Avoid Claims Of Bankruptcy Fraud Amid Creditor Scrutiny

By **Rachel Maimin, Gregory Baker, Michael Kaplan and Rachel Moseson** (June 10, 2020, 3:28 PM EDT)

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In the weeks and months since COVID-19 effectively brought many sectors of the U.S. economy to a screeching halt, numerous major retailers, recreation and travel companies, grocery chains and restaurants have filed for bankruptcy, in addition to an untold number of small businesses and individuals in economic distress.

Most analysts and industry professionals believe that the filings to date are just the tip of the iceberg. Companies and individuals considering bankruptcy, or those already in bankruptcy, must be mindful of one its central tenets: transparency.

Bankruptcy policy requires near-complete transparency with respect to companies' business decisions and financial transactions leading up to filing and gives parties in interest broad investigatory rights related to the debtor.

When directors and officers have taken actions that devalued the company, creditors who are likely to receive pennies on the dollar are highly incentivized to scrutinize every act or omission by directors and officers — particularly in the time period leading up to the company's bankruptcy filing — for indicators of civil fraud. Recovery of assets that may have been transferred fraudulently benefits the creditors, as it increases the pool of assets to be distributed among them.

Federal prosecutors are likewise directed to evaluate criminal bankruptcy fraud both as an independent charge and as an additional charge against defendants already charged with other financial crimes, like securities fraud or tax evasion, or crimes related to corruption.

Indeed, the U.S. Department of Justice published a bulletin in 2018 encouraging prosecutors to pursue bankruptcy fraud charges when they will either reflect the "nature and extent" of the defendant's criminal conduct or otherwise "significantly strengthen the case" against the defendant.[1]

Below, we explore the hallmarks both of civil and criminal bankruptcy fraud — of which both creditors and debtors should be aware, delineate gray area between the two and compare the penalties associated with each.

While we focus on corporate bankruptcies, individual consumers that seek bankruptcy protection under Chapter 7 or Chapter 13 of the Bankruptcy Code should likewise be aware of decisions and activities that may derail their filings or expose them to criminal prosecution.[2]

Civil Fraud

When large corporations file for bankruptcy, there are frequently many creditors vying to collect whatever assets will be available either through a straight liquidation under Chapter 7 or after a sale or reorganization process under Chapter 11. In Chapter 11 proceedings, the United States Trustee Program will appoint a committee of unsecured creditors, generally composed of creditors holding the largest unsecured claims against the debtor.[3] The committee and its members are statutorily charged with a fiduciary duty to protect the interests of all unsecured creditors.

Rule 2004 of the Federal Rules of Bankruptcy Procedure vests the committee and other stakeholders with broad powers to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business and other matter relevant to the case of the formulation of a plan."[4]

Committees are tasked with securing the best possible outcomes for unsecured creditors — which are typically among the last parties in interest to be paid under the Bankruptcy Code's priority scheme — and are therefore incentivized to use their investigatory powers to consider every action taken by the debtor in the lead-up to the filing under a magnifying glass. The question becomes, what are committees looking for and why?

Certain financial decisions or transactions executed by a company prior to or during a bankruptcy case, which extract value from the company leaving the debtor with fewer assets from which creditors can be paid, may be set aside or avoided by the committee.[5]

A committee examines the conduct of the debtor to look for evidence of, among other things, constructive or actual fraudulent transfers, and presents challenges to the debtor's conduct with the goal of having the subject transfers or transactions avoided, and the value of those transactions thereby recouped to the estate for distribution to creditors.

A constructive fraudulent transfer occurs when the debtor transfers an interest in property or incurs an obligation "within two years before the date of the filing of the petition"[6] if the debtor:

(1) "Received less than a reasonably equivalent value in exchange," and (2) (a) was already insolvent or became insolvent because of the transfer or obligation; (b) engaged "or was about to engage in business or a transaction for which" the debtor's remaining property was unreasonably small capital; or (c) intended to or believed it would incur debts beyond its ability to pay.[7]

Constructive fraudulent transfers do not require malicious intent by the debtor and can even occur unintentionally. For example, if, while insolvent, a company engages in a prepetition sale of an asset for less than what is ultimately determined to be reasonably equivalent value — that is, if the sale was an unfair exchange for the debtor — that would constitute a constructive fraudulent transfer.

In practice, while these transfers are subject to avoidance and the estate's recovery of the value of such transfer, they generally do not result in sanctions against the debtor. Meanwhile, an actual fraudulent transfer occurs when the debtor transfers an interest in property or incurs an obligation with "actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."[8]

Generally, fraudulent transfers are avoided or unwound, either by the committee or the trustee, and the value of the transfer is recovered and added back to the debtor's assets. If the committee suspects that the debtor is engaging in more widespread misconduct, as opposed to concern about a particular transaction, there are additional remedies that can be pursued, including appointment of a trustee or examiner.

Standing alone, the fact that a debtor may have fraudulently conveyed assets is not per se criminal; the line between civil and criminal acts in the bankruptcy space hinges on the question of intent.

Criminal Fraud

Prosecutors are generally alerted about the potential of bankruptcy fraud through referrals from the U.S. Trustee Program, or USTP, which has a statutory duty to report any potentially criminal activity during or related to bankruptcy filings to the United States Attorney's Office.[9]

In 2018, the USTP sent 2,257 bankruptcy and related criminal referrals to federal prosecutors and law enforcement agencies.[10] The overwhelming majority of those referrals (54.6%) were actually for tax fraud; bankruptcy fraud came in third, with 426, or 18.9% of referrals.[11]

The latter category of fraudulent transfers discussed above — those undertaken with the actual intent to defraud — may be prosecuted under the federal criminal code. This intentionality is where the line is drawn between civil fraud — which can be either intentional or unintentional, and either actual or constructive — and criminal bankruptcy fraud.

Prosecutors look for evidence that a defendant knowingly and fraudulently misrepresented material facts before, in the course of, or after bankruptcy proceedings. Bankruptcy fraud is most frequently prosecuted under Title 18, Chapters 152 and 157.[12]

Chapter 152 focuses on fraudulent actions, including intentional concealment of assets, destruction of records, falsification of documents, fraudulent transfers of property or obligations, and perjury, among other things. Chapter 157 focuses on fraudulent statements and provides that any person who "devised or intend[ed] to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so" made "a false or fraudulent representation, claim, or promise" related to a bankruptcy filing, whether undertaken before or after filing for bankruptcy protection.

Prosecutions solely for bankruptcy fraud are rare but do occur from time to time. More frequently, criminal charges for bankruptcy fraud are pursued when a prosecutor believes the charges will either demonstrate the nature and extent of the defendant's other criminal conduct or significantly strengthen the case against the defendant in some other way.[13]

Moreover, the defendant's intent is key to sentencing.

For example, in one celebrity bankruptcy case out of New Jersey, after filing for bankruptcy in 2009 and claiming approximately $11 million in debt, Joe and Teresa Giudice of "The Real Housewives of New Jersey" fame were indicted in 2013 on 39 counts — including conspiracy to commit wire and mail fraud, bank fraud, loan application fraud and bankruptcy fraud — for concealing assets during their bankruptcy filing and for continuing to submit fraudulent documents to the court even during the course of their own prosecution.

Teresa Giudice was sentenced to 15 months in federal prison and Joe Giudice was sentenced to 41 months.[14]

This kind of active concealment and purposeful, knowing misrepresentation of a debtor's assets draws the line between civil and criminal bankruptcy fraud. Constructive fraudulent transfers and other avoidable conveyances are typically not concealed; indeed, they are frequently uncovered and dealt with in the normal course of disclosure and discovery during bankruptcy proceedings.

But where a debtor conceals or attempts to shield the assets they possess, they pervert the bankruptcy process and they exploit the protection it is meant to provide debtors in financial distress — and that exploitation is criminal.

Whatever the situation, awareness of the need for transparency and the other hallmarks of fraud are key to successful restructurings and liquidations. It is critical both for corporations and individual consumers to be aware of these standards whether they are leading up to, within, or past the period of bankruptcy filing, especially since certain types of civil fraud do not require intent.

While the vast majority of bankruptcy fraud is disposed of by committees and trustees in the civil context, criminal actions are possible where debtors' actions are intentional.

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[1] Charles R. Walsh, Why is a Bankruptcy Charge Valuable to Any Investigation?, 66 Bankruptcy & Bankruptcy Fraud 131 (March 2018), https://www.justice.gov/usao/page/file/1046201/download.

[2] Conduct that may except certain categories of fraudulently-obtained debts (or debtors themselves) from discharge under the Bankruptcy Code is beyond the scope of this article.

[3] 11 U.S.C. § 1102(a), (b)(1).

[4] 11 U.S.C. § 1103(c)(1)-(3).

[5] See 11 U.S.C. § 550(a). Although the Bankruptcy Code provides the trustee, or a debtor-in-possession with avoidance powers, since company management is not often incentivized to initiate proceedings that highlight its own misconduct, in many cases, committees seek and obtain standing to bring such actions.

[6] 11 U.S.C. § 548(a)(1). Certain states may provide for longer "look-back" periods.

[7] 11 U.S.C. § 548(a)(1)(B).

[8] 11 U.S.C. § 548(a)(1)(A).

[9] 28 U.S.C. § 586(a)(3)(F).

[10] DOJ Executive Office for U.S. Trustees, Report to Congress: Criminal Referrals by the United States Trustee Program Fiscal Year 2018 (May 2019), https://www.justice.gov/ust/file/criminal_report_fy2018.pdf/download.

[11] Id.

[12] 18 U.S.C. §§ 152, 157.

[13] Walsh, supra note 1, at 131.

[14] Misty Carter, CFE, CIA, The Fraud Examiner: Falsely Pleading Poverty: A Look at Bankruptcy Fraud, Association of Certified Fraud Examiners, https://www.acfe.com/fraud-examiner.aspx?id=4294994439 (last visited June 4, 2020).