DEPARTMENT OF JUSTICE

28 CFR Part 58

RIN 1105–AA32

Qualifications and Standards for Standing Trustees

AGENCY: United States Trustees, Department of Justice.

ACTION: Final rule.

SUMMARY: This final rule amends the qualifications for appointment as a standing trustee, sets forth the continuing qualifications for appointment and standards of conduct for standing trustees, and corrects certain typographical errors in part 58.

The qualifications for appointment as a standing trustee are amended to provide that certain persons who are related to standing trustees and bankruptcy judges and clerks cannot be appointed as standing trustee. The rule also sets forth fiduciary standards that govern a standing trustee's operation. These fiduciary standards address the employment of relatives, dealings with related parties, and employment of other standing trustees. The rule will aid the Director of the Executive Office for United States Trustees and the United States Trustees in supervising standing trustees in the administration of cases and in evaluating the actual, necessary expenses of standing trustees relative to fixing appropriate percentage fees and compensation. Adherence to the rule will help to ensure the fair, impartial administration of the office of the standing trustee, to maximize the efficiency of case administration, and to avoid improprieties, whether actual or perceived, that could diminish the integrity of the standing trustee system and the administration of chapter 12 and chapter 13 bankruptcy cases.

EFFECTIVE DATE: This rule is effective July 2, 1997 to those standing trustees who are appointed as of July 2, 1997, this rule will be applicable on the first day of the next fiscal year (*i.e.*, October 1, 1997 for chapter 13 trustees, and January 1, 1998 for chapter 12 trustees).

ADDRESSES: Office of the General Counsel, Executive Office for United States Trustees, 901 E Street, N.W., Room 740, Washington, D.C. 20530.

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SUPPLEMENTARY INFORMATION: This final rule amends the qualifications for appointment as standing trustee and establishes standards for standing trustees appointed and supervised by United States Trustees. Finally, it corrects typographical errors in part 58. A proposed rule on these subjects was published in the **Federal Register** on July 18, 1996 (61 FR 37426) (the ''proposed rule''). A summary of background information, public comment, and agency response follows.

I. Background and Rulemaking History

Chapter 13 makes bankruptcy relief available to individuals with regular income and limited debt. Chapter 13 debtors propose plans to repay their creditors over a three-year period, unless the court, for cause, approves a longer period that cannot exceed five years. The plans must meet certain requirements and must be confirmed by the court. 11 U.S.C. 1322, 1325. Cases are administered by a private trustee appointed by the United States Trustee.

Chapter 12 of the Bankruptcy Code provides for the adjustment of debts of a family farmer with regular income. Like chapter 13, chapter 12 enables debtors to devote their disposable income to a repayment plan over a three-year period, unless the court, for cause, approves a longer period that cannot exceed five years. As in chapter 13, debtors' payments in chapter 12 are collected and disbursed by a private trustee appointed by the United States Trustee.

When the Bankruptcy Code was adopted pursuant to the Bankruptcy Reform Act of 1978, Public Law 95–598, 92 Stat. 2549 (1978), Congress established a pilot United States Trustee Program in 18 districts. Congress created this system to assume administrative tasks that the bankruptcy courts had performed previously. Congress' review of the prior bankruptcy system had led it to conclude that court oversight did not work well and created the appearance of bias. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 88–109 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6049–71.

The success of the pilot Program led Congress in 1986 to expand it nationwide as a permanent component of the Department of Justice. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Public Law 99–554, 100 Stat. 3088 (1986). Today, United States Trustees are appointed by the Attorney General to serve in 21 regions defined in 28 U.S.C. 581. The Attorney General provides general supervision, coordination and assistance to the United States Trustees, 28 U.S.C. 586(a)(5)–(6), (c), and is assisted by the Director of the Executive Office for United States Trustees (''Director''). 28 CFR 0.38. Throughout this Preamble, the Department will refer to the Director and the United States Trustees collectively as the ''Program.''

With regard to the administration of chapter 12 and 13 cases, the United States Trustee is authorized to appoint one or more standing trustees, subject to the Attorney General's approval, if ''the number of cases * * * commenced in a particular region so warrants * * *'' 28 U.S.C. 586(b). Once appointed, the standing trustee administers all chapter 12 or 13 cases filed in a designated geographic area unless a conflict exists. The United States Trustees supervise ''any such individual appointed as standing trustee in the performance of the duties of standing trustee.'' 28 U.S.C. 586(b). If a standing trustee has not been appointed or has a conflict of interest, the United States Trustees appoint individuals to serve as trustees on a case-by-case basis pursuant to 11 U.S.C. 1202(a) or 1302(a) or will themselves serve as trustee.

Standing trustees appointed under 28 U.S.C. 586(b) serve the same function in administering cases as trustees appointed under 11 U.S.C. 1202(a) or 1302(a) to handle a particular case, but the method by which standing trustees receive compensation and reimbursement of expenses is entirely different. Trustees appointed on a case-by-case basis are awarded compensation and reimbursement of expenses from each specific estate by order of the bankruptcy court, after application, notice and hearing. *See* 11 U.S.C. 326(b), 330 (authorizing bankruptcy courts to award compensation to trustees appointed on a case-by-case basis under sections 1202(a), 1302(a)). In contrast, standing trustees collect a flat percentage of plan payments made by debtors in all cases that they administer to fund their compensation and expenses. 28 U.S.C. 586(e); *see also* 11 U.S.C. 326(b) (prohibiting courts from awarding compensation or reimbursement of expenses to standing trustees appointed under 28 U.S.C. 586(b)).

The percentage fee that each standing trustee collects is set by the Director as the Attorney General's delegatee, in consultation with the United States Trustee for the region in which the standing trustee operates. 28 U.S.C. 586(e)(1)(B). The Attorney General also has authorized the Director to set the maximum annual compensation of each standing trustee at an amount not to exceed the highest annual rate of basic pay in effect for level V of the Executive Schedule and the comparable cash value of employment benefits. 28 U.S.C. 586(e)(1)(A).

To determine which expenses are actual and necessary, the Director and the United States Trustee have adopted certain procedures. Before each fiscal year, standing trustees submit proposed budgets with projected revenues and expenses to the United States Trustee in their region. Program employees analyze the budgets and supplemental documents that are submitted and request additional information when appropriate. The Director ultimately determines which expenses appear to be ''actual'' and ''necessary.'' The Director, in consultation with the appropriate United States Trustee, also establishes the annual compensation for each standing trustee. Once compensation and expenses are determined, a percentage fee for each standing trustee is calculated and memorialized.

In a chapter 13 case, the fee may not exceed ten percent of payments received under the plan. 28 U.S.C. 586(e)(1)(B)(i). In a chapter 12 case, the fee may not exceed 10 percent of all payments made by the debtor up to $450,000 and three percent of all payments over $450,000. 28 U.S.C. 586(e)(1)(B)(ii). The funds collected pursuant to the percentage fee can be used only to pay the standing trustee's compensation and ''actual, necessary expenses.'' 28 U.S.C. 586(e)(1). If excess funds are collected, they must be turned over to the United States Trustee System Fund. 28 U.S.C. 586(e)(2).

Therefore, regardless of the number of cases that a standing trustee administers, the trustee's maximum annual compensation cannot exceed the statutory limit, nor can the total amount of compensation and expenses exceed 10% of total plan payments (or whatever lesser percentage has been fixed by the Attorney General). The legislative history notes that this system was enacted ''to encourage the standing trustees to keep costs low at the risk of reduced compensation.'' H.R. Rep. No. 595, 95th Cong., 1st Sess. 107 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6068.

The need for adequate safeguards has become increasingly important in chapter 13 standing trustee operations given the numbers of cases and the sums of monies entrusted to standing trustees. According to information published by the Administrative Office of the United States Courts in 1983, ''Chapter XIII flourished under the Bankruptcy Act[,] increasing from 3,260 cases in 1940 to 39,442 cases in 1979.'' V–A Administrative Office of U.S. Courts, Guide to Judiciary Policies and Procedures, Bankruptcy Manual, Ch. III, app. 1 at 2 (Jan. 17, 1983). For the year ending September 30, 1996, annual national filings climbed to 336,615 new chapter 13 cases and more than $2 billion was administered. In FY 96, the entire chapter 13 system was managed by approximately 170 individuals who served as standing trustees. Their use of trust funds requires adequate safeguards to ensure the debtors' monies are expended appropriately.

Beginning in late 1994, the United States Trustee and the Director considered the standing trustees' practices of hiring relatives, engaging in related-party transactions, and allocating expenses between related parties. They also considered revising the qualifications for appointment. A subcommittee of United States Trustee analyzed these issues. The United States Trustee and the Director concluded that promulgation of a rule would provide standards, achieve greater consistency in the application of Program policies, and open the bankruptcy system.

Before the rule was published, the Program engaged in wide-ranging consultation on the issues to be addressed by the rulemaking. Various United States Trustee, the Director, the Deputy Directory, and other Program employees met with standing trustees and representatives from the National Association of Chapter 13 Trustees and the Association of Chapter 12 Trustees. On August 1, 1995, the United States Trustees distributed draft standards to all standing trustees and solicited written comments.

Upon consideration of the submitted comments, the standards were revised. Throughout the revision period, members of the subcommittee and the Executive Office continued to meet with standing trustees, their associations, bankruptcy judges, and other interested parties at meetings across the country to discuss the proposed standards and obtain additional comments. The result of this lengthy process culminated in the publication of a proposed rule in the **Federal Register** for notice and comment. *See* 61 FR 37426 (July 18, 1996) (to be codified at 28 CFR 58.4).

II. Purpose of the Rule

Through this rulemaking, the Program is adopting a prophylactic rule to prohibit standing trustees from hiring relatives and from engaging in dealings with themselves and related parties. Under the compensation mechanism set forth in 28 U.S.C. 586, standing trustees collect a percentage of all payments made by debtors to fund their operations. These monies are used, first, to pay all actual and necessary expenses of the trustee, and, second, to pay the trustee's compensation.

When the Code was first adopted in 1978, standing trustee operations were much smaller than they are today. At that time, substantial economic incentive existed for standing trustees to minimize their expenses because every dollar that funded expenses meant one less dollar was available to pay the standing trustee's compensation.

This built-in incentive to minimize costs has largely vanished. Chapter 13 case filings have surged without a corresponding increase in the total number of standing trustees appointed. Standing trustees now administer significantly greater numbers of cases and handle vastly larger sums of money.

Trustee operations have grown so large and handle so much money that, in FY 97, 83 percent of chapter 13 standing trustees are eligible to earn maximum compensation (which the Attorney General has fixed at $126,473). With larger operations, however, comes a potential for misuse of trust funds and an opportunity for standing trustees to augment their personal or family's income by using trust funds to hire relatives or otherwise engage in self-dealing. These situations may also tempt standing trustees to expand the concept of necessary personnel benefits. For example, one commenter stated that standing trustees should be permitted to use trust funds to purchase such items as flowers, alcohol, food, party supplies, and gifts for their staff members. The Program believes that such items are not normally necessary to the administration of bankruptcy cases. When the items are purchased to benefit relatives of the trustee, it becomes even more difficult to determine whether the items are actually necessary for the administration of the trust or whether the trustee's relationship with relatives played a role in the decision to purchase the items.

Because the use of trust funds in connection with related parties raises similar issues that are far more difficult to identify and evaluate, the Program is adopting a rule prohibiting future employment of relatives and future contracts or expense allocations between related parties. A prophylactic rule avoids situations in which United States Trustees have to micromanage daily or monthly expenditures by the standing trustees and bolsters public confidence that the bankruptcy system is not being operated to benefit the standing trustees at the expense of the debtors and creditors they are appointed to serve.

However, application of this rule change current operations in some standing trustee offices and, thus, certain provisions of the rule minimize possible disruption and allow a gradual transition. All spouses who were hired prior to August 1, 1995, are excepted from the rule prohibiting the hiring of relatives. Standing trustees also may seek two-year waivers from their United States Trustees to allow them to retain other currently employed relatives if the trustees can demonstrate that the relative's continued employment is necessary to the trust and the cost of the relative's compensation is reasonable.

The differing treatment of existing spouses and non-spousal relatives is attributable to several concerns that standing trustees raised during the informal consultation period. Some trustees located in rural areas have come to rely on their spouses to provide necessary office support; if spouses can no longer serve this function, the local employment base may make it difficult for the standing trustees to find replacements with comparable skills and experience. To require their replacement may visit a unique disruption on the standing trustees' operations. Standing trustees also argued that spouses generally played a vital role in starting their operations and thus acquired knowledge about the standing trustee operation that cannot be easily replaced.

To minimize possible disruption and allow a gradual transition to implement the rule governing related-party transactions, standing trustees may also seek an extension of time for compliance, not to exceed specified deadlines. The rule prohibiting all related-party transactions also gives United States Trustees the discretion to grant a waiver in situations involving a newly-appointed trustee who is starting operations. Finally, the rule prohibiting allocations among related parties gives the United States Trustees discretion to grant a limited waiver in appropriate circumstances, such as when a standing trustee is not able to earn compensation or when a standing chapter 13 trustee also serves as a chapter 12 trustee.

III. Summary of Major Changes in Final Rule

The final rule differs from the proposed rule in the following ways: First, the Program has modified the rule's effective date. The final rule will be effective 30 days after publication except as to current standing trustees. With respect to existing chapter 13 standing trustees, the rule is effective on October 1, 1997, the first day of their next fiscal year. As to current chapter 12 standing trustees, the rule is effective January 1, 1998, the first day of their fiscal year. Second, the final rule changes the definition of ''relative'' by identifying the relatives so as to provide clearer guidance to those who must abide by and implement the rule.

The final rule also incorporates certain technical changes to clarify that, to obtain a waiver, a standing trustee must demonstrate that the expense is being used to purchase a good or service that is necessary to the administration of the bankruptcy cases and that the price is reasonable. This clarification comports with the statutory requirement that expenses be ''actual'' and ''necessary.'' The Program believes that an expense is an ''actual, necessary expense'' if it is actually used to purchase a good or service that is necessary for the administration of the bankruptcy cases, and the amount of the expense is reasonable for that particular good or service. Other technical changes clarify the definition of ''region'' and clarify that the rule applies to individuals only in their capacity as standing trustees.

IV. Discussion of Public Comments

The Program received 20 comments on the proposed rule. Although four comments were submitted late, the Program noted that the late submissions either reflected concerns that had been raised in timely comments or reflected amendments to earlier comments. The Program chose to consider these submissions even though they were untimely. One comment was submitted by an attorney who represents standing trustees; one comment was submitted by a bankruptcy judge; and two comments were submitted by trustee organizations. The remaining comments were submitted by standing trustees. The Program has considered each comment carefully and appreciates the time taken to provide them. The Program's responses to the comments are discussed below, either in the ''General Comments'' section or in the ''Section-by-Section Analysis''.

A. General Comments

1. A number of commenters questioned whether the Department has the authority to promulgate the rule. One commenter added that only the Attorney General has the authority to issue the proposed regulation.

The Program has determined that it possesses ample statutory authority to promulgate this regulation pursuant to these sources: 5 U.S.C. 301, which enables the Attorney General to issue regulations governing the conduct of Department employees and the performance of agency business; 28 U.S.C. 509, which vests in the Attorney General all functions of her employees; 28 U.S.C. 586, which authorizes the Attorney General and the United States Trustees to appoint and supervise standing trustees, to fix compensation and the percentage fee of standing trustees based on their actual, necessary expenses, and to prescribe by rule the qualifications for appointment of standing trustees; and 28 U.S.C. 586(c), which obligates the Attorney General to supervise United States Trustees and provide them with general coordination and assistance. The Attorney General has delegated her authority to issue this rule to the Director. Order No. 2041–96 (July 5, 1996). *See also* 28 U.S.C. 510.

2. Several commenters stated that the promulgation of the rule exceeds the authority that Congress granted to the Program in that Congress did not intend the United States Trustees to supervise the conduct of standing trustees. This position is not supported by either the statute or its legislative history.

Section 586 confers broad powers on the United States Trustees to review the conduct of standing trustees that they have appointed. Each United States Trustee ''shall * * * supervise the administration of cases and trustees in cases under chapter * * * 12 or 13.'' 28 U.S.C. 586(a)(3). Moreover, ''[t]he United States Trustee * * * shall supervise any such individual appointed as standing trustee in the performance of the duties of standing trustee.'' 28 U.S.C. 586(b). Finally, the Program is authorized to set both the compensation of the standing trustee and the fee that may be collected from cases to cover the standing trustee's compensation and ''actual, necessary expenses.'' 28 U.S.C. 586(e)(1). The legislative history supports this conclusion:

> The nature of the duties of the United States trustees makes them the administrative officers of the bankruptcy system * * *. The United States trustees will, * * * be responsible for the day-to-day operations of the bankruptcy system. They will supervise trustees, assist them in the performance of their duties, oversee their actions, and see to it that the bankruptcy laws are properly executed * * *.
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> * * * [The United States trustees] will be responsible for determining the needs of the chapter 13 system, and whether a particular judicial district is best served by a private standing trustee or an assistant United States trustee. They will enforce the qualifications prescribed by the Attorney General for service as a chapter 13 trustee, and will supervise the performance of chapter 13 trustees. They will consult with the Attorney General to fix the fees that a private standing chapter 13 trustee may charge, and the salary that the private trustee may receive.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 109 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6070–71. *See also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 102

(1977), *reprinted in* 1978 U.S.C.C.A.N. 6063 (''United States trustees will also monitor the performance of panel members and standing chapter 13 trustees in order to determine whether they should be continued in or removed from panel membership or office.'').

The Program's authority over the compensation and expenses of standing trustees is further necessitated by the express lack of court authority over these matters. Section 326(b) of title 11, U.S. Code, prohibits a court from awarding compensation and expenses to a standing trustee appointed under 28 U.S.C. 586(b). Thus, unless the Program exerts supervision in this critical area, standing trustees would be unsupervised in their use of debtors' funds for the expenses of their trust operations.

Several standing trustees also averred in their comments that the standards run contrary to Congressional intent in that Congress did not expect a centralized office to run the Program and that the rule eliminates the flexibility that Congress intended to build into the system. These comments reflect a misunderstanding of the statute and mistake the genesis of the rule. As noted above, Congress gave the Attorney General the authority to prescribe the qualifications for appointment as standing trustee, establish the compensation of standing trustees, determine the ''actual, necessary expenses'' that may be compensated from chapter 12 and 13 estates, and set the percentage fee to be charged to each bankruptcy case. 28 U.S.C. 586 (d), (e)(1). The Attorney General also established the Executive Office for United States Trustees to fulfill her responsibility of providing ''general coordination and assistance to the United States Trustees'' who supervise the standing trustees. 28 U.S.C. 586(c).

The rule was proposed by the United States Trustees after they considered the problems caused when standing trustees hire relatives and engage in related-party transactions. The proposed rule was then considered and issued by the Director, pursuant to the authority delegated to him by the Attorney General. Thus, promulgation of the rule does not contravene the administrative scheme that Congress envisioned in 1978.

On the contrary, the rule helps fulfill Congress' original intent to create a standing trustee fee system that provided an incentive to minimize administrative expenses: ''The fee system [for standing trustees] is designed to encourage the standing trustees to keep costs low at the risk of reduced compensation.'' H.R. Rep. No. 595, 95th Cong., 1st Sess. 107 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6068. When limited funds are available, a standing trustee theoretically will minimize costs to maximize the funds available to pay compensation.

As we explain in Section II of this preamble, the concept of the limited funds no longer exists. Standing trustees who receive maximum compensation, as most do today, have no institutional incentive to minimize costs. Without a profit motive to hold down expenses and with compensation set at maximum levels, the potential exists to augment compensation through expenses that accrue to the benefit of the standing trustee or a related party. As one commenter candidly admitted, ''This [rule] is an attempt to prohibit a non government employee from achieving additional income at no detriment to the debtors and/or taxpayers.'' This attitude ignores the fact that unnecessary costs hurt creditors by diminishing the amounts they receive on their claims or hurt debtors by requiring them to make larger payments under confirmed plans. Furthermore, when those costs are paid to the standing trustee or a related entity, they are perceived to compromise the standing trustee's fiduciary obligations.

3. Several commenters stated that the Program is improperly issuing retroactive rules. These commenters misapprehend the concept of retroactivity.

As discussed previously, the rule will be implemented prospectively. Generally, the rule will go into effect 30 days after the date of publication. With respect to current standing trustees, the rule will not be effective until the first day of the trustees' next fiscal year. That date is October 1, 1997, for standing trustees who serve in chapter 13 cases and January 1, 1998, for standing trustees who serve in chapter 12 cases. All budgeted expenses that have been submitted and approved for the current fiscal year will be unaffected by this rule. Moreover, certain standards, such as those prohibiting the hiring of relatives and prohibiting related-party transactions, provide for limited waivers in appropriate circumstances. Thus, provisions of the rule will be applied prospectively and are not retroactive rulemaking.

4. One commenter argued that the rulemaking is unconstitutional because the final rule will not apply to bankruptcy cases in two states (Alabama and North Carolina) and, thus, will violate the Uniformity Clause of the U.S. Constitution, art. I, Section 8, cl. 4 (''The Congress shall have Power * * * [t]o establish * * * uniform Laws on the subject of Bankruptcies throughout the United States; * * *'').

The Program disagrees with this legal conclusion. Congress initially established the Program in 1978 as a pilot program in 18 federal judicial districts. Bankruptcy Reform Act of 1978, Public Law 95–598, § 1501, 92 Stat. 2652 (1978). After evaluating the pilot program, Congress in 1986 made the Program permanent in all federal judicial districts but decided to phase in implementation, bringing some federal districts in later than others. Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Public Law 99–554, 100 Stat. 3118–24, Sections 301–02 (1986). The last six judicial districts, which covered the states of Alabama and North Carolina, were scheduled to come into the Program no later than October 1, 1992. In 1990, Congress extended the deadline for the final six districts to October 1, 2002. Judicial Improvements Act of 1990, Public Law 101–650, 104 Stat. 5115, Section 317(a) (1990). It is the statute, not this rulemaking, that creates the distinction between cases in Alabama and North Carolina and those in the rest of the country.

These rules are promulgated in furtherance of the Program's statutory obligations to oversee the administration of bankruptcy cases and standing trustees. The statute does not alter substantitive bankruptcy law but simply authorizes the United States Trustees to further the efficient administration of bankruptcy matters. The United States Trustees' statutory duties are described in terms such as ''supervise,'' ''monitor,'' ''appoint,'' and ''make * * * reports.'' 28 U.S.C. 586. The organic statute creating the Program leaves the substantive debtor-creditor relationship unchanged; it simply provides for an administrative watchdog, the Program, to ensure the fairness and efficacy of the process through which debtors and creditors resolve their rights and obligations under substantive bankruptcy law. This does not violate the Uniformity Clause.

Furthermore, Congress' decision to implement the Program gradually was rational. Congress has applied the statute in all federal districts; it has simply phased in its application. The Uniformity Clause does not preclude such a phase-in. *Cf. City of New Orleans* v. *Dukes,* 427 U.S. 297, 303 (1976) (per curiam) (''Legislatures may implement their program step by step''). Accordingly, the Program finds no merit to this constitutional concern.

5. A few commenters implied that many actual abuses had to exist before the Program had a right to promulgate

standards. One stated, ''A few instances of abuse cannot in any reasonable mind be considered as grounds for national standards * * *.'' Another asserted that the United States Trustees presently have all the tools they need to combat fraud and abuses within the standing trustee system.

The Department of Justice, through the Program, is responsible for supervising standing trustees and establishing their compensation and percentage fees. Congress established and then expanded the Program to improve and strengthen the integrity of the bankruptcy system and eliminate the problems that arose when the system was administered by the courts.

Based on the United States Trustees' expertise and experience in supervising standing trustees, a prophylactic rule is desirable and necessary, particularly in the area of related-party dealings. These dealings foster recurring problems such as hiring relatives at above market rates, hiring relatives where the United States Trustee could not verify that the relatives performed services, renting office space to trustee operations at above the market rate to cover mortgage payments and taxes, and using bankruptcy trust funds to subsidize another business in which the trustee is involved.

When the trustee decides to hire a relative as a new employee, establishes a salary for that employee, and ultimately analyzes the relative's advancement within the trustee's organization, the trustee as decisionmaker has a conflict of interest. For similar reasons, nepotism is prohibited within the Federal government and in many private sector organizations. When trustees employ relatives, it is difficult for the supervising United States Trustees to review the trustees' employment decisions and to assess whether the expense is ''actual'' and ''necessary'' without micromanaging the trustees' operations. A prophylactic rule is needed to prevent the problems widely associated with nepotism and related-party dealings.

Experience has taught that the overall impact of a relative's hiring cannot be easily evaluated or discovered through any review or other documentary process. Nor can such problems be identified through personal interviews with the trustees' employees. Employees are understandably reluctant to critize the trustee's relative or to describe the deleterious effects on office morale.

Standing trustees who contract or otherwise do business with related parties face a similar conflict of interest that is exacerbated because the trustee derives income or other financial benefits from these transactions. The current system, in which more than three-fourths of the standing trustees earn maximum compensation, offers no economic incentive to minimize or reduce expenses. Related-party arrangements increase a trustee's personal or family income and are paid for by the bankruptcy estates. Yet chapter 12 or 13 debtors cannot challenge these expenses; nor can they select a trustee through a competitive process. The bankruptcy system does not allow a debtor to retain the service provider (standing trustee) whose expenses are lower or less questionable.

Because of the difficulties inherent in related-party transactions, other agencies have promulgated prophylactic rules in similar circumstances: 42 CFR 413.153(b), (c) (Medicare regulation prohibiting reimbursements for interest expenses on loans between related parties); 29 CFR 2550.408b–2 (Department of Labor regulations prohibiting self-dealing of ERISA trustees).

Bankruptcy trustees under the common law are held to the highest fiduciary standards of loyalty, which standards have been implemented and applied with ''[u]ncompromising rigidity.'' *Meinhard* v. *Salmon,* 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C.J.). In *Woods* v. *City National Bank & Trust Co.,* 312 U.S. 262, 278, *reh'g denied,* 312 U.S. 716 (1941), the Supreme Court held that trustees who violated the duty of loyalty are not entitled to any compensation for services to the bankruptcy estate regardless of whether the estate had been harmed. *Woods,* 312 U.S. at 268.

The Court reemphasized this principle in *Mosser* v. *Darrow,* 341 U.S. 26 (1951), when it found that a bankruptcy trustee could be surcharged for $40,000 in profits he permitted his employees to earn using fiduciary monies. The Court rejected the trustee's argument that his actions had not damaged the estate:

> Equity tolerates in bankruptcy trustees no interest adverse to the trust. This is not because such interest are always corrupt but because they are always corrupting. By its exclusion of the trustee from any personal interest, it seeks to avoid such delicate inquiries as we have here into the conduct of its own appointees by exacting from them forbearance of all opportunities by exacting from them forbearings of all opportunities to advance self-interest that might bring the disinterestedness of their administration into question.
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> These strict prohibitions would serve little purpose if the trustee were free to authorize others to do what he is forbidden. While there is no charge of it here, it is obvious that this would open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own. The motives of man are too complex for equity to separate in the case of its trustees the motive of acquiring efficient help from motives of favoring help, for any reason at all or from anticipation of counterfavors later to come. We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for benefit of others as they would have been on behalf of the trustee himself.

Id. at 271–72. These principles remain viable today. *See, e.g., United States Trustee* v. *Bloom (In re Palm Coast, Matanza Shores Ltd. Partnership),* 101 F.3d 253, 257–58 (2d Cir. 1996) (applying common law of trusts).

A prophylactic rule is needed to address the standing trustees' current practices of hiring relatives and engaging in other related-party transactions. Promulgation of the rule will provide direction to standing trustees about permissible uses of fiduciary funds and will prevent abuses, thereby benefitting creditors and debtors. The rule also will assist the United States Trustees' supervision of standing trustees by providing direction on these important issues. This rule will bolster public confidence in a bankruptcy system that is operated fairly and impartially and not for the financial benefit of the professionals involved.

6. One commenter asked whether the Program intended through the rule to make standing trustees employees of the United States Trustees. By promulgating this rule, the Program does not make standing trustees federal employees.

7. Several commenters submitted their thoughts on handbook provisions that the United States Trustees implemented in 1996. The revisions to the handbooks were not published in the **Federal Register** and are not within the scope of this rulemaking.

8. One commenter noted that the proposed rule contains no protocol for starting a chapter 13 office or for the transfer of an existing office. With respect to related-party allocations, the final rule provides that United States trustees may, in appropriate circumstances, permit a newly-appointed standing trustee to contract with or allocate expenses between related parties. To the extent that this commenter seeks detailed procedures for starting a standing trustee operation, that matter is beyond the scope of this rulemaking.

9. One standing trustee described the rule as inequitable because it ''clearly'' restricts the standing trustees' discretion but does not decrease their liability.

The Program believes that this comment misapprehends the scope of the rule. Section 586 of title 28 requires the United States Trustees to appoint and supervise the conduct and expenses of standing trustees. The Program is promulgating the rule in furtherance of these responsibilities and pursuant to statute.

10. One commenter amended its earlier objections to suggest detailed factors for the United States trustees to analyze when considering whether to grant a waiver from the rule's application in limited situations. The Program has not incorporated the precise factors suggested because the standard set forth in the rule provides sufficient flexibility to United States Trustees to consider waiver requests in light of local or unique circumstances. However, the Program has made a few technical changes to the standard for waiver by deleting the requirement of ''extraordinary'' and by clarifying that waivers may be granted if the standing trustees can demonstrate a compelling need to the trustee operation and the necessity and reasonableness of the expense. These technical changes will bolster the United States Trustees' discretion in these matters and cause the rule to track more closely the statute's requirements that expenses be ''actual'' and ''necessary.''

B. Comments on Specific Subsections of the Proposed Rule

1. Definition of Relative

Comment: In connection with the initial qualifications for appointment and the prohibition on hiring of relatives, several standing trustees commented that they were unclear as to which relatives were encompassed by the proposed rule.

Response: In response to this comment, the Program has revised the definition of ''relative'' in 58.4(a)(2) to list each specific relationship that is subject to the rule. The definition of ''relative'' set forth in the proposed rule was derived from 11 U.S.C. 101(45), which defines ''relative'' as an ''individual related by affinity or consanguinity within the third degree as determined by the common law, or individual in a step or adoptive relationship within such third degree''.

The final rule lists the specific relationships encompassed within the word ''relative'' to provide clearer guidance to those who must implement or abide by the rule. Furthermore, the adoption of this definition will establish a uniform, national standard. Although the final definition excludes certain relationships that were covered by the definition in the proposed rule as applied in some jurisdictions (*e.g.,* great-grandparents, great-aunts, great-uncles, second cousins), the goal of prohibiting favored treatment and any appearance of impropriety will be better attained through this more specific approach.

The language in the final rule is derived from the definition of ''relative'' that applies to United States Trustees with respect to their hiring, promotion and salary practices. The Civil Service Reform Act makes nepotism a prohibited personnel practice. 5 U.S.C. 2302(b)(7). Section 3110(b) also prevents a United States Trustee from appointing, employing, promoting, or in any way advancing one of their relatives. 5 U.S.C. 3110(b). The term ''relative'' is defined for both statutory subsections in 5 U.S.C. 3110(a)(3).

In the final rule, the definition of ''relative'' expands the language in 5 U.S.C. 3110(a)(3) to include ''an individual whose close association is the equivalent of a spousal relationship.'' This additional definitional category comports with those courts that have extended the Bankruptcy Code provisions restricting pre-petition transfers to insiders or relatives to include those persons living with debtors in the equivalent of spousal relationships. *See, e.g., Gennet* v. *Docktor (In re Levy),* 185 B.R. 378, 384–85 (Bankr. S.D. Fla. 1995); *Freund* v. *Heath (In re McIver),* 177 B.R. 366, 370–71 (Bankr. M.D. Fla. 1994); *Wiswall* v. *Tanner (In re Tanner),* 145 B.R. 672, 677–78 (Bankr. W.D. Wash. 1992); *Loftis* v. *Minar (Matter of Montanino),* 15 B.R. 307, 310–11 (Bankr. D.N.J. 1981).

The definition of ''relatives'' in the final rule is consistent with federal law and rationally relates to the legitimate governmental goal of reducing potential or actual improprieties within the standing trustee employment system. The rest of the definitions in 58.4(a) remain unchanged.

2. Qualifications for Appointment

Comment: One standing trustee commented that the qualifications for appointment should be stated in the positive rather than the negative.

Response: The qualifications for appointment are intended to restrict the United States Trustees' discretion to appoint individuals as standing trustees. It would be awkward and unclear to express these restrictions in a positive manner. Accordingly, we reject this comment.

Comment: Several standing trustees commented that the proposed qualifications for initial appointment of standing trustees are too narrow and should be expanded. These standing trustees did not agree, however, as to the scope of expansion. Several standing trustees believed that the qualifications should prohibit the appointment of individuals who are relatives of district court and circuit court of appeals judges; one even suggested that relatives of Supreme Court justices should not be deemed qualified for appointment.

Response: The Program does not find it necessary to expand the restriction beyond the bankruptcy judges and clerks in the region where the standing trustee serves. Through this regulation, the Program seeks to strengthen the integrity of the bankruptcy administrative process by circumscribing the United States Trustees' discretion to appoint certain individuals who are related to standing trustees and other frequent participants in the federal bankruptcy system. As previously discussed, the Program was created to remove administrative functions from the bankruptcy courts and to remedy the existence and perceptions of cronyism that existed within the prior administrative system. The rule will promote an appointment process that is based on merit, untainted by perceptions that appointments are restricted to insiders. Moreover, it will enhance the integrity of the current system by reducing—if not eliminating—the opportunities for a bankruptcy court to be faced with real or perceived conflicts of interest that arise if the court were to rule on bankruptcy cases in which a relative was the case trustee.

Finally, promulgation of this rule is consistent with the policies codified in Fed. R. Bankr. P. 5002, which prohibits nepotism in bankruptcy court appointments and employment. *See* 18 U.S.C. 1910 (making it a criminal offense for a judge to appoint a relative as trustee); 28 U.S.C. 458 (prohibiting judicial appointments or employment in court offices of relatives of judges).

Comment: One standing trustee commented that the standards for appointment of United States Trustees and standing trustees should be the same.

Response: The Program does not find this comment to be apposite. United States Trustees are senior officials of the Department of Justice who serve at the pleasure of the Attorney General. United States Trustees are appointed to a five-year term pursuant to 28 U.S.C. 581 and their obligations to supervise bankruptcy administration and trustees encompass a wide range of matters detailed in 28 U.S.C. 586. Their duties cover all chapters of the Bankruptcy Code and include the duty to assist the

United States Attorney, upon request, to carry out the prosecution of federal criminal actions. Because United States Trustees have the responsibility under 11 U.S.C. 307 to appear in court, the Attorney General appoints attorneys to these positions. United States Trustees also serve as policy-making, policy-advocating officers.

Standing trustees are private individuals appointed pursuant to 28 U.S.C. 586(b) to serve as fiduciaries in cases commenced under chapter 12 or chapter 13 of the Bankruptcy Code. Standing trustees must honor the administrative duties that are outlined in 11 U.S.C. 1202 and 1302; and the law specifically states that they need not be attorneys. 28 U.S.C. 586(d). Given these differences, we do not find any comparison between the two positions to be relevant for purposes of analyzing the rule. We note, however, that applicable law prohibits a United States Trustee from hiring relatives or taking official actions that affect their personal or their family's financial interests. 5 U.S.C. 2302(b)(7), 3110(b); 18 U.S.C. 208.

Comment: One standing trustee asked why the initial qualifications for appointment were being revised.

Response: The rule updates current appointment policy and informs all prospective applicants of the restrictions applicable to the United States Trustees' appointment authority. Moreover, as explained above, the rule avoids many of the actual or perceived conflicts of interest that arise when a standing trustee is related to other frequent participants in the bankruptcy system. It therefore promotes the fair and efficient administration of chapter 12 and chapter 13 estates.

Comment: One standing trustee raised questions concerning the legal basis for a United States Trustee's refusal to reappoint a standing trustee. This standing trustee also asked how section 324 of the Bankruptcy Code affects the United States Trustee's authority to refuse to reappoint a standing trustee.

Response: Currently there is no reappointment process for standing trustees once they are appointed. Standing trustees are appointed and serve until they retire or resign, the Untied States Trustee stops assigning cases to them, or the bankruptcy court removes them from their existing cases for cause under 11 U.S.C. 324. *See generally Richman* v. *Straley,* 48 F.3d 1139, 1143–44 (10th Cir. 1995) (discussing the distinction between removal under section 324 and termination of future case assignments).

Comment: One standing trustee contended (without discussion) that the imposition of initial qualifications for appointment violates the equal protection guarantees in the Federal Constitution.

Response: The Program has the authority under 28 U.S.C. 586 to promulgate regulations governing the initial qualifications for appointment. The qualifications contained within this final rule do not violate the Equal Protection guarantees in the Fifth Amendment to the Constitution because they do not classify individuals based on impermissible criteria; nor do they improperly deny applicants a fundamental constitutional right.

The qualifications promulgated here advance the legitimate governmental goal of appointing standing trustees who can perform their fiduciary and statutory obligations free from any actual bias or potential conflict of interest. The qualifications also further the legitimate governmental goal of ensuring that its programs, here the appointment of standing trustees, are administered in a fair and open manner. The legislative history for the 1978 Bankruptcy Reform Act chronicled the problems inherent in a closed bankruptcy network run by insiders. *See, e.g.,* H.R. Rep. No. 595, 95th Cong. 1st Sess. 88–99 (1977). Accordingly, we do not agree with this comment.

Comment: One standing trustee stated that there is no rational basis for the prohibition against appointing a standing trustee who is related to another standing trustee.

Response: The Program is a young agency that does not have the regulatory history of other agencies; however, it does have the benefit of a century of history of bankruptcy administration and repeated studies of pre-existing abuses. *See, e.g.,* H.R. Rep. No. 595, 95th Cong. 1st Sess. (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963; *Report of the Commission of Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong. 1st Sess. (1973); *Report to the President on the Bankruptcy Act and its Administration in the Courts of the United States dated December 5, 1931, reprinted in* S. Doc. No. 65, 72d Cong. 1st Sess. (1932); William J. Donovan, *House Committee on the Judiciary, Administration of Bankrupt Estates*, 71st Cong. 3d Sess. (Comm. Print 1931). In the past, United States Trustees have appointed individuals as standing trustees who were related to other standing trustees, but, based on this experience, they have concluded that such appointments do not create an optimal situation. For example, certain standing trustees have indicated that they believed one of their relatives should be appointed as their successor. These circumstances tend to perpetuate the perception, if not the existence, of a closed bankruptcy network. The rule prohibiting appointments of individuals who are relatives of standing trustees fosters the congressional policy of encouraging an open bankruptcy system, untainted by cronyism in any form.

3. Hiring of Relatives

Comment: Two standing trustees asserted that the restriction on their hiring of relatives was unconstitutional. One of these standing trustees argued that this restriction discriminates against a suspect class, that of women over the age of 40. The other stated that the Program is discriminating against a class created by birth or marriage. Finally, a third standing trustee contended that any individuals terminated after this rule is promulgated would be denied their rights to due process. In a variation on this theme, a different standing trustee argued that, if he is forced to fire his daughter, she will have a difficult time obtaining comparable employment because her skills are so specialized.

Response: The prohibition against hiring relatives is intended to ensure that standing trustees comply with the fiduciary duty of loyalty and to minimize any incentive or opportunity for standing trustees to incur unreasonable or unnecessary expenses at the expense of bankruptcy debtors and creditors. That prohibition does not discriminate against my suspect class. The rule does not impinge any fundamental rights; and it does not employ any improper characteristics (such as race, national origin, citizenship, or sex) to define the affected persons. Indeed, non-spousal relatives who will be affected by the rule include men and women.

Second, promulgation of the rule does not violate the Due Process Clause, U.S. Const. amend. V. The rule does not deprive the affected relatives of any liberty or property interest; and it rationally relates to the legitimate governmental interest in the fair, impartial, and efficient administration of chapter 12 and chapter 13 bankruptcy estates. Nor do standing trustees have any such liberty or property interest because expenses are budgeted and approved on a year-to-year basis. There is no guarantee that a standing trustee will get new cases or a similar number of cases every year, that the same expenses will be approved from year to year, or that the percentage fee will be sufficient each year to cover long-term expenses that the standing trustee has incurred. Thus, a standing trustee has no entitlement to have future expenses compensated in precisely the same manner that they were compensated in the past.

Finally, the affected relatives are employed in jobs requiring legal, clerical, administrative, accounting or computer skills that can be transferred to other positions within the public or private sectors. Since the relatives are presumed to be paid market salaries (or even less than market rates, as some commenters suggest), these relatives should be able to obtain other similar positions during the transition period provided.

Comment: One standing trustee asserted without evidentiary support that the prohibition on employment of relatives is not necessary because situations in which standing trustees employ relatives are more the exception than the rule. This standing trustee also contended, again without evidence, that relatives in smaller offices are paid less than market rate and bear more responsibility than the average employee.

Response: In FY 1996, 50 of the 170 appointed chapter 13 trustees had hired relatives to work for them as employees. This represents 30 percent of all chapter 13 trustees, not an insignificant percentage.

With respect to salaries, the Program has no evidence—and the standing trustees presented no evidence—to support the position that relatives in smaller offices currently receive less than market rate and bear more responsibility than their counterparts in larger offices. Moreover, the relationship between the standing trustee and his or her relatives may affect the exercise of the standing trustee's judgment and may make it difficult, if not impossible, for the standing trustee to make a fair and unbiased assessment of the work performed by his or her relative.

Comment: Several standing trustees and their associations criticized the application of this rule to relatives other than spouses. These commenters argue that imposition of the rule on non-spousal relatives will lead to unfair and inappropriate results; that there is no rational distinction between spouses and other relatives; and that the implementation of this standard will cause standing trustees to lose experienced and valuable personnel who they cannot quickly replace. One standing trustee argued that the rule should be modified to address nepotism issues on a case-by-case basis. Others contended that all relatives currently employed by standing trustees should be exempted from the rule's application.

Response: The Program does not find these arguments persuasive. The rule proscribes the employment of all relatives in the future, spouses and non-spousal relatives alike. This comment is addressed to subsection (d)(1)(iii) of the rule in which the Program exempted those spouses employed as of August 1, 1995, from the rule's application. With respect to relatives who are not spouses, the Program has delayed implementation until October 1, 1998 to provide a transition period.

A prophylactic rule is needed to address the employment of relatives because, in the Program's experience, abuses within the system are not readily discovered or easily remedied. When the standing trustee decides to add a new employee to the payroll, selects an applicant for the job, establishes compensation, and determines an employee's advancement, the standing trustee's objectivity inevitably is called into question when the decision involves the trustee's relative. It is also difficult for the United States Trustee to evaluate the necessity of the expense without inquiring into the standing trustee's motives or at least the determination that the relative was hired on the basis of merit, that the employed relative was performing duties commensurate with the relative's salary, or that an employed relative deserved a raise or promotion. The United States Trustees do not have the resources to conduct such examinations every time a standing trustee wants to hire, promote, or increase the salary of a relative; and, even if resources were available, such examinations would likely be perceived as micromanagement of the standing trustee operations.

We also note that employees in offices where relatives have left the trustees' employ have commented on the improvement in office morale after the relative no longer worked in the office. Such comments support our conclusion that the implementation of this rule will help ensure that chapter 12 and chapter 13 cases are administered fairly and efficiently and solely for the benefit of the debtors and creditors who have an interest in the property of the estates.

The rule recognizes, however, that to impose this regulation immediately on all relatives may cause some disruption to the operations of standing trustees. Standing trustees argued that the local employment base in rural areas may make it difficult for those standing trustees to find personnel with comparable skills and experience to replace their spouses. Moreover, because many spouses are employed in supervisory or management positions and because spouses generally helped the standing trustees to start their operations, the rule excepts all spouses employed by the standing trustees as of August 1, 1995, the date on which the Program first distributed draft standards prohibiting the employment of relatives. To minimize any disruption with respect to non-spousal relatives, the Program has delayed implementation of this rule concerning those relatives until October 1, 1998. This period will give standing trustees time to hire and train other employees and has the added benefit of enabling affected relatives to find alternative employment in an orderly fashion. Finally, in situations where standing trustees can demonstrate the existence of compelling circumstances for the trustee operations and can show that the employees are being paid no greater than market rates, the rule gives the United States Trustees the discretion to grant a two-year waiver for those standing trustees to continue to employ a non-spousal relative. This waiver can be renewed if the standing trustee continues to satisfy the waiver requirements in the rule.

Comment: One standing trustee contended that the rule prohibiting nepotism should not be applied because no government funds are involved in a chapter 13 trustee operation and, thus, the Program is interfering in what is essentially a private enterprise.

Response: The Program disagrees with this analysis. A standing trustee operation differs dramatically from a private enterprise in that it is funded entirely from debtor receipts and is not subject to a competitive market. Debtors are not allowed to choose their standing trustee. Most areas have only one standing trustee and chapter 13 or chapter 12 debtors are forced to use the standing trustee in their area, regardless of the debtor's satisfaction with services rendered. Even in the minority of areas where more than one standing trustee serves, a debtor is assigned to a specific trustee and there is no administrative mechanism to transfer the case if a debtor is unhappy with the trustee's performance or expenditures, short of asking the court to remove the trustee under 11 U.S.C. 324. Indeed, the standing trustee system is the only system within the Bankruptcy Code that does not permit election of case trustees. *Cf.* 11 U.S.C. 702, 1104. In conclusion, competition, which helps keep private enterprises' expenses low, does not operate in the standing trustee system.

Moreover, as fiduciaries, the standing trustees owe their allegiance to the bankruptcy estates they administer, not to third parties such as their relatives. The Program has a statutory responsibility to establish the maximum annual compensation of standing trustees and to establish a percentage fee that will cover the standing trustees' compensation and ''actual, necessary expenses incurred by'' the standing trustees. 28 U.S.C. 586(e)(1). The Program is promulgating this rule to ensure that the percentage fees collected from chapter 12 and chapter 13 cases are used to pay only those expenses that are ''actual'' and ''necessary'' and that standing trustees fulfill their fiduciary duties undistracted by their own self-interests or familial interests.

Comment: Several standing trustees asserted that the imposition of this standard will interfere unnecessarily with employment relationships. One standing trustee commented that if employees are receiving market rates as salaries, their hiring should not be prohibited merely because they are related to the standing trustee.

Response: The rule does not unduly interfere with the standing trustee's employment relationships. A standing trustee who hires relatives has dual and perhaps competing loyalties: loyalties to his or her family members and loyalties to debtors and creditors in bankruptcy cases. As noted above, such conflicts of interest are inconsistent with the standing trustee's duty of undivided loyalty to the trust. Moreover, because debtors do not choose their trustee, there are no market forces to ensure that the standing trustee minimizes the costs to the estate. Although the United States Trustees supervise standing trustees and review the appropriateness of all expenses, they do not have the resources to examine the day-to-day expenses of each standing trustee to make sure that each payment to the standing trustee's relative is, indeed, an ''actual, necessary expense'' that is properly charged to the estate.

Comment: One standing trustee argued that he should be permitted to hire his children at minimum wage for a limited number of hours per quarter ''to accomplish tasks around the office that would be too expensive or inefficient to contract for and too far outside the job descriptions of staff members to assign to them.'' He cited as an example the task of stuffing envelopes.

Response: The Program does not question the standing trustee's purported need to stuff envelopes or perform other ministerial tasks. It is unclear why a relative is better suited than other regular employees to perform these tasks or why regularly employed clerical staff do not already perform these duties. The rule does not interfere with a standing trustee's ability to hire necessary staff, whether temporary, part-time or full-time; it prohibits only the employment of relatives.

Comment: One association asserted that the rule does not account for local considerations or the economic detriment to bankruptcy estates that will be caused if trustees can no longer employ relatives.

Response: The rule prohibiting employment of non-spousal relatives will not be enforced until October 1, 1998, which should give the standing trustee time to hire a suitable replacement. After that date, the Program has accounted for local considerations and economic factors by permitting a standing trustee to seek a wavier of the rule prohibiting employment of non-spousal relatives in situations where compelling circumstances exist.

4. Related Party Transactions

Comment: Several standing trustees and their organizations contend that it is unfair to forbid related party transactions and allocations when certain transactions and allocations have been permitted in the past. These commenters also assert that implementation of this standard will violate and interfere with vested contract rights of related parties. Finally, one association characterizes the rule as unfair because it terminates contracts for no legal or valid basis.

Response: The Program has concluded that, in the future, it should not permit contracts or allocations between standing trustees and related third parties except in narrow circumstances. A prophylactic rule is desirable because, when a trustee purchases or leases goods or services from himself or a related party, it is difficult to detect or remedy circumstances in which estate funds are being used inappropriately.

The rule will go into effect with respect to existing standing trustees on the first day of their next fiscal year. However, because some standing trustees have contractual relationships with related parties, and, in some cases, it would pose an undue hardship to end those contractual relationships by the first day of the next fiscal year, the rule provides for delayed implementation in appropriate situations. For instance, the rule permits a United States Trustee to grant a reasonable extension to a standing trustee who needs additional time to comply with this rule. To obtain an extension, the standing trustee must submit written evidence, satisfactory to the United States Trustee, to demonstrate that the expense is necessary and at or below market rate.

The rule also provides for waiver in certain limited situations where the standing trustee has a natural incentive to conserve expenses. For instance, a newly-appointed trustee can apply for a waiver from the prohibition on related-party transactions and allocations if the standing trustee can demonstrate in writing that the waiver is necessary for the trustee operation and the cost for which the trustee seeks permission is at or below market rate. United States Trustees are given the flexibility to permit an exception in these circumstances because trustees who are starting their operations and are not receiving maximum compensation have an inherent incentive to keep their expenses low. This flexibility also will assist new trustees in starting their operations.

The rule also permits a standing trustee who has not earned maximum compensation to seek a provisional waiver from the prohibition on related-party allocations. Economic reality requires distinguishing in appropriate circumstances between standing trustees who are earning maximum compensation and those who are not. Under the fee structure established in 28 U.S.C. 586, a standing trustee must pay expenses first, his or her compensation second, and any excess monies to the United States Trustee System Fund. When a standing trustee is earning less than maximum allowable compensation, every dollar used to pay for expenses is one less dollar that is available to fund compensation. The incentive to minimize expenses because the standing trustee otherwise will receive reduced compensation is lacking for the approximately 80 percent of chapter 13 trustees who in FY 96 received maximum compensation of $124,333, plus all expenses.

Once standing trustees are earning maximum compensation, the only way they can increase their compensation is indirectly. A standing trustee who is also a practicing attorney could offer a justification to acquire a law library payable out of the trustee expense funds when, in fact, the library is intended to benefit the law firm primarily, thereby subsidizing the law firm's expenses and increasing the profit to the firm's members. One standing trustee justified unfettered expenses by asserting that the system does ''not cost taxpayers a penny.'' Although the costs of operating the standing trustee system are not paid by a direct appropriation from Congress, they are borne by debtors' payments under the financing mechanism in 28 U.S.C. 586.

Because the economic pressures to minimize expenses cease to exist once standing trustees are earning maximum compensation, there is a rational basis to permit trustees who are not earning maximum compensation to allocate certain expenses while simultaneously prohibiting trustees who receive maximum compensation from allocating expenses.

Finally, the United States Trustee has the power to grant a provisional waiver of the allocation prohibition to a standing trustee who serves in both chapter 12 and chapter 13 cases. These circumstances do not involve a trustee who is contracting or allocating with a related party. Trustees in these situations are sharing or allocating expenses between two trusts. Thus, the conflicts of interest inherent when a standing trustee contracts or allocates with himself or a related party do not exist.

Comment: One standing trustee commented that the rule as to related-party transactions is unreasonable when applied to standing trustees who are also attorneys. This standing trustee asserted, without evidence, that if he is forced to move the trustee operations from his law office, the trustee will incur larger rent expenses. Another standing trustee argued that the present policy allowing allocations permits standing trustees to ''effect economies not otherwise available.''

Response: Whether a standing trustee administers 1,000 cases or 10,000 cases, the trustee's maximum annual compensation cannot exceed the statutory limit, nor can the total amount of compensation and expenses exceed 10% of the total plan payments. Although the numbers of cases being administered certainly allows standing trustees to achieve economies of scale, the Program has not found that allocation of expenses among related parties, itself, has permitted ''economies of scale not otherwise available.'' To the contrary, the Program has found that this is a very difficult and troubling area to monitor.

Many trustees engage in other occupations, particularly as attorneys. The desire to keep both the standing trustee office and the law firm operating under the same roof is understandable, because the situation is convenient, and likely well-intentioned. Once the standing trustee operations grow to the point that they are able to support maximum compensation for the trustee and all the trustee's costs, the trustee can increase his or her compensation by having the trustee operation enter into a contract with a person or entity who is related to the trustee. For example, the trustee could have his or her law partnership lease office space or equipment to the trustee operation. The trustee would then receive compensation and the income derived from the lease, a situation too easily susceptible to manipulation and difficult to detect. Accordingly, related-party transactions and allocations in the future will be permitted only in limited circumstances that are amenable to adequate supervision or where the incentive ''to keep costs low at the risk of reduced compensation'' still exists.

Comment: A standing trustee and one association stated that, although standing trustees should not profit from the trust, neither should they incur a loss. These commenters hypothesized that it might not be practical for smaller standing trustees to purchase separate equipment, computers, furniture, etc. for the exclusive use of the trustee's office and argued that the United States Trustee should permit some reasonable allocation of cost sharing. Finally, the association stated that the United States Trustee has offered standing trustees no real opportunity to try to refute the conclusion that allocations are inappropriate.

Response: As discussed above, under the rule, a standing trustee who is not earning maximum compensation may seek a provisional waiver from the supervising United States Trustee. A provisional waiver also may be requested if the standing trustee serves in chapter 13 and chapter 12 cases and the trustee wishes to allocate between these two operations. Therefore, the Program has provided for allocations in warranted circumstances.

Regarding the comment that trustees should not be forced to operate at a loss, all actual and necessary expenses are funded by debtors' payments under the statutory scheme set out in 28 U.S.C. 586. Standing trustees do not personally pay expenses. All expenses are paid out of the trust fund, including any monies that the standing trustee advanced for expenses during the start-up phase of a new trustee operation. Trustees who administer a large number of cases will be able to absorb any cost differential in operational and overhead expenses. The Program cannot assess the economic impact on the standing trustee's personal interests in related entities, however.

The Program has made a policy decision, based on its experience, to prohibit future transactions and expense allocations between related parties. This decision will provide clearer direction to those who must abide by and those who must administer the strictures of 28 U.S.C. 586(e).

Comment: Several standing trustees and an association commented that this rule violates the Bankruptcy Code because United States Trustees do not have the jurisdiction to decide whether expenses are ''actual and necessary''. Pursuant to this perspective, the United States Trustees can only rubber-stamp the expenses submitted by the standing trustees; if there is any dispute about these expenses, only the bankruptcy courts have the authority to decide the question. The association added that the standing trustee's role is to seek a court ruling on any items that the United States Trustee disputes as unnecessary.

Response: These comments do not comport with the compensation scheme outlined in 28 U.S.C. 586(e), which both empowers and obligates the Attorney General, in consultation with the United States Trustees, to establish compensation and a percentage fee for standing trustees.

As discussed in the General Comments above, the Attorney General—not bankruptcy courts—is empowered to establish compensation for each standing trustee. Once compensation has been set, the statute then requires the Attorney General to establish a percentage fee sufficient to pay the trustee's compensation *and* all actual, necessary expenses. 28 U.S.C. 586(e)(1).

The language ''actual, necessary'' is language of limitation that modifies the noun ''expenses.'' Thus, Congress did not want to permit standing trustees to recoup every expense no matter how remotely related to the trustee operation. Moreover, Congress did not define the words ''actual'' and ''necessary.'' *Cf.* 11 U.S.C. 330 (where Congress engrafted various factors for the bankruptcy courts to consider when awarding fees to trustees in chapter 7 and 11 cases and other professionals). *See also Patterson* v. *Shumate,* 504 U.S. 753, 758 (1992) (use of broad language supports more expansive reading especially when Congress has used narrower language in other subsections of statute). Instead, Congress authorized the Attorney General to decide which expenses are ''actual'' and ''necessary'' and thus are appropriately factored into the percentage fees charged to the bankruptcy cases. At the same time, Congress mandated in section 326(b) that ''[i]n a case under chapter 12 or 13 of this title, the court may not allow compensation for services or reimbursement of expenses of the United States trustee or of a standing trustee appointed under section 586(b) of title 28, * * *'' Congress entrusted the administration of the standing trustee system, including the calculation of compensation and percentage fees, to the Attorney General, not the bankruptcy courts.

Comment: One standing trustee argued that the need to prohibit related-party transactions is undercut by the fact that this standard is not to be implemented until 2005 in certain situations. This standing trustee concluded that the United States Trustees must not believe that related-party transactions are really a problem.

Response: The delayed implementation of this rule in limited situations involving real estate is not a reflection of the need for the rule. Instead, it reflects the Program's desire to minimize the disruption in the administration of chapter 12 and chapter 13 estates that might otherwise result from immediate implementation.

Comment: Two standing trustees asserted there is no rational justification for the distinction in treatment between smaller trustees and those who earn maximum compensation. A variation on this assertion was the comment that existing budgeting and auditing procedures should be sufficient to prevent improper expenditures.

Response: As explained in detail earlier in this subsection, there are valid economic reasons to distinguish between standing trustees who are earning maximum compensation and those who are not. Those standing trustees who are earning less than maximum allowable compensation have an incentive to minimize expenses because every dollar that is used on expenses means one less dollar is available to pay for the trustee's compensation.

Comment: One commenter stated that the rule with respect to allocations is unfair because chapter 7 trustees are permitted to allocate costs among their individual chapter 7 cases.

Response: There are different methods for allocating costs and expenses in chapter 7 cases and chapter 12 or 13 cases. As noted above, section 586(e) directs the Attorney General to establish a percentage fee that is collected from all plan payments received by the standing trustee. The monies generated by these fees are then used to pay the compensation of the standing trustee and the ''actual, necessary expenses incurred by such individual as standing trustee'' in administering all chapter 12 or chapter 13 cases. 28 U.S.C. 586(e)(1).

In contrast, the compensation and reimbursement of expenses of chapter 7 trustees are determined on a case-by-case basis after an application, notice, a hearing, and a court order. Courts generally allow a chapter 7 trustee to be reimbursed for expenses that he or she incurs to administer a discrete and identifiable chapter 7 estate. The chapter 7 trustee is prohibited from recovering overhead or ''general 'stay in business' costs''. *See, e.g., Sousa* v. *Miguel (In re United States Trustee),* 32 F.3d 1370, 1376–77 (9th Cir. 1994). As the Ninth Circuit has observed, standing trustees operate under a different mechanism, which makes their compensation and expenses inapposite to the analysis required to award compensation in chapter 7 cases. *Id.* at n. 5. *See also Dunivent* v. *Schollett (In re Schollett),* 980 F.2d 639, 643–45 (10th Cir. 1992); *In re Savage.* 67 B.R. 700, 706–07 (D.R.I. 1986) (Selya, J.).

Comment: One standing trustee asserted, without proof, that the commercial reasonableness of contractual relationships, including those between related parties, is ''easily and objectively measurable'' and, therefore, should be permitted.

Response: As discussed in other responses to this subsection, contractual relationships between related parties are not ''easily and objectively measurable.'' Moreover, when standing trustees use fiduciary funds to lease property from themselves or related parties, the trustees are using fiduciary funds for their own personal or family's benefit, and are abrogating their fiduciary duty of loyalty. Even where these dealings are well-intentioned and not motivated by a desire for personal profit, standing trustees in these circumstances have created an irreconcilable conflict and, at the very least, an appearance of impropriety.

5. Employment of Other Standing Trustees

Comment: One standing trustee questioned the basis for this standard.

Response: This rule simply memorializes current practice pursuant to which the Program prohibits one standing trustee from hiring another. The rationale behind this policy is to eliminate any conflicts of interest or dual loyalties and to prevent a reoccurrence of the closed bankruptcy network that existed prior to the Program's creation.

Comment: Two commenters asserted that imposition of this standard has the potential to restrict standing trustees from hiring their most effective or cost-efficient counsel. One of these commenters cited as an example his use of another standing trustee as an expert witness in a bankruptcy case. The commenter noted that the standing trustee who served as the expert witness received no fee.

Response: The imposition of this rule should not create additional costs. Indeed, the standing trustee and the association who made this comment conceded no existing attorney-client relationships were affected by the rule. Furthermore, the promulgation of the rule will not prevent a standing trustee from serving as an expert witness in the circumstances that one commenter described because the testifying trustee did not receive a fee. The rule permits one standing trustee to assist another provided no compensation is paid. Expenses for the assisting standing trustee can be reimbursed provided that the United States Trustee has pre-approved this expenditure.

Comment: One standing trustee argued against the imposition of this standard, alleging that the Department of Justice currently has a conflict of interest in that the Department represents major federal claimants in bankruptcy and the United States Trustees. Alternatively, this commenter contended that this dual representation by the Department should be banned.

Response: Congress has determined as a matter of public policy that the Program most appropriately resides in the Department of Justice. The legislative history for the Bankruptcy Reform Act of 1978 demonstrates that ''[t]he decision to place the United States trustee system in the Department of Justice was reached as a result of thorough deliberations'', including careful consideration of the same conflicts of interest raised by these commenters. H.R. Rep. No. 595, 95th Cong., 1st Sess. 111 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6072–73. After analyzing this issue, Congress rejected the concern about such conflicts of interest as being ''theoretical, not real.'' H.R. Rep. No. 595, 95th Cong., 1st Sess. 114 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6075. This issue was raised and again rejected when Congress expanded the Program nationwide in 1986. *See, e.g.,* The United States Trustee System: Hearing Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 99th Cong., 2d Sess. (1986). Thus, in deciding to place the Program within the Department, Congress considered and rejected the very argument this standing trustee raised in objection to the rule.

Certifications

Executive Order 12866

This rule has been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. The Director, Executive Office for United States Trustees, (''Director'') has determined that this rule is not a ''significant regulatory action'' under Executive Order 12866, section 3(f), Regulatory Planning and Review, and, accordingly, this rule has not been reviewed by the Office of Management and Budget.

Regulatory Flexibility Act

In accordance with the Regulatory Flexibility Act (5 U.S.C. § 605(b)), the Director has reviewed this rule and by approving it certifies that it will not have a significant impact on a substantial number of small entities. The only parties affected are the approximately 200 individuals who serve as standing trustees. Moreover, the rule provides direction to standing trustees in the performance of their fiduciary duties and, thus, will not have a significant economic impact.

Paperwork Reduction Act

This rule contains no new information collection or recordkeeping requirements under the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Unfunded Mandates Reform Act of 1995

This rule will not result in the expenditure by State, local and tribal governments, in the aggregate, or by the private sector, of $100,000,000 or more in any one year, and it will not significantly or uniquely affect small governments. Therefore, no actions were deemed necessary under the provisions of the Unfunded Mandates Reform Act of 1995.

Small Business Regulatory Enforcement Fairness Act of 1996

This rule is not a major rule as defined by § 804 of the Small Business Regulatory Enforcement Fairness Act of 1996. This rule will not result in an annual effect on the economy of $100,000,000 or more; a major increase in costs or prices; or significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based companies to compete with foreign-based companies in domestic and export markets.

List of Subjects in 28 CFR Part 58

Bankruptcy, Trusts and trustees.

For the reasons set forth in the preamble, the Department of Justice proposes to amend 28 CFR part 58 as follows:

PART 58—REGULATIONS RELATING TO THE BANKRUPTCY REFORM ACTS OF 1978 AND 1994

1. The authority citation for part 58 is revised to read as follows:

Authority: 28 U.S.C. 509, 510, 586, 5 U.S.C. 301.

2. In § 58.1, paragraph (a) is revised to read as follows:

§ 58.1 Authorization to establish panels of private trustees.

(a) Each U.S. Trustee is authorized to establish a panel of private trustees (the ''panel'') pursuant to 28 U.S.C. 586(a)(1).

* * * * *

3. Section 58.4 is revised to read as follows:

§ 58.4 Qualifications for appointment as standing trustee and fiduciary standards.

(a) As used in this section—

(1) The term *standing trustee* means an individual appointed pursuant to 28 U.S.C. 586(b).

(2) The term *relative* means an individual who is related to the standing trustee as father, mother, son, daughter, brother, sister, uncle, aunt, first cousin, nephew, niece, husband, wife, father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, sister-in-law, stepfather, stepmother, stepson, stepdaughter, stepbrother, stepsister, half brother, half sister, or an individual whose close association to the standing trustee is the equivalent of a spousal relationship.

(3) The term *financial or ownership interest* excludes ownership of stock in a publicly-traded company if the ownership interest in not controlling.

(4) The word *region* means the geographical area defined in 28 U.S.C. 581.

(b) To be eligible for appointment as a standing trustee, an individual must have the qualifications for membership on a private panel of trustees set forth in §§ 58.3 (b)(1)–(4), (6)–(8). An individual need not be an attorney to be eligible for appointment as a standing trustee. A corporation or partnership may be appointed as standing trustee only with the approval of the Director.

(c) The United States Trustee shall not appoint as a standing trustee any individuals who, at the time of appointment, is:

(1) A relative of another standing trustee in the region in which the standing trustee is to be appointed;

(2) A relative of a standing trustee (in the region in which the standing trustee is to be appointed), who, within the preceding one-year period, died, resigned, or was removed as a standing trustee from a case;

(3) A relative of a bankruptcy judge or a clerk of the bankruptcy court in the region in which the standing trustee is to be appointed;

(4) An employee of the Department of Justice within the preceding one-year period; or

(5) A relative of a United States Trustee or an Assistant United States Trustee, a relative of an employee in any of the offices of the United States Trustee in the region in which the standing trustee is to be appointed, or a relative of an employee in the Executive Office for United States Trustees.

(d) A standing trustee must, at a minimum, adhere to the following fiduciary standards:

(1) *Employment of Relatives.* (i) A standing trustee shall not employ a relative of the standing trustee.

(ii) A standing trustee shall also not employ a relative of the United States Trustee or of an Assistant United States Trustee in the region in which the trustee has been appointed or a relative of a bankruptcy court judge or of the clerk of the bankruptcy court in the judicial district in which the trustee has been appointed.

(iii)(A) Paragraphs (d)(1) (i) and (ii) of this section shall not apply to a spouse of a standing trustee who was employed by the standing trustee as of August 1, 1995.

(B) For all other relatives employed by a standing trustee as of August 1, 1995, paragraphs (d)(1) (i) and (ii) of this section shall be fully implemented by October 1, 1998, unless specifically provided below:

(*1*) The United States Trustee shall have the discretion to grant a written waiver for a period of time not to exceed 2 years upon a written showing by the standing trustee of compelling circumstances that make the continued employment of a relative necessary for a standing trustee's performance of his or her duties and written evidence that the salary to be paid is at or below market rate.

(*2*) Additional waivers, not to exceed a period of two years each, may be granted under paragraph (d)(1)(iii)(B)(*1*) of this section provided the standing trustee makes a similar written showing within 90 days prior to the expiration of a present waiver and the United States Trustee determines that the circumstances for waiver are met.

(*3*) No waivers will be granted for a relative of the United States Trustee or of an Assistant United States Trustee.

(2) *Related Party Transactions.* (i) A standing trustee shall not direct debtors or creditors of a bankruptcy case administered by the standing trustee to an individual or entity that provides products or services, such as insurance or financial counseling, if a standing trustee is a relative of that individual or if the standing trustee or relative has a financial or ownership interest in the entity.

(ii) A standing trustee shall not, on behalf of the trust, contract or allocate expenses with himself or herself, with a relative, or with any entity in which the standing trustee or a relative of the standing trustee has a financial or ownership interest if the costs are to be paid as an expense out of the fiduciary expense fund.

(iii) (A) The United States Trustee may grant a waiver from compliance with paragraph (d)(2)(ii) of this section for up to three years following the appointment of a standing trustee if the newly-appointed standing trustee can demonstrate in writing that a waiver is necessary and the cost is at or below market.

(B) The United States Trustee may grant a provisional waiver from compliance with the allocation prohibition contained in paragraph (d)(2)(ii) of this section if one of the following conditions is present:

(*1*) A standing trustee has insufficient receipts to earn maximum annual compensation as determined by the Director during any one of the last three fiscal years and provides the United States Trustee with an appraisal or other written evidence that the allocation is necessary and the allocated cost is at or below market rate for that good or service, or

(*2*) A Chapter 13 standing trustee also serves as a trustee in Chapter 12 cases and provides the United States Trustee with an appraisal or other written evidence that the allocation is necessary and the allocated cost is at or below market rate for that good or service.

(C) Except as otherwise provided in this paragraph, a standing trustee may seek a reasonable extension of time from the United States Trustee to comply with paragraph (d)(2)(ii) of this section. To obtain an extension, a standing trustee must demonstrate by an appraisal or other written evidence, satisfactory to the United States Trustee, that the expense is necessary and at or below market rate. In no event shall an extension be granted for the use and occupation of real estate beyond October 1, 2005. For personal property and personal service contracts, no extension shall be granted beyond October 1, 1998.

(3) *Employment of Other Standing Trustees.* A standing trustee shall not employ or contract with another standing trustee to provide personal services for compensation payable from the fiduciary expense fund. This section does not prohibit the standing trustee from reimbursing the actual, necessary expenses incurred by another standing trustee who provides necessary assistance to the standing trustee provided that the reimbursement has been pre-approved by the United States Trustee.

(e) Paragraph (d) of this section is effective July 2, 1997. As to those standing trustees who are appointed as of July 2, 1997, paragraph (d) will be applicable on the first day of their next fiscal year (i.e., October 1, 1997 for chapter 13 trustees and January 1, 1998 for chapter 12 trustees).

Dated: May 22, 1997.

Joseph Patchan,

Director.

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