

STATEMENT OF
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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 to discuss the United States Trustee Program's (USTP or Program) recent activities, including our implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). This past year has been extraordinarily busy for the Program and the bankruptcy system. I will update you today on achievements in our key areas of responsibility, as well as highlight our significant progress in making the new bankruptcy reform law work as intended by Congress for the benefit of debtors, creditors, and the public.

The United States Trustee Program is the component of the Department of Justice whose mission it is to promote the integrity and efficiency of the bankruptcy system by enforcing bankruptcy laws, appointing and overseeing private trustees, and carrying out important regulatory and administrative duties. In addition to our obligations under titles 11 and 28 of the United States Code, the Program has been given vast new responsibilities under the BAPCPA.

Promoting the Integrity and Efficiency of the Bankruptcy System

The USTP continues to make significant progress in combating bankruptcy fraud and abuse and taking other important actions to promote the integrity and efficiency of the bankruptcy system.

Civil Enforcement

For the past five years, the centerpiece of the Program's anti-fraud and abuse efforts has been the National Civil Enforcement Initiative. The Initiative focuses on wrong-doing both by debtors and by those who exploit debtors. The Program combats debtor fraud and abuse primarily by seeking case dismissal if a debtor has an ability to repay debts and by seeking denial of discharge for the concealment of assets and other violations. The Program protects consumer

debtors from wrongdoing by attorneys, bankruptcy petition preparers, creditors, and others by seeking a variety of remedies, including disgorgement of fees, fines, and injunctive relief.

Since FY 2003, more than 165,000 civil enforcement and related actions have been brought by the Program, yielding \$1.75 billion in monetary results. In FY 2005, more than 50,700 actions were initiated that generated nearly \$594 million in potential returns to creditors through debts not discharged and other remedies. USTP attorneys prevailed in over 96 percent of the actions resolved by judicial decision or consent in the fundamental areas of dismissal for substantial abuse (11 U.S.C. § 707(b)), denial of discharge (11 U.S.C. § 727), fines against bankruptcy petition preparers (11 U.S.C. § 110), and disgorgements of debtor attorneys' fees (11 U.S.C. § 329).

Following are illustrative examples of the variety of cases brought under the National Civil Enforcement Initiative.

- The Bankruptcy Court for the District of Oregon revoked the discharge of a debtor who tried to discharge \$1,931,157 in unsecured debt. Discovery initiated by the U.S. Trustee's office in Portland suggested the debtor had transferred to his girlfriend more than \$400,000 from a company he controlled, and then concealed the transfer. He also allegedly made false statements and false oaths in his bankruptcy case.
- In response to a motion by the U.S. Trustee's New York office seeking dismissal for substantial abuse, a debtor converted to chapter 11. The debtor, a financial consultant, earned almost \$300,000 per year and listed \$470,735 in unsecured debt. Although his wife did not work, the debtor scheduled the following monthly expenses relating to his four-year-old son: \$1,650 for an apartment for an au pair, \$516 for the au pair, \$1,375 for a private school, and \$560 for day care. Other scheduled monthly expenses included \$6,307 for apartment rent and utilities, \$3,600 for recreation, \$1,600 for clothing, \$1,121 for dry cleaning, \$650 for transportation, \$560 for maid service, and \$450 for telephone. The debtor also maintained a condominium in Marseille, France.
- The Bankruptcy Court for the Central District of California granted a motion to dismiss by the U.S. Trustee's Los Angeles office, preventing the discharge of \$316,571 in debt on 79 credit cards. The debtor, who lived with his parents, claimed no secured debt, no income, and no expenses. The U.S. Trustee sought dismissal for substantial abuse because the debtor incurred the credit card debt at a time when he earned less than \$8,000 a year.
- On motion of the U.S. Trustee's Pittsburgh office, the Bankruptcy Court for the Western District of Pennsylvania barred an attorney from practice before the bankruptcy court after she misappropriated client funds. During a chapter 13 proceeding, the attorney attended the closing of a sale of her clients' real property.

A check for approximately \$104,000 was made payable to the chapter 13 trustee to pay off the mortgage. The attorney deposited the check into her own account instead of delivering it to the trustee. The sale proceeds were used, at least in part, to pay the attorney's federal tax debt and to pay other clients from whom she misappropriated funds.

The Program has also pursued instances of creditor abuse. One recent example involved conduct by the financing arm of a national consumer goods manufacturer that was unfairly pressuring unrepresented debtors to reaffirm debt on goods, even though the manufacturer had asserted no lien or security interest in the goods and the debtors did not need to enter into a reaffirmation agreement in order to retain the goods. A coordinated response resulted in the courts denying the creditor's attempts to have debtors reaffirm dischargeable debts.

Criminal Enforcement

Criminal enforcement is another key component of the Program's efforts to promote the integrity of the bankruptcy system. In 2003, the Criminal Enforcement Unit (CREU) was established to coordinate the criminal referral responsibilities carried out by our 95 field offices and to directly assist prosecutors in pursuing bankruptcy crimes. CREU has made a marked difference in the quality of our criminal program by providing extensive training, developing resource materials, and enhancing coordination for the benefit of USTP staff, federal prosecutors, and other law enforcement personnel.

In FY 2005, the Program made 744 criminal referrals, a 12 percent increase over FY 2004. In many cases, USTP lawyers directly prosecuted or assisted the prosecution team in cases initiated as a result of criminal referrals made by Program offices. Four veteran career prosecutors within CREU, plus approximately 25 attorneys in field offices across the country who have been designated as Special Assistant U.S. Attorneys, are available to try cases involving bankruptcy crimes. In addition, the majority of Program field offices participate in bankruptcy fraud workings groups which are headed by U.S. Attorneys' offices and often involve the FBI, USPIS, IRS-CI, and HUD-OIG. With the enactment of 18 U.S.C. § 158 as part of the BAPCPA, every United States Attorney office is required to designate a prosecutor and every FBI field office an agent who will assume primary responsibility for bankruptcy fraud cases. This provision will further strengthen existing working groups by formalizing points of contact and provide a foundation for establishing working groups where currently none exist.

Some recent examples of successful prosecutions that originated with criminal referrals from the USTP follow.

- A former commodities trader and investment firm executive was sentenced in the Northern District of Illinois to 190 years in prison and ordered to pay \$1.4 million in restitution following his conviction on 18 counts of bankruptcy fraud, wire fraud, and money laundering, and one count of using a fire to commit wire fraud. The defendant intentionally set fire to his residence to obtain insurance money,

making it appear as if the fire were set by his elderly mother, who died in the fire. After receiving the insurance proceeds, he secreted them in an offshore account in Curacao. He later filed bankruptcy and concealed the offshore account containing more than \$300,000. The case was prosecuted by the Program's Regional Criminal Coordinator in Chicago, and an Assistant U.S. Trustee from Atlanta testified as an expert witness.

- A debtor in the Western District of Tennessee was sentenced to 46-months in prison for her use of two stolen Social Security numbers in two bankruptcy filings and her failure to disclose prior bankruptcy filings. The debtor was also ordered to pay restitution. The Memphis office referred the matter for investigation and a trial attorney from that office served as a Special Assistant U.S. Attorney.
- A bankruptcy attorney in the Southern District of Texas was sentenced to 30 months in prison and five years probation based on her guilty plea to wire fraud and bankruptcy fraud. The attorney defrauded her clients and their creditors by incurring unauthorized charges on her clients' credit cards and by taking possession of and using collateral her clients intended to surrender to creditors. The Program's Houston office referred the matter and assisted in the investigation and prosecution.

Chapter 11 Reorganizations

The Program carries out a wide array of responsibilities in chapter 11 reorganization cases. Our primary role is to ensure that cases proceed expeditiously and with transparency in accordance with law. By statute, our principal responsibilities include: the appointment of official committees of creditors and equity holders; objections to the retention and compensation of professionals; the review of disclosure statements, particularly in smaller cases; and the appointment of trustees or examiners when warranted. Chapter 11 cases often present the Program with highly complex issues of law and require time intensive financial reviews.

In FY 2005, the Program filed nearly 3,000 motions to convert or dismiss chapter 11 cases. The grounds for such motions, which are critical to the effective functioning of the reorganization provisions of the Bankruptcy Code, typically include failure to file financial reports or dissipation of estate assets without a reasonable likelihood of rehabilitation.

Provided below are some recent examples of important actions taken by the Program in larger chapter 11 cases:

- After much negotiation, the Program reached a stipulated agreement with the management services provider in the chapter 11 case of Enron Corporation to reduce by \$12.5 million the success fee it requested for its work in the case. In reviewing the provider's motion for a \$25 million success fee, the U.S. Trustee initiated an investigation that uncovered unacceptable billing practices and billing

irregularities. The bankruptcy court held a hearing on the motion, but withheld its ruling pending the filing of a response by the U.S. Trustee. The stipulated agreement was approved by the bankruptcy court on March 24, 2006.

- The Tenth Circuit Court of Appeals in Houlihan Lokey Howard & Zukin Capital v. Unsecured Creditors' Liquidating Trust (In re Commercial Financial Services, Inc.), 427 F.3d 804 (10th Cir. 2005), affirmed a ruling by the Bankruptcy Appellate Panel for the Tenth Circuit, denying fees to the financial advisor for the committee of asset-based securities holders. Upon objection by the Tulsa office and the unsecured creditors' committee, the Bankruptcy Court for the Northern District of Oklahoma denied fees of more than \$1.9 million sought by the financial advisor, which were determined according to a flat monthly rate. The bankruptcy court did, however, allow fees of \$905,000 based on an hourly rate supported by contemporaneous time records. The Bankruptcy Appellate Panel affirmed this ruling and the financial advisor appealed. The Tenth Circuit Court of Appeals ruled that the bankruptcy court appropriately exercised its powers to require the financial advisor to report the number of hours it worked and to calculate a reasonable fee looking to rates charged by other financial advisors employed in the case.
- Based upon action brought by the Boston office, the Bankruptcy Court for the District of Massachusetts agreed that a chapter 11 trustee should be appointed in related cases filed barely 180 days after the debtors' reorganization plan was confirmed in a prior chapter 11 case. In addition to objecting to the debtors' request for financing, the U.S. Trustee noted potential conflicts of interest of various professionals and the debtors' failure to inform the court of the failed prior chapter 11 case or to produce current financial information. Within about six months after being appointed by the U.S. Trustee, the chapter 11 trustee negotiated sales of the debtors' assets, including the sale of a manufacturing facility for approximately \$181 million, a sum sufficient to pay general unsecured claims in full and provide a substantial distribution to equity holders.

Private Trustee Oversight

One of the core functions of the United States Trustee is to appoint and supervise the private trustees who administer consumer bankruptcy estates and distribute dividends to creditors. The Program also trains trustees, evaluates their overall performance, reviews their financial accounting, and ensures their prompt administration of estate assets.

In FY 2005, over 1.6 million consumer and other non-business reorganization cases were filed under chapters 7, 12, and 13 of the Bankruptcy Code in the 88 judicial districts covered by the Program. The U.S. Trustee oversees the activities of the approximately 1,800 private trustees appointed by them to handle the day-to-day activities in these cases. With distributions by these trustees of about \$5.3 billion last fiscal year, the Program's effectiveness in this area is critical.

The Program has continued to strengthen its partnership with the private trustee organizations to address areas of mutual concern and enhance the operation of the bankruptcy system. In preparation for assuming new responsibilities under bankruptcy reform, the Program worked closely with the trustees and provided extensive training.

Two other ongoing efforts that have been undertaken to enhance consumer bankruptcy case administration are: the development of uniform trustee final reports which will improve access to case data and allow for greater analysis of the bankruptcy system; and coordination with the Internal Revenue Service on the use of a new protocol that enables trustees to obtain the federal tax refunds of debtors directly from the Service.

Management Accomplishments

In January 2006, the Office of Management and Budget (OMB) completed its review of USTP operations under the Program Assessment Rating Tool and awarded the USTP its highest rating of “effective.” The Program’s numerical score placed it among the top 15 percent of highly performing agencies in the Executive Branch. The OMB rating reflected the USTP’s efforts over the past five years to adopt performance-based management systems, including better measurements of results achieved and tying programmatic success to budget formulation.

Bankruptcy Reform

The United States Trustee Program has responsibility for carrying out many key features of the bankruptcy reform law. From enactment of the BAPCPA in April through the general effective date of October 17, 2005, the Program engaged in an extraordinary effort to develop comprehensive implementation plans and issue guidance necessary to accomplish our new and expanded responsibilities.

The magnitude of the challenge of implementing bankruptcy reform increased substantially with the additional burden of administering the unprecedented number of bankruptcy cases filed immediately prior to the October 17 effective date. In the four weeks leading up to that date, more than 726,500 cases were filed in the 88 judicial districts covered by the Program. By contrast, post-October 17 filings have decreased substantially, with only about 115,000 cases having been filed in the subsequent five months. The filing rate is increasing at a moderate pace.

Despite the difficulties presented by the pre-BAPCA filing surge, we have made great progress implementing and enforcing many of the new law’s important provisions. Moreover, we are acquiring valuable information every day as we gain experience in enforcing statutory provisions and in carrying out wholly new responsibilities that were not previously part of our mission. We expect that we will be engaged in a significant amount of litigation as bankruptcy courts are called upon to interpret statutory provisions for the first time. Of important note is our coordination with the Justice Department’s Civil Division in defending the early challenges to the constitutionality of the debt relief agency provisions of the BAPCPA.

The new law provided substantial additional responsibilities to the Program primarily, but not exclusively, in five major areas: means testing; credit counseling and debtor education; small business chapter 11s; debtor audits; and studies and data collection. This past year, we have dedicated significant resources to developing appropriate policies, procedures, and systems to ensure successful implementation. A critical part of our work has been outreach to the bench, the bar, other state and federal agencies, the private trustee organizations, and industry and consumer groups.

Means Testing

The means testing provisions of the BAPCPA provide an objective approach for assessing a debtor's eligibility for chapter 7 relief. Under the means test, debtors with income above their State median income will be presumed abusive if they have a certain level of disposable income after the deduction of expenses allowed under the statutory formula. Among other things, United States Trustees must file a statement within 10 days of conclusion of the section 341 meeting of creditors if the case is presumed abusive. Within 30 days thereafter, the UST must file a motion to dismiss the case or provide an explanation as to why such a motion is not warranted.

The Program has worked extensively with the Judicial Conference's Advisory Committee on Bankruptcy Rules in its development of the necessary official forms and accompanying rules to perform the means test. In addition, in the absence of a mandate by the Administrative Office of United States Courts to require data tagging software, the Program deployed its own partially automated system to expedite calculations of debtor information under the statutory means testing formula. Moreover, the Program made a major investment in training field personnel to perform the means test, including guidance to attorneys on the appropriate exercise of discretion in deciding whether to file a motion to dismiss a case under the presumed abuse standard. To that end, we issued a directive to ensure that our staff consider the adverse financial impact of Hurricane Katrina to generally constitute special circumstances that outweigh the presumed abuse criterion for dismissal.

As of March 31, 2006, of the cases where a review had been completed, the Program had filed 84 motions to dismiss under 11 U.S.C. § 707(b)(2) and 32 declination statements explaining why a motion to dismiss was not appropriate. The most common reasons for declination have been the debtor was a victim of Hurricane Katrina which supports an expense adjustment as a "special circumstance," or the debtor experienced a post-petition change in status that supports an income adjustment, such as seasonal employment or disability.

Credit Counseling and Debtor Education

The credit counseling and debtor education provisions of the reform law provide potentially salutary protections for consumer debtors by helping ensure that debtors enter bankruptcy with full knowledge of their options and exit with information to help them avoid future financial calamity.

The USTP is charged with responsibility to approve eligible providers of credit counseling and debtor education services. Individual debtors generally must seek counseling from these providers as a condition of filing and receiving a discharge of debts. Although enforcement practices differ according to local court rules, USTP offices often are the primary agency ensuring debtor compliance.

The USTP has determined that there is adequate capacity to provide debtors with credit counseling and debtor education services in every district within our jurisdiction, except for the four districts impacted most significantly by Hurricane Katrina. In those four districts, the Program temporarily waived the statutory requirements for credit counseling and debtor education due to infrastructure impediments and the dislocation of a large numbers of residents. As of the end of March 2006, the Program had approved 142 credit counseling agencies covering 88 judicial districts for pre-bankruptcy counseling. In addition to offering Internet and telephonic access, there are 754 walk-in locations for credit counseling throughout 82 judicial districts. For post-bankruptcy debtor education, by the end of last month, the Program had approved 241 debtor education providers covering 88 judicial districts. In addition to debtor education providers offering Internet and telephonic access, there are 915 walk-in locations in 82 judicial districts.

Applications and reapplications from credit counseling agencies and debtor education providers are received and processed continuously. We are currently processing complete applications within 30 to 45 days of receipt, and work with applicants where there are deficiencies to collect additional information as needed so they can qualify for approval. Common reasons for the delay or denial of approval of credit counseling agencies are failure to demonstrate nonprofit status, failure to provide information in connection with on-going audit of an agency's activities by the Internal Revenue Service, failure to demonstrate independence of the board of directors, and inappropriate relationships with a third party which appear to generate private benefit to an individual or group. The delay or denial of debtor education provider applications generally relate to inadequate materials; failure to employ trained personnel; and fee disclosure issues.

The Program is working with the Internal Revenue Service and the Federal Trade Commission to refine the application and post-approval auditing process. In addition, we are proceeding with formal rule-making and, in the near term, expect to publish slightly revised applications as Interim Rules. Thereafter, we will publish in the Federal Register more comprehensive, proposed final rules for public notice and comment. This process will give the Program more latitude in developing standards that address the myriad issues that arise in the regulation of credit counseling agencies and debtor education providers.

Small Business Chapter 11 Cases

The small business provisions of the BAPCPA establish new deadlines and greater uniformity in financial reporting to ensure that cases move expeditiously through the chapter 11 process before assets are dissipated. They also provide important new enforcement tools to the United States Trustees. To implement the BAPCPA's oversight provisions, the Program developed a new Monthly Operating Report (MOR) form for small business chapter 11 cases to

make financial reporting simpler and more uniform. A pilot of the MOR is being conducted and, at a recent meeting of the Judicial Conference's Advisory Committee on Bankruptcy Rules, the Program presented its initial analysis. While it is still early in the process, the Committee voted to recommend the MOR form, with a few modifications, to be published for public comment as a proposed Official Form which the BAPCPA requires be promulgated by the Judicial Conference. The Advisory Committee also sought input from the USTP on drafting a form small business plan and disclosure statement which will be issued for public comment as well.

Although it is too soon to measure the effect of the small business provisions in cases filed after October 17th, our field offices are tracking the new deadlines and routinely use the new initial debtor interview (IDI) provision to identify important issues early in the case. For example, the IDI process recently helped identify two cases as health care businesses that may require appointment of an ombudsman to protect patients. Other information yielded from the IDIs has included early disclosure of the failure of debtor businesses to file tax returns and the identification of financial irregularities requiring immediate corrective action or case dismissal.

Debtor Audits

Under BAPCPA, the USTP must contract for random and targeted audits to verify the financial information provided by debtors. This provision will help the Program identify fraud, deter the filing of false financial information, and potentially provide a baseline for measuring fraud, abuse, and errors in the bankruptcy system. The debtor audits mandated by the BAPCPA will commence on October 20, 2006 – 18 months after the law's April 20, 2005, enactment date. Independent auditors will conduct random audits of no fewer than 1 of every 250 cases in each judicial district. They will also conduct targeted audits of cases filed by debtors with income and expenses higher than the norm of the district. An estimated 7,338 cases will be audited in the first year, with 6,338 random audits and 1,000 targeted audits. The Program expects to issue a Request for Proposals for contract auditors by the end of May.

Studies and Data Collection

The BAPCPA requires the EOUST to undertake several studies, including (1) consulting with experts in the field of debtor education to develop, test, and evaluate a financial management training curriculum and materials; (2) evaluating the impact of the use of the IRS standards for determining the current monthly expenses under 11 U.S.C. § 707(b) on debtors and bankruptcy courts; and (3) evaluating the impact of the new definition of "household goods" in section 313 of the BAPCPA.

Data collection and extraction will be important to the successful completion of these studies, particularly those of the IRS standards and household goods, and to the effective and efficient processing of cases. Last year, a Senate Appropriations Committee Report endorsed the idea of the Administrative Office of the U.S. Courts (AOUSC) working with the U.S. Trustee Program on the development of data tags to provide an automated approach to extracting essential data from bankruptcy forms for such purposes as analyzing the means test, selecting cases for targeted debtor audits, conducting the evaluation studies, reporting to Congress, and

processing cases more efficiently. A document containing data tags is sometimes referred to as a “smart form”– that is, a form that is data-enabled so that, when it is saved into the industry standard Portable Document Format (PDF), it contains searchable data. I am pleased to report that the Program, in conjunction with the AOUSC, developed a smart form standard that was released to the bankruptcy form software vendors. AOUSC is now considering whether to make smart forms mandatory.

Fiscal Year 2007 Appropriations Request

The Administration has requested FY 2007 appropriations of \$236.1 million, including 1,519 positions and 1,486 workyears. This represents an increase of 11.6 percent over FY 2006. Included in the request is \$11.2 million for mandatory adjustments to base necessary to meet pay and rent increases and to fund second year costs associated with the 270 new positions approved in FY 2006. The budget also requests program enhancements totaling \$12.7 million. The program enhancements would be devoted exclusively to bankruptcy reform – \$4.8 million to fund the new debtor audits required under the BAPCPA which will commence on October 20, 2006; and \$7.9 million in enhancements requested, but not appropriated last year, including \$5.1 million and 51 new positions for means testing and credit counseling, \$2.3 million for related facilities expansion, \$1 million for information technology, and \$500,000 for statutorily mandated studies.

The USTP is funded entirely from bankruptcy filing fees and chapter 11 quarterly fees. As fees are collected, they are deposited into the U.S. Trustee System Fund and available to the Program as appropriated by the Congress. The FY 2007 revenue projections that accompany the USTP budget request follow Congressional Budget Office estimates for bankruptcy filings. These estimates were made prior to the pre-October 17 bulge in bankruptcy filings and without regard to the subsequent concomitant filing decrease.

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This is a time of unprecedented opportunity for the United States Trustee Program to make bankruptcy reform work for all stakeholders in the bankruptcy system, including debtors, creditors, and the public. The new law provides many important tools that will assist the USTP in enhancing the integrity and efficiency of the bankruptcy system. Enforcement and implementation of the new law has created many daunting challenges, but we believe that we are off to an excellent start.

Thank you for the opportunity to testify on the recent activities of the United States Trustee Program. I am pleased to answer any questions from the Subcommittee.