

## **HOW TO KEEP YOUR CLIENTS *AND YOU* FROM BECOMING ENFORCEMENT TARGETS**

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Attorneys who practice bankruptcy law in Maryland with some regularity may have noticed an increase in activity and involvement by the U.S. Trustee in certain aspects of the bankruptcy process. More cases are being reviewed for substantial abuse. U.S. Trustee attorneys are attending more Section 341 Meetings and asking questions regarding a debtor's identity, petition preparers, transfers of assets, or amounts paid to attorneys. U.S. Trustee attorneys are in court more frequently arguing such matters as objections to discharge or fee disgorgement actions. These actions on the part of the U.S. Trustee are all signs that the U.S. Trustee's Civil Enforcement Initiative is getting into full swing both here in Maryland and nationally.

The term "civil enforcement" in the bankruptcy context refers primarily to efforts and mechanisms aimed at curbing abuse of the bankruptcy system. Although civil enforcement efforts and mechanisms have been around as long as the Bankruptcy Code and the United States Trustee Program, civil enforcement has recently become the clear number one priority for the United States Trustees. On October 30, 2001, the U.S. Trustee Program publicly announced its new Civil Enforcement Initiative and reported that the U.S. Trustees would more aggressively use existing civil enforcement methods to address fraud and abuse of the bankruptcy system. This shift in focus appears to stem in part from a recognition that if the U.S. Trustee Program is provided with sufficient resources to enforce current laws aggressively, the U.S. Trustees can significantly reduce many of the abuses that plague the system today - many of the same abuses that have been the driving force behind Congress' recent efforts to overhaul the Bankruptcy Code.

Due to the intensity and scope of the U.S. Trustee's Civil Enforcement Initiative, it is likely to have some impact on almost everyone who practices bankruptcy law. The primary purpose of this article is to provide a brief overview of what the United States Trustee's new Civil Enforcement Initiative is and offer some general guidance on how to keep your clients and yourself from becoming civil enforcement targets.

### **I. The U.S. Trustee's Current Civil Enforcement Priorities**

Immediately after being appointed as the new Director of the U.S. Trustee Program earlier this year, Lawrence Friedman noted that addressing fraud and abuse in the bankruptcy system is one of his primary mandates from the Attorney General. In an October 30, 2001 press release, then Acting (now Deputy) Director Martha Davis identified the following specific priorities of the U.S. Trustee's Civil Enforcement Initiative:

- Ensuring that Chapter 7 is not abused and that Chapter 7 debtors are held accountable;-
- Protecting consumer debtors, creditors, and others who are victimized by those who mislead or misinform debtors, make false representations in connection with a bankruptcy case, or otherwise abuse the bankruptcy process;
- Ensuring that Chapter 11 debtors proceed with their cases promptly, and are informed of and held to account for their obligations under the Bankruptcy Code; and
- Fighting fraud and abuse by making criminal referrals and assisting the United States Attorneys in criminal prosecutions.

In order to meet these priorities, the U.S. Trustee's offices in Maryland have employed a number of techniques to identify abusive cases which include, among other items, a random

screening of cases filed, a random review of Section 341 Meeting testimony, and a renewed emphasis on referrals by case trustees or other parties in interest concerning suspicious activity in a case.

## **II. How To Keep Your Clients From Becoming An Enforcement Target**

One of the main keys to helping your client avoid becoming an enforcement target is to be intimately familiar with the sections of the Bankruptcy Code that contain the most important civil enforcement remedies and the case law that has developed under these sections. It is also prudent to have reasonable familiarity with the bankruptcy crimes provisions located at 18 U.S.C. § 151 *et seq.*

### **i.) Dismissal For Substantial Abuse - 11 U.S.C. § 707(b).**

One of the most commonly utilized civil enforcement sections of the Bankruptcy Code is 11 U.S.C. § 707(b). Section 707(b) provides that the court “may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. . . .” What constitutes “substantial abuse” is not defined by the Bankruptcy Code but, rather, has been left to the courts to sort out. The controlling case in the Fourth Circuit on dismissal for substantial abuse is Green v. Staples (In re Green), 934 F.2d 568 (4<sup>th</sup> Cir. 1991). In Green, the Fourth Circuit rejected the argument that a debtor's ability to repay debts, by itself, constituted grounds for dismissing a case as substantial abuse of Chapter 7. Instead, the Fourth Circuit found that in order to determine whether a case should be dismissed for substantial abuse a court must apply a “totality of the circumstances test” which involves a consideration of the debtor's ability to repay debts and factors such as the following: “(1) Whether the bankruptcy petition was filed because of sudden illness,

calamity, disability, or unemployment; (2) Whether the debtor incurred cash advances and made consumer purchases far in excess of his ability to repay; (3) Whether the debtor's proposed family budget is excessive or unreasonable; (4) Whether the debtor's schedules and statement of current income and expenses reasonably and accurately reflect the [debtor's] true financial condition; and (5) Whether the petition was filed in good faith.” Id. at 572.

Although the Fourth Circuit in Green established that the ability of a debtor to repay debts is not the only factor in considering whether a case constitutes a substantial abuse of the provisions of Chapter 7, it did hold that ability to repay is one of the primary factors to be considered. Id.; In re Dominguez, 166 B.R. 66, 68 (Bankr. E.D.N.C. 1994); In re Smurthwaite, 149 B.R. 409, 410 (Bankr. N.D.W.VA. 1992). In several recent bankruptcy cases in the Fourth Circuit, however, the ability to repay has morphed its way into *the* primary factor to be considered under a substantial abuse analysis. In re Schmonsees, 2001 WL 1699664, \*2 (Bankr. M.D.N.C. 2001); In re Rodriguez, 228 B.R. 601, 603 (Bankr. W.D.VA. 1999); In re Norris, 225 B.R. 329, 332 (Bankr. E.D.VA. 1998).

Because a debtor's ability to repay debts is rather easy to determine from the debtor's statements and schedules (assuming they are complete and accurate as required), any debtor who files a petition with sufficient disposable income (or unnecessary expenses which if subtracted will yield disposable income) to fund a modest payment under a Chapter 13 plan faces a very good possibility that such a case will be identified as a potential substantial abuse case and will receive a full review by the U.S. Trustee. Although mere identification of a case as a possible substantial abuse case certainly does not mean that the court will ultimately dismiss the case, a substantial abuse review can be costly to all involved. Even if the debtor decides to convert the case to Chapter 13 to avoid dismissal, the conversion process and the additional creditors' meeting will necessitate

additional time and fees that would not have been required had the case been filed as a Chapter 13 case at the outset. In addition, once a substantial abuse case is converted to Chapter 13, it is likely that the U.S. Trustee's office will monitor the case closely to ensure that the debtor is complying with all the requirements of Chapter 13. If the case is ultimately dismissed for substantial abuse, the debtor will have endured many of the burdens of a bankruptcy case without its ultimate benefit - a discharge. A debtor whose case has been so dismissed may be able to discharge debts in a subsequent bankruptcy case. But see Kestell v. Kestell (In re Kestell), 99 F.3d 146 (4<sup>th</sup> Cir. 1996) (finding of substantial abuse under Section 707(b) used to affirm order denying debtor a discharge under Section 727). However, unless the debtor's circumstances change significantly, the debtor is likely to have no practical choice but to file under Chapter 13; and even then the debtor will have wasted significant time (in some cases up to a year), attorneys' fees, and the effort it took to file the Chapter 7 case with no results.

Accordingly, when advising a prospective bankruptcy client on his options, it is very important to thoroughly examine the client's budget to determine whether the case may constitute substantial abuse if filed under Chapter 7. Because gathering income and expense information should be one of the very first things a consumer practitioner does when meeting with a potential bankruptcy client, this information should be available early on in the consultation process. Although the vast majority of debtors' attorneys have a good understanding of their clients' budgets well before advising them on their bankruptcy options, it is unfortunately not uncommon in the Section 341 Meeting rooms in Maryland to witness a debtor's attorney reviewing the debtor's budget, specifically the debtor's payroll deductions and alleged expenses, with the client for the first time while the client is under oath at a Meeting of Creditors.

Although determining disposable income is vitally important from a substantial abuse standpoint, it should not be the end of the inquiry; rather, it should be the starting point. Certain expense items which appear unreasonably high or unnecessary, as well as bad faith and other fraudulent or abusive behavior, are likely to trigger a review of the case.

A few examples of the types of expenses that may attract attention are payments for expensive automobiles, contributions to 401k or similar retirement plans, mortgage payments on expensive homes or vacation property, and excessive entertainment expenses. Alternatively, a common mistake is for counsel and debtors to fail to list actual, necessary expenses on the expense statement. Nothing is more wasteful and frustrating to all involved in a substantial abuse inquiry than for the debtors to finally disclose for the first time, months after the case was filed, that they have additional, necessary, monthly expenses which, when added into expenses, eliminate any disposable income.

Counsel should be very careful about how they advise their clients regarding disposable income. The safest method for all involved is for the attorney to first gather the income and expense information, ensure that it is accurate and complete, and then discuss its impact. Gathering budget information in this manner makes it less likely that a client will inadvertently be coached to list fraudulent budget numbers to eliminate disposable income - a practice which will expose the debtor not only to a substantial abuse motion, but to an objection to discharge under 11 U.S.C. § 727(a)(4) and criminal prosecution under 18 U.S.C. § 152(2) for knowingly making a false oath. Counseling a client in the manner suggested herein also prevents an allegation by the client that the attorney told the client to fudge the budget to reduce disposable income.

If, after the attorney has gotten a clear picture of the client's budget figures, there appears to

be sufficient disposable income to fund a modest Chapter 13 plan, the attorney should then review the balance of the “totality of the circumstances” factors set forth in Green. If the client needs to file bankruptcy simply because he incurred consumer debt in excess of his ability to repay, then it is likely that such a case will also fail the first (filing due to sudden calamity), second (consumer purchases in excess of ability to pay), and possibly the third (unreasonable family budget) Green factors. Even if the case was filed in good faith, recent bankruptcy court cases indicate that cases resulting only from a debtor's over extension of credit likely will be found to be a substantial abuse. See e.g., In re Reading, 2001 WL 1700148 (Bankr. M.D.N.C. 2001); In re Schmonsees, 2001 WL 1699664 (Bankr.M.D.N.C. 2001); In re Norris, 225 B.R. 329 (Bankr. E.D.VA. 1998). If the case involves prepetition bad faith or fraudulent conduct on the part of the debtor, then counsel should seriously consider counseling such a client to file a Chapter 13 to avoid the substantial abuse objection that the U.S. Trustee will almost certainly file.

**ii.) Dismissal For Cause - 11 U.S.C. § 707(a).**

Section 707(a) serves as safety net for abuse cases that might not otherwise fall squarely within the ambit of the other civil enforcement sections of the Bankruptcy Code. Section 707(a) provides that the bankruptcy court may dismiss a case for cause. The section lists three examples of “cause” for dismissal including: unreasonable delay by the debtor, nonpayment of statutory fees, and the failure of the debtor to file the required schedules and statements. The three examples of cause for dismissal under Section 707(a) are, however, not all-inclusive. The Third, Sixth and Eighth Circuits have held that bad faith on the part of a debtor is grounds for dismissal. In re Tamecki, 229 F.3d 205 (3<sup>d</sup> Cir. 2000); In re Huckfeldt, 39 F.3d 829 (8<sup>th</sup> Cir. 1994); In re Zick, 931 F.2d 1124 (6<sup>th</sup> Cir. 1991). The Ninth Circuit, on the other hand, has found that Chapter 7 has no

explicit good faith requirement and, thus, that bad faith cannot constitute cause for dismissal under Section 707(a). In re Padilla, 222 F.3d 1184 (9<sup>th</sup> Cir. 2000). Although the Fourth Circuit has not published any cases discussing dismissal of a case for bad faith pursuant to Section 707(a), the Fourth Circuit has made it clear that there is a good faith component to Chapter 7 and that such a requirement “prevents abuse of the bankruptcy process by debtors whose overriding motive is to delay creditors without benefitting them in any way or to achieve reprehensible purposes.” Kestell, 99 F.3d at 147. Thus, if you have a client whose use of the bankruptcy code to discharge debts would be antithetical to the fundamental bankruptcy principal that a discharge is designed to give honest debtors a fresh start not a head start, then you should consider whether your client will have to defend a motion to dismiss under Section 707(a) if the client files Chapter 7.

The flip side of the Section 707(a) analysis is when a debtor realizes he is a civil enforcement target and tries to avoid the civil action by filing a motion to dismiss. Beware, however, that there is no absolute right to dismiss a Chapter 7 case. In re Payne, 240 B.R. 688 (Bankr. D.Md. 1999). If a party in interest, such as the Chapter 7 trustee or the U.S. Trustee, objects to a debtor's motion to dismiss, it may be difficult for the debtor to get out of bankruptcy. Id.

### **iii.) Denial of Discharge - 11 U.S.C. § 727.**

Before an attorney recommends a Chapter 7 bankruptcy case to a client, the attorney should have questioned the client thoroughly to make certain that the client has not engaged in any activity that would constitute grounds for the denial of the client's discharge pursuant to 11 U.S.C. § 727. There is no worse civil outcome for a bankruptcy debtor than to have his discharge denied pursuant to Section 727. He will have incurred all the burdens of a bankruptcy case - the cost and time associated with filing, poor credit for up to ten years and, possibly, the liquidation and sale of

nonexempt assets, without receiving the ultimate bankruptcy goal: a discharge. If an attorney does a good job of spotting possible Section 727 issues in a case, not only will the attorney be in a good position to help a client avoid the disastrous civil consequences of being denied a discharge, but the attorney may also be able to help the client avoid being charged with a bankruptcy crime because the same conduct which gives rise to a Section 727 action may also constitute a bankruptcy crime.

#### **iv.) Bankruptcy Crimes**

The bankruptcy crimes section of the U.S. Code, 18 U.S.C. § 151 *et seq.*, is very short and relatively straight-forward. Therefore, anyone practicing bankruptcy law should have a basic understanding of the types of conduct that will constitute a bankruptcy crime. Although all of the bankruptcy crimes provisions are important, two of the most important sections for attorneys representing debtors are Sections 152 and 157. Section 152 contains a list of nine types of behavior in connection with a bankruptcy case that constitute crimes. Many of the nine categories cover such behavior as knowingly and fraudulently concealing property of the estate, making a false oath in connection with a case, and transferring property with the intent to conceal it. Section 157, which was added to the U.S. Code in 1994, is one of the broadest of all the bankruptcy crimes provisions. Section 157 provides generally that any person who, having devised a scheme or artifice to defraud and for the purpose of executing or concealing such scheme or artifice, files a petition, files a document, or makes a fraudulent representation in connection with a bankruptcy proceeding shall be fined, imprisoned not more than 5 years, or both. The language of Section 157 is so broad that it covers almost any act involving fraud in connection with a bankruptcy, regardless of whether it is prepetition or postpetition fraud.

### **III. How To Keep Yourself From Becoming An Enforcement Target**

If you are reading this article, the chances are that you will never be the subject of a civil enforcement action because you, like the vast majority of bankruptcy practitioners, do an outstanding job representing your clients and invariably comply with all required procedural rules. However, it can never hurt to be informed about some of the areas of practice that trustees and the U.S. Trustee consider to be primary areas of concern from a civil enforcement standpoint.

**i.) Required Fee Disclosures**

The attorney fee disclosure requirements contained in the Bankruptcy Code and the Bankruptcy Rules are relatively straightforward. Bankruptcy Code Section 329(a) and Bankruptcy Rule 2016(b) together provide that attorneys representing debtors in connection with a bankruptcy case must, within 15 days after a case is filed, file with the court and serve on the U.S. Trustee a statement disclosing the “compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition.” Section 329(a) also requires that the source of the compensation be disclosed. Accordingly, if a third party pays any portion of the attorney fees, the payment and the source of payment must be included in the fee disclosure. Rule 2016(b) also requires attorneys to disclose whether they have agreed to share their compensation with any other entity, but does not require disclosure of the details of any agreement for the sharing of compensation with a member or regular associate of the attorney’s law firm. Finally, Rule 2016(b) requires that a supplemental statement complying with Section 329 and Rule 2016 must be filed with the court and a copy transmitted to the U.S. Trustee within 15 days after any payment or agreement not previously disclosed.

Because the attorney fee disclosure requirements are viewed as vitally important to protect the debtors and the bankruptcy process, any attorney who fails to make the full, accurate, and timely

fee disclosures required by the Code and Rules runs the risk that the bankruptcy court will order disgorgement of the entire fee received in the case. See e.g., Law Office of Nicholas A. Franke v. U.S. Trustee (In re Lewis), 113 F.3d 1040, 1045 (9<sup>th</sup> Cir. 1997); Hale v. U.S. Trustee (In re Basham), 208 B.R. 926, 930 (9<sup>th</sup> Cir. BAP 1997); In re Woodward, 229 B.R. 468, 473 (Bankr. N.D.Okla. 1999). Because of the importance of accurate and timely fee disclosures, even a negligent or inadvertent non-disclosure may result in denial of all fees. Law Office of Nicholas A. Franke, 113 F.3d 1040. Moreover, the court may order disgorgement regardless of whether any harm has been done to the estate as a result of the non-disclosure. Woodward, 229 B.R. 468; In re Saturley, 131 B.R. 509, 517 (Bankr. D.Me. 1991).

The risks associated with inadequate fee disclosures are so great that debtors' attorneys should take great care to ensure that they comply with the requirements of Section 329 and Rule 2016 by clearly and unambiguously disclosing all fees received and all agreements for the payment of fees. If doubt ever arises as to whether a fee or fee agreement should be disclosed, that doubt should always be resolved in favor of disclosure. If a fee agreement includes a limitation on the scope of representation, the limitation should be clearly spelled out in the fee disclosure. Moreover, counsel should be certain that any limitation of representation complies with Maryland Local Bankruptcy Rule 9010-5, which governs the scope of a debtor's attorney's duties. One of the most common fee disclosure mistakes is the failure to file an amended disclosure when additional fees are received from a debtor after the filing of the initial fee disclosure. Even if the initial fee disclosure sets forth the rates for certain post-petition work (e.g., defending lift stay motions), if that work is performed and an additional fee is received, that fee must be disclosed in an amended fee disclosure statement.

Although proper disclosure of all fees and agreements for fees does not guarantee that the U.S. Trustee and/or the court will not examine the amount of the fees for reasonableness, pursuant to Section 329 and Rule 2017, it does ensure that fees will not be at risk due merely to inadequate disclosure.

## **ii.) Inadequate Services**

Unfortunately, over the past several years there has been a noticeable decline in the quality of services provided by a small number of “repeat offender” bankruptcy practitioners. To the extent the services provided by a debtor's attorney are not adequate, the U.S. Trustee likely will take action under Section 329(b) to seek a reduction or complete disgorgement of the attorney's fee. The most common area of concern involves sloppy, incomplete, or inaccurate schedules and statements. When incomplete or inaccurate schedules and statements are filed, it undermines the entire bankruptcy process. Consequently, this is a primary area of inquiry for the U.S. Trustee. One way debtor's counsel can avoid criticism for sloppy schedules and statements is to make certain that the intake documents and consultation process clearly evidence that any problems with the documents were not counsel's fault. Some of the other most common areas of concern are:

- Failing to sufficiently advise clients on their obligation to bring certain documents to the Section 341 Meeting of Creditors;
- Failing to sufficiently advise clients regarding the documents that are being filed on the clients' behalf; and
- Failing to provide sufficient personal consultation with the client (as opposed to having a paralegal conduct all in-person interviews with the client).

Although this is by no means a complete list of the problems which may attract a civil

enforcement review, these are likely to remain high civil enforcement priorities for the foreseeable future.

#### **IV. Conclusion**

Civil enforcement is not new in bankruptcy, but it is, without doubt, now bigger than ever. I am optimistic that the new focus on civil enforcement in bankruptcy will help enhance the image of an often criticized bankruptcy system - a system which is truly capable of providing the honest debtor a needed fresh start while preventing the non-deserving debtor from getting an unfair head start at great expense to others.