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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Attorney General And The Director, Administrative Office Of The U.S. Courts

Greater Oversight And Guidance Of Bankruptcy Process Needed

The Bankruptcy Reform Act of 1978 is intended, in part, to more equitably balance the interests of debtors and creditors GAO reviewed the activities of bankruptcy trustees in eight judicial districts to determine if the act's intent was being achieved

GAO found disparate treatment of creditors and debtors within and among the eight districts Specifically, trustees did not consistently invest funds from liquidated assets and inconsistently established minimum dollar limits when deciding whether to liquidate or abandon assets Additionally, GAO found some trustees were paid attorney fees for performing trustee duties and exceeded the maximum compensation and expense allowance provided by statute

GAO recommends that the Attorney General and the Director of the Administrative Office of the U S Courts coordinate their efforts and provide more guidance to, and supervision of, bankruptcy trustees

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-205847

The Honorable William French Smith
The Attorney General

William E. Foley, Director
Administrative Office of the
U.S. Courts

This report discusses how the administration of chapter 7 and chapter 13 bankruptcy cases can be improved to protect the interests of debtors and creditors in bankruptcy. We found that the management of estate funds and inconsistent case processing by trustees resulted in the disparate treatment of creditors and debtors within and among the eight bankruptcy courts visited. These problems can be resolved by better guidance and closer supervision of bankruptcy trustees by the judiciary and the Department of Justice.

We are also sending copies of this report to the Chief Justice of the United States; the Chairman, Judicial Conference Committee on the Administration of the Bankruptcy System; and each of the bankruptcy courts visited.

William J. Anderson
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE ATTORNEY GENERAL
AND THE DIRECTOR, ADMINISTRATIVE
OFFICE OF THE U.S. COURTS

GREATER OVERSIGHT AND
GUIDANCE OF BANKRUPTCY
PROCESS NEEDED

D I G E S T

Bankruptcy trustees are responsible for administering bankruptcy cases for the purpose of protecting the interests of debtors and creditors. In this regard, bankruptcy trustees handle thousands of cases and hundreds of millions of dollars annually. GAO found that trustees in the eight judicial districts visited were not adequately protecting the interests of debtors and creditors, resulting in their not realizing the full benefits of the bankruptcy process. GAO found that management of estate funds and inconsistent case processing by trustees resulted in the disparate treatment of creditors and debtors within and among the eight bankruptcy districts reviewed. GAO believes these problems could be resolved by better guidance and closer supervision of bankruptcy trustees by the judiciary and the Department of Justice.

The Bankruptcy Reform Act of 1978 is intended, in part, to more equitably balance the interests of debtors and creditors involved in bankruptcy proceedings. The act created the U.S. Trustee Program as a pilot project in 18 of the 94 judicial districts and assigned the Department of Justice the responsibility to implement the program. In the 18 pilot districts U.S. Trustees are responsible for overseeing the administration of bankruptcy cases by monitoring the activities of the bankruptcy trustees who administer individual cases for the purpose of protecting the interests of debtors and creditors. In the remaining 76 judicial districts, the responsibility for overseeing case administration falls primarily on the Clerks of Court or the

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Deputy Clerks of Court for Estate Administration (commonly referred to as estate administrators).

GAO initiated its review to determine if the practices and procedures used to administer cases were adequate to protect the interests of debtors and creditors. GAO's review was performed in four pilot[1] and four nonpilot[2] judicial districts.

TRUSTEES' PRACTICES IN ADMINISTERING CHAPTER 7 ASSET CASES NEED TO BE MONITORED AND IMPROVED

Chapter 7 of the bankruptcy act provides for the liquidation of debtors' assets that are not exempt under federal and state laws. In each chapter 7 case, a bankruptcy trustee is appointed by the court in the nonpilot districts and by the U.S. Trustee in the pilot districts to represent the bankrupt estate and liquidate any nonexempt assets and disperse the funds to the debtor's creditors. In the eight districts visited, GAO found that (1) trustees did not always administer cases in a manner which provided the greatest benefits to creditors; and (2) trustees used different case processing practices, resulting in debtors being treated inconsistently. The primary factors causing these problems were the limited monitoring and supervision of trustee activities and the inadequate guidance provided trustees by the Justice Department and the judiciary.

GAO believes that if the judiciary and the Department of Justice more closely monitored

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[1]Central district of California, southern district of New York, eastern district of Virginia, and the district of New Jersey.

[2]Southern districts of California and Ohio and the eastern districts of Kentucky and New York.

trustee activities and provided detailed procedural guidance to bankruptcy trustees, the bankruptcy process would be enhanced and would enable debtors and creditors to more fully realize the benefits of the bankruptcy process. The following areas demonstrate trustee activities that did not sufficiently protect the interests of debtors and creditors.

Investment of estate funds would result in greater return to creditors

GAO's review of all asset chapter 7 cases (771) closed during the period April 1, 1982, to September 30, 1982, showed that trustees did not earn interest on the funds generated from the liquidation of debtors' assets in 662 of the 771 cases in seven of the eight bankruptcy courts visited.[3]

In the seven districts with closed asset cases (502 of the 662), GAO determined that $863,436 had been deposited in noninterest-bearing accounts for an average of 170 days. Had these funds been invested in interest-bearing accounts yielding a minimum annual interest rate of 5.5 percent compounded daily, an additional $20,254 would have been available for distribution to creditors. In the remaining 160 cases GAO was unable to calculate the amount of interest forgone from the $395,711 generated from liquidation of assets because neither the judiciary nor the U.S. Trustees had the data necessary to make such a determination. (See pp. 7 to 10.)

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[3]One district had no asset cases closed during GAO's sample period; therefore, the district was not used in GAO's analysis of the extent to which trustees invested funds or received dual compensation.

Elimination of dual compensation would result in more funds being available to creditors

The act provides that the bankruptcy judges may appoint trustees to act as their own attorneys to represent bankruptcy estates if such authorization is in the best interest of the estate. This provision was enacted to reduce the administrative costs associated with the handling of the bankruptcy estate.

In both the pilot and nonpilot districts visited, GAO found that some trustees who were appointed by the court to act as their own attorneys were paid attorney fees for performing trustee duties. This resulted in trustees being paid twice for performing trustee duties, which had the effect of increasing the administrative costs of the bankruptcy cases. It also reduced the amount of funds available for distribution to creditors, but the extent of the reduction could not be determined from case records.

GAO's review showed that the bankruptcy judges appointed trustees to act as their own attorneys in 429 of the total 771 closed asset cases. Trustees' detailed billing statements for attorney services showed that in 268 of the 429 cases the trustee/attorneys were paid for performing trustee duties, thus receiving dual payments for duties that they are paid for through trustee fees and required by the act to perform. As a result, creditors were adversely affected because fewer funds were available for distribution to creditors. (See pp. 10 to 12.)

Varying asset liquidation levels affect debtors and creditors

In both the pilot and nonpilot districts visited, GAO found that trustees established various minimum dollar limits when they would liquidate nonexempt debtors' assets[4] or abandon them. If assets are abandoned, the secured creditors[5] have the option to repossess the assets or allow the debtor to retain them. The dollar limits generally represented the point where the trustees' administrative fees would consume all the proceeds from the liquidation of assets, thus leaving no funds for distribution to creditors.

GAO found that some trustees would not liquidate assets if the liquidation yielded less than $1,000 to the estate; however, other trustees liquidated assets which yielded as little as $42. These varying limits resulted in disparate treatment of debtors and creditors by impacting the amount of assets retained by debtors and the amount of funds available for distribution to creditors. (See pp. 12 and 13.)

BETTER CONTROL OVER CHAPTER 13 TRUSTEES' FINANCIAL ACTIVITIES NEEDED

Chapter 13 of the bankruptcy act provides debtors the opportunity to retain their assets when they agree to pay creditors over time, usually not more than 36 months. In these cases, chapter 13 trustees are responsible for collecting and disbursing to creditors money received from debtors under various repayment plans. The bankruptcy act provides that trustees may receive a maximum of 10 percent of the debtors' payments for their compensation and expenses. In the districts visited,

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[4]A debtor may elect to claim exemptions under either federal or state law unless the state has opted out of the federal exemptions under 11 U.S.C. 522(b)(1).

[5]Those who have a lien on, or other legal interest in, an asset which provides some assurance for payment of a debt.

GAO found that trustees improperly claimed and received compensation and expenses above the 10-percent ceiling.

GAO found that chapter 13 trustees in four of the eight bankruptcy courts visited exceeded the 10-percent ceiling. The excess compensation and expenses resulted because trustees were retaining the interest earned on estate funds or merely claimed and received excess funds. For example, in one district two trustees exceeded the ceiling by about $13,000 and $38,000, respectively, because they retained interest derived from estate funds.

Thus, in cases where the trustees merely exceeded the ceiling limitation, creditors would have received additional funds. In cases where the excess resulted from trustees retaining interest, the excess should have been returned to the U.S. Treasury. However, if interest is properly used to defray trustee expenses as indicated by the legislative history, the trustees' percentage fee for expenses then could be reduced, thereby increasing the monetary return to creditors. Both the Executive Office for U.S. Trustees and the judiciary could resolve this situation by improving the supervision and oversight of trustee activities. (See pp. 14 to 17.)

RECOMMENDATIONS TO THE ATTORNEY GENERAL AND THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS

Even though GAO's analysis cannot be projected to the nation's bankruptcy system as a whole, GAO believes that the problems identified were of such frequency and magnitude that similar conditions are likely to exist in other bankruptcy districts. Therefore, to ensure that the debtors and creditors receive the full benefit of the bankruptcy process and to improve the administration of chapter 7 asset cases and chapter 13 bankruptcy cases, GAO recommends that the Attorney General and the

Director, Administrative Office of the U.S. Courts,[6] coordinate their efforts and:

--Require the trustees to invest estate funds to reduce the cost of estate administration and provide the maximum return to creditors.

--Instruct trustees that if they act as their own attorneys they will not be reimbursed for attorney fees when they perform trustee duties.

--Require U.S. Trustees and estate administrators to scrutinize trustees' billing statements and advise bankruptcy judges of the appropriateness of the services rendered.

--Require U.S. Trustees and estate administrators to develop districtwide dollar limits for trustees to follow when deciding to liquidate assets.

--Require U.S. Trustees and estate administrators to closely monitor chapter 13 trustees' annual financial reports to ensure trustees are not exceeding the maximum compensation and expense levels. In addition, supplement the monitoring activities by having internal audit staffs of Justice and the judiciary review the financial activities of bankruptcy trustees.

AGENCY COMMENTS AND GAO'S EVALUATION

The Chairman of the Judicial Conference's Committee on the Administration of the Bankruptcy System, the Administrative Office of the U.S. Courts, four of the eight bankruptcy courts visited, and the Department of Justice provided written comments on the report. Of the

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[6]This agency provides management and administrative support to the judiciary.

remaining four courts visited two provided oral comments and two chose not to respond. The first two entities generally agreed with the report's findings, while the responses from the six bankruptcy courts were mixed. In commenting on the draft report, the Department of Justice generally disagreed.

Although the six courts for the most part agreed with the report's findings they did express certain reservations. Of the deficiencies discussed in the report the one addressing the need for investing estate funds drew the most comments. Although four courts that commented on this issue agreed that estate funds should be invested in certain cases and that guidelines should be developed and implemented, they did express a number of concerns. These concerns dealt primarily with the practicality of investing funds from small estates and the time available to trustees to invest the funds before distribution to creditors. However, as pointed out by the Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System and the Administrative Office, Bankruptcy Rule 5008(i), which became effective August 1, 1983, permits the aggregation of funds from several estates into a single account, thereby making the investment of funds from small estates more feasible. In regard to the courts' other concern, GAO's analysis of 502 cases amounting to $863,437 showed that these funds laid idle in noninterest-bearing accounts for an average of 170 days. This provided the trustees with sufficient time to invest the funds before distribution to creditors. (See pp. 19 and 20.)

The Department of Justice disagreed with the findings discussed in the report. Among its concerns was that the report did not recognize the guidance that had been provided by the Executive Office for U.S. Trustees and the U.S. Trustees Offices relating to the administration of chapter 7 asset cases. Justice also expressed concern that GAO's audit work was performed at a time when the U.S. Trustee Program was functioning under budgetary constraints.

With regard to guidance, GAO believes the guidance given trustees by Justice relating to the issues discussed in the report has not been adequate because it merely presents a broad discussion of the issues. For example, in the area of investing funds, Justice provided in support of its position a 1980 document sent to U.S. Trustees stating that it would shortly be promulgating a policy concerning the investment of funds. As of June 1984 no policy or guidance has been issued. Two pilot district courts supported GAO's position by stating that guidance was needed to ensure that estate funds were properly invested. Therefore, GAO continues to believe that additional guidance is needed to minimize the inconsistent treatment of debtors and creditors. (See pp. 20 to 25.)

Justice's claim that budgetary constraints have hampered the operations of the U.S. Trustee Program is accurate. However, this is the result of Justice's reluctance to request funding for the program for fiscal years 1982 and 1983. In fiscal year 1984 Justice requested funding to maintain the program until its then scheduled termination date of April 1, 1984. The termination date is now September 30, 1986. It has been Justice's position that the U.S. Trustee Program is a function of the judiciary, and therefore it has not requested funding for the program. While the deficiencies noted in the report can to an extent be attributed to Justice's reluctance to provide financial support for the program, other factors, such as need for adequate guidance and monitoring, have also played a major role in hampering the program's effectiveness. (See p. 31.)

C o n t e n t s

APPENDIX

CHAPTER 1

INTRODUCTION

The Bankruptcy Reform Act of 1978, Public Law 95-598, (commonly referred to as the code) was enacted on November 6, 1978, and became effective on October 1, 1979. This act was the first comprehensive revision to the bankruptcy statutes since 1938 and was intended, in part, to balance more equitably the interests of debtors and creditors. The code attempted to separate the bankruptcy judges from the administrative aspects of case processing in an effort to eliminate the potential impropriety that could arise by having the judges responsible for both the judicial and administrative functions of a case. In an experiment to determine the most effective way to handle the administrative functions of cases, the code created the U.S. Trustee Program, under the direction of the Executive Office for U.S. Trustees, within the Department of Justice. This pilot program was implemented in 18 judicial districts and is scheduled to terminate on September 30, 1986. In the remaining 76 judicial districts the responsibility for case administration falls primarily on the Clerks of Court and the Deputy Clerks of Court for Estate Administration (estate administrator).

OBJECTIVES, SCOPE, AND METHODOLOGY

Our review was initiated to determine if the U.S. Trustees and estate administrators were adequately protecting the interests of debtors and creditors involved in chapter 7 and chapter 13 bankruptcy proceedings. Chapters 7 and 13 of the code provide the framework for personal bankruptcy. Chapter 7, titled "Liquidation," is the "straight bankruptcy" chapter and provides for the liquidation and distribution of the debtor's non-exempt[1] assets, if any, to creditors. Chapter 13, titled "Adjustment of Debts of an Individual with Regular Income," differs from chapter 7 in that it does not require that property be surrendered for liquidation and distribution to creditors. Instead, it provides the debtor the opportunity to retain his/her assets when he/she agrees to pay creditors over time, usually

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[1]A debtor may elect to claim exemptions under either federal or state law unless the state has opted out of the federal exemptions under 11 U.S.C. 522(b)(1).

not more than 36 months. Under chapter 13, a proposed repayment plan is prepared and must be approved by the bankruptcy court. Both chapters 7 and 13 bankruptcy cases can be filed by debtors regardless of whether or not they are financially insolvent; that is, their debts do not have to exceed their assets.

To assess the activities of U.S. Trustees and estate administrators, we reviewed (1) the adequacy of the guidance and directives provided by the Executive Office for U.S. Trustees and the Administrative Office of the U.S. Courts and (2) the extent to which the fees for trustees' and experts' (such as accountants, attorneys, or appraisers) services were monitored to ensure their reasonableness. To accomplish these objectives we selected eight bankruptcy districts consisting of four pilot and four nonpilot districts. The pilot districts were the central district of California, the district of New Jersey, the southern district of New York, and the eastern district of Virginia. The nonpilot districts included the southern districts of California and Ohio, and the eastern districts of Kentucky and New York. In the eight districts, we reviewed and evaluated the procedures and practices used by trustees when administering chapters 7 and 13 bankruptcy cases.

The scope of our review included an analysis of closed chapter 7 asset cases and the financial operations of chapter 13 trustees. We did not review chapter 11 business reorganization cases because at the time of our review a private consulting firm hired by the Department of Justice was performing an in-depth study of the U.S. Trustee Program which concentrated on chapter 11 cases. The purpose of the study was to assist Justice in advising the Congress about determining the future of the U.S. Trustee Program when it terminates in September 1986. In discussing the scope of the contractor's study with the contractor, we decided that any work we performed on chapter 11 cases would be duplicative. Our review differed from the private contractor's in that we performed a detailed case analysis of 771 asset chapter 7 cases closed during the period April through September 1982 and a detailed analysis of chapter 13 trustees' financial operations. For a more detailed discussion of our scope and methodology, see page 32. Our review was conducted in accordance with generally accepted government auditing standards.

STRUCTURE OF THE FEDERAL BANKRUPTCY COURT SYSTEM

The Bankruptcy Reform Act of 1978 revised the structure of bankruptcy courts within the judicial branch of the government. The "courts of bankruptcy" created under the previous law were the district courts. However, nearly all bankruptcy cases were administered by referees who were appointed and supervised by U.S. district court judges. While referees were vested with jurisdiction to exercise certain powers of the court, the jurisdiction generally was limited to matters involving property in the actual or constructive possession of the court and was subject to a review by a district court judge. The code changed this system by establishing federal bankruptcy courts in the judicial districts as adjuncts of the U.S. district courts. This included jurisdiction of all matters arising under or related to bankruptcy cases.

The code provided that the new bankruptcy court system was to become effective on April 1, 1984, after a transition period which began October 1, 1979, the effective date of the code. During this period the bankruptcy courts were to exercise their broadened authority. In addition, the Administrative Office of the U.S. Courts, which provides management and administrative support to the federal judiciary, was required to determine and recommend to the Congress the number of bankruptcy judges needed to serve in the bankruptcy court system after the transition period was completed. The bankruptcy judges were to be appointed by the President for 14-year terms. In the 94 federal judicial districts throughout the United States and its territories, 242 bankruptcy judgeship positions (230 full-time and 12 part-time) were authorized for fiscal year 1984 in 91 federal bankruptcy courts administering federal bankruptcy law.

However, the status of the bankruptcy court system became unclear due to a June 28, 1982, Supreme Court decision declaring that the broad grant of jurisdiction to bankruptcy judges under the code violated Article III of the Constitution.[2] The court concluded that by expanding the jurisdiction of bankruptcy judges the code gave them Article III[3] powers without providing

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[2] Supreme Court's decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co. et al, 458 U.S. 50 (1982).

[3] Judges appointed under Article III of the Constitution have life tenure and may only be removed by impeachment. Their salaries may not be reduced.

them with life tenure and other Article III protections. In rendering its decision, the Supreme Court delayed its application until October 4, 1982, in order to afford the Congress an opportunity to resolve the matter without impairing the administration of the bankruptcy laws. Subsequently, the Supreme Court extended its stay until December 24, 1982. Since this date the federal bankruptcy courts have been operating under interim guidelines established by the Judicial Conference of the United States, the policymaking body of the federal judiciary.

The Bankruptcy Amendments of 1984, Public Law 98-353, addresses the Supreme Court decision. This act would continue to have bankruptcy judges act as adjuncts to federal district courts in the resolution of bankruptcy cases. Certain types of proceedings related to bankruptcy cases, such as personal injury and wrongful death cases, generally may not be referred by a district court judge to a bankruptcy judge for final judgment. However, bankruptcy judges can hear these cases and make recommendations so long as the final judgment is rendered by a district court judge. Only if the parties involved in these proceedings consent may a district court judge refer these proceedings to a bankruptcy judge for final judgment. Finally, this law now calls for the appointment of bankruptcy judges by the United States Courts of Appeals for a term of 14 years.

THE BANKRUPTCY PROCESS

A bankruptcy process begins with the filing of a petition in the bankruptcy court. The debtor must also file a schedule of all debts, creditors, assets, and, in the case of chapter 13, a proposed repayment plan which generally shows (1) monthly income, (2) monthly expenses, and (3) the amount which the debtor proposes to repay his/her creditors. After the petition is filed, the court appoints an interim trustee under chapter 7 or a trustee under chapter 13 to administer the bankrupt estate.[4] The trustee is the representative of the debtors' estate and is required to (1) recover and liquidate assets not exempt under law for the benefit of the debtor's creditors in chapter 7 cases

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[4]In the pilot districts the U.S. Trustee appoints the interim trustee in chapter 7 cases, and the U.S. Trustee, with the approval of the Attorney General, appoints the chapter 13 trustees.

and (2) review and oversee the fulfillment of the debtor's chapter 13 repayment plan. This responsibility includes receiving the debtor's payments and making payments to the debtor's creditors.

Within 20 to 40 days after a bankruptcy petition is filed, the court is required to hold a meeting of creditors. A purpose of the meeting is to provide the creditors with an opportunity to examine the debtor while he/she is under oath. In chapters 7 and 13 cases, creditors generally must file a proof of claim with the bankruptcy court to substantiate the debts owed by the debtors. Generally, if proofs of claims are not filed, the creditors are barred from participating in any distributions to creditors made by the trustee of (1) assets liquidated under a chapter 7 process or (2) payments made by the debtors pursuant to a chapter 13 repayment plan. In chapter 7 cases, the creditors may elect a trustee of their choice during the creditors' meeting. When the creditors do not elect a permanent trustee, the interim trustee becomes the permanent trustee. In chapter 13 cases, the creditors do not have the right to elect a trustee of their choice.

After completion of the chapter 7 or chapter 13 process, the debtor generally receives a discharge from the bankruptcy court. The discharge relieves the debtor from legal liability for the payment of all debts owed at the time of bankruptcy and listed by the debtor with certain exceptions, such as taxes, alimony, and child support. After a chapter 7 discharge has been granted, the debtor cannot be granted a discharge under chapter 7 for 6 years, but he/she can file under chapter 13 at any time. After a chapter 13 discharge has been granted, the debtor can file another chapter 13 at any time. However, the chapter 13 debtor can be granted a discharge under chapter 7 within 6 years only if the payments under the chapter 13 plan totalled at least an amount equal to (1) 100 percent of the allowed unsecured claims or (2) 70 percent of the unsecured claim when the plan was proposed by the debtor in good faith and was the debtor's best effort.

CHAPTER 2

INTERESTS OF DEBTORS AND CREDITORS

NOT BEING PROTECTED

Debtors and creditors involved in chapter 7 asset cases and chapter 13 cases have not always received the full benefits of the bankruptcy process because neither the U.S. Trustees nor the estate administrators have effectively monitored the administration of bankruptcy cases or provided the chapters 7 and 13 trustees adequate guidance concerning case administration. Thus, varying case processing practices have been used by bankruptcy trustees, with the result that reduced amounts of funds have been available for creditors, and debtors are treated inconsistently. To resolve these situations, the judiciary and the Department of Justice need to monitor and more closely oversee the activities of the chapter 7 and chapter 13 trustees who handle individual bankruptcy cases.

TRUSTEES' PRACTICES IN ADMINISTERING CHAPTER 7 ASSET CASES NEED TO BE MONITORED AND IMPROVED

In seven of the eight districts[1] visited we found that the chapter 7 trustees were not maximizing the financial return to creditors because estate funds were not being invested and trustees were receiving dual compensation. These actions limited the amount of funds available for distribution to creditors. Also, debtors were treated differently in the eight districts visited because trustees were inconsistently establishing monetary ceilings for determining when an asset would be liquidated. These deficiencies can be attributed to the inadequate guidance provided bankruptcy trustees and the limited monitoring of trustee activities by Justice and the judiciary.

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[1]The southern district of California had no asset cases closed during our sample period; therefore, this district was not used in our analysis of the extent to which trustees invested funds or received dual compensation.

Investment of estate funds would result in greater return to creditors

One of the trustees' responsibilities is to administer the bankrupt estate in a manner compatible with the best interests of debtors and creditors. One way this objective can be met in chapter 7 liquidation cases is by investing the funds generated from the liquidation of assets until the funds are distributed to creditors. Our analysis of the total 771 closed asset chapter 7 liquidation cases in 7 of the 8 districts showed that funds generated from the liquidation of assets were invested in 109 cases. Of the remaining 662 cases in which funds were not invested, we were able to determine that funds in 502 cases were available for investment for an average of 170 days.

This situation exists because the Executive Office for U.S. Trustees and the Administrative Office of the U.S. Courts have not provided the trustees with adequate guidance regarding the investment of proceeds from the liquidation of assets in chapter 7 cases. Therefore, for the most part, trustees used their own judgment when deciding whether to invest the proceeds from liquidated assets. We found that in the majority of cases reviewed trustees were not investing funds and therefore not maximizing the return to creditors.

Our review showed that trustees invested estate funds in only 109 of the 771 asset chapter 7 liquidation cases. The table on the following page illustrates the amount of funds available for investment and the number of cases in which the trustees did, or did not, invest the proceeds from liquidated assets.

Net amount available for investment	Cases which earned interest		Cases which did not earn interest[a]	
	Pilot district	Nonpilot district	Pilot district	Nonpilot district
Less than $ 1,000	14	19	165	306
$ 1,000 - $ 2,999	15	23	28	89
$ 3,000 - $ 4,999	6	3	14	18
$ 5,000 - $ 9,999	4	6	6	14
$10,000 - $14,999	3	5	3	3
$15,000 - $19,999	1	4	0	4
$20,000 or more	2	4	6	6
Total	45	64	222	440

[a]Cases not earning interest were identified through a review of case files, bank statements, and cancelled checks. All cases dealt only with cash transactions, not in-kind transactions.

In commenting on the report, the Justice Department said that there is no way to discern whether the problems of not investing funds are isolated instances of poor judgment by a few trustees or systemwide inadequacies. In this regard, we analyzed the 222 pilot district cases which did not earn interest and found that a total of 44 trustees administered the cases (6 trustees in central California handled 11 cases; 8 trustees in New Jersey handled 36 cases; 5 trustees in the southern district of New York handled 12 cases; and 25 trustees in the eastern district of Virginia handled 163 cases).

Because inadequate guidance has been given to the trustees regarding the investment of funds by either the Executive Office for U.S. Trustees or the Administrative Office of the U.S. Courts, differing investment practices among the trustees have evolved. For example:

--A trustee in the eastern district of Virginia (a pilot district) invested $300 from the proceeds of a liquidated asset for 4 months and earned $5 interest, while another trustee in this district held $41,000 from liquidated assets for 15 months in a noninterest-bearing account.

--A trustee in the southern district of Ohio (a nonpilot district) earned $30 interest on an estate of $2,033 for 5-1/2 months, while another trustee in this district placed $5,015 in a noninterest-bearing account for over 10 months.

--One trustee in the eastern district of New York (a non-pilot district) invested $700 for 19 days and earned $2 interest, while another trustee in this district earned no interest on $1,584 during the 18 months the estate funds laid idle.

On the basis of the cases we analyzed we found that the financial practices used by trustees did not always maximize the financial return to creditors. Of the 662 cases which earned no interest, we were able to calculate, in 502 cases, the number of days the funds were not invested. Our analysis showed that $863,437 was not invested for an average of 170 days. Had these funds been invested in interest-bearing accounts yielding a minimum annual interest rate of 5.5 percent compounded daily, an additional $20,254 would have been available for distribution to creditors. We were unable to calculate the interest forgone from the $395,711 in the remaining 160 cases because neither the bankruptcy districts nor the U.S. Trustees had the data necessary to make such a determination. The following table illustrates the amount of funds available for investment, the number of cases in which the funds were or were not invested, and the amount of interest earned or forgone.

Net amount available for investment	Cases which earned interest: Number	Total interest earned	Average period available for investment[a] (days)	Cases which did not earn interest: Number	Total interest foregone	Average period available for investment[b] (days)
Less than $ 1,000	33	$ 216	121[2]	370	$ 3,217	177
$ 1,000 - $ 2,999	38	1,360	180	80	2,788	149
$ 3,000 - $ 4,999	9	668	263	22	1,999	164
$ 5,000 - $ 9,999	10	13,966	315	14	1,488	108
$10,000 - $14,999	8	5,212	139	4	1,064	151
$15,000 - $19,999	5	3,602	125	4	1,730	148
$20,000 or more	6	10,383	307	8	7,968	183
Total	109	$35,407	185	502	$20,254	170

[a]The average period available for investment is the average number of days from the date of the last deposit of estate funds by the trustee to the date the trustee prepared the final report regarding the disposition of the chapter 7 case. For the cases that earned interest on several occasions we used the date the last asset was liquidated until the trustee prepared the final report because the date of the final deposit of funds was not available.

[b]We were unable to determine in four cases the number of days the funds were invested.

The preceding table shows that there is a potential for the trustees to increase the financial value of the bankrupt estates, thereby resulting in more money being available for distribution to creditors. On a nationwide basis we attempted to calculate the amount of interest forgone to creditors from the bankruptcy case data collected by the Administrative Office of the U.S. Courts. This effort was unsuccessful because the specific data needed to make such a calculation is not collected. The only way such a calculation can be made is by performing a systematic analysis of each of the 91 bankruptcy courts. However, we were able to determine from data gathered that during the year ended June 30, 1983, 20,617 chapter 7 liquidation cases were closed and $117 million of estate funds were available for distribution to creditors. If the same percentage of funds was not invested in these cases as in the cases we reviewed, as much as $75 million in estate funds may not have been invested.

To provide creditors with the full benefit of the bankruptcy process, trustees should invest the proceeds from the estates. If this is to occur, the Executive Office for U.S. Trustees and the Administrative Office must require trustees to invest the proceeds from the estates they administer and monitor the trustees' activities to ensure the investment policies are implemented. Such actions would be appropriate even for small estates because the new Bankruptcy Rule 5008(i) that became effective August 1, 1983, permits the aggregation of estate funds.

Elimination of dual compensation would result in more funds being available to creditors

The code states that the bankruptcy judge may appoint a trustee, if qualified, to act as his/her own counsel if it is in the best interest of the estate. The judge is also responsible for approving the attorneys' fees for services rendered in the case. According to the legislative history of the act, the purpose of permitting a trustee to serve as his/her own counsel, in lieu of retaining an attorney, is to reduce the administrative cost of handling the estate. It was not intended to provide the trustee with additional compensation for performing trustee duties, or to exceed the maximum trustee fee established by the code. However, in seven of the eight districts visited, we found some trustees that acted as their own attorneys were paid attorney fees for performing trustee duties. Thus, the intent of this provision was being negated because it was not reducing the administrative cost of the estates.

In 429 of the 771 cases we reviewed, the bankruptcy judges appointed trustees to also act as their own attorneys for the estates. On the basis of a review of trustees' detailed billing statements for attorney services, we found that in 268 cases the trustee/attorneys were compensated for performing trustee duties. In 65 cases we were unable to determine if the trustee/attorneys performed trustee or attorney duties because the billing statements were either incomplete or illegible. In the remaining 96 cases where the trustees were appointed by the judges to act as attorneys they did in fact perform attorney duties and not trustee duties and thus were entitled to reimbursement.

The code (11 U.S.C. §704) describes the duties and responsibilities of trustees administering chapter 7 cases as follows:

--Collecting and liquidating the property of the debtor's bankruptcy estate, and closing the estate as expeditiously as is compatible with the best interests of the parties involved.

--Accounting for all property received.

--Investigating the financial affairs of the debtor.

--Examining proofs of claims and objecting to the allowance of any claim that is improper.

--If advisable, opposing the discharge of the debtor.

--Furnishing information concerning the bankruptcy estate and its administration as is requested by the parties in interest.

--Furnishing reports concerning the debtor's business, if it is authorized to be operating.

--Making a final report and filing a final account of administration with the court.

In the 268 cases where trustees were appointed as attorneys and being compensated for performing trustee duties, at least one or more of the above-mentioned duties was specifically listed on the trustees/attorneys' billing statements. When one of these specific duties was not listed, other duties were listed on the attorneys' billing statements that were directly related to those specified in the code as trustee duties. For example, trustee/attorney billing statements contained the following description of services rendered:

--preparing a list of questions to ask the debtor,

--examining the debtor at the first meeting of creditors,

--reviewing the debtor's petition and schedules, and

--answering letters from creditors regarding the status of the case.

We believe these duties specifically fall under the categories listed in the code that require the trustee to investigate the financial affairs of the debtor and to provide information to the parties involved in the case.

It is important to note that to qualify as a trustee in a case, an individual need not have a legal background or possess a law degree. Therefore, the trustee duties outlined in 11 U.S.C. § 704 are general responsibilities not requiring legal expertise. In the 268 cases we reviewed where the trustees acted as their own attorneys and received attorney compensation for performing trustee duties, they were receiving dual compensation. That is, they were receiving attorney fees in addition to their trustee fees to perform trustee duties. Although we were unable to determine the dollar value of these duties because the claims for compensation did not specify the amounts of time spent performing each task, the ultimate effect is that fewer funds were available for distribution to creditors.

To assist the bankruptcy judges in monitoring claims for attorney services in the future, the U.S. Trustees and estate administrators should review the claims and provide their suggestions to the bankruptcy judges regarding whether the services rendered were in fact appropriate attorney duties. It is important that the claims for attorney services be closely monitored if the interests of the creditors in the bankruptcy process are to be protected.

Varying asset liquidation levels affect debtors and creditors

Trustees in the eight districts visited had varying approaches regarding what minimum dollar amount of nonexempt assets must be available for liquidation before they attempt to liquidate the assets. These varying approaches resulted in the inconsistent treatment of debtors and creditors. For example, depending on the trustee administering the case one debtor may be permitted to retain as much as $1,000 in assets, while another debtor in the same bankruptcy court may have all of his/her assets liquidated. Of course, the debtors would only be able to retain the assets the trustee did not liquidate if the secured creditors decided not to repossess them on their own. The dollar limits represent the point where the trustees' administrative fees would consume all the proceeds from the liquidation of assets.

The minimum amount of assets a trustee is willing to liquidate has a direct impact on what belongings a debtor will retain after bankruptcy and the amount of funds creditors will receive from the debtor's estate. In the southern district of California, a trustee told us he will not liquidate assets in a case unless the liquidation will yield at least $1,000 to the estate. If debtors' assets amount to less than $1,000, the trustee abandons[2] them. This procedure, in effect, provides debtors an additional $1,000 exemption. In contrast, other trustees in this district set their liquidation ceilings at $500.

The U.S. Trustee in the eastern district of Virginia has authorized trustees not to liquidate assets which, when liquidated, will yield less than $200 for the estate. This procedure was instituted to avoid the situation wherein all funds from the liquidated estate would go towards cost of administration rather than to creditors. However, our case review showed that the trustees in this district varied from this threshold. For example, one trustee in the eastern district of Virginia liquidated assets which yielded as little as $42, and the entire amount was absorbed by the trustee's compensation and expenses. Overall, 30 of the 193 cases reviewed in this district yielded less than $200, and in 11 of these cases all proceeds from liquidated assets were used for trustee compensation and expenses.

To alleviate the inconsistent treatment of debtors and creditors within districts, the judiciary and Justice should establish minimum liquidation thresholds on a districtwide basis to ensure that all debtors and creditors are treated equally.

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[2]Property which is abandoned in a case is kept by the debtor unless a creditor pursues a valid lien against the property.

BETTER CONTROL OVER CHAPTER 13 TRUSTEES' FINANCIAL ACTIVITIES NEEDED

In four of the eight districts visited we found that chapter 13 trustees exceeded the 10-percent ceiling for compensation and expenses as established by the code. If the trustees had not exceeded the ceiling limitation, creditors would have received additional funds and more fully realized the benefits of the bankruptcy process. The excess compensation and expenses claimed in the four districts could have been identified if the annual financial reports the trustees are required to submit had received closer scrutiny by the U.S. Trustees and estate administrators.

In chapter 13 cases trustees deduct their compensation and expenses from the amount debtors are required to pay according to the terms of their court-approved repayment plans. During the tenure of the plans, usually a maximum of 3 years, the trustees' functions include:

--monitoring the debtors' payments to ensure their accounts do not become delinquent;

--initiating court action to dismiss cases which become delinquent, or convert them to chapter 7 liquidation cases;

--investing idle account funds and using the interest earned to offset operating expenses; and

--periodically collecting funds from the debtor and disbursing funds to the creditors.

In return for administering chapter 13 cases the trustees are reimbursed for their expenses in addition to their compensation.

The code allows each bankruptcy court in the nonpilot districts and the Attorney General in the pilot districts to establish the compensation and expenses trustees receive for administering estates subject to the following restrictions:

--Compensation may not exceed 5 percent of the debtors' planned payments.

--The 5-percent maximum compensation may not exceed, annually, the salary of a government employee at grade 16, step 1, of the General Schedule.

--If the total compensation and actual necessary expenses incurred by a trustee exceed 10 percent, or a lower percentage as established by the U.S. Trustee or bankruptcy courts, of debtors' planned payments, the excess must be returned to the U.S. Treasury.

We found four districts that exceeded the 10-percent ceiling. In a fifth district--the southern district of New York--we were unable to make such a determination because the trustee had not, as of September 30, 1983, submitted his fiscal year 1982 annual report. Furthermore, his annual reports for fiscal years 1980 and 1981 could not be analyzed for compliance with the code because they covered 19-month and 5-month periods rather than the required 12-month period. The following examples demonstrate the extent to which the trustees exceeded the 10-percent ceiling.

--The three chapter 13 trustees in the eastern district of Virginia exceeded the 10-percent ceiling by receiving a total of approximately $20,000 over the ceiling for fiscal years 1980, 1981, and 1982.

--In fiscal year 1982 the two chapter 13 trustees in the district of New Jersey received compensation and expenses in excess of the ceiling by approximately $13,000 and $38,000 respectively. These funds were derived from the interest earned on estate funds.

--In the eastern district of New York one of the chapter 13 trustees also exceeded the 10-percent ceiling. In fiscal year 1982 the trustee exceeded the ceiling by $29,000 because he was basing his fee and expenses, in part, on receipts from a prior year. At the time of our review this trustee and the Administrative Office were in the process of resolving the issue.

--The trustee in the eastern district of Kentucky exceeded the ceiling by $15,000 in fiscal year 1982. In commenting on the draft report, the bankruptcy judge from this district said that he believes that the trustee should be permitted to use interest income beyond the 10-percent maximum for compensation and expenses if the trustee incurs an extraordinary expense. Thus, he believes that the trustee was justified in exceeding the statutory limit because he incurred extraordinary costs for computer services, and in the future this will reduce the trustee's compensation and expenses. We believe the law is very specific that the 10-percent ceiling cannot be exceeded and, further, there is no guarantee that the trustee's percentage fee for compensation and expenses will be reduced in the future.

In the New Jersey district where the trustees exceeded the 10-percent ceiling because of the interest earned on estate funds, officials from the Executive Office for U.S. Trustees and the chapter 13 trustees told us that trustees were entitled to use the interest earned on estate funds even though the 10-percent ceiling would be exceeded. In their opinion, interest earned on estate funds is not subject to the 10-percent ceiling because the code is silent on the use of interest income. We disagree with their interpretation because the legislative history of 11 U.S.C. 541 (a)(6) clearly indicates that the Congress intended that any interest or gain realized on the investment of funds will become property of the estate and thus increase the funds distributed to the creditors. (House Report No. 95-595, September 8, 1977, p. 368.) In two districts we were unable to determine from the trustees' records or through interviews why the trustees exceeded the 10-percent ceiling. The explanation provided by officials from the Executive Office for U.S. Trustees and the Administrative Office was that the trustees were not entitled to the funds and the trustees' annual financial reports would be more closely monitored to prevent this from occurring again.

In commenting on the report, Justice misunderstood our presentation of how creditors would have benefited if trustees would not have exceeded the 10-percent ceiling either by retaining interest on estate funds or by improperly accounting for estate funds. In this regard, where the trustees were retaining interest on estate funds that resulted in their total compensation and expenses exceeding the 10-percent limit, the excess should have been returned to the Treasury. However, if interest is properly used to defray trustee expenses as indicated by the legislative history, the trustees' percentage fee for expenses then could be reduced, thereby increasing the monetary return to creditors. In situations where the excess stemmed from the trustees inappropriately retaining estate funds, creditors would have received additional funds if the estates funds had been properly accounted for by the trustees. The proper administration of these estates by the trustees in the circumstances just discussed would have permitted the creditors to more fully realize the full benefits of the bankruptcy process.

Both the Executive Office for U.S. Trustees and the judiciary could reduce the extent to which the problems we identified occur by improving the supervision and oversight of trustee activities. To further improve the monitoring of trustee activities the Executive Office for U.S. Trustees and the judiciary should obtain the assistance of their internal audit staffs. The audit staffs would supplement the oversight of the U.S. Trustees and estate administrators by reviewing whether trustees are adhering to the provisions of the code and the guidelines issued by Justice and the judiciary. The audit staffs could be also used for in-depth audits of the trustees' financial activities when the U.S. Trustees or estate administrators become aware of problems.

CONCLUSIONS

Our review of the procedures used to process bankruptcy cases in four pilot and four nonpilot districts showed that trustees administering chapter 7 asset cases and chapter 13 cases need to be more closely monitored, and better guidance needs to be provided by the Executive Office for U.S. Trustees and the judiciary. We found that the trustees in both pilot and nonpilot districts were not adequately protecting the interests of debtors and creditors and thus the debtors and creditors were not realizing the full benefits of the bankruptcy process. For example, trustees' financial management and inconsistent case processing practices created disparate treatment of debtors and creditors within the districts we visited. Some of the practices identified were advantageous to some debtors and creditors, yet adversely affected others. The inconsistent administration of bankruptcy cases could be resolved through better dissemination of guidance from, and closer supervision by, the judiciary and the Department of Justice.

RECOMMENDATIONS TO THE ATTORNEY GENERAL AND THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS

Although our analysis cannot be projected to the nation's bankruptcy system as a whole, we believe that the problems identified were so frequent and of such magnitude that similar conditions are likely to exist in other bankruptcy districts. Therefore, to ensure that the debtors and creditors receive the full benefit of the bankruptcy process and to improve the administration of chapter 7 asset cases and chapter 13 cases, we recommend that the Attorney General and the Director of the Administrative Office of the U.S. Courts coordinate their efforts and:

--Require trustees to invest estate funds to reduce the the cost of estate administration and provide the maximum return to creditors.

--Instruct trustees that if they act as their own attorneys they will not be reimbursed for attorney fees when they perform trustee duties.

--Require U.S. Trustees and estate administrators to scrutinize the trustees' billing statements and advise bankruptcy judges of the appropriateness of the services rendered.

--Require U.S. Trustees and estate administrators to develop districtwide dollar limits for trustees to follow when deciding to liquidate assets.

--Require U.S. Trustees and estate administrators to closely monitor chapter 13 trustees' annual financial reports to ensure trustees are not exceeding the maximum compensation and expense levels. In addition, supplement the monitoring activities by having the internal audit staffs of Justice and the judiciary review the financial activities of bankruptcy trustees.

CHAPTER 3

AGENCY COMMENTS AND OUR EVALUATION

The Judicial Conference's Committee on the Administration of the Bankruptcy System, the Administrative Office of the U.S. Courts, four of the eight bankruptcy courts visited, and the Department of Justice provided written comments on this report. (See apps. I to VI). Of the remaining four courts visited two provided oral comments and two chose not to respond. The first two generally agreed with our conclusions and recommendations, while the reactions of the six courts were mixed. In contrast, the Department of Justice generally disagreed with the report's conclusions and recommendations.

The following is a discussion of the comments received and our evaluation of the comments.

INVESTMENT OF ESTATE FUNDS

The Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System and the Administrative Office said they believed that trustees should be encouraged to invest funds as a means of defraying the costs of administration and providing the maximum return to creditors in bankruptcy. In addition, the Chairman and Administrative Office stated that most chapter 7 cases have no assets and there are situations in which investment of estate funds would not be in the best interest of the estates. However, the Chairman and Administrative Office added that the new Bankruptcy Rule 5008(i) which became effective August 1, 1983, permits the aggregation of funds, thereby making the investment of funds from small estates more feasible.

Four of the six bankruptcy courts commented on this section of the report. Two of the four stated that guidelines and supervision were needed to guide trustees regarding the investment of bankruptcy funds. However, the four courts did express concern that (1) investing funds from small estates is futile because of the small return to creditors, (2) interest earned from an estate may not offset the paperwork time and costs associated with preparing income tax returns, and (3) the length of time between the liquidation of the assets and the distribution of funds to creditors may not justify the investment of funds. With regard to the small amount of funds, we believe that our recommendation to require trustees to invest estate funds to maximize the return to creditors and the bankruptcy rule pertaining to the aggregation of funds would address the concern about the small dollar amount of funds available for investment.

The courts also raised the concern as to whether the interest to be earned from investing funds would be negated by the cost of preparing tax returns. We wish to point out that trustees are not required to prepare a federal income tax return unless an individual estate has gross income of $2,700 or more.[1] For those estates that earn income above $2,700 we do not believe that the cost of preparing a tax return would negate the interest earned.

The final concern raised by the courts was that the time between liquidation of the assets and the distribution of funds to creditors had to be of such duration to make it beneficial to invest funds. We agree with this concern; however, as shown on page 9 of this report, estate funds in the amount of $863,437 laid idle in the noninterest-bearing accounts for an average of 170 days.[2] In our opinion, this time period allowed sufficient time to invest funds.

In commenting on the section of the report Justice echoed the concerns raised by the bankruptcy courts just discussed and stated that the Executive Office for U.S. Trustees and U.S. Trustees Offices have offered guidance on the investment of funds. While this is true, we believe the guidance given has not been adequate (see pp. 7 to 10). Further, the comments received from two courts which were pilot districts support our belief in that these courts stated that guidance was needed. To support its contention concerning guidance, Justice attached to

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[1]The provision of the Internal Revenue Code relating to income tax returns and filing requirements for bankruptcy estates is section 6012 (a)(9).

[2]The average period available for investment is the average number of days from the date of the last deposit of estate funds by the trustee to the date the trustee prepared the final report regarding the disposition of the estate.

its comments a memorandum dated April 10, 1980, which included a statement that the Executive Office for U.S. Trustees would shortly be promulgating a policy concerning the investment of estate funds. In the interim, U.S. Trustees were told to do everything possible to ensure that estate funds were being invested. However, as of June 1984, the Executive Office had not issued any policy or guidance pertaining to the investment of funds as indicated in the 1980 memorandum.

In the absence of uniform national guidance some U.S. Trustees had developed guidance for the trustees in their districts. Justice provided copies of such documents issued by three of the four U.S. Trustees included in our review that it contends provides guidance to trustees on the investment of estate funds. Although these documents discuss the investment of estate funds, in our opinion they cannot be categorized as adequate guidance. For the most part the three documents provided us by the Executive Office merely advised the trustees to invest estate funds without providing any specific guidance. Consequently the investment practices between and among the U.S. Trustee Offices have been inconsistent. For example, a concern of many of the trustees we interviewed was that a federal tax return was required of an estate that earned interest no matter what the amount. However, only one of the documents provided us on the investment of estate funds pointed out that a federal tax return need not be prepared unless gross income from an individual estate amounts to $2,700 or more.

In this regard, adequate guidelines on the investment of estate funds should as a minimum include such provisions as (1) the trustees' responsibilities for preparing tax returns when interest is earned on estate funds, (2) revisions to federal rules of bankruptcy procedure that pertain to the investment of estate funds, and (3) the type of secure investments that will result in a substantial return. These provisions are not all inclusive but merely demonstrate the type of guidance the Executive Office for U.S. Trustees could provide on the investment of estate funds. On the basis of the issues just discussed and the evidence presented in the report, we believe the guidance provided by the Executive Office on the investment of estate funds needs to be improved to ensure greater consistency among U.S. Trustees.

ELIMINATION OF DUAL COMPENSATION

In responding to the issue that some trustees acting as their own attorneys were receiving compensation as attorneys for performing trustee services, not legal services, the Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System and the Administrative Office agreed that more guidance in this area was needed. Of the six bankruptcy courts responding, two addressed this issue and provided mixed comments, while the Department of Justice disagreed for a number of reasons.

The Committee Chairman and the Administrative Office stated that the additional guidance needed dealt with instructing estate administrators and U.S. Trustees to scrutinize trustees' billing statements more carefully and to advise their courts to disallow attorney compensation where the services rendered constitute trustee duties. In further support of our position both parties pointed out that the Administrative Office's Office of Management Review in its audits of individual bankruptcy courts has also discovered instances where trustees have claimed attorney fees for performing trustee duties. To prevent this from occurring in the future, the Office of Management Review has recommended corrective action and greater supervision of the trustees by the pertinent courts.

A concern expressed by one of the two courts and Justice was that the deficiencies we identified may be attributable to what they believe to be an inadequate fee structure for trustee compensation in chapter 7 asset cases. They contended that the commissions trustees receive for administering the assets of an estate are unreasonably low. Therefore, because of the unreasonable fee structure bankruptcy judges may not be inclined to strictly enforce the rule that attorneys should not be compensated for performing trustee duties, thereby leading to the situations we identified. In regard to this observation, we found no support that judges approved fees for this reason.

The other court commenting on this issue stated that creditors are given the opportunity to object to the fees requested by trustees. However, the court states that the creditors rarely object to the fees. As a consequence, the court believes that it is being criticized for lack of meticulousness in looking after the interest of disinterested creditors. Even though creditors rarely object to trustees' fees, we do not believe this relieves the court of its responsibility for ensuring that legal fees are not being paid for performing trustee duties. In fact, the Bankruptcy Reform Act of 1978 is very clear that the judge is responsible for approving the appointment of attorneys and approving their fees.

In addition to its previously discussed concern, Justice submitted to us a number of documents which it believes provide guidance to trustees on the issue of claiming legal services. The documents were from two of the four U.S. Trustee Offices included in our review. No documents on this subject were provided by the Executive Office for U.S. Trustees or the remaining two U.S. Trustees Offices we reviewed. We have continually requested such documents from the Executive Office and none have been forthcoming. The documents that were submitted did not address the issue of dual compensation as discussed in the report. Of the five documents submitted for one U.S. Trustee's Office only two discussed the retention of counsel. One document provided the trustees with examples to use on their application to the court justifying the need for counsel so as not to be questioned by the judges. The other document informed trustees to perform some legal services if they were going to claim compensation as an attorney. The documents submitted for the second U.S. Trustee's Office addressed the reimbursement of trustee compensation and expenses and not the retention of counsel. These documents do not provide specific guidance for trustees to follow and do not address our recommendation that instructs trustees that if they act as their own attorneys they will not be reimbursed for attorney fees when they are performing trustee duties.

VARYING ASSET LIQUIDATION LEVELS

In commenting on the need to develop districtwide dollar limits for trustees to follow when deciding to liquidate assets, the Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System, the Administrative Office, the Department of Justice, and three of the six courts responding expressed mixed views concerning this issue.

Two of the three courts that commented agreed that liquidation limits would be appropriate. One of the courts that agreed stated:

"In connection with the problem concerning the inequities which have arisen from different liquidation limits within a district, there can be no question but that this is a proper recommendation and should be implemented and carried out to the fullest extent possible."

The court that disagreed stated that the administration of justice is an imprecise science that results in many inequities, such as nonuniform sentences for the same crime and disparate awards for the same injuries. It is true that such conditions prevail. However, that in and of itself does not make it appropriate. In fact, the Congress is presently attempting to establish sentencing guidelines to reduce the disparity in sentencing practices that this court has alluded to. Similarly, we are attempting to limit the disparate treatment of debtors and creditors in the bankruptcy process.

The Committee Chairman, the Administrative Office, and Justice questioned the need for establishing mandatory limits. The Committee Chairman and Administrative Office agreed that the concept may have merit and would be considered further. However, both agreed that they are not convinced that mandatory dollar limits for liquidation on a districtwide basis would be the most effective approach to ensuring equal treatment of debtors and creditors. They said they were concerned that such an approach may be too inflexible to accommodate the variety of situations in which a decision must be made on whether liquidating an asset would be justified in light of the costs associated with liquidation. Justice, in its comments, echoed these concerns and added that many U.S. Trustees have attempted to set minimum liquidation guidelines, and the success of this effort has been mixed. Our review of documents from four U.S. Trustees Offices indicated that only one office established minimum liquidation guidelines (see p. 13 of the report).

In addressing these concerns, it should be recognized that the recommendation contained in the report is an attempt to narrow to the extent possible the inconsistencies that presently exist when trustees decide to liquidate or abandon an asset. We realize that there are valid exceptions to any standard, and we would expect them to occur if the judiciary and Justice implemented our recommendation. The establishment of dollar limits for liquidation would provide the trustee with a point of reference to use when deciding whether or not to liquidate an asset and provide a more consistent treatment of debtors and creditors. However, the limit established should only be deviated from for good reason, such as when it would be cost effective to not liquidate the asset or assets. If the judiciary and Justice do not establish the dollar limits pertaining to the liquidation of assets then each individual trustee within each bankruptcy district will continue to determine his/her own limits, as is evidenced by the report. As a consequence, the inconsistent treatment of debtors and creditors will go unchecked.

BETTER CONTROL OVER CHAPTER 13 TRUSTEE ACTIVITIES

The Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System, the Administrative Office, and three of the six bankruptcy courts commenting agreed that the financial activities of the chapter 13 trustees should be closely monitored and the financial reports should be reviewed to ensure that trustees are not exceeding the statutory maximum authorized for compensation and expenses. However, Justice disagrees and states

> "The main thrust of the criticism of chapter 13 case administration seems to be that creditors are not receiving monies due them because the interest earned on funds invested by the standing trustees is not used to pay creditors, but is being used to increase the trustees' compensation."

Justice believes that the concerns discussed in the report pertaining to the administration of chapter 13 cases are based on a misreading of the law by GAO.

We believe that Justice's comments (1) do not accurately characterize our concerns with the administration of chapter 13 cases; (2) do not distinguish between what the law allows trustees to collect as a percentage fee from debtor payments and what may be retained from that fee as compensation; (3) do not address the proper effect on, and treatment of, amounts collected under the percentage fee as a result of using interest earned to offset expenses; and (4) reflect an excessively restrictive application of the code and its legislative history with regard to 11 U.S.C. 541(a)(6) and the treatment of interest earned.

Justice's characterization of our concerns with chapter 13 case administration is not accurate because it focuses solely on the issue of whether creditors are to directly receive interest earned on debtor payments. Rather, our finding is that trustees are receiving funds in excess of the statutorily prescribed limits contained in 11 U.S.C. § 1302(e). Whether and to what extent creditors are not receiving the full benefits of the bankruptcy process represents a result of trustees retaining the excess. Our finding is equally valid even if creditors receive full payment for their claims to the extent that the excess is not returned to the Treasury, or used as a basis for reducing the debtor's payments under a modification of the payment plan under 11 U.S.C. § 1329(a). Because Justice focused on the interest issue, the matter is discussed in detail below.

While Justice acknowledges that excess compensation is to be returned to the U.S. Treasury under 11 U.S.C. § 1302, it also characterizes that requirement as applying to amounts in excess of 10-percent compensation. As we pointed out on pages 14 and 15 of the report, the code limits the amount of the percentage fee to be retained as compensation to 5 percent of the payments. The differential between that 5 percent and the percentage fee collected from the payments, as fixed by the court but not to exceed 10-percent, may be retained only to the extent needed to cover actual, necessary expenses. Justice's comments do not recognize this distinction between the maximum 10 percent percentage fee which may be collected by the trustee and the amount of that percentage fee which may be retained as compensation.

This distinction is important in analyzing the proper effect on, and treatment of, the amounts collected under the percentage fee as a result of using interest earned to offset expenses. It was expected that the percentage fee set by the court would generate sufficient funds to cover the compensation for the trustee (not to exceed 5 percent of payments made under the plans) as well as the trustee's office expenses.[3] The legislative history of 11 U.S.C. § 1302(e) further indicates that the court would fix the percentage fee on the basis of a "budget" which would be prepared by considering the anticipated caseload of the trustee, the payments that would result from such cases, and the trustee's projected office expenses. In recognition of the possibility that future developments might result in the amounts collected by the trustee under the percentage fee exceeding the allowed compensation and actual, necessary expenses, 11 U.S.C. §1302(e)(2) provides that the excess be returned to the Treasury.

The earning of interest on the debtor's payments, and the trustee's use of that interest to defray expenses, is just such a development. Under the budget and fee setting process described above, the fee should reflect what is needed to provide

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[3]See House Report 95-595, p. 106 (1977).

the trustee with compensation and expense reimbursement. If interest earned is retained by standing trustees to cover office expenses, then the amount of the percentage fee that is needed to be retained to cover remaining expenses should be reduced. In such a case, with compensation limited to 5 percent under 11 U.S.C. § 1302(e)(2)(A) and the full amount of the remaining 5 percent (assuming a 10-percent fee) not needed to cover expenses, there will be excess from the percentage fee. This excess must be returned to the Treasury under section 1302(e)(2).

However, our report describes cases in which trustees retained the interest and the 10-percent fee without returning funds to the Treasury. Justice did not provide a legal basis justifying the retention of funds totaling more than 10 percent of debtor payments, other than to suggest that it may be permissible to use interest earned to offset administrative expenses carried over into the next year. We find no basis for such a construction of the statute either in the code or in its legislative history. Section 1302(e)(2) provides that amounts remaining from the percentage fee after paying compensation and expenses shall be paid annually to the Treasury.

While Justice acknowledges that interest is to be used to defray expenses, it does not trace through the effect this will have. We did not intend that our comment be interpreted to suggest that interest should or is supposed to go directly to the creditors. Of course, if excess from the percentage fee occurs under the analysis described above, the immediate effect is that it must be returned to the Treasury. However, as discussed below, we also took into account that the proper treatment of interest should affect the percentage fee which should be established, and thereby ultimately benefit creditors.

Using interest to defray expenses can ultimately result in enhancing the recovery of creditors. By paying expenses with earned interest and thereby reducing the need to pay expenses out of the percentage fee, the opportunity exists for reducing the fee. The reduction need not apply to the maximum 5-percent compensation authorized by section 1302(e)(2)(A), but to the remaining 5 percent (assuming a 10-percent fee) originally allocated to cover necessary, actual expenses. This can occur under 11 U.S.C. § 1329(a) which provides a basis for modification of the payment plan. There also is judicial precedent for bankruptcy judges to make an equitable adjustment in the amount the chapter 13 trustee can collect from plan payments.[4] Of course,

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[4]Matter of Eaton, 1 B.P. 433 (1979).

whether the plan should be modified or the percentage fee reduced must be examined on a case-by-case basis. However, if standing trustees are returning funds to the Treasury or, as we found, retaining the interest in addition to a 10 percent percentage fee, it appears reasonable that some equitable adjustment should at least be considered. There was no indication during our review that such actions occurred or were considered. Thus, we recommend that U.S. Trustees and estate administrators closely monitor chapter 13 trustees' annual financial reports and that internal audit staffs of Justice and the judiciary review the financial activities of trustees. We have clarified the discussion on page 16 to reflect the distinction between the immediate effect and the potential benefit of eliminating the trustees retention of excess funds.

The analysis discussed throughout is based on our applying 11 U.S.C. § 541(a)(6), as incorporated by 11 U.S.C. § 345, to chapter 13 cases. We believe that Justice's comments reflect an excessively restrictive application of the code and its legislative history. Not only does 11 U.S.C. § 103(a) provide that chapter 3 (containing section 345) and chapter 5 (containing 541(a)(6) apply to chapter 13 cases, but the legislative history of the sections in question provides no basis for limiting their application to chapter 7. We believe the legislative history of these sections indicates a broader application.

Section 345 authorizes trustees to invest money of the estate. Section 541(a)(6) provides that the estate includes "proceeds, product, offspring, rents, and profits of or from property of the estate." The legislative history clearly shows the interrelationship of these two sections. Committee reports on section 345 state that:

> "Under proposed 11 U.S.C. § 541(a)(6), * * * any interest or gain realized on the deposit or investment of funds under this section will become property of the estate, and will thus enhance the recovery of creditors."[5]

With regard to estates administered by U.S. Trustees in pilot districts, 11 U.S.C. § 15345 authorizes the aggregation of estates in order to maximize return on investment and requires that:

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[5]House Report 95-595, p. 333 (1977); Senate Report 95-989, p. 44 (1978).

"any return on any such deposit or investment shall be paid by the United States trustee into the Treasury."[6]

The legislative history clearly shows that "the interest earned on estate funds will further defray the cost of the United States Trustee system."

While the law is not as clear with regard to the treatment of interest by chapter 13 standing trustees as it is for U.S. Trustees, the legislative intent is unmistakable. The committee reports reveal that the authority for private trustees to aggregate estates would be left to the Rules of Bankruptcy Procedure. However, in specifically mentioning standing chapter 13 trustees, the reports state that when funds are invested, "the interest or return on the funds would defray the costs of administering the cases in which the private standing trustee serves."[7]

Further, the Judicial Conference Advisory Committee on Bankruptcy Rules stated, in its note to the new bankruptcy rule for section 345, that combined deposits or investments may be particularly beneficial when a standing chapter 13 trustee has a large number of plans to administer. In light of these legislative and judicial pronouncements and the clear interrelationship between sections 345 and 541(a)(6), we found unsupportable Justice's comment that our statements regarding the investment of funds do not apply to chapter 13 cases.

SCOPE AND METHODOLOGY

The Department of Justice took issue with the scope and methodology of our work. In commenting on the report Justice questioned why we conducted our review because ABT Associates in their study covered chapter 7 and chapter 13 cases. In this regard, we specifically explained the differences between our review and ABT Associates (see p. 33). Our review differed from ABT Associates in that we concentrated solely on closed chapter 7 asset cases, whereas ABT's study included chapter 7 cases

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[6]Section 15345 was moved from section 345 when it was agreed that the U.S. Trustee system would be a pilot program.

[7]House Report 95-595 p. 334; Senate Report 95-989 p. 44.

filed. ABT Associates used data collected by the Administrative Office of the U.S. Courts for the purpose of selecting a universe of chapter 7 cases to sample. However, ABT Associates discovered, as we did during a prior bankruptcy study,[8] that the chapter 7 cases filed as recorded by the Administrative Office did not distinguish between asset and no asset cases until the case was closed. Also, ABT Associates discovered as we did that the bulk of the chapter 7 cases filed were not asset cases. Therefore, the sample taken by ABT Associates contained a limited number of chapter 7 asset cases. As a result, we obtained from the Administrative Office a universe of closed chapter 7 asset cases and concentrated solely on these cases.

Our review further differed from ABT's in that we concentrated on the financial operations of chapter 13 trustees, whereas ABT limited its evaluation to a broad overview of the chapter 13 process. ABT's review was limited because the Executive Office for U.S. Trustees had limited resources devoted to the chapter 13 process.

Justice's final comment on this section is that our sampling techniques and methodology are statistically unsound. In support of this position Justice constructed a chart (see p. 53) which compares for each district we reviewed the number of cases we reviewed, which Justice labels as sample cases, to the total number of chapter 7 cases filed during fiscal year 1982 and chapter 7 asset cases active at the end of fiscal year 1982 for the four pilot districts included in our review. By comparing filed and pending cases to the cases we reviewed, Justice arrived at a very low percentage of cases analyzed as compared to the total universe of chapter 7 cases filed and active asset cases. On the basis of these percentages, Justice concluded that our methodology was unsound.

However, Justice's conclusion that the cases reviewed were selected from a sample and consisted of both chapter 7 asset and nonasset cases is not accurate. This was not the methodology we used, which is explained on pages 32 to 34 of the report. On page 34 of the report we have added additional language to clarify that we analyzed the entire universe of chapter 7 asset cases and that a sample of cases was not taken because of the limited universe. Although our analysis cannot be projected to

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[8]Bankruptcy Reform Act of 1978--A Before and After Look (GAO/GGD-83-54, July 20, 1983).

the nation's bankruptcy system as a whole, we believe that the problems identified were so frequent and of such magnitude that similar conditions are likely to exist in other bankruptcy districts.

OVERALL COMMENTS BY JUSTICE

Justice stated that during the April 1982 to September 1982 period in which the cases we reviewed were terminated, the U.S. Trustee Program operated under budgetary constraints, thus hampering the operation of the program. In particular Justice stressed that the budget constraints resulted in a reduction of staff that reduced their oversight of chapter 7 and chapter 13 cases. Justice's statement is accurate to the extent that the program has been and continues to be affected by a reduction in staff due to budgetary constraints. However, the budgetary constraints stemmed from Justice's unwillingness to support the program, because it contended that the U.S. Trustee Program was properly a function of the judiciary and not the Department of Justice.

In this regard Justice had not requested funding for the program in fiscal years 1982 and 1983. Even though Justice did not request funding or permit the Executive Office for U.S. Trustees to prepare a budget, the Congress still provided funding--$5.7 million and $7.5 million in fiscal years 1982 and 1983 respectively. These funding levels were such that the Executive Office was required to initiate a reduction-in-staff. In fiscal year 1984, Justice initially did not request funding; however, it subsequently requested $6.8 million to continue the program until April 1, 1984, the then scheduled termination date. However, the Congress subsequently extended the program from April 1, 1984, to September 30, 1984, and provided $8.2 million to operate the program.

The deficiencies noted in the report can to an extent be attributed to Justice's unwillingness to financially support the U.S. Trustee program. However, the limited guidance and monitoring in the administration of chapter 7 asset cases also contributed to the deficiencies identified.

CHAPTER 4

SCOPE AND METHODOLOGY

We reviewed the implementation of the Bankruptcy Reform Act of 1978, as it related to bankruptcy cases filed under chapters 7 and 13, because of our continuing interest in improving the operations of the federal judiciary. The review was initiated to determine (1) the adequacy of the guidance and directives provided by the judiciary and the Executive Office for U.S. Trustees on case administration, (2) if the interests of debtors and creditors were being adequately protected, and (3) the extent to which the fees for trustees' and experts' services were monitored to ensure their reasonableness. To accomplish these objectives we selected eight bankruptcy court districts consisting of four pilot and four nonpilot districts. The pilot districts are under the purview of the U.S. Trustee Program administered by the Department of Justice which the Congress established as an experimental pilot program, and which is scheduled to terminate in September 1984. In these districts a U.S. Trustee is responsible for overseeing the administration of cases. In the four nonpilot districts, which are not part of the experiment, the responsibility for overseeing case administration rests with the Clerks of Court and the Deputy Clerks of Court for Estate Administration (estate administrators).

During the planning and scoping phase of this assignment, a literature search was performed. We identified studies completed and underway that dealt with the administration of bankruptcy cases. From the results of the studies identified, interviewing individuals knowledgeable in the bankruptcy field, and our own work, an audit approach was developed to accomplish our objectives.

Our review included an assessment of the administration of closed chapter 7 asset cases and the financial operations of chapter 13 trustees, but it did not include an assessment of the administration of chapter 11 business reorganization cases because of the efforts expended in this area by a private contractor. The contractor was hired by the Department of Justice to conduct a study of the U.S. Trustee Program as required by the code.[1] After reviewing the statement of work for the

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[1]ABT Associates, (JYUST-82-C-101), required by Public Law 95-598.

contract and discussing our efforts with the contractor's project manager we decided that any work we would perform on administration of chapter 11 cases would be duplicative. Although the private contractor's effort also included chapters 7 and 13 cases, our review differed because we performed a detailed analysis of 771 closed asset chapter 7 cases and a detailed review of chapter 13 trustees' financial operations.

SELECTION OF LOCATIONS

The detailed audit for this assignment was performed at 8 of the 91 bankruptcy courts which handle bankruptcy cases for the 94 judicial districts. These courts were selected because of the expertise of the staff that was available in our regions that had performed work on a prior review of bankruptcy operations. That assignment addressed the impact of the Bankruptcy Reform Act of 1978 on bankruptcy filings. The report was issued on July 20, 1983, and is entitled Bankruptcy Reform Act of 1978--A Before and After Look, (GAO/GGD-83-54). Five of the eight districts visited during this assignment were also included in the prior assignment. Three additional bankruptcy districts were added to provide us with broader coverage. The additional districts included two pilot districts (the district of New Jersey and the eastern district of Virginia) and one nonpilot district (the southern district of California). Thus, our review included four pilot[2] and four nonpilot[3] districts. These eight bankruptcy districts represented approximately 22 percent of all chapter 7 cases terminated and 20 percent of all chapter 13 cases filed during statistical year 1982 (July 1, 1981, to June 30, 1982). The eight districts included four districts on the east coast, two districts on the west coast, and two districts in the midwest.

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[2]Central district of California, district of New Jersey, southern district of New York, and the eastern district of Virginia.

[3]Southern districts of California and Ohio and the eastern districts of Kentucky and New York.

SELECTION OF ASSET CASES REVIEWED

We reviewed all 771 asset chapter 7 cases that were terminated during the period April 1, 1982, to September 30, 1982. This time frame was selected because court officials told us that this would have allowed the trustees ample time to become familiar with the changes in the code that affected the procedures for administering cases. Therefore, we would be in a better position to evaluate how case administration affected debtors and creditors in the bankruptcy process. These 771 cases consisted of 574 nonbusiness cases and 197 business cases. Rather than sampling from the 771 cases, we analyzed the entire universe of cases. The table below shows the chapter 7 asset cases reviewed, by bankruptcy court district, and distinguishes between business and nonbusiness cases.

District	Non-business	Business	Total
Central California	4	8	12
Southern California[a]	0	0	0
Eastern Kentucky	32	13	45
New Jersey	19	27	46
Eastern New York	73	39	112
Southern New York	11	5	16
Southern Ohio	274	73	347
Eastern Virginia	161	32	193
Total	574	197	771

[a]This district closed no asset chapter 7 cases during our sample period.

Our review work was conducted between January 1983 and February 1984. We analyzed the procedures used by U.S. Trustees and the bankruptcy courts to administer chapters 7 and 13 cases. At each court visited, we interviewed judges; chapters 7 and 13 trustees; Clerks of Court; and, where applicable, U.S. Trustees and Deputy Clerks of Court for Estate Administration. We discussed their procedures for appointing trustees, trustees being appointed as attorneys, the reasonableness of the fees charged by experts, and how the bankruptcy process could be improved.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

EDWARD J. RYAN
BANKRUPTCY JUDGE
UNITED STATES COURTHOUSE
FOLEY SQUARE
NEW YORK, N. Y. 10007

XXXXXX
212-791-0145

March 21, 1984

William J. Anderson, Esq.
Director
United States General Accounting Office
General Government Division
Justice Audit Site
441 G Street, N.W., Room 3862
Washington, D. C. 20548

Dear Mr. Anderson:

At a meeting of the United States Bankruptcy Judges for the Southern District of New York held on March 5, 1984, inter alia, we gave consideration to a "Draft of a Proposed Report: Greater Oversight and Guidance of Bankruptcy Process Needed."

It would appear to the judges that much of the critical comment is directed to administrative matters under the supervision of the Office of the United States Trustee in this District. That office is making a direct reply. In view of the statutory placement of the oversight function with the Office of the U. S. Trustee, not the bankruptcy judges, it is unclear why the report stresses the need for judicial supervision. For example at page 6, the proposed report states:

> "These deficiencies can be attributed to inadequate guidance provided bankruptcy trustees and the limited monitoring of trustee activities by the Justice and the judiciary."

Perhaps the reference is intended to be only to "the judiciary" in non-pilot districts.

While many of the comments are well taken generally, there are countervailing considerations in individual cases.

William J. Anderson, Esq., GAO 2.

Needless to say, in order to accomplish the suggestions in the proposed report, a substantial increase in high quality staff is required in our court and I am sure in the Office of the United States Trustee for this District.

Very truly yours,

Edward J. Ryan
United States Bankruptcy Judge

EJR:eej

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF VIRGINIA
206 NORTH WASHINGTON STREET
SUITE 410
ALEXANDRIA, VIRGINIA 22314

CHAMBERS OF
MARTIN V B BOSTETTER, JR.
JUDGE

(703) 557-3867

March 22, 1984

Mr. William J. Anderson
Director
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Anderson:

Reference is made to your letter of February 23, 1984 enclosing a copy of the draft of a proposed report concerning greater oversight and guidance of the bankruptcy process. I have reviewed the report carefully and discussed the same with the other bankruptcy judges of this district and will reply <u>seriatim</u> to the five problems raised through the recommendations of your report.

You have clearly outlined in your report that this district is part of the United States Trustee pilot program, whereby the United States Trustee appoints and supervises the trustees in this district, and thus the problems outlined are within his province and this reply, accordingly, should be viewed in that context.

A consideration of the investment of funds by trustees must necessarily take into account several factors: (1) the size of the amount to be invested, (2) the length of time between liquidation and distribution and (3) the possibility of emergency payments that can arise before distribution is made and which could require immediate payment.

The requirement imposed upon trustees to file tax returns for estates where income is earned requires a consideration of the amount earned. The ultimate effect being that if the amount earned does not warrant the necessary time in filing a tax return, there is a resulting negative impact. In addition, it is important to consider the time between the receipt of the funds and the distribution of the same. If the investment of the funds unduly delays distribution to the creditors, then this could be in conflict with the spirit of the act. The requirement for reserving funds for emergency payments can arise in certain cases and must be taken into account by the trustee and, on occasion, can present a delay or prevent an investment of the funds.

There can be no doubt that in a large number of cases it is not only practicable but crucial that funds be invested for the longest period possible. This concept should be implemented by well-drawn guidelines, a thorough educational process of the trustees through the United States Trustee or estate administrator, and a continuing close scrutiny to make sure that where practicable there is adherence to such guidelines.

The area concerning the overlapping of trustee duties with attorney functions is not an easy one to monitor. This area has been monitored not only by the United States Trustee but, also, by the Court of this district, and certain guidelines have been informally established to prevent as far as possible such overlapping. The general format followed is that any procedure which could be performed by a client without legal help is ordinarily a function charged to the trustee. On the other hand, any function requiring the expertise of an attorney is ordinarily considered a legal function, e.g., the initial letter sent to the debtors of the bankrupt demanding payment is a trustee function, since this could have been accomplished by a client who has no legal training, e.g., preparation of pleadings is an attorney function. 1

In connection with the problem concerning the inequities which have arisen from different liquidation limits within a district, there can be no question but that this is a proper recommendation and should be implemented and carried out to the fullest extent possible.

The recommendation in connection with close monitoring by the United States Trustee and estate administrators of Chapter 13 trustees along with internal audits is, again, one which is a proper function and should be instituted if not already in place or implemented where necessary.

It should be noted that all the above problems have been of ongoing concern in this district, and the United States Trustee has generally carried out these functions well, but that lack of sufficient funding and, in turn, lack of adequate personnel has no doubt hampered the effort.

I trust that the foregoing will be of help on the report.

Very truly yours,

Martin V. B. Bostetter, Jr.
United States Bankruptcy Judge

MVBB,Jr/jpm

1We found no evidence of nor when requested were we provided with documents by the district of formal or informal guidelines pertaining to the overlapping of trustee duties with attorney functions.

United States Bankruptcy Court
District of New Jersey
U. S COURT HOUSE
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RICHARD W HILL
BANKRUPTCY JUDGE

(609) 989 2018
FTS 483 2018

March 23, 1984

William J. Anderson, Director
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

I want to thank you for the opportunity to respond to the draft report of the United States General Accounting Office respecting the operation of Chapter 7 and Chapter 13 of the new Bankruptcy Code. Much of the report involves the supervision of Chapter 7 and Chapter 13 trustees. You must appreciate that because New Jersey is a United States Trustee Pilot area, that direct supervision of the trustees is principally the responsibility of the United States Trustee, although in certain areas, particularly the fixing of fees, the Court has an independent role to play.

I am going to direct my comments generally to some of the comments found in Chapter 2 of the draft report. I will organize my comments by your subheadings.

<u>INVESTMENT OF ESTATE FUNDS</u> (Page 7)

I think that everyone would agree that investment of funds in the appropriate case is beneficial. I think, however, that what is really required is not a directive that all estate funds always be invested. Rather, what is required are guidelines and supervision with respect to the investment of monies. For example, on page 8, 588 cases of the 662 cases which earned no interest fall in the zero to $2,999 category. On page 9, in the less than $1,000 category, you indicate that in 370 cases, $3,217 in interest was foregone. That is less than $10 a case. I would suggest that it is a futile effort to require a trustee to invest money when the rate of return is less than $10 a case.

I am not a tax expert, but it has always been my understanding that trustees who had interest income, regardless of the amount, are required to file a tax return. If that assumption is correct, it is even more clear that investment activity in small cases is futile. At the very least, as a trustee invests money he must apply for a taxpayer identification number for each case (except for a corporation). The $10 worth of interest earned will not justify the paperwork involved in processing an application for a employer's identification number, much less paying for the preparation of a tax return.

I think it is clear that there must be guidelines respecting investment of money and policing of those guidelines. The per case income, however, must justify the expense. For example, you report on page 8 that a trustee in New Jersey neglected to invest $72,500 for seven months. That is inexcusable. I think that the trustee should be surcharged for the lost interest.[1]

ELIMINATION OF DUAL COMPENSATION (Page 10)

I agree that counsel for trustees and trustees should not be compensated for the same services. That is a problem even where the trustee retains separate counsel. In that case, the trustee is content to apply for his commissions and frequently his attorney will attempt to be compensated for services which really should have been compensated for in the commissions area.

Although I agree that the four duties referred to at the bottom of page 11 are frequently trustee duties and not attorney duties, I would suggest to you that in complicated cases, an attorney for the trustee might justifiably perform these duties.[2]

I think that one of the major problems respecting fees, particularly in small cases, is that the commissions available under the Code are unrealistically low. I think that if we return to the practice under the Act of permitting the Bankruptcy Judge award a limited flat fee ($150 under the Act) regardless of whether the commissions justified the fee, that judges would be more inclined to strictly enforce the rule that attorneys should not be compensated for performing trustee's work.

VARYING ASSET LIQUIDATION LEVELS (Page 14)

I agree that there should be guidelines with respect to what assets are abandoned. I think that you should keep in mind, however, that if you have unsecured claims which total $7,000 and you have a gross recovery of $500, that after the payment of fees and expenses, very little remains to be distributed to creditors. $250 distributed among $7,000 is a return of less than .04¢ on the dollar. I am not altogether sure that the credit industry has any desire for a recovery of that limited amount.

In any event, guidelines would be appropriate.

CONTROL OVER CHAPTER 13 TRUSTEES' FINANCIAL ACTIVITIES (Page 14)

I agree that the financial activities of Chapter 13 trustees should be carefully checked and monitored. Since the judges do not fix fees in United States Trustee pilot areas, I cannot comment on the propriety of Chapter 13 trustees receving 10% plus the interest generated on the funds collected. I would suggest, however, that your comment on page 13 suggesting that creditors would have received additional funds if this had not occurred is inaccurate. What creditors receive is determined by the confirmed plan. For example, if the unsecured creditors were to receive .50¢ on the dollar, I do not believe that trustee investment could or would increase that amount.

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[1]Because of additional information provided by the Executive Office for U.S. Trustees this example was deleted from the report.

[2]We agree that attorney services may be required in complicated cases. Therefore, when making the determination of dual compensation we reviewed both the trustees' billing statements and the case files. If these documents in any way indicated that a particular service required legal input we did not question the compensation paid.

What trustee investment of funds appears to do is to provide additional sources of revenue with which to meet expenses and commissions. Ideally, the interest earned should permit the reduction of the percentage figure so that debtors pay less.

If your legal position is correct, I think that instead of benefiting the creditors, that the excess monies should have been paid into the Treasury of the United States.

While we are talking about the commissions of Chapter 13 trustees, I do think that several other matters in the area should be addressed. Particularly at a time of high filings, trustees seem to generate sufficient income to meet expenses. At other times, however, trustees may operate at a loss. I think that the statute should be amended or regulations drafted to permit losses incurred by Chapter 13 trustees to be satisfied by "profits" made in other years.[3]

Finally, I believe that because of the large amount of money involved on a national basis, that Chapter 13 trustees should be closely monitored and their accounts audited by major accounting firms which have developed expertise in this area. In fact, the United States Trustee Program does use a "Big 8" accounting firm on a national basis.

For Chapter 7 and Chapter 13 to work well, supervision is required either by the United States Trustee's Office or the Estate Administrator in non-poilot areas. I know in New Jersey that the United States Trustee's Office is not sufficiently staffed to appropriately supervise Chapter 7 operations. I am sure that in non-pilot areas there is not sufficient monies to appropriately staff the Estate Administrator's Office. Appropriate supervision, bottom line, requires an additional commitment of monies. Only Congress can provide that.

I might make one other comment about supervision in the Chapter 7 or Chapter 13 areas. It is literally impossible and not cost effective to audit every case. I do think, however, that some thought should be given to random auditing of trustees on a very intensive basis. This might be the most cost effective way to proceed.[4]

Thank you for the opportunity to comment on the draft report. Please call me if I can be of any further assistance.

Sincerely,

Richard W. Hill

RWH/kmc

cc: Each Judge, District of New Jersey
Clifford P. Kirsch, Clerk

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[3]Trustees can carry a loss forward only to the extent the loss is first offset against the trustee's compensation and the amount carried over is only for expenses.

[4]The report does not recommend auditing every case.

ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS
WASHINGTON, D C 20544

WILLIAM E. FOLEY
DIRECTOR

JOSEPH F. SPANIOL JR
DEPUTY DIRECTOR

April 2, 1984

Mr. William J. Anderson, Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

I appreciate the opportunity to review and comment on your proposed report to the Congress entitled, "Greater Oversight and Guidance of Bankruptcy Process Needed." The draft report has been reviewed by Judge Robert E. DeMascio, Chairman of the Judicial Conference Committee on the Administration of the Bankruptcy System, and by the Bankruptcy Division of this office and other members of my staff. Judge DeMascio and I are in agreement in our views regarding the report, and the judge has asked that I express his appreciation to your staff for the additional week in which to coordinate this response. I should note that the Judicial Conference Committee will meet next in July and will consider the comments and recommendations of your office at that time.

We agree that greater supervision is needed of trustees appointed under chapters 7 and 13 of the Bankruptcy Code, and we endorse your recommendation that additional guidance and direction be given to trustees. To this end, we support a strengthened bankruptcy administrator system within the Judicial Branch to supervise the day-to-day activities of bankruptcy trustees, and we plan to examine ways in which the Judicial Conference and the Administrative Office might provide greater guidance and direction to the courts within the framework of current statutory authorities.

It should be emphasized that the position of United States trustee in the Department of Justice and that of deputy clerk for estate administraton in the courts are not analogous. While the estate administrator program has served as a stopgap in many non-pilot districts in the short period since its inception in 1981, we are of the view that an expanded and upgraded bankruptcy administrator system within the Judicial Branch is necessary on a national basis -- such as proposed in S. 443, 98th Congress -- to provide for the efficient administration of bankruptcy petitions and the effective supervision of bankruptcy trustees.

William J. Anderson
Page Two

We regret that the draft report does not include an assessment of the pilot United States trustee program--which will expire on September 30, 1984--and a comparison of that program with an upgraded bankruptcy administrator program. We believe that your office could have provided a timely and truly objective evaluation that would have been of great assistance. For instance, the report's findings as to chapter 13 trustees present a significant difference in the pilot and non-pilot districts.

Your draft report finds a need for greater guidance and supervision of trustees in the areas of: investment of estate funds, compensation of attorneys for trustees' duties, district-wide threshold dollar amounts for the liquidation of assets, and retention by chapter 13 trustees of interest paid on estate accounts. Each of the problem areas discussed in the report has been identified by our Office of Management Review and has been the subject of specific recommendations to the individual courts, who control the practices and procedures of trustees and authorize their fees.

The 1978 Bankruptcy Reform Act evidences a clear intent to encourage the investment of estate funds by giving trustees specific authority to deposit and invest monies of the estates, usually without prior court approval. We agree that investment by trustees should be encouraged as a means of defraying the costs of administration and providing the maximum return to creditors in bankruptcy. Most chapter 7 cases have no assets available for distribution to creditors. Estate funds in the remaining "asset" cases are frequently very limited in amount, and there are situations in which the investment of estate funds would not be in the best interest of the estates. Nevertheless, new Bankruptcy Rule 5008(i), which became effective August 1, 1983, now permits the aggregation of funds from several estates into a single account, thereby making the investment of funds from small estates more feasible. We agree that estate administrators and United States trustees should be encouraged to have trustees invest estate funds wherever that is in the best interests of the estates.

As part of its audits of individual bankruptcy courts, our Office of Management Review has discovered instances where chapter 7 trustees have claimed attorney fees for performing trustee duties and has recommended corrective action and greater supervision of the trustees by the pertinent courts. We agree that additional guidance may be needed in general for estate administrators and United States trustees, instructing them to scrutinize trustees' billing statements more carefully and to advise their court to disallow attorney compensation where the services rendered are part of the trustees' own responsibilities.

William J. Anderson
Page Three

It is not certain at this point whether the establishment of mandatory threshold dollar amounts for the liquidation of assets on a district-wide basis would be the most effective way of assuring equal treatment among debtors and creditors. Such an approach may be too inflexible to accommodate the variety of situations in which a decision must be made on whether the costs, time and effort in liquidating the assets is in the best interests of the estate. Nevertheless, the concept may have merit and will be considered further.

We agree that estate administrators and United States trustees should closely monitor chapter 13 trustees' annual reports to ensure that trustees are not exceeding maximum authorized compensation and expense levels. It is the position of the Administrative Office that chapter 13 trustees may not retain income and investment interest to the extent that such income and interest would cause the trustee's percentage fee to be exceeded. This position has been communicated to all clerks of the bankruptcy courts.

In the non-United States trustee districts chapter 13 trustees are required to submit financial reports to the clerk of the bankruptcy court semi-annually and to the Administrative Office annually. These annual reports are reviewed carefully by the Administrative Office, and where trustees are found to have exceeded their authorized compensation and expense levels the matter is brought to the attention of the court for corrective action. Moreover, where the annual receipts of a chapter 13 trustee exceed $200,000, an annual audit must be performed by an independent accountant and submitted to the court.

To the extent that resources are available, we also agree that the internal audit staff of the Administrative Office should assist or supplement the local monitoring activities by reviewing financial activities of trustees.

In addition to the above comments, which are directed to matters of policy, specific suggestions for technical improvements in the draft report have been prepared and our office will discuss them with your staff next week.

Mr. William J. Anderson
Page 4

We appreciate the opportunity to review and comment on the draft report. We agree generally with the observations and recommendations. The Judicial Conference and the Administrative Office will consider each recommendation further to determine whether additional guidance is needed for the bankruptcy courts, including the possible adoption of suggested local procedures and practices.

Sincerely,

William E. Foley
Director

U.S. Department of Justice

April 5, 1984

Washington, D.C. 20530

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson

This letter responds to your request to the Attorney General for the comments of the Department of Justice (Department) on your draft report entitled "Greater Oversight and Guidance of Bankruptcy Process Needed."

It is difficult to reply to the criticisms contained in the General Accounting Office's draft report for several reasons. The observations and comments are superficial, inadequately documented, vague and fail to supply any hints as to possible solutions to the problems. The assumption underlying the report, that rigid guidelines can be set, demonstrates a lack of understanding of the bankruptcy process and the necessarily independent role of fiduciaries. There is no specific delineation of the standards to which the trustees should be adhering and to which, according to the report, they are not. For example, the report seems to criticize trustees for liquidating and investing insignificant sums, yet the largest number of cases in the section criticizing the trustees' failure to invest funds are those involving small dollar amounts.

Most importantly, however, it is impossible to analyze the adequacy of the data on which the report is based. Of eight districts surveyed, in only three were more than 50 cases reviewed. In the remaining five districts, a total of 119 cases were analyzed. Accordingly, almost 85% of the sample is based on cases in only three out of the eight districts. Further, as no indication of the number of trustees involved is supplied, there is no way to discern whether the "problems" are isolated instances of poor judgment by a few trustees or system-wide inadequacies. The compensation paid to trustees is inadequate, to save time and money they tend to submit groups of reports at one time. As a result, without knowing the number of trustees involved, it is impossible to determine whether the cases reviewed by GAO are representative. For example, all 12 cases from the Central District of California may have been handled by one trustee.

The conclusions of the report regarding the United States Trustee Program are suspect insofar as they are based on inadequate or misunderstood data, a failure to consider all of the dispositive factors regarding numerous issues, and a general lack of knowledge regarding the bankruptcy process. As the numerous letters, memoranda and pleadings attached to this response indicate, the U.S. Trustees currently perform, and were performing at the time of GAO's study, all of the functions GAO suggests be performed.[1] These functions were performed, although sometimes not fully documented, to the best of the

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[1]Due to the volume of documents submitted they were not included in the report. However, the contents of the documents and their relevance to the report are discussed on pages 20, 21, 23, and 24.

-2-

trustees' capability in 1982, despite severe budget and personnel constraints. Insofar as the report provides only undefined, broad recommendations regarding guidance and supervision, it is insufficient in providing specific guidance as to which individual offices and areas need further improvement.

In addition to the summary of our comments provided above, we are enclosing copies of comments received from various U.S. Trustee offices, four of which were chosen as sample districts in responding to the report. The following are more specific comments pertaining to each of the sections of the report cited.

Digest (pp. i-vi)

There is some validity to the concern of GAO that monitoring of trustees in both pilot and non-pilot districts is not perfect, no system really is. To recite this fact, without presenting an entire picture of the bankruptcy system at the time of the study, however, is misleading at best. No reference is made to the volume of case filings, staffing and budgetary constraints, or the relationship between the duties of the United States Trustees and the courts, factors which necessarily affect the quantity and quality of duties that are performed.

Furthermore, as the letters in Enclosure A indicate, the United States Trustees spent many hours attempting to educate GAO personnel regarding the bankruptcy system and the role of the U.S. Trustee offices. Unfortunately, the report does little to illustrate GAO's understanding of either area. 2

Chapter 1 - Introduction (pp. 1-5)

This chapter is intended essentially to acquaint the reader with the bankruptcy process. Initially, one should be aware that only Title I of the Bankruptcy Reform Act is codified in Title 11 of the U.S. Code and is referred to as the "Code." Title II of the Act amends and is codified in Title 28. Title III amends other statutes and Title IV contains the transition provisions. Footnote 1 on page 1 would be more correct if it stated that the "debtor may elect to claim exemptions under either Federal or State law unless the State has opted out of the Federal exemptions under 11 U.S.C. 522(b)(1)." It should also be noted that, in pilot districts, the United States Trustee appoints the interim trustee in chapter 7 cases, and the United States Trustee, with the approval of the Attorney General, appoints the standing trustee who handles the chapter 13 cases in his/her district. The statement at the top of page 5 is incorrect. The creditors' meeting must be noticed within 20 days and held 20 to 40 days after the petition is filed. Furthermore, almost all chapter 7 debtors receive their discharges before the case is closed. Unlike the former Bankruptcy Act, there is no requirement under the Code that in order for a creditor to file a claim, the debts must be "provable." The chapter 7 debtor can file another chapter 7 petition within 6 years, however, he/she cannot receive a discharge within 6 years of a prior discharge. Finally, a chapter 13 discharge does not affect the availability of a discharge in a subsequent chapter 7 proceeding if the chapter 13 plan was the debtor's best effort and paid 70% of all general unsecured claims, not 100% of them. To the extent this chapter deals with the scope and methodology of the report, we have consolidated our comments thereon with those regarding chapter 3 of the report. 3

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[2]Due to the volume of documents submitted they were not included in the report. However, their comments were incorporated in this document.

[3]Changes were made to pages 1 and 5 of the report.

Chapter 2 - Interests of Debtors and Creditors Not Being Protected (pp. 6-17)

Although GAO purports to have evaluated how the interests of debtors are protected, the report does not elsewhere address this topic with any factual detail. Furthermore, while the report criticizes the varying case processing practices used by bankruptcy trustees which result in inconsistent treatment, GAO ignores the fundamental fact that varying philosophies and practices of local bankruptcy judges often dictate particular local approaches. The extent to which such local requirements are subject to uniform regulation is often minimal. Furthermore, no two cases or trustees are exactly alike. Many tasks performed by trustees require creative treatment and individual judgment. For the foregoing reasons, although the EOUST has developed some uniform guidelines in the chapter 7 area, all of the U.S. Trustee offices have developed their own local guidelines and practice manuals for panel trustees. Samples of such guidelines are enclosed (see Index of Enclosures). In addition, the EOUST holds periodic training sessions for trustees, and U.S. Trustee conferences are held twice a year to ensure consistency in nationwide approaches.

Trustees' Practices in Administering Chapter 7 Cases Need to Be Monitored and Improved (pp. 6-13)

The draft report indicates, that due to the United States Trustees' inadequate guidance to and limited monitoring of chapter 7 trustees, creditors are not receiving the maximum possible return. The report alleges that trustees establish arbitrary cut-offs in determining when to liquidate assets, do not invest estate funds, and receive dual compensation. Since the United States Trustees have issued guidelines respecting all three of these issues, it is unclear whether the chapter 7 trustees are ignoring the guidelines, the existing guidelines are difficult to follow or understand, or the existing guidelines set unreasonably high dollar figures.

Investment of estate funds would result in greater return to creditors (pp. 7-10)

The report's comment that trustees are inconsistent in determining the minimum dollar level below which estates should not be liquidated appears without much discussion and is used to make the point that debtors are inconsistently treated. This probably is true as well as appropriate. Often trustees, believing that significant assets exist, liquidate small items only to discover either that no further assets are available or that none can be liquidated in a cost effective manner. Sometimes larger assets are so illiquid as to make the cost of selling them more burdensome to the estate than is warranted given the projected return to unsecured creditors. While some guidance may, should be and has been offered on this matter, trustees, as fiduciaries, must be allowed a great deal of latitude on such judgment calls. In evaluating investment practices, GAO reviewed 771 closed asset cases in seven of the eight sample districts. (It is unclear why the eighth district, the Southern District of California, was chosen for this study since there were no chapter 7 cases closed there during the sample period.) Nowhere does GAO indicate the total number of chapter 7 cases in the districts, nor do they indicate whether the cases in a particular district were administered by one,

-4-

few or many different trustees. With regard to cases in which funds went uninvested, it is not possible to tell in which particular districts such cases were handled. It is impossible to determine the extent of the problem without such information. For example, in the Central District of California, the study involved 12 chapter 7 cases while there were 20,153 chapter 7 cases filed in that district in Fiscal Year 1982. Were those 12 all part of the 222 cases in which no funds were invested or were they part of the 45 cases in which investment occurred? Furthermore, there is no indication whether any of the cases sampled were filed under the former Bankruptcy Act and prior to the establishment of the United States Trustee Program (and thus over which the Program has no control), and the new Code requirements regarding investments.[4] The Act required the creditors' consent to the investment of estate funds as well as court approval.

Both the EOUST and the local U.S. Trustee offices have offered guidance regarding the investment of money of estates. Within a particular case, however, the trustee must make a judgment whether the administrative cost of placing money in high interest bearing accounts or investments is outweighed by the return on the investment. For example, most banks charge for services. This, coupled with the time involved in preparing tax returns on earned interest, may make it cost ineffective to invest when estate funds are not substantial. [Remember, all costs of administration are paid from estate funds before other creditors are paid.] The trustee is required to close out the estate as expeditiously as possible, not to let funds sit merely to accrue interest. As is obvious from the table on page 8 of the report, 471 of the 662 cases (71%) in which money was not invested involved amounts less than $1,000, a total of 588 cases (89%) involved less than $3,000. In terms of interest foregone in cases with less than $1,000 to invest, GAO has projected a loss on its chart on page 9 which amounts to approximately $8.69 per case. Assuming ten creditors per case, this averages out to 87 cents per creditor, whereas the cost of administering the investment could be equal to or greater than that amount. For cases with less than $3,000, the amount of interest foregone would be approximately $34.73 per case, or about $3.50 per creditor in most cases.

At the other end of the spectrum, two cases in the $20,000+ category account for 65% of the "lost" interest in that category. Of the remaining six cases, we do not know whether the trustees expected to close or did close the cases so quickly that investment of funds did not appear to be warranted. The report's failure to identify the number of trustees involved and to treat extreme cases separately casts doubt on the conclusions GAO has reached based on this chart.

Furthermore, although the methodology is unclear, the figures for funds on hand seem to be taken from listings on the trustees' final reports which do not necessarily relate to cash, but may in fact reflect the value of "in-kind assets" that the trustees administered but did not disburse. For example, on page 8, GAO criticizes a New Jersey trustee for not investing $72,500. That amount, which largely consisted of the proceeds of the sale of a real estate asset, was in the trustee's account for only one week before it was taken out of the account to make mortgage pay-off payments to the mortgagee.[5] The money remained in the bank for that period in order that the funds encompassed by the trustee's check to the mortgagee would clear. In any event, the money did not remain uninvested for a long period of time as GAO indicates. Of the 12 cases over $20,000 where GAO found that no interest was earned, one must also question how many involved creditors' funds or in-kind assets.

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[4] All cases sampled and analyzed during our review were filed after the new code requirements came effective.

[5] Because of additional information provided by the Executive Office for U.S. Trustees this example was deleted from the report.

Banking practices and requirements vary locally. If a separate account for each estate must be opened, many banks have minimum deposit amounts, do not allow aggregation of funds from different estates and, in small towns, do not even offer interest bearing checking accounts. Indeed, prior to the beginning of the phase-out of Regulation Q, estate accounts could not qualify as "savings" accounts unless all creditors were individuals or charitable institutions. Prior to the existence of Bankruptcy Rule 5008 which became effective in 1983, there was no authority to aggregate money of chapter 7 estates. Although that rule allows for such aggregation subject to court approval, it remains to be seen whether banks will be willing to establish such accounts, especially banks in small towns or remote locations. [6]

Elimination of dual compensation would result in more funds being available to creditors (pp. 10-12)

The comments regarding dual compensation reflect both a lack of understanding of the law and of the realities of bankruptcy practice. While the Code enumerates the duties of the trustees, and specifically contemplates non-attorney trustees, it also provides that trustees may hire counsel, including themselves, with court approval. Trustees may hire counsel to perform legal work but not to perform trustees' duties, however, the line between these duties is far from clear. For example, examination of a claim may require only verification of dates and amounts, if so, the trustee should receive only that compensation due as trustee. If, however, a question arises as to whether a security interest has been properly perfected, the examination may require legal knowledge and research, in which case the trustee should receive compensation as attorney for the estate. This is precisely the situation which the United States Trustees have attempted to monitor very carefully (see Index of Enclosures), but the report does not indicate whether any opposition to the cited requests had been filed or whether the United States Trustees have been satisfied that the compensation requested was appropriate. [7]

The report fails to recognize that ultimately the courts must approve the compensation of trustees and their attorneys.[8] Unfortunately, it is not always possible to convince the court to reduce a trustee's request for fees. On the contrary, different courts have adopted different standards with regard to drawing the extremely difficult and fine line that often must be drawn between trustee and attorney activities. There are legitimate "attorney" duties which are directly related to "trustee" duties, but which cannot be performed by one who is not licensed to practice law. It is not correct to assume that the duties listed in 11 U.S.C. §704 will never require legal expertise or the services of an attorney admitted to practice before the court.[9] Most importantly, there is no mention of the real problem in chapter 7 cases which is the inadequate fee structure for trustee compensation. Sympathy for this inadequacy has encouraged judges to construe trustee activities which are colorably legal functions as attorney services for which the trustee may receive attorney fees.

It is this fee structure which acts as a disincentive to trustees to liquidate small amounts of property at great effort. Perhaps dual compensation concerns would be reduced if trustees received adequate compensation.

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[6]Even though some banks may be reluctant to aggregate estate funds, Justice should attempt to persuade such banks to cooperate.

[7]There was no evidence in either the court files or U.S. Trustees' files as to whether the U.S. Trustees objected to the request for compensation.

[8]Page 10 of the report states that this is the courts' responsibility.

[9]The report does not conclude that the duties included in 11 U.S.C. § 704 will never require legal expertise.

Varying asset liquidation levels affect debtors and creditors (pp. 12-13)

It is not unusual to find that different trustees liquidate different amounts, nor is there, per se, a problem with that fact. It is expected that based on the particular facts in any given case, the trustee will make a reasoned judgment whether to liquidate property when it is apparent that no meaningful benefit will inure to the creditors. The limits various judges will accept also differ. Determinations whether to abandon property are not purely linked to dollar amounts. For example, a trustee must consider the kind of property involved, whether it is liquid or encumbered, whether the administrative cost of liquidating it exceeds the probable return from liquidation, the market available and the time and difficulty involved in finding a buyer, the basis the debtor used in valuing the property, etc. Obviously, if one looks only at the debtor's schedules to determine the value of an item to be abandoned, and the debtor has inflated the value, one cannot reasonably determine, without more information, whether the trustee's decision not to liquidate the item is reasonable. Thus it is very difficult, if not impossible, to set tight monetary guidelines in this area. Nonetheless, many of our U.S. Trustee offices have in fact attempted to set minimum guidelines, and the success of doing so has been the subject of many discussions in this program.

On a technical point, the text on page 12 states that ". . . the debtors would only be able to retain the assets the trustee did not liquidate if the creditors decided not to repossess them on their own." This concept applies only to secured creditors. [10]

Better control over chapter 13 trustees' financial activities needed (pp. 14-17)

The main thrust of the criticism of chapter 13 case administration seems to be that creditors are not receiving monies due to them because the interest earned on funds invested by the standing trustees is not used to pay creditors, but is being used to increase the trustees' compensation. This is incorrect and based on a complete misreading of the law. The "excess" compensation is to be returned to the U.S. Treasury under 11 U.S.C. §1302, not paid to the creditors under 11 U.S.C. §541(a)(6). GAO's reference to the legislative history regarding the investment of funds pertains to chapter 7 rather than chapter 13 cases in which excess amounts are either returned to the Treasury under 11 U.S.C. §1302, or used to offset expenses in administering the chapter 13 cases--in either event they do not go directly to creditors. While the statute makes clear that trustees are not to receive in excess of 10% compensation, it is not clear that it is impermissible to use interest earned on invested funds to offset administrative expenses carried over into the next year.

A review of the standing trustees' final reports in the four pilot districts sampled revealed only one trustee who exceeded the 10% limit on compensation and expenses. This trustee exceeded the limit by only $406 in 1982. In 1983, this same trustee took $1,500 less than the total amount he was entitled to, thus offsetting the 1982 amount.[11] Furthermore, the report overlooks the fact that in addition to reviewing the reports prepared by the trustees themselves, nationwide audits of all of the chapter 13 trustee offices in U.S. Trustee districts have been performed on a consistent basis by outside auditors--Peat, Marwick, Mitchell & Company. [12]

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[10] Change made to page 9 of the report.

[11] Justice arrived at figures different from ours because it used different fiscal years.

[12] These are strictly financial audits that account for estates funds and do not address the trustees' compliance with either the chapter 13 guidelines issued by the Executive Office for U.S. Trustees or with provisions of the law dealing with the administration of chapter 13 cases.

The report indicates, in passing, that there may be some inefficiencies in standing trustee operations which would result in a greater return to creditors by reducing trustee expenses, but fails to indicate what they are. With regard to GAO's criticism of the trustee in the Southern District of New York, the matter is explained in Enclosure A-5. 13

Assistance of the internal audit staff to improve monitoring of trustee activities (pp. 17)

We agree that the Departmental Audit Staff can provide assistance to the EOUST in monitoring trustee activities. The Audit Staff is now discussing potential audit areas with the EOUST. Current plans are to perform financial and compliance audits of selected chapter 13 trustees located in pilot districts. These audits will include a follow-up on the weaknesses identified in the GAO report. In addition, the Audit Staff will review a selected number of reports issued by a national accounting firm under arrangement with the EOUST to perform audits of chapter 13 trustees in the pilot districts.

Other areas under discussion include financial and compliance audits of chapter 7 and chapter 11 bankruptcy cases. In March 1984, the Audit Staff began reviewing administrative controls in the U.S. Trustees' offices, including a review of those policies and procedures governing case monitoring activities and an examination of financial reports.

Chapter 3 Scope and Methodology (pp. 2, 32-34)

We have a number of concerns with both the methodology and sample selected by GAO, particularly as it relates to the United States Trustee Program.

Time period selected

GAO selected the period April 1982 to September 1982 for reviewing bankruptcy operations. As GAO was fully aware, the United States Trustee Program underwent severe budget and personnel constraints during this time. These constraints seriously impacted on bankruptcy operations, including personnel, space, travel, training, and administrative support. To remain viable as an operating organization significant adjustments had to be made.

The effect of the adjustments on the program were immediate. A policy decision was made to concentrate resources in the areas of chapter 11 and chapter 7 large asset cases. These cases have the highest dollar amounts associated with them and also the greatest risk of losses to creditors if monitoring is inadequate. The decision to focus on these cases forced the United States Trustees to rely more heavily on trustees appointed from the private sector to administer chapter 7 no-asset or nominal asset cases and chapter 13 cases. Careful screening of panel trustee members assured that persons selected to be on the panel would perform their functions with expertise and integrity.

Thus, although the United States Trustees concentrated their resources heavily in chapter 11 and large asset chapter 7 cases, GAO chose to look at an area which, of necessity, was monitored under unavoidable constraints at the time of the study. Moreover, ABT Associates has recently performed a study and

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13 Justice believes that the trustee in question will never reach the maximum allowable for compensation and expenses because of the size of the trustees operation. This is an incorrect assumption on the part of Justice. No matter how large a trustee's operation may be he/she can reach the allowable maximum because it is based on a percentage of net receipts from debtors' payments. Therefore, unless the trustee begins submitting timely and accurate reports Justice will never know if the trustee has exceeded the maximum.

issued a report in April 1983 covering chapter 7 and 13 bankruptcy activities. The case sample selection and qualitative analysis for the study covered bankruptcy activities from July 1, 1980 to mid-1982 (ABT Report, pp. 89-192). During the planning and scoping phase of their audit, GAO performed a literature search to identify studies completed and underway that dealt with the administration of bankruptcy cases. We would be interested in obtaining a list of the literature and studies GAO was able to locate since the material could be of value to us in evaluating and monitoring bankruptcy activities. 14

Sample selected

While GAO states that the cases they chose in the eight sample districts represent approximately 22% of all chapter 7 cases terminated, they fail to indicate that one of the districts, the Central District of California, accounted for 10% of all cases filed, and nearly 40% of the chapter 7 cases filed in the sample districts during Fiscal Year 1982.

GAO does not indicate the total number of chapter 7 cases in the districts from which the 771 sample cases were selected. The 771 cases should be compared to the 52,587 cases filed in the sample districts in Fiscal Year 1982. This sample is extremely small given the perhaps 150,000 cases which were pending nationwide at that time--less than one-half of 1%. In addition, the sites selected do not bear comparison. For example, how does one compare 193 cases in Virginia to 347 cases in Ohio and then project the conclusions derived therefrom to the entire United States bankruptcy system which does not involve the same trustees or the same supervision. Why was the Southern District of California selected when it had no closed chapter 7 cases during the period? 15

Using the sampling techniques and methodology employed by GAO, it is statistically unsound to conclude that greater oversight and guidance are needed for the nation's bankruptcy process. The following table illustrates how skewed the sample is, as the sample pertains to pilot U.S. Trustee districts.

GAO SAMPLE CASES IN PILOT UNITED STATES TRUSTEE DISTRICTS

Districts	GAO Sample	Total Chapter 7 Cases Filed in FY 1982	GAO Sample as a Percentage of Chapter 7 Cases Filed	Chapter 7 Asset Cases Active End of FY 1982	Sample as a Percentage of Active Chapter 7 Asset Cases
S.D.N.Y.	16	5,232	0.3	894	1.8
D.N.J.	46	5,352	0.9	791	5.8
E.D. Va	193	5,258	3.7	805	24.0
C.D. Cal.	12	20,153	0.1	939	1.2

In pilot districts in the Southern District of New York and the Central District of California, GAO is inferring conclusions based on less than one-half percent of the chapter 7 cases filed in Fiscal Year 1982. For these districts, the percentage of sample cases closed to the total inventory of

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14 We provided Justice with this material on May 30, 1984.

15 Although no cases were analyzed in this district we did interview chapter 7 trustees on how they administer their cases as discussed on page 13 of the report. Also, we evaluated the financial operations of the chapter 13 trustee in this district.

chapter 7 asset cases at the end of the study period was less than two percent. A more representative sample would have taken into account the different filing rates, or the different inventory levels of active chapter 7 asset cases. Controlling the sample for either measure would have improved the sample's acceptability.

In summary, the report is extremely difficult to use or analyze. It is impossible to constructively criticize the report's statistics. They appear incomplete or inconsistent without detailed explanation. Finally, GAO appears to have overlooked the meaning of the concept "supervision." It is the private trustees who have daily fiduciary responsibility for carrying out their responsibilities. The United States Trustees' responsibility is to issue guidance and provide general oversight through the use of good monitoring systems.

We believe strongly in establishing meaningful controls, not arbitrary numerical ceilings or floors. Each case must be separately analyzed. For example, an estate of $500 may well be worth administrating where there are only one or two creditors, but a waste of time with no benefit to creditors where there are several hundred creditors. A high level of discretion must be allowed and encouraged. Congress intended the United States Trustee Program not to be a rigid centralized bureaucracy, but a system that is "locally based." H.R. Rep. No. 595, 95th Congress, 1st Sess. p. 101. (1977).

<u>Recommendations</u> (p. 17)

As expressed in the text of this response, all of the functions GAO recommends be initiated are already being performed.[16] Despite the recent budgetary and personnel constraints, performance of these functions is continuing consistent with our limited staff resources. As GAO is aware, significant adjustments have been made in order to maintain an acceptable level of performance. Moreover, we have been and are continuing to scrutinize our operations to implement any changes that would improve the administration of chapter 7 and 13 cases as recommended by GAO. We are hopeful that through the process of evaluation, monitoring, and audit, additional improvements can be made.

We appreciate the opportunity to comment on the report while in draft form. Should you need any additional information, please feel free to contact me.

Sincerely,

Kevin D. Rooney

Kevin D. Rooney
Assistant Attorney General
for Administration

Enclosures

[16] On the basis of the deficiencies we identified (see ch. 2), and our evaluation of agency comments (see ch. 3), we believe that our recommendations are not being performed.

GAO Note: Page numbers have been changed to correspond to the final report.

United States Bankruptcy Court
FOR THE
Eastern District of Kentucky

CHAMBERS OF
JOE LEE
JUDGE

April 13, 1984

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson,

Thank you for permitting me to review and comment upon the draft of the proposed GAO report to the Attorney General and the Director of the Administrative Office of the United States Courts based on your study of the administration of chapter 7 and chapter 13 cases under the Bankruptcy Code

I have these general comments.

I disagree with the premise that bankruptcy trustees are responsible for protecting the interests of debtors in administering chapter 7 bankruptcy cases. The trustee is the appointed or elected representative of creditors and is the adversary of the debtor who is generally represented by his own counsel. A rule specifying that trustees in chapter 7 cases shall not liquidate or convert to cash non-exempt items of property of nominal value in order that debtors may be permitted to retain such property would amount to trustees being required by administrative fiat to grant debtors exemptions in addition to those provided by law. The rule-making power of the court is limited to adoption of rules that are not inconsistent with the Code. It strikes me that such a rule as you propose would be inconsistent with the Code. There is no language that I know of in the Bankruptcy Code that imposes on the trustee a fiduciary duty to look after the interests of debtors by means of the even-handed administration of assets which you suggest. [1]

The debtor who files a chapter 7 case agrees to surrender all of his non-exempt assets for the benefit of creditors. He has no basis for complaint when all such non-exempt assets are, in fact, liquidated by the trustee, even though all assets may not

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[1] The premise of the report is not that bankruptcy trustees are responsible for protecting the interests of debtors. We recognize that, as stated in 11 U.S.C. 323(a), the trustee is the representative of the bankrupt estate. However, we do not view this as suggesting that there should not be an evenhanded administration of assets, or that the trustees are simply representatives of the creditors and adversaries of the debtors. Rather, we believe that by administering the estate consistent with the code and bankruptcy rules, trustees do in fact protect the interests of all parties whether they be creditors or debtors.

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be liquidated in another case The administration of justice is an imprecise science that results in non-uniform sentences for the same crimes, disparate awards for the same injuries, etc

The finding that estate administrators in non-pilot districts have not effectively monitored the administration of bankruptcy cases is hardly fair in view of the fact the finding is made on the basis of a study of cases closed before the office of estate administrator was created. For example, no estate administrator was hired in this district until April 1982. The cases you audited in this district were filed between 1979 and 1980. These were among the first cases filed under the new Bankruptcy Code, when the panels of trustees provided for by the Bankruptcy Reform Act of 1978 were just being established. Since the hiring of an estate administrator, regular seminars and training programs are provided for trustees. It strikes me that the GAO study would have been more effective if later, more representative cases had been selected for study. 2

Your draft report indicates that an additional $20,254.00 in interest could have been earned by depositing estate funds in interest-bearing accounts. Your analysis indicates that in 502 cases with deposits aggregating $863,437.00, funds were not invested for an average of 170 days resulting in a loss of $20,254.00 in interest that could have been earned on these deposits. The analysis further indicates that the amount on deposit in 325 of these 502 cases was less than $1,000 00. In fact, $863,437.00 divided by 502 indicates that the average amount on deposit was $1,720.00 per case. Deposit of less than $1,000.00 at interest for an average of 170 days (approximately 6 months) might produce an estimated additional $15.00 per case from which there would have to be deducted $2.25 as additional compensation for the trustee. The remaining $12.75, when prorated among creditors, would not add significantly to the amount of dividend payable to unsecured creditors

In this District, as an accommodation to the Court, the banks forego service charges for checking accounts in which small balances are maintained by trustees We doubt the banks would continue to forego service charges if they were required to pay interest on these accounts. We think the failure of the trustee to deposit estate funds at interest when the amount involved is less than $1,000.00 as was so in 325 of the 502 cases you studied is understandable

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[2]As stated on page 1 of the report the responsibility for case administration fell on the Clerks of Court and Deputy Clerks of Court for Estate Administration in the nonpilot districts. Although the court did not have an estate administrator until April 1982, the clerk of court during the time the cases we reviewed were filed was responsible for case administration.

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We do not know how many of the 502 cases referred to in the study were commenced by corporate debtors. This is relevant because exemptions are not available to corporate debtors and because the trustee would be required to employ an accountant to prepare fiduciary returns on interest earned on monies in the estate of a corporate debtor. The cost of preparing such returns might exceed the interest earned on an amount of less than $1,000.00. 3

On the issue of dual compensation, this court is aware that trustees sometimes make application for legal fees for duties which the trustee is required to perform However, making application and receiving compensation for same are two different matters. When it appears that dual compensation is being claimed, the court grants compensation only for allowable services rendered. 4 It should also be observed that creditors receive notice of the hearing on the fee applications of the trustee and the attorney for the trustee and are afforded an opportunity to object to the fees requested. Objections which would be of assistance to the court in determining fees are rare. The court is being criticized for lack of meticulousness in looking after the interests of disinterested creditors.

The assertion that Chapter 13 trustees improperly claimed and received compensation and expenses above the 10% ceiling is somewhat misleading in that I don't find any basis for the assertion that trustees received excess compensation Your claim that trustees received excess expenses is apparently based on the fact that interest earned on CD's purchased by the trustee was used to fund office expenses and the adding in of this interest resulted in a total amount available in excess of the 10% ceiling for payment of the compensation and expenses of the trustee

You suggest that if the trustee had not exceeded the ceiling limitation, creditors would have received additional funds and more fully realized the benefits of the bankruptcy process That is simply not true. The debtor's plan provides for payment of a fixed amount to unsecured creditors. Unsecured creditors do not receive interest on their claims in a chapter 13 case. Consequently, they receive the same amount on their claims whether or not interest on funds deposited by the trustee is paid to creditors.

3Estates filed under chapter 7 do not have to file federal income tax returns unless the estate has gross income of over $2,700. If this occurs, then we believe the cost of preparing a tax return is justified.

4The report states on page 11 that in 268 cases trustees were appointed as attorneys and were compensated at attorney fee rates for performing trustee duties.

APPENDIX VI

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The trustee in chapter 13 cases, unlike the trustee in chapter 7 cases, is permitted to aggregate funds for the purpose of deposit. The chapter 13 trustee receives from debtors various amounts ranging from $10.00 to perhaps up to $200.00 per month as payments under plans These monies are deposited in a single account from which the trustee withdraws an aggregate amount for the purchase of a CD. Allocating the interest earned on such a CD back to the account of individual debtors on some sort of pro rata basis would be no easy task. Old cases will be closed and new cases opened while the CD is in effect, making the allocation of interest an administrative nightmare.

We note that the IRS has suggested that the chapter 13 trustee should be required to pay interest on CD's to individual debtors rather than to the estate in order that the debtors may be required to pay taxes on such earnings. That suggestion is just as impractical as the suggestion that the interest be allocated back to individual estates and paid to creditors.

While it is true that in a given year a chapter 13 trustee may utilize interest on a CD to meet extraordinary operating expenses that exceed the 5% limit, it is also true that in other years interest earned may enable the trustee to reduce the assessment against estates for administrative expenses below the 10% level. For example, the $15,000.00 extra expense of the trustee in this district resulted from the cost of changing computer services and paying for reprogramming, a non-recurring expense. We believe that permitting the trustee to utilize interest on CD's to meet operating expenses will, in the long run, reduce the amount of assessment against estates for operating expenses below the 10% level in most years and is, therefore, the only logical use for such monies

Yours truly,

Joe Lee

Joe Lee

Jl.ds

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