# ADMINISTRATION OF CASES UNDER THE BANKRUPTCY CODE

The costs of administering a bankruptcy case are paid prior to any payment to creditors, including other priority creditors.[2111] Creditors, debtors, and other parties in interest thus all benefit from the efficient administration of bankruptcy cases. Fair and expeditious administration of cases provides quick and often better results for creditors by lowering the estate's administrative costs. The Commission's Recommendations on bankruptcy administration focus on increasing the efficiency and fairness of the system and reducing the costs of administering bankruptcy cases.

[2111] 11 U.S.C. § 507(a) (1) (1994) (ranking administrative expenses under section 503(b) as the highest priority claim).

# RECOMMENDATIONS

**3.3.1** ***United States Trustee Program***

**The Director of the Executive Office for United States Trustees should hold the position of Assistant Attorney General.**

**The United States Trustee regions should match the number, size and configuration of the federal judicial circuits.**

**3.3.2** ***Personal Liability of Trustees***

**Trustees appointed in cases under Chapter 7, 11, 12 or 13 of the Bankruptcy Code should not be subject to suit in their individual capacity for acts taken within the scope of their duties as delineated in the Bankruptcy Code or by order of the court, as long as the applicable order was issued on notice to interested parties and there was full disclosure to the court.**

**Chapter 7, 12 and 13 trustees only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee acted with gross negligence in the performance of the trustee's fiduciary duties. Gross negligence should be defined as reckless indifference or deliberate disregard of the trustee's fiduciary duty.**

**A Chapter 11 trustee of a corporate debtor only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee has violated the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.**

**Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.**

**3.3.3** ***Qualification of Professionals under 11 U.S.C. § 1107(b)***

**Section 1107(b) should be amended to provide that a person should not be disqualified for employment under § 327 solely because such person**

**holds an insubstantial unsecured claim against or equity interest in the debtor. Section 327 and § 101(14) should remain unchanged.**

### 3.3.4 *National Admission to Practice*

**Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure.**

**The Recommendation will not affect requirements (if any) to associate with local counsel. Similarly, the Recommendation will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The Recommendation will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located to appear in a particular bankruptcy case.**

### 3.3.5 *Fee Examiners*

**The Bankruptcy Code should explicitly preclude the appointment of fee examiners as an improper delegation of the court's duty to review and award compensation under 11 U.S.C. § 330. The Recommendation does not affect the court's authority under 11 U.S.C. § 1104(c) to appoint an examiner to investigate and report on certain aspects of a Chapter 11 case, for example, a potential fraudulent transfer or a particularly complicated claims estimation.**

### 3.3.6 *Attorney Referral Services*

**11 U.S.C. § 504 should be amended to permit an attorney compensated out of a bankruptcy estate to remit a percentage of such compensation to a bona fide, nonprofit, public service referral program. Such attorney referral program must be operating in accordance with state laws and ethical rules and guidelines governing referrals. The Recommendation does not affect the requirement that all compensation arrangements be disclosed in the application for retention under Fed. R. Bankr. P. 2014 and in the application for compensation under Fed. R. Bankr. P. 2016(a).**

# DISCUSSION

Two groups are principally involved in the administration of bankruptcy cases. The United States Trustee Program is an executive branch agency within the Department of Justice that is responsible for overall bankruptcy administration in forty-eight states, Puerto Rico & Guam.[2112] The United States trustee is responsible for the oversight of bankruptcy cases as well as panel and standing trustees and professionals retained in bankruptcy cases.[2113] In addition to its oversight function, the United States trustee may "appear and be heard on any issue in any case or proceeding" under the Bankruptcy Code.[2114] The United States Trustee Program is funded, in principal part, by fees collected in bankruptcy cases.[2115]

Private professionals (usually attorneys) also assist in the administration of bankruptcy cases either as standing or panel trustees or as professionals retained by the estate.[2116] Similar to U.S. trustee's fees, standing trustees, panel trustees, and estate professionals are paid on an administrative priority basis, ahead of any

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[2112] 28 U.S.C. § 581 (1994). The remaining six judicial districts in North Carolina and Alabama do not have United States trustees. The Bankruptcy Administrator ("BA") system is responsible for bankruptcy administration in those districts. Section 302(d)(3)(I) of the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 authorized the Judicial Conference of the United States to establish a bankruptcy administrator program. The BA system is part of the judicial branch under the Administrative Office of the U.S. Courts. Pub. L. No. 99-554, 100 Stat. 3088 (1986). The BA system is currently scheduled to opt-in to the U.S. trustee program no later than October 1, 2002.

The Commission discussed the BA system, but does not make a recommendation.

[2113] 28 U.S.C. § 586 (1994). Section 586 outlines the responsibilities of the United States trustee.

[2114] 11 U.S.C. § 307 (1994). The only restriction on a United States trustee under this section is the inability to file a plan pursuant to section 1121(c).

[2115] 28 U.S.C. § 589(a)(b) (1994)(listing the percentage of the fees collected in bankruptcy cases pursuant to 28 U.S.C. § 1930 that are deposited in the United States Trustee System Fund).

[2116] *See, e.g.*, 28 U.S.C. § 586(a)(1) & (b) (1994) (authorizing the U.S. trustee to appoint and supervise panel and standing trustees). Panel trustees are appointed to supervise cases filed under Chapter 7. 28 U.S.C. § 586(a)(1) (1994). Standing trustees are appointed to supervise cases filed under Chapters 12 or 13. 28 U.S.C. § 586(b) (1994).

distribution to unsecured creditors.[2117] Efficient use of bankruptcy professionals' time thus results in lower administrative costs. Bankruptcy professionals and trustees also must meet certain conflict of interest requirements under the Bankruptcy Code prior to being retained.[2118] The statutory requirements do not provide a bright line rule for professionals or courts to determine whether a particular professional is eligible for retention by the estate.[2119] These provisions are thus a source of confusion for bankruptcy professionals seeking to be retained and compensated as well as for the bankruptcy courts reviewing their retention and fee applications.[2120]

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[2117] *See* 28 U.S.C. § 586(e)(1)(B) (1994) (allocating percentage payment to Chapter 12 and 13 standing trustees out of payments made under the debtor's plan); 11 U.S.C. § 326 (limiting the compensation of Chapter 7 or Chapter 11 trustees to certain percentages of amounts disbursed or turned over in the case).

[2118] *See, e.g.,* 11 U.S.C. § 327(a) (1994) (requiring professionals retained by the estate to be "disinterested" and have no "interest adverse to the estate"); 11 U.S.C. § 701(a)(1) (1994) (requiring one "disinterested" member of the panel of private trustees to be appointed as interim trustee).

[2119] *Compare* 11 U.S.C. § 101(14)(E) (1994) (defining disinterestedness as one "who does not have an interest materially adverse to the estate") *with* 11 U.S.C. § 327(a) (1994) (requiring that professionals be both "disinterested" and not "hold or represent an interest adverse to the estate").

[2120] The Third, Sixth and Eighth Circuits as well as the Ninth Circuit Bankruptcy Appellate Panel have all adopted *per se* interpretations of the disqualification provisions of section 327(a). Michel v. Federated Dep't Stores, Inc. (*In re* Federated Dep't. Stores), 44 F.3d 1310, 1318 (6th Cir. 1995) (overruling lower courts' equitable approval of investment banker who did not meet disinterestedness requirements of section 327(a)); United States Trustee v. Price Waterhouse (*In re* Sharon Steel), 19 F.3d 138 (3d Cir. 1994) (finding that debtor's prepetition accounting firm was not disinterested and could not be retained under section 327(a) where accounting firm held $875,000 unsecured claim); Michel v. Eagle-Picher Indus., Inc. (*In re* Eagle-Picher Indus., Inc.), 999 F.2d 969, 972 (6th Cir. 1993) (debtor's prepetition investment bank disqualified as not disinterested where professional served as underwriter for outstanding securities of the debtor; court found that a professional could be "not disinterested, yet without an adverse interest" requiring disqualification); Childress v. Middleton Arms, L.P. (*In re* Middleton Arms, Ltd. Partnership), 934 F.2d 723 (6th Cir. 1991) (insider of debtor could not be retained as real estate broker; court found that a not disinterested person could not be employed even if that person did not hold an interest adverse to the estate); Pierce v. Aetna et al., 809 F.2d at 1362 (disqualifying attorney who held prepetition security interest as not disinterested; recognizing that the attorney might not hold material adverse interest, but that "the intent of the statute is clear; if a professional is a creditor, then that person is not disinterested"); First Interstate Bank of Nevada, N.A. v. CIC Investment Corp., (*In re* CIC Investment Corp.), 175 B.R. 52 (B.A.P. 9th Cir. 1994) (professional was not disinterested where prepetition claim was secured by debtor's property).

Numerous lower courts and one circuit court, however, have found that the statutory results are illogical. These courts hold that unless the disinterested professional also holds a material adverse interest, the fact that the professional is disinterested (as defined by section 101(14) will not, without more, disqualify the professional. *In re* Martin, 817 F.2d 175, 180 (1st Cir. 1987) (upholding mortgage on debtor's property in favor of attorneys; case remanded for inquiry into whether "acceptance of the mortgage by [the attorneys] created either a meaningful incentive to act

The Commission's Recommendations on bankruptcy administration focus on the relationship between these two groups and the bankruptcy process in an effort to improve the administration of bankruptcy cases and thereby lower administrative costs. The Recommendations accomplish this goal in a number of ways. The U.S. trustee Recommendations are designed to improve the stature and visibility of the Program as well as to increase uniformity of policy among the U.S. trustee regions. The standing and panel trustee Recommendations resolve a conflict among the circuit courts by proposing a uniform personal liability standard for breach of a trustee's fiduciary duty. The bankruptcy professional Recommendations are designed to reduce inequities under the disinterestedness requirements for professionals retained by a debtor in possession. The remaining administrative Commission Recommendations are designed to enforce certain obligations under the Code and streamline certain specific procedures in an effort to reduce administrative costs.

### 3.3.1 *United States Trustee Program*

**The Director of the Executive Office for United States Trustees should hold the position of Assistant Attorney General.**

**The United States trustee regions should match the number, size and configuration of the federal judicial circuits**.

For more than sixty years the separation of bankruptcy adjudication from bankruptcy administration has been debated.[2121] Before the adoption of the 1978

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contrary to the best interests of the estate and its sundry creditors -- an incentive sufficient to place those parties at more than acceptable risk -- or the perception of one."); *In re* PHM Credit Corp., 110 B.R. 284, 288 (E.D. Mich. 1990) (applying equitable analysis to disinterestedness requirement; "[s]tatutes should be interpreted to avoid unreasonable results whenever possible."); *In re* Microwave Prods. of Am., Inc., 94 B.R. 971, 974-75 (Bankr. W. Tenn. 1989) (approving retention of public relations firm who held prepetition claim); *In re* Viking Ranches, Inc., 89 B.R. 113 (Bankr. C.D. Cal. 1989) (applying section 1107(b) as an exception to disinterestedness requirement unless material adverse interest exists); *In re* Best W. Heritage Inn Partnership, 79 B.R. 736 (Bankr. E.D. Tenn. 1987) (attorneys' prepetition claims did not result in per se disqualification; existence of material adverse interest was only ground to disqualify firm); *In re* Heatron, 5 B.R. 703 (Bankr. W.D. Mo. 1980) (authorizing retention of attorney who held prepetition unsecured claim; concluding "that an attorney who has represented the debtor prior to the filing of the bankruptcy proceeding, who assisted in the preparation of the petition and who is a major creditor, without more, does not have an interest adverse to the debtor.").

[2121] In the 1930s, various reports were submitted to Congress and the Judicial Conference recommending the creation of a centralized supervisory body in the executive branch to relieve the bankruptcy courts of their administrative responsibilities. The first reports was submitted by the Sabath Committee. *See* HOUSE COMM. ON THE JUDICIARY, REPORT ON ADMINISTRATION OF BANKRUPTCY ESTATES, 71st Cong., 3d Sess. (Comm. Print 1931). The Sabath Committee was established by the Judiciary Committee. Its recommendations led directly to the Securities and

Reform Act, the bankruptcy system often consisted of a closed practice, ex parte communications, cronyism and judicial control.[2122] Reformers at the time believed that bankruptcy courts should operate like other federal courts in order to remain feasible in an economically uncertain future. The reformers were right. Despite the volume of attacks on the current system, it is virtually certain that during the remarkably tumultuous 1980's the old bankruptcy system would have been considered a national scandal and the reforms enacted in response would have been draconian. Cronyism is no longer a systemic problem in bankruptcy. Concern over separation of functions has shifted to questions concerning the placement and structure of the entity responsible for bankruptcy administration.

There is a great deal of geographic diversity as well as differences in operations and management styles between the various regional U.S. trustee offices. The Commission solicited comments and suggestions from interested persons across the country in an effort to gain a broad-based view of the U.S. Trustee program's strengths and weaknesses. The Commission devoted four working group sessions to the operation of the U.S. Trustee program; two of these sessions were held in Washington, DC; and one each in Detroit, MI and Chicago, IL. The Commission also actively solicited comments from members of the legal community and public during its meetings around the country, including meetings (in addition to Washington, DC) in Santa Fe, NM, San Diego, CA, Akron, OH, Des Moines, IA, Seattle, WA, New York, NY, Detroit, MI, and Chicago, IL. The Commission's Recommendations are based on the discussions and open forum suggestions on how to improve the operation of the U.S. Trustee system.

### A. Bankruptcy Administration Under the 1978 Reform Act

Incorporating some of the 1973 Commission's Recommendations, the 1978 Reform Act expanded the jurisdiction of the bankruptcy judges to resolve bankruptcy-related disputes.[2123] At the same time, the Reform Act removed most of the bankruptcy judges' administrative responsibilities for bankruptcy cases.[2124] The

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Exchange Commission's role in Chapter X cases. *Hearings Before House Judiciary Committee on H.R. 9 and H.R. 6963,* 75th Cong., 1st Sess. 10 (1937).

[2122] REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, at 93 (1973) (hereinafter "COMMISSION REPORT").

[2123] The functions of all bankruptcy judges have changed since enactment of the Reform Act, as their jurisdiction has been limited in light of the Supreme Court's opinion in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.,* 458 U.S. 50 (1982).

[2124] To some extent, the requirement that a bankruptcy judge approve any matter that is not contested by the parties or the trustee is an administrative function. It was suggested that after a strong U.S. Trustee program or other public administrator is established nationally, it could be legislative history indicates that achieving this separation was a principal goal of the Reform Act:

> Bankruptcy judges administer the present bankruptcy system, and are responsible for the administration of individual bankruptcy cases. Their administrative, supervisory, and clerical functions in these matters are in addition to their judicial duties in bankruptcy cases. . . . [T]he inconsistency between the judicial and administrative roles of the bankruptcy judges . . . places him (sic) in an untenable position of conflict, and seriously compromises his impartiality as an arbiter of bankruptcy disputes.[2125]

Congress created the U.S. Trustee program as a pilot program under the supervision of the Attorney General to provide for the performance of the administrative duties that were removed from the judges. The U.S. trustees were charged with supervising the administration of bankruptcy cases in eighteen of the ninety-four federal judicial districts ("pilot districts"). The Reform Act did not provide for the performance of administrative duties in those districts for which no U.S. trustee was authorized ("non-pilot districts"). To the extent these duties were performed, they were divided among bankruptcy judges, the bankruptcy court clerks, estate administrators, and the Administrative Office. The decision to place the pilot program in the Department of Justice ("DOJ") resulted from consideration of a number studies,[2126] as well as the executive nature of the duties assigned.[2127] Initially, the program was slated to sunset on April 1, 1984.[2128] The Attorney General was directed to submit a report to Congress, the President and the Judicial Conference no later than January 3, 1984, on the feasibility, cost and effectiveness of the program, along with recommendations as to its implementation in all federal judicial districts.[2129]

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charged with approving uncontested matters after taking account of the public interest, leaving the judges to resolve only contested matters. While the Reform Act did not eliminate this judicial oversight function, it did eliminate this portion of the judges' responsibility for initiating and supervising administrative matters.

[2125] H.R. REP. No. 95-595, at 88-89 (1977).

[2126] *See* COMMISSION REPORT, *supra* note 2122, at 103-56; P. FISH, THE POLITICS OF FEDERAL JUDICIAL ADMINISTRATION (1973); Frank R. Kennedy, *Restructuring Bankruptcy Administration: The Proposals of the Commission on Bankruptcy Laws*, 30 BUS. LAW. 398, 401-405 (1975).

[2127] *See* H.R. REP. No. 95-595, at 111 (1977).

[2128] Bankruptcy Reform Act of 1978, § 224, 28 U.S.C. § 581 (amended 1986).

[2129] Pub. L. No. 95-598, § 408(b), 92 Stat. 2687 (1978) (repealed 1986).

In order to fulfill this responsibility, the DOJ commissioned an in-depth study of the pilot program.[2130] The study, completed in 1983, concluded that the program had been successful because case administration within the pilot districts was better than in the non-pilot districts.[2131] The report recommended nationwide expansion of the program on a regional basis under the auspices of the DOJ.[2132] Subsequently, various professional organizations adopted and seconded the Recommendation.[2133]

In January 1984, the Attorney General issued a report which concluded that the pilot program had been successful.[2134] Although the Attorney General's Report set forth a proposed organizational structure for a nationwide U.S. Trustee program,[2135] it made no firm recommendation as to which government agency should house the program[2136] and refused to make a recommendation regarding nationwide expansion until Congress resolved the problem of the bankruptcy courts' jurisdiction in light of the *Northern Pipeline* decision.[2137] Shortly thereafter, the General Accounting Office assessed the effectiveness of the bankruptcy process and concluded that more guidance and supervision of private trustees was necessary.[2138]

Deliberations on the jurisdiction and structure of the bankruptcy courts occupied Congress until July of 1984. In the meantime, the expiration date of the

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[2130] JYUST-82-C-001. The study included data collected in 20 federal judicial districts, and an analysis of over 1500 bankruptcy cases. Abt Associates of Cambridge, MA was retained to perform the study.

[2131] *See* Abt Associates, Inc., An Evaluation of the U.S. Trustee Pilot Program for Bankruptcy Administration: Findings and Recommendations 280 (1983) (hereinafter cited as "*Abt Report*").

[2132] *Id.* at 280.

[2133] *See, e.g.* letter from Leonard M. Rosen, Chairman, and Frank R. Kennedy, Secretary, National Bankruptcy Conference, to Attorney General William French Smith (November 5, 1984).

[2134] *See* UNITED STATES DEP'T. OF JUSTICE, REPORT OF THE ATTORNEY GENERAL ON THE UNITED STATES TRUSTEE SYSTEM ESTABLISHED IN THE REFORM ACT OF 1978 FOR THE PERIOD OCTOBER 1, 1979 TO DECEMBER 31, 1983, 53-55 (1984).

[2135] *Id.* at 61-66.

[2136] *Id.* at 57-61.

[2137] *Id.* at 55-57. Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

[2138] U.S. GENERAL ACCOUNTING OFFICE, REPORT TO THE ATTORNEY GENERAL AND THE DIRECTOR, ADMINISTRATIVE OFFICE OF THE U.S. COURTS: GREATER OVERSIGHT OF BANKRUPTCY PROCESS NEEDED (1984).

U.S. Trustee program was twice extended.[2139] In 1985, Abt Associates conducted an additional study and confirmed its earlier findings and recommendations.[2140] Finally, with the restructuring of the jurisdiction of the bankruptcy courts completed in the 1984 amendments, the executive branch prepared legislation to establish a national U.S. Trustee system and Congress turned its attention to the U.S. trustees.

B. Expansion of the Pilot Program

i. The House of Representatives

In July, 1985, hearings on the U.S. Trustee program were held by the Subcommittee on Monopolies and Commercial Law of the House Judiciary Committee.[2141] All of the witnesses favored expansion of the program.[2142] Although there appeared to be no question that some entity was required to handle the administrative aspects of bankruptcy cases, the placement of that entity was the subject of contention among the branches of the federal government. Six witnesses, including the Associate Attorney General of the DOJ, testified in favor of continuation of the U.S. Trustee program within the DOJ,[2143] while two other witnesses, both judges, stressed that the program should be located within the judicial branch.[2144]

The main issue raised throughout the hearings was the potential for conflicts of interest should the program be administered by the DOJ, since that agency

[2139] The program was extended until September 30, 1984 by Pub. L. No. 98-166, 97 Stat. 1081 (1983). It was later extended until September 30, 1986 by Pub. L. No. 98-353, § 323, 98 Stat. 333 (1984).

[2140] *See* Abt Associates, Inc., An Evaluation of the U.S. Trustee Pilot Program for Bankruptcy Administration: August 1985 Update (1985).

[2141] *The U.S. Trustees Act of 1985: Hearings on H.R. 2660 and H.R. 3664 Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 99th Cong., 1st & 2d Sess. 1-154 (1985 & 1986) (hereinafter cited as *House Hearings*).

[2142] All of the witnesses, except one, were current or former members of the U.S. Trustee program. The exception, Judge Jeremiah E. Berk, heard cases in both pilot and non-pilot districts.

[2143] *See House Hearings supra* note 2141, at 195-275 (testimony and prepared statements of Arnold I. Burns, Associate Attorney General, DOJ; J. Ronald Trost, Esq., and Professor Lawrence P. King of the National Bankruptcy Conference; Joseph Matz, Esq., and Arthur Ungerman, Esq. of the Commercial Law League of America; Richard J. Leighton, Esq. of the U.S. Chamber of Commerce; and the Hon. Cornelius Blackshear, bankruptcy judge for the Southern District of New York).

[2144] *See id.* at 275-316 (testimony and prepared statement of the Hon. Robert E. DeMascio, on behalf of the Judicial Conference of the U.S. and the Hon. G. William Brown, bankruptcy judge for the Western District of Kentucky).

represents most governmental agencies in bankruptcy cases.[2145] Proponents argued that placement of the program in the executive branch had not given rise to any of the theoretical problems cited by the opponents, including, formerly, the DOJ, which had vehemently opposed responsibility for the pilot program in 1978.

The bill passed by the House, H.R. 5316, set the term of office of a U.S. trustee at five years, rather than the four-year term originally proposed in other House bills. This was done in order to minimize politicization of the office of the U.S. Trustee. The bill required the Attorney General to find "cause" to remove a U.S. trustee, again to minimize undue political influence. While retaining the duties set forth for the U.S. trustees in general, the bill enumerated eight specific duties to be performed where appropriate.

ii. The Senate

On March 25, 1986, the Senate held hearings on its bill, S. 1961.[2146] Testimony in favor of the program's expansion was received from representatives of the DOJ and various professional groups, while representatives from the Judicial Conference and members of the bench voiced concerns regarding expansion of the program and its placement.[2147]

The judicial branch strongly opposed placement of the U.S. Trustee program in the DOJ, proposing instead a system of "bankruptcy administrators" housed within

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[2145] *Id.* at 65-66, 115-116, 204, 215-16, 279, 289-290. This issue, first raised by the DOJ, had been considered and rejected by Congress in 1977 when it initially considered the placement of the program. *See* H.R. REP. NO. 95-595, at 111, 114-15 (1977).

[2146] *The U.S. Trustee System: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 99th Cong., 2d Sess. (1986).

[2147] The witnesses who testified in favor of the program's expansion included Associate Attorney General Arnold I. Burns and Thomas J. Stanton, Director and Counsel of the Executive Office for U.S. Trustees for the DOJ; Professor Lawrence P. King of the National Bankruptcy Conference; Richard K. Kaufman, Esq. of the National Association of Credit Management; Benjamin Zion, Esq., and Hal Coskey, Esq. of the Commercial Law League of America; Robert Anderson, Esq. of the National Association of Bankruptcy Trustees and the Hon. Robert Ginsberg, bankruptcy judge for the Northern District of Illinois. Witnesses opposed to the continuation or expansion of the U.S. Trustee system included the Hon. Robert DeMascio of the Judicial Conference; the Hon. James Hancock, district judge for the Northern District of Alabama; the Hon. William Brown, bankruptcy judge for the Western District of Kentucky; the Hon. T. Glover Roberts, bankruptcy judge for the Southern District of Mississippi; the Hon. Thomas M. Moore, bankruptcy judge for the Eastern District of North Carolina; the Hon. Algernon Butler, representing the North Carolina Bar Association and Robert Sawdey, Esq., representing the Michigan State Bar Association.

the judicial branch.[2148] In April 1986, the Director of the Administrative Office forwarded a Proposal to Congress titled the "Bankruptcy Administration Improvements Act of 1986".[2149]

The Proposal authorized the Judicial Conference to determine the number of bankruptcy administrators (with a maximum limit of one per judicial district), who would be appointed for a term of five years and were removable only for cause by the courts of appeals.[2150] The Proposal strongly resembled earlier Proposals for separate administrative systems, especially with regard to the duties to be performed by the bankruptcy administrators.[2151] It gave bankruptcy administrators the duty of reviewing all pleadings filed with the court and reporting whether a matter involved a dispute and whether the administrator objected to it.[2152] Bankruptcy clerks were empowered to enter final orders in matters where no objection had been filed.[2153] The bankruptcy administrators were given standing to raise, appear and be heard on issues[2154] and were allowed to present to the court, on the record and with notice, any views or recommendations regarding matters within the scope of their duties.[2155] Finally, the administrators were authorized to investigate any allegations of fraud and misconduct. The court was empowered *sua sponte* to take any action it deemed necessary in a case to ensure its expeditious disposition.[2156] This Proposal was never introduced in either house of Congress, although its presence influenced some of the final provisions in the 1986 Amendments.

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[2148] *See* S. 443, 98th Cong. (1983).

[2149] 132 CONG. REC. S4216 (daily ed. April 14, 1986); 132 CONG. REC. H1632 (daily ed. April 8, 1986). *See* Letter from Leonidas Ralph Mecham, Director of the Administrative Office of the U.S. Courts, to the Hon. Thomas P. O'Neill, Speaker of the House of Representatives (March 28, 1986), *reprinted in House Hearings*, *supra*, note 2141, at 461.

[2150] *House Hearings, supra* note 2141, at 434.

[2151] *Id.* at 438-441.

[2152] *Id.*

[2153] *Id.*

[2154] *Id*. at 447.

[2155] *Id*. at 440-41.

[2156] *Id*. at 447.

On May 7, 1986, the Senate began consideration of its version of bankruptcy judgeship legislation, S. 1923.[2157] An amendment to establish the U.S. Trustee system nationwide[2158] was adopted. On May 8, the Senate also began consideration of H.R. 2211 relating to family farmer bankruptcies,[2159] a companion bill passed by the House and referred to the Senate.[2160] The Senate passed H.R. 2211, striking out everything after the enacting clause, and substituting the text of S. 1923, as amended.[2161] The Senate insisted on its amendments and asked for a conference.[2162]

As passed by the Senate, the provisions in H.R. 2211 pertaining to the U.S. Trustee program differed substantially from other bills. As a compromise to satisfy those who opposed the U.S. Trustee program's expansion -- principally members of the judiciary and attorneys in certain jurisdictions[2163] -- the bill provided an "opt out" alternative.[2164] In districts which chose to "opt out", the duties proposed to be performed by the U.S. trustees were to be performed by officers of the courts.[2165]

iii. Final Passage

A Conference was called to reconcile the differences between the House and Senate versions of the Bill. The Conference Report created a U.S. Trustee program consisting of 21 regions.[2166] U.S. trustees were to be appointed for five-year terms

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[2157] *Id*.

[2158] Amendment No. 1844, 132 CONG. REC. S5628 (daily ed. May 8, 1986) (introduced by Sen. Thurmond) This amendment added the text of S. 1961, with a modification by Sen. Heflin which provided individual districts the opportunity to "opt out" of the U.S. Trustee program.

[2159] H.R. 2211, 99th Cong. (1985), 131 CONG. REC. H2530 (daily ed. April 24, 1985).

[2160] 131 CONG. REC. 16,923 (1985). The bill's principal proponent was Rep. Mike Synar.

[2161] 132 CONG. REC. S5643 (daily ed. May 8, 1986).

[2162] *Id*. at S11,907. The Senate conferees were Sens. Thurmond, Hatch, Grassley, DeConcini and Heflin. 132 CONG. REC. H6488 (daily ed. Sept. 9, 1986). The House conferees were Reps. Rodino, Edwards, Hughes, Synar, Glickman, Feighan, Fish, Shaw, Moorhead and Hyde.

[2163] *See* letter from Robert C. Vaughan, Jr., President, North Carolina Bar Association, to Attorney General Edwin Meese (Jan. 16, 1986) (requesting that the judicial districts in North Carolina be excluded from any legislation extending the U.S. Trustee program).

[2164] H.R. 2211, 99th Cong. § 255 (1986), 132 CONG. REC. S5632 (daily ed. May 8, 1986).

[2165] H.R. 2211, at § 255(d)(1).

[2166] *Id*. §§ 101 and 111(b).

by the Attorney General,[2167] who was granted completely unfettered discretion to remove both U.S. trustees and assistant U.S. trustees.[2168] Although it did not contain an "opt out" provision, it provided that the judicial districts in Alabama and North Carolina would not come into the U.S. Trustee program until 1992, unless they decide to "opt in" sooner.[2169] The "opt in" provision has since been extended to October 1, 2002.[2170]

On October 27, 1986, President Reagan signed Pub. L. No. 99-554, the "Bankruptcy Judges, U.S. Trustees, and Family Farmer Bankruptcy Act of 1986" into law.[2171] The 1986 Amendments provided for the national and permanent expansion of the U.S. Trustee system to 48 states, Puerto Rico, the U.S. Virgin Islands, and Guam.[2172]

C. Reforming the U.S. Trustee Program

While much of the criticism leveled at the U.S. Trustee program has been addressed in independent studies and in testimony before the Commission, one persistent concern has been frequently expressed: the U.S. Trustee program is subject to a great deal of inconsistency in the implementation of its policies and in the positions it takes from region to region. This criticism, in the Commission's view, has some merit. While some local variance is appropriate, as one witness noted,

> The treatment accorded by a federal agency must be uniform. Unfortunately, the U.S. Trustee program suffers because of the intentional, though, in retrospect, possibly misguided and probably misunderstood, emphasis of the legislation on local variance. Local variance is a resource and emphasis issue. While many, if not most of the U.S. Trustee offices operate well, several U.S. trustees have taken positions and instituted programs that are contrary to sound bankruptcy administration. The Department of Justice consistently

[2167] *Id*. § 111(b).

[2168] *Id*. § 111(c) and (d).

[2169] *Id*.

[2170] *See supra* note 2112.

[2171] Pub. L. No. 99-554 , 100 Stat. 3088 (1986) ("1986 Amendments").

[2172] *Id*. § 111; 28 U.S.C. § 581. All federal judicial districts were placed under the jurisdiction of the U.S. Trustee system except those in North Carolina and Alabama. Those two states are to come under the program's jurisdiction in 2002, unless they opt to do so sooner.

> has failed to recognize the need for strong and clear national policies for this fledgling program....[2173]

The U.S. Trustee program must balance the need for a national policy on substantive issues of bankruptcy law with the need to adopt local practices to meet local variations. For example, local variations on fee awards should be acceptable in order to reflect local markets. A national uniform policy should exist, however, on issues related to creditors' committee formation. The premise that like cases should be treated alike runs throughout the Bankruptcy Code. An integral role of the U.S. trustee is to enforce uniform bankruptcy policy on a national level. Two structural changes would address this issue and would serve to elevate the U.S. Trustee program within the DOJ.

1. Management Structure of the U.S. Trustee Program

The Director of the Executive Office for U.S. Trustees ("EOUST") should be designated an Assistant Attorney General. The current structure creates confusion about who runs the U.S. Trustee program - the Attorney General and the Director or the regional U.S. trustees. The confusion plays a large role in the lack of consistency in policy development and implementation. In 1995, the National Academy of Public Administration ("NAPA") conducted a study of alternative structures for the U.S. Trustee Program.[2174] The NAPA Report concluded:

> To improve the program's ability to change policies and procedures, the panel believes the head of the program should be an Assistant Attorney General, rather than a director. This change would elevate the program's status within the Department of Justice . . . and allow it to advocate more strongly for the flexibility and authority it needs to fulfill its mission.

[2173] Statement of Jean K. FitzSimon at Open Forum of the National Bankruptcy Review Commission on the U. S. Trustee Program, February 20, 1997. Ms. FitzSimon serves as the Chair of the American Bar Association Business Section Subcommittee on Bankruptcy Administration and U.S. Trustees. Ms. FitzSimon was also a panel member of the National Academy of Public Administration, Report on Alternative Structures for the United States Trustee Program and her government service includes senior attorney-adviser to the Assistant Attorney General, Office of Legal Policy and Acting United States Trustee for the Northern District of Illinois.

[2174] National Academy of Public Administration, Alternative Structures for the United States Trustee Program; Report by a Panel of the National Academy of Public Administration (1995) (hereinafter the *NAPA Report*). The NAPA panel was chaired by a former Commissioner of the Internal Revenue Service. Panel members included bankruptcy as well as nonbankruptcy attorneys, a former U.S. trustee, and members of the academic community.

> This change would also likely enhance the program's status within the bankruptcy community.[2175]

In the 1978 Reform Act creating the U.S. Trustee program, an additional Assistant Attorney General position was established for the Director of the EOUST, but designation of the Director to that position was not mandatory.[2176] At that time, the DOJ did not use this additional position for the director of the U.S. Trustee program. Since 1978, the EOUST Directorship has never been elevated to the Assistant Attorney General position created in the Reform Act. It is unclear why the EOUST Director has never been appointed to the position that was clearly created for that purpose.

The position of Assistant Attorney General for the EOUST Director would assist the U.S. Trustee program in a number of ways. First, it would clarify that the Director is the head of the program and not just the executive office. Second, it would help centralize discussions and positions on bankruptcy policy within the DOJ. Currently, bankruptcy issues are considered in a variety of fora with little (if any) coordination of effort or coherence of approach. As an Assistant Attorney General, the Director could coordinate bankruptcy policy initiatives and ensure a coherent approach. The broad impact of bankruptcy policy deserves a consistent approach and coordination of effort.

The Recommendation's goal could be accomplished by either appointing the EOUST Director to the tenth Assistant Attorney General position created in the 1978 Reform Act or by increasing the number of Assistant Attorney Generals to eleven.

#### 2. Geographic Structure of the U.S. Trustee Regions

The number of U.S. trustee regions should be reconfigured to match the number and size of the federal judicial circuits. The current hodgepodge of 21 regions is the result of political compromises made when the program was expanded nationally in 1986. The size and workload of these regions vary widely. The lack of a rational structure also leads to confusion about the role that the U.S. trustees should play. Reducing the number of regions would streamline the management structure

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[2175] *Id.* at 58.

[2176] The Bankruptcy Reform Act amended 28 U.S.C. § 506 to increase the number of assistant attorneys general to ten. *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-593, § 218, 92 Stat. 2549 (1978).

and would give the remaining trustees a clearer role in assuring the consistent development and implementation of policy.

The NAPA Report recommended that the U.S. trustee regions be reconfigured and reduced in number, noting that, while some coordination of policies is already performed by the EOUST, its role could be enhanced to work more directly with the field offices to ensure the appropriate level of uniformity.[2177] The U.S. Trustee Program currently has one of the most widespread regional structures of any federal agency or department. There are 21 regional offices, compared with a norm of approximately 10.[2178] In addition to the 21 regional offices, the program also has 93 field offices, 20 of which are located within the regional offices.[2179] According to the NAPA Report, much of the work performed by the regions is duplicated by either field office staff or the EOUST. The NAPA Report concluded that reconfiguration would significantly streamline the structure of the U.S. Trustee program and allow the EOUST to take on more responsibility for collaborating directly with field offices on special problems of program-wide significance.[2180]

U.S. trustee regions that comport with the federal judicial circuits will have a number of advantages. First, the same circuit-wide law will apply throughout a single U.S. trustee region. This will eliminate the U.S. trustee regions that cover more than one circuit.[2181] Second, U.S. trustee policy will be uniform on a circuit-wide basis. In addition, this Recommendation is consistent with the Commission's Recommendation for appeals of final bankruptcy court orders to go directly to the courts of appeals in order to increase bankruptcy *stare decisis.* Reducing the number of regions to the current federal judicial circuits and thereby shortening the administrative distance between the EOUST and the field offices will increase uniformity throughout the U.S. Trustee program.

[2177] *NAPA Report, supra* note 2174, at 65.

[2178] *Id.* at 54.

[2179] *Id.*

[2180] *Id.* at 58.

[2181] *See* 28 U.S.C. § 581(a)(4) & (21) (1994). Section 581(4) delineates a U.S. trustee region that covers part of the fourth circuit and the District of Columbia. Section 581(21) delineates a U.S. trustee region that covers parts of the first, third and eleventh circuits.

### 3.3.2 *Personal Liability of Trustees*

**Trustees appointed in cases under Chapter 7, 11, 12 or 13 of the Bankruptcy Code should not be subject to suit in their individual capacity for acts taken within the scope of their duties as delineated in the Bankruptcy Code or by order of the court, as long as the applicable order was issued on notice to interested parties and there was full disclosure to the court.**

**Chapter 7, 12 and 13 trustees only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee acted with gross negligence in the performance of the trustee's fiduciary duties. Gross negligence should be defined as reckless indifference or deliberate disregard of the trustee's fiduciary duty.**

**A Chapter 11 trustee for a corporate debtor only should be subject to suit in the trustee's representative capacity and subject to suit in the trustee's personal capacity only to the extent that the trustee has violated the standard of care applicable to officers and directors of a corporation in the state in which the Chapter 11 case is pending.**

**Debtors in possession should remain subject to suit to the same extent as currently exists under state or federal law.**

The Bankruptcy Code provides that the trustee[2182] is the representative of the estate and can sue and be sued.[2183] A trustee must "manage and operate" estate property according to applicable law, the same as an owner of the property.[2184] Some courts require compliance with applicable nonbankruptcy law when a trustee manages estate property, but not when the trustee is liquidating estate property.[2185] Despite

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[2182] The term "trustee" or "bankruptcy trustee" when used throughout this Recommendation means Chapter 7, Chapter 12, and Chapter 13 trustees. Chapter 7 trustees are the most prone to suit due to the broad nature of their duties. The Recommendation addresses the personal liability standard for Chapter 11 trustees for corporate debtors separately.

[2183] 11 U.S.C. § 323 (1994). Section 959(a) of title 28 also permits a suit against a trustee, without leave of the appointing court, for "any of their acts or transactions in carrying on business connected with such property." 28 U.S.C. § 959(a) (1994).

[2184] 28 U.S.C. § 959(b) (1994).

[2185] Section 959(b) generally has not been applied to liquidating trustees. *See, e.g.* Alabama Surface Mining Comm'n v. N.P. Mining Inc. (*In re* N.P. Mining, Inc.), 963 F.2d 1449 (11th Cir.

this distinction, courts have had difficulty finding Chapter 7 or 11 trustees to serve in cases "where there are environmental problems under federal or state laws which impose personal liability on 'owners or operators' and have had to dismiss such cases."[2186]

Bankruptcy trustees have statutory as well as common law fiduciary duties governing the operation and liquidation of property of the estate. A number of post-petition scenarios can lead to litigation against the trustee, for example, environmental obligations discovered post-petition,[2187] failure to operate the debtor's business in a prudent manner,[2188] erroneous disbursements of funds,[2189] or failure to properly supervise estate professionals.[2190] Under these scenarios, a trustee may be sued as the representative of the estate, to the extent of assets held by the estate. Determining whether trustees may be *personally* liable for negligence in the performance of their statutory and common law duties is more difficult.

The Bankruptcy Code does not provide a personal liability standard for bankruptcy trustees. Since 1978, the courts that have addressed this issue have come to contrary conclusions. Under what has been described as a "crazy quilt" of decisions,[2191] trustees are held to standards of care ranging from personal liability for

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1992); Missouri Dep't of Natural Resources v. Valley Steel Prods. Co. (*In re* Valley Steel Prods. Co.), 157 B.R. 442 (Bankr. E.D. Mo. 1993).

[2186] 2 COLLIER ON BANKRUPTCY ¶ 323.02, 323-6 (Lawrence P. King et al. eds. 15th ed. 1996) *citing* *In re* FCX, Inc., 96 B.R. 49, 55 (Bankr. E.D.N.C. 1989); *In re* Charles George Reclamation Trust, 30 B.R. 918, 921 (Bankr. D. Mass. 1983) (U.S. trustee unwilling to become Chapter 7 trustee); *In re* Commercial Oil Service, Inc., 58 B.R. 311, 317 (Bankr. N.D. Ohio 1986); *In re* Mattiace Indus., Inc., 76 B.R. 44 (Bankr. E.D.N.Y. 1987) (Chapter 11 trustee).

[2187] *See, e.g.,* Wisconsin v. Better Brite Plating, Inc., 466 N.W.2d 239 (Wis. Ct. App. 1991) (state brought civil forfeiture action for clean-up costs against bankrupt corporation, former Chapter 11 trustee and former Chapter 7 trustee).

[2188] *See, e.g.,* Reading Co. v. Brown, 391 U.S. 471 (1968) (trustee who was unable to obtain insurance, except at exorbitant cost, was sued for damages resulting from fire on debtor's premises).

[2189] *See, e.g.,* Nelson v. Bunker (*In re* XRX Inc.), 77 B.R. 797, 798 (Bankr. D. Nev. 1987) (trustee sued for making erroneous disbursement of funds to pay administrative expenses).

[2190] *See, e.g.,* Mosser v. Darrow, 341 U.S. 267 (1951) (trustee sued for damages resulting from failure to supervise his employees who illicitly profited at estate's expense).

[2191] *See* Memorandum from David W. Allard on behalf of the National Association of Bankruptcy Trustees, Bankruptcy Trustees Should be Provided a Uniform Standard of Care Governing Personal Liability - Support for a Revision of the United States Bankruptcy Code (April 1997).

negligence[2192] to personal liability for willful and intentional acts in violation of the trustee's duties.[2193] Some courts also find that trustees have derived judicial immunity for acts taken within the scope of their authority.[2194] The only Supreme Court decision in this area, *Mosser v. Darrow*, held a trustee personally liable for allowing his agents to profit at the estate's expense.[2195] Unfortunately, *Mosser* has not provided much guidance to subsequent courts and has been cited for a broad range of positions.[2196]

Any attempt to codify a standard for personal trustee liability runs the risk that some measures would provide too little protection and some measures would provide too much protection. Too little protection might expose a trustee to excessive personal liability and dissuade capable people from becoming trustees.[2197] Too much

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[2192] *See In re* Gorski, 766 F.2d 723, 727 (2d Cir. 1985) (personal liability for mere negligence); Red Carpet Corp. of Panama City Beach v. Miller, 708 F.2d 1576, 1578 (11th Cir. 1983) (same); Hall v. Perry (*In re* Cochise College Park, Inc.), 703 F.2d 1339, 1357 (9th Cir. 1983) (same); *In re* Tremont Corp., 143 B.R. 989 (Bankr. W.D.N.Y. 1992) (same); *In re* Consupak, Inc., 87 B.R. 529, 542 (Bankr. N.D. Ill. 1988) (same); *In re* Sturm, 121 B.R. 443 (Bankr. E.D. Pa. 1990) (court reluctantly followed old Third Circuit precedent, but failed to find that the trustee had acted negligently).

[2193] McGahren v. First Citizens Bank & Trust (*In re* Weiss), 111 F.3d 1159, 1168 (4th Cir. 1997) (trustee may be held personally liable for willful or intentional misconduct only); Lopez-Stubbe v. Rodriguez-Estrada (*In re* San Juan Hotel Corp.), 847 F.2d 931, 937 (1st Cir. 1988)(trustee has personal liability only for willful and deliberate violations of the trustee's duties); *In re* Chicago Pacific Corp., 773 F.2d 909, 929 (7th Cir. 1985)(same); United States v. Sapp, 641 F.2d 182, 185 (4th Cir. 1981)(same); Sherr v. Winkler, 552 F.2d 1367 (10th Cir. 1977) (same).

[2194] Bennett v. Williams, 892 F.2d 822, 823 (9th Cir. 1989) (trustee has broad immunity for acts taken within scope of authority, but still may be liable for intentional or negligent violations); Yadkin Valley Bank & Trust v. McGee, 819 F.2d 74, 76 (4th Cir. 1987) (trustee has derived judicial immunity); Lonneker Farms, Inc. v. Klobucher, 804 F.2d 1096, 1097 (9th Cir. 1986) (trustee entitled to derived judicial immunity); Boullion v. McClanahan, 639 F.2d 213, 214 (5th Cir. 1981) (same).

[2195] 341 U.S. 267 (1951).

[2196] *Compare San Juan Hotel*, 847 F.2d at 936 (surcharging trustee 3.4 million; citing *Mosser* for proposition that a trustee may only be held for an intentional breach of fiduciary duty) *with Gorski*, 766 F.2d at 726 (citing *Mosser* for proposition that trustee may be held personally liable for negligent conduct). *See also* Central Transp., Inc. v. Roberts (*In re* Tucker Freight Lines, Inc.), 62 B.R. 213, 217 (Bankr. W.D. Mich. 1986) (listing divergent *Mosser* authorities); James I. Shepard, Damage Control or the Art of Avoiding Personal Liability 3 (1996) ("*Mosser v. Darrow* is cited almost exclusively as the font of all authority on the subject of trustees' breach of fiduciary duty.").

[2197] This risk is particularly acute where possible environmental liability exists:

> It may seem to impose a hardship upon the trustee that he should be held

protection will not encourage responsible decision making on difficult estate management issues. The balance sought by the Recommendation is to protect trustees from personal liability where warranted while encouraging responsible administration of estate assets. The Recommendation proposes a uniform personal liability standard for a trustee's breach of fiduciary duty only and not for a trustee's personal liability to third parties.

Under the Recommendation, trustees (including Chapter 11 trustees) would not be subject to suit in their individual capacity for acts taken within the scope of their statutory or court-ordered authority, so long as the applicable court order was issued on notice to interested parties and full disclosure to the court. Outside that scope of authority, trustees would be personally liable for gross negligence in the performance of their fiduciary duties. Thus, to hold a trustee personally liable for a breach of fiduciary duty, a plaintiff would have to show (1) that the trustee was not acting within the scope of authority granted under the Bankruptcy Code or by court order; and (2) that the trustee was grossly negligent in the performance of the trustee's fiduciary duties. The Recommendation defines gross negligence as reckless indifference or deliberate disregard of the trustee's fiduciary duty.[2198] This definition is consistent with the definition of gross negligence in other civil liability contexts.[2199]

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> personally liable, and it is arguable that where he is not at fault he should be liable only to the extent to which he can obtain indemnity out of the trust estate. On the other hand, there is no reason why the victim of the tort should be denied relief merely because the estate is insufficient to indemnify the trustee. The risk of personal liability in tort is a risk that the trustee runs in undertaking the administration of the trust. Ordinarily he can protect himself by taking out liability insurance and paying premiums out of the trust estate.

Charles F. Lettow & Joyce E. McCarty, Courts, Congress Address Potential Superfund Liability of Fiduciaries, 13 No. 8 Banking Policy Report, *7 (April 18, 1994) (citing 3A SCOTT ON TRUSTS § 264 (4th ed. 1988)).

[2198] *See, e.g.*, W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS 209, 212 (5th ed. 1984) (defining gross negligence as "a failure to exercise even that care which a careless person would use. Several courts, however, dissatisfied with a term so nebulous, and struggling to assign some more or less definite point of reference to it, have construed gross negligence as requiring willful, wanton, or reckless misconduct, or such utter lack of care as will be evidence thereof -- sometimes on the ground that this must necessarily have been the intent of the legislature."); Leite v. City of Providence, 463 F. Supp. 585, 591 (D.R.I. 1978) (distinguishing ordinary and gross negligence in that "one requires only a showing of unreasonableness while the other demands evidence of near recklessness or shockingly unjustified and unreasonable action").

[2199] *See, e.g.*, Potter v. Pohlad, 560 N.W.2d 389, 392 (Minn. Ct. App. 1997) ("Delaware courts have repeatedly defined gross negligence as 'reckless indifference to or a deliberate disregard' . . . or actions which are 'without the bounds of reason.'" citing Smith v. Van Gorkum, 488 A.2d

A. Codifying Current View on Derived Judicial Immunity

A majority of circuits find that trustees have derived judicial immunity for actions taken within the scope of their duties.[2200] The scope of a trustee's duties includes any action (including an exercise of business judgment)[2201] taken pursuant to statute or court order.[2202] Often times, a party that is dissatisfied with the result of a court order disposing or otherwise administering an estate asset will attempt to collaterally attack the order by suing the trustee personally.[2203] Even the threat of a suit against the trustee during negotiations in order to gain leverage may have equally pernicious effects. Under these circumstances, a trustee should have derived judicial immunity from suit.[2204]

858, 873 n.13 (Del. 1985)).

[2200] Bennett v. Williams, 892 F.2d 822, 823 (9th Cir. 1989) (trustee has broad immunity for acts taken within scope of authority, but still may be liable for intentional or negligent violations); Yadkin Valley Bank & Trust v. McGee, 819 F.2d 74, 76 (4th Cir. 1987)(trustee has derived judicial immunity); Boullion v. McClanahan, 639 F.2d 213, 214 (5th Cir. 1981), Lonneker Farms, Inc. v. Klobucher, 804 F.2d 1096, 1097 (9th Cir. 1986)(trustee entitled to derived judicial immunity).

[2201] Hon. Susan Pierson Sonderby & Lisa Ramsden, Current Developments: Trustees/Examiners and U.S. Trustees Liability/Immunity, 617 PLI/COMM 893, 903 (April-June 1992) ("The courts consistently grant the trustee immunity for business judgments provided the trustee was acting within lawful authority pursuant to court order or other statutory duty. If the trustee claims he was acting pursuant to court order, then the order must have been granted following full disclosure and notice. A trustee will also not be held liable for the negligence of agents unless the trustee negligently supervised the agents.").

[2202] *See, e.g.*, Gregory v. United States Bankruptcy Court, 942 F.2d 1498, 1500 n.1 (10th Cir. 1991) ("Absolute quasijudicial immunity for a lawyer serving as a trustee and merely executing the bankruptcy judge's orders concerning the collection and disposition of estate property is essential for the efficient functioning of the bankruptcy court.") *cert. denied,* 504 U.S. 941 (1992).

[2203] One recommendation to the Commission cited "the 'militia movement' and similar anti-government groups" as creating "an environment which encourages litigation whenever anyone is disappointed by the outcome of a case." Henry C. Seals, Trustees Need Relief, Suggestions for the National Bankruptcy Review Commission, 4 AM. BANKR. INST. L. REV. 548 (1995) (recommending that trustees be given relief from these nuisance suits with "legislation specifying the scope and extent of their immunity.").

[2204] *See, e.g.,* Gordon v. Bunker (*In re* XRX, Inc.), 77 B.R. 797, 798 (Bankr. D. Nev. 1987) (trustee has judicial immunity for acting pursuant to court order and making erroneous disbursement to administrative expense creditor); Weissman v. Hassett, 47 B.R. 462, 466 (Bankr. S.D.N.Y. 1985) (dismissing action against trustee for damages arising out of preparation and dissemination of report on debtor's possible fraud; "[j]ust as receivers and trustees are immune from suit for actions taken to assemble a bankruptcy estate's assets, so too a reorganization trustee should be immune for an

There are a myriad of difficult decisions that may face a trustee trying to administer an estate:

> In fact, trustees are commonly faced with decisions to either take action or not, whether it be to file a complaint, a motion to set aside a judgment, or to assume or reject a lease or other contract with virtually no notice. Sometimes trustees have only hours to make such decisions and are faced with the unenviable duty of preserving the status quo under the threat of rule 11 sanctions or being sued personally for failure to preserve and protect an intangible asset of the estate. Other decisions trustees face frequently include the decision whether or not to close a business in Chapter 11 or an operating Chapter 7, whether or not to attempt to sell assets or surrender them to secured creditors, whether to administer or abandon causes of action, and a myriad of other decisions which trustees must make upon conflicting, second-hand information being provided by the debtor and creditor groups, as well as professionals upon whom the trustee relies. Despite all this, trustees are expected to make such decisions in a timely manner. A trustee, unlike the debtor who often purchased the assets and created the problems which caused the filing, never holds a "full deck of cards to play."[2205]

The Recommendation alleviates this burden by protecting a trustee who is acting pursuant to a court order or a statute. The Supreme Court in *Mosser* noted that seeking instructions from the court is a means by which a trustee can resolve a difficult decision and also avoid personal liability.[2206]

Full disclosure of all relevant facts to the court and interested parties is required for judicial immunity to cover actions taken in furtherance of a court order. One court described the scope of immunity as depending "upon the totality of the

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investigation and report furthering the same purposes.").

[2205] *Allard*, supra note 2191, at 4-5.

[2206] Mosser v. Darrow, 71 S. Ct. 680, 683 (1951) ("The practice is well established by which trustees seek instructions from the court, given upon notice to creditors and interested parties, as to matters which involve difficult questions of judgment. . . . It is hardly probable that a candid disclosure to creditors, to the court, and to interested parties would have resulted in instructions to have pursued this course; but had it been authorized, at least the assenting creditors might have found themselves estopped to question the transaction.").

circumstances in which an order is drawn."[2207] To the extent that the trustee seeks court authorization in a fully disclosed and informed process with notice and a hearing, derived judicial immunity will attach.[2208] Failure to "analyze the risks inherent in the various known options and bring the risks to the attention of the court and the parties for their consideration" will result in a lack of immunity.[2209] Under these circumstances, a trustee would have to defend an action on the basis of whether it was within a reasonable business judgment.[2210]

By providing immunity from suit under these circumstances, the Recommendation encourages trustees to seek guidance from the court on difficult estate issues. A court order in this context would require notice to creditors, the debtor, and other parties in interest, and these parties would not be able to collaterally attack the order by suing the trustee personally after the fact.[2211] Thus, the Recommendation (1) encourages trustees to seek court approval of difficult estate decisions, (2) gives them immunity for actions taken to implement such decisions, and (3) requires diligence on the part of interested parties to seek direct review of these orders rather than collaterally attacking the order later by bringing a personal suit against the trustee. The Recommendation promotes the interest of the estate in two ways. First, capable professionals are not dissuaded from becoming trustees and the clear liability guidelines permits them to work effectively. Second, trustees are encouraged to seek guidance from the courts before making difficult estate administration decisions.

### B. Immunity Consistent with Environmental Liability Under CERCLA and Other State Clean-up Laws

Possible personal liability for environmental clean-up costs under CERCLA and other state clean-up laws has been cited as an impediment to obtaining a trustee

[2207] *In re* Sundance Corp., 149 B.R. 641, 654-55 (Bankr. E.D. Wash. 1993).

[2208] *Id.*

[2209] *Id.*

[2210] *Id.*

[2211] Concern was expressed that courts may refuse to enter orders of this type if no contested matter is involved. *See* Letter of David W. Allard to Elizabeth Warren 2 (September 26, 1997) ("the bankruptcy court is no longer involved in the administration of cases under the Code and is available only to resolve disputes in contested matters. Thus, 'comfort orders' will not be permitted.").

to administer a bankruptcy estate.[2212] At least one court has held in the bankruptcy context that Congress did not abrogate judicial immunity for trustees and other estate administrators when it enacted CERCLA.[2213] In *Sundance*, the debtor and a creditor brought a strict liability action against the state receiver/bankruptcy custodian[2214] for the clean-up costs associated with the use of certain pesticides on the debtor's fruit orchard during the receiver's tenure.[2215] The court held that the receiver cannot be held strictly liable for actions taken within the scope of its judicial authority, even if those actions may have been unlawful.[2216] The Recommendation would preserve immunity from environmental clean-up costs resulting from conduct within the scope of a trustee's duties. To the extent that a trustee acts outside the scope of the trustee's authority and in gross negligence of the trustee's fiduciary duty, the trustee should be individually liable under CERCLA or other relevant state environmental clean-up law. This approach is consistent with a recent CERCLA amendment that limits the environmental liability of, among others, trustees and other fiduciaries.[2217]

### C. Immunity Consistent with Administering an Estate's Tax Obligations

Personal liability for failure to administer adequately a bankruptcy estate's tax obligations is another risk facing bankruptcy trustees. As part of the 1978 Reform Act, trustees under title 11 were exempted from liability to the federal government for

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[2212] "The potential for personal liability of the trustee is nowhere more graphically illustrated than in the 'hazardous waste' cases." Irving Sulmeyer, 1995 Collier Handbook for Trustees and Debtors in Possession, § 4.08, 4-16.

[2213] *In re* Sundance Corp., 149 B.R. 641 (Bankr. E.D. Wash. 1993).

[2214] *Id.* at 649. At the time the Chapter 11 petition was filed, the state receiver was permitted to continue in possession, under the control of the bankruptcy court under section 543(d).

[2215] *Id.* at 647-48.

[2216] *Id*. at 652. The Sundance court agreed with State of Wisconsin v. Better Brite Plates, Inc., 483 N.W.2d 574, 582 (1992) (concluding that a violation of state law may not necessarily be outside the scope of a receiver's authority).

[2217] The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, 110 Stat. 1344 (codified at 42 U.S.C. §§ 6991b(h), 9601(20) & 9607). The Act clarifies the liability of lenders and fiduciaries for hazardous waste clean-up costs. Specifically, Congress added section 9607(n)(1) which limits a fiduciary's liability to the assets held as a fiduciary. 110 Stat. § 107 at 1345. The Act does not protect a fiduciary whose negligence causes or contributes to the hazardous or threatened release. 42 U.S.C. § 9607(n)(3). For a complete discussion of the amendments see Baxter Dunaway & Andrew C. Cooper, Good News for Lenders and Fiduciaries Under Superfund, 11 PROB. & PROP. 49 (June 1997).

paying claims prior to paying unpaid government claims.[2218] This provision (31 U.S.C. § 3713(b)) has been interpreted literally, to bar personal trustee liability

> imposed by section 3713 and does not exempt them from liability from other sources; it merely relieves the trustee from liability from the federal priority statute and no other. In other words, the relief from liability under section 3713 is very limited, trustees may be held personally liable for the unpaid taxes of the estates they administer if such liability can be grounded on any other law, such as breach of fiduciary duty, breach of official duty, or possibly even negligence or, were there any, some other statutory source of liability.[2219]

Other statutory provisions impose liability, however, notwithstanding the exemption in section 3713(b). For example, personal liability for administrative tax penalties is imposed on "responsible persons who fail to withhold and pay federal employment taxes."[2220] Similarly, trustees have been found liable for the capital gains taxes on the sale of estate property.[2221]

Trustees should be encouraged to determine the tax effects of estate administration. Compliance with the provisions of section 505(b) will exempt a trustee (among others) from any liability associated with such tax.[2222] The Recommendation would not preempt the section 505 procedure for determination and discharge of an estate's tax liability. The Recommendation also would not alter a trustee's statutory liability for nonpayment of trust fund taxes. As stated above, to the extent that a bankruptcy trustee is acting pursuant to a court order, the trustee should have derived judicial immunity from personal liability resulting from the trustee's performance. Similarly, if the trustee is acting outside the scope of the trustee's authority and in

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[2218] *Shepard*, *supra* note 2196, at 26 ("'A representative of a person or an estate (*except a trustee acting under title 11)* paying any part of a debt of the person or estate before paying a claim of the government is liable to the extent of the payment for unpaid claims of the government.'" 31 U.S.C. § 3713(b) (1996) (emphasis supplied); The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 322(b), 92 Stat. 2679 (1978)).

[2219] *Shepard*, *supra* note 2196, at 27.

[2220] 26 U.S.C. § 6672(a) (1996). *See also*, *In re* San Juan Hotel Corp., 847 F.2d 931, 937 n.37 (1st Cir. 1988); *In re* Joplin, 882 F.2d 1507 (10th Cir. 1989).

[2221] *Sulmeyer*, *supra* note 2212, at ¶ 4.09, 4-17 (citing United States v. Sampsell, 266 F.2d 631 (9th Cir.), *cert. denied*, 105 S. Ct. 2707 (1959)).

[2222] 11 U.S.C. § 505(b) (1994)(outlining the procedure to determine a tax liability of the estate and gain a discharge from the liability associated with the tax).

gross negligence of the trustee's fiduciary duty, the trustee should be personally liable for tax liabilities or penalties incurred as a result.

### D. Personal Liability for Gross Negligence Outside Scope of Trustee's Authority

The Recommendation contemplates that personal liability for a breach of fiduciary duty would attach only to the extent a trustee acted with gross negligence outside the scope of the trustee's Bankruptcy Code or court-ordered authority. Actions for mere negligence could still be asserted against the trustee as the representative of the estate, but not in the trustee's personal capacity. In order to hold a trustee personally liable, it would be necessary to demonstrate that (1) the trustee's conduct was outside the scope of judicial authorization or statutory duty to administer the estate or manage the debtor's business; *and* (2) the complained of conduct was grossly negligent of the trustee's fiduciary duties. Gross negligence is defined as reckless indifference or deliberate disregard of the trustee's fiduciary duties.

The National Association of Bankruptcy Trustees ("NABT") recommended a "willful and intentional" standard for personal trustee liability.[2223] Specifically, the NABT Proposal would add section 323(c), to provide that

> The trustee in a case under this title may only be sued in the trustee's representative capacity, unless the trustee has committed willful and intentional acts in violation of the trustee's fiduciary duties.[2224]

While the NABT provided good arguments to support its Proposal, in some instances their standard would provide too much protection for trustees and would not encourage trustees to seek court approval of difficult estate administration decisions.

A good example of circumstances in which a "willful and intentional" standard would provide too much protection is *Mosser v. Darrow*.[2225] In *Mosser*, the bankruptcy trustee permitted his assistants to trade extensively in bonds issued by the debtor's subsidiaries, often selling their holdings to the trustee at a profit.[2226] During the course of administration, the trustee never had any financial interest in the profits

[2223] *See Allard*, *supra* note 2211.

[2224] *Id.* at 3.

[2225] 341 U.S. 267 (1951).

[2226] *Id.* at 269.

made by his employees.[2227] Over eight years of trusteeship, the trustee filed one accounting for one of the debtor-corporations and none for the other.[2228] When the trustee finally resigned and filed his accounts and request for fees, the Securities and Exchange Commission objected, as did the successor trustee. The district court agreed with the special master's report and surcharged the trustee $43,447.46. The court of appeals disagreed and found that "principles of negligence applied and that a trustee could not be surcharged . . . unless guilty of 'supine negligence.'"[2229] The court of appeals was further persuaded by the argument that "this surcharge creates a very heavy liability upon a man who enjoyed no personal profit and must be condoned 'so as not to strike terror into mankind acting for the benefit of others and not for their own.'"[2230]

The Supreme Court disagreed, finding that personal liability was the "most effective means" of encouraging diligent administration of bankruptcy estates.[2231] The *Mosser* Court noted that a trustee could obtain protection from personal liability by "seek[ing] instructions from the court, given upon notice to creditors and interested parties, as to matters which involve difficult questions of judgment."[2232] The trustee in *Mosser* did not willfully and intentionally violate his fiduciary duties, and arguably would not be found personally liable under the NABT standard.[2233] The facts in *Mosser* are the type of circumstances in which the Recommendation would impose personal liability, without making trustees personally liable for mere negligence.

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[2227] *Id*. at 275.

[2228] *Id.* at 270.

[2229] *Id*. at 272.

[2230] *Id.* at 273 (quoting Mosser v. Darrow, 184 F.2d 1, 8 (1950)).

[2231] *Id.* at 273-74.

[2232] *Id.* at 274.

[2233] In discussing the trustee's intent, the *Mosser* Court stated

> In fairness to the trustee, it is to be noted that there is no hint or proof that he has been corrupt or that he has any interest, present or future, in the profits he has permitted these employees to make. For all that appears, he was simply misled into thinking these persons indispensable, but he entered into an arrangement which courts cannot sanction unless they are to open the door to practices which would demoralize trusteeships and discredit bankruptcy administration.

*Id.* at 275.

In Chapter 11 cases, the debtor ordinarily remains in possession of the estate to manage its property and conduct its business. The scope of liability of officers and directors of a corporation is set by appropriate state law. The Recommendation recognizes that the debtor in possession should be held to the same standard of care as existed prepetition with regard to the debtor. When a trustee is appointed in a Chapter 11 case, the trustee acts in place of the debtor in possession and should be subject to the standard of care for officers and directors set forth by the state where the Chapter 11 case is pending. The Recommendation does not change the result from current law.

*Competing Considerations*. The scope of a trustee's fiduciary duty is defined by state law as well as the Bankruptcy Code.[2234] It may be argued that the standard for breach of that fiduciary duty should be determined by the courts on a case-by-case basis. Trustees encounter problems, however, when administering estates that encompass two circuits with divergent personal liability standards. Moreover, trustees argue that an unclear standard of care encourages personal suits because the case law in this area supports divergent outcomes. The Recommendation may not result in fewer actions being filed against trustees, but it will provide courts with a clear standard to judge personal liability. As discussed earlier, trustees want a clear personal liability standard for breaches of fiduciary duty in order to better govern their conduct. The Recommendation achieves this result, even if it does not adopt the standard proposed by the NABT. The Commission sought a fair middle ground that would encourage trustees to seek court guidance on difficult decisions and protect trustees only under circumstances warranting protection.

### 3.3.3 *Qualification of Professionals under 11 U.S.C. § 1107(b)*

**Section 1107(b) should be amended to provide that a person should not be disqualified for employment under § 327 solely because such person holds an insubstantial unsecured claim against or equity interest in the debtor. Section 327 and § 101(14) should remain unchanged.**

[2234] *See In re* Chicago Art Glass, Inc., 155 B.R. 180, 187 (Bankr. N.D. Ill. 1993) ("The basis for imposing liability on a trustee who improperly administers a bankruptcy estate is found in the trustee's status as fiduciary.... Therefore, bankruptcy trustees must act with reasonable care in discharging their statutory duties."). Chapter 7 trustees' statutory duties include the duty to (1) collect and reduce the property of the estate to money and close the estate as expeditiously as is compatible with the best interests of parties in interest; (2) be accountable for all property received; (3) investigate the financial affairs of the debtor; (4) examine proofs of claim where useful and object to the allowance of any claim that is improper; and (5)oppose the discharge of the debtor if advisable. 11 U.S.C. § 704 (1994).

**[Comments By Commissioner Edith H. Jones]**

## Sections 327 and 1107(b): Disinterestedness for Debtor in Possession's Professionals

Under 11 U.S.C. § 327(a), the trustee, "with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons." Section 1107(a) makes this provision applicable to a debtor in possession. The so-called "disinterestedness requirement" has been interpreted strictly by most courts, has been used to disqualify counsel with *any* interest adverse to the estate, and does not require a showing that the adverse interest be material in nature. The Commission considered and initially adopted a Proposal which would have replaced this traditional standard with one which would have required disqualification of a debtor in possession's professionals only on a showing of an interest which is materially adverse to the estate. On reconsideration, however, the Proposal was rejected in favor of a substitute Proposal which retains the disinterestedness requirement but amends § 1107(b) to provide that a person is not disqualified for employment solely because he holds an insubstantial unsecured claim against, or equity interest in, the debtor.

During the meeting of the Service to the Estate and Ethics Working Group (the "Working Group") in June, 1996, it was proposed that Section 327(a) be amended to eliminate the so-called "disinterestedness" requirement from Section 327(a) as it applies to counsel and professionals for a debtor in possession (the "First Proposal"). The First Proposal was supported by the Memorandum of Professor Lawrence P. King and Elizabeth I. Holland dated August 22, 1996 (the "King Memo"). The First Proposal was adopted by a vote of the Commission at its September 1996 meeting. In December 1996, the Working Group formulated a companion Proposal to define adverse interest in Section 327(a). Under the terms of this Proposal, a professional retained by a debtor in possession would be disqualified from such representation only if the professional had a "conflict of interest," defined as a "substantial risk that such professional's representation . . . will be materially and adversely affected by the professional's own interests or by the professional's duties to another person that currently employs or formerly employed such professional, or a third person." (the "Second Proposal" and together with the First Proposal, the "Proposals"). The Second Proposal to define conflict of interest under Section 327(a) was never adopted by the Commission.

In April, 1997, Commissioner Edith H. Jones requested reconsideration of the Commission's vote, and supported her request with a Memorandum dated April 22, 1997, written by Judge Jones and Professor Todd J. Zywicki. In July, 1997, in response to this Memorandum and subsequent discussion, the original affirmative vote in favor of the First Proposal was reconsidered and reversed by a 7-2 vote. The Commission then voted to amend § 1107(b) to address specifically the problem resulting from unnecessary disqualification a professional who holds an insubstantial unsecured claim against or equity interest in the debtor. This suggested modification constitutes the Commission's Recommendation to Congress.

Given the strong policies that are advanced by a strict disinterestedness requirement**S**policies respecting the administration of the bankruptcy system and public confidence in the integrity of the bankruptcy system**S**the Commission decided to retain the general requirement of disinterestedness and instead recommend specific and narrowly-tailored remedies aimed at specific problems. Other narrowly-tailored statutory reforms were also considered but found to be either unworkable or undesirable. None of the reasons advanced to support the First Proposal persuaded the Commission of the need for complete repeal of disinterestedness in debtor in possession cases.

This report summarizes the Commission's reasons and conclusions. Part I clarifies how the Recommendation affects the Bankruptcy Code. Part II presents the reasons favoring retention of the current disinterestedness requirement. Part III addresses competing considerations advanced in the discarded First Proposal. Part IV then details this Recommendation by the Commission to modify § 1107(b) and the reasons for that conclusion.

## I. Defining "Disinterestedness"

Under § 327(a), the trustee, "with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties . . . ." Section 1107(a) provides a debtor in possession with the same powers to employ professionals, subject to the same limitations, as imposed on a trustee. Thus, under the terms of § 327(a), a debtor in possession may employ only professionals who (1) do not hold or represent an interest adverse to the estate and (2) are "disinterested persons."

Section 327(a) incorporates the definition of "disinterested person," found in § 101(14). Section 101(14) regulates two types of relationships: subsections (A) through (D) regulate preexisting relationships between the debtor's counsel and the debtor; subsection (E), on the other hand, regulates relationships between the debtor's counsel and third parties, such as creditors of the debtor. In relevant part, subsection (E) defines a "disinterested person" as one who "does not have an interest *materially* *adverse* to the interest of the estate or 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...."[2235] By its own terms, the statutory language of § 101(14)(E), incorporated by reference into § 327(a), requires that any relationship to, connection with, or interest in the debtor be material.

Courts have construed § 101(14)(E) "rigidly."[2236] As a result, in practice, § 101(14)(E) has been applied as a "catch-all clause."[2237] In particular, the final sentence of § 101(14)(E) requiring a lack of disinterestedness "for any other reason" has been characterized as being "broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code."[2238]

In addition to requiring that professionals be "disinterested persons," current § 327(a) also requires that those professionals "do not hold or represent an interest adverse to the estate." Unlike the literal definition of "disinterested person," this provision of § 327(a) contains no materiality requirement. Case law, however, has incorporated this requirement that counsel have no interest adverse to the estate–regardless of materiality—into the definition of § 101(14)(E). Thus, rather than construing the "no adverse interest" requirement of § 327(a) directly, case law has instead applied this requirement in a round-about manner through § 101(14)(E)'s disinterestedness requirement. Despite this ambiguity, we will assume throughout this memo that the use of the term "disinterestedness" in the proposed draft of § 327(a)(2) incorporates the case law construing that term rigorously, thereby requiring that the applicant have *no* interest adverse to the estate, regardless of materiality.

Thus, it is unsettled whether the current strict standard governing the relationship between debtor's counsel and third parties is rooted in the "disinterestedness" requirement of § 327 (incorporating § 101(14)(E)) or in § 327's prohibition against having any "interest adverse to the estate." Despite this ambiguity in the source, however, one thing is clear: in order to serve as counsel to a debtor in

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[2235] 11 U.S.C. § 101(14)(E) (emphasis added).

[2236] *See* 2 COLLIER ON BANKRUPTCY at ¶ 327.03, p. 327-31 (Lawrence P. King et al. eds. 15th ed. 1996) (citing cases).

[2237] *Id.* at p. 327-48 (footnote omitted).

[2238] *Id.* *See also In re* Consolidated Bancshares, Inc., 785 F.2d 1249, 1256 (5th Cir. 1986)

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possession or trustee, an attorney is required to show a lack of *any* interest adverse to the estate, *regardless* of materiality.

The Recommendation would amend § 1107(b) to exempt from the strict disinterestedness requirement those situations in which a professional who seeks to represent the debtor or trustee held an insubstantial unsecured prepetition claim against or equity interest in the debtor. This exception is structured similarly to the current provision in § 1107(b) permitting continued representation of a debtor by a professional who represented the debtor before the debtor sought bankruptcy relief.

## II. Purposes of the Disinterestedness Requirement

The disinterestedness requirement is now applied both to cases where a trustee is appointed and where a debtor remains in possession in Chapter 11. The requirement that professional persons employed by a trustee have no interest adverse to the estate originated in former Bankruptcy Rule 215(a).[2239] Under the Bankruptcy Act, only the attorney (but no other professionals) appointed to represent a Chapter X trustee was required to be "disinterested," as that term was defined in former Rule 1-202(c)(2).[2240] Disinterestedness under the Act was defined similarly to the current rigorous definition of disinterestedness under the Code. Section 327(a) expanded the disinterestedness requirement, though, to apply to all professional persons in all cases under the Code, regardless of whether a trustee is actually appointed.[2241]

As now applied to professionals employed by a trustee or debtor in possession, the disinterestedness requirement is extremely strict. "As a general principle, professional persons employed by the trustee should be free of any conflicting interest which might in the view of the trustee or the bankruptcy court affect the performance of their services or which might impair the high degree of impartiality and detached judgment expected of them during the administration of a case."[2242]

There are three primary reasons for strict adherence to standards of disinterestedness. First, "strict standards are necessary in light of the unique nature

[2239] *See* COLLIER ON BANKRUPTCY at ¶ 327.03, p. 327-27.

[2240] *Id.* at p. 327-29.

[2241] COLLIER ON BANKRUPTCY at ¶ 327.03, p. 327-29 (noting that this requirement "effects a change from prior law").

[2242] *Id.* at 327-33.

of the bankruptcy process."[2243] Second, strict disinterestedness requirements are necessary to preserve public and judicial confidence in the bankruptcy system.[2244] Third, ethical standards for bankruptcy practice should be consistent with state ethical rules. All three of these of these policy goals are relevant regardless of whether a case involves a trustee or a debtor in possession.

### A. Disinterestedness and the Bankruptcy Process

Strict disinterestedness standards are necessary because of the unique pressures inherent in the bankruptcy process.[2245] The trustee and his professionals are required to act as a fiduciary for the estate, its creditors, other parties in interest, and the court, and not solely as the trustee's advocate. The disinterestedness standard, therefore, is designed to insure that all issues relevant to the administration of the estate are properly raised and vented before the court. As such, a *strict* disinterestedness standard is designed to eliminate *any* conflicts that might cause the trustee and his professionals to favor one party over another, to "take it easy" on one creditor or group of creditors, or to refuse to pursue possible claims or avenues of inquiry because of any direct or indirect pressures. As one commentator has observed, "Indirect or remote associations or affiliations, as well as direct, may engender conflicting loyalties. The purpose of the [disinterestedness] rule is to prevent even the emergence of a conflict irrespective of the integrity of the person under consideration."[2246]

After all, it is the creditors' money that we are talking about: they are entitled to have debtor's professionals who will be free of pressures to compromise the

[2243]*Consolidated Bancshares*, 785 F.2d at 1256, n.6 (citing *In re* Cropper Co., 35 B.R. 625, 629 (Bankr. M.D. Ga. 1983)).

[2244]*Id.* (citing *In re* Philadelphia Athletic Club, Inc., 20 B.R. 328, 334 (E.D. Pa. 1982)).

[2245]Heightened standards of disinterestedness are required in other areas of law where particular public policy and fiduciary concerns make higher-than-usual standards necessary. *See, e.g.*, Securities Investor Protection Act of 1970, 15 U.S.C. § 78eee(B)(6); *see also In re* Blinder, Robinson & Co., 131 B.R. 872, 878 (D. Colo. 1991).

[2246]COLLIER ON BANKRUPTCY at ¶ 327.03, p. 327-51. The treatise goes on to argue caution in the application of § 101(14)(E) in a prophylactic manner so as not to disqualify professionals on the basis of "[r]elationships remote from the instant case which do not involve confidential information." This qualification, however, does not mitigate the danger of "conflicting loyalties" that might arise from direct and indirect pressures on even the most ethical lawyers.

interests of some or all of them.[2247] The fundamental reality of a reorganization case is that the debtor is buying its continued existence with someone else's money. Creditors are being forced to forego payment, so that the debtor can spend money in hopes of reorganizing its operations—and paying its attorneys, accountants, and other professionals. It may be that creditors are better off overall as a result of foregoing payment in the short run, in exchange for a larger payoff at the end of the collective proceeding. This does not change the fact, however, that the debtor is spending the creditors' money. As a result, creditors are entitled to demand that the debtor's professionals be free of pressures to compromise their interests.[2248]

The pressures of the bankruptcy system will bear on estate administration regardless of whether the estate is being administered by a trustee or a debtor in possession. In fact, because the debtor in possession has inherent conflicts of interest and is by definition not disinterested, an even stricter adherence to disinterestedness may be appropriate for the debtor in possession's professionals than for those of a disinterested trustee.

### B. Disinterestedness and Public Confidence in the Bankruptcy System

Disinterestedness is also critical to the preservation of public and judicial confidence in the integrity of the bankruptcy system. Because of the nature of a bankruptcy case, there must always be vigilance to ensure that the public has confidence in the bankruptcy system's fairness and that it is operating to the public benefit, not just to enrich debtors and their professionals. Already, widespread public perception, whether accurate or not is beside the point here, is that the bankruptcy system is nothing more than "a cash cow to be milked to death by [bankruptcy] professionals."[2249] Several recent disqualification battles have been widely covered by the press, not only by traditional legal periodicals, shaking the confidence of many observers in the fairness of the bankruptcy system.[2250]

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[2247] *In re* Rusty Jones, Inc., 134 B.R. 321, 333 (Bankr. N.D. Ill. 1991).

[2248] *See* Todd J. Zywicki, *Mend It, Don't End It: The Case for Retaining the Disinterestedness for Debtor in Possession's Professionals*, 18 Miss. Col. L. Rev. (forthcoming 1998).

[2249] *In re* Chas. A. Stevens & Co., 105 B.R. 866, 872 (Bankr. N.D. Ill. 1989).

[2250] *See* R. Craig Smith, Note, *Conflicts of Interest under the Bankruptcy Code: A Proposal to Increase Confidence in the Bankruptcy System*, 8 Geo. J. Legal Ethics 1045, 1046 (1995) (describing several articles in the New York Times and Wall Street Journal reporting on the disqualification debate in the *Leslie Fay* case and "suggesting an unseemly connection between the [disqualified law firm's] success and their repeated conflicts violations.").

Maintaining the disinterestedness of the estate's professionals is critical to correcting the perception that the bankruptcy system is being administered unfairly. The system needs attorneys to adhere to high ethical standards whether they represent a trustee or a debtor in possession. In fact, requiring disinterestedness is probably even more important when the estate is being administered by a debtor in possession; arguably, the debtor in possession and any creditors' committee lack the same incentives and ability to monitor the performance of counsel that a trustee has.

By replacing disinterestedness with a less rigorous showing of materially adverse conflict, the Proposals ignored the long-understood reality that conflicts of interest actually do exist and can cripple public confidence in the bankruptcy system even if their magnitude cannot be quantified. As Justice Douglas observed in *Woods v. City Nat'l Bank & Trust*, "Where an [attorney] was serving more than one master or was subject to conflicting interests, he should be denied compensation. It is no answer to say that fraud or unfairness were not shown to have resulted."[2251] Justice Douglas explained the reason for this prophylactic rule was that

> the incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary, or otherwise to dilute the undivided loyalty owed to those whom the claimant purported to represent. Where an actual conflict of interest exists, no more need be shown . . . .[2252]

### C. Disinterestedness and State Ethical Standards

The third factor underlying strict adherence to disinterestedness for counsel is the desirability of consistency between the ethical rules of the Bankruptcy Code and the various state ethical rules. A brief overview of existing ethical rules under the ALI's Restatement of the Law Governing Lawyers, the Model Rules, and the Model Code will demonstrate that the current strict disinterestedness requirement is more consistent with other ethical imperatives to which all lawyers are bound than the Second Proposal's standards. Under governing state ethical codes, a lawyer is forbidden from representing one client in asserting or defending a claim against

[2251] Woods v. City Nat'l Bank & Trust, 312 U.S. 262, 268 (1941).

[2252] *Id.*

another current client–even if the simultaneous representation is in connection with unrelated matters–unless consent is given by *all* affected parties."[2253]

The Proposals would have established a lower ethical standard than those prevailing under state regulations of the practice of law. Such incongruity is largely avoided by the final Recommendation's modest modification of disinterestedness.

### 1. ALI Restatement of the Law Governing Lawyers

Under the ALI's Restatement of the Law Third, The Law Governing Lawyers (the "Restatement"),[2254] it is not completely clear whether bankruptcy lawyers must comply with § 209, which deals with the ethical obligations associated with representing parties with conflicting interests in civil litigation, or § 201, which applies to conflicts of interest in transactional matters.[2255] The most recent proposed amendments to the Restatement opted to take "no position on the applicability" of § 209(2) in bankruptcy,[2256] thereby leaving the question unanswered. Other indicia of intent, however, suggest that ethical issues in bankruptcy should continue to be governed by § 209. For instance, all discussion of bankruptcy matters is found in the comments to § 209.[2257] Moreover, Comment b to § 201 specifically assumes that §

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[2253]The difficulties of securing conflicts waivers in large bankruptcy cases are discussed below.

[2254]RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (Proposed Final Draft No. 1, March 29, 1996).

[2255]*See* Letter of Susan M. Freeman to National Bankruptcy Review Commission 6 (August 9, 1997) ("The initial drafts of the Restatement failed to address bankruptcy cases, leaving to conjecture whether § 209 governing civil litigation applied to the entirety of bankruptcy cases or only to litigated matters within such cases."). Section 209 provides:

> §209. Representing Parties with Conflicting Interests In Civil Litigation
>
> Unless all affected clients consent to the representation under the limitations and conditions provided in § 202, a lawyer in civil litigation may not:
>
> . . .
>
> (2) represent one client in asserting or defending a claim against another client currently represented by the lawyer, even if the matters are not related.

[2256]Proposed Text on Bankruptcy-Related Issues in § 209 Restatement of the Law Governing Lawyers (Draft, October 31, 1996).

[2257]*See* RESTATEMENT § 209, Comment d(iii) (Complex and multi-party litigation) (discussing conflicts of interest in bankruptcy); *Id.* Reporter's Note to Comment d(iii) (Complex and multi-party litigation) (citing cases discussing conflicts of interest in bankruptcy).

209 applies, rather than § 201, in "situations, not involving litigation, in which significant impairment of a client's expectations of the lawyer's loyalty would be similarly likely."[2258] Thus, even if the text of the Restatement does not mandate treating bankruptcy proceedings as litigation matters, the commentary strongly indicates that this should be the case.

Section 209 imposes much stricter ethical requirements on counsel than does § 201.[2259] As one commentator has observed, § 209 "contains a special, per se rule regarding representation of clients that are adverse to each other in civil litigation." This per se rule is grounded in the "underlying assumption that litigation involving the assertion or defense of a claim between two clients always creates a 'substantial risk' that the lawyer's representation of one client or the other will be 'materially and adversely' affected by the simultaneous representation of both clients, even in unrelated matters."[2260] The rationale for applying § 209 is as appropriate in bankruptcy cases as it is in civil litigation, and militates retaining a strict disinterestedness requirement. Concerns that a lawyer may pursue a case less effectively out of deference to another client[2261] are as realistic in bankruptcy as they are elsewhere, and similarly affect public confidence in the integrity of the legal system.[2262] What is relevant for current purposes is that under § 209, a lawyer may not represent one client in asserting or defending a claim against another current client, even if the simultaneous representation is in connection with unrelated matters.

The traditionally-applied stricter requirements of § 209 are more suitable to bankruptcy cases then the more liberal rules in § 201. The contrary view, however, is apparently rooted in a belief that only adversary and contested matters in a bankruptcy case rise to a level sufficient to implicate the safeguards of § 209, and that most matters are administrative in nature or do not result in direct conflicts between the debtor and individual parties.

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[2258]RESTATEMENT § 201, Comment (b) (Rationale).

[2259]Section 201 defines a conflict of interest as "a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interest or by the lawyer's duties to another current client, a former client, or a third person." If the representation of a client would give rise to such a conflict of interest, then counsel is forbidden to undertake such representation absent consent by "all affected clients and other necessary persons."

[2260]"Ethical Considerations for Bankruptcy Professionals" Questions Regarding Impact of Proposed American Law Institute Restatement of the Law Governing Lawyers at 2-3.

[2261]*See* RESTATEMENT § 209, comment e (Suing present client in unrelated matter).

[2262]*See* RESTATEMENT § 209, comment c (Clients aligned in opposition to each other).

This artificial distinction between "litigation" and "administrative" functions, however, is untenable in a typical bankruptcy case. The general administration of the estate and particularly the development and confirmation of a plan frequently involve significant controversies that can have the greatest practical impact on the outcome of a claim. While these issues do not technically qualify as "contested" or "adversary" proceedings, they are adversarial in nature, are often more important to the case's outcome than formal contested proceedings, and are interwoven throughout the "administrative" proceedings of the case.[2263] Moreover, if counsel were deemed to be disinterested for purposes of an "administrative" proceeding but not for a contested matter, this would create an incentive for debtor's counsel to settle or otherwise avoid such issues before they rise to the level of a contested matter from which counsel might be disqualified. The results of these settlements or other conflict-avoidance strategies by debtor's counsel, of course, would be funded by other creditors who lack the leverage of a credible threat to disqualify debtor's counsel. As a result, many of bankruptcy's routine "administrative" proceedings create the same tensions as formal litigation, and should be governed by the same ethical rules.

### 2. Consistency with State Ethical Codes

The ABA's Model Rules of Professional Conduct (the "Model Rules") and the Model Code of Professional Conduct (the "Model Code") similarly provide no concrete guidance for resolving the unusual tensions which arise in a bankruptcy proceeding. Upon review, however, it is evident that the traditional disinterestedness standard is more consistent with the ethics rules of many states, and ensures that lawyers are in compliance with both the bankruptcy and state law.

Under Model Rule 1.7(a), representation in litigation matters is not permitted if the representation will have any adverse affect on the other client. Similarly, the Model Code forbids representation of multiple clients in litigation with "differing" interests, and rarely permits representing in litigation multiple clients with potentially differing interests, unless all relevant parties consent. Moreover, under Canon 9 of the Model Code, an attorney is required to "avoid[] even the appearance of impropriety." Although Canon 9 has been replaced by the Model Rules, it remains effective in the approximately 15 states which continue to follow the Model Code.

It may be argued that the application of these rules to bankruptcy practitioners is unwise, or that the rules themselves are unwise (such as the Model Code's appearance of impropriety standards). Perhaps the disinterestedness standard is in some cases overbroad. For now, both sets of standards are harmonious.

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[2263]Even a confirmed plan is treated as a judgment which is then binding all creditors and parties in interest.

## III. Competing Considerations

The First Proposal claimed four advantages would result from eliminating the disinterestedness requirement for a debtor-in-possession's counsel: (1) it corrected a perceived "drafting error" in the Code, (2) it protected debtors' freedom to choose their counsel, (3) it allowed debtors to draw upon a larger pool of specialized counsel with sufficient resources for undertaking complex representation, and (4) it would be applied uniformly, as the existing standard had not been, and thereby reduce litigation.

The first of these perceived advantages rests on what can only be an inaccurate perception. The history of the bankruptcy system during the period 1890-1939,[2264] together with the legislative history of the 1978 Code, tends to show that Congress consciously implemented broader application of disinterestedness. This was no "drafting error." Application of disinterestedness to debtors' attorneys is a sensible restraint when under Code § 1107(a), "a debtor in possession [stands] in the shoes of a trustee in every way."[2265]

The second "advantage" is inconsistent with the reality of bankruptcy practice. In bankruptcy, the debtor and its counsel owe fiduciary duties to the estate and its creditors. As such, a debtor's attorney is not free to act only to advance his client's interests; rather, he must serve the policy and goals of the bankruptcy system as diligently as he serves his debtor-client. So long as the debtor is choosing among disinterested counsel, the debtor's choice should be honored. However, debtors should not be free to retain counselSeven their own pre-petition counselSwhen those counsel will be required to serve conflicting interests.

The third alleged benefit solves a problem[2266] that no one has empirically proved to exist. No one presented evidence showing a shortage of capable debtors' counsel, harm to debtors or the system resulting from disqualification of interested

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[2264]*See* H.R. REP. No. 95-595, at 95-98 (1977).

[2265]*Id.*, at 404; H.R. Rep. No. 95-989, at 116 (1978); COLLIER ON BANKRUPTCY at ¶ 327.03, p. 327-94 n.3 (citing *In re* Urrutia, 114 B.R. 342, 344 (D.P.R. 1990)).

[2266]As one notable commentator has asserted:

> Past experience has shown that in large Chapter 11 reorganization cases with widespread creditor interests, it has become increasingly difficult to obtain the services of competent counsel with offices sufficiently staffed to handle all of the varied legal services required in the case, who could meet the strict requirements of "disinterestedness."

COLLIER ON BANKRUPTCY at ¶ *327.03, p. 327-76-77.*

counsel, or that any such unproven harm would outweigh the policies favoring impartial counsel. Nor has any evidence demonstrated that interested counsel who wish to serve in spite of conflicts are unable to secure conflict waivers upon disclosure to affected clients. If such waivers are, in fact, difficult to obtain, the logical conclusion is that the conflict is indeed important, influential, and potentially harmful, and should be avoided, not ignored. The *Leslie Fay* case[2267] is an instructive example of the problems conflicts can cause.

The final alleged advantage of the First Proposal is reduction of litigation and inconsistent standards, which is to be achieved by substituting a test of "material adverse interest" for the current disinterestedness standard. As set forth above, the current standard serves very important policy goals and prevents real problems from arising. It is apparent that uniformity attained by eliminating the disinterestedness requirement would not achieve the desired ethical or practical result. It is not apparent that the material adverse interest standard would lead to more uniform case law. Further, the arena of litigation would shift from the appointment-of-counsel stage of the bankruptcy case to the time and place when a party feels he has been harmed by an attorney's divided loyalties. As either standard seems destined to foster litigation, then it seems better that it take place at the threshold of a case instead of far into its progress.

## IV. Discussion of Recommendation

The foregoing considerations convinced the Commission that the general requirement of disinterestedness should be retained. Nonetheless, one discrete problem was identified for which it was concluded that a specific remedy would be desirable and feasible. The Commission recommends (the "Recommendation") that § 1107(b) be amended to read as follows (suggested new text underlined):

> (b) Notwithstanding § 327(a) of this title, a person is not disqualified for employment under § 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case, <u>or solely because of such person's being the holder of an insubstantial unsecured claim against or equity interest in the debtor</u>.

The purpose of this change is to facilitate the representation of Chapter 11 debtors when the professional sought to be employed by the debtor holds an

[2267] *In re* The Leslie Fay Companies, 175 B.R. 525 (Bankr. S.D. N.Y. 1994).

unsecured claim against or equity interest in the debtor that is, relative to other claims or interests, insubstantial.[2268]

It was determined by the Commission that the purposes of the disinterestedness requirement were not compromised by permitting a debtor in possession to employ professionals who held an unsecured claim against the estate or equity interest in the debtor, so long as that interest was insubstantial in amount in relation to the other claims and interests present in the case. In such circumstances, the interests of the professional are unlikely to diverge substantially from the interests of other creditors and parties. Further, the professional is unlikely to be influenced by such a relatively small claim or equity position in a manner which would sacrifice the interests of the estate to the professional's private interests. It is appropriate to exempt these conflicts from the reach of the disinterestedness requirement.

The Recommendation will eliminate the overinclusive reach of the disinterestedness requirement in the narrow situations described. Under § 1107(b), the debtor in possession is permitted to retain prepetition counsel, but under § 101(14)(A) counsel is considered not to be disinterested when it remains unpaid for prepetition services to the debtor. Debtor's counsel, however, often will have a claim against the estate for unpaid fees and expenses incurred in the period preceding and including the filing of bankruptcy. The definition's prohibition renders § 1107(b) ineffective, as a practical matter, in many cases.

The courts have responded to this contradiction in an *ad hoc* fashion, occasionally permitting representation only upon waiver by counsel of its prepetition claim, or by authorizing another similar remedy. In practice, courts have held that a prepetition claim disqualifies prepetition counsel from serving as counsel to the debtor in possession unless the prepetition claim is solely the result of work done in preparation for the bankruptcy filing.[2269] But this result is far from uniform. Moreover, the distinction drawn between a general claim for services and services incurred specifically in preparation for filing bankruptcy is artificial and unrealistic.

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[2268] *See* Memorandum from Commissioner Edith H. Jones to Susan Jensen-Conklin, re: Disinterestedness/Conflicts of Interest (July 18, 1997) (ballot of Commissioners to vote on the Recommendation).

[2269] *See* John D. Penn & Stacey Jernigan, *Survey of the Law: Disqualification of Professionals Having Prepetition Claims, in* 1996-1997 ANN. SURVEY OF BANKR. L. 167, 168 (William L. Norton, Jr., ed. 1996).

Because the Recommendation would not undermine the purposes of the disinterestedness requirement and would also serve to resolve the anomaly between § 1107(b) and § 327, the Commission advocates amending § 1107(b) as indicated.

### 3.3.4 *National Admission to Practice*

**Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court, to appear in the other bankruptcy court without the need for any other admission procedure.**

**The Recommendation will not affect requirements (if any) to associate with local counsel. Similarly, the Recommendation will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The Recommendation will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located to appear in a particular bankruptcy case.**

Bankruptcy courts exist in the various federal judicial districts to supervise cases commenced under the Bankruptcy Code and adjudicate disputes arising in such cases. Attorneys who practice in the bankruptcy courts are required, at a minimum, to be admitted to practice in their home districts. Often attorneys appear in bankruptcy courts in other districts because their clients are involved as parties in bankruptcy cases in such out-of-town districts. In order to represent such clients, these attorneys must be admitted specially in the bankruptcy court where the case is pending, usually on motion of a local attorney. These special admission requirements are particularly burdensome on creditors (both private and government) and their counsel who usually receive notice of bankruptcy proceedings with little time to prepare and are often called to distant fora to defend claims and interests of their clients.

Admission of nonresident[2270] attorneys to practice before a particular district court generally applies to the bankruptcy court in that district.[2271] The local rules of the bankruptcy court in each district (with a few exceptions) provide the admission terms for attorneys to participate in a particular case when they are not admitted to the district court bar of the district where the bankruptcy court is located.[2272] For the most part, these local rules closely follow the admission rules for the district court where the bankruptcy court is located.[2273] While these rules vary widely among the ninety-four districts, there are distinct similarities that are worth noting. Virtually all of the bankruptcy courts provide for either (1) admission to practice in a particular case after meeting certain requirements (usually a certificate of good standing from another federal court or the highest court in a state and the payment of a fee), *or* (2) appearance by *pro hac vice* motion. Additionally, a considerable number of bankruptcy courts waive the special admission requirements for attorneys representing the United States government or any of its agencies when appearing in a particular bankruptcy case.[2274] Very few bankruptcy courts, however, waive the

[2270] The term "nonresident" is used throughout this Recommendation to mean an attorney (i) who is not a resident of the state in which the bankruptcy court sits, and (ii) who has not been admitted to the district court bar in the relevant district.

[2271] *See, e.g.*, Bankr. Ct. S.D.N.Y. LBR 2090-1(a) ("An attorney who may practice in the District Court pursuant to General Rule 2(a) and (b) of the District Rules may practice in this Court."); Bankr. Ct. D. MD. 4(a) ("*except* as otherwise provided, ... only members of the Bar of the District Court may appear as counsel.").

[2272] The local bankruptcy rules that do not provide for the admission of nonresident attorneys generally incorporate by reference the local rule of the district court. *See, e.g.*, Bankr. D. Conn. Local Rule 2 ("Only persons admitted to practice in the United States District Court for the District of Connecticut or admitted as visiting lawyers pursuant to the Local Rules of Civil Procedure shall practice in the Bankruptcy Court.").

[2273] The local bankruptcy rules often refer as well as conform to the district rule governing admission of attorneys. *See, e.g.*, Bankr. Ct. N.D. Fla. Rule 106 A ("Except as provided herein, Local Rule 11.1 of the United States District Court for the Northern District of Florida governs the admission and appearance of nonresident attorneys before the Bankruptcy Court."); Bankr. Ct. N.D. W. Va. Rule 5.205(a) (adopting the applicable district court's rule governing admission of nonresident attorneys).

[2274] See notes 2277-79 and accompanying text, *infra*.

special admission provisions for nonresident state attorneys representing state agencies[2275] outside the state in which the bankruptcy court sits.[2276]

Certain district courts and the bankruptcy courts within those districts admit attorneys who are members of the bar in another U.S. court to appear in a particular case.[2277] These districts generally require (1) the submission of a certificate of good standing; (2) knowledge of, and consent to abide by, the disciplinary rules in the district; and (3) payment of a fee.[2278] Most districts that admit attorneys based on admission in other districts require the attorney to associate with local counsel.[2279]

The vast majority of bankruptcy courts have provisions for admission of a nonresident attorney by *pro hac vice* motion.[2280] Despite its popularity, *pro hac vice* admission has its limitations, which vary depending on the local requirements.

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[2275] *See* Bankr. Ct. N.D. Ill. Local Rule 600(c) (waiving the trial bar admission requirements for "the attorney general or other highest legal officer of any state").

[2276] Some courts, however, waive admission requirements for attorneys appearing on behalf of the state in which the bankruptcy court sits. *See, e.g.*, Bankr. N.D. Ill. Local Rule 600(C) (waiving the trial bar admission requirements for, among others, "the state's attorney of any county in the State of Illinois."); Bankr. S.D. Fla. Local Rule 910(F) (waiving admission requirement for attorney appearing on behalf of the state of Florida).

[2277] Bankr. D. Ariz. (admitted to practice in any federal court); Bankr. E.D. Ark. (member of bar in state of residence and admitted in any other federal court); Bankr. D. Conn. (same); Bankr. D. Mont. (same); Bankr. W.D. Pa. (admitted in U.S. Supreme Court or any district court); Bankr. E & S.D.N.Y. (admitted in district court in N.J., Conn. or Vt. and state bar of relevant district court); Bankr. S.D. Tex. (admitted in any district court); Bankr. D. Vt. (admitted in any district court within the First or Second Circuits).

[2278] *See, e.g.*, Bankr. D. Ariz. (submit application attesting to having read local disciplinary rules, attach certificate of good standing, and pay $50 fee); Bankr. D. Conn. (member of bar must sponsor visiting attorney's admission; must be a member in good standing and attorney nor any member of attorney's firm can have been denied admission to bar or disciplined under local rule 3; and include $25 fee).

[2279] In Connecticut, for example, the sponsoring attorney may be excused from further attendance in court upon granting of the motion to admit a non-resident attorney. Despite being excused from attending hearings, the sponsoring attorney is not excused from any other obligation of an appearing attorney. D. Conn. Rule 2(d).

[2280] In fact, a study done by the Federal Judicial Center found that ninety out of ninety-four (96%) of the federal districts permit *pro hac vice* appearances. The four districts that do not have these provisions (D. Ariz., E.D. Mich., W.D. Pa., & E.D. Wis.) have adopted alternative admissions procedures that make *pro hac vice* provisions unnecessary. *See* Marie Cordisco, Eligibility Requirements for, and Restrictions on, Practice Before the Federal District Courts, Federal Judicial Center (Nov. 7, 1995).

These limitations run the gamut. Some courts require foreign attorneys to associate with local counsel to make the motion, while other courts require counsel to file a written motion. Still other courts require counsel to file the motion with the clerk of the district court, in addition some require payment of a fee, and others require the motion to be filed three days prior to the hearing for which admission is requested.

A fair percentage of local bankruptcy rules waive the admission requirements for attorneys appearing on behalf of the federal government and its agencies.[2281] Very few local rules waive the admission requirements for attorneys representing state governments, even for attorneys representing the state in which the bankruptcy court sits.

The Commission has heard (both in testimony and by correspondence) that creditor participation in bankruptcy cases is very low. Disenfranchisement of creditors due to a bankruptcy filing in an inconvenient forum was the single most cited reason in favor of a Proposal to amend the venue provisions of 28 U.S.C. § 1408(1).[2282] The cost to creditors of defending their claims in bankruptcy is also part of the low creditor participation equation. While the Recommendation does not eliminate the costs of participation, it does reduce some of the expense of defending a claim in a nonlocal forum.

Bankruptcy proceedings also differ considerably from ordinary civil litigation. "Appearance" by counsel in a bankruptcy proceeding (as opposed to a district court proceeding) is often less formal and may be only for discrete hearings on issues that may affect the interests of that counsel's client. Accordingly, admission procedures and rules should conform to these differences. For example, the Middle and Southern Districts of Florida distinguish between an attorney's

[2281] *See, e.g.*, Bankr. N.D. Ala. Local Rule 83.1 (waiving admission requirement for federal government attorneys); Bankr. S.D. Ala. Local Rule 3 (waiving *pro hac vice* requirement for federal government attorneys but requiring written certification that attorney read local rules); Bankr. D. Ak. (no *pro hac vice* requirements for federal government attorneys); Bankr. M.D. Fla. Local Rule 1.07(b) (same); Bankr. D. Idaho Local Rule 105(a) (same); Bankr. W.D. Mo. Local Rule 9.010 (same).

[2282] The Commission received numerous letters supporting an amendment to the venue provisions of 28 U.S.C. § 1408(1) to eliminate place of incorporation as a permissible venue. Many of these letters cited creditor disenfranchisement and the cost of defending a claim in a distant forum as the reason for low creditor participation. National Bankruptcy Review Commission Database, Jurisdiction and Procedure, Venue (1997).

appearance for administrative bankruptcy matters and an appearance for contested or adversary proceedings.[2283]

For many creditors, both private and government creditors, bankruptcy is a national practice. They may retain legal representation from parts of the country other than the judicial district where a case under the Bankruptcy Code is pending. If an attorney has been admitted in any bankruptcy court pursuant to the rules of admission for that court, which generally involves being admitted to practice in the federal district court for that district, the admission should enable the attorney to appear in any other bankruptcy court. This would obviate the need for special admission or admission by *pro hac vice* motion. Under the Recommendation, however, it would not, however, eliminate the need for local counsel where required by local rule. The Recommendation also contemplates a Bankruptcy Code provision requiring attorneys who appear under this provision to read the applicable local rules and to submit to the disciplinary authority of the court where the case is pending.

National admission will also greatly assist attorneys who appear in bankruptcy cases on behalf of government entities, particularly state governments. Governmental entities are often brought into the bankruptcy court on short notice (often in injunctive matters) and, accordingly, government attorneys have very little time to coordinate admission with other attorneys in the district where the bankruptcy case is pending. Government entities should be able to appear with the least obstructions possible. National admission will streamline the appearance process for governmental entities.

The Recommendation does not alter local counsel requirements. To the extent that the local rules in a particular jurisdiction require the association of local counsel to participate in a case, those requirements are not altered by the Recommendation. The Recommendation eliminates special admission procedures in an effort to reduce the costs of participating in a bankruptcy case. Increasing creditor participation by reducing creditors' costs to participate in the bankruptcy process is consistent with a number of the Commission's Proposals. In particular, the proposal to eliminate place of incorporation as a permissible bankruptcy venue

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[2283] *See* Bankr. M.D. Fla. Local Rule 1.07(b) (providing that an attorney residing outside the state of Florida and not admitted to the district court may appear without special admission in the following circumstances: 1. Filing a notice of appearance and a request for notices; 2. Preparation and filing of a proof of claim; 3. Attending and participating in the § 341 meeting; and 4. "[A]ttendance and representation of a creditor at a hearing that has been noticed to all creditors generally except the representation of a party in a contested matter or adversary proceeding.").

will reduce creditor disenfranchisement due to a bankruptcy filing in a distant forum.[2284]

*Competing Considerations.* The concept of nationwide admission is new and might seem to impair the local autonomy of courts. It may also be seen, however inappropriately, as a limitation of the supervisory control over attorneys by the courts before whom attorneys practice. As demonstrated above, courts already admit nonresident attorneys under a variety of requirements and still maintain disciplinary control of bankruptcy proceedings. Some local courts presently charge a fee (often about $75) for special admission which may be used for federal bar purposes, the fee could be lost if there was nationwide admission. The Recommendation, however, will reduce the participation costs for creditors and other parties in interest. The beneficial result may be an increase in creditor participation.

### 3.3.5 *Fee Examiners*

**The Bankruptcy Code should explicitly preclude the appointment of fee examiners as an improper delegation of the court's duty to review and award compensation under 11 U.S.C. § 330. The Recommendation does not affect the court's authority under 11 U.S.C. § 1104(c) to appoint an examiner to investigate and report on certain aspects of a Chapter 11 case, for example, a potential fraudulent transfer or a particularly complicated claims estimation.**[2285]

Fee examiners are generally appointed by bankruptcy judges to (a) review fee applications of professionals retained under section 327 and (b) submit a report to the court critiquing the professionals' fee applications.[2286] The vast majority of fee examiners are appointed in large cases with multiple committees and, therefore, with a large number of professionals retained by the estate under section 327.[2287] In large cases, the responsibility to review the professionals' fee applications can be very

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[2284] *See* Commission Recommendation 3.1.4 to Amend Venue Provisions of 28 U.S.C. § 1408.

[2285] *See, e.g.*, *In re* Columbia Gas System, Inc., Case Nos. 91-803, 91-804 (Bankr. D. Del.) (court appointed examiner to evaluate complicated UCC oil and gas claims estimation issues).

[2286] *See In re* Maruko, Inc., 160 B.R. 633, 637 (Bankr. S.D. Cal. 1993) (describing fee examiner's duties).

[2287] *In re* Columbus Mortgage and Loan Corp. of Rhode Island, 155 B.R. 297, 298 (Bankr. D. R.I. 1993) ("In the majority of cases in this jurisdiction, however, the size of the case and shortage of funds in the first place, rules out the option of special counsel or the independent fee examiner, leaving the issue, again, with the Court.").

burdensome, especially if the professionals seek compensation on an interim basis.[2288] Fee examiners are also appointed for their expertise in reviewing fee applications. Most fee examiners utilize special computer programs to evaluate and collate the fee data submitted by professionals.

There are no explicit provisions permitting the appointment of fee examiners or providing for payment of compensation to them in cases under the Bankruptcy Code. Courts that do utilize fee examiners tend to rely on two bases for their appointment. Some bankruptcy courts appoint fee examiners on the theory that the authority to do so exists under section 105.[2289] Other courts appoint them under certain circumstances to "look after the interests of the Estate."[2290] The Recommendation concludes (1) that the appointment of fee examiners is inappropriate and not sound policy, and (2) that the Bankruptcy Code should expressly provide that fee examiners may not be appointed by the court.

*Rationale.* The Bankruptcy Code imposes the duty to review fee applications on, among others, the bankruptcy court.[2291] Fee examiners, however, are appointed by some courts to review fee applications and submit a report to the bankruptcy court critiquing the professionals' fee applications. In this regard, fee examiners assume a judicial function, akin to special masters, whose appointment is not permitted in bankruptcy cases.[2292]

Under section 330, "reasonable compensation" is awarded for "actual" and "necessary" services. Whether services were "necessary" is viewed at the time they

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[2288] Interim compensation of professionals (prior to the final fee application) is authorized under 11 U.S.C. § 331. Under section 331, a professional may apply to the court every three months for compensation and reimbursement.

[2289] *See In re* Continental Airlines, Inc., 138 B.R. 439 (Bankr. D. Del. 1992) (appointing fee examiner under section 105 in order to implement section 330), *rev'd on other grounds*, United States v. Continental Airlines, Inc. (*In re* Continental Airlines), 150 B.R. 334 (D. Del. 1993) (ordering that court could not limit access to fee examiner's report).

[2290] *See Columbus Mortgage*, 155 B.R. at 298 (reviewing fee applications, court stated that it is "saddled with the independent obligation to: (1) look as closely at the law and the facts of the case, as to the impassioned pleas of professionals in behalf of their fee requests; or (2) in appropriate cases, to appoint special counsel or an independent fee examiner to look after the interests of the Estate.").

[2291] 11 U.S.C. § 330 (1994) (court is under obligation to review fee applications and award reasonable compensation for actual and necessary services).

[2292] FED. R. BANKR. P. 9031 (1995).

were rendered and not with the benefit of hindsight.[2293] Unlike the judge, the U.S. trustee, or the creditors' committee, fee examiners are involved only in the fee application portion of a case and do not participate in any other part of a Chapter 11 case. As a result, whether certain work was required and benefitted the estate is examined after the fact, with the benefit of hindsight, which in itself is not a proper criterion. The "amount of time" spent on a particular matter is of critical importance in determining whether or not it is compensable.[2294] The necessity of the time spent can only be fairly viewed at the time the services were rendered and not after the fact.[2295]

In large Chapter 11 cases, fee examiners are appointed because judges feel they do not have the time and sometimes do not have the desire to perform the tedious task of reviewing fee applications. Irrespective of these reasons, bankruptcy judges should not be able to delegate this portion of their independent obligation imposed by the Code to review fee applications and oversee the professional fees in a case. Moreover, fee examiners are appointed by the judge, arguably perpetuating the same problems of cronyism that existed under the former Bankruptcy Act. The Bankruptcy Code purposely removed any appointing power from the court and placed it in the office of the U.S. trustee. The court may not appoint a trustee under any of the chapters of the Code and may not appoint any members of an official committee. Court appointment of a fee examiner directly contravenes established Congressional policy.

The actual fee examiner process also runs counter to the requirements of section 330 for a full and fair fee determination by the court. In practice, the fee examiner process amounts to a negotiated fee reduction between the fee examiner and the professional. The professional submits its application to the fee examiner who reviews it and then sends a preliminary report on that professional's fees only to that professional. The professional then answers any questions the fee examiner may have and negotiates both the amount of the fee examiner's suggested discount as well as the language of the fee examiner's report that will be filed with the court. At the end of this process, the court is presented with a negotiated fee and a consensual description of the professional's application. This process is in sharp contrast to the

[2293] *In re* Ames Dep't Stores, Inc., 76 F.3d 66, 72 (2d Cir. 1996) (holding necessity of work should be evaluated at time work was performed).

[2294] *In re* Garland Corp., 8 B.R. 826, 829 (Bankr. D. Mass. 1981) ("As a starting point, the time spent on the case is of major importance to the courts in passing judgment on fees.").

[2295] *Ames*, 76 F.3d at 72.

direct fee application process to the court under the Bankruptcy Code as well as according to the U.S. Trustee fee application guidelines.[2296]

Under the Recommendation, the judge, the U.S. trustee, and other professionals should review the fee applications. Under the 1994 amendments, the U.S. trustee should assist the court by fulfilling its statutory obligation to examine fee applications and comment on them as it determines necessary.[2297] It is the role of the U.S. trustee to review fee applications and the appointment of a fee examiner usurps this role.[2298] The U.S. trustee should be the independent party to object to fee applications, when necessary, and the judge should make the determination based on that objection as well as any others.[2299] Fee examiners have become akin to special masters or "pseudo-special masters" and, as such, the Bankruptcy Code should preclude their appointment.

All interested parties, particularly the debtor in possession and all official committees, have a responsibility to review all fee applications submitted to the court. Greater compliance with this duty would alleviate the court's burden significantly.

*Competing Considerations*. Fee examiners have principally been appointed in large cases with multiple committees and professionals where the court carries a heavy burden to review fee applications. As a result, it may be unrealistic to demand that the court, the U.S. trustee, and other parties in interest carefully review each fee application. It may be argued that in order to meet this obligation, the court should be able to designate an independent party to review the fee applications and file a report with the court. There are structural reasons, discussed above, why this responsibility should not be delegated to a third party who has no other involvement in the case. The responsibility to review fee applications is indeed a burden. The Recommendation recognizes this burden, but instead of condoning the practice of

[2296] 11 U.S.C. § 330 (1994) (outlining court-ordered compensation for "actual, necessary services" after notice and a hearing"); Executive Office for United States Trustees, Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed under 11 U.S.C. § 330 (March 22, 1995).

[2297] 28 U.S.C. § 586(a)(3)(A)(i) (1994).

[2298] Section 586(a)(3)(A)(i) & (ii) requires the U.S. trustee to review fee applications and file objections when appropriate.

[2299] The Recommendation will not affect the U.S. trustee's use of outside services (even if separately funded by a bankruptcy estate) to assist it in reviewing fee applications.

appointing fee examiners, places the burden with the U.S. trustee, parties in interest and the court as envisioned under the Bankruptcy Code.[2300]

### 3.3.6 *Attorney Referral Services*

> **11 U.S.C. § 504 should be amended to permit an attorney compensated out of a bankruptcy estate to remit a percentage of such compensation to a bona fide, nonprofit, public service referral program. Such attorney referral program must be operating in accordance with state laws and ethical rules and guidelines governing referrals. The Recommendation does not affect the requirement that all compensation arrangements be disclosed in the application for retention under Fed. R. Bankr. P. 2014 and in the application for compensation under Fed. R. Bankr. P. 2016(a).**

Local bar associations frequently sponsor nonprofit, public service attorney referral services. An attorney referral service refers clients in search of legal counsel to attorneys. Occasionally, these referral services are supported by bar association dues. In order for these referral services to be self-funding, the American Bar Association's House of Delegates adopted a rule that provides "a qualified service, may, in addition to any referral fee, charge a fee calculated as a percentage of legal fees earned by any lawyer panelist to whom the service has referred a matter."[2301] The ABA also noted

> that ethics opinions have consistently held that a percentage fee program is a legitimate way for a referral service to generate income if: first, the funds collected through percentage fee funding are used solely to defray the service's operating costs or for other public service programs and, second, attorneys to whom cases are referred are barred from charging more for their legal services to offset the fees they remit to the referral service.[2302]

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[2300] 28 U.S.C. § 586(a)(3)(A) (1994) (requiring uniform review of fee applications in accordance with guidelines adopted by the U.S. trustee and filing comments with the court, where appropriate).

[2301] American Bar Association, Model Supreme Court Rules Governing Lawyer Referral and Information Services and "Model Lawyer Referral and Information Service Quality Assurance Act" Model Rule IX (August 1993).

[2302] *ABA Votes to Urge Fee-Splitting Between Debtor's Counsel and Referral Services*, BNA BANKR. L. DAILY (February 21, 1997).

The ABA has endorsed use of public service referral services under these circumstances.

Collecting a percentage of an attorney's fee as a means of funding the referral service, however, does not comport with certain provisions of the Bankruptcy Code. Bankruptcy Code section 504 prohibits fee-splitting arrangements except under two limited circumstances: (1) where a person is a partner or otherwise associated with an individual compensated from an estate; or (2) where an estate-compensated attorney for a creditor who filed an involuntary case under section 303 is assisted by another attorney. These provisions preclude fee-splitting in the case of a lawyer referral service that refers estate-compensated work to an attorney. In order to address this problem, the American Bar Association ("ABA") adopted the following resolution related to the payment of attorney referral fees at its meeting on February 3, 1997:

> RESOLVED, That the American Bar Association urges the amendment of the United States Bankruptcy Code, to allow an attorney to remit a percentage fee awarded or received under the Bankruptcy Code to a bona fide public service lawyer referral program, operating in accordance with state or territorial laws regulating lawyer referral services or the rules of professional responsibility governing the acceptance of referrals.

The types of attorney referral services considered in the Recommendation are those nonprofit services set up principally by state and local bar associations. This type of arrangement is not a classic fee-splitting scenario where two attorneys have an arrangement to share the fee. An attorney referral service under the Recommendation is compensated from amounts paid to the attorney up to a limit in exchange for referring the representation to the attorney. So long as the arrangement with the referral service is disclosed (1) in the application for retention under Fed. R. Bankr. P. 2014, and (2) in the application for compensation under Fed. R. Bankr. P. 2016(a), there should be no prohibition against the use of these types of referral services in bankruptcy. The Recommendation facilitates the ability of judges and clerks to refer *pro se* debtors seeking counsel to these types of services. Cottage industry opportunities for abusive referral services are limited because only not-for-profit organizations are eligible under the Recommendation.

*Competing Considerations*. Some attorneys argue that there is no need for this provision to assist low income debtors as these services are already available and affordable. Attorneys who represent low-income clients are unable to charge very much and may already donate a fair portion of their time to assist these types of debtors. Requiring these types of attorneys to split their fees may deter them from accepting referred cases. The Recommendation only permits a percentage payment if the attorney accepts the referral and agrees to assist the client. The Recommendation will have no effect on an attorney who chooses not to accept the referral in the first instance.