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VOLUME 3: CHAPTER 11 CASE ADMINISTRATION

CHAPTER 3-1: POLICY CONSIDERATIONS

3-1.1 GENERALLY

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

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

During the initial stages of a case, the United States Trustee should focus on certain principal administrative responsibilities. The debtor and its counsel should be contacted and provided with guidance and instruction regarding their statutory responsibilities and fiduciary obligations. A creditors' committee must be formed promptly, if possible. The first meeting of creditors must be scheduled within the time limits established by the Federal Rules of Bankruptcy Procedure.

The United States Trustee may, at his/her discretion, limit his/her involvement in those chapter 11 cases with significant creditor interest and activity. In many instances, the presence of competing interests will serve to ensure that significant issues in a case are raised and resolved by the

parties themselves, and will assist in moving the case forward without frequent involvement by the United States Trustee. The United States Trustee should not seek to substitute his/her business judgment for that of creditors or other parties in interest. For example, creditors vote on plans of reorganization. They have the right to make their own determinations as to what would constitute an acceptable return under the terms of a given plan.

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

Chapter 11 cases often present circumstances requiring the United States Trustee to take a more active role. For example, creditor involvement may be limited or non-existent. Also, issues involving the fundamental integrity of the bankruptcy system, e.g., conflicts of interest or allegations of criminal misconduct, must be addressed quickly and thoroughly by the United States Trustee. Because these matters must be confronted, the United States Trustee should use his/her discretion in the optimum allocation of resources.

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

CHAPTER 3-2: VOLUNTARY CASE ADMINISTRATION

3-2.1 FILING REQUIREMENTS

To commence a chapter 11 case, the debtor must file a bankruptcy petition, as well as items set forth in Fed. R. Bankr. P. 1007, which generally are described as lists, schedules, and statements. The official forms prescribe the content of many of these documents. Local bankruptcy court rules or procedures may require additional information or otherwise change the official requirements. The United States Trustee should ensure that the schedules, statement of financial affairs, and other required documents are filed in a timely manner.

3-2.2 CASE FILING NOTIFICATION AND DOCUMENT RECEIPT

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

3-2.3 INITIAL REVIEW

3-2.3.1 Signature Requirements

The United States Trustee should review the petition and related documents to ensure that they have been signed. This is important in the event of a subsequent perjury investigation.

3-2.3.2 Authorization for Filing

The consent of all general partners is necessary for a voluntary partnership bankruptcy filing. Fed. R. Bankr. P. 1004(a). If less than all of the partners consent, the filing is involuntary. 11 U.S.C. § 303(b)(3)(A).

State law may be pertinent to the issue of the appropriate authority for filing bankruptcy, particularly in the case of corporations. See, e.g., Hager v. Gibson, 108 F.3d 35, 39-40 (4th Cir. 1997) (citing Price v. Gurney, 324 U.S. 100, 106 (1945)); Keenihan v. Heritage Press, Inc., 19 F.3d 1255, 1258 (8th Cir. 1994). State law often requires a board of director's resolution as authorization for a corporate bankruptcy case and, in these cases, the United States Trustee should ensure that a resolution has been adopted. If an appropriate resolution has not been passed, the United States Trustee should file a motion to dismiss the case. Case law supports dismissal under these circumstances. In re Moni-Stat, Inc., 84 B.R. 756, 757 (Bankr. D. Kan. 1988); In re Farner, Boring & Tunneling, Inc., 26 B.R. 29 (Bankr. E.D. Tenn. 1982); In re Autumn Press, Inc., 20 B.R. 60 (Bankr. D. Mass. 1982).

A custodian, such as a state court receiver, may file a voluntary bankruptcy case if state law authorizes the receiver to do so and the filing is not otherwise prohibited by bankruptcy law. See In re Milestone Educ. Inst., Inc., 167 B.R. 716, 720-21, 724 (Bankr. D. Mass. 1994) (suspending bankruptcy proceedings to permit appeal to state court regarding receiver’s authority under state law to file bankruptcy); In re Monterey Equities-Hillside, 73 B.R. 749 (Bankr. N.D. Cal. 1987) (state law authorized partnership bankruptcy filing, but filing prohibited by Fed. R. Bankr. P. 1004(a) because general partner did not consent).

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

3-2.3.3 Debtor Eligibility

The United States Trustee should ensure that each chapter 11 debtor satisfies the eligibility requirements for filing a case as set forth in 11 U.S.C. § 109. Certain entities are not eligible for relief. Stockbrokers and commodity brokers specifically are precluded from filing a chapter 11 petition. 11 U.S.C. § 109(d). Certain foreign, federal, or state regulated businesses, including insurance companies, banks, savings banks, cooperative banks, savings and loan associations, and credit unions, also are not eligible for chapter 11 relief. 11 U.S.C. § 109(b) and (d).

Railroads, however, expressly are authorized to file for chapter 11 relief. 11 U.S.C. § 109(d). Certain provisions of chapter 11 apply only to railroads. 11 U.S.C. § 103(g); 11 U.S.C. § 1161 et seq.

Trusts present special eligibility questions. With one exception, a trust is not eligible for relief under title 11. In re Medallion Realty Trust, 103 B.R. 8, 10 (Bankr. D. Mass. 1989), aff'd, 120 B.R. 245 (D. Mass. 1990). A business trust is included within the definition of a corporation set forth in 11 U.S.C. § 101(9)(A)(v), and it therefore is eligible for relief. See generally In re Sung Soo Rim Irrevocable Intervivos Trust, 177 B.R. 673, 675 (Bankr. C.D. Cal. 1995). A variety of tests have been applied to determine whether an entity is a business trust. See discussion in Medallion Realty Trust, 103 B.R. at 10-11. In general, a business trust is one "created for the purpose of carrying on some kind of business, whereas the purpose of a non-business trust is to protect and preserve the trust res." In re Secured Equipment Trust of Eastern Airlines, 38 F.3d 86, 89 (2d Cir. 1994). It is not necessary for debtors to engage in business to qualify for relief. Toibb v. Radloff, 501 U.S. 157 (1991).

The United States Trustee should review cases to ensure that all joint petitions are properly filed. A joint petition is filed appropriately only by an individual that may be a debtor and that individual's spouse. 11 U.S.C. § 302(a). Cases naming an individual and a corporation as debtors, cases naming two or more corporations as debtors, cases naming a partnership and one or more individuals as debtors, or cases naming two or more unmarried individuals, as defined by state law, as debtors are not authorized and the United States Trustee must move to dismiss these cases.

3-2.4 REPRESENTATION BY COUNSEL

It has long been established that a corporate debtor involved in proceedings before a court must be represented by licensed counsel and may not appear pro se. See Osborn v. President, Directors and Company of the Bank of the United States, 22 U.S. (9 Wheat.) 738 (1824). This rule applies to bankruptcy cases. See Fed. R. Bankr. P. 9010; In re Dick Tracy Ins. Agency, Inc., 204 B.R. 38, 39 (Bankr. W.D. Mo. 1997). The

United States Trustee must move to dismiss cases involving a corporate debtor appearing pro se.

3-2.5 GENERAL CASE REVIEW

As soon as case documents are received, the United States Trustee should review the documents to become generally familiar with the debtor and its business, as well as to identify any problems requiring immediate attention. The schedules and statement of financial affairs should be reviewed to determine the nature of the debtor's business and the extent of its assets and liabilities. Potential problems relating to insiders, such as loans or related entity control, should be identified. The attorney disclosure statement filed pursuant to Fed. R. Bankr. P. 2016 should be reviewed and any apparent or potential problems regarding disinterestedness, conflicts of interest, or the terms of any retainer agreement noted.

3-2.6 RELATIONSHIPS WITH OTHER GOVERNMENTAL AGENCIES

The United States Trustee should contact the appropriate individuals at any other federal, state, or local agencies that have been actively involved prepetition in investigating or litigating with a debtor. Valuable insights about the debtor or its operations can be obtained from these contacts, and this information can be used to identify problems and issues that require the attention of the United States Trustee.

3-2.7 MONITORING BANK ACCOUNTS

3-2.7.1 11 U.S.C. § 345

The United States Trustee should establish procedures to ensure that a debtor complies with 11 U.S.C. § 345(a) to protect estate funds from loss. A trustee or debtor in possession may make deposits or invest estate funds that will yield the maximum reasonable net return on money, taking into account the safety of the deposit or investment. 11 U.S.C. § 345(a).

Section 345(b) of the Bankruptcy Code provides that if the aggregate amount of funds on deposit for a particular estate exceeds that which is

insured or guaranteed by the United States or by a department, agency, or instrumentality of the United States (e.g., FDIC $100,000 insurance), or backed by the full faith and credit of the United States, the funds shall be deposited in a banking institution that has posted either a bond in favor of the United States or has deposited securities with the Federal Reserve Bank in an account maintained by the United States Trustee.

The court, upon a showing of cause, can modify or waive these requirements. This last provision, designed to overrule the decision in In re Columbia Gas Sys., Inc., 33 F.3d 294 (3d Cir. 1994), grants the court discretion to allow a debtor in possession or trustee to pursue a riskier investment strategy. This discretion has been exercised in a small number of larger cases involving sophisticated financial and investment counselors. Because the debtor is waiving the usual protections of a safe return and an insured balance, the United States Trustee should ensure that the permitted investment strategy is articulated clearly and limited, when appropriate. If possible, the person or entity controlling the funds should be covered by a bond.

Pursuant to 28 U.S.C. § 586, each United States Trustee must establish procedures requiring each bank that serves as a depository for bankruptcy estate funds to submit monthly or quarterly status reports regarding those accounts. In those instances in which a depository institution fails to report to the United States Trustee or fails to maintain an adequate bond or pledge of securities, the United States Trustee shall direct the removal of all estate funds from the institution. Absent court authorization, a debtor in possession may not use depositories that have not agreed to comply with reporting requirements established by the United States Trustee.

3-2.7.2 Pledges of Securities at the Federal Reserve Bank

All federally insured banks are required by the Federal Reserve to maintain separate accounts for reserves, for money, and for securities in the Federal Reserve Bank that cover their "home" office. The securities are deposited in separate accounts according to the monies being collateralized. Securities pledged to secure repayment of bankruptcy estate trust accounts exceeding federal insurance limits are maintained in a

"154 account" (named after Treasury Department Circular No. 154). When these 154 accounts are maintained in the "home" Federal Reserve Bank, debits and credits are recorded instantly. This centralized system offers the Board a more accurate reading of the depository institution's financial status.

The Federal Reserve will provide the United States Trustee with quarterly reports applicable to their region and will notify them of deposits, withdrawals, and substitutions of collateral.

3-2.7.3 Acceptable Securities for Pledge as Collateral

As required by 11 U.S.C. § 345(b)(2), securities used as collateral must be of the kind specified in 31 U.S.C. § 9303, which specifies that government obligations may be used as security. A government obligation is defined in 31 U.S.C. § 9301(2) as a public debt obligation of the United States Government and an obligation whose principal and interest is unconditionally guaranteed by the government. In light of this definition, only United States Treasury Bills, Bonds, or Notes are deemed to constitute acceptable securities for purposes of the authorized depository system.

3-2.7.4 Deposit or Investment Secured by a Bond

A bond may be posted by a depository in lieu of pledging securities. Any bond posted must be large enough to cover the amount in each account over the FDIC insured limit of $100,000 for each account at the depository related to a case under title 11. See 3 Lawrence P. King, Collier on Bankruptcy ¶ 345.04 (15th ed. rev. 1998) (citing United States ex rel Willoughby v. Howard, 302 U.S. 445 (1938) and In re Dayton Coal and Iron Co., 239 F. 737 (E.D. Tenn. 1916)). In addition, the United States Trustee should be certain that the bond complies with the requirements of 11 U.S.C. § 345(b)(1).

3-2.8 REVIEW OF INITIAL PLEADINGS

The chapter 11 debtor frequently files a variety of pleadings either with the petition or shortly after the case is commenced. These pleadings often

request an expedited hearing, affording interested parties little notice or opportunity for review. Such a request is not inappropriate and interim relief for a limited period may be necessary in order to guarantee the debtor's uninterrupted operations. The United States Trustee should seek to ensure that parties in interest are not precluded from raising and litigating these issues at a later date.

Initial requests typically include applications to employ attorneys, accountants, and other professionals; applications regarding payments to officers and employees; applications for cash collateral; applications for financing; and applications to allow payments to prepetition creditors. Administrative requests typically include applications to jointly administer or procedurally consolidate two or more cases and applications to continue cash management systems.

3-2.8.1 Employment of Professionals

Applications to employ an attorney and an accountant frequently are presented for court approval shortly after a case is filed. 11 U.S.C. §§ 1107(a) and 327. The employment application, at a minimum, must specify the name of the professional to be employed; the reason for selection; the services to be performed; the proposed compensation terms; and the professional's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee. Fed. R. Bankr. P. 2014(a). The application must be accompanied by a verified statement of the person to be employed setting forth the connections with the parties listed above. Fed. R. Bankr. P. 2014(a).

The United States Trustee should examine the above-referenced information, as well as the disclosures required by Fed. R. Bankr. P. 2016 and that portion of the statement of financial affairs relating to contact with and payments to attorneys, to determine whether the applicant is precluded from employment by virtue of the Bankruptcy Code or applicable ethical rules. Concerns should be raised and thoroughly addressed at the first opportunity.

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

See USTM 3-6 and 3-7 for further discussion of issues regarding the employment and compensation of professionals.

3-2.8.2 **Employment of Other Professionals**

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

3-2.8.2.1 Classification as a Professional

There may be an issue as to whether or not the person to be employed is a professional and thus subject to the employment and compensation requirements of the Bankruptcy Code. See USTM 3-6.1.3. If the person to be employed will be actively involved in case administration, the United States Trustee should assert that they are professionals. See, e.g., In re Bartley Lindsay Co., 120 B.R. 507 (Bankr. D. Minn. 1990), aff'd, 137 B.R. 305 (D. Minn. 1991) (management consultant is a professional); In re Grimes, 115 B.R. 639 (Bankr. D.S.D. 1990) (farm consultant denied compensation and required to disgorge amounts paid); In re WFDR, Inc., 22 B.R. 266 (Bankr. N.D. Ga. 1982) (management consultant denied compensation when employment not approved). Other decisions regarding classification as a professional include United States ex rel Kraft v. Aetna Casualty and Sur. Co., 43 B.R. 119 (M.D. Tenn. 1984)(appraiser); In re Neidig Corp., 117 B.R. 625 (Bankr. D. Colo. 1990)(operator of radio station was a professional person -- the operator provided specialized services and acted with relatively unfettered autonomy and discretion); and In re Providence Television Ltd. Partnership, 113 B.R. 446 (Bankr. N.D. Ill. 1990)(media broker). It should be noted that if a business regularly has employed a professional person on salary, that person may be retained or replaced without court approval if necessary to the operation of the business. See 11 U.S.C. § 327(b).

3-2.8.2.2 Duties and Compensation

If other professionals are to be employed, the United States Trustee may wish to recommend a specific delineation of duties with automatically executing termination dates. All professionals should be required to keep detailed time records documenting their services. Monthly or total caps on compensation also may be advisable. When the person or firm to be employed is essentially performing the functions of management, the United States Trustee should oppose any compensation package that exceeds those typical in the industry. The United States Trustee should ensure that these professionals are aware of the requirements of the Bankruptcy Code regarding compensation and reimbursement of expenses. See 11 U.S.C. §§ 330 and 331 and USTM 3-7.

3-2.8.3 Cash Collateral Use and Financing Orders

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

1. determine whether the transaction properly is characterized as use of cash collateral as opposed to postpetition financing;

2. insist on adequate notice and opportunity for interested parties to be heard;

3. alert the court to substantive issues that should be preserved until interested parties are able to be heard; and

4. where necessary, take substantive positions to prevent overreaching.

3-2.8.3.1 Cash Collateral Versus Postpetition Financing

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

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

Because of the enhanced protections available for postpetition financing, creditors often will strain to characterize their financing arrangement as

such. For example, a typical situation might involve a prepetition lender who has a lien on inventory to secure the debt. The debtor may agree to pay down the secured interest from the sale of the inventory in exchange for the lender extending "new credit" that is secured by a lien on the debtor in possession's postpetition inventory. Functionally, this arrangement is indistinguishable from an agreement to use cash collateral with adequate protection in the form of a lien on postpetition assets. However, if the transaction is characterized as postpetition financing rather than the use of cash collateral, the lender may be entitled to a superpriority, as well as the "safe harbor" on appeal. Thus, the parties' characterization of the arrangement should not end the inquiry regarding the actual nature of the relationship. For a more complete discussion of this issue, see Warfield, Is It Use of Cash Collateral or Postpetition Borrowing: How Much Protection Does the Creditor Deserve, 94 Commercial L. J. 369 (1989).

3-2.8.3.2 Notice and Hearing Requirements

In addition to determining whether the motion is for use of cash collateral or for postpetition financing, the United States Trustee must consider whether the appropriate parties have received adequate notice of the proceedings.

1. General Requirements

The rules governing the scope and timing of notice for cash collateral motions (Fed. R. Bankr. P. 4001(b)) and postpetition financing motions (Fed. R. Bankr. P. 4001(c)) are virtually identical. Both require at least 15 days notice to any appointed or elected committees or their authorized agents, or, if there is no committee, to the twenty largest unsecured creditors, and to such other entities as the court may direct. The United States Trustee also must receive notice (Fed. R. Bankr. P. 9034). The only difference is that for cash collateral motions, the entity with an interest in the cash collateral also must be served.

Where there has been agreement to use cash collateral or where the debtor and a secured creditor have agreed to the creation of new

liens to facilitate postpetition financing, the Code does not require a hearing. Instead, there must be notice of the motion and a 15 day period for the served parties to object (Fed. R. Bankr. P. 4001(d)(1), (2) and (3)). If no objection is filed, the court can approve or disapprove the agreement without conducting a hearing. If there is objection and the court determines that a hearing is appropriate, then a hearing may be held with no less than five days notice to the appropriate parties (Fed. R. Bankr. P. 4001(d)(3)).

2. Interim Relief

If requested, the court can conduct a preliminary hearing with less than 15 days notice, but it may only authorize the use of that amount of cash collateral or credit as is necessary "to avoid immediate and irreparable harm" to the estate pending a final, adequately noticed hearing. (Fed. R. Bankr. P. 4001(b)(2) and 4001(c)(2)). However, occasionally a debtor, arguing exigent circumstances, will seek approval of a financing order on the day the case is filed. The question then becomes whether it is necessary to conduct a hearing at all and how much, if any, notice is required.

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

In In re Blumer, 66 B.R. 109, 113-14 (B.A.P. 9th Cir. 1986), aff'd, 826 F.2d 1069 (9th Cir. 1987), the Ninth Circuit Bankruptcy Appellate Panel held that, whether or not a hearing takes place, notice is always required. The court noted that while the Bankruptcy Code permits shortened notice "as is appropriate in the particular circumstances," it does not permit dispensing with notice

altogether (as is expressly allowed for relief from stay requests or motions to prohibit or condition the use, sale, or lease of property in Fed. R. Bankr. P. 4001). See also 9 Lawrence P. King, Collier on Bankruptcy, ¶ 4001.06[4] (15th ed. rev. 1998).

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

The amount of notice required necessarily will depend on the circumstances. Thus, the court in Blumer noted “in an emergency situation, telephonic notice may suffice.” 66 B.R. at 113. But see In re Center Wholesale, Inc., 759 F.2d 1440 (9th Cir. 1985) (holding that one day's notice was inadequate in light of the facts and circumstances present). In essence, the determination of whether a hearing is necessary and what constitutes adequate notice -- whether or not there is a hearing--is a matter of balancing the asserted need for emergency relief against the necessity of preserving the due process rights of the parties involved.

3. Notice Issues

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

Often, the interim order proposed by the parties will fail to specify that a final hearing will be held or that appropriate parties will have an opportunity to object. A final hearing (or at least an

opportunity to object) is always required even when all parties received appropriate notice of the interim hearing. Thus, at the interim hearing, the United States Trustee should ensure that the order approving financing or use of cash collateral is not final and that appropriate notice of a final hearing is served in accordance with the Federal Rules of Bankruptcy Procedure.

4. Scheduling of the Final Hearing

Although Fed. R. Bankr. P. 4001(b) and (c) establish a 15 day requirement before a final hearing can be held, this is a minimum rather than a maximum time for holding the hearing. In many cases, the creditors' committee will have been recently appointed. In order to assure that the unsecured creditors will have a say, the United States Trustee should request that the final hearing not be set until after the duly appointed unsecured creditors' committee has had an opportunity to review the terms of the proposed cash collateral or financing order.

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

3-2.8.3.3 United States Trustee’s Role on Substantive Issues

1. Overview

The United States Trustee is principally concerned with preserving the right of the unsecured creditors to review and comment on the early financing motions which can have a substantial impact on the future conduct of the case. Assuring adequate notice and the opportunity for creditors' committee input before a final ruling are essential in this regard, but these generic concerns may not be enough to convince the court to burden the debtor with the delay

that such considerations would necessitate. Thus, whenever possible, the United States Trustee should highlight those specific issues that are likely to raise concerns for unsecured creditors at the interim hearing, thereby bolstering the argument for preserving the creditors' opportunity for review. Of course, once the interested parties have responded, the United States Trustee generally should refrain from asserting positions.

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

2. Relevant Substantive Issues

-- Review by the United States Trustee to Prevent Overreaching

In reviewing whether the substantive provisions of a proposed financing order are objectionable, the United States Trustee should focus on the effect that the order will have on the general creditor body. This usually involves balancing the benefit to the estate from obtaining the financing against the detriment to the creditor body of providing special benefits to a particular creditor. This is inherent in the requirement established in 11 U.S.C. §§ 364(c) and 364(d)(1)(A) that the trustee must be unable to obtain the credit otherwise.

The need for financing may be so desperate that the debtor in possession will agree to almost any terms the creditor demands, which can lead to overreaching by the creditor. An example of a case where the court found overreaching is In re Tenney Village Co., 104 B.R. 562 (Bankr. D.N.H. 1989). There, the debtor agreed to a provision waiving a prepetition fraudulent conveyance and preference claims

against a secured creditor, as well as to automatic relief from stay upon "termination events," cross-collateralization, limitations on compensation of debtor's counsel, and the right to designate the debtor's counsel and CEO. The court determined that such sweeping concessions evidenced a breach of the debtor's fiduciary duty to the estate, as well as overreaching by the secured creditor. While it is difficult to establish a formula for determining when a particular arrangement constitutes overreaching, the following discussion of considerations related to various substantive provisions should provide some guidance.

-- Adequate Protection -- Cash Payments

Many interim cash collateral and financing orders contain some provision for adequately protecting the secured creditor by making "a cash payment or periodic cash payments" under 11 U.S.C. § 361(1). The United States Trustee should consider whether the proposed amount is appropriate in light of the debtor's ability to pay based on the projections of operations during the interim period. It may even be appropriate to move that the debtor and secured creditor be required to present evidence on these issues. If the evidence indicates that the size of the payments will inhibit the debtor's ability to operate, the United States Trustee should consider objecting.

-- Cross-Collateralization

The most contentious issue in many financing orders is whether an existing creditor can, postpetition, secure its existing or new debt. The United States Trustee should be concerned when a prepetition creditor who is undersecured or unsecured attempts to "bootstrap" its status by acquiring liens on postpetition assets to secure its prepetition debt. Because this increased security would come at the expense

of other unsecured creditors, it is unlikely to be in the best interests of the general creditor body.

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

However, the majority view seems to find cross-collateralization provisions acceptable under certain circumstances. In In re Vanguard Diversified, Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983), the court established a four part test that has met with general acceptance: (1) the business will not survive without the financing; (2) the debtor cannot obtain alternate financing on acceptable terms; (3) the lender will not accept less favorable terms; and (4) the proposed financing is in the best interest of the general creditors. See also In re Adams Apple, Inc., 829 F.2d 1484, 1490 (9th Cir. 1987) (cross-collateralization may provide only means of saving debtor); In re Ames Dept. Stores, Inc., 115 B.R. 34, 39-40 (Bankr. S.D.N.Y. 1990) (where debtor demonstrated that unsecured financing was unavailable, cross-collateralization permitted); In re Roblin Indus., 52 B.R. 241, 244 (Bankr. W.D.N.Y. 1985).

Even among courts that accept cross-collateralization, it is a disfavored means of financing. See Vanguard Diversified, 31 B.R. at 366 (cross-collateralization is a disfavored means of financing and is to be authorized only after hearing with notice to creditors). Thus, it is important to ensure that the other creditors have adequate notice and opportunity to object. At a minimum, the United States Trustee should emphasize the disfavored status of such

financing provisions and seek to have the court apply the four part test set forth in Vanguard.

-- Superpriority Provisions

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

In addition, it may be consistent with the interests of the general creditor body to consider carving out certain classes of claims from a grant of superpriority status. For example, provisions should be made for the payment of fees for debtor's counsel and for counsel to the creditors' committee. If a financing order is entered before any official committees are appointed, the United States Trustee should object to any carve-out for professional fees that does not include fees for committee professionals. If these professionals cannot be paid, the debtor may be unable to propose a plan and the interests of general unsecured creditors and other parties in interest may go unrepresented.

Further, under 11 U.S.C. § 1129(a)(12), the United States Trustee's quarterly fees must be paid on or before the effective date of any plan as a condition of confirmation. Thus, the United States Trustee should insist that a carve-out be provided for quarterly fees from any superpriorities or liens, or the debtor may be unable to remain in chapter 11 and confirm a reorganization plan.

If the case converts to chapter 7, the United States Trustee's quarterly fees and chapter 7 administrative expenses take priority over chapter 11 administrative expenses. 11 U.S.C. § 726(b). In re Endy, 104 F.3d 1154, 1157 (9th

Cir. 1997); In re Juhl Enterprises, 921 F.2d 800, 803 (8th Cir. 1990).

-- Validation of Prepetition Liens and Waiver of Claims

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

-- Priming of Liens

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

-- Default Provisions with Automatic Remedies

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

fiduciary duties). Similarly, a provision that all terms of a financing order will be binding on any subsequently appointed trustee may impair the ability of the United States Trustee to find candidates to fill such a position and therefore is objectionable.

-- Conclusion

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

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

3-2.8.4 **Payments to Prepetition Creditors**

One of the matters that frequently arises immediately after the filing of a case is a request by the debtor to pay certain prepetition creditors. The debtor usually seeks authority to pay these creditors on an emergency basis with shortened notice to a limited number of creditors. The nature of the requests vary from payment of employee wages to payment of unsecured supplier creditors. Most requests are accompanied by a representation that the payments are essential for the continued existence

and/or viability of the debtor's business. While payment to unsecured creditors may seemingly be beyond the scope of the provisions of the Bankruptcy Code, an increasing number of courts are authorizing such payments by invoking the necessity of payment doctrine. The legal basis for application of the doctrine of necessity is tenuous.

3-2.8.4.1 Background of the Doctrine of Necessity

The doctrine of necessity is an equitable principle that evolved from two related rules--the necessity of payment rule and the six months rule. See Eisenberg & Gecker, The Doctrine of Necessity and Its Parameters, 73 Marq. L. Rev. 1, 2-5 (1989). The necessity of payment rule allows a court to authorize the payment of pre-existing claims in railroad reorganization cases, if such payments are essential to the railroad's continued existence. See In re Boston and Maine Corp., 634 F.2d 1359 (1st Cir. 1980), cert. denied, 450 U.S. 982 (1981); In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989). The six month rule authorizes administrative expense priority treatment to creditors supplying services and goods to railroads within the six month period prior to case filing.

The doctrine of necessity is now widely used in non-railroad bankruptcy cases, though its use is restricted to instances where the payments are essential and necessary to the debtor’s continued existence. Compare In re Eagle-Picher Industries, Inc., 124 B.R. 1021 (Bankr. S.D. Ohio 1991) (in case where debtor was automobile parts manufacturer, failure to pay prepetition debts would jeopardize debtor's relationship with customers) and In re Gulf Air, Inc., 112 B.R. 152 (Bankr. W.D. La. 1989) (in case concerning a regional commuter airline, payment of prepetition wage and employee benefit claims held to be “essential”) with In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989) and In re Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987) (payment of certain prepetition employee claims held not to be essential).

Some courts have refused to apply the doctrine on the grounds that payments in certain cases would constitute preferential treatment over similarly classified creditors. See In re B & W Enters., Inc., 713 F.2d 534 (9th Cir. 1983) (rule not extended to allow cross-collateralization for purposes of postpetition financing in a trucking company case); but see

Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), cert. denied, 485 U.S. 962 (1988) (doctrine not extended to permit payments for reconstructive surgery or in vitro fertilization for women injured by the Dalkon shield outside of properly presented plan of reorganization); In re Adams Apple, Inc., 829 F.2d 1448 1490 (9th Cir. 1987); In re FCX, Inc., 60 B.R. 405 (E.D.N.C. 1986) (doctrine not extended to permit payment of employees and grain producers because to do so would violate priorities established by Bankruptcy Code); In re Timberhouse Post and Beam, Ltd., 196 B.R. 547, 550 (Bankr. D. Mont. 1996) (following B & W Enters., Inc.). See also Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations, 65 Am. Bankr. L.J. 75, 100 (1991).

3-2.8.4.2 Statutory References

1. 11 U.S.C. § 105(a)

The statute most frequently cited to support application of the doctrine of necessity is 11 U.S.C. § 105(a) which empowers a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The courts invoking 11 U.S.C. § 105(a) for this purpose rationalize that since the fundamental purpose of a chapter 11 is to allow a debtor to reorganize, 11 U.S.C. § 105 may be used to avert the consequences of a failed reorganization that may result if the payment to prepetition creditors is not allowed. See, e.g., In re Ionosphere Clubs, Inc., 98 B.R. 174, 175-177 (Bankr. S.D.N.Y. 1989).

Courts refusing to apply 11 U.S.C. § 105(a) rely upon limitations imposed by concepts of the Bankruptcy Code. These courts usually rule that prepetition creditor payments upset the priority scheme of 11 U.S.C. § 507 and/or the principle, embodied in 11 U.S.C. §§ 1122-1129, that similarly situated creditors be similarly treated. See, e.g., Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987), cert. denied, 485 U.S. 962 (1988) (clear language of Bankruptcy Code and Rules does not authorize payment or advance of monies to or for

the benefit of unsecured creditors prior to approval of plan); In re FCX, Inc., 60 B.R. 405, 410-11 (E.D.N.C. 1986) (settling certain claims prior to filing plan of reorganization held to be inequitable); In re Structurlite Plastics Corp., 86 B.R. 922, 929-33, explained 91 B.R. 813, 816 (Bankr. S.D. Ohio 1988) (allowing payment of prepetition claims to the extent that they are priority claims). Courts using 11 U.S.C. § 105(a) counter that 11 U.S.C. §§ 507 and 1122-1129 are not inflexible and that the latter statutes apply only in the plan confirmation context. See, e.g., In re Chateaugay Corp., 80 B.R. 279, 287 (S.D.N.Y. 1987) (rigid application of section 507 would be inconsistent with fundamental purpose of reorganization which is to permit debtor's survival and payment to creditors).

2. 11 U.S.C. § 363

Some courts cite 11 U.S.C. § 363(b) or 363(c)(1) which permit the debtor to use property of the estate in the operation of the business as a basis for application of the doctrine of necessity. By viewing the debtor's application to pay certain prepetition claims as a request for authority to expend funds outside of the ordinary course of business pursuant to 11 U.S.C. § 363, some courts have required that the debtor articulate a sound business reason for the decision to do so. See, e.g., In re Ionosphere Clubs, Inc., 98 B.R. at 175-176.

3. 11 U.S.C. § 507

Courts may approve payments to prepetition creditors on the theory that 11 U.S.C. § 507(a) which defines administrative expenses provides priority status to the requested payments. See In re Structurlite Plastics Corp., 86 B.R. 922, 933 (Bankr. S.D. Ohio 1988). While 11 U.S.C. § 507 does not authorize immediate payment of priority claims, these courts apparently rationalize that the claims will ultimately be paid in full and no one is harmed by early payment.

3-2.8.4.3 Types of Requests

1. Employees (Non-Management)

The most common use of the doctrine of necessity concerns prepetition employee payroll and benefits claims. Typical requests include seeking authorization to pay prepetition payroll and work benefits and to reimburse employee expenses. These types of requests are often granted, particularly if the payments requested fall within the 11 U.S.C. § 507(a) priority parameters. See Eisenberg & Gecker, supra, at 12-14; see also In re FCX, Inc., 60 B.R. 405, 412 (E.D.N.C. 1986) (only employee wage claims under section 507(a)(3) entitled to priority); In re Structurlite Plastics Corp., 86 B.R. 922 (Bankr. S.D. Ohio 1988) (payment of prepetition medical claims would be allowable pursuant to section 507(a)(4) as contributions to employee benefit plan).

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

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

2. Management

Requests for authorization to pay prepetition wages sometimes include requests to pay management salaries, expenses, or benefits.

Occasionally, authorization for payments to prepetition creditors is sought on the ground that payment of these creditors will allow management to focus its attention on the debtor's reorganization. Payments to creditors to whom management may be personally liable, such as taxing entities or holders of guaranteed debt, may be requested under this theory. See, e.g., In re Revco D.S., Inc., 91 B.R. 777 (Bankr. N.D. Ohio 1988) (denying request to pay only prepetition trust fund taxes but no other taxes entitled to 507(a)(7) priority so that principals could avert threat of personal assessment).

3. Customers

Courts that allow use of the doctrine of necessity generally approve requests that preserve customer good will. The doctrine may be used to authorize payment of warranty claims, return of customer deposits, honoring customer gift certificates or payment of customer referral commissions. See In re Eagle-Picher Indus., Inc., 124 B.R. 1021 (Bankr. S.D. Ohio 1991) (customers would perceive unfair conduct if automotive toolmaker creditors not paid).

4. Suppliers

Some courts authorize payments to critical suppliers or service providers. See, e.g., Eagle-Picher Indus., Inc., 124 B.R. at 1023 (payments to prepetition unsecured toolmakers authorized). Payments may be sought for several reasons. The debtor may allege that a creditor will not supply essential supplies, will go out of business to the debtor's economic detriment, or will ruin the debtor's reputation if the prepetition debt is not paid.

5. Foreign Creditors

The doctrine of necessity may be used to justify payments to foreign creditors. Eisenberg & Gecker, supra at 16-17. Utilization of the doctrine may avoid expensive legal proceedings and preserve the debtor's image abroad where perceptions of

bankruptcy may differ. Application of the doctrine also avoids testing the validity of the automatic stay in other countries and the initiation of self help or other legal remedies available in the foreign creditor's country.

3-2.8.4.4 United States Trustee's Position on Doctrine of Necessity Requests

The United States Trustee should endeavor to ensure the broadest possible notice of doctrine of necessity requests in the context of the case. The scope and length of notice urged will be dependent on the time sensitivity of the request, the payment amount requested, the cost of notice, and the existence of effective creditor advocates, such as an active creditors' committee. Fed. R. Bankr. P. 4001 offers general guidance on the minimal length of notice appropriate for emergency and non-emergency situations.

Discretion should be exercised in determining substantive positions on case specific doctrine of necessity requests. Factors that may suggest decreased scrutiny by the United States Trustee include active creditor participation, full notice of the proposal with an ample objection period, requests involving minimal expenditures in comparison with case size, requests to pay creditors entitled to priority pursuant to 11 U.S.C. § 507 (which are likely to be paid in full anyway), and payments that are obviously essential to the debtor's continued existence. Factors that may suggest increased scrutiny include requests that are beneficial to the debtor's management, requests for payments that do not seem essential, and requests for payments to creditors whose class is not likely to be paid in full through the bankruptcy process.

Due consideration should be given to the difficulty of evaluating the economic consequences of nonpayment and the probability of uncontroverted testimony from the debtor's management. Unless presented with egregious or obviously overreaching requests (such as when insider or creditor intimidation is indicated), the United States Trustee should rely on the affected parties to challenge doctrine of necessity requests.

3-2.8.5 Joint Administration and Substantive Consolidation

Fed. R. Bankr. P. 1015(b) allows the court to order the joint administration of two or more related cases. Joint administration affects procedural matters only (In re Amdura Corp., 121 B.R. 862, 868 (Bankr. D. Colo. 1990)) and is appropriate if it enables the estates to be administered more efficiently, expeditiously, and/or with less cost. It allows hearings, pleadings, notices, or other matters involving several distinct cases to be combined. See Unsecured Creditors Comm. v. Leavit Structural Tubing Co., 55 B.R. 710, 712 (N.D.Ill. 1985), aff'd, 796 F.2d 477 (7th Cir. 1986).

Joint administration must be distinguished from substantive consolidation of cases. Substantive consolidation results in asset and liability pooling and may substantially affect the rights of creditors. See, e.g., Holywell Corp. v. Bank of New York, 59 B.R. 340, 347 (S.D. Fla. 1986); In re Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988). The United States Trustee should oppose substantive consolidation if it is requested on limited or shortened notice. See, e.g., In re Auto Train Corp., 810 F. 2d 270, 278 (D.C. Cir. 1987) (consolidation motion required reasonable notice and opportunity for hearing). Complete and appropriate notice should be provided to all creditors regarding any such request.

3-2.8.6 Small Business Election

The Bankruptcy Reform Act of 1994 amended the Bankruptcy Code to expedite the process by which small businesses may reorganize under chapter 11. A small business is defined as “a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed $2,000,000.” 11 U.S.C. § 101(51C). A qualified small business debtor who elects coverage under this provision (i) may seek to dispense with the appointment of a creditors' committee (11 U.S.C. § 1102(a)(3)); (ii) is granted an exclusive period of 100 days within which to file a plan (11 U.S.C. § 1121(e)); and (iii) is subject to more flexible provisions for

disclosure and solicitation of acceptances for a proposed reorganization plan (11 U.S.C. § 1125(f)).

The Bankruptcy Code does not provide a time limit within which the small business election must be made. A debtor may elect to be considered a small business by filing a written statement of election no later than 60 days after the order for relief (or by such later date as the court, for cause, may fix). Fed. R. Bankr. P. 1020. The United States Trustee must review any such election to determine if the debtor is eligible for treatment as a small business and object if necessary.

Further, the Bankruptcy Reform Act of 1994 amended 11 U.S.C. § 1102 to provide that, on request of a party in interest in small business cases and for cause, the court may order that a creditors' committee not be appointed. 11 U.S.C. § 1102(a)(3). In re Haskell-Dawes, Inc., 188 B.R. 515 (Bankr. E.D. Pa. 1995). Although the Code does not provide any definition of what would constitute “cause” for purposes of 11 U.S.C. § 1102(a)(3), the United States Trustee should scrutinize any application to ensure that adequate notice and an opportunity for a hearing is provided.

CHAPTER 3-3: INITIAL DEBTOR INTERVIEWS

3-3.1 INITIAL DEBTOR INTERVIEWS (IDIs)

Immediately following the entry of an order for relief, the United States Trustee should schedule an initial debtor interview (“IDI”) with the principals of the debtor and debtor’s counsel. The purpose of the IDI is two-fold: (1) to provide the United States Trustee with vital information so that an early assessment can be made as to the veracity of the debtor’s schedules and statements and the debtor’s financial ability to reorganize; and (2) to ensure the debtor is aware of its new fiduciary obligations and the United States Trustee’s role in the administration of chapter 11 cases.

3-3.1.1 **Procedure for Setting Up the IDI**

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

Prior to the IDI, the United States Trustee should make a written request for certain financial and other information pertaining to the debtor's business or affairs. The request can vary depending on the nature or size of the business. Typically, financial statements, prepetition bank statements and checks, federal tax returns, material lawsuits, and executory contracts should be requested. The debtor should also be asked to provide documentation such as proof of a debtor in possession account, evidence of insurance, as well as counsel's employment order, to ensure the case is in administrative compliance. Regardless of the debtor's complete compliance, the IDI should proceed.

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

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

reviewed carefully with the debtor and debtor's counsel in order to identify any inconsistencies or omissions based upon the information disclosed during the IDI.

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

3-3.1.3 Familiarizing the Debtor with its New Fiduciary Obligations

At the IDI, the United States Trustee should set forth the statutory duties and obligations of a debtor in possession. The debtor's representatives should be provided with a copy of the Program's chapter 11 operating guidelines and monthly report forms, which should be explained and discussed. The procedures for calculating and paying the quarterly fee assessed pursuant to 28 U.S.C. § 1930(a)(6) should be explained. The United States Trustee should ensure that the debtor has closed its former bank accounts and established separate debtor in possession bank accounts. The debtor should be required to provide proof that appropriate insurance coverage is being maintained. If applicable, the statutory requirements regarding the use of cash collateral should be explained.

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

Information and commitments regarding either compliance matters or document requests which are obtained from the debtor's representatives at the IDI should be documented and retained in the case file. A specific time frame within which any outstanding deficiencies or issues will be resolved should be established prior to the conclusion of the IDI. The debtor's

failure to adhere to any such agreement should result in prompt action by the United States Trustee.

3-3.2 OPERATING GUIDELINES

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

3-3.2.1 General Provisions

The debtor should be advised of its obligation to comply with the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, local rules, and any court order, and that postpetition debts must remain current and prepetition debts may not be paid. The debtor should be instructed to close its books and records as of the date of filing and to open new postpetition books and records. The debtor should be notified that pleadings and notices are to be served upon the United States Trustee and an appropriate mailing address should be given to do so. Finally, the debtor should be advised of the consequences of failing to comply with the operating guidelines and reporting requirements. The United States Trustee should specifically spell out the method of calculating and paying the United States Trustee’s quarterly fees.

3-3.2.2 Bank Accounts

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

funds for the payment of postpetition taxes (including, for example, payroll and sales or excise taxes) when such liabilities are incurred.

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

The debtor in possession's account checks and statements should be imprinted with the phrase "Debtor in Possession." For example, the checks could be styled as follows:

Estate of XYZ Corporation
Debtor in Possession
101 Main Street
Anywhere, U.S.A. 11111

This caption on the checks is intended to notify creditors and third parties that the debtor is operating under the protection of the bankruptcy court. Notice is thereby given to all persons who may receive the check that they are doing business with a debtor and that they may have different rights and responsibilities than when dealing with a non-debtor individual or entity, i.e., that they may have an administrative claim if the check is not honored. Creditors receiving such checks for the improper, unauthorized payment of prepetition debts may disclose this information to the court and the United States Trustee, who may take corrective action. In re Young, 205 B.R. 894 (Bankr. W.D. Tenn. 1997); In re Gold Standard Baking, Inc., 179 B.R. 98 (Bankr. N.D. Ill. 1995); In re Johnson, 106 B.R. 623 (Bankr. D. Neb. 1989) (debtors not required to imprint "debtor in possession" on checks).

3-3.2.3 **Insurance**

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

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

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

3-3.3 FINANCIAL REPORTS

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

The debtor in possession should file operating reports each month throughout the pendency of the case. A deadline for the submission of the initial report should be set at the initial debtor interview. The report should be filed with both the United States Trustee and the clerk of the court. The debtor should also provide a copy of the report to the Chair of any creditors' committee appointed to serve in the case.

The United States Trustee retains the discretion to waive or modify the reporting requirements. The rationale underlying any such decision, however, should be documented in writing and maintained in the file. Moreover, this discretion should be exercised sparingly, given both the importance of timely and accurate financial information in the reorganization process, as well as the need to avoid the appearance that a debtor is receiving disparate treatment. The debtor's obligation to file monthly operating reports ends when a case is converted or dismissed. Postconfirmation, the United States Trustee should require submission and filing of reports pursuant to 11 U.S.C. § 1106(a)(7). See USTM 3-10.7.

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

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

3-3.3.1 Cash Receipts and Disbursements Statement

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

Aside from the income and other items comprising cash receipts, the cash statement should contain the debtor's expenditures for inventory, salaries,

taxes, etc. The United States Trustee can use the information reported in these statements to discover:

1. whether the debtor is making unauthorized payments to professionals;

2. whether the debtor is improperly paying prepetition debts;

3. whether the debtor has sufficient cash flow to effectively reorganize;

4. whether inordinate payments are being made for travel, entertainment, or other employee benefits; and,

5. whether improper payments are being made by the debtor that will hamper its ability to reorganize.

3-3.3.2 Statement of Operations

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

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

The accrual income statement is also important since it indicates the cost of goods sold. This requires a beginning inventory figure based upon a physical or perpetual inventory. The beginning inventory figure is critical since it is only after purchases have been added and ending inventory

deducted that one arrives at the cost of goods sold. This will determine the debtor's gross profit margin. At this point, a comparative financial analysis can be accomplished using statistics from prior years.

3-3.3.3 Balance Sheet

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

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

3-3.3.4 Schedule of Postpetition Liabilities

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

3-3.3.5 Postpetition Taxes Payable (Tax Reconciliation) Statement

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

The United States Trustee should maintain an information exchange program with the Special Procedures Staff of the Internal Revenue Service. This exchange will provide an independent means of checking and verifying the debtor's information regarding federal tax obligations. The Internal Revenue Service, in turn, is authorized to notify the United States Trustee when its records indicate that a debtor has failed to satisfy a postpetition tax obligation.

3-3.3.6 Additional Reporting Requirements

In addition to the five standard forms previously discussed, the United States Trustee retains the discretion to require any additional reports necessary to ensure that a case is properly monitored and administered. Examples would include:

1. A requirement that copies of previous years' tax returns and financial statements be filed with the United States Trustee.

2. A requirement that a debtor file a list of inventory.

3. A requirement that a debtor file a list of its employees and their current salaries.

4. A requirement that a debtor provide an aging statement regarding its accounts receivable.

5. In a real estate case, a requirement that a debtor submit a rent roll.

6. A requirement that a debtor submit a check register.

7. A requirement that a debtor submit a statement of sources and uses of cash (Cash Flow Statement).

CHAPTER 3-4: CREDITORS' COMMITTEES

3-4.1 11 U.S.C. §§ 1102 AND 1103

Section 1102 of the Bankruptcy Code directs and authorizes the United States Trustee to appoint an official unsecured creditors' committee and provides the United States Trustee with the discretion to appoint additional committees, including equity security holders' committees. The United States Trustee must endeavor to appoint a committee of creditors holding unsecured claims "as soon as practicable after the order for relief. . . and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate." 11 U.S.C. § 1102(a)(1). "On request of a party in interest, the court may order the appointment of additional committees . . . if necessary to assure adequate representation of creditors or of equity security holders." 11 U.S.C. § 1102(a)(2). "On request of a party in interest in a case in which the debtor is a small business [as defined in 11 U.S.C. § 101(51C)] and for cause, the court may order that a committee of creditors not be appointed." 11 U.S.C. § 1102(a)(3).

It has been held that a court could not use its equitable powers to override the United States Trustee's decision to appoint an additional committee. In re New Life Fellowship, Inc., 202 B.R. 994 (Bankr. W.D. Okla. 1996).

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

The powers and duties of a creditors' committee are set forth in 11 U.S.C. § 1103(c). As part of those powers and duties, the committee may: (1) review and investigate the acts, conduct, and financial condition of the debtor; (2) consult with the debtor concerning the administration of the case; and (3) participate in the formulation of the plan of reorganization. 11 U.S.C. § 1103. As part of their obligation to represent creditor interests as a whole, members of a committee have fiduciary obligations. See

Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268-269 (1941), reh'g denied, 312 U.S. 715 (1941).

3-4.2 ORGANIZATIONAL MEETING

3-4.2.1 Purpose

An organizational meeting of creditors is held for the purpose of providing the United States Trustee with information regarding the debt structure of the case, as well as to identify creditors willing to serve on the creditors' committee. Based upon what is learned at the meeting, information previously obtained, and the policies set forth herein, a formation meeting enables the United States Trustee to appoint the creditors' committee quickly at the outset of the case.

3-4.2.2 Notice

The United States Trustee, through the use of a notice and questionnaire transmitted by facsimile reproduction, overnight mail, or electronic transmission should contact the creditors holding the largest unsecured claims against the debtor, based upon the list of the 20 largest unsecured creditors provided by the debtor. The notice should be issued as soon as possible after the petition is filed. When the creditors are contacted, they should be informed that the case has been filed; that they are listed as one of the largest unsecured creditors in the case; and that they are, therefore, being invited to a creditors' committee organizational meeting. If possible, a formation meeting should be held as soon as practicable.

3-4.2.3 Attendance

The debtor should be invited (but it is not required) to the organizational meeting to give a short presentation concerning the events that led to the filing of the case, as well as to respond to limited inquiries by creditors regarding the case. Given the close-knit associations that often exist in the credit community, it is not unusual for more creditors to appear than have been invited to attend. Any creditor who expresses interest should be provided a notice and questionnaire and permitted to attend the formation meeting.

The purpose of the formation meeting is to allow the United States Trustee to obtain information and deliberate as to the proper structure of the creditors' committee. Accordingly, these meetings should not be treated as public meetings and should not be opened to the press.

Generally, the questionnaire distributed by the United States Trustee will solicit all of the information ordinarily necessary to evaluate a creditor's candidacy for committee membership; therefore, great detail on the sign-in sheet is duplicative and unnecessary.

While the committee is usually composed of non-lawyer employees of creditors, there may be situations in which outside counsel or other professional persons seek appointment to the committee in their own right (and not as representatives of specific creditors) as "agents" of the creditor. See generally In re A.H. Robins Co., 65 B.R. 160 (E.D. Va. 1986); In re Dow Corning Corp., 194 B.R. 121 (Bankr. E.D. Mich. 1996), rev'd, 212 B.R. 258 (E.D. Mich. 1997); In re Celotex Corp., 123 B.R. 917 (Bankr. M.D. Fla. 1991); In re Johns-Manville Corp., 36 B.R. 743 (Bankr. S.D.N.Y. 1984); In re M.H. Corp., 30 B.R. 266 (Bankr. S.D. Ohio 1983).

It is not uncommon for attorneys, accountants, and other professional persons to attend a formation meeting even though they do not have a client who is a party in interest in the case. These professionals usually wish to solicit representation of the committee. In larger cases or cases of notoriety, a significant number of professionals may fall into this category. It is helpful to the committee if the United States Trustee has all of these professionals sign in on a separate sheet, colloquially referred to as a "pitch sheet." This may assist the committee in determining whom it will interview.

3-4.2.4 **Agenda**

3-4.2.4.1 Introduction

The representative of the United States Trustee should identify him or herself, announce the style of the case(s), introduce the debtor's representative(s) and counsel, and indicate that invitations to the meeting were extended to the unsecured creditors holding the 20 largest claims in the case. It should be stated that this meeting is not the statutory meeting

of creditors that will be held on notice to all creditors pursuant to 11 U.S.C. § 341(a). If it has already been established, the date, time and location of the section 341 meeting may be announced. The United States Trustee should also indicate the purpose of the meeting and the agenda to be followed. It is also helpful to reiterate the “ground rules” for active participation in the meeting, including the query regarding the presence of the media.

3-4.2.4.2 Explanation of Roles of the United States Trustee and the Creditors' Committee

The United States Trustee should explain the role of the United States Trustee in chapter 11 cases, as well as the separate role and function of the bankruptcy court as the forum for dispute resolution in the process. It should be emphasized that in supervising the administration of a case certain concerns of the United States Trustee parallel those of the appointed creditors' committee (e.g., concerns about the administrative expenses of the case, maintenance and adequacy of insurance, timely payments of postpetition obligations, and review of financial statements). It is in the interest of both the United States Trustee and the creditors' committee to ensure that the case moves promptly towards resolution.

The United States Trustee should explain that members of a creditors' committee are fiduciaries and represent the entire unsecured creditor body. See Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262, 268 (1941); In re Celotex Corp., 123 B.R. 917, 920 (Bankr. M.D. Fla. 1991) (fiduciary duty of committee and, by extension, committee’s counsel); In re El Paso Refinery L.P., 196 B.R. 58, 74, (Bankr. W.D. Tex. 1996) (comparing the committee member’s fiduciary duty with the member’s legitimate right to pursue self-interest). The United States Trustee should inform the creditors of the responsibilities and remedies available to a committee as set forth in 11 U.S.C. § 1103(c).

3-4.2.4.3 Debtor's Presentation

After the roles of the United States Trustee and the creditors' committee have been explained, the debtor should be given an opportunity to make a brief presentation concerning the reasons for the filing and what the

debtor hopes to accomplish during the course of the case. A principal of the debtor or other knowledgeable officer customarily delivers this presentation, although sometimes debtor's counsel fulfills this role. After the presentation is concluded, the representative of the debtor can be allowed to respond to questions regarding the status of the case; however, the attendees should be cautioned that this is not the section 341 meeting. The questioning should be kept brief, so as not to unduly delay the meeting. The United States Trustee must be mindful that sometimes professionals attempt to use the question/answer period as a showcase to demonstrate their skills and zeal to the creditors who will in short order be selecting professionals to assist the committee.

3-4.2.4.4 Appointment of the Creditors' Committee

After consideration of the information gathered at the meeting, the United States Trustee should announce the composition of the committee. Following the announcement, the newly selected committee should be asked to remain, the general formation meeting should be adjourned, and all non-selected attendees should be excused. Consideration should be given to inviting the debtor and counsel to briefly remain in attendance, but outside of the meeting room, in case the committee has any specific need to deal immediately with the debtor. The United States Trustee should then meet with the members of the creditors' committee and advise them regarding actions that should be undertaken. The following items should be discussed:

1. Selection of one or more chairperson(s).

2. Adoption of procedural rules or by-laws (e.g., quorum, voting).

3. Selection of professionals. The committee, under 11 U.S.C. § 1103(a), may select and authorize the employment of an attorney(s), an accountant(s), or other agents, if approved by the court. The United States Trustee may discuss the payment of the committee's professionals' fees by the estate and comment upon the availability, or lack thereof, of a "carve out" for fees in any debtor in possession financing facility that may be proposed or in place.

4. Allowance of expenses of a committee (see 11 U.S.C. § 503(b) and applicable case law).

The United States Trustee should not attempt to exclude attorneys representing individual committee members from this meeting; however, these attorneys should not be permitted to utilize the meeting as a forum to campaign for selection as the committee's counsel.

At the conclusion of the meeting, the United States Trustee should prepare a Notice of Appointment which should include the names, addresses, and telephone and facsimile numbers of the committee members. The notice of appointment should be filed with the bankruptcy court and copies forwarded to debtor's counsel and each member of the committee.

3-4.2.5 Selection of Professionals

The selection of professional assistance is often the first major decision that a creditors' committee will make. A great degree of care should be exercised in the selection process, as the professionals selected will be the standard bearers for the community of interests represented by the committee. The committee may wish to interview various firms before making its decision. The United States Trustee should not promote or encourage the selection of any particular individual or firm. The committee should be made aware of its obligation to oversee and direct the efforts of its professionals, as well as to scrutinize their fees and expenses.

Decisions regarding the employment of professionals should be made as soon as prudently possible. Many major events can occur during the early days and weeks of a case that may have ramifications throughout the entire pendency of the case. It is not unusual for a committee to recess for a short period of time after the organizational meeting, reconvene at a mutually acceptable place and time, and decide on the retention of professionals at that subsequent meeting.

The professionals selected to be retained by the committee must be approved by the court. 11 U.S.C. § 1103(a). As with the appointment of debtors' professionals, it is incumbent on a person being employed by a committee to disclose any circumstances that raise conflict of interest issues at the time of retention. Fed. R. Bankr. P. 2014. 11 U.S.C. § 1103

does not specifically require professionals employed by a committee to be "disinterested persons" (as defined in 11 U.S.C. § 101(14)); however, 11 U.S.C. § 1103(b) provides that an attorney or accountant employed to represent the creditors' committee may not, at the same time, represent an entity having an "adverse interest" in connection with the case. Representation of a creditor of the same class, i.e., unsecured, does not per se constitute an adverse interest. See In re National Liquidators, Inc., 182 B.R. 186, 192 (S.D. Ohio 1995). 11 U.S.C. § 1103(b) seeks to draw a distinction between potential conflicts and actual conflicts. In re Levy, 54 B.R. 805 (Bankr. S.D.N.Y. 1985); see also In re Oliver's Stores, Inc., 79 B.R. 588 (Bankr. D.N.J. 1987). For example, an actual conflict is presented when counsel seeks to represent the committee while simultaneously representing an individual member of the committee in claims objection litigation concerning its particular claim against the debtor. See In re Caldor, Inc. - NY, 193 B.R. 165 (Bankr. S.D.N.Y. 1996) (A creditor committee's retention of legal and accounting professionals who were simultaneously representing the creditors' committee of the debtor's competitor in a separate bankruptcy case was not barred by section 1103(b), where neither debtor was a creditor of the other. The court, overruling the United States Trustee's objection, found that an "adverse interest in connection with the case" means a competing claim in the same bankruptcy case).

The committee should be informed of the potential for excessive costs that may arise if large numbers of professionals are employed in a case. The legislative history of the Bankruptcy Code indicates that, absent unusual circumstances (such as a very large and complex case), appointment of co-counsel is not warranted, as it greatly increases the likelihood of duplication of services between the two attorneys. The duplication will work either to the detriment of the estate by increasing administrative costs or to the detriment of the professionals since both will not be compensated for services rendered. See In re Electrical Materials Co., 160 B.R. 1016, 1017 (Bankr. W.D. Mo. 1993) ("If the work of a second professional will be clearly duplicative and wasteful, the court should deny the committee's request for employment of another professional . . . ."). Furthermore, one of the two attorneys may be more likely to consent to proposed conduct by a debtor which may lead to a situation where the debtor seeks to avoid one attorney and submit all matters to the other. The United States Trustee should carefully review applications to employ co-counsel to ensure that

appropriate justification has been demonstrated. For example, if lead counsel for the committee is an out of town firm, the employment of local counsel to assist with the case may well be justified and it may be required by local rules. Applications to employ co-counsel should clearly delineate the responsibilities and duties of each applicant. The United States Trustee should object to deficient applications.

3-4.2.6 Fees of Professionals

The United States Trustee should advise the creditors' committee that the fees to be paid to the counsel it selects will be paid from the debtor's estate upon appropriate application and approval of the bankruptcy court (see 11 U.S.C. § 330(a)), provided funds are available because they are unencumbered or are carved out. The committee should manage and guide the efforts of its professionals to control the level of fees and expenses incurred. The committee should be informed that the United States Trustee will review the fee applications of professionals and may support or object to such applications in accordance with the United States Trustee’s guidelines and any local court guidelines on fees.

3-4.2.7 Expenses of Committee Members

Prior to the enactment of the Bankruptcy Reform Act of 1994, there was a split in the case law regarding the recovery of expenses by members of a creditors' committee. In the majority of jurisdictions, committee members could recover their out-of-pocket expenses from the debtor's estate following application and order of the bankruptcy court. See In re George Worthington Co., 921 F.2d 626, 632-33 (6th Cir. 1990). Effective October 22, 1994, 11 U.S.C. § 503(b)(3)(F) was enacted which specifically permits members of committees to receive court-approved reimbursement of their out-of-pocket expenses. The expenses must be actual, necessary, and reasonable. See In re Western Co. of North America, 123 B.R. 546, 548 (N.D. Tex. 1991); In re Fireside Office Supply, Inc., 17 B.R. 43, 46 (Bankr. D. Minn. 1981).

3-4.3 FORMATION OF A CREDITORS' COMMITTEE BY ALTERNATIVE MEANS

Certain cases may warrant alternative committee formation procedures. When time is of the essence, a conference telephone call with prospective committee members may be organized. If time is available, solicitation of the creditor group in writing, using express mail service, facsimile transmission, or electronic transmission is appropriate. Solicitation materials should include a letter from the United States Trustee informing creditors of the filing and providing them with basic information regarding the duties and responsibilities of a creditors' committee. A questionnaire that can be completed and returned to the United States Trustee by creditors willing to serve on a committee should also be provided. The questionnaire should capture basic information regarding the identity of the creditor and the nature of its claim, as well as whether the creditor is an insider or a competitor.

Once the questionnaires have been collected and a decision regarding the composition of the committee made, the United States Trustee must give notice to the individuals appointed and encourage them to schedule a committee meeting amongst themselves and to employ counsel, if necessary, at the earliest possible date. The United States Trustee may choose to convene the first meeting for these purposes, or alternatively offer the offices of the United States Trustee as an initial meeting site should the committee so require.

3-4.4 THE COMMITTEE SELECTION PROCESS

Most routine chapter 11 cases lack significant creditor participation and, as a result, the United States Trustee may be compelled to expend considerable time and resources in order to form a committee. On the other hand, in large cases where there is often significant creditor participation, the United States Trustee must carefully evaluate the existing debt structure and seek to balance the interests of the various creditor groups in selecting committee members.

The goal in the creditors' committee formation process is to structure a committee representative of the unsecured creditor body that can assist in moving the case toward resolution in an expeditious manner. The

resolution of issues regarding the number and composition of creditors' committees is fundamental to the proper discharge of the United States Trustee's responsibilities in this area. While the law provides no set formula for determining the number of committees to be appointed, the policy is to limit the number of committees, preferably to one, and to confine the size of the committee to under ten creditors. The United States Trustee should not ordinarily appoint a committee of two members and should never appoint a committee of one. The membership of creditors' committees should be the subject of ongoing review throughout a case. As the circumstances of a case change, so may the factors that determine the committee's structure. The United States Trustee, in the exercise of his/her statutory discretion, may modify the composition of the committee without leave of court.

The United States Trustee should not simply appoint the seven largest creditors to serve on a committee, but should appoint, after thorough analysis of the interests of the constituencies and discussions with parties in interest, representatives reflecting those interests. A thorough comprehension of the interests at stake in a case must be gained through an examination of the debtor's financial structure, as well as through discussions with the debtor and creditors. Only then will the United States Trustee be in a position to exercise appropriately the discretion accorded by 11 U.S.C. § 1102.

The Bankruptcy Code's demand that creditors' committees provide for adequate representation of the creditor class implicitly recognizes that creditors will disagree on strategy and objectives. The committee's decision-making process in its fiduciary role can provide a method for resolution of these conflicts. The mere presence of a conflict between creditor interests does not mandate the appointment of separate committees. The United States Trustee must determine whether the various classes of unsecured debt have divergent interests that may require different treatment under either the reorganization plan or at some other particular segment of the case, thereby warranting the appointment of separate committees. See In re The Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 212 (Bankr. S.D.N.Y. 1990). This may be unclear at the commencement of the case, thereby providing an initial bias toward the appointment of a single committee.

The committee must adequately represent the diverse unsecured creditor interests involved. This does not require that all interests be represented on the committee. The committee should reflect the reality of the debt structure, and the position of those holding comparatively small claims should not be enhanced by over-representation. Similarly, under-representation of significant creditor interests can impede the reorganization effort. The courts have recognized the need to structure a committee that is reflective of the various unsecured creditor interests. See In re Sharon Steel Corp., 100 B.R. 767, 778 (Bankr. W.D. Pa. 1989). See also In re Dow Corning Corp., 194 B.R. 121, 141 (Bankr. E.D. Mich. 1996) ("For a particular group of creditors to be adequately represented by an existing committee, it is not necessary for the committee to be an exact reflection of that committee's designated constituents. Instead, adequate representation exists if the interests of that particular group of creditors have a meaningful voice on the committee in relation to their posture in the case. . ."), rev'd on other grounds, 212 B.R. 258 (E.D. Mich. 1997); In re Public Service Co. of New Hampshire, 89 B.R. 1014, 1020 (Bankr. D.N.H. 1988); In re Grynberg, 10 B.R. 256, 257 (Bankr. D. Colo. 1981).

3-4.4.1 Membership Issues

3-4.4.1.1 Unions

Unions are eligible for appointment to creditors' committees. See In re Altair Airlines, Inc., 727 F.2d 88 (3d Cir. 1984); In re Enduro Stainless, Inc., 59 B.R. 603 (Bankr. N.D. Ohio 1986); In re Northeast Dairy Coop. Fed., Inc., 59 B.R. 531 (Bankr. N.D.N.Y. 1986). If the union's entire claim is entitled to priority treatment pursuant to 11 U.S.C. § 507(a)(3) and(4), however, then the union should not be appointed to the unsecured creditors' committee, as its interest is fundamentally different from that of the general unsecured creditors. But see In re Plabell Rubber Prods., 140 B.R. 179 (Bankr. N.D. Ohio 1992) (United States Trustee ordered under section 105 to add union to committee, where none of the extant members represented a similar claim.) See USTM 3-4.8.4 for a discussion of a bankruptcy court's ability to alter committee membership since the repeal of 11 U.S.C. § 1102(c).

When considering the appointment of labor representatives to the committee, the United States Trustee must consider the impact of any "first

day orders" that may permit the debtor in possession to pay prepetition wages in the ordinary course of the debtor's postpetition operations and which may permit the debtor in possession to honor prepetition obligations for employee benefits in the ordinary course. In In re Barney's, Inc., 197 B.R. 431, (Bankr. S.D.N.Y. 1996), a benefit fund representative was appointed. See USTM 3-4.4.1.6 for a discussion of the participation of the Pension Benefit Guarantee Corporation ("PBGC") on creditors' committees.

3-4.4.1.2 Landlords

The claims of landlords for unpaid rent may be substantial in certain cases (e.g., a department store chain). These claims may increase if leases are rejected pursuant to 11 U.S.C. § 365. To the extent the debtor intends to reject of a number of its leases in the bankruptcy proceeding, the presence of a landlord will be helpful to the committee in analyzing particular dispositions. If, however, the particular landlord's lease is assumed and all defaults are cured, the landlord is no longer a creditor. The landlord should be informed by the United States Trustee that if the landlord's lease is assumed, the landlord should resign from the committee. This analysis is equally applicable when dealing with franchisers, licensors, and other parties to executory contracts.

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

3-4.4.1.3 Secured Creditors

Secured creditors should, of course, not be appointed to a committee of unsecured creditors. Accord In re America West Airlines, 142 B.R. 901, 903 (Bankr. D. Ariz. 1992) (United States Trustee acted properly in removing a creditor from the creditors' committee after it extended postpetition financing on terms which effectively secured most of its prepetition claim. Creditor's motion for reinstatement was denied because

creditor no longer represented an unsecured claim). Creditors holding claims that are only partially secured, however, are eligible. In re Walat Farms, Inc., 64 B.R. 65 (Bankr. E.D. Mich. 1986).

3-4.4.1.4 Competitors

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

3-4.4.1.5 Professionals Formerly Employed by the Debtor

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

3-4.4.1.6 Governmental Units

A governmental unit is generally ineligible to serve on a creditors' committee unless it qualifies as a "person." Only persons are eligible to serve pursuant to 11 U.S.C. § 1102(b)(1), and the term "person" is defined to exclude governmental units, except to the extent that a governmental unit (1) has acquired an asset from a person as a result of a loan guarantee agreement or as a receiver or liquidating agent of a person; (2) is a guarantor of a pension benefit payable by or on behalf of a debtor or an affiliate of the debtor; or (3) is the legal or beneficial owner of an asset of an employee pension benefit plan that is a governmental plan as defined by the Internal Revenue Code ("IRC") or an eligible deferred compensation plan as defined in the IRC. 11 U.S.C. § 101(41). See also In re Mansfield Tire & Rubber Co., 39 B.R. 974 (N.D. Ohio 1983); In re VTN, Inc., 65 B.R. 278 (Bankr. S.D. Fla. 1986); In re Baldwin-United Corp., 38 B.R. 802, 806 (Bankr. S.D. Ohio 1984).

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

Unless there is current under funding, the debtor in possession may not identify the PBGC as one of the twenty largest unsecured creditors at the commencement of the case. If the United States Trustee determines that the bankruptcy case will likely be a liquidation and that there are potential pension plan issues, the United States Trustee may wish to consider inviting the PBGC to consider candidacy.

3-4.4.1.7 Insiders

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

3-4.4.1.8 Contingent, Unliquidated, or Disputed Claims

The mere fact that a creditor holds a claim that is contingent, unliquidated, or disputed does not disqualify the creditor from appointment to the committee. This is clear from the definitions of "claim" and "creditor" set forth in the Code, 11 U.S.C. § 101(5), (10). See generally In re Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996).

3-4.4.1.9 Indenture Trustees

The Trust Indenture Act of 1939 (15 U.S.C. § 77aaa-77bbbb) defines an "indenture" as any mortgage, deed of trust, trust, or other indenture under which securities are outstanding or are to be issued, whether or not any property, real or personal, is or is to be pledged, mortgaged, assigned, or conveyed thereunder. 15 U.S.C. § 77ccc(7). The Bankruptcy Code defines an indenture similarly at 11 U.S.C. § 101(28). The indenture defines the relationship between an issuer of securities (often a debtor in bankruptcy) and the indenture trustee, typically a financial institution that has agreed to serve for the equal and ratable benefit of the holders of the securities. In the event of a default by the issuing company under the indenture, the indenture trustee typically undertakes to exercise the rights given it by contract with the same degree of care and skill as a prudent person in the conduct of his/her own affairs. The failure to exercise this degree of care on behalf of the holders can subject the indenture trustee to liability for negligence.

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

On the other hand, the appointment of an indenture trustee as a voting member (the United States Trustee does not appoint non-voting (ex-officio) members to a committee) may be the only way to assure adequate representation of the public debt holders where large institutional investors cannot be identified or do not exist. Accordingly, the policy with respect to the appointment of indenture trustees to unsecured creditors' committees as members cannot be expressed as a per se rule, but rather must depend on the circumstances of the case and the need to include or exclude indenture trustees in order to assure adequate representation. See In re Value Merchants, Inc., 202 B.R. 280, 290 (E.D. Wis. 1990) (district court affirmed bankruptcy court's finding that United States Trustee acted arbitrarily and capriciously in excluding indenture trustees from voting membership on unsecured creditors' committee).

3-4.4.1.10 Equity Security Holders

It certain cases, large unsecured creditors who also hold stock of the debtor will seek membership on the committee. In this type of situation, the United States Trustee may wish to undertake an analysis akin to that

utilized for undersecured creditor candidates and discussed in In re Walat Farms, Inc., 64 B.R. 65 (Bankr. E.D. Mich. 1986). Factors that may be relevant include, but are not limited to, the type of stock held, e.g., preferred or common, voting or non-voting, the size of the shareholding relative to all issued and outstanding shares, the value of the shares, and the length of time held.

3-4.4.1.11 Claims Trading

The trading of claims against bankruptcy estates has become commonplace. Many types of claims are routinely transferred including "trade claims," distressed bonds, and "bank debt." The United States Trustee may wish to consider certain attributes of traded claims when evaluating a claim purchaser's candidacy for committee membership.

1. Closing Date

The questionnaire for service on the committee oftentimes asks whether the candidate holds an unsecured claim against the estate and, if so, the amount of the claim. For prepetition claims, no further inquiry may be necessary. If a claim was acquired after the date of the commencement of the bankruptcy case, it may be prudent to inquire of the creditor as to the date of the closing on the transfer and the consideration paid for the claim.

Generally, trades of distressed bonds close quickly because these transactions are governed by the rules and requirements of the exchange on which they are offered. Such trades are usually "final." Trade claims are not subject to the same administrative requirements and the agreement of sale may contain contingencies that would permit the purchaser to undo the transaction. Specifically, some agreements for the transfer of trade claims contain a "put" provision under which the seller must repurchase the claim for the full amount paid by the purchaser and, in addition, pay interest on the purchase price. This transaction structure may be significant to the committee selection process in two ways. First, if a transaction has not become final, the beneficial ownership of the claim may be difficult to ascertain. Second, if a purchaser can escape an unsatisfactory transaction by "putting" the claim back

to the seller, thereby limiting or eliminating the amount at risk, one may question whether such a holder would be truly representative of general unsecured creditors.

2. Purchase Price

Distressed claims of all sorts are usually traded at a discount. The discounts may vary depending on certain attributes of a claim and the date when the sale was made. For instance, if a trade claim contains both a reclamation component (11 U.S.C. § 546(c)) as well as a general unsecured component, the discount rate for the reclamation component may be much less than for the general unsecured component (which may be deeply discounted), due to the protections that a reclamation claim receives. Also, because market forces are at work, the value of a distressed claim (measured by its discount rate) may vary periodically to reflect the market's perception of the bankruptcy case. The United States Trustee may wish to obtain specific facts regarding purchase price in order to determine whether or not a particular committee candidate would adequately represent the general unsecured creditor body. An entity that speculates in claims makes its profit on the difference between what it pays for the claim and the ultimate dividend paid under a plan of reorganization. A speculator who pays a small percentage of the face value of a claim has proportionally less at risk than a creditor whose exposure is at the full face value. Having much less at risk, such a speculator may profit handsomely from, and vote to support, a plan that pays much less than would be acceptable to those creditors whose exposure is measured by the full face amount of the claim. See In re Four Seasons Nursing Ctrs., Inc., 472 F.2d 747 (10th Cir. 1973).

3-4.4.2 Prepetition Committees

Creditors may form a committee prior to the commencement of a case. If such a committee was fairly chosen and is representative of the various kinds of claims presented, the United States Trustee must give strong consideration to appointing the members of the prepetition committee to the committee of unsecured creditors in the case. 11 U.S.C. § 1102(b)(1). The standards for determining whether a prepetition committee was fairly

chosen are set forth in Fed. R. Bankr. P. 2007(b) and require a consideration of factors including:

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

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

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

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

If the United States Trustee appoints the prepetition committee and an objection is raised, the court, after notice and hearing, may determine whether the requirements of 11 U.S.C. § 1102(b)(1) have been met.

Fed. R. Bankr. P. 2007(a). If a determination is made that the requirements of 11 U.S.C. § 1102(b)(1) have not been met, the court will direct the United States Trustee to vacate the appointment of the committee. Fed. R. Bankr. P. 2007(c).

3-4.4.3 Attempts to Preempt the Selection Process

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

3-4.4.4 Small Businesses -- Requests Not to Form a Creditors' Committee

The new 11 U.S.C. § 1102(a)(3) provides:

> On request of a party in interest in a case in which the debtor is a small business and for cause, the court may order that a committee of creditors not be appointed.

Under the new 11 U.S.C. § 1102(a)(3), which was added by the Bankruptcy Reform Act of 1994, a party in interest in the chapter 11 case of a small business (defined under 11 U.S.C. § 101(51C) as ". . . a person engaged in commercial or business activities [but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto] whose aggregate non-contingent liquidated secured and unsecured debts as of the date of the petition do not exceed $2,000,000") may move the bankruptcy court to enter an order, for cause, prohibiting the United States Trustee from forming a creditors' committee. It is the Program's policy, however, to appoint creditors' committees in all cases, including those of small business debtors, where holders of unsecured claims express an interest in forming one.

In the only reported decision to date, a bankruptcy court found that the debtor's unsubstantiated allegations that the formation of a creditors' committee would increase administrative expenses, delay its

reorganization, and dilute the ultimate dividend to unsecured creditors did not constitute "cause" for purposes of 11 U.S.C. § 1102(a)(3). The court further found that the monetary benefits to be gained by a committee in negotiating a larger dividend with the debtor would likely outweigh the fees and expenses its professionals would incur and that a committee could assist in resolving obstacles to plan confirmation. See In re Haskell-Dawes, Inc., 188 B.R. 515 (Bankr. E.D. Pa. 1995).

3-4.4.5 Involuntary Cases

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

3-4.5 NUMBER OF COMMITTEES

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

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

The appointment of several separate committees can lead to posturing among the creditor groups that might not otherwise arise. Moreover, counsel for a single committee may be more apt to encourage creditors to resolve their differences, as opposed to counsel for separate committees

who may be inclined to litigate such matters. The proliferation of committees to serve special interests has an adverse impact on the efficient administration of a case. See In re Baldwin-United Corp., 45 B.R. at 376. Rather than striving to resolve creditor differences, separate committees tend to prolong the process of reconciling differences into a consensus in support of a plan of reorganization. Compelling creditors with diverse interests to serve on the same committee may create opportunities for creditors to resolve their differences consensually.

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

The appointment of a separate committee may be appropriate, however, if conflicts among creditors are of such a magnitude as to impair the ability of a committee to function effectively. In re McLean Indus., Inc., 70 B.R. 852, 861 (Bankr. S.D.N.Y. 1987). See also In re Johns-Manville Corp., 38 B.R. 331 (Bankr. S.D.N.Y. 1983). This is especially true in a large, complex case in which the debtor's business is extremely unstable. As such a case progresses, the interests of creditors may diverge and they may take more extreme positions than would otherwise be expected. For example, in the Beker Indus. Corp. case, the debtor's survival depended upon obtaining additional financing. 55 B.R. at 949. The financing agreement would have impacted various creditor groups in materially different ways. The court, therefore, directed the appointment of an additional committee of debenture holders due to the unstable nature of the case and the need for the active participation of the debenture holders to protect their interests. Accord In re Dow Corning Corp., 194 B.R. 121, 143-45 (Bankr. E.D. Mich. 1996) (a case involving trade creditors, tort claimants, and insurance and indemnity claims relating to breast implants merited appointment of

multiple committees because no single committee could adequately represent all of their conflicting interests). Cf. In re Hills Stores Co., 137 B.R. 4 (Bankr. S.D.N.Y. 1992) (court denied request to appoint separate committee of subordinated bondholders absent evidence that a conflict among creditors would impede extant committee's ability to function).

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

3-4.6 EQUITY SECURITY HOLDERS' COMMITTEE

The Bankruptcy Code (11 U.S.C. § 1102(a)(1)) authorizes the appointment by the United States Trustee of additional committees, including a committee of equity security holders. If the United States Trustee declines to exercise the discretion to appoint a supernumerary committee, the court may order the appointment of a committee by the United States Trustee. 11 U.S.C. § 1102(a)(2). While there is no statutory requirement to do so, practitioners should be encouraged to submit requests for additional committees first to the United States Trustee prior to moving for relief from the court, as this may achieve the desired result without the need for litigation. If a party in interest moves the court for an order directing the appointment of a committee, the court can grant the relief only upon finding that the appointment of the additional committee is "necessary to assure adequate representation" of the movant's interests. In re Edison Bros. Stores, Inc., 1996 WL 534853 (D. Del. Sept. 17, 1996); In re Lykes Bros. S.S. Co., 200 B.R. 933 (M.D. Fla. 1996). If the court directs the appointment, the United States Trustee actually selects and appoints the committee.

The appointment of an equity committee is the exception rather than the rule, with the burden on the requesting party in interest to demonstrate the need for adequate representation. See Edison Bros, Stores, Inc., supra; In re Johns-Manville Corp., 68 B.R. 155, 158 (S.D.N.Y. 1986). While equity holders clearly have an interest different from that of unsecured creditors, this is not a sufficient reason to routinely establish an equity committee.

There are many sources of adequate representation aside from the appointment of an official committee. See Johns-Manville, 68 B.R. at 163; In re Hills Stores Co., 137 B.R. 4 (Bankr. S.D.N.Y. 1992). Generally, the board of directors acts for the shareholders. Once a company becomes insolvent, the directors still owe a fiduciary duty to the shareholders. Commodities Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985); In re Bush Terminal Co., 78 F.2d 662, 665 (2d Cir. 1935); In re Lionel, 30 B.R. 327 (Bankr. S.D.N.Y. 1983). Upon commencement of a bankruptcy case, the board's fiduciary duty is extended to the creditors. Commodities Futures Trading Comm'n v. Weintraub, supra. Pure speculation that a debtor's board and management will sacrifice equity to placate the creditors is insufficient to establish the need for an equity committee. Edison Bros. Stores, Inc., supra.

The United States Trustee may consider all relevant factors in determining whether or not to appoint an equity committee. Factors to consider may include whether the debtor is hopelessly insolvent (In re Emons Indus, Inc., 50 B.R. 692 (Bankr. S.D.N.Y. 1985)); whether the stock is publicly traded and widely held (In re Wang Labs., Inc., 149 B.R. 1 (Bankr. D. Mass. 1992) and In re Johns-Manville Corp., 68 B.R. 155 (S.D.N.Y. 1986)); whether a case is complex (financially as compared with operationally) (In re Edison Bros. Stores, Inc., 1996 WL 534853 (D. Del. Sept. 17, 1996)); timeliness of the request for the committee (In re Kalvar Microfilm, Inc., 195 B.R. 599 (Bankr. D. Del. 1996)); additional cost to the estate, id.; and alternative sources of adequate representation (Edison Bros. Stores, Inc., supra; In re Hills Stores Co., 137 B.R. 4 (Bankr. S.D.N.Y. 1992)).

If an equity security holders' committee is to be appointed, the United States Trustee should seek to obtain a list of the largest beneficial holders of the debtor's securities. Large blocks of stock are often held in a "street name" by brokerage houses or "in trust" at financial institutions, making it difficult to determine the identity of the beneficial interest holders. The regional office of the U.S. Securities and Exchange Commission may be able to assist in this process. The list should contain the names of at least the forty largest beneficial holders, as potential members often reside throughout the country and it may, therefore, be difficult to find stockholders willing to serve.

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

3-4.7 NOTIFICATION TO COURT REGARDING INABILITY TO APPOINT A COMMITTEE

If circumstances such as a lack of eligible creditors or lack of interest prevent the formation of a committee, a short statement to that effect may be filed with the court.

3-4.8 MODIFICATION OF COMMITTEE MEMBERSHIP

3-4.8.1 Considerations

Proper supervision of an estate requires a continuing review of its circumstances. A modification of a committee's structure may at some point become necessary. Although the court retains authority under the current version of 11 U.S.C. § 1102(a)(2) to order the appointment of additional committees, the deletion of subsection (c) from that section in the 1986 Amendments reflects the relocation of administrative responsibility for modifying creditors' committees to the United States Trustee. Since the repeal of 11 U.S.C. § 1102(c), the court has no authority to appoint specific members to a committee. In re Wheeler Tech., Inc., 139 B.R. 235 (B.A.P. 9th Cir.1992); In re Doehler-Jarvis, Inc., 9 Bankr. L. Rep. (BNA) 1384 (D. Del. Oct. 7, 1997); In re Victory Mkts., Inc., 196 B.R. 1 (Bankr. N.D.N.Y. 1995), appeal dismissed, 195 B.R. 9 (N.D.N.Y. 1996), reh'g denied, 1996 WL 365675 (N.D.N.Y. June 21, 1996); In re Drexel Burnham Lambert Group, Inc., 118 B.R. 209 (Bankr. S.D.N.Y. 1990); In re Gates Eng'g Co., 104 B.R. 653 (Bankr. D. Del.

1989); In re First RepublicBank Corp., 95 B.R. 58 (Bankr. N.D. Tex. 1988).

Many courts have nonetheless held that the decisions of the United States Trustee regarding committee composition may be reviewed under an abuse of discretion standard. See Doehler-Jarvis, Inc., supra; In re Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996); In re Trans World Airlines, Inc., 1992 WL 168152 (Bankr. D. Del. Mar. 20, 1992); In re Columbia Gas Sys., Inc., 133 B.R. 174 (Bankr. D .Del. 1991). Those courts which have considered the issue focus on two concepts: whether or not the committee related decisions of the United States Trustee are at all subject to any judicial scrutiny and, if they are, what is the scope of relief that the court may direct. Courts that believe they can review generally rely on 11 U.S.C. § 105(a). Committee related decisions of the United States Trustee are not subject to review under the "agency discretion" exception to the Administrative Procedures Act, 5 U.S.C. § 701(a)(2). See generally Shaltry v. U.S., 87 F.3d 1322 (9th Cir. 1996)(chapter 7 trustee removal by United States Trustee not subject to APA); Richman v. Straley, 48 F.3d 1139 (10th Cir. 1995)(chapter 13 trustee has no property interest in continuing trusteeship, therefore no statutory right of review).

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

3-4.8.2 **Substitutions**

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

3-4.8.3 **Removal of Members**

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

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

3-4.8.4 **Applicable Standard of Review**

The Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 (Oct. 27, 1986), repealed 11 U.S.C. § 1102(c). That subsection had provided:

> (c) On request of a party in interest and after notice and a hearing, the court may change the membership or the size of

> a committee appointed under subsection (a) of this section if the membership of such committee is not representative of the different kinds of claims or interests to be represented.

The legislative history accompanying this repeal makes it clear that the appointment of a creditors' committee is an administrative task to be performed by the United States Trustee and not the court. H.R. Rep. No. 764, 99th Cong., 2d Sess. 28 (1986). The court in In re Drexel, Burnham Lambert Group, Inc., 118 B.R. 209, 210 (Bankr. S.D.N.Y. 1990), found it noteworthy that the 1986 amendments left no indication in the statute that the court had any power left to add to or delete an unsecured creditor from a committee. The court in In re Victory Mkts., Inc., 196 B.R. 1 (Bankr. N.D.N.Y. 1995), appeal dismissed, 195 B.R. 9 (N.D.N.Y. 1996), reh'g denied, 1996 WL 365675 (N.D.N.Y. June 21, 1996), rejected case authority holding that 11 U.S.C. § 105(a) gives the court power to order the United States Trustee to appoint a creditor to a committee because "it is in derogation of the express statutory language of Code § 1102." Accord In re New Life Fellowship, Inc., 202 B.R. 994 (Bankr. W.D. Okla. 1996)(court could not upset the decision of the United States Trustee to appoint a separate bondholders' committee).

Fed. R. Bankr. P. 2020, which became effective August 1, 1991, provides for judicial review of the United States Trustee's acts or failures to act. It must be stressed, however, that rules of court do not create substantive rights that do not already exist elsewhere. In re Barney's, Inc., 197 B.R. 431, 438 (Bankr. S.D.N.Y. 1996) (citing 28 U.S.C. § 2075); In re Columbia Gas Sys., Inc., 133 B.R. 174, 176 (Bankr. D. Del. 1991). The Committee Note to this Rule expressly states that the Rule "is not intended to limit the discretion of the United States trustee, provided that the United States trustee's act is authorized by, and in compliance with, the Code, title 28, these rules, and other applicable law." The appointment of individual members of a creditors' committee is eminently a matter committed to the discretion of the United States Trustee. Neither title 11 nor title 28 state as a matter of substantive law who the United States Trustee must appoint to a creditors' committee. In re Gates Eng'g Co., 104 B.R. 655, 656 (Bankr. D. Del. 1989). Accordingly, the United States Trustee's decisions in this area are entitled to deference. Notwithstanding several cases finding de novo review appropriate (see, e.g., In re Sharon Steel Corp., 100 B.R. 767 (Bankr. W.D. Pa. 1989); In re Public Service

Co. of New Hampshire, 89 B.R. 1014 (Bankr. D.N.H. 1988); In re Texaco, 79 B.R. 560 (Bankr. S.D.N.Y. 1987); In re McLean Indus., 70 B.R. 852 (Bankr. S.D.N.Y. 1987)), the correct standard of review where adequacy of representation is not the issue is the arbitrary and capricious standard applicable to administrative review. See In re Value Merchants, Inc., 202 B.R. 280 (E.D. Wis. 1996); In re Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996); In re America West Airlines, 142 B.R. 901, 902 (Bankr. D. Ariz. 1992); In re Plabell Rubber Prods., 140 B.R. 179 (Bankr. N.D. Ohio 1992); In re First Republic Bank Corp., 95 B.R. at 60; In re Public Service Co. of New Hampshire, 89 B.R. 1014 (Bankr. D.N.H. 1988).

On the other hand, the court may order the appointment of additional committees "if necessary to assure adequate representation of creditors." 11 U.S.C. § 1102(a)(2). The issue of adequate representation is a question of substantive law and may be determined by the court de novo. The United States Trustee, however, would actually appoint the members of any additional committees which the court found necessary. First Republic Bank Corp., 95 B.R. at 59.

There is no statutory authority for the proposition stated in In re Public Service Co., supra, that the power to order the appointment of additional committees includes the inherent power to provide the "lesser included remedy" of altering the composition of an existing committee. In re Public Service Co., 89 B.R. at 1021. The actual composition of the membership of any committee is an administrative task entrusted solely to the United States Trustee by statute. Committee composition may not be disturbed unless it is arbitrary and capricious.

CHAPTER 3-5: SECTION 341 MEETING

3-5.1 INTRODUCTION

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

3-5.2 SCHEDULING

The United States Trustee must schedule a meeting of creditors to be held not less than 20 nor more than 40 days after the order for relief. Fed. R. Bankr. P. 2003(a). However, if the United States Trustee designates a place for the meeting that is not regularly staffed by the United States Trustee, then the meeting may be scheduled not more than 60 days after the order for relief. The enlargement or reduction of these time periods is prohibited. Fed. R. Bankr. P. 9006(b)(2) and 9006(c)(2). If there is an appeal from or a motion to vacate the order for relief, or if there is a motion to dismiss the case, the United States Trustee may schedule a later date for the meeting. Fed. R. Bankr. P. 2003(a). The meeting may be held at a regular place for holding court or at any other place designated by the United States Trustee within the district convenient for the parties in interest. Fed. R. Bankr. P. 2003(c).

3-5.3 NOTICE

Notice of the section 341 meeting must be provided to all parties of interest. Fed. R. Bankr. P. 2002(a)(1). Notice of the section 341 meeting is given by the clerk of the court or some other person as the court may direct (e.g., the debtor or an outside service) pursuant to Fed. R. Bankr. P. 2002(a)(1). At least 20 days notice of the meeting by ordinary mail is required under Fed. R. Bankr. P. 2002(a). Notice can be given by publication if notice by mail is impracticable or is desirable to supplement the notice. Fed. R. Bankr. P. 2002(1). The 20 day notice period may be modified by order of the court. Fed. R. Bankr. P. 9006. The United States Trustee should provide the clerk with the location, date, and time of the meeting well in advance of the noticing period to permit the clerk to notice the meeting in a timely fashion. The United States Trustee should ensure that committees, trustees, and examiners appointed after the noticing of the meeting or after the initial meeting be advised of the meeting or any adjourned meeting.

3-5.4 SCOPE OF EXAMINATION

The scope of examination of the debtor pursuant to 11 U.S.C. § 343:

> [M]ay relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. . . . [T]he examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan.

Fed. R. Bankr. P. 2004(b).

The examination constitutes a broad inquiry into the debtor's financial condition, the operation of its business, the desirability of its continuation, and all related matters including matters relevant to the formulation of a plan of reorganization. Questioning should not be allowed to deteriorate to a level constituting harassment or to focus on the dischargeability of a particular debt. Parties who wish to examine the debtor regarding dischargeability of particular debts or regarding other matters beyond the scope of the examination should be advised to consider alternate means of discovery. In re Nixon Elec. Supply, Inc., 85 B.R. 988 (Bankr. W.D. Tex. 1988). A section 341(a) examination is not a substitute for discovery in connection with an adversary proceeding.

3-5.5 CONDUCTING THE MEETING

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

The meeting must be recorded electronically or transcribed by a court reporter. The tape or record of the meeting must be preserved by the United States Trustee and be available for public access until two years after the conclusion of the meeting. At an entity's request, the United

States Trustee shall provide a copy or transcript of the recordings at the entity's expense. Fed. R. Bankr. P. 2003(c).

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

> My name is __________. I am an (attorney/analyst/etc.) in the Office of the United States Trustee, a component of the United States Department of Justice. The United States Trustee supervises the administration of bankruptcy cases under the Bankruptcy Code. The debtor is required to appear and to be examined under oath regarding the bankruptcy case. The examination will be recorded. All persons questioning the debtor must state their names and indicate who they represent. An appearance sheet will be circulated. If you wish to receive notice of any adjourned meeting, you must fill out the appearance sheet.

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

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

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

The presiding officer has the authority to administer oaths or affirmations. There is no requirement that the presiding officer be a notary. 11 U.S.C. § 343; Fed. R. Bankr. P. 2003(b)(1) and 9012.

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

3-5.6 QUESTIONING THE DEBTOR

The United States Trustee should review the debtor's schedules and statements and other documents in the file prior to the section 341 meeting. The person questioning the debtor should also confer with the person who conducted the IDI and review information and report from the IDI. Examination of the file may provide answers to questions that might otherwise be asked or may disclose additional areas of inquiry. The United States Trustee may also request that the debtor bring specific documents to the meeting and follow up on information required and not produced at the IDI. The examination conducted by the United States Trustee should be flexible, incisive, and responsive to the circumstances of the proceeding and the case. The examination should be sufficiently detailed so that the United States Trustee has an understanding of the debtor's business and its operations. The meeting also provides the opportunity to remind debtors of their duties and to question them regarding compliance with those duties, such as filing operating reports and the payment of United States Trustee quarterly fees. The United States Trustee should take notes of the meeting and maintain a written record either in the form of a minute report or memo to the file in the case file. The United States Trustee should obtain the spelling of the names of parties in the event a transcript of the meeting is requested at a later date. Creditors and other parties in interest must also be given an opportunity to ask questions and examine the debtor. See In re Kincaid, 146 B.R. 387 (Bankr. W.D. Tenn. 1992). The Federal Rules of Evidence do not apply to examinations conducted at a section 341 meeting and objections predicated upon those rules should not be entertained. However, the presiding officer must maintain control over the proceeding and preserve the professional atmosphere and decorum appropriate to the situation.

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

Meetings are open to the public, except that the court may not attend. 11 U.S.C. § 341(c). Representatives of the media are permitted to be present, but not to televise or photograph the proceedings or to ask questions at the meeting. See In re Astri Inv., Management and Sec. Corp., 88 B.R. 730 (D. Md. 1988). Only those entities identified in

11 U.S.C. § 343, e.g., creditors, any indenture trustee, any trustee or examiner in the case, or the United States Trustee may examine the debtor. Debtors, creditors, indenture trustees, equity security holders, committees, or other parties may be represented by an authorized agent, attorney in fact, or proxy. Fed. R. Bankr. P. 9010(a).

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

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

If the debtor or another witness claims the privilege, this fact should (when appropriate) be reported to the United States Attorney. If the debtor or other witness is granted immunity by the United States Attorney, he/she can be required to testify.

If the debtor asserts the Fifth Amendment privilege against self-incrimination in response to a question, the United States Trustee should proceed with the meeting and continue to question the debtor. A “blanket” assertion of the privilege is inappropriate and the debtor should be compelled to assert the privilege in response to each question propounded. A debtor's discharge may not be denied for properly invoking the privilege against self-incrimination. 11 U.S.C. § 727(a)(6)(c). United States v. Kras, 409 U.S. 434 (1973); In re Krohn,

886 F.2d 123 (6th Cir. 1989); In re French, 127 B.R. 434 (Bankr. D. Minn. 1991). See also In re McCormick, 49 F.3d 1524 (11th Cir. 1995) (confirmation of a chapter 11 debtor's plan of reorganization cannot be denied solely because the debtor invoked his Fifth Amendment privilege in an adversary proceeding). The failure to answer questions at a section 341 meeting, however, may be cause to dismiss or convert the case or to seek the appointment of a trustee. Cf. In re Connelly, 59 B.R. 421 (Bankr. N.D. Ill. 1986). Alternatively, the United States Trustee may seek an order from the court compelling the debtor to testify.

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

The examination of the debtor in a chapter 11 case, as indicated by the legislative history, allows a broad inquiry into the debtor's financial condition, the operation of its business, the desirability of its continuance, and all related matters, including matters relevant to the formulation of a plan of reorganization. While this section requires that the debtor appear and submit to an examination at the meeting of creditors under 11 U.S.C. § 341(a), it should be noted that the debtor may be ordered to appear for examination upon specific request. 11 U.S.C. § 343; Fed. R. Bankr. P. 2004(a) and 4002(1).

3-5.9 **PROOFS OF CLAIM**

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

3-5.10 CONTINUANCES AND APPEARANCES

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

The debtor or a designated representative of a partnership or corporation must attend the section 341 meeting and submit to examination under oath. 11 U.S.C. § 343; In re Steinmetz Group, Ltd., 85 B.R. 633 (Bankr. S.D. Fla. 1988). The person appearing on behalf of the debtor should be an official who is prepared to respond effectively to the examination. If a chapter 11 trustee has been appointed, the trustee would give a report and be examined.

When spouses have filed a joint petition, they must both be present. If only one debtor appears, the United States Trustee may elect to examine the attending debtor and continue the section 341 meeting for the examination of the other. If requiring the other debtor to appear for examination would cause extreme hardship and there are no objections from creditors, the United States Trustee should obtain necessary information from the attending debtor. (This allowance may vary depending on local court rule.) However, if any creditor present wishes to examine the absent debtor, a continuation must be granted and the absent debtor required to attend.

With respect to hearing-impaired debtors, the United States Trustee must take appropriate steps to ensure effective communication and must furnish appropriate auxiliary aids where necessary to afford a handicapped person an equal opportunity to participate. 28 C.F.R. § 39.160(a)(1); see

USTM 3-5.12. The services of foreign language interpreters may also be required. The interpreter must be placed under oath.

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

When a debtor's attorney fails to appear, the debtor may either choose to proceed with the examination without representation or request a continuance. The decision on whether to grant a continuance should be based upon a review of the following conditions:

1. Whether the reason for non-attendance is one that rendered appearance impossible, e.g., illness or sudden emergency, or whether non-attendance merely involved a scheduling conflict.

2. Whether the United States Trustee was notified in advance of the non-appearance.

3. Whether creditors appearing at the section 341 meeting traveled a great distance and how many were in attendance.

4. Whether the particular attorney has failed to attend previous section 341 meetings for other debtors.

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

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

3-5.11 ADJOURNMENTS AND SPECIAL MEETINGS

Fed. R. Bankr. P. 2003(e) provides that "[t]he meeting may be adjourned from time to time by announcement at the meeting of the adjourned date and time without further written notice." If no further information is necessary, the meeting should be concluded. Any adjournment of the meeting and the length of time of any adjournment will be determined after taking into consideration such matters as the need to examine the debtor, the necessity to resolve matters that are still open at the conclusion of the prior meeting, and the need to monitor closely the particular case. At the conclusion of the section 341 meeting, an announcement should be made by the United States Trustee regarding the date and time of the next meeting, unless later written notification will be made. Where no further notice will be given, the attendees should be so notified.

Fed. R. Bankr. P. 4003(b) provides that a trustee or creditor may file objections to claimed exemptions within 30 days after the conclusion of the section 341 meeting. Adjournment of the meeting may improperly impede an individual debtor's right to establish his/her exemptions, unless the court fixes a date certain to object to such claimed exemptions. In re Vance, 120 B.R. 181 (Bankr. N.D. Okla. 1990).

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

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

Part 39 of the Code of Federal Regulations, entitled "Enforcement of Non-Discrimination on the Basis of Handicap in Programs or Activities Conducted by the Department of Justice," prohibits discrimination on the basis of handicap (including impaired hearing) in activities conducted by the Department of Justice. 28 C.F.R. § 39.130. Since section 341

meetings are "activities" of the United States Trustee conducted under the authority of 11 U.S.C. § 341, the regulation applies. Because the regulation prohibits discrimination "directly or through contractual, licensing, or other arrangements," (28 C.F.R. § 39.130(b)(1)), chapter 11 trustees who conduct section 341 meetings under authority derived from the United States Trustee are also bound by the regulation.

For hearing-impaired persons, the regulation states:

> (a) The agency shall take appropriate steps to ensure effective communication with applicants, participants, personnel of other Federal entities, and members of the public.
>
> (l) The agency shall furnish appropriate auxiliary aids where necessary to afford a handicapped person an equal opportunity to participate in, and enjoy the benefits of, a program or activity conducted by the agency.

28 C.F.R. § 39.160(a)(1).

The auxiliary aids mentioned have been defined in the regulation as ". . . interpreters, notetakers, written materials, and other similar services and devices." 28 C.F.R. § 39.103.

The United States Trustee must provide auxiliary aids at no cost to the handicapped person. Depending on the expected length and complexity of the section 341 meeting and the preference of the hearing-impaired debtor, there are two primary methods that can be employed in order to ensure effective communication. They are:

1. The provision of a notepad and written questions. This method is recommended if a paucity of questions and questioners are expected or if the hearing-impaired person cannot or prefers not to communicate using sign language. When employing this method, it is advisable to inform creditors in advance of this procedure and to request that they bring written questions to the section 341 meeting. An announcement on the use of the procedure should be made at the beginning of the meeting. The debtor should be

properly sworn in writing using the same oath customarily given at section 341 meetings. Prior to the completion of the hearing, questions to the debtor and the debtor's responses should be read into the record. Additionally, the written questions and responses should be attached to the United States Trustee's proceeding memorandum. This method has the advantage of being relatively inexpensive and produces a "hard" copy of the exchange to which the debtor can be held accountable. The disadvantage is that it may be very time consuming.

2. The provision of a sign language interpreter. This method is recommended particularly if a long or complex section 341 meeting is anticipated or if the hearing-impaired debtor strongly prefers to communicate his/her response using sign language. If the hearing-impaired debtor requests that the United States Trustee provide an interpreter, the United States Trustee should assist the debtor in requesting a list of certified sign language interpreters from the clerk of the United States district court where the bankruptcy is filed. This request should be made pursuant to 28 U.S.C. § 1827(c)(1). The debtor should be instructed to choose an interpreter from the list, and the United States Trustee should assist the debtor in contacting the interpreter. The cost of the interpreter's services shall be paid by the United States Trustee through the use of the Government VISA card or a VISA check. See USTM 6-15. At the section 341 meeting, the interpreter should be sworn that they will accurately and truthfully translate from English to sign language the questions to the debtor and from sign language to English the responses from the debtor. The United States Trustee should then swear in the debtor via the interpreter. The primary advantage of using an interpreter is that it promotes a quick exchange between the debtor and the questioners. The disadvantage is the expense and the possibility of an inaccurate translation.

3-5.13 **FOREIGN LANGUAGE INTERPRETERS**

If the debtor cannot speak English well enough to understand the questions asked at the section 341 meeting, an interpreter should be

provided. Usually the expense will be charged to the Program's expense funds. The United States Trustee should make sure that the interpreter understands enough business and bankruptcy terminology to be able to obtain intelligent and meaningful responses to the questions. The interpreter should be sworn at the start of this inquiry.

3-5.14 SECURITY AT SECTION 341 MEETINGS

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

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

CHAPTER 3-6: EMPLOYMENT ISSUES

3-6.1 EMPLOYMENT OF PROFESSIONALS

3-6.1.1 11 U.S.C. § 327 and Fed. R. Bankr. P. 2014

Sections 327, 1103, and 1107 of the Bankruptcy Code govern the employment of professionals in connection with a chapter 11 case. For professionals employed by creditors' committees pursuant to 11 U.S.C. § 1103, see USTM 3-4.2.5. The following discussion is primarily directed at the employment of professionals by debtors in possession and chapter 11 trustees. Unless the professional comes within the limited exception provided for by 11 U.S.C. § 327(b), prior court approval of the employment of a professional person is necessary. The retention process is designed to ensure public confidence in the bankruptcy system, to prevent abuses, and to achieve some degree of economy in the

administration of the case by limiting the retention of professionals only to those instances where it can be demonstrated that the services are necessary. Furthermore, the requirements of 11 U.S.C. § 327 "serve the important policy of ensuring that all professionals appointed pursuant to [the section] tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." Rome v. Braunstein, 19 F.3d 54, 58 (1st Cir. 1994). 28 U.S.C. § 586(a)(3)(H) specifically requires the United States Trustee to monitor employment applications and, when appropriate, to file with the court comments with respect to the approval of such applications.

Court approval of a professional person's employment is contingent upon a finding that the applicant has met a two-pronged test: (1) the professional must be disinterested, 11 U.S.C. § 327(a) (see USTM 3-6.2); and (2) must not hold an interest adverse to the estate. The question of whether a professional meets the standards of the law is one for the court to adjudicate after a full disclosure of the facts. In re Leslie Fay Cos., Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994). A failure to disclose constitutes an independent basis for disqualification. In re Diamond Mortgage Corp., 135 B.R. 78 (Bankr. N.D. Ill. 1996).

A professional's conflict of interest may render him or her ineligible to serve as a professional under 11 U.S.C. § 327(a). Despite the requirements of that section and the definition of a "disinterested person" that appears in 11 U.S.C. § 101(14), a professional is not necessarily disqualified from employment because of representation of both the trustee and a creditor. 11 U.S.C. § 327(c) requires the presence of an actual conflict of interest; however, the statute does not define an actual conflict of interest. Whether the professional's representation is precluded is dependent on a detailed consideration of the relevant circumstances. Few per se rules exist in this area; however, case law can provide some guidance regarding specific situations. See In re W.F. Dev. Corp., 905 F.2d 883 (5th Cir. 1990), cert. denied, 499 U.S. 921 (1991) (holding that when one attorney represents both limited and general partners in bankruptcy, there will always be a potential for conflict and disqualification is proper).

Some courts require an actual conflict of interest to render counsel not disinterested. See In re Waterfall Village of Atlantic, Inc., 103 B.R. 340, 344 (Bankr. N.D. Ga. 1989); In re Stanford Color Photo, Inc., 98 B.R. 135, 137-38 (Bankr. D. Conn. 1989). Other courts find a potential conflict is disabling. See Matter of Codesco, Inc., 18 B.R. 997, 999 (Bankr. S.D.N.Y. 1982); In re Proof of the Pudding, Inc., 3 B.R. 645, 647 (Bankr. S.D.N.Y. 1980); see also In re Bohack Corp., 607 F.2d 258, 263 (2d Cir. 1979). Some courts find that there is no distinction between a potential or an actual conflict. See, e.g., In re Adams Furniture Indus., Inc., 158 B.R. 291, 301 (Bankr. S.D. Ga. 1993); see generally Comment, Bankruptcy Code Section 327(a) and Potential Conflicts of Interests - Always or Never Disabling?, 29 Hous. L. Rev. 433 (1992). Generally, a finding of actual conflict warrants disqualification of a professional under 11 U.S.C. § 327(a). See, e.g., In re Roberts, 46 B.R. 815, 847 (Bankr. D. Utah 1985), aff'd in part, 75 B.R. 402 (D. Utah 1987). For an extended discussion, see 5 ABI Law Review Number 1 (Spring 1997) and Smith, Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases, 485 Case Law Review 794 (Summer 1997).

In addition, under the appropriate circumstance, the appearance of impropriety or an appearance of potential conflict can be grounds for disqualification of counsel. See, e.g., In re Braten, 73 B.R. 896, 899 (Bankr. S.D.N.Y. 1987) (citing Sapienza v. New York News, Inc., 481 F. Supp. 676 (S.D.N.Y. 1979)); In re Proof of the Pudding, Inc., 3 B.R. 645, 648 (Bankr. S.D.N.Y. 1980).

For example, in Codesco, the court stated that:

> [t]here is no question that the purpose of the incorporation of the disinterest requirement in 11 U.S.C. § 327 was to prevent even the appearance of a conflict irrespective of the integrity of the person or firm under consideration. Certainly, a “disinterested” person should be divested of any scintilla of personal interest which might be reflected in his decision concerning estate matters.

18 B.R. at 999 (citing In re Realty Assoc. Sec. Corp., 56 F. Supp. 1007 (E.D.N.Y. 1944)). In TWI Int’l., Inc. v. Vanguard Oil and Service Co.,

162 B.R. 672 (S.D.N.Y. 1994), the district court noted that given the parameters of sections 327(a) and 101(14):

> [d]isqualification should be mandated when an actual, as opposed to hypothetical or theoretical, conflict is present. This in no way precludes disqualification for a potential conflict. The test is merely one of a potential actual conflict.

162 B.R. at 675 (quoting In re O'Connor, 52 B.R. 892, 897 (Bankr. W.D. Okla. 1985)).

In In re Marvel Entertainment Group, 140 F.3d 463 (3d Cir. 1998), the Third Circuit reversed the district court’s denial of the trustee’s retention of his law firm as trustee’s counsel. In reversing the lower court, the circuit court emphasized that mere “horrible imaginings” could not rise to the level of a conflict requiring disqualification. In this case, the trustee hired his law firm to represent him in administering this large chapter 11 estate. The firm had earlier represented a creditor in an unrelated matter for which it had received $48,000 (less than 1 percent of firm revenues for the year). Additionally, the firm had obtained unconditional waivers and had disengaged from further representation of the creditor. In ruling for the trustee, the circuit court noted that an actual conflict would per se require disqualification and a potential conflict would require the trial court to exercise its discretion. However, in this particular case, neither of the disqualifying situations were present.

Pursuant to 11 U.S.C. § 328(c), the court may deny allowance of compensation for services and reimbursement of expenses to a professional employed pursuant to 11 U.S.C. § 327 or 1103 of that title if the court finds that at any time during the employment the professional was not a disinterested person or held or represented an interest adverse to the estate.

In In re Granite Partners, L.P., 219 B.R. 22 (Bankr. S.D.N.Y. 1998), the bankruptcy court found that the law firm retained by the chapter 11 trustee represented potentially adverse interests to the estate relating to investigative work undertaken at the trustee’s request and that the law firm had failed to disclose same to the court. In admonishing the law firm, the

court noted the necessitation of imposing a severe sanction, i.e., significantly reducing the requested compensation. Although the court acknowledged that an independent examiner concluded that no harm had been inflicted on the estate, the willfulness exhibited by the law firm's flagrant non-disclosure required the sanction.

The United States Trustee should examine the application for employment and its accompanying verified statement expeditiously to determine not only if the proposed professional service is necessary, but also for any disclosures suggesting questionable relationships, divided loyalties, or disqualifying adverse interests. Issues that may warrant closer scrutiny include multiple debtor representation, simultaneous representation of a limited partnership and a general partner, representation of a corporation and an affiliate or shareholder, receipt of a preference or unpaid fees, security interests taken to secure the payment of fees or other unusual arrangements for compensation, and prior or concurrent representation of a major creditor. Where appropriate, the United States Trustee should insist on further disclosure or comment on any unusual aspects of the application. The United States Trustee should object to the employment when the services are unnecessary or duplicative, the applicant is not disinterested, or representation of adverse interests warrants disqualification.

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

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

1. specific facts showing the necessity of the employment;
2. the name of the person to be employed;
3. the reasons for the selection;

4. the professional services to be rendered;
5. any proposed arrangement for compensation; and
6. all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee.

Fed. R. Bankr. P. 2014 disclosure requirements are to be strictly construed. Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994); In re Arlan's Dep't Stores, Inc., 615 F.2d 925, 933 (2d Cir. 1979) (decided under substantially similar predecessor to Fed. R. Bankr. P. 2014). All facts that may have any bearing on the disinterestedness of a professional must be disclosed. It is the responsibility of the professional, not of the court, to ensure that all relevant connections have been brought to light. See, e.g., Rome v. Braunstein, 19 F. 3d at 58-60; In re Glenn Elec. Sales, 99 B.R. 596, 599 (D.N.J. 1988); Diamond Lumber, Inc. v. Unsecured Creditors' Committee, 88 B.R. 773, 776 (N.D. Tex. 1988). Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification. See In re Futuronics Corp., 655 F.2d 463, 469 (2d Cir. 1981), cert. denied, 455 U.S. 941 (1982); In re Arlan's Dep't Stores, Inc., 615 F.2d at 933; Rome v. Braunstein, 19 F.3d at 59; In re Leslie Fay Cos., Inc., 175 B.R. 525 (Bankr. S.D.N.Y. 1994); In re Granite Sheet Metal Works, Inc., 159 B.R. 840, 847 (Bankr. S.D. Ill. 1993); In re Envirodyne Indus., Inc., 150 B.R. 1008, 1021 (Bankr. N.D. Ill. 1993).

Until such time as an order is entered authorizing employment, professionals perform services at their peril. Some circuits enforce a rule denying compensation to professionals for work done prior to the filing of an application for employment unless, as a matter of fundamental fairness, the court approves a nunc pro tunc application. See Lavender v. Wood Law Firm, 785 F.2d 247 (8th Cir. 1986). Another line of cases, represented by In re Triangle Chemicals, Inc., 697 F.2d 1280 (5th Cir. 1983), superceded by 11 U.S.C. § 327 as stated in In re Sound Radio, Inc., 145 B.R. 193 (Bankr. D.N.J. 1992), limits entry of nunc pro tunc employment orders to extraordinary circumstances and not merely because the appointment requirement was overlooked. Mere oversight and inadvertence of counsel are not extraordinary circumstances. In re Jarvis, 53 F.3d 416 (1st Cir. 1995); In re F/S Airlease II, Inc., 844 F.2d 99

(3d Cir.), cert. denied, 488 U.S. 852 (1988); In re Arkansas Co., Inc., 798 F.2d 645 (3d Cir. 1986). See also In re Diamond Mort. Corp., 77 B.R. 597 (Bankr. E.D. Mich. 1987). In In re Triangle Chemicals, the court concluded that the bankruptcy judge, in the exercise of sound discretion and as a court of equity, may enter an order nunc pro tunc. 697 F.2d at 1289.

The more liberal line of cases is represented by In re Vlachos, 61 B.R. 473, 479 (Bankr. S.D. Ohio 1986) and In re Georgetown of Kettering, Ltd., 750 F.2d 536 (6th Cir. 1984).

The "liberal approach" would permit a nunc pro tunc order if:

1. the application would have been approved originally by the court;

2. evidence appears in the record that demonstrates that the court and other interested parties had actual knowledge of the services being rendered;

3. an application seeking an order nunc pro tunc has been filed as soon as the matter is brought to the applicant's attention; and

4. a sustainable objection has not been filed to the application for fees.

The better practice is to seek an order of employment prior to the commencement of services. The United States Trustee should enforce the requirement of prior court approval and object to the entry of nunc pro tunc orders, if appropriate.

3-6.1.2 11 U.S.C. § 329 and Fed. R. Bankr. P. 2016(b) and 2017

Every attorney for a debtor must file the statement required by 11 U.S.C. § 329 within 15 days of the order for relief setting forth the compensation paid or agreed to be paid for services rendered or to be rendered in contemplation of or in connection with the bankruptcy case and the source of such compensation. Fed. R. Bankr. P. 2016(b) also requires disclosure of any agreement to share compensation with any other entity (other than

a member or regular associate of the attorney's law firm). Fed. R. Bankr. P. 2017 permits the court on the motion of a party in interest or on its own initiative to determine whether any payment or transfer to an attorney is excessive. Pursuant to 11 U.S.C. § 329(b), the court may order the return of any excessive payments to the estate or the entity that made the payment.

3-6.1.3 Definition of Professional Person

Professional persons employed pursuant to 11 U.S.C. § 327 or 1103 may be awarded compensation pursuant to 11 U.S.C. §§ 330 and 331. Clearly, the statute recognizes that attorneys, accountants, appraisers, and auctioneers are professional persons for whom prior court approval of employment would be required. Occasionally, it is necessary for the trustee, debtor in possession, or committee to contract with outside firms or individuals who do not fall within these categories for assistance in the performance of their statutory duties. In these circumstances, the question sometimes arises whether an order of employment is required. The classic definition of professional person for purposes of 11 U.S.C. § 327(a) limits the term to "persons in those occupations which play a central role in the administration of the debtor proceeding." In re Marion Carefree Ltd. Partnership, 171 B.R 584 (Bankr. N.D. Ohio 1994); In re Seatrain Lines, Inc., 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981). The degree of autonomy and discretion exercised by the firm or individual in question is also a relevant consideration in determining whether the requirements of 11 U.S.C. § 327(a) apply. In re Bicoastal Corp., 149 B.R. 216 (Bankr. M.D. Fla. 1993); In re Park Ave. Partners Ltd. Partnership, 95 B.R. 605 (Bankr. E.D. Wis. 1988). See USTM 3-2.8.2.1.

3-6.1.4 Auctioneers and Appraisers

The court must approve the retention of appraisers and auctioneers who must meet the same statutory requirements as other professionals. 11 U.S.C. § 327(a). Fed. R. Bankr. P. 6005 requires that the order of retention fix the amount or rate of compensation. The Rule further provides that no employee or officer of the judiciary or of the Department of Justice may act as an appraiser or auctioneer, and provides that no residence or licensing requirement is to be required, even though most

states require an auctioneer to be licensed and bonded. It is not unusual for an appraiser to be compensated on a per diem basis and an auctioneer to be compensated at a percentage of the gross proceeds of sale. Local rules may govern the maximum allowable percentage to auctioneers. The appraiser and the auctioneer should not be one and the same person. An obvious conflict arises where the same person appraises items that he/she will be auctioning, and the United States Trustee should object if it is proposed that one person be employed in both capacities.

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

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

3-6.1.5 **11 U.S.C. § 327(e)**

An attorney who may be ineligible for employment under 11 U.S.C. § 327(a) may be hired under 11 U.S.C. § 327(e) if the employment is for a specified special purpose (other than general conduct of the case), provided that the employment is in the best interest of the estate and the attorney does not hold or represent an interest adverse to the estate with respect to the particular matter for which such attorney is employed. Note that 11 U.S.C. § 327(e) applies only to attorneys. Accountants and other professional persons are not eligible for employment pursuant to that section. Moreover, at least one district court in parsing the statute has required counsel to have been formerly employed by the debtor. See Meespierson v. Strategic Telecom, Inc., 202 B.R. 845 (D. Del. 1996).

An analysis of whether special counsel qualifies for employment under 11 U.S.C. § 327(e) should begin with an understanding of applicable ethical regulations. Certain potential conflicts are capable of being

waived after full disclosure and consent. Most often, the question will become whether the conflicting interest that makes counsel ineligible for employment under 11 U.S.C. § 327(a) is such that counsel is rendered incapable of exercising independent professional judgment on behalf of the client. If the employment necessarily requires that one interest be served at the expense of the other, an adverse interest exists which should disqualify counsel for employment pursuant to 11 U.S.C. § 327(e).

3-6.2 THE DISINTERESTED PERSON REQUIREMENT FOR THE EMPLOYMENT OF PROFESSIONALS AND THE APPOINTMENT OF TRUSTEES AND EXAMINERS

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

3-6.2.1 Statutory Provisions

3-6.2.1.1 11 U.S.C. §§ 101(14) and 327(a)

"Disinterested person" is defined at 11 U.S.C. § 101(14) as a person that:

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

(B) is not and was not an investment banker for any outstanding security of the debtor;

(C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;

(D) is not and was not, within two years before the date of the filing of the petition a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and

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

Section 327(a) of the Bankruptcy Code involves the application of a two-pronged test. First, the professional must be disinterested as defined in 11 U.S.C. § 101(14). Second, the professional must not have an interest adverse to the estate. Failure to meet either condition of employment can result in disqualification. In re Interwest Business Equip., Inc., 23 F.3d 311 (10th Cir. 1994); In re Pierce, 809 F.2d 1356, 1362 (8th Cir. 1987); In re Leisure Dynamics, Inc., 32 B.R. 753, 754 (Bankr. D. Minn. 1983), aff'd, 33 B.R. 121 (D. Minn. 1983).

3-6.2.1.2 11 U.S.C. § 101(14)(A)-(D)

The language of 11 U.S.C. § 101(14)(A)-(D) mandates a literal approach to the disinterested person requirement and sets forth in detail a series of characteristics that disqualify a person from being "disinterested." These paragraphs do not call for any "weighing" or "balancing" of the impact of disqualification. A judicial determination that a person's characteristics would pose problems for the administration of the bankruptcy estate is not a prerequisite for disqualification. Each paragraph refers to characteristics of a person that are either carefully defined within the Bankruptcy Code or are easily understood. See, e.g., 11 U.S.C.§ 101(10) ("creditor"), (17) ("equity security holder"), and (31) ("insider"). If a professional has the characteristic, then disqualification is automatic. The fact that the interest in question may arguably be considered "de minimus" is of no importance in the analysis. Since the language of the statute is clear, it must be applied as written. This "plain language" approach is represented by the following cases: In re Middleton Arms, Ltd. Partnership, 934 F.2d 723 (6th Cir. 1991) (insider disqualified from employment as property manager); In re Siliconix, Inc., 135 B.R. 378 (N.D. Cal. 1991) (creditor disqualified from employment as accounting firm); In re Watervliet Paper Co., 96 B.R. 768 (Bankr. W.D. Mich. 1989), aff'd, 111 B.R. 131 (W.D. Mich. 1989) (prepetition claim of debtor's counsel equal to .003% of total

debt disqualifying); In re Anver Corp., 44 B.R. 615 (Bankr. D. Mass. 1984) (attorney who owned 1% of debtor's stock disqualified); and In re Cropper, 35 B.R. 625 (Bankr. M.D. Ga. 1983) (ownership of stock in major customer of debtor disqualifying).

An agreement to subordinate a claim to payment of all other claims in a case will not cure a disinterestedness problem. However, waiver of the claim will render an applicant disinterested and thus in compliance with the statute. In re Roberts, 46 B.R. 815, 849 (Bankr. D. Utah 1985), aff'd in part and rev'd in part on other grounds, 75 B.R. 402 (D. Utah 1987).

3-6.2.1.3 Overlap of 11 U.S.C. § 101(14)(E) and 11 U.S.C. § 327(a)

A more difficult inquiry must be undertaken to determine whether the professional meets the adverse interest standard of 11 U.S.C. §§ 101(14)(E) and 327(a). Subparagraph (E) of 11 U.S.C. § 101(14), the so-called “catch-all” provision, provides that a person is disinterested if the person:

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

Section 327(a) of the Bankruptcy Code provides that the trustee may employ professionals “that do not hold or represent an interest adverse to the estate, and that are disinterested persons. . . .” See, e.g., In re Lee Way Holding Co., 100 B.R. 950 (Bankr. S.D. Ohio 1989); In re McKinney Ranch Associates, 62 B.R. 249 (Bankr. C.D. Calif. 1986); In re Philadelphia Athletic Club, Inc., 20 B.R. 328 (Bankr. E.D. Pa. 1982); In re Codesco, Inc., 18 B.R. 997 (Bankr. S.D.N.Y. 1982). There is thus some overlap between the no adverse interest requirement of 11 U.S.C. § 327(a) and the materially adverse interest standard of 11 U.S.C. § 101(14)(E). Viewed practically, persons failing one of the requirements will often fail the other as well.

The conclusion that retention is improper requires a careful consideration and weighing of the totality of the circumstances presented; however, it is not a balance of impropriety against the alleged disruption disqualification will create. If the circumstances reveal a conflict impeding the exercise of independent judgment by the professional, an objection to the retention should be made. In re Sauer, 191 B.R. 402 (Bankr. D. Neb. 1995).

There are differences between 11 U.S.C. § 327(a) and 11 U.S.C. § 101(14)(E). 11 U.S.C. § 327(a) refers merely to an interest that is "adverse," whereas 11 U.S.C. § 101(14)(E) refers to a "materially adverse" interest. This would suggest that a somewhat broader standard is contained in 11 U.S.C. § 327(a). Subparagraph (E) of 11 U.S.C. § 101(14), however, appears to be more stringent than 11 U.S.C. § 327(a) in one regard. The adverse interest clause of 11 U.S.C. § 327(a) merely precludes the employment of persons holding or representing an interest adverse to the estate, whereas subparagraph (E) expands the proscription to include interests that are materially adverse not only to the estate, but also to any class of creditors or equity security holders.

These statutory distinctions complicate the analysis that must be undertaken. Further complexity results from the provision of 11 U.S.C. § 327(c) which states that a professional is not disqualified for employment "solely because of such person's employment by or representation of a creditor, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest." Thus, a professional is not ineligible for employment simply because he/she represents a creditor, absent an actual conflict. Furthermore, 11 U.S.C. § 1107(b) provides that, notwithstanding the requirements of 11 U.S.C. § 327(a), a person is not disqualified for employment by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case. Proper application of these varied statutory provisions demands a painstaking analysis of the unique facts and circumstances presented in each case.

3-6.2.2 **Special Problems in Related Cases**

3-6.2.2.1 Appointment of a Trustee

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

The definition of a disinterested person proscribes various types of disqualifying interests. As a general matter, 11 U.S.C. § 101(14) does not disqualify persons because of whom they represent, but rather because of the nature of their personal status, e.g., because they personally are creditors of the debtor or because they personally "have an interest" which is "materially adverse" under subparagraph (E). Therefore, the mere fact that a trustee may assert a claim against one estate in his/her representative capacity for another estate does not make him or her a "creditor" in an individual sense for purposes of applying 11 U.S.C. § 101(14)(A). In re BH & P, Inc., 949 F.2d 1300 (3d Cir. 1991). Cf. In re Hartley, 50 B.R. 852, 861 (Bankr. N.D. Ohio 1985) (noting that the trustee succeeds to the debtor's property interests by operation of law).

Moreover, the "materially adverse" requirement of 11 U.S.C. § 101(14)(E) should not be read to prevent a single trustee from serving in related cases. A standard that automatically disqualifies a trustee from serving in jointly administered cases where there are inter-debtor claims is overbroad. Indeed, the provisions of Fed. R. Bankr. P. 2009 specifically allow the appointment of a single trustee for jointly administered cases. The United States Trustee must weigh a number of competing interests when deciding whether a single trustee can serve in such cases. A single trustee is often able to maximize the return to jointly administered estates through increased economy and efficiency. Moreover, jointly administered estates will virtually always have inter-

debtor claims or potential claims. Were the use of a single trustee precluded in jointly administered estates, these cases would be exposed to increased costs and inefficiency. In re BH & P, Inc., 949 F.2d 1300 (3d Cir. 1991).

However, there are circumstances where the appointment of one trustee in multiple cases may be inappropriate. Fulfilling fiduciary obligations to one estate may require that the trustee take actions that adversely impact the others. Genuine conflicts may arise. The presence and size of assets to pursue in the related estates, the disputed nature of the claims, and the relationship of the various classes of unsecured creditors must be examined. The issue to be resolved is whether the need for advocating competing interests among and between the estates is such that it interferes with the ability of the trustee to exercise independent judgment on behalf of one or more class of creditors. If creditors of the different estates will be prejudiced by conflicts of interest of a common trustee, the court should order the appointment of separate trustees for jointly administered cases. See Fed. R. Bankr. P. 2009.

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

In cases involving multiple representation of related debtors, steps can be taken to cure conflicts. The O.P.M. court noted that the potential conflict

regarding the debtors' respective rights to litigation proceeds did not require the appointment of different trustees because apparent conflicts of interest "might be resolved in a number of ways," including the appointment of special counsel. In re O.P.M., 16 B.R. at 939 (quoting In re General Economics Corp., 360 F.2d 762, 766 (2d Cir. 1966)). The appointment of separate or special counsel has been endorsed by several courts as an acceptable remedial measure. See, e.g., Katz v. Kilsheimer, 327 F.2d 633, 636 (2d Cir. 1964); In re Fondiller, 15 B.R. 890, 892 (B.A.P. 9th Cir. 1981), appeal dismissed on other grounds, 707 F.2d 441 (9th Cir. 1983) (11 U.S.C. § 327(a) precludes representation of adverse interests relating to the services to be performed); In re O'Connor, 52 B.R. 892 (Bankr. W.D. Okla. 1985); see also In re Iorizzo, 35 B.R. 465, 468-69 (Bankr. E.D.N.Y. 1983).

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

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

3-6.2.2.2 Retention of Professionals

In related cases, the professional's representation of all the debtors ultimately depends upon whether the professional's capacity for independent judgment and the vigorous pursuit of the interests of a particular debtor are infringed. See In re Consol. Bancshares, Inc., 785 F.2d 1249 (5th Cir. 1986). But see In re W. F. Dev. Corp., 905 F.2d 883 (5th Cir. 1990), cert. denied, 499 U.S. 921 (1991) (one attorney may not

represent both limited and general partners in bankruptcy because there will always be a potential for conflict). As with the case of the multiple debtor trustee, the cost of obtaining different professionals, as well as the expense that accrues when a professional is employed late in a case, are significant factors. The nature of disclosure at the time of retention, whether the interests of related estates are parallel or conflicting, and the type of the inter-debtor claims are also significant. The size and nature of inter-debtor claims, whether they are disputed or hold priority status, and whether the various debtor interests diverge in some material way must also be examined. Ultimately, the efficiency and economy that favors multiple representation must be weighed against the need that the interests of each of the estates be adequately represented. See In re Interwest Business Equip., Inc., 23 F.3d 311 (10th Cir. 1994); In re BH & P, Inc., 949 F.2d 1300 (3d Cir. 1991).

CHAPTER 3-7: COMPENSATION ISSUES

3-7.1 DETERMINATION OF REASONABLE COMPENSATION, 11 U.S.C. § 330 AND FED. R. BANKR. P. 2016(a)

Section 330(a) of the Bankruptcy Code authorizes the court, after notice and a hearing, to award to a trustee, an examiner, or other professional person employed under 11 U.S.C. § 327 or 1103 --

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

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

In 1994, this section was amended to add various criteria by which the court could evaluate the request for compensation. 11 U.S.C. § 330(a)(3) provides:

> In determining the amount of reasonable compensation to be awarded, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including –
>
> (A) the time spent on such services;
> (B) the rates charged for such services;
> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and
> (E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

Fed. R. Bankr. P. 2016(a) prescribes that any entity seeking interim or final compensation for services or reimbursement of expenses shall file a detailed statement of the services rendered, the time expended, the expenses incurred, and the total amount requested. If the amount requested exceeds $500, Fed. R. Bankr. P. 2002(a)(6) requires at least 20 days' notice to creditors and parties in interest of the hearing set to consider the application. This period may be reduced for cause pursuant to Fed. R. Bankr. P. 9006(c)(1).

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

> Except as provided in subparagraph (B), the court shall not allow compensation for –
>
> (i) unnecessary duplication of services; or

(ii) services that were not--

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

(II) necessary to the administration of the case.

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

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

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

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

* * *

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

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

What is a reasonable hourly rate? "Congress expressed its intent that there should be no distinction between fees set in bankruptcy cases and those set in non-bankruptcy cases." Grant v. George Schumann Tire & Battery Co., 908 F.2d at 878. See also In re UNR Indus., Inc., 986 F.2d 207,

209-10 (7th Cir. 1993). Therefore "the starting point for the calculation of fees is the applicant's 'normal billing rate'." Generally, so long as the rates being charged are the applicant's normal rates charged in bankruptcy or non-bankruptcy matters alike, they will be afforded a presumption of reasonableness." In re Jefsaba, Inc., 172 B.R. 787, 798 (Bankr. E.D. Pa. 1994) (citations omitted). As the rate must be reasonable "so must the time spent by the professionals on the various tasks to be performed." Id. Indeed,

> We review fee applications paying particular attention to the level of professional . . . billing time viz-a-viz the complexity of the task being performed. The nature, extent and complexity of the task . . . determines the level of professional . . . who should perform the task, and, consequently, the reasonableness of the fees charged . . . It is unreasonable for a senior attorney to perform routine tasks such as preparing a debtor's schedules . . . . Consequently, fees charged at a senior attorney's hourly rate for such services are unreasonable.

Id. at 796-97 (citation omitted).

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

The United States Trustee faces an interesting challenge when presented with a fee application by non-local counsel who seek rates comparable to their home jurisdiction and usually well in excess of local rates. Rigid enforcement of a policy allowing only local rates is inappropriate, as each situation has its own facts and circumstances that must be taken into account. See In re Western Co. of North America, 123 B.R. 546, 549 (N.D. Tex. 1991). In determining reasonable compensation allowable to non-local counsel, the courts should begin with counsels' customary rates,

and then make reductions based on other factors if necessary. See Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc., 50 F.3d 253, 260-61 (3d Cir. 1995).

Section 586(a)(3)(A) of title 28 was amended in 1994 to require review of applications for compensation and reimbursement under 11 U.S.C. § 330 "in accordance with procedural guidelines adopted by the executive office of the United States trustee (which guidelines shall be applied uniformly by the united states trustee except when circumstances warrant different treatment) . . . ." The guidelines were promulgated and, after an opportunity for comment had passed, were published as final in 1996. The guidelines established a policy favoring project billing which simplifies the review process. The guidelines are an internal work tool and do not take the place of local rules or precedent. However, many courts have adopted the guidelines, in whole or in part, as a local rule. In addition, some United States Trustees have established exceptions to the guidelines for small fee applications.

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

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

1. failure to obtain prior court approval of the employment;
2. inadequate disclosure of relationships or possible conflicts;
3. non-compliance with timing or format requirements;

4. inadequate descriptions of services rendered;
5. services performed outside the scope of employment;
6. inappropriate rounding or lumping of time;
7. duplication of effort, inefficient delegation, or excess time spent in performance of a given task;
8. services not reasonably likely to benefit the estate or not necessary to the administration of the case;
9. overhead items inappropriately billed or expensed;
10. inadequate documentation of expenses; and
11. excessive charges for preparing the fee application.

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

3-7.2 RETAINERS

A retainer has been defined as the fee that a client pays when he/she employs an attorney to act for him or her, thereby preventing that attorney from working for an adversary. Black's Law Dictionary 1183 (5th ed. 1979). 11 U.S.C. § 328(a) permits the court to authorize the employment of professional persons on any reasonable terms and conditions, including a retainer.

The United States Trustee must scrutinize retainers for several reasons: (1) to assure that the amount of a retainer is not so substantial as to drain a chapter 11 debtor of all of its working capital; (2) to prevent overreaching by counsel who might be taking advantage of a debtor who is not in a position to effectively negotiate the terms of its representation; (3) to review whether the amount of a retainer is likely to give one administrative claimant a preference over other administrative claims in the event of liquidation; (4) to assure that the retainer is paid from a proper source; and (5) to analyze any potential conflicts. Of course, not all of these concerns will be present in each case. For example, in a large chapter 11, it is likely that the debtor will be able to negotiate an arms length agreement for its legal representation. In small cases, however, the

same equality of bargaining power may not exist. As a general rule, the United States Trustee should view retainer agreements as contractual agreements that have been negotiated at arms length between parties with equal bargaining positions and, absent facts that tend to raise questions as described in a specific case, the United States Trustee should not object to retainers.

Pursuant to 11 U.S.C. § 329 and Fed. R. Bankr. P. 2016(b) and 2017, the amount and source of prepetition retainers must be disclosed. Postpetition retainers that are paid from the estate must be paid pursuant to the 20-day notice requirements of Fed. R. Bankr. P. 2002(a)(6) or court order and must be authorized in compliance with the substantive provisions for compensation found in 11 U.S.C. §§ 330 and 331 and Fed. R. Bankr. P. 2016(a). Postpetition retainers paid from some source other than the estate must be disclosed as required by Fed. R. Bankr. P. 2016(b) and 2017.

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

Payments may be made by debtors to their counsel or other professionals during the "gap" period following the filing of an involuntary proceeding and prior to entry of an order for relief pursuant to 11 U.S.C. § 303(f). 11 U.S.C. § 549(b) allows attorneys who provide services to a gap period putative debtor to be paid for contemporaneous services during the gap period, without court order. There is no need for counsel to seek court

authorization for employment until an order for relief is entered and the debtor becomes a debtor in possession.

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

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

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

If a retainer is construed to be property of the estate, there are additional considerations. For example, a final fee application would be necessary even if the amount requested did not exceed the amount of the retainer. In

a failed chapter 11 that is converted to an administratively insolvent chapter 7, a professional who received a retainer could be required to repay the retainer into the estate due to the administrative priority accorded to chapter 7 expenses by 11 U.S.C. § 726(b).

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

Prepetition retainers also may trigger a preference analysis. Frequently, counsel may be owed money for prepetition services not rendered in connection with the chapter 11 filing. Counsel who receives payment prior to a filing needs to determine how the funds will be applied. If counsel deems this payment as a retainer for future services, counsel will likely have to waive his/her prepetition claim in order to be disinterested. If, on the other hand, counsel applies all or a portion of this payment to prepetition services, counsel is subject to potential preference actions, as well as disqualification, since counsel arguably would be required to advise the debtor as to whether or not to pursue that potential preference.

In some jurisdictions, counsel receives security interests in some or all of a debtor's assets as a retainer. The issue that arises in this situation is whether counsel can qualify as "disinterested," notwithstanding his/her security interest. In In re Carter, 116 B.R. 123, 126 (Bankr. E.D. Wis. 1990), the court noted the split in the two circuits that have addressed this issue. The Eighth Circuit (In re Pierce, 809 F.2d 1356, 1362-63 (8th Cir. 1987)) has adopted a per se rule that counsel cannot be disinterested in such circumstances, while the First Circuit (In re Martin, 817 F.2d 175, 183 (1st Cir. 1987)) provides a more flexible approach requiring the analysis of numerous factors. These cases are not as inapposite as they might first appear. Pierce involved a mortgage interest that was taken to secure the prepetition claim of debtor's counsel, and it represents the traditional view that a creditor is disqualified to serve as a professional. Martin addresses the far more difficult situation that is presented when counsel acquires a security interest in consideration for its agreement to

represent the debtor in a bankruptcy proceeding. This will most likely occur when debtors are cash poor and unable to pay a retainer. Assuming that only bankruptcy-related services are involved, counsel who receives security interests in property are not totally unlike those who receive a cash retainer insofar as both guarantee payment for services rendered or to be rendered in connection with the bankruptcy case.

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

3-7.3 INTERIM COMPENSATION, 11 U.S.C. § 331

Section 331 of the Bankruptcy Code provides that

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

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

An interim application filed pursuant to 11 U.S.C. § 331 must be evaluated on the same basis as a final application under 11 U.S.C. § 330, i.e., the nature, extent, and value of the services, the time spent, and the cost of comparable services. The value of the services cannot be fully ascertained until the conclusion of the case when the overall results obtained are quantifiable. As a result, many courts impose a holdback on

interim fees rather than allow interim compensation in the full amount sought. See In re Bank of New England Corp., 134 B.R. 450, 458-59 (Bankr. D. Mass. 1991). A holdback serves several purposes. First, it is not always possible to predict administrative solvency at the conclusion of the case, particularly if super priorities pursuant to 11 U.S.C. § 364 have been granted in connection with postpetition financing. Interim fee allowances are always subject to reexamination and adjustment at the final hearing. 11 U.S.C. § 330(a)(5). However, interim payment percentages should be crafted to guard against the unpleasant task of seeking the disgorgement of fees already paid in the event of administrative insolvency. See, e.g., U.S. Trustee v. Johnston, 189 B.R. 676, 677 (N.D. Miss. 1995); In re Gherman, 114 B.R. 305, 307 (Bankr. S.D. Fla. 1990). Second, although professionals need not finance the case, the allowed percentages should be balanced against the debtor's need for working capital. It may be that certain debtors simply cannot afford to reorganize and pay the fees associated with the effort at the same time. Third, the holdback may provide an incentive to the professional to pursue the case diligently to a conclusion so that the amounts held back can finally be awarded and paid.

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

Professionals engaged in a large reorganization case will generally seek at an early stage of the case court approval for interim payment procedures at intervals more frequent than once every 180 days. For example, in In re Knudsen Corp., 84 B.R. 668, 671-72 (B.A.P. 9th Cir. 1988), professionals were allowed to receive monthly payments on account pending court approval at periodic formal fee hearings. In an instance where substantial professional time is devoted to a case on a monthly basis, it is consistent with the purpose and intent of 11 U.S.C. § 331 for the United States Trustee to participate in the negotiation of an

appropriate fee review procedure order. Any such order should provide for a United States Trustee review of invoices prior to payment and preserve the right of objection at all stages of the procedure. Formal court approval should be provided for at regular periodic intervals after notice and a hearing. Holdbacks on fees should be provided for in an appropriate case.

3-7.4 RESPONSIBILITY OF PARTIES TO CONTROL COSTS

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

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

3-7.5 FEE PROCEDURE ORDERS

In larger reorganization cases, various bankruptcy courts have issued administrative orders which address procedural and, to some extent, substantive requirements for all fee applications in a given case. Fee

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

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

“Automatic” payment procedures are arguably allowed by the “more often if the court permits” language of 11 U.S.C. § 331. The United States Trustee should discourage the use of this procedure except in rare instances. To the extent that professionals insist on such procedures, the United States Trustee should request safeguards, which may include:

1. A holdback ranging up to as much as 50 percent or more of the requested fees depending on the projected solvency of the estate.

2. An opportunity to object and request hearings based on reviews of the “automatic” fee petitions.

3. A provision in the order directing debtor's counsel to review all interim fee requests and to file a written analysis of its review.

4. A provision in the order requiring all applicants to file formal applications periodically, and prohibiting the debtor from paying any applicant who is not in compliance with that provision of the order.

5. Other safeguards as appear necessary.

3-7.6 TRUSTEE COMPENSATION

A trustee's compensation is determined under 11 U.S.C. § 330 and the statutory cap set out in 11 U.S.C. § 326(a), as amended in 1994. That section provides that:

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

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

Many trustees view the maximum fee as a minimum, but there are instances where a reasonable fee is clearly less than the maximum allowed. “The fact is that the Bankruptcy Code provides no formula for determining the minimum compensation that a trustee is entitled to be paid . . . . Nowhere has § 326 been construed to create an entitlement to the maximum amount provided for under that section . . . .” In re Draina,

191 B.R. 646, 648 (Bankr. D. Md. 1995). See also In re Dorn, 167 B.R. 860, 866 n.11 (Bankr. S.D. Ohio 1994).

A trustee may seek an interim payment of compensation and expenses (11 U.S.C. § 331), although there appears to be some statutory conflict with 11 U.S.C. § 326 if there has not been a distribution. See In re Heatherly, 179 B.R. 872, 874-75 (Bankr. W.D. Tenn. 1995); In re Tom Carter Enters, 49 B.R. 243, 245-46 (Bankr. C.D. Cal. 1985). In Heatherly, the court read the distribution as modifying the limitation on the fee and not on eligibility for an interim allowance.

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

Interim awards are interlocutory and subject to full review and adjustment at a later date. See In re Stable Mews Assocs., 778 F.2d 121, 123 n.3 (2d Cir. 1985).

CHAPTER 3-8: QUARTERLY FEES

3-8.1 INTRODUCTION

Pursuant to 28 U.S.C. § 1930(a)(6), every open case or every debtor in a case pending under chapter 11 must pay a fee each quarter to the United States Trustee. See the favorable decision of In re CF&I Fabricators of Utah, Inc., 1998 WL 348030 (10th Cir. 1998), for an elaborate discourse on the myriad of arguments raised in opposition to the imposition and collection of the postconfirmation quarterly fee. The monies generated from quarterly fee payments represent a significant source of revenue for the United States Trustee System Fund. See generally In re Prines,

867 F.2d 478 (8th Cir. 1989). Consequently, the monitoring and collection of quarterly fees is an integral part of the United States Trustee's oversight of chapter 11 cases. Efforts to ensure the prompt payment of fees begin at the inception of the case and continue until the case is closed, or beyond. Offices are responsible for submitting timely and accurate information to the Executive Office for the centralized billing system. In addition, the United States Trustee must take appropriate action when quarterly fees remain unpaid.

3-8.2 INFORMING PARTIES OF THE FEE REQUIREMENT

The United States Trustee should inform the debtor and the debtor's attorney of the obligation to pay quarterly fees as soon as practicable after the case is filed. The initial debtor conference is usually the first opportunity to discuss these requirements. The debtor's obligation to pay quarterly fees, the schedule of fees, and the consequences for nonpayment should also be incorporated in any chapter 11 operating guidelines adopted by the United States Trustee. Chapter 11 trustees must also be advised of the fee requirement shortly after their appointment.

3-8.3 FEE AMOUNT AND DUE DATE

3-8.3.1 Calculation of the Fee

Section 1930(a)(6) of title 28 sets forth a sliding schedule of fees based on the amount of money that is disbursed during a calendar quarter. If no disbursements are made in a quarter, the minimum fee must still be paid. See In re Smith & Son Septic and Sanitation Serv., 20 Bankr. Ct. Dec. (CRR) 1815 (Bankr. D. Utah Oct. 5, 1990); cf. In re Torres-Ruiz, 123 B.R. 696, 697 (D.P.R. 1990).

The Program adheres to the plain meaning of the word “disbursement,” but debtors have made numerous attempts to narrow the category of disbursements that are subject to quarterly fees. Before embarking on a disbursement definition battle, the United States Trustee should first consider whether the dispute will actually affect the amount of fees owed. Since the disbursement categories set forth in 28 U.S.C. § 1930(a)(6) are quite large, differences in definition may have no practical consequence.

The United States Trustee must also consult with the General Counsel in deciding whether to undertake litigation in this area.

3-8.3.1.1 Operating Expenses

Disbursements encompass all expenses paid by the debtor. See In re Wernerstruck, Inc., 122 B.R. 1017, 1021-22 (Bankr. D.S.D. 1991) (funds spent to maintain level of inventory required by lender were disbursements upon which quarterly fee should be based), rev'd on other grounds, 130 B.R. 86 (D.S.D. 1991). Disbursements subject to quarterly fees are not limited to payments to prepetition creditors. In re Ozark Beverage Co., 105 B.R. 510, 511-12 (Bankr. E.D. Mo. 1989).

3-8.3.1.2 Cash Collateral/Financing Order Payments

Payments to secured creditors pursuant to cash collateral or financing orders are disbursements upon which the quarterly fee is calculated. Debtors and secured creditors often structure financing orders that are designed to permit the continued use of cash collateral. Pursuant to these arrangements, the debtor usually pays the creditor the cash collateral, which the creditor then loans back to the debtor. Regardless of how the parties may choose to characterize the debtor's payments, they are still considered disbursements for purposes of calculating quarterly fees. See In re Wernerstruck, Inc., 130 B.R. 86, 88-89 (D.S.D. 1991).

3-8.3.1.3 Payments Out of Escrow or By Third Parties

Disbursements include payments made on behalf of the debtor by an escrow company or other third party. St. Angelo v. Victoria Farms, Inc., 38 F.3d 1525, 1534-35 (9th Cir. 1994), modified, 46 F.3d 969 (9th Cir. 1995); In re Hays Builders, Inc., 144 B.R. 778, 779-80 (W.D. Tenn. 1992), rev'g 95 B.R. 79 (Bankr. W.D. Tenn. 1988) and 96 B.R. 142 (Bankr. W.D. Tenn. 1989).

3-8.3.1.4 Non-Cash Transactions

Disbursements are calculated upon cash transfers, not transfers in kind. For example, when estate assets are sold and the purchaser assumes an obligation of the debtor as part of the sale consideration, the amount

assumed is not considered a disbursement for purposes of calculating the quarterly fee.

3-8.3.2 Fee Due Dates and Periods Covered

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

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

The obligation to pay quarterly fees ceases when the case is no longer pending under chapter 11, i.e., when a final decree closing the case is entered or the case is either converted or dismissed. The date the final decree, dismissal, or conversion order is docketed should be used as the ending date for the quarterly fee obligation.

The commencement and termination of a chapter 11 case will occur at varying points within a quarter. The fee for partial quarters is calculated on disbursements that were made during the period of time the case was pending under chapter 11. The fee, itself, is not prorated. See In re Smith & Son Septic and Sanitation Serv., 20 Bankr. Ct. Dec. (CRR) 1815, supra.

3-8.3.3 Fees in Jointly Administered and Substantively Consolidated Cases

Jointly administered cases remain distinct. Each case must pay a quarterly fee based upon its respective disbursements. Substantively consolidated cases become one case and are subject to only one fee from the time the substantive consolidation order is docketed. See In re Carr, Nos. 87-40067, 87-40068 (Bankr. D.S.D. June 29, 1989)(unreported decision).

3-8.4 BILLING AND COLLECTION PROCEDURES

3-8.4.1 Bill Generation Process

The United States Trustee is responsible for submitting data on the identity and status of chapter 11 cases to the Executive Office. Based on this information, bills are generated each quarter from a central computer facility and sent to all chapter 11 debtors and chapter 11 trustees throughout the country. The bill shows a return address of the local United States Trustee's office and instructs payments to be mailed to a lockbox facility in Atlanta, Georgia. After each quarterly billing, a list of the bills generated is forwarded to each field office to verify the accuracy of the information.

The Executive Office issues data call memoranda to field offices specifying the format and dates for the submission of quarterly fee data. The Budget Formulation and Revenue Branch of the Executive Office acts as the central processing point. It assists offices with generic account problems and provides information regarding reports, forms, and procedures.

As of early 1998, the Fee Information and Collection System (FICS) sends out computer generated invoices, but not delinquency notices. The United States Trustee is responsible for generating delinquency and other reports from the FICS and sending delinquency notices to debtors.

3-8.4.2 Fee Payments and Refunds

3-8.4.2.1 Payment Procedures

Every quarter, computer-generated bills are sent to all chapter 11 debtors. The bills are preprinted with the debtor's account information, and contain a payment stub for use in making quarterly fee payments to a lockbox facility in Atlanta, Georgia. Offices should maintain a supply of blank “Chapter 11 Quarterly Disbursement and Fee Report” forms in case payment stubs are lost or the debtor wishes to make payments for more than the current quarter.

Checks should be made payable to the “United States Trustees” or the “U.S. Department of Justice” and mailed directly to the Atlanta, Georgia address, along with the preprinted payment stub (or a completed Chapter 11 Quarterly Disbursement and Fee Report). If payment verification is time sensitive, the debtor should be instructed to furnish an informational copy of its remittance to the local United States Trustee's office.

Offices receiving cash, checks, or other negotiable instruments for the payment of quarterly fees must process those payments and forward them for deposit on a daily basis. The following guidelines must be observed:

1. Receipt of Cash

   All debtors should be instructed to make payments by check or money order. Cash payments should not be refused; however, if a debtor pays in cash, the payment should be immediately converted to some form of financial institution check or a money order, such as a U.S. Postal money order. Any cost incurred by an employee for the conversion of cash to a money order is reimbursable. Employees incurring such an expense shall submit a properly completed “Claim for Reimbursement for Expenditures on Official Business” (SF-1164) with supporting receipts to the Executive Office for reimbursement. Under no circumstances shall any employee deposit debtor payments into his/her own personal account (checking or otherwise) to meet the conversion requirement. Nor shall any employee request that checks or money orders be made payable to him/her personally. All checks and money orders shall be made payable to the “United States Trustees” or “U.S. Department of Justice.” (U.S. Treasury Fiscal Manual; I TFM 5-2000, Section 2020; Inscription of Checks)

   Chapter 11 quarterly fee payments are to be mailed to the United States Trustee Payment Center in Atlanta, Georgia, while all other types of payments are to be mailed to the Executive Office for processing. As a result, chapter 11 quarterly fee cash payments must not be combined with other types of cash payments into a single check or money order.

2. Receipt of Other Negotiable Instruments

If a debtor pays with a negotiable instrument other than cash, check, or money order, the United States Trustee should immediately contact the Budget Formulation and Revenue Branch of the Executive Office.

3. Receipt of Payments Made Payable to an Employee of the United States Trustee

As previously indicated, all debtors should be instructed to make payments by check or money order payable to the "United States Trustees" or the "U.S. Department of Justice." If, however, a debtor inadvertently makes his/her payment personally payable to an employee of the United States Trustee, immediately upon receipt of such a payment, the check or money order must be restrictively endorsed "For Deposit Only to the Account of the United States Trustees Without Recourse (signature of employee)." This endorsement provides appropriate internal control, as well as protection for the employee. The check or money order should then be processed according to the guidelines detailed in the next paragraph.

4. Processing Guidelines

A standard form check register has been developed to control all cash, checks, or other negotiable items received and processed via offices of the United States Trustee. Copies of the check register form can be obtained from the Budget Formulation and Revenue Branch of the Executive Office, and the guidelines and instructions for its use appear on the back.

One employee in each office should be designated to receive all incoming payments. Besides those payments received through the mail, any payments delivered in person, by courier, etc., must be given directly to the designated employee. That employee is responsible for the conversion of all cash payments received to checks or money orders and for contacting the Executive Office to obtain instructions regarding the handling of other types of negotiable instruments. The employee must account for all

payments received by completing the following columns on the check register:

Date Received by United States Trustee's Office: Enter the date payment was received in the office.

Time Received by United States Trustee's Office: Enter the time the payment was received in the office.

Received by (Last Name): Enter the last name of the designated employee actually receiving the payment.

Check Number: Enter the number listed on the check or money order. (NOTE: Cash or other negotiable item information should not be entered in this column. Refer to the sections pertaining to the receipt of cash or other negotiable items.)

Amount of Check: Enter the exact amount of the debtor's payment. If cash or other negotiable items for more than one debtor have been received and converted to a single check or money order by the United States Trustee's office, each debtor's payment must be listed separately on the check register. The numerical amount and the amount written in long hand on checks or money orders should always be verified and discrepancies should be brought to the debtor's attention immediately.

Date of Check: Enter the date on which the payment was drawn. For cash or other negotiable items converted to a check or money order, enter the date on which the check or money order was drawn.

Was Correspondence Received with Cash, Check, or Other Negotiable Item? Enter “yes” or “no” as appropriate.

Name of Payor: Enter the name of the debtor in possession or trustee.

After completing the above steps, the designated employee shall deliver all payments (checks and money orders), the check register(s) documenting those payments, and any correspondence received with the payments to another employee who will be responsible for the processing and subsequent mailing of the payments. The United States Trustee should periodically review the check processing procedure that has been established. If an office is too small to permit an appropriate segregation of duties in this area, monitoring and oversight of the check processing system is an even greater necessity.

5. Mailing Payments

One employee in each office must be designated to mail payments. If possible, this employee should be someone other than the employee designated to receive payments. The employee must mail the payment together with all necessary documentation to the Atlanta, Georgia, payment center and complete the following columns of the check register:

Date Mailed: Enter the date on which the chapter 11 quarterly fee payment(s) and supporting documentation are actually mailed for deposit to the lockbox bank in Atlanta, Georgia, or the date the transmittal memorandum and other payment(s) are mailed to the Executive Office.

Mailed by (Last Name): Enter the last name of the designated employee actually mailing the payment(s).

6. Verification that Payment has been Received or Processed

One employee in each office must be designated to verify that each payment has been received by either the Executive Office or processed by the lockbox bank. Again, if possible, this employee should be someone other than the employees designated for processing and mailing payments. The proper receipt and deposit of all payments listed on the register must be verified on at least a quarterly basis throughout the year.

3-8.4.2.2 Determination of Payments

An office can determine the quarterly fees paid and the amounts credited to each quarter by examining the FICS report. Additional reports can be obtained from the Budget Formulation and Revenue Branch of the Executive Office upon request. If rapid information about the status of fee payments is needed, a request may be faxed to the Executive Office and a prompt reply will ensue.

3-8.4.2.3 Payment Problems

The Budget Formulation and Revenue Branch of the Executive Office should be contacted for assistance with procedural payment problems and questions about payment allocation.

3-8.4.2.4 Payment Refunds

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

3-8.4.3 **Payment Adequacy Review**

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

The fullest review possible should be conducted. For some offices, this may include review of all payments in pending chapter 11 cases. For offices that cannot review every payment, this review can be conducted on a sampling basis provided that a minimum of 5 percent of the cases billed are reviewed for payment adequacy each quarter.

Case review and follow-up must be documented. In addition, field offices must submit a quarterly memorandum to the regional office detailing fee adequacy review efforts. The memorandum should include: (1) the total number of chapter 11 cases billed for the quarter; (2) the number and percentage of fee payments actually reviewed for compliance with the fee schedule; (3) the number of payments found to be less than the debtor's obligation; and (4) a statement of the date on which corrective action was initiated or a date certain by which corrective action will be initiated.

3-8.4.4 Delinquent Payment Review and Collection Efforts

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

1. Continued section 341 meetings are held. These meetings can be used to obtain an explanation for lack of payment and an agreement to a specific deadline for payment on the record.

2. The debtor fails to file operating reports. Failure to file reports is often indicative of other compliance deficiencies. Quarterly fee payment status should be examined.

3. Cash collateral use or financing is sought. The United States Trustee should ensure that any proposed order limiting operating budgets includes the payment of quarterly fees. Proposed orders should also be examined to ascertain whether superpriority is proposed pursuant to 11 U.S.C. § 364(c)(1). If such priority is sought, a quarterly fees exclusion should be requested.

4. A motion to transfer venue is filed. Payment of fees should be required prior to case transfer. See In re 1606 New Hampshire Ave. Assocs., 85 B.R. 298, 312 (Bankr. E.D. Pa. 1988) (court conditioned transfer of venue upon payment of quarterly fees).

5. The exclusivity period terminates or a motion is filed to extend the exclusivity period. If quarterly fees are not current, the United

States Trustee may oppose an exclusivity extension or request a short deadline for disclosure statement and plan submission.

6. A fee application is filed. The United States Trustee should consider opposing interim payments to professionals if there are delinquent quarterly fees.

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

8. A motion to convert, dismiss, or for the appointment of a trustee is contemplated or filed. See USTM 3-9.5 for an in-depth discussion of dismissal and conversion motions.

9. A plan and/or disclosure statement is filed. The United States Trustee must take affirmative action to ensure that any plan of reorganization meets the tests of 11 U.S.C. § 1129(a)(12) which requires the debtor to be current on 28 U.S.C. § 1930 fees or that "the plan provides for the payment . . . on the effective date." The plan should provide for continuing payment of quarterly fees until a final decree is entered. The case must be reviewed for payment compliance by the time that confirmation objections are due. The plan's definition of the effective date should be reviewed to ensure that it is within a reasonable time after plan confirmation. The plan should also be reviewed for any other provisions affecting quarterly fees, such as a requirement to file claims and deadlines. Such requirements are generally objectionable. Otherwise, the United States Trustee must take all measures called for under the plan to ensure timely payment after confirmation.

10. A motion for entry of a final decree is filed. The United States Trustee should consider filing a motion under Fed. R. Bankr. P. 9013 asking the court to compel the debtor to comply with 28 U.S.C. § 1930(a)(6). Alternately, if local practice permits, the United States Trustee may respond to a motion for a final decree with a "response" or "statement" requesting that the court direct

payment of the statutory fee. An objection should not be filed unless there are other substantive reasons to object to the closing of a case.

3-8.4.5 Encouraging Voluntary Compliance

Voluntary compliance with chapter 11 fee provisions should be sought by personal contacts before motions are filed. Agreements to pay should be documented with a confirming letter specifying the date by which payment will be made. Collection letters can also be forwarded to the debtor and the debtor's attorney. These letters, which can be produced efficiently through the use of ACMS query and word processing mail merge features, should include a deadline for fee payment and set out the consequences of failure to pay the fee.

3-8.4.6 Legal Action

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

Non-payment of fees is a specifically enumerated ground for dismissal or conversion pursuant to 11 U.S.C. § 1112(b)(10). If fees are unpaid, the case should be reviewed for other deficiencies, including failure to file operating reports, failure to pay administrative creditors, or lack of insurance. A motion to convert or dismiss for non-payment of fees should include, as further grounds, all identified deficiencies.

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

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

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

If a case converts to another chapter, the United States Trustee must file a timely proof of claim for unpaid quarterly fees. Any claim filed in a chapter 7 case should clearly request chapter 7 administrative priority status pursuant to 11 U.S.C. § 507(a)(1). The amount of the proof of claim should be calculated on the basis of disbursements during the unpaid quarters. If disbursements are not known, the minimum fee should be claimed. See In re Flowers by Mike & Ray, Inc., 95 B.R. 31, 34-35 (Bankr. D. Md. 1988) (United States Trustee must make a good faith determination of the disbursements and cannot just claim maximum fee). If all delinquent quarters are noted on the proof of claim, upward amendments to the claim can be submitted if further information develops. The time within which to file a chapter 11 claim in a subsequent chapter 7 case is governed by Fed. R. Bankr. P. 1019(6).

In chapter 7, unpaid quarterly fees have the same first priority status as chapter 7 administrative claims. 11 U.S.C. § 726(a) calls for distribution first to 11 U.S.C. § 507 claims, in the order of their priority. 11 U.S.C. § 507(a)(1) affords first priority to administrative expenses allowed under

11 U.S.C. § 503(b) and fees and charges assessed under chapter 123 of title 28. Since the obligation to pay chapter 11 quarterly fees arises under chapter 123 of title 28, unpaid fees have a first priority status. 11 U.S.C. § 726(b), which subordinates 11 U.S.C. § 503(b) expenses incurred during chapter 11 to 11 U.S.C. § 503(b) expenses incurred during chapter 7, is inapplicable to fees arising under chapter 123 of title 28. In re Juhl Enters., Inc., 921 F.2d 800, 802-03 (8th Cir. 1990); In re Darmstadt Corp., 164 B.R. 465, 470-71 (D. Del. 1994); In re Metro Transp. and Health Referral, Inc., 165 B.R. 832, 833-34 (Bankr. N.D. Ohio 1994); In re K & M Printing & Lithographing, Inc., 135 B.R. 404, 406-07 (Bankr. D. Or. 1992); In re AM-PM Photo Camera Fashions, Inc., 116 B.R. 222 (Bankr. D. Idaho 1990). Contra In re Wetmore, 117 B.R. 201, 202 (Bankr. W.D. Pa. 1990). Compare In re Rose Truck Brokers, Inc., 166 B.R. 179 (M.D. Fla. 1992), rev'g 122 B.R. 465 (Bankr. M.D. Fla. 1990) (bankruptcy court's ruling conflicts with the clear command of Congress; fees are due regardless of whether a plan is ever confirmed).

3-8.5 WRITE-OFF PROCEDURES

The United States Trustee is delegated write-off authority limited to $20,000 per case. If the debt is the subject of appellate litigation, the United States Trustee's write-off authority is further subject to the Director's approval. Permission to write-off amounts in excess of $20,000 must be requested of the Executive Office with submission to the Assistant Attorney General for Administration for action.

3-8.5.1 Confirmed Chapter 11 Cases

Under the provisions of 11 U.S.C. § 1129(a)(12), the court shall confirm a plan in a chapter 11 case only if the preconfirmation quarterly fees have been paid; otherwise, the plan must provide for their payment on the effective date of the plan. If pre or postconfirmation fees remain unpaid after the effective date of a confirmed plan, the circumstances of the case are to be evaluated and a determination made as to whether to seek enforcement of the plan or pursue other remedies. The United States Trustee may subsequently determine that the account is uncollectible according to the guidelines set forth at USTM 3-8.5.4.2.

3-8.5.2 Dismissed Chapter 11 Cases

The court may convert or dismiss a chapter 11 case for cause which may include the nonpayment of quarterly fees. 11 U.S.C. § 1112(b)(10). The prospect of this remedy provides a strong incentive for debtors to pay quarterly fees in order to remain in chapter 11. However, if fees are not paid and the chapter 11 case is dismissed, appropriate collection action is to be undertaken or, if the fee account is uncollectible, it should be written off according to the guidelines set forth in at USTM 3-8.5.4.2.

3-8.5.3 Converted Chapter 11 Cases

When quarterly fees remain unpaid in a chapter 11 case that has been converted to another chapter, the United States Trustee shall file a proof of claim in the converted case and/or take whatever steps are appropriate under the laws or rules applicable in the converted chapter. The balance owing after the filing of a no-asset report in the converted case or after a distribution to creditors in the converted case will ordinarily be treated as discharged under governing bankruptcy laws. Accordingly, the United States Trustee should recommend write-off of the debt as soon as practicable following conversion, but only after ensuring that the claim will be recognized and paid in the event of a distribution.

3-8.5.4 Standards

3-8.5.4.1 Timing of Write-off

Write-off should occur when, after pursuing all reasonable collection efforts, the United States Trustee determines that an account is uncollectible, that active collection efforts should terminate, and that the obligation should be removed as a receivable from the records.

3-8.5.4.2 Write-off Guidelines

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

1. The cost of further collection action will probably exceed the amount that could be recovered, taking into consideration:

   a. The fees associated with any collection activity. There are currently no procedures that allow the United States Trustee to incur costs for filing suit, obtaining or docketing judgments, and collecting on such judgments. Even if the United States Trustee obtains a judgment from the bankruptcy court, the court costs, filing fees, and other expenses of judgment collection may exceed any potential recovery. However, the United States Trustee can undertake collection efforts pursuant to the Federal Debt Collection Act. 28 U.S.C. § 3011. Under the Act, a surcharge of 10 percent of the amount of the debt can be imposed to cover costs of processing and handling the litigation and enforcement.

   b. The cost, in terms of time and resources, of further collection by the United States Trustee.

   c. The United States Trustee's inability to pass administrative costs (i.e., the cost of collection) along to the debtor or to otherwise recover them from other sources.

2. The likelihood of recovery is too remote to justify retaining the debt as a receivable because:

   a. the debtor cannot be located; or

   b. the debtor has no unencumbered property from which the amounts owed can be collected; or

   c. the applicable statute of limitations has expired; or

d. the debtor is deceased. (However, the United States Trustee may be able to file a claim against the debtor's probate estate if assets are available.)

3. The United States Trustee is unable to collect any substantial amount on the unpaid quarterly fees, taking into consideration:

a. the result of collection actions already undertaken by the United States Trustee (i.e., demand letters, telephone call, investigation into the debtor's assets, and the likelihood of recovery); or,

b. the failure of the bankruptcy court to render a judgment for unpaid quarterly fees; or,

c. the present and future financial condition of the debtor; or,

d. the age and health of the debtor, including disability status.

3-8.5.4.3 Effect of Write-off

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

3-8.5.5 **Debt Collection by Third Parties**

Though no uniform procedures have been adopted to refer unpaid quarterly fees to the United States Attorney (pursuant to 4 C.F.R. § 105.4) or to any other third party for collection, such action is not precluded in instances where the United States Trustee determines that recovery is feasible and the third party agrees to undertake such an effort.

3-8.5.6 **Documentation**

The United States Trustee is to report the write-off of all debts to the Budget Formulation and Revenue Branch of the Executive Office so that

appropriate adjustments in the chapter 11 accounting system can be made. A standardized form promulgated by the Executive Office for this purpose may be utilized. The write-off amount should be reconciled with quarterly disbursement and fee reports, listings, etc., and any discrepancies should be resolved prior to submission of the write-off. The United States Trustee must approve, in writing, all write-offs.

CHAPTER 3-9: MONITORING THE CASE

3-9.1 CASE ADMINISTRATION

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

3-9.2 STANDING

Section 307, added to the Bankruptcy Code in 1986, explicitly grants the United States Trustee standing in bankruptcy cases, including those under chapter 11. Several cases have also clarified the United States Trustee's standing. See In re Columbia Gas Sys., Inc., 33 F.3d 294, 296-97 (3d Cir. 1994); In re Clark, 927 F.2d 793, 796 (4th Cir. 1991); In re Plaza de Diego Shopping Ctr., Inc., 911 F.2d 820, 824 (1st Cir. 1990); In re Revco D.S., Inc., 898 F.2d 498, 499-500 (6th Cir. 1990); Hayes and Son Body Shop, Inc. v. United States Trustee, 124 B.R. 66, 68 (W.D. Tenn. 1990), aff'd, 958 F.2d 371 (6th Cir. 1992). A challenge to the United States Trustee's standing in a chapter 11 case may be sanctionable. See Hayes and Son Body Shop, 124 B.R. at 68.

3-9.3 OBTAINING EVIDENCE

3-9.3.1 Section 341 Meeting

The efficacy of the United States Trustee's enforcement actions is dependent upon the compilation of a comprehensive evidentiary record. The foundation of that record most often consists of documents such as schedules and operating reports. In some instances, however, it may be necessary to obtain additional material for use at an evidentiary hearing. 11 U.S.C. § 341 requires that the United States Trustee convene a meeting of creditors in each case. The business of the meeting includes the examination of the debtor under oath. See 11 U.S.C. § 343 and Fed. R. Bankr. P. 2003(b)(1). The scope of the examination that can be conducted at the meeting is very broad. Questioning that relates to the acts, conduct, property, liabilities and financial condition of the debtor; the administration of the estate; or the debtor's right to a discharge is permissible. The examination may also relate to the operation of the debtor's business and issues relevant to the formulation of a plan. See Fed. R. Bankr. P. 2004(b). As a result, the examination of the debtor at the section 341 meeting is often a vital and productive source of information. Because the United States Trustee schedules and presides over the meeting, may continue the meeting from time to time to allow for additional questioning, and may even convene a special meeting if necessary, the meeting has great importance as a discovery device. See Fed. R. Bankr. P. 2003(e) and (f). For a further discussion of section 341 meetings, see USTM 3-5.

3-9.3.2 Fed. R. Bankr. P. 2004 Examination

Fed. R. Bankr. P. 2004 provides that the court, on motion of any party in interest, may order the examination of any entity. In addition to obtaining a court order, a subpoena should be issued to the person sought for examination, unless the examination is by agreement. The permissible scope of an examination under Fed. R. Bankr. P. 2004 is very broad. See In re Isis Foods, Inc., 33 B.R. 45, 46-47 (Bankr. W.D. Mo. 1983). However, the examination must not stray into matters irrelevant to the basic inquiry and cannot be utilized for purposes of abuse or harassment. See In re Mittco, Inc., 44 B.R. 35, 36 (Bankr. E.D. Wis. 1984). See also In re M4 Enters., Inc., 190 B.R. 471, 475 (Bankr. N.D. Ga. 1995).

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

A Fed. R. Bankr. P. 2004 examination may not be available if a contested matter has already been commenced. Some courts have ruled that a party to a contested matter has to use the procedures for taking a deposition rather than those for a Fed. R. Bankr. P. 2004 examination when that party seeks information after filing its motion. See In re Blinder, Robinson & Co., 127 B.R. 267, 274 (D. Colo. 1991); In re Ecam Publications, Inc., 131 B.R. 556, 559 (Bankr. S.D.N.Y. 1991). Accordingly, the United States Trustee should conduct appropriate Fed. R. Bankr. P. 2004 examinations prior to filing a motion or application.

3-9.3.3 Other Discovery Devices and Orders to Compel Attendance for Examination

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

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

3-9.4 PROBLEMS AND RESPONSES

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

3-9.4.1 Failure to File Schedules

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

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

The United States Trustee should seek to ensure that the schedules are on file prior to the first section 341 meeting. However, even if the schedules have not been filed by that date, the section 341 meeting must be conducted as scheduled. The meeting can then be continued to a later date to allow for further examination of the debtor regarding the content of the schedules.

3-9.4.2 Failure to Attend Section 341 Meeting

Section 343 of the Bankruptcy Code requires the debtor to appear and be examined by creditors, the United States Trustee, and other parties in interest at the section 341 meeting. If the debtor fails to appear, cause exists for the dismissal or conversion of the case. See In re Rust, 1 B.R. 656, 657 (Bankr. M.D. Tenn. 1979). The totality of the circumstances must be considered when determining the appropriate action to take. See In re Vilt, 56 B.R. 723, 725 (Bankr. N.D. Ill. 1986).

3-9.4.3 Failure to Designate Corporate Official

A corporate or partnership debtor must designate an official to act on its behalf during bankruptcy proceedings, as, for example, by appearing at the first section 341 meeting or a Fed. R. Bankr. P. 2004 examination, or by signing appropriate documents as required by rule or order of the court.

The failure to designate a corporate official occurs most frequently in involuntary cases.

Pursuant to Fed. R. Bankr. P. 9001(5), any one of the officers, a member of the board of directors, a controlling stockholder of a corporate debtor, or any person in control may be designated by court order to perform certain acts or to appear for examination. Such an order may help lay the groundwork for a motion to dismiss a case. For example, if an order is entered compelling a corporate officer to attend a section 341 meeting and the officer fails to attend, then cause may exist to dismiss the case.

Rather than obtaining an order directing an individual to appear on behalf of the debtor, the United States Trustee may immediately move for the conversion or dismissal of the case. The debtor's failure to designate an individual may indicate significant problems with the debtor and its operations that would constitute “cause” under 11 U.S.C. § 1104 or 1112.

3-9.4.4 **Failure to File Operating Reports**

Pursuant to 11 U.S.C. § 704(7) and (8) (made applicable in chapter 11 cases by 11 U.S.C. §§ 1106(a)(1) and 1107(a) and Fed. R. Bankr. P. 2015), the debtor is required to file financial reports on a periodic basis. See In re Cloisters of Brevard, Inc., 117 B.R. 722, 723 (Bankr. M.D. Fla. 1990); In re Modern Office Supply, Inc., 28 B.R. 943, 945-46 (Bankr. W.D. Okla. 1983). If a debtor does not file these reports, then the ability of parties in interest and the United States Trustee to monitor the operations of the debtor is impaired. For example, the United States Trustee will not be able to determine if the debtor is current with postpetition obligations, is making improper payments to professionals, or has paid the correct United States Trustee quarterly fee.

If a debtor fails to file complete financial reports, the United States Trustee may seek an order compelling the filing of the reports or may request more drastic relief, such as the appointment of a trustee or examiner, conversion, or dismissal. If the United States Trustee elects to request an order compelling filing, that order should also direct the debtor to file all future reports timely. Violation of such an order may be cause for dismissal or conversion.

The failure to file complete financial reports may constitute cause for the appointment of a trustee or an examiner. See In re Cumberland Inv. Corp., 118 B.R. 3, 7-8 (Bankr. D.R.I. 1990), aff'd and appeal dismissed, 133 B.R. 275 (D.R.I. 1991); In re Cohoes Indus. Terminal, Inc., 65 B.R. 918, 922-23 (Bankr. S.D.N.Y. 1986); In re Pittman, 58 B.R. 502, 502-03 (Bankr. S.D. Tex. 1986). The failure to file reports may also constitute cause for the conversion or dismissal of a case. See In re Berryhill, 127 B.R. 427, 433-34 (Bankr. N.D. Ind. 1991); In re Cloisters of Brevard, Inc., 117 B.R. at 723-24; In re Vallejo, 77 B.R. 365, 367 (Bankr. D.P.R. 1987); In re Wells, 71 B.R. 554, 557-58 (Bankr. N.D. Ohio 1987). See also In re Tornheim, 181 B.R. 161, 164 (Bankr. S.D. N.Y. 1995).

3-9.4.5 Failure to Maintain Insurance or to Pay Administrative Taxes

The chapter 11 debtor is authorized to continue to operate its business, unless the court orders otherwise. 11 U.S.C. § 1108. A debtor has all of the duties and responsibilities of a trustee, including the obligation to maintain insurance and pay taxes. 11 U.S.C. § 1107(a).

A debtor's failure to maintain proper insurance is a breach of its fiduciary obligations. See In re Caroline Desert Disco, Inc., 5 B.R. 536 (Bankr. C.D. Cal. 1980). The insurance required of a debtor extends beyond property insurance to protecting the tangible assets of the estate from loss. For example, if the debtor's business is open to the public and the debtor does not have liability insurance, the business should be closed until such time as insurance is obtained and written verification submitted to the United States Trustee. In order to minimize the risk to innocent third parties, any motion seeking to terminate the debtor's operations should also request an expedited hearing. If the debtor is unable to purchase insurance, then a motion to convert or dismiss is appropriate.

Failure to remit taxes is also a breach of the debtor's statutory obligations and fiduciary duties. See 11 U.S.C. § 346(f); 28 U.S.C. §§ 959 and 960. A debtor is presumed to be aware of the withholding requirements of federal and state law. See In re WPAS, Inc., 6 B.R. 40, 44 (Bankr. M.D. Fla. 1980). Unpaid postpetition taxes are administrative claims, and failure to make payment prejudices the estate and creditors. Nicholas v. United States, 384 U.S. 678 (1966); In re Laub Baking Co., 642 F.2d 196, 197 (6th Cir. 1981). But see 11 U.S.C. § 305(b)(1)(A). A failure to remit taxes may indicate the absence of a reasonable likelihood of rehabilitation,

which constitutes grounds for conversion or dismissal pursuant to 11 U.S.C. § 1112(b)(1).

When the United States Trustee commences a proceeding to convert or dismiss a case because of the failure to pay postpetition taxes, the United States Attorney, the State's Attorney General, or any appropriate taxing authorities should be notified so that they may respond to the motion. The United States Trustee's arguments may be strengthened by the participation at the hearing of other governmental agencies and taxing authorities.

3-9.4.6 Failure to File a Plan of Reorganization and/or Disclosure Statement

Section 1121(d) of the Bankruptcy Code authorizes the court, for cause, to extend, shorten, or fix the time during which only the debtor may file a plan and disclosure statement. 11 U.S.C. § 1121(b) and (e), which establish the exclusive period within which only the debtor may file a plan, do not impose any requirement that the debtor actually file a plan or suffer specific consequences. See In re Fernandez, 97 B.R. 262, 263 (Bankr. E.D.N.C. 1989). The bankruptcy court has the authority to set a deadline for the filing of a plan and disclosure statement. See In re Hollander, 50 B.R. 15 (Bankr. S.D. Fla. 1985).

In some districts, local rules or standing orders set deadlines for the filing of plans and disclosure statements. If no previous order or rule has established a deadline, then the United States Trustee may apply to the court for an order fixing a date for the debtor to file a plan and disclosure statement. Such a motion should be filed only after giving due consideration to the size and complexity of a case, as well as to the status of any outstanding litigation and ongoing negotiations. If an order is entered directing the debtor to file a plan and disclosure statement and those documents are not filed by the time set forth in the order, cause exists to convert or dismiss the case. 11 U.S.C. § 1112(b)(4). See also In re Kang, 18 B.R. 680, 680-81 (Bankr. N.D. Ind. 1982).

The United States Trustee may also object to an application of the debtor to extend the exclusivity period. A debtor seeking an extension of the exclusivity period must demonstrate that "cause" justifying the extension exists. See In re All Seasons Indus., Inc., 121 B.R. 1002 (Bankr. N.D. Ind. 1990); In re United Press Int'l, Inc., 60 B.R. 265, 269 (Bankr. D.D.C.

1986). Cause might include an unusually large case or recalcitrance among creditors. The debtor must demonstrate some promise of probable success in the reorganization effort. S. Rep. No. 989, 95th Cong., 2d Sess. 118 (1978). A request for an extension must be made prior to the expiration of the exclusivity period. 11 U.S.C. § 1121(d). The United States Trustee should object to an untimely request for an extension. See In re Cramer, Inc., 105 B.R. 433, 434 (Bankr. W.D. Tenn. 1989).

Section 158(a) of title 28, as amended by the Bankruptcy Reform Act of 1994, allows an immediate appeal as of right to the district court from a bankruptcy court's order extending or reducing the debtor's exclusivity period. Participation by the United States Trustee in such an appeal must be authorized by the Executive Office.

3-9.4.7 Failure to Give Proper Notice of a Settlement Agreement, the Disposition of Property, or a Cash Collateral/Adequate Protection Agreement

Fed. R. Bankr. P. 2002 and 4001 require specific notice of certain actions by the debtor. The technical requirements of these rules may be violated, intentionally or not, in three common situations: use/sale/lease of property other than in the ordinary course of business; settlement of a controversy; or settlement of a cash collateral or adequate protection dispute.

If notice of a transaction has not been given, the United States Trustee should alert the parties involved. If these parties fail to remedy the notice problem, the United States Trustee should apply to the court for an appropriate remedy, such as setting aside the transaction. The fact that a sale may have been for full value or that the settlement is appropriate does not excuse failure to comply with Fed. R. Bankr. P. 2002 and 4001, but may influence the choice of remedial action.

3-9.4.8 Failure to Deposit or Invest Funds as Required by 11 U.S.C. § 345

Usually the debtor in possession is required to open new bank accounts in an authorized depository, which is a bank that agrees to post collateral or a bond to protect uninsured amounts or deposits and also to report on a debtor’s bank activity on a monthly basis. Protection may also be provided by a deposit or investment “insured or guaranteed by the United

States . . . or backed by the full faith and credit of the United States. . . ." 11 U.S.C. § 345(b). The court, for cause, may modify these requirements.

Each region should have in place an authorized depository program. Banks participating in the program must agree to pledge appropriate securities to the Federal Reserve Bank to protect any bankruptcy estate funds not covered by deposit insurance (any amount over $100,000 per debtor is not insured) or to post a bond. As required by 11 U.S.C. § 345(b)(2), securities used as collateral must be of the kind specified in 31 U.S.C. § 9303. Section 9303 specifies that government obligations may be used as security. A "government obligation" in turn is defined in 31 U.S.C. § 9301(2) as a public debt obligation of the United States Government and an obligation whose principal and interest is unconditionally guaranteed by the government. In light of this definition, only United States Treasury Bills, Bonds, or Notes are deemed to constitute acceptable securities for purposes of the authorized depository system. See In re Columbia Gas Sys., Inc., 33 F.3d 294 (3d Cir. 1994).

If a debtor fails to deposit funds in an insured account or otherwise fails to comply with 11 U.S.C. § 345, the United States Trustee must take action. The United States Trustee should seek an order of the court directing the debtor to comply with the requirements of 11 U.S.C. § 345. The debtor's failure to comply constitutes cause for the United States Trustee to seek conversion, dismissal, or the appointment of a trustee.

Foreign bank accounts present special problems and concerns. In cases requiring the maintenance of foreign accounts, consideration should be given to the development of investment guidelines. Such guidelines (in the form of a court order) can be utilized to establish maximum deposit levels for foreign accounts and minimum ratings for banks which the debtor proposes to utilize. The guidelines should also set forth any additional reporting or oversight procedures necessary for the United States Trustee to properly monitor the overseas accounts. See In re Interco, Inc., 130 B.R. 301, 303 (Bankr. E.D. Mo. 1991).

If the depository elects to provide protection by posting a bond, the United States Trustee must ensure that the amount of the bond is adequate. It should exceed, by a healthy margin, the total of all deposits. The United States Trustee should also ensure that the surety has adequate reserves to make good on the bond. Before approving the surety, the United States

Trustee should inquire as to the amount of other bonds issued for this purpose to be certain the surety is not overextended.

3-9.4.9 **Continuing Losses or Other Diminution of the Estate**

If the debtor is operating at a deficit during the pendency of a case, the United States Trustee should consider filing a motion to convert the case. However, before filing such a motion, the United States Trustee must consider any special circumstances that exist in the case. For example, the debtor may possess assets which would return value over the long term but do not contribute much to cash flow or may possess intangible assets of value (e.g., tax benefits) or may be able to obtain an infusion of third party funds that would allow it to emerge successfully from chapter 11.

3-9.4.10 **Improper Postpetition Transfers**

Generally, if a debtor transfers property of the estate after the commencement of the case outside the ordinary course of business and the transfer is not authorized pursuant to an order of the court or under the Bankruptcy Code, the debtor has entered into a voidable postpetition transaction. 11 U.S.C. § 549. For example, a debtor may pay all or part of its prepetition obligations to its suppliers for fear that they might otherwise refuse to do business with the debtor. Such conduct "raises serious questions as to the ability and motivation of the debtor in possession. . . ." See In re E. Paul Kovacs and Co., 16 B.R. 203, 205 (Bankr. D. Conn. 1981).

If the debtor fails to take any corrective action, the United States Trustee should seek the appointment of a trustee or an examiner with the power to review and pursue such postpetition payments. In the alternative, such complete disregard for the requirements of the Bankruptcy Code constitutes cause for conversion or dismissal of the case under 11 U.S.C. § 1112. See In re Sal Caruso Cheese, Inc., 107 B.R. 808, 821 (Bankr. N.D.N.Y. 1989).

3-9.4.11 **Failure to Comply with Court Order**

If an order has been entered directing the debtor to file operating reports, schedules, a plan, etc., and the debtor has failed to comply with such an order, the United States Trustee should move to convert or dismiss the

case or seek the appointment of a trustee. Failure to comply with a court order may demonstrate both an inability to reorganize, as well as a lack of adherence to fiduciary standards. Such a failure has been held to be cause justifying dismissal or conversion of a case. See In re Bayou Self, Inc., 73 B.R. 682, 683-84 (Bankr. W.D. La. 1987); In re Coram Graphic Arts, 11 B.R. 641, 645 (Bankr. E.D.N.Y. 1981). Some courts have held that failure to pay postpetition taxes may constitute cause to convert or dismiss under 11 U.S.C. § 1112(b). See In re Berryhill, 189 B.R. 463, 465-66 (N.D. Ind. 1995).

3-9.4.12 Unauthorized Postpetition Payments to Professionals

If a debtor pays any of its professionals subsequent to the commencement of the case and without court approval, the United States Trustee should first ask the professional to remit the amount received. If the professional ignores the request, the United States Trustee may apply to the bankruptcy court for an order directing disgorgement of the payments. See Lavender v. Wood Law Firm, 785 F.2d 247, 249 (8th Cir. 1986); Matter of Kero-Sun, Inc., 58 B.R. 770, 780-81 (Bankr. D. Conn. 1986). Such payments also qualify as improper postpetition transfers and the remedies discussed at USTM 3-9.4.10 should be considered.

3-9.4.13 Ongoing Insolvency Proceedings in Another Forum

A chapter 11 case may be commenced for or against a debtor that is already subject to similar proceedings in another state or country, or against a partnership that is already winding up its affairs pursuant to state law. 11 U.S.C. § 305 permits the bankruptcy court to abstain from hearing such a case or to suspend the proceedings in the case for a period of time.

11 U.S.C. § 305 can be invoked when: (1) the debtor is involved in a bankruptcy case in a foreign country; or (2) the debtor is a partnership that has dissolved pursuant to state law and is "winding up" under applicable state statutes. See In re AXL Indus., Inc., 127 B.R. 482, 485 (S.D. Fla. 1991), aff'd in part dismissed in part, 977 F. 2d 598 (11th Cir. 1992); In re Trina Assocs., 128 B.R. 858, 867-68 (Bankr. E.D.N.Y. 1991).

Suspension of all proceedings in a case pursuant to 11 U.S.C. § 305 also suspends the debtor's obligation to pay United States Trustee quarterly fees.

3-9.4.14 Sale of Substantially All of a Debtor's Assets

The sale of all or substantially all of a debtor's assets is usually accomplished through a plan of reorganization. However, in some instances, debtors have sought court authority to consummate such a sale by motion. Obviously, a motion to sell can be addressed and resolved more quickly than a plan can be brought to confirmation. Many courts do not find a sale of most or all of a debtor's assets by motion to be objectionable. See Stephens Indus., Inc. v. McClung, 789 F.2d 386, 388-90 (6th Cir. 1986); In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983). Other courts, however, have found such sales objectionable on the grounds that they short circuit the protections for creditors crafted into the plan confirmation requirements of the Bankruptcy Code. See In re Braniff Airways, Inc., 700 F.2d 935, 939-40 (5th Cir. 1983), reh'g denied, 705 F.2d 450 (5th Cir. 1983). Such sales may also have significant tax consequences that must be considered.

The United States Trustee must become familiar with the prevailing case law regarding this issue in his/her district(s). If significant asset sales outside the context of a plan are allowed in a district, the United States Trustee must ensure that the sales are properly noticed. If a previous order has been entered in the case limiting notice, consider whether notice of the proposed transaction should be expanded to include all creditors and parties in interest. If the sale is a private sale, consideration should be given as to how value was determined. The United States Trustee should assess whether an auction of the assets is likely to generate more for the estate. If the sale is to an insider, valuation methods should be closely scrutinized to guard against the potential for fraud and/or criminal violations, as well as to ensure that full value is provided to the estate. Similarly, greater scrutiny by the United States Trustee of valuation methods is required in cases where there is no active creditors' committee.

3-9.4.15 Failure to Pay Quarterly Fees

Prior to confirmation, if informal efforts to obtain payment of delinquent quarterly fees are not successful, the United States Trustee should

consider filing a motion to convert or dismiss or seek an order of the court directing payment, depending on the circumstances. A debtor that is not paying quarterly fees most likely has other outstanding postpetition obligations. The motion to convert or dismiss should identify all the deficiencies. The United States Trustee should not favor conversion over dismissal merely because quarterly fees have not been paid in full. See In re Markhon Indus., Inc., 100 B.R. 432, 434-36 (Bankr. N.D. Ind. 1989). A reorganization plan cannot be confirmed unless provision is made for the payment of all outstanding quarterly fees no later than the effective date of the plan. See 11 U.S.C. § 1129(a)(12).

The issue of performance by the reorganized debtor under the confirmed plan is complex. Very often creditors lose contact and are unaware that the reorganized entity is not doing what the plan requires. Creditors are also unsure as to how to remedy such a problem. Complaints to the United States Trustee may lead to temporary relief, but remedies are limited. Some courts will not entertain a motion compelling performance.

The issue of requesting conversion or dismissal as a remedy for nonperformance is more complex. The courts are split in their analysis of the effect of conversion upon a chapter 11 case with a confirmed plan. Some courts take the position that, upon conversion of a chapter 11 case postconfirmation, only those assets remaining that did not revest in the debtor become part of the chapter 7 estate. See In re T.S.P. Indus., Inc., 117 B.R. 375, 378-79 (Bankr. N.D. Ill. 1990). In most cases, this would leave the chapter 7 trustee with nothing to administer.

Some courts, however, have found that assets in which "the Debtor had a cognizable legal or equitable ownership interest on the date of confirmation will be properties of the estate in a Chapter 7 case, but properties which are clearly acquired by the Debtor postconfirmation will not be subject to administration by the Chapter 7 trustee." See In re Calania Corp., 188 B.R. 41, 43 (Bankr. M.D. Fla. 1995).

Other cases appear to have gone even further and hold that assets acquired after confirmation but before conversion are also subject to chapter 7 administration. See In re Midway, Inc., 166 B.R. 585, 590 (Bankr. D.N.J. 1994). In order to avoid this potential problem, the United States Trustee should consider language in the confirmation order that revests all property in the estate upon conversion.

In all likelihood, if a debtor is not paying postconfirmation quarterly fees, the debtor is not making payments under the confirmed plan. If, in fact, there is no money to pay anyone and there is no property for a chapter 7 estate, dismissal is most appropriate in those jurisdictions where case law would leave nothing in the estate of a converted debtor. See In re Motorworks, Inc., 85 B.R. 661, 662 (Bankr. S.D. Ga. 1988).

3-9.4.16 **Environmental Problems**

State or federal regulatory agencies may be pursuing a debtor because the debtor's operations generate or have generated toxic waste. The debtor may be liable for cleanup costs of environmentally contaminated sites. See generally the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"), 42 U.S.C. § 9601 et. seq. If significant litigation regarding environmental problems is ongoing in another forum, parties may ask the bankruptcy court to abstain from exercising jurisdiction in the case or to suspend all proceedings pursuant to the provisions of 11 U.S.C. § 305(a). In most instances, the United States Trustee should not initiate such an action.

If the environmental problems present in a particular case are of such magnitude that the debtor has no realistic prospect of reorganization, the United States Trustee should seek dismissal of the case. Conversion would create significant problems and potential liability for a chapter 7 trustee.

3-9.5 **CHOICE OF REMEDY--DISMISSAL OR CONVERSION**

3-9.5.1 **11 U.S.C. § 1112**

Section 1112 of the Bankruptcy Code contains the statutory provisions applicable to the conversion or dismissal of chapter 11 cases. 11 U.S.C. § 1112(a) gives the debtor the absolute right to convert a voluntary chapter 11 case in which the debtor remains in possession to a case under chapter 7. In re Dieckhaus Stationers of King of Prussia, Inc., 73 B.R. 969, 971 (Bankr. E.D. Pa. 1987). 11 U.S.C. § 1112(b) provides that the court, on request of a party in interest or the United States Trustee and after notice and a hearing, may dismiss or convert a chapter 11 case for "cause." The statute contains a list of ten factors which may constitute cause, including the inability to effectuate a plan and unreasonable delay

by the debtor. The list is not exclusive. Additional benchmarks of cases unlikely to confirm a plan include failure to comply with a court order, failure to timely satisfy filing or reporting requirements, failure to appear before the court or the United States Trustee for scheduled hearings or meetings, failure to pay postpetition taxes or file postpetition tax returns, and failure to act diligently in proposing a plan. The court is able to consider other factors as they arise and use its equitable powers to reach an appropriate result in a particular case. See H. Rep. No. 595, 95th Cong., 1st Sess. 405 (1977).

Once cause has been established, the decision whether to dismiss or convert a case is made by determining which of these remedies is in the best interest of creditors and the estate in the matter under consideration. In the event that cause is established after a plan is confirmed, additional considerations may apply. See USTM 3-10.7 on postconfirmation monitoring. 11 U.S.C. § 1112(c) provides that the court may not convert a chapter 11 case to a case under chapter 7 if the debtor is a farmer or is not a moneyed, business, or commercial corporation, unless the debtor requests such conversion. 11 U.S.C. § 1112(d) sets forth the conditions under which a chapter 11 case may be converted to a case under chapter 12 or chapter 13. Finally, 11 U.S.C. § 1112(f) provides that a chapter 11 case may not be converted to a case under any other chapter of the Bankruptcy Code unless the debtor is eligible to be a debtor under that chapter. See 11 U.S.C. § 109.

3-9.5.2 Dismissal

Dismissal of a chapter 11 case is preferable to conversion if no assets remain to be administered by a chapter 7 trustee. In addition, conversion of a case should be avoided when such an action would subject a chapter 7 trustee to risk of liability, such as when the debtor holds property contaminated by toxic waste.

The effect of an order dismissing a bankruptcy case is governed by 11 U.S.C. § 349. Section 349(a) provides, in general, that the dismissal of a case is without prejudice. However, a dismissal with prejudice can be imposed if the court, for cause, so orders. A dismissal with prejudice bars the discharge in a later case of debts that were dischargeable in the case dismissed. 11 U.S.C. § 349(b) provides that an order of dismissal operates to undo the bankruptcy case, in so far as practicable, and restores

the status quo regarding property rights that existed at the commencement of the case.

The United States Trustee should ensure that an order of dismissal is conditioned on payment of any unpaid quarterly fees. If the order conditions dismissal upon the filing of a report of all unpaid administrative expenses and the payment of those sums, the United States Trustee should ensure that those conditions are met.

3-9.5.3 Conversion

Conversion of a case from chapter 11 to chapter 7 may be appropriate if assets exist which can be liquidated for the benefit of creditors. Conversion is not appropriate if the debtor merely seeks to unburden itself of environmental problems and saddle a trustee with those liabilities.

The effect of an order converting a bankruptcy case is governed by 11 U.S.C. § 348. Section 348(a) provides that conversion constitutes an order for relief under the new chapter. However, except as provided in 11 U.S.C. § 348(b) and (c), the conversion of a case does not effect a change in the filing date, the commencement of the case, or the date of the order for relief. Under 11 U.S.C. § 348(d), a claim arising after the order for relief under chapter 11, but before conversion of the case under 11 U.S.C. § 1112 (other than a claim specified in 11 U.S.C. § 503(b)), "shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition."

Most claims arising in the chapter 11 case have a lower priority than those arising under the new chapter. An exception is United States Trustee quarterly fees. Conversion terminates the service of any trustee or examiner appointed in the chapter 11 case. See 11 U.S.C. § 348(e). However, that trustee may be reappointed as the chapter 7 trustee. See 11 U.S.C. § 701(a)(1).

Conversion does not negate all actions taken while the case was pending in chapter 11. The schedules, statement of financial affairs, and statement of executory contracts filed in the prior case are deemed to be filed in the converted case. If any of these documents were not filed, the debtor is required to comply with Fed. R. Bankr. P. 1007 as if an order for relief

had been entered on the date of the order of conversion. See Fed. R. Bankr. P. 1019(1).

The conversion of a case to chapter 7 results in the immediate ouster of the debtor in possession and the appointment of an interim trustee as provided in 11 U.S.C. § 701. Unless the interim chapter 7 trustee seeks a court order authorizing the continued operation of the business, the business operations of the debtor must cease immediately upon conversion of the case. See 11 U.S.C. § 721. In the event the assets of a partnership debtor are insufficient to pay claims, a trustee may have a claim against the general partner to the extent of the general partner's personal liability under applicable non-bankruptcy law. See 11 U.S.C. § 723 and Fed. R. Bankr. P. 1007(g).

If a case is converted to one under chapter 7, 12, or 13 pursuant to 11 U.S.C. § 1112, the debtor is required to file a schedule of unpaid obligations incurred after the commencement of the chapter 11 case. See Fed. R. Bankr. P. 1019(5). The United States Trustee should file a proof of claim for unpaid quarterly fees in the converted case. Pursuant to 11 U.S.C. § 726(b), fees assessed under 28 U.S.C. § 1930 (including United States Trustee quarterly fees) are not subordinated to chapter 7 administrative expenses. See, e.g., In re Juhl Enters., Inc., 921 F.2d 800, 803 (8th Cir. 1990); In re K & M Printing & Lithographing, Inc., 135 B.R. 404, 406-07 (Bankr. D. Or. 1992); In re AM-PM Photo Camera Fashions, Inc., 116 B.R. 222, 222 (Bankr. D. Idaho 1990). See also In re Endy, 104 F.3d 1154, 1157-58 (9th Cir. 1997).

3-9.6 APPOINTMENT OF A TRUSTEE OR EXAMINER

3-9.6.1 11 U.S.C. § 1104

Section 1104 of the Bankruptcy Code sets forth the statutory provisions regarding the appointment of a trustee or examiner. 11 U.S.C. § 1104(a)(1) permits the court, upon request by the United States Trustee or a party in interest, to order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause . . . ."

In the alternative, the court can order the appointment of a trustee pursuant to the provisions of 11 U.S.C. § 1104(a)(2). This subsection provides that the court may order the appointment of a trustee if such an appointment is determined to be in the interests of creditors, any equity security holders, and other interests of the estate.

If the court does not order the appointment of a trustee, subsection (c) permits the court, on request of a party in interest or the United States Trustee, to order the appointment of an examiner. Such an appointment shall be ordered: (i) if it is determined to be in the interests of creditors, any equity security holders, and other interests of the estate; or (ii) if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

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

3-9.6.2 Choice of Remedy -- Trustee or Examiner

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

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

Under 11 U.S.C. § 1104(a)(2), a trustee may also be appointed if it is in the interest of creditors. In cases where the principal dies or resigns, the United States Trustee should apply for an order directing the appointment of a trustee. See In re William A. Smith Constr. Co., 77 B.R. 124, 127-28 (Bankr. N.D. Ohio 1987); In re Martin, 26 B.R. 39, 40-41 (Bankr. S.D. W. Va. 1982). The United States Trustee should also consider moving for the appointment of a trustee in those cases in which the debtor's property is in the possession of a receiver or custodian. For example, if the debtor has not sought a turnover of property of the estate under 11 U.S.C. § 543 and the United States Trustee has reason to believe that the receiver has acted wrongfully or is not rendering satisfactory reports, then the United States Trustee should seek the appointment of a trustee to oust the receiver. See In re WPAS, Inc., 6 B.R. 40, 42-43 (Bankr. M.D. Fla. 1980).

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

Section 1104(c) of the Bankruptcy Code requires the court to order the appointment of an examiner if a request for the appointment is made by the United States Trustee or other party in interest, and the debtor's fixed, liquidated, unsecured debts (other than debts for goods, services, taxes, or owing to an insider) exceed $5 million. See In re Revco D.S., Inc., 898 F.2d 498, 500-01 (6th Cir. 1990). The United States Trustee should not automatically request the appointment of an examiner in each case in which the dollar ceiling is exceeded, but should give careful consideration of all relevant circumstances, including whether the tangible benefit of an examiner warrants the additional administrative costs.

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

3-9.6.3 **Selection Process**

If a motion requesting the appointment of a trustee or an examiner is granted by the court, an order directing the appointment will be entered. The statutory duties of both chapter 11 trustees and examiners are set out in 11 U.S.C. § 1106. Section 1106(a)(3) grants the court the authority to restrict the scope of the investigation that a trustee is authorized to conduct. 11 U.S.C. § 1106(b) contains similar language authorizing the court to limit the scope of the investigation to be conducted by an examiner. Court-imposed limitations on the permissible scope of an examination are most frequently set forth in the same order which authorizes the appointment of the trustee or examiner. The United States Trustee should ensure that any restrictions and limitations contemplated by the court are clearly set forth in the order. This will avoid the delay and expense that would be engendered by having to return to the court for clarification of the original order.

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

Section 1104(d) of the Bankruptcy Code requires the United States Trustee to consult with parties in interest prior to appointing a chapter 11 trustee or examiner. The United States Trustee should try to schedule a meeting with representatives of the major parties participating in a case. If a meeting is conducted, a written record should be maintained indicating who attended the meeting, the substance of the discussion, and the list of nominees suggested by the parties. If a meeting is impractical to schedule, the United States Trustee should telephone parties in interest and ask them to identify any particular qualifications they believe a candidate should possess. The focus should be on the needs of the particular case, not the candidate.

The United States Trustee should give full and fair consideration to each candidate. The United States Trustee is not required to select one of the candidates nominated by the parties, and the qualifications of the person chosen should always be a paramount consideration in the selection

process. However, the consultation process must be meaningful and the views of parties in interest must be accorded great weight in the decision-making process. Other significant factors to be considered include the nature of the task to be performed and the amount of time that the appointee will be able to devote to the case.

The statute speaks to the appointment of a disinterested person. The definition of the word "person" set forth in 11 U.S.C. § 101(41) includes partnerships and corporations, as well as individuals. While partnerships and corporations may be eligible to serve as trustees or examiners, the United States Trustee should, in most circumstances, appoint only individuals to fill these positions. By appointing an individual, responsibility and accountability are centered on one person rather than being diffused throughout a larger organization.

The implementation of this policy raises an important issue. The Bankruptcy Code does not expressly authorize the employment of professionals by examiners. Some courts hold that examiners may not employ professionals under 11 U.S.C. § 327. In some instances, this problem has been avoided by appointing a partnership or corporation to serve as an examiner. Such an appointment allows a number of professionals in the firm selected to assist with an investigation without requiring a resolution of the employment issue. At the same time, the accountability that comes with the appointment of an individual is sacrificed. Since the language of the Bankruptcy Code does not specifically prohibit the employment of professionals by examiners, the United States Trustee should not oppose such requests without adequate justification. See In re Tarkowski, 104 B.R. 828, 829-30 (Bankr. E.D. Mich. 1989); In re Tighe Mercantile, Inc., 62 B.R. 995, 999-1002 (Bankr. S.D. Cal. 1986). The appointment of an individual who shall retain professionals satisfies the need for accountability while ensuring that the examiner shall have adequate resources to conduct a thorough investigation.

Relatives of either the bankruptcy judge making the appointment or the United States Trustee responsible for the case cannot be appointed to serve as trustees or examiners. See Fed. R. Bankr. P. 5002. 11 U.S.C. § 1104(d) prohibits the United States Trustee from serving as a trustee or an examiner in a chapter 11 case. In addition, a person who has served as

the examiner in a case may not subsequently serve as trustee in the same case. See 11 U.S.C. § 321(b).

Treasury Circular 570 lists those companies holding certificates of authority as acceptable sureties on federal bonds. Only companies appearing on this list should be approved as sureties on trustee bonds by the United States Trustee.

All persons appointed to serve as trustees or examiners in a chapter 11 case must undergo a security clearance. In addition to their initial application form, they will be required to complete an affidavit in a format prescribed by the Executive Office and provide the information necessary to conduct name, fingerprint, tax, and credit checks. This information should be forwarded to the Office of Review and Oversight ("ORO") within ten working days after an appointment is made. ORO will notify the United States Trustee of any background information that requires additional clarification by the trustee or examiner. The resolution of questionable information will require an affidavit from the trustee or examiner.

Application forms are not required of any individual for whom a background investigation is already in progress or has been completed within the preceding five (5) years in connection with another chapter 11 appointment or as part of being appointed as a panel or standing trustee.

3-9.6.4 Court Approval of Trustee and Examiner Appointments

The United States Trustee's selection of a chapter 11 trustee or examiner is subject to court approval. 11 U.S.C. § 1104(d). After the selection has been made, the United States Trustee must prepare an application for approval of the appointment as prescribed by Fed. R. Bankr. P. 2007.1(c). The application must contain the following information:

1. the name of the person appointed; and

2. a statement, made to the best of the applicant's knowledge, of all the appointee's connections with the debtor, creditors, any other parties in interest, their respective attorneys and accountants, the United States Trustee, and all persons employed in the Office of the United States Trustee.

The appointee must also prepare a verified statement setting forth any connections, which should be attached to and filed with the United States Trustee's application. The term "connections" is not defined in the rules, however, the Advisory Committee note accompanying the rule contains the following explanation:

> The requirement that connections with the United States trustee or persons employed in the United States trustee's office be revealed is not intended to enlarge the definition of "disinterested person" in § 101(13) [redesignated as § 101(14)] of the Code, to supersede executive regulations or other laws relating to appointments by United States trustees, or to otherwise restrict the United States trustee's discretion in making appointments. This information is required, however, in the interest of full disclosure and confidence in the appointment process and to give the court all information that may be relevant to the exercise of judicial discretion in approving the appointment of a trustee or examiner in a chapter 11 case.

Fed. R. Bankr. P. 2007.1 Advisory Committee Note (1991).

If the appointee is a former employee of the United States Trustee's office responsible for the case, or has a past professional relationship with either the United States Trustee or an employee of the United States Trustee in the region where the case is pending, that relationship must be disclosed. Other factors may be significant and any reasonable doubts regarding the relevance of a particular set of circumstances should be resolved in favor of full disclosure. See In re The Leslie Fay Cos., Inc., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994).

While 11 U.S.C. § 1104(d) grants the court authority to approve the United States Trustee's appointment of a chapter 11 trustee or examiner, the scope of the court's review is not unlimited. See In re Lathrop Mobile Investors, 55 B.R. 766, 768-69 (B.A.P. 9th Cir. 1985). In determining whether to approve an appointment, it is permissible for the court to consider factors including: (1) whether the United States Trustee has properly consulted with parties in interest; (2) whether the appointee is a disinterested person; and (3) whether the United States Trustee has abused his/her discretion by appointing an unqualified or inexperienced person. See In re Capital Servs. & Invs., Inc., 90 B.R. 382, 384-86 (Bankr. C.D.

Ill. 1988). The court, however, may not usurp the appointment process or otherwise seek to supplant the judgment exercised by the United States Trustee during that process. See In re Plaza de Diego Shopping Ctr., Inc., 911 F.2d 820, 830-32 (1st Cir. 1990).

3-9.6.5 Termination of a Trustee's Appointment

Under 11 U.S.C. § 1105, the court, on request of the United States Trustee or a party in interest and after notice and a hearing, may terminate the trustee's appointment and restore the debtor to possession. The removal of the trustee may reflect a change in the circumstances under which the appointment was made. See In re Eastern Consol. Utils., Inc., 3 B.R. 591, 592-93 (Bankr. E.D. Pa. 1980). While the result of this order would place the debtor in possession back in control of the operation of the business, the court may nevertheless order the operation of the business to cease under 11 U.S.C. § 1108.

3-9.6.6 Removal of a Trustee or Examiner

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

The Bankruptcy Code does not list specific grounds constituting cause for removal. Determining whether circumstances warrant the removal of a trustee or examiner is necessarily left to the court on a case-by-case basis. Many of the reported decisions on the application of 11 U.S.C. § 324 arise in the context of chapter 7 cases. See USTM 2-2.16.3. As with chapter 7 trustees, the United States Trustee must ensure that chapter 11 trustees and examiners are appropriately supervised and held accountable for their actions. To the extent that these individuals are not filing reports or otherwise complying with their fiduciary obligations, a motion seeking their removal should be filed. Unless the court orders otherwise, the removal of a trustee or an examiner in any one bankruptcy case effects their removal in all other cases in which they are then serving. 11 U.S.C. § 324(b).

A trustee who has been removed must still file a final report and account of the administration of the estate. See 11 U.S.C. § 704(9) made applicable to chapter 11 trustees by 11 U.S.C. § 1106(a)(1). The removed

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

3-9.7 ELECTION OF A TRUSTEE

The Bankruptcy Reform Act of 1994 amended 11 U.S.C. § 1104 to allow creditors to elect a trustee in chapter 11 cases. Pursuant to 11 U.S.C. § 1104(b), the election of the chapter 11 trustee is to be conducted in the same manner as the election of a chapter 7 trustee. See Fed. R. Bankr. P. 2007.1 for procedures for the election of a chapter 11 trustee.

3-9.7.1 Requests for Election

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

If a timely request for election is made, the United States Trustee must convene a meeting of creditors. Notice should be given in the same manner as for any section 341 meeting. See Fed. R. Bankr. P. 2007.1(b)(2). Parties should be able to request the court to shorten the normal 20 day notice period. See Fed. R. Bankr. P. 9006(c)(1).

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

> [C]reditors may elect one person to serve as trustee in the case if election of a trustee is requested by creditors that may vote under

> subsection (a) of this section, and that hold at least 20 percent in amount of the claims specified in subsection (a)(1) of this section that are held by creditors that may vote under subsection (a) of this section.

As the language of 11 U.S.C. § 1104(b) specifically refers to 11 U.S.C. § 702(b), it would appear that Congress intended that eligible voters holding at least 20 percent in the amount of claims must request the election at the meeting convened upon the request of a party in interest. Therefore, although any single party in interest may request the United States Trustee to convene a meeting of creditors for the purpose of electing a trustee, the 20 percent "requesting" requirement of 11 U.S.C. § 702(b) must be met before the election may proceed. This interpretation comports with the policy underlying the enactment of 11 U.S.C. § 702(b), namely, "to insure that a trustee is elected only in cases in which there is true creditor interest, and to discourage election of a trustee by attorneys for creditors." H.R. Rep. No. 595, 95th Cong., 1st Sess. 102 (1977).

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

Because of the necessity for prompt disposition of objections to claims for the purposes of voting in an election, courts may make a temporary or provisional allowance of a claim without determining the amount or allowability of a claim for purposes of distribution. See In re Cohoes Indus. Terminal, Inc., 90 B.R. 67, 69-70 (S.D.N.Y. 1988); In re DB Drilling, Inc., 73 B.R. 953, 955 (Bankr. N.D. Tex. 1987). A claim or interest is deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a). A claim executed and filed in accordance with the rules constitutes prima facie evidence of the amount and validity of the claim. See Fed. R. Bankr. P. 3001(f). Accordingly, most courts have concluded

that a claim that is prima facie valid may not be denied the right to vote because of a mere general assertion that the claim is invalid. See, e.g., In re Poage, 92 B.R. 659, 664 (Bankr. N.D. Tex. 1988). The party objecting to the claim for voting purposes must go forward with the evidence to establish the invalidity of the claim. See In re Metro Shippers, Inc., 63 B.R. 593, 599 (Bankr. E.D. Pa. 1986).

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

The first step in determining whether a sufficient number of creditors has made a request for an election is to determine the proper "claims base" against which the 20 percent "requesting" requirement may be measured. There has been disagreement among courts over the method of calculating this percentage.

The court in In re Tartan Constr. Co., 4 B.R. 655 (Bankr. D. Neb. 1980), used as a base figure all scheduled non-priority unsecured creditors without regard to whether proofs of claim had been filed. The court included both wholly unsecured claims and the unsecured portion of secured claims in calculating the base figure. The court in Tartan determined that the intent of true creditor control would be frustrated if the determination was based only on claims filed. The court noted that the time period for filing a proof of claim extends well beyond the first meeting and, therefore, the claim cannot be considered "nonallowable" until the period has passed. Id. at 658. Several courts have agreed that the amount of scheduled unsecured claims should be used as the base figure. See In re Lindell Drop Forge Co., 111 B.R. 137, 144-45 (Bankr. W.D. Mich. 1990); In re DB Drilling, Inc., 73 B.R. 953, 955 (Bankr. N.D. Tex. 1987).

The opposite conclusion was reached in In re I.J.F., Inc., 1 C.B.C. 2d 907 (Bankr. S.D. Fla. 1980). The court determined that the calculation of the total amount of unsecured claims is limited to those claims on file at the time of the creditors' meeting. Id. at 908. The court based this conclusion on the language of Fed. R. Bankr. P. 2003(b)(3), which provides that a

creditor is only entitled to vote if a proof of claim has been filed. Id. A court has agreed with the line of cases which look to the proofs of claims on file as of the date of the section 341 meeting to determine the base of eligible claims. See In re Lake States Commodities, Inc., 173 B.R. 642, 646 (Bankr. N.D. Ill. 1994).

The Tartan line of cases is more persuasive in the context of the election of a chapter 11 trustee. As there is no requirement for filing a proof of claim in chapter 11, if the claim is not disputed, unliquidated, or contingent, the base for determining eligible claims should be the amount of scheduled unsecured claims.

3-9.7.2 Election Procedures

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

1. the case name and number;

2. the date of the meeting;

3. the names of all parties in attendance;

4. the name of the individual requesting the election and the claim represented, including the amount of the claim;

5. the name of the claimant requesting an election, a copy of the claim, and a copy of any power of attorney; and

6. if an attorney is voting a claim, a statement from the attorney that the claimant is a regular client of that attorney or a solicitation statement from the attorney.

Upon completion of an undisputed election, the United States Trustee shall promptly file with the court a report of the election including the name and address of any person elected as trustee and a statement that the

election is undisputed. See Fed. R. Bankr. P. 2007.1(b)(3)(A). If it is necessary to resolve a dispute regarding the election,

> the United States trustee shall promptly file a report stating that the election is disputed, informing the court of the nature of the dispute, and listing the name and address of any candidate elected under any alternative presented by the dispute. The report shall be accompanied by a verified statement by each candidate elected under each alternative presented by the dispute, setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys, the United States trustee, and any person employed in the office of the United States trustee.

Fed. R. Bankr. P. 2007.1(b)(3)(B).

All parties in interest who have made a request to convene a meeting under 11 U.S.C. § 1104(b) are to receive a copy of the report, and all committees appointed under 11 U.S.C. § 1102 are to be served with the report as well. Id. A motion for resolution of the dispute must be filed within 10 days after the date the United States Trustee files the report. If no motion for resolution of the dispute is filed within the 10 day period, the person appointed by the United States Trustee in accordance with 11 U.S.C. § 1104(d) and approved in accordance with Fed. R. Bankr. P. 2007.1(c) shall serve as trustee. If a motion is timely filed and the court approves the person elected, "the report will constitute appointment of the elected person as of the date of entry of the order approving the appointment." See Fed. R. Bankr. P. 2007.1(b)(3)(B). Pending disposition by the court of a disputed election, the interim trustee shall continue in office. See Fed. R. Bankr. P. 2007.1(b)(1).

3-9.7.3 **Eligible Voters**

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

A priority unsecured creditor or a secured creditor is clearly not eligible to vote. However, there is some dispute as to whether an undersecured creditor should be allowed to vote the unsecured portion of its claim. See In re Tartan Constr. Co., 4. B.R. 655, 658 (Bankr. D. Neb. 1980) (undersecured creditor allowed to vote unsecured portion of claim as Congress intended to allow all unsecured creditors the right to vote). But see In re Lindell Drop Forge Co., 111 B.R. 137 (Bankr. W.D. Mich. 1990).

An unsecured creditor with an interest materially adverse to the estate may not vote in a trustee election. 11 U.S.C. § 702(a)(2). For example, an unsecured creditor has a material adverse interest when facts indicate that the creditor has received a voidable preferential transfer. See In re Lang Cartage Corp., 20 B.R. 534, 536 (Bankr. E.D. Wis. 1982). However, the suspicion of an avoidable preference is insufficient to prohibit a creditor from voting. See In re Poage, 92 B.R. 659, 665 (Bankr. N.D. Tex. 1988).

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

3-9.7.4 Determining Election Results

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

The 20 percent "requesting" requirement of 11 U.S.C. § 702(b) is independent of the 20 percent "quorum" requirement of 11 U.S.C. § 702(c)(1). See In re Oxborrow, 913 F.2d 751, 753-54 (9th Cir. 1990). At least 20 percent of eligible creditors must request an election regardless of the number of creditors who actually cast votes at an election. Id.

3-9.7.5 Solicitation of Proxies

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

Proxy holders who have solicited proxies for voting at the election of a trustee must follow the rules set forth in Fed. R. Bankr. P. 2006. The court may reject any proxies, on motion of a party in interest or on its own motion, if there has been a failure to comply with this rule. Fed. R. Bankr. P. 2006 applies in chapter 11 trustee elections. See Fed. R. Bankr. P. 2007(b)(2).

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

> Creditor control was a basic feature of the Act and is continued, in part, by the Code. Creditor democracy is perverted and the congressional objective frustrated, however, if control of administration falls into the hands of persons whose principal interest is not in what the estate can be made to yield to the unsecured creditors but in what it can yield to those involved in its administration or in other ulterior objectives.

Id.

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

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

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

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

Fed. R. Bankr. P. 2006(c)(1).

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

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

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

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

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

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

A number of bankruptcy courts have refused to recognize proxies that were solicited by attorneys at law. See In re Oxborrow, 104 B.R. 356, 362 (E.D. Wash. 1989), aff'd, 913 F.2d 751 (9th Cir. 1990); In re Brent Indus., Inc., 96 B.R. 193, 196 (Bankr. N.D. Iowa 1989); In re Phillips, 24 B.R. 715, 717 (Bankr. E.D. Cal. 1982). These courts recognized that the drafters of the Bankruptcy Rules made a conscious and deliberate decision to prohibit solicitation by attorneys.

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

1. a copy of the solicitation;

2. identification of the solicitor, the forwarder, . . . and the proxy holder. . . . If the solicitor, forwarder, or proxy holder is an association, there shall also be included a

statement that the creditors whose claims have been solicited . . . were members in good standing and had allowable unsecured claims . . . ;

3. a statement that no consideration has been paid or promised by the proxy holder for the proxy;

4. a statement as to whether there is any agreement . . . for the payment of any consideration in connection with voting the proxy, or for the sharing of compensation with any entity, other than a member or regular associate of the proxy holder's law firm, which may be allowed the trustee . . . ;

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

6. if the solicitor, forwarder, or proxy holder is a committee, a statement signed and verified by each member as to the amount and source of any consideration paid or to be paid . . . .

Fed. R. Bankr. P. 2006(e).

3-9.7.6 Qualifications of an Elected Trustee

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

If the elected trustee has provided no indication of his/her ability or intent to comply with the Bankruptcy Code and Rules and to adhere to fiduciary standards, the court may refuse to certify the election. See In re Frederick Petroleum Corp., 92 B.R. 273, 275-76 (Bankr. S.D. Ohio 1988) (court refused to approve election of trustee who had no bankruptcy experience and had never served as trustee); In re Kam Kuo Seafood Corp., 42 B.R. 558, 563 (Bankr. S.D.N.Y. 1984). However, the individual chosen as trustee by the creditors through the election process should be given the highest consideration and the creditors' choice should not be overruled without substantial reasons. 4 Lawrence P. King, Collier on Bankruptcy, ¶ 702.05 at 702-27, 28 (15th ed. rev. 1998).

CHAPTER 3-10: REVIEW OF DISCLOSURE STATEMENTS AND PLANS

3-10.1 INTRODUCTION

Section 586(a)(3)(B) of title 28 provides that the United States Trustee shall monitor plans and disclosure statements filed in cases under chapter 11 and file with the court comments with respect to such plans and disclosure statements. The disclosure process is the heart of the reorganization provisions of the Bankruptcy Code. Full disclosure is required before solicitation of acceptances of a plan of reorganization, thereby enabling creditors to make an informed judgment in accepting or rejecting a plan.

As stated in the legislative history of the Bankruptcy Code:

> The premise underlying the consolidated chapter 11 of this bill is the same as the premise of the securities law. If adequate disclosure is provided to all creditors and stockholders whose rights are to be affected, then they should be able to make an informed judgment of their own, rather than having the court or the Securities and Exchange Commission inform them in advance of whether the proposed plan is a good plan. Therefore, the key to the consolidated chapter is the disclosure section.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 226 (1977).

Pursuant to 11 U.S.C. § 1125(b), acceptance or rejection of a plan may not be solicited unless accompanied by a disclosure statement found by the court to contain "adequate information" regarding the plan. The practical approach to disclosure embodied in 11 U.S.C. § 1125, however, is quite unlike the standardized approach to disclosure embodied in the federal securities laws. This is illustrated by 11 U.S.C. § 1125(a)(1), which qualifies the sufficiency requirement with the following reasonableness standard:

> "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan . . . .

11 U.S.C. § 1125(a)(1). Section 1125(d) elaborates by providing that "adequate information is not governed by any otherwise applicable nonbankruptcy law, rule, or regulation. . . ."

The United States Trustee's review of disclosure statements focuses on the adequacy of disclosure. The role of the United States Trustee in reviewing disclosure statements is critical to the protection of creditors who have not directly participated in the negotiations, or when committees are inactive or have not been appointed.

The Bankruptcy Code permits the court to "approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets." 11 U.S.C. § 1125(b). Congress recognized that the circumstances will vary widely from one chapter 11 case to the next and, therefore, the parameters of "adequate information" will also vary. The legislative history states:

> The Supreme Court's rulemaking power will not extend to rulemaking that will prescribe what constitutes adequate information. . . . Precisely what constitutes adequate information in any particular instance will develop on a case-by-case basis. Courts will take a practical approach as to what is necessary under the circumstances of each case, such as the cost of preparation of the statements, the need for relative speed in solicitation and

> confirmation, and, of course, the need for investor protection. There will be a balancing of interests in each case. In reorganization cases, there is frequently great uncertainty. Therefore, the need for flexibility is greatest.

H.R. Rep. No. 595 at 409.

A review of case law illustrates what courts consider "adequate information" based on the facts of each case. See In re Northwest Recreational Activities, Inc., 8 B.R. 10, 12 (Bankr. N.D. Ga. 1980) (perfunctory and modest disclosure statement approved because information already was available to all creditors, all five being lien holders); In re Bel Air Assocs., Ltd., 4 B.R. 168, 175 (Bankr. W.D. Okla. 1980) (no disclosure statement required where plan contained adequate information and movant, a limited partner in debtor, had other sources of information). Information may vary depending upon the sophistication of the class. See In re Bloomingdale Partners, 155 B.R. 961, 972 (Bankr. N.D. Ill. 1993); In re Egan, 33 B.R. 672, 676-77 (Bankr. N.D. Ill. 1983) (disclosure statement containing statements of opinion without factual support, along with lack of cooperation by the debtor, disapproved and petition dismissed); In re Adana Mortgage Bankers, Inc., 14 B.R. 29 (Bankr. N.D. Ga. 1981) (mere summary of the plan inadequate-the disclosure statement must discuss the plan as well as provide other information). But see In re Walker, 198 B.R. 476, 479-80 (Bankr. E.D. Va. 1996) (court held that the information need only be the best prediction that the debtor can make based upon information available).

The process for obtaining approval of a disclosure statement and soliciting votes for a plan of reorganization has been simplified for small business debtors. A small business debtor may obtain conditional approval of a disclosure statement which can then be utilized to solicit votes regarding a plan. The conditionally approved disclosure statement can be mailed to creditors as few as ten days prior to the date of the hearing on confirmation of the plan. The court can then hold a single hearing to consider both final approval of the disclosure statement and plan confirmation. 11 U.S.C. §§ 105(d)(2)(B)(vi) and 1125(f)(3); Fed. R. Bankr. P. 3017.1.

3-10.2 THE CONCEPTUAL FRAMEWORK

3-10.2.1 Items to Include

The United States Trustee should not advocate a "checklist approach to the review of disclosure statements. The disclosure statement certainly should discuss the elements set out in 11 U.S.C. § 1123 insofar as they are in the plan filed. Reference to case law regarding information to be included is essential. See, e.g., Hall v. Vance, 887 F.2d 1041, 1043 (10th Cir. 1989); In re Metrocraft Publ'g Servs., Inc., 39 B.R. 567, 568-69 (Bankr. N.D. Ga. 1984); In re Malek, 35 B.R. 443, 443-44 (Bankr. E.D. Mich. 1983); In re A.C. Williams Co., 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982).

3-10.2.2 "Safe Harbor," 11 U.S.C. § 1125(e)

Under 11 U.S.C. § 1125(e), a person who solicits acceptances or rejections of a plan in good faith and in compliance with the Bankruptcy Code is not liable on account of such solicitation for the violation of any applicable law, rule, or regulation governing the offer, issuance, sale, or purchase of securities. The purpose of this section is to protect creditors, creditors' committees, counsel for committees, and others involved in a case from potential liability for use of an approved disclosure statement.

This safe harbor rule was intended to codify the result of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), reh'g denied, 425 U.S. 986 (1976), which held that proof of scienter is a prerequisite to the imposition of civil liability under the antifraud provisions of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. It was also intended to extend the good faith safe harbor to the imposition of injunctive liability. See H.R. Rep. No. 595 at 229-31.

3-10.2.3 Factors Affecting Adequacy of Disclosure

Several factors can affect the appropriate quantity and quality of disclosure in a given case, including: (1) the nature of the proposed plan of reorganization or liquidation; (2) the sophistication of the various holders of claims and interests and their familiarity with the debtor and its business; (3) whether the expense of the disclosure would substantially outweigh its anticipated benefit to creditors and stockholders; (4) the

peculiarities of the debtor's business or financial condition; (5) the need for an expeditious resolution; and (6) the access of a plan proponent, other than the debtor, to factual information regarding the debtor.

An inordinately long or complex disclosure statement may confuse rather than enlighten creditors. In such cases, the deletion of certain materials or the preparation of a summary may be suggested; however, care must be taken to ensure that significant material is not deleted.

3-10.3 CONDUCTING THE REVIEW

3-10.3.1 Standard Language

The use of some standardized language in disclosure statements is appropriate. For example, all documents should indicate that any representations made in order to secure an acceptance of the plan that are not contained in the disclosure statement are to be reported to the debtor, the creditors' committee, the United States Trustee, and the bankruptcy court for such action as may be appropriate.

Similarly, there should be a statement that the plan represents a legally binding arrangement and should be read in its entirety, as opposed to relying on the summary in the disclosure statement. Accordingly, creditors may wish to consult with their own lawyers and the creditors' committee and its lawyer to understand the plan more fully. The disclosure statement should also refer to “the right to vote for acceptance or rejection” of the plan or “the right to vote upon” the plan. While the disclosure statement may serve the parallel purpose of solicitation, the solicitation aspect of the statement should be clearly identified as such and kept distinct from the disclosure aspect. For example, the disclosure statement may state that “as a creditor, your acceptance is important” but such a statement should not be included in a paragraph describing voting procedures. It is permissible, however, for a discussion of the voting process to state that it is important for each creditor to vote.

The disclosure statement should indicate that bankruptcy court approval of the disclosure statement is not a ruling by the bankruptcy court on the merits of the plan. The disclosure statement should indicate which classes are impaired and are, therefore, entitled to vote on the plan and should define impairment in plain language. The voting requirements under

11 U.S.C. § 1126 for acceptance must be set forth in the disclosure statement. Voters should be told where the ballots must be sent and the deadline for voting. The ballots should not be sent to the United States Trustee.

3-10.3.2 **Description of the Debtor's Business**

The disclosure statement should describe the nature of the debtor's business. In cases in which the plan contemplates cash payments upon confirmation, a brief narrative description should suffice. If the plan contemplates deferred payments or the issuance of common or preferred stocks to creditors and, therefore, its implementation depends upon the future course of the business, the description should be more detailed. Items to look for in the latter case are: (1) material factors peculiar to the specific business of the debtor, such as seasonality, limited sources of supply, limited number of potential customers, patents or licenses, special capital needs, regulatory problems, or backlog; (2) principal product and services present, contemplated, or under development; (3) competitive conditions in the applicable market; and (4) material contracts and leases, including important terms such as expiration dates. Of course, if detailed information would have a detrimental impact on the debtor's competitive position, general terms may be permissible.

3-10.3.3 **Reasons for Financial Difficulties and Correction of Those Factors**

The disclosure statement should give a brief narrative description of the factors leading to the debtor's financial difficulties, together with a listing of the steps already taken or to be taken by the debtor to correct the problems. This description should be reviewed from the standpoint of the assistance it will provide the holders of claims and interests in assessing the likelihood of any recurrence of prior difficulties and, thus, the feasibility of the proposed plan. In cases in which the plan has neither deferred payments nor issuance of common or preferred stock, an elaboration of the reasons for the debtor's financial difficulties and the correction of those factors are less important and may be dealt with summarily.

3-10.3.4 Historical and Current Financial Information

Historical financial information, such as cash flow statements and profit and loss statements (statements of operation), should, where relevant, provide the holders of claims and interests some perspective regarding the debtor's financial situation and future prospects (as reflected in any projections included in the disclosure statements). See “Projections” infra.

Current financial information, such as cash flow statements, profit and loss statements (statements of operations), and balance sheets, provide holders of claims and interests with important information about the debtor's performance during the pendency of the chapter 11 case. Of particular importance is the comparison of the current balance sheet with the balance sheet as of the commencement of the case.

The disclosure statement should include, as an exhibit, a summary of the results of the operations during the pendency of the chapter 11 case. In re Merrimack Valley Oil Co., 32 B.R. 485, 488 (Bankr. D. Mass. 1983); In re Western Management, Inc., 6 B.R. 438, 442-43 (Bankr. W.D. Ky. 1980). The summary should be in a format consistent with the projections so that creditors can make a meaningful comparison of the past with future projections. The format of the summary and the projections should be consistent with regard to time and designation of income and expense items.

The disclosure statement should also include a projection of the financial condition of the debtor upon confirmation of the plan. This information enables the court and creditors to determine if the debtor will need further financial reorganization or if the plan will be followed by a liquidation. 11 U.S.C. § 1129(a)(11).

The extent to which financial statements are prepared in accordance with generally accepted accounting principles (“GAAP”) will vary. The period covered by historical financial information may vary based on the nature of the plan, the condition of the debtor's books and records (11 U.S.C. § 1125(a)(1) expressly recognizes this as a variable), and the nature of the debtor's business. Any financial statements that have not been prepared in accordance with GAAP due to the condition of the debtor's books and records should contain appropriate disclaimers and a brief explanation of the accounting methods employed.

The American Institute of Certified Public Accountants issued Statement of Position (SOP) 90-7, on November 19, 1990. The statement provides guidance for the financial reporting of entities currently in chapter 11 which expect to reorganize as going concerns.

3-10.3.5 Material Postpetition Events

The disclosure statement should briefly describe all material postpetition events including: (1) borrowings, (2) issuance of securities, (3) sales or transfers of assets other than in the ordinary course of business, and (4) lease assumptions and/or assignments or rejections (along with other executory contracts).

3-10.3.6 Outline of the Plan

The degree of detail in which the proposed plan of reorganization should be outlined in the disclosure statement will vary greatly with the complexity of the plan. In some instances, cross-references in the disclosure statement to pertinent plan provisions will suffice. In other instances, complex features of the plan may need to be separately, but briefly, described in the disclosure statement. For example, if the plan contemplates deferred payments to unsecured creditors out of retained earnings in excess of a stated figure, look for some explanation of this feature in the disclosure statement. Similarly, complex plan provisions often involve definitional problems that should be clarified in the disclosure statement. For example, the amount of deferred payments to a particular class of creditors may be expressed as a percentage of "net sales," a term which should be defined. Any default provisions or affirmative and negative covenants contained in the plan (e.g., dividend restrictions, limitations on further borrowing, and board memberships) should be explained. Information on the amount of claims in each class should be provided in tabular form in order to allow computations of the possible distribution to be made under the plan. The disclosure statement should also predict when confirmation will occur.

3-10.3.7 Means of Effectuating the Plan

Information relating to the source and application of funds to effectuate the proposed plan of reorganization should appear in the disclosure statement, including an estimate of the amounts necessary for the initial

payments under the plan. This number should be compared to the cash on hand. If the amount needed to confirm is greater than the cash available, there should be an explanation concerning the source of the additional funds. There should also be a brief description of the structure of any transaction related to carrying out the plan (e.g., the sale of stock or of assets). There should be an indication as to whether there exists any avoidable transfers (preferences and/or fraudulent conveyances) and whether the debtor (or acquiring entity) intends to prosecute these claims. These potential causes of action should be factored into the estimated liquidation analysis.

The disclosure statement should contain a brief description of the terms of any material agreements relating to the effectuation of the plan which the debtor has executed or proposes to execute (e.g., funding agreements, security agreements, guarantees, trust indentures, and agreements for the sale of stock or assets). For example, the plan may contemplate the use of a trust indenture in connection with deferred payments to creditors. In that event, the scope of discretionary authority lodged in the indenture trustee (e.g., the discretion to pledge assets to facilitate new financing or to subordinate the security interest granted to creditors) and the identity and affiliations of the indenture trustee should be disclosed. If there are to be guarantees for debtor's obligations under the plan , the guarantors should be identified and the nature and scope of guarantees described. In addition, the guarantor's ability to support the guarantee (e.g., a net worth statement in the case of an individual guarantor) should be discussed.

If a third party (including debtor’s principal) is to provide the necessary funds for confirmation, there should be some financial information with respect to the third party. If the third party does not want to be disclosed or does not want to disclose its financial condition, there are acceptable alternatives. For instance, if the funds are deposited in an identifiable escrow account for confirmation or by an irrevocable letter of credit, financial disclosure about the third party may not be necessary. Terms of the advance loan or contribution to capital should also be set forth. This should also be reflected in a projection which assumes confirmation of the plan.

The disclosure statement should indicate if there are any conditions that have to be met by any party in order for the plan to be confirmed. The

disclosure statement should also state the likelihood of the requisite events occurring as scheduled.

3-10.3.8 Securities to be Issued

In rare instances, a case will involve the issuance of securities. If such a case arises, the disclosure statement should provide information about any securities to be issued pursuant to the plan of reorganization, where applicable, as to: (1) dividend rights, management's dividend policies, and external constraints on the payment of dividends (e.g., a negative covenant in a loan agreement); (2) liquidation rights and preferences; (3) voting rights; (4) sinking fund payments; (5) conversion features; (6) preemptive rights; (7) redemption provisions; (8) provisions relating to interest, amortization, and maturity; (9) provisions restricting the issuance of additional securities; and (10) other special rights and preferences (e.g., the right to elect a majority of the board of directors in the event of defaults on payments in respect to debentures issued or the right to veto certain corporate changes, such as recapitalization, that could adversely affect the security holders' rights).

The disclosure statement should indicate whether the issuance of the securities in question is exempt from the registration requirements of federal and state securities laws by virtue of 11 U.S.C. § 1145(a) or a different exemption, or whether it is contemplated that the securities will be registered.

It may be appropriate for the disclosure statement to include information relating to the current and anticipated postconfirmation distribution of ownership of equity securities. This information could serve to inform the holders of claims and interests as to any dilution or changes in control likely to result from the issuance of securities contemplated by the plan of reorganization. Even in those cases where existing stockholders do not have preemptive rights, if the stock is being diluted, the existing stockholders are impaired. Cf. In re Barrington Oaks General Partnership, 15 B.R. 952 (Bankr. D. Utah 1981).

If there is a market for the securities to be issued (or the securities into which they are convertible), the disclosure statement should identify the principal markets involved. If the securities are traded on an exchange,

information as to high and low sales prices in the recent past should be included. If the principal market for such securities is not an exchange, there should be included information as to high and low bid quotations in the recent past (together with disclosure of the source of those quotations). If there is no market for such securities, the disclosure statement should so state, and should also state whether it is expected that a market will exist for securities distributed under the confirmed plan. If the securities are publicly held, but not traded because of past failure to disseminate public information (see Securities Exchange Act Rule 15c2-11), that fact should be disclosed. If it is expected that the disclosure being made will cure the deficiency so that trading can resume, then that expectation should be noted.

Finally, the disclosure statement should briefly describe applicable law relating to the resale of the securities to be issued under the plan of reorganization. There is a limited exemption in 11 U.S.C. § 1145(d) from the provisions of the Trust Indenture Act of 1939.

3-10.3.9 Projections

"[T]he essence of disclosure in a reorganization case, and the essence of valuation of a business as a going concern, is a projection of future earnings of the business." H.R. Rep. No. 595 at 230-31. If the plan of reorganization does not contemplate any deferred payments or the issuance of any equity security, such projections are unnecessary. In all other cases, projections are critical to the creditors' and shareholders' ability to assess the viability of the plan and of the debtor. It should be noted that the Securities and Exchange Commission encourages the use of projections of future economic performance. See Securities Act Release No. 33-5992 (November 7, 1978), 43 F.R. 53246.

The projections should include both cash flow and earnings estimates. All payments contemplated under the plan should be factored into the cash flow projections. If earlier projections are available, they should be compared in the disclosure statement with actual results for the periods covered. Creditors will then be able to assess management's powers of projection.

There may be instances in which payments under the plan are tied to specific financial measures (e.g., net sales, pre-tax profits, retained earnings, or other measures). In such circumstances, the projections should set forth estimates in terms of the appropriate measure.

The United States Trustee should ensure that the underlying assumptions utilized by management in developing the projections are disclosed as specifically as possible. There may exist, however, legitimate reasons for a vague statement concerning such items as the introduction of a new product or the gearing down of operations. It should be understood that the disclosure of "adequate information" may conflict with the debtor's legitimate need to protect its competitive position. For example, the disclosure of market study results for a proposed new product, while of significant informational value to creditors, might not be appropriate. Where the assumptions made relate to the factors cited as reasons for the debtor's financial difficulties and are intended to correct those factors, the connection should be made clear.

Cases may arise in which alternative sets of projections, or at least ranges of projections, would be appropriate. For example, the plan of reorganization may offer creditors two or more payment options. Alternative sets of projections or ranges of projections may be desirable to reflect the different results that would flow from the election of each option. Similarly, alternative sets of projections or ranges of projections may be appropriate when there is a reasonable prospect of a change affecting the debtor's business (e.g., regulatory changes, introduction of a new product, or new market entrants).

3-10.3.10 **Management, 11 U.S.C. § 1129(a)(5)**

Even if the plan of reorganization contemplates exclusively cash payments upon confirmation, the disclosure statement must identify the anticipated postconfirmation directors and executive officers of the debtor, and indicate the extent to which this represents a change from preconfirmation management. The disclosure statement should contain a brief account of the business experience of each director and executive director, together with their age, tenure, and possible retirement where relevant. Information as to compensation arrangements with the debtor's directors and executive officers should also be disclosed. The disclosure statement

should also include any other information relevant to the integrity and competence of management (e.g., criminal or regulatory proceedings and prior bankruptcies or receiverships).

3-10.3.11 **Controlling Persons**

In the case of a plan of reorganization that will be implemented over time, the disclosure statement should identify any "persons" (as defined in 11 U.S.C. § 101(41)) that will "control" the debtor following confirmation of the proposed plan of reorganization.

With respect to any "person" that is to "control" the debtor, the disclosure statement should provide at least the following information: (1) the nature and extent of "control" to be exercised; (2) a brief narrative description of the business of the controlling person; (3) the identity of persons that control such controlling person; (4) the identity and experience of management of the controlling person; (5) the identity of affiliates of the controlling person; (6) an outline of the transaction whereby control is to be acquired; (7) if known, the business plans of the controlling person for the debtor; and (8) pertinent financial information regarding the controlling person, if available.

3-10.3.12 **Insider and Affiliate Claims**

The disclosure statement should list any claims held by "insiders" (as defined in 11 U.S.C. § 101(31)) or "affiliates" (as defined in 11 U.S.C. § 101(2)) of the debtor and should include: (1) the identity of the claimant; (2) the claimant's affiliation with the debtor; (3) the circumstances giving rise to the claim; (4) the amount of the claim; and (5) the treatment to be afforded the claim in accordance with the plan.

3-10.3.13 **Transactions with Insiders and Affiliates**

The disclosure statement should contain a brief description of any present or proposed material transactions of the debtor in which "insiders" or "affiliates" of the debtor (as defined in 11 U.S.C. §§ 101(31) and (2), respectively) have any interest. The insider or affiliate should be identified, the affiliation with the debtor described, and the nature of the interest in the transaction explained. For example, rentals paid by or to

the debtor should be compared to existing market rates. If any transactions have given rise to claims either on behalf of or against the debtor in the chapter 11 case, they should be disclosed.

3-10.3.14 **Disputed Claims**

Any material claims that the debtor disputes or proposes to dispute, in whole or in part, should be listed and there should be a disclosure of: (1) the identity of the claimant; (2) the nature of the claim; (3) the full amount of the claim and the amount subject to dispute; and (4) the grounds of the debtor's challenge to the claim (e.g., voidable preference, fraudulent transfer, or lack of collateral value). It may also be appropriate for the disclosure statement to explain the effect upon the plan of reorganization (and the related projections, if any) of the allowance or disallowance of the disputed claim.

3-10.3.15 **Legal Proceedings**

The disclosure statement should give a brief description of any material legal proceedings to which the debtor is a party, which the debtor contemplates instituting, or which are threatened against the debtor. This disclosure should include information as to: (1) the identity of the parties to the litigation; (2) the nature of the claims; (3) the factual basis alleged to underlie the proceedings; (4) the court in which the litigation is pending; (5) the relief sought; (6) the present status of the litigation; and (7) a statement as to whether a judgment adverse to the debtor might seriously affect the debtor's business or financial conditions or the debtor's ability to effectuate the plan of reorganization.

3-10.3.16 **Tax Consequences**

In some instances, the proposed plan of reorganization will engender federal tax consequences for the debtor that may have a material affect upon the future financial prospects of the debtor. If material in their affect, these tax consequences should be explained. For example, the discharge of the debtor from indebtedness pursuant to the plan of reorganization may affect the debtor's net operating loss carryovers, investment tax credits, capital loss carryovers, or basis in assets. Similarly, a plan that contemplates a corporate reorganization (e.g.,

transfer of the debtor's assets to another corporation in exchange for stock) may or may not be tax-free at the corporate level. Information relating to the tax consequences upon the debtor of the plan of reorganization obviously will be relevant and feasible only in larger chapter 11 cases.

3-10.3.17 Trustee or Examiner

If a trustee or an examiner has been appointed in a chapter 11 case, the identity and the reasons for the appointment of the trustee or examiner should be disclosed. Similar information regarding an elected trustee should be provided. If the trustee or the examiner has prepared a report regarding the operations of the debtor, and if it is not too voluminous, a copy should be attached to the disclosure statement. If it is not attached, it should be summarized in the disclosure statement, with directions on how to obtain a copy of the report.

3-10.3.18 Creditors' Committees and Equity Security Holders' Committees

The disclosure statement should indicate whether there are any creditors' or equity security holders' committees, together with a list of the members of such committees, their addresses, and whether the proposed plan of reorganization has been negotiated with the committees. Any professionals retained by the committees should also be disclosed. The position of the committees on the plan should be disclosed and what role, if any, the committees will play after confirmation.

3-10.3.19 Information Regarding Plan Proponent

Occasionally, a plan and disclosure statement may be offered by a party other than the debtor, the trustee, or the creditors' committee. The proponent must be a “party in interest” under 11 U.S.C. § 1121. In those situations, the disclosure statement should clearly describe the position of the proponent relative to the debtor (e.g., a supplier holding an unsecured claim against the debtor in the amount of $20,000), since it may affect the proponent's access to the information and, thus, the quality and quantity of disclosure. On the other hand, disclaimers by an “outside” plan proponent as to the absence of information regarding the debtor must also be scrutinized, since the formulation of a plan by the proponent necessarily involved certain assumptions, if not “hard” information, regarding the

debtor. The standard of adequate information should not change depending upon the proponent of the plan. Any assumptions should be disclosed and the proponent should be compelled to obtain the necessary, existing information in order for the disclosure statement to be approved. See In re Civitella, 15 B.R. 206, 208 (Bankr. E.D. Pa. 1981) (disclosure statement for a plan proposed by three secured creditors denied approval because no factual information provided, only allegations and opinions). Where other plans have been proposed, their existence and the fact that they are on file with the court should be disclosed. These are potential alternatives to the plan that creditors/equity holders are being asked to vote upon.

3-10.3.20 Liquidation Analysis

A creditor cannot make an informed judgment regarding a proposed plan of reorganization without information as to the available alternatives. The most obvious alternative is liquidation of the debtor under chapter 7. Any reference to liquidation should be prefaced with the term "estimated," since liquidation has not occurred. These statements of alternatives should be neutral. Other alternatives may have been considered by the proponent of the plan during the course of the chapter 11 case (e.g., a competing plan of reorganization) and, in that event, the disclosure statement could briefly describe the alternatives considered and the reasons for finding the proposed plan of reorganization preferable.

In most cases an elaborate liquidation analysis should not be necessary. A brief tabular presentation, setting forth estimated administration expenses (including pre and postconfirmation United States Trustee quarterly fees; estimated priority, secured, and unsecured claims; and estimated asset values, together with disclosure of the source of those estimates) should suffice. The disclosure statement should indicate the percentage distribution, if any, to creditors on liquidation.

The disclosure statement should enable the reader to determine what assumptions were made in connection with the estimate of claims and asset values (e.g., the assumptions regarding disallowance of certain claims, recoverable transfers, the book figures upon which the liquidation values are based, and the method employed in computing the book figures or the discount applied to accounts receivable and how this discount

relates to the debtor's actual prepetition and postpetition collection experience). Certain assets, such as leases and real estate, may not be reflected accurately on the balance sheet, although quite valuable upon liquidation. Any adjustments that are made should be disclosed.

If liquidation will not be immediate, an estimate of the length of time that would be required to liquidate the assets of the debtor should be included. If relevant, the liquidation analysis should factor in available exemptions provided by the Bankruptcy Code. If claims incorporated in the liquidation analysis are held by "insiders" or "affiliates" of the debtor, that fact should be mentioned. In the case of a partnership, the disclosure statement should include financial information about the partners so that creditors can determine if the plan is in their "best interest." 11 U.S.C. § 1129(a)(7); see also 11 U.S.C. § 723 (partnership distributions in chapter 7).

Section 1112(c) of the Bankruptcy Code provides that the court may not convert the chapter 11 case of a "farmer" (as defined in 11 U.S.C. § 101(20)) or "a corporation that is not a moneyed, business, or commercial corporation" unless the debtor so requests. Arguably then, a liquidation analysis is unnecessary with respect to cases involving farmers or charitable institutions. There are, however, three factors that should be considered in determining whether a liquidation analysis should be included in such circumstances. First, there may be a legitimate question as to whether the debtor fits the definition of "farmer" in 11 U.S.C. § 101(20) or is a "corporation that is not a moneyed, business, or commercial corporation." Second, 11 U.S.C. § 1112(c) seems to prohibit involuntary conversion to chapter 7, but does not seem to prohibit dismissal of the chapter 11 case, and the ultimate effect of dismissal may be liquidation of the debtor. Finally, a creditor faced with the proposed plan may elect to reject the plan and seek to structure a competing plan which provides for partial or complete liquidation of the debtor. 11 U.S.C. § 1123(b)(4).

Section 1125(b) of the Bankruptcy Code indicates that the court may approve a disclosure statement without a valuation of the debtor or an appraisal of its assets. Appraisals are, however, performed in most cases and their incorporation in the disclosure statement enhances the liquidation analysis. (Disclosure of information relating to an appraisal

may be restricted.) If an appraisal is too voluminous, a summary and information on how to obtain a copy of the appraisal will generally suffice. In either event, the disclosure statement should (1) identify the appraiser, (2) identify the party who commissioned the appraisal, and (3) disclose the purpose of the appraisal. The proponent of the plan of reorganization may want to argue that one of the appraisals is especially reliable and the reasons for this conclusion.

3-10.3.21 Vote Required for Acceptance

The disclosure statement should briefly describe the vote required for acceptance of the plan by the various classes of holders of claims and interests under 11 U.S.C. § 1126, and should specifically identify which classes are impaired and voting on the plan. The disclosure statement should also establish a record date for voting on the plan of reorganization by holders of equity securities.

3-10.3.22 "Cram Down"

Although the application of 11 U.S.C. § 1129(b) is essentially a question for confirmation, the discussion in the disclosure statement of "cram down" raises a difficult problem. The term "cram down" is used to describe the power of the bankruptcy court to confirm a reorganization plan even though one or more impaired classes of creditors does not accept the plan. 5 Lawrence P. King, Collier on Bankruptcy, ¶ 1111.02 (15th ed. rev. 1998). At a minimum, if the debtor intends to invoke the "cram down" provisions against a dissenting class, that intention should be disclosed. Moreover, if the invocation of "cram down" is intended, the disclosure statement should contain a brief summary of the operation of 11 U.S.C. § 1129(b) as it would affect the class in question, as well as a brief outline of the "fair and equitable" standard that would be applied should "cram down" be invoked.

The disclosure problem is further complicated to the extent there may be, as a legal matter, significant doubt as to the availability of "cram down" in a given case. For example, although a plan of reorganization proposes that stockholders will receive cash payments in exchange for their shares, the disclosure statement may state (or at least suggest) that 11 U.S.C. § 1129(b) "may be" invoked against unsecured creditors as a class. The

availability of "cram down" in those circumstances may be questionable. It is misleading to even suggest to creditors that the debtor may invoke 11 U.S.C. § 1129(b) without an explanation. Thus, in every case in which the debtor states or suggests that "cram down" is contemplated, the United States Trustee should analyze the legal issue and formulate a judgment as to the availability of "cram down" under the circumstances. If the United States Trustee questions the availability of "cram down," an objection to the disclosure statement should be made. The remedy may be deletion or the inclusion of an explanation of the legal issues involved.

Moreover, the disclosure statement should include a statement to the effect that, if a senior class of creditors rejects the plan, the court may find that the junior class (or classes) may not receive a distribution under the plan or retain its interests in the reorganized debtor unless they satisfy the "new value exception" which would require that the junior class (or classes) contribute new value to the debtor that is new, substantial, money, or money's worth; necessary for a successful reorganization; and in an amount reasonably equivalent to the value of the interest or distribution that they are retaining or receiving. In re One Times Square Assocs. Ltd. Partnership, 159 B.R. 695, 706-08 (Bankr. S.D.N.Y. 1993).

3-10.3.23 **Miscellaneous Matters**

The disclosure statement should identify the leases or executory contracts being assumed or rejected under the plan. To the extent a lease or executory contract is being rejected, a claim for damages may arise. An estimate of these damage claims should be set forth and factored into the estimated amount of claims in each class.

The disclosure statement should set forth any default provisions under the plan and the consequences attendant to a default. For example, a default could trigger an acceleration of the total future payments under the plan or an immediate conversion to chapter 7.

3-10.3.24 **Summary and Table of Contents**

If the disclosure statement is voluminous, the inclusion of a table of contents and a brief summary of the plan, of alternatives to the plan, and of the debtor's future prospects may be appropriate.

3-10.3.25 **Notice**

The notice of the hearing on a disclosure statement must be sent to all creditors. Fed. R. Bankr. P. 2002(b)(1). This may be only a one-page notice and need not include the proposed disclosure statement. The notice should indicate that copies are available, if requested, and that the original is on file with the court.

In a small business case, a conditionally approved disclosure statement need only be mailed to creditors ten days prior to the hearing on confirmation of the plan. 11 U.S.C. § 1125(f)(2).

After a disclosure statement is approved, it must be sent to all creditors along with the plan, a ballot, and the order approving the disclosure statement. That order should indicate the date by which ballots must be received, the persons to whom they must be sent, the date of the confirmation hearing, and the date by which any objections to confirmation must be filed.

On the subject of notice, see Fed. R. Bankr. P. 3017(d) (giving the court discretion to direct that disclosure statements, plans, and notices of time for filing ballots not be sent to unimpaired classes of creditors or equity security holders); In re Douglas Hereford Ranch, Inc., 76 B.R. 781, 783 (Bankr. D. Mont. 1987) (the affirmative vote of one impaired class was necessary to invoke cram down; deemed acceptance was not enough); In re Russell, 44 B.R. 452, 453 (Bankr. E.D.N.C. 1984) (the deemed acceptance of an unimpaired class is different from the affirmative acceptance of an impaired class required by section 1129(a)(10)). The United States Trustee should ensure that classes are described properly so that adequate notice is given.

3-10.4 **PREPETITION SOLICITATION**

A plan proponent may wish to utilize acceptances to its plan that were solicited and obtained prior to the commencement of the case during an "out of court composition" or "work out" arrangement--the so-called prepackaged plan. These ballots may be used if the prepetition solicitation was in compliance with "applicable nonbankruptcy law, rule, or regulation" pursuant to 11 U.S.C. § 1126(b)(1) and if the procedures set

forth in Fed. R. Bankr. P. 3018(b) were followed. There is general agreement that the securities laws constitute "applicable nonbankruptcy law." In re Southland Corp., 124 B.R. 211, 225 (Bankr. N.D. Tex. 1991) was the first significant decision dealing with prepackaged plans.

3-10.5 PLAN MODIFICATION

The plan proponent may wish to modify the plan either prior to or after confirmation. 11 U.S.C. § 1127. To the extent that the change is not a "material" modification, additional disclosure and a re-solicitation may not be necessary. See 11 U.S.C. § 1127(c) and the legislative history. Obviously, any downward change in the amount of distribution or the payment schedule would constitute a material modification requiring a re-solicitation. Such a procedure may be in the form of a "negative solicitation," i.e., members of the class may be given an opportunity to (1) change their vote, (2) vote if they had not already done so, or (3) do nothing and their vote could be counted as originally cast. The United States Trustee should review any modification and make such recommendation to the court as is appropriate.

3-10.6 REVIEW OF PLAN AND CONFIRMATION

The United States Trustee should ensure that the party proposing the plan and disclosure statement has the authority to do so. For example, in In re New Haven Radio, Inc., 18 B.R. 977, 979 (Bankr. D. Conn. 1982), the court held that a sole stockholder had no authority to file a disclosure statement in the absence of any corporate resolution, minutes, correspondence, or any other document attached to the disclosure statement. The court stated that there must be "credible evidence" that the person submitting the plan is a duly authorized agent of the debtor in order to file a plan while the debtor's period of exclusivity is in effect.

The United States Trustee should review the plan to determine that it meets the requirements of 11 U.S.C. § 1129. Confirmation issues that may concern the United States Trustee include: the inappropriate classification of claims and interests; administrative solvency or insolvency (whether the administrative and priority claims can be paid in full or properly deferred); a request for discharge in contravention of 11 U.S.C. § 1141(d); provisions for the release of, or injunctions in favor

of, guarantors, partners, or non-debtor entities in contravention of 11 U.S.C. § 524(e); inappropriate exculpatory clauses releasing professionals and disbursing agents from liability beyond the scope of 11 U.S.C. § 1125(e); the bonding of escrow or disbursing agents where appropriate; and ensuring that the plan includes a provision for payment of any outstanding quarterly fees on the effective date of the plan and for the payment of postconfirmation quarterly fees. Objections premised upon lack of feasibility should be filed in cases where a debtor's financial projections are totally unrealistic, as, for example, if unsupported by experience of the entity or the industry.

While the United States Trustee has the discretion to file objections to confirmation, confirmation issues should generally be left to creditors after full and fair disclosure, absent egregious circumstances. If creditors are not active or are unrepresented, as when a committee could not be appointed, the United States Trustee's role is more important.

3-10.7 POSTCONFIRMATION MONITORING

The minimum duties of the United States Trustee in this area are set forth in a Memorandum of Understanding ("MOU") with the Administrative Office of the United States Courts dated October 1991. Pursuant to the MOU, the United States Trustee must review all final reports and motions for final decrees filed in chapter 11 cases and object if appropriate. In addition, in cases where no such pleadings have been submitted, the United States Trustee must initiate action to compel the filing of a final report.

After confirmation of the plan, the reorganized debtor is required to "file such reports as are necessary or as the court orders." 11 U.S.C. § 1106(a)(7). If no such reports are required by local rule or guideline, the United States Trustee should require the reorganized debtor to file and serve postconfirmation reports on a periodic basis (monthly or quarterly) sufficient for the United States Trustee to determine the amount of the debtor's receipts and disbursements and to collect all postconfirmation quarterly fees that are owing. In addition, the reports should contain sufficient information for the United States Trustee to determine whether the reorganized debtor has substantially consummated the plan and whether the debtor is entitled to a final decree pursuant to 11 U.S.C. § 350

and Fed. R. Bankr. P. 3022. If necessary, the United States Trustee should interpose an objection to the plan of reorganization to require such reporting, along with appropriate language to confirm the reorganized debtor's continued obligation to pay quarterly fees until case dismissal, conversion, or closure.

Often parties in interest will move to dismiss or convert a confirmed case. Because the grounds for conversion or dismissal listed under 11 U.S.C. § 1112(b) include the inability to effectuate substantial consummation of a confirmed plan (11 U.S.C. § 1112(b)(7)) and material default by the debtor with respect to a confirmed plan (11 U.S.C. § 1112(b)(8)), it is clear that the courts retain jurisdiction to hear such motions postconfirmation. The United States Trustee may be requested to state his/her position at such hearings.

The United States Trustee should review carefully the reported decisions within the applicable jurisdiction, if any, as the courts are divided over whether dismissal or conversion is the appropriate remedy in such situations. Some courts hold that unless the plan or order of confirmation provides otherwise, the property permanently revests in the reorganized debtor and, absent revocation pursuant to 11 U.S.C. § 1144, dismissal is the appropriate remedy since a chapter 7 trustee would have no estate property to administer for the benefit of creditors. In re K & M Printing, Inc., 210 B.R. 583, 586 (Bankr. D. Ariz. 1997); In re H.R.P. Auto Ctr., Inc., 130 B.R. 247, 257 (Bankr. N.D. Ohio 1991); In re T.S.P. Indus., Inc., 117 B.R. 375, 377-78 (Bankr. N.D. Ill. 1990). Other courts hold that regardless of the plan or order of confirmation, conversion is an effective remedy for postconfirmation defaults by the reorganized debtor because the chapter 7 trustee can administer the debtor's property for the benefit of creditors. In re Smith, 201 B.R. 267, 271 (D. Nev. 1996); In re Calania Corp., 188 B.R. 41, 42-43 (Bankr. M.D. Fla. 1995); In re Midway, Inc., 166 B.R. 585, 590 (Bankr. D.N.J. 1994). Still other courts hold that conversion is appropriate where the trustee may pursue certain claims on behalf of creditors such as avoidance actions, partnership claims, or other claims for relief. In re T.S. Note Co., TFC, 140 B.R. 812, 813-14 (Bankr. D. Kan. 1992) (case converted to allow trustee to investigate potential avoidance actions).

Before taking a position, the United States Trustee also should review the plan and disclosure statement, order of confirmation, and the reorganized debtor's postconfirmation reports, if any. The United States Trustee also should determine whether any postconfirmation fees are owing and consider whether case closure is preferable to dismissal or conversion.

To the extent that the United States Trustee becomes aware of cause to revoke the order of confirmation pursuant to 11 U.S.C. § 1144, the United States Trustee should pursue such action. For example, if there is a material misrepresentation in the disclosure statement discovered within six months after confirmation or there was a concealment of assets, the United States Trustee should move to revoke confirmation. Revocation of confirmation requires the filing of an adversary complaint and a specific showing of fraud. See In re Longardner & Assocs., Inc., 855 F.2d 455, 460 (7th Cir. 1988), cert. denied, 489 U.S. 1015 (1989); In re Gross, 121 B.R. 587, 592 (Bankr. D.S.D. 1990); In re Nyack Autopartstores Holding Co., Inc., 98 B.R. 659, 663 (Bankr. S.D.N.Y. 1989).

CHAPTER 3-11: INVOLUNTARY CHAPTER 11 CASE ADMINISTRATION

3-11.1 INTRODUCTION

An involuntary case is commenced by the filing of a petition under 11 U.S.C. § 303. Although the automatic stay under 11 U.S.C. § 362(a) is triggered by the filing of the petition, some statutory provisions do not take effect until the order for relief is entered .

Generally, the debtor may continue to operate as if no case were commenced under title 11:

> Notwithstanding section 363 of this title, except to the extent that the court orders otherwise, and until an order for relief is entered in the case, any business of the debtor may continue to operate, and the debtor may continue to use,

> acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced.

11 U.S.C. § 303(f).

Prior to the entry of an order for relief, the United States Trustee undertakes no oversight activity, unless the court orders otherwise. 11 U.S.C. § 303(g). No section 341 meeting can be held and no creditors' committee can be appointed. The United States Trustee, however, should monitor the case and be prepared to assume an active role if the debtor and/or the petitioning creditors engage in conduct designed to defeat the provisions of the Bankruptcy Code or that justify the appointment of a trustee.

3-11.2 STATUTORY AND BANKRUPTCY RULE PROVISIONS

Involuntary chapter 11 bankruptcy cases are governed by the provisions of 11 U.S.C. § 303 which states, in part:

> An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced.

11 U.S.C.§ 303(a); see 11 U.S.C. §§ 109(b) and 101(41).

An involuntary petition can be filed by (i) three or more creditors holding liquidated, undisputed claims which aggregate at least $10,000 more than the value of any collateral securing the claims (11 U.S.C. § 303(b)(1)); (ii) by one or more creditors holding liquidated, undisputed claims equaling at least $10,000 if fewer than 12 non-employee and non-insider creditors exist (11 U.S.C. § 303(b)(2)); (iii) by fewer than all general partners in a partnership (11 U.S.C. § 303(b)(3)); or (iv) by a foreign representative of the estate in a foreign proceeding regarding the debtor (11 U.S.C. § 303(b)(4)). A foreign representative may file an involuntary petition to administer assets of the debtor in the United States and prevent their seizure by local creditors. See 2 Lawrence P. King, Collier on Bankruptcy, ¶ 303.10 (15th ed. rev. 1998). A foreign representative may

also commence a case ancillary to a foreign proceeding pursuant to the provisions of 11 U.S.C. § 304. By operation of 11 U.S.C. § 104, on April 1, 1998, the statutory dollar minimum of $10,000 was raised to $10,775 and will be adjusted again on April 1, 2002.

Fed. R. Bankr. P. 1018 identifies the rules in Part VII of the Federal Rules of Bankruptcy Procedure (regarding adversary proceedings) that "apply to all proceedings relating to a contested involuntary petition . . . except as otherwise provided in Part I of these rules and unless the court otherwise directs. The court may direct that other rules in Part VII shall also apply." The effect of Fed. R. Bankr. P. 1018 is to make Rules 5, 8, 9, 15 and 56 of the Federal Rules of Civil Procedure "generally applicable" to the raising of defenses and objections to the petition.

Section 303(d) of the Bankruptcy Code permits the alleged debtor to file an answer to contest the entry of an order for relief. If no timely answer is filed, the court will enter an order for relief. 11 U.S.C. § 303(h).

If an involuntary case is contested, the court will conduct a trial to determine whether the statutory requirements for the entry of an order for relief have been met. The petitioners must establish that they are sufficient in number, type of debt, and amount of debt to fulfill the requirements of 11 U.S.C. § 303(b) and that the debtor is generally not paying its undisputed debts as they become due or that a custodian has been appointed within 120 days of the filing of the petition to take charge of less than substantially all of the debtor's assets. 11 U.S.C. § 303(h); In re Mayhew, 194 B.R. 6, 6-7 (Bankr. D.R.I. 1996); In re Norris, 183 B.R. 437, 449-50 (Bankr. W.D. La. 1995).

The filing of an involuntary petition is an extreme action that may affect the alleged debtor's credit standing, cause public embarrassment, and impact its ability to carry on business affairs or transfer assets. In re Reid, 773 F.2d 945, 946 (7th Cir. 1985). The court may offer protection to the debtor under such circumstances, In re Cates, 62 B.R. 179, 181 (Bankr. S.D. Tex. 1986), such as by dismissing the petition or requiring the posting of a bond. 11 U.S.C. § 303(e). If the petition is dismissed, other than with the consent of the parties, the court may assess costs, attorney fees, compensation, and punitive damages against the petitioning creditors. 11 U.S.C. § 303(i); In re Landmark Distributors, Inc., 195 B.R.

837, 845-48 (Bankr. D.N.J. 1996); In re Val W. Poterek & Sons, Inc., 169 B.R. 896, 905 (Bankr. N.D. Ill. 1994).

3-11.3 APPOINTMENT OF A TRUSTEE PRIOR TO ENTRY OF AN ORDER FOR RELIEF

Section 1104 of the Bankruptcy Code authorizes the appointment of a trustee "[a]t any time after the commencement of the case but before confirmation of a plan . . . ." Therefore, even prior to the entry of the order for relief, the court may order the United States Trustee to appoint a trustee in an involuntary chapter 11 case. See In re Advanced Elecs., Inc., 99 B.R. 249, 249-50 (Bankr. M.D. Pa. 1989); In re Petralex Stainless, Ltd., 78 B.R. 738, 744-45 (Bankr. E.D. Pa. 1987) (court ordered appointment of trustee in the involuntary case because the corporate board was deadlocked). Generally, a motion for the appointment of a trustee prior to the entry of an order for relief should be made by the creditors rather than the United States Trustee.

The appointment of a trustee in an involuntary chapter 7 case is authorized expressly:

> At any time after the commencement of an involuntary case under chapter 7 . . . but before an order for relief . . . the court, on request of a party in interest, after notice to the debtor and a hearing, and if necessary to preserve the property of the estate or to prevent loss to the estate, may order the United States trustee to appoint an interim trustee under section 701 . . . .

11 U.S.C. § 303(g). Fed. R. Bankr. P. 2001(b) requires the party moving for appointment of a trustee in a chapter 7 case to post a bond.

The debtor may attempt to remove a "gap period" trustee by converting the case to one under chapter 11 or by filing a new chapter 11 case. Conversion terminates the service of a trustee serving before the conversion. 11 U.S.C. § 348(e). This effort may be of limited practical use as parties in interest could immediately move in the new case for appointment of a trustee. At least one court has held that the filing of a voluntary chapter 11 does not automatically cause removal of the trustee. In re Alpine Lumber and Nursery, 13 B.R. 977, 979 (Bankr. S.D. Cal. 1981). The court reasoned that the debtor had to post a bond under

11 U.S.C. § 303(g) to remove the trustee or to show that the reason for the appointment no longer existed.

3-11.4 PROFESSIONAL FEES DURING THE GAP PERIOD

Professional fees incurred during the gap period raise unique issues that must be addressed by the United States Trustee and the court. If an order for relief is entered, courts have held that professionals rendering bankruptcy services during the gap period are entitled to the priority afforded by 11 U.S.C. § 507(a)(1), just as if their claims were professional fees requested pursuant to 11 U.S.C. § 330. See In re Sun Spec Indus., Inc., 3 B.R. 703, 705-06 (Bankr. S.D.N.Y. 1980). As a result, such fees should be monitored by the United States Trustee pursuant to 28 U.S.C. § 586(a)(3)(A)(i). See In re Shah Int'l, Inc., 94 B.R. 136,138-39 (Bankr. E.D. Wis. 1988) (retainer paid professional during gap period was reviewable by the court). However, if the case is dismissed prior to the entry of an order for relief, the United States Trustee should not seek to review fees.

3-11.5 DISMISSAL

Section 303(j) of the Bankruptcy Code permits dismissal of an involuntary case only after notice to all creditors and a hearing. Generally, in determining whether to sustain such a motion, the court must weigh the interests of the estate and the creditors. In re 1820-1838 Amsterdam Equities, Inc., 176 B.R. 127, 129 (S.D.N.Y. 1994). The case should be dismissed where dismissal would best serve the interests of the parties. 11 U.S.C. § 305(a). Where the involuntary case is, in reality, a two party dispute with adequate remedies available, the involuntary case should be dismissed. In re Axl Indus., Inc., 127 B.R. 482, 484 (S.D. Fla. 1991). In determining whether to dismiss, the court should consider the prejudice to the parties availability of another forum and issues of non-bankruptcy law. In re Ethanol Pacific, Inc., 166 B.R. 928, 931 (Bankr. D. Idaho 1994). The court should always consider whether the petition has been filed in bad faith. In re Accident Claim Determination Corp., 146 B.R. 64, 68-69 (Bankr. E.D.N.Y. 1992).

In order to guard against collusive dismissal of an involuntary petition to the detriment of nonpetitioning creditors, the court may not dismiss an involuntary petition until there has been notice to all creditors and a

hearing. 11 U.S.C. § 303(j). The United States Trustee should object to any dismissal of an involuntary petition if proper notice and opportunity for a hearing have not been given. The United States Trustee may also consider objecting to dismissal if the debtor and petitioning creditors work out an arrangement in which the petitioning creditors receive payment in preference over other creditors as consideration for dismissal. See also In re Broshear, 122 B.R. 705, 708 (Bankr. S.D. Ohio 1991) (Dismissal of involuntary case vacated unless petitioning creditors returned monies paid them in consideration of dismissal).

CHAPTER 3-12: RAILROAD REORGANIZATIONS

3-12.1 INTRODUCTION

A railroad is defined as a "common carrier by railroad engaged in the transportation of individuals or property, or owner of trackage facilities leased by such a common carrier." 11 U.S.C. § 101(44). A railroad is not eligible to file under chapter 7 of the Bankruptcy Code, but may file for reorganization pursuant to the provisions of 11 U.S.C. § 1161 et. seq. Liquidation may occur in chapter 11 as if the case were a case under chapter 7 if the court finds that the debtor cannot be reorganized or if certain time limits are not met. See 11 U.S.C. § 1174.

A railroad reorganization is markedly different from a typical chapter 11 reorganization. Certain otherwise applicable sections of the Bankruptcy Code are specifically made inapplicable to a case concerning a railroad. 11 U.S.C. § 1161.

The following sections do not apply in a railroad reorganization:

11 U.S.C. § 341:	Meetings of Creditors and Equity Security Holders
11 U.S.C. § 343:	Examination of the Debtor
11 U.S.C. § 1102(a)(1):	Appointment of Creditors' and Equity Security Holders' Committees

11 U.S.C. § 1104:	Appointment of Trustee or Examiner
11 U.S.C. § 1105:	Termination of Trustee's Appointment
11 U.S.C. § 1107:	Rights, Powers, and Duties of Debtor in Possession
11 U.S.C. § 1129(a)(7):	Confirmation Standards Relating to an Acceptance by Impaired Classes
11 U.S.C. § 1129(c):	Confirmation Standards in the Context of More Than One Plan

Because the appointment of a trustee is mandatory in a railroad reorganization, 11 U.S.C. § 1107 is arguably not necessary. 11 U.S.C. §§ 1129(a)(7) and 1129(c) have corresponding standards codified at 11 U.S.C. §§ 1173(a)(2) and (b), respectively. Curiously, however, there is no statutory provision whatsoever for a meeting of creditors or examination of the debtor in the railroad reorganization subchapter. While 11 U.S.C. § 1102(a)(1) is expressly inapplicable to railroads, 11 U.S.C. § 1102(a)(2) remains applicable. Accordingly, the United States Trustee may appoint a committee if the court orders one in response to a request by a party in interest.

3-12.2 APPOINTMENT OF A TRUSTEE

Section 1163 of the Bankruptcy Code indicates that it is the duty of the Secretary of Transportation to submit a list of five disinterested persons that are qualified and willing to serve as the railroad reorganization trustee as soon as practicable after the order for relief. In some cases, the attorney for the debtor railroad may already have contacted the Department of Transportation prior to the filing of the petition in order to expedite provision of the list. Otherwise, since the United States Trustee is required to make the appointment, the United States Trustee should promptly initiate contact with the Department of Transportation and request that a list be provided as soon as possible.

Because 11 U.S.C. § 1104 and Fed. R. Bankr. P. 2007.1 do not apply, court approval of the appointment is not required and, technically,

consultation with parties in interest concerning the selection is not necessary. Prudence would dictate, however, that if parties in interest are available that they be consulted regarding the relative merits and demerits of the five prospective appointees. The customary chapter 11 form of affidavit must be completed by the appointee and submitted so that a background investigation can be initiated.

The United States Trustee determines the amount and sufficiency of the railroad reorganization trustee's bond pursuant to 11 U.S.C. § 322. The appointee qualifies as a trustee if the bond is filed with the court within five days after his/her selection.

3-12.3 OPERATIONS DURING THE GAP PERIOD

Clearly, some period of time will elapse between the filing of a railroad case and the appointment of a trustee authorized to operate it. Technically, due to the inapplicability of 11 U.S.C. § 1107 in a railroad reorganization case, the debtor is de facto left in possession during this gap period. The debtor's rights, powers, and duties under these circumstances are neither defined nor authorized by the Bankruptcy Code. Depending on the circumstances of the case, it may be appropriate for the United States Trustee or the debtor's attorney to urge an emergency motion for an operating order that would define the scope of the debtor's operating authority pending the appointment of a trustee. In addition, due to the peculiar feature contained in 11 U.S.C. § 1171 which accords administrative expense priority to both pre and postpetition claims of individuals or personal representatives for personal injury or wrongful death, it is incumbent upon the United States Trustee to verify the existence of adequate liability insurance coverage at or before the initial debtor interview before permitting the debtor's operations to continue.

3-12.4 OTHER PROVISIONS APPLICABLE ONLY TO RAILROAD REORGANIZATIONS

The United States Trustee supervising the administration of a railroad reorganization estate should be cognizant of certain features of this type of case that are not typical of the ordinary chapter 11. First, in addition to the consideration generally given to the interests of the debtor, creditors, and equity security holders, the court is required to consider the "public

interest" in applying certain provisions of this subchapter. 11 U.S.C. § 1165. Given the fact that the Surface Transportation Board and the Department of Transportation, as well as any state or local commission having regulatory jurisdiction over the debtor, are accorded the right to be heard on any issue in the case, it may be presumed that these agencies will assist in informing the court of what the public interest is. See 11 U.S.C. § 1164. Other language within the subchapter indicates that the public interest would include, among other things, maintenance of adequate rail service and considerations having to do with the impact of the court's decisions on employees, shippers, and communities affected by the debtor's operations.

Notwithstanding 11 U.S.C. §§ 365 and 1113, the wages and working conditions of railroad employees established by a collective bargaining agreement cannot be changed by the trustee or the court except as permitted by non-bankruptcy laws. Other preferences in favor of railroad employees are afforded in connection with abandonments, 11 U.S.C. § 1170(e)(1) and (2), and transfer of operations, 11 U.S.C. § 1172(c)(1) and (2).

The ability of the debtor to reorganize may be significantly affected by the provisions of 11 U.S.C. § 1168, which essentially provide an automatic relief from stay to a creditor holding a purchase money security interest in the debtor's rolling stock or equipment after 60 days, unless the trustee cures all defaults and agrees to perform all the debtor's obligations under the security agreement.