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A Call to Arms: A Bankruptcy Fraud Superfund

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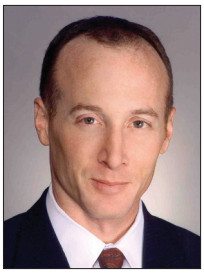
In one of my many former lives, I was a professional hockey referee. During my training, I was taught the rules, how to position myself on the ice, what bars to stay out of and a list of foods containing the appropriate amount of pre-game carbs. What I wasn't taught—in fact, what couldn't possibly be taught—was the art of exercising good judgment. Sure, referees were introduced to the notion; we saw films, spent hours hearing from 20-year veterans who had "seen it all" and even pretended that when a game went smoothly, we had in fact mastered the concept. Yet it took dozens of games over several years to get one of the key principles: *The rules are useless if you don't enforce them*, leading to bench-clearing brawls and bad press for the refs in the morning paper.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Fast-forward to my current career as a fraud-busting attorney with a practice committed exclusively to ferreting out insurance fraud, bank fraud, occupational fraud, asset concealment and (one of my personal favorites) bankruptcy fraud. In fact, more than 50 percent of my cases that start somewhere other than bankruptcy ultimately end up there (my typical response to a threat of going into bankruptcy court by one of my fraudsters is: "Get in; I'll drive!"). The bankruptcy courts present unique opportunities for expedited discovery, crippling interim relief, avoidance of an array of fraudulent transfers and the piercing of the so-called "asset protection" plans. However, having practiced my craft in courts all over the country, it is with great pain that I make the following observation: *We are not enforcing the rules*. Though I have yet to see a bench-clearing brawl in a bankruptcy court (much as I'd like to), the players are out of control and the press is equally condemning. Let's take some examples for a lap around the rink.

About the Author

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1. *With a creditor on his tail, the debtor takes himself and his solely-owned businesses into bankruptcy, though not before running to the Secretary of State to open another business with a very similar name and conducting the same business*. The trustee overlooked this little gem and gave the debtor a pass with a no-asset report. Oddly, the creditor discovered hundreds of thousands of dollars in hidden assets after the discharge was granted. Yet the trustee refused to seek revocation for fear of facing insufficient assets in the end.

2. *This fraudster was living large: two houses in Hawaii, a big condo in Chicago, mastermind of a mega-commercial real estate portfolio and affiliated with nearly 110 corporate entities bearing his name in some capacity*. He transferred all sorts of property and interests in properties as part of an "asset-protection plan." The kids were in private school and he was turning deals, netting $1 million every few months while dumping proceeds into select corporate entities allegedly belonging to others, lying to the IRS, bankruptcy court, insurance companies and municipal government. An aggressive creditor forced the fraudster into bankruptcy with an involuntary petition under §303. The fraudster's response was: "I don't have any assets." The creditor successfully secured an interim gap trustee appointment before adjudication (nearly impossible to get). Hundreds of thousands of pages of documents were seized from the fraudster's offices, all of which demonstrated commingling interests in properties and the aforementioned lies. Once the gap trustee became the full-time trustee, he retained counsel, to whom the hard-working creditor's attorney passed the baton.

It is at this point that the case comes to a screeching halt. Dozens of depositions are suspended, the trustee's counsel backs off temporary restraining orders and agrees to a leaner, lower-calorie preliminary injunction *lite* (nearly all the taste with only half the effectiveness), and then enters into year-long settlement talks with the debtor's camp. Now, nearly two years postpetition and after months of nagging and threats from the creditor, the trustee finally forces a healthy settlement in excess of $12 million and both he and his counsel have been paid handsomely for a job that was mostly performed by the creditor.

3. *Another creditor chases a judgment debtor into bankruptcy and again takes the lead when the appointed trustee initially has no money to spend*. Bankruptcy fraud becomes painfully obvious during the §341 meeting due to the creditor attorney's prepetition investigations. With the full support of the trustee, the creditor's attorney

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seeks orders compelling inspection of the debtor's several computers (allegedly owned by the debtor's wife). In the seven days between the order and the inspection, the debtor wipes his computers clean, leaving a trail as big as bowling balls. An *ex parte* court-ordered raid of the debtor's residence by U.S. marshals, also obtained by the creditor's attorney, ultimately reveals the whereabouts of the debtor's backed-up data files.

These three examples illustrate two key points: (1) trustees have no incentive to ferret out fraud; and (2) debtors work under the assumption that they can get away with murder in bankruptcy courts. For the most part, they are right.

We Need a Change in Attitude

We're simply not enforcing the rules. Arguably, we're not even watching the game. I couldn't possibly venture a guess as to how much money creditors are losing to fraud. If we don't investigate and prosecute fraud, the losses can't be counted. Trustees and even judges have been slow to lower the hammer using the many noncriminal tools available when confronted with fraudulent activity in their courts (the guy who erased all the computer data is still awaiting a ruling on a motion for contempt—now more than nine months later). You can forget about criminal prosecutions: The FBI is so inundated with international terrorism that getting an agent dispatched is nearly impossible, especially for matters involving less than $500,000.

We need to do something before the benches clear. Exercising good judgment in a bankruptcy tribunal is the same as applying the rules as a hockey referee: You've got to pull tight on the reins before you can let them out. We must collectively begin employing more aggressive techniques to show would-be crooks that bankruptcy courts are not places of refuge to be used as tools to delay proceedings and frustrate creditors, and certainly not the place to pretend that you have no assets ("we" includes the U.S. Trustee Program, the U.S. Attorneys and judges alike). Although the Enrons, WorldComs and other mega-cases in recent years have brought fame and notoriety to a select few, the true fraudster is lurking in the courtroom or §341 meeting room at this very moment (Bernie Madoff and Tom Petters will no doubt re-write several books on Ponzi schemes and will no doubt be battled in the bankruptcy courts for years as the receivers and trustees attempt to recover assets). However, the scariest cases will not make the six o'clock news.

To fight fraud, we must first use the tools that we have been given. We can demand explanations, scan computers, review documents—especially schedules and statements of financial affairs—and seek to punish misconduct. If there is no money to pay, enlist the help of creditors and their counsel. Reach out for assistance by finding young, aggressive, contingency-fee attorneys who will reach for the brass ring. We can learn how to use tools such as *ex parte* motions for inspections and collection of assets and take depositions from family members.

The rules are there. We need to exercise them early, aggressively and consistently, until the message is conveyed that if you break the rules, you will pay.

Bankruptcy Fraud Superfund

Concurrently, I propose a new weapon be developed for the trustee's arsenal: the creation and deployment of a bankruptcy fraud "Superfund." Administered by the U.S. Trustee Program, the Superfund would be used to subsidize fraud investigations in estates that otherwise lack assets.

Here's how it works: Perhaps at the §341 meeting, or with the help of a creditor and a few seemingly out-of-place documents, the trustee smells a rat. She prepares a request for an allocation, which is submitted to the U.S. Trustee's office with a simple proffer as to the source of the smell (each regional office will assign a current staff attorney to review Superfund submissions, and a program will be developed that will standardize the review process nationally). If approved, the U.S. Trustee's office will unleash $25,000, which will be used exclusively to hire special counsel from an approved list of attorneys with specific experience in combating fraud in bankruptcy. Special counsel will use the funds to conduct a preliminary (Phase I) fraud investigation, which will no doubt include a few Rule 2004 exams and document requests, perhaps even a spot inspection of the debtor's assets, residence or computers (it's truly amazing what $25,000 can unveil when used effectively). If during the Phase I investigation special counsel unearths more dirt and a more intense stench, then he and the trustee can submit a more formal proposal and budget (the Phase II component) which, if approved, will result in additional allocations from the Superfund at the direction of the U.S. Trustee's office. This money will be used to complete an investigation, file avoidance and §727 actions, and otherwise seek to recover assets rightfully belonging to the estate and its creditors. Whether the arrangement going forward is a general retention, a blended fee or a straight contingency will be decided on a case-by-case basis and will be dependent on a number of factors that need not be fully outlined here. The point is simply that when it makes sense, money will be available, and we will not be passing on fraud investigations just because you started with a zero-asset estate (many of my biggest victories came from estates with debtors who claimed to be poor).

So now, let us get to the question that you are all asking: Where do we get the money? Well, I heard that President Barack Obama is printing money, so why shouldn't we get our share in order to help stampout bankruptcy fraud? I only half jest. Who loses the most to bankruptcy fraudsters? Creditors, of course, and who are the biggest creditors? Banks, mortgage and other lenders, credit card companies and a variety of utilities and product/service providers.

Many of these creditors are currently in a heap of trouble and are receiving aid from Washington, which, presumably, has a vested interest in the success of these creditors going forward. Recovering and preventing losses due to bankruptcy fraud works right to the bottom line and should be high on the agenda of these creditors, as it is in the U.S. Trustee Program (and should be throughout the bankruptcy bar). Accordingly, we are going to levy ("tax" is such an ugly word) a single-digit percentage of all distributions to creditors in asset cases during a given period. Perhaps we could then guarantee these levies through the bailout process to further justify the investment.

Of course, any money recovered through the fraud investigations will first go to repay the Superfund so that in theory, it will become self-sustaining going forward. Certainly, we will need an annual review and oversight, which will not only serve to re-assess the allotments

and levies, but will also ensure the integrity of the fund going forward.

The Superfund is clean, does not cost the taxpayers any more money and will undoubtedly put money back into the hands of creditors that otherwise are seeing the money walk out the back door of the bankruptcy court. While we continue to iron out the details, I welcome any dialogue on the specifics of the proposal so that we can create what might be the most comprehensive bankruptcy fraud offensive to date.

In short, we must do something other than simply writing off fraud. If the fraud is there, even if it is small, we must send the message that fraud is wrong. It may cost us a few dollars, sure, but it will be far less than the dollars that are being lost to fraud.

Let's start enforcing the rules we have and pulling the reins in tight so that one day we can let them loose again. The rules are there. We need to exercise them early, aggressively and consistently, until the message is conveyed that if you break the rules, you will pay. We must also look for new low-cost, high-yield tools, like the "Superfund," instead of merely looking to make new laws that we will not enforce. We must take a unified stance against this dangerous and destructive trend that has debtors believing it is OK to lie to the trustee, court and anyone else. Like the player who realizes the ref has his whistle in his pocket, debtors in bankruptcy are realizing that they can get away with something akin to the "bench-clearing brawl." In the end, we'll find them sitting in the stands enjoying the game with an ice-cold beer. ■

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