. 477 (Bankr. D. Neb. 2007); *In re Bullard*, 358 B.R. 541 (Bankr. D. Conn. 2007). Thus, in most jurisdictions, debtors may not retain any pre-petition property over the dissenting votes of an unsecured class of creditors.

Absolute priority rule considerations are often complicated and may depend upon case specific facts. Creditors are in a better position to address these issues directly with plan proponents. As a result, the United States Trustee should not take a position on this issue at the time of plan confirmation. Instead, the United States Trustee should consider objecting to the adequacy of the disclosure statement if it does not contain adequate information to enable unsecured creditors to understand their rights. *See In re Ferguson*, 474 B.R. 466, 477 (Bankr. D.S.C. 2012) (denying approval of a disclosure statement that did "not provide adequate information with respect to the absolute priority rule").

3-12.1.6 An Individual Chapter 11 Debtor Does Not Receive a Discharge until after All Plan Payments Have Been Completed

Generally, pursuant to section 1141(d)(5), the plan payments must be completed before an individual chapter 11 debtor receives his or her discharge. The United States Trustee should closely scrutinize efforts by individual chapter 11 debtors to obtain a discharge before they have completed the payments called for by their plans. Specifically, the court may grant an early discharge after notice and a hearing "for cause," section 1141(d)(5)(A), or if unsecured creditors have received at least as much as they would have in chapter 7 and modification of the plan under section 1127 is impracticable. 11 U.S.C. § 1141(d)(5)(B). The inclusion of language in a proposed plan providing for an immediate discharge upon confirmation does not meet these requirements and is objectionable. Upon the filing of a motion for early discharge, courts should require that debtors provide evidence establishing cause to depart from Congressional intent that debtors receive their discharge only upon the completion of plan payments.

3-12.1.7 The Plan Can Be Modified Post-Confirmation

Pursuant to section 1127(e), the plan of an individual chapter 11 debtor can be modified at any time after confirmation on request of the debtor, the trustee, the United States Trustee, or the holder of an allowed unsecured claim in order to: increase or decrease the amount of payments on claims in a particular class, extend or reduce the time period for payments, or alter the amount of distribution to a creditor who has received payments outside of the plan. The United States Trustee should be alert to and monitor any such motion to alter plan payments to ensure that any proposed modification satisfies section 1127(e).

3-12.1.8 Individual Debtor Can Be a Small Business Debtor at the Same Time

Because of the many special rules affecting small business chapter 11 cases, it is important that United States Trustees understand that an individual chapter 11 debtor can, at the same time, also be a small business debtor. Therefore, when staff ensures that all small business debtors are identified, United States Trustees should ensure that staff understands that individual debtors are not automatically excluded from such analysis, and can be small business debtors.

3-12.2 PRE-CONFIRMATION MONITORING OF CHAPTER 11 CASE FILED BY AN INDIVIDUAL

Among the United States Trustees' most important duties is to monitor pending chapter 11 cases without confirmed plans to ensure compliance with the Bankruptcy Code and to take appropriate action when debtors show that they are unable or unwilling to discharge their fiduciary duties. While some cases warrant the appointment of a chapter 11 trustee, the appropriate remedy for debtor

misconduct is most often conversion or dismissal of the case under section 1112(b). Nothing in the BAPCPA relieves United States Trustees of the obligation to conduct pre-confirmation monitoring. In fact, the statute affirmatively requires United States Trustees to file conversion or dismissal motions if material grounds for such relief exist. 28 U.S.C. § 586(a)(8).

In evaluating whether grounds exist for conversion or dismissal of individual chapter 11 cases, United States Trustees must consider the impact of section 1115, added by the BAPCPA. Under section 1115, an individual chapter 11 debtor's post-petition income from personal services, like that of a chapter 13 debtor, is property of the estate.

Since section 1115(a)(2) makes an individual chapter 11 debtor's income from personal services property of the estate, questions have arisen over what, if any, authorization the debtor must seek to pay ordinary living expenses. Section 363(c) authorizes the trustee, which would include the debtor as debtor in possession, to use estate property in the ordinary course of business if the trustee is authorized to operate the debtor's business. 11 U.S.C. § 363(c). Because an individual's ordinary living expenses are not business expenses, at best section 363(c) provides an uncertain basis for the debtor to use estate property to pay living expenses.

Some have therefore suggested that individual chapter 11 debtors should be required to submit and comply with a budget for the period between the filing of the case and confirmation of a plan. Nothing in the Bankruptcy Code or Bankruptcy Rules provides for such a procedure. Section 1115(b) provides that "except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate." Section 1306 of the Bankruptcy Code contains almost identical provisions to section 1115, and there is no case law questioning the ability of a chapter 13 debtor to pay living expenses from current income. It is possible to infer from these provisions Congressional intent to allow individual debtors to use estate property to pay ordinary living expenses, as the right to possess the property has no value without the right to use it.

Because of this legal uncertainty, United States Trustees should not take steps to impose budgetary requirements on individual chapter 11 debtors. In appropriate cases, debtors may be advised at initial debtor interviews that fiscal discipline will be necessary for any proposed plan of reorganization to meet feasibility and confirmation requirements imposed by the Code. In all cases, monthly operating reports should be carefully monitored for evidence of profligate expenditures of estate assets. Importantly, if evidence of unusual and unjustified spending arises, the United States Trustee should seek an appropriate remedy, such as conversion or dismissal. *See, e.g.*, 11 U.S.C. § 1112(b)(4)(A) and (B) (substantial and continuing loss to or diminution of the estate without a reasonable likelihood of reorganization, and/or gross mismanagement of the estate).

3-12.3 CLOSURE OF CHAPTER 11 CASE FILED BY AN INDIVIDUAL

Under 28 U.S.C. § 1930(a)(6), quarterly fees must be paid to the United States Trustee until a chapter 11 case is "converted or dismissed." While the statute does not list case closing as an event that will stop the accrual of fees, the United States Trustee Program has consistently taken the position that the closing of the case does have that effect. Since the passage of the BAPCPA, many debtors and courts have sought to close individual chapter 11 cases even though a discharge has not been granted. These efforts are clearly designed to stop the accrual of quarterly fees during the term of the plan, which could extend for five years or more. The debtors propose to reopen the cases once all payments have been made so that the court can grant them their discharge under section 1141(d)(5)(A).

It is appropriate for United States Trustees not to object to requests by individual chapter 11 debtors with confirmed plans to close their cases before discharge, subject to reopening for the entry of a discharge upon the completion of plan payments under section 1141(d)(5)(A), if the estate has been fully administered as described below, any trustee has been discharged, and the eventual discharge hearing is the only business remaining before the court. United States Trustees should conduct the same analysis in individual and business chapter 11 cases when determining whether to object to a request to close the case, regardless of whether the debtor receives a discharge. In no event, however, should the United States Trustee be a proponent of closing individual chapter 11 cases, because the decision to close better resides in the debtor, subject to objection by parties in interest and adjudication by the court.[12]

The analysis begins with the language of section 350(a): "After an estate is fully administered and the court has discharged the trustee, the court shall close the case." 11 U.S.C. § 350(a). Because very few chapter 11 cases have trustees, the case can be closed once the estate has been fully administered. Bankruptcy Rule 3022 provides that "after an estate is fully administered in a chapter 11 reorganization case, the court, on its own motion or on motion of party in interest, shall enter a final decree closing the case." Fed. R. Bankr. P. 3022. The Advisory Committee Notes to the Rule are instructive:

> Entry of a final decree closing a chapter 11 case should not be delayed solely because the payments required by the plan have not been

---

[12] *See Shotkoski v. Fokkena (In re Shotkoski)*, 420 B.R. 479 (B.A.P. 8th Cir. 2009) (holding that bankruptcy courts are charged with reviewing case closing requests on a case-by-case basis to determine whether the estate has been fully administered). The *Shotkoski* court found that the bankruptcy court has broad discretion to allow or disallow the closing of a case before discharge based on the facts and circumstances of the case. In affirming the bankruptcy court's order denying the individual debtors_ motion to close the case, the panel clarified that "we are *not* holding that every individual Chapter 11 case must remain open until such time as all long-term payments have been completed and a discharge is entered." 420 B.R. at 483 (emphasis in original).

> completed. Factors that the court should consider in determining whether the estate has been fully administered include (1) whether the order confirming the plan has become final, (2) whether deposits required by the plan have been distributed, (3) whether the property proposed by the plan to be transferred has been transferred, (4) whether the debtor or the successor of the debtor under the plan has assumed the business or the management of the property dealt with by the plan, (5) whether payments under the plan have commenced, and (6) whether all motions, contested matters, and adversary proceedings have been finally resolved.
>
> The court should not keep the case open only because of the possibility that the court's jurisdiction may be invoked in the future. A final decree closing the case after the estate is fully administered does not deprive the court of jurisdiction to enforce or interpret its own orders and does not prevent the court from reopening the case for cause pursuant to § 350(b) of the Code.

Fed. R. Bankr. P. 3022, Advisory Committee Note (1991).

The drafters of the committee notes advised against keeping a chapter 11 case open because the court's jurisdiction could possibly be invoked in the future. An exhaustive search of reported authorities reveals no cases holding that a bankruptcy case must remain open because a debtor might receive a discharge in the future. The Code specifically provides that "a case may be reopened . . . to accord relief to the debtor," section 350(b), which presumably includes the entry of a discharge if the requirements of section 1141(d)(5) are met. Further, a payment default will now prevent the individual debtor from receiving a discharge.

Other Code provisions also contemplate the prospect of invoking the court's jurisdiction in the future but do not prevent case closing if the estate has been fully administered. For example, under the BAPCPA, the confirmed plan in an individual chapter 11 case is subject to modification after substantial consummation but before the completion of payments under the plan. 11 U.S.C. § 1127(e). The possibility that the debtor or another party in interest might seek to modify the plan post-consummation is not so certain that courts should keep these cases open when the estates have otherwise been fully administered. Similarly, chapter 11 cases are not kept open solely to await the expiration of the 180-day period during which a party in interest may seek revocation of confirmation. 11 U.S.C. § 1144. By analogy, chapter 7 cases are also routinely closed well before the expiration of the one-year period during which a revocation of discharge may be sought for fraud. 11 U.S.C. § 727(e)(1). Cases may be reopened under section 350(b) if and when circumstances warrant.

For these reasons, United States Trustees should not object to an individual chapter 11 debtor's request to close the case before discharge once the estate has been fully administered and the court has discharged any trustee. However, a

number of case-specific factors should be carefully considered any time an individual chapter 11 debtor makes such a request:

1. Disclosure statements and plans should clearly set out the debtor's intention to seek to close the case before the discharge, and should specify the time when the debtor anticipates the case might be reopened for the grant of a discharge;

2. Plans should subject debtors to clear, enforceable payment obligations. For instance, a plan that simply provides that a debtor will sell property and distribute proceeds to creditors should be scrutinized. A timetable for the sales and payments and appropriate reporting should be included. Creditors should not have to guess whether a debtor has defaulted under a confirmed plan;

3. Cases should not be closed until the estate has been fully administered. In deciding whether to object to a proposed closing, United States Trustees should be guided by the factors outlined in the notes to Rule 3022, including the vesting of property of the estate in the reorganized debtor or another entity under section 1141(b), the commencement of plan payments (e.g., providing notes on the effective date that are payable in the future will not satisfy this requirement), the payment of all quarterly fees, and the resolution of all pending adversary proceedings, contested matters, and other issues before the court;

4. Courts should not mechanically allow closure of a case upon substantial consummation. Substantial consummation, as defined in section 1101(2), is not the same thing as the full administration of the estate under section 350(a). For instance, a plan might be substantially consummated even though multiple appeals related to the case are pending and the court has not yet ruled on claims challenges. The case should not be closed until these pending matters are resolved;

5. Even if the chapter 11 estate has been fully administered, the United States Trustee should not affirmatively seek to close the case before discharge. Once the case is closed, individual debtors lose the protections of the automatic stay without the benefit of the discharge injunction. 11 U.S.C. § 362(c)(2)(A). Nevertheless, both the debtor and creditors are bound by the confirmed plan, and creditors cannot undertake collection activities as long as the debtor complies with the plan. 11 U.S.C. § 1141(a);

6. The clerk must give notice to all parties in interest if an individual's case is closed without the entry of an order of discharge. Fed. R. Bankr. P. 4006. The notice should accurately reflect the status of the case and not mislead creditors into believing they may pursue immediate collection of the full amount of their allowed claims; and

7. Courts should adopt procedures for individual chapter 11 debtors seeking to reopen their cases to obtain a discharge after the completion of plan

payments under section 1141(d)(5)(A). Those procedures should require that the debtor file a motion with the court under section 350(b) and serve all parties in interest. The motion should be accompanied by a detailed accounting demonstrating that the debtor has made all payments called for under the confirmed plan. Parties should have sufficient time to object to the motion, and the court should treat any objection to the motion or accounting as a contested matter under Fed. R. Bankr. P. 9014, with the debtor bearing the burden of establishing entitlement to a discharge.

CHAPTER 3-13: PRE-PETITION ACCEPTANCE OR REJECTION OF THE PLAN

The term "prepackaged bankruptcy" (prepack) appears nowhere in the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure. Nevertheless, the prepack is an established and legal device for expediting a chapter 11 case. In a prepack, the debtor negotiates and drafts a plan of reorganization before filing a petition. It then circulates the plan with a disclosure statement and a ballot to creditors and, if appropriate, to equity security holders. Parties who have been solicited are given time to review the plan and disclosure statement and to vote. If the debtor obtains sufficient acceptances to confirm the plan under the Bankruptcy Code, the debtor files a chapter 11 petition and simultaneously files the plan, the disclosure statement, the ballots, and a pleading seeking confirmation of the plan.

In other words, the essential element of the prepackaged plan is the solicitation of the plan acceptances prior to the debtor's commencement of its chapter 11 case. Having successfully solicited plan acceptances on a pre-petition basis, the debtor can then commence its chapter 11 case and proceed almost directly to a hearing on confirmation of its proposed plan, submitting the pre-petition acceptances as permitted by section 1126(b).

The concerns of the United States Trustee in connection with such a procedure include compliance with Bankruptcy Rule 6003 and other related statutes, inclusion of KERP Plans, and other improper distributions.

3-13.1 STATUTORY FRAMEWORK: 11 U.S.C. § 1126(b) and BANKR. RULE 3018(b)

Subsection 1126(b) is designed to further the concept that the existence of the Bankruptcy Code provides not only an incentive for an out-of-court workout, but also a template against which a debtor and its creditors can negotiate a reorganization plan. Subsection 1126(b) must be read in conjunction with Fed. R. Bankr. Proc. 3018(b), which relates to acceptances and rejections obtained pre-petition.

The debtor's goal in filing a prepack is to obtain confirmation of a plan as soon as possible. Section 1126(b) authorizes the court to consider pre-filing acceptances and rejections of a plan under certain circumstances:

> "(b) For the purposes of subsections (c) and (d) of this section, a holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if —
>
> (1) the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or
>
> (2) if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information, as defined in section 1125(a) of this title."

11 U.S.C. § 1126(b). If a debtor has gathered sufficient acceptances during its pre-petition solicitation, the case can proceed straight to a confirmation hearing without the delay normally caused by the requirement that a disclosure statement be approved and submitted to stakeholders before their acceptances are solicited.

Federal Rule of Bankruptcy Procedure 3018(b) establishes procedures to be followed by the court in determining whether pre-petition acceptances or rejections of a plan should be considered in connection with a confirmation hearing. It provides:

> (b) *Acceptances or Rejections Obtained Before Petition.* An equity security holder or creditor whose claim is based on a security of record who accepted or rejected the plan before the commencement of the case shall not be deemed to have accepted or rejected the plan pursuant to § 1126(b) of the Code unless the equity security holder or creditor was the holder of record of the security on the date specified in the solicitation of such acceptance or rejection for the purposes of such solicitation. A holder of a claim or interest who has accepted or rejected a plan before the commencement of the case under the Code shall not be deemed to have accepted or rejected the plan if the court finds after notice and hearing that the plan was not transmitted to substantially all creditors and equity security holders of the same class, that an unreasonably short time was prescribed for such creditors and equity security holders to accept or reject the plan, or that the solicitation was not in compliance with § 1126(b) of the Code.

The requirement that the pre-petition solicitation be directed to "substantially all" of the creditors or equity security holders of a particular class in order for the pre-petition votes from that class to be considered in connection with confirmation has two implications. First, a plan proponent cannot "cherry-pick" a class by sending out solicitations to only those holders of claims or interests who are

amenable to the plan's provisions.[13] Second, and somewhat less obviously, this rule permits "partial prepacks," or cases where one or more classes of claims or interests are solicited pre-petition and the remaining classes are solicited after the post-petition approval of a disclosure statement. In the case of a partial prepack, the court will consider both pre-petition and post-petition acceptances in determining whether a plan should be confirmed.

A prepack must be contrasted with a "pre-negotiated" case. A pre-negotiated case has been described as:

> A reorganization or restructuring that is, prior to the commencement of bankruptcy, (1) negotiated with representatives of the most significant constituencies that are expected to be impaired and whose acceptance is sought or needed for confirmation (i.e., the senior lenders, bondholders, and principal equity security holders), (2) agreed to by those representatives (even if those representatives, by themselves, are not sufficient in number or amount to assure acceptance of the particular classes of debt that they represent), and (3) memorialized in written agreements containing the basic terms of a reorganization plan.

"*Out-of-Court Workouts, Prepacks and Pre-Arranged Cases: A Primer,*" 24-APR Am. Bankr. Inst. J. 16 (2005).

In a pre-negotiated case, no actual pre-petition solicitation occurs; votes are solicited only after the court approves a disclosure statement under section 1125.

3-13.2: SECTION 341 MEETINGS IN PRE-PACKAGED CHAPTER 11 CASES

Section 341(e) provides:

> Notwithstanding subsections (a) and (b), the court, on the request of a party in interest and after notice and a hearing, for cause may order that the United States trustee not convene a meeting of creditors or equity security holders if the debtor has filed a plan as to which the debtor solicited acceptances prior to the commencement of the case.

The United States Trustee will be confronted with two significant issues in connection with section 341(e):

1. In what cases may the court order that a section 341(a) meeting not be held?
2. Under what circumstances should the United States Trustee oppose a motion filed under section 341(e)?

---

[13]Under 11 U.S.C. § 1126(c) and (d), whether a class of claims or interests has accepted a plan is determined based upon the votes actually cast for acceptance or rejection; it is therefore vital that all or virtually all members of a class be given the opportunity to vote on a proposed plan.

Section 341(e), by its terms, applies to a case where "the debtor has filed a plan as to which the debtor solicited acceptances prior to the commencement of the case." This can be broken down into two requirements. First, the debtor must have filed a plan either before or simultaneous with the filing of the motion seeking the section 341 meeting waiver. Determining whether this requirement has been met should not cause any difficulty. Second, the debtor must have solicited acceptances of the plan prior to the commencement of the case. The party in interest seeking the section 341 waiver, which is most likely the debtor, should detail its pre-petition solicitation efforts in the motion. To use the categories discussed above, a waiver motion would be appropriate in a prepack. It would not be appropriate in a partial prepack or pre-negotiated case, and United States Trustees should be alert to efforts by debtors to avoid a section 341 meeting by mis-characterizing pre-petition negotiations as pre-petition solicitations.

When a § 341(e) motion is filed in a prepackaged case, the United States Trustee should notify the Office of the General Counsel when there is a question as to the appropriateness of the relief requested. Section 341(e) requires that the court find "cause" to order the United States Trustee not to convene a section 341 meeting. While the movant will have the burden to establish cause, it is likely that a routine section 341(e) motion will become part of the first day motions filed in a prepack. The report of the National Bankruptcy Review Commission gives a road map as to what might constitute cause in a prepack. First, debtors are likely to allege that creditors would receive no significant benefit from a section 341 meeting when they have negotiated and voted on the plan before the filing. Second, debtors will allege that holding a section 341 meeting will unnecessarily delay confirmation of the plan.

A request to waive the section 341 meeting will often be included as part of a motion to schedule a combined hearing on the disclosure statement and confirmation of the plan. If the waiver of the section 341 meeting is appropriate, it is important that the waiver be conditioned on confirmation of the prepackaged plan occurring by a date certain. If the court does not confirm the prepackaged plan by this date, then the United States Trustee should schedule and convene the section 341 meeting.

In a true prepackaged case, the combined hearing motion is typically heard on the first day of the case. This motion will seek to dispense with the requirement for a separate disclosure statement. The motion will claim that the disclosure statement is unnecessary because all creditors have either been solicited pre-petition or are unimpaired. In the true prepack, this request is rather routine and non-controversial. In a partial prepack or a pre-negotiated case, the United States Trustee should object to any requests to combine these hearings.

While the appropriate response of a United States Trustee to a section 341(e) motion will necessarily be based on the facts of each case, some general principles should be considered. First, when it appears that a debtor has fully solicited votes from all classes entitled to vote on a plan and is ready to proceed to

a confirmation hearing, the United States Trustee should consider not objecting to the motion. If, however, the United States Trustee becomes aware that constituencies in the case have not been solicited or that information in the pre-petition solicitation was incomplete or misleading, the United States Trustee should object to the motion.

As a general rule, but recognizing that each case must be determined on its facts and circumstances, a section 341(e) motion would not be appropriate in a partial prepack case. Entire classes of creditors or equity security holders will not have received formal information about the plan before the filing of the case, and the section 341 meeting will provide them the opportunity to examine the debtor's representative under oath.

3-13.3 CREDITORS' COMMITTEES IN PRE-PACKAGED CHAPTER 11 CASES

Section 1102 does not excuse the United States Trustee from the duty to appoint a creditors' committee in a prepackaged case. It is often the case, however, that a creditors' committee will not be appointed in a prepackaged case. The United States Trustee may in his or her discretion appoint a creditors' committee in a prepackaged case, assuming interest to serve from eligible creditors. The United States Trustee should object to any request to limit the United States Trustee's authority to appoint a committee.

3-13.4 POST-PETITION DISCLOSURE AND SOLICITATION

Section 1125(g) provides:

> Notwithstanding subsection (b), an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law.

This is a change to the Bankruptcy Code recommended by the National Bankruptcy Reform Commission. *See* NBRC Final Report, October 20, 1997, Recommendation 2.4.18. According to the commission, this provision would ameliorate some of the harsh consequences caused by the strict application to prepacks of the section 1125(b) prohibition against post-petition solicitation of acceptances without an approved disclosure statement. First, if a debtor had not quite completed a prepack solicitation but was forced into an involuntary filing by circumstances beyond its control, it would lose many of the advantages of the prepack and be returned to the "slower chapter 11 track." Second, this provision would prevent a small group of dissident creditors from seeking an unfair

bargaining advantage by threatening to derail a prepack solicitation by filing an involuntary petition against the debtor.[14] NBRC Final Report, at 596.

While section 1125(g) authorizes the post-petition solicitation of plan acceptances without an approved disclosure statement, it is important to recognize just how limited this exception to the general rule is. Each holder that is solicited post-petition must have been solicited pre-petition. If certain classes of creditors or equity security holders did not receive pre-petition solicitations, the plan proponent must have a disclosure statement approved by the court before it can solicit acceptances of the plan. Therefore, section 1125(g) is properly viewed as a "cleanup" provision enabling a plan proponent to contact parties in interest who have been solicited pre-petition and to urge them to get their votes in, and not as a major exception to the general disclosure statement requirement.

CHAPTER 3-14: SMALL BUSINESS CHAPTER 11 CASES

3-14.1 STATUTORY FRAMEWORK

The BAPCPA made several revisions to the treatment of small business debtors in chapter 11 cases. In general, these revisions reflected Congressional concerns that small business cases were experiencing excessive delays, that certain small business debtors were using chapter 11 to delay their creditors when they had no realistic prospect of reorganization, and that many small business estates were being depleted by chapter 11 professional fees.[15] Although relatively few published decisions have addressed small businesses under the BAPCPA, the small business provisions raise several developing legal issues of which United States Trustee Program staff should be aware.

Before 2005, the debtor could elect whether to be treated as a small business. Under the BAPCPA, such designation is mandatory and it is the duty of the debtor to self-designate in connection with the filing of the petition. If the debtor fails to do so, the United States Trustee should ensure that the proper designation takes place.

---

[14]Before the adoption of section 1125(g), the filing of an involuntary petition would stop the solicitation of votes for a prepack. Section 1125(b) prohibits the solicitation of acceptances or rejections of a plan without an approved disclosure statement "after the commencement of the case." The filing of an involuntary petition commences a case. 11 U.S.C. § 303(b). Under prior law, therefore, several creditors who were unhappy with how they were treated in a prepack could, by filing an involuntary petition, stop the prepack solicitation in its tracks. This course of action could engender significant additional delay and costs for the debtor.

[15]See 147 Cong. Rev. S 2018-03, at 2046-2047, 2051, 107th Cong., 1st Sess. (March 8, 2001) (Proceedings and Debates - Comments by Sen. Bond).

Note that this chapter 3-14 applies only to cases of small business debtors that do not elect to proceed under subchapter V of chapter 11. Cases under subchapter V are considered separately under Manual chapter 3-17.

The principal Code provisions affecting small business debtors are:

1. 11 U.S.C. § 101(51C) (defining a "small business case" as a chapter 11 case in which the debtor is a "small business" debtor and has not elected that subchapter V of chapter 11 will apply);
2. 11 U.S.C. § 1116 (establishing various reporting and disclosure requirements for small business debtors);
3. 11 U.S.C. § 1112(b)(4)(H) (providing that failure to file required reports is cause for conversion or dismissal of case);
4. 11 U.S.C. § 1121(e) (providing a 180-day exclusivity period for a small business debtor to file a plan, providing that the debtor's plan must be filed no later than 300 days from the petition date, and restricting the ability of debtor to seek extensions of these deadlines);
5. 11 U.S.C. § 1102(a)(3) (providing that no committee will be appointed in a small business case unless the court orders such an appointment for cause)[16]; and
6. 11 U.S.C. § 1125(f) (authorizing waiver or expedited consideration of the disclosure statement in a small business case)

There are additional provisions regarding small business cases set out in Fed. R. Bankr. P. 1020. These provisions include a requirement that small business debtors self-designate as such. Interim Bankruptcy Rule 1020 deletes references in Rule 1020 to committee appointments because of the SBRA amendments to the small business definition and to section 1102(a)(3).

3-14.2 DEFINITION OF A SMALL BUSINESS

A small business debtor is defined as a debtor that is engaged in commercial or business activities and has no more than $2,725,625[17] in non-contingent

[16]Note that the SBRA amended section 1102(a)(3) to limit committee appointments in small business and subchapter V cases unless the court orders such an appointment for cause.

[17]This figure applies to cases commenced on or after April 1, 2019. Section 104(b) provides that amounts are adjusted on a three-year basis to account for inflation.

liquidated secured and unsecured debt. 11 U.S.C. § 101(51D). More than 50 percent of the aggregate debt must have arisen from the commercial or business activities of the debtor. If the debtor's primary activity is the business of owning single asset real estate real property, the debtor is not a small business debtor. *Id.* (*See* section 101(51B) for definition of "single asset real estate).

A debtor who is an "affiliate" as defined in section 101(2), of a small business debtor will itself be considered a small business debtor as long as aggregate non-insider debts of the affiliated debtors do not exceed the $2,490,925 debt limit. *Id.* If, therefore, both an individual and that person's closely held corporation or limited liability company (LLC) file chapter 11 petitions and if the aggregate debts of the two entities do not exceed the $2,490,925 limit, both entities will be treated as small business debtors. If, on the other hand, an individual who is employed by a closely held corporation or LLC files a personal petition, but the closely held business or LLC entity does not, the individual would most likely not be a small business debtor because the business entity, and not the individual, is the person "engaged in commercial or business activities."

3-14.3 SMALL BUSINESS DEBTOR DESIGNATION

A debtor must declare on the face of its petition whether it is a small business debtor. Fed. R. Bankr. P. 1020(a). The case will proceed in accordance with the debtor's designation unless the court enters an order finding that the debtor's statement is incorrect. Any objection to a debtor's designation must be filed by the United States Trustee or by a party in interest not later than 30 days after the conclusion of the section 341 meeting, or within 30 days after any amendment to the debtor's statement, whichever is later. Fed. R. Bankr. P. 1020(b). United States Trustees must, therefore, scrutinize questionable designations early in the case and, if appropriate, expeditiously seek a court order correcting an inappropriate designation. If the deadline for objecting to the debtor's designation has passed, a United States Trustee should under no circumstances institute or support any effort to change that designation.

3-14.4 CREDITORS' COMMITTEE FORMATION

The SBRA amended section 1102(a)(3) to provide that unless the court for cause orders otherwise a committee of creditors may not be appointed in a small business case or in a case under subchapter V of chapter 11. 11 U.S.C. § 1102(a)(1), (3). The United States Trustee will appoint a committee if the court orders such an appointment for cause.

3-14.5 INITIAL FILING REQUIREMENTS AND DEBTOR REQUIREMENTS

A small business debtor is required to file certain financial documents with the petition or to file a statement under perjury that such documents do not exist. 11 U.S.C. § 1116(1). In addition, a small business debtor must, among other things, attend an initial debtor interview (IDI) with the United States Trustee, timely file

schedules and statements of financial affairs, file periodic reports on its business operations, and allow the United States Trustee to inspect its business premises and/or records. 11 U.S.C. § 1116. The United States Trustee must conduct the IDI early in the case to determine a debtor's ability to reorganize and to inform the debtor of its obligations under the Bankruptcy Code. 28 U.S.C. § 586(a)(7).

The United States Trustee should closely monitor a small business debtor's compliance with its obligations under section 1116. While a number of questions about how to enforce those requirements arose soon after the BAPCPA was implemented, these questions appear to have subsided. As a practical matter, the United States Trustee's two options for enforcing these requirements are to contact counsel (or the debtor, if counsel has authorized direct contact) to urge compliance or, if such non-judicial efforts are unavailing, to bring motions to convert or dismiss under section 1112.

A plain reading of section 1112 suggests that if a debtor fails to comply with the reporting requirements of section 1116, dismissal or conversion of the debtor's case is mandatory. In particular, section 1112(b)(1) states that the court "shall" convert or dismiss a case for cause, in contrast to the pre-BAPCPA text of the statute, which provided that a court "may" dismiss or convert for cause. In addition, "cause" is expressly defined under section 1112(b)(4)(F) and (H) to include both failure to comply with a United States Trustee's requests for information and failure to timely satisfy reporting requirements. Notwithstanding this, at least one court has apparently continued to apply pre-BAPCPA standards by holding that dismissal of a case is discretionary, not mandatory, when a debtor fails to file documents required by section 1116. *See In re Franmar, Inc.,* 361 B.R. 170, 178 (Bankr. D. Colo. 2006) (holding that where debtor failed to file section 1116 reports, court would not dismiss case if it concluded that debtor's failure was excusable).

Because the specifications of "cause" are now significantly broader, United States Trustees should exercise prudence in bringing a motion to convert or dismiss. The United States Trustee should take guidance from 28 U.S.C. § 586(a)(8), which requires that they promptly bring motions to convert or dismiss when they have *material* grounds for such motions. A single serious incident can certainly constitute material grounds, or the United States Trustee might establish material grounds by demonstrating to the court a pattern of debtor inattention to the requirements placed on debtors in possession under the Bankruptcy Code.

3-14.6 EXCLUSIVITY PERIODS, AND THE PLAN AND DISCLOSURE STATEMENT

The exclusivity periods for small business debtors differ from those of other chapter 11 debtors. A small business debtor has an initial exclusivity period of 180 days, as compared to 120 days for other chapter 11 debtors. 11 U.S.C. § 1121(e)(1). A small business debtor must file its reorganization plan no later than 300 days from the order of relief. 11 U.S.C. § 1121(e)(2). If a court

determines that the plan by itself provides adequate information, the court is permitted to find that a separate disclosure statement is not necessary. 11 U.S.C. § 1125 (f)(1). It may also approve a disclosure statement submitted on standard forms approved by the court. 11 U.S.C. § 1125(f)(2). The court may also conditionally approve a disclosure statement without a separate hearing, with final approval of the disclosure statement being deferred until the hearing on confirmation. 11 U.S.C. § 1125(f)(3); Fed. R. Bankr. P. 3017.1.

A court is also required to confirm a plan in a small business case not later than 45 days after the plan is filed, if the plan is filed in compliance with section 1121(e). 11 U.S.C. § 1129(e). As a practical matter, given the short statutory time frame available to the court to consider a plan for a small business debtor, such debtors will almost inevitably have to seek conditional approval of their disclosure statements, and the court will hold combined hearings on the adequacy of disclosure and confirmation of the plan.

The ability of a debtor to obtain extensions of these deadlines is limited by section 1121(e)(3). Specifically, the debtor must demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable time. In addition, the court must impose a new deadline at the time the extension is granted, and the order granting the extension must be signed before the existing deadline expires. United States Trustees should, in appropriate cases, object to extensions when it appears that debtors will not meet the statutory standards for such extensions.

As small business cases filed since the effective date of the BAPCPA progressed through the system, issues inevitably arose over the effect of and extension of these deadlines. With respect to the debtor, the 300-day deadline is a bar date, and the debtor is prohibited from filing a plan once this deadline has lapsed. On the other hand, as discussed below, there is authority that the 300-day deadline is not binding on a creditor plan proponent. As a result, if the 300-day period has expired, the United States Trustee should, in most cases, immediately move to convert or dismiss the case. In some cases, however, special circumstances may exist that would justify a different response. For example, the United States Trustee may seek to appoint a chapter 11 trustee instead of moving to convert or dismiss. See 11 U.S.C. § 1104(a)(3). Circumstances could arise, however, where such a motion might not be appropriate. In other cases, dismissal or conversion may be inappropriate if it is likely that a non-insider creditor will file a plan after the expiration of the 300-day deadline. In addition, it may be permissible under some circumstances for a debtor to file a plan after the expiration of the 300-day deadline as a co-proponent with a non-insider creditor, even though it would have been inappropriate for the debtor to file the plan as the sole proponent.

Two issues of first impression under section 1121(e) were addressed in *In re Florida Coastal Airlines, Inc.,* 361 B.R. 286 (Bankr. S.D. Fla. 2007), where the court first faced the issue of whether a creditor could file a plan of reorganization

after expiration of the 300-day period. The court concluded that the 300-day period applies only to debtors and not to creditors. While the statutory language is less than completely clear, the court's rationale seems supportable. As a practical matter, because creditors seldom seek to file plans in small business cases, the acceptance of the court's conclusion should not significantly impair the effectiveness of the 300-day deadline as a mechanism for assuring that small business cases move expeditiously through the system.

The second issue considered by the *Florida Coastal Airlines* court is whether a debtor may, after the expiration of the 300-day period, amend a plan filed before the expiration of the period. The court concluded that, so long as the amended plan is simply a revised version of the original plan, the filing date would "relate back" to the filing date of the original plan. The court reached this conclusion by analogy to Fed. R. Civ. P. 15, and the case law under that rule that permits amended complaints to relate back to before the expiration of a statute of limitations so long as the complaints arise from the same factual occurrence. The court's decision seems consistent with general principles of law. The United States Trustee, however, should be alert to attempts by small business debtors to file skeletal plans and disclosure statements immediately before the expiration of the 300-day period and then attempt to flesh them out. The United States Trustee should also be cognizant of attempts by small business debtors to file plans after the 300-day bar date by using a straw man.

CHAPTER 3-15: INVOLUNTARY CHAPTER 11 CASE ADMINISTRATION

3-15.1 INTRODUCTION

An involuntary case is commenced by the filing of a petition under section 303. The automatic stay under section 362(a) is triggered by the filing of the petition. Some statutory provisions, however, do not take effect until the order for relief is entered.

Generally, the debtor may continue to operate as if no case were commenced under title 11:

> Notwithstanding section 363 of this title, except to the extent that the court orders otherwise, and until an order for relief is entered in the case, any business of the debtor may continue to operate, and the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced.

11 U.S.C. § 303(f).

3-15.2 STATUTORY AND BANKRUPTCY RULE PROVISIONS

Involuntary chapter 11 bankruptcy cases are governed by section 303, which states, in part:

> An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced.

11 U.S.C. § 303(a); *see* 11 U.S.C.§ 109(b) and 101(41).

An involuntary petition can be filed by:

1. three or more creditors holding liquidated, undisputed claims that aggregate at least $14,425 more than the value of any collateral securing the claims (11 U.S.C. § 303(b)(1));
2. by one or more creditors holding liquidated, undisputed claims equaling at least $14,425 if fewer than 12 non-employee and non-insider creditors exist (11 U.S.C. § 303(b)(2));
3. by fewer than all general partners in a partnership (11 U.S.C. § 303(b)(3)); or
4. by a foreign representative of the estate in a foreign proceeding regarding the debtor (11 U.S.C. § 303(b)(4)). An entity that is the subject of a foreign proceeding may also commence an ancillary case under chapter 15 of the Code. *See* 11 U.S.C. § 1501 *et seq*. By operation of 11 U.S.C. § 104, the statutory amount is adjusted every three years.

Fed. R. Bankr. P. 1018 identifies the rules in Part VII of the Federal Rules of Bankruptcy Procedure (regarding adversary proceedings) that "apply to all proceedings relating to a contested involuntary petition . . . except as otherwise provided in Part I of these rules and unless the court otherwise directs. The court may direct that other rules in Part VII shall also apply." The effect of Fed. R. Bankr. P. 1018 is to make Rules 5, 8-10, 15, 16, 24-26, 28-37, 52, 54, 56, and 62 of the Federal Rules of Civil Procedure "generally applicable" to the raising of defenses and objections to the petition.

Section 303(d) permits the alleged debtor to file an answer to contest the entry of an order for relief. If no timely answer is filed, the court will enter an order for relief. 11 U.S.C. § 303(h).

If an involuntary case is contested, the court will conduct a trial to determine whether the statutory requirements for the entry of an order for relief have been met. The petitioners must establish that they are sufficient in number, type of debt, and amount of debt to fulfill the requirements of section 303(b), and that the debtor is generally not paying its undisputed debts as they become due or that a custodian has been appointed within 120 days of the filing of the petition to take

charge of less than substantially all of the debtor's assets. 11 U.S.C. § 303(h); *In re Byrd*, 357 F.3d 433 (4th Cir. 2004); *In re Mayhew*, 194 B.R. 6, 6-7 (Bankr. D.R.I. 1996).

The filing of an involuntary petition is an extreme action that may affect the alleged debtor's credit standing, cause public embarrassment, and impact its ability to carry on business affairs or transfer assets. The court may offer protection to the debtor under such circumstances, such as by dismissing the petition or requiring the posting of a bond. 11 U.S.C. § 303(e). If the petition is dismissed, other than with the consent of the parties, the court may assess costs, attorney fees, compensation, and punitive damages against the petitioning creditors. 11 U.S.C. § 303(i); *In re John Richards Home Bldg. Co., LLC*, 405 B.R. 192 (E.D. Mich. 2009); *In re Paczesny*, 282 B.R. 646 (Bankr. N.D. Ill. 2002); *In re Landmark Distributors, Inc.*, 195 B.R. 837, 845-48 (Bankr. D.N.J. 1996).

3-15.3 APPOINTMENT OF TRUSTEE PRIOR TO ENTRY OF ORDER FOR RELIEF

Section 1104 authorizes the appointment of a trustee "at any time after the commencement of the case but before confirmation of a plan . . . ." Therefore, even prior to the entry of the order for relief, the court may order the United States Trustee to appoint a trustee in an involuntary chapter 11 case. Generally, a motion for the appointment of a trustee prior to the entry of an order for relief should be made by the creditors rather than the United States Trustee.

A debtor faced with an involuntary chapter 7 petition may attempt to remove a "gap period" trustee by converting the case to one under chapter 11, or by filing a new chapter 11 case. Conversion terminates the service of a trustee serving before the conversion. 11 U.S.C. § 348(e). This effort may be of limited practical use as parties in interest could immediately move for appointment of a trustee in the chapter 11 case subsequent to conversion, or upon the filing of the new chapter 11 petition.

3-15.4 PROFESSIONAL FEES DURING THE GAP PERIOD

Professional fees incurred during the gap period raise unique issues that must be addressed by the United States Trustee and the court. If an order for relief is entered, courts have held that professionals rendering bankruptcy services during the gap period are entitled to the priority afforded by section 507(a)(2), just as if their claims were professional fees requested pursuant to section 330. As a result, such fees should be monitored by the United States Trustee pursuant to 28 U.S.C. § 586(a)(3)(A)(i). However, if the case is dismissed prior to the entry of an order for relief, the United States Trustee should not seek to review fees.

3-15.5 DISMISSAL

Section 303(j) permits dismissal of an involuntary case only after notice to all creditors and a hearing. Generally, in determining whether to sustain such a motion, the court must weigh the interests of the estate and the creditors. The case should be dismissed where dismissal would best serve the interests of the parties. 11 U.S.C. § 305(a). Additionally, where the involuntary case is in reality a two-party dispute and adequate non-bankruptcy remedies are available, the involuntary case should be dismissed. In determining whether to dismiss, the court should consider the prejudice to the parties, availability of another forum, and issues of non-bankruptcy law. The court should always consider whether the petition has been filed in bad faith. *See In re E.S. Professional Services, Inc.*, 335 B.R. 221, 224-26 (Bankr. S.D. Fla. 2005).

To guard against collusive dismissal of an involuntary petition to the detriment of non-petitioning creditors, the court may not dismiss an involuntary petition until there has been notice to all creditors and a hearing. 11 U.S.C. § 303(j). The United States Trustee should object to any dismissal of an involuntary petition if proper notice and opportunity for a hearing have not been given. The United States Trustee may also consider objecting to dismissal if the debtor and petitioning creditors work out an arrangement in which the petitioning creditors receive payment in preference over other creditors as consideration for dismissal.

CHAPTER 3-16: RAILROAD REORGANIZATIONS

3-16.1 INTRODUCTION

A railroad is defined as a "common carrier by railroad engaged in the transportation of individuals or property, or owner of trackage facilities leased by such a common carrier." 11 U.S.C. § 101(44). A railroad is not eligible to file under chapter 7 of the Bankruptcy Code, but may file for reorganization pursuant to the provisions of 11 U.S.C. § 1161 *et seq*. Liquidation may occur in chapter 11 as if the case were a case under chapter 7 if the court finds that the debtor cannot be reorganized or if certain time limits are not met. *See* 11 U.S.C. § 1174.

A railroad reorganization is markedly different from a typical chapter 11 reorganization. Certain sections of the Bankruptcy Code that are generally applicable in chapter 11 reorganization proceedings are made specifically inapplicable to a case concerning a railroad. *See* 11 U.S.C. § 1161. More particularly, the following sections do not apply in a railroad reorganization:

11 U.S.C. § 341:	Meetings of Creditors and Equity Security Holders
11 U.S.C. § 343:	Examination of the Debtor
11 U.S.C. § 1102(a)(1):	Appointment of Creditors' and Equity Security Holders' Committees

11 U.S.C. § 1104:	Appointment of Trustee or Examiner
11 U.S.C. § 1105:	Termination of Trustee's Appointment
11 U.S.C. § 1107:	Rights, Powers, and Duties of Debtor in Possession
11 U.S.C. § 1129(a)(7):	Confirmation Standards Relating to an Acceptance by Impaired Classes
11 U.S.C. § 1129(c):	Confirmation Standards in the Context of More Than One Plan

Because the appointment of a trustee is mandatory in a railroad reorganization, section 1107 is arguably not necessary. Sections 1129(a)(7) and 1129(c) have corresponding standards codified at 11 U.S.C. § 1173(a)(2) and (b), respectively. Curiously, however, there is no statutory provision for a meeting of creditors or examination of the debtor in the railroad reorganization case. While section 1102(a)(1) is made expressly inapplicable in railroad reorganization cases, section 1102(a)(2) remains applicable. Accordingly, the United States Trustee may appoint an official creditors' committee if the court orders one in response to a request by a party in interest.

3-16.2 APPOINTMENT OF A TRUSTEE

Section 1163 of the Bankruptcy Code indicates that it is the duty of the Secretary of Transportation, as soon as practicable after the order for relief, to submit a list of five disinterested persons who are qualified and willing to serve as the railroad reorganization trustee. In some cases, the attorney for the debtor railroad may already have contacted the Department of Transportation prior to the filing of the petition in order to expedite provision of the list. Otherwise, because the United States Trustee is required to make the appointment, the United States Trustee should promptly initiate contact with the Department of Transportation and request that a list be provided as soon as possible.

Because the trustee appointed under section 1163 must be disinterested, the United States Trustee should immediately contact the five candidates to obtain information about their connections, if any, with the debtor and the debtor's creditors.

Because section 1104 and Fed. R. Bankr. P. 2007.1 do not apply, court approval of the appointment is not required and, technically, consultation with parties in interest concerning the selection is not necessary. Prudence would dictate, however, that parties in interest, if they are available, be consulted regarding the relative merits and demerits of the five prospective appointees. The customary chapter 11 form of affidavit must be completed by the appointee and submitted so that a background investigation can be initiated.

The United States Trustee determines the amount and sufficiency of the railroad reorganization trustee's bond pursuant to section 322. The appointee qualifies as

a trustee if the bond is filed with the court within five days after his or her selection.

3-16.3 OPERATIONS DURING THE GAP PERIOD

Clearly, some period of time will elapse between the filing of a railroad case and the appointment of a trustee authorized to operate it. Technically, due to the inapplicability of section 1107 in a railroad reorganization case, the debtor is *de facto* left in possession during this gap period. The debtor's rights, powers, and duties under these circumstances are neither defined nor authorized by the Bankruptcy Code. Depending on the circumstances of the case, it may be appropriate for the United States Trustee or the debtor's attorney to urge an emergency motion for an operating order that would define the scope of the debtor's operating authority pending the appointment of a trustee. In addition, due to the peculiar feature contained in 11 U.S.C. § 1171 which accords administrative expense priority to both pre- and post-petition claims of individuals or personal representatives for personal injury or wrongful death, it is incumbent upon the United States Trustee to verify the existence of adequate liability insurance coverage at or before the initial debtor interview before permitting the debtor's operations to continue.

3-16.4 OTHER PROVISIONS APPLICABLE ONLY TO RAILROAD REORGANIZATIONS

The United States Trustee supervising the administration of a railroad reorganization estate should be cognizant of certain features of this type of case that are not typical of the ordinary chapter 11 case. First, in addition to the consideration generally given to the interests of the debtor, creditors, and equity security holders, the court is required to consider the "public interest" in applying certain provisions of this subchapter. 11 U.S.C. § 1165. Given that the Surface Transportation Board and the Department of Transportation, as well as any state or local commission having regulatory jurisdiction over the debtor, are accorded the right to be heard on any issue in the case, it may be presumed that these agencies will assist in informing the court of the nature of the public interest. *See* 11 U.S.C. § 1164. Other language within the subchapter indicates that the public interest would include, among other things, maintenance of adequate rail service and considerations having to do with the impact of the court's decisions on employees, shippers, and communities affected by the debtor's operations.

Notwithstanding sections 365 and 1113, the wages and working conditions of railroad employees established by a collective bargaining agreement cannot be changed by the trustee or the court except as permitted by non-bankruptcy laws. *See* 11 U.S.C. § 1167. Other preferences in favor of railroad employees are afforded in connection with abandonments, 11 U.S.C. § 1170(e)(1) and (2), and transfer of operations, 11 U.S.C. § 1172(c)(1) and (2).

The ability of the debtor to reorganize may be significantly affected by the provisions of 11 U.S.C. § 1168, which essentially provide an automatic relief from stay to a creditor holding a purchase money security interest in the debtor's rolling stock or equipment after 60 days, unless the trustee cures all defaults and agrees to perform all of the debtor's obligations under the security agreement.

CHAPTER 3-17: SUBCHAPTER V CHAPTER 11 CASES

3-17.1 INTRODUCTION

The Small Business Reorganization Act of 2019 ("SBRA"), Pub. L. No. 116-54, effective February 19, 2020, provides that a small business debtor may elect at the time of filing to proceed under a new subchapter V of chapter 11. This section of the manual discusses the provisions of the new law, including the legal rights and duties of the debtor and other parties, and the new responsibilities of the United States Trustee. The section will also specifically address changes to subchapter V effected by the CARES Act, effective for cases filed on or after March 27, 2020 and before March 27, 2021.

3-17.1.1 Statutory Framework

The major changes to chapter 11 made by SBRA for small business cases in which the debtor elects to proceed under subchapter V are highlighted below:

- A trustee is appointed in every case tasked primarily with facilitating a consensual plan.
- The court conducts a mandatory status conference within the first 60 days of the case. A status report must be filed by the debtor before the status conference.
- There is no required disclosure statement or mandatory unsecured creditors' committee, unless the court orders otherwise for cause.
- Only the debtor may file a plan, but it must do so within 90 days of the petition date, except with permission of the court for cause as described below.
- Plans may be confirmed consensually or through cram down. Each leads to different results under SBRA in terms of trustee retention, plan modification requirements, and timing of discharge, among other things.
- Debtors are not required to pay quarterly fees to the United States Trustee.

The legislative purpose of the SBRA was to provide a fast track for small businesses to confirm a consensual plan with the assistance of a private trustee. SBRA's key provisions seek: to increase a debtor's ability to negotiate a successful reorganization while retaining control of its business; to reduce "unnecessary procedural burdens and costs" by eliminating the creditors' committee and disclosure statement requirements; and to increase oversight and ensure quick reorganizations.

Debtors electing to proceed under subchapter V are subject to several additional requirements, set forth in more detail in Manual 3-17.5 below. These include reporting to the court and parties on progress towards achieving a consensual plan of reorganization and adhering to an accelerated schedule for confirming a plan.

3-17.1.2 Role of the United States Trustee in General

Under SBRA, the United States Trustee appoints and supervises subchapter V trustees and, as in other chapter 11 cases, takes enforcement action to ensure compliance with the Bankruptcy Code and Rules. As a practical matter, the United States Trustee generally should not take an enforcement action in a subchapter V case without first consulting and coordinating with the trustee appointed in the case to ensure that the United States Trustee is not frustrating the trustee's ability to facilitate a consensual plan. This is especially true during the first 90 days of the case. Moreover, the United States Trustee should not take action that would unduly frustrate the debtor's implementation of a consensual plan.

3-17.2.1 ELIGIBILITY FOR SUBCHAPTER V ELECTION

The CARES Act amended the definition of "debtor" in 11 U.S.C. § 1182(1) to substantially increase the debt limits for eligibility for relief under subchapter V. As amended, section 1182(1) increases the debt limit from the current limit of section 101(51D) of $2,725,625 to $7,500,000. This higher limit applies only to chapter 11 cases filed on or after March 27, 2020 until March 27, 2021. But for this higher debt limit, the definition of "debtor" for subchapter V cases in section 1182(1) is identical to the definition of "small business debtor" under section 101(51D), which after the CARES Act no longer applies to cases where eligible debtors elect the application of subchapter V.

Note that the amendments to the Code effected by the CARES Act will sunset on March 27, 2021. CARES Act sec. 1113(2). The sunset provisions effectively reverse the amendments made by the CARES Act.

3-17.2.2 SUBCHAPTER V ELECTION BY THE DEBTOR

Election to proceed under subchapter V is at the discretion of the debtor, but this election should be made in the petition (or, in an involuntary case, within 14 days of the entry of the order for relief). *See* Proposed Int. R. Bankr. P. 1020(a). Although neither the Bankruptcy Code nor the Bankruptcy Rules discuss amending the election after the petition has been filed, there is a general right to amend a voluntary petition under Rule 1009. The United States Trustee generally should not object to such an amendment unless it appears to be offered in bad faith or to adversely affect the rights of creditors.

3-17.3 ROLE OF THE SUBCHAPTER V TRUSTEE

The United States Trustee will appoint a private trustee in each subchapter V case. Section 1183(a) provides that the United States Trustee may appoint a standing trustee pursuant to 28 U.S.C. § 586(b) to handle such cases. If no standing trustee has been appointed, the United States Trustee shall appoint a disinterested person to serve as the trustee for a case. If necessary, the United States Trustee may serve as trustee. This should occur in only the rarest of circumstances, and the United States Trustees should not appoint themselves without obtaining approval from the Assistant Director for Oversight.

Under section 1183(b)(1), upon appointment, the trustee shall perform the duties specified in sections 704(a)(2), (5), (6), (7), and (9):

- Being accountable for all property received. 11 U.S.C. § 704(a)(2).
- Examining proofs of claim and objecting as needed. 11 U.S.C. § 704(a)(5).
- Opposing the debtor's discharge, if advisable. 11 U.S.C. § 704(a)(6).
- Furnishing information concerning the estate requested by a party in interest, unless the court orders otherwise. 11 U.S.C. § 704(a)(7).
- Making a final report and filing an account of the administration of the estate with the court and the United States Trustee. 11 U.S.C. § 704(a)(9).

If there is a claim for a domestic support obligation with respect to the debtor, the trustee must furnish the notice required by section 704(c).

The trustee also is charged with facilitating the development of a consensual plan of reorganization and ensuring that the debtor commences making timely payments under any confirmed plan. 11 U.S.C. §§ 1183(b)(4), (7). The trustee must also take part in the status conference required by section 1188(a) and at any hearing concerning the value of property subject to a lien, confirmation of a plan, or sale of property of the estate. 11 U.S.C. § 1183(b)(3).

Given the prescribed duties, the trustee should attend the initial debtor interview (IDI) convened by the United States Trustee with the debtor and debtor's counsel within 10 days after the case is filed and begin the process of facilitating a consensual plan with the debtor. And the trustee should participate in the section 341 meeting of creditors convened by the United States Trustee to question the debtor and to continue the facilitation of a consensual plan. The United States Trustee may also consult with the trustee to determine whether an inspection of the debtor's business premises, books, and records permitted under section 1116(7) is necessary or appropriate. 11 U.S.C. §§ 1116(7) and 1187(b). In addition, the trustee should be heard by the court on any extension sought by the debtor under section 1189(b) to file a plan beyond 90 days after the order for relief.

Section 1194 permits, but does not require, a debtor to make adequate protection

payments through the trustee. If the trustee holds funds pre-confirmation, then upon confirmation, section 1194 directs that the trustee either distribute those funds in accordance with a confirmed plan or return those funds to the debtor after deducting any (1) unpaid administrative expenses, (2) adequate protection payments due to a secured lender, and (3) fees owing to the trustee.[18] 11 U.S.C. § 1194(a).

For cause, and upon the request of a party in interest, the court may also require the trustee to perform the duties specified in sections 1106(a)(3), (4), and (7)—to investigate the conduct and financial condition of the debtor, and any other matter relevant to the case; to file a report of any investigation conducted; and, after confirmation, to file any such reports that are necessary or as the court orders. 11 U.S.C. § 1183(b)(2).

In addition, if the court orders under section 1185 that the debtor shall no longer be a debtor in possession, the trustee shall perform the duties required by section 704(a)(8) and section 1106(a)(1), (2), and (6), including:

- Operating the debtor's business. 11 U.S.C. § 1183(b)(5).
- Filing any required schedules and statements. 11 U.S.C. § 1106(a)(2).
- Filing periodic operating reports. 11 U.S.C. § 704(a)(8).
- Serving as the administrator of any employee benefit plan. 11 U.S.C. § 704(a)(11).
- Making reasonable efforts to transfer patients from a closing health care business to a new provider offering similar services. 11 U.S.C. § 704(a)(12).
- And, for any year in which a tax return has not been filed, furnishing such information as may be required by the applicable governmental entity. 11 U.S.C. § 1106(a)(6).

11 U.S.C. § 1183(b)(5). In such cases, the trustee is an independent third party who "steps into the shoes" of the debtor's management and becomes a fiduciary with an obligation of fairness to all parties in the case.

Note that although the subchapter V trustee may employ professionals under section 327(a), subchapter V is intended to be a quick and low cost process to enable debtors to confirm consensual plans in a short period with less expense while returning appropriate dividends to creditors. Therefore, the services required of outside professionals, if any, will be limited in many cases. This is especially important in cases in which the debtor remains in possession.

Additional information regarding the role, qualifications, and oversight of subchapter V trustees may be found in Manual 3-17.16.

[18]The trustee's fees should not be paid until they are awarded by the court pursuant to 11 U.S.C. § 330. *See* Manual 3-17.15.2.

3-17.4 CREDITORS' COMMITTEE ONLY ON ORDER OF COURT

SBRA amended section 1102(a)(3) to provide "[u]nless the court for cause orders otherwise, a committee of creditors may not be appointed in a small business case or a case under subchapter V of this chapter."[19] Therefore, the United States Trustee will not appoint a creditors' committee in either a small business case or a subchapter V case unless the court orders such an appointment for cause. Generally, the United States Trustee will not have sufficient information to establish cause for the appointment of a creditors' committee.

3-17.5 SUBCHAPTER V DEBTOR'S DUTIES

Subchapter V debtors are subject to many of the same requirements as non-electing small business debtors, despite the fact that section 1116 does not apply in subchapter V cases. *See* 11 U.S.C. § 1181(a). That is because section 1187 applies most of the duties under section 1116 to subchapter V cases by reference. For example, section 1187(a) applies most of subsection 1116(a)(1), and section 1187(b) applies subsections 1116(a)(2)-(7).

As a result, subchapter V debtors must:

- File the small business case documents required by section 1116(1). 11 U.S.C. § 1187(a).
- File the periodic financial reports required by section 308 and Rule 2015(a)(6). 11 U.S.C. § 1187(b).
- Attend meetings scheduled by the United States Trustee and the court, including IDIs, scheduling conferences and section 341 meetings as required by section 1116(2). 11 U.S.C. § 1187(b).
- Timely file all schedules and statement of financial affairs. 11 U.S.C. § 1187(b).
- File post-petition financial and other reports as required by section 1116(4), including a list of the 20 largest unsecured creditors (*see* Rule 1007(d)), monthly operating reports (*see* Rule 2015(a)(6)), and entity ownership reports (*see* Rule 2015.3). 11 U.S.C. § 1187(b).
- Maintain insurance per section 1116(5). 11 U.S.C. § 1187(b).
- File tax returns per section 1116(6). 11 U.S.C. § 1187(b).
- Allow the United States Trustee to inspect the debtor's premises, books, and records per section 1116(7). 11 U.S.C. § 1187(b).

But unlike non-electing small business debtors, subchapter V debtors must also attend a status conference no later than 60 days after the order for relief to further the expeditious and economical resolution of the case, and to encourage and facilitate the attainment of a consensual plan. 11 U.S.C. § 1188(a). This 60-day

[19]SBRA deleted the existence or level of activity of a creditors' committee as a criterion for status as a "small business debtor," including a subchapter V debtor. 11 U.S.C. § 101(51D).

period can be extended for circumstances for which the debtor should not justly be held accountable. 11 U.S.C. § 1188(b). Not later than 14 days before the status conference the debtor is required to file with the court and serve on all parties a report detailing the debtor's past and anticipated efforts to attain a consensual plan of reorganization. 11 U.S.C. § 1188(c).

3-17.6 UNITED STATES TRUSTEE'S OVERSIGHT OF SUBCHAPTER V CASES

It is important to note that 28 U.S.C. § 586(a)(7) *does not apply* to subchapter V cases. This subsection is the source of many of the United States Trustee's duties to oversee small business cases. But by its terms, subsection 586(a)(7) applies only to "small business cases," which are chapter 11 cases of small business debtors that have not elected treatment under subchapter V. *See* Pub. L. No. 116-54, § 4(a)(1)(A); and 11 U.S.C. § 101(51C).

This does not mean, however, that the United States Trustee will not monitor subchapter V cases. SBRA amended 28 U.S.C. § 586(a)(3) to expressly include the United States Trustee's general duty to supervise the administration of subchapter V cases.

Thus, in general, the United States Trustee should take appropriate action where a debtor is not fulfilling its duties as a debtor in possession, but remain mindful of SBRA's goals of increasing the debtor's ability to negotiate a successful reorganization by reducing unnecessary procedural burdens and costs.

Similarly, as more fully set forth in Manual 3-17.16, the United States Trustee should also supervise the trustee pursuant to 28 U.S.C. § 586(a)(3) and take appropriate action where a trustee is not fulfilling the required trustee duties, or is engaging in misconduct. If necessary, the United States Trustee may seek to remove a trustee pursuant to section 324. The Office of the General Counsel must review and approve all proposed motions by United States Trustees to remove a trustee. The United States Trustee should consult the Office of Oversight prior to submitting the proposed motion to the Office of the General Counsel. The United States Trustee also must notify the Office of Oversight whenever a motion to remove a trustee under section 324 has been filed by third parties.

When a subchapter V case is filed, the United States Trustee appoints the trustee and schedules the section 341 meeting of creditors in accordance with Rule 2003. If the United States Trustee has a pool of case-by-case trustees available for appointment instead of a standing trustee, the United States Trustee should review the facts and circumstances of the case and the skills of the trustees in the pool to select the trustee best suited for the given case. The United States Trustee, who generally presides at the meeting of the creditors, should schedule the meeting after consulting with the trustee to ensure the trustee is available to attend the meeting, consistent with the trustee's duty to facilitate a consensual plan under section 1183(b)(7).

The United States Trustee must communicate the selection of the trustee (if a case-by-case trustee) and the date of the section 341 meeting quickly to the clerk of court (within one to two days after the case is filed, if possible) to avoid unduly delaying the initial administration of the case. In addition to notifying the clerk about the selection of the trustee and the date of the section 341 meeting, the United States Trustee should concurrently or promptly thereafter file a Notice of Appointment with the court with an attached verified statement by the trustee disclosing that the trustee is disinterested and the trustee's proposed arrangement for compensation.

The United States Trustee should facilitate the participation of the trustee in the United States Trustee's case oversight activities, such as the IDI or any site visit. The United States Trustee should coordinate with the trustee in scheduling the IDI within 10 days after the case is filed. At the IDI, the United States Trustee should discuss the facts of the case and explain the administrative requirements of the case to the debtor and debtor's attorney with the trustee present, including required financial information, taxes, insurance, debtor in possession bank accounts, and monthly reports.

The United States Trustee may also consult with the trustee to determine whether an inspection of the debtor's business premises, books, and records permitted under section 1116(7) is necessary or appropriate. 11 U.S.C. §§ 1116(7) and 1187(b). Any such inspection should be coordinated with the debtor, debtor's counsel, and the trustee. There should be no "surprise" inspections.

The United States Trustee should review the materials received from subchapter V debtors under section 1187. The United States Trustee should also review the debtor's report and attend and participate in the status conference required by section 1188(a) to inform the court about any administrative deficiencies or other concerns in the case. Before the status conference, the United States Trustee should consult with the trustee, who is required to attend, about the trustee's views of the case.

Under section 1185, the United States Trustee and other parties may file a motion to remove the debtor in possession for "cause," including pre- or post-petition "fraud, dishonesty, incompetence, or gross mismanagement" or for default under a confirmed plan. 11 U.S.C. § 1185(a). *See also* 11 U.S.C. § 307. If the court grants the motion, or acts *sua sponte*, the debtor in possession is removed and the subchapter V trustee is empowered to operate the business, file reports with the court, and file tax returns. 11 U.S.C. § 1183(b)(5).

Other duties of the United States Trustee include reviewing the plan, monitoring the case post-confirmation and, if necessary, reappointing a trustee. The post-confirmation duties are described in Manual 3-17.10.

3-17.7 SUBCHAPTER V EXCLUSIVITY PERIODS AND DISCLOSURE REQUIREMENTS

SBRA imposes substantially different exclusivity period and disclosure statement requirements for cases under subchapter V. Section 1121 does not apply with respect to exclusivity. 11 U.S.C. § 1181(a). Instead, only the debtor may file a plan, and that plan must be filed not later than 90 days after the order for relief under chapter 11. 11 U.S.C. § 1189(a), (b).

The court may extend the 90-day period if the need for the extension "is attributable to circumstances for which the debtor should not justly be held accountable." 11 U.S.C. § 1189(b). The statute does not limit the length or number of potential extensions. The United States Trustee should review requests for extensions and in most cases, discuss those requests with the trustee serving in the case. The trustee should be heard by the court on such extensions. After consulting with the trustee, the United States Trustee should consider objecting if it appears that the case is languishing with no real prospect for rehabilitation.

Section 1125 does not apply in subchapter V unless the court for cause orders otherwise. 11 U.S.C. § 1181(b). Therefore, absent a court order, the debtor need not file a disclosure statement with the plan.[20] The plan, however, must include:

- a brief history of the business operations of the debtor;
- a liquidation analysis; and
- projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization.

11 U.S.C. § 1190(1). This information is the core information that creditors and other interested parties would expect to see included in a disclosure statement filed under section 1125. The United States Trustee should review plans filed under subchapter V and file comments or objections if the disclosures appear to be inadequate. *See* 28 U.S.C. § 586(a)(3)(B).

[20]Note that if the court directs the filing of a disclosure statement in a subchapter V case, section 1125(f) will apply. 11 U.S.C. § 1187(c). That subsection relaxes disclosure requirements for small business cases. 11 U.S.C. § 1125(f). *See also* Official Bankr. Form 425B.

3-17.8 SUBCHAPTER V PLAN REQUIREMENTS

The requirements for a plan in a subchapter V case can be found in certain subsections of 1123 and in new sections 1181(a) and 1190. Specific confirmation requirements are discussed further in Manual 3-17.9.

In general, section 1123 of the Code governing the contents of chapter 11 plans applies in subchapter V cases. Significantly, sections 1181(a), 1190(2), and 1190(3) contain three exceptions for subchapter V cases filed by individual debtors.

First, section 1181(a) provides that subsection 1123(a)(8), which requires that an individual chapter 11 debtor dedicate earnings from personal services as are necessary for the execution of the plan, does not apply in subchapter V cases. Instead, the plan must provide for the submission of such portion of the future earnings or other future income of the individual debtor to the supervision and control of the trustee as is necessary for the execution of the plan. 11 U.S.C. § 1190(2). Note that this requirement applies only if the plan provides for periodic payments from income. Although most plans will contain such a provision, it is not required unless the plan is confirmed non-consensually under section 1191(b), as discussed in Manual 3-17.9.

Second, section 1181(a) provides that subsection 1123(c) does not apply. That subsection provides that a plan concerning an individual chapter 11 debtor cannot rely on the debtor's exempt property unless the debtor consents. It is unnecessary in a subchapter V case because only the debtor may file a plan.

Third, section 1190(3) creates a limited exception to the general proposition that a plan of reorganization cannot provide for the modification of a claim secured only by a security interest in the principal residence of an individual debtor. *See* 11 U.S.C. § 1123(b)(5). Section 1190(3) permits the modification of the rights of the holder of such a claim if the new value received by the debtor in connection with the granting of the security interest was not used primarily to acquire the residence and was used primarily in connection with the debtor's small business. 11 U.S.C. § 1190(3). Secured creditors holding such claims are expected to police their own rights in connection with plans providing for the modification of their claims.

Other provisions of section 1123 govern all plans filed in subchapter V cases, including plans filed by individual debtors. In addition, section 1190(1) specifies the required disclosures in the subchapter V plan, as discussed in Manual 3-17.7. 11 U.S.C. § 1190(1).

3-17.9 SUBCHAPTER V PLAN CONFIRMATION

Confirmation of a plan is governed by a combination of certain subsections of section 1129 and new section 1191. Section 1191(a) provides that the following

subsections of section 1129 *do not* apply in a subchapter V case: 1129(a)(15) (means test in individual chapter 11 cases); 1129(b) (cram down provisions); 1129(c) (court may confirm only one plan); and 1129(e) (requirement that plan in small business case be confirmed within 45 days).

Subchapter V does require that the plan classify claims and that it be submitted to creditors for balloting. 11 U.S.C. §§ 1122 and 1191(a). As discussed below, confirmation of a plan under section 1191 is either consensual or, if one or more impaired classes votes to reject the plan, non-consensual.

Note that priority claims under sections 507(a)(2) (administrative expenses) and 507(a)(3) (unsecured "gap period" claims in involuntary cases) may be paid over the life of the plan, presumably in full, notwithstanding section 1129(a)(9)(A). 11 U.S.C. § 1191(e). A plan providing for such delayed payment of these priority claims must be confirmed non-consensually under 11 U.S.C. § 1191(b).

As described below, a plan that cannot be confirmed consensually under 11 U.S.C. § 1191(a) may still be confirmed non-consensually (*i.e.*, by "cram down") if the requirements of 11 U.S.C. § 1191(b) are met.

3-17.9.1 Consensual Plans

Section 1191(a) provides that the court may confirm a plan only if all requirements of section 1129(a) other than 1129(a)(15) are met. This is "consensual" confirmation. Effectively, this requires that all impaired classes accept the plan.

In a consensual plan, the debtor generally makes payments under the plan directly. Except as otherwise provided in the plan or confirmation order, the confirmation of a consensual plan discharges the debtor under section 1141(d), and section 1141(d)(5) does not apply in subchapter V cases to delay the discharge for individual debtors. 11 U.S.C. § 1181(a).

The trustee's services are terminated upon the substantial consummation of a consensual plan. 11 U.S.C. § 1183(c)(1).

3-17.9.2 Non-consensual Plans

A plan that is not confirmed consensually under section 1191(a) can still be confirmed "non-consensually" under section 1191(b). Generally, section 1129(b) does not apply in a subchapter V case. Instead, section 1191(b) permits the court, on request of the debtor, to confirm a plan that does not meet the requirements of subsections 1129(a)(8), (10), or (15). Subsection (a)(8) requires that all impaired classes accept the plan. Subsection (a)(10) requires, as a prerequisite to cram down under 11 U.S.C. § 1129(b), that at least one impaired class of claims has accepted the plan. And subsection (a)(15) requires that if an unsecured creditor objected to the plan in a case filed by an individual debtor, the debtor pays the greater of the amount of the claim or the debtor's projected disposable income for five years.

To confirm a subchapter V plan non-consensually under section 1191(b), the court must find that the plan does not discriminate unfairly and that the plan is fair and equitable with respect to each class of impaired claims or interests that has not accepted the plan. While the standards for the unfair discrimination prong are the same as under section 1129(b)(1) applicable to other chapter 11 cases, what is "fair and equitable" with respect to unsecured creditors is different and the absolute priority rule of subsection 1129(b)(2) does not apply.

Section 1191(c) defines "fair and equitable" under a non-consensual plan. There are four requirements.

First, for a class of secured claims, subsection 1191(c)(1) incorporates the fair and equitable standards from subsection 1129(b)(2)(A). Section 1129(b)(2)(A) provides three alternatives for what is "fair and equitable" treatment for a secured claim. First, the plan may provide for the retention by the holder of the claim of the liens securing the claim and the payment to the holder of deferred cash payments totaling at least the allowable amount of the claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in the property securing the liens. 11 U.S.C. § 1129(b)(2)(A)(i). Second, the plan may provide for the sale, subject to 11 U.S.C. § 363(k), of the property securing the liens, free and clear of the liens, with the liens to attach to the proceeds of such sale, and the treatment of such liens under subsection (i) or (iii) of section 1129(b)(2)(A). 11 U.S.C. § 1129(b)(2)(A)(ii). Third, the plan may provide for the realization by the holder of the secured claim of the "indubitable equivalent" of such claim. 11 U.S.C. § 1129(b)(2)(A)(iii).

Second, for other impaired classes, a plan is fair and equitable if, as of the effective date of the plan, it provides that (a) all of the debtor's projected disposable income for the three- to five-year period (as fixed by the court) will be applied to make payments under the plan, *or* (b) the value of the property to be distributed under the plan during the three to five-year period is not less than the projected disposable income of the debtor. 11 U.S.C. § 1191(c)(2). Thus, the debtor is not required to satisfy the "absolute priority rule" applicable in other chapter 11 cases.

For purposes of 11 U.S.C. § 1191(c)(2)(A), "disposable income" is defined as income received by the debtor that is not reasonably necessary to be expended for the maintenance or support of the debtor or a dependent of the debtor, for a post-petition domestic support obligation, or for the payment of necessary business expenditures. 11 U.S.C. § 1191(d). For individual debtors, the disposable income test is akin to that in chapter 12, *see* 11 U.S.C. § 1225(b)(2), and is not based on the "means test" as in chapter 7 under section 707(b)(2) or in chapter 13 under section 1325(b)(2).

Third, the plan must provide that the debtor will be able to make all plan payments or that there is a reasonable likelihood that the debtor will be able to make the payments. 11 U.S.C. § 1191(c)(3)(A).

Finally, the plan must provide "appropriate remedies" to protect holders of claims

or interests if the payments are not made, including liquidation of nonexempt assets. 11 U.S.C. § 1191(c)(3)(B).

When a plan is confirmed non-consensually, under section 1192 the debtor will not receive a discharge until after the debtor has made all plan payments due within three to five years, as set by the court. Section 1141(d)(5), which would otherwise delay discharge for individual debtors, does not apply in subchapter V cases. 11 U.S.C. § 1181(a). Debts on which the last payment is due after the first three years of the plan, or up to five years as fixed by the court, are not discharged. 11 U.S.C. § 1192(1). Furthermore, debts excepted from discharge under section 523(a) are not discharged. 11 U.S.C. § 1192(2).

In a non-consensual plan, except as otherwise provided in the plan or the confirmation order, the trustee shall make the payments to creditors under the plan, pursuant to section 1194(b).

3-17.10 SUBCHAPTER V POST-CONFIRMATION

Not later than 14 days after the debtor's consensual plan is substantially consummated, the debtor shall file a notice of substantial consummation and serve this notice on the subchapter V trustee, the United States Trustee, and all parties in interest. 11 U.S.C. § 1183(c)(2).

If the trustee is holding funds upon confirmation, regardless of whether the plan is consensual or non-consensual, the trustee should distribute those funds in accordance with the plan. 11 U.S.C. § 1194(a).

If the plan is consensual, unless otherwise provided in the plan or ordered by the court, the subchapter V trustee's duties terminate with substantial consummation. 11 U.S.C. § 1183(c)(1). Trustees should promptly file their compensation and expense requests, pursuant to section 330 for case-by-case trustees or 28 U.S.C. § 586 for standing trustees (*see* Manual 3-17.15), and distribute any funds on hand in accordance with the plan. In cases in which trustees made no distributions, the trustee shall file a report of no distribution with the court in accordance with section 1183(b)(1), which incorporates section 704(a)(9). In cases in which the trustee made distributions, the trustee should promptly submit the final report and account of administration to the United States Trustee for review pursuant to section 1183(b)(1). After review, the final report and account will be filed with the court. 11 U.S.C. §§ 1183(b)(1); 704(a)(9).

If the plan is non-consensual, the trustee will disburse payments under the plan, unless otherwise provided in the plan or confirmation order. 11 U.S.C. § 1194(b). The trustee should file with the court quarterly reports as prescribed by the court, and submit a copy of those quarterly reports to the United States Trustee for review, during the period in which the trustee continues to make plan payments. 11 U.S.C. §§ 1183(b)(2); 1106(a)(7). Upon completion of all plan payments, the trustee should submit the final report and final account of the

administration of the estate to the United States Trustee for review pursuant to section 1183(b)(1). After review, the final report and account will be filed with the court. 11 U.S.C. §§ 1183(b)(1); 704(a)(9).

If the debtor fails to perform under the plan, the United States Trustee should consider the appropriate response, which could include a motion for conversion or dismissal, revocation of the confirmation order if circumstances warrant under section 1144, or reappointment of a previously terminated trustee. *See generally* Manual 3-11.6.

3-17.10.1 Final Decree and Case Closing

After substantial consummation of a consensual plan, as provided in section 1101(2), and termination of the trustee's services pursuant to section 1183(c)(1), the debtor may proceed to seek entry of a final decree closing the case pursuant to section 350(a) and Fed R. Bankr. P. 3022, upon a showing that the estate has been fully administered and that there are no remaining matters for which the court must continue to exercise jurisdiction.

If the confirmed plan is non-consensual and the trustee is responsible for making plan payments to creditors, the case ordinarily will remain open after substantial consummation until the trustee has made all payments, the trustee has filed his final report and account, and there are no remaining matters for which the court must continue to exercise jurisdiction. *See* 11 U.S.C. § 350(a).

3-17.11 MODIFICATION OF SUBCHAPTER V PLANS

While section 1127 of the Code does not apply in subchapter V cases, many aspects of section 1127 allowing modification have been retained in some form under section 1193. One notable change is that in cases with proposed modifications either before confirmation or after confirmation but before substantial consummation, lien stripping may be allowed as to certain secured liens in the debtor's personal residence. 11 U.S.C. § 1190(3). Further, while section 1127 allows modification of plans in individual cases after confirmation but before completion of all plan payments, modification after substantial consummation in subchapter V cases is limited to non-consensual plans within three to five years of confirmation as long as the requirements of section 1191(b) for non-consensual plans are met. 11 U.S.C. § 1193(c). Finally, as with the initial proposed plan, disclosure requirements under section 1125 are not required for plan modifications in subchapter V cases. 11 U.S.C. § 1181(a) (section 1127 inapplicable in subchapter V; disclosure statement requirement found in 1127(c).

3-17.11.1 Modification before Confirmation

The debtor may modify a plan at any time before confirmation, but may not modify the plan so that as modified it fails to meet the requirements of sections 1122 and 1123 of the Code, other than section 1123(a)(8) (modification of lien on principal residence). 11 U.S.C. § 1193(a). The plan as modified becomes the plan upon filing with the court.

3-17.11.2 Modification after Confirmation

The debtor may modify a plan that has been consensually confirmed under section 1191(a) at any time before the plan is substantially consummated. The plan as modified must meet the requirements of sections 1122 and 1123 of the Code, other than section 1123(a)(8) (modification of lien on principal residence). The modified plan becomes the plan only if the court finds that circumstances warrant the modification and, after notice and a hearing, confirms the plan under section 1191(a). 11 U.S.C. § 1193(b).

Note that holders of claims or interests that have accepted or rejected a plan that was confirmed consensually under section 1191(a) are deemed to have similarly accepted or rejected the plan as modified unless, within the time fixed by the court, the holder changes its previous acceptance or rejection. 11 U.S.C. § 1193(d).

The debtor may modify a plan that has been confirmed non-consensually under section 1191(b) at any time during the three- to five-year period after confirmation (as set by the court). The plan as modified must meet the requirements of section 1191(b). The modified plan becomes the plan only if the court finds that circumstances warrant the modification and, after notice and a hearing, confirms the plan under section 1191(b). 11 U.S.C. § 1193(c).

3-17.11.3 Reappointing a Subchapter V Trustee Post-confirmation

Section 1185(a) provides that the debtor in possession can be removed for, among other reasons, failure to perform "the obligations of the debtor" under a plan that is confirmed consensually under section 1191(a). Upon the debtor in possession's removal under section 1185(a), section 1183(c)(1) provides that the United States Trustee may reappoint a trustee (1) as needed to appear and be heard on post-confirmation modifications and (2) as needed for performance of the debtor in possession's duties, including the obligations under the confirmed plan.

3-17.12 TRANSACTIONS WITH PROFESSIONALS IN SUBCHAPTER V CASES

Section 1195 provides that a professional is not disqualified for employment under section 327(a) solely because that person holds a claim of less than $10,000 that arose before the commencement of the case. Such a claim would otherwise make the professional a creditor and *per se* not disinterested.[21] 11 U.S.C. § 101(14)(A). Although SBRA is silent as to the priority of the professional's pre-petition claim, nothing in the SBRA or elsewhere in the Code would allow the

[21]This means that the United States Trustee should not object to the retention of a professional who waives the amount of any pre-petition claim exceeding $10,000. Similarly, the United States Trustee should not object to the retention of a professional who returns to the estate the total of pre-petition fee payments that are voidable as preferences under 11 U.S.C. § 547 and waives the amount of any resulting claim under 11 U.S.C. § 502(d) exceeding $10,000.

claim as other than a general unsecured claim.

3-17.13 SUBCHAPTER V TRUSTEE QUALIFICATIONS FOR APPOINTMENT

3-17.13.1 Qualifications and Acceptance

To ensure accountability, the United States Trustee generally will appoint individuals to serve as subchapter V trustees.[22] Subchapter V trustees may not accept appointment to cases in which they have a conflict and they must successfully complete background investigations. As discussed in Manual 3-17.16.2, the trustee must also either post or maintain an appropriate bond. In addition, pursuant to section 321(a), the trustee must be competent to perform the statutory duties set out in section 1183. For case-by-case trustees, additional considerations for the selection may be based on the unique circumstances of the specific case.

3-17.13.2 A Trustee Must Not Have Conflicts of Interest

The subchapter V trustee is an independent third party who owes fiduciary duties of fairness and impartiality to all parties in the case. *CFTC v. Weintraub*, 471 U.S. 343 (1985). The trustee must be free of conflicts of interest that might impair the trustee's ability to carry out these duties.

Conflicts of interest include, without limitation, the representation by a trustee's firm of a debtor or any party in interest in any case being administered by the trustee. Further, a conflict exists if the representation of a client by a trustee or the trustee's firm requires the trustee to take a position contrary to the fiduciary responsibilities of the trustee.

SBRA also specifies that a person appointed as a case-by-case subchapter V trustee must be "disinterested." 11 U.S.C. § 1183(a). Among other things, to be disinterested, a person must not be a creditor, equity security holder, or insider of the debtor. 11 U.S.C. § 101(14). Practically, the United States Trustee will insist that standing trustees decline cases in which they lack disinterestedness.

The trustee must decline to accept any appointment where the trustee has a conflict of interest. Moreover, the trustee's duty to review for conflicts in assigned cases is ongoing. The trustee must advise the United States Trustee in writing of any actual or potential conflicts upon becoming aware of them, and disclose any actual or potential conflicts at the meeting of creditors or on the court record, if applicable. If the trustee discovers a conflict after accepting an appointment, the trustee must immediately file a notice of resignation in the case

---

[22] All subchapter V standing trustees under subchapter V, as well as chapters 12 and 13, must be individuals. 28 U.S.C. § 586(b). Subchapter V case-by-case trustees must be "persons," 11 U.S.C. § 1183(a), which include partnerships and corporations in addition to individuals. 11 U.S.C. § 101(41). Pursuant to section 321(a)(2), partnerships and corporations that are authorized by their charters or bylaws to act as trustees are eligible to serve as case-by-case trustees. Nevertheless, as with the subchapter V standing trustees, the United States Trustee will generally appoint individuals as subchapter V case-by-case trustees.

and notify the United States Trustee, who will reassign the case to another trustee.

Conflict waivers by either the debtor or a creditor are not effective to obviate the necessity for the trustee to decline an appointment or to resign from the case. And to the extent that a standing trustee has a large number of resignations due to conflicts, the United States Trustee, with the approval of the Director of EOUST, may appoint another standing trustee.

3-17.13.3 Background Investigation

All persons appointed to serve as a trustee in a subchapter V case must undergo and successfully complete a security background investigation. Once the Assistant Director for Oversight has approved the United States Trustee's tentative recommendation of a candidate, the proposed appointee must promptly submit to the United States Trustee a Form E-Mail Pre-background (Form 8 in the trustee recruitment and selection package); USCIS – Form I-9 – Employment Eligibility Verification (form 9) and Subchapter V Trustee Notice and Acknowledgement (form 10); the trustee's full name and address (including middle name); the trustee's e-mail address; and the addresses to which each trustee candidate wants background documents sent.

After the United States Trustee reviews the documents for completeness and accuracy, the documents and information should be transmitted to the Office of Oversight for final review and processing. The Facilities and Security Branch of the Office of Administration will then initiate the background process directly with trustee candidates. The Office of Oversight will inform the United States Trustee when the trustee candidate has been preliminarily qualified to be a member of a pool subject to the completion of a full background check.

If the individual is in a pool of case-by-case trustees or is a standing trustee, then new security application forms are not required if a background investigation is in progress or has been completed within the preceding five years in connection with another chapter 11, chapter 7, or standing trustee appointment.

3-17.14 SUBCHAPTER V TRUSTEE RECRUITMENT

When seeking applicants for a position as subchapter V trustee, the United States Trustee, in consultation with the Assistant Director for Oversight, will engage in a process of public advertising and outreach to identify persons interested in serving. The United States Trustee should try to recruit a broad group of individuals to serve as subchapter V trustees who are not limited to attorneys or current trustees and include individuals with business and accounting backgrounds. All trustee appointments are made by the United States Trustee on a non-discriminatory basis.

Initially, the United States Trustees plan to appoint case-by-case trustees in subchapter V cases, learning from actual experience and may adjust this policy over time. To encourage broad professional and cultural representation among trustees, the United States Trustee should meet and speak with appropriate local

affinity organizations and community groups to remove real or perceived barriers to participation in the bankruptcy process and to broaden the awareness of opportunities the system affords.

The United States Trustee should recruit individuals who are interested in potential appointment as a subchapter V trustee through a public solicitation. The Program has adopted standard public vacancy notices to attract a pool of qualified applicants. All advertisements must conform to these notices, which may be obtained from the Office of Oversight.

Before commencing any solicitation, the United States Trustee must forward the advertisement and solicitation package to the Office of Oversight for review and suggestions. The solicitation package includes a proposed notice, a list of non-traditional contacts or sources in the community, and a description of proposed outreach efforts to encourage a pool of applicants.

After review by the Office of Oversight, the Administrative Officer or another person designated by the United States Trustee will place the advertisement. The Office of Oversight will post the recruitment announcement on the Program's Website. The United States Trustee will handle local posting of announcements. The United States Trustee will also provide information concerning trustees to any local professional groups for notice to their membership where possible. The Office of Administration may also provide targeted notices of the solicitation to participants in professional or employment websites to increase the possible number of qualified applicants for the United States Trustee to review. All recruitment notices are to be advertised for a reasonable period.

The United States Trustee must follow the advertising policy set forth herein and avoid making any appointments of individuals who have not responded to a solicitation as described above.

The number of trustees in any judicial district is determined by the United States Trustee, in consultation with the Assistant Director for Oversight. The assignment of specific cases to trustees is within the discretion of the United States Trustee. The trustee must be competent to perform the duties of the office as defined by statute, be an able administrator, and be able to carry out fiduciary duties free from improper influence or conflict.

3-17.15 TRUSTEE COMPENSATION AND BENEFITS

Compensation for subchapter V trustees is determined by both the disposition of the case and whether the trustee is a case-by-case trustee or a standing trustee. Section 326(a), which sets forth limitations on chapter 11 trustees' compensation based on moneys disbursed or turned over in cases by the trustees, does not apply to subchapter V trustees. Pub. L. No. 116-54, § 4(a)(4)(A).

3-17.15.1 Effect of Disposition of the Case

How a trustee collects compensation depends on the outcome of the case. For cases with plans confirmed non-consensually under section 1191(b), the trustee

will remain in place throughout the life of the plan and generally disburse payments received from the debtor in accordance with the plan and confirmation order, including payments to satisfy the trustee's compensation. 11 U.S.C. § 1194(b).

By contrast, in cases with plans confirmed consensually under section 1191(a), the trustee's service ends with substantial consummation of the plan under section 1183(c)(1).

3-17.15.2 Case-by-Case Trustee Compensation

Subchapter V case-by-case trustees are compensated through section 330(a)(1)(A), which allows for "reasonable compensation for actual, necessary services rendered by the trustee … and by any paraprofessional person employed by any such person." The trustee may also be reimbursed for "actual, necessary expenses" pursuant to section 330(a)(1)(B).

These section 330 compensation provisions apply regardless of whether the case-by-case trustee makes disbursements of estate funds. SBRA specifically excludes all subchapter V trustees from section 326(a), which sets limits on other chapter 11 trustees' compensation based on the moneys they disburse or turn over. Pub. L. No. 116-54, § 4(a)(4)(A). And subchapter V case-by-case trustees are not subject to the section 326(b) limitation of compensation to five percent of plan payments that is applicable to chapter 12 and 13 case trustees. *See* 11 U.S.C. § 326(b), as amended by Pub. L. No. 116-54, § 4(a)(4)(B).[23]

When submitting their fee applications, trustees are encouraged to keep in mind Congress' stated intent that subchapter V cases not be burdened with excessive administrative expenses.

The United States Trustee should object or take other appropriate action in response to requests by subchapter V case-by-case trustees for excessive fees and expenses.

3-17.15.3 Standing Trustee Compensation

Like chapter 12 and chapter 13 standing trustees, subchapter V standing trustees are compensated pursuant to 28 U.S.C. § 586(e). The Director of EOUST, by delegation from the Attorney General and in consultation with the United States Trustee, sets the standing trustees' annual compensation and a percentage fee, including overhead, of no more than 10% of plan payments. 28 U.S.C.

---

[23]Section 326(b) provides, in part, that the court may allow reasonable compensation to case trustees in chapter 12 and chapter 13 cases, not to exceed 5% upon all payments under the plan. SBRA amended section 326(b) to make clear that the court may not award compensation to subchapter V standing trustees under section 330(a), but SBRA did not further revise section 326(b) to provide that the 5% cap on plan payments expressly applies to subchapter V case-by-case trustees. Instead, the 5% cap remains effective only as to chapter 12 and 13 case-by-case trustees appointed under sections 1202(a) and 1302(a), respectively. As a result, there appears to be no express statutory limit on the compensation that can be awarded to subchapter V case-by-case trustees beyond the general "reasonableness" requirement imposed by section 330(a).

§ 586(e)(1).

Note that SBRA amended 28 U.S.C. § 586(e) to add a new subsection (5) specifically for subchapter V standing trustees. Pub. L. No. 116-54, § 4(b)(1)(D)(3). Subsection (5) provides that if a subchapter V case is converted or dismissed, or a consensually confirmed plan is substantially consummated, thereby impairing the ability of the standing trustee to collect an adequate percentage fee, the court may allow compensation consistent with the services performed by the trustee and subject to limits on the trustee's overall compensation established by the Attorney General. Note that this new provision applies only to standing subchapter V trustees.

3-17.16 SUPERVISION OF SUBCHAPTER V TRUSTEES

Subchapter V trustees are required to perform many duties in administering the cases in which they are appointed by the United States Trustee. In general, among the most important duties are assessing the financial viability of the small business debtor, facilitating a consensual plan of reorganization, and helping ensure that the debtor files or submits complete and accurate financial reports. Moreover, the statute sets forth specific case administration duties. Subchapter V trustees must be accountable for all property received during their administration of cases; they must retain all payments and funds received in cases until confirmation or denial of the plan; they must distribute such funds as authorized by the court or in accordance with any confirmed plan, or return the funds to the debtor if the court denies confirmation of the plan; and they must act as a disbursing agent under confirmed plans in certain cases. 11 U.S.C. §§ 1183(b)(1) (incorporating 11 U.S.C. §§ 704(a)(2), 1194(a)-(c)). In certain cases, they may be required to replace the debtor in possession and operate the business. 11 U.S.C. § 1185(a).

In addition, subchapter V trustees are required to preserve and safeguard all funds they administer, and they must be adequately bonded in all cases they administer. 11 U.S.C. §§ 322, 345(a). They also are required to file final reports and fully account for their administration of estates. 11 U.S.C. § 1183(b)(1) (incorporating 11 U.S.C. § 704(a)(9)).

The United States Trustee is charged with the responsibility to "appoint" the subchapter V trustees and "supervise" their administration of small business cases. 11 U.S.C. § 1183(a); 28 U.S.C. § 586(a)(3). Pursuant to this broad statutory mandate, the United States Trustee performs a variety of oversight functions as part of the supervision of subchapter V trustees. This is to ensure that the trustees are adequately performing their duties and to determine whether they should be appointed to administer future cases. These trustee oversight functions cover the duties performed by the trustees under SBRA and are similar

to the United States Trustee's oversight functions in supervising trustees who are appointed under other chapters of the Bankruptcy Code.

The United States Trustee's oversight functions include reviewing and evaluating subchapter V trustees' banking practices to ensure estate funds are preserved and accounted for, determining the amount and sufficiency of trustee bonds for the cases they administer, monitoring and reviewing certain trustee financial and case reports to ensure proper case administration and safeguarding of assets and personally identifiable information (PII), conducting audits and other periodic trustee reviews and evaluations, and undertaking enforcement actions, when appropriate and necessary.

In judicial districts in which the United States Trustee has appointed standing subchapter V trustees, the United States Trustee's oversight duties also will include reviewing and approving budgets for these trust operations, similar to the budget approval process currently in effect for trust operations for standing trustees in chapter 12 and 13 cases. 28 U.S.C. § 586(b).

These trustee oversight functions are further described below.

3-17.16.1 Banking[24]

Not all subchapter V trustees will hold or disburse estate funds. But to the extent that they do, trustees must preserve and safeguard estate funds by following statutory requirements for deposit and investment of money of the estates that they administer. 11 U.S.C. § 345(a). The United States Trustee closely supervises the trustees' banking practices to ensure performance of these specified duties, pursuant to 28 U.S.C. § 586(a)(3).

A trustee who holds estate funds or acts as a disbursing agent for plan payments "may make such deposit or investment of the money of the estate for which such trustee serves as will yield the maximum reasonable net return on such money, taking into account the safety of such deposit or investment." 11 U.S.C. § 345(a). Unless the funds are insured, guaranteed, or backed by the full faith and credit of the United States Government or its agencies, the institution holding the estate funds must post a bond in favor of the United States. 11 U.S.C. § 345(b)(1). In the alternative to posting a bond, the institution must deposit securities of the kind specified in 31 U.S.C. § 9303, and the trustee cannot accept or use other types of securities or investments absent court approval. 11 U.S.C. § 345(b)(2).

As a result of these statutory requirements, trustees must deposit all receipts into a banking institution that is insured by the Federal Deposit Insurance Corporation (FDIC), and is approved by the United States Trustee to hold deposits of bankruptcy estate funds as authorized depositories. 11 U.S.C. § 345(b). Each

[24] *See generally* Manual Volume 7.

regional office of the United States Trustee maintains a list of authorized depositories, which the trustee should request immediately upon appointment.[25]

It is the trustee's responsibility to ensure that the banking institution is in compliance with section 345 to the extent of the trustee's deposits. If the aggregate funds on deposit for an estate in a single institution exceed the FDIC's insurance limits, the excess funds must be bonded or adequately collateralized as required by section 345(b). The trustee must promptly notify the United States Trustee if the amount on deposit in an estate in any single depository exceeds or is expected to exceed the FDIC's insurance limits.

The types of trustee bank accounts also vary depending on whether the trustee is acting as a case-by-case trustee or a standing trustee. Case-by-case trustees must open a separate estate account for each case administered by the trustee. All receipts and disbursements of the trustee related to the case are made through this estate account, including all plan payments, administrative expenses allowed under 11 U.S.C. § 503, and any compensation that is awarded to the trustee under 11 U.S.C. § 330.

Standing trustees must establish and maintain two accounts. The first is a trust account for receipts and disbursements for all cases administered, and the second is an operating expense account for depositing all percentage fee income, interest income, awards of compensation to the trustee, and other receipts not deposited into the trust account. The standing trustee must pay all compensation, operating expenses, and payments to the United States Trustee System Fund out of the operating expense account. 28 U.S.C. §§ 586(e)(1), (e)(2). The percentage fee and any other compensation awarded to the trustee are to be transferred from the trust account to the operating expense account after all other section 503(b) awards have been paid.

Generally, a trustee should utilize a single banking institution. Bankruptcy-related funds may not be deposited to the trustee's business, personal, or trust account. And a standing trustee may not use the operating expense account for deposit or payment of any funds unrelated to the administration of the standing trustee's cases.

All trustee bank accounts should include the trustee's name and capacity as trustee. Individual estate accounts opened by case-by-case trustees should also include the case name and number.

Trustees must disclose to the United States Trustee the identity of each banking institution in which the trustee has an estate account (case-by-case trustees) or trust and operating accounts (for standing trustees) for the cases administered. If a bond in favor of the United States is filed to protect the deposit of estate funds, the United States Trustee must approve the corporate surety securing the bond. 11 U.S.C. § 345(b)(l)(B). The United States Trustee can only approve a surety

[25]To be approved by the United States Trustee, the banking institution must execute a Uniform Depository Agreement.

listed in Treasury Circular 570. The United States Trustee also receives a periodic report from the Federal Reserve to review the sufficiency of collateral posted by the banking institutions under 11 U.S.C. § 345(b)(2).

To assist in monitoring trustee accounts, trustees must supply all bank account information to the United States Trustee, including an authorization for the bank's release of information to the United States Trustee.

3-17.16.2 Bonding[26]

To qualify as a subchapter V trustee, the trustee has a duty to post and maintain a bond in favor of the United States, conditioned on the trustee's faithful performance of the trustee's duties. 11 U.S.C. § 322(a). The bond must be posted for every case in which the trustee is appointed regardless of whether the trustee administers any estate funds or acts as a disbursing agent, or whether the trustee is appointed as a case-by-case trustee or a standing trustee. 11 U.S.C. § 322(a). The trustee is not qualified to serve as a trustee in a case unless and until the bond has been filed with the court. 11 U.S.C. § 322(a). The bond must be posted before seven days after selection to serve as trustee in a case.

The United States Trustee determines the initial amount and sufficiency of the bond. 11 U.S.C. § 322(b). The United States Trustee may authorize the issuance of a blanket bond to cover a trustee for multiple cases or to cover multiple trustees for multiple cases in a particular jurisdiction. Fed. R. Bankr. P. 2010.[27] Pursuant to this statutory duty, the United States Trustee will direct the trustee whether to participate in a blanket bond or to procure an individual bond.

The initial amount of the bond shall be set by the United States Trustee after consultation with the trustees in the region, but shall not be less than $50,000 per trustee. Only companies that appear on Treasury Circular 570 are approved by the United States Trustee as sureties for issuing trustee bonds, but it is the trustee's responsibility to procure the bond and ensure that the bonding company is an approved surety. After approval of the amount of the bond and the sufficiency of the surety, the original bond and any riders will be filed by the United States Trustee with the court.

From time to time, the amount of the bond may need to be increased. Adjustments to the bond should be made only as approved by the United States Trustee.

---

[26] *See generally* Manual Volume 7.

[27] An individual case bond insures a single case for a single amount. A blanket bond covers multiple cases for one or more trustees. Two types of blanket bonds are schedule bonds and aggregate bonds. A schedule bond covers all listed trustees in a particular jurisdiction, with a listed limit per trustee and often with a listed case limit. An aggregate bond covers all listed trustees and their cases in an amount equal to the face amount of the bond.

It is the trustee's duty to monitor the bond and to ensure that it is maintained in an appropriate amount throughout the case. The trustee must promptly notify the United States Trustee of any significant increases in bank balances or any anticipated increases in funds because these might warrant an increase in the trustee's bond. 11 U.S.C. § 322.

A trustee who assumes the duties of a debtor in possession under section 1185 must promptly confer with the United States Trustee about whether a separate bond is required in the case or whether anticipated activity in the case requires an increase to the existing bond. The United States Trustee makes the final determination of the amount and sufficiency of the bond that must be posted for the trustee to remain as trustee in the case. 11 U.S.C. § 322(b).

As soon as the trustee becomes aware of an incident that may give rise to a claim against the trustee's bond, the trustee must notify the United States Trustee and the bonding company. 28 U.S.C. § 586(a)(3). The United States Trustee or any other party in interest may make a claim on the trustee's bond by filing an adversary proceeding no later than two years after the date on which the trustee was discharged. 11 U.S.C. § 322(d); Fed. R. Bankr. P. 9025.

3-17.16.3 Reporting

In addition to their court reporting responsibilities in specific cases, including filing final reports for each case administered (*see* Manual 3-17.10), subchapter V trustees must submit monthly and annual reports to the United States Trustee to assist the United States Trustee in supervising the administration of cases and ensuring accountability for any estate funds received or disbursed. 28 U.S.C. § 586(a)(3); 11 U.S.C. § 1183(b)(1) (incorporating 11 U.S.C. § 704(a)(2)). For case-by-case trustees, the monthly and annual reports will include the activity in the estate account(s) used for each assigned case during the period; for standing trustees, these reports will include the activity in the trust and operating expense accounts.

The trustee's monthly report will show activity in the various bank accounts maintained by the trustee, beginning and ending balances for each account, the trustee's receipts and disbursements, information related to the collateralization of funds and the sufficiency of the trustee's bond, case filing and closure information for all assigned cases, and such other information as is required by the United States Trustee. 28 U.S.C. § 586(a)(3). The monthly report shall be in the form prescribed by the United States Trustee in the Subchapter V Trustee Handbook. The trustee must submit the monthly report, together with copies of corresponding bank statements, to the United States Trustee within 30 days after the end of each month. 11 U.S.C. § 1183(b)(1) (incorporating 11 U.S.C. § 704(a)(2)).

The trustee's annual report will show the activity in the bank accounts maintained by the trustee, beginning and ending year-end balances for each account, the trustee's receipts and disbursements, case filing and closure statistics for the cases administered, information regarding the trustee's compensation received in the

cases administered, and such other information as is required by the United States Trustee. 28 U.S.C. § 586(a)(3). The trustee must submit the annual report to the United States Trustee in the form prescribed by the United States Trustee in the Subchapter V Trustee Handbook. 11 U.S.C. § 1183(b)(1) (incorporating 11 U.S.C. § 704(a)(2)). Case-by-case trustees must submit their annual reports to the United States Trustee within 45 days after the end of the fiscal year. Likewise, standing trustees must submit their annual reports to the United States Trustee within 45 days from the end of the fiscal year in which they are serving as standing trustees.

Trustees also are required to promptly report to the United States Trustee the loss, or potential loss, of PII in connection with cases the trustee administers.[28] The trustee's reporting obligation applies to, among other instances, the loss or potential loss of PII arising from the theft of paper files, personal computers, laptops, electronic devices, and removable drives such as USB flash drives and CDs. The trustee, in consultation with the United States Trustee, shall develop a plan of corrective action that the trustee will undertake to remediate the breach. The plan shall include the trustee's notifications to the affected individuals, law enforcement officers, and insurance carriers, as appropriate or required by law. The trustee also should take appropriate actions to mitigate the risk of further losses of PII, which largely will depend on the circumstances of the suspected breach.

3-17.16.4 [Reserved]

3-17.16.5 Audits, Periodic Reviews, and Evaluations

In addition to monitoring for compliance as described elsewhere in this Manual, the United States Trustee will conduct periodic audits, reviews and evaluations of the subchapter V trustees' performance of their duties similar to those conducted for trustees whom the United States Trustee regularly appoint and supervise in other chapters. This oversight function is separate and apart from specific monitoring and enforcement activity in particular cases, which the United States Trustee also is authorized to undertake in subchapter V cases. 11 U.S.C. § 307.

These periodic audits, reviews and evaluations are performed regardless of whether the trustee administers any estate funds or acts as a disbursing agent during the review period, or whether the trustee is appointed as a case-by-case trustee or serves as a standing trustee. 28 U.S.C. § 586(a)(3). They are essential for the United States Trustee to determine not only whether the trustee is adequately performing his or her duties in the cases administered, but also to

[28]This reporting obligation applies when the loss or potential loss of PII originates from the trustee's operation. The debtor may have separate duties to report PII losses consistent with applicable law.

determine whether the trustee should be appointed by the United States Trustee to administer future cases.

The trustee must submit to independent audits conducted periodically at the direction of the United States Trustee. 11 U.S.C. § 1183(b)(1) (incorporating 11 U.S.C. § 704(a)(2)). The United States Trustee will conduct an audit at least every three years regarding the cases and bank accounts administered by the trustee. The frequency of these audits is consistent with the frequency of audits conducted for other trustees appointed and supervised by the United States Trustee under other chapters.[29]

The audit is designed to determine the sufficiency of internal controls over estate accounts, the accuracy of the trustee's reporting to the United States Trustee, and the trustee's compliance with the United States Trustee's practices and procedures. Audits are the starting point for determining the adequacy of the trustee's financial management, internal control procedures, and organizational support. Audit firms are selected by the Office of Oversight, and the expense of the audit is paid from the United States Trustee Program's funds. The scope of the audit and the audit procedures are further described in the Subchapter V Trustee Handbook.

At the conclusion of the audit, the auditor will issue a report with findings. The trustee is required to satisfactorily respond to any noted deficiencies or inadequate findings, and to take corrective action as necessary or appropriate. The United States Trustee must report the trustee's failure to satisfactorily respond to the audit findings or take appropriate corrective action to the Assistant Director for Oversight and the Deputy Director for Field Operations, with a recommendation as to the appropriate response or enforcement action.

When an audit contains, in the judgment of the United States Trustee, serious findings, the United States Trustee may make a follow-up visit to the trustee's office to verify subsequent corrective actions and compliance. A follow-up visit also may be appropriate based on the auditor's disclosure of material weaknesses in internal controls or issuance of a qualified opinion, adverse opinion or disclaimer of opinion. Resolution of serious findings and audit deficiencies is an integral component of the United States Trustee's effective supervision of trustees. Failure by a trustee to implement necessary changes will result in appropriate action by the United States Trustee.

In those years in which no independent audit is performed, the United States Trustee may, but is not required, to conduct an office visit of the trustee. The scope of the office visit generally is more limited than an audit and largely dictated by areas of the trustee's past performance, if any, that may warrant further review. The trustee will be expected to satisfactorily address and resolve any performance issues or problems that are detected in connection with these office visits. The trustee's failure to implement any necessary changes may

[29]Chapter 7 trustees and chapter 12 standing trustees are audited every 3 to 4 years. Manual 2-2.7, 4-4.1. Standing chapter 13 trustees are audited annually. Manual 4-4.1.

result in appropriate remedial action by the United States Trustee.

In addition to audits and field office visits, the United States Trustee will evaluate the trustees and their performance on a periodic basis as part of the United States Trustee's ongoing supervisory responsibility. As part of these evaluations, the United States Trustee will review and evaluate the trustee's case administration, success rate in negotiating consensual plans, performance in making any plan disbursements, banking and bonding practices, professional conduct, and cooperation with the United States Trustee, among other review areas.

Standing trustees will be formally evaluated at least biennially. These evaluations will be documented in a formal written report, as further described in the Subchapter V Trustee Handbook.

Issues relating to the trustee's performance may result in remedial actions by the United States Trustee. For a standing trustee, this might include the termination of future case assignments. Because case-by-case trustees are appointed at the sole discretion of the United States Trustee, they should have no expectation of any future case assignments, regardless of the results of any particular audits or performance reviews.

3-17.16.6 Enforcement Actions Against Subchapter V Trustees

The United States Trustee's supervision of subchapter V trustees necessarily includes bringing actions in the bankruptcy court when performance problems or issues arise. Among others, enforcement actions in a specific case may include an objection to the trustee's final report and account, an objection to the trustee's requested compensation, requests for turnover of books and records, or an action to recover unauthorized expenses or compensation. These case-specific enforcement actions are prosecuted in the bankruptcy cases in which the trustee was appointed by the United States Trustee. The United States Trustee will make a concerted effort to resolve disputes consensually with the trustees, when appropriate, but final outcomes may be determined by the court when these efforts are unsuccessful or unavailable, or when a consensual resolution otherwise requires court approval.

If the United States Trustee has reason to believe that the trustee has engaged in conduct during the administration of a case that has resulted in harm to the estate, the debtor, creditors or other parties in interest, the United States Trustee also may commence a recovery action against the trustee to remedy such harms. This may include filing suit against the trustee and the trustee's surety in appropriate cases. The outcomes of these actions likewise are adjudicated by the bankruptcy court.

The United States Trustee also may move to remove the trustee from any or all assigned cases for "cause." 11 U.S.C. § 324(a). "Cause" is not defined in the Bankruptcy Code, but it may include the trustee's failure to properly administer cases, including the failure to comply with reporting obligations; discovery of fraud or embezzlement; mismanagement; or other misconduct or unsatisfactory

performance by the trustee. Whenever the court grants a motion to remove a trustee, the trustee is removed from all other cases in which the trustee is serving, unless the court orders otherwise. 11 U.S.C. § 324(b).

In addition, if the trustee has engaged in criminal misconduct, the United States Trustee may refer the matter to the appropriate law enforcement authorities for further investigation. 18 U.S.C. §§ 152-158; 28 U.S.C. § 586(a)(3)(F).