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Federal Crimes: The Trustee's Role

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Most practitioners in the bankruptcy field are aware that bankruptcy trustees will refer evidence of criminal misconduct to the appropriate authorities. However, many are not aware that trustees are statutorily obligated to do so.

Duty to Investigate and Refer

A judge or private trustee "having reasonable grounds for believing that any violation under chapter 9 of this title or other laws of the United States relating to insolvent debtors, receiverships or reorganization plans has been committed, or that an investigation should be had in connection therewith, shall report to the appropriate United States attorney all the facts and circumstances of the case, the names of the witnesses and the offense or offenses believed to have been committed. Where one of such officers has made such report, the other need not do so." 18 U.S.C. §3057(a).

Pursuant to 28 U.S.C. §586(a)(3)(F), a U.S. Trustee has the duty of "notifying the appropriate United States attorney of matters which relate to the occurrence of any action which may constitute a crime under the laws of the United States and, on the request of the United States attorney, assisting the United States attorney in carrying out prosecutions based on such action." It should be noted that this section encompasses any crime, not just bankruptcy crimes, and it imposes a duty to assist, as well as to report evidence of crimes.

The case trustee plays a vital role in maintaining the integrity of the bankruptcy system. In many circumstances, the case trustee may be the only person who will examine the case. It is incumbent upon the case trustee to refer matters for further investigation when it appears that someone is abusing the bankruptcy system. Trustees are generally directed by their U.S. Trustee to make referrals to that office, but in certain districts, the referral is made directly to the U.S. Attorney. The author makes his criminal referrals directly to the Region 21 Office of the U.S. Trustee, with certain exceptions where prosecutors with the U.S. Attorney have requested direct referrals (*e.g.*, mortgage fraud referrals), in which case the U.S. Trustee is copied on the referral. The *Chapter 7 Trustee Handbook* actually sets forth the items to be included in the referral and serves as a guide to the case trustee in making it.

About the Author

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Trustee Talk

Selected Criminal Statutes

Bankruptcy Crimes

All bankruptcy practitioners should be familiar with the bankruptcy crime statutes and, in particular, 18 U.S.C. §§152(1) through (9) relating to concealment of assets, false oaths and claims, and bribery, as well as the bankruptcy fraud provisions of 18 U.S.C. §157 and the related provisions in §§1032 and 3284. Many bankruptcy attorneys are aware that concealment of assets and false oaths can lead to a denial of discharge in an individual case but seem completely unaware that the same factual predicates can lead to criminal prosecution. It is surprising how rarely debtors actually invoke their Fifth Amendment privilege against self-incrimination, preferring to falsely testify about certain conduct, thereby compounding their problems by the addition of perjury counts. While investigating bankruptcy crimes, the trustee will often discover additional crimes such as mail fraud, 18 U.S.C. §1341, aggravated identity theft, 18 U.S.C. §1028(A), and various forms of mortgage fraud and tax fraud.

Once a trustee becomes familiar with the patterns and telltale signs of a particular fraud and knows what questions to ask, it becomes fairly simple to develop an appropriate criminal referral. However, most referrals do not result in criminal prosecutions. Due to the allocation of limited resources, some referrals are not acted upon. In most districts the U.S. Attorney's Office has a dollar limitation, which varies from district to district, that comprises part of the criteria in selecting a case for criminal prosecution. Nevertheless, those limitations cannot absolve the trustee from the statutory duty to make the referral. Often, even if the trustee's referral would not independently satisfy the criteria for criminal prosecution, the U.S. Attorney might already have an active investigation underway, and the trustee's referral leads to additional counts in an indictment or is used for historical purposes or at sentencing.

In cases involving Ponzi schemes, bleedouts, bustouts, mortgage fraud, tax fraud and even arson, trustees may work directly with agents from the Federal Bureau of Investigation, the Secret Service, the Department of Alcohol, Tobacco and Firearms, and the Internal Revenue Service, as well as Postal Inspectors, Assistant U.S. Attorneys, and attorneys with the Securities Exchange Commission and other government agencies.

Ponzi Schemes (Investor Fraud)

Ponzi schemes involve soliciting investments by promising returns or a rate well above the market rate (or in the Bernard Madoff situation, the same steady returns in good times and bad). Early investors recover their investments with a promised rate of return and encourage others to invest. As the scheme begins to crumble, investors are unable to recover their original investments and interest is no longer paid. Chapter 11 cases are filed to allow the debtor to continue the scheme. When the scheme collapses before bankruptcy, either a voluntary or involuntary case is filed. Trustees look for the promise of a very high return on an investment. Once it fails, many investors are reluctant to complain because they realize they have been duped. It is important that trustees identify and contact the investors, who are generally excellent witnesses.

Some Ponzi schemes have a real estate foundation. Limited partnership interests, mortgages or mortgage notes on residential property are sold to investors. The real estate securing the investment is insufficient to support the shares or interests sold. Additional funds are removed from the investment properties through large management and general partnership fees paid to insiders. Investments are comingled. Numerous and complex banking transactions make it nearly impossible to trace funds.

In *In re Plaza Mortgage & Finance Corp.,* 187 B.R. 37 (Bankr. N.D. Ga. 1995), an appropriate criminal referral was made and the principal of the debtor was prosecuted and convicted by the U.S. Attorney for the District of New Jersey. The Ponzi scheme investors had been the clients of the principal of the debtor who was their trusted, personal accountant for many years. For that reason, no due diligence was done by the investors prior to investing with him.

For Ponzi scheme referrals in cases, trustees work closely with federal law enforcement agents to supply information and background, but the investigative agencies do not share their information with the trustee. It is typically a one-way street. Most Ponzi schemes will meet the dollar thresholds and have a sufficient number of defrauded investors to result in a criminal prosecution. When these cases drift into the bankruptcy courts, there are usually bankruptcy crimes committed in addition to mail and wire fraud, tax fraud and state and federal theft violations. These other charges will be added to the indictment. The perpetrators of Ponzi schemes attempt to move on to other schemes as soon as the subject Ponzi scheme has collapsed. Protecting the public is another reason that the U.S. Attorney gives high priority to shutting down and prosecuting such individuals.

Bleedouts

Bleedouts usually involve an existing company and the depletion of assets over a relatively long period by insiders. There are often concealed assets or false statements in this situation. Longstanding owners or corporate raiders can be perpetrators of a bleedout. Examples include:

Insider sales. Under cover of a nonbankruptcy workout in which misrepresentations are made to creditors and the assets are sold to undisclosed insiders for inadequate consideration;

Corporate raider bleedouts. Where a stable company with very liquid assets is acquired in a leveraged buyout and is operated for the sole purpose of allowing the insiders to bleed the company. A chapter 11 is filed to allow the insiders to complete their scheme. Business transactions are complex and purposefully confusing, which makes fraudulent conveyance actions expensive and difficult to prove; and

Parallel entities. A frequent example includes a long-standing company that experiences financial problems. Insiders create a new business in the same industry (often with a similar name) just before or soon after the bankruptcy filing. In some cases, the debtor sells some of its assets to the new entity for a fraction of its value just before the bankruptcy or makes outright undisclosed transfers of those assets. The nondebtor entity is usually not disclosed. The insiders operate the debtor until they have successfully transferred the debtor's inventory, receivables, customers and goodwill to the new company. The insiders may use the debtor to purchase goods and services for the new company with the intent of never repaying the chapter 11 administrative creditors. Select vendors may be paid on a current basis and will continue to do business with the new company without realizing that it is a different company due to the similarity in names, business and principal officers. When the assets are depleted, the case is converted to chapter 7 and the case trustee has no assets from which to fund the necessary investigation, allowing the perpetrators to successfully defraud creditors.

In one such case, the business filing for bankruptcy was under the name of Fire Equipment Services Inc. The trustee was only able to find obsolete assets and virtually no receivables. The company bank account was overdrawn. On further investigation, it was discovered that the debtor had started a business under the name Fire Equipment Services Company with his mother listed as the principal officer and the only authorized signatory to the bank account. Phone calls to the debtor business were forwarded to the new business. The new business was capitalized with the accounts receivable of the debtor business that had been collected and deposited into the new company's account. The debtor company's inventory and functional equipment were also transferred into the new company. None of this was disclosed. The debtor's customers were unaware that they were dealing with a new business entity altogether. The foregoing is a typical example of a parallel entity bleedout. Appropriate criminal referrals were made.

Bustouts

Inventory bustouts. These typically involve using an existing company's credit to obtain any and all goods available on credit, without the intent to pay. A company will generally operate for a period of time and establish good credit ratings with large manufacturers. Orders increase suddenly, and payments are not made. Lulling techniques are used to forestall creditors. Goods are sold at below cost for cash, and bankruptcy is filed. Schedules show large trade debt owed to manufacturers with inventory unusually low compared to the date the debt was incurred, but the cash has already been diverted. An alternative is to hold on to the inventory and file for bankruptcy. The insider has personally guaranteed an inventory-secured loan. The increased inventory allows the insider to benefit by full payment on the loan the insider has guaranteed.

Credit card bustouts. This variation of bustout is generally found in individual cases. The trustee in reviewing the debtor's schedules will notice very little property but a tremendous amount of credit card debt. The trustee will inquire about the use of the credit cards and will typically receive a response that the debt was incurred in connection with undocumented gambling losses or "normal" living expenses. If the trustee requests the credit card statements going back several years, the trustee may discover that there were minimal gambling losses and that substantial amounts of personal property were acquired but not accounted for.

One referral on a substantial credit card bustout did result in a criminal indictment and conviction of the debtor for bankruptcy and credit card fraud. In another case, there were hundreds of thousands of dollars of credit card debt but virtually no personal-property assets. The debtor was vague and evasive when asked to explain what was acquired with so much credit and did not cooperate in producing the credit card records. The trustee determined that the debtor had used the credit cards to buy vehicles at auctions that he had shipped to a relative in Nigeria and then filed for bankruptcy to discharge the debts.

Mortgage Fraud

Mortgage fraud is defined as the intentional misstatement, misrepresentation or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase or to insure a mortgage loan. Since Georgia is one of the top 10 mortgage fraud states, the U.S. Attorney for the Northern District of Georgia has made prosecuting such crimes a high priority. Two Assistant U.S. Attorneys are assigned full time to prosecuting these crimes. Trustees work directly with them in making referrals and copy the U.S. Trustee on them. A number of these referrals have resulted in criminal prosecutions or lawyer disbarments, or were used as historical background in investigations and prosecutions. The referral can also overlap into other criminal violations. There are too many varieties of mortgage fraud to cover fully, but a few examples are discussed below.

Flipping. In one case, a residential real estate appraiser who filed for bankruptcy managed to commit bankruptcy, tax and mortgage fraud. Through a mortgage-flipping scam, the debtor had been involved in the sale of several properties for which she received net sale proceeds (according to the HUD-1 settlement statements for the various closings) of approximately $575,000. Only one of the sales was disclosed in the Statement of Financial Affairs. The state grantor/grantee deed index was checked, and other transactions were found. Debtors are required to produce their most recently filed income tax returns to the trustee. 11 U.S.C. §521(e)(2). The trustee was then able to see that debtor also failed to disclose these transactions and gains in the tax returns. A referral for mortgage, bankruptcy and tax fraud was made to the U.S. Trustee and the U.S. Attorney.

Straw buyer. When the debtor acts as a straw buyer, usually in a flipping transaction, although not disclosed in the HUD-1 settlement statement, the seller, coordinating broker or ringleader will kick back money to the debtor/buyer. The ringleader collects the rents if there is a tenant, but does not make more than a few mortgage payments, if any. In these cases, the debtor frequently receives very little compensation for the use (and destruction) of his or her credit, but the case trustee collects as much detail as possible, including the names and contact information of all the participants, obtains the closing documents and makes an appropriate referral for mortgage fraud.

As the gatekeeper, if the trustee does not make the determination that a crime has potentially been committed, the criminal activity is likely to go undetected. This highlights the importance of the role the trustee plays in the bankruptcy court system.

Phantom lien. Where the debtor acts as seller in a mortgage fraud, often the net sale proceeds that should have been paid to the debtor are diverted through phantom liens reflected on the HUD-1 settlement statement for home improvements that never occurred. Although these monies can often be recovered and utilized for the benefit of the bankruptcy estate's creditors, the case trustee makes the criminal referral as well.

Short sale. Most think of mortgage fraud as only involving the sale of properties at inflated prices. However, with the housing bubble bursting and the decline in home values, short-sale fraud has become just as prominent. Here, the short sale buyer and seller have persuaded the mortgage lender that the property is worth far less than it actually is with the result that a much smaller payoff is made at closing for release of the mortgage. The property is then quickly "flipped" for its fair-market value, enabling the parties to clear a substantial sum.

In one case, the parties persuaded the existing mortgage lender to accept a substantial reduction in its payoff in a short sale. The day after the closing, the buyer put the property under contract for $75,000 more and closed 30 days later on that sale. The documentation submitted to the lender was wholly fictitious, but the lender did no due diligence.

First-Time Homebuyer Tax Credit Fraud

One of the legislative initiatives of Congress in the aftermath of the burst of the housing bubble was to extend an $8,000 tax credit to first-time homebuyers. The Treasury Department has stated that at least 19,000 filers for this tax credit had not bought homes but claimed $139 million in tax credits and were reimbursed. An additional 74,000 tax credit claims, valued at $500 million, were awarded where evidence of previous homeownership would make the claims invalid. More than 500 people under the age of 18, including a 4-year-old, also had their names on applications for the credit.

The initial legislation had no minimum age requirement and required absolutely no documentation. Trustees are in a position to see not only the tax returns and whether such a credit was claimed, but when debtors actually purchased their homes and whether it was their first home. The IRS has made investigation and prosecution a high priority, and the trustee is in a position to facilitate these prosecutions. The IRS and the Justice Department are reportedly investigating more than 100 suspected criminal schemes involving tax return preparation services. Thus, even a single small referral by a trustee could be added to a larger investigation and prosecution that is costing taxpayers hundreds of millions of dollars.

Conclusion

The more prepared and educated the trustee is in discerning the *indicia* of a particular type of fraud and criminal activity, the better the trustee will be in policing the case and making the appropriate criminal referral. As the gatekeeper, if the trustee does not make the determination that a crime has potentially been committed, the criminal activity is likely to go undetected. This highlights the importance of the role the trustee plays in the bankruptcy court system. ■

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