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Report to the Chairman, Subcommittee on Economic and Commercial Law, Committee on the Judiciary, House of Representatives

BANKRUPTCY TRUSTEES

Oversight Improved But Extent of Trustee Fraud Is Unknown

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The Honorable Jack Brooks
Chairman, Subcommittee on
Economic and Commercial Law
Committee on the Judiciary
House of Representatives

Dear Mr. Chairman:

Over the last several years, bankruptcy filings have increased more rapidly than any other time in history. Since 1986, filings have increased 109 percent, from 507,544 to 1,063,000 in 1992 (estimated), and predictions are that over 1.2 million bankruptcies will be filed in 1993. According to a Justice official, over $26 billion in estate funds is estimated to be involved. These dramatic increases over a short period of time have raised concerns about the integrity of the system and its ability to handle the increased caseload. The concerns include allegations of fraud committed by private trustees charged with managing and disbursing to creditors the assets of bankruptcy estates.

This report responds to your request that we analyze the extent of trustee fraud, the adequacy of Department of Justice bankruptcy trustee oversight, and the potential for conflict of interest in the U.S. Trustee (UST) program.

Results in Brief

The oversight and monitoring of bankruptcy trustees is one of several areas in Justice designated as "high risk." The trustee system is vulnerable to fraud because of the large number of trustees who administer tens of billions of dollars in estate funds and the limited resources available to conduct and thoroughly follow up on trustee audits and reports. However, because of data limitations, we were unable to quantify how much trustee fraud exists. Neither the Federal Bureau of Investigation (FBI) nor the U.S. Attorneys collect statistics on the number or type of trustee fraud cases investigated or prosecuted.

The increasing bankruptcy caseload requires aggressive action toward those trustees who fail to obey the law. Since 1988, the Executive Office for U.S. Trustees (EOUST) in Justice has actively sought to improve UST program oversight and to impose accountability on the bankruptcy system through trustee selection, reporting requirements, training, and audits of trustees. In April 1992, the Attorney General emphasized the high priority

Justice places on dealing with the growing threat of bankruptcy fraud and stated that the demand for trustees to adhere to fiduciary standards is paramount.

While the UST program has made progress in addressing the bankruptcy system's vulnerability to fraud by trustees through implementation of new program initiatives and the Attorney General's designation of the program as a high priority, certain challenges remain for the EOUST to address. These challenges include the number of cases open for long periods of time, problems identified on Inspector General (IG) audits, and funding limitations.

Conflict-of-interest concerns focus on Justice being responsible for bankruptcy administration while at the same time representing the federal government in its role as a creditor in bankruptcy cases. However, we found that Justice's ability to promote the claims of a government agency over other creditors' claims is limited by the role and authority of the bankruptcy courts. Required court approval of key case administration decisions provides checks and balances within the system to help prevent abuse. In our prior work, interviews with Justice and officials from the Administrative Office of the U.S. Courts (AO) involved in bankruptcies identified only two cases since 1989 in which a potential conflict of interest was alleged to have occurred.

Background

The U.S. bankruptcy system seeks to resolve conflicts that arise among a debtor's creditors, ensure that all creditors are treated fairly, and provide debtors with a "fresh start." Under the Constitution, Congress has established federal bankruptcy laws with jurisdiction vested in federal district courts. District courts refer bankruptcy proceedings to judges who preside over the cases in separate bankruptcy courts.

Before 1978, bankruptcy judges were responsible for the administration of individual bankruptcy cases, including appointing trustees to administer the cases and monitoring individual cases. In addition to case adjudication, this arrangement placed the administrative, supervisory, and clerical functions associated with bankruptcies under the control of bankruptcy judges. According to the legislative history of the Bankruptcy Reform Act, allegations of cronyism and favoritism between some judges and trustees were commonplace. Concerns arose over the integrity of the system, particularly as it related to the selection and oversight of trustees.

Bankruptcy Reform Act Created USTs

In 1978, Congress passed the Bankruptcy Reform Act (P.L. 95-598), the first comprehensive reform of the bankruptcy system in 40 years. To correct the perception of unfairness and cronyism caused by the bankruptcy judges' dual responsibilities, the act shifted administrative and supervisory responsibilities from the courts to the Department of Justice. The act created the UST program within Justice, to be pilot-tested in 18 of the 94 judicial districts. In 1986, additional legislation[1] expanded the UST program to 88 districts nationwide[2] and established 21 regions, each administered by a UST who is appointed by the Attorney General for a 5-year term. The Attorney General established the EOUST to provide legal, administrative, and management support to the individual UST districts. (The 21 UST regions are illustrated in app. I.)

One of the functions of USTs is to establish panels of private trustees who are appointed, using a blind rotation system, to serve in Chapter 7 liquidation cases. In a Chapter 7 case, the debtor's nonexempt property is placed under the control of a trustee, who is responsible for liquidating the assets and disbursing the funds to creditors. Selecting individuals to be trustees, appointing them to specific cases, supervising their performance, and monitoring the progress of their cases is the responsibility of UST staff.

Chapter 7 trustees are responsible for managing bankruptcy estates for the benefit of creditors, administering cases in an efficient manner, and closing cases as soon as possible. Trustees are not employees of the court; most are attorneys and experienced bankruptcy practitioners. The trustee represents and is responsible to the estate—not solely to the debtor—and is held accountable for all property received. In addition, the trustee is required to

- furnish information concerning the estate and his/her administration of it as requested by parties in interest (e.g., creditors);
- file reports accounting for his/her administration; and
- otherwise perform his/her fiduciary obligations.

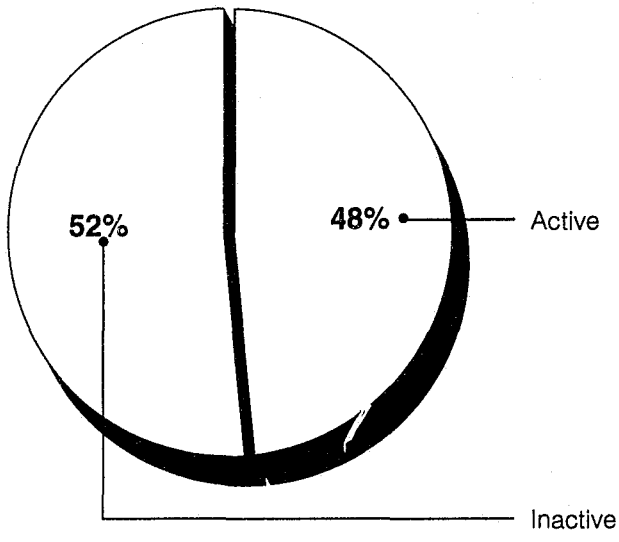
In March 1992, about 1,311 individuals nationwide actively served on Chapter 7 trustee panels. At that time, an additional 1,392 inactive trustees

[1]The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 (P.L. 99-554).

[2]According to congressional legislation, bankruptcy administration in six districts in the states of North Carolina and Alabama remains under the jurisdiction of the judicial branch until 2002, at the latest.

no longer served on panels and did not receive new cases but continued to administer their existing cases. (See fig. 1.)

Figure 1: Percentage of Active and Inactive Panel Trustees as of March 1992



Source: EOUST data.

Bankruptcy Fraud Designated a Higher Priority by Attorney General

The increasing bankruptcy caseload requires aggressive action toward those who fail to obey the law. In its fiscal year 1993 budget request, the FBI stated that the volume and complexity of bankruptcy filings and the dollar amounts involved offer an opportunity for abuse and that this abuse is largely unaddressed. In part, this is because, in prosecuting trustees for wrongdoing, a substantial amount of time and effort is involved. Most criminal actions by trustees are discovered through audits related to the trustee's failure to file reports and close cases. In many instances, a financial reconstruction must be done of all the trustee's cases. This consists of an examination of each bank account maintained by the trustee for each estate. For each bank account, all financial documentation must be examined, including all bank statements, canceled checks, and deposit slips. Further, inspection of the trustee's personal accounts must be conducted in a similar manner.

In an April 1992 memorandum, the Attorney General emphasized the high priority Justice places on dealing with the growing threat of bankruptcy fraud. He stated that the demand for private trustees to adhere to fiduciary standards is paramount and that private trustees who administer estates to their own advantage cannot be tolerated. He further stated that Justice must marshal its efforts and that these efforts require a melding of the expertise and resources of Justice as a whole; each component is responsible for establishing effective relationships to coordinate these efforts. Specifically, the FBI and each U.S. Attorney and UST are to designate individuals to be accountable for the process.

According to an EOUST official, since the April 1992 memorandum, steps have been taken to strengthen various Justice components. Training conferences have been held, and others are scheduled, with participation by UST and U.S. Attorney staff and agencies including the FBI, Internal Revenue Service (IRS), Social Security Administration, U.S. Postal Service, and the Departments of Labor, Health and Human Services, and Housing and Urban Development. Multiagency working groups and advisory committees have been established that meet regularly on bankruptcy matters. To enhance the quality of UST criminal referrals, the EOUST is developing a manual on criminal procedure.

Objectives, Scope, and Methodology

As a part of its larger review of the bankruptcy system, the Subcommittee requested that we analyze

- the extent of trustee fraud and Justice efforts to prosecute it,
- Justice oversight of bankruptcy trustees,
- the potential for conflict of interest in the UST program, and
- whether political appointees meet the criteria for UST positions.

To determine the extent of trustee fraud, we interviewed EOUST officials and visited two districts—Houston, TX, and Indianapolis, IN, where we interviewed UST staff, U.S. Attorneys, FBI agents, and bankruptcy judges. In addition, we interviewed private trustees in Indianapolis. We selected these two districts because they were among the regions from which the Subcommittee received complaints of trustee fraud. To obtain information and documentation on allegations of potential fraud, we reviewed the actual complaints that the Subcommittee received and interviewed complainants. We obtained data on the number of trustees indicted or convicted and under investigation from the EOUST, FBI, and Executive Office for U.S. Attorneys (EOUSA).

To ascertain the adequacy of Justice oversight of bankruptcy trustees, we obtained information on EOUST efforts to enhance oversight. These efforts included conducting audits on trustee operations and establishing reporting requirements relating to trustees' administration of cases. In this regard, we analyzed IG audit findings and reports as well as bankruptcy data obtained from the EOUST, FBI, and EOUSA. We limited our analysis to data on Chapter 7 bankruptcy trustees because they constituted almost 70 percent of all bankruptcies filed in 1991.

To determine whether a conflict of interest exists in the UST program with regard to the placement of the program in Justice and whether political appointees meet established criteria for UST positions, we interviewed EOUST and district UST officials, bankruptcy judges, and trustees. We reviewed the criteria for selecting USTs and compared them to the qualifications of the UST in that position. Additionally, we reviewed complaints and interviewed complainants to obtain information and documentation for conflict-of-interest allegations. In the districts we visited, we asked UST staff, bankruptcy judges, and trustees to identify cases in which UST staff acted to promote the claims of a government agency over other creditors' claims.

Our audit work was done between December 1991 and September 1992 in accordance with generally accepted government auditing standards.

Trustee System Vulnerable to Fraud

The trustee system is vulnerable to fraud because of the large number of trustees who administer tens of billions of dollars in estate funds and the limited resources available to conduct and thoroughly follow up on trustee audits and reports.

According to the Office of Management and Budget (OMB), in October 1989, the administration made a major commitment to identifying the areas of highest risk and vulnerability to fraud and abuse in government operations. High-risk areas are those where the government is especially vulnerable to fraud. Agency heads are required to periodically report to OMB on their plans to correct deficiencies and the progress made in these areas. In 1989, OMB assessed the oversight and monitoring of bankruptcy trustees as a high-risk area.

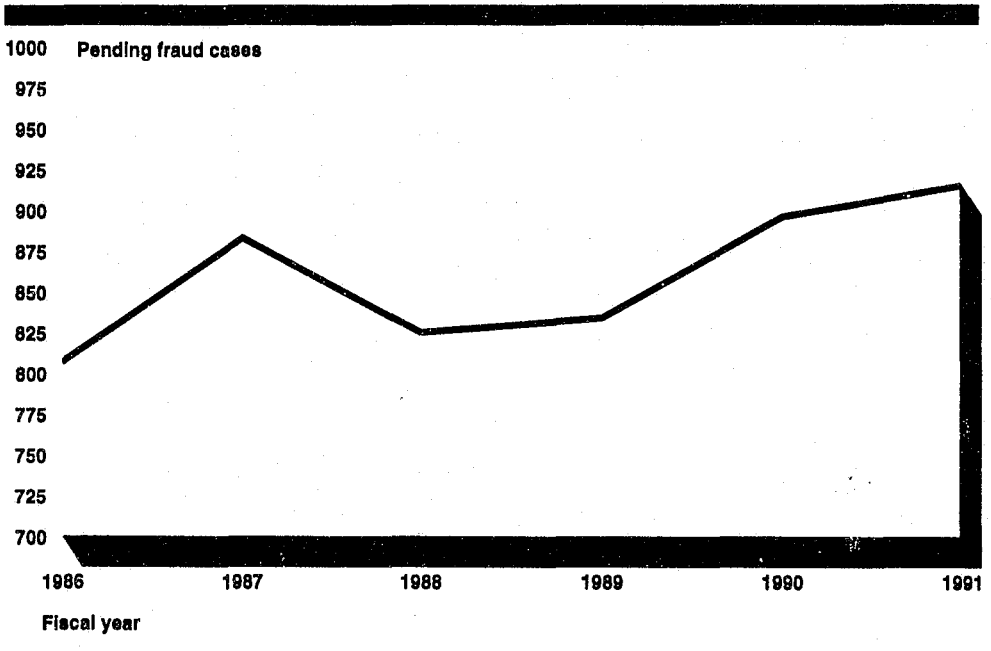
Trustee fraud is committed when assets of bankruptcy estates are misappropriated by the trustee. Fraudulent activities by trustees may include the embezzlement of estate funds, the theft and/or sale of estate

assets by trustees to insiders, or illegal fee arrangements. Generally, when trustee fraud is suspected, a financial reconstruction of the trustee's cases is done by the EOUST. This consists of an examination of all bank statements maintained by the trustee for each estate, including bank accounts holding estate funds. If a misappropriation of estate funds is confirmed, the UST office is to refer the case to the U.S. Attorney's office for further investigation and prosecution.

Extent of Trustee Fraud Unknown

Because of data limitations, we were unable to determine the extent of trustee fraud. Neither the FBI nor the U.S. Attorneys collect statistics on the number or type of bankruptcy trustee fraud cases investigated or prosecuted. The FBI's bankruptcy fraud data combine debtor fraud and trustee fraud cases. The 1986 through 1991 FBI data on its pending bankruptcy fraud cases showed a slight increase (from 807 to 915 cases). (See fig. 2.) However, during the same period, bankruptcy filings increased 81 percent (from 507,544 to 918,956 filings). (See app. II.)

Figure 2: Pending FBI Bankruptcy Fraud Cases



Source: FBI data.

Data provided by the EOUSA on the number of criminal bankruptcy cases in U.S. district courts also showed a small increase in the number of cases over a 3-year period. (See table 1.) For fiscal years 1989 through 1991, 249 bankruptcy criminal cases were filed, and 223 were terminated.

Table 1: Bankruptcy Criminal Cases in U.S. District Courts

	Fiscal year 1989	Fiscal year 1990	Fiscal year 1991
Cases filed	75	89	85
Cases terminated	62	77	84

Source: EOUSA data.

While neither FBI nor U.S. Attorney data distinguished between debtor and trustee fraud, Justice officials told us that most of the cases involved debtor—not trustee—fraud.

EOUST Has Sought to Improve Trustee Oversight

With the increasing number of cases—involving significant sums of money—the UST program recognized that standards of accountability and proper trustee oversight were critical to protect estate assets for the creditors. According to the EOUST Director, when the UST program was expanded nationwide in 1986, it encountered a variety of problems in the local bankruptcy districts, including a wide range of local procedures, customs, and practices. Cases did not move toward resolution in a timely manner, and some trustees were not even aware of the cases assigned to them. In some instances, reporting requirements regarding the administration of estates were basically nonexistent, as were recordkeeping procedures. Trustees were given little or no guidance as to what was expected of them, and their backgrounds were not reviewed before they were appointed. After confronting its own start-up difficulties, since 1989 the EOUST has actively sought to improve trustee oversight.

In response to the need for better trustee oversight, in 1989 a new Director was appointed for the UST program, and Justice undertook providing greater central oversight of what had traditionally been a very decentralized program. The UST program has sought to impose accountability on the bankruptcy system in a number of areas, including trustee selection, training, reporting requirements, and audits of trustees.

Improvements in Trustee Selection Process

The UST program now must more rigorously examine the suitability of potential trustees to hold the office. The credentials of those seeking

appointment to the panel are to be carefully examined, and candidates are to be interviewed. All trustees must undergo a name, fingerprint, credit, FBI background, and tax record check to ensure that nothing in the individual's history indicates that he or she could not or would not adhere to the fiduciary duties of a trustee. The legislative history of the Bankruptcy Reform Act indicates that before the UST system was established, trustees in many cases were appointed by bankruptcy judges who also supervised the trustees' administration of cases and often suggested asset recovery actions a trustee might take. The legislative history also indicates that some judges considered the trustee position to be one of patronage, and other judges often appointed friends.

Reporting Requirements

Under the prior system, there was no standard reporting process for trustees. UST procedures now require trustees to report semiannually to their district's UST on each case they are assigned. The reports include information on the bank accounts where estate funds are maintained, the bond amount, and the status and disposition of estate assets. The trustee must enumerate all estate assets under his or her administration, note any security interest held in those assets, disclose the liquidation of assets into cash, and maintain a journal of cash receipts and disbursements. The reports can be a valuable tool to determine how effectively and efficiently trustees are moving cases toward resolution.

The EOUST Director stated that through these reporting requirements, progress in administering a particular debtor's estate can be monitored, as well as the trustee's adherence to fiduciary standards. To the degree that deficiencies in one case are noted, the reporting procedures allow an examination of all cases assigned to the trustee.

Training

During 1991 and 1992, the UST program has sponsored several conferences throughout the country on the supervision of Chapter 7 trustees. EOUST officials said that at these sessions UST staff were to be given hands-on training on proper Chapter 7 case administration, case closing processes, and trustee monitoring. Moreover, several joint conferences on bankruptcy fraud were held involving the UST, FBI, U.S. Attorneys, IRS, and other federal officials.

Trustee Audits

The UST program has also instituted audit procedures whereby a trustee's overall operation and financial recordkeeping are examined periodically

by the Justice IG. Until 1991, the audits focused on trustee cash management and operations. At that time the scope of the audits was expanded and refocused on areas that experience had shown to be susceptible to problems. Audits are now to include

- the tracking of assets,
- an in-depth review of internal controls,
- an examination of actual cases, and
- third-party confirmations to validate whether creditors actually received a distribution.

In this way, the audit reportedly seeks to demonstrate that the trustee took control over all assets, liquidated them in a timely manner, maintained money in interest-bearing accounts, kept adequate records, and made proper distributions to creditors.

The EOUST Director said that a basic responsibility of the UST program is to strengthen the integrity of the bankruptcy system by ensuring the efficient and effective administration of cases. In our opinion, these initiatives represent a critical first step to improving the system and increasing accountability of those involved in the system.

Challenges Facing the System

While the UST program has made progress in addressing the bankruptcy system's vulnerability to trustee fraud through implementation of the program's Chapter 7 initiatives, certain challenges remain for the EOUST to address. These challenges include

- the number of cases open for long periods of time,
- problems identified in audits,
- insufficient authority to hold trustees accountable for departures from fiduciary responsibilities, and
- funding limitations.

Old Cases in the System

The Bankruptcy Code requires that in addition to liquidating assets of an estate, one of the primary duties of a Chapter 7 trustee is to close the case ". . . as expeditiously as is compatible with the best interests of parties in interest . . .".[3] According to an EOUST official, some cases remain open for legitimate reasons (e.g., pending litigation) while others remain open for unacceptable reasons, such as trustee neglect or because the trustee

[3]Title 11, U.S.C., Section 704.

continues to charge the estate for expenses. The official said that in addition to requiring efficient case management, allowing cases to remain open for long periods of time increases the opportunity for trustees to improperly manage bankruptcy estates and makes the estates more vulnerable to fraudulent activities.

For example, according to an EOUST official, the trustee may keep a case open to administer secured debt, which would enhance the trustee's compensation but would be of no benefit to the estate. Because payments to most creditors are delayed until the case is closed, creditors' returns may be substantially less over time as a result of diminution of their claim.

In November 1989, when the transition provisions for the 1986 legislation expanding the UST program nationwide were completed, Justice assumed responsibility for many "old" bankruptcy cases.[4] Some of these cases had been open since 1979, yet the assets still had not been administered or disbursed to creditors. Although a greater percentage (57.5) of old cases was being administered by active trustees under the UST system, a notable percentage (41.6) was being administered by trustees who were inactive or were appointed under the prior system when there was limited oversight.

In January 1992 an old caseload baseline was established. According to quarterly data provided by UST regions to the EOUST, about 13 percent of open Chapter 7 cases (1979-1988) were identified as old. EOUST officials cautioned that the January figure is the result of a first call for data from regions and that the call specified no format or guidance on data classification. Our analysis of quarterly reports demonstrated that between January 1992 and October 1992 there was a 67.6-percent decrease in the number of old Chapter 7 cases. (See table 2.)

Table 2: Old Cases by Year Filed

Date inventory taken	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Total
January 1992 baseline	142	749	615	1,062	1,471	2,038	2,923	5,107	7,298	11,727	**33,132**
April 1992	173	601	374	625	947	1,279	1,846	3,189	4,848	8,522	**22,404**
July 1992	174	580	316	568	797	1,102	1,543	2,532	3,820	6,183	**17,615**
October 1992	23	100	194	358	526	708	991	1,642	2,456	3,742	**10,740**

Source: EOUST October 1992 data.

[4]"Old" cases are defined by the EOUST as those cases that have been open for more than 3 years. Thus, for this report, old cases are those filed before 1989.

According to the UST program's Chapter 7 initiatives, unless trustees can demonstrate the necessity for keeping a case open, by the end of fiscal year 1992, trustees will be required to close all of 1987 or earlier cases and 50 percent of their open 1988 caseload. Those trustees who do not comply will be subject to removal from active rotation (i.e., those trustees will be appointed to no new cases) until the old cases fall below 10 percent of the trustee's caseload.

Although the EOUST has directed that old cases be closed promptly (over 22,000 have been closed from January to October 1992), a number of old cases remain open. Data for the two judicial districts we visited showed that in one district, although there was a 49.2-percent decrease in the number of old cases (between April 1992 and October 1992), 26.5 percent of the open cases were old (the oldest was from 1979). The other district reported a 62-percent decrease in old cases during the same period and listed as old 17.8 percent of its total open caseload (the oldest was from 1981). According to EOUST officials, about 30 percent of the remaining old cases (10,740) are open for unacceptable reasons, such as trustee neglect.

IG Audits Consistently Identified Problems

Since 1988, the Justice IG has audited trustees for the EOUST through a reimbursable agreement. From fiscal years 1988 through 1991, the IG performed about 1,355 audits of Chapter 7 trustees. These audits identified multiple deficiencies in trustee operations that included weaknesses in

- case records and reports (inadequate and/or incomplete);
- bonding and banking requirements (including commingling of funds);
- case administration (slow case closure, shortage of estate funds, no system for identifying or tracking case status);
- internal controls and accounting procedures; and
- documentation to support receipts and disbursements.

(See table 3.)

Table 3: Summary of Selected Deficiencies Found During IG Audits

	Frequency of occurrence by fiscal year			
Finding	**1988**	**1989**	**1990**	**1991**
Case records/reports				
Inadequate, inaccurate, or incomplete estate cash records	156	231	246	158
Inaccurate, incomplete, or no estate reports prepared	109	212	290	297
Receipts and disbursements				
Lack of court order or other documentation supporting payment of estate expenses before case closure or unallowable charges made against debtor	7	60	28	52
Estate receipts were not supported by documentation or sales/action were not authorized by court	NR	[a]	8	49
Bonding/banking requirements				
Panel trustees were underbonded	100	135	99	108
Estate funds invested in improper accounts, not invested in interest-bearing accounts or kept in estate accounts after case was closed	37	104	97	113
Commingling of estate funds	23	34	21	11
Internal controls/accounting procedures				
Weak internal controls and/or related procedures	205	335	325	308
Case administration				
Slow case closure or poor estate administration	80	90	101	108
No system for identifying or tracking status of cases	NR	69	20	41
Shortage of estate funds	NR	4	2	1

NR = Not reported.

[a]Included in category above.

Source: IG data on Chapter 7 audits.

In the two locations visited, we found that follow-up action by the UST office generally consisted of requiring the panel trustee to furnish written

documentation outlining the corrective action taken. There was little, if any, evidence in the trustee files that UST staff visited the panel trustees to verify that the corrective action was taken.

Many of these deficiencies were recognized in a September 1992 IG audit report entitled Monitoring of Private Trustees. The IG office reported that of 118 Chapter 7 reviews examined in its sample, 116 had weaknesses that warranted follow-up. The IG considered follow-up inadequate when the UST region did not verify by documentation or on-site visit that the weaknesses were corrected. The IG found that 37 of the 116 reviews (32 percent) were not adequately followed up on.

These weaknesses also reduce the likelihood that erroneous or fraudulent transactions would be detected, and they result in a lack of assurance that the estates are adequately safeguarded against loss or misuse. Moreover, these weaknesses have been cited as trustee fraud indicators by EOUST officials and others in Justice. The fact that these weaknesses have been identified consistently in trustee audits also raises questions about how much trustee misconduct may exist.

EOUST officials cited improvements that have been made in trustee audits. Accelerated restricted scope audits[5] of trustees are to be conducted by a UST evaluation team bi-annually. The trustee is to respond to the findings within 30 days. If there are consequential audit findings, verification of trustee compliance is to be made within 6 months of the trustee's response by a UST team. In addition, the regional UST staff is to make office visits to trustees who are not receiving either an IG or an accelerated restricted scope audit. According to an EOUST official, these office visits are to supplement IG audits and are to be used to expand the UST's supervision of trustees.

From September 1987 to September 1992, 29 trustees or their employees were indicted or convicted of estate fund embezzlement. Many of these trustees were identified as a result of audits. For those convicted, the sentences ranged from 5 months to 12 years, and most included probation, fines, and restitution. (See table 4.) In addition, as of September 1992, there were pending inquiries on 32 trustees or employees. Many of these trustees either were identified from audits or were undergoing a reconstruction audit.

[5]This type of audit is conducted by UST staff and is limited to a sample of the trustee's cases. It provides information about the trustee's financial management, internal control procedures, and administration of his or her cases.

Table 4: Embezzlement Cases Against Trustees or Their Employees, for September 1987 Through September 1992

Year	Total cases	Indictment	Declination	Conviction	Total restitution ordered	Total fines ordered	Total sentence (years)	Total probation (years)
1987	3			3	$ 750,797	$10,000	14.0	10
1988	2		1	1	1,440		.5	
1989	6[a]			6	1,123,843		35.0	6
1990	7[b]		1	6	2,205,464	10,000	3.5	6
1991	9[c]	1		8	71,484	6,200	7.7	14
1992	5[d]	2	1	2	115,449		4.0	
Total	**32**	**3**	**3**	**26**	**$4,268,477**	**$26,200**	**64.7**	**36**

[a]Two of the six cases were filed against employees of the trustee.

[b]One of the seven cases was filed against an employee of the trustee.

[c]Three of the nine cases were filed against employees of the trustee.

[d]Two of the five cases were filed against employees of the trustee.

Source: EOUST data.

The following examples illustrate the problems identified through trustee audits.

In the Northern District of California, during an audit of a panel trustee, the UST staff examined 2,000 bank statements, 5,600 canceled checks, and 450 deposit slips. The audit revealed what turned out to be embezzlement of estate funds in 117 cases totaling $1.9 million. To discover, reconstruct, and successfully present the case to the U.S. Attorney absorbed more than 2-1/2 years.

In the Northern District of Iowa, a trustee was discovered to have embezzled $741,000. The reconstruction required the UST staff to review and examine 193 cases, 2,484 bank statements for 69 separate bank accounts, and all canceled checks and deposit slips. Each financial transaction was reviewed to determine the exact date and extent of loss so that claims could be made for recovery under 15 separate bonds, each having different effective dates and levels of coverage. The verification of receipts and disbursements involved obtaining written confirmation and documentary evidence from 5 banks, 1,286 creditors and debtors, auctioneers, realtors, attorneys, accountants, agents, and purchasers with whom the trustee dealt. The case took 2 years to reconstruct before it was presented to the U.S. Attorney's office.

UST Program Has Limited Enforcement Authority

The UST program has limited authority to administratively enforce trustee compliance with its policies and procedures. The program can take a range of actions against a trustee who fails to adhere to fiduciary standards. Some enforcement actions do not require court action and may take the following forms:

- temporary suspension from rotation;
- permanent removal from the panel of trustees (i.e., trustee retains and administers current caseload but is no longer a member of the trustee panel and is not appointed to new cases); and
- a complaint filed against the trustee with a professional licensing authority (e.g., state bar association).

In addition, the UST must file motions before the court for

- sanctions against the trustee;
- disgorgement of previously paid funds;
- objections to applications for fees; and
- removal of trustee from all of his/her cases (i.e., trustee is no longer on the trustee panel, is appointed to no new cases, and does not retain his/her current caseload).

According to EOUST officials, it is difficult to obtain court approval for actions against the trustee. Consequently, the only significant enforcement option that the UST program has is to remove a trustee from the active rotation list. However, those private trustees who no longer receive new cases have little incentive to close the ones they retain.[6] According to EOUST officials, in many instances trustees resign, leaving their cases to be administered and closed by other panel trustees or the UST.

In an effort to improve the administration of bankruptcy cases, Justice submitted a draft bill to Congress in June 1992 requesting statutory authority to ensure that trustees who administer bankruptcy cases adhere to their fiduciary duties. Sections of the proposed bill would

- require a trustee to maintain records and make them available to the UST,
- authorize the Attorney General to establish standards for proper administration of bankruptcy cases,
- authorize the Attorney General to remove trustees who depart from those standards, and

[6]Compensation paid to private trustees is dictated by the Bankruptcy Code. Currently, trustees are paid a $45 fee for each Chapter 7 no-asset case and a percentage of the moneys disbursed by the trustee in Chapter 7 asset cases.

- provide for the imposition of civil penalties upon those trustees who depart from established standards.

EOUST officials said that the proposed legislation will address these needs by both codifying UST requirements and providing removal authority.

Funding Limitations

While Congress set up the U.S. Trustee system to be self-financing by the users of the system, its statutory spending ceiling has resulted in millions of dollars in bankruptcy fees being transferred to the Treasury. According to EOUST officials, these fees could have been well spent by the program in its efforts to improve trustee oversight.

Various bankruptcy fees are deposited in the UST System Fund. The legislation establishing the fund included a provision that if the fund balance exceeded 110 percent of the appropriated budget at the end of any fiscal year, the excess must be transferred into the general fund of the U.S. Treasury (P.L. 99-554). Because the money generated by the dramatic increases in bankruptcy filings and corresponding fees has increased at a faster rate than program spending, the fund exceeded the 110-percent threshold in 1990 and a portion of bankruptcy fees ($6.4 million) was transferred to the Treasury's general fund. According to an EOUST official, about $25 million could be transferred in 1993.

These funds could have been used to improve program oversight. For example, the UST program's goal was to audit trustees every 3 years; however, EOUST officials said that because of funding limitations, these audits have been occurring about once every 4 years. In addition, as of December 1992, there were 225 active trustees who had never been audited. Seventy-four trustees did not have any cases assigned to them. The remaining 151 trustees had 3,296 cases. Several of these trustees had over 100 cases. For example, 3 trustees appointed in 1989 in one region had a total of 486 cases. Along with the 225 active trustees, there were 595 inactive trustees who had not been audited.

In addition, follow-up actions to the audits by the UST offices in the districts we visited generally have consisted of requiring trustees to furnish written documentation of corrective action taken. There was little evidence in the UST files to verify that the corrective action was taken by the trustee. Current staffing limitations prohibit the UST from more aggressively ensuring that the problems identified in the audits are addressed by the trustee.

The rapid growth in bankruptcy filings has generated a workload that UST staffs are straining to keep up with. From 1987 through 1992, the number of bankruptcy filings increased 87 percent. From 1987 through 1990, UST staffing remained the same. In 1991, UST staffing increased by 31 positions; in 1992, 186 additional staff were authorized for the program. While Justice asked Congress for 198 new staff additions in fiscal year 1993, no new positions were authorized. EOUST officials believed that within their current personnel allocations, district UST staffs are not able to conduct the oversight required to adequately ensure that sound internal and financial controls have been implemented and that trustees are adhering to fiduciary standards.

In March 1992, Justice submitted a draft bill to OMB that included a provision eliminating the requirement that annual excess funds be transferred to the Treasury. However, OMB deleted this provision. In a previous report, we recommended repealing the statutory limit on spending.[7] Our position is that if the funds available exceed those necessary to properly run the program, the fees should be reduced, because the program was never intended to generate revenue.

Conflict-of-Interest Concern Has Not Been Borne Out

The conflict-of-interest concern with the UST program has focused on the potential problem of having the program located within Justice in cases in which the government is a creditor.

The legislative history for the act provides a detailed rationale for taking the administrative function from bankruptcy judges and placing it in the executive branch. According to the history, having the judges exercise both administrative and judicial responsibilities for individual bankruptcy cases placed them in an untenable position and seriously compromised their impartiality as arbiters of disputes in bankruptcy cases. In response, responsibility for administering cases, (i.e., appointing trustees and overseeing their efforts) was transferred to Justice, leaving bankruptcy judges responsible for adjudicating the cases.

In this process, some thought that placing the case administration function in Justice created a potential conflict of interest in cases in which the U.S. government was a creditor. In these cases, Justice attorneys, either in the offices of the U.S. Attorneys or in Justice program divisions, represent the

[7]Bankruptcy Administration: Justification Lacking for Continuing Two Parallel Programs (GAO/GGD-92-133, Sept. 28, 1992).

government's interest while other Justice officials—UST staff—oversee case administration.

There were concerns that this arrangement could create an appearance that the government creditor could be given an advantage over other creditors; Congress rejected these concerns in both the 1978 and 1986 legislation. The legislative history of the act recognizes that the potential for a conflict of interest exists in both the executive and judicial branches. While the UST program may be sited within the Justice Department, it does not represent the government as a creditor and may, in fact, be in an adversarial position to the Justice attorneys representing the government. At other times, the UST program may support the position of a governmental creditor—the position is predicated on the type of action and benefit to the estate rather than the fact that the UST program and the U.S. Attorney are within the Justice Department. Ultimately, it is the court that has the role of arbiter and must approve any actions to be taken. Congress decided that Justice was the best placement for the program given the functions, powers, and duties of the UST program.

Independent studies done in 1983 and 1985 by Abt Associates were unable to identify any examples in which a conflict of interest between the federal government as a creditor and the case administrator actually occurred.[8] In our September 28, 1992, report, we also asked UST staff and bankruptcy judges in the districts visited to identify cases in which UST staff acted to promote the claims of a government agency over other creditors' claims; no one could.

Officials of the AO cited two cases since 1989 in which they thought conflict of interest might possibly have been an issue. However, these two cases, even if substantiated, would represent a negligible proportion of the 3,700,000 cases the program has supervised since the UST program's nationwide expansion in 1987. These circumstances suggest that no significant conflict-of-interest problem actually exists.

USTs Appear to Meet Established Criteria

Concerns have also been raised as to whether the current USTs, who are political appointees, have the credentials to effectively administer the program. By statute, the Attorney General appoints a UST to head each bankruptcy region for a 5-year term. EOUST officials said that candidates are interviewed by the EOUST Director and Deputy Director, who make

[8]Nancy L. Ames, Lindsey D. Stellwagen, and Ralph T. Jones, An Evaluation of the U.S. Trustee Pilot Program for Bankruptcy Administration: Findings and Recommendations (Cambridge: Abt Associates, 1983) and the August 1985 update of this report.

recommendations to the Attorney General. The Attorney General or his or her representatives then interview candidates for final selection and appointment.

Within each region, the UST is the program head and the liaison with officials of EOUST, Justice and other governmental agencies, the judiciary, attorneys, and the public. The UST is responsible for overall bankruptcy case administration and supervision and exercises direct supervision over regional staff members to ensure that program goals are achieved.

According to the position description, USTs must exercise considerable independent discretion and judgment in both substantive legal matters and managerial responsibilities. It requires that a UST possess knowledge of bankruptcy, corporate, commercial, and consumer law, with extensive experience in finance and accounting. Equally important is that each UST possess broad executive as well as independent professional skills and experience. Successful performance of the duties requires knowledge of budgeting and resource allocations, personnel management, systems management, and supervision of an extensive system of financial and operational reporting.

Officials in the EOUST who are responsible for nominating potential USTs to the Attorney General said they look for experience in leadership, management, bankruptcy, and litigation, as well as people skills. These officials further stated that of primary importance are a candidate's leadership and management skills. EOUST officials said that their program has experienced problems in the past with individual USTs; since November 1989, when the current director was appointed, 14 USTs have been replaced, including 7 for performance-related reasons.

On the basis of information provided to us by the EOUST, each of the current USTs appears to meet the required criteria for the job. Most have prior bankruptcy and litigation experience. For example,

- two are former estate administrators,
- one served as a Clerk of Court (bankruptcy),
- two are former Assistant U.S. Attorneys,
- four are former trustees,
- one was an acting municipal court judge,
- one was a district court judge, and
- two were bankruptcy attorneys.

Conclusions

Since 1988, Justice has actively taken steps to improve its oversight of private bankruptcy trustees. These steps include more rigorous review of trustee candidates, enhanced trustee reporting requirements, more extensive trustee audit coverage by the IG, and the replacement of 14 of the 21 USTs. The Department has now placed a high priority on the growing threat of bankruptcy fraud. Yet, certain challenges remain to be addressed, including the number of old cases, problems identified by IG audits, and funding limitations.

Concerns over the potential for conflict of interest between those parts of Justice representing the federal government as a creditor in bankruptcy cases and the EOUST have not been borne out. Only two potential cases of conflict have been identified in which conflict of interest might have been an issue. The authority of the bankruptcy courts in approving key case administration decisions provides a check and balance to Justice's dual role.

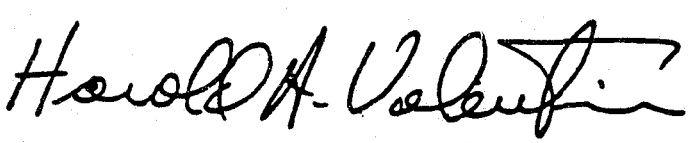
Agency Comments

We discussed the contents of this report with EOUST officials. They generally agreed with the information presented and they provided suggestions, which we incorporated where appropriate.

As agreed with the Subcommittee, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

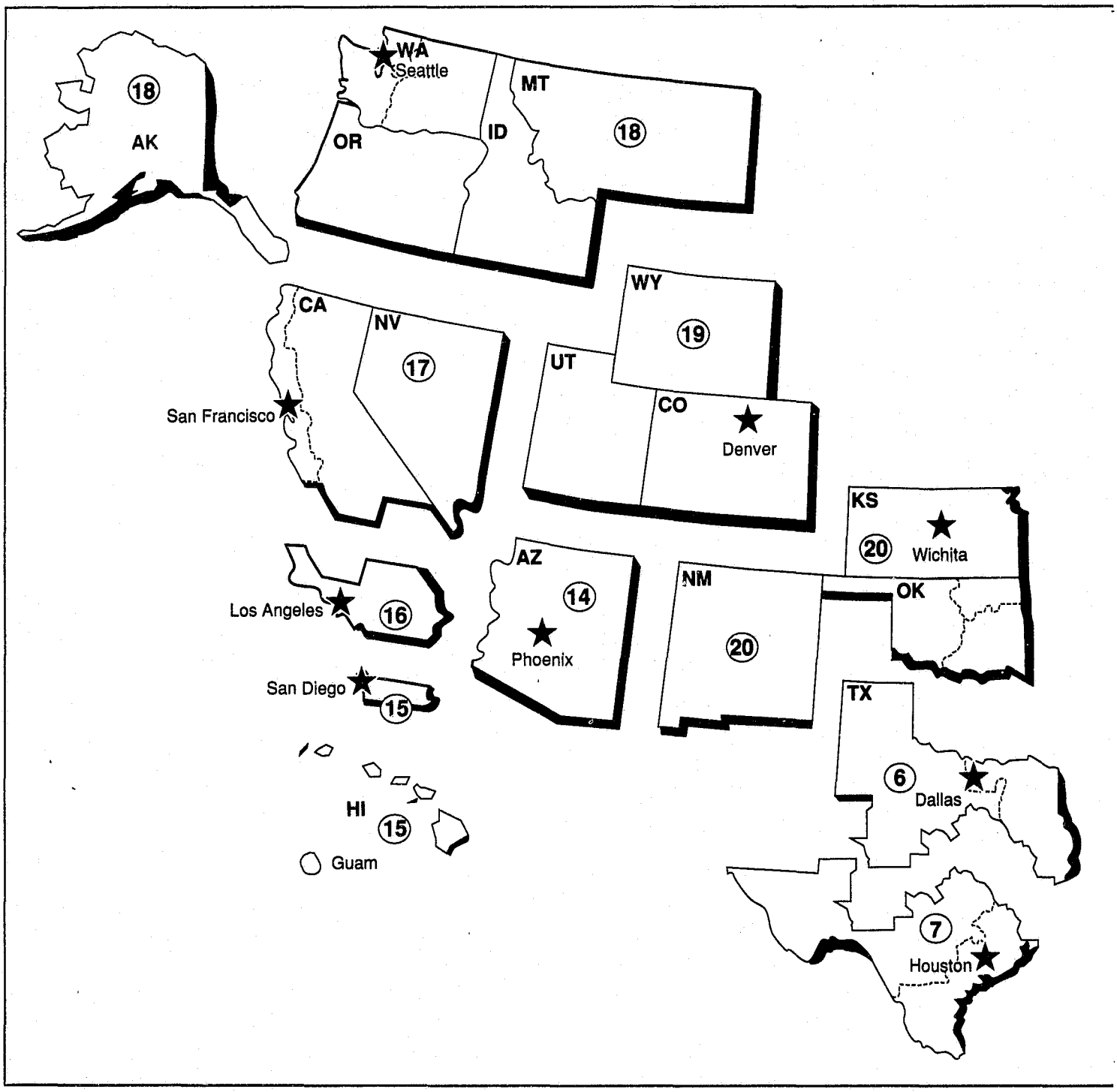
Major contributors to this report are listed in appendix III. If you have questions about this report, please call me on (202) 566-0026.

Sincerely yours,



Harold A. Valentine
Associate Director, Administration
of Justice Issues

UST Regions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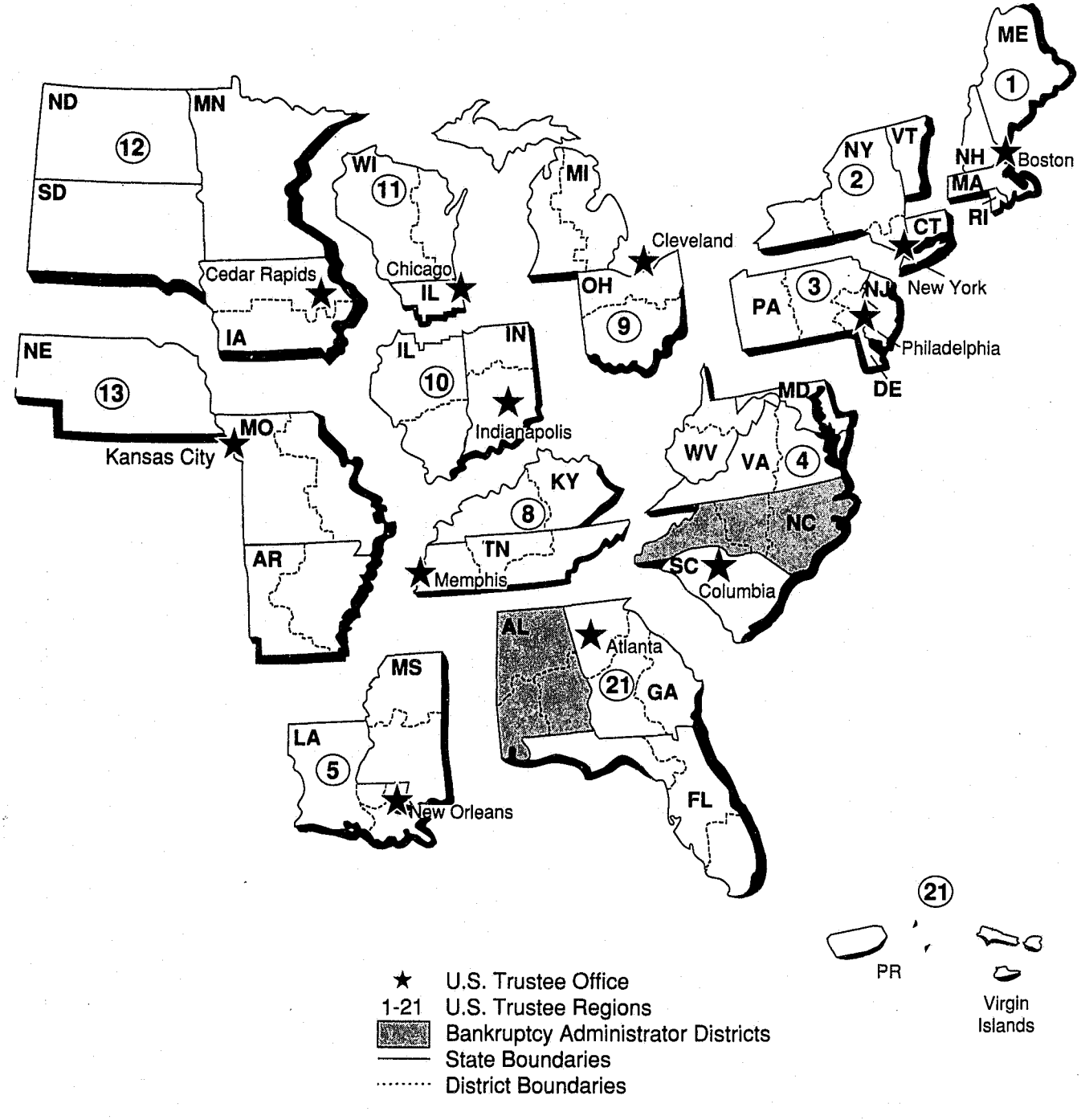
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Bankruptcy Administrator Districts
State Boundaries
District Boundaries

Comparison of Bankruptcy Case Filings by Region (1986-1991) and Percent of Increase in Filings From Fiscal Years 1986 to 1991

UST regional office	Judicial district	Total bankruptcy case filings for fiscal year 1986	Total bankruptcy case filings for fiscal year 1991	Percent of increase in bankruptcy filings from fiscal years 1986 - 1991
1. Boston	ME, MA, NH, RI	4,723	22,780	382
2. New York	NY, VT, CT	19,242	51,384	167
3. Philadelphia	PA, NJ, DE	20,718	44,208	113
4. Columbia	SC, VA, MD, WV, DC	25,709	52,909	106
5. New Orleans	LA, MS	19,298	26,235	36
6. Dallas	TX-E, TX-N	11,008	21,646	97
7. Houston	TX-S, TX-W	18,234	26,270	44
8. Memphis	TN, KY	29,886	57,863	94
9. Cleveland	MI, OH	36,025	68,372	90
10. Indianapolis	IN, IL-C, IL-S	26,171	39,318	50
11. Chicago	IL-N, WI	30,981	42,283	36
12. Cedar Rapids	IA, MN, SD, ND	17,040	26,173	54
13. Kansas City	MO, AR, NE	18,130	30,619	69
14. Phoenix	AZ	7,916	19,792	150
15. San Diego	CA-S, HI, GUAM, NMI[a]	9,123	15,170	66
16. Los Angeles	CA-C	44,893	75,493	68
17. San Francisco	CA-E, CA-N, NV	35,917	50,782	41
18. Seattle	WA, AK, ID, MT, OR	31,965	38,956	22
19. Denver	CO, UT, WY	18,662	26,884	44
20. Wichita	KS, NM, OK	21,360	30,187	41
21. Atlanta	GA, FL, PR, VI	37,803	106,514	182
Non-UST[b]	AL-M, AL-N, AL-S, NC-E, NC-M, NC-W	22,740	45,118	98
Total		**507,544**	**918,956**	**81**

[a]Northern Mariana Islands.

[b]Districts in the Bankruptcy Administrator program.

Source: EOUST data.

Major Contributors to This Report

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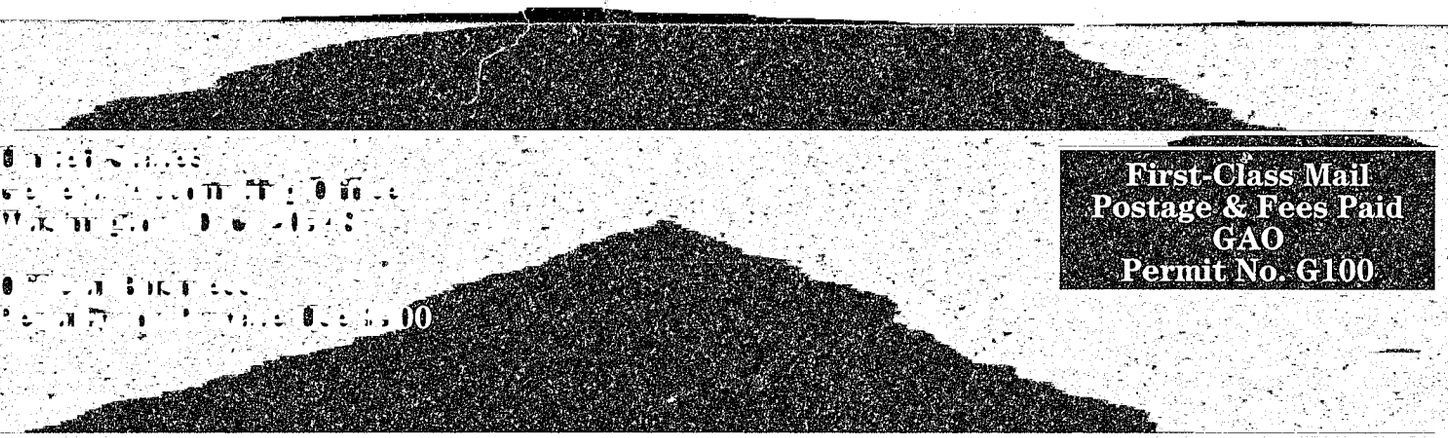

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