COMMON BANKRUPTCY FRAUDS

Bankruptcy fraud generally occurs when an individual knowingly engages in prohibited conduct during the pendency of a bankruptcy proceeding with a fraudulent intent to defeat the bankruptcy laws. The following are some common bankruptcy schemes.

CONCEALED ASSETS

The most common type of bankruptcy fraud scheme involves the concealment of assets rightfully belonging to a debtor's estate to avoid forfeiting the assets in bankruptcy. In these schemes, concealed assets might include cash, consumer property, houses, and interests in partnerships and corporations, as well as lawsuits in which the debtor is a plaintiff. Concealed assets might also include the debtor's books and records.

FRAUDULENT CONVEYANCE

Debtors often attempt to conceal their assets by transferring the assets to individuals or companies. A transfer is a fraudulent conveyance if the purpose of the transfer is to hinder, delay or defraud a creditor. Many countries have laws that prohibit fraudulent conveyances. Depending on the law, a court or a bankruptcy trustee might have the power to set aside a fraudulent conveyance and seize the assets that were fraudulently conveyed.

PLANNED BUSTOUT

A bustout is a planned and fraudulent bankruptcy. It can take many different forms, but the basic approach is for an apparently legitimate business to order large quantities of inventory or other goods on credit, and then dispose of those goods through legitimate or illegitimate channels. Because the point of the bustout scheme is to quickly resell the goods for cash, the fraudster is likely to purchase more liquid items like inventory than real estate, insurance policies or services. The perpetrator then closes shop, absconding with the proceeds and leaving the suppliers unpaid. The debtor might then go into bankruptcy. Often, by this point the debtor has already made false accounting entries or taken other steps to conceal the assets or make the sales look legitimate. Other times, debtors simply flee the jurisdiction or don't show up at the proceedings.

Bustout schemes are planned and perpetrated by individuals both before and after the formation of new business entities. Here are additional characteristics of bustout schemes:

- Sometimes organized crime is involved.
- Credit is established with numerous vendors. Prompt payments are made to all vendors, and vendors feel comfortable in dealings, thereby extending existing credit lines.
- Perpetrators build inventory by ordering everything they can from vendors. They promise to pay soon and order more merchandise.
- Perpetrators sell out inventory at a deep discount or move it before vendors can take possession of it.

DETECTION

Here are some red flags that signal a bustout scheme might be in progress:

- A business relationship exists that's based principally on trust. Creditors are willing to offer extended terms for payment, hold checks or take postdated checks – all of which makes them vulnerable.
- The buyers have a history of purchasing goods for unreasonable discounts.
- The offending company has many bank accounts, which indicates a possible kiting scheme. ("Kiting" is the fraudulent use of a financial instrument to obtain additional credit that's not authorized. See "Kiting," by James Chen, Investopedia, Jan. 20, tinyurl.com/eext7j3w.) The perpetrator occasionally pays some creditors with funds generated by floating checks between bank accounts.
- Inexplicably large purchases of inventory or goods (e.g., perishable goods that couldn't likely be sold to customers before going bad) are made.

PREVENTION

To help prevent this type of bankruptcy fraud, lenders and suppliers should evaluate potential customers carefully before extending credit by performing due diligence and obtaining detailed background information. Lenders and suppliers should occasionally visit their customers' locations to verify businesses' legitimacy.

MULTIPLE FILINGS

Multiple filing schemes occur when the same debtor files for bankruptcy several times, using either false or real information, in several different jurisdictions. Generally, the debtor will make multiple filings to obtain automatic stays, which occur at the beginning of a bankruptcy proceeding and prevents creditors from continuing attempts to collect debts from the petitioner. The automatic stay occurs once the debtor files the initial bankruptcy petition. Usually, in these schemes the petitions are dismissed for failure to file the required statements or to appear for examination. False statements on petitions are common, including a denial that the debtor has filed any previous petition.

CREDIT CARD BUSTOUT

In a credit card bustout scheme, the debtor intentionally runs up several credit cards to their limits and files bankruptcy with no intent to repay. The credit card debts might include purchases for jewelry, luxury items or other personal property that aren't disclosed on the schedules. Credit card debt also might include large cash advances taken prior to filing the bankruptcy petition.

FORGED FILINGS

Fraudsters file bankruptcy petitions with forged documents and often with stolen identities – usually as part of a larger scheme. A debtor might also file for bankruptcy using a name obtained from obituary notices.

PETITION MILLS

These schemes involve companies that file bankruptcy petitions on behalf of others, typically low-income and unsuspecting clients. To obtain cooperation, they might promise to erase debtors' poor credit records or offer some other fake financial service. The filing entity often says it's a renter's rights group and hasn't told the "clients" how it will accomplish what it's promised. And, sometimes debtors aren't aware of the filings or the bankruptcies' effects on the debtors' credit ratings.

Petition mills might file false documents for debtors with deliberately wrong government identification numbers or other incorrect information. The petitions often contain numerous false statements.

Adapted from the ACFE *Fraud Examiners Manual*, Section 2: Law/Bankruptcy (Insolvency) Fraud/ Bankruptcy Schemes

