BANKRUPCTY FRAUD which lessened during the pandemic, could increase this year

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CHANGES IN U.S. STATUTES LOWER THE BAR FOR PROSECUTIONS

U.S. bankruptcies – and bankruptcy fraud – greatly decreased during the pandemic because of temporary lifelines. But as government stimulus, pliant lenders, and cheap and easy funding dissipates, we're seeing crimes rise. Changes in U.S. federal bankruptcy law could accelerate prosecution of bankruptcy fraud.

Just before he filed for Chapter 7 bankruptcy, Alan Russell Cook, the CEO of a private jet charter company, transferred $350,000 to his former girlfriend and had her open accounts in her name and in the name of a fake company to receive his personal property.

Yet he failed to tell creditors about this — or that his other bank accounts contained thousands of dollars in casino cash-outs — claiming that his company hadn't generated a penny since 2017. In December 2021, Cook was convicted of multiple fraud charges tied to the bankruptcy case after he discharged over $6 million in personal debt. (See "CEO of Private Jet Charter Company Convicted of Bankruptcy Fraud," the U.S. Department of Justice, Dec. 8, 2021, tinyurl.com/2ujujctx.)

Bankruptcies such as this may have fallen drastically in 2021, but the pace of Chapter 7 and 13 filings is expected to pick up in 2022 as lifelines for those struggling financially disappear.

During the pandemic many corporations have avoided seeking court settlements and stayed afloat thanks to government stimulus and pliant lenders, as well as easy and cheap funding in the capital markets. However, that could all change as states withdraw support, interest rates start to rise, and markets become tougher to access. (See "US corporate bankruptcy pace likely to speed up in 2022," S&P, Oct. 11, 2021, tinyurl.com/mbnezxmm and "'2022 could be the year of financial reckoning': Bankruptcies fell dramatically in 2021, but these challenges await," MarketWatch, Jan. 8, 2022, tinyurl.com/2p83rhky.)

The federal government helped fill the economic void for those Americans and businesses hit by the downturn following the outbreak of COVID with nearly $5 trillion in relief and stimulus packages. Additionally, eviction moratoriums kept citizens in their homes when they weren't able to pay the rent. However, most of those packages have expired. And many U.S. businesses are facing sink-or-swim situations.

Experts predict that 2022 may be the year of financial reckoning. "There are many forces that are pushing people to not file bankruptcy right now and definitely throughout 2021," said Professor Pamela Foohey, J.D., a consumer bankruptcy expert teaching at Yeshiva University's Benjamin N. Cardozo School of Law. "2022 could be the year of financial reckoning where people start having to pay more on their debts," Foohey said. (See the Jan. 8 MarketWatch article, tinyurl.com/2p83rhky.)

U.S. bankruptcy filings actually declined in 2021, primarily because of the government's intervention of financial aid extended to businesses and individuals. (See "Bankruptcy Filings Drop 24 Percent," United States Courts, Judiciary News, Feb. 4, tinyurl.com/mrrv7eck.) But the U.S. Supreme Court struck down the Center for Disease Control's evictions moratorium in August 2021, and mortgage interest rates have risen in 2022 — fulfilling Foohey's prediction about the cost of debt. Forbearance agreements (in which lenders agree to reduce mortgage payments — or even suspend them entirely) reached in 2020 and 2021 are expiring. Plus, courts have adapted to conditions COVID imposed on hearings and are now handling increasing caseloads. All signs point to an uptick in filings.

Against that backdrop, we'll describe various aspects of bankruptcy fraud, including "fraudulent transfers" and "constructive" fraud. We'll also discuss how U.S. states have changed the statutes for fraudulent transfers to "voidable transactions," which lowers the bar for investigators and lawyers to prosecute frauds.

WHAT IS BANKRUPTCY FRAUD?

If a person or business can't repay debts they owe to creditors, they may file for bankruptcy — or insolvency — to initiate a process to resolve those debts. Debtors' largest benefit, of course, is the potential to partially or fully discharge debts.

Bankruptcy fraud commonly takes four general forms:

1. A debtor conceals assets to avoid having to forfeit them. (Nearly 70% of all bankruptcy fraud involves concealment of assets.)
2. An individual intentionally files false or incomplete forms, including false information on a bankruptcy form that could constitute perjury.
3. An individual files multiple times using either false information or real information in several jurisdictions.
4. An individual bribes a court-appointed trustee.

Commonly the criminal commits one of these forms of fraud with another crime, such as identity theft, mortgage fraud, money laundering or public corruption. For any investigation into financial crimes, fraud investigators need to be able to consider the role bankruptcy might play if attempting to recover the victim's assets. Losses because of fraud might also cause a company or individual to file for bankruptcy, which could lead to an investigation into the source of the fraud. [See the ACFE *Fraud Examiners Manual*, Section 2: Law/Bankruptcy (Insolvency) Fraud, and "Bankruptcy fraud," Legal Information Institute, tinyurl.com/2p82tkx5.]

The opening case illustrates the most common type of bankruptcy fraud: concealed assets. The perpetrators carried out their crimes through what's called fraudulent conveyance or transfers — when a debtor transfers assets to hinder, delay or defraud a creditor. Other schemes, among others, include planned bustouts, multiple filings, credit card bustouts, forged filings, and typing services or petition mills. (See the sidebar on pages 56.)

UNDERSTANDING CHANGES IN BANKRUPTCY LAW

Fraud investigators are keenly aware that financial duress, such as what happened during the COVID health crisis, provides fertile soil for fraudsters. As *Fraud Magazine* has repeatedly reported, all three elements of Cressey's Fraud Triangle (perceived unshareable financial need, perceived opportunity and rationalization) are not only met, but enhanced during a time of financial crisis. (See ACFE.com/fraud-triangle.)

NAVIGATING BANKRUPTCY LAW

Federal bankruptcy law has been the roadmap for fraud investigators who've represented creditors, examiners and trustees for years. The Bankruptcy Code recognizes two types of fraudulent transfers: actual fraud and constructive fraud where intent to defraud is irrelevant to a case. These distinctions are important in light of recent changes to federal law that fraud investigation professionals need to understand. (See the Law Offices of Stimmel, Stimmel & Roeser, tinyurl.com/2p89nwuh.)

In 2014, the (U.S.) National Conference of Commissioners on Uniform State Laws approved a set of amendments (the "2014 Revision") to the Uniform Fraudulent Transfer Act (UFTA) in an effort to create uniform and more coherent rules around illicit transfers of assets during bankruptcy. It was retitled the Uniform Voidable Transaction Act (UVTA) and is now becoming the commonly used statute for addressing these issues. At that time, UVTA was adopted in nearly every state, except for Alaska, Kentucky, Louisiana, Maryland, New York, South Carolina and Virginia. Since then, almost half of the states have adopted the 2014 Revision (or a modified version), and two additional states — Massachusetts and North Carolina — have introduced bills to enact the 2014 Revision. [See "Uniform Voidable Transitions Act (Formerly Uniform Fraudulent Transfer Act As Amended in 2014)," National Conference of Commissioners on Uniform State Laws, tinyurl.com/2p9k25de.]

There are several differences between the UFTA and the UVTA. First, "transfer" is replaced by "transaction" to correctly indicate that the act applies not only to transfers of property but also to the incurrence of obligations that are voidable under the act.

Second, the UVTA contains a clear choice-of-law provision (UVTA § 10) that clarifies which jurisdiction's laws apply to voidable transfers. The newly added section now explains that the applicable law for a voidable transaction claim is the law of the jurisdiction where the debtor is located at the time of the transfer or obligation [UVTA § 10 (b)]. This is important as it helps avoid

any disputes over which governing law to use, especially when different jurisdictions are involved.

Third, UVTA lowers the burden of proof for a creditor challenging a debtor's transfer of assets. Under the new rules, a creditor only needs a preponderance of evidence for all claims rather than clear and convincing evidence, which applies to proving common-law fraud. (See "Clear and Convincing Evidence Standard," LegalMatch, tinyurl.com/bdz9rh7r.)

Fourth, "fraudulent" is replaced by "voidable" to clarify that actual fraud isn't the only reason to void such a transfer. Language in state statutes often describe fraudulent conveyance as an "actual intent to hinder, delay, or defraud." This wording dates back to England's Fraudulence Conveyance Act of 1571 but has less relevance to modern-day civil cases and has led some to misunderstand that the law requires proof of fraudulent intent. (See "Fraudulent Transfers And The Statute of 13 Elizabeth Translated To Contemporary Legal English," by Jay Adkisson, Forbes, July 8, 2019, tinyurl.com/97sfb4n6.)

This new nomenclature makes sense. That's because these cases often don't involve actual fraud but rather a debtor placing assets farther from the reach of creditors through what's called constructive fraud. Courts deem it to be constructive fraud when the debtor received less than "reasonably equivalent value" in the exchange and was already insolvent or became insolvent as a result of the transaction. Bad intent or dishonesty aren't requirements for constructive fraud. (See "What You Need to Know About the Uniform Voidable Transactions Act," by Lawrence Peitzman, Orrick, Sept. 16, 2015, tinyurl.com/2ebrbhw9 and "The 2014 Amendments to the Uniform Fraudulent Transfer Act: Preparing for the New Rules," by Professor Kenneth C. Kettering and Edwin E. Smith, Strafford, Dec. 9, 2014, tinyurl.com/y628ve28.)

CONSTRUCTIVE FRAUD ... OR NOT

However, determining "reasonably equivalent value" can prove tricky, including whether indirect benefits to another party constitute value or not. The bankruptcy case of Steven and Lori Palladino, who went to prison for running a multimillion-dollar Ponzi scheme, and their victims' efforts to claw back their losses, is instructive.

In 2016, bankruptcy trustee, Mark DeGiacomo, filed a complaint against Sacred Heart University to recover about $65,000 that the Palladinos had paid for their 18-year-old daughter's tuition, arguing that this was a fraudulent transfer based on both actual intent to defraud and constructive fraud. The bankruptcy judge dismissed the actual fraud claim after determining that there was no proof that the Palladinos had intentionally paid the tuition to scam its creditors. As for constructive fraud, the court ruled in favor of the university, reasoning that earning a degree enhances the "financial well-being" of the child and in turn the parents. In other words, there was quid pro quo that constituted "reasonably equivalent value." [See "DeGiacomo v. Sacred Heart Univ., Inc. (In re Palladino), Opinion, casetext, Sept. 10, 2016, tinyurl.com/yc3kce8j and "Sacred Heart University Dodges Fraudulent Transfer Claim For Tuition Paid In Palladino," by Jay Adkisson, Forbes, Aug. 22, 2016, tinyurl.com/3cftk6jm.]

In November 2019, however, the First Circuit Court of Appeals reversed that decision, and held that the Palladinos received no value by paying for tuition as they were under no legal obligation to cover the college costs of their adult child. [Courts have ruled differently for minors. See "Robert L. Geltzer of the Estate of Michel v. Academy (In re Michel)," Opinion, casetext, Sept. 18, 2017, tinyurl.com/yc3yecrt.] The court also noted that the purpose of fraudulent transfer provisions in the Bankruptcy Code was "to preserve the debtor's estate for the benefit of unsecured creditors" and that "tuition payments here depleted the estate and furnished nothing of direct value to the creditors." [See "DeGiacomo v. Sacred Heart Univ., Inc. (In re Palladino), casetext, Nov. 12, 2019, tinyurl.com/96xs6msn and "In Re Palladino (1s Cir)," Corey R. Weber, Brutzkus Gubner Rozansky Seror Weber, through California Lawyers Association, tinyurl.com/mr3be53a.]

Here are some other points and rulings to consider when assessing value in constructive fraud cases:

1. Exact equality in value exchanged isn't required for reasonable equivalence, but the value exchanged should be "approximately equivalent" or "roughly equivalent" and not "disproportionately small." (See "In re Churchill Mortg. Inv. Corp.," casetext, Dec. 26, 2000, tinyurl.com/bdet8bpt.)

2. The determination of reasonable equivalence is calculated on the date of transaction. Hindsight can't be used in deciding objective value even if the transaction may have been unwise or caused harm to the debtor. (See "In re Treasure Valley Opportunities," Opinion, casetext, April 1, 1994, tinyurl.com/2p982mhj and "In re Lindell," Opinion, casetext, Sept. 29, 2005, tinyurl.com/528xzhzv.)

3. Reasonably equivalent value can be non-monetary. [See "Weinman v. Walker (In re Adam Aircraft Indus., Inc.)," Opinion, casetext, Oct. 15, 2005, tinyurl.com/z6rbm7yv.]

THE SOLVENCY TEST

This brings us to the other yardstick used to define constructive fraud: whether the debtor was already insolvent or became insolvent as a result of the transaction. Three tests in such cases determine "solvency." First is the "balance sheet" test. Most entities are considered "insolvent" if the company's liabilities exceed its assets at a "fair valuation" at the time of the challenged transaction. Generally, the "fair value" of an asset is the amount a reasonable, informed buyer and seller would exchange the asset for within a reasonable period. [See "11 U.S. Code § 548 - Fraudulent transfers and obligations," Legal Information Institute (LII), tinyurl.com/yc8jw39z; 11 U.S. Code § 101 – Definitions," LII, tinyurl.com/2p8apbd5; and "In re O'Neill Enterprises, Inc.," casetext, March 14, 1973, tinyurl.com/3722jwt5.]

The second test is "cash flow," also described as the "inability to pay debts as they become due." This depends on whether the debtor intended or believed that it would incur debts beyond its ability to pay as they become due. [See "11 U.S. Code § 548 - Fraudulent transfers and obligations," LLI, tinyurl.com/yc8jw39z and "Paloian v. LaSalle Bank Nat'l Ass'n (In re Doctors Hosp. of Hyde Park, Inc."), Opinion, casetext, tinyurl.com/2p9c88mv.]

The third, and lesser-used, test is when a transaction can be voided if the debtor is left with "unreasonably small capital." In other words, the

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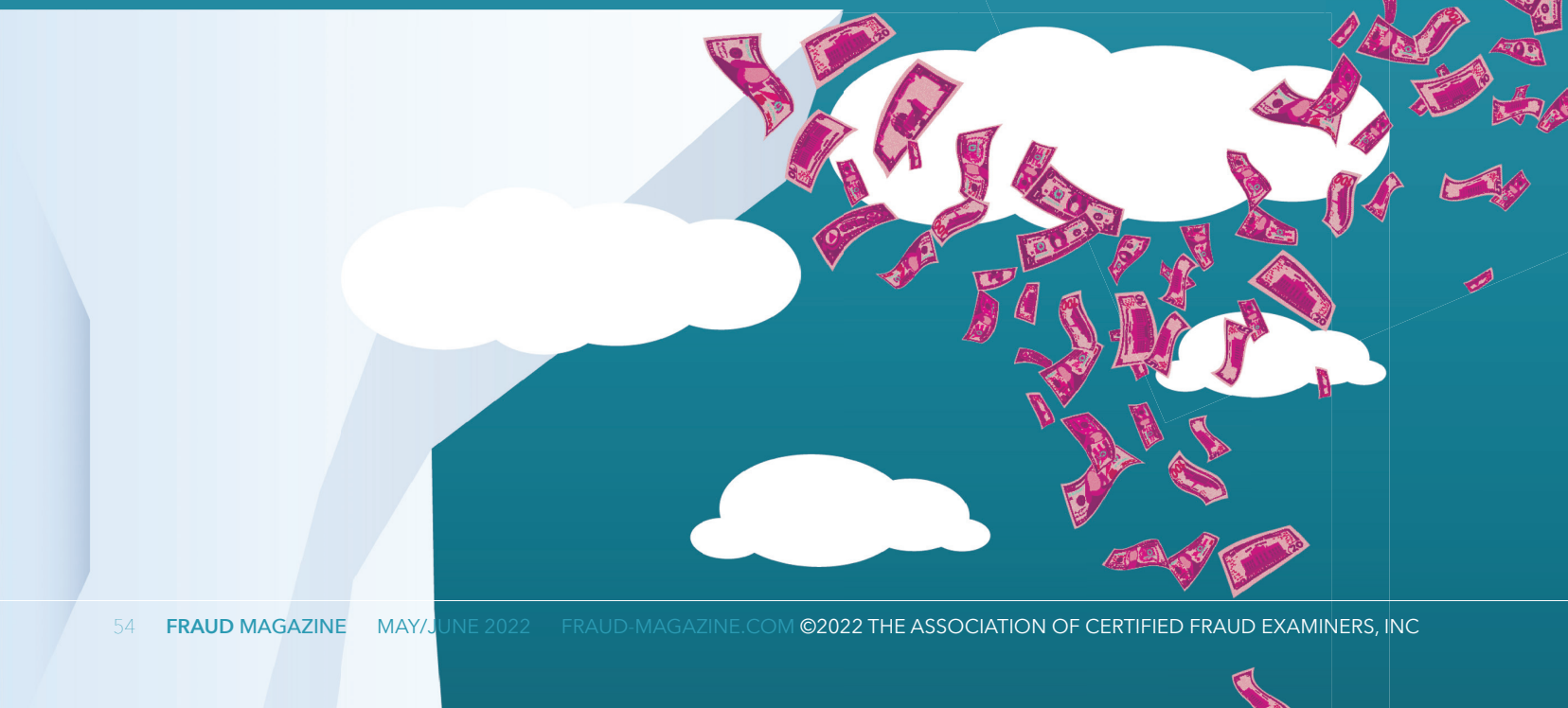

company is unable to generate enough cash flow to sustain operations after the exchange. Technically it may be solvent, but it's doomed to fail. [See "11 U.S. Code § 548 - Fraudulent transfers and obligations," LLI; "Mukamal v. Nat'l Christian Charitable Found., Inc. (In re Palm Beach Fin. Partners, L.P.), Opinion, casetext, March 20, 2019, tinyurl.com/tufmjsc7; and "Kipperman v. Onex Corp.," Opinion, casetext, Aug. 13, 2009, tinyurl.com/stkm2cks.]

ESOTERIC LAWS MADE ALIVE

Here are some real-life applications of changes in bankruptcy laws that place these concepts into context. When C.F. Foods filed for involuntary Chapter 7 bankruptcy, a trustee presented proof of constructive fraud through testimony of a certified public accountant who reviewed and analyzed the debtor's books and records as well as other financial documents obtained from third-party sources. The court held that the trustee proved that the debtor didn't receive "reasonably equivalent value" for the transfers, which were donations to Campus Crusade for Christ, now known as Cru. (See "In re C.F. Foods," Opinion, casetext, July 3, 2002, tinyurl.com/mr5y89wu.)

As to insolvency, it was demonstrated that the debtor fabricated business records and the debtor's operations were nothing more than a Ponzi scheme. The court found that: (1) the trustee demonstrated insolvency under the "unreasonably small capital" test because the debtor's ability to generate cash flow to pay its liabilities came only from the continuation of the fraudulent scheme, and therefore the operation could never be sustainable, and (2) the trustee also demonstrated insolvency under the cash-flow test because the operation of a Ponzi scheme in itself showed an intent to incur debts beyond the debtor's ability to pay as they became due since an eventual collapse was inevitable.

In another case, the bankruptcy trustee moved to avoid — as constructively fraudulent — a transfer of an interest in real property to the debtors' mother nine months before the bankruptcy. "Reasonably equivalent value" wasn't met because no benefit was provided to the debtors in exchange for the transaction. Both sides introduced balance sheets. The defendants introduced one that supposedly demonstrated solvency, which one of the debtors and a bank loan officer created just six days prior to the transaction. In contrast, the trustee introduced a balance sheet that took into consideration the debtors' tax returns and bankruptcy schedules, which demonstrated a negative net worth. The court ultimately held, based on the evidence, that the value stated on the defendants' balance sheet was overstated, and the debtors were insolvent as of the date of the transfer. (See "In re Steven Eubanks and Jeania Eubanks," Opinion, casetext, Dec. 29, 2020, tinyurl.com/37eszwfa.)

Most famous and infamous bankruptcy fraud cases are classic examples of actual fraud. Business publications and tabloids are filled with examples of celebrities, athletes, musicians and reality show stars who hide assets from creditors. Few question the intent behind their actions; the facts normally are clear that assets were transferred to "hinder, delay, or defraud" creditors from collecting their due. Constructive fraud, while possibly less salacious in nature, has equal economic impact and requires the right sets of skills to effectively prosecute.

Fraud investigators, of course, can't accurately predict the future, but the signs are pointing to increased bankruptcy filings, which will undoubtedly lead to increased bankruptcy fraud — and more opportunities for anti-fraud professionals. Familiarization with basic valuation techniques and knowledge of the governing laws can lead to an entirely new field of focus for fraud investigators. ■ FM

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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

