

## **Strong Internal Controls are Essential to Protection of Bankruptcy Estate Assets**

by

Suzanne Hazard, Deputy Assistant Director, Chapter 7 Oversight  
Executive Office for U.S. Trustees<sup>1</sup>

Chapter 9 of the *Handbook for Chapter 7 Trustees* discusses the internal controls that chapter 7 trustees must implement for their bankruptcy operations. The purpose of the internal control system described in the *Handbook* is to safeguard bankruptcy estate assets. A strong internal control environment will detect, deter and prevent defalcations; ensure that funds are properly accounted for; and provide accurate and reliable record keeping and reporting. In this article we review the internal controls that trustees are responsible for implementing, as well as the benefits of those controls.

### *Detect, Deter and Prevent Defalcations*

No one wants to discover that funds have been stolen from a bankruptcy estate. Yet, it can happen. The methods include: the direct theft of incoming receipts such as cash, money orders and checks returned by creditors for insufficient address, or more elaborate schemes such as changing a claimant's address and diverting estate funds to an account or address controlled by the perpetrator, or re-issuing stale creditor checks and forging the trustee's signature on them. These schemes can involve the use of falsified bank statements and altered records to hide the embezzlement.

You, as chapter 7 trustee, are the chief internal control for detecting, deterring and preventing these acts by personally performing the following important tasks: closely supervising your employees and independent contractors; obtaining and reviewing bank statements for unauthorized transactions; establishing procedures for handling stale and returned checks; ensuring that the person who opens the mail also logs and endorses incoming chapter 7 receipts; and refraining from commingling estate funds. These essential tasks are discussed below.

Your close supervision of the employees and independent contractors who work for your trustee operation acts as a fraud deterrent measure. It also ensures that errors are caught and corrected quickly and increases the likelihood that defalcations, if they occur, are uncovered and stopped as promptly as possible.

Obtaining bank statements sealed in their envelopes and personally reviewing them along with the check images allows you to immediately identify unauthorized transactions such as transfers and checks you did not initiate or approve. You must complete this review within 10 days of receipt and report any discrepancies to the bank within 30 days of receipt. Evidence of forgeries or alterations must be reported to the United States Trustee.

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<sup>1</sup>This is the first in a series of articles featuring key provisions of the *Handbook for Chapter 7 Trustees*.

Checks outstanding for more than 90 days and checks returned by a creditor or the post office afford the opportunity for someone to divert funds without your knowledge. It is important that these stale and returned checks are processed by someone not involved with the initial check preparation and authorization. The checks should be voided and the reason they were returned or not cashed should be researched before the checks are re-issued. You must authorize and issue stop payments for checks outstanding more than 90 days. When signing the replacement checks, review the original supporting documentation to make sure the address on the check matches the invoice. If the addresses are different, investigate and determine why, rather than assume there is a new valid address for the vendor or claimant.

The *Handbook* requires the person who opens the mail to log in checks and endorse them, thereby assigning the responsibility for controlling and handling the receipt to a single person until it has been recorded and endorsed. This procedure provides a record of the receipt at the earliest possible point and prevents those who subsequently handle the receipt from negotiating it. This requirement has been in the *Handbook* for many years, yet 30 percent of the audits and field exams conducted in 2009 and 2010 reported that trustees were not following it. Some trustees said they did not know about the requirement; others said they could not implement it because their mail is opened in the mail room or by the law firm receptionist. If trustee mail is currently opened by mail room personnel or the firm receptionist, we recommend that you change this procedure so that all trustee correspondence and funds are handled by employees under your direct supervision. You can go a step further by having two people open the mail together. This is required in chapter 13 trust operations, but not in chapter 7 because of the small size of most panel trustee operations. Checks that are received outside of the normal process, such as funds received at section 341 meetings, must also be recorded in the receipts log.

Finally, you may never commingle estate funds—including currency and wire transfers—in law firm trust accounts and other business or personal accounts. Deposits from bidders related to a sale or auction must be wired or deposited to the regular estate account or a special estate account set up for this purpose. Law firm trust accounts and other non-bankruptcy accounts are vulnerable to embezzlement schemes because the internal controls over such accounts may be weak or non-existent.

### *Accounting for Estate Funds*

The second benefit of a strong internal control environment is that it helps ensure proper accounting of funds. This means that estate funds are timely received, safeguarded until deposited, deposited to the correct estate account and disbursed for valid estate expenses.

Again, you are the key to the success of internal controls designed to ensure the proper accounting of funds. Some of these internal controls are: adequate supervision of the professionals who collect assets on your behalf; use of a receivables ledger and/or tracking system; timely bank reconciliations; and personal approval of supporting documentation for disbursements and signing of checks.

The professionals who collect assets on your behalf must be under your direct personal supervision, including regular contact concerning the status of the matter being handled by the

professional, follow-up to ensure that the funds are promptly turned over, and, when applicable, verification that the professional is bonded and insured. Adherence to these internal controls will alert you to possible problems and allow you to take prompt action before a defalcation occurs, or, in a worst-case scenario, upon its discovery.

Two recent auctioneer defalcations illustrate this point. In each case, a claim was made against the auctioneer's bond, and the timeliness of the trustee's follow-up was critical. In one case, the auctioneer disappeared with the proceeds from the sale of a vehicle. The trustee followed up when the proceeds were not remitted within 30 days of the auction, and became suspicious after the auctioneer did not respond to inquiries. Further investigation revealed that the auctioneer was no longer at his business location and had left town. Losses were covered by the bonding company. In the other situation, after the auctioneer's death the trustee discovered he had been using the proceeds from one auction to pay what he owed for another auction. His heirs did not have the funds to turn over the auction proceeds owed to various bankruptcy estates, but, as in the case described above, the bonding company covered the losses.

The second type of control designed to ensure proper accounting of funds is the use of a receivables ledger and/or a tracking system that alerts you and your staff when payments are past due so action can be taken to recover the funds for the estate. A tracking system is not just for receivables. If a settlement agreement or court order requires the payment of funds within a certain number of days or by a certain date, the tracking mechanism can be used to alert you when the deadline has passed. Your timely follow-up increases the likelihood that the funds will be collected.

Timely bank reconciliations are critical because they identify transactions that cleared the bank that are not recorded on the Cash Receipts and Disbursements Record (Form 2) and, conversely, transactions on Form 2 that did not clear the bank. Bank reconciliations will immediately identify checks you did not write, transfers you did not authorize and deposits to the wrong estate. There is a detailed description of the reconciliation procedure in Appendix J of the *Handbook*.

Finally, it is important that you personally approve the supporting documentation for disbursements and personally sign the checks. Although some trustees assert that their signature on the check is their approval of an invoice, the *Handbook* requires you to initial or stamp the supporting documents to indicate approval. This accomplishes several things. It allows you to compare the invoice amount to the check amount; helps avoid a mis-disbursement or a duplicate disbursement; permits you to verify that the address on the check matches the invoice; and allows you to observe that the expenditure is a legitimate expense for the estate, which is particularly important for expenditures that do not require a court order. There have been instances where fictitious invoices were submitted for services such as lock-smithing, storage and grounds maintenance that were not performed. To avoid such occurrences, it is important for you to verify that the work was performed, by a vendor whom you know.

#### *Accurate and Reliable Record Keeping*

The third benefit of a strong internal control environment is that it helps produce accurate and reliable record keeping and reporting. The benefits are that: the Individual Estate Property Record and Report (Form 1) is updated when appropriate and receipts from the liquidation of

assets are posted to the correct asset; receipts and disbursements are accurately coded, entered and described on Form 2; computer records and equipment are protected with passwords and other access controls; and estate records are kept in well-organized and complete files that are protected from unauthorized disclosure.

The internal controls that help ensure the accuracy and reliability of your record keeping and reporting include: maintaining financial records contemporaneously with transactions; establishing unique passwords and appropriate access rights for employees and independent contractors; maintaining programmed data controls; safeguarding computer equipment; and protecting personally identifiable information (PII).<sup>2</sup>

To properly perform the trustee's duties and effectively administer an asset case, you must establish an appropriate accounting system and maintain financial records on a contemporaneous basis for each estate, utilizing the uniform record keeping and reporting system described in the *Handbook*. This system includes Form 1 and Form 2. Maintaining these financial records on a contemporaneous basis means that Form 1 must be updated when the schedules are amended. Transactions must be recorded on Form 1 and Form 2 as they occur, rather than at the end of the month or when your annual Trustee Interim Report is due.

You, as trustee, must enforce unique passwords that are changed at least annually and you must ensure that access rights are appropriate for each employee and independent contractor. Access should be tied to an individual's job duties. A person whose sole chapter 7 job function is to record receipts in the log should not have the ability to edit claims and write checks. In addition, you must periodically review your computer system's access log to review who has had access to the system.

It is also important to preserve and maintain the programmed data entry controls in your case management software to prevent the deletion of transactions; the alteration of key fields including date, check number, payee and amount; and the insertion or back-dating of transactions in the cash receipts log as well as Form 2. Attempts to override the controls have been linked to attempts to cover up defalcations. With the controls in place, attempts to override them to hide a defalcation or manipulate the report will be evident.

Two other important controls are to safeguard computer equipment, including desktop computers, laptops, personal digital assistants and removable drives such as USB flash drives and CD-ROMs, and to ensure that remote access to your computer system is via a secure connection to prevent unauthorized use of the equipment to write checks, alter data and gain access to the sensitive information stored on it.

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<sup>2</sup>PII is defined in the *Handbook* as "information which can be used to distinguish or trace an individual's identity, such as name, Social Security number, or biometric records, etc. alone, or when combined with other personal or identifying information, which is linked or linkable to a specific individual, such as date and place of birth or mother's maiden name, etc." See *Handbook*, pp. 9-25-9-26.

Finally, it is imperative that you protect records and computer equipment containing PII by handling them in a secure manner and protecting them from loss or theft. Establish controls to protect computer equipment and bankruptcy papers containing PII in your office and when portable devices such as laptops and papers containing PII are used outside of your office.

### Conclusion

The goal of this article has been to highlight some of the key internal controls required by the *Handbook for Chapter 7 Trustees*, and to explain the benefits and importance of establishing and maintaining a strong internal control environment. We encourage you to review Chapter 9 of the *Handbook* and to make any changes necessary to strengthen the internal controls in your office. As always, if you have any questions, please contact your local United States Trustee's office.