STATEMENT OF
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UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before you on behalf of the Department of Justice to discuss the role of the United States Trustee in reviewing applications to employ and compensate professionals in large chapter 11 bankruptcy cases. As the Acting United States Trustee for Region 3, I have responsibility for some of the largest cases filed in the country, including those filed in the district of Delaware.

Title 11 of the United States Code, known as the Bankruptcy Code, provides a comprehensive scheme for the employment of bankruptcy professionals who are paid from bankruptcy estate funds. Under 28 U.S.C. § 586 and other provisions of law, the United States Trustee has authority to review, comment upon, or object to applications to retain and compensate bankruptcy professionals.

Chapter 11 debtors are authorized to employ attorneys, accountants, and other necessary professionals to assist them in the reorganization process. Similarly, official committees of creditors or equity security holders, which are appointed under 11 U.S.C. § 1102, are authorized to employ

professionals to assist the committees in carrying out their responsibilities. In light of the multiplicity of interests present in bankruptcy cases and the frequent lack of natural tension that exists in the typical two-party civil proceeding, Congress has imposed special rules governing the employment of bankruptcy professionals. Most importantly, professionals may not be employed without approval of the bankruptcy court. Court approval is sought by filing an application which is noticed to the United States Trustee and, frequently, to other parties in the case. The terms of engagement must be disclosed, including any contingency fee arrangements.

The applicant must demonstrate that it is eligible for employment. The Bankruptcy Code and Rules impose a burden of full disclosure. The professional is required to submit to the court an application that states the following: the specific facts showing the need for the services to be rendered, the name of the person to be employed, the reasons for the selection, the particulars of the services to be rendered, and the terms of compensation. In addition, a verified statement is required from the professional that sets forth all connections the professional has or had with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States Trustee. Full and complete compliance requires that the professional report all connections, not just those connections that, in the judgment of the professional, may be relevant. It is the court's task to determine whether the connections are disqualifying. In its administration of chapter 11 cases, the United States Trustee endeavors to assure that the self-reporting required of professionals is provided and that disqualifying connections are brought to the attention of the court.

The basic requirements for the employment of a debtor's professionals are contained in 11 U.S.C. §§ 327, 328, and 101(14). Among other things, professionals "may not hold or represent an interest adverse to the estate [and must be] disinterested." In section 101(14), the term "disinterested person" is defined and sets forth five disqualifying conditions. Some of these conditions are general, but others are more specific. For example, directors and officers who served in those capacities within two years of the filing are per se excluded from employment. The basic requirements for committee professionals are contained in 11 U.S.C. § 1103. These requirements are similar, but not identical to, those governing the debtor's professionals. The notice requirements are contained in Federal Rule of Bankruptcy Procedure 2014 and local rules.

Professionals employed by the debtor or official committees may be paid fees and reimbursed for expenses out of estate funds. Congress has established a scheme for the application, review, and approval of fees in 11 U.S.C. §§ 330 and 331. Other basic requirements are set forth in the Federal Rule of Bankruptcy Procedure 2016 and local rules. Professionals may be compensated only after application, notice to parties, and approval by the bankruptcy court. Congress set forth the standards for approval of fees and expenses in § 330. The court may allow "reasonable compensation for actual, necessary services" and "reimbursement for actual, necessary expenses." By statute, the court must weigh such factors as time spent in rendering services, customary compensation charged by comparably skilled practitioners in non-bankruptcy cases, complexity of the services rendered, and benefit to the estate. Courts may award interim compensation, but all such interim awards are subject to final review and modification at the end of the case.

There are also other provisions of the Bankruptcy Code governing compensation of third parties for making a substantial contribution to the chapter 11 estate, but those involve more narrow circumstances and are not addressed in this testimony.

Although only the bankruptcy court may approve employment and compensation, and although creditors and parties in interest may object to employment and compensation, the United States Trustee Program considers its authority to review these applications to be an important tool in carrying out its mission to uphold the integrity and efficiency of the bankruptcy system. The precise level of United States Trustee review depends upon a variety of factors, including the success of the case and participation by other parties. Review also may vary according to the size and staffing of an office. In some offices, trained paralegals may undertake an initial review, but attorneys may conduct the entire review in other offices. In addition, standard operating procedures may vary according to local practice and the circumstances of a particular case. Offices often are able to resolve many questions or disputes informally without resort to litigation. For example, some deficiencies can be remedied by supplemental disclosure. Similarly, fee reductions may be obtained prior to filing an objection or by amending the application. Furthermore, the substantive outcome may vary somewhat from district to district according to controlling case law.

The United States Trustee Program has published fee guidelines to help standardize the content and organization of applications. The centerpiece of the guidelines is a task-based billing approach by

which applicants organize their time entries by discrete activities so that the costs and benefits of accomplishing specific tasks can be more easily determined.

As the Program has reported to the Subcommittee in previous hearings, we have made numerous management improvements over the past three and one-half years. Among our management advances has been institution of an automated Significant Accomplishments Reporting System by which we measure the work done in our field offices. In the future, these data should assist field office managers and the national Program leadership in setting priorities and allocating scarce resources. Although it is particularly difficult to quantify work done in the review of chapter 11 retention and fee applications, we do collect limited information.[1]

We have recently compiled our Fiscal Year 2003 data which will be published shortly and made available in an Annual Report to be distributed to members of Congress, the bankruptcy community, and the general public. Based upon data entered by our field offices, in Fiscal Year 2003, Program staff took 9,264 actions on employment and compensation applications. These actions ranged from informal negotiations to filing and arguing objections in court. A high percentage of these actions led to a successful result, including satisfactory amendment of an application or favorable adjudication

[1] Data reported herein include actions in chapter 7 and chapter 11 cases. Entered data exclude some reductions obtained by fee committees on which the United States Trustee is a participant. In addition, actions taken to achieve additional disclosures and fee reductions prior to filing an application are not captured in the database.

by the bankruptcy judge. A total of 3,746 formal objections were filed in court. As best we can quantify the results, our actions directly resulted in fee or expense reductions of $44.8 million.

We also have compiled data for the first six months of Fiscal Year 2004. From October 1, 2003, through March 31, 2004, Program staff took 2,965 actions on employment and fee applications. A total of 1,559 formal objections were filed in court. As best we can quantify the results, our actions resulted in fee or expense reductions of $34.9 million.

Numbers alone cannot adequately convey the significance of the actions we have taken. Just as with other regulatory or enforcement agencies, our selection of the right cases and obtaining the right results may have deterrent and other salutary effects that promote the integrity of the process, including the expanded disclosure of conflicts and greater restraint on fees. Following are examples of recent cases in which the United States Trustee litigated important matters of retention and compensation of professionals.

– In *In re Pillowtex, Inc.*, 304 F.3d 246 (3d Cir. 2002), the Court of Appeals for the Third Circuit sustained the United States Trustee's position and held that the bankruptcy court could not approve an employment application until it resolved allegations that proposed counsel for the debtor had received a preferential transfer and, therefore, was not disinterested. The law firm settled the matter after remand for a six figure disgorgement.

– In *In re Safety Kleen,* Case No. 00-02303 (Bankr. D. Del.), the United States Trustee for Region 3 objected to the retention of a financial advisory firm because a principal of the firm had served as the debtor's CFO pre-petition and was connected to a lawsuit against the debtor. In a related matter arising in *In re Harnischfeger,* Case No. 99-02171 (Bankr. D. Del.), the United States Trustee moved to disqualify the same firm and for disgorgement due to its failure to disclose connections involving the firm's investment affiliate and the appointment of one of the firm's principals to the board of one of the debtors. After extensive litigation, a settlement was reached, which was approved by the court, in which the firm disgorged $3.25 million.

– In *In re Fleming Companies, Inc.*, 304 B.R. 85 (Bankr. D. Del. 2003), the United States Trustee for Region 3 objected to the fee applications of debtor's counsel. In a published opinion, the Bankruptcy Court found that the two firms had rendered services which unnecessarily generated litigation and did not benefit the estate. The court also found that the hourly rates of one of the firm's practitioners were impermissibly higher than the hourly rates charged by similarly experienced attorneys in other practice areas within the same firm.

– In *United States v. Schilling (In re Big Rivers Elec. Corp.)*, 355 F.3d 415 (6th Cir. 2004), approximately $2.6 million in fees awarded to the examiner were disallowed based on objections filed by the United States Trustee for Region 8 and other parties.

The court ruled that the examiner failed to adhere to the standards of behavior required of a bankruptcy professional and was not entitled to any of the $2.6 million in fees originally awarded, including $960,000 in fees already in his possession which he was required to disgorge.

– In *In re Jore Corp.*, 298 B.R. 703 (Bankr. D. Mont. 2003), the United States Trustee for Region 18 moved to disqualify debtor's counsel because of counsel's failure to disclose it represented the debtor's primary lender in unrelated matters. The court granted the motion to disqualify and disallowed more than $1.8 million in fees.

– In *In re 360Networks (USA), Inc.*, Case No. 01-13721 (Bankr. S.D.N.Y.), the debtor's law firm agreed to reduce its fees by $1.35 million after the United States Trustee for Region 2 questioned the nature and manner of the firm's disclosures. In its final fee application, the firm revealed for the first time that, pre-petition, it received significant payments from the debtor that might qualify as preferential payments. The reduction in fees was approved by the court.

In recent years, the chapter 11 bankruptcy landscape has changed and new issues have emerged. This may require new approaches by the courts, United States Trustees, and others. Some of these issues are highlighted in recent chapter 11 cases associated with corporate malfeasance that

occurred in the late 1990s. Other issues have emerged as law firm, business, and finance practices have evolved.

In the area of conflicts of interest and compensation, the United States Trustee is confronting dynamic situations in which new fact scenarios must be applied to established statutory and case law. Examples include the following.

– Investment banks, financial advisors, and turnaround firms often have affiliates that manage investment funds that provide financing or capital to reorganize bankrupt companies.

– Financial services firms wish to serve on creditors' committees and continue to trade in the debtor's securities. Case law does not proscribe trading, but requires, at a minimum, erection of ethical barriers.

– Professionals and other third parties increasingly seek releases and exculpation, even though the bankruptcy discharge traditionally only protects debtors and is not designed to affect claims between third parties. In *In re United Artists Theatre Co. v. Walton (In re United Artists Theatre Co.)*, 315 F.3d 217 (3d Cir. 2003), the United States Trustee brought an action decided by the U.S. Court of Appeals for the Third Circuit.

The Court held that agreements to indemnify financial advisors for their negligence may be reasonable under § 328(a).

Published reports from bankruptcy experts tell us that the spike in public company and other mega-chapter 11 filings has subsided. Although many of the largest business reorganization cases were filed in 2001 and 2002, some remain pending in bankruptcy court. The size and complexity of some of these cases are of unprecedented magnitude. The resulting fee applications are of similar unprecedented proportions. This has prompted the courts, United States Trustees, and others to consider new approaches to fee review. Among the new approaches taken have been the following.

– Courts have appointed fee examiners and fee review committees who submit periodic reports to the court with recommendations for professional compensation awards. Some of these committees have professional staff and some are comprised only of major participants in the case. Several months ago, the United States Trustee Program conducted an informal survey of our field offices and identified at least fifteen on-going fee committees.

– Automated fee review procedures have been employed in a number of cases. Courts have allowed payment to private companies that conduct computerized analysis of fee applications to identify, among other things, possible duplication of effort (e.g., multiple lawyers at meetings and inter-office conferences) and the cost of particular tasks (e.g.,

aggregate time expended to develop a plan of reorganization). The United States Trustee also sometimes uses an internal computer program that is effective under certain circumstances. With automated fee review systems, professionals submit data in electronic format. The computer program allows fees to be analyzed across the board for all professionals employed in the case. Full text searching allows particular entries to be identified, grouped, and totaled. Among other things, this helps identify excessive meetings and consultations among professionals in different firms employed in the case.

– Some courts require professionals to submit budgets reflecting anticipated fees and expenses so that the court, debtor, and parties may better evaluate the likely future course of the case and the costs of professionals. Other devices have also been employed to encourage cost-cutting, including discounts off of standard hourly rates.

These and other strategic approaches have been and ought to be continually explored by the courts, the United States Trustees, and others to enhance the quality of fee review, especially in larger chapter 11 cases. A single approach may not be effective for all cases. Cases of different size and complexity may call for different methods of review. In addition, scholarly research may assist in determining anticipated costs of reorganization. Although each case is different, compilations of empirical data may help identify excessive costs or raise red flags to prompt further inquiry of professionals whose charges exceed a normal range.

Congress has prescribed a comprehensive regimen of legal standards and procedures governing the retention and compensation of professionals employed in chapter 11 cases. Bankruptcy courts are expressly required to review and approve the employment of all professionals and the payment of all fees and expenses. The responsibility to identify non-compliance with these standards and procedures in chapter 11 cases is a responsibility shared among the courts, the United States Trustees, and other participants in the bankruptcy system. I appreciate the opportunity to discuss some of the challenges that this responsibility presents, as well as some emerging issues and possible approaches for future action.

I would be happy to answer any questions from the Subcommittee.