

United States Trustees – Bankruptcy Watchdogs and Appellate Advocates

Written by:

*P. Matthew Sutko, Associate General Counsel for Appellate Practice
Saleela Khanum Salahuddin, Trial Attorney
Executive Office for United States Trustees
Washington, D.C.*

Introduction

The United States Trustee Program acts as the nation’s “bankruptcy watchdog” to protect debtors, creditors and the bankruptcy system. In fulfilling this statutory role, the Program – working in tandem with other Department of Justice components – regularly appears as appellant, appellee and amicus curiae before bankruptcy appellate panels, district courts, courts of appeals and the Supreme Court.

Two overarching goals underlie the Program’s appellate practice. First, the Program works to ensure justice is done, and the law is followed. Second, the Program promotes predictability and consistency in the bankruptcy system by participating in important appeals that construe Bankruptcy Code provisions.

To fulfill those goals, the Program participates in appeals that address a variety of legal issues under chapters 7, 11, 12 and 13. Last year, we participated in more than one hundred appeals.

The past three years have been a particularly busy time for bankruptcy practitioners, and for the Program, because courts have been called upon to interpret a number of Bankruptcy Code provisions enacted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Many have reached district courts and bankruptcy appellate panels. Increasingly, United States courts of appeals are addressing these questions.

The United States Trustee Program does more than litigate issues relating to the 2005 Act, however. This article highlights four core areas of bankruptcy appeals in which United States Trustees, and other components of the Department of Justice, are currently involved: (1) chapter 11 litigation; (2) creditor abuse litigation; (3) means testing litigation; and (4) debt relief agency litigation.

Chapter 11 Litigation

The Program has for many years played an active appellate role in a variety of important chapter 11 issues. Program appeals have helped settle when an independent trustee is appropriate, when a professional is eligible under the Code to represent a debtor in possession or a committee, and what constitutes appropriate compensation for the services those professionals provide. Our appeals have also helped settle when a chapter 11 debtor’s case should be

converted to chapter 7 or dismissed.

As the Program continues to focus on these recurring issues, it has also found it necessary to address new ones. One new issue arises from the 2005 Act's limitation upon the use of Key Employee Retention Plans. In the past, KERPs were often used by corporate debtors to pay large retention bonuses to company executives. Through its 2005 enactment of 11 U.S.C. § 503(c)(1), Congress strictly limited the circumstances in which debtor corporations may pay retention bonuses to corporate officers and other insiders. Since 2005, the Program has enforced the statutory restriction before trial and appellate courts. The Program will continue to do this.

The Program has also been actively involved in appeals that seek to ensure that chapter 11 trustees continue to be appointed in appropriate cases. Some corporate debtors have sought to evade Bankruptcy Code requirements by seeking court approval to designate third parties who operate free of the Bankruptcy Code's comprehensive system governing independent bankruptcy fiduciaries. In response, the Program is participating in appeals that seek to curb this practice and the Program will continue to do so should others engage in similar practices.

Creditor Abuse Litigation

_____ The Bankruptcy Code requires debtors to take many affirmative steps to obtain bankruptcy relief. But the very integrity of the system mandates this cannot be a one-way street. For the bankruptcy system to work, creditors must meet their responsibilities under the Code, and must deal fairly with debtors, with each other, and with the courts.

Unfortunately, in some instances, creditors, including secured lenders, have fallen short of their obligations. This has led United States Trustees to ask federal courts to use their statutory and inherent powers to curb those abuses, and prevent their reoccurrence. The Program has opposed creditor efforts to foreclose judicial review of their conduct by appealing discovery orders and orders authorizing Rule 2004 examinations. In those appeals, some creditors have raised novel jurisdictional and standing arguments in suggesting bankruptcy courts cannot rectify alleged creditor abuses. The Program has vigorously defended those appeals. To date, the appellate courts have universally recognized that creditors must submit to discovery, have recognized that United States Trustees can ask federal courts to curb creditor misconduct, and have recognized that United States bankruptcy courts possess jurisdiction to impose appropriate remedies when faced with creditor abuse.

Means Test Litigation

The 2005 Act created a means test that determines whether above-median income chapter 7 debtors' cases should be dismissed as presumptively abusive. The means test also has significance for chapter 13 cases because the Act imported means testing concepts into the determination of above-median income chapter 13 debtors' disposable income.

The means test raises many interpretive issues. The Program has been most actively involved in four of these issues, discussed below.

Vehicle Ownership Expense Amounts

The Bankruptcy Code allows debtors to claim a vehicle ownership expense, in a set amount, when that expense is “applicable” under 11 U.S.C. § 707(b)(2)(A)(ii)(I). It was Congress’ expressed intent in enacting the 2005 Act to ensure that above-median income debtors repay their debts when they can, and to eliminate abuse of the bankruptcy system by debtors who seek to avoid debts they can repay. Thus, in both the chapter 7 and chapter 13 contexts, the Program has argued that debtors may not claim a vehicle ownership expense amount as “applicable” when they do not have actual vehicle ownership expenses, such as a loan or lease payment.

The vehicle ownership expense amount issue is pending in the Sixth, Seventh, Eighth, Ninth and Tenth circuits. The United States is a party to those appeals, or is participating as amicus curiae.

Projected Disposable Income

The 2005 Act amended 11 U.S.C. § 1325, which governs confirmation of a chapter 13 plan, to change the definition of “disposable income” to mean “current monthly income received by the debtor . . . less amounts reasonably necessary to be expended” for maintenance or support or necessary business expenses. The new definition defines “disposable income” based on an average of past monthly income and expense figures, and, for above-median debtors, requires the use of the same standard expenses mandated for certain debtors under 11 U.S.C. § 707(b)(2).

The question is whether the word “projected” means “disposable income” is subject to adjustment to take into account likely changes to a debtor’s income. The United States has argued that a debtor’s historical “disposable income” is only the starting point in determining “projected disposable income” under 11 U.S.C. § 1325, and courts should take into account significant changes in the debtor’s financial condition if necessary to reflect the debtor’s ability to fund a plan.

Ruling on the projected disposable income issue, the Ninth Circuit, in *Maney v. Kagenveama* (*In re Kagenveama*), – F.3d –, 2008 WL 2485570 (9th Cir. June 23, 2008), held, in part, that projected disposable income under 11 U.S.C. § 1325(b)(1)(B) is calculated according to the historical definition of “disposable income,” and is not subject to adjustment in light of changed circumstances.

The *Kagenveama* holding will be disadvantageous to debtors who suffer financial setbacks shortly before plan confirmation. The United States disagrees with the Ninth Circuit’s ruling in *Kagenveama* on the meaning of projected disposable income and is pressing the issue, as either a party or as amicus curiae, in the Fifth and Tenth circuits.

Surrender

In both the chapter 7 and chapter 13 contexts, the Program has taken the position that,

under the means test, codified in 11 U.S.C. § 707(b)(2), a debtor should not be allowed to deduct payments to secured creditors when the debtor intends to surrender the secured property to the secured creditor.

The surrender issue is pending before the First Circuit. In the decision preceding the appeal to the First Circuit, *Rudler v. Morse (In re Rudler)*, 388 B.R. 433 (B.A.P. 1st Cir. 2008), the United States Bankruptcy Appellate Panel for the First Circuit held that, in calculating disposable income under the means test, 11 U.S.C. § 707(b)(2)(A)(iii) allows debtors to deduct secured payments due at the time of filing the petition, regardless of the debtor's ultimate intent concerning the secured property. The ensuing First Circuit appeal is in the midst of briefing.

The Totality of Circumstances of a Debtor's Financial Situation

The 2005 Act allows courts to dismiss chapter 7 cases when the totality of the circumstances of a debtor's financial situation demonstrates abuse. Specifically, 11 U.S.C. § 707(b)(3)(B) permits a court deciding whether to dismiss a chapter 7 case for abuse to consider whether "the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor's financial situation demonstrates abuse."

This section represents a significant departure from prior law. Under section 707(b)(3)(B), courts now consider whether the totality of a debtor's financial circumstances, standing alone, justifies dismissal when the debtor has the ability to repay a portion of outstanding debt. To determine the totality of someone's financial situation, section 707(b)(3)(B) requires courts to factor in likely increases and decreases in income, expenses, assets and liabilities. Thus, whenever a life event – e.g., retirement, serious illness, childbirth – will likely change the debtor's income, expenses, assets or liabilities, the court must incorporate the financial effect of that likely change in its totality of the financial circumstances evaluation. Conversely, life events that will not affect financial condition in a particular case have no legal significance under a section 707(b)(3)(B) analysis.

The issue of the totality of a debtor's financial situation is pending before the Ninth Circuit. The United States Trustee is an appellee in that appeal.

Debt Relief Agency Litigation

_____ The 2005 Act added sections 526, 527 and 528 of the Bankruptcy Code. These sections establish minimum standards for "debt relief agencies," a term defined to include "any person" who provides bankruptcy assistance to assisted persons in exchange for a fee. Some attorneys and clients have asked federal courts to rule that an attorney is never subject to sections 526 - 528 because they are not a "debt relief agency" under the statute. A number of suits have also alleged that a few subsections of sections 526 - 528 violate the First Amendment. Most consistently, parties have alleged that section 525(a)(4), which prohibits debt relief agencies from advising clients to incur debt in contemplation of bankruptcy, violates the First Amendment.

Most courts have concluded attorneys are debt relief agencies subject to sections 526 - 528 when they provide bankruptcy assistance to assisted persons for a fee. Most recently, the Eighth Circuit held in *Milavetz & Gallop v. United States*, – F.3d –, 2008 WL 4068448 (8th Cir. Sept. 4, 2008), that attorneys who provide bankruptcy assistance to assisted persons are debt relief agencies. *Milavetz* also rejected constitutional challenges to sections 528(a)(4) and 528(b)(2), which require debt relief agencies to make various disclosures in their advertisements and the materials they provide to assisted persons. The decision upheld Congress' right to require those disclosures, finding they are reasonably related to the government's interest in protecting consumer debtors from deceptive advertising. However, the majority of the *Milavetz* panel ruled section 526(a)(4)'s prohibition against attorneys advising clients to incur debt in contemplation of bankruptcy was unconstitutionally overbroad in violation of the First Amendment. A dissenting panel member disagreed.

Debt relief agency issues remain on appeal before the Second, Fifth and Ninth circuits. The United States is participating in each of those appeals.

Conclusion

The United States Trustee Program brings its national perspective to bankruptcy appeals in an effort to foster clear and coherent case law. An essential element of justice and fairness is equal application of the law. From bankruptcy courts to courts with appellate jurisdiction, United States Trustees endeavor to litigate bankruptcy issues consistently across a wide range of areas to ensure such equal application of the law and to benefit the entire bankruptcy system.