Bankruptcy and Bankruptcy Fraud

March
2018
Volume 66
Number 2

United States
Department of Justice
Executive Office for
United States Attorneys
Washington, DC 20530

James A. Crowell IV
Acting Director

The United States Attorneys' Bulletin is published pursuant to 28 C.F.R. § 0.22(b).

The United States Attorneys' Bulletin is published by the
Executive Office for United States Attorneys
Office of Legal Education
1620 Pendleton Street
Columbia, South Carolina 29201

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Cite as:
66 U.S. Attorneys' Bulletin,
March 2018

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Part I: Executive Office for United States Attorneys

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Introduction

James A. Crowell IV
Acting Director
Executive Office for United States Attorneys

Thousands of debtors each year enter bankruptcy proceedings owing money to the United States or to victims of federal crime, including tax debtors, corporations, restitution judgment debtors, individuals, partnerships, farmers, sole proprietorships, and others. Through its adept and capable attorneys, the Department of Justice represents and advocates on behalf of the United States as a creditor or party in interest in Title 11 bankruptcy matters.

Assistant United States Attorneys (AUSAs) handling bankruptcy matters have two primary and equally important objectives. First, AUSAs seek to preserve the United States' monetary claims against bankruptcy debtors and estates and to collect debts owed to the government or victims of federal crimes. AUSAs in the civil divisions of United States Attorney's Offices (USAOs) represent many federal Departments/Agencies in bankruptcy court—Education, Agriculture, Internal Revenue Service, Environmental Protection Agency, Housing and Urban Development, and Small Business Administration, to name a few. These AUSAs advocate to preserve non-dischargeable debts for later collection action after the end of the bankruptcy case. For example, AUSAs appear in bankruptcy court to preserve from discharge student loan debt owed by capable debtors who have borrowed the money from the federal government to fund their education and should be held to the loan repayment terms. When criminals file bankruptcy to try to shed their debt, AUSAs in bankruptcy courts advocate that restitution judgments are not dischargeable, preserving the debt for the benefit of federal crime victims. AUSAs also undertake collection of debt owed to the United States through the bankruptcy process. A portion of debt owed to the United States might be paid monthly by the debtor through a Chapter 13 plan of reorganization or in a Chapter 7 liquidation distribution from the case trustee. In both instances, AUSA advocacy benefits the public fisc.

The second objective is prosecuting bankruptcy crimes, which are addressed by AUSAs in the USAOs' criminal divisions. Bankruptcy crimes and procedures are set forth in Title 18 of the United States Code, and include knowing and fraudulent concealment of assets, false oaths and claims, bribery, embezzlement from the bankruptcy estate, and bankruptcy fraud. The long-standing concept for bankruptcy relief in the United States is to provide honest but unfortunate debtors with a fresh start. However, dishonest debtors who engage in fraud, concealment of assets, and perjury in bankruptcy matters are not deserving of a fresh start—and will find themselves under indictment, before a judge, and punished. For example, in one recent case, AUSAs prosecuted debtors who failed to disclose in their bankruptcy petitions $350,000 in cash, a country chalet, a 1932 Ford hot rod, and a 50-item weapon collection; and in another case the debtor failed to disclose insurance policies valued at more than $100,000. In addition to concealment of assets and fraud cases, AUSAs have successfully prosecuted individuals for bankruptcy perjury and making threats against a U.S. Bankruptcy Judge. As an AUSA in the District of Maryland, I prosecuted numerous bankruptcy fraud cases. I understand the seriousness of these offenses and the need to prosecute them and deter fraudsters from taking advantage of our bankruptcy system. Accordingly, it is with great pleasure that I present this issue of the USABulletin focused on bankruptcy issues.

The articles selected for this issue provide information and insight into the practice, challenges, and objectives of the USAOs and the Department of Justice in these cases. Some of the articles, such as *Dischargeability of Debt* and *Direct Appeals*, give insight into the complexity of bankruptcy law under Title 11 of the United States Code. Other articles, including *Collection of Criminal Penalties and the*

Automatic Stay and *Protecting the Medicare Program in Health Care Provider Bankruptcy Cases,* highlight the specialized legal expertise needed to represent the United States and victims of crime in bankruptcy cases. As Acting Director of EOUSA, I am committed to providing Department attorneys with the training and assistance necessary to successfully litigate their cases. I hope the issues presented in this Bulletin serve as an important resource when protecting the government's claims in bankruptcy and prosecuting those who attempt to abuse the system.

The Civil Division’s Role in Bankruptcy Litigation

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Civil Division

I. Introduction

The Civil Division protects the United States’ interests in bankruptcy related civil litigation unless the litigation involves matters that fall within the purview of another Division of the Department of Justice (for example, tax and environmental litigation matters). The Assistant Attorney General for the Civil Division delegates most bankruptcy litigation matters to United States Attorneys, but generally retains authority to represent the United States in large dollar, complex bankruptcy cases and some non-routine bankruptcy litigation matters. The Civil Division also represents the United States when constitutional issues involving the Bankruptcy Code arise and handles bankruptcy cases in the United States Courts of Appeals. In addition to litigating bankruptcy cases, the Civil Division advises United States Attorneys’ Offices on a myriad of bankruptcy related litigation issues. Within the Civil Division, the Commercial Litigation Branch’s Corporate/Financial Litigation Section is responsible for bankruptcy cases in bankruptcy and district courts, and the Appellate Staff oversees bankruptcy litigation in courts of appeals.

II. Civil Division Bankruptcy Cases

The Corporate/Financial Litigation Section, which is a component within the Civil Division’s Commercial Litigation Branch, handles a diverse range of civil litigation matters involving both affirmative and defensive claims for money and property, but its largest practice area is bankruptcy. Large Chapter 11 cases make up the bulk of the Corporate/Financial Litigation Section’s bankruptcy caseload. The Corporate/Financial Litigation Section also represents the United States as a creditor in Chapter 9 and Chapter 15 cases. The Section occasionally handles Chapter 7 liquidation cases that involve large dollar claims or first impression legal issues, and also defends constitutional challenges to the Bankruptcy Code. Approximately forty-five percent of the Section’s cases involve bankruptcy, with about half of those cases pending in the District of Delaware and the remainder spread throughout the United States. The Section represents the United States in matters involving many different federal agencies. Claims involving the energy industry, healthcare providers, and civil fraud currently make up a large portion of the Section’s docket. The Rural Utilities Service and the Department of Energy are among the agencies that have large delinquent loan debts that the Section seeks to recover through bankruptcy.

III. Bankruptcy Case Delegation

The Civil Division works closely with United States Attorneys’ Offices to determine handling for large dollar bankruptcy cases. Case handling decisions take into account the amount of the United States’ claims, the potential complexity of the potential litigation, and the expertise residing in the local United States Attorney’s Office. Early identification of cases with large dollar claims is a high priority as large Chapter 11 cases frequently proceed on a fast pace, and federal interests can be impacted early in a case before proofs of claim are filed. The Corporate/Financial Litigation Section works closely with the

United States Attorney's Office for the District of Delaware to ensure that cases in that district are identified promptly. Assistant United States Attorneys (AUSAs) in other districts and agency counsel are encouraged to contact the Corporate/Financial Litigation Section as soon as cases that potentially involve large-dollar government claims or issues of nation-wide importance are filed in their districts. Title 31 of the Codes of Federal Regulations § 904.1 governs the referral of debts due the United States to the Department of Justice.[1]

Civil Directive 1-15 governs the delegation of monetary and non-monetary claims from the Civil Division to United States Attorneys.[2] This delegation includes representation of the United States in bankruptcy cases. Pursuant to Directive 1-15, United States Attorneys generally represent the United States in civil bankruptcy matters when the gross amount of the claim is less than $10,000,000.[3] The value of a government claim may be estimated using the liquidation value of the claim in a hypothetical liquidation of the bankruptcy estate.[4] Unfortunately, this number can rarely be determined with any certainty when a bankruptcy case is commenced. United States Attorneys also handle routine non-monetary claims.[5] The Civil Division typically handles matters that present novel questions of law or policy, as well as cases that, as a practical matter, could control the disposition of large amounts of funds.[6]

United States Attorneys have authority, to the extent authorized in Directive 1-15, to initiate, settle, and resolve litigation involving delegated claims. Typically, United States Attorneys have authority to settle or close affirmative claims that are less than $10,000,000, and defensive claims up to $1,000,000. This authority extends to bankruptcy appeals that are being heard in district court or before a bankruptcy appellate panel.[7] When the United States Attorney lacks authority to settle a bankruptcy claim, the AUSA responsible for the case should consult with the Corporate/Financial Litigation Section if the matter is pending in bankruptcy or district court, and with the Appellate Staff if the matter is pending in a court of appeals.

IV. Bankruptcy Appeals

AUSAs should contact the Civil Division's Appellate Staff when appellate issues arise.[8] Civil Division authority is not needed to appeal an adverse bankruptcy court decision, but AUSAs are encouraged to contact the Corporate/Financial Litigation Section when issues that may implicate other cases arise. Title 2 of the United States Attorney's Manual sets forth the procedures and time limitations.[9] When a district court or a bankruptcy appellate panel issues an appealable adverse decision in a bankruptcy matter, the procedures for notifying the Appellate Staff of the Civil Division should be followed just as in any other case. The Solicitor General must approve any appeal of an adverse decision by a district court or bankruptcy appellate panel reviewing a bankruptcy decision, as well as the direct appeal of an adverse bankruptcy court decision to a court of appeals.[10]

[1] 31 C.F.R. § 904.1 (2018).
[2] U.S. DEP'T. OF JUSTICE, U.S. ATTORNEYS' MANUAL CIVIL RESOURCE MANUAL § 46 [hereinafter USAM].
[3] *Id.* at 4.
[4] *Id.* at 7(b).
[5] *Id.* at 1(c)(1).
[6] *Id.* at 1(e)(1).
[7] *Id.* at 6.
[8] *Id.*
[9] USAM § 2.
[10] USAM § 46 at 6.

V. Conclusion

The Civil Division supports the United States Attorneys' Offices with their bankruptcy litigation practice in other ways. Civil Division attorneys have significant expertise concerning bankruptcy issues and can offer advice and support when complex litigation issues arise.

Relevant authorities:

28 C.F.R. 0.45

28 C.F.R. 0.160-0.169

31 C.F.R. Part 904.

ABOUT THE AUTHOR

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Dischargeability of Debt

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I. Introduction

At the conclusion of a successful bankruptcy case, the bankruptcy court will issue a discharge order relieving the individual or corporate debtor from the obligation to pay any outstanding dischargeable debts. A bankruptcy discharge voids any judgment and operates as an injunction against collection of prepetition debts.[1] It is the permanent manifestation of the automatic stay, 11 U.S.C. § 362, which stops collection activities during the pendency of a bankruptcy case.[2]

Violation of the discharge injunction is punishable by civil contempt.[3] "An aggrieved debtor [may] obtain compensatory damages, attorney's fees, and the offending creditor's compliance with the discharge injunction."[4] Punitive damages are not available against a governmental unit under 11 U.S.C. § 106(a)(3), which restricts the waiver of sovereign immunity to preclude an award of punitive damages.[5]

This article provides a broad overview of the law of dischargeability of debt in bankruptcy and identifies the federal debts to which it applies.

II. The Scope of an Ordinary Discharge

In the absence of an objection to discharge or dischargeability filed by a creditor or a trustee, a discharge is granted to the debtor by the bankruptcy court as a matter of course. Under chapter 7 of Title 11, United States Code, a discharge is granted to an individual within sixty days of the first meeting of creditors.[6] A chapter 7 business case does not result in discharge as the business ceases to exist at the conclusion of the case.[7] In chapter 13 cases, discharge is granted to an individual or to joint individual debtors after completion of the chapter 13 plan of reorganization.[8] In chapter 11, a corporate discharge is effective upon plan confirmation.[9] A chapter 11 individual debtor discharge usually occurs upon completion of the chapter 11 plan payments.[10]

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[1] 11 U.S.C. § 524(a) (2012).
[2] 11 U.S.C. § 362 (2012).
[3] Walls v. Wells Fargo Bank, N.A., 276 F.3d 502 (9th Cir. 2002) (a violation is enforced through the bankruptcy court's contempt authority under 11 U.S.C. § 105(a) (2012)).
[4] Walls, 276 F.3d at 507.
[5] 11 U.S.C. § 106(a)(3) (2012); *see* Jove Engineering, Inc. v. I.R.S., 92 F.3d 1539, 1548-60 (11th Cir. 1996) (punitive fine could not be ordered because Congress has not waived sovereign immunity for punitive damages).
[6] FED. R. BANKR. P. 4004(a).
[7] 11 U.S.C. § 727(a)(1) (2012).
[8] 11 U.S.C. § 1328(a) (2012).
[9] 11 U.S.C. § 1141(d)(1)(A) (2012) (no discharge if business is liquidated).
[10] § 1141(d)(5)(A).

The scope of the discharge varies slightly by Bankruptcy Code chapter.[11] Although discharge varies, it is not waivable. A discharge expressly applies to community property debts.[12] Thus, a discharge obtained by a debtor spouse may affect a debt owed by the non-filing spouse.[13]

Fortunately, for federal claim holders, many debts owed to the government are excepted from discharge by operation of law pursuant to Section 523(a) of Title 11. Section 523(a) provides a list of debts that cannot be discharged in bankruptcy and will continue to be owed by the debtor following the closing of the bankruptcy case, including:

- some taxes;
- some unscheduled debts;
- fine, penalty, or forfeiture;
- education loans;
- FDIC orders;
- restitution;
- FERC fines;
- prisoner litigation fees;
- securities laws.[14]

Although a debtor is not personally liable for discharged debts, a valid lien that has not been avoided in the bankruptcy case will remain on the property after the bankruptcy case is closed. Therefore, a secured creditor may enforce the lien to recover the property secured by the lien even after a discharge is entered by the bankruptcy court.

III. Action to Determine Dischargeability

A debt may also be excepted from discharge if it was incurred under false pretenses, fraud, and for willful and malicious injury.[15] In this way, bankruptcy cannot be used to shield a debtor from the victims of their improper conduct.

A party seeking to except a debt from discharge under Section 523(a) (2), (4), or (6) of Title 11, must initiate an adversary proceeding in the bankruptcy court to obtain a judgement that the debt is nondischargeable.[16] The burden of proving a ground for objection is on the objecting party.[17] The burden may be met under a preponderance of the evidence standard.[18]

While federal law controls the issue of nondischargeability, a determination of the existence and amount of the underlying debt is controlled by state law or other relevant non-bankruptcy law.[19] The establishment of the debt is governed by the applicable state statute of limitations law.[20] If the suit is not brought within the time period allotted under state law, the debt cannot be established.

[11] *See* § 727, § 1141, 11 U.S.C. § 1228 (2012) (amended 2017), or § 1328.
[12] 11 U.S.C. § 523(a)(3) (2012) (amended 2016); *see also* 11 U.S.C. § 524(b) (2012) (list exceptions).
[13] *See, e.g.*, Rooz v. Kimmel (*In re* Kimmel), 378 B.R. 630 (B.A.P. 9th Cir. 2007), aff'd, 302 F. App'x 518 (9th Cir. 2008).
[14] § 523(a).
[15] § 523(a)(2), (4), (6).
[16] § 523(c).
[17] Grogan v. Garner, 498 U.S. 279, 288-90 (1991).
[18] *Id.* at 289.
[19] *Id*. at 279, 283, 284 n.9.
[20] Banks v. Gill Distribution Centers, Inc., 263 F.3d 862 (9th Cir. 2001) (citation omitted).

A. False Statements, 11 U.S.C. § 523(a)(2)

A debt, extension, or renewal of credit is nondischargeable to the extent it was obtained by "false pretenses, a false representation, or actual fraud" (other than a fraudulent financial statement).[21] Most courts hold that it is not necessary to show the debtor obtained direct benefit from the fraudulent conduct.[22]

A prima facie case under 11 USC § 523(a)(2)(A)[23] requires a showing that: (1) the defendant made representations; (2) the defendant knew them to be false when they made them; (3) the debtor made the representations with the intent and purpose to deceive the plaintiff; (4) the plaintiff justifiably relied on the representations; and (5) as a result, the plaintiff sustained damage.[24] These elements are virtually identical to the elements of common law or actual fraud.[25] Fraudulent "[i]ntent may properly be inferred from the totality of the circumstances and the conduct of the person accused."[26]

Only justifiable reliance is required under 11 U.S.C. § 523(a)(2),[27] which is less demanding than the reasonable reliance required for actual fraud under California law.[28] The standard "turns on a person's knowledge under the particular circumstances."[29] "Justification is a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than of the application of a community standard of conduct to all cases."[30] "[A] person is justified in relying on a representation of fact 'although he might have ascertained the falsity of the representation had he made an investigation.'"[31]

If the false statement involves the use of financial statements, slightly different requirements are involved.[32] Section 523(a)(2)(B) applies to use of a statement in writing—

> (i) that is materially false;
> (ii) respecting the debtor's or an insider's financial condition;
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
> (iv) that the debtor caused to be made or published with intent to deceive.[33]

Examples of common dischargeability complaints by the United States include certain types of Social Security Administration (SSA) overpayments, Department of Agriculture lien claims, and Small

[21] 11 USC § 523(a)(2)(A) (2012) (amended 2016).
[22] *See* Muegler v. Bening, 413 F.3d 980, 983-84 (9th Cir. 2005).
[23] § 523(a)(2)(A).
[24] Younie v. Gonya (*In re* Younie), 211 B.R. 367, 373 (B.A.P. 9th Cir. 1997); *see also* Providian Bancorp v. Bixel (*In re* Bixel), 215 B.R. 772, 776-77 (Bankr. S.D. Cal. 1997); *citing* Field v. Mans (*In re* Field), 516 U.S. 59, 74-75 (1995) (holding that "§ 523(a)(2)(A) requires justifiable, but not reasonable, reliance").
[25] *In re* Younie, 211 B.R. at 374; Advanta Nat'l Bank v. Kong (*In re* Kong), 239 B.R. 815, 820 (B.A.P. 9th Cir. 1999).
[26] *See* Ormsby v. First Am. Title Co. of Nev. (*In re* Ormsby), 591 F.3d 1199, 1206 (9th Cir. 2010); *citing* Kaye v. Rose (*In re* Rose), 934 F.2d 901, 904 (7th Cir. 1991).
[27] 11 U.S.C. § 523(a)(2) (2012) (amended 2016).
[28] *In re* Field, 516 U.S. 59, 61 (1995).
[29] Citibank, N.A. v. Eashai (*In re* Eashai), 87 F.3d 1082, 1090 (9th Cir. 1996).
[30] RESTATEMENT (SECOND) OF TORTS § 545A CMT. B (AM. LAW INST., 1977); *quoted in* Field v. Mans (*In re* Field), 516 U.S. 59, 71 (1995).
[31] *In re* Field, 415 U.S. at 70.
[32] *See* § 523(a)(2)(B); *In re* Field, 516 U.S. at 69.
[33] 11 U.S.C. § 523(a)(2)(B) (2012) (amended 2016).

Business Administration loans.[34] Actions against the United States, where the debtor is trying to prove what a debt is, or what should be discharged, frequently involve the discharge of tax debt or student loans.

B. Defalcation or Larceny Misappropriation, 11 U.S.C. § 523(a)(4)

Section 523(a)(4) of Title 11 of the United States Bankruptcy Code provides that an individual is not discharged "from any debt for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."[35] The fiduciary capacity requirement applies only to debts for fraud or defalcation. Embezzlement and larceny do not require the existence of a fiduciary relationship.[36]

"Embezzlement" within the meaning of § 523(a)(4) "requires three elements: '(1) property rightfully in the possession of the nonowner; (2) nonowner's appropriation of the property to a use other than that for which [it] was entrusted; and (3) circumstances indicating fraud.'"[37] The elements of larceny differ only in that a larcenous debtor has come into possession of funds wrongfully.[38]

C. Willful and Malicious Injury, 11 U.S.C. § 523(a)(6)

Debts for the debtor's "willful and malicious injury" to another entity, or the property of another entity, are nondischargeable except in chapter 13 cases where the debtor completes all plan payments and obtains a full compliance discharge.[39]

Under section 523(a)(6) of the Bankruptcy Code, the plaintiff must show that the injury was both willful and malicious.[40] The term willful means a deliberate or intentional act.[41] "A 'malicious' injury involves (1) a wrongful act; (2) done intentionally; (3) which necessarily causes injury; and (4) is done without just cause or excuse."[42]

Determining the intent aspect of a malicious injury is a subjective standard, focusing on the debtor's state of mind.[43] The debtor must have the subjective intent to harm or the belief that harm is substantially certain.[44] In the case of a conversion that is both intentional and "willful—malice may be inferred from the nature of the wrongful act."[45]

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[34] *See e.g.* United States v. Hall (*In re* Hall), 515 B.R. 515, 520 (Bankr. S.D. W.Va. 2014) (debtor not entitled to discharge for disability overpayment obtained from SSA through silence regarding return to work).
[35] § 523(a)(4).
[36] *See* Cal-Micro, Inc. v. Cantrell (*In re* Cantrell), 329 F.3d 1119, 1125 (9th Cir. 2003); *see also* Lewis v. Scott (*In re* Lewis), 97 F.3d 1182, 1185 (9th Cir. 1996); Transamerica Commercial Fin. Corp. v. Littleton (*In* re Littleton), 942 F.2d 551, 555 (9th Cir. 1991).
[37] *In re* Littleton, 942 F.2d at 555; *citing* Hoffman v. Hoffman (*In re* Hoffman), 70 B.R. 155, 162 (Bankr. W.D. Ark. 1986).
[38] U-Save Auto Rental of Am. v. Mickens (*In re* Mickens), 312 B.R. 666, 680 (Bankr. N.D. Cal. 2004); Ormsby v. First Am. Title Co. of Nev. (*In re* Ormsby), 591 F.3d 1199, 1205 (9th Cir. 2010) (larceny may be determined by federal common law as a "felonious taking of another's personal property with intent to convert it or deprive the owner of the same.").
[39] 11 U.S.C. § 523(a)(6) (2012) (amended 2016), 11 U.S.C. § 1328(a) (2012).
[40] Baldwin v. Kilpatrick (*In re* Baldwin), 249 F.3d 912, 917 (9th Cir. 2001).
[41] Brown v. Brown (*In re* Brown), 331 B.R. 243, 250 (Bankr. W.D. Va. 2005).
[42] Carrillo v. Su (*In re* Su), 290 F.3d 1140, 1146-47 (9th Cir. 2002)*; see* Petralia v. Jercich (*In re* Jercich), 238 F.3d 1202, 1209 (9th Cir. 2001) (citing Bammer v. Bammer (*In re* Bammer), 131 F.3d 788, 791 (9th Cir.1997)).
[43] *In re* Su, 290 F.3d at 1144-46.
[44] *Id.* at 1144.
[45] Thiara v. Spycher Brothers (*In re* Thiara), 285 B.R. 420, 434 (2002) (citation omitted).

IV. Adversary Proceeding Requirements

The legal proceeding to determine dischargeability of debt is called an adversary proceeding, which is commenced with a complaint under Section 523.[46] An adversary proceeding is a lawsuit related to a bankruptcy case and given its own docketing. Most of the Federal Rules of Civil Procedure are applicable.[47] The summons and complaint may be served by regular mail.[48]

Routine complaints to determine whether a debt was discharged may be filed "at any time," even after the bankruptcy case is closed. However, this does not apply to complaints under Section 523(c).[49] As mentioned above, debts based upon false statements, defalcation, larceny misappropriation, or willful and malicious injury will be discharged unless an adversary proceeding is filed.[50]

In chapter 7 and chapter 13 bankruptcy cases, Section 523(c) complaints must be filed no later than sixty days after the first date set for the meeting of creditors under section 341(a).[51] This occurs soon after the bankruptcy petition is filed. In chapter 11 cases, the deadline to file a complaint to determine dischargeability is the first date set for plan confirmation.[52] These deadlines allow a debtor to address the issue in conjunction with the granting of a discharge.

On a motion of a party in interest, after hearing on notice, the court may extend time for cause. The motion must be filed before the time has expired.[53] Extensions of these deadlines are generally disfavored.

Many United States Attorney's Offices have "new complaint" procedures. This may require the Assistant United States Attorney (AUSA) to prepare a written memorandum explaining the basis for the complaint, and to obtain written approval from the Civil Chief before filing an adversary proceeding. Also, Executive Order 12988 Civil Justice Reform Guidelines may require pre-filing notice of a complaint.[54]

The bankruptcy court may award costs and attorney's fees to a debtor in a discharge action regarding "consumer debt" if the position of the creditor was not substantially justified or would be unjust.[55] The Bankruptcy Code defines "consumer debt" as "debt incurred by an individual primarily for a personal, family, or household purpose."[56]

V. Conclusion

Successfully litigating a dischargeability action can result in meaningful recovery for the United States of otherwise dischargeable debts. It also presents an opportunity to advance the mission of an agency and further the interests of justice. However, an action to determine the dischargeability of debt carries a high burden. Courts cite the "fresh start policy" to find that "exceptions to discharge should be strictly construed against an objecting creditor and in favor of the debtor."[57] Case selection and prosecutorial judgment are paramount. Please consult with a bankruptcy attorney in the United States

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[46] FED. R. BANKR. P. 7001(6).
[47] FED. R. BANKR. P. 7002, PART VII.
[48] FED. R. BANKR. P. 7004(b).
[49] FED. R. BANKR. P. 7004(b).
[50] 11 U.S.C. § 523(c) (2012) (amended 2016).
[51] FED. R. BANKR. P. 4007(c).
[52] *See* 11 U.S.C. § 1141(d)(1)(A) (2012).
[53] *See* FED. R. BANKR. P. 4007(c), 9006(b)(3) (authorizing enlargement of time).
[54] Exec. Order No. 12,988, 61 F.R. § 4729 (1996).
[55] § 523(d).
[56] 11 U.S.C. § 101(8) (2012) (amended 2016).
[57] *See, e.g., In re* Riso, 978 F.2d 1151, 1154 (9th Cir. 1992).

Attorney's Office or the Executive Office for United States Attorneys if you have any questions concerning the discharge of debt owed to the United States in bankruptcy cases.

ABOUT THE AUTHOR

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Collection of Criminal Restitution and the Automatic Stay

Greg D. Stefan
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I. Introduction

The intersection of bankruptcy and criminal collection is a complicated area of the law. There is no one-size-fits-all answer as to what collection action the government may take when a defendant files bankruptcy. Therefore, when possible, Financial Litigation Unit AUSAs in the United States Attorneys' Offices (USAO) should consult with a bankruptcy attorney in the USAO or the Executive Office for United States Attorneys prior to taking collection action when a debtor files bankruptcy.

II. The Nature of Restitution

When sentencing a defendant, a court is required to consider, among other things, "the need to provide restitution to any victims of the offense."[2] "Although restitution enables victims to recover losses that might be available in civil litigation, restitution is nonetheless part of the criminal defendant's sentence."[3] Restitution serves both a compensatory and punitive purpose.[4]

In 1996, Congress passed the Mandatory Victim Restitution Act of 1996 ("MVRA") as Title II of the Anti-Terrorism and Effective Death Penalty Act of 1996,[5] which provides that "[n]othwithstanding any other provision of law, when sentencing a defendant convicted of any offense described in subsection (c), the court shall order . . . that the defendant make restitution to the victim of the offense . . ."[6] The crimes to which mandatory restitution applies include crimes involving physical or pecuniary loss, crimes of violence, crimes against property, and crimes involving tampering with consumer products.[7] A sentencing court is required to order restitution in the full amount of a victim's losses without considering the economic consequences to the defendant.[8]

III. Enforcement of Restitution

Restitution may be enforced through criminal or civil means. Severe criminal penalties exist when a defendant defaults on a restitution order. The court may (1) revoke supervised release, (2) modify the terms or conditions of supervised release, (3) resentence the defendant, (4) hold the defendant in

[1] The views expressed in this document are the personal views of Mr. Stefan and do not necessarily reflect the views of the United States Attorney's Office for the Eastern District of Virginia.
[2] 18 U.S.C. § 3553(a)(7) (2012).
[3] United States v. Cohen, 459 F.3d 490, 496 (4th Cir. 2006).
[4] *See* United States v. Blackman, 746 F.3d 137, 143 (4th Cir. 2014); *see also* Paroline v. United States, 134 S. Ct. 1710, 1726 (2014).
[5] Codified at 18 U.S.C. §§ 2248, 2259, 2264, 2327, 3556, 3563, 3572, 3611, 3612 (amended 2016), 3613 (amended 2016), 3613A, 3614, 3663, 3663A, 3664 (2012), and FED. R. CRIM. P. 32. Section 3663A.
[6] 18 U.S.C. § 3663A(a)(1) (2012).
[7] § 3663A(c).
[8] 18 U.S.C. § 3664(f)(1)(A) (2012).

contempt, (5) enter a restraining order, (6) order sale of the defendant's property, (7) accept a performance bond, (8) impose or adjust a payment schedule, or (9) take other necessary action.[9] In addition, if a defendant "knowingly fails to pay a delinquent fine or restitution the Court may resentence the defendant to any sentence which might originally have been imposed."[10] Finally, there is a separate offense known as "criminal default" for a defendant who willfully fails to pay a fine or restitution order.[11]

Restitution also may be enforced through civil remedies. An order of restitution may be enforced in the same manner as a fine.[12] The operative enforcement provision is 18 U.S.C. § 3613, which is captioned "Civil remedies for satisfaction of an unpaid fine," but is fully "available to the United States for the enforcement of an order of restitution."[13] Section 3613 creates a lien and provides a framework for collecting restitution. Under § 3613, a lien arises upon the imposition of restitution, which has the same status as a tax lien and, accordingly, attaches to all property and rights to property of the defendant.[14] A bankruptcy discharge does not discharge restitution or affect a restitution lien.[15] Under § 3613, "[n]otwithstanding any other Federal law," the government is authorized to collect criminal fines and restitution "in accordance with the practices and procedures for the enforcement of a civil judgment under Federal law or State law."[16] The federal law that provides the practices and procedures for the enforcement of a civil judgment is the Federal Debt Collection Procedures Act (the "FDCPA").[17] The FDCPA may be utilized to collect judgments entered in favor of the United States in a criminal proceeding.[18] Two of the most common collection tools authorized by the FDCPA are the filing of a notice of lien and the issuance of a writ of garnishment.[19] An FDCPA proceeding to enforce a criminal restitution judgment is civil in nature.[20]

IV. Overview of the Bankruptcy Automatic Stay

Immediately upon filing a bankruptcy petition, Bankruptcy Code § 362(a) automatically stays an entity's efforts to collect debts owing by a bankruptcy debtor.[21] If the bankruptcy stay applies to particular collection action and has not terminated, a creditor must obtain relief from stay under 11 U.S.C. § 362(d) before seeking to collect. It is important to understand that the automatic stay applies to the debtor, to property of the debtor, and to property of the estate. As it pertains to the debtor and to the property of the debtor, the automatic stay applies only if the debt arose before the bankruptcy case. Concerning property of the estate, the automatic stay applies regardless of whether the debt arose before or after the bankruptcy case was filed.

The concept of property of the estate is broad and differs depending upon the chapter of the Bankruptcy Code under which the bankruptcy case is filed. In all cases, property of the estate generally consists of all legal and equitable interests a debtor holds in property on the bankruptcy filing date, plus

[9] § 3613A(a)(1).
[10] § 3614(a).
[11] 18 U.S.C. § 3615 (2012).
[12] § 3664(m)(1)(A)(i); *see also* 18 U.S.C. § 3613(f) (2012) (amended 2016) (stating that provisions of § 3613 apply to an order of restitution).
[13] § 3613(f).
[14] § 3613(c).
[15] § 3613(e).
[16] § 3613(a).
[17] 28 U.S.C. §§ 3001-08 (2012).
[18] § 3001(a)(1); § 3002(8).
[19] 28 U.S.C. § 3201(a) (2012); 28 U.S.C. § 3205 (2012).
[20] United States v. Cohen, 798 F.3d 84, 89 (2d Cir. 2015); United States v. Kollintzas, 501 F.3d 796, 800 (7th Cir. 2007).
[21] 11 U.S.C. § 362 (2012).

certain postpetition property interests acquired by bequest or inheritance, as a result of a divorce decree or settlement, or as beneficiary under a life insurance policy.[22] In a Chapter 7 case, postpetition earnings from services performed are not property of the estate; however rents and profits from property of the estate are included in the estate.[23] In addition to all property specified in Bankruptcy Code § 541, property of the estate in an individual Chapter 11 case and in a Chapter 13 case includes all property acquired by the debtor and all earnings for services performed by the debtor after the commencement of the case, but before the case is closed, dismissed, or converted.[24]

The automatic stay and the property it protects are expansive in nature. However, the stay is not without limits. Bankruptcy Code § 362(b)(1) excepts certain criminal proceedings from the reach of the stay. In addition, one may utilize 18 U.S.C. § 3613(a) to overcome the automatic stay.

V. The Bankruptcy Code Section 362(b)(1) Exception and Criminal Remedies

Bankruptcy Code § 362(b)(1) exempts from the automatic stay "the commencement or continuation of a criminal action or proceeding against the debtor."[25] The stay exception for commencement or continuation of criminal actions or proceedings is an absolute exception that excepts all criminal proceedings and actions from the reach of the automatic stay.[26]

Section 3663A(a)(1) requires a sentencing court to order restitution for certain offenses "[n]otwitstanding any other provision of law . . ."[27] It is well established that the imposition of restitution as part of a criminal sentence is excepted from the automatic stay by Bankruptcy Code § 362(b)(1) and § 3663A(a)(1).[28]

"Because a criminal sentence would be meaningless absent authority to ensure that it is complied with, an action . . . to enforce the terms of a sentence is clearly a continuation of a criminal action."[29] For example, courts have held that revocation proceedings are excepted from the automatic stay as being a continuation of a criminal action.[30]

[22] 11 U.S.C. § 541(a) (2012) (amended 2016).
[23] § 541(a)(6).
[24] 11 U.S.C. § 1115(a) (2012); 11 U.S.C. § 1306(a) (2012).
[25] § 362(b)(1).
[26] Bartel v. Walsh (*In re* Bartel), 404 B.R. 584, 590 (B.A.P. 1st Cir. 2009).
[27] 18 U.S.C. § 3663A(a)(1) (2012).
[28] *See* United States v. Caddell, 830 F.2d 36, 39 (5th Cir. 1987) (rejecting argument that the entry of a restitution order violated the automatic stay); *cf.* Simonini v. Bell (*In re* Simonini), 69 F. App'x 169 (4th Cir. July 1, 2003) (holding that automatic stay did not apply to criminal prosecutions and refusing to enjoin state financial fraud prosecution); Gruntz v. County of Los Angeles (*In re* Gruntz), 202 F.3d 1074, 1085-86 (9th Cir. 2000) (automatic stay did not prohibit state court prosecution based upon failure to pay child support).
[29] Bryan v. Rainwater, 254 B.R. 273, 278 (N.D. Ala. 2000).
[30] *See e.g.*, Caddell, 830 F.2d at 39 (revocation of probation for failure to pay restitution); Bryan, 254 B.R. at 278 (revocation based upon failure to pay restitution); *but see In re* Coulter, 305 B.R. 748, 761 (Bankr. D.S.C. 2003) (stating that the court held that automatic stay did not prohibit revocation hearing, but held that terms of confirmed plan which provided for payment of restitution prohibited State's revocation of probation based solely upon failure to pay restitution).

VI. The Bankruptcy Code Section 362(b)(1) Exception and Civil Remedies

The case of *United States v. Troxler Hosiery Company, Inc*., held that actions to collect fines imposed as part of a criminal sentence were excepted from the automatic stay by virtue of Bankruptcy Code § 362(b)(1).[31] In *Troxler Hosiery*, a defendant was convicted of contempt of court and fined $80,000. The defendant filed a bankruptcy case which was converted to a Chapter 7 proceeding. The government filed a proceeding to determine that the automatic stay did not apply to its efforts to collect the fine. In holding that the government's collection efforts fell within the Bankruptcy Code § 362(b)(1) exception, the *Troxler Hosiery* court reasoned:

> A criminal sentence without accompanying authority to ensure service by the defendant as ordered would be meaningless. Action by the government to enforce the terms of a sentence are plainly a continuation of the entire criminal proceeding. The fact that the government may resort to collection means which are civil in nature does not transform a criminal case into a civil one.[32]

The holding of *Troxler Hosiery* was undercut by two cases. In *In re Reasonover*, the United States filed its notice of restitution lien after the debtor had filed a Chapter 7 bankruptcy petition, and the trustee asserted priority over the restitution lien.[33] In dicta, the bankruptcy court dismissed the argument that enforcement of restitution orders, as distinguished from fines, is excepted from the automatic stay.[34] In so doing, it distinguished *Troxler* by contrasting the non-compensatory aspects of a fine with the compensatory aspects of restitution.[35] The bankruptcy court ultimately decided in favor of the trustee on grounds unrelated to the automatic stay. Specifically, the *Reasonover* court found that since notice of the restitution lien was not filed before the bankruptcy case, the restitution lien was not perfected and, accordingly, did not defeat the trustee in his status as a hypothetical bona fide purchaser.[36] In the other case, *United States v. Robinson,* the court found that the plain language of Bankruptcy Code § 362(b)(1) limited its application to criminal proceedings against the debtor and thus did not enable the government to collect from property of the estate under that exception.[37] Nevertheless, *Robinson*, as will be discussed below, held that the automatic stay did not apply because of 18 U.S.C. § 3613.

VII. 18 U.S.C. § 3613(a) and the Automatic Stay

18 U.S.C. § 3613(a) states that "Notwithstanding any other Federal law . . . a judgment imposing a fine [or restitution] may be enforced against all property or rights to property of the person fined [with certain enumerated exceptions]."[38] In *Robinson*, the Court analyzed § 3613(a) and its impact on the automatic stay. In *Robinson*, the defendant defrauded over one thousand victims in a mail fraud scheme, and was ordered to pay $286,875 in criminal restitution.[39] The government filed an action seeking a declaratory judgment that the automatic stay did not prohibit enforcement action to collect criminal

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[31] United States v. Troxler Hoisery Co., Inc., 41 B.R. 457 (M.D.N.C. 1984), aff'd per curiam, 796 F.2d 723 (4th Cir. 1986) (stating that in *Troxler Hosiery*, the Fourth Circuit Court of Appeals adopted the "excellent opinion" of the District Court.).
[32] *Id*. at 460.
[33] *In re* Reasonover, 236 B.R. 219 (Bankr. E.D.Va. 1999).
[34] *Id*. at 235-36.
[35] *Id*. at 235.
[36] *Id*. at 236.
[37] United States v. Robinson (*In re* Robinson), 764 F.3d 554, 559 (6th Cir. 2014).
[38] 18 U.S.C. § 3613(a) (2012).
[39] *In re* Robinson, 764 F.3d at 557.

restitution.[40] The Court held that the notwithstanding clause in § 3613(a) overrode the automatic stay and permitted collection action against property of the estate.[41] In reaching its decision, the Court reasoned:

> [T]he Bankruptcy Code, like any other federal statute, must yield if it conflicts with § 3613(a). Though the automatic stay prohibits the enforcement of prepetition judgments against property of the estate, § 3613 allows the government to collect criminal restitution despite "any other Federal law." This language overrides the application of § 362(a)'s various stays, which distinguish among the debtor in personam, property of the debtor, and property of the estate. Unlike the Bankruptcy Code, § 3613 does not use these terms of art. We therefore conclude that the government may enforce the restitution orders against property of the bankruptcy estate.[42]

Similarly, *Partida v. United States* held that § 3613(a) precluded operation of the automatic stay and authorized enforcement of criminal restitution obligations against a debtor and property of the bankruptcy estate.[43] Prior to filing bankruptcy, the Chapter 13 debtor in *Partida* was convicted of embezzlement and theft of labor union assets and ordered to pay $193,337.33 in criminal restitution.[44] The United States offset the debtor's pension and retirement benefits while the bankruptcy case was pending, and the debtor filed a contempt motion arguing that the government's actions violated the automatic stay.[45] The Court rejected the debtor's argument and held that the MVRA's enforcement provision was intended to override any other federal law, including the Bankruptcy Code's automatic stay provisions.[46] Based on the reasoning of *Robinson* and *Partida*, the automatic stay must yield to § 3613's enforcement framework.

VIII. Practice Notes for AUSAs in Restitution Cases

Prudence dictates that the government take precautionary measures prior to pursuing collection action. This may be accomplished by three principal means. First, one may file a motion for entry of a stipulated order that the bankruptcy does not apply to collection and enforcement of restitution. Second, Chapter 11, 12 or 13 plan provisions may be negotiated, which similarly provide that collection and enforcement of restitution are not stayed or affected by the bankruptcy filing. It is important in Chapter 12 and 13 cases that the consent of the standing trustee be obtained. Third and finally, an adversary complaint to declare the stay not applicable may be filed absent an agreement. If one utilizes an adversary complaint to decide the issue, a motion to withdraw the bankruptcy reference should be filed so that the matter is decided by the district court. Before employing these methods, one should exercise careful judgment to ensure that the *Robinson* argument is raised in appropriate cases. Factors which should be considered include whether victims cannot otherwise vindicate their rights, the existence of other worthy creditors, and whether bankruptcy may be a better vehicle for providing compensation for the victims.

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[40] *Id.*

[41] *Id*. at 560; United States v. Henricks, No. 13-CR-83-BBC, 2015 WL 106160, at *2 (W.D. Wis. January 7, 2015) (stating that While *Robinson* is a powerful tool to overcome the automatic stay to pursue collection against a defendant and his or her assets, the government still must file a motion for relief from stay to be able to enforce against jointly owned assets or assets owned by another person, such as a defendant's spouse. Also holding that § 3613(a) did not override the automatic stay in a bankruptcy case filed by a defendant's wife).

[42] *In re* Robinson, 764 F.3d at 560.

[43] Partida v. United States (*In re* Partida), 862 F.3d 909 (9th Cir. 2017).

[44] *Id*. at 911.

[45] *Id*. at 911-12.

[46] *Id*. at 912-13.

IX. Conclusion

If the defendant files bankruptcy in the Sixth or Ninth Circuits, a United States Attorney's Office may feel confident taking action to collect restitution. For all other circuits, a bankruptcy attorney in the USAO or the Executive Office for United States Attorneys should be consulted before taking any collection action as the law in this area is not yet firmly established in circuits other than the Sixth and Ninth Circuits.

ABOUT THE AUTHOR

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Direct Appeals of Bankruptcy Court Orders Under 28 U.S.C. § 158(d)(2)

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I. Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[1], amended section 158 of title 28 to give the courts of appeals, under certain conditions, jurisdiction to hear an appeal from an order, judgment, or decree of a bankruptcy court, thereby bypassing a district court's or bankruptcy appellate panel's (BAP) intermediate review. Effective December 1, 2014, Bankruptcy Rule 8006 superseded Bankruptcy Rule 8001(f) and sets forth the procedures for appeals taken under section 158(d)(2). This article will explain the standards for direct appeals under § 158(d)(2) and the procedures under Rule 8006 for seeking a direct appeal.

II. Section 158(d)(2)

BAPCPA amended section 158 of title 28 by adding subsection (d)(2), which grants appellate jurisdiction to the courts of appeals from orders, judgments, or decrees of a bankruptcy court under certain circumstances.[2] If a bankruptcy court order is certified and direct appeal is authorized, the intermediate level of appeal is eliminated. "The two primary goals behind this provision are (i) to provide a quicker and less costly means of resolving significant issues that are inevitably bound for the court of appeals, and (ii) to facilitate the development of more binding precedents in bankruptcy law."[3]

The subsection consists of five subparts. Subpart (A) creates a certification procedure applicable to any order described in § 158(a), which includes (i) final judgments, orders, or decrees; (ii) interlocutory orders or decrees under 11 U.S.C. § 1121(d); and (iii) other interlocutory orders and decrees. Subsection (A) gives the appropriate court of appeals jurisdiction of such orders if either (1) the involved bankruptcy court, district court, or BAP, acting either on its own motion or at the request of any party to the judgment, or (2) all the appellants and appellees (if any), acting jointly, certify that one or more of four circumstances exist. Those circumstances are listed in subsection (d)(2)(A)(i)-(iii) as follows:

> (i) the judgment, order, or decree involves a question of law as to which there is no controlling decision of the court of appeals for the circuit or of the Supreme Court, or involves a matter of public importance;
>
> (ii) the judgment, order or decree involves a question of law requiring resolution of conflicting decisions; or

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[1] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (2005).
[2] 28 U.S.C. § 158(d)(2) (2012).
[3] Jaffé v. Samsung Elecs. Co. (*In re* Qimonda AG), 470 B.R. 374, 382-83 (E.D. Va. 2012) (citing H.R. Rep. No. 109-31(1), at 148 (2005)).

> (iii) an immediate appeal from the judgment, order, or decree may materially advance the progress of the case or proceeding in which the appeal is taken.[4]

Note that even though subsection (d)(2)(A) has three subsections, there are, in fact, four grounds for certifying a direct appeal since two grounds are stated in the disjunctive in romanette (i).[5]

Note also that the parties themselves ("all the appellants and appellees (if any) acting jointly") can certify a matter for direct appeal without any court involvement, which appears to be a unique appeal avenue in the Federal system.[6]

Even if the involved court or all the parties, acting jointly, make a certification, the court of appeals will not take jurisdiction of the appeal unless it exercises its own discretion to authorize a direct appeal of the judgment, order, or decree.[7] Hence, the court of appeals retains the final and necessary authority to approve a direct appeal.[8]

Subpart (B) amplifies the certification process. The involved court "shall" make the certification if it determines that at least one of the circumstances specified in section 158(d)(2)(A)(i)-(iii) exists.[9] In addition, the involved court "shall" certify the judgment when it receives a request to that effect made by a majority of the appellants and a majority of appellees (if any).[10] This latter "majority" scenario is different than the scenario in subsection (d)(2)(A) when *all* of the parties certify jointly and the involved court has no role.

Subpart (C) provides that the parties may supplement the certification with a short statement of the basis for the certification. Such a statement appears necessary if the involved court certifies under § 158(d)(2)(B)(ii) (request from a majority of the appellants and a majority of the appellees), but does not independently determine that any of the circumstances required for certification exists.

Subpart (D) provides that an appeal under § 158(d)(2) does not stay any proceeding, unless the court in which the certification is made or the court of appeals issues a stay pending appeal.

Subpart (E) requires that any request for certification under subpart (B) (either by a party or a majority of the appellants and a majority of appellees) be made not later than sixty days after the entry of the judgment, order, or decree which is the subject of the certification. This time restriction would not seem to apply to the involved court's authority to certify on its motion.

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[4] § 158(d)(2)(A)(i)-(iii).

[5] § 158(d)(2)(A)(i) ("[N]o controlling decision of the court of appeals . . . or involves a matter of public importance); Wilmington Trust Co. v. Tribune Media Co. (*In re* Tribune Media Co.), No. 08-13141-KJC, 2016 WL 1451161, at *3 (D. Del Apr. 12, 2016); *In re* Millennium Lab Holdings II, LLC, 543 B.R. 703, 708 (Bankr. Del. 2016).

[6] 1 Collier on Bankruptcy, ¶ 5.06 at 5-22 ("The ability of the parties themselves, acting unanimously and without court involvement, to certify a matter for direct appeal has no parallel in current federal practice.").

[7] § 158(d)(2)(A) ("[A]nd if the court of appeals authorizes the direct appeal of the judgment, order, or decree").

[8] Weber v. United States Trustee, 484 F.3d 154, 161 (2d Cir. 2007) ("[C]ongress has explicitly granted us plenary authority to grant or deny leave to file a direct appeal, notwithstanding the presence of one, two, or three of the threshold conditions."); Schmidt v. Villarreal (*In re* OGA Charters, LLC), 2017 WL 3141918 *3 (S.D. Tex. 2017) ("[T]he appeal must still be authorized by the court of appeals."); Idea Boardwalk, LLC v. Revel AC, Inc., (*In re* Revel AC, Inc.), No. 15-299(JBS), 2015 WL 333341, at *2 (D. N.J. Jan. 23, 2015) ("Such direct appeal is subject to the authorization of the court of appeals.").

[9] 28 U.S.C. § 158(d)(2)(B)(i) (2012).

[10] § 158(d)(2)(B)(ii).

III. Case Law Interpreting Section 158(d)(2)

Only a few decisions have applied and interpreted § 158(d)(2) since its 2005 enactment. Those decisions addressing the provision have, however, been largely consistent in their interpretation.

Generally, the Second Circuit has stated the "[l]egislative history confirms that Congress intended § [158(d)(2)] to facilitate [courts of appeals'] provision of guidance on pure questions of law."[11] "Indeed, Congress believed direct appeal would be most appropriate where we are called upon to resolve a question of law not heavily dependent on the particular facts of a case, because such questions can often be decided based on an incomplete or ambiguous record."[12] Accordingly, "most courts addressing requests for certification conclude that direct appeals should be reserved for questions of law rather than questions that are factual or mixed."[13]

A. Absence of Controlling Law from the Circuit or Supreme Court (Section 158(d)(2)(A)(i))

"Courts have interpreted the controlling precedent prong to require that there be "no governing law on the issue before the court."[14] Moreover, "[c]ontrolling law for the purposes of section 158(d)(2)(A)(i) is that which admits of no ambiguity in resolving the issue . . . [and which] may be supplied by combining holdings from multiple cases."[15] If there is no controlling law from the circuit or the Supreme Court, the court is required to certify the appeal.[16]

B. Matter of Public Importance (Section 158(d)(2)(A)(i))

According to Collier's, a matter of public importance "should transcend the litigants and involve a legal question the resolution of which will advance the cause of jurisprudence to a degree that is usually not the case."[17] Most courts have agreed with this view and applied this prong narrowly.[18] In addition, a substantial impact on jobs or other vital community interests could satisfy this prong.[19]

The effect of an appeal on other parties to a bankruptcy does not establish a matter of public importance.[20]

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[11] Weber, 484 F.3d at 158.
[12] *Id*. (citing H.R. Rep. No. 109-31, at 148-49 (2005)).
[13] *In re* Abengoa Bioenergy Biomass of Kan., LLC, No. 16-10446, 2016 WL 3180587, at *1 (D. Kan. May 26, 2016) (citing Weber).
[14] *In re* Nortel Networks Corp., No. 09-10138 (KG), 2010 WL 1172642, at *1 (D. Del. Mar. 18, 2010) (citing Mull Drilling Co. v. SemCrude, L .P. (*In re* SemCrude, L.P.), 407 B.R. 82, 111 (Bankr. D. Del. 2009)).
[15] *In re* Millennium Lab Holdings II, LLC, 543 B.R. 703, 711-12 (Bankr. D. Del. 2016) (citing Stanziale v. Car-Ber Testing, Inc. (*In re* Conex Holdings, LLC), 534 B.R. 606, 611 (D. Del. 2015) and *In re* Tribune Co., 477 B.R. 465, 471 (Bankr. Del. Del. 2012)).
[16] *In re* Tribune Media Co., 2016 WL 1451161, at *3 (D. Del. Apr. 12, 2016).
[17] 1 COLLIER ON BANKRUPTCY, ¶ 5.06(4)(b) at 5-28 (citing as an example, among others, the constitutionality of a provision of Title 11).
[18] Troiso v. Erickson *(In re* IMMC Corp.), No. 08-11178 (KJC), 2016 WL 356026, at *6 (D. Del. Jan. 28, 2016); *In re* Conex Holdings, LLC, 534 B.R. at 611; Am. Home Mortgage Inv. Corp. v. Lehman Bros., Inc., (*In re* Am. Home Mortg. Inv. Corp.), 408 B.R. 42, 44 (D. Del. 2009); *In re* MPF Holding U.S. LLC, 444 B.R. 719, 726 (S.D. Tex. 2011).
[19] 1 COLLIER ON BANKRUPTCY, ¶ 5.06(4)(b) at 5-28 (citing *In re* Qimonda AG, 470 B.R. 374 (E.D. Va. 2012)).
[20] *In re* Conex Holdings LLC, 534 B.R. at 611 (citing Goody's Family Clothing, Inc. v. Blue Dog Properties Trust, (*In re* Goody's Family Clothing Inc.), 2009 WL 2355705, at *2 (D. Del. July 30, 2009); Mark IV Industries, Inc. v. New Mexico Env't Dep't, 452 B.R. 385, 389 (S.D. N.Y. 2011)).

C. Conflicting Decisions (Section 158(d)(2)(A)(ii))

Section 158(d)(2)(A)(ii) requires an intra-circuit split not an inter-circuit split.[21] The statute is unclear at what court level the split must exist, but courts have certified direct appeals based on conflicting decisions among bankruptcy judges in the same district, as well as conflicting decisions among bankruptcy courts in the same circuit.[22]

D. Materially Advance the Progress of the Case (Section 158(d)(2)(A)(iii))

In *Weber*, the Second Circuit stated the following regarding this condition:

> Where a bankruptcy court has made a ruling which, if correct, will essentially determine the result of future litigation, the parties adversely affected by the ruling might very well fold up their tents if convinced that the ruling has the approval of the court of appeals, but will not give up until that becomes clear. Where that ruling is manifestly correct or manifestly erroneous, the parties would profit from its immediate review in this court.[23]

Only a few courts have found this condition satisfied in certifying a direct appeal.[24] Most courts take a more restrictive view.[25]

E. Miscellaneous Holdings Regarding Direct Appeals

A court's denial of a certification request for direct appeal is not a final, appealable order.[26]

A court of appeals lacks "jurisdiction to consider, on a direct certified appeal, the merits of an unauthorized bankruptcy court order entered without consent in a related non-core proceeding."[27] Such an order must be considered a report with proposed findings of fact and conclusions of law that must first be reviewed by a district court.[28]

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[21] *In re* Millennium Lab Holdings II, LLC, 543 B.R. 703, 714 (Bankr. D. Del. 2016) ("[I]nter-circuit splits do not satisfy section 158(d)(2). Rather, section 158(d)(2) references conflicting decisions within the same circuit.") (citing WestLB AG v. Kelley, 514 B.R. 287, 294 (D. Minn. 2014); *In re* Gen. Motors Corp., 409 B.R. 24, 29 (S.D. N.Y. 2009) ("[D]ecisions from outside the Circuit are not a basis for § 158(d)(2) review.").

[22] *In re* Jones, 352 B.R. 813, 825-26 (Bankr. S.D. Tex. 2006); *In re* Pajian, 785 F.3d 1161, 1162 (7th Cir. 2015); Deutsche Bank Nat'l Trust Co. v. Tucker, 621 F.3d 460, 461 (6th Cir. 2010).

[23] Weber v. United States Trustee, 484 F.3d 154, 158 (2d Cir. 2007).

[24] *See, e.g.*, Rodriguez v. Wolfe, (*In re* Rodriguez), 513 B.r. 767, 770 (Bankr. S.D. Fla. 2014) (holding case would be materially advanced when creditor appellant challenging debtor's one and half year old discharge "had demonstrated that he will not relent until the Eleventh Circuit has decided the issue").

[25] *See e.g.*, *In re* Millennium Lab Holdings II, LLC, 543 B.R. at 716-17 ("[E]ven the near certainty that this appeal will ultimately end up before the Third Circuit is not a basis on which to certify"); WestLB AG, 514 B.R. at 293 ("[I]t is not enough to rely on the truism that leapfrogging district-court review always advances litigation").

[26] Tomkow v. Barton, (*In re* Tomkow), 563 B.R. 716, 731 (B.A.P. 9th Cir. 2017) (analogizing to decisions holding denials of certifications under 28 U.S.C. § 1292(b) to be nonappealable).

[27] Wortley v. Bakst, 844 F.3d 1313, 1322 (11th Cir. 2017); Ortiz v. Aurora Health Care, Inc. (*In re* Ortiz), 665 F.3d 906, 915 (7th Cir. 2011).

[28] Wortley, 844 F.3d at 1322.

IV. Federal Rule of Bankruptcy Procedure 8006

Rule 8006 governs the procedures for certification of a direct appeal. A certification for direct review in the court of appeals is not effective until:

(i) the certification has been filed,

(ii) an appeal has been taken under Rule 8003 (appeal as of right) or 8004 (appeal by leave); and

(iii) the notice of appeal has become effective under Rule 8002.[29]

A notice of appeal is ordinarily effective when it is filed in the bankruptcy court, but Rule 8002 delays the effectiveness when the notice of appeal is filed after (i) the announcement of a decision or order but prior to the entry of judgment, order, or decree; or (ii) the announcement or entry of a judgment, order, or decree but before the bankruptcy court rules on certain post judgment motions.[30] In the first instance, the notice becomes effective on the date and as of the entry of the judgment or order,[31] and in the second instance, the notice becomes effective upon entry of the order disposing of the last remaining motion.[32]

The certification must be filed in the court where the matter is pending, which is defined as the bankruptcy court for thirty days after the effective date under Rule 8002 "[b]ecause of the prompt docketing of appeals in the district court or BAP under Rules 8003 and 8004."[33] As the notes further state, the provision's intent is to "give the bankruptcy judge, who will be familiar with the matter being appealed, an opportunity to decide whether certification for direct review is appropriate."[34]

After thirty days, the matter is deemed to be pending in the district court or the BAP. Marking a change from the prior rule, subdivision (d) makes clear that only the court where the matter is pending may certify a direct review on request of the parties or on its own motion.[35] Hence, when a certification request is made to the bankruptcy court within the thirty-day period, but not ruled upon before expiration of that period, the matter is no longer pending in the bankruptcy court, and only the district court or the BAP has the power to make the certification.

Subdivision (c), (e), and (f) address the three different ways in which an appeal may be certified for direct review, respectively:

(i) a joint certification from all appellants and appellees;

(ii) a bankruptcy court's, district court's, or BAP's own motion; or

(iii) a bankruptcy court's, district court's, or BAP's certification on request of a party or a majority of appellants and a majority of appellees.[36]

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29 FED. R. BANKR. P. 8006(a).
30 FED. R. BANKR. P. 8002.
31 FED. R. BANKR. P. 8002(a)(2).
32 FED. R. BANKR. P. 8002(b)(2).
33 FED. R. BANKR. P. 8006 advisory committee's notes to 2014 amendment.
34 *Id.*; *In re* Revel AC, Inc., No.15-299 (JBS), 2015 WL 333341, at *2 (D. N.J. Jan. 23, 2015).
35 Buchwald Capital Advisors, LLC v. Papas *(In re* Greektown Holdings, LLC), No. 08-53104, 2016 WL 825537, at *1-2 (E.D. Mich. Feb. 24, 2016).
36 FED. R. BANKR. P. 8006.

A joint certification under subdivision (c) requires using Official Form 424.[37] Further, subdivision (c) permits, but does not require, a statement to accompany the certification, stating the basis for the certification. From a strategic perspective, submitting such a statement is prudent in order to persuade the court of appeals to take the direct appeal.[38]

A certification on the court's own motion under subdivision (e) must be set forth in a separate document and accompanied by an opinion or memorandum containing the information required by subdivision (f)(2)(A)-(D). Within fourteen days after the court's certification, parties may file with the clerk of the certifying court a short supplemental statement regarding the certification's merits.

A certification by request under subdivision (f) must be filed with the clerk of the court where the matter is pending, within sixty days after the entry of the judgment, order, or decree, mirroring section 158(d)(2)(E).[39] Subdivision (f)(2) sets forth what must be included in the request, including the circumstances in section 158(d)(2)(A)(i)-(iii) justifying a direct appeal. Subdivision (f)(3) provides parties fourteen days within which to file a response or a cross-request for certification.

Subdivision (g) sets a thirty-day deadline for filing a request to the court of appeals for permission to take a direct appeal once a court has issued a certification.[40] This reflects § 158's clear statement that the court of appeals must itself authorize the appeal.[41] "The purpose of Bankruptcy Rule 8006(g) is to bring the certification to the attention of the court of appeals, at which time it can decide whether or not to hear the appeal."[42]

Within the thirty-day deadline, the request must be filed with the circuit clerk in accordance with Rule 6(c) of the Federal Rules of Appellate Procedure. Failure to file a timely petition for permission to appeal under the rule is not a jurisdictional time bar.[43] Such a failure may, however, render the appeal procedurally untimely and subject to dismissal.[44]

V. Federal Rule of Appellate Procedure 6

If the court of appeals authorizes a direct appeal under 28 U.S.C. § 158(d)(2), the Federal Rules of Appellate Procedure generally apply, including Rule 5, which governs appeals by permission to circuit courts under 28 U.S.C. § 1292(b).[45]

VI. Department Guidance Regarding 28 U.S.C. § 158(d)(2)

The Solicitor General has responsibility, in consultation with each agency or official concerned, for determining whether, and to what extent, the government will pursue appeals in the courts of appeals,

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[37] Stanziale v. Car-Ber Testing, Inc. (*In re* Conex Holdings, LLC), 534 B.R. 606, 609 n.2 (Bankr. D. Del. 2015) (declining to grant a single certification request from the only appellant and only appellee when the record did contain the joint certification on the official form).
[38] 10 COLLIER ON BANKRUPTCY, ¶ 8006.03 ("[A] statement that 'sells' the appeal to the circuit court is probably a wise thing.").
[39] FED. R. BANKR. P. 8006(f).
[40] FED. R. BANKR. P. 8006(g).
[41] 28 U.S.C. § 158(d)(2)(A) (2012) ("if the court of appeals authorizes the direct appeal").
[42] 10 COLLIER ON BANKRUPTCY, ¶ 8006.07 at 8006-9.
[43] Lynch v. Jackson, 853 F.3d 116, 120 (4th Cir. 2017) ("[S]ection 158(d)(2)(A) does not create a jurisdictional time bar, and, therefore, the parties delay in filing [a petition for permission to appeal] did not deprive this court of its jurisdiction.").
[44] *Id.* at n.5; Troiso v. Erickson (*In re* IMMC Corp.), No. 08-11178 (KJC), 2016 WL 2899247, at *4-6 (Bankr. D. Del. 2016).
[45] FED. R. APP. P. 6(c); FED. R. APP. P. 5.

USAM § 2-1.000, including whether to request a district court to certify an issue for interlocutory appeal under 28 U.S.C. § 1292(b).[46] A request for certification under § 158(d)(2) is similar to a request to certify an issue for appeal under § 1292(b) and Rule 5 of the Federal Rules of Appellate Procedure. Therefore, the Department's procedures for requesting § 158(d)(2) certifications are similar to those for requests to certify an issue for interlocutory appeal.

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[46] U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL § 2-2.311 (2009).

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Setoff and Recoupment Through the Lens of SSA Fraud Recovery in Bankruptcy

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This article explores how the Social Security Administration's mandate against paying benefits to fraud debtors interacts with the bankruptcy code's automatic stay injunction, which broadly prohibits debt collection activities once a debtor files for bankruptcy protection. While this article is focused on a single agency-specific issue, the concepts at play—set-off and recoupment—have potentially broad application for the United States given the many circumstances in which the United States and its counterparties have debt claims cutting both ways.

Annual benefit overpayments by the SSA, though small in amount compared to SSA's total annual benefits payments, add up to significant bottom line numbers. Many of these overpayments are incurred innocently or negligently. For those overpayment debtors, SSA's regulations allow the agency the discretion to negotiate a repayment plan that takes into account the financial constraints of the overpayment debtor. On the other hand, for those overpayment debtors who incurred their debts by fraud, SSA's regulations impose an absolute rule: no payment of benefits until the fraudulently incurred overpayment debts are paid in full.

The article begins by describing SSA's statutory and regulatory scheme for recovering fraudulent overpayment debts. Next, it describes the automatic stay and its relationship to two related but mutually exclusive equitable defenses to payment: recoupment and setoff. Then it analyzes a Third Circuit decision, *Lee v. Schweiker*, which rejected certain debt recovery arguments advanced by SSA in the bankruptcy context.[1] Finally, it analyzes whether *Lee*'s approach was misguided in light of recoupment theory's historical background and in light of how recoupment theory has developed in the thirty years since *Lee*.

I. SSA's Overpayment Recovery System

SSA's statutes and regulations anticipate that some recipients of benefits will incur overpayment debts to SSA and provide a mechanism for recovering those overpayments. For most overpayment debts, SSA is afforded considerable discretion in exercising its recovery mechanism. SSA's statutes and regulations further anticipate that some of the overpayment debts will be incurred by fraud. For fraudulent debts, SSA has an administrative system for assessing overpayments and imposing related penalties that offers the alleged fraud debtor the opportunity to contest the fraud allegation before an administrative law judge, pursue an administrative appeal, and seek review before a federal circuit court of appeals in some circumstances. Unlike innocently incurred overpayment debts, SSA's discretion is constrained when it comes to recovering overpayment debts that are determined to be fraudulent.

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[1] Lee v. Schweiker, 739 F.2d 870 (3d Cir. 1984).

SSA's mechanism for recovering overpayments is provided by § 204 of the Social Security Act, codified as 42 U.S.C. § 404, which directs that a "proper adjustment or recovery shall be made, under regulations prescribed by the Commissioner of Social Security," whenever there is an underpayment or overpayment of benefits.[2] In cases of overpayments, the statute provides several mechanisms for recovery, including reduction of benefit payments, requirements that the overpayment recipient refund the overpayment, and recovery of tax refunds.[3] In instances where the overpayment was incurred without fault, overpayment recovery is limited.[4]

The regulations on overpayment recovery called for by 42 U.S.C. § 404 were promulgated as 20 C.F.R. §§ 404.501-404.545. The default rule is that overpayment debtors are not entitled to receive benefit payments until the overpayment has been repaid.[5] Instead, monthly benefits are withheld and applied to the debt.[6] That rule is subject to a significant exception in that withholding can be reduced to just ten dollars per month in cases where withholding full benefits would "defeat the purpose" of SSA benefits by depriving the benefit recipient "of income required for ordinary and necessary living expenses."[7] Likewise, the applicable regulations grant SSA the authority to compromise the amount of overpayment debts and to suspend or terminate collection efforts for those debts in light of the overpayment debtor's financial circumstances.[8]

While SSA has discretion to compromise overpayment claims in most cases, it lacks that discretion when it comes to overpayment debts incurred by fraud. The hardship exception to benefit withholding[9] is not "available if the overpayment was caused by the individual's intentional false statement or representation, or willful concealment of, or deliberate failure to furnish, material information."[10] Instead, no payment may be made to fraud debtors until the debt is repaid.[11] The regulations also deprive SSA of compromise authority in cases of fraud.[12]

Fraud comes in many varieties. Fraudulently incurred overpayments to SSA can range from feigned disabilities, to the maintenance of a false identity to collect benefits, to failure to report benefit-disqualifying employment activity. In practice, SSA considers an overpayment to have been fraudulently incurred for purposes of 20 C.F.R. § 404.502(c)(2)'s mandatory full withholding requirement when the overpayment has been adjudicated as fraudulent. That occurs most commonly in instances of criminal prosecution of the fraud, a bankruptcy court determination of non-dischargeability for fraud under 11 U.S.C. § 523(a)(2), or an SSA agency determination of fraud that has become final and non-appealable. While the judicial processes for determining fraud are well understood by most practitioners, the agency process is well known only to specialists. That process is therefore described in more detail here.

Congress provided SSA an administrative tool for assessing overpayments incurred by fraud and imposing penalties.[13] The statute applies to overpayments incurred by statements that the benefit recipient "knows or should know is [sic] false or misleading," statements made with "knowing disregard for the

[2] 42 U.S.C.A. § 404(a)(1) (2012) (amended 2015).
[3] § 404(a)(1)(A).
[4] § 404(b).
[5] 20 C.F.R. § 404.502(a)(1) (2018).
[6] § 404.502(a)(1).
[7] § 404.502(c)(1); *see* 20 C.F.R. § 404.508 (2018) (providing guidance on when recovery would "defeat the purpose" of the Social Security Act).
[8] 20 C.F.R. § 404.515(a) (2018).
[9] § 404.502(c)(1).
[10] § 404.502(c)(2).
[11] 20 C.F.R. § 404.502(c)(2) (2018).
[12] § 404.515(b)(1).
[13] 42 U.S.C.A. § 1320a-8 (2012) (amended 2015).

truth," and omissions that the benefit recipient knows or should know are material to the benefits determination.[14] The Office of the Inspector General (OIG) for SSA makes a determination of a fraud-related civil monetary penalty and overpayment assessment based on the fact record that it develops.[15] The OIG then provides notice of the proposed determination and the facts underlying the determination to the alleged overpayment debtor, along with notice of the overpayment debtor's right to a hearing.[16] When a final determination is reached—following a hearing if one is requested or following the expiration of the statutory time period for making that request if one is not—it is subject to review by the United States Court of Appeals for the applicable circuit, but the scope of that review is limited to matters that were raised or could have been raised in an administrative hearing.[17]

SSA's statutes and regulations anticipate benefit recipients incurring overpayment debts to the agency from time to time and provide a detailed framework for recovering those overpayment debts via benefits withholding and other means. In most cases, benefits withholding is limited or even abated entirely out of concern for the financial limitations of the benefits recipient or to the benefits recipient's lack of culpability in causing the overpayment to accrue. However, where the benefits recipient incurs the debt by fraud (as found by a final judicial or administrative determination), SSA's mandate is clear: withhold all benefits until the overpayment is repaid.

II. The Recovery of Mutual Debts in Bankruptcy

This section examines how a bankruptcy filing impacts two equitable doctrines—setoff and recoupment—that may apply in circumstances where A owes B and B owes A. First it describes the doctrines, then analyzes how a bankruptcy filing impacts their availability.

A. Setoff Allows Parties to Net Mutual Debts

The right of setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[18] It is a common law right that the bankruptcy code expressly preserves for creditors of a bankruptcy debtor.[19] Further, the bankruptcy code includes setoff as a statutory defense to a request to turn over estate property.[20]

The Unites States has a right to offset claims, just as any private entity does.[21] The "right of setoff is inherent in the United States Government," and that right "exists independent of any statutory grant of authority to the executive branch."[22] A setoff of claims is mandatory if the United States has a right of setoff under the common law.[23]

Setoff is permitted only for "mutual" debts. Mutuality "is satisfied when the offsetting obligations are held by the same parties in the same capacity (that is, as obligor and obligee) and are valid and enforceable, and (if the issue arises in bankruptcy) both offsetting obligations arise either prepetition or

[14] § 1320a-8.
[15] 20 C.F.R. § 498.106 (2018).
[16] 20 C.F.R. § 498.109 (2018).
[17] § 1320a-8(d); 20 C.F.R. § 498.127 (2018).
[18] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995) (quoting Studley v. Boylston Nat. Bank, 229 U.S. 523, 528 (1913)).
[19] 11 U.S.C.A. § 553(a) (2012); United States v. Maxwell, 157 F.3d 1099, 1102 (7th Cir. 1998).
[20] 11 U.S.C.A. § 542(b) (2012).
[21] United States v. Munsey Tr. Co. of Washington, D.C., 332 U.S. 234, 239 (1947).
[22] United States v. Tafoya, 803 F.2d 140, 141 (5th Cir. 1986). *Cf. In re* Calore Exp. Co., Inc., 288 F.3d 22, 44 (1st Cir. 2002) ("[w]hen the federal courts make new federal common law, it is to protect strong federal interests").
[23] *Cf.* 31 U.S.C.A. § 3728 (2012).

postpetition, even if they arose at different times out of different transactions."[24] As a result, prepetition debts generally cannot be set off against postpetition debts and vice versa. The prohibition against setting off debts that are on opposite sides of the petition date is in deference to the bankruptcy code's "fresh start" policy; permitting "the setoff of prepetition debts owed by the debtor against independent postpetition debts owed to the debtor would be a complete frustration of any fresh start."[25] SSA's obligation to pay benefits arises afresh each month and, therefore, constitutes a postpetition obligation each postpetition month.[26]

While the bankruptcy code expressly preserves the right to set off mutual prepetition debts,[27] nothing in the bankruptcy code purports to eliminate other setoff rights. Therefore, courts widely recognize "the right to setoff for postpetition debts."[28] Where a debt is not subject to discharge such that it rides through the bankruptcy to become a debt owed by the postpetition debtor, that debt may be set off against debts owed to the postpetition debtor.[29] This happens as a matter of course in the case of nondischargeable prepetition tax debt being recovered by withholding refunds for postpetition tax years.[30]

SSA's obligation to pay benefits arises afresh each month and therefore constitutes a postpetition obligation each postpetition month.[31] In light of that, non-fraud prepetition SSA overpayment debts that *are* subject to discharge cannot be set off against postpetition SSA benefits payments.[32] In contrast, nondischargeable prepetition overpayments—for example, those incurred by fraud and excepted from discharge by 11 U.S.C. § 523(a)(2)—can be set off against postpetition benefits payments.[33]

B. Recoupment Eliminates the Payment Obligation to Pay in Certain Cases of Closely Intertwined Debts

Recoupment is a concept that is related to setoff, but it applies in a narrower set of circumstances than setoff and is accompanied by an enhanced set of rights.

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[24] *In re* Doctors Hosp. of Hyde Park, Inc., 337 F.3d 951, 955 (7th Cir. 2003); *see* Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 149 (2d Cir. 2002).
[25] *In re* Mohawk Indus., Inc., 82 B.R. 174, 177 (Bankr. D. Mass. 1987).
[26] *In re* Otto, 509 B.R. 566, 568 (S.D. Tex. 2014); *In re* Rowan, 15 B.R. 834, 840 (Bankr. N.D. Ohio 1981); *see* 42 U.S.C.A. § 402(a) (2012) (amended 2015).
[27] 11 U.S.C.A. § 553(a) (2012).
[28] *In re* Gordon Sel-Way, Inc., 239 B.R. 741, 751 (E.D. Mich. 1999) (collecting cases), *aff'd In re* Gordon Sel-Way, Inc., 270 F.3d 280 (6th Cir. 2001); *In re* Reed, 500 B.R. 564, 566 (Bankr. W.D. Wis. 2013) ("a postpetition claim may be offset against a postpetition debt so long as the claim and debt constitute valid, mutual obligations") (quoting 5 COLLIER ON BANKRUPTCY § 553.03[6], at 553-52 (16th ed.)).
[29] *In re* Gordon Sel-Way, Inc., 239 B.R. at 751 (although claim "arose before the bankruptcy petition was filed, it became a postpetition obligation when the Plan of reorganization did not discharge the debt"); *In re* Marsha J. Bennett, No. 14-20342, 2015 WL 94549, at *3 (Bankr. E.D. Ky. Jan. 7, 2015) (prepetition obligation "is treated as a postpetition obligation for purposes of set-off because it survived the discharge"); *In re* Seal, 192 B.R. 442, 457 (Bankr. W.D. Mich. 1996) (although "the genesis of this obligation is prepetition, the debt is now an unsecured postpetition obligation under the Debtors' confirmed 100% repayment plan").
[30] *E.g.*, *In re* Matunas, 264 B.R. 365, 369 (Bankr. D.N.J. 2001).
[31] *In re* Otto, 509 B.R. at 568; *In re* Rowan, 15 B.R. at 840; see § 402(a).
[32] *See, e.g.,* Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984).
[33] Practitioners should note that the fraud exception to discharge is not self-executing, unlike most of § 523(a)'s categories. Instead, fraud-induced debts are excepted from bankruptcy discharge only after the creditor prevails in lawsuit to challenge dischargeability under § 523(a)(2)'s fraud exception. 11 U.S.C.A. § 523(c) (2012) (amended 2016); FED. R. BANKR. P. 7001(6). Such a lawsuit must be brought within sixty days of the first meeting of creditors under 11 U.S.C.A. § 341(a) (2012) or is barred. FED. R. BANKR. P. 4007(c).

Recoupment is "the common law precursor to the modern *compulsory* counterclaim."[34] This contrasts with setoff, which is the ancestor of the *permissive* counterclaim.[35] Compulsory counterclaims must be raised in a pleading or are permanently waived.[36] Permissive counterclaims are optional, so failure to assert them in a pleading does not result in waiver.[37] A compulsory counterclaim is one that "arises out of the transaction or occurrence that is the subject matter of the opposing party's claim."[38]

Recoupment is an equitable concept that—like compulsory counterclaim—applies when a defendant meets an assertion of liability with a countervailing claim that arose out of the same transaction.[39] While a setoff is a defense to reduce a valid right to payment, recoupment cuts deeper. When a valid recoupment counterclaim or defense is asserted, the party seeking payment "has no interest in the funds" sought.[40] Thus, when the two debts are so closely related as to be part of the "same transaction," recoupment recognizes that "it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."[41] Put differently, recoupment applies when "equity demands that the debtor's claim cannot be considered without taking account of the creditor's claim."[42] Given that purpose, a valid recoupment assertion is *not* subject to a statute of limitations.[43]

What counts as a "single transaction" for recoupment purposes varies by circuit. Some apply a "logical relationship" test when considering if two debts arose as part of a "single transaction."[44] The "logical relationship" test derives from the Supreme Court's holding in *Moore v. New York Cotton Exchange*, which held that determining whether claims were part of a single transaction for compulsory counterclaim purposes depended on the "logical relationship" between the claims.[45]

The alternative to the "logical relationship" test is the "identical transaction" test, which limits recoupment's scope to claims arising out of an "identical relationship."[46] As a practical matter, the "identical transaction" test limits recoupment largely to cases where the mutual claims arise out of the same contract.[47] The Third Circuit is the only circuit that has expressly adopted the "identical transaction" test.[48]

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[34] Berger v. City of N. Miami, Fla., 820 F. Supp. 989, 992 (E.D. Va. 1993) (emphasis added).
[35] Coplay Cement Co. v. Willis & Paul Group, 983 F.2d 1435, 1440 (7th Cir. 1993).
[36] Baker v. Gold Seal Liquors, Inc., 417 U.S. 467, 483 n.1 (1974).
[37] Switzer Bros. v. Locklin, 207 F.2d 483, 488 (7th Cir. 1953).
[38] FED. R. CIV. P. 13(a)(1)(A).
[39] Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392, 1399 (9th Cir. 1996); Matter of U.S. Abatement Corp., 79 F.3d 393, 398 (5th Cir. 1996); *In re* Smith, 737 F.2d 1549, 1553 (11th Cir. 1984); *In re* Flagstaff Realty Assocs., 60 F.3d 1031, 1035 (3d Cir. 1995).
[40] *In re* Holford, 896 F.2d 176, 179 (5th Cir. 1990).
[41] *In re* University Medical Center, 973 F.2d 1065, 1081 (3d Cir. 1992).
[42] *In re* Chapman, 265 B.R. 796, 807 (Bankr. N.D. Ill. 2001), *aff'd sub nom.* Chapman v. Charles Schwab & Co., No. 00 A 0358, 2002 WL 818300 (N.D. Ill. Apr. 30, 2002).
[43] Reiter v. Cooper, 507 U.S. 258, 263-64 (1993).
[44] *E.g.*, Newbery Corp., 95 F.3d at 1402-03.
[45] Moore v. New York Cotton Exch., 270 U.S. 593, 609-10 (1926).
[46] *In re* University Medical Center, 973 F.2d at 1079-80.
[47] *See* Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984).
[48] *See In re* Health Mgmt. Ltd. P'ship, 336 B.R. 392, 396 (Bankr. C.D. Ill. 2005) (commenting that most "district and bankruptcy courts have also rejected the Third Circuit's" identical transaction test); *but see In re* Malinowski, 156 F.3d 131, 133-34 (2d Cir. 1998) (criticizing the "logical relationship" test, suggesting that scope of a "transaction" should be narrower in recoupment than in compulsory counterclaim context, citing University Medical with approval, but not expressly adopting the "identical transaction" test).

In addition to the courts that have expressly adopted the broader "logical relationship" test, some courts have rejected the Third Circuit's narrower view of recoupment in favor of a broader concept without expressly mentioning the "logical relationship" test.[49]

C. The Bankruptcy Code's Automatic Stay Enjoins Setoff but Not Recoupment

The filing of a bankruptcy petition imposes (in most cases) an injunction, known as the automatic stay, which stays most actions against the debtor to collect debts, obtain debtor property, or bring or continue lawsuits against the debtor.[50] The scope of the automatic stay is intended to be broad, and the statutory exceptions to the automatic stay's scope are interpreted narrowly.[51] The automatic stay explicitly prohibits a creditor from exercising a right of setoff against a debtor.[52] The bankruptcy code is silent as to what effect the automatic stay has on recoupment rights.

Though the automatic stay enjoins the exercise of setoff rights, the bankruptcy code includes a separate statutory preservation of setoff rights.[53] That statutory preservation is limited to mutual debts that "arose before the commencement of the [bankruptcy] case."[54] The bankruptcy code's preservation of setoff rights "neither expands nor constricts the common law right to set off. Rather, it preserves . . . whatever right exists outside bankruptcy."[55] Therefore, setoff may be applied in the case of mutual postpetition debts.[56]

To exercise a right of setoff during the pendency of the automatic stay injunction, a creditor must obtain a modification of the stay to permit the assertion of the setoff.[57] The bankruptcy code requires the court to grant relief from the automatic stay upon a showing of "cause, including the lack of adequate protection of an interest in property."[58] Where a creditor demonstrates a right of setoff, it establishes a prima facie showing of "cause" for stay relief purposes.[59] The burden then shifts to the debtor to rebut the prima facie showing by, among other options, challenging the right of setoff or showing that the movant is adequately protected.[60] Adequate protection means demonstrating that the creditor's interest in debtor's property will not be impaired while the stay is pending (for example, demonstrating proof of insurance for a lien on a vehicle, or demonstrating the debtor is cash flow positive for a lien on all assets of a business).[61] It is difficult for a cash strapped debtor to demonstrate adequate protection for a setoff right

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[49] *In re* Holyoke Nursing Home, Inc., 372 F.3d 1, 4 (1st Cir. 2004) (rejecting the Third Circuit's analysis in favor of the interpretation of recoupment that "has been embraced by the overwhelming majority of district and bankruptcy courts nationwide which have ruled to date").

[50] 11 U.S.C.A. § 362(a) (2012).

[51] *In re* Grede Foundries, Inc., 651 F.3d 786, 790 (7th Cir. 2011).

[52] § 362(a)(7).

[53] 11 U.S.C.A. § 553 (2012).

[54] § 553(a).

[55] U.S. v. Maxwell, 157 F.3d 1099, 1102 (7th Cir. 1998).

[56] *In re* Davidson Lumber Sales, Inc., 66 F.3d 1560, 1569 (10th Cir. 1995); *In re* Doctors Hosp. of Hyde Park, Inc., 337 F.3d 951, 955 (7th Cir. 2003); *In re* Reed, 500 B.R. 564, 566 (Bankr. W.D. Wis. 2013).

[57] The pendency of the automatic stay varies in length based largely on which chapter the bankruptcy case is brought under. The stay terminates upon the debtor receiving a discharge of debts (the purpose for many bankruptcies) in chapter 7, 9, 11, 12, or 13. But the timeline to discharge varies among chapters. It is a matter of months for a chapter 7, but a matter of years for chapter 13.

[58] 11 U.S.C.A. § 362(d)(1) (2012).

[59] *In re* Reed, 500 B.R. at 569; *see In re* Nuclear Imaging Sys., Inc., 260 B.R. 724, 730 (Bankr. E.D. Pa. 2000) (citing *In re* Orlinski, 140 B.R. 600, 603 (Bankr. S.D. Ga. 1991); *In re* Coleman, 52 B.R. 1, 3 (Bankr. S.D. Ohio 1985); *In re* Flanagan Bros., Inc., 47 B.R. 299, 303 (Bankr. D.N.J. 1985)).

[60] *In re* Reed, 500 B.R. at 569.

[61] *See* 11 U.S.C.A. § 361 (2012).

against a stream of monthly payments, because the payments are received and immediately consumed by living expenses.

Once the creditor seeking stay relief has established a setoff right, some courts have held that the decision on whether to grant stay relief rests within the discretion of the court,[62] whereas others have stated that the right to stay relief is absolute and not subject to equitable considerations.[63] Even those courts that hold discretion plays a role have held that this discretion is not boundless. Rather, the bankruptcy code's policy is to allow setoffs, and courts should not "disturb this policy unless compelling circumstances require it."[64] The debtor's financial need for funds subject to setoff is not enough by itself to establish an equitable ground to deny stay relief.[65]

Recoupment, in contrast, is not impacted by the automatic stay. The statute imposing the automatic stay expressly prohibits setoffs without court permission[66] but says nothing about recoupment. It is well recognized that exercising a recoupment does not violate the automatic stay and does not require court permission.[67] Likewise, unlike "setoff, recoupment is not limited to pre-petition claims and thus may be employed to recover across the petition date."[68] The justification for advantaging recoupment over setoff in these ways is that funds subject to recoupment "are not the debtor's property."[69] An alternative, but similar, justification is that recoupment governs situations where it would be inequitable for the debtor "to enjoy the benefits of that transaction without also meeting its obligations."[70]

The rationale (and result) is similar to how recoupment plays out in the statute of limitations context: recoupment "goes to the foundation of plaintiff's claim by deducting from plaintiff's recovery all just allowances or demands accruing to the defendant with respect to the same contract or transaction" and is therefore not impacted by otherwise applicable claim-limiting laws such as statutes of limitations or the automatic stay.[71]

III. The Recovery of SSA Overpayments and Recoupment

Having set the table with a discussion of how setoff and recoupment rights differ in their properties and in their treatment within bankruptcy, this paper now turns to how those rights apply in the specific circumstance of withholding SSA benefits to recover an overpayment. This portion begins by considering the only circuit level case to have taken up the issue: *Lee v. Schweiker*.[72]

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62 *In re* Medina, 205 B.R. 216, 223 (B.A.P. 9th Cir. 1996).
63 *In re* Krause, 261 B.R. 218, 223 (B.A.P. 8th Cir. 2001); *In re* Applied Logic Corp., 576 F.2d 952, 957-58 (2d Cir. 1978).
64 Bohack Corp. v. Borden, Inc., 599 F.2d 1160, 1165 (2d Cir. 1979).
65 *In re* Lazar, 219 B.R. 212, 214 (Bankr. N.D. Ohio 1998).
66 11 U.S.C.A. § 362(a)(7) (2012).
67 *In re* University Medical Center, 973 F.2d 1065, 1079 (3d Cir. 1992); *In re* Malinowski, 156 F.3d 131, 133 (2d Cir. 1998); Matter of Kosadnar, 157 F.3d 1011, 1013-14 (5th Cir. 1998); *In re* TLC Hospitals., Inc., 224 F.3d 1008, 1011 (9th Cir. 2000); *In re* Holyoke Nursing Home, Inc., 372 F.3d 1, 3 (1st Cir. 2004).
68 *In re* TLC Hospitals, Inc., 224 F.3d at 1011.
69 *In re* Malinowski, 156 F.3d at 133.
70 *In re* Holyoke Nursing Home, Inc., 372 F.3d at 3; (quoting *In re* University Medical Center, 973 F.2d at 1081).
71 Distribution Servs., Ltd. v. Eddie Parker Interests, Inc., 897 F.2d 811, 812 (5th Cir. 1990) (discussing recoupment's exemption from statutes of limitations).
72 Lee v. Schweiker, 739 F.2d 870 (3d Cir. 1984).

A. The Third Circuit Considers and Rejects the Argument that Withholding Benefits to Recover SSA Overpayments Is Recoupment in an Opinion that Presumes Overpayment Debt is Subject to Discharge

Lee involved an SSA benefits recipient, Lillie Lee, who incurred a very modest overpayment debt to SSA.[73] The overpayment was incurred due to Lee earning, but not reporting, income that reduced her benefits entitlement.[74] Once the overpayment was discovered, SSA and Lee agreed to a recovery schedule by which twenty-five percent of Lee's monthly benefits would be withheld and applied to the overpayment.[75]

After just a few months of benefits withholding, Lee filed for bankruptcy.[76] SSA continued to withhold benefits despite the bankruptcy, and Lee sued to end the benefits withholding and recover those benefits withheld during the bankruptcy.[77] The SSA offered several legal bases for its postpetition benefits withholding, but this analysis focuses on just one: the withholding was a recoupment and did not implicate the automatic stay.[78]

The district court held that SSA's debt to Lee and Lee's debt to SSA arose out of the same transaction, which made the mutual debts subject to recoupment, and that recoupments are not subject to the automatic stay.[79] The Third Circuit disagreed.

The Third Circuit began its analysis by contrasting setoff and recoupment, focusing on the limitations that 11 U.S.C. § 553 placed on setoff but not recoupment.[80] The Third Circuit observed that "pre-petition claims against the debtor cannot be setoff against post-petition debts to the debtor" but that recoupment "allows the creditor to assert that certain mutual claims extinguish one another in bankruptcy, in spite of the fact that they could not be 'setoff' under 11 U.S.C. § 553."[81] The court opined that the reason that setoff is limited to mutual prepetition debts but recoupment is not is that "where the creditor's claim against the debtor arises from the same transaction as the debtor's claim, it is essentially a defense to the debtor's claim against the creditor rather than a mutual obligation, and application of the limitations on setoff in bankruptcy would be inequitable."[82]

The Third Circuit next turned to whether the SSA's obligation to pay benefits to Lee and Lee's overpayment debt to SSA constituted debts arising from the "same transaction" for recoupment purposes. The court observed that recoupment "has been applied primarily where the creditor's claim against the debtor and the debtor's claim against the creditor arise out of the *same contract*."[83] The logic of the cases applying recoupment to mutual contract debts is that it is inequitable for the debtor to assume favorable aspects of contract (postpetition payments) and reject the unfavorable aspects (prepetition debts).[84]

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73 *Id.* at 873.
74 *Id.*
75 *Id.*
76 *Id.*
77 *Id.*
78 *Id.* at 874. It is worth observing—for reasons that will be touched on in the following section—that SSA did *not* argue (to the circuit court at least) that Lee's overpayment debt was incurred by fraud or excepted from discharge by 11 U.S.C.A. § 523(a)(2) (2012) (amended 2016) or any other statute.
79 *Id.*
80 11 U.S.C.A. § 553 (2012).
81 Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984).
82 *Id.*
83 *Id.* (emphasis supplied).
84 *Id.* at 876.

The Third Circuit then turned its recoupment analysis to SSA benefits and overpayment obligations. The court, citing four opinions, stated that other courts have generally held that "a social-welfare statute entitling an individual to benefits is not a contract, and that the obligation to repay a previous overpayment is a separate debt subject to the ordinary rules of bankruptcy."[85] In other words, recoupment applies to debts arising out of contracts negotiated among parties, but the Social Security benefit program is a social welfare program, not a negotiated agreement, and therefore recoupment does not apply to Social Security overpayment debts.

The four cases that the Third Circuit cited for the proposition that courts do not consider social welfare benefits to be contract obligations for recoupment analysis offer weak support for that proposition. *In re Neavear*[86] rejected an argument that the Social Security Act's anti-assignment clause's statement that SSA benefit payments are not subject "to the operation of any bankruptcy or insolvency law" deprived the bankruptcy court of subject matter jurisdiction over SSA and made all SSA overpayments exempt from the operation of the bankruptcy code such that all debts to SSA are excepted from discharge. *In re Hawley*[87] and *In re Rowan*[88] held the same. *In re Howell* concerned the recovery of a disability overpayment incurred under a Department of Labor program and rejected sovereign immunity and setoff arguments made by the United States, but did not consider whether recoupment justified the benefit withholding the Department of Labor sought.[89] *Hawley*, *Rowan*, and *Howell* do not mention the word "contract" at all. *Neavear* mentions the word once in service of distinguishing a case.[90] The Third Circuit's stated rationale for denying SSA withholdings recoupment status—social welfare statutes are not contracts—was a novel development in recoupment jurisprudence.

The Third Circuit finished its recoupment analysis with a public policy observation. The court pointed out that the purpose of the Social Security Act is "to provide income to qualifying individuals."[91] In light of that purpose, SSA's overpayment recovery rights "should be subject to the limitations on setoff" just as they are "limited by the provisions for exemption and discharge;" they should not enjoy expanded recoupment rights.[92] This last observation presumed without discussion that SSA overpayment debts are categorically subject to discharge. That overlooks the fact that fraudulently incurred overpayments—like any fraudulently incurred debt—are excepted from discharge by 11 U.S.C. § 523(a)(2) and that the Social Security Act and incorporate regulations set forth a complex scheme for recovering overpayments when they occur.[93]

B. An Alternative to *Lee*: Courts Should Defer to Legislative Intent When Considering if SSA Benefits Withholding Is Recoupment

The Third Circuit's *Lee* opinion is premised on an outlier approach to recoupment and an unexamined assumption about the intent of the Social Security Act: that its purpose is to provide "entitlement" income in all cases, regardless of recipient conduct. Most other circuits that have closely examined recoupment have articulated a conception of recoupment that extends beyond the Third Circuit's "identical transaction" approach that limits the doctrine almost exclusively to mutual contract

[85] *Id.*
[86] Matter of Neavear, 674 F.2d 1201 (7th Cir. 1982).
[87] Matter of Hawley, 23 B.R. 236 (Bankr. E.D. Mich. 1982).
[88] *In re* Rowan, 15 B.R. 834 (Bankr. N.D. Ohio 1981).
[89] *In re* Howell, 4 B.R. 102 (Bankr. M.D. Tenn. 1980).
[90] Matter of Neavear, 674 F.2d at 1205 no.10.
[91] Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984).
[92] *Id.*
[93] 11 U.S.C. § 523(a)(2) (2012) (amended 2016).

debts. This section examines the majority approach to recoupment and analyzes how the recovery of fraudulent overpayment debt by the SSA fits within it.

A string of cases evaluating whether Medicare overpayments are subject to recoupment by withholding Medicare benefits provide a critique to the approach to recoupment advanced by the Third Circuit in *Lee*. The first circuit-level court to reach this question was the same Third Circuit, about eight years later in *In re University Medical Center*.[94] That court based its recoupment analysis on the framework provided by *Lee*, characterizing the *Lee* approach as limiting recoupment to claims arising out of an "identical transaction."[95] The court observed that recoupment applies most frequently to claims arising from a single contract but cautioned that "an express contractual right is not necessary to effect a recoupment."[96] In so doing, *University Medical* put distance between itself and *Lee*, which dismissed recoupment's application to SSA overpayment recovery on grounds that "a social-welfare statute entitling an individual to benefits is not a contract."[97]

The *University Medical* decision then directly addressed recoupment's relationship to compulsory counterclaims, noting that appellant United States had urged the court to apply the same "broad and flexible standard" to recoupment as is applied to compulsory counterclaims.[98] The Third Circuit rejected this invitation, stating that the compulsory counterclaim conception of a "transaction" was "inadequate for determining whether two claims arise from the same transaction for the purposes of equitable recoupment in bankruptcy."[99] Rather, recoupment should apply only where "it would be inequitable for the debtor to enjoy the benefits of [a] transaction without also meeting its obligations."[100] Further, because recoupment is an equitable exception to a statute—11 U.S.C. § 362(a)'s automatic stay—it must be "narrowly construed."[101]

The *University Medical* analysis on this point failed to consider that outside the bankruptcy context, recoupment is well recognized as overriding applicable statutes of limitations.[102] Statutes of limitations and the automatic stay are conceptually similar because they both place time limits on the assertions of certain claims: the statute of limitations based on time from claim accrual, and the automatic stay based on accrual before or after the petition date. The Third Circuit identifies—and the author's research uncovered—no precedent suggesting that the recoupment doctrine's "transaction" conception is applied more narrowly when overriding a statute of limitations. In light of that, the Third Circuit's decision to apply a narrower conception of recoupment in deference to the automatic stay can be seen as a questionable break from recoupment precedent. As will be discussed below, *University Medical*'s statutory deference argument for narrow recoupment application in bankruptcy also overlooks another source of statutory guidance: the Social Security Act's provisions requiring the withholding of benefits to recoup overpayments.

Having adopted *Lee*'s conception of recoupment (a view the Third Circuit acknowledged is narrower than applied outside of bankruptcy), *University Medical* concluded that Medicare withholding was not recoupment, largely on grounds that recovering payments across healthcare provider cost-years was too attenuated to be part of an "identical transaction." *University Medical* observed that "each provider cost-year is subject to a distinct annual audit" and that the Medicare statute directs that payment

[94] *In re* University Medical Center, 973 F.2d 1065 (3d Cir. 1992).
[95] *Id.* at 1080.
[96] *Id.*
[97] Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984).
[98] *In re* University Medical Center, 973 F.2d at 1081.
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] Reiter v. Cooper, 507 U.S. 258, 264 (1993). (citing Bull v. United States, 295 U.S. 247, 262 (1935)).

shall be made "with necessary adjustments on account of previously made overpayments."[103] Despite the fact that the statute called for benefit withholdings to recover past overpayments, the Third Circuit held that the current year's "payments were independently determinable and were due for services completely distinct from those reimbursed through" the prior year's overpayment.[104] In the Third Circuit's view, that was enough to render a prior year's overpayment a separate transaction such that withholding to recover that prior year was not recoupment.[105]

After *University Medical*, three more circuit courts considered the same argument over whether Medicare withholding was recoupment. Each rejected *University Medicare*'s analysis, focusing specifically on the Third Circuit's outlier approach to recoupment.

The first circuit court to consider and depart from the *University Medical* analysis was the D.C. Circuit in *United States v. Consumer Health Services of America, Inc.*[106] The court observed that the Third Circuit had adopted a "stricter standard" for recoupment that departed from the standard applied in the compulsory counterclaims context.[107] The D.C. Circuit criticized the *University Medical*'s focus on the fact that Medicare overpayment recoveries occur across cost-years as an arbitrary way to determine whether those recoveries were part of the same transaction.[108] Instead, in "determining whether the pre-petition and post-petition services should be thought of as one transaction, the key to us is the Medicare statute."[109] The D.C. Circuit observed that "Congress rather clearly indicated that it wanted a provider's stream of services to be considered one transaction for purposes of any claim the government would have against the provider."[110] Thus, *Consumer Health Services* stands for the proposition that it is appropriate for courts to defer to legislative intent when considering whether claims are part of a "single transaction" subject to recoupment.

Next, the Ninth Circuit considered whether recoupment applied to Medicare withholdings in *In re TLC Hospitals, Inc*.[111] The Ninth Circuit explained its conception of recoupment as encompassing debts arising from the same transaction, as determined by the "logical relationship" test first articulated by the Supreme Court in *Moore*,[112] a case that arose in the compulsory counterclaim context.[113] The court held that withholding present benefits to recover past Medicare overpayments constituted a single transaction under the logical relationship test and there should be afforded recoupment treatment.[114] In so holding, the court adopted *Consumer Health Services*'s reasoning that it is appropriate for courts to defer to legislative intent when considering whether to apply the equitable doctrine of recoupment.[115] The *TLC Hospitals* court went on to consider and reject the reasoning of the Third Circuit in *University Medical*, stating that it declined to adopt the "identical transaction" limitation on recoupment urged by *University Medical*, stating that the court "did not accept the Third Circuit's narrow definition of 'transaction.'"[116]

[103] *In re* University Medical Center, 973 F.2d 1065, 1080 (3d. Cir. 1992) (citing 42 U.S.C.A. § 1395g(a) (2012)).
[104] *Id.* at 1081.
[105] *Id.* at 1081-82.
[106] United States v. Consumer Health Servs. of Am., Inc., 108 F.3d 390 (D.C. Cir. 1997).
[107] *Id.* at 395.
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] *In re* TLC Hospitals., Inc., 224 F.3d 1008 (9th Cir. 2000).
[112] Moore v. New York Cotton Exch., 270 U.S. 593, 609-10 (1926).
[113] *In re* TLC Hospitals, Inc., 224 F.3d at 1012.
[114] *Id.* at 1012-13.
[115] *Id.*
[116] *Id.* at 1013-14.

Finally, the First Circuit considered the same issue in *In re Holyoke Nursing Home, Inc.*[117] The court began by describing the *University Medical* decision's rationale for holding that Medicare overpayment recovery is not recoupment: since the government "annually pays providers only for medical services provided in the current cost year, each annual payment constitutes a distinct and segregable 'transaction.'"[118] The court observed that the "Third Circuit is the only court of appeals which has adopted this rationale to date."[119] The First Circuit declined to follow *University Medical* and instead adopted the approach of the D.C. and Ninth Circuits in deferring to Congressional intent when determining if debts were part of the same transaction, an interpretation that "has been embraced by the overwhelming majority of district and bankruptcy courts nationwide which have ruled to date."[120]

The statutory and regulatory scheme applicable to the recovery of fraudulently induced SSA overpayments is similar to the Medicare payment recovery scheme held to be a recoupment in *Holyoke, Consumer Health Services*, and *TLC Hospitals*. Section 404 of the Social Security Act mandates that when an individual is overpaid, "recovery shall be made," and provides that "under regulations prescribed by the Commissioner of Social Security . . . the Commissioner of Social Security shall decrease any payment . . . to which such overpaid person is entitled."[121] The regulations anticipated by § 404(a) that apply here are 20 C.F.R. §§ 404.502 and 404.515. Section 404.502(a)(1) provides that for individuals who have received overpayments, "no benefit for any month and no lump sum is payable . . . until an amount equal to the amount of the overpayment has been withheld or refunded."[122] While the Act creates a hardship exemption if the benefits withholdings would "deprive the person of income required for ordinary and necessary living expenses",[123] that adjustment applies only to persons who received an overpayment through no fault of their own[124] and "will not be available if the overpayment was caused by the individual's intentional false statement or representation."[125]

Likewise, while SSA may compromise its overpayment claim in most circumstances, "a claim for overpayment will not be compromised, nor will there be suspension or termination of collection of the claim . . . if there is an indication of fraud."[126] So, the applicable statutory and regulatory scheme is this: the overpayment collection statute provides that SSA must collect overpayments by withholding payments according to SSA's regulations, and those regulations require a 100 percent withholding in cases where the overpayment was incurred by fraud. By conditioning the right to payments on the repayment of past fraud overpayments, the SSA statutory scheme shows clear Congressional intent to treat the stream of SSA payments and overpayments as a single transaction. That is enough to justify application of the recoupment doctrine under *Holyoke*, *Consumer Health Services*, and *TLC Hospitals*.

Further, the SSA statutory scheme also undermines the "public purpose" argument relied on by *Lee* in its holding that SSA withholding is not recoupment. *Lee* observed that "the primary purpose of [the Act] is to provide income security" immediately before concluding that SSA's right "to recover prepetition debts should be subject to the limitations on setoff, just as it is limited by the provisions for exemption and discharge."[127] *Lee*'s concern appeared to be that recoupment would allow SSA to make an end run around the discharge injunction and collect debts otherwise subject to discharge, a result *Lee*

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[117] *In re* Holyoke Nursing Home, Inc., 372 F.3d 1 (1st Cir. 2004).
[118] *Id.* at 4.
[119] *Id.*
[120] *Id.*
[121] 42 U.S.C.A. § 404(a) (2012) (amended 2015).
[122] 20 C.F.R. § 404.502(c)(1) (2018).
[123] § 404.502(c)(1), *see* 20 C.F.R. § 404.508 (2018); § 404(b).
[124] § 404(b), 20 C.F.R. §§ 404.506(a) (2018), 404.507 (2018).
[125] § 404.502(c)(2).
[126] 20 C.F.R. § 404.515(b)(1) (2018).
[127] Lee v. Schweiker, 739 F.2d 870, 876 (3d Cir. 1984) (emphasis supplied).

viewed as at odds with the purposes of the Act.[128] In the case of fraudulently incurred overpayments, that concern is misplaced both because such debts are excepted from discharge[129] and because the Act and its regulations mandate 100 percent withholding of benefits in cases of fraud.[130]

SSA's statutory scheme predicates the right to receive SSA benefits on the SSA beneficiary first returning past overpayments induced by fraud. That is a close analog to the Medicare statutory scheme that the *Holyoke*, *Consumer Health Services*, and *TLC Hospitals* courts concluded was recoupment. The reasoning of those decisions is more persuasive than the reasoning of *Lee*, which arbitrarily applied a narrower conception of recoupment in the bankruptcy context only. At least one district court has found the analogy persuasive and concluded that withholding fraudulently induced SSA overpayments is recoupment.[131] Others should follow.

IV. Conclusion

The distinction between setoff and recoupment is important to determining the rights of a creditor in bankruptcy in two respects. First, a creditor cannot enact a setoff without court permission, whereas a creditor can enact a recoupment as a matter of right. Second, setoffs are generally limited to mutual debts that accrued both prepetition or both postpetition, whereas recoupment allows a creditor to recover a prepetition debt against a postpetition obligation in all cases.

Courts generally agree that recoupment applies only to debts arising out of a "single transaction," but the scope of a "single transaction" differs by circuit. The majority of circuits that have considered the matter have held that the question of what constitutes a recoupment in bankruptcy should be resolved by applying the same conception of "single transaction" as is applied in the compulsory counterclaim context, a test sometimes referred to as the "logical relationship" test. The Third Circuit alone has held that the conception of recoupment in bankruptcy should be evaluated by the far narrower "identical transaction" test.

The Third Circuit is the only circuit that has taken up the issue of whether SSA benefits withholding is a recoupment and has held that it is not. Most other circuits would likely reach the opposite conclusion based on their application of a broader conception of recoupment in bankruptcy to the question of SSA benefits withholding. That prediction is based on the First, Ninth, and D.C. Circuits break from the Third Circuit in addressing whether Medicare overpayment recover is a recoupment. The Third Circuit—applying its narrower bankruptcy specific understanding of recoupment—concluded that Medicare overpayment recovery is not a recoupment. The First, Ninth, and D.C. circuits applied a traditional understanding of recoupment to conclude that Medicare overpayment recovery fit within the doctrine. This article concludes that the majority approach of applying the same principles to recoupment within bankruptcy that apply outside of bankruptcy is the better of the two approaches.

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[128] *Id.*
[129] 11 U.S.C.A. § 523(a)(2) (2012) (amended 2016); 11 U.S.C.A. § 1328(a)(2) (2012).
[130] That is not to say that *only* fraudulent SSA overpayments should be subject to recoupment; the Act and its regulations contemplate withholding of overpayments incurred without fraud as well.
[131] Wernick v. United States, No. 16-CV-5313, 2016 WL 7212508, *5 (N.D. Ill. Dec. 13, 2016).

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Protecting the Medicare Program in Health Care Provider Bankruptcy Cases

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I. Introduction

The United States often has substantial interests at stake when a health care provider files for bankruptcy protection. This article discusses several issues that an attorney representing the United States will likely encounter when a financially troubled health care provider participates in the Medicare Program. Bankruptcy cases can move rapidly, and the attorney must quickly determine what types of claims the United States may have. If the United States has, or is likely to have claims against the health care provider, the attorney should act to protect the United States' recoupment and setoff rights, especially when the health care provider seeks bankruptcy court approval for postpetition financing or to use cash collateral. The attorney should also ensure that disputes under the Medicare Program, such as denial or suspension of reimbursements, overpayment determinations, or provider termination, are adjudicated through the administrative process, and not as part of the bankruptcy case.[1]

II. The United States' Claims in Health Care Provider Bankruptcy Cases

Two common claims the United States has in health care provider bankruptcy cases are claims for Medicare overpayments and claims arising under the False Claims Act.[2]

A. Medicare Overpayment Claims

In general, the Medicare Act[3] and its implementing regulations[4] provide that the Centers for Medicare & Medicaid Services (CMS), a component of the United States Department of Health and Human Services (HHS), pays Medicare providers' reimbursement claims through its contractors after only a minimal review. Later, CMS conducts a closer review and reconciliation, which often results in determinations that CMS overpaid the provider. Ongoing Medicare reimbursements are usually adjusted to recover these overpayments. Given this process of post-payment reconciliation and adjustment,

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[1] Assistant United States Attorneys should contact the appropriate Regional Chief Counsel's Office of the U.S. Department of Health and Human Services when they learn of a health care provider bankruptcy case filed in their district. *See Regional Offices Key Personnel*, U.S. DEP'T. OF HEALTH & HUMAN SERVICES, REGIONAL OFFICES (last visited February 27, 2018). Assistant United States Attorneys should also contact the Corporate/Financial Litigation Section of the Commercial Litigation Branch if the claims appear to be large, or whenever specific advice or support is needed.
[2] The United States may have additional claims on behalf of the Internal Revenue Service, the military, and other federal agencies. Such claims should also be protected, but are beyond the scope of this article.
[3] 42 U.S.C. § 1395 (2012) *et seq.*
[4] 42 C.F.R. Chapter 4.

Medicare providers commonly have outstanding overpayments when they file a petition for bankruptcy protection. The overpayments are a debt to the government and may be substantial, depending on the provider's volume of Medicare business.

Medicare overpayments resulting from services rendered prepetition are unsecured claims if the amounts cannot be recovered through recoupment or setoff.[5] If the provider continues operations after filing its bankruptcy petition, the United States will also likely have administrative expense claims[6] by virtue of overpayments resulting from services rendered postpetition. These postpetition overpayments should be afforded a higher priority and must be paid in full.[7]

B. False Claims Act Claims

Health care provider bankruptcy cases often involve claims arising under the False Claims Act (FCA Claims).[8] A provider may have potential False Claims Act exposure whenever it misstates a bill or other claim for payment under the Medicare Program.[9] FCA Claims are generally unsecured and are frequently the largest unsecured claims in these bankruptcy cases.

In some situations, the FCA Claims may not be dischargeable at the conclusion of the case because the Bankruptcy Code excepts from discharge debts that arise from fraud.[10] If the FCA Claims are not discharged, the United States may continue to pursue collection of the claims from the reorganized debtor after the bankruptcy case has concluded.

One goal of the United States in health care provider bankruptcy cases is to preserve the FCA Claims from discharge, and in certain circumstances that is accomplished by filing an adversary proceeding. Usually, in a Chapter 11 bankruptcy case, the United States should not need an adversary proceeding to prevent discharge of its FCA Claims.[11] In other situations, however, the United States must file an adversary proceeding to avoid discharge.[12] The deadline for filing an adversary proceeding generally occurs two to three months after the bankruptcy petition is filed. The timing is governed by FED. R. BANKR. P. 4007(c).[13] If the debtor fails to list the United States' FCA Claims on its bankruptcy schedules,[14] the attorney will need to determine the first date set for the meeting of creditors and then calculate the deadline for initiating an adversary proceeding. Debtors will often consent to an extension of this deadline.

At times, a reorganizing debtor may elect to resolve nondischargeable FCA Claims through its plan of reorganization to avoid a collection action post-bankruptcy. If the health care provider is

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[5] Recoupment and setoff are discussed in more detail, *infra,* in Section III of this article.

[6] Administrative expense claims include "the actual, necessary costs and expenses of preserving the [debtor's] estate." 11 U.S.C. § 503(b)(1)(A) (2012).

[7] *See* § 503(b)(1)(A), 11 U.S.C. § 1129(a)(9)(A) (2012).

[8] 31 U.S.C. § 3729 (2012) *et seq.*

[9] FCA Claims may also involve claims arising under the Anti-Kickback statute (42 U.S.C. § 1320a-7b (2012) (amended 2015)) and the federal Ethics in Patient Referral Act (42 U.S.C. § 1395nn (2012)), commonly known as the Stark Law.

[10] *See* 11 U.S.C. §§ 523(a)(2) (2012) (amended 2016), 1141(d)(6)(A) (2012).

[11] *See* § 1141(d)(6)(A); *In re* Hawker Beechcraft, Inc., 515 B.R. 416 (S.D.N.Y. 2014). Nevertheless, the attorney should consider an adversary proceeding as a precaution, if collection, after the bankruptcy case seems feasible.

[12] *See* § 523(a)(2), (a)(4), (a)(6), (c).

[13] FED. R. BANKR. P. 4007(c). The deadline by which to file an action to determine dischargeability under § 523(c) is sixty days after the first date set for the meeting of creditors under § 341(a). If the deadline for filing a complaint to determine dischargeability indicated on the court issued notice of the bankruptcy filing is later than sixty days after the first date for the creditors' meeting, it is recommended to follow Rule 4007(c), unless the later date was ordered by the bankruptcy court in response to a motion to extend the deadline.

[14] This is to be expected when a debtor may not be aware of a FCA investigation or lawsuit.

liquidating, however, no assets will be available to pay the FCA Claims after the case concludes, and so an exception to discharge would add little value in such cases.[15]

C. Practice Pointers

In Chapter 11 cases involving a sale of assets, the debtor can seek a higher price through a bankruptcy sale under section 363(f)[16] of the Bankruptcy Code, by working to remove liabilities associated with the assets. In order to purchase a health care provider's assets (including assignment of its Medicare provider agreements) free and clear of all liens, claims, and encumbrances, including potential FCA Claims, the potential buyer may need to address both the Medicare overpayments and the FCA Claims associated with the Medicare provider agreements before the sale is approved by the court and consummated.[17]

The attorney for the United States should prepare to play a pivotal role in a health care provider's bankruptcy case due to the speed at which a typical bankruptcy case progresses and the complex interplay of the Bankruptcy Code with the Medicare Act. The sheer size of the Medicare overpayment claims and FCA Claims often place the United States at the center of a health care provider's bankruptcy case.

III. Protecting the United States' Recoupment and Setoff Rights in Cash Collateral and Debtor-in-Possession Financing Orders

When a health care provider files for bankruptcy, the United States must act quickly to protect its rights of recoupment and setoff. Often, as a first step, health care providers seek court orders authorizing cash collateral use or debt incurrence. Such orders can immediately impair the United States' recoupment and setoff rights, so early involvement is key to protecting the government's interests.

A. Cash Collateral Use and Debtor-in-Possession (DIP) Financing

In Chapter 11 cases, debtors frequently move for authority to use cash collateral and grant adequate protection or to obtain postpetition debtor-in-possession (DIP) financing.[18] This authorization is commonly sought as a means to ensure that the debtor has sufficient cash flow to operate its business.

Secured parties or lenders (collectively, Lenders) will not provide DIP financing or allow cash collateral use without receiving adequate protection from debtors. Under the Bankruptcy Code, adequate protection may consist of cash payments, replacement liens, or "other relief."[19] Not surprisingly, Lenders ask for every available means of adequate protection, including "priming" liens on all of the debtor's assets. Granting a priming lien places that lien ahead of other creditors' rights. When priming liens are proposed as adequate protection for the Lender, and purport to prime the United States' recoupment or

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[15] One potential exception is if the health care provider is an individual. If such individual is likely to earn substantial income after the Chapter 7 case concludes, a debt excepted from discharge may eventually be fully or partially satisfied.

[16] 11 U.S.C. § 363(f) (2012).

[17] Issues related to assumption and assignment of Part A Medicare provider agreements under section 365, as well as debtors' attempts to sell such provider agreements under section 363(f) without meeting the requirements of section 365, are not covered by this article. Generally speaking, however, a free and clear sale is objectionable because a sale that allows the buyer to step into the shoes of the debtor and avoid any gap in Medicare reimbursement requires assumption and assignment of the existing provider agreement and thus successor liability as mandated by 42 C.F.R. § 489.18 (2018). *See* Deerbrook Pavilion, LLC v. Shalala, 235 F.3d 1100, 1104 (8th Cir. 2000); United States. v. Vernon Home Health, Inc., 21 F.3d 693, 696 (5th Cir. 1994); *In re* Charter Behavioral Health Sys., LLC, 227 B.R. 54 (Bankr. D. Del. 2002).

[18] *See* § 363, 11 U.S.C. § 364 (2012).

[19] 11 U.S.C. § 361 (2012).

setoff rights, the United States is forced to object to the use of cash collateral or DIP financing in order to protect its position.

Debtors usually file these early motions on an emergency basis with shortened response deadlines. The emergency motions often seek to elevate Lenders' interests over the United States' rights of setoff and recoupment, either by providing Lenders with adequate protection liens that prime the rights of the United States, or by stripping the United States of its rights. These motions rarely preserve the United States' recoupment and setoff rights.

Bankruptcy courts are familiar with these motions and often enter an interim order within forty-eight hours, with a final hearing set in as few as two weeks. It is essential that the attorney representing the United States promptly review these early motions for objectionable terms that could impair setoff or recoupment. The United States may have very little time to object or negotiate a resolution with the debtor and Lenders.

B. Recoupment and Setoff in Bankruptcy

Recoupment is the right to reduce or abate a claim arising out of the same transaction that gives rise to the liability sought to be reduced.[20] Recoupment is the means used to determine the proper liability on amounts owed between two parties, *Reiter v. Cooper*,[21] and it allows the United States to reduce the amount of its claim against the health care provider when the health care provider's claim against the United States arose out of the same transaction.[22] The right of recoupment is grounded in federal common law and codified in the Medicare statutes and regulations.[23]

The United States' right of recoupment is not affected when a debtor files a bankruptcy case. The automatic stay does not apply to recoupment,[24] and recoupment is not restricted to transactions that both arose either before or after the petition date. In jurisdictions other than the Third Circuit, prepetition Medicare overpayments arising from prepetition services may be recouped from postpetition Medicare reimbursements for postpetition services.[25] In the Third Circuit, however, recoupment is permissible in the Medicare context, but is generally restricted to transactions in the same cost year.[26]

Setoff, on the other hand, involves the adjustment of debts arising from two separate transactions. The doctrine of setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[27] The United States' setoff

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[20] 5 Collier on Bankruptcy ¶ 553.10 at 553-92 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2015).
[21] Reiter v. Cooper, 507 U.S. 258, 265 n.2 (1993).
[22] *See In re* Malinkowski, 156 F.3d 131, 133 (2d Cir. 1998).
[23] *See* 42 U.S.C. §§ 1395g(a) (2012), 1395gg(b) (amended 2013), 1395ddd(f)(2)(A) (amended 2016), 1395cc(j)(6) (amended 2016); 42 C.F.R. §§ 405.370(a) (2018), 405.371(a)(3) (2018).
[24] Matter of Kosadnar, 157 F.3d 1011, 1016 (5th Cir. 1998); *In re* Malinowski, 156 F.3d at 133; U.S. v. Consumer Health Servs. Of America, Inc., 108 F.3d 390, 395 (D.C. Cir. 1997); Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392, 1399-1400 (9th Cir. 1996); *In re* Flagstaff Realty Assocs., 60 F.3d 1031, 1035 (3d Cir. 1995).
[25] *See, e.g., In re* Slater Health Ctr., Inc., 398 F.3d 98 (1st Cir. 2005); *In re* TLC Hospitals., 224 F.3d 1008 (9th Cir. 2000); Consumer Health Servs., 108 F.3d at 390.
[26] *See In re* University Medical Center., 973 F.2d 1065, 1081 (3d Cir. 1992) ("[A] mere logical relationship is not enough . . . both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."). The single integrated transaction test is more restrictive than the "logical relationship test" used in other circuits. The logical relationship test merely requires that two events have a logical relationship to each other to be viewed as arising from the same transaction. *See also In re* TLC Hospitals., 224 F.3d 1008 (9th Cir. 2000).
[27] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 19 (1995) (quoting Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913)).

rights are recognized and protected under federal common law.[28] Because the United States is a unitary creditor, the United States may set off debts that a health care provider owes to one federal agency against debts that another federal agency owes the health care provider.[29]

Section 553 of the Bankruptcy Code generally preserves the right of setoff. The exercise of setoff rights, however, differs from recoupment in that setoff of prepetition debts is stayed by the bankruptcy filing unless the United States obtains relief from section 362's automatic stay. In order to preserve its right to setoff claims against health care providers for Medicare overpayments, FCA Claims, and other amounts due the United States, CMS should place a temporary administrative freeze on Medicare reimbursements not yet paid, and it should do so as soon after the debtor files its bankruptcy petition as possible.[30] Thereafter, as soon as the United States determines the amount of its claims and the amount it owes the provider, the United States should move for relief from the automatic stay to set off these reimbursements.[31]

C. Protecting Recoupment Rights in Cash Collateral and DIP Financing Orders

If a health care provider attempts to impair or subordinate the United States' right of recoupment in cash collateral use and DIP financing orders, the United States should object.

First, because amounts subject to recoupment are not property of the debtor's bankruptcy estate, the amounts are not cash collateral. Section 541 of the Bankruptcy Code lists property that constitutes a debtor's bankruptcy estate. Section 541(a)(1) states that estate property includes "all legal or equitable interests of the debtor in property."[32] Because the estate can have no greater right to property than the debtor, amounts subject to recoupment are not estate property and, thus, cannot function as cash collateral.[33] Also, because recoupment is a defense to a payment obligation rather than a debt owed, the United States' recoupment right is not a "lien" or "interest in property" that can be subordinated pursuant to sections 363(e) and 364(d)(1) of the Bankruptcy Code.[34]

Furthermore, article 9 of the Uniform Commercial Code confirms that Lenders take a lien subject to the United States' right of recoupment. The health care provider cannot assign greater rights in

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[28] *In re* Calore Exp. Co., Inc., 288 F.3d 22, 43 (1st Cir. 2002); United States v. Munsey Tr. Co. of Washington, D.C., 332 U.S. 234 (1947) ("The government has the same right 'which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him.'" (citing Gratiot v. United States, 40 U.S. 336, 370 (1841))); *see also In re* Myers, 362 F.3d 667, 675 (10th Cir. 2004); Amoco Prod. Co. v. Fry, 118 F.3d 810, 817 (D.C. Cir. 1997) ("Like private creditors, the federal government has long possessed the right of offset at common law.").
[29] *See* U.S. v. Maxwell, 157 F.3d 1099, 1102 (7th Cir. 1998).
[30] The attorney handling the case should instruct other agencies that may hold funds to which the debtor has a claim to implement an administrative freeze as well.
[31] *See* Strumpf, 516 U.S. at 19-21; 11 U.S.C. § 362(d) (2012).
[32] 11 U.S.C. § 541(a)(1) (2012) (amended 2016).
[33] *See* Matter of Kosadnar, 157 F.3d 1011, 1016 (5th Cir. 1998); *In re* Flagstaff Realty Assoc., 60 F.3d 1031, 1035 (3d Cir.1995) (landlord-debtor had no interest in future rental to extent of tenant's recoupment claim); *In re* Hiler, 99 B.R. 238 (Bankr. D.N.J. 1989) (under § 541(a)(1) property subject to recoupment is not property of the estate); *see also* United Structures of Am., Inc. v. G.R.G. Eng'g, S.E., 9 F.3d 996, 999 (1st Cir. 1993) ("[A] debtor has, in a sense, no right to funds subject to recoupment.").
[34] *See* Folger Adam Security, Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252, 254, 258-64 (3d Cir. 2000) (§ 363 sale context); *In re* Lawrence United Corp., 221 B.R. 661, 669 (Bankr. N.D.N.Y. 1998) (§ 364 DIP financing context).

property than it possesses, and sections 9-404(a)(1) and (a)(2) of the Uniform Commercial Code specifically subject Lenders to the right of recoupment.[35]

The United States should also object to cash collateral use and DIP financing when the debtor intends to have the requested relief function as an injunction. Any effort to enjoin recoupment rights should require an adversary proceeding and a temporary restraining order.[36]

Injunctive relief requires the debtor to establish irreparable harm and demonstrate that equity tips in its favor.[37] Emergency motions seeking cash collateral use or DIP financing rarely address irreparable harm or the equities involved. Accordingly, these motions, to the extent used as an injunctive vehicle, are legally and procedurally deficient.

D. Protecting Setoff Rights in Cash Collateral and DIP Financing Orders

The United States should also object to any proposed impairment of setoff rights. As with recoupment, the United States' setoff rights are recognized and protected under federal common law. Setoff rights are not liens or property interests that may be primed or stripped away, and they take precedence over the security interests of other creditors.

Debtors may argue that Medicare reimbursements are property of the estate.[38] Although it is accurate to treat a provider's claims for Medicare reimbursement as property of the estate, the actual unpaid amounts in the Medicare trust fund are not. The Medicare trust fund is the United States' property. These unpaid amounts only become property of the debtor's estate if they are paid from the Medicare trust fund to the debtor.

Debtors may also argue that the Uniform Commercial Code or other state law permits the bankruptcy court to prime the United States' setoff rights, but those arguments are inconsistent with federal law and should be rejected. Moreover, even the Uniform Commercial Code provides that the assignee's (Lender's) rights are subject to all other defenses of the account debtor (the United States) against the assignor (the bankrupt health care provider) that accrue before the account debtor receives notice of the assignment to the assignee.[39] Courts have held that Lenders are subordinate to the United States' right of setoff as well as recoupment.[40]

The United States' setoff rights provide it a secured claim under section 506(a) of the Bankruptcy Code. Section 506(a) provides that a creditor's claim "secured by a lien on property in which the estate has an interest, or . . . subject to setoff under section 553 . . . is a secured claim . . . to the extent of the

[35] U.C.C. § 9-404(d)(10) (generally makes article 9 inapplicable to the right of setoff or recoupment. U.C.C. § 9-109(d)(10)(B) does, however, make § 9-404 applicable to the defense or claims of an account debtor, which is arguably the United States' status when it is paying funds under the Medicare program.).
[36] *See* FED. R. BANKR. P. 7001.
[37] Winter v. Nat. Res. Def. Council, Inc., 555 U.S. 7, 24 (2008).
[38] Debtors may raise this argument at the hearing for approval of DIP financing or cash collateral use, or may raise it in a separate adversary proceeding for turnover of property of the estate under 11 U.S.C. § 542 (2012) of the Bankruptcy Code.
[39] *See, supra*, note 35.
[40] *In re* Calore Exp. Co., 288 F.3d 22, 47 (1st Cir. 2002) (holding that a dispute between a secured creditor and the government did not involve conflicting security interests but the validity of an account debtor's (government) claim or defense against the assignor); *see also* Rochelle v. United States, 521 F.2d 844, 855 (5th Cir. 1975); *In re* All. Health of Ft. Worth, Inc., 240 B.R. 699, 704 (N.D. Tex.1999) (holding that United States could set off Medicare payments to debtor against tax debts notwithstanding lender's perfected security interest in debtor's account receivables); *In re* Metro. Hosp., 110 B.R. 731, 739-40 (Bankr. E.D. Pa. 1990), *aff'd*, 131 B.R. 283 (E.D. Pa. 1991) (holding HHS's right to set off prepetition Medicare underpayment against prepetition overpayment had priority over security interest in underpayment).

amount subject to setoff . . . and is an unsecured claim to the extent that the . . . amount so subject to setoff is less than the amount of such allowed claim."[41] Thus, as the holder of secured claims, the United States warrants adequate protection.

Identifying claims against the debtor and the debtor's claims against the United States become key concerns for the government attorney. The United States, however, may be unable to identify the nature and amount of its claims early in a case when the debtor's cash collateral use and DIP financing motions are filed. Medicare overpayments may not have been determined yet, or they may be subject to review in the administrative process. In addition, the United States' FCA Claims may not have been reduced to judgment or settled. Debtors may question the United States' ability to determine whether it has claims or the amounts, but the unavailability of such information at this early stage of a bankruptcy case is not a reason to strip the United States of its rights.

When the United States has identified amounts that are owed and currently due, it should administer a freeze of the amounts it allegedly owes to the health care provider. An administrative freeze of prepetition Medicare reimbursements, however, may disrupt the debtor's business and the delivery of medical care to patients. If the debtor wishes to receive and use prepetition Medicare reimbursements that otherwise would be administratively frozen (or actually recouped), it must provide the United States with adequate protection.[42] As a holder of a secured claim, the United States is entitled to receive adequate protection from the debtor the same as Lenders.

The United States should be prepared to act quickly to address this issue and determine if adequate protection that allows for a release or partial release of pending Medicare reimbursements can be negotiated. If a health care provider, for example, owes $30 million to CMS for previously determined prepetition overpayments, and CMS owes the health care provider $15 million in previously determined prepetition claim reimbursements, then the United States is entitled to set off the full $15 million owed in reimbursements,[43] and until the setoff takes place, the United States has a secured claim of $15 million. It is important to note that once a bankruptcy case is filed, if the United States voluntarily releases prepetition Medicare reimbursements to the debtor, the United States' secured claim is reduced.[44] For this reason, as quickly as possible CMS should freeze all prepetition Medicare reimbursements that might otherwise be due the debtor.

Finally, as with recoupment, to the extent the health care provider's effort to impair setoff rights is meant to enjoin the United States, the United States should object because an injunction is procedurally deficient by motion.

IV. Bankruptcy Court Jurisdiction Over Medicare Disputes

In some health care provider bankruptcy cases, the debtor has claims that are the subject of pending administrative proceedings, such as claim reimbursement denials, overpayment determinations, terminations of Medicare provider agreements, or suspensions of reimbursements due to credible

[41] 11 U.S.C. § 506(a) (2012).
[42] The Civil Division's Commercial Litigation Branch has developed adequate protection language that resolves its objections to the use of cash collateral and DIP financing orders. This language may be obtained from the Commercial Litigation Branch.
[43] CMS could also recoup these amounts, unless the bankruptcy case is in the Third Circuit and recoupment would involve crossing two different cost years.
[44] 42 U.S.C. § 1395u(c)(3)(B)(i) (2012) (amended 2016) (The Medicare program requires a two-week lag between Medicare approval of claims submitted for reimbursement and payment of those claims, known as the "payment floor."). Thus, when a bankruptcy case is filed, at least two weeks' worth of prepetition reimbursements will always be due the debtor. After this two week period, other reimbursements for prepetition services may be in the pipeline to be paid postpetition, but these payments may be difficult for the CMS contractors to identify.

allegations of fraud. Debtors sometimes seek to have these claims adjudicated in the bankruptcy court instead of through the administrative process. Federal courts, however, have no jurisdiction to entertain Medicare disputes that have not exhausted administrative review.

Historically, the Social Security Act has been interpreted to bar Federal court jurisdiction over virtually all claims arising under the Act unless and until the claimant has presented a claim to HHS and exhausted all administrative remedies with respect to that claim.[45] The basis for this strict limitation arises from the jurisdictional and administrative remedy exhaustion provisions of 42 U.S.C. § 405(h), (g),[46] which are incorporated in the Medicare context by 42 U.S.C. § 1395ii.[47] As discussed below, the exhaustion requirement applies equally to bankruptcy court jurisdiction, with one caveat: Ninth Circuit precedent allows health care providers to argue that the bankruptcy court has jurisdiction to hear Medicare disputes before the debtor has exhausted its administrative remedies.

A. Administrative Exhaustion

Currently, section 405(h) of the Social Security Act states that "[n]o action against the United States, the Commissioner of Social Security, or any officer or employee thereof shall be brought under section 1331 or 1346 of Title 28 to recover on any claim arising under this subchapter."[48] Section 405(g) further provides for judicial review only of a "final decision" of the Secretary "made after a hearing."[49]

As originally drafted, however, section 405(h) of the Social Security Act specifically precluded a broad range of jurisdictional bases, including bankruptcy jurisdiction pursuant to 28 U.S.C. § 1334.[50] However, after Congress recodified the United States Code in 1948, the Office of Law Revision Counsel, an independent office inside the U.S. House of Representatives, "revised" Section 405(h) of the Social Security Act to reference only "section 1331 or 1346 of Title 28."[51] Congress adopted the revision in the Deficit Reduction Act of 1984, but stated that none of the amendments "shall be construed as changing or affecting any right, liability, status, or interpretation which existed . . . before th[e] date [of enactment]."[52] Thus, omitting section 1334 of title 28 from section 405(h) of the Social Security Act was a codification error.

B. Bankruptcy Court Jurisdiction

Bankruptcy court jurisdiction is generally broad and is codified in sections 1334 and 157 of title 28 of the United States Code. Bankruptcy courts have original, but not exclusive, jurisdiction over civil proceedings that arise in, arise under, or are related to bankruptcy cases. Section 1334 of title 28 grants district courts "original and exclusive jurisdiction of all cases under title 11."[53] The statute further

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[45] *See* 42 U.S.C. § 405(g), (h) (2012) (amended 2015).
[46] § 405(g), (h).
[47] 42 U.S.C. § 1395ii (2012); *see generally* Shalala v. Illinois Council on Long Term Care, 529 U.S. 1, 5, 10 (2000).
[48] § 405(h).
[49] § 405(g).
[50] As originally enacted, § 405(h) provided that "[n]o action against the United States, the Board or any officer or employee thereof shall be brought under section 24 of the Judicial Code of the United States to recover on any claim arising under this title." Social Security Act Amendments of 1939, Pub. L. No. 379, § 205(h), 53 Stat. 1360, 1371 (1939). Prior to the enactment of title 28, section 24 of the Judicial Code was classified to section 41 of title 28. "Jurisdictional provisions previously covered by section 41 of Title 28 are *covered by sections 1331 to 1348*, 1350 to 1357, 1359, 1397, 1399, 2361, 2401, and 2402 *of Title 28*." Bodimetric Health Servs, Inc. v. Aetna Life & Cas., 903 F.2d 480, 488-89 (7th Cir. 1990) (emphasis added) (quoting 42 U.S.C.A. § 405 (West 1982)) (codification note).
[51] 28 U.S.C. § 1334 (2012).
[52] *Citing* Deficit Reduction Act of 1984, Pub. L. 98–369, § 2664(b), 98 Stat. 1171 (1984).
[53] 28 U.S.C. § 1334(a) (2012).

provides, however, that ". . . notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11[,]"[54] that is, bankruptcy cases.

District courts refer civil proceedings "arising under" title 11, "arising in" title 11, or "related to" cases under title 11, to bankruptcy courts.[55] Proceedings "arising under" title 11 involve causes of action created or determined by a statutory provision of that title.[56] Proceedings "arising in" title 11 are those not created or determined by the Bankruptcy Code, but which would have no existence outside of a bankruptcy case.[57] Proceedings "related to" a case under title 11 affords bankruptcy courts with broad jurisdiction, including nearly every matter directly or indirectly related to the bankruptcy.[58]

C. Case Law Regarding the Interplay of Section 405(h) and Section 1334(b)

The majority view, which is the United States' position, is that bankruptcy courts do not have jurisdiction to hear Medicare disputes until the administrative process is complete.[59,60] The Eleventh Circuit and the vast majority of district and bankruptcy courts have correctly held that section 405(h) of title 42 bars bankruptcy jurisdiction over Medicare disputes until the debtor has exhausted its administrative remedies.[61]

Nevertheless, health care providers in bankruptcy continue to argue that the court can determine Medicare disputes although the administrative process has not been exhausted. Only the Ninth Circuit presently has held[62] that section 405(h) of the Social Security Act does not bar bankruptcy jurisdiction

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[54] § 1334(b).
[55] 28 U.S.C. § 157(a) (2012).
[56] *See* § 157(b); *see also In re* Wilshire Courtyard, 729 F.3d 1279, 1285 (9th Cir. 2013).
[57] *In re* Wilshire Courtyard, 729 F.3d at 1285.
[58] *Id*. at 1287. For a recent and in-depth discussion of bankruptcy jurisdiction, including a bankruptcy court's Constitutional adjudicatory authority to enter final orders with respect to certain claims, see *In re* Millennium Lab Holdings, II, LLC, 575 B.R. 252 (Bankr. D. Del. 2017).
[59] *See generally* Livingston Care Ctr., Inc. v. United States, 934 F.2d 719 (6th Cir. 1991) (dismissing, for lack of jurisdiction, suit by nursing home that was terminated from Medicare and declared bankruptcy).
[60] *See In re* Bayou Shores SNF, LLC, 828 F.3d 1297 (11th Cir. 2016) (lack of referencing section 1334 in 42 U.S.C. § 405(h) was a codification error, and thus there was no section 1334 jurisdiction over Medicare determination to terminate nursing home provider agreement), cert. denied, 85 U.S.L.W. 3569 (U.S. June 5, 2017) (No. 16-967); *In re* The Orthotic Center, Inc., 193 B.R. 832, 835 (N.D. Ohio 1996) ("[T]he bankruptcy court does not have jurisdiction over Medicare disputes"); *In re* St. Mary Hosp., 123 B.R. 14, 18 (E.D. Pa. 1991) (rejecting trustee's argument that 28 U.S.C. § 1334 provided an independent basis of jurisdiction notwithstanding section 405(h), finding that "[t]he trustee's suggested reading of section 405(h) would make the administrative system superfluous."); Matter of Clawson Med., Rehab. and Pain Care Ctr., P.C., 12 B.R. 647 (E.D. Mich. 1981); *Cf.* Nichole Med. Equip. & Supply v. TriCenturion Inc., 694 F.3d 340 (3d Cir. 2012) (in case involving jurisdiction under 28 U.S.C. § 1332, court held that Congress clearly expressed its intent not to alter substantive scope of section 405(h)); Midland Psychiatric Assocs., Inc. v. United States, 145 F.3d 1000, 1004 (8th Cir. 1998) (same); Bodimetric Health Servs., Inc. v. Aetna Life & Cas., 903 F.2d 480 (7th Cir. 1990) (Although Bodimetric addressed claims brought under diversity jurisdiction (28 U.S.C. § 1332), its analysis is applicable to section 1334. Section 405(h), cannot logically be simultaneously interpreted to bar jurisdiction under section 1332 and yet yield a "plain language" reading to permit jurisdiction under section 1334).
[61] *See, e.g., In re* Bayou Shores SNF, LLC, 828 F.3d at 1314 ("[W]e align ourselves with the Seventh, Eighth, and Third Circuits and hold that § 405(h) bars § 1334 jurisdiction over claims that 'arise under [the Medicare Act].'").
[62] In one case, the Third Circuit determined that the Bankruptcy Court had jurisdiction to consider whether the United States had recouped overpayments or exercised setoff rights in violation of the automatic stay. *See In re* University Med. Ctr., 973 F.2d 1065 (3d Cir. 1992) (holding that 11 U.S.C. § 101 et seq., 28 U.S.C. §§ 157, 158 and 1334, provided an independent source of jurisdiction to review whether the United States' withholding of

when the health care provider has not yet exhausted its administrative remedies.[63] Without explanation, the Ninth Circuit held that, under the plain language rule, 28 U.S.C. § 1334 grants bankruptcy courts jurisdiction over matters involving Medicare, even though the Bankruptcy Code does not mention Medicare.[64] The decision fails to consider that the lack of a reference to section 1334 is a mere codification error.[65]

V. Conclusion

In a health care provider bankruptcy case, Medicare overpayment claims and FCA Claims may be the front and center of the bankruptcy storm. To weather this storm, the attorney representing the United States needs to move swiftly once a bankruptcy petition is filed to review early "emergency" motions for problematic language and to establish close coordination with the Department of Health and Human Services' Office of General Counsel and attorneys in the Fraud and Corporate/Financial Litigation sections as the case dictates.

ABOUT THE AUTHOR

❑ **Leah V. Lerman** joined the United States Department of Justice's Civil Division in January 2015. She has represented the United States in complex bankruptcy cases in various industries, including health care, energy, education, oil and natural gas, and government contracting. In the health care context, her cases have included laboratories, skilled nursing facility chains, ambulatory services companies, home health care businesses, hospice care facilities, and pharmacies. Prior to joining the U.S. Department of Justice, she served as a law clerk to a U.S. Bankruptcy Court judge and as an associate practicing law in the areas of bankruptcy and complex commercial litigation.

The author wishes to thank Matthew Howatt, Jan Lundelius, and Ted Yasuda of the Office of General Counsel, HHS, and Ruth Harvey, Margaret Newell, Michael Quinn, Matthew Troy, Mary Schmergel, Rodney Morris, Seth Shapiro and Donna Hagen of the Civil Division, for their assistance in preparing this article.

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postpetition reimbursements to recover prepetition overpayments constituted recoupment or impermissible setoff). The court held that the claims arose under the Bankruptcy Code, not the Medicare Act, when both parties stipulated to the amount of the overpayments and the debtor's adversary proceeding contended that the United States had violated the automatic stay. *See id*. at 1073. The Third Circuit's determination that bankruptcy court jurisdiction existed in University Med. Ctr. is arguably dicta because it also held the dispute was one of bankruptcy law, not Medicare law.

[63] *See In re* Town & Country Home Nursing Servs., Inc., 963 F.2d 1146, 1155 (9th Cir.1991) (11 U.S.C. § 106(a)'s waiver of sovereign immunity as to a governmental entity was "meant to alter" the landscape of statutes such as the Federal Tort Claims Act (FTCA) and the Medicare Act, which prescribe certain conditions prior to the government's waiver of immunity, i.e. presentment of a claim and exhaustion of administrative remedies).

[64] *Id*.; Subsequently, the Ninth Circuit held that section 405(h) bars section 1332 diversity jurisdiction. *See* Kaiser v. Blue Cross of California, 347 F.3d 1107, 1113-14 (9th Cir. 2003) (citing Bodimetric Health Servs., Inc. v. Aetna Life & Cas., 903 F.2d 480 (7th Cir. 1990)); *but see* Do Sung Uhm v. Humana, Inc., 620 F.3d 1134, 1141 n.11 (9th Cir. 2010) (discussing the "broad nature" of section 1334).

[65] Town & Country fails even to mention section 2663 and 2664 of DEFRA, the history of section 405(h), or relevant case law. Town & Country's primary focus was on sovereign immunity, not the relationship between 28 U.S.C. § 1334 and 42 U.S.C. § 405(h). Town & Country's view that § 106 is an independent grant of jurisdiction has been superseded by statute. *See* Bankruptcy Reform Act of 1994, Pub.L. No. 103–394, § 702(b)(2)(B), 108 Stat. 4150 (1994) (codified at 11 U.S.C. § 101 (2012) (amended 2016)). Numerous courts have expressly criticized and rejected Town & Country's analysis.

Federal Student Loan Debt in Bankruptcy: Recent Movement Towards Income-Driven Repayment Plans in Chapter 13

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I. Introduction

Student loan debt is generally nondischargeable. If an individual with student loan debt files for relief under Chapter 7, 11, 12, or 13 of the Bankruptcy Code, at the end of the bankruptcy case the debtor is still personally liable for any balance due on the student loan debt. Some debtors find that at the end of five years of Chapter 13 plan payments, they owe more in student loan debt than when they started because interest continues to accrue.

Recently, some Chapter 13 debtors have proposed to repay their student loan debts during their Chapter 13 plans through Income-Driven Repayment (IDR) plans offered by the United States Department of Education (ED). The Executive Office for United States Attorneys (EOUSA), in consultation with ED, developed a template that describes the responsibilities of debtors who wish to repay student loans through an IDR plan during a Chapter 13 plan, and that protects ED from claims in these cases that its IDR loan servicing activities violate the automatic stay. This article will first provide data on student loan debt in the United States and discuss the history of dischargeability of student loans in bankruptcy proceedings. Next, the types of student loans and student loan repayment plans available from ED are reviewed. Lastly, to explain the need for the template and how it works in Chapter 13, a discussion of the challenges of addressing student loan debt in Chapter 13 cases, a description of the template and some thoughts on the benefits of using the template are provided.

The template has been reviewed by ED, EOUSA, the National Association of Chapter 13 Trustees, Assistant United States Attorneys (AUSAs) who handle bankruptcy cases, and bankruptcy judges, who provided input and suggested revisions. The template is not in the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, or the Official Bankruptcy Forms. It is not nationally adopted, mandated, or required. Developed in response to efforts by the debtors' bar to include student loan plan payments in Chapter 13 plans, the template provides the minimum requirements and terms necessary to facilitate the debtor's participation in an IDR plan during Chapter 13. Use of the template could expedite consent and approval of a Chapter 13 plan that includes IDR provisions. There is no guarantee that bankruptcy judges, the Chapter 13 bankruptcy trustee, or other unsecured creditors in a case will accept the template language. However, earlier versions of this template have been successfully included in Chapter 13 plans and agreed orders. Using the template will assist Chapter 13 debtors with management of their nondischargeable student loan debt, and will benefit the United States as payments on the student loans will be made, and not deferred, in individual Chapter 13 cases.

II. Federal Student Loan Data

In his introductory letter to the *Federal Student Aid Annual Report FY 2015*, the Chief Operating Officer of Federal Student Aid states:

> Federal Student Aid witnessed a number of significant organizational milestones in FY 2015. The federal student loan portfolio grew to more than $1.2 trillion, representing an increase of over 7 percent compared to FY 2014. In total, Federal Student Aid delivered over $128 billion in aid to almost 12 million students at over 6,100 schools this past fiscal year.[1]

According to the Federal Reserve Bank of New York, "[s]tudent loan debt is the only form of consumer debt that has grown since the peak of consumer debt in 2008. Balances of student loans have eclipsed both auto loans and credit cards, making student loan debt the largest form of consumer debt outside of mortgages."[2] In fiscal year (FY) 2016, there were 19.2 million Federal Student aid applications processed by ED, and 13.2 million postsecondary student aid recipients received $125.7 billion in federal student aid.[3] At the close of FY 2016, 42.3 million student loan borrowers had outstanding student loan debt in excess of $1.29 trillion.[4] The debt continues to increase. At the end of the fourth quarter of FY 2017, 42.6 million student loan borrowers had outstanding student loan debt totaling over $1.36 trillion.[5]

The use of IDR plans to repay student loan debt is growing. In an introduction to the *Federal Student Aid Annual Report FY 2016,* the Chief Operating Officer of Federal Student Aid states*:*

> [W]e have continued expanding our push to enroll borrowers who would benefit most from income-driven repayment, or IDR, plans . . . This past spring's announcement that IDR growth will see enrollment of 2 million borrowers between April, 2016, and April, 2017, helped us become even more focused on meeting that goal. I am pleased to say we are on target, which will mean nearly 7 million borrowers will be in IDR plans by next April.[6]

A nondischargeable student loan debt is almost assured to be too large for a debtor to repay in the five year span of a Chapter 13 plan. Further, a student loan debtor is not required by the Bankruptcy Code to accelerate their loan payments and pay the student loan debt in full during the course of a Chapter 13 case. Student loan debtors in bankruptcy may pay that debt according to the terms of their original loan, such as a ten-year standard repayment plan. However, once in Chapter 13, the debtor's Chapter 13 plan

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[1] U.S. DEPT. OF ED. FED. STUDENT AID, *Annual Report FY 2015*, Washington, D.C., 2015. ("Federal Student Aid, a principal office of the United States Department of Education, is required by legislation to produce an *Annual Report*, which details Federal Student Aid's financial and program performance. The *Federal Student Aid Annual Report FY 2015* is a comprehensive document that provides an analysis of Federal Student Aid's financial and program performance results for Fiscal Year 2015.").
[2] *Student Loan Debt by Age Group*, FED. RESERVE BANK OF NEW YORK (Mar. 29, 2013).
[3] U.S. DEPT. OF ED. FED. STUDENT AID, *Annual Report FY 2016*, Washington, D.C., 2016.
[4] The Department of Education's Federal Student Aid Office provides statistics by student loan type, including dollars outstanding and number of loan recipients. *See* https://studentaid.ed.gov/sa/about/data-center/student/portfolio.
[5] *Id.*
[6] U.S. DEPT. OF ED. FED. STUDENT AID, *Annual Report FY 2016*, Washington, D.C., 2016.

payments or plan percentage might be too low to fulfill the standard plan monthly payment amount. If the debtor's confirmed Chapter 13 plan provides for less than the full monthly payment on the Federal student loan, then due to partial payments the student loan will soon be in default. Additionally, the nondischargeable debt will continue to grow due to interest. The bankruptcy community should encourage Chapter 13 debtors to pay down their student loan debt while their bankruptcy cases proceed. By addressing student loan debt in an IDR plan during the Chapter 13 plan, the debtor will not face later the setback of an undischarged student loan debt with accrued interest in default status.

III. The History of Student Loan Dischargeability in Bankruptcy Proceedings

The United States Constitution provides, "[t]he Congress shall have the power . . . to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States . . ."[7] From the Constitution's effective date in 1789 until 1800, only state insolvency laws existed. From 1800 until 1898, Congress enacted temporary Federal bankruptcy laws in response to specific financial and economic crises. Once each crisis passed, the Federal law was repealed, and creditors and debtors were dependent again upon state insolvency laws. The three temporary Federal bankruptcy laws were:

- The Bankruptcy Act of 1800 that provided involuntary bankruptcy proceedings applicable to merchants only;
- The Bankruptcy Act of 1841 that provided voluntary bankruptcy proceedings for individuals; and
- The Bankruptcy Act of 1867 that provided both voluntary and involuntary proceedings and applied to individuals and merchants.

The first permanent Federal bankruptcy law in the United States was enacted by Congress as the Bankruptcy Act of 1898, commonly known as the Nelson Act, later amended by the United States Bankruptcy Act of 1938—the Chandler Act. The Chandler Act (aka the Bankruptcy Act) provided for both voluntary and involuntary proceedings for a corporation, partnership, or an individual.

Section 17 of the Chandler Act provided: "Debts Not Affected By A Discharge—A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part. . ." The Chandler Act excepted from discharge: debts incurred for tax levied by the United States; liabilities for obtaining money or property by false pretenses or representation; willful and malicious injuries; alimony or for maintenance and support of a wife or child; debts not scheduled; debts created by fraud, embezzlement, misappropriation, or defalcation; three months wages due to employees; money of an employee received or retained by the employer to secure the employees' faithful performance under an employment contract.[8]

Private student loans were not excepted from discharge under the Act. At this time, bankruptcy proceedings were available as liquidation [think today's Chapter 7] or through a court approved plan [akin to Chapter 11]. A wage-earners repayment plan like today's Chapter 13 proceedings did not exist.

Federal student loans first became available in 1958. In the late 1960s to early 1970s, student loan balances and discharge in bankruptcy were under scrutiny. News reports and anecdotes indicated that students completing college and graduate school would immediately file bankruptcy proceedings to shed all of their student loan debt, and then proceed on to lucrative careers. In 1970, Congress authorized the formation of a *Commission on the Bankruptcy Laws of the United States*. Following public hearings,

[7] U.S. CONST. ART I, § 8 cl. 4.
[8] Pub. L. No. 75-696, 52 Stat. 851 (1938).

testimony, and research, the Commission produced its *Report to Congress* on July 30, 1973.[9] As is true today, at the time of the Commissions' 1973 Report, the Federal government ". . . [was] by far the largest higher education student loan financing system in the country . . ." [10] The 1973 Report states the Commission heard testimony and received communications and information "to the effect that easy availability of discharge from education loans threatens the survival of existing educational loan programs."[11] At public hearings, concern was expressed by representatives of the National Council of Higher Education Loan Programs and the New Jersey Board of Higher Education about anticipated student loan defaults and bankruptcies.[12] Although the Commission was not aware of evidence suggesting significant problems with student loan discharge, it advised that the use of bankruptcy to avoid payment of student loans without "any real attempt to repay the loan . . . discredit[s] the system and cause[s] disrespect for the law and those charged with its administration."[13] The Commission stated:

> . . . examples of the abuse of the discharge in the case of educational loans have . . . come to the Commission's attention. Some individuals have financed their education and upon graduation have filed petitions under the Bankruptcy Act and obtained a discharge without any attempt to repay the educational loan and without the presence of any extenuating circumstances, such as illness. The Commission is of the opinion that not only is this reprehensible but that it poses a threat to the continuance of educational loan programs. The Commission, therefore, recommends that, in the absence of hardship, educational loans be nondischargeable unless the first payment falls due more than five years prior to the petition.[14]

Part II of the 1973 Report contains proposed statutory language to effect the Commission's recommendations. The proposed definition of educational debt was "any debt to a nonprofit educational institution for expenses of post-secondary education or a debt for a loan made, guaranteed, or funded by the United States, a state, or a subdivision thereof or by a nonprofit educational or charitable organization for such expenses. . . " And, for the first time in United States history, a dischargeability exception concerning student loans was proposed:

> . . . any educational debt if the first payment of any installment thereof was due on a date less than five years prior to the date of the petition and if its payments from future income or other wealth will not impose an undue hardship in the debtor and his dependents . . .[15]

Concerned over high student loan losses, Congress enacted statutory provisions—outside of the Bankruptcy Act—to protect Federal investments. This was the first legislated restriction on discharge of student loan debt in the United States. In 1976, Congress enacted section 1087-3 of Title 20, United States Code, providing that for bankruptcy petitions filed on or after September 30, 1977, guaranteed student loan program loans that were in repayment status less than five years could be discharged if the court determined undue hardship and a general discharge order was entered. Enacting the 1973 Report recommendations, this measure was intended to prevent students from graduating with a higher degree and then immediately entering bankruptcy to shed their student loan debt. However, it provided an exception for cases in which the court determined repayment for loans in repayment status

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[9] House Doc. No. 93-137 Part I, II (September 6, 1973) (hereinafter 1973 Report). The Commission's recommendations formed the basis for discussion and debate in Congress, and the foundation for the next bankruptcy legislation—the 1978 Bankruptcy Reform Act.
[10] 1973 Report, Part I, fn 4, at 178-79.
[11] 1973 Report, Part I, at 11.
[12] 1973 Report Part I, fn 4, at 178.
[13] 1973 Report, Part I, at 170.
[14] 1973 Report, Part 1, p. 176-77.
[15] 1973 Report, Part II, pp. 3, 136.

less than five years would cause undue hardship. Loans in repayment status for five years or more and national direct student loans/Perkins Loans still could be discharged by a general bankruptcy discharge order.

Soon thereafter, the Bankruptcy Code[16] made significant changes to the bankruptcy laws in the United States based upon the Commission's 1973 Report. In addition to eliminating the necessity to "prove" debts, eliminating the requirement of insolvency to file bankruptcy, creating Bankruptcy Courts, creating bankruptcy judgeships, and generally modernizing the U.S. bankruptcy system, the legislative measure created Chapter 13 proceedings for individual debtors—the Chapter 13 wage earners plan. Restrictions on the discharge of student loans appeared in section 523(a)(8):

> (a) A discharge under section 727, 1141, or 1328 of this title does not discharge an individual debtor from any debt . . .
>
> (8) to a governmental unit, or a nonprofit institution of higher education, for an educational loan, unless—
>
> (A) such loan first became due before five years before the date of the filing of the petition; or
>
> (B) excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents . . .[17]

This restriction on the discharge of student loan debts in the Bankruptcy Code reflected the Higher Education Act's 1976 provisions that absent a finding of undue hardship, student loans could not be discharged within the first five years after they became due. A student loan debt in repayment status for five years or more still could be discharged under the Bankruptcy Code.

In 1990, the five year period was extended. Section 3621(1) of Pub. L. No. 101-647[18] amended section 523(a)(8) of title 11, United States Code, by adding that "educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution or for an obligation to repay funds received as an educational benefit, scholarship or stipend" and by extending subparagraph (A) from five years to seven years "exclusive of any applicable suspension of the repayment period." This reflected the legislative intent that after a seven year repayment period had expired, the public policy concerns over potential abuse of the student loan system and risks to the system's financial stability are outweighed by the public policy to provide debtors with a fresh start. The seven-year period began to run on the date the first installment payment on a student loan became due.

In 1998, Congress amended the Bankruptcy Code and deleted section 523(a)(8)(A), leaving "undue hardship" as the sole basis for discharging an educational loan or benefit. The elimination of the seven-year rule applied to all bankruptcy cases commenced after October 7, 1998. In 2005, Congress expanded nondischargeability to include private student loans.

[16] Pub. L. No. 95-598, 92 Stat. 2549 (1978).
[17] 11 U.S.C. § 523(a)(8) (2012) (amended 2016).
[18] Pub. L. No. 101-647, 104 Stat. 4789 (1990).

IV. Nondischargeability and Undue Hardship Discharge Today

Section 523(a)(8) of the Bankruptcy Code excepts from discharge:

(A) (i) an education benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

(ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or

(B) any other educational loan that is a qualified education loan.[19]

Student loan debt is presumptively nondischargeable. The Bankruptcy Code permits a court to discharge student loan debt only upon a finding that payment of the debt will cause undue hardship to the debtor and debtor's dependents. A debtor seeking discharge of student loan debt must affirmatively seek an exception to nondischargeability by filing a complaint to determine dischargeability.[20]

A complaint to determine dischargeability of student loan debt may be filed at any time. A closed bankruptcy case can be reopened to file the complaint.[21] No-asset Chapter 7 cases are processed somewhat quickly. The debtor may file a complaint to determine dischargeability of student loan debt at any time before or after a Chapter 7 discharge is entered in the case. If the Chapter 7 case is closed, the debtor may file a motion to reopen for the purpose of filing a complaint to determine dischargeability.

But what about debtors in Chapter 13 repayment plans, which can last up to sixty months before a discharge is entered? Some courts hold that a Chapter 13 debtor cannot file a complaint to determine dischargeability of student loan debt at the beginning of the Chapter 13 case, but must wait until they are closer to the issuance of a discharge.[22]

Once the adversary proceeding complaint to determine dischargeability is filed, the initial burden is on the student loan lender to establish the existence of the debt.[23] Once the debt is established, the burden shifts to the debtor to prove undue hardship. Nine Federal Judicial Circuits[24] use the *Brunner* test, first articulated in *Brunner v. New York Higher Education Services Corp*.[25] The *Brunner* test uses a three prong assessment to evaluate whether the debtor has proven undue hardship warranting discharge of their student loan debt:

- That the debtor cannot, based on current income and expenses, maintain a minimal standard of living for himself or herself and his or her dependents if forced to repay the student loans;
- That this state of affairs is likely to persist for a significant portion of the repayment period of the student loan; and
- That the debtor has made good faith efforts to repay the loans.

The Eighth Circuit rejects the *Brunner* test, and instead relies upon a *totality of the circumstances* test to determine whether the debtor would face undue hardship absent a discharge of student loans.

[19] § 523(a)(8).
[20] FED. R. BANKR. P. 4007.
[21] FED. R. BANKR. P. 4007(b).
[22] *See* Wheeler v. ECMC, 555 B.R. 464 (Bankr. M.D. Pa 2016).
[23] *In re* Rumer, 469 B.R. 553 (Bankr. M.D. Pa 2012).
[24] The *Brunner* test is used in the 2nd, 3rd, 4th, 5th, 6th, 7th, 9th, 10th, and 11th Circuits.
[25] Brunner v. New York Higher Education Services Corp, 831 F.2d 395 (2nd Cir. 1987).

Under the *totality of the circumstances* test, courts in the Eighth Circuit[26] assess:

- The debtor's past, present, and reasonably reliable future financial resources;
- A calculation of the debtor's reasonable necessary living expenses; and
- Any other relevant facts and circumstances surrounding the case.

The First Circuit has not explicitly adopted either the *Brunner* test or the *totality of the circumstances* test to determine whether a debtor has established undue hardship and eligibility for discharge of student loan debt. As described by the First Circuit Bankruptcy Appellate Panel, "[a]lthough the First Circuit acknowledged the two approaches in *Nash,*[27] it declined to adopt formally a particular test for determining undue hardship, and it remains an undecided issue in this circuit."[28] Bankruptcy and District Courts within the First Circuit apply either test and hybrid variations.[29]

V. Federal Student Loan Programs

An important first step for an AUSA when handling a bankruptcy case involving student loans is to determine the type of loans involved, and whether each loan is financed by ED, another Federal agency, or by a non-Federal organization. ED finances a number of student loan programs that involve a variety of lenders and guarantors. Rules for discharge of loans made by other Federal agencies may differ from those governing discharge of Department of Education financed loans. Appendix 2 provides a description of each type of ED-financed Federal student loan. Most bankruptcy cases involve loans made under the following three Federal student loan programs: the Federal Family Educational Loan Program (FFELP); the William D. Ford Federal Direct Loan Program (Direct Loans); and the Federal Perkins Loan Program (Perkins Loans).

VI. Loan Servicers and Loan Holders

A loan holder is the entity that holds the loan promissory note and has the right to collect from the borrower. ED is the legal holder of all Direct Loans. FFELP loans, on the other hand, may be held by a lender, guaranty agency, or ED—if defaulted or sold. Perkins Loans may be held by the school that made the loan or by ED.

ED and many lenders, guarantors, and schools contract with loan servicers. Servicers are the primary point of contact for borrowers related to their student loans. A loan servicer is a company that collects payments, responds to customer service inquiries, and performs other administrative tasks associated with maintaining a Federal student loan on behalf of a loan holder. Servicers are the primary point of contact for borrowers related to their student loans. ED currently uses nine loan servicers. Most loans are serviced by one of the following four: Nelnet, Navient, FedLoan Servicing, or Great Lakes. The other servicers are Cornerstone, MOHELA, Granite State, HESC/Edfinancial, and OSLA servicing.

VII. Repayment of Student Loans

Borrowers in repayment status—not in default—have several repayment options depending on the type of loans and when the loans were obtained. Repayment plans include:

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[26] Hurst v. Southern Arkansas University, 553 B.R. 133 (B.A.P. 8th Cir. 2016); Fern v. Fedloan Servicing et al, (*In re* Fern) Case No. 14-00168, 2016 WL 3564376 (Bankr. N.D. Iowa 2016).
[27] *In re* Nash, 446 F. 3d 188, 190 (1st Cir. 2006).
[28] *In re* Bronsdon, 435 B.R. 791, 797 (B.A.P. 1st Cir. 2010).
[29] *See In re* Blanchard, 2014 WL 4071119 (Bankr. D. N.H. August 14, 2014); Ayele v. Educational Credit Management Corp., 490 B.R. 460 (D. Mass. 2013).

Standard—Under a Standard repayment plan, payments are fixed and made for up to ten years (between ten and thirty years for consolidated loans). Monthly payments may be slightly higher than payments made under other plans, but this often results in the loan being paid in the shortest time;

Extended—A borrower may extend repayment over a longer period of time, up to twenty-five years, and make lower payments than under a Standard plan. This plan results in the borrower repaying a larger amount to pay off the loan;

Graduated—Under a graduated plan, monthly payments start low and increase every two years, for up to ten years (between ten and thirty years for consolidated loans);

Income-Sensitive—Income-sensitive plans are available to low income borrowers who have FFELP Loans (Direct Loans are not eligible). Monthly payments increase or decrease based on annual income and are made for a maximum period of ten years; or

Income-Driven—Under an IDR plan, the monthly loan payment is a percentage of discretionary income. After twenty to twenty-five years, unpaid balances are forgiven.[30]

VIII. Income-Driven Repayment Plan

The first IDR plan, the Income Contingent Repayment Plan, was authorized by Congress in the 1990s. Generally, the monthly payment amount under an IDR plan is a percentage of the individual's *discretionary income*. The percentage differs depending on the type of IDR plan. Under all four IDR plans, any remaining loan balance is forgiven if the Federal student loans are not fully repaid at the end of the repayment period. Whether the individual will have a balance to be forgiven at the end of the repayment period depends on a number of factors, such as how quickly the individual's income rises and the individual's income relative to debt. Because of these factors, an individual might fully repay the loan before the end of the repayment period; in such a case, there would be no amount remaining due to be forgiven.

Only borrowers who are *not in default* on their Federal student loans can apply to enroll in an IDR plan. IDR Plans require application by the borrower, approval by ED, and annual recertification by the student loan borrower. The student loan borrower's monthly payments can be adjusted up or down by ED based upon the annual recertification data.

If the borrower is making payments under an IDR plan and simultaneously working toward loan forgiveness under the Public Service Loan Forgiveness (PSLF) Program, the borrower may qualify for forgiveness of any remaining loan balance after making ten years of qualifying payments, instead of twenty or twenty-five years. Qualifying payments for the PSLF Program include payments made under any of the IDR plans.

Due to borrower outreach initiatives, approximately four million Direct Loan borrowers were enrolled in IDR plans at the close of FY 2015,[31] a fifty percent increase over FY 2014 enrollments.[32] By the close of FY 2015, loan servicers were enrolling several thousands of borrowers in IDR plans daily.[33] IDR enrollments continued to increase in 2016; ED reported 6.5 million borrowers enrolled in IDR plans as of December 31, 2016.[34] The different IDR plans are:

[30] Perkins loans are not repayable under IDR plans, but a borrower may consolidate those loans into a Direct Consolidation Loan, which would be eligible.
[31] U.S. DEPT. OF ED. FED. STUDENT AID, *Annual Report FY 2015*, Washington, D.C., 2015.
[32] *Id.*
[33] *Id.*
[34] U.S. DEPT. OF ED. FED. STUDENT AID, *Annual Report FY 2016*, Washington, D.C., 2016, p. ii.

REPAYE: Any borrower with eligible Federal student loans can make payments under this plan. Payment is generally ten percent of discretionary income, over a term of twenty years if all loans being repaid under the plan were received for undergraduate study, or twenty-five years if any loans being repaid under the plan were received for graduate or professional study.

PAYE and Income-Based Repayment (IBR): Each of these plans has an eligibility requirement. To qualify, the payment, which is based on income and family size, must be less than what the individual would pay under the Standard Repayment Plan with a ten-year repayment period.

If the amount the individual would have to pay under the PAYE or IBR plan was more than what the individual would have to pay under the ten year Standard Repayment Plan, the individual would not benefit from having the monthly payment amount based on income, so the individual does not qualify. Generally, individuals meet this requirement if their Federal student loan debt is higher than their annual discretionary income or represents a significant portion of their annual income.

In addition, to qualify for the PAYE Plan, an individual must also be a new borrower as of Oct. 1, 2007, and must have received a *disbursement* of a Direct Loan on or after Oct. 1, 2011. An individual is a new borrower if the individual had no outstanding balance on a Direct Loan or FFELP loan when the individual received a Direct Loan or FFELP loan on or after Oct. 1, 2007.

PAYE: Payment is generally ten percent of discretionary income, but never more than the ten-year Standard Repayment Plan amount, over a twenty year term.

IBR: Payment is generally ten percent of discretionary income for a *new borrower* on or after July 1, 2014, but never more than the ten-year Standard Repayment Plan amount, or fifteen percent of discretionary income for an individual who is not a new borrower on or after July 1, 2014, but never more than the ten-year Standard Repayment Plan amount. The repayment term is twenty years for a new borrower on or after July 1, 2014, and twenty-five years for an individual who is not a new borrower on or after July 1, 2014.

Income Contingent Repayment (ICR): Any borrower with a Direct Loan can make payments under this plan. This plan is the only available income driven repayment option for parent *PLUS loan* borrowers. Although PLUS loans made to parents cannot be repaid under any of the income driven repayment plans (including the ICR Plan), parent borrowers may consolidate their Direct PLUS Loans or Federal PLUS Loans into a *Direct Consolidation Loan* and then repay the new consolidation loan under the ICR Plan (though not under any other income-driven plan). Payment is twenty percent of discretionary income or what the individual would pay on a repayment plan with a fixed payment over the course of twelve years, adjusted according to the individual's income, over a twenty-five year term.

Details on each plan can be found at https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven. Table 1, below, provides a comparison of the various repayment plans using the same fact scenario assuming $30,000 in Federal student loan debt and income that increases over time, starting with an income of $25,000.

TABLE 1[35]

Repayment Plan	Initial Payment	Final Payment	Time in Repayment	Total Paid	Loan Forgiveness
Standard	$666	$666	10 years	$79,935	N/A
Graduated	$381	$1,143	10 years	$85,272	N/A
Extended-Fixed	$387	$387	25 years	$115,974	N/A
Extended-Graduated	$300	$582	25 years	$126,173	N/A
REPAYE	$185	$612	25 years	$131,444	$0
PAYE & IBR (new borrowers)	$185	$612	20 years	$97,705	$41,814
IBR (not new borrowers)	$277	$666	18 years, 3 months	$107,905	$0
ICR	$469	$588	13 years, 9 months	$89,468	$0

Comparison of Repayment Plans for Undergraduate Loan Debt in Direct Unsubsidized Loans*

*Loan debt does not include any consolidation loans.

IX. Hurdles and Obstacles for Chapter 13 Debtors With Student Loan Debt

Generally, when a debtor is not in default on student loans and files a petition for relief under Chapter 7, 11, 12, or 13 of the Bankruptcy Code, ED and the student loan servicer will put the debtor's Federal student loans into *administrative forbearance* status to comply with the bankruptcy automatic stay in section 362 of title 11. ED suspends collection and communication activity until the bankruptcy case is dismissed or a discharge is entered. Nondischargeable student loans continue to accrue interest after the debtor files a bankruptcy petition.

Because ED is an unsecured nonpriority creditor, it might receive small sums monthly under the terms of a Chapter 13 plan. While the loan is in forbearance status, ED posts and applies payments it receives but, because of the automatic stay, does not send the debtor billing statements or other communications. If the debtor's Chapter 13 plan payments to ED are not sufficient to pay the debtor's monthly student loan payment in full, the loan may go into default status; due to administrative forbearance, the debtor will not receive notice of the underpayment, balance due, or status change.

At the end of the bankruptcy case, the debtor continues to owe the balance due on the nondischargeable student loan debt. The outstanding accrued interest is capitalized (added to the principal balance), which can significantly increase a borrower's balance and result in higher monthly student loan payments *after* the bankruptcy case ends. If the student loan went into default status during the Chapter 13 case, ED can initiate collection activity against the student loan borrower at the conclusion of the bankruptcy case, including garnishment, Treasury Offset Program, and other measures. After five years of bankruptcy plan payments, the debtor is still in debt and faces collection action.

As Chapter 13 cases last between three to five years,[36] some debtors seek to continue to repay their student loans under their ED repayment plan[37] during the Chapter 13 case. A Chapter 13 plan may

[35] *Federal Student Aid: Income Driven Plans*, U.S. DEPT. OF ED. (last visited February 27, 2018).
[36] 11 U.S.C. § 1322(d) (2012) (amended 2016).
[37] *See supra* Repayment of Student Loans.

separately classify claims, and must provide the same treatment for all claims within a class.[38] For example, a Chapter 13 plan can have a class consisting of the secured mortgage lender, a class of secured automobile note holders, a class of priority tax debts, and a class of general unsecured creditors (credit cards, doctors' bills etc.). "The plan may designate a class or classes of unsecured claims . . . but may not discriminate unfairly against any class designated."[39] To put a substantially similar type of claim into a different class to treat it better or worse than the other similar claims is claims discrimination. There must be a valid reason to classify and treat seemingly similar claims differently.

If student loan debt is included in the class of general unsecured creditors, the proposed percentage to be paid to the student loan holder might be less than the amount of the debtor's monthly student loan plan payment. For example, if the debtor owes $150,000 in student loan debt, and under the Chapter 13 plan the class of general unsecured creditors will receive ten percent of their claims, the student loan would be paid $15,000 through the plan over the course of sixty months—$250 per month. That monthly payment amount might be *well below* the amount the debtor was paying under the Standard student loan repayment plan. By only paying the unsecured creditor percentage provided in the Chapter 13 plan towards the nondischargeable Federal student loan, the debtor will underpay the Federal student loan for three to five years. The deficit will grow each month the debtor is in bankruptcy, and interest will accrue to be capitalized later.

If, however, the Chapter 13 plan classifies unsecured student loan debt separately from general unsecured debt, and the plan proposes that student loan debt receives the full monthly student loan repayment plan amount (at a higher percentage of repayment than to other unsecured creditors), the Chapter 13 trustee or a general unsecured creditor could object to plan confirmation, or the court could reject the Chapter 13 plan as proposed based on unfair discrimination within the unsecured debt class.[40] Recently, some bankruptcy courts now permit nondischargeable student loan debt to be classified separately from other general unsecured creditors.[41] When a bankruptcy court confirms a Chapter 13 plan in which the debtor separately classifies unsecured student loan debt to be paid at a rate that satisfies an ED repayment plan, the Chapter 13 debtor will make substantial and actual progress towards the repayment of that nondischargeable debt during the course of the bankruptcy case. For debtors enrolled in an IDR plan, the time spent making IDR payments while in bankruptcy also applies towards the total time required to attain student loan forgiveness under the IDR plan.

X. Chapter 13 Plan Template for IDR in Chapter 13 Cases

In response to Chapter 13 debtors who have proposed to repay their student loan debts through IDR plans during their Chapter 13 bankruptcy cases, EOUSA has developed template language for use in

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[38] § 1322(a)(3), (b)(1).

[39] § 1322(b).

[40] McCullough v. Brown (In *re* Brown), 162 B.R. 506 (D. N.D. Ill. 1993) (reversing judgment, holding that debtors' plans, which provided for full payment of their student loans and payments of only 10 percent to other unsecured creditors, "discriminated unfairly" against the other unsecured creditors in violation of the Bankruptcy Code).

[41] *In re* Engen, 561 B.R. 523 (Bankr. D. Kan. 2016) (separate classification of a student loan debt in a Chapter 13 plan did not discriminate unfairly or violate 11 U.S.C. § 1322(b)(1)). *See also In re* Boscaccy, 442 B.R. 501 (Bankr. N.D. Miss. 2010) (Debtor may separately classify student loan debt under cure-and-maintenance provisions); *In re* Johnson, 446 B.R. 921 (Bankr. E.D. Wis. 2011) (holding that student loans could be separately classified as long-term debts); *In re* Williams, 253 B.R. 220 (Bankr. W.D. Tenn. 2000) (the court allowed student loan arrearages to be paid in full through the plan as long as the student loan was treated as a long term debt under § 1325(b)(5)); *In re* Chandler, 210 B.R. 898 (Bankr. D. N.H. 1997) (the court held separate treatment of student loans was permitted as long as there was no "unfair" discrimination); *In re* Cox, 186 B.R. 744 (Bankr. N.D. Fla. 1995) (§ 1322(b)(5) specifically sanctions separate classification long term debts); *In re* Benner, 156 B.R. 631 (Bankr. D. Minn. 1993) (the court held § 1322(b)(5) authorizes separate treatment of long term debts, and any resulting discrimination is not "unfair").

a Chapter 13 repayment plan. This is not part of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, or the Official Bankruptcy Forms. It is only suggested language that may be considered to accommodate an IDR plan during Chapter 13 bankruptcy. The template is designed as an insert into the section of a Chapter 13 plan for “non-standard plan provisions,” or alternatively, to be used as the basis for an agreed order separate from, but referenced in, the Chapter 13 plan. Only student loan borrowers who are not in default are eligible to apply for the IDR repayment plan. Student loan borrowers who are in default will not be able to use a proposed Chapter 13 plan to gain entry into an IDR plan. The main features of the template:

- Provide the debtor may not use the Chapter 13 plan to discharge all or part of the debtor’s unpaid student loan (which is nondischargeable absent an undue hardship finding by the court);
- Identify the student loan(s);
- Confirm the debtor is not in default on Federal student loan debts;
- Provide the debtor may continue in or apply to enroll in IDR;
- Provide the amount of the debtor’s monthly IDR plan payment and the day each payment is due;
- Indicate the student loan(s) creditor class;
- Indicate if IDR plan payment will be made through the Chapter 13 trustee’s office or outside of the Chapter 13 plan by the debtor;
- Explicitly provide that the debtor waives 362(a) stay violation and 362(d) causes of action against ED for its communication, administrative processing, and recertification of the debtor’s IDR plan; and
- Provide a process for debtor to exit the IDR plan voluntarily, and the consequences of a debtor’s failure to pay the monthly IDR plan payment.

XI. How the Template Contemplates the Initiation or Continuation of an IDR plan While the Debtor is in Chapter 13

The template contemplates that the debtor will make monthly IDR plan payments during the life of the Chapter 13 plan, either through the Chapter 13 trustee’s office or outside of the Chapter 13 plan. Separate claim classification is warranted because unlike dischargeable general unsecured debts, the unsecured student loan debt will not be discharged at the conclusion of the Chapter 13 case. As one Bankruptcy Court noted:

> Failing to allow separate classification and favorable treatment of student loans leads to a disharmonious outcome under the Code in which student loans are special enough not to discharge unless the rigorous undue hardship test is met, but not sufficiently special to separately classify. Separate classification is proper under the Code and student loans “can be classified separately from other types of Schedule F nonpriority unsecured debt.[42]

[42] *In re* Engen, 561 B.R. at 533 (citing Daniel A. Austin & Susan E. Hauser, Graduating with Debt: Student Loans under the Bankruptcy Code 69-70 (ABI, 2013). *See also In re* Potgieter, 436 B.R. 739, 743 (Bankr. M.D. Fla. 2010) (“[T]he separate classification of the debtor's student loan obligations does not violate Section 1122.”); *In re* Coonce, 213 B.R. 344, 345 (Bankr. S.D. Ill. 1997) (separate classification of student loan debt is permissible).

Under this reasoning, to create separate classes of unsecured debt based on this substantial distinction is not discriminatory against other fully dischargeable unsecured debt classes. "Debtors with student loan obligations face a quagmire. Without separate classification, debtors may face a higher debt burden after bankruptcy than before. This Court respectfully disagrees with other courts' holdings that without more, nondischargeability of student loans is an insufficient reason for discriminating in favor of Student Loan Claims."[43]

By classifying the student loan debt separately, the debtor will be able to make IDR plan payments during the Chapter 13 plan at a different percentage than is paid to general unsecured creditors. By making IDR plan payments during the life of the Chapter 13 plan, the debtor receives credit from ED for the three to five years of IDR plan payments. Without the ability to enter into or remain in an IDR plan, the debtors would most likely spend that time in student loan administrative forbearance status with interest continuing to accrue, and would emerge from bankruptcy with a larger student loan principal balance at the conclusion of their Chapter 13 plan then at the start. And they would emerge from bankruptcy in default on the loan.

It is important, however, that routine loan servicing not be considered in violation of the automatic stay as ED processes the debtor's IDR plan enrollment, requests recertification documentation, and attends to administrative matters relating to the IDR plan. Therefore, the template Chapter 13 plan language includes a waiver by the debtor of the automatic stay concerning ED and the IDR plan administrative actions. Without this waiver, ED is unlikely to agree to a Chapter 13 plan that contemplates initiation or continuation of an IDR repayment plan.

The Chapter 13 trustee may request assurances in the plan that the IDR plan payment will be remitted timely by the debtor, that delayed or missed IDR plan payments will not affect the Chapter 13 trustee's remittance to other creditors in the case, and that the Chapter 13 trustee's office will not be liable to fund any missed IDR plan payments. The trustee's participation as a pass-through entity for debtor's IDR plan payments is as a courtesy to the debtor, with the mutual goal that the debtor with nondischargeable student loan debt will be in a better financial position at the conclusion of the bankruptcy case.

A draft of the template language has been successfully used in several jurisdictions, both as an insert to the 'special provisions' section of the national Chapter 13 plan form and as a separate agreed order. The Northern and Southern Districts of Ohio, districts in North Carolina, and the Northern District of New York have experimented with the template language permitting an IDR plan to proceed simultaneously with a Chapter 13 plan.

XII. Conclusion

Students in the United States have amassed a staggering amount of higher education loan debt. Congress has determined as a matter of public policy that students who borrow funds to finance their education should repay those loans, absent undue hardship. EOUSA, in consultation with ED, the National Association of Chapter 13 Trustees, and Bankruptcy Judges, has devised template Chapter 13

[43] *In re* Engen, 561 B.R. at 541.

plan language that may be considered to accommodate an IDR payment plan during Chapter 13 bankruptcy. This method can help honest debtors with student loans work their way toward resolution of all their debts and a fresh start.

ABOUT THE AUTHORS

❑ **Amanda L. Anderson** is a contract attorney at the Executive Office for United States Attorneys, Office of Legal and Victim Programs, Asset Recovery, focused on bankruptcy law and asset recovery on behalf of the United States government. Before assuming this role, Ms. Anderson served for over fifteen years at the Administrative Office of the United States Courts in Washington, D.C., in various attorney roles including Deputy Chief and Division Chief of the Bankruptcy Judges Division, and as a Senior Attorney in the Defender Services Office. Her portfolio included national policy development and implementation; legislation; publications; judgeship and clerks' office issues; and liaison and ombudsman for all bankruptcy judges. Previously, Ms. Anderson worked in private practice, with experience as both creditors' and debtors' counsel. She began her bankruptcy law career as a judicial law clerk to the Honorable Charles M. Caldwell, S.D. Ohio.

A graduate of the American University's Washington College of Law in Washington, D.C., and Tulane University in New Orleans, Louisiana, Ms. Anderson has been a frequent lecturer and guest speaker at judiciary, bankruptcy association, and bar association seminars and educational symposia on bankruptcy law, federal courts, and legislation.

❑ **Mark A. Redmiles** has served in a bankruptcy and financial litigation leadership capacity for the Department of Justice for over sixteen years. Since 2012, he has been the Assistant Director for Asset Recovery Staff with the Executive Office for U.S. Attorneys. Mr. Redmiles provides executive leadership to the asset forfeiture, bankruptcy, and financial litigation program areas and staff.

From 2002 to 2012, he was with the Executive Office for United States Trustees and was Deputy Director for five of those years. Mr. Redmiles also has served as a Professorial Lecturer in Law at the George Washington University Law School, where he has taught a Creditors' Rights and Debtors' Protection course.

Appendix 1: Federal Student Aid Portfolio Summary

Data Source: National Student Loan Data System (NSLDS)

Includes outstanding principal and interest balances										
		Direct Loans		**Federal Family Education Loans (FFEL)**		**Perkins Loans**		**Total**[1]		
Federal Fiscal Year[2]		**Dollars Outstanding (in billions)**	**Recipients**[3] **(in millions)**	**Dollars Outstanding (in billions)**	**Recipients (in millions)**	**Dollars Outstanding (in billions)**	**Recipients (in millions)**	**Dollars Outstanding (in billions)**	**Unduplicated Recipients (in millions)**
2007		$106.8	7.0	$401.9	22.6	$8.2	2.8	$516.0	28.3
2008		$122.5	7.7	$446.5	23.7	$8.5	2.9	$577.0	29.9
2009		$154.9	9.2	$493.3	25.0	$8.7	3.0	$657.0	32.1
2010		$224.5	14.4	$516.7	25.1	$8.4	2.9	$749.8	34.3
2011		$350.1	19.4	$489.8	23.8	$8.3	2.9	$848.2	36.5
2012		$488.3	22.8	$451.7	22.4	$8.2	2.9	$948.2	38.3
FY 13	**Q1**	$508.7	23.4	$444.9	22.1	$8.2	3.0	$961.9	38.7
	Q2	$553.0	24.1	$437.0	21.6	$8.3	3.0	$998.6	38.9
	Q3	$569.2	24.3	$429.5	21.2	$8.2	2.9	$1,006.8	38.7
	Q4	$609.1	25.6	$423.0	20.9	$8.1	2.9	$1,040.2	39.6
FY 14	**Q1**	$626.5	26.2	$417.1	20.6	$8.2	3.0	$1,051.8	40.0
	Q2	$669.0	26.5	$409.7	20.2	$8.3	3.0	$1,087.0	40.0
	Q3	$685.7	26.7	$402.5	19.8	$8.2	2.9	$1,096.5	39.9

	Q4	$726.6	27.9	$395.0	19.4	$8.2	2.9	$1,129.8	40.7
FY 15	**Q1**	$744.3	28.5	$387.6	19.1	$8.2	3.0	$1,140.1	41.1
	Q2	$787.0	28.7	$379.1	18.6	$8.3	2.9	$1,174.4	41.0
	Q3	$803.1	28.8	$370.9	18.2	$8.2	2.9	$1,182.1	40.8
	Q4	$840.7	29.9	$363.6	17.9	$8.1	2.8	$1,212.4	41.6
FY 16	**Q1**	$854.8	30.3	$357.3	17.5	$8.1	2.9	$1,220.3	41.8
	Q2	$896.6	30.5	$350.2	17.2	$8.2	2.8	$1,254.9	41.7
	Q3	$911.6	30.5	$342.6	16.8	$8.0	2.7	$1,262.2	41.5
	Q4	$949.1	31.5	$335.2	16.4	$7.9	2.7	$1,292.2	42.3
FY 17	**Q1**	$963.5	31.9	328.3	16.1	$7.9	2.7	$1,299.7	42.4
	Q2	$1,003.3	32.1	$320.5	15.7	$7.9	2.6	$1,331.7	42.3
	Q3	$1,017.0	32.0	$312.6	15.2	$7.8	2.6	$1,337.4	42.0
	Q4	$1,053.5	33.0	$305.8	14.9	$7.6	2.5	$1,366.9	42.6

Notes:

[1] Totals may not equal the sum of Direct Loans, FFEL, and Perkins Loans due to rounding and the timing of the data runs.

[2] Data is run at the end of the corresponding Federal fiscal year or at the end of each quarter listed by Federal fiscal year. Each Federal fiscal year begins October 1 and ends September 30. Q1 ends 12/31, Q2 ends 3/31, Q3 ends 6/30, and Q4 ends 9/30.

[3] Recipient is the student that benefits from the Federal student loan. In most cases, the recipient is the borrower, but in parent PLUS loans, the parent is the borrower and their child is the recipient.

Appendix 2: Federal Student Loan Programs

A. Federal Family Education Loan Program (FFELP) (formerly Guaranteed Student Loan Program) (Title IV-B of the Higher Education Act of 1965, as amended (HEA) (20 U.S.C. §§1071 et. seq.)) (Regulations at 34 C.F.R. Part 682)

As of July 1, 2010, no new FFELP loans may be made, pursuant to the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111–152, 3/30/2010). All Federal Stafford, PLUS, and Consolidation Loans first disbursed on or after July 1, 2010, are made under the Federal Direct Loan Program. Nevertheless, FFELP loans continue to be serviced according to the terms and conditions of the FFELP and the borrowers' promissory notes. ED purchased some outstanding FFELP loans under authority granted by Ensuring Continued Access to Student Loans Act during the credit crisis of 2008. FFELP loans continue to comprise a significant percentage of the outstanding student loans.

In the FFELP, ED acts primarily as reinsurer of student loans. Different types of guaranteed loans are described here. The promissory note, ED, and the guarantor's computer records identify the type of loan.

Under the FFELP, loans made by banks or other lending institutions were guaranteed by state or non-profit guarantors and reinsured by ED. 20 U.S.C. §1078(c). At least one guaranty agency operated in every state; several guaranty agencies, such as United Student Aid Funds, operated in numerous States. Most FFELP loans were made by few large banks with nationwide lending programs. A variety of financial institutions comprised a very active secondary market in FFELP loans, including banks, State and non-profit student loan "Authorities," and the Federally-chartered Student Loan Marketing Association ("Sallie Mae" or SLMA, now known as Navient).

If a debtor defaults, files a bankruptcy petition, dies, or becomes disabled, the guaranty agency reimburses the holder of the loan, takes assignment of the loan, and promptly claims reimbursement from ED under its reinsurance agreement. Although ED pays reinsurance promptly to the guaranty agency, the guarantor retains the loan and must then use "due diligence" in collecting the loan, remitting most of its recoveries to ED. 34 C.F.R. 682.4101(b)(4). ED can demand assignment of reinsured loans from guarantors, and has taken assignment of a large number of these loans.

FFELP loans include the following:

1. Federal Stafford Loans: The basic FFELP student loan (the type you are most likely to have used to finance your own education) was called a "GSL" and is now called a Stafford Loan. Interest that accrues on Stafford Loans may be subsidized by ED during in-school, grace, and deferment periods for borrowers who qualify under a need-based assessment process, 20 U.S.C. § 1078(a); a borrower who does not meet the needs test may receive an "Unsubsidized Stafford Loan," 20 U.S.C. § 1078-8, on which interest accruing during these periods is typically capitalized. Unsubsidized Stafford Loans replace the Supplemental Loans for Students.

2. Supplemental Loans for Students (SLS): Under the SLS Program, banks and other financial institutions made loans to independent undergraduate students and to graduate and professional students. 20 U.S.C. § 1078-1 (1991). The authority for SLS Loans ended July 1, 1994. A similar program, the Auxiliary Loans to Assist Students (ALAS) Program, which provided loans to students and parents, was authorized under 20 U.S.C. § 1078-2 (1986) from 1980 to 1986, when it was replaced by SLS and PLUS. Many SLS and ALAS loans remain outstanding.

3. Federal PLUS Loans: PLUS loans were made by banks and other financial institutions to parents of dependent students. 20 U.S.C. § 1078-2. Unlike Stafford and SLS loans, repayment must begin on PLUS loans promptly after disbursement. PLUS loans are also available to graduate students. The loans are commonly called Parent PLUS or Graduate PLUS to distinguish which type of borrower is incurring the loan.

4. Federal Consolidation Loans under the Consolidation Loan Program: Lenders made loans to borrowers to pay off ("consolidate") outstanding student loans. 20 U.S.C. § 1078-3. Consolidation Loans have longer repayment terms that, depending on the amount borrowed, may extend for up to 30 years.

B. William D. Ford Federal Direct Loan Program (Title IV-D of the HEA (20 U.S.C. § 1087a et seq.), regulations at 34 C.F.R. Part 685).

Under the Direct Loan Program, ED makes loans directly to borrowers, who repay the loans to ED. Direct Loan Program loans generally mirror the FFELP program loans: ED makes -

1. Federal Direct Stafford Loans;
2. Federal Direct PLUS Loans;
3. Federal Direct Unsubsidized Stafford Loans; and
4. Federal Direct Consolidation Loans.

Direct Loans generally have the same terms as their FFELP counterparts. Unlike their FFELP counterparts, ED makes the loans with Federal funds, which are serviced by ED directly or by contract servicers, and no financial institution or guarantor is involved. The vast majority of all Federal student loans made after July 1, 2010, are Direct Loans

C. Federal Perkins Loan Program (formerly known as the National Direct Student Loan Program or the National Defense Student Loan Program) (Title IV-E of the HEA (20 U.S.C. 1087aa-1087hh)) (Regulations found in 34 C.F.R. Part 674).

Some schools continue to make Perkins Loans. Federal funds partially capitalize a loan fund from which colleges make student loans under the Perkins Loan Program (formerly known as the National Direct Student Loan Program, which was in turn the successor to the National

Defense Student Loan Program), authorized under Title IV, Part E of the HEA. 20 U.S.C. §§ 1087aa - 1087hh. Regulations are found in 34 C.F.R. Part 674.

D. Federal Insured Student Loan Program (FISLP)

ED has in the past directly guaranteed student loans, under FISLP. 20 U.S.C. §§1077, 1079, 1080. Some FISLP loans remain outstanding.

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Bankruptcy and Bankruptcy Fraud

Part II: Executive Office for United States Trustees

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Introduction

Clifford J. White III
Director
Executive Office for United States Trustees

Enforcement of the bankruptcy laws is a uniquely federal function, and ensuring fidelity to the Bankruptcy Code and related provisions in the Criminal Code is critical to safeguarding the integrity of our Nation's bankruptcy system. Article 1, Section 8, Clause 4 of the U.S. Constitution recognizes the importance of "uniform Laws on the subject of Bankruptcies throughout the United States."[1] By giving debtors a "fresh start" and providing creditors with a system for the repayment of debts that avoids an inefficient "race to the courthouse," individuals and businesses have the opportunity to emerge from financial distress and, once again, contribute to the national economy.

The United States Trustee Program (USTP or Program) was created in 1978[2] as the "watchdog" of the bankruptcy system. We are a national program with 92 field office locations and jurisdiction in eighty-eight federal judicial districts. Our mission is very broad: to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public. We aggressively pursue this mission by combating fraud and abuse by debtors, creditors, professionals, and other participants in a bankruptcy case through a variety of civil enforcement remedies. We file or pursue more than 30,000 civil enforcement actions each year. These include objecting to a debtor's discharge; seeking victim compensation and other remedies from those who take advantage of vulnerable consumers; moving for sanctions, disciplinary action, and fee disgorgement from attorneys; and seeking injunctions to shut down unlawful credit repair scam operations.

We also have a statutory duty under 28 U.S.C. § 586(a)(3)(F) to refer matters to the United States Attorneys' offices for investigation and prosecution that "relate to the occurrence of any action which may constitute a crime" and to assist each United States Attorney in "carrying out prosecutions based on such action."[3] The USTP is privileged to have developed close ties with our law enforcement partners in the Department of Justice, including the U.S. Attorneys' offices, the Federal Bureau of Investigation, and the Criminal Division, and with other agencies through our participation in more than seventy bankruptcy fraud working groups and other specialized task forces throughout the country. These partnerships have resulted in countless successful prosecutions and have helped to ensure the integrity of the bankruptcy system.

Each year, the Program makes more than 2,000 bankruptcy and bankruptcy-related criminal referrals to law enforcement, and must report annually to Congress on the number and types of referrals made and the outcome of those referrals, among other things. Notably, these referrals cover a broad range of conduct—nearly fifty categories of allegations—from the concealment of assets to tax, mortgage and rescue fraud to embezzlement and money laundering. Illustrative of the breadth of conduct in our referrals are the following cases, which are discussed in detail in this issue of the *USA Bulletin*:

- A referral by the Program's Portland, Oregon, office led to the prosecution of a prominent businessman who defrauded an elderly widow out of $1.1 million before he filed bankruptcy in an attempt to discharge $148 million in debt. The defendant pleaded

[1] U.S. CONST. ART. I, § 8, cl. 4.
[2] The USTP began initially as a pilot program under the Bankruptcy Reform Act of 1978 and, through the Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, was made permanent and expanded nationwide (excluding Alabama and North Carolina).
[3] 28 U.S.C.A. § 586(a)(3)(F) (2012).

guilty to wire fraud, money laundering, and bankruptcy fraud, and was sentenced to seventy months in prison and ordered to pay $1.1 million in restitution.

- A referral by our Tampa office of the operator of a foreclosure rescue scheme who victimized distressed homeowners by falsely promising to save their homes from foreclosure and then filing fraudulent bankruptcies in their names without their knowledge or consent resulted in a guilty plea. The defendant was sentenced to three years in federal prison for bankruptcy fraud and making a false statement during a bankruptcy proceeding, required to pay $25,000 in restitution, and enjoined from participating in businesses involving mortgage brokerage, real estate sales, or credit.
- A referral by our Shreveport office resulted in the guilty plea of an attorney to bankruptcy fraud for improperly collecting filing fees from clients without informing the bankruptcy court. The attorney was sentenced to thirty-four months in prison and three years of supervised relief and ordered to pay nearly $70,000 in restitution.

The USTP is willing and able to assist prosecutors and investigators with cases. Our attorneys, auditors, and paralegals can review and analyze bankruptcy documents; explain or provide training on bankruptcy laws and procedures; serve as expert or fact witnesses; and, where designated, serve as Special Assistant United States Attorneys. That assistance also can extend to cases that are not referred by our offices. Bankruptcy requires full disclosure of a debtor's financial situation under penalty of perjury and, as a result, bankruptcy filings often yield written evidence that can be helpful in the investigation of other white collar crimes.

We are extremely pleased to have the opportunity to bring bankruptcy to the forefront in this issue of the *USA Bulletin*. The articles will provide important insights into successful prosecutions and useful information on such topics as using information from bankruptcy cases in a criminal investigation, making charging decisions, sentencing and restitution, the interplay between asset forfeiture and bankruptcy, and parallel proceedings.

I invite you to contact your local United States Trustees' office for more information on how we can work together to combat and deter bankruptcy-related crimes. A complete listing of offices is available on our website at www.justice.gov/ust.

ABOUT THE AUTHOR

❑ **Clifford J. White, III** is the Director of the Executive Office for United States Trustees. He is a career civil servant who has led the United States Trustee Program (USTP) for more than ten years. In May 2005, he was named Acting Director and then was appointed Director in 2006. During his thirty-seven years of public service, Mr. White has served as Deputy Director of the USTP, as an Assistant United States Trustee, and in other positions.

Among Mr. White's accomplishments as Director, the USTP implemented major provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, launched an enforcement campaign to protect consumer debtors against parties who violate bankruptcy law, promulgated new attorney fee guidelines to eliminate premium billing and promote market-based billing practices, and designed strategies to ensure greater accountability by management of corporations seeking to reorganize under chapter 11.

Mr. White is a frequent speaker at bankruptcy conferences and legal education programs across the country, and regularly contributes articles to national professional publications. He has received two Presidential Rank Awards, the highest recognition accorded to career officials, one from President Bush and one from President Obama. He is an honors graduate of the George Washington University and the George Washington University Law School.

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Basic Bankruptcy

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I. Introduction and Overview

While the bankruptcy system is specialized, one does not need to be a bankruptcy expert to obtain information relevant to a bankruptcy case. A basic understanding of the bankruptcy system, the bankruptcy process, and the role of the various players, as well as knowledge of the types of information that can be found, are all that is needed. This article provides an overview to help prosecutors and investigators.

By virtue of Section 8 of Article 1 of the U.S. Constitution, Congress is empowered to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[1] The purpose of bankruptcy is twofold: "(1) to enable the debtor to get a fresh start . . . by relieving him of the burden of his unpaid debts; and (2) to provide for an equitable distribution of the debtor's assets among creditors."[2]

As stated by the Supreme Court, bankruptcy is for the "honest but unfortunate debtor."[3] Indeed, the bankruptcy system "depends on full and honest disclosure by debtors of all of their assets."[4] The Bankruptcy Code, Bankruptcy Rules, and Bankruptcy Forms have numerous provisions that implement this disclosure requirement.

Consequently, bankruptcy proceedings and documents filed in bankruptcy cases may contain a wealth of financial information. Testimony is taken under oath during various types of proceedings, and many require documents signed under penalty of perjury. Furthermore, filing bankruptcy is sometimes the last step for individuals or entities that have engaged in crimes as diverse as mail fraud, securities fraud, embezzlement, and drug dealing. An understanding of "basic bankruptcy" is a valuable resource for anyone involved in law enforcement.

[1] U.S. CONST. ART. I, § 8, cl. 4.
[2] *In re* Hiller's Estate, 240 F.Supp. 504, 504 (N.D. Cal. 1965).
[3] Grogan v. Garner, 498 U.S. 279, 286-87 (1991).
[4] Rosenshein v. Kleban, 918 F.Supp. 98, 104 (S.D.N.Y. 1996).

II. Basic Bankruptcy

A. How a Bankruptcy Case is Initiated

1. Voluntary Bankruptcy Case

"A voluntary [bankruptcy] case . . . is commenced by the filing with the bankruptcy court of a petition . . . by an entity that may be a debtor" under the chosen chapter of the Bankruptcy Code.[5] Such commencement "constitutes an order for relief" under that chapter.[6] "A joint case . . . is commenced by the filing with the bankruptcy court of a single petition . . . by an individual . . . and such individual's spouse."[7] When it comes to who may be a debtor, definitions count. Only a "person" may be a debtor under title 11.[8] "The term 'person' includes individual, partnership, and corporation, but does not include [most] government unit[s]."[9] A "corporation" includes certain associations, a joint stock company, and a business trust.[10]

Generally, if a debtor is represented by counsel, the petition must be electronically filed with the bankruptcy court, whereas an unrepresented debtor may manually file the petition in the office of the clerk of the bankruptcy court or submit it by mail. A master address list of all creditors must be filed with the petition.[11] The clerk mails notice of the commencement of the bankruptcy case and applicable deadlines to the creditors on the master address list.[12] The notice of mailing is entered on the docket with a certification by the clerk and a detailed account of who was served by U.S. mail or served by email. The clerk usually does not refuse to accept a filing, even if it is facially deficient.

2. Involuntary Bankruptcy Case

An involuntary bankruptcy case is commenced only under chapter 7 or 11, and only against "persons" who do not fall within enumerated categories. Generally speaking, an involuntary case is commenced by the filing of a petition by three or more creditors. If there are fewer than twelve such creditors—excluding insiders, employees, and recipients of voidable transfers—the involuntary petition may be filed by only one creditor.[13]

The filing of an involuntary petition, like the filing of a voluntary petition, imposes the automatic stay.[14] (See Section D of this article for more information on the automatic stay.) Unlike the filing of a voluntary petition, however, the filing of an involuntary petition is akin to the filing of a complaint. The debtor may file an answer opposing entry of an order for relief.[15] A trial is then held to determine if the involuntary bankruptcy case should proceed. Sometimes an involuntary case is filed for an improper purpose such as to obtain retribution against a third party or to further a foreclosure rescue scheme. Under those circumstances, the court will typically dismiss the case.

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[5] 11 U.S.C. § 301(a) (2012).
[6] § 301(b).
[7] 11 U.S.C. § 302(a) (2012).
[8] 11 U.S.C. § 109(a) (2012 & Supp. III 2015) (amended 2016).
[9] 11 U.S.C § 101(41) (2012) (amended 2016). Municipalities may, however, be debtors under Chapter 9 of the Bankruptcy Code. § 109(a), (c).
[10] § 101(9).
[11] 11 U.S.C. § 521(a) (2012 & Supp. III 2015) (amended 2014); FED. R. BANKR. P. 1007(a)(1).
[12] 11 U.S.C. § 342(a) (2012); FED. R. BANKR. P. 2002(a), (f).
[13] 11 U.S.C. § 303 (2012) (amended 2016).
[14] 11 U.S.C. § 362(a) (2012).
[15] § 303(d).

B. The Bankruptcy Chapters

The different chapters of bankruptcy relief correspond to actual chapters in the Bankruptcy Code. All are odd numbered, except for chapter 12. With limited exceptions, the provisions of chapters 1, 3, and 5—which cover general matters such as definitions, applicability, case administration, and debtor and creditor duties—apply in cases under chapters 7, 11, 12, and 13.[16]

1. Chapter 7—Liquidation

In chapter 7 cases, trustees are appointed by the United States Trustee upon filing.[17] The trustee essentially steps into the shoes of the debtor, becoming the representative of the debtor's estate, with the capacity to sue and be sued.[18] Unsecured creditors holding fixed, allowable, liquidated, and undisputed claims may elect a trustee at the section 341 meeting of creditors to take the place of the appointed trustee if certain requirements of 11 U.S.C. § 702 are met.

A chapter 7 case is primarily focused on the trustee finding assets that can be liquidated, with the proceeds distributed for the benefit of unsecured creditors. After investigation, the trustee designates the case as either a "no asset" case, which will be closed with no payments to creditors, or an "asset" case, which indicates that there are non-exempt assets with equity that can be sold to repay unsecured creditors.

2. Chapter 11—Reorganization

In a chapter 11 case, there is a presumption that the debtor remains in possession of the estate. Unless the court orders the appointment of a trustee pursuant to 11 U.S.C. § 1104, the debtor-in-possession (or "DIP") remains the authorized representative of the estate.[19] Often, the DIP is an artificial entity, such as a corporation, but individuals are also eligible to file a chapter 11 case.

The DIP is authorized to continue to operate the business of the debtor during the bankruptcy case unless the court orders otherwise. The use of property outside the ordinary course of business requires prior court approval, but transactions in the ordinary course of business do not.[20] The DIP must operate its business as a fiduciary for creditors and is charged with certain duties of an independent private trustee.[21]

The goal in a chapter 11 bankruptcy case is for the debtor to confirm a plan pursuant to 11 U.S.C. § 1129. The plan may involve a reorganization of the debtor's business and financial affairs or an orderly liquidation of the estate. Certain creditors have the right to vote on a proposed chapter 11 plan.[22] Generally, they are entitled to receive at least as much money under the plan as they would if the case were in a chapter 7 liquidation.[23]

3. Chapter 13—Repayment Plan for Individuals

A chapter 13 bankruptcy case is sometimes referred to as a wage earner's plan. It enables individuals (as opposed to artificial entities) who have a regular source of income and whose debts do not exceed a certain limit[24] to develop a plan to repay all or part of their debts. Chapter 13 is often used to

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[16] 11 U.S.C. § 103(a) (2012).
[17] 11 U.S.C. § 701 (2012).
[18] 11 U.S.C. § 323 (2012).
[19] 11 U.S.C. §§ 1104, 1107, 1108 (2012).
[20] 11 U.S.C. § 363(b), (c) (2012).
[21] § 1107.
[22] 11 U.S.C. § 1126 (2012).
[23] 11 U.S.C. § 1129(a)(7) (2012).
[24] Non-contingent, liquidated, unsecured debts of less than $383,175 and non-contingent, liquidated, secured debts of less than $1,149,525. 11 U.S.C. § 109(e) (2012) (amended 2016). These amounts are adjusted periodically.

save a home from foreclosure by allowing the debtor to cure mortgage arrearages over time while maintaining the ongoing postpetition mortgage payments.

In every chapter 13 case, a trustee is appointed by the United States Trustee.[25] Creditors and trustees, as parties in interest, may file objections to the debtor's proposed plan.[26] But unlike creditors in chapter 11, creditors do not vote on the chapter 13 plan. The focus in a chapter 13 case is on a debtor's cash flow and the disposable income available to make plan payments.[27] The debtor's assets are still relevant, however, since the plan payments must return at least as much to creditors as they would receive if the assets were liquidated in a chapter 7 case.[28]

4. The Other Chapters—9, 12, and 15

Chapter 9 is exclusively for municipalities.[29] A municipality is defined as a "political subdivision or public agency or instrumentality of a State."[30] Historically, this has included entities such as cities, towns, utility and irrigation districts, special tax districts, and school districts.

Chapter 12 is essentially a chapter 13 for family farmers or family fishermen with regular annual income, as defined in 11 U.S.C. § 101(18) through (19B). With few exceptions, a trustee is appointed in every chapter 12 case.[31] The trustee evaluates the case and serves as a disbursing agent, collecting payments from the debtor and making distributions to creditors.[32] The debtor remains a debtor in possession unless removed by the court for cause.[33] Chapter 12 has higher debt limits than chapter 13 and is more streamlined than chapter 11, thus making it well suited for family farmers and fishermen.

Chapter 15 governs ancillary and other cross-border cases. It provides for recognition of certain foreign proceedings by United States bankruptcy courts in order to facilitate the administration of cross-border insolvencies. A case is commenced under chapter 15 by the filing of a petition for "recognition" by a foreign representative.[34]

C. The United States Trustee and the Private Trustees

1. United States Trustees

The United States Trustee is the regional official of the United States Trustee Program, which is a civil, litigating component of the United States Department of Justice that protects the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public. The Program is often referred to as the "watchdog" of the bankruptcy system. It has twenty-one regions; ninety-two field office locations; and a headquarters office, the Executive Office for United States Trustees, in Washington, D.C.[35]

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[25] 11 U.S.C. § 1302 (2012).
[26] 11 U.S.C. § 1324(a) (2012) (amended 2016).
[27] 11 U.S.C. § 1325(b)(1), (2) (2012) (amended 2016).
[28] § 1325(a)(4).
[29] § 109(c)(1).
[30] 11 U.S.C. § 101(40) (2012) (amended 2016).
[31] 11 U.S.C. § 1202 (2012).
[32] § 1202.
[33] 11 U.S.C. §§ 1203, 1204 (2012).
[34] 11 U.S.C. §§ 1504, 1515 (2012).
[35] The United States Trustee Program has jurisdiction in all judicial districts except those in Alabama and North Carolina. In those districts, the Bankruptcy Administrator, an official of the courts, performs similar functions.

United States Trustees have the power to raise and be heard on any issue in any bankruptcy case or proceeding, but may not file a chapter 11 plan.[36] The duties of the United States Trustees, in general, include monitoring cases for compliance with the Bankruptcy Code and Rules, reporting suspected bankruptcy crimes to the United States Attorney, and appointing and supervising private trustees.[37]

United States Trustees have civil litigation authority and pursue civil enforcement actions to protect the integrity of the bankruptcy system and the parties involved in it. For instance, United States Trustees may seek to deny or revoke debtors' discharges,[38] move for the imposition of fines and penalties against non-attorney bankruptcy petition preparers,[39] take formal and informal actions against creditors that file inaccurate or incomplete proofs of claim and other documents,[40] and object to fees requested by professionals.[41]

United States Trustees may conduct discovery pursuant to the Federal Rules of Civil Procedure as incorporated in the Federal Rules of Bankruptcy Procedure, but have no formal investigators and no administrative subpoena process. Any crimes discovered must be reported to the United States Attorney.

2. Private Trustees

Bankruptcy trustees are representatives of the bankruptcy estate.[42] Trustees are appointed in cases under chapter 7, chapter 12, and chapter 13. On occasion, trustees are also appointed in chapter 11 cases. The United States Trustee supervises bankruptcy trustees in the performance of their statutory duties.[43] Private trustees are not government employees or agents.

Appointment

Chapter 7 trustees are members of a panel of private individuals appointed and supervised by the United States Trustee.[44] It is the United States Trustee's duty to appoint a person from this panel to serve as trustee in chapter 7 cases.[45] Trustees must meet certain minimum requirements set by the United States Trustee, but beyond those requirements, trustees have diverse backgrounds. They have included, for example, attorneys, accountants, real estate agents, retired FBI agents, certified fraud examiners, and business persons.

Most chapter 13 trustees and many chapter 12 trustees are "standing" trustees. Standing trustees are individuals appointed by the United States Trustee and are assigned all cases of a particular type within a geographic area.[46] If there are not enough cases in a geographic area to warrant a standing trustee, the United States Trustee will appoint chapter 12 and/or chapter 13 trustees on a case by case basis.

Chapter 11 trustees are individuals appointed by the United States Trustee to serve in specific chapter 11 cases. If the court orders the appointment of a chapter 11 trustee, the United States Trustee first consults with parties in interest.[47] The United States Trustee identifies candidates whose experience and

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[36] 11 U.S.C. § 307 (2012).
[37] *See, e.g.*, 28 U.S.C. § 586(a) (2012); 11 U.S.C. § 1104(e) (2012).
[38] 11 U.S.C. § 727(a), (d) (2012).
[39] 11 U.S.C. § 110 (2012).
[40] FED. R. BANKR. P. 3001, 3002, 3002.1, 3003.
[41] 11 U.S.C. § 330 (2012).
[42] *See* 11 U.S.C. § 323(a) (2012).
[43] *See* 28 U.S.C. § 586(a)(1), (3), (b) (2012).
[44] § 586 (a)(1).
[45] 11 U.S. C. § 701(a)(1) (2012).
[46] *See* 11 U.S.C. §§ 1202(a), 1302(a) (2012); § 586(b); 1 COLLIER ON BANKRUPTCY, ¶ 6.13 (16th ed. 2013).
[47] 11 U.S.C. § 1104(d) (2012).

education make them qualified for appointment in the particular case. The United States Trustee selects a candidate, makes the appointment, and then applies to the court for an order approving that appointment.[48]

As noted previously, in chapter 11 there is a presumption that the DIP remains in control of the case. Under certain circumstances the court will order the appointment of a chapter 11 trustee, based on cause, such as fraud or incompetence by debtor's management, or the interests of creditors.[49]

If appointment of a trustee is not ordered, but there are allegations of wrongdoing or incompetence on the part of debtor's management, then a party in interest or the United States Trustee may request the appointment of an examiner to conduct an investigation of the debtor.[50] As soon as practicable, the examiner is to file a statement of the investigation.[51] In some instances, the examiner's findings may provide evidence leading to the appointment of a chapter 11 trustee, but the person serving as examiner may not serve as trustee in the same case.[52]

Duties

Regardless of the chapter under which they serve, trustees are fiduciaries. They are representatives of the estate and have the capacity to sue and be sued.[53] The United States Trustee is charged by statute to supervise the administration of their cases to ensure that they are discharging their fiduciary responsibilities and are performing their statutory duties.[54]

A trustee enjoys quasi-judicial immunity with respect to actions that are "functionally comparable to those of judges, i.e., those functions that involve discretionary judgment."[55] Moreover, under what is known as the *Barton* doctrine, a party must obtain leave of the bankruptcy court before it initiates an action in another forum against a bankruptcy trustee for acts taken in the trustee's official capacity.[56]

The chapter 7 trustees' duties are enumerated in 11 U.S.C. § 704(a). The principal duties are to collect and liquidate the property of the estate, pay creditors with the proceeds, and close the case as expeditiously as is compatible with the best interests of parties in interest.[57] Among other things, chapter 7 trustees must also be accountable for property received; investigate the financial affairs of the debtor; examine and object to proofs of claim if appropriate; oppose the debtor's discharge if advisable; furnish information requested by parties in interest; file periodic reports in operating businesses; and file a final report and account of their administration of the estate.[58]

Prior to administering an asset, the trustee must consider whether sufficient funds will be generated to make a meaningful distribution to unsecured creditors. In making this determination, the trustee considers: the fair market value of the property; the amount, validity, and perfection of purported

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[48] § 1104(d); FED. R. BANKR. P. 2007.1(c).
[49] § 1104(a)(1), (2).
[50] § 1104(c).
[51] 11 U.S.C. § 1106(b) (2012).
[52] 11 U.S.C. § 321(b) (2012).
[53] 11 U.S.C. § 323 (2012).
[54] 28 U.S.C. § 586(a)(3) (2012). If a trustee fails to adequately satisfy the trustee's duties, the United States Trustee may, among other things, object to the trustee's compensation. 11 U.S.C. § 330(a)(2) (2012).
[55] *See In re* Castillo, 297 F.3d 940, 947 (9th Cir. 2002).
[56] *See* Barton v. Barbour, 104 U.S. 126, (1881); Villegas, et al v. Schmidt, 788 F.3d 156 (5th Cir. 2015), *cert denied*, (U.S. Dec. 7, 2015) (No. 15-407); *In re* Crown Vantage, Inc., 421 F.3d 963, 970 (9th Cir. 2005).
[57] 11 U.S.C. § 704(a)(1) (2012).
[58] § 704(a).

security interests against such property; applicable exemptions; tax considerations of a sale; and administrative expenses and litigation costs to be incurred through recovery and sale of the property.

Although the collection and disbursement of the debtor's plan payments are central to the operation of a chapter 13 trustee's office,[59] chapter 13 trustees are more than disbursing agents. Their duties include some chapter 7 trustee duties (unrelated to selling assets) and duties specific to chapter 13, including the following: investigating the financial affairs of the debtor; opposing the discharge of the debtor if advisable; appearing at any hearing concerning the value of property subject to a lien, confirmation of a plan, or modification of a plan after confirmation; advising the debtor, other than on legal matters, and assisting the debtor in performance under the plan; and ensuring that the debtor commences making timely payments under the plan.[60]

The chapter 12 trustees' duties are very similar to those of the chapter 13 trustees.[61] However, the chapter 12 trustees are also required to participate in any court hearings that concern the sale of property of the estate.[62] In addition, if the debtor ceases to be a debtor-in-possession, the trustee must assume a number of the debtor's duties.[63]

In addition to performing certain duties of a chapter 7 trustee, the chapter 11 trustee "steps into the shoes" of the debtor's management and becomes a fiduciary with an obligation of fairness to all parties in the case. A chapter 11 trustee is authorized to operate the debtor's business.[64] In addition, the trustee must investigate the acts, conduct, assets, liabilities, and financial condition of the debtor; the operation of debtor's business and the desirability of its continuance; and any other matter relevant to the case or to the formulation of a plan.[65] As soon as practicable, the chapter 11 trustee must file a statement of the trustee's findings, including facts pertaining to wrongdoing or incompetence on the part of the debtor's management.[66] The trustee must also file a plan, file a report on why the trustee will not file a plan, or recommend conversion of the case to another chapter or dismissal of the case.[67]

Compensation

A chapter 7 trustee receives a sixty dollar administrative fee per case,[68] which is paid from filing fees in the case. The trustee is also entitled to receive "reasonable compensation." This amount generally consists of varying percentages of all moneys disbursed to parties in interest other than the debtor, subject to a statutory limit.[69] Generally, in cases where there are no assets to liquidate, the trustee's compensation for the case is the sixty dollar administrative fee.

Chapter 11 trustees file fee applications with the court, showing that their requested compensation is "reasonable" and for "actual, necessary services."[70] Compensation of the chapter 11 trustees may not exceed the same sliding scale of percentages of disbursements applicable to chapter 7 trustees.[71]

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[59] 11 U.S.C. § 1326 (2012) (amended 2016).
[60] 11 U.S.C. § 1302(b)(2), (3), (4), (5) (2012).
[61] 11 U.S.C. §1202 (2012).
[62] § 1202(b)(3)(D).
[63] § 1202(b)(5).
[64] 11 U.S.C. § 1108 (2012).
[65] 11 U.S.C. § 1106(a)(3) (2012).
[66] § 1106(a)(4).
[67] § 1106(a)(5).
[68] 11 U.S.C. § 330(b)(1) (2012).
[69] 11 U.S.C. § 326(a) (2012).
[70] § 330(a)(1).
[71] § 326(a).

The Attorney General, through the Director of the United States Trustee Program, fixes a maximum annual compensation for the chapter 12 and chapter 13 standing trustees.[72] The standing trustees' salaries, as well as their actual and necessary expenses, are funded by a percentage fee collected from each debtor's plan payments.

D. Automatic Stay and Discharge

The filing of a bankruptcy petition generally gives rise to an "automatic stay" against the commencement or continuation of any action or proceeding against the debtor or against property of the estate. The stay is broad, prohibiting such things as the enforcement of prepetition judgments, acts to obtain possession of property of the estate, and acts to create or perfect a lien.[73] Often, the immediate goal in filing a bankruptcy case is to stop some sort of creditor collection activity—for example, foreclosure, eviction, repossession, levy, entry of a judgment, or a trial.

Some actions, however, are not subject to the automatic stay and therefore may be commenced or continued after the filing of a case. Examples include: criminal proceedings against the debtor; civil actions concerning paternity, domestic support, child custody, and the like; suspension of a driver's or professional license; interception of a tax refund; tax audits and assessments; and residential evictions where the lessor obtained a judgment for possession before the case was filed.[74]

The duration of the automatic stay is not unlimited. For instance, on a creditor's motion, the court may terminate the stay for a variety of reasons, such as cause, lack of equity in the subject property, and/or fraud.[75] Moreover, by operation of law, the stay ends with respect to many actions when a case is dismissed or closed or when the debtor receives a discharge (although the stay may still prohibit actions against property of the estate, if there is any).[76] In addition, the stay may be limited in cases involving serial bankruptcy filers.[77]

A discharge order forever prohibits creditors from any attempt to collect from the debtor a debt that has been discharged. Obtaining a discharge is very important to most debtors who are trying to resolve their financial obligations and receive the bankruptcy fresh start through a liquidation or a repayment plan.

By contrast, unscrupulous individuals or entities may file bankruptcy for themselves or associated entities with no intent of completing the case but solely to trigger the automatic stay. For these individuals or entities, obtaining the automatic stay delays collection actions and creates barriers to investigations by creditors attempting to collect what they are owed. In certain instances, "automatic stay" cases may be incomplete or involve multiple case filings and the intentional change of business or personal identifiers to avoid detection. For example, an individual may use different Social Security numbers to disguise how many cases he or she has filed, or an individual or entity may file multiple cases to facilitate mortgage fraud schemes targeting homeowners.

[72] 28 U.S.C. § 586(e) (2012).
[73] 11 U.S.C. § 362(a) (2012).
[74] § 362(b).
[75] § 362(d).
[76] § 362(c).
[77] § 362(c)(3), (4).

E. Civil Enforcement Remedies

As noted previously, the United States Trustee engages in a variety of civil enforcement actions, as appropriate, to address potential abuses and violations of the Bankruptcy Code. The following are among the more common remedies sought through these actions.

1. Dismissal of the Case

The pre-discharge dismissal of a case returns the parties to their prepetition positions. For example, any prepetition custodian, such as a state court receiver, becomes reinstated.[78] Moreover, the automatic stay is no longer in effect.[79] Lawsuits, levies, foreclosures, evictions, repossessions, and other collection actions may resume. Nonetheless, dismissal is not always the most effective tool against a noncompliant or abusive debtor, because dismissal is usually without prejudice to the filing of another case.[80]

Denial or Revocation of Discharge

Denial or revocation of discharge is a remedy of considerable consequence for an individual, in that generally all debts that existed when the case was filed are barred from future discharge.[81] Statutes of limitations may run on the debts, or creditors may write them off, but the debts may not be discharged in a future bankruptcy case.

The grounds for denial of discharge generally include some sort of fraudulent conduct, such as transfer or concealment of assets, or false oaths in the Schedules or in sworn testimony at the section 341 meeting of creditors.[82] However, a debtor's failure to maintain adequate books and records or to satisfactorily explain a loss of assets is sufficient to warrant denial of discharge regardless of intent.[83] In a chapter 13 case, the grounds for objecting to discharge are more limited.[84]

In chapters 7 and 13, a complaint to deny an individual debtor's discharge may be filed no later than sixty days after the first date set for the section 341 meeting of creditors. In chapter 11, the complaint may be filed no later than the first date set for a hearing on plan confirmation.[85] The deadlines may be extended, provided a motion for an extension is filed before the time has expired.[86]

In chapter 7, once a discharge has been granted, a party in interest and the United States Trustee may seek to have it revoked, but only if the discharge was obtained through fraud of the individual debtor and the requesting party did not know of the fraud until after the discharge was granted.[87] A complaint to revoke discharge generally must be filed within one year after the discharge was granted.[88]

Denial of discharge under 11 U.S.C. § 727 is to be distinguished from nondischargeability under 11 U.S.C. § 523. A finding of nondischargeability results in a particular debt being barred from future discharge. Some of the types of debts listed in § 523 are per se nondischargeable, such as domestic

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78 11 U.S.C. § 349(b)(1) (2012).
79 11 U.S.C. § 362(c) (2012).
80 § 349(a).
81 11 U.S.C. § 523(a)(10) (2012) (amended 2016); *see also In re* Klapp, 706 F.2d 998, 1000 (9th Cir. 1983).
82 *See, e.g.*, 11 U.S.C. § 727(a)(2), (4) (2012).
83 § 727(a)(3), (5).
84 11 U.S.C. § 1328(f) (2012).
85 FED. R. BANKR. P. 4004(a).
86 FED. R. BANKR. P. 4004(b).
87 § 727(d)(1).
88 11 U.S.C. § 727(e)(1) (2012).

support obligations,[89] while some require the filing of an adversary proceeding to prove nondischargeability, such as debts for fraud while acting in a fiduciary capacity, [90] or debts procured by fraud pre-filing. Nondischargeability actions are brought by the creditors to whom the specific debts are owed, not by the trustees or the United States Trustee.

Appointment of a Trustee in Chapter 11

In chapter 11, at any time after the commencement of the case but before confirmation of a plan, a party in interest or the United States Trustee may file a motion for appointment of a chapter 11 trustee, either for "cause" (including fraud, dishonesty, incompetence, or gross mismanagement by the debtor's management) or if such appointment is in the interests of creditors.[91] Appointment of a chapter 11 trustee removes control of the estate from the debtor.

During that same time period, if the court has not ordered the appointment of a trustee, the United States Trustee or a party in interest may move for appointment of an examiner to investigate any allegations of wrongdoing by the debtor's management.[92] As noted before, the examiner's work culminates in a report to the court.[93]

Case Conversion

In chapter 11 and chapter 13, a party in interest may move for conversion of the case to chapter 7.[94] In chapter 11, "cause" for conversion includes various forms of noncompliance with the debtor's duties: loss or diminution of the estate and the absence of a reasonable likelihood of rehabilitation, gross mismanagement, failure to pay fees or taxes, and other conduct.[95] In chapter 13, "cause" includes such things as unreasonable delay, nonpayment of fees, failure to timely file a plan or make plan payments, denial of confirmation, default under a confirmed plan, and revocation of confirmation.[96]

Typically, a debtor who files under chapter 13 or chapter 11 possesses nonexempt assets such as real estate or vehicles. In such circumstances, the debtor may oppose conversion to chapter 7, because the trustee will liquidate those assets for the benefit of creditors.

The Bankruptcy Code permits a debtor, under appropriate circumstances, to convert his or her case to another chapter that the debtor is eligible to file.

III. Full and Complete Disclosure

A. Bankruptcy as a Resource

Debtors generally file bankruptcy to obtain the protection of the automatic stay and the benefit of a bankruptcy discharge or a confirmed reorganization plan. In return, debtors are required to be open and honest about their financial affairs and to perform their duties under the Bankruptcy Code and Rules.[97]

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[89] 11 U.S.C. § 523(a)(5) (2012) (amended 2016).
[90] § 523(a)(4), (c).
[91] 11 U.S.C. § 1104(a) (2012).
[92] § 1104(c).
[93] 11 U.S.C. § 1106(b) (2012).
[94] 11 U.S.C. § 1112(b) (2012); 11 U.S.C. § 1307(c) (2012).
[95] § 1112(b)(4).
[96] § 1307(c).
[97] 11 U.S.C. § 521 (2012) (amended 2014); FED. R. BANKR. P. 4002.

Most bankruptcy documents filed by the debtor are signed under penalty of perjury. For example, the voluntary petition for individuals unequivocally states, in relevant part, above the debtor's signature line: "I have examined this petition, and I declare under penalty of perjury that the information provided is true and correct . . . I understand making a false statement, concealing property, or obtaining money or property by fraud in connection with a bankruptcy case can result in fines up to $250,000, or imprisonment for up to 20 years, or both."[98] This acknowledgement of the potential penalties for making false or misleading statements can be very useful in front of a criminal jury as evidence of intent when the statements contained in the documents are false.

11 U.S.C. § 343 requires each bankruptcy debtor to appear and submit to examination under oath at the section 341 meeting of creditors. These meetings are electronically recorded. The United States Trustee must preserve the recordings for at least two years and make them available for public access.[99] As a practical matter, an office may retain the recordings for considerably longer. Recordings of the meeting may generally be played for a jury, thereby making the debtors/defendants witnesses against themselves if they made false or misleading statements to the trustee or explained their business transactions in a manner inconsistent with their criminal defense.

A debtor's bankruptcy Schedules and master address list provides valuable information about people and entities whose interests may be adverse to the debtor or who may have knowledge of the debtor's pre-filing conduct. The individuals and entities listed in those documents have extended money, property, or services to the debtor, and have not been paid in return. Notably, what is called the "ex factor" is often in play in a bankruptcy case. Ex-spouses, ex-employees, ex-business partners, and other third parties are often willing to share information regarding concealed assets, undisclosed transactions, unlisted bank accounts, and the like.

Other participants in the bankruptcy system are also required to sign certain documents under penalty of perjury, such as creditors' proofs of claims or declarations. Adversary proceedings, motions, and other pleadings filed with the court must be truthful and comply with Bankruptcy Code requirements and Bankruptcy Rule 9011. Information from these documents and court filings may also prove to be valuable.

B. Bankruptcy Documents and Other Information

Debtors are required to file petitions, Schedules, and Statements of Financial Affairs as well as other documents such as tax returns and pay advices.[100] There are two sets of official forms for the Schedules and Statement of Financial Affairs—one for use by individuals and the other for use by non-individuals such as corporations and partnerships. They all require the debtor or the representative of a non-individual debtor to sign the documents under penalty of perjury. The questions in the documents are designed to elicit a complete picture of the debtor's assets, debts, and financial affairs.[101]

Full and accurate disclosure by the debtor is required. Failure to make full and complete disclosure may subject a debtor to civil and criminal enforcement actions.

1. The Petition

The Petition for Individuals (Official Form 101) requires debtors to provide general information including their full names and any other names used within eight years of filing, the last four digits of their Social Security Number or Individual Taxpayer Identification Number, and any business names with

[98] 18 U.S.C. §§ 152, 1341, 1519, 3571 (2012).
[99] FED. R. BANKR. P. 2003(c).
[100] § 521.
[101] A complete list of the required forms, copies of the official forms, and their instructions may be found at www.uscourts.gov.

Employer Identification Numbers. The clerk of the bankruptcy court receives the full identifying numbers and furnishes that information to the creditors, the trustee, and the United States Trustee. Debtors are also required to disclose their current address and to provide information about bankruptcy cases they filed within the last eight years. If they are not represented by counsel, individual debtors are required to sign and file an additional page (Page 8) that acknowledges the risks of filing without an attorney and asks whether they paid or agreed to pay a non-attorney to prepare the bankruptcy forms. The Petition for Non-Individuals (Official Form 201) asks for much of the same basic information, but does not include matters that pertain strictly to individuals.

Individual debtors and authorized representatives of non-individual debtors sign the petition under penalty of perjury. Counsel representing debtors must also sign the petition and provide their contact information. For individual debtors, their counsel must certify that counsel has no knowledge after an inquiry that the information in the Schedules filed with the petition is incorrect.[102] Counsel for non-individuals are not required to make that certification.[103]

2. The Schedules

There are ten Schedules for individual debtors and seven Schedules for non-individual debtors, each asking for specific categories of information. The questions for non-individuals ask for financial and asset information traditionally associated with businesses.

The forms were revised effective December 1, 2015, and some of the Schedules were combined into a single Schedule. Schedules filed prior to that date have the same information, but are separately labeled. The Schedules for individuals comprise Official Form 106. Those for non-individuals comprise Official Form 206.

The debtor must attest to the accuracy of the Schedules under penalty of perjury. For individual cases, the debtor signs the petition. For non-individual cases, the petition is signed by the authorized representative of the debtor.

Schedule A/B—Assets

Schedule A/B is the property schedule and is a "snapshot" of all of a debtor's assets at the time the case is filed. (In older cases there will be a separate Schedule A and Schedule B. A lists real property; B lists personal property). Schedule A/B asks debtors to disclose everything they own, including interests in real property, vehicles, personal and household items for individuals, financial assets, business related property, and farm-and commercial fishing related property. At the end of Schedule A/B, debtors are provided one more opportunity to disclose their assets fully and are required to state affirmatively that they have listed all assets.

Schedule C—Exemptions

The Bankruptcy Code provides individual debtors the right to protect certain specific assets up to a certain dollar amount from liquidation by the trustee, such as a house, a car, or a pension, based on either federal or state exemption laws. Most states require debtors to use state exemptions, but a number allow their residents to choose between federal or state exemptions. To claim an exemption, a debtor must describe on Schedule C each item of property claimed as exempt, the dollar amount of the exemption, and the statute under which each item is being exempted. If an asset is not listed on Schedule A/B, it cannot be exempted on Schedule C.[104] Non-individual debtors do not have a corresponding right to claim exemptions, and therefore Schedule C is not included in the Non-Individual Schedules.

[102] Official Form B 101; 11 U.S.C. § 707(b)(4)(D) (2012) (amended 2016); FED. R. BANKR. P. 9011(a), (b).
[103] Official Form B 201.
[104] 11 U.S.C. § 522 (2012) (amended 2016).

Schedule D—Secured Creditors

Schedule D requires the debtor to disclose all secured creditors, the amounts of their claims, the description of the collateral securing the claims, the nature of the liens, and the like. Examples of secured debt that must be disclosed are mortgage loans, car loans, letters of credit, and pledges of assets as collateral for business or personal loans. Schedule D provides information about people and entities that have a prior relationship with the debtor and are owed money.

Schedule E/F—Unsecured Creditors

Schedule E/F requires debtors to disclose the names of all creditors with unsecured claims, the nature and amount of the claim, and the creditor's contact information. It asks for priority unsecured claims such as domestic support obligations, taxes, wages, salaries, commissions, contributions to employee benefit plans, and consumer deposits, as well as all nonpriority unsecured claims such as trade debts, credit card debt, student loans, and unsecured loans from individuals or entities. Like Schedule D, Schedule E/F provides information about people and entities that have a prior relationship with the debtor and may be owed money.

Schedule G—Executory Contracts and Unexpired Leases

Schedule G requires the debtor to disclose any contracts under which some performance is still to be completed and any leases that are still in force, such as rental agreements, vehicle leases, business contracts, and cell phone contracts.

Schedule H—Co-debtors

Schedule H requires the debtor to disclose all individuals or entities that are also liable for any of the debtor's obligations, such as a guarantor, business partner, cosigner, or a spouse who is not a joint debtor in the bankruptcy case.

Schedule I—Income

Individual debtors are required to disclose their current occupation, employer, and monthly income information. They must also disclose that information for a non-filing spouse. The income is divided into categories by source, such as wages, rent, business income, interest and dividends, family support, unemployment compensation, Social Security, and retirement income. Payroll deductions are subtracted, essentially leaving a monthly take-home figure. Non-individual debtors do not file a Schedule I, and therefore the form is not included in the Non-Individual Schedules.

Schedule J—Expenses

Individual debtors are required to disclose their dependents (by relationship, not by name) and all ongoing current monthly expenses. Most of the expenses are estimates and are broken down into numerous categories and subcategories. Broadly, the categories include home ownership, food and housekeeping, childcare and education, clothing, personal care, medical and dental, transportation, entertainment, charitable contributions, insurance, taxes, car payments, and support payments. The bottom line is the debtor's monthly net income. A final question asks whether the debtor expects an increase or decrease in expenses within the year after filing the form. Non-Individual debtors are not required to file Schedule J, and therefore the form is not included in the Non-Individual Schedules.

Both Schedules I and J provide information that may be helpful in identifying internal inconsistencies in bankruptcy documents or other sworn documents such as tax returns, financial statements, and sworn testimony. For example, Schedule I might disclose interest and dividend income that is not included on the debtor's tax return. Schedule J might show business-related expenses, while

Schedule A/B may not show an ownership interest in any business. Or Schedule I might show rental income although Schedule A/B may not show an ownership interest in real property.

3. The Statement of Financial Affairs

Unlike the Schedules, the Statement of Financial Affairs (referred to as the SOFA) seeks historical information and asks a series of questions about the debtor's financial transactions over a set period of time prior to filing. There are two official forms—Form 107 for individuals and Form 207 for non-individuals.

The categories of information requested on the SOFA for individuals include: income (Part 2); prepetition transfers of money or other property (Part 3, Part 5, and Part 7); lawsuits and foreclosures (Part 4); prepetition losses such as from theft or gambling (Part 6); prepetition financial accounts, safe deposit boxes, and storage units (Part 8); and businesses in which the debtor has been involved (Part 11).

For all questions, full disclosure is mandatory, and the answers are given under penalty of perjury (Part 12). A comparison of the SOFA against the Schedules and other documents may reveal internal inconsistencies that suggest an asset may have been concealed. If an asset was in the possession of the debtor within a year before filing, it should be reflected in the A/B Schedules as being currently owned, or it should be accounted for in response to one of the questions in the SOFA.

The detailed questions posed by the SOFA for individuals allow for the tracing of pre-filing assets that are no longer owned or in control of the debtor. For example, if the debtor owned gold coins within a year of filing but did not disclose the coins in the Schedules, the debtor's SOFA responses should provide information concerning the disposition of the property, such as whether the coins were repossessed (Part 4, Question 10), lost (Part 6, Question 15), or transferred (Part 7, Question 18). If the property is not disclosed in either the Schedules or the SOFA, that may suggest concealment of the asset. Similarly, the answers may reveal patterns that also suggest assets may not have been disclosed.

The SOFA for non-individuals includes similar questions, plus others that are more business oriented. For example, Part 8 asks for information pertaining to bankruptcy filings by health care providers (Question 15). Part 9 asks whether the debtor collects and retains personally identifiable information of its customers (Question 16), and whether within the prior six years any of the debtor's employees participated in an employee benefit pension or profit-sharing plan (Question 17). Part 13 asks about the debtor's books and records and financial statements (Question 26); about inventories taken of the debtor's property (Question 27); and about past and present officers and others in control of the debtor, and any value paid to them during the prior year (Questions 28-30). The SOFA for non-individuals is signed by the debtor's representative under penalty of perjury (Part 14). Comparison of the Schedules and SOFA for non-individuals is helpful in evaluating the pre-filing financial condition of the debtor and assessing whether the debtor has discharged its duty to make full and complete disclosure.

4. The Disclosure of Compensation

Any attorney representing a debtor in connection with a bankruptcy case is required to file with the court a statement of the compensation paid or agreed to be paid to the attorney, if such payment or agreement was made within the year prior to the filing of the bankruptcy case.[105] By signing the disclosure form, the debtor's counsel certifies that counsel has fully disclosed the agreement or arrangement for payment for representing the debtor in the bankruptcy proceeding. The appropriate form

[105] 11 U.S.C. § 329(a) (2012).

for use in both individual and non-individual cases is Director's Procedural Form B 2030, Disclosure of Compensation of Attorney for Debtor.[106]

A bankruptcy petition preparer, often called a BPP, is a person, other than an attorney for the debtor or an employee under the direct supervision of such attorney, who is compensated to prepare a document for filing in connection with a bankruptcy case.[107] A BPP who has participated in the preparation of the debtor's bankruptcy documents must disclose any fee received from or on behalf of the debtor within the prior year and any unpaid balance due.[108] The appropriate form to make these disclosures is Director's Procedural Form B 2800, Disclosure of Compensation of Bankruptcy Petition Preparer.[109]

Further, the BPP must sign a Bankruptcy Petition Preparer's Notice, Declaration, and Signature, Official Form 119, making additional disclosures regarding notices given to the debtor, services performed, and documents prepared or caused to be prepared.[110] A BPP must provide a full Social Security number on Official Form 119.

Among other things, these disclosure requirements for attorneys and BPPs assist the court, the United States Trustee, and creditors in determining whether compensation is reasonable. The court has broad authority to disgorge unreasonable compensation.[111]

C. Section 341 Meeting of Creditors

After the petition is filed, the bankruptcy court assigns a case number and assigns a judge. If the case is filed under chapter 7, 12, or 13, a trustee is assigned and a meeting of creditors, often called a section 341 meeting, is scheduled within 21 to 60 days.[112] All debtors are required to appear at the section 341 meeting and to testify under oath about their financial affairs.[113]

A "notice of commencement of case" is mailed to all listed creditors informing them that the named debtor has filed the bankruptcy case, the automatic stay is in place, and a meeting will be held on a specific date and time, at which the creditors may question the debtor about the debtor's financial affairs. The notice contains the debtor's complete Social Security number, although the copy accessible from the court's docket shows a redacted Social Security number.

If the completed Schedules, Statement of Financial Affairs, or other required documents are not filed within the time period prescribed by the Bankruptcy Code, the case may be dismissed for noncompliance.

The section 341 meeting provides the trustee, the United States Trustee, and creditors the opportunity to examine the debtor under oath about assets and liabilities. Generally, the meetings are brief

[106] Form B 2030 is issued by the Director of the Administrative Office of the United States Courts. Because it is not prescribed by the Judicial Conference of the United States, Form B 2030 is not an Official Form. FED. R. BANKR. P. 9009. Nevertheless, the form is commonly used by attorneys to satisfy their statutory disclosure obligations.
[107] 11 U.S.C. § 110(a)(1) (2012).
[108] § 110(h)(2); FED. R. BANKR. P. 2016(c).
[109] Like Form B 2030, Form B 2800 is issued by the Director of the Administrative Office of the United States Courts. Although it is not an Official Form, Form B 2800 is commonly used by BPPs to satisfy their statutory disclosure obligations.
[110] § 110(b)(1), (c)(1); *see also* Page 8 of the petition.
[111] 11 U.S.C. § 329(b) (2012); § 110(h)(3).
[112] 11 USC § 341 (2012).
[113] All 341 meetings are digitally recorded. The United States Trustee is required to maintain a copy of the recording until at least two years after the conclusion of the meeting, but most offices keep the copy for a longer period of time. FED. R. BANKR. P. 2003(c). The recordings may be obtained from the United States Trustee's office for the district where the case was filed. The court may not preside over or attend a 341 meeting. § 341(c).

and focus on the information disclosed in the Schedules and SOFA. The trustee presides at the meeting and places the debtors under oath. The debtor must provide proof of identity, generally in the form of a government issued photo ID, and proof of Social Security number, generally a Social Security card. At the start of the meeting, the trustee will ask questions to verify the reliability of the debtor's Schedules and SOFA. The trustee also asks specific questions based upon the representations made by the debtor and to investigate additional matters as appropriate.[114]

D. Initial Debtor Interview, Monthly Operating Reports, Documents

A case filed under chapter 11 often involves an operating business. In all chapter 11 cases, an Initial Debtor Interview (IDI) is scheduled and conducted by the United States Trustee within a short period of time after the case is filed. The meeting is generally conducted by one of the United States Trustee Program's Bankruptcy Analysts and attended only by the debtor's attorney and the debtor or the debtor's principal or financial expert such as a chief financial officer, accountant, or financial manager. The meeting is not recorded and the debtor or debtor's representative is not placed under oath.

Before the IDI, the United States Trustee sends a letter to the debtor requesting production of additional documents that may include proof of insurance, profit and loss statements, tax returns, and other financial documents. The Bankruptcy Analyst meets with the debtor or its representative and the attorney to discuss important financial and background information regarding the debtor's business. In addition, the Bankruptcy Analyst discusses chapter 11 reporting requirements, including the filing of monthly operating reports.

A chapter 11 debtor must file periodic operating reports, generally on a monthly basis (Monthly Operating Reports or MORs), with the bankruptcy court and the United States Trustee, as determined by the local rules.[115] The MOR shows all income received and payments made in the previous month, as well as any accumulating debt. The United States Trustee and other parties in interest monitor these reports to assess the debtor's financial performance and compliance with fiduciary duties. Copies of the MORs are available from the federal courts' Public Access to Court Electronic Records system (PACER) or directly from the United States Trustee's office.

In a chapter 12 or chapter 13 case in which the debtor has an operating business, the trustee may require the debtor to attend a meeting similar to the IDI conducted in a chapter 11 case. At that meeting, the chapter 12 or chapter 13 debtor may be asked to provide information and documents.

E. Proofs of Claim

In chapters 9, 11, 12, and 13, and in asset chapter 7 cases, unsecured creditors must generally file a proof of claim in order to be paid.[116] The proof of claim form is not maintained on the main docket, but is found on a separate claims register in PACER, which can be accessed by a link on the docket. The proof of claim sets forth the nature of the claim, the amount owed, and when the claim was incurred. It may contain supporting documentation such as contracts, loan agreements, or promissory notes. The proof of claim is signed under penalty of perjury by the creditor or the creditor's authorized agent or by a non-creditor third party.[117]

F. Other Motions; Adversary Proceedings

Many motions filed in a bankruptcy case can be a source of useful information because they may provide additional insight into the debtor's financial affairs and the other participants in the case. Often

[114] Debtors who are hearing impaired, or who speak limited or no English, are provided with interpreters.
[115] 11 USC §§ 704(a)(8), 1106(a)(1), 1107(a) (2012).
[116] FED. R. BANKR. P. 3002(a).
[117] *See* Official Form B 410.

these motions are accompanied by documents such as financial statements provided to lending institutions, deposition transcripts from prepetition litigation, FED. R. BANKR. P. Rule 2004 motions, or affidavits that are publically available on the court's electronic docket.

For example, a motion for relief from the automatic stay by a mortgage lender asking the court to permit it to pursue the debtor outside of bankruptcy may reveal a fractionalized interest foreclosure rescue scheme involving numerous properties and bankruptcy filings.

A motion for appointment of a chapter 11 trustee or examiner may also yield valuable information. This motion may be based on conduct that involves fraud and misconduct prior to or after the filing of the case. For example, a judgment creditor may seek the appointment of a trustee based on evidence that the debtor concealed or converted estate assets.

An adversary proceeding[118] seeking to have a debt determined non-dischargeable under 11 U.S.C. § 523 as being incurred through fraud, or an adversary proceeding seeking to deny or revoke the debtor's entire discharge under 11 U.S.C. § 727 for fraud or similar misconduct, may reveal criminal wrongdoing as well as civil fraud. A third type of adversary proceeding that might provide information useful to an investigation is an avoidance action under 11 U.S.C. § 547 or 548, in which a party seeks to have the court undo a pre-bankruptcy transfer because it preferred one creditor over other similarly situated creditors or because it was made with actual or constructive fraudulent intent.

IV. How to Access Bankruptcy Information

A. Finding Out About a Filing

There are two primary ways to find out about a bankruptcy filing—through PACER or through commercial data bases. Both require registration, a user ID, and a password. Certain fees apply as well.

The PACER Case Locator or National Case Party Index serves as a locator index for PACER. It can be used to conduct nationwide searches to determine whether a party is involved in a bankruptcy case or other federal case. Once a court and a case number have been identified, a PACER search of that court's records will provide access to the docket as well as the documents filed in the case.

Commercial data bases such as LexisNexis and Clear may also be used to identify bankruptcy filings. The CourtLink feature of LexisNexis provides access to copies of the dockets and documents.

B. Reviewing the Files

Most bankruptcy court files are maintained in electronic form. With a PACER account, the documents in a case may be viewed online for a per-page charge. Documents may also be viewed in person at the office of the clerk of the bankruptcy court, using computers available to the public.

Sealed documents and Social Security statements filed in bankruptcy court are not available to the public. However, an entity acting pursuant to the police or regulatory power of a domestic governmental unit may, upon ex parte application demonstrating cause, be given access to certain sealed documents.[119] PACER may show old case files as purged or otherwise unavailable, but those files are usually maintained in alternative form and may be obtained from the clerk of the bankruptcy court by using an archive request form. All court documents can be certified by the clerk for use as evidence in court.

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[118] An adversary proceeding is a lawsuit filed within the bankruptcy case. The clerk of the bankruptcy court assigns a case number to the adversary proceeding and maintains a separate docket that can be accessed by using a link on the main case docket under "related cases." *See* FED. R. BANKR. P. 7001 *et seq.*

[119] 11 U.S.C. § 107(c)(2) (2012).

V. Conclusion

A basic understanding of the bankruptcy system, the process, and the players can prove invaluable to prosecutors and investigators. The debtor's petition, Schedules, and Statement of Financial Affairs, the creditors' proofs of claim, the section 341 meeting of creditors, and other documents and proceedings relating to the case can provide a wealth of information. The United States Trustee Program serves as an important resource to provide our law enforcement partners with assistance in understanding bankruptcy law, the bankruptcy system, and the significance of the information available in the case.

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Bankruptcy Jargon Deciphered: A Short Guide to Bankruptcy Terminology

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I. Introduction

Like most areas of law, bankruptcy has its own special vocabulary that can be puzzling to the non-specialist. This article is intended to be used as a quick reference and to provide a short glossary of the most common bankruptcy law terms.

II. Glossary of Terms

341 Meeting – See Section 341 Meeting.

727 Action – See Objection to Discharge.

Adversary Proceeding – A lawsuit related to the bankruptcy case that is commenced by the filing of a complaint with the bankruptcy court. Certain types of disputes cannot be resolved by the filing of a motion in the bankruptcy case, but instead require the commencement of an adversary proceeding. At the time the complaint is filed, the clerk's office will prepare the summons and provide it to the plaintiff. The summons and complaint must be served on all parties that may be affected by the action described in the complaint, including the defendant, the trustee in the underlying bankruptcy case and any creditor that may be affected. The defendant has thirty days from the day the summons is issued to respond to the complaint by filing an answer with the court admitting or denying the allegations and setting forth any defenses. An adversary proceeding follows the course of any other civil litigation. Examples of adversary proceedings include actions to revoke or deny a discharge, to recover money or property of the bankruptcy estate, and to obtain an injunction. A nonexclusive list of adversary proceedings is set forth in FED. R. BANKR. P. 7001.[1] The clerk of the bankruptcy court maintains a separate docket for each adversary proceeding.

Assume – See also Executory Contract. To agree to continue performing duties under an unexpired lease or contract. If a debtor has an unexpired lease or contract at the time of the bankruptcy filing, the trustee or debtor-in-possession can assume it within a set time period. Common examples of unexpired leases and contracts are rental agreements, ongoing business contracts, and car leases.[2]

Automatic Stay – An injunction, triggered by the filing of a bankruptcy petition, which immediately stops lawsuits, foreclosures, garnishments, evictions, and all collection activity against the debtor.[3] The automatic stay provides a debtor with protection from creditors' actions and an opportunity to reorganize finances. The automatic stay applies whether or not a creditor has received notice of the bankruptcy filing and is in effect even if the documents filed are incomplete or deficient. Generally, the

[1] FED. R. BANKR. P. 7001.
[2] 11 U.S.C § 365 (2012).
[3] 11 U.S.C. § 362(a) (2012).

automatic stay remains in effect during the bankruptcy case unless a creditor files a motion for relief from the stay and the court approves it. Creditors who attempt collection without obtaining court ordered relief from the automatic stay could face sanctions by the bankruptcy court for violating the stay. The automatic stay is sometimes used as part of a fraud scheme to lull victims and delay or prevent an event, such as eviction or foreclosure, or to stop a lawsuit. There are exceptions to the automatic stay, including the police or regulatory power exception that applies to a governmental unit's enforcement of laws that affect health, welfare, morals and safety. This exception covers criminal investigations and prosecutions.[4]

Bankruptcy Administrator – An official of the federal judiciary system who oversees the administration of bankruptcy cases and private trustees in the judicial districts of Alabama and North Carolina. Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the United States Trustee Program.[5]

Bankruptcy Estate – All legal, future and equitable interests of the debtor in property at the time the bankruptcy case is filed. The commencement of the case is the key point in identifying the assets of the bankruptcy estate, which includes all property in which the debtor has an interest, even if it is owned or held by another person. For example, if the debtor is entitled to a tax refund, the right to a refund is property of the bankruptcy estate. Similarly, if the debtor is entitled to receive money through a personal injury lawsuit or as an inheritance, the monies constitute property of the estate.[6]

Bankruptcy Fraud Statutes – Bankruptcy fraud statutes appear in Title 18 U.S.C. §§ 152 through 157. Other relevant criminal statutes include mail fraud, wire fraud, bank fraud and corporate fraud.[7] Some examples of criminal conduct uncovered in bankruptcy cases include Ponzi schemes, mail fraud, bank fraud, foreclosure rescue schemes, tax fraud, identity theft, embezzlement, health care fraud, and money laundering.

BPP – See Petition Preparer.

Chapter 7 Bankruptcy – A liquidation proceeding available to individuals and to non-individuals.[8] An individual debtor receives a complete discharge from debt under chapter 7, except for certain debts that are prohibited from discharge by the Bankruptcy Code. United States Trustees appoint and supervise private trustees, who are not government employees, to administer consumer bankruptcy estates under chapter 7 of the Bankruptcy Code. Chapter 7 trustees are often referred to as panel trustees because they are appointed by the United States Trustee to a panel in each judicial district. Once trustees are appointed to the panel, chapter 7 cases generally are assigned through a random rotation process. The chapter 7 trustee collects non-exempt assets in which the debtor has equity, liquidates the assets, and distributes the proceeds to creditors.[9]

Chapter 11 Bankruptcy[10] **–** A proceeding by which an individual or an entity can reorganize its debts while continuing to operate. The vast majority of cases under chapter 11 of the Bankruptcy Code are filed by businesses. The debtor, often with participation from creditors, proposes a plan of reorganization to either remain in operation or conduct an orderly litigation and to repay part or all of its debts over a period set forth in the plan. Repayment of creditors typically comes from future operating revenue or liquidation of assets in which the debtor has equity. The majority of chapter 11 cases do not have a trustee appointed. Rather, a chapter 11 debtor usually remains in control as debtor-in-possession

[4] § 362(b).
[5] Contact information for the Bankruptcy Administrators is available at http://www.uscourts.gov/services-forms/bankruptcy/trustees-and-administrators.
[6] 11 U.S.C. § 541 (2012) (amended 2016).
[7] 18 U.S.C. §§ 1341, 1343, 1344, 1519 (2012).
[8] 11 U.S.C. § 109(a), (b) (2012) (amended 2016).
[9] 11 U.S.C. § 701 (2012) *et seq*.
[10] 11 U.S.C. § 1101 (2012) *et seq*.

and is charged by statute with some of the fiduciary responsibilities of a trustee. In two instances the Bankruptcy Code empowers the court to appoint a trustee or examiner in chapter 11. The first is an appointment for "cause" including fraud, dishonesty, incompetence, or gross mismanagement of the debtor's affairs. The second is when the appointment of a trustee or examiner is in the best interests of creditors. The appointment of a trustee results in the replacement of the debtor-in-possession by the trustee, who assumes all responsibilities for the debtor. An examiner, by contrast, is appointed to investigate the debtor-in-possession's acts, conduct, assets, liabilities, business operations, and financial condition, as set forth in a court order. The examiner does not take control of or operate the debtor-in-possession. A chapter 11 trustee or examiner is not a government employee.

Chapter 13 Bankruptcy[11] **–** A proceeding, often called wage-earner bankruptcy, used by individuals to reorganize their financial affairs under a repayment plan that must be completed within three or five years. To be eligible for relief under chapter 13 of the Bankruptcy Code, a consumer must have a regular source of income and may not have more than a certain amount of debt, as set by statute.[12] United States Trustees appoint and supervise private trustees, who are not government employees, to administer bankruptcy estates under chapter 13. Chapter 13 trustees are called standing trustees because, pursuant to statute, they have a standing appointment from the United States Trustee to administer chapter 13 cases within a particular geographic area. Standing trustees' duties include evaluating the financial affairs of the debtor, making recommendations to the court regarding confirmation of the debtor's repayment plan, and administering the court-approved plan by collecting payments from the debtor and disbursing the funds to creditors.

Civil Enforcement Action – Enforcement activity by the United States Trustee Program that is designed to advance and protect the integrity of the federal bankruptcy system through the use of civil litigation authorized by the Bankruptcy Code. The United States Trustee Program and each United States Trustee maintains broad oversight and review functions in the bankruptcy system, with a focus on ensuring the proper administration of the bankruptcy laws. Civil enforcement encompasses the identification of bankruptcy related matters that have some indicia of fraud and abuse. For example, the United States Trustee may object to a debtor's discharge based upon fraud, object to creditors' claims, file a motion against an undisclosed petition preparer involved in a rescue scheme, challenge the reasonableness of professional fees billed in a case, or object to employment of a law firm on the ground that the firm has a conflict of interest.

Claim – A creditor's assertion of a right to payment. The Bankruptcy Code defines a claim as a right to payment or right to an equitable remedy whether or not such right "is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured [sic], disputed, undisputed, legal, equitable, secured, or unsecured[.]"[13] To be eligible to receive a distribution, a creditor must file a proof of claim using Official Form 410 and must attach documents that support the claim, such as promissory notes, invoices, purchase orders, contracts and judgments. Proofs of claim are signed by the creditor under penalty of perjury. A properly filed proof of claim is prima facie evidence of the validity and the amount of the claim.

Clerk of the Bankruptcy Court – The bankruptcy court official who manages the court's non-judicial functions in compliance with policies set by the court and reports directly to the court through the chief judge. The clerk maintains the court records and dockets, provides courtroom support services, manages the court's technology systems, and collects filing fees and other costs. Certified copies of documents filed with the bankruptcy court can be obtained from the clerk.

[11] 11 U.S.C. § 1301 (2012) *et seq*.
[12] § 109(a), (e).
[13] 11 U.S.C. § 101(5) (2012) (amended 2016).

Confirmation – A bankruptcy judge's approval of a plan of reorganization or liquidation in chapter 11 or a payment plan in chapter 13. In chapter 11, creditors vote on the debtor's plan of reorganization, which is confirmed only upon the affirmative votes of the creditors, who are divided into payment classes based upon the characteristics of their claims.[14] If the debtor cannot obtain the votes necessary to confirm a chapter 11 plan, the debtor may be able to have the plan confirmed despite creditor opposition by meeting certain statutory tests. In chapter 13, a plan must be submitted for court approval and must provide for payments of fixed amounts to the trustee on a regular basis, typically biweekly or monthly.[15] The chapter 13 trustee, creditors, and other parties may object to the proposed plan.[16] If the plan is approved by the court, the trustee distributes the funds to creditors according to the terms of the plan. In both chapters 11 and 13, parties are bound by the terms of a confirmed plan, and the amounts repaid to unsecured creditors may be less than the full amount of their claims.

Contested Matter – A legal action commenced by the filing of a motion with the bankruptcy court. FED. R. BANKR. P. 7001 sets forth legal actions that must be filed as complaints rather than by motion.[17] For example, a request for relief from the automatic stay is a contested matter commenced by a motion, while an objection to discharge is an adversary proceeding that must be filed by complaint.

Convert – To change from one bankruptcy chapter to another.

Credit Counseling – Counseling provided by an approved credit counseling agency before an individual may file bankruptcy. Under the Bankruptcy Code, before filing bankruptcy an individual must obtain credit counseling from an agency approved by the United States Trustee or the Bankruptcy Administrator.[18] The primary purpose of the counseling is to help the individual determine whether there is an alternative to filing bankruptcy. The agency issues a certificate of credit counseling that the individual must file with the bankruptcy court. The United States Trustee and the Bankruptcy Administrator maintain a public list of approved agencies.[19]

Creditor – A person or entity to whom the debtor owes money or who claims to be owed money by the debtor.[20]

Creditors' Committee – A committee formed by the United States Trustee in chapter 11 cases. The United States Trustee shall appoint a committee of unsecured creditors in a chapter 11 case and may, as is appropriate, appoint additional committees such as an equity security holders committee.[21] A creditors' committee represents the interests of all unsecured creditors and participates in the case on behalf of its constituents.[22]

Creditors' Meeting – See Section 341 Meeting.

Criminal Referral – Notification of a possible bankruptcy related crime, along with supporting documentation. The United States Trustee has a statutory duty to notify the appropriate United States Attorney of matters that relate to the occurrence of any action that may constitute a crime, and upon request, to assist with carrying out prosecutions.[23] A judge or trustee having reasonable grounds for

[14] 11 U.S.C. § 1126 (2012).
[15] 11 U.S.C. § 1325 (2012) (amended 2016).
[16] 11 U.S.C. § 1324 (2012).
[17] FED. R. BANKR. P. 7001.
[18] 11 U.S.C. § 109(h) (2012) (amended 2016).
[19] *Credit Counseling & Debtor Education Information*, UNITED STATES DEPARTMENT OF JUSTICE (last visited Feb. 6, 2018).
[20] 11 U.S.C § 101(10) (2012) (amended 2016).
[21] 11 U.S.C. § 1102(a)(1) (2012).
[22] 11 U.S.C. § 1103 (2012).
[23] 28 U.S.C. § 586(a)(3)(F) (2012).

believing that a violation of the laws of the United States—relating to insolvent debtors, receiverships, or reorganization plans--has been committed also has a statutory duty to refer.[24]

Debtor – A person or entity who has filed a petition for relief under the Bankruptcy Code.[25]

Debtor-in-Possession – Also called the DIP, the debtor in a chapter 11 case, unless a trustee is serving in the case.[26] The debtor-in-possession is charged with nearly the same obligations and duties of a trustee.[27]

Debtor Education – A personal financial management course that an individual debtor must complete after filing bankruptcy in order to receive a discharge. Pursuant to statute, the United States Trustee or the Bankruptcy Administrator approves post-bankruptcy providers of debtor education.[28]

Discharge – A permanent order that releases a debtor from some or all liability—depending on the type of case filed—for certain debts known as dischargeable debts, and prohibits the creditors owed those debts from taking any action against the debtor to collect the debts. The debtor is no longer legally obligated to pay debts that are discharged.[29]

Disclosure Statement – A written document prepared by the chapter 11 debtor or other plan proponent that is designed to provide "adequate information" to creditors to enable them to evaluate the chapter 11 plan of reorganization for purposes of voting for or against it. A disclosure statement typically includes information explaining the history of the debtor, the circumstances that led to the bankruptcy filing, the debtor's performance during the chapter 11 case, the debtor's assets and liabilities, and how claims are to be treated in the plan of reorganization.[30]

Equity – The value of a debtor's interest in property after liens and interests of third parties, such as co-owners, are considered. For example, if a car is valued at $10,000, and a bank has a lien on the car for $7,000, there remains $3,000 in equity.

Executory Contract – See also Assume and Reject. A contract or lease under which both parties to the agreement have duties remaining to be performed. Common examples of executory contracts are rental agreements, unexpired business contracts, and car leases. A debtor may assume or reject an executory contract.

Exempt Asset – Asset owned by an individual debtor that the debtor is permitted to keep from unsecured creditors. There are federal and state exemptions; state law determines which are available to the debtor.[31] The trustee or any party may object to the debtor's exemption claim within the time frame set forth in FED. R. BANKR. P. 4003(b).[32]

Fraudulent Conveyance – The transfer of an asset when the debtor is insolvent and the transfer is for less than satisfactory consideration, or when the transfer was made with the intent to keep the asset from creditors. Federal and state look-back periods may apply, depending on the circumstances. Pursuant to the Bankruptcy Code, the trustee or debtor-in-possession may file a lawsuit to set aside or "avoid" an objectionable transfer.[33] An example of a fraudulent conveyance would be to purchase a car and put the

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[24] 18 U.S.C. § 3057 (2012).
[25] § 101(13); 11 U.S.C § 109 (2012) (amended 2016).
[26] 11 U.S.C § 1107 (2012).
[27] § 1107(a).
[28] *Credit Counseling & Debtor Education Information*, UNITED STATES DEPARTMENT OF JUSTICE (last visited Feb. 6, 2018).
[29] 11 U.S.C. §§ 727, 1141, 1328 (2012).
[30] 11 U.S.C. § 1125 (2012).
[31] 11 U.S.C § 522 (2012) (amended 2016).
[32] FED. R. BANKR. P. 4003(b).
[33] 11 U.S.C. § 548 (2012).

title in the name of a family member without receiving consideration. The trustee may file an adversary complaint to recover a fraudulently transferred asset or the value of that asset. Recovered assets or their proceeds are part of the bankruptcy estate.

Hotline – A means by which the public may report suspected bankruptcy fraud to the United States Trustee Program**.** Information can be sent via email to USTP.Bankruptcy.Fraud@usdoj.gov or via mail to Executive Office for U.S. Trustees, Office of Criminal Enforcement, 441 G Street, NW, Suite 6150, Washington, DC 20530. The public may also refer suspected bankruptcy fraud to the local office of the United States Trustee.

Insider – If the debtor is an individual, insiders include the relatives of the debtor or of a general partner of the debtor; a partnership in which the debtor is a general partner; a general partner of the debtor; a corporation of which the debtor is a director, officer, or person in control; an affiliate of the debtor; and a managing agent of the debtor. If the debtor is a corporation or partnership, insiders include directors, officers, persons in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, and a relative of a general partner. The trustee may avoid a fraudulent or preferential transfer to an insider.[34]

Lien – An encumbrance on a debtor's property taken as security or payment for a debt owed, such as a mortgage on a home or business assets.[35]

Liquidation – The sale of a debtor's nonexempt assets in which the debtor has equity, and the distribution of the proceeds to creditors.

Monthly Operating Report – Also called an MOR. A report of account that debtors-in-possession and chapter 11 trustees are required to submit pursuant to 11 U.S.C. §§ 1107(a), 1106(a)(l), and 704(8).[36] The MOR provides information for the United States Trustee and the parties to monitor the chapter 11 debtor's financial condition and business operations during the case. Just as importantly, the MOR contains information that aids in the detection of fraud or abuse or the deterioration of the debtor's financial condition. The MOR is signed under penalty of perjury and is filed with the court with copies provided to the United States Trustee. The MOR must contain the debtor's basic financial information during the pendency of the chapter 11 case, including cash receipts, disbursements, aging accounts receivable, postpetition liabilities accruing, and a profit and loss statement.

Motion for Relief from the Automatic Stay – Also called a motion to lift the stay. A motion filed with the bankruptcy court by a creditor to allow the creditor to continue a prepetition action such as a lawsuit, foreclosure, collection action, or garnishment that was stopped by the filing of the bankruptcy petition.[37]

No-Asset Case – A chapter 7 case in which there are no non-exempt assets with equity available to repay unsecured creditors' claims. In the vast majority of chapter 7 cases, the clerk of the bankruptcy court notifies creditors that there appear to be no assets available from which to pay creditors. If the chapter 7 trustee identifies assets to be liquidated, the clerk sends creditors a second notice informing them of the change in status and setting a deadline, often called the bar date, for creditors to file their proofs of claim.

Non-Dischargeable Debt – Debt that cannot be eliminated in bankruptcy.[38]

[34] 11 U.S.C. § 101(31) (2012) (amended 2016).
[35] § 101(51).
[36] 11 U.S.C. §§ 1107(a), 1106(a)(l), 704(8) (2012).
[37] 11 U.S.C. § 362(d) (2012).
[38] 11 U.S.C. § 523 (2012) (amended 2016).

Non-Exempt Asset – Asset owned by an individual debtor that is subject to being sold by the trustee to repay creditors.

Objection to Discharge – A complaint filed with the bankruptcy court pursuant to 11 U.S.C. § 727 that initiates an adversary proceeding to deny or revoke a debtor's discharge.[39] The United States Trustee, the trustee, or a creditor has standing to file the complaint no later than sixty days after the first date set for the section 341 meeting of creditors. A motion to extend the time to object to discharge may be filed before the time for objection has expired and before the discharge is granted. A discharge may be denied for any of the reasons set forth in 11 U.S.C. § 727(a), including transfer or concealment of property with intent to hinder, delay, or defraud creditors; failure to account for the loss of assets; destruction or concealment of books and records; perjury; violation of a court order, and other fraudulent acts.[40] A discharge may also be revoked under certain circumstances if the discharge was obtained fraudulently. The United States Trustee, the trustee, or a creditor may request revocation of a discharge within one year after the discharge was entered.

Order for Relief – An order issued by the clerk of the bankruptcy court upon the filing of a voluntary bankruptcy petition, to provide notice to creditors that a case has been filed.[41]

PACER – An acronym for Public Access to Court Electronic Records. PACER is an electronic public access service of United States federal court documents. It allows users to obtain case and docket information, for a fee, from the United States courts of appeals, district courts, and bankruptcy courts.

Pay Advices – Pay stubs. Unless the court orders otherwise, within a period set by the Bankruptcy Code, individual debtors must submit documentation of all income received from an employer in the six months before filing bankruptcy. In addition, pursuant to 11 U.S.C. § 521(e)(2)(A), a debtor must provide the trustee with a copy of the debtor's most recent filed tax return.[42]

Petition – Official Form 101 filed by an individual, or Official Form 201 filed by a non-individual, which opens the bankruptcy case, creates a bankruptcy estate and automatically stays collection activity, foreclosures, lawsuits, and garnishments against the debtor.[43] On the petition, the filer provides identifying information and indicates the bankruptcy chapter under which the case is filed. The petition contains questions, including whether the debtor has filed bankruptcy previously, and requests information about businesses, an estimate of the number of creditors owed, and an estimate of the debtor's assets and liabilities. The petition is signed under penalty of perjury.

Petition Preparer – Also called a bankruptcy petition preparer or BPP. A business or individual not authorized to practice law that prepares bankruptcy petitions for a fee.[44] The Bankruptcy Code requires bankruptcy petition preparers to sign a declaration under penalty of perjury that they prepared the documents, to disclose their full Social Security number, and to provide written notice to prospective debtors that the bankruptcy petition preparer is not an attorney. The Bankruptcy Code also prohibits them from practicing law or giving legal advice. The type of conduct prohibited by a petition preparer includes advising a debtor on whether to file a petition for relief; whether chapter 7, 11, 12 or 13 is appropriate; what assets may be retained; tax consequences of filing; whether to reaffirm debts; how to characterize the debtor's interest in property or debts; and bankruptcy procedures and rights. Violating these prohibitions may result in fines, sanctions, and an injunction to prevent the business or individual from acting as a petition preparer.

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[39] 11 U.S.C. § 727 (2012).
[40] § 727(a).
[41] 11 U.S.C. § 342 (2012).
[42] 11 U.S.C. § 521(e)(2)(A) (2012) (amended 2014).
[43] 11 U.S.C. § 101(42) (2012) (amended 2016).
[44] 11 U.S.C. § 110 (2012).

Plan – A debtor's detailed description of how the debtor proposes to pay some or all of what is owed to creditors over a fixed period of time. Plans are not filed in chapter 7, the liquidation chapter of the Bankruptcy Code, but are filed in other chapters. In chapter 13 an individual with a regular source of income may propose a plan, sometimes called a wage earner's plan, to make installment payments to creditors over three to five years.[45] In chapter 11 the debtor, often with participation from creditors, proposes a plan of reorganization to either remain in operation or conduct an orderly litigation and to repay part or all of its debts over a period set forth in the plan.[46] A confirmed plan alters unsecured creditors' prepetition rights, and the amount repaid to those creditors may be less than the full amount of their claims.[47]

Police Power – An exception to the automatic stay that allows a governmental unit to enforce its organization's police or regulatory power. This exception applies to a governmental unit's enforcement of laws affecting health, welfare, morals, and safety, but not to regulatory laws that directly conflict with the control of property by the bankruptcy court.

Postpetition Transfer – A transfer of the debtor's property made after the commencement of the bankruptcy case. An unauthorized postpetition transfer can be recovered by a trustee.[48]

Prepetition – Before a bankruptcy case is filed.

Preferential Transfer – A payment that is made to a non-insider creditor within ninety days or to an insider creditor within a year before a debtor files bankruptcy, and that gives the creditor more than it would receive in a chapter 7 case.[49] The trustee has the power to recover a payment that preferred one creditor over another and to distribute the recovered funds among all creditors. An example is if a debtor were to repay a relative on an unsecured loan shortly before filing bankruptcy.

Priority – The Bankruptcy Code's statutory ranking of claims that determines the order in which claims are paid.[50] The costs of administering the bankruptcy case, child support obligations, and governmental taxes are examples of priority claims. Funds are first paid to priority unsecured creditors. If money remains, the trustee pays general unsecured creditor claims, with equity holders of an entity being the last class to receive payment. After all creditor classes are paid in full, remaining funds are returned to the debtor.

Proof of Claim – See Claim.

Property of the Estate – See Bankruptcy Estate.

Reject – To decline to continue performing duties under an unexpired lease or contract. If a debtor has an unexpired lease or contract at the time of the bankruptcy filing, the trustee or debtor-in-possession can reject it, relieving the debtor or debtor-in-possession from further performance. Common examples of unexpired leases and contracts are rental agreements, ongoing business contracts, and car leases. Damages arising from rejection are typically treated as unsecured debt.[51]

Rule 2004 Examination – A pre-discovery investigative tool available under FED. R. BANKR. P. 2004 to be used before the commencement of an adversary proceeding or contested matter.[52] A Rule 2004 examination is broader than discovery under the Federal Rules of Civil Procedure and is sometimes referred to as a fishing expedition. Any party, including the United States Trustee and the trustee, who

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45 11 U.S.C. §§ 1321 (2012), 1322 (2012) (amended 2016).
46 11 U.S.C. §§ 1121, 1122, 1123 (2012).
47 11 U.S.C. §§ 1129 (2012), 1325 (2012) (amended 2016).
48 11 U.S.C. § 549 (2012).
49 11 U.S.C § 547 (2012) (amended 2016).
50 11 U.S.C § 507 (2012) (amended 2016).
51 11 U.S.C. §§ 365 (2012), 1123(b)(2).
52 FED. R. BANKR. P. 2004.

seeks to issue a Rule 2004 discovery request must first obtain court approval. Documents and testimony may be sought from the debtor or a third party who has knowledge or information relevant to issues in the bankruptcy case, including the debtor's conduct, property, liabilities, financial condition, and right to a discharge. A Rule 2004 examination provides an opportunity to investigate a bankruptcy filing in more detail than the section 341 meeting of creditors provides. Once an adversary proceeding is commenced, the Federal Rules of Civil Procedure apply, and a Rule 2004 examination is generally not allowed.

Schedules – Documents filed by the debtor that disclose the debtor's assets, liabilities, and other financial information. There are separate forms for the schedules filed by individual debtors (Official Form 106) and by non-individual debtors (Official Form 206).

Section 341 Meeting – Also called the section 341 meeting of creditors, first meeting of creditors, or 341 meeting. The meeting of creditors required by 11 U.S.C. § 341 at which the debtor is questioned under oath by the United States Trustee, a bankruptcy trustee, and/or creditors about the debtor's financial affairs.[53] The oral examination of the debtor is conducted by the panel trustee in a chapter 7 case, by the standing trustee in a chapter 13 case, and by the United States Trustee's representative in a chapter 11 case. Questions are designed to elicit verification of the information disclosed in the bankruptcy documents and to obtain additional information about the debtor's assets, income, expenses and financial affairs. The section 341 meeting is digitally recorded; the official recording may be obtained from the United States Trustee. Most section 341 meetings in cases under chapters 7 and 13 are short because a number of meetings are scheduled for the same day and time period. If more time is needed to complete the examination, or additional documents from the debtor are required, the trustee will adjourn the meeting to a later date.

Secured Creditor – A creditor holding an interest in an asset of the debtor that secures payment of its debt and gives the creditor the right to liquidate that asset to pay its claim. An example of a secured creditor is a mortgage lender whose loan is secured either by a first or second lien on a property. The automatic stay bars a secured creditor from liquidating an asset to satisfy its lien without an order from the bankruptcy court allowing it to do so.

Skeletal Filing – Also called a bare-bones filing. A bankruptcy case that has been filed without all of the required forms. In a skeletal filing the debtor submits the minimal documentation necessary to initiate a bankruptcy case, typically only the petition and list of creditors. All other required forms must be filed within fourteen days after the date the case is commenced. A skeletal filing may be an indicator of fraud or abuse in an attempt to take advantage of the automatic stay without intending to pursue the bankruptcy case further.

SOFA – See Statement of Financial Affairs.

Statement of Financial Affairs – Also called the SOFA. An official form with a series of questions a debtor must answer in writing, under penalty of perjury, concerning sources of income, transfers of property, gifts, lawsuits by creditors, closed financial accounts, businesses, losses, and other information about the debtor's financial transactions in the years prior to filing for bankruptcy relief. There are two official SOFA forms—Official Form 107 for individuals and Official Form 207 for non-individuals. Some questions are the same on both forms; other questions are tailored to collect information specific to individuals or entities.

Sworn Testimony – In bankruptcy matters, sworn testimony may be provided in a number of circumstances, including at the section 341 meeting of creditors, at Rule 2004 examinations, in civil depositions, in affidavits, and in bankruptcy court.

Transfer – Any method by which a debtor disposes of estate property.

[53] 11 U.S.C. § 341 (2012).

Trustee – See also chapter 7, chapter 12, chapter 13, and chapter 11. The representative of the bankruptcy estate who serves as a fiduciary and exercises statutory powers under the supervision of the United States Trustee or Bankruptcy Administrator.[54] The trustee is not a government employee. Rather, the trustee is a private individual appointed by the United States Trustee in all chapter 7, chapter 12, and chapter 13 cases and some chapter 11 cases. The trustee's responsibilities include reviewing the debtor's petition and schedules and bringing actions against creditors or the debtor to recover property of the bankruptcy estate. In chapter 7, the trustee liquidates property of the estate and makes distributions to creditors.[55] In chapters 11, 12 and 13, the trustee has duties similar to those of a chapter 7 trustee and the additional responsibilities of overseeing the debtor's plan, receiving payments from debtors, and disbursing plan payments to creditors.[56] Pursuant to 18 U.S.C § 3057, trustees have a duty to refer to the United States Attorney matters in which they suspect criminal conduct.[57] Under United States Trustee Program policy, trustees also refer such matters to the United States Trustee.

United States Trustee – A regional official of the United States Trustee Program appointed by the Attorney General. Nationwide, the United States Trustee Program has twenty-one regions and ninety-two office locations. The United States Trustee's duties are set forth at 28 U.S.C. § 586.[58] Pursuant to 11 U.S.C. § 307, the United States Trustee may raise and may appear and be heard on any issue in any case or proceeding under the Bankruptcy Code.[59]

United States Trustee Program – Also called the USTP or the Program. The litigating component of the United States Department of Justice that is responsible for overseeing the administration of bankruptcy cases and private trustees under 28 U.S.C. § 586 and 11 U.S.C. § 101, et seq. To further the public interest in the just, speedy, and economical resolution of cases filed under the Bankruptcy Code, the United States Trustee Program monitors the conduct of bankruptcy parties and private trustees, oversees related administrative functions, and acts to ensure compliance with applicable laws and procedures. It also identifies and helps investigate bankruptcy fraud and abuse in coordination with United States Attorneys, the Federal Bureau of Investigation, and other law enforcement agencies. The mission of the United States Trustee Program is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public.

Unscheduled Debt – A debt that the debtor should, but does not, disclose in the schedules filed with the court. A debtor must disclose all debt owed, the names of and contact information for all creditors, the amount owed to each creditor, and the nature of the debt.

Unsecured Creditor – A creditor that does not hold collateral to ensure payment of its claim or debt. Examples of unsecured creditors are those with claims to repayment of credit card debt and medical debt.

Unsecured Priority Creditor – See also Priority. A claim that is not secured by the debtor's property but is nonetheless entitled to payment ahead of general unsecured claims based on the Bankruptcy Code's statutory ranking of claims. Examples of unsecured priority claims include child

[54] 11 U.S.C. §§ 701, 1104, 1202, 1302 (2012).
[55] 11 U.S.C § 704 (2012).
[56] 11 U.S.C. §§ 1106(a) (2012), 1202(b),(c), 1302(b),(c).
[57] 18 U.S.C § 3057 (2012).
[58] 28 U.S.C. § 586 (2012).
[59] 11 U.S.C. § 307 (2012).

support owed to a spouse, and wages, salaries, or commissions owed to employees that were earned within 180 days of the bankruptcy filing.

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Bankruptcy Statistics Offer View of Filings, Enforcement, Distributions

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I. Introduction

Sometimes a picture really is worth a thousand words. The charts and tables in this article provide a numerical overview of the bankruptcy system and bankruptcy enforcement for those who are not bankruptcy specialists. They display statistics and statistical trends relating to bankruptcy filing numbers, the variety and impact of the U.S. Trustee Program's (USTP) criminal enforcement and civil enforcement activities, and the amount of funds distributed by bankruptcy trustees.

II. Bankruptcy Filings

Over the past decade, annual bankruptcy filings nationwide have ranged from a high of approximately 1.6 million to a low of around 800,000. During FY 2017, bankruptcy filings were in the midst of a seven-year decline reaching fifty percent, after having doubled in the previous three years. In FY 2017, 790,830 bankruptcy cases were filed nationwide.[1]

[1] By statute, the U.S. Trustee Program does not operate in the judicial districts in Alabama and North Carolina, but the data provided here include those jurisdictions.

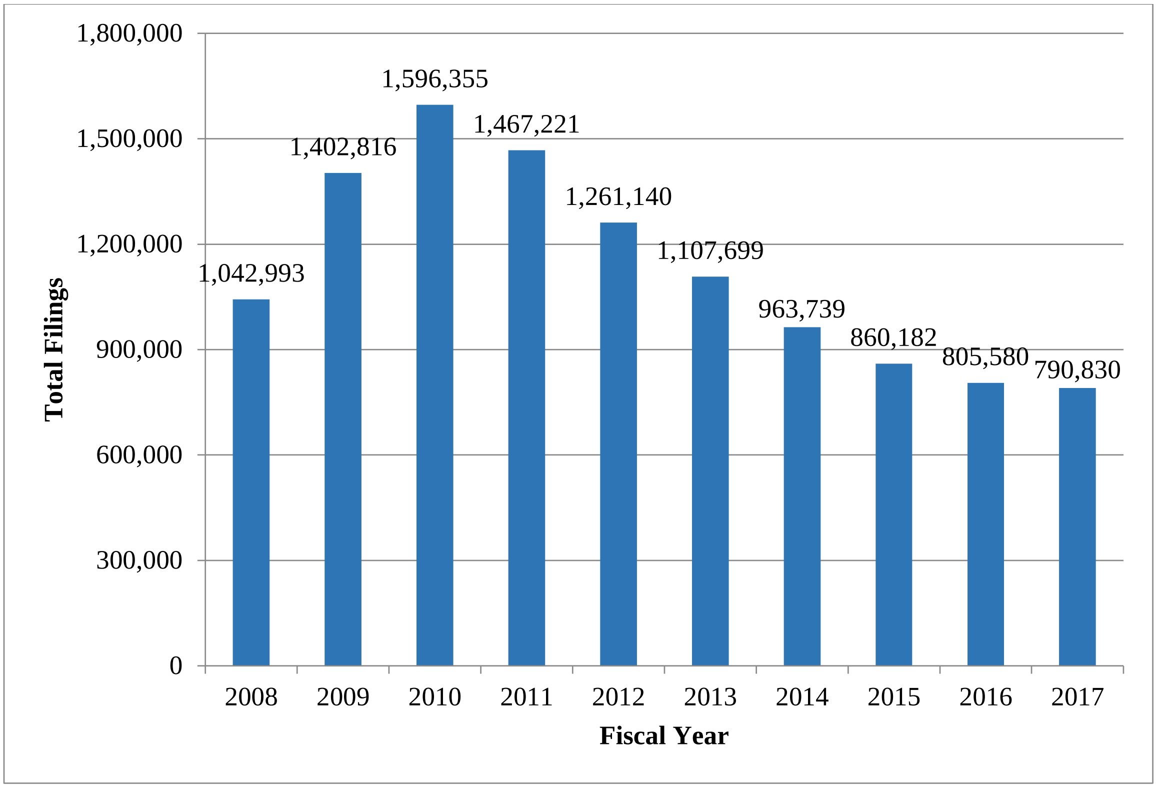

Figure 1. Total Bankruptcy Filings, FY 2008-2017

A bankruptcy case is a proceeding under federal law to discharge or reorganize the financial obligations of an individual or entity. The chapters under which bankruptcy cases may be filed correspond to chapters in the Bankruptcy Code (Title 11 of the U.S. Code).

Briefly, chapter 7 bankruptcy is a liquidation proceeding available to individual consumers and businesses, chapter 11 allows individuals and businesses to reorganize debts while continuing to operate, and chapter 13 allows individuals to reorganize their financial affairs under a three- to five-year repayment plan. Other bankruptcy proceedings that are much less common are those under chapter 9 (municipalities), chapter 12 (family farmers), and chapter 15 (cross-border insolvencies).

Over the past ten years, approximately two-thirds of all bankruptcy cases were filed under chapter 7, nearly one-third were filed under chapter 13, and a little under one percent were filed under chapter 11, with the remaining fraction of one percent filed under chapters 9, 12, and 15.

III. U.S. Trustee Civil Enforcement

One of the USTP's core functions is to combat bankruptcy fraud and abuse through civil enforcement, typically resulting in around $1 billion per year in debts not discharged, fines, and other remedies. The Program combats fraud and abuse committed by debtors by seeking denial of discharge, by moving for case conversion or dismissal, and by taking other civil enforcement actions. The Program also pursues a variety of actions involving consumer protection. For example, the Program seeks remedies—including fee disgorgement, fines, injunctive relief, consumer remediation, and referrals to attorney disciplinary authorities—to address fraud and abuse committed against consumer debtors by attorneys, non-attorney bankruptcy petition preparers, creditors, and others.

The Program also carries out significant civil enforcement responsibilities in chapter 11 reorganization cases. For example, the Program oversees business reorganization cases by, among other things, moving to dismiss or convert cases not progressing towards financial rehabilitation, appointing trustees and examiners when warranted, objecting to excessive fees, enforcing statutory limits on insider and executive compensation, and taking other enforcement actions.

Total Financial Impact	$884,128,119
Total Actions	9,835
Fraud/Abuse by Debtors	2,420
Consumer Protection	1,179
Chapter 11 Case Administration and Oversight	3,728
Other Civil Enforcement	2,508

Figure 2. USTP Formal Civil Enforcement Actions, FY 2017

A. Actions Against Debtors: Discharge Denial, Case Dismissal

The USTP's primary enforcement tools against debtor fraud and abuse are objections to discharge under 11 U.S.C. § 727,[2] and motions for case dismissal under 11 U.S.C. § 707(b).[3] Over the past ten years, the USTP has filed more than 40,000 complaints and motions under those statutory sections.

The U.S. Trustee may file a complaint to deny or revoke a bankruptcy discharge under § 727 if the debtor engaged in improper conduct such as transferring, concealing, or destroying property to hinder or defraud a creditor or the trustee; knowingly and fraudulently making a false oath; refusing to obey a court order; or failing to keep or preserve financial records. The debtor may voluntarily waive discharge under the same statutory section.[4]

The U.S. Trustee may file a motion to dismiss under § 707(b) if, among other things, the debtor's chapter 7 filing is presumed abusive under a statutorily defined means test that measures the debtor's ability to make payments to creditors and the debtor fails to demonstrate special circumstances to rebut the presumption.[5]

B. Consumer Protection Actions

1. Actions Against Underperforming Consumer Debtors' Attorneys

The Program has a long history of utilizing statutory tools to sanction consumer debtors' attorneys who fail to fulfill their basic obligations to their client by, for example, failing to meet with their client, causing costly delays by not appearing at court or creditors' meetings required to be held under the Bankruptcy Code, and engaging in a range of other unprofessional behavior. The victims of such professional misconduct are not only the debtor client, but also creditors and the court. Under the

[2] 11 U.S.C. § 727 (2012).
[3] 11 U.S.C. § 707(b) (2012) (amended 2016).
[4] § 727.
[5] § 707(b).

Bankruptcy Code, this conduct may be sanctionable and debtors may receive refunds of the attorneys' fees already paid.

Among the more noteworthy allegations the Program investigates are instances of lawyers not merely failing to perform, but misusing the client relationship to sell services that are of little or no value to the debtor. Some of these schemes may be abusive and others may be fraudulent.

2. Actions Against Non-Attorney Bankruptcy Petition Preparers

U.S. Trustees file actions against bankruptcy petition preparers who violate the consumer protection provisions of 11 U.S.C. § 110,[6] with nearly 4,000 actions initiated over the past decade.

A bankruptcy petition preparer is a non-attorney who prepares debtors' bankruptcy documents for a fee. Section 110 requires bankruptcy petition preparers to disclose in court filings their identities and the fees they receive, and bars them from activities such as offering legal advice, using the word "legal" or similar terms in advertisements, charging excessive fees, collecting clients' court filing fees, or engaging in unfair, deceptive, or fraudulent conduct.[7]

Nonetheless, some petition preparers charge excessive fees, fail to make required disclosures, and engage in other prohibited conduct. Most notably, some petition preparers operate "rescue" schemes to defraud consumers who seek home loan modification or face foreclosure or eviction. For example, scheme operators may contact homeowners whose names are found in foreclosure listings and promise, for a fee, to help them avoid foreclosure. Instead of negotiating with the lender, however, the petition preparer places the homeowner in bankruptcy to delay foreclosure temporarily. There are many variations of this scheme, including those targeting religious or ethnic affinity groups.

3. Actions Against Creditors

The USTP has played an active part in the Department of Justice efforts to protect consumers from financial fraud and abuse. In FY 2015 and 2016, the Program's actions resulted in more than $130 million in relief to homeowners through settlements with major national creditors JPMorgan Chase Bank N.A. and Wells Fargo Bank N.A.

These settlements resulted from the Program's focus on enforcing the Bankruptcy Code and Rules against mortgage servicers that inflate their claims or otherwise fail to comply with bankruptcy requirements of accuracy, disclosure, and notice to their customers in bankruptcy. This multi-year effort has led to improvements in industry compliance and self-reporting. The USTP also polices the conduct of unsecured creditors to ensure against improper disclosure of consumers' personal information, unlawful attempts to collect on debt discharged in a prior bankruptcy, the robo-signing of court documents, and other activities prohibited by the Bankruptcy Code and Rules.

C. Actions in Chapter 11 Cases

The Program carries out significant responsibilities in chapter 11 reorganization cases. For example, the Program moves to dismiss or convert about one-third of chapter 11 cases each year because they are not progressing towards financial rehabilitation. The Program also objects when appropriate to the retention and compensation of professionals such as attorneys and financial advisers, reviews and objects to disclosure statements to ensure adequate information is provided to stakeholders, and enforces the statutory limitations on insider and executive compensation. When fraud or gross mismanagement is suspected, the Program's civil enforcement responsibilities include filing a motion to replace management

[6] 11 U.S.C. § 110 (2012).
[7] § 110.

in favor of an independent chapter 11 trustee to run the business, or to appoint an examiner to conduct an independent investigation, as provided under 11 U.S.C. § 1104.[8] Over the past ten years, the USTP has filed over 1,000 motions requesting appointment of a trustee or examiner.

In most chapter 11 cases, the debtor's management remains in control of the entity, but a chapter 11 trustee may be appointed when there are grounds to suspect that current management participated in gross mismanagement, fraud, dishonesty, or other improper activity. The trustee runs the debtor's operations and participates in the development of the debtor's plan of reorganization or liquidation. For example, in the District of Massachusetts, the U.S. Trustee obtained the appointment of a trustee in the chapter 11 case of a company that purported to provide inexpensive Internet phone service worldwide. In reality, it operated a massive international pyramid scheme in which, according to federal prosecutors, more than 965,000 victims lost approximately $1.76 billion. The trustee's tasks include reconstructing the debtors' books and records, many of which are computer records in foreign languages; identifying assets and liabilities, and developing an electronic process for the submission and allowance of creditors' claims. The debtor's two principals in the United States were charged with criminal fraud; one pleaded guilty in October 2016 and the other fled the country. In January 2017, another defendant was charged with conspiring to commit money laundering after investigators found $20 million hidden under his mattress.

Alternatively, the U.S. Trustee or another party may seek the appointment of an examiner when an independent investigation is appropriate in a chapter 11 case. The examiner may, for example, investigate allegations of fraud, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor's affairs. In response to two competing motions for the appointment of an examiner, filed by the debtor and by an official noteholders' committee in the bankruptcy case of Caesars' Entertainment Operating Company, Inc., the U.S. Trustee in the Northern District of Illinois supported the appointment of an examiner empowered to conduct a full investigation of all potential causes of actions the estate might have against insiders. The debtor had requested an examiner who could investigate only certain transactions. The bankruptcy court agreed with the U.S. Trustee, who then selected and appointed the examiner. Ultimately, the examiner's report issued in March 2016 provided a roadmap for a more efficient resolution of the case, including the potential recovery of more than $5 billion for the bankruptcy estate.

IV. Criminal Enforcement

Criminal enforcement is an essential component of the USTP's efforts to uphold the integrity of the bankruptcy system. The Program has a statutory duty to refer matters to the U.S. Attorneys' offices for investigation and prosecution that relate to "the occurrence of any action which may constitute a crime."[9] The statute also requires each U.S. Trustee to assist the U.S. Attorney in carrying out prosecutions. Assistance may include providing technical bankruptcy-related information during the investigation, providing expert or fact testimony at criminal trials, or serving as a Special Assistant U.S. Attorney to prosecute the case.

Bankruptcy crimes are committed not only by debtors but also by other wrongdoers, including professionals such as attorneys, real estate brokers, and financial advisers; creditors; and non-attorney bankruptcy petition preparers who operate "foreclosure rescue" schemes and similar unlawful activities that defraud consumers in financial distress.

The Program has experienced nearly continuous growth in the number of bankruptcy and bankruptcy-related criminal referrals over the past ten years, making 2,171 referrals in FY 2017. Referrals

[8] 11 U.S.C. § 1104 (2012).
[9] 28 U.S.C. § 586 (2012).

cover a broad range of crimes, with the FY 2016 report on Criminal Referrals by the United States Trustee Program showing forty-seven types of violations.[10] The five most common allegations contained in the USTP's criminal referrals involve tax fraud, false oath or statement, concealment of assets, bankruptcy fraud scheme, and identity theft or use of false/multiple Social Security numbers.

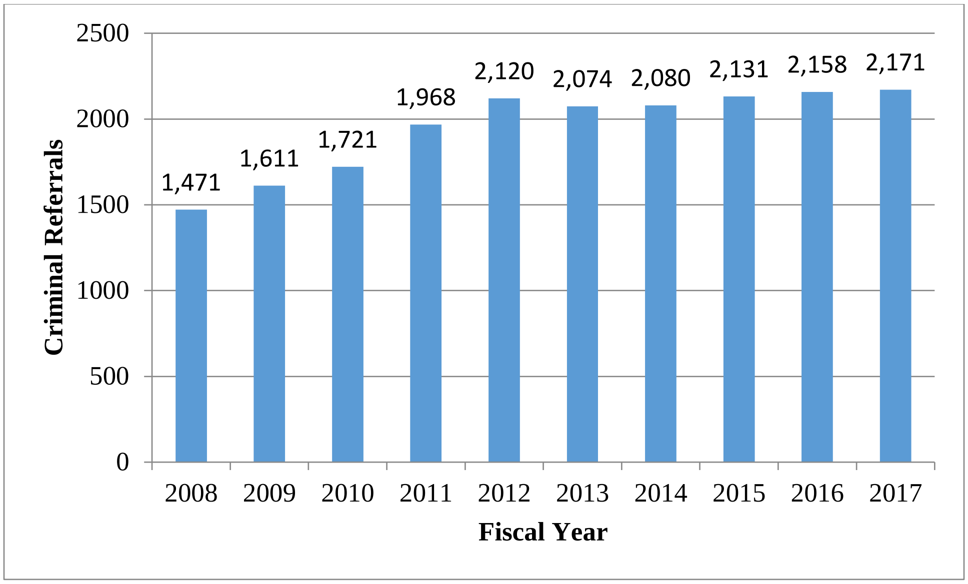

Figure 3. USTP Criminal Referrals, FY 2008-2017

V. Distributions by Bankruptcy Trustees

The USTP appoints and supervises private trustees, who are not government employees, to administer bankruptcy estates and distribute payments to creditors in cases filed under chapters 7, 12, and 13.

Chapter 7 trustees collect a debtor's assets that are not exempt from payment to creditors, liquidate the assets, and distribute the proceeds to creditors. Chapter 12 and chapter 13 trustees evaluate the financial affairs of a debtor, make recommendations to the court regarding confirmation of a debtor's repayment plan, and administer the court-approved plan by collecting payments from the debtor and disbursing the funds to creditors.

In FY 2016, U.S. Trustees oversaw the activities of approximately 1,400 private trustees appointed by them to handle the day-to-day activities of around 1.7 million ongoing cases.[11]

On average over the past ten fiscal years, cases under chapters 7, 12, and 13 have generated between $9 billion and $10 billion in total distributions to creditors and other recipients, with chapter 7 asset cases accounting for approximately $3 billion of that amount and cases in chapters 12 and 13 generating an average of $6.2 billion.

[10] *Criminal Referrals by the United States Trustee Program Fiscal Year 2016*, UNITED STATES DEPARTMENT OF JUSTICE EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES (2017).
[11] *United States Trustee Program Annual Report of Significant Accomplishments Fiscal Year 2016*, UNITED STATES DEPARTMENT OF JUSTICE EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES.

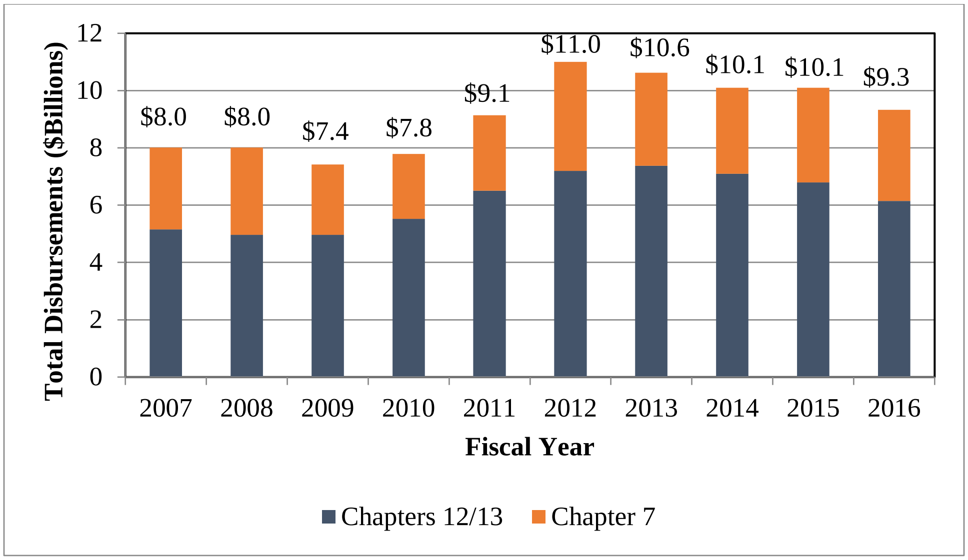

Figure 4. Total Disbursements in Cases under Chapters 7, 12, and 13, FY 2007-2016

VI. Conclusion

With hundreds of thousands of cases filed annually, around $1 billion in financial impact resulting from USTP civil enforcement actions per year, and around $10 billion in annual distributions by private trustees, the bankruptcy system is a dynamic and far-reaching part of our nation's legal and economic system. It is interconnected with dozens of other areas of law, ranging from the most complex corporate matters to the most personal consumer matters. An understanding of bankruptcy's impact on individuals, entities, and the national economy is useful to prosecutors, analysts, and other law enforcement personnel, regardless of their own areas of expertise.

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Interplay Between Forfeiture and Bankruptcy

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I. Introduction

In recent years, the Department of Justice ("Department") has prosecuted a number of complex fraud schemes involving billions of dollars in victim losses, most notably the cases of Bernard Madoff (Southern District of New York) and Thomas Petters (District of Minnesota). These schemes spawned significant criminal, civil, and bankruptcy litigation which ultimately generated huge recoveries for victims—more than $16 billion in the Madoff case alone. In such larger fraud cases, it is not uncommon for the perpetrator or his creditors to initiate bankruptcy proceedings. This article will examine the ways that bankruptcy and forfeiture intersect, including their respective benefits and limitations.

Bankruptcy law has two key goals: to provide honest but unfortunate debtors with a fresh start, and to facilitate orderly payment of debts to creditors. Bankruptcies may take the form of either a liquidation where the debtor's assets are sold and distributed (Chapter 7), or a reorganization where the debtor retains its assets and pays its creditors over time with future income and assets (Chapter 11). The bankruptcy trustee has statutory duties and powers to maximize recovery for the creditors, including the power to undo certain transfers and to quickly sell assets. "The purpose of a bankruptcy action is to help those in bad financial positions move forward, [and] not, as with a criminal prosecution, to resolve harms against society deserving of punishment."[1]

In general, the government pursues forfeiture cases to deprive criminals of the proceeds of crime and to compensate victims. A key difference between bankruptcy and forfeiture is that forfeiture provides recovery for victims who may not qualify as creditors in a bankruptcy setting. Forfeiture of the proceeds of a fraud is not discretionary; rather, it is a statutory mandate.[2] While the remission of forfeited proceeds of crime to victims is a discretionary "act of grace," the Department policy is that victims have priority to forfeited funds after the resolution of any claims of innocent owners, lienholders, and the payment of eligible government expenses.[3]

In prosecuting civil or criminal cases involving bankruptcy, government attorneys should be aware of the differences between the two regimes in order to leverage both for maximum recovery for victims. When the government and the trustee work together to define each other's roles and responsibilities, all parties win.

[1] United States v. Wanland, 830 F.3d 947, 956-57 (9th Cir. 2016), *cert. denied*, No. 16-7565 (Mar. 6, 2017).
[2] *See* 18 U.S.C. § 3663A(a)(1) (2012); 18 U.S.C. § 982(a)(1) (2012); 28 U.S.C. § 2461(c) (2012).
[3] *See* Asset Forfeiture Policy Manual (2016), Chap. 12, Sec. A.3 ("Priority in the distribution of forfeited assets is given to valid owners, lienholders, federal financial regulatory agencies, and victims (in that order), who in turn have priority over official use requests and equitable sharing requests.").

II. Benefits of Forfeiture and Bankruptcy

Crime victims' interests are typically better protected if a defendant's assets are forfeited rather than administered through the bankruptcy estate. In criminal cases, Congress provided that defendants must compensate their victims for the full amount of the loss caused by the criminal conduct, without regard to the defendant's economic circumstances.[4] When assets are forfeited in a criminal case that has identifiable victims, the Attorney General may either apply the assets toward the defendant's restitution obligation or return the funds directly to victims through remission.[5] Because criminal forfeiture does not provide a recovery for a defendant's unsecured creditors unless they are also victims of the crime, victims stand to recover a larger share of their losses through forfeiture than in bankruptcy.

In addition, the forfeiture process is generally more cost efficient than bankruptcy. In forfeiture, the only expenses that are taken from assets forfeited in a particular case are actual out-of-pocket costs associated with the storage and liquidation of the assets, and in some cases, the costs of evaluating petitions for remission and the distribution of funds to victims. The remaining costs are paid from agency accounts.[6] In larger victim cases, the Money Laundering and Asset Recovery Section (MLARS) may authorize the appointment of a special master or claims administrator to manage the victim remission process.[7] Because of internal efficiencies, the direct costs associated with the remission process are typically a small fraction of the forfeiture recoveries.

By contrast, creditors in a bankruptcy case are compensated pursuant to a statutory priority scheme, under which all of the debtor's secured and unsecured creditors, lenders, suppliers, employees, as well as administrative expenses and attorney fees, are paid from recovered assets ahead of crime victims.[8] Because most bankruptcies recover substantially less than the amount lost by secured and unsecured creditors, victims may be left with little or no recovery. Indeed, in some bankruptcy cases the administrative expenses alone can render an estate "administratively insolvent," meaning that only the professional fees and other costs of administration are paid.

In cases involving foreign assets, governments and international law enforcement agencies are generally more receptive to assisting with a forfeiture action than with a purely civil process like bankruptcy. With defendants increasingly transferring criminal proceeds into and out of foreign jurisdictions, a United States court order can be highly persuasive in convincing a foreign court or government to assist in recovering assets. Moreover, forfeiture empowers the government to recover certain assets that may not be reachable by the bankruptcy estate. For example, the "relation-back doctrine" vests title to property in the United States retroactive to the time of the offense underlying the forfeiture, which is not available in bankruptcy law.[9]

Likewise, a bankruptcy trustee has some powers not available to the government in a forfeiture action. For example, the trustee may investigate and recover a variety of claims against third parties, including preference claims under 11 U.S.C. § 547(b) and actions to avoid certain transfers, such as payments the debtor made to third parties shortly before seeking bankruptcy protection.[10] A trustee can also engage in broad examinations of the "acts, conduct, or property or to the liabilities and financial condition" of the debtor.[11] In addition, bankruptcy can be more effective in dealing with particular types

[4] 18 U.S.C. § 3664(f)(1)(A) (2012).
[5] *See* 28 C.F.R. § 9.8 (2018).
[6] *See* 28 U.S.C. § 524(c)(1)(E) (2012) (amended 2015); 31 U.S.C. § 9705(a)(1)(E) (2012) (amended 2015).
[7] 28 C.F.R. § 9.9(c) (2018).
[8] 11 U.S.C. § 507 (2012) (amended 2016).
[9] 21 U.S.C. § 853(c) (2012).
[10] 11 U.S.C. § 547 (2012) (amended 2016).
[11] FED. R. BANKR. P. 2004(b).

of assets, such as complicated business assets. The Bankruptcy Code provides a process to collect accounts receivables, to handle payroll and employee benefits, to sell office equipment, to transfer intellectual property, and to reject leases. The Bankruptcy Code also facilitates the sale of assets free and clear of any liens or interests.[12]

III. Intersection of Forfeiture Law and Bankruptcy Law

In order to understand the intersection of asset forfeiture and bankruptcy law, it is important to review how bankruptcy law and forfeiture law interact at the start of a bankruptcy proceeding, the relation-back doctrine, and how an innocent third party may assert an interest in property in a forfeiture case. In short, bankruptcy proceedings do not stay forfeiture actions, but trustees and certain creditors may participate in the forfeiture proceedings.

A. Forfeiture Proceedings are Not Subject to the Automatic Stay

When a debtor files a bankruptcy petition, the Bankruptcy Code provides an "automatic stay," which enjoins the commencement or continuation of actions against the debtor personally as well as any act to obtain possession of property of the bankruptcy estate.[13] Two exceptions to the automatic stay allow the forfeiture process to continue unabated. First, the automatic stay does not affect "the commencement or continuation of a criminal action or proceeding against the debtor."[14] Second, the stay does not affect "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's . . . police and regulatory power" against the debtor or property of the estate.[15] Courts have generally held that federal forfeitures fall within the government's police powers and thus are an exception to the automatic stay.[16]

B. The Relation-Back Doctrine and its Interaction With Bankruptcy

The relation-back doctrine is a well-established principle of forfeiture law. Under the doctrine, the government's interest in forfeitable property vests at the time of the offense giving rise to forfeiture.[17] For purposes of bankruptcy law, this doctrine means that the debtor's forfeitable property may not become property of the bankruptcy estate.

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[12] 11 U.S.C. § 363(f) (2012).
[13] 11 U.S.C. § 362(a)(1), (3) (2012).
[14] § 362(b)(1); *see* United States v. Colasuonno, 697 F.3d 164, 172 (2d Cir. 2012).
[15] § 362(b)(4).
[16] *See, e.g.*, *In re* James, 940 F.2d 46, 51 (3d Cir. 1991) ("[W]e conclude that the district court here was correct in holding that a civil forfeiture action proceeding is an exception to the automatic stay under the 'police power' exception of section 362(b)(4)."); United States v. Erpenbeck, 682 F.3d 472, 480-81 (6th Cir. 2012) (the automatic stay does not apply to criminal forfeitures, so the district court properly entered a preliminary order); *In re* Robinson, 764 F.3d 554, 559-63 (6th Cir. 2014) (the automatic stay does not enjoin criminal restitution judgments). *But cf*. *In re* Finley, 237 B.R. 890, 895 (Bankr. N.D. Miss. 1999) (automatic stay provision applies to state-law civil forfeitures).
[17] *See* 21 U.S.C. § 853(c) (2012) ("All right, title, and interest in [forfeitable] property . . . vests in the United States upon the commission of the act giving rise to forfeiture under this section"); 18 U.S.C. § 981(f) (2012) (amended 2016) (same). United States v. U.S. Currency in the Amount of $228,536.00, 895 F.2d 908, 916 (2d Cir. 1990) (because "the forfeiture occurs when the crime is committed," a defendant has no interest in the forfeited property "as of that moment").

Determining what constitutes property of the bankruptcy estate is a matter of both state and federal non-bankruptcy law.[18] Under forfeiture law, the title to the tainted property is transferred to the government retroactively to the date that the offense was committed, even though the government's title does not perfect until the forfeiture is completed.[19] Secured creditors that foreclose upon and sell property do not have a similar retroactive right to the property. Property subject to forfeiture because it is tainted generally should not be treated as property of the bankruptcy estate. Depending on the facts of the case, a bankruptcy trustee may have authority to assert a claim in the forfeiture proceeding. Property that the government may seek to forfeit as substitute assets may also qualify as property of the bankruptcy estate.

C. Forfeiture's Protection for Third Parties

Criminal defendants can only be made to forfeit their own interest in property.[20] Thus, forfeiture law provides a mechanism for innocent third parties to recover their interest in any property preliminarily forfeited to the government.[21] Under criminal forfeiture statutes, a third party may petition for a hearing to adjudicate its alleged interest in property to be forfeited in an "ancillary proceeding" conducted after the court enters its preliminary order of forfeiture.[22] A court resolving a third party petition does not necessarily need to conduct a hearing; rather, the ancillary proceedings resemble civil actions, may involve discovery, and may be resolved by motion to dismiss or for summary judgment.[23] If the court does conduct a hearing, both the petitioner and the government are entitled to present evidence, including portions of the criminal record.[24] Like a civil action, the burden is ultimately on the petitioner to prove his or her claim by a preponderance of the evidence.[25]

There are only two ways that a third party may show a valid interest in property subject to a criminal forfeiture under § 853(n)(6). The petitioner must either: (A) have an interest in the property that is superior to the criminal defendant's interest and arose before the commencement of the crime; or (B) qualify as a "bona fide purchaser for value" of the property who was "reasonably without cause to believe that the property was subject to forfeiture" at the time of purchase.[26] In general, a party who acquires a bona fide interest in a property after the offense has standing to assert an interest in the property notwithstanding the relation-back doctrine.[27]

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[18] 11 U.S.C. § 541(a) (2012) (amended 2016); *see* Patterson v. Shumate, 504 U.S. 753, 757-66 (1992) (ERISA qualified trusts are not property of the estate based on federal nonbankruptcy law); Begier v. IRS, 496 U.S. 53, 58-67 (1990) (funds held in a federally mandated "special trust" are not property of the estate).
[19] *See* United States v. Parcel of Land, Bldgs., Appurtenances & Improvements, Known as 92 Buena Vista Ave., Rumson, N.J., 507 U.S. 111, 125 (1993) (the relation-back doctrine's "fictional and retroactive vesting [is] not self-executing.").
[20] Pacheco v. Serendensky, 393 F.3d 348, 355 (2d Cir. 2004).
[21] *See, e.g.*, United States v. Ramunno, 599 F.3d 1269, 1273 (11th Cir. 2010) (the purpose of the ancillary proceeding is to exempt the interests of qualifying third parties from the final forfeiture order).
[22] *See* § 853(n)(2).
[23] *See* Pacheco, 393 F.3d at 351-52; United States v. Marion, 562 F.3d 1330, 1342 (11th Cir. 2009) (following Pacheco); United States v. Salti, 579 F.3d 656, 667 (6th Cir. 2009) (same).
[24] *See* 21 U.S.C. § 853(n)(5) (2012); FED. R. CRIM. P. 32.2(c)(1)(B) (discovery is permitted "if the court determines that discovery is necessary or desirable to resolve factual issues").
[25] § 853(n)(6).
[26] § 853(n)(6). *See*, *e.g*., United States v. Monea Family Tr. I, 626 F.3d 271, 277 (6th Cir. 2010); United States v. Timley, 507 F.3d 1125, 1130 (8th Cir. 2007); United States v. Schecter, 251 F.3d 490, 493-94 (4th Cir. 2001).
[27] Parcel of Land, Bldgs., Appurtenances and Improvements, Known as 92 Buena Vista Ave., Rumson, N.J., 507 U.S. 507 U.S. 111, 129 (1993) (plurality opinion).

If the petitioner cannot meet the requirements of either § 853(6)(A) or 6(B), it cannot demonstrate a legally recognized interest in property subject to forfeiture.[28]

General unsecured creditors—like a trade creditor or service provider—have no standing to petition the court in a forfeiture proceeding.[29] Following the sentencing court's disposition of all third party petitions filed in the ancillary proceedings, or upon the expiration of time to file a petition, the court enters a final order of forfeiture, and the government obtains clear title to the forfeited property.[30]

Civil forfeiture proceedings are in rem actions that can take place independently from a criminal case.[31] Civil forfeiture provides defenses for "innocent owners" that are similar to the defenses provided under § 853(n)(6) for criminal forfeiture.[32] If a claimant can demonstrate by a preponderance of the evidence that he or she meets the statutory definition of an "innocent owner," then his or her interest in the property will not be forfeited.[33] The civil forfeiture statute defines an "owner" as a claimant holding an interest in the specific property, including leases, liens, mortgage, or a valid assignment of an interest.[34] Just like with criminal forfeiture, a general unsecured creditor will not qualify as an owner for purposes of this defense.[35]

To qualify as an "innocent owner" in civil forfeiture, the claimant must show that he or she has a superior interest or qualifies as a bona fide purchaser for value.[36] For a superior interest holder, the claimant must have obtained an interest before the property was involved in illegal conduct and either: (A) did not know of the property's involvement in illegal conduct; or (B) upon learning of the conduct, took all reasonably expected steps to terminate the property's illegal use.[37] A bona fide purchaser who acquired an interest after the property's illegal use also must not know or have reasonable cause to believe the property was subject to forfeiture at the time the purchaser acquired his or her interest in the property.[38]

D. Third Parties Must Either Participate in an Ancillary Proceeding or Must Participate as a Claimant in the Civil Forfeiture Case to Receive Judicial Relief

Aside from participation in ancillary proceedings initiated after a defendant's conviction, there is no judicial procedure for a third party to claim an interest in property subject to criminal forfeiture. For criminal forfeiture proceedings, 21 U.S.C. § 853(k) explicitly bars intervention:

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28 *See, e.g.*, United States v. Hooper, 229 F.3d 818, 822-23 (9th Cir. 2000) (given the clear direction in § 853(n)(6) limiting recovery to two categories of claimants, courts are not at liberty to create additional grounds for relief); United States v. Kennedy, 201 F.3d 1324, 1335 (11th Cir. 2000) (the grounds set forth in § 853(n)(6)(A) & (B) are the only grounds for recovery in ancillary proceedings, and one of them "is emphatically *not* that the criminal defendant gave the third party a gift.").

29 *See, e.g.*, DSI Assocs. LLC v. United States, 496 F.3d 175, 184 (2d Cir. 2007); United States v. Watkins, 320 F.3d 1279, 1283-84 (11th Cir. 2003) (unsecured creditors lack standing to contest the criminal forfeiture via an ancillary proceeding because they have no interest in the particular assets subject to forfeiture).

30 *See* 21 U.S.C. § 853(n)(7) (2012); FED. R. CRIM. P. 32.2(B)(3), (C)(2).

31 *See generally*, 18 U.S.C. §§ 981, 983 (2012) (amended 2016); FED. R. CIV. P. Supplemental Rule G.

32 § 983(d).

33 § 983(d)(1).

34 § 983(d)(6)(A).

35 § 983(d)(6)(B)(i).

36 § 983(d)(2), (3).

37 18 U.S.C. § 983(d)(2)(A) (2012) (amended 2016).

38 § 983(d)(3)(A).

> Except as provided in subsection (n) of this section [i.e., through the ancillary proceedings described above], no party claiming an interest in property subject to forfeiture under this section may—
>
> > (l) intervene in a trial or appeal of a criminal case involving the forfeiture of such property under this section; or
> >
> > (2) commence an action at law or equity against the United States concerning the validity of his alleged interest in the property subsequent to the filing of an indictment or information alleging that the property is subject to forfeiture under this section.[39]

Courts have uniformly held that creditors, trustees, and the like may not challenge any aspect of the criminal forfeiture proceedings, except in the context of ancillary proceedings pursuant to § 853(n)(6).[40]

Civil forfeiture does not have a similarly explicit bar to outside litigation as § 853(k) for criminal forfeiture. However, civil forfeitures are in rem cases where the property is the defendant. The court becomes the exclusive forum for adjudicating what should happen to the property at issue.[41] In addition, § 981(c) provides that the "taken or detained" property is not "repleviable, but shall be deemed to be in the custody" of the government until the district court orders otherwise.[42] Thus, a potential claimant to the property should participate in the civil forfeiture proceeding rather than seeking to adjudicate interests in the property in a bankruptcy case.[43]

IV. Considerations in Parallel Forfeiture and Bankruptcy Proceedings

Government attorneys seeking forfeiture, and trustees tasked with administering a bankruptcy estate, are each responsible for returning assets to their respective claimants in a fair, equitable, orderly, and cost effective manner. Balancing the differing priorities between the two processes requires that practitioners understand and recognize the differences and seek accommodation when possible. Thus, the USAO and the bankruptcy trustee should communicate early in the case and undertake a candid assessment of the available assets and the tools available to each for collecting, liquidating, and distributing those assets.

Below are some considerations that should help you analyze your case to facilitate cooperation with the bankruptcy trustee or similar counterparts. Each case is different, and there is often no "right" answer. The best results will vary depending on the type of assets recovered, nature of the crime, and position of the victims.

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[39] 21 U.S.C. § 853(k) (2012).

[40] *See, e.g.*, United States v. Cambio Exacto, S.A., 166 F.3d 522 (2d Cir. 1999) (person to whom a money transmitter owes money lacks standing as a general creditor to contest forfeiture of money transmitter's account); United States v. Lazarenko, 476 F.3d 642 (9th Cir. 2007) (liquidators appointed by High Court of Antigua in bankruptcy-like proceeding have no standing to contest criminal forfeiture).

[41] *See* Cason v. Holder, 815 F. Supp. 2d 918, 926 (D. Md. 2011) ("Civil forfeiture proceedings are *in rem*. Permitting competing actions to each lay claim to the right to adjudicate title to the res opens the door to inconsistent results and clouded title."), *aff'd* 464 F. App'x 131 (4th Cir. 2012).

[42] 18 U.S.C. § 981(c) (2012) (amended 2016).

[43] A third party that does not participate in the ancillary proceeding or civil-forfeiture proceeding may still petition the Attorney General for remission or mitigation. *See* 28 C.F.R. Part 9.

A. Assets

1. Threshold Questions

At what stage is each proceeding? If the civil or criminal forfeiture case is in its early stages and the bankruptcy trustee has already recovered assets, it may be preferable to have the trustee liquidate and distribute those assets, separate from and independent of the government's forfeiture action. This may expedite an initial distribution to victims, even if non-victim general creditors may take a portion of the distribution. Bankruptcy trustees may also make interim distributions either through a confirmed Chapter 11 plan of reorganization or with court permission in a Chapter 7.

In *Madoff*, for example, the liquidating trustee, under the jurisdiction of the bankruptcy court, made several distributions to defrauded investors before the government's initial distribution. The timing was due primarily to the greater volume and complexity of the claims submitted to the government. However, the government's later distribution reached tens of thousands more victims who were not eligible for a distribution from the trustee. On the other hand, if the forfeiture case has been progressing for some time and the government has already restrained or seized substantial assets, it may be preferable for the government to take the lead in distribution to victims. The government should consider the classes of victims, the assets involved, and the potential costs of administering the bankruptcy estate in making this determination.

Who is better positioned to seize and control the assets? If the case involves significant transfers to third parties (for example, early payees in a Ponzi scheme), the trustee may be better positioned to recover such assets through claw back actions and other powers that are not generally available to the government through forfeiture. However, the government may be better positioned to seize and take custody of assets that remain under the direct or indirect control of the defendant.

What government entities are involved? Government or industry regulators—such as the Securities and Exchange Commission, Commodity Futures Trading Commission, or Securities Investor Protection Corporation—may be interested parties in large fraud cases. These entities should be consulted to determine what, if any, actions they have taken to recover assets and compensate victims.

Do other government personnel regularly deal with the trustee or bankruptcy court? Local AUSAs, Assistant United States Trustees, and other government attorneys who often handle bankruptcy matters may have special insight into a particular bankruptcy trustee and/or the bankruptcy judge. These attorneys may work on a daily basis with the trustee and can be a key broker for a cooperation agreement. They may also have invaluable tactical information that may be the key difference in reaching a settlement that is in the victims' best interest.

Have receivers already been appointed in federal, state, or foreign proceedings? Federal, state, or foreign receivers should be consulted in connection with any previous efforts to recover assets associated with the fraud.

What assets are directly traceable to the criminal activity? The government will aggressively seek to forfeit assets that are directly traceable to the criminal activity. In particular, 18 U.S.C. § 981 subjects to civil forfeiture:

> [a]ny property, real or personal, which constitutes or is derived from proceeds traceable to . . . any offense constituting "specific unlawful activity" (as defined in section 1956(c)(7) of this title), or a conspiracy to commit such offense.[44]

[44] § 981(a)(1)(C).

The term "specific unlawful activity" includes, among other things, wire fraud and securities fraud.[45]

Although § 981 is a civil forfeiture statute, 28 U.S.C. § 2461(c) provides that criminal forfeiture is authorized where federal law provides for civil forfeiture and there is no parallel criminal forfeiture provision.[46] In addition to the statutory provisions described above, other forfeiture provisions authorize the forfeiture of directly traceable assets that the government should vigorously pursue even in the face of a parallel bankruptcy.

Are criminal assets commingled with legitimate assets? One of the greatest challenges of any criminal case is tracing criminal proceeds that have been commingled with the debtor's legitimate assets. A cooperation agreement can parse out which assets will be handled by the bankruptcy trustee versus the government, and what information about each asset can be lawfully shared.

Is the asset a business? Forfeiture of an ongoing legitimate business can be problematic because the government typically lacks the resources to manage and operate a business. Separating criminal proceeds from legitimate business income may be difficult, along with a broad range of collateral issues, from environmental cleanup to pension claims. The government may consider directing this type of asset to the bankruptcy trustee, who generally has greater experience in dealing with ongoing businesses.

Are any assets located in a foreign jurisdiction? With increasing frequency, foreign countries are able to afford full faith and credit to United States forfeiture judgments affecting property within their borders through mutual legal assistance treaties and other mechanisms. A foreign government and its law enforcement infrastructure are typically more receptive to assisting with a law enforcement task such as enforcing a forfeiture order rather than a purely civil function such as a bankruptcy. However, the government may be forced to rely on the judgment of foreign counterparties or courts as to whether the assets will be released or continue to be restrained by foreign liquidators.

Are there substitute assets? Substitute assets are those not directly traceable to the crime (i.e., "untainted" assets). The decision of whether to forfeit substitute assets will generally require an agreement with the bankruptcy trustee regarding the allocation of those assets directly traceable to, or involved in, the criminal activity, versus those that are not. In determining whether to pursue forfeiture of substitute assets, bear in mind that where tainted and untainted funds or property are commingled, the government may forfeit only the amount up to the value of the tainted assets.[47]

Who is better equipped to administer or sell the asset? The U.S. Marshals Service (USMS) has taken steps to facilitate the liquidation of diverse assets through the auction website www.bid4assets.com. The USMS may liquidate high end vehicles, collector cards, real estate (residential, commercial, and agricultural), timeshares, sport-fishing vessels, aircraft, artwork, jewelry, financial instruments, and much more. However, the bankruptcy trustee may be better positioned to liquidate intangible assets such as promissory notes and accounts receivables.

Will liquidating the asset require costly litigation? The litigation costs associated with the forfeiture of assets are not deducted from forfeited funds, while bankruptcy trustees (and related professionals) are able to recoup litigation costs and fees. Though this appears to weigh in favor of forfeiture, we must also determine whether the litigation is of the type that the government is prepared to undertake. Litigation among former business partners, family members, or complex fraud schemes can sometimes reach epic proportions that can significantly drain the assets available to victims.

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[45] *See* 18 U.S.C. § 1956(c)(7)(A) (2012) (amended 2016); 18 U.S.C. § 1961(l) (2012) (amended 2016) (listing "section 1343 (relating to wire fraud)" and "fraud in the sale of securities").
[46] 28 U.S.C. § 2461(c) (2012).
[47] 21 U.S.C. § 853(p)(2) (2012).

Will the creditors in the bankruptcy be paid in full? Unlike in forfeiture, if a bankruptcy trustee recovers assets sufficient to compensate each of the debtor's creditors in full, the remainder is returned to the debtor.

2. Practice Pointers

- Consider the amount of work, resources, and effort already expended by the government, bankruptcy trustee, and regulatory agencies when determining the allocation and distribution of assets.
- If significant delays arise in the prosecution of, and exhaustion of appeals by, the defendant that will, in turn, delay any criminal forfeiture, consider having the trustee distribute the assets. A cooperation agreement between the government and the trustee should address the classes and priorities of creditors and victims, and the costs and expenses of the trustee and related professionals.
- In general, the debtor's assets that are directly traceable assets to the crime are forfeited by the government, and some portion of the commingled or substitute assets are allocated to the bankruptcy estate. Consider releasing substitute assets to the bankruptcy trustee when negotiating a cooperation agreement.
- Consider directing complex business assets to the bankruptcy trustee, who may be in a better position to unwind such assets.
- When seeking to restrain and/or seize foreign-based assets, rely upon mutual legal assistance treaties, multilateral conventions, and forfeiture agreements with other governments. If faced with challenges by foreign receivers or liquidators, consider: (1) the likelihood that the government will lose control of the assets if we litigate; (2) the speed at which assets can be returned to victims through settlement or other non-forfeiture means; (3) the potential costs or fees that will be incurred by all parties by litigation for control over the assets; and (4) the possibility of releasing the assets to foreign trustees to distribute while minimizing costs, fees, and other expenses.

B. Victims

1. Threshold Questions

Are all the victims in the criminal forfeiture case in the same class of creditors? The government cannot remit forfeited funds to general unsecured creditors unless they are also the direct victims of the fraud underlying the forfeiture.[48] For example, remission is not available to non-victim vendors to whom the bankrupt entity owes money. Such creditors must normally recover, if at all, through the bankruptcy process. Indeed, there may be instances where there are victims of other crimes committed by the debtor that are unrelated to the crime underlying the forfeiture. Those victims will not qualify as victims for purposes of remission, but they may be proper claimants in the bankruptcy case.

Are the victims in the criminal forfeiture case also qualified creditors in the bankruptcy proceedings? If the victims in the criminal case are the debtor's secured or unsecured creditors, it may be more cost-effective and efficient to have the trustee determine the victims' losses and priorities of distribution in the bankruptcy proceeding. Although the government has authority to remit forfeited funds to secured creditors (for example, lenders and lienholders), it may be more efficient to have the bankruptcy trustee handle these claims.

[48] 28 C.F.R. § 9.6(a) (2018).

Is the bankruptcy estate a victim? If the sole victim in the criminal case is the bankruptcy estate (e.g., due to bankruptcy fraud), then any forfeited assets would normally be remitted to the bankruptcy trustee.

Are the victims located in a foreign jurisdiction? If the case involves a foreign receiver or trustee acting on behalf of foreign victims, the government should consider the location of the assets being liquidated and whether that foreign jurisdiction has reliable processes for redress to victims. Depending upon the answers to these initial inquiries, it may be more efficient to allow the foreign receiver or liquidator to distribute forfeited funds in accordance with laws of the foreign jurisdiction. Any such arrangement must be conditioned on the foreign receiver's agreement to comply with U.S. regulations regarding remission of forfeited assets to the victims.

Are the victims identified in a restitution order? If the victims of an offense underlying a forfeiture are already identified in a criminal restitution order, the USAO may elect to request MLARS to have the forfeiture proceeds turned over to the court for distribution. However, a restitution order must accurately reflect the total population of victims and otherwise comply with the remission regulations.

Is the debtor a victim? If the debtor is a business, it may be a victim of the crime underlying forfeiture (e.g., embezzlement). If the debtor/business requests remission, MLARS and the applicable USAO must determine whether the business was innocent of the fraud or was complicit or willfully blind to it.[49]

Is the victim part of a class of victims represented by counsel? In large fraud cases, victims may bring a class action against the bankrupt individual or entity. A creditor's committee may also be appointed. Counsel for the class or creditors' committee should be consulted in determining whether to enter into a cooperation agreement or settlement with the class or the bankruptcy trustee.

Is the fraud such that certain victims will reap unfair benefits? Certain classes of victims may be entitled to distributions from other sources such as class action settlements or insurance distributions. To ensure a fair and equitable distribution, the government should determine which victims have received, or are expected to receive, payments from such other collateral sources. When appropriate, collateral recoveries should be deducted from the victims' recognized losses for purposes of remission (and potentially the bankruptcy). The bankruptcy trustee and government should closely coordinate and share information (to the extent allowable under the law) to ensure that each victim receives a fair share of the recovered funds. In no case should a victim receive total compensation in excess of their net loss amount.[50]

What is the most effective way to distribute assets to the victims? MLARS has initiated a national claims administration contract that can handle large scale claims and distribute funds to large numbers of victims at minimal cost. In most cases, the MLARS process will be more cost-effective than bankruptcy. However, if the case involves numerous victims and the trustee has already established a claims-administration process, it may be more efficient to "piggyback" the remission process on to the trustee's process if costs are reasonable and it conforms to the applicable remission regulations. Transfer of forfeited assets to the trustee for distribution to victims should be conditioned on an express agreement regarding the trustee's fees and related expenses.

2. Practice Pointers

- Direct the seized or forfeited assets to the bankruptcy estate if the victims are also secured creditors in the bankruptcy proceeding and the trustee's distribution would be more efficient.

[49] *See* 28 C.F.R. § 9.8(b)(3) (2018).
[50] § 9.8(g).

- Retain forfeited assets for victims of the offense underlying the forfeiture who are not secured or general creditors of the debtor.
- Share documentation with the trustee, when possible, to more accurately ascertain the victims' losses and avoid duplication.
- The remission process is generally more equitable and cost-effective than bankruptcy with regard to victims.

V. Cooperation Agreements

Whenever feasible, the government should work with the bankruptcy trustee to ensure the maximum recovery for victims, while at the same time accommodating the trustee's fiduciary duty to compensate secured and unsecured creditors who are not direct victims of the crime underlying the forfeiture. While cooperation is favored, the government should zealously oppose any actions of a trustee or receiver that would adversely impact the interests of crime victims.

In several recent large Ponzi schemes involving bankruptcies, cooperation between the government and the bankruptcy trustee has yielded outstanding results. In *Madoff*,[51] the government and the Securities Investor Protection Corporation trustee conducted parallel investigations of Madoff and his investors, and agreed to work cooperatively to marshal assets and maximize recovery. In total, the government seized and forfeited nearly $10 billion as proceeds of the crime, of which approximately $5.5 million was transferred to the trustee for distribution to Madoff's direct investors. The trustee separately recovered more than $7 billion from avoidance and claw back actions. Through separate distribution programs, the government and the trustee have returned to date more than $11 billion to more than 27,000 victims of the Madoff scheme.

In *United States v. Petters et al*., two bankruptcy trustees were appointed for Thomas Petters and a business associate after the commencement of separate bankruptcy proceedings following the discovery of Petters' multi-billion dollar Ponzi scheme.[52] The USAO subsequently entered into a coordination agreement with the two trustees concerning the recovery and disposition of the assets controlled by Petters and his business entities. The parties agreed that the assets of Petters' companies currently in bankruptcy proceedings would be handled through the bankruptcy process, while the personal assets of Petters and other individual defendants, including transfers made to third parties, would be handled through the forfeiture process. The trustees provided substantial assistance to the USAO and MLARS in processing and evaluating the victims' claims. Through this cooperation, more than $16 million was recovered for the victims.

Another case involving a successfully negotiated cooperation agreement between the government and the bankruptcy trustee is *United States v. Dreier*.[53]

Factors to consider when negotiating and drafting a cooperation agreement include:

- Early coordination and communication between the government and the bankruptcy trustee is essential.
- Whose case is further developed may be a factor in determining the allocation and distribution of assets.
- "Untainted" or substitute assets can provide the government with some flexibility when negotiating with the bankruptcy trustee regarding the allocation of those assets directly

[51] United States v. Bernard L. Madoff, No. 09-CR-213 (S.D.N.Y) (and associated criminal and civil cases).
[52] United States v. Thomas Joseph Petters, No. 08-CR-364 (D. Minn).
[53] United States v. Dreier, No. 09-CR-085 (S.D.N.Y. Dec. 18, 2009).

traceable to, or involved in, the criminal activity, versus those assets that are not. Some trustees may be willing to reduce their professional fees in exchange for being able to handle those assets through the bankruptcy process. Secured creditors may also be willing to "carve out" a percentage of the amount recovered for the purpose of ensuring that general unsecured creditors receive some funds.

- Forfeiture is *generally* the better mechanism for recovering assets directly traceable to the crime.
- The bankruptcy trustee may be better suited to deal with certain complex assets such as businesses.
- Work as a partnership—the government and the bankruptcy trustee—to coordinate the proceedings.
- Bankruptcy courts and district courts can facilitate and support cooperation through settlement conferences and ADR programs.
- Every case is different—*flexibility is the key*.

VI. Conclusion

Cooperation between government attorneys and trustees avoids needless litigation and helps ensure that crime victims obtain "full and timely restitution" as mandated by the Crime Victims' Right Act.[54] While forfeiture and bankruptcy are distinct and specialized fields, it has been shown repeatedly that the two regimes can augment and complement each other in victim cases.

In *United States v. Dreier*, District Judge Jed Rakoff observed:

> An under-appreciated evil of substantial frauds like those of Marc Dreier is how they pit their victims against one another. Where, as here, the funds remaining after the fraud is uncovered are insufficient to make whole Dreier's numerous victims and creditors, these unfortunates are left to squabble over who should get what. In this case, moreover, resolution of these competing claims involves consideration of three bodies of law—criminal law, securities law, and bankruptcy law—that cannot always be reconciled without some friction.[55]

[54] 18 U.S.C. § 3771(a)(6) (2012) (amended 2015).
[55] United States v. Dreier, 682 F. Supp. 2d 417, 418 (S.D.N.Y. 2010).

Judge Rakoff further noted: "[T]hese inherent tensions are best addressed through coordination and cooperation by all concerned."[56]

ABOUT THE AUTHOR

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[56] *Id.*

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Why is a Bankruptcy Charge Valuable to Any Investigation?

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I. Introduction

Bankruptcy charges are often overlooked in complex financial and corruption crimes, and they should not be. Federal prosecutors in white-collar cases receive training to distill the "lying, cheating, and stealing" from complex financial scenarios and therefore select charges facilitating the presentation of this theme to a judge and jury. Prosecutors should undertake the same analysis when a bankruptcy case is connected to a pending investigation, considering how the fraudulent activity in the bankruptcy proceeding can enhance a criminal case. At a minimum, the bankruptcy filing provides the judge and jury with a complete picture of a defendant's criminal activity. Furthermore, the Principles of Federal Prosecution encourage limiting charges to the "most serious offense that is consistent with the nature of the defendant's conduct."[1] For these reasons, the mail and wire fraud statutes are viewed as powerful and understandable charges that readily apply to the most complex situations. Although these charges often form the backbone of a white-collar criminal prosecution, this article explores why bankruptcy charges can further the successful prosecution of a case.

Although the five year statutory maximum of the bankruptcy crimes contained in Title 18 Section 152 of the United States Code[2] will rarely qualify as the "the most serious offense," the Principles of Federal Prosecution provide guidance for the inclusion of additional charges. Two such situations when additional charges should be considered are when they are "necessary [to] adequately reflect the nature and extent of the criminal conduct involved" and "when an additional charge or charges would significantly strengthen the case against the defendant or a codefendant."[3] This article will explore the situations when a bankruptcy charge should be considered as additional charges in a prosecution.

II. Principles of Federal Prosecution—Adequately Reflecting the Nature and Extent of Criminal Conduct

Perhaps the most important reason that bankruptcy charges should not be overlooked by a federal prosecutor is that prosecution of bankruptcy crimes protects the integrity of the bankruptcy process, an area of law exclusively in the federal domain.[4] This concept was reaffirmed by the Supreme Court in June 2016 when it held that a state-based debt restructuring scheme was preempted by the Bankruptcy Code.[5] As such, if a federal prosecutor declines to pursue the bankruptcy charges, it is unlikely that state charges will follow.

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[1] U.S. DEP'T. OF JUSTICE, U.S. ATTORNEYS' MANUAL § 9-27.300 [hereinafter USAM].
[2] 18 U.S.C. § 152 (2012).
[3] USAM § 9-27.320.
[4] U.S. CONST. ART. I, § 8, cl. 1.
[5] Puerto Rico v. Franklin-California Tax Free Trust, 136 S. Ct. 1938 (2016).

In addition, much like the Internal Revenue Code, the Bankruptcy Code is largely reliant on the disclosures of an "honest but unfortunate debtor"[6] The disclosures made in the bankruptcy petition, statement of financial affairs, and the meeting of creditors form the backbone and starting point for the debtor's bankruptcy process. Therefore, like tax evasion cases, the possibility of criminal prosecution presents a strong public deterrent against individuals who seek to take advantage of the protections offered in the Bankruptcy Code.

Bankruptcy crimes of concealment and omission, or bankruptcy schemes whether connected or not to a larger fraud or corruption scheme, involve the intentional deception of a federal judicial body or the use of the federal court system. As such, they are crimes that can only be addressed by federal prosecution. Effectively charged bankruptcy crimes help protect the federal court system from widespread abuse and further a substantial federal interest in the bankruptcy laws. This deterrence factor is consistent with the Principles of Federal Prosecution that recognize that, even if certain crimes appear to be "not of great importance by themselves," the prosecutor should consider bringing charges if these crimes "commonly committed would have a substantial cumulative impact on the community".[7]

III. Principles of Federal Prosecution—Additional Charges Significantly Strengthen the Case

Moreover, the inclusion of bankruptcy crimes can significantly strengthen a case at trial. For instance, false representations in financial fraud cases or Ponzi schemes often involve the defendant exaggerating or falsifying his or her financial resources and net worth, while false representations in a bankruptcy case usually involve the concealment of assets and minimization of resources. The ability to prove and present both false representations without having to resort to Federal Rule of Evidence 403 and its limitations on the form and manner of the presentation of evidence can reduce pretrial litigation and mitigate appellate risk.

This can be particularly effective in mortgage fraud and other investment schemes where the defendant presents two conflicting financial profiles to two different audiences. For instance, in *United States v. Pacheco*,[8] the defendant solicited investments to finance a debt elimination program to individual investors. During the presentations to investors, the defendant touted his financial acumen and sophistication. However, unbeknownst to the victims, the defendant was also undergoing bankruptcy proceedings and omitted substantial information about his finances and employment. At trial, the defendant's presentation of two completely different financial profiles—one to the investment fraud victims and another to the bankruptcy court—was effective in counteracting any defense that the defendant acted in a mistaken good faith belief about the efficacy of his financial programs.

In addition, depending on the facts of the case, the list of creditors submitted to the bankruptcy court by a defendant can provide a sympathetic victim list. For instance, the fact that a doctor filed bankruptcy to discharge medical malpractice lawsuits while concealing assets can provide a motive for the underlying bankruptcy case and can show a knowing and intentional use of a federal court system to victimize those harmed by the conduct.[9]

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[6] *In re* Demesones, 406 B.R. 711, 713 n. 1 (Bankr. E.D. Va. 2008).
[7] USAM § 9-27.230.
[8] United States v. Pacheco, 791 F.3d 171, 174-76 (1st Cir. 2015).
[9] *See e.g.*, United States v. Colon-Ledee, 772 F3d 21, 25 (1st Cir. 2014).

IV. Additional Considerations

Another factor warranting the inclusion of bankruptcy charges to a larger case is when the underlying charges do not provide readily presentable or ascertainable victims. Furthermore, it is not uncommon for individuals involved in expansive and long-term fraud schemes to have numerous creditors who, although not necessarily direct victims of the underlying fraud, suffer financial losses as a result of the defendant's actions. This is especially true when some of the bankruptcy creditors are the victims of the larger scheme, such as in investor or rescue fraud cases. As noted above, the Principles of Federal Prosecution contemplate this possibility even when the offense considered is relatively minor.[10]

In addition to banks, not commonly viewed as sympathetic victims by juries, individuals involved in larger fraud schemes often owe monies to small businesses and individuals whom they have promised to pay in exchange for them providing services in advance. Although these individuals and entities may not be considered victims proximately harmed by the underlying fraudulent activities, inclusion of bankruptcy charges in the indictment would preclude the defense from arguing that these creditors are too remote from the underlying fraud to qualify to receive restitution under the Mandatory Victim Restitution Act.[11]

Lastly, bankruptcy proceedings require the defendant to generate and produce numerous documents, provide testimony under oath, and provide a detailed financial history in the schedule of financial affairs. Although these documents and statements are presumably admissible as statements of a party opponent pursuant to Federal Rule of Evidence 801(d)(2), if not admitted in connection with an underlying bankruptcy charge a prosecutor may face difficulties convincing the court that the evidence is not unduly prejudicial, likely to confuse the jury, or the timing of the statement was too remote in time to be relevant to the primary charges.[12] The inclusion of a bankruptcy charge substantially raises the probative value such that it would almost guarantee admission at trial.

Even if bankruptcy charges are ultimately not included in the charges, as discussed elsewhere in this bulletin, the inclusion of the United States Trustee's office early in the investigation can provide valuable documents and information about the defendant and victims that might not be readily ascertainable from other sources.

V. Conclusion

The inclusion of bankruptcy charges in an already complex financial fraud case will undoubtedly require the dedication of additional time and resources to the prosecution of a case. However, as set forth above, the dedication of time and resources can substantially strengthen a case should it go to trial. Furthermore, prosecutors should consider whether bankruptcy charges address an abuse of an exclusively

[10] USAM § 9-27.230.
[11] 18 U.S.C. § 3663A (2012).
[12] FED. R. EVID. 403.

federal judicial process or can address harms to innocent creditors whose interactions with the accused may be too remote to address the underlying fraudulent activity.

ABOUT THE AUTHOR

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Parallel Bankruptcy and Criminal Proceedings: Why Parallel Bankruptcy Proceedings are Different

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I. Introduction

Given the size and reach of the federal and state governments, parallel proceedings—concurrent civil and criminal proceedings based on the same set of facts—are commonplace. Whether it is the Environmental Protection Agency ("EPA") seeking civil remedies while an investigation is taking place for potential criminal violations, or the Securities and Exchange Commission ("SEC") pursuing both civil and criminal remedies, the list of state and federal governmental authorities that can simultaneously pursue both civil and criminal remedies is lengthy.

Bankruptcy cases are no exception. Within the bankruptcy context, parallel civil proceedings, including state court litigation, tax adjudications, EPA and SEC investigations, etc., are not only common, but built into the liquidation and reorganization processes. Indeed, bankruptcies are often filed for the primary purpose of staving off the tide of other pending litigation, and bankruptcy courts are designed to effect an orderly liquidation or reorganization despite other litigation. But, while Bankruptcy Courts are no strangers to parallel civil proceedings, bankruptcy cases are distinct and present a number of legal and practical complexities, particularly when the parallel proceeding is criminal in nature. This article, therefore, discusses parallel proceedings in general, and then discusses the issues that are unique to parallel bankruptcy and criminal proceedings.

II. Parallel Proceedings Generally

A. The General Concept

There is no globally accepted definition of parallel proceedings, but generally, "[c]ivil and criminal actions arising from the same facts are commonly referred to as either 'parallel proceedings' or 'concurrent proceedings.'"[1] In *Sec. & Exch. Comm' v. Dresser Indus., Inc.*, the court stated that parallel proceedings arise because civil and regulatory laws of the United States frequently overlap with the criminal laws, creating the possibility of parallel civil and criminal proceedings, either successive or simultaneous.[2]

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[1] Note, *Using Equitable Powers to Coordinate Parallel Civil and Criminal Actions*, 98 HARV. L. REV. 1023, 1044 no.5 (1985) (citations omitted); *see also* 1 Crim. Prac. Manual § 16:2, Defining parallel proceedings ("Although the expression "parallel proceedings" conjures an image of two simultaneous legal actions flowing symmetrically alongside each other, the phrase is misleading since the myriad proceedings which individual and corporate targets may face often intersect, overlap, and intrude on each other.").
[2] Sec. & Exch. Comm'n v. Dresser Indus., Inc., 628 F.2d 1368, 1374 (D.C. Cir. 1980).

Agencies have also adopted similar definitions of parallel proceedings that relate to concurrent civil and criminal proceedings. For the EPA:

> [P]arallel proceedings means overlapping criminal and civil or administrative enforcement activities with respect to the same or related parties and that deal with the same or a related course of conduct. The overlapping activities may be undertaken simultaneously or sequentially. These activities include enforcement actions brought to obtain criminal sanctions, civil penalties, injunctive relief, compliance orders, or cost recovery, as well as pre-filing activities directed at enforcement, including investigative efforts.[3]

In other contexts, however, the term refers only to concurrent civil proceedings. For instance, in the abstention context, parallel proceedings are often civil only. "Federal and state proceedings are "concurrent" or "parallel" for purposes of abstention when the two proceedings are essentially the same; that is, there is an identity of parties, and the issues and relief sought are the same."[4]

Thus, there are a variety of definitions describing the same general concept of concurrent proceedings based on a similar set of facts. As will be described below, bankruptcy cases can be parallel to both civil and criminal proceedings, but the primary discussion focuses on the parallelism of bankruptcy cases and criminal proceedings.

B. Applicable Law

While courts apply different definitions of parallel proceedings, the general permissibility of parallel proceedings is settled.

In *United States v. Kordel*, the U.S. Food and Drug Administration ("FDA") initiated an investigation into the president and vice-president of Detroit Vital Foods, Inc. for possible violations of the Food, Drug, and Cosmetic Act.[5] As part of the investigation, the FDA served interrogatories.[6] Three days later, the FDA served a notice that the agency was considering criminal charges.[7] In response, the subjects moved to stay the civil action or extend the time to answer the interrogatories on the basis that responding to the interrogatories would "work a grave injustice against the claimant" and "enable the Government to have pretrial discovery of the respondents' defenses to future criminal charges."[8] The district court denied the motion and the respondents answered the interrogatories.[9] Thereafter, the respondents were convicted of crimes based, at least in part, on information contained in the interrogatory responses.[10] On appeal, the appellate court reversed, finding that the interrogatory responses were involuntary and left the respondents with no constitutionally adequate choices.[11] The Supreme Court

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[3] ENVIRONMENT AND NATURAL RESOURCES DIVISION DIRECTIVE 2008-02; PARALLEL PROCEEDINGS POLICY (2000).
[4] Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Karp, 108 F.3d 17, 22 (2d Cir. 1997); AXA Corp. Sols. v. Underwriters Reinsurance Corp., 347 F.3d 272, 278 (7th Cir. 2003) (parallel proceedings exist when "substantially the same parties are contemporaneously litigating substantially the same issues in another forum.").
[5] United States v. Kordel, 397 U.S. 1, 2 (1970).
[6] *Id.* at 3-4.
[7] *Id.* at 4.
[8] *Id.* at 4-5.
[9] *Id.* at 5.
[10] *Id.* at 6.
[11] *Id.* at 10.

again reversed, finding that the respondents, represented by counsel, never invoked their Fifth Amendment rights and that the dual regulatory and criminal proceedings were proper.[12] The Court stated:

> It would stultify enforcement of federal law to require a government agency . . . invariably to choose either to forgo [sic] recommendation of a criminal prosecution once it seeks civil relief, or to defer civil proceedings pending the ultimate outcome of a criminal trial.[13]

The Court also noted that the civil action did not involve bad faith.[14] It was not brought "solely" to obtain evidence for the criminal prosecution, the government did not hide the criminal investigation, the respondents were represented by counsel, and there were no other "special circumstances that might suggest the unconstitutionality or even the impropriety of this criminal prosecution."[15]

In *United States v. Stringer*, the SEC began investigating three individuals and their company for civil securities fraud violations.[16] Two weeks after the civil investigation began, the SEC met with the United States Attorneys' Office ("USAO") and the FBI quickly opened a criminal investigation.[17] The SEC and FBI conducted their investigations in tandem, but the criminal team directed at least a portion of the SEC discovery, including witness interviews and depositions, while keeping the criminal investigation secret.[18] The Assistant U.S. Attorney further instructed the court reporter to keep the criminal investigation confidential.[19] When the targets inquired of the SEC whether a criminal investigation was pending, the SEC lawyer instructed the targets to contact the USAO.[20] The district court found that the government's conduct amounted to "trickery and deceit",[21] but the Ninth Circuit reversed, holding that because the government made no affirmative misrepresentation regarding the existence of a criminal investigation, no misconduct occurred.[22] Moreover, the defendants were aware that the information could be used against them since the subpoenas included a supplemental document containing a criminal penalty warning.[23] Consequently, dismissal of the indictments was improper.[24] Parallel proceedings are, therefore, generally permissible.[25]

C. The Department of Justice's View

So settled is the permissibility of parallel proceedings that the Department of Justice (the "Department") has issued two memorandums encouraging their use.

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[12] *See generally id.*
[13] *Id.* at 11.
[14] *Id.* at 6; 11-12.
[15] *Id.* at 11-12.
[16] United States v. Stringer, 535 F.3d 929, 932 (9th Cir. 2008).
[17] *Id.* at 933.
[18] *Id.* at 934.
[19] *Id.*
[20] *Id.* at 935.
[21] *Id.* at 936.
[22] *Id.* at 942.
[23] *Id.* at 938.
[24] *Id.* at 942.
[25] *See also* United States v. Unruh, 855 F.2d 1363, 1374 (9th Cir. 1987) ("The prosecution may use evidence obtained in a civil proceeding in a subsequent criminal action unless the defendant shows that to do so would violate his constitutional rights or depart from the proper administration of criminal justice."); United States v. Teyibo, 877 F. Supp. 846, 856 (S.D.N.Y. 1995) (parallel proceedings are permissible as long as a defendant's due process rights were not violated); Sec. & Exch. Comm'n v. Dresser Indus., Inc., 628 F.2d 1368, 1374 (D.C. Cir. 1980) ("In the absence of substantial prejudice to the rights of the parties involved, such parallel proceedings are unobjectionable under our jurisprudence.").

Attorney General Janet Reno issued the first memorandum regarding parallel criminal, civil and administrative proceedings on July 28, 1997. The memorandum stressed that, "in order to maximize the efficient use of resources [combating white collar crime]," the USAOs and Department should implement procedures for coordinating the criminal, civil and administrative aspects of all white collar crime matters, including:

- timely assessment of the civil and administrative potential in all criminal case referrals, indictments, and declinations;
- timely assessment of the criminal potential in all civil case referrals and complaints;
- effective and timely communication with cognizant agency officials, including suspension and debarment authorities, to enable agencies to pursue available remedies;
- early and regular communication between civil and criminal attorneys regarding qui tam and other civil referrals, especially when the civil case is developing ahead of the criminal prosecution; and
- coordination, when appropriate, with state and local authorities.[26]

On January 30, 2012, Attorney General Eric Holder issued a memorandum confirming the Department's commitment to utilizing parallel proceedings. The memorandum states that the Department has a "longstanding policy that ensures that Department prosecutors and civil attorneys coordinate together and with agency attorneys in a manner that adequately takes into account the government's criminal, civil, regulatory and administrative remedies."[27] The memorandum then confirms that Department attorneys are to coordinate their efforts to ensure "early, effective, and regular communication between criminal, civil, and agency attorneys to the fullest extent appropriate to the case and permissible by law."[28] The logic is simple. "Where parallel proceedings are conducted effectively, the government is able to make more efficient use of its investigative and attorney resources."[29]

The advantages do not stop at bare efficiency. Parallel proceedings may provide the government additional benefits.

Foremost, the government can obtain evidence directly from the target. Whether by deposition or interrogatory, the target must participate in the discovery process and is compelled to respond under penalty of perjury. Even statements made during settlement negotiations can be used against a target in a subsequent or parallel criminal case.[30]

Second, the scope of civil discovery is broad. FED. R. CIV. P. 26 allows parties, including the government, to obtain evidence from the target that is "relevant to any party's claim or defense and proportional to the needs of the case"—no search warrant based on a showing of probable cause is required.[31]

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[26] Memorandum from the Attorney General on Coordination of Parallel Criminal, Civil, and Administrative Proceedings to all United States Attorneys (July 28, 1997).
[27] Memorandum from the Attorney General on Coordination of Parallel Criminal, Civil, Regulatory, and Administrative Proceedings to all United States Attorneys (January 30, 2012).
[28] *Id.*
[29] *Id.*
[30] United States v. Prewitt, 34 F.3d 436, 439 (7th Cir. 1994) (admissions and statements made during settlement discussions in a civil proceeding are admissible in a later criminal case); *see also* FED. R. EVID. 408, Committee Notes on Rules—2006 Amendment ("Where an individual makes a statement in the presence of government agents, its subsequent admission in a criminal case should not be unexpected.").
[31] FED. R. CIV. P. 26. *See* Sec. & Exch. Comm'n v. Dresser Indus., Inc., 628 F.2d 1368, 1376 (D.C. Cir. 1980) (noting that a civil proceeding might "expand rights of criminal discovery beyond the limits of FED. R. CRIM. P.

Third, a parallel proceeding in which the criminal investigation is kept secret enables the government to conduct covert operations. Whether through confidential informants or undercover agents, the government could surreptitiously build its criminal case during a civil proceeding.

Fourth, targets are typically more candid in civil proceedings. Unaware of a criminal investigation, a target is more apt to speak freely and provide incriminating statements.

Fifth, targets in a civil proceeding may create additional evidence. When a target takes steps to derail an investigation, including producing false documents, providing false testimony, etc., the actions may themselves be criminal and create additional charges or, at the least, provide additional evidence for the criminal investigation.

D. Limitations of Parallel Proceedings

Notwithstanding the general permissibility and benefits of parallel proceedings, parallel proceedings have practical and legal limits.

1. Premature Disclosure of Investigation and Evidence

Parallel proceedings do not benefit the government exclusively. While the upside of parallel proceedings for targets is limited, there are some. A target could obtain an early preview of the government's criminal case through civil discovery and could conduct offensive discovery in anticipation of criminal charges by, for instance, deposing government witnesses.[32] Such discovery would not be available in a criminal case.[33] The disclosure of an investigation and supporting evidence may counterbalance the benefits that the government otherwise has in conducting parallel proceedings.

2. Invocation of Fifth Amendment Rights

The utility of a parallel proceeding may be limited if the target invokes his/her Fifth Amendment rights in the civil case. However, while the option may prevent the target from making incriminating statements and minimize the disadvantages of a parallel proceeding, the choice could be detrimental. For instance, a negative inference could be drawn from the invocation and jeopardize the entire civil case.[34] If the target is the plaintiff, the target will also likely be precluded from continuing the civil case. "[O]ne may not bring a suit, 'wave the sword' of the fifth amendment [sic], and then maintain the suit."[35]

16(b)" and "expose the basis of the defense to the prosecution in advance of criminal trial, or otherwise prejudice the case."); *see also* Randy S. Eckers, *Unjust Justice in Parallel Proceedings: Preventing Circumvention of Criminal Discovery Rules*, 27 HOFSTRA L. REV. 109, 112 (1998).

[32] *See* S.E.C. v. Doody, 186 F. Supp. 2d 379, 381 (S.D.N.Y. 2002) (noting that once an indictment is issued, a defendant may attempt to gain "premature access to evidence and information pertinent to the criminal case.").

[33] *See* United States v. Cutler, 806 F.2d 933, 936 (9th Cir. 1986) (depositions are not permitted under Federal Rule of Criminal Procedure 15 for the sole purpose of discovery); *see also In re* Grand Jury Subpoena, 866 F.3d 231, 234 (5th Cir. 2017) ("Civil and criminal proceedings are subject to different procedural rules; less restrictive civil discovery could undermine an ongoing criminal investigation and subsequent criminal case.").

[34] Keating v. Office of Thrift Supervision, 45 F.3d 322, 326 (9th Cir. 1995) ("it is even permissible for the trier of fact to draw adverse inferences from the invocation of the Fifth Amendment in a civil proceeding.").

[35] Afro-Lecon, Inc. v. United States, 820 F.2d 1198, 1205 (Fed. Cir. 1987).

3. Stay of Proceedings

The non-criminal proceeding could be stayed, lessening the benefits of a parallel proceeding. Courts apply a flexible test in deciding whether to stay a civil proceeding pending the outcome of a parallel criminal investigation or case.

> The decision whether to stay civil proceedings in the face of a parallel criminal proceeding should be made 'in light of the particular circumstances and competing interests involved in the case.' This means the decisionmaker should consider 'the extent to which the defendant's fifth amendment rights are implicated.' In addition, the decisionmaker should generally consider the following factors: (1) the interest of the plaintiffs in proceeding expeditiously with this litigation or any particular aspect of it, and the potential prejudice to plaintiffs of a delay; (2) the burden which any particular aspect of the proceedings may impose on defendants; (3) the convenience of the court in the management of its cases, and the efficient use of judicial resources; (4) the interests of persons not parties to the civil litigation; and (5) the interest of the public in the pending civil and criminal litigation.[36]

The decision to stay a civil proceeding pending a parallel criminal case is discretionary.[37] "[T]he power to stay proceedings is incidental to the power inherent in every court to control the disposition of the causes on its docket with economy of time and effort for itself, for counsel, and for litigants."[38]

"[A] defendant has no constitutional right to a stay simply because a parallel criminal proceeding is in the works."[39] "The Constitution does not generally require a stay of civil proceedings pending the outcome of criminal proceedings, absent substantial prejudice to a party's rights."[40] There is substantial prejudice to a party's rights if the government essentially conducts its criminal case through the civil proceeding. "[T]there is a special danger that the government can effectively undermine rights that would exist in a criminal investigation by conducting a de facto criminal investigation using nominally civil means. In that special situation, the risk to individuals' constitutional rights is arguably magnified."[41]

4. Government Abuse

The government cannot abuse parallel proceedings. "Notwithstanding this general approval of the practice of conducting parallel civil and criminal proceedings, the government's ability to do so is not wholly unrestrained."[42] Abuse occurs if the government oversteps its legitimate authority to conduct parallel proceedings and abuses the civil process, i.e., if the government engages in bad faith. If this occurs, a defendant within a criminal case can move to suppress any evidence obtained in the civil proceeding or dismiss the criminal case in its entirety.

In *Kordel*, the Court noted several factors that suggest bad faith, including (1) when the government brings a civil action solely to obtain evidence for its criminal prosecution, (2) when the government fails to advise the defendant that it contemplates criminal prosecution; (3) where a defendant is without counsel or reasonably fears prejudice from adverse pretrial publicity or other unfair injury; and

[36] Keating, 45 F.3d at 324-25 (internal citations omitted); *see also* Microfinancial, Inc. v. Premier Holidays Int'l, Inc., 385 F.3d 72, 78 (1st Cir. 2004) (adding "good faith of the litigants (or the absence of it)" and "the status of the cases" as factors).
[37] Sec. & Exch. Comm'n v. Dresser Indus., Inc., 628 F.2d 1368, 1375 (D.C. Cir. 1980) (citing United States v. Kordel, 397 U.S. 1, 12 no.27 (1970)).
[38] Gray v. Bush, 628 F.3d 779, 785 (6th Cir. 2010) (alteration in original) (quoting Landis v. N. Am. Co., 299 U.S. 248, 254 (1936)) (internal quotation marks omitted).
[39] Microfinancial, Inc., 385 F.3d at 77-78.
[40] Creative Consumer Concepts, Inc. v. Kreisler, 563 F.3d 1070, 1080 (10th Cir. 2009).
[41] Sterling Nat. Bank v. A-1 Hotels Int'l, Inc., 175 F. Supp. 2d 573, 579 (S.D.N.Y. 2001).
[42] United States v. Posada Carriles, 541 F.3d 344, 354 (5th Cir. 2008).

(4) other special circumstances that might suggest the unconstitutionality or even the impropriety of a criminal prosecution.[43]

The most cited recent case discussing government abuse of parallel proceedings is *United States v. Scrushy*.[44] In *Scrushy*, the SEC was investigating Scrushy's potential involvement in a health care fraud scheme.[45] The USAO simultaneously began investigating Scrushy's conduct and utilizing the civil discovery to advance the criminal case.[46] For instance, the SEC moved the location of Scrushy's deposition from Atlanta, Georgia to Birmingham, Alabama to create venue over any false statements.[47] The USAO also instructed the SEC on what questions to ask during Scrushy's deposition, and what not to ask.[48] The district court held that such conduct impermissibly commingled the two proceedings.[49] The Court stated, "[t]o be parallel, by definition, the separate investigations should be like the side-by-side train tracks that never intersect."[50] Because the government manipulated the civil investigation and "merged" it into the criminal investigation, justice was not administered properly.[51]

Bad faith may also arise if the government abuses the grand jury process. FED. R. CRIM. P. 6(e) protects the secrecy of the grand jury process and prohibits the disclosure of "matters occurring before the grand jury." "[A] government prosecutor is barred, absent judicial approval, from sharing grand jury material with government civil attorneys."[52] A breach of that secrecy occurs if grand jury matters are disclosed to governmental civil agents who are not "assisting Government attorneys to enforce federal criminal laws."[53]

The standard to establish bad faith, however, is high. Courts typically only find bad faith "'Where the government made affirmative misrepresentations or conducted a civil investigation solely for the purposes of advancing a criminal case,' or where the Government has otherwise engaged in some form of fraud, trickery, or deceit."[54] For example, "[t]he mere failure of a revenue agent (be he regular or special) to warn the taxpayer that the investigation may result in criminal charges, absent any acts by the agent which materially misrepresent the nature of the inquiry, do not constitute fraud, deceit and trickery."[55]

Moreover, a defendant may need to overcome procedural hurdles to challenge a parallel proceeding based on bad faith. For example, district courts will not likely permit a fishing expedition of government's motives for conducting parallel proceedings and may require requisite showing of bad faith

[43] United States v. Kordel, 397 U.S. 1, 11-12 (1970).
[44] United States v. Scrushy, 366 F. Supp. 2d 1134 (N.D. Ala. 2005).
[45] *Id.* at 1136.
[46] *See generally id.*
[47] *Id.* at 1138.
[48] *Id.*
[49] *Id*. at 1139-40.
[50] *Id.* at 1139.
[51] *Id.* at 1140; *see also* S.E.C. v. Healthsouth Corp., 261 F. Supp. 2d 1298, 1326 (N.D. Ala. 2003) (citing Sterling Nat. Bank v. A-1 Hotels Int'l, Inc., 175 F. Supp. 2d 573, 579 (S.D.N.Y. 2001)) (describing the case as one "where the government has undoubtedly manipulated simultaneous criminal and civil proceedings."); United States v. Tweel, 550 F.2d 297, 298 (5th Cir. 1977) (government's deceit about an investigation may violate an individual's Fourth Amendment rights).
[52] *In re* Grand Jury Subpoena, 175 F.3d 332, 337 (4th Cir. 1999).
[53] United States v. Kilpatrick, 821 F.2d 1456, 1471 (10th Cir. 1987); *see also In re* Grand Jury Subpoena, 920 F.2d 235, 241 (4th Cir. 1990).
[54] United States v. Ogbazion, No. 3:15-CR-104, 2016 WL 6070365, at *3 (S.D. Ohio Oct. 17, 2016) (citing United States v. Stringer, 535 F.3d 929, 937-41 (9th Cir. 2008)).
[55] United States v. Marra, 481 F.2d 1196, 1203 (6th Cir. 1973) (quoting United States v. Prudden, 424 F.2d 1021, 1033 (5th Cir. 1970) (internal quotation marks omitted)); *see also* United States v. Posada Carriles, 541 F.3d 344, 354 (5th Cir. 2008) (reversing district court's finding that the government had acted in bad faith in conducting parallel proceedings).

prior to holding an evidentiary hearing. In at least some cases, courts have conditioned an evidentiary hearing on a showing of bad faith that is "sufficiently definite, specific, detailed, and nonconjectural to enable the court to conclude that contested issues of fact . . . are in question.'"[56]

Thus, parallel proceedings have practical and legal limitations, but the practical limitations are few, and the hurdles to halt a parallel proceeding or obtain a remedy in a criminal case are high.

III. Parallel Proceedings in Bankruptcy

Parallel proceedings in bankruptcy are not just common, but a staple of the bankruptcy process. Notwithstanding the commonality, however, there are several distinguishing characteristics of parallel proceedings involving bankruptcies and criminal investigations.

A. General Distinctions of Parallel Bankruptcy and Criminal Proceedings

1. Multiple Level Parallel Proceedings

While parallel proceedings typically involve one civil proceeding and one criminal proceeding, a bankruptcy case adds a third parallel proceeding. That is, an individual could be involved in a civil proceeding, a criminal investigation, and then file bankruptcy. The bankruptcy could be directly linked to the civil and criminal issues and both would be issues that the bankruptcy court could address.

Indeed, there could even be a fourth level of proceedings (or more). Because the Federal Rules of Bankruptcy Procedure permit parties to file independent lawsuits and adjudicate claims within the bankruptcy court,[57] a party could file an adversary proceeding in the bankruptcy court and litigate issues that are being addressed in the three other forums. For example, in *In re Gov't Sec. Corp*., the debtor sought to stay a bankruptcy adversary proceeding brought by the U.S. Trustee on the grounds that the SEC and possibly the FBI were investigating similar issues.[58] Although the bankruptcy court denied the request as speculative, debtors may encounter situations where similar issues are being addressed in three different forums.

Or, consider an individual who solicits investors for potential real estate investments and absconds with the funds. The SEC could investigate the individual for securities violations, the USAO could investigate potential criminal charges, and the individual could file bankruptcy to address the SEC's civil proceeding. If the victim investors have not already filed a state court action(s) to recover their funds, they could file an adversary proceeding(s) to enforce federal rights, including obtaining a judgment exempting the debt against the individual from discharge (or also remove state court fraud or contract claims to the bankruptcy court).[59] Bankruptcy cases may, therefore, create multiple layers of proceedings that are parallel to a criminal investigation.

2. Statutory Provisions Addressing Parallel Proceedings

Unlike other forums, bankruptcy courts have built-in statutory mechanisms to address civil and criminal parallel proceedings.

Section 362 is the best example. Section 362 automatically stays most types of proceedings once a debtor files bankruptcy.[60] The stay automatically halts the progress of other proceedings that could be

[56] United States v. Watson, 404 F.3d 163, 167 (2d Cir. 2005) (citing United States v. Pena, 961 F.2d 333, 339 (2d Cir. 1992)); *see also* United States v. Mahaffy, 446 F. Supp. 2d 115, 127 (E.D.N.Y. 2006).
[57] S*ee* FED. R. BANKR. P. 7001-87.
[58] *In re* Gov't Sec. Corp., 81 B.R. 692, 693 (Bankr. S.D. Fla. 1987).
[59] *See* FED. R. BANKR. P. 4007; 11 U.S.C.A. § 523 (2012) (amended 2016).
[60] 11 U.S.C.A. § 362 (2012).

adverse to the debtor, including state court actions (e.g., tort litigation, intellectual property disputes, and breaches of contract), foreclosure proceedings (judicial and non-judicial), tax adjudications, state and federal agency enforcement actions (e.g., EPA and SEC), etc. Debtors regularly file bankruptcy to avail themselves of this powerful tool and obtain breathing room from pending litigation.

Section 362(d) also provides a mechanism to obtain relief from the automatic stay. In appropriate circumstances, a creditor/adverse party can seek bankruptcy court authority to adjudicate the pending proceeding in another forum. The other forum may be the preferred forum with expertise and/or familiarity with the case. If the bankruptcy court grants the relief, the two proceedings proceed concurrently. Section 362's primary purpose is, therefore, to address parallel proceedings by balancing a debtor's need for breathing room against the best interests of creditors and the bankruptcy estate.

Section 362, however, specifically does *not* stay the commencement or continuation of a criminal investigation or case against a debtor.[61] Consequently, one of the most powerful tools of bankruptcy has no impact on criminal investigations or cases.

Thus, bankruptcy courts regularly address the implications of parallel proceedings and have statutory mechanisms to do so.

3. Additional Government Advantages

Beyond those advantages already discussed, the government has even greater advantages when a target files bankruptcy. Those additional advantages are: (1) enhanced discovery; (2) new criminal charges, and (3) secrecy.

Discovery

A bankruptcy exposes a debtor's financial secrets. A debtor gains the benefits of the automatic stay and discharge of debts, but a debtor must provide total financial transparency throughout the entirety of a bankruptcy proceeding, information that could be used in a later criminal prosecution.

Under § 521, every debtor has strict statutory "duties," including filing, among other things, a comprehensive schedule of income and expenditures, and a statement of financial affairs.[62] That duty is continuous and does not end at the bankruptcy filing.[63] A debtor has a further duty to cooperate with the case trustee to provide all necessary information for the efficient and effective liquidation of the bankruptcy estate.[64] These reporting and cooperation requirements can be arduous, often necessitating multiple amendments to a bankruptcy filing and lengthy disclosures to a trustee.

Case law similarly requires total transparency.

> [T]he hallmark of every bankruptcy case is transparency—the full, fair and timely disclosure of information that affects the administration of the estate. A debtor in possession is not fulfilling his obligations if he inhibits or delays the flow of information that should be available to the creditors, the United States Trustee or the court.[65]

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[61] § 362(b)(1).
[62] 11 U.S.C.A. § 521 (2012) (amended 2014); *see, e.g., In re* Wilkinson, 346 B.R. 539, 545 (Bankr. D. Utah 2006) ("the Debtor's statutory duty under § 521(a)(1) to file certain documents is both clear and unforgiving.").
[63] *In re* Superior Crewboats, Inc., 374 F.3d 330, 335 (5th Cir. 2004).
[64] § 521(a)(3) (debtors must "cooperate with the trustee as necessary to enable the trustee to perform the trustee's duties under this title."); *see also In re* Restaurant Development Group, Inc., 402 B.R. 282, 287 (Bankr. N.D. Ill. 2009) (Section 521(a)(3) "sets forth a general open-ended duty of the Debtor . . . to cooperate with the trustee.").
[65] *In re* Gordon Properties, LLC, 514 B.R. 449, 460 (Bankr. E.D. Va. 2013).

"Debtors must divulge *all* relevant facts in order to receive the full benefits and protections of the Bankruptcy Code, with the broad policy and goals of the Code 'favor[ing] transparency and disclosure whenever possible.'"[66] Thus, the Bankruptcy Code and public policy require full transparency.

In addition, the Bankruptcy Code includes additional discovery tools to achieve the goals of the bankruptcy case, discovery that can affect a criminal investigation. Two of those tools are the meeting of creditors pursuant to 11 U.S.C. § 341(a) and an examination pursuant to Bankruptcy Rule 2004.

Section 341(a) provides:

> Within a reasonable time after the order for relief in a case under this title, the United States trustee shall convene and preside at a meeting of creditors.[67]

Any creditor can attend a meeting of creditors and examine the debtor. The testimony is audio recorded and is under oath. The purpose of the meeting "is to enable creditors and the trustee to determine if assets have improperly been disposed of or concealed or if there are grounds for objection to discharge."[68] "The scope of examination at a § 341 meeting is quite broad . . ."[69] and "the Federal Rules of Evidence do not apply at a § 341 meeting."[70]

Bankruptcy Rule 2004 provides that the court may order the examination of the debtor or any party, including the production of documents and testimony under oath. The scope of the examination is as follows:

> The examination of an entity under this rule or of the debtor under § 343 of the Code may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge.[71]

The scope of a Rule 2004 examination is extremely broad. "Rule 2004 examinations have been characterized as 'fishing expeditions' because of the broad scope of inquiry the rule permits."[72] "[C]ourts have recognized that Rule 2004 examinations are broad and unfettered and in the nature of fishing expeditions."[73]

Moreover, production of discovery pursuant to a Rule 2004 examination preserves discovery that could otherwise be lost. While criminal investigations can take months or years to develop, oral testimony

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[66] *In re* McDowell, 483 B.R. 471, 477 (Bankr. S.D. Tex. 2012) (internal citations omitted); *see also In re* Bell & Beckwith, 44 B.R. 661, 664 (Bankr. N.D. Ohio 1984) ("This policy of open inspection, established in the Bankruptcy Code itself, is fundamental to the operation of the bankruptcy system and is the best means of avoiding any suggestion of impropriety that might or could be raised."); *In re* Crawford Furniture Mfg. Corp., 460 B.R. 586, 592 no.1 (Bankr. W.D.N.Y. 2011) ("The concept of transparency is manifest throughout the Bankruptcy Code.").
[67] 11 U.S.C.A. § 341(a) (2012).
[68] *In re* McFadden, 477 B.R. 686, 692 (Bankr. N.D. Ohio 2012) (citations omitted); *see also In re* Chandler, 66 B.R. 334, 337 (N.D. Ga. 1986) "[T]the purpose of the 341(a) meeting is discovery.").
[69] *In re* Woods, 69 B.R. 999, 1004 (Bankr. E.D. Pa. 1987).
[70] *In re* Morrison, 443 B.R. 378, 380 no.2 (Bankr. M.D.N.C. 2011) (The scope of a debtor's examination at a meeting of creditors is the same as the scope of a Rule 2004 examination); *but see In re* McFadden, 477 B.R. at 692 ("a creditor's examination of the debtor is not unfettered. '[I]f the debtor believes that the questions are beyond the scope permitted, or unduly repetitious, the debtor may object and even refuse to answer.'") (citing 3 COLLIER ON BANKRUPTCY ¶ 341.02[5][e], 341-13 (16th ed. 2011)).
[71] FED. R. BANKR. P. 2004.
[72] *In re* Hope 7 Monroe St. Ltd. P'ship, 743 F.3d 867, 874 (D.C. Cir. 2014) (citations omitted).
[73] *In re* Enron Corp., 281 B.R. 836, 840 (Bankr. S.D.N.Y. 2002); *In re* Washington Mut., Inc., 408 B.R. 45, 50 (Bankr. D. Del. 2009) (same); *but see In re* Strecker, 251 B.R. 878, 880 (Bankr. D. Colo. 2000) ("FED. R. BANKR. P. 2004 examinations are not an unfettered and totally unqualified tool for 'fishing' for adverse information.").

given in a bankruptcy may solidify testimony before a witness's memory fades.[74] The production of documents similarly preserves evidence that could otherwise be lost or destroyed during an extended criminal investigation.

To obtain the benefits of a bankruptcy, a debtor must, therefore, provide a large amount of information and subject him/herself to extensive discovery—all of which may be used against him or her in a criminal case.

New Criminal Charges

Unlike the classic parallel proceedings where an individual or entity is involved in a civil proceeding while simultaneously being investigated for criminal violations based on a similar known set of facts, the filing of a bankruptcy may create a brand new set of criminal violations that the government investigates in conjunction with a pending criminal investigation or independently. Depending on the strength of the pending investigation, these new criminal violations can either supplement or replace the existing case against a target.

Sections 152 through 157 set forth the bankruptcy crimes. These six sections contain numerous subparts and cover all forms of potential criminal conduct related to a bankruptcy case. The two primary sections are §§ 152 and 157. Section 152 contains nine subparts and criminalizes everything from the concealment of assets, to the making of false oaths and declarations in bankruptcy, to the withholding of information from a trustee. The section "attempts to cover all the possible methods by which a bankrupt or any other person may attempt to defeat the Bankruptcy Act through an effort to keep assets from being equitably distributed among creditors."[75] Section 157 criminalizes the use of a bankruptcy case to further a prepetition scheme. The "focus of § 157 is a fraudulent scheme outside the bankruptcy which uses the bankruptcy as a means of executing or concealing the artifice."[76]

Bankruptcy crimes can occur both at the time of filing and throughout the duration of the bankruptcy case. While §§ 152 and 157 both contain criminal violations that occur at the time of a bankruptcy filing, § 152 also criminalizes false oaths, declarations, claims etc. made at any time during a bankruptcy case.[77] Section 153 criminalizes embezzlement from a bankruptcy estate at any time. Thus, the filing of a bankruptcy may create additional charges to those being investigated prior to the bankruptcy.

Whether the investigation into new criminal bankruptcy fraud merges with a pending criminal investigation or forms the basis of a new investigation, however, depends primarily on the nature of the alleged pending criminal violations and what agencies are involved. By statute, the FBI is the agency tasked with investigating bankruptcy crimes,[78] although the IRS, HUD, Postal Service and other agencies also investigate these crimes on occasion. If the FBI is already investigating potential criminal violations and an individual then commits bankruptcy fraud, the investigation will likely merge. The FBI will likely expand its existing investigation and utilize the same grand jury. If, on the other hand, another agency having little to no familiarity with bankruptcy crimes is handling the existing criminal investigation, the FBI will likely open an independent investigation. While the two law enforcement agencies will undoubtedly share information, the investigations may be managed independently, depending on the peculiarities of the facts and litigation strategy.

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[74] *See In re* Anderson, 349 B.R. 448, 459 (E.D. Va. 2006) (affirming bankruptcy court denial of stay because witnesses' recollection of events was critical to the bankruptcy case).
[75] Stegeman v. United States, 425 F.2d 984, 986 (9th Cir. 1970) (citing 2 COLLIER ON BANKRUPTCY 1151 (14th ed. 1968)).
[76] United States v. Milwitt, 475 F.3d 1150, 1155 (9th Cir. 2007).
[77] *See* 18 U.S.C. §§ 152, 157 (2012).
[78] 18 U.S.C.A. § 158 (2012).

As a result of a bankruptcy, the government may, therefore, replace weaker charges with stronger bankruptcy related charges or add additional charges against a target.

Secrecy

The government also has the advantage of secrecy. Because the government does not initiate a bankruptcy (with the exception of an involuntary bankruptcy), it may have no role in the bankruptcy case, or a limited role as a creditor. The bankruptcy can proceed for months or years while a non-public criminal investigation is pending—all while the debtor/target is providing the disclosures required by the Bankruptcy Code, and providing oral testimony, under oath, during 341(a) meetings and Rule 2004 examinations. Since there are no limitations on the number of questions a trustee can ask during a meeting of creditors, and multiple creditors may take Rule 2004 examinations, the testimony may aggregate to numerous days of sworn testimony while the government quietly watches.

In addition, while law enforcement are secretly investigating a debtor/target, the bankruptcy trustee may be assisting a criminal investigation by providing access to incriminating evidence. In *United States v. Pavlock*,[79] a business called Michael's Automotive Services, Inc. filed bankruptcy. The case trustee seized control of all assets as required by the Bankruptcy Code and permitted the FBI to search the business's files.[80] Pavlock, a member and organizer of the entity, was criminally indicted and moved to suppress evidence against him that the FBI had obtained from a consent search of Michael's Automotive Services, Inc.[81] The district court rejected the challenge finding that the bankruptcy trustee was the party with authority to consent to any search and that the defendant had no standing to challenge the search.[82] There is, therefore, nothing inherently suspect about a trustee's cooperation with law enforcement, and trustees may consent to searches of a debtor's property, even without a debtor/target's knowledge.

Thus, when a debtor files a voluntary bankruptcy proceeding, criminal investigators gain a potentially significant discovery edge without unveiling the criminal investigation.

4. Distinctions in the Application of Parallel Proceeding Law

Bankruptcy courts apply the general law discussed above with respect to requests to stay a bankruptcy case pending the outcome of a criminal investigation and when determining whether the government abused a bankruptcy proceeding; however, the application of the authority differs given the peculiarities of bankruptcy cases.

Bankruptcy Stays

Bankruptcy courts apply the traditional factors when determining whether to stay a bankruptcy proceeding pending a criminal investigation or case.[83] Yet, their application differs as follows.

Public policy concerns, including the expeditious equitable distribution of assets to creditors, have significant implications on the stay analysis. For example, in *Romany v. Vidal*, the trustee served document subpoenas on third parties seeking evidence in support of a complaint to recover estate assets

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[79] United States v. Pavlock, No. 1:10CR07, 2010 WL 4702372, at *1 (N.D.W. Va. Oct. 26, 2010); United States v. Pavlock, No. 1:10-CR-7, 2010 WL 4683724 (N.D.W. Va. Nov. 12, 2010).
[80] *Id.* at 3-4.
[81] *See id.* at 3-5.
[82] *Id.* at 5.
[83] *E.g.*, *In re* Blankenship, 408 B.R. 854, 861 (Bankr. N.D. Ala. 2009) (applying Kordel to determine that a stay of the bankruptcy adversary proceeding was appropriate pending resolution of criminal charges.); *In re* Ross, 162 B.R. 860, 862 (Bankr. D. Idaho 1993) (analyzing traditional factors to determine if stay of bankruptcy case was warranted).

and avoid transfers.[84] The debtor/defendant moved to quash the subpoenas arguing, among other things, that "the federal interests in the bankruptcy arena cannot overshadow or supersede the constitutionally guaranteed rights of a criminal defendant when *identical issues* are raised in parallel proceeding."[85] The bankruptcy court rejected the argument finding that the policy goals of bankruptcy warranted denying the motion to quash. The bankruptcy court stated:

> The public interest in recuperating estate assets which the Trustee claims Debtor fraudulently transferred overcomes Debtor's undocumented fear [that the government will gain an unfair discovery advantage]. The effective enforcement of these bankruptcy provisions require an agile Trustee who moves quickly to recuperate estate assets. If the U.S. Attorney moves too slowly, then there is the real danger that witnesses may die or move away, assets may be hidden so effectively that the Trustee may not be able to located [sic] these, memories fade, documentary and physical evidence is lost, misplaced or destroyed.[86]

Bankruptcy courts may, therefore, elevate the concerns of the estate over prejudice to debtors facing a criminal investigation or case.

The impact on judicial resources may similarly affect the stay analysis. For instance, there could be multiple—even thousands—of persons involved in a bankruptcy and elaborate notice procedures set up to inform the massive number of parties-in-interest about important issues and events in a bankruptcy case, like the filing of proofs of claim against the estate. Putting the brakes on a bankruptcy may cause a tremendous strain on a bankruptcy court that has already adjudicated and established claims processes and timelines for reorganization. The bankruptcy court could be required to re-litigate issues, find ways to address the implications of the stay on the bankruptcy case and creditors, and equitably address creditors' concerns. In more complex bankruptcy cases with rapidly evolving dynamics, this would require the expenditure of significant court resources.

The analysis may also differ because bankruptcy cases are not necessarily "parallel" proceedings. If a bankruptcy court adopts the narrow definition of a parallel proceeding such as those used in abstention cases, a bankruptcy case—by definition—is not a parallel proceeding and could not be stayed.[87] Because a main bankruptcy case (not an adversary proceeding) involves numerous parties, including debtors, the trustee, the US Trustee, creditors, and other parties-in-interest, there can never be an exact identity of parties and issues between a bankruptcy case and a criminal investigation.[88]

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[84] *In re* Ortiz Romany, No. 04-03074 SEK, 2006 WL 3909778, *1 (Bankr. D.P.R. June 16, 2006).

[85] *Id.*

[86] *Id*. at 3; *see also In re* Gov't Sec. Corp., 81 B.R. 692, 694 (Bankr. S.D. Fla. 1987) (denying request for stay of adversary proceeding because public interests warranted prompt resolution); *In re* Financial Federated Title & Trust, Inc., 252 B.R. 834, 839 (Bankr. S.D. Fla. 2000) (denying stay because the "the public interest in administering the estate and compensating creditors, can only be served by resolving this Adversary Proceeding."); *In re* Blinder Robinson & Co., Inc., 135 B.R. 892, 898 (D. Colo. 1991) (declining to "second-guess" the bankruptcy court's refusal to stay an adversary proceeding).

[87] *See* Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Karp, 108 F.3d 17, 22 (2d Cir. 1997) ("Federal and state proceedings are "concurrent" or "parallel" for purposes of abstention when the two proceedings are essentially the same; that is, there is an identity of parties, and the issues and relief sought are the same."); *In re* Blixseth, No. 09-60452-7, 2011 WL 3274042, at *9 (Bankr. D. Mont. Aug. 1, 2011), order amended on denial of reconsideration, *In re* Blixseth, 463 B.R. 896 (Bankr. D. Mont. 2012) ("In the context of a motion for abstention in bankruptcy, a parallel proceeding requires "that the state proceeding involve the same issues as the federal proceeding.") (citing *In re* Bay Vista of Virginia, Inc., 394 B.R. 820, 843 (Bankr. E.D. Va. 2008)).

[88] *E.g.*, *In re* Financial Federated Title & Trust, Inc., 252 B.R. at 839 (denying stay request because, among other things, the government was not a party in the adversary proceeding).

The traditional factors that courts consider when granting a stay do not, however, *require* an identity of parties and issues, although the similarity of parties and issues are key factors.[89]

Abuse of Parallel Proceedings

The potential for abuse within a bankruptcy cases exists like any other parallel proceeding; however, there are several additional considerations that impact the abuse analysis.

One of the primary concerns in *Kordel*—whether the government abused the civil action by initiating it solely to obtain discovery—does not usually exist in the bankruptcy context.[90] Unlike a parallel regulatory or other civil proceeding, the government does not generally initiate a bankruptcy. With the rare exception of involuntary bankruptcy cases, debtors voluntarily initiate bankruptcies. The government has no control over a debtor's decision to file bankruptcy and the debtor voluntarily submits to the rigors of a bankruptcy to obtain the substantial benefits. Thus, the government cannot typically bring a bankruptcy "solely" to obtain evidence for a criminal prosecution. A bankruptcy proceeding, therefore, could not serve as an abusive pretext for the government to obtain improper discovery.

Moreover, even if the government does file an involuntary bankruptcy against a debtor while simultaneously investigating criminal violations, the filing of the bankruptcy is not inherently abusive. In *In re Caucus Dist., Inc.*, the U.S. was investigating Caucus Distributors, Inc. for potential criminal violations.[91] While the investigation was pending, the U.S. filed an involuntary bankruptcy against the company pursuant to Section 303(b).[92] The bankruptcy code permits creditors to file a bankruptcy on behalf of a debtor that is not paying its debts as they become due.[93] The debtor challenged the involuntary petition on the grounds that the government cannot in good faith file an involuntary bankruptcy against an entity that it is simultaneously investigating for criminal violations.[94] Although the court ultimately dismissed the case on other grounds, the court found "no improprieties in the prosecution of the parallel criminal and civil proceedings against the alleged debtors."[95]

Another concern in *Kordel* was whether the government advised the defendant in the civil proceeding that it contemplated criminal prosecution or lured the defendant into providing incriminating evidence.[96] Again, however, the government does not typically initiate a bankruptcy. Nor does the government compel a debtor to participate in § 341(a) meetings of creditors or other discovery, including Rule 2004 examinations. Unless the government has a specific reason to participate in the bankruptcy and conduct its own discovery, the debtor will provide information to third parties, and is statutorily obligated to do so. Thus, debtors may provide potentially adverse information regardless of the government's involvement. The government, therefore, cannot be accused of failing to advise a debtor of potential criminal implications when it may not even participate in the discovery.

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[89] *See* Keating v. Office of Thrift Supervision, 45 F.3d 322, 324-25 (9th Cir. 1995) (internal citations omitted); Microfinancial, Inc. v. Premier Holidays Int'l, Inc., 385 F.3d 72, 78 (1st Cir. 2004); *see also In re* Shubh Hotels Pittsburgh, LLC, 495 B.R. 274, 288 (Bankr. W.D. Pa. 2013) (the most significant threshold issue in determining whether to grant a stay is "the extent to which the issues in the civil and criminal cases overlap."); Ashworth v. Albers Med., Inc., 229 F.R.D. 527, 531 (S.D.W. Va. 2005) ("As a preliminary matter, the requirement of the existence of a nexus between the parallel proceedings sufficient to show that such proceedings are related and involve substantially similar issues is the threshold factor for a stay.").
[90] United States v. Kordel, 397 U.S. 1, 12-13 (1970).
[91] *In re* Caucus Distributors, Inc., 106 B.R. 890 (Bankr. E.D. Va. 1989).
[92] *Id.* at 893.
[93] 11 U.S.C.A. § 303 (2012) (amended 2016).
[94] *In re* Caucus at 893-95.
[95] *Id.* at 896.
[96] Kordel at 12-13.

In addition, debtors are generally aware that statements made in a bankruptcy case could be used against them in a criminal proceeding. Competent bankruptcy attorneys advise their clients that false statements can give rise to criminal liability and even include language in their engagement agreements about potential criminal liability. Bankruptcy petitions conspicuously advise debtors that the information is provided under penalty of perjury. Warning signs often hang on the wall in rooms where meetings of creditors occur reminding debtors that bankruptcy fraud is a crime. The Bankruptcy Code further mandates the referral of potential criminal activity to the USAOs. 18 U.S.C. § 3057 requires judges and trustees to refer potential criminal matters if they have "reasonable grounds" to believe a criminal violation has occurred.[97] 28 U.S.C. § 586(a)(3)(F) requires the local U.S. Trustee to notify the U.S. 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."[98] Consequently, while these things may not fully ensure all debtors are aware of the potential criminal implications of a bankruptcy, the chance that a debtor is wholly surprised by the use of their statements in a criminal case is lessened.

Intentional unfair collusion between the government and the bankruptcy trustee to further a criminal investigation is also unlikely. Bankruptcy trustees may permissibly facilitate a criminal investigation by, for instance, providing access to documents produced in a bankruptcy.[99] Indeed, they may be required to do so pursuant to the statutory requirements set forth in 18 U.S.C. § 3057, requiring the trustee to furnish "all the facts and circumstances of the case, the names of the witnesses and the offense or offenses believed to have been committed."[100] A chapter 7 trustee also has a statutory duty to independently investigate and administer assets of the estate. Under 11 U.S.C. § 323, the trustee is the estate's representative[101] and § 704(a)(4) requires a trustee to, among other things, "investigate the financial affairs of the debtor."[102] While that investigation may coincidentally assist criminal investigators, as long as the trustee has a justifiable reason for his/her actions to fulfill the statutory requirement, the collaboration is not unfair or abusive.

Inadvertent abuse is more likely. For instance, absent specific authorization, FED. R. CRIM. P. 6(e) prevents the disclosure of grand jury materials to bankruptcy trustees.[103] Criminal investigators and attorneys may, however, obtain information that significantly affects the administration of a bankruptcy case, including information about secret or fraudulently transferred assets. This information may be time sensitive and critical to a trustee's mission. Even though criminal prosecutors and investigators may attempt to rigidly adhere to those secrecy requirements, inadvertent disclosure may occur.

Notwithstanding the potential for inadvertent abuse, however, a finding of sanctionable abuse—the suppression of evidence of dismissal of a criminal case—is unlikely. To be sanctionable, the government's conduct must rise to the level of outrageousness and "[w]ill only be found in the rarest circumstances."[104] Those circumstances include trickery, deceit or affirmative material

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[97] 18 U.S.C.A. § 3057 (2012).
[98] 28 U.S.C.A. § 586(a)(3)(F) (2012).
[99] *See* United States v. Pavlock, No. 1:10CR07, 2010 WL 4702372, at *1 (N.D.W. Va. Oct. 26, 2010), report and recommendation adopted, No. 1:10-CR-7, United States v. Pavlock, No. 1:10-CR-7, 2010 WL 4683724 (N.D.W. Va. Nov. 12, 2010).
[100] § 3057.
[101] 11 U.S.C. § 323 (2012).
[102] 11 U.S.C. § 704(a)(4) (2012).
[103] FED. R. CRIM. P. 6(e).
[104] United States v. Posada Carriles, 541 F.3d 344, 353 (5th Cir. 2008) (citations omitted).

misrepresentations.[105] Inadvertent missteps will not rise to the requisite level warranting the suppression of evidence or dismissal of a criminal case; the misrepresentations/trickery/deceit must be deliberate.[106] So too with an inadvertent disclosure of grand jury materials, dismissal is "exceedingly rare."[107] "It is granted only where 'it is impossible to restore a criminal defendant to the position that he would have occupied vis-a-vis the prosecutor' or 'when the pattern of misconduct is widespread or continuous.'"[108]

Last, a parallel bankruptcy case and criminal investigation will not likely exhibit the same abusive characteristics as those addressed in *Scrushy*. While *Scrushy* held that the government abused the otherwise legitimate parallel proceeding process by merging the civil and criminal investigation, the government cannot merge a bankruptcy case and criminal investigation.[109] As discussed previously, debtors voluntarily initiate bankruptcies. Debtors, trustees, creditors and other parties then dictate the process—not the government. The government may not even participate and, if it does, it may be required as a creditor. Thus, unlike in *Scrushy* where the government brought both the civil and criminal investigation, controlled the proceedings and then merged them, the government cannot do the same in a bankruptcy absent some egregious interference with the role of the trustee and the trustee's violation of his/her statutory duties to act in the best interest of the estate.

Issues arising in parallel bankruptcy and criminal proceedings are, therefore, governed by the general law on the issue, but the application of those laws may vary greatly.

IV. Conclusion

Parallel bankruptcy and criminal proceedings are, therefore, typical is many legal respects, but can be wildly different in application.

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[105] United States v. Stringer, 535 F.3d 929, 940 (9th Cir. 2008) ("A government official must not "affirmatively mislead" the subject of parallel civil and criminal investigations 'into believing that the investigation is exclusively civil in nature and will not lead to criminal charges.'") (citations omitted).
[106] *See id.*
[107] United States v. Bellomo, 944 F. Supp. 1160, 1168 (S.D.N.Y. 1996).
[108] *Id.*
[109] United States v. Scrushy, 366 F. Supp. 2d 1134, 1140 (N.D. Ala. 2005).

The Bankruptcy System: A Valuable Resource for Fraud Prosecutions

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I. The Role of Bankruptcy in the Federal System

More than two-thirds of the cases in the federal judicial system are bankruptcy cases.[1] Consistent with this, United States Attorneys receive numerous referrals of potential criminal activity relating to bankruptcy, including thousands each year from the United States Trustee Program (USTP). Prosecution of bankruptcy-related crimes is integral to addressing and deterring criminal wrongdoing, as well as to protecting the integrity of the federal bankruptcy court system.

The bankruptcy system has roots going back well before the founding of the United States. The Constitution specifically grants Congress the power to enact nationwide laws on bankruptcy.[2] However, there was only short lived federal bankruptcy legislation until the Bankruptcy Act of 1898. Perhaps the main reason for this was the deep disagreement among those, often in the south and west, who advocated for the interest of debtors and those, often representing the great financial centers, who took the side of creditors. Similar tensions have persisted since then, leading to periodic and sometimes significant revisions to the bankruptcy laws. In addition to innumerable smaller changes, major changes to the bankruptcy laws have taken place in 1938 (the Chandler Act); 1978 (the Bankruptcy Reform Act of 1978); 1984 (the Bankruptcy Amendments and Federal Judgeship Act of 1984); 1986 (the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986); 1994 (the Bankruptcy Reform Act of 1994); and 2005 (the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

Thus, the bankruptcy system as it currently stands, represents a democratic compromise balancing the interests of debtors, creditors, and the system as a whole. This delicate accommodation of interests may be traced throughout the bankruptcy laws.

II. Structure of the Bankruptcy Code

For individuals, there are four chapters under which a bankruptcy petition may be filed, two of which are also available to businesses. In all of these, the basic approach is to marshal the debtor's assets (except those subject to exemptions) and distribute them to creditors, who in many cases will only receive a small percentage of their original claims.

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[1] *See* ADMIN. OFF. OF THE U.S. COURTS, *Table F. U.S. Bankruptcy Courts—Bankruptcy Cases Commenced, Terminated and Pending During the 12-Month Periods Ending September 30, 2016 and 2017.* (As of September 30, 2017, there were 1,069,373 pending bankruptcy cases in the United States); *see also* ADMIN. OFF. OF THE U.S. COURTS, *United States District Courts—National Judicial Caseload Profile*, (as of the same date there were 425,162 cases pending in district courts); and ADMIN. OFF. OF THE U.S. COURTS, *U.S. Court of Appeals—Judicial Caseload Profile*, (as of the same date, there were 39,400 appeals pending in the courts of appeals).
[2] U.S. CONST. ART. I, § 8, cl. 4.

Chapter 7 is the liquidation chapter, under which either an individual or a business turns over all nonexempt assets held as of the petition date to the chapter 7 trustee for distribution to creditors. A chapter 7 case, in general, takes less time to be completed than cases filed under other chapters, in part because there are no periodic payments to creditors from the debtor. Consistent with this, the discharge is generally granted within several months after the case is filed, unless the court orders otherwise. In 2005, to prevent abuse of this chapter—by, for instance, individuals with high incomes and substantial but exempt assets such as retirement accounts—Congress enacted more rigorous requirements. This enabled courts to dismiss cases for abuse, or to permit debtors to avoid dismissal by converting to another chapter, under which they make periodic payments to creditors. These anti-abuse provisions include a "means test" to require dismissal or conversion to another chapter when debtors have sufficient income to pay a significant proportion of their debts over time.

Chapter 11 provides for reorganization, under which either an individual or a business makes periodic payments to creditors pursuant to a plan. While the plan is in effect, the debtor must file periodic operating reports.

Chapter 12 provides for adjustment of debts by family farmers and is very similar to chapter 13, discussed below. It is, by a wide margin, the least used of the four chapters described here.

Chapter 13 provides for adjustment of debts for individuals who have regular income and whose debts do not exceed certain limits—currently, $394,725 in unsecured debts and $1,184,200 in secured debts.[3] Under this chapter, the debtor makes periodic payments to the chapter 13 trustee over a period ranging from three to five years for distribution to creditors under a plan, and obtains a discharge when all plan payments are completed. Typically, debtors are required to devote all of their disposable income, other than amounts needed to pay "necessary" expenses, to plan payments.

III. Powers of the Bankruptcy Court

Because of the need for prompt resolution of bankruptcy cases, bankruptcy judges can engage in comparatively summary resolution of cases and issues, and bankruptcy courts act as courts of equity when, for example, they are regulating relations between debtors and their creditors by the process of allowing and disallowing claims.[4] Thus, cases and issues in bankruptcy courts are typically decided much more quickly than cases in district courts.

Bankruptcy courts, as such, were first established by the Bankruptcy Reform Act of 1978, which was modified by the Bankruptcy Amendments and Federal Judgeship Act of 1984, after the Supreme Court found the 1978 legislation unconstitutional in part.[5] Before then, bankruptcy matters were generally handled by "referees" appointed by the district court. Unlike the district courts, bankruptcy courts are created under Article I of the Constitution, which addresses Congress' powers, not Article III, which deals with the powers of the judiciary. Bankruptcy judges are appointed for fourteen year terms, unlike district judges who have life tenure. Moreover, bankruptcy judges do not exercise jurisdiction independently; rather, they do so based on a reference by the district court for that district and as units of that district court.[6] Every district court has adopted rules or orders referring bankruptcy cases to the district court, but a district court has the power to withdraw the reference as to any case or proceeding.[7]

[3] 11 U.S.C. § 109(e) (2012) (amended 2016).
[4] *See*, *e.g.*, Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 56-59 (1989) (citing Katchen v. Landy, 382 U.S. 323, 336 (1966).
[5] *See* N. Pipeline Const. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982) (plurality opinion).
[6] 28 U.S.C. §§ 151, 157(a), (b) (2012).
[7] § 157(d).

Because bankruptcy courts are not Article III courts, the limits of their powers continue to generate substantial litigation, up to the level of the Supreme Court.[8] Moreover, bankruptcy courts' final decisions are subject to appeal to the district court,[9] or to a bankruptcy appellate panel, composed of bankruptcy judges, when such a panel has been established by the circuit's judicial counsel.[10]

Bankruptcy courts can enter final judgment only on "core proceedings"—which in the most common situations means proceedings directly tied to the bankruptcy estate, defined generally as nonexempt assets of the debtor.[11] Moreover, the Supreme Court has ruled that, even as to some core proceedings as to which Congress purported to confer jurisdiction upon bankruptcy courts, such courts cannot constitutionally enter final judgment.[12] In addition, bankruptcy courts cannot empanel juries (at least without all parties' consent),[13] and therefore cannot typically grant relief for which a jury trial is required.

Most courts that have addressed the issue have found that bankruptcy courts have no criminal contempt powers, although they can refer conduct to the district court to take whatever action it deems appropriate, including criminal contempt proceedings. However, most courts have found that bankruptcy courts have inherent powers to impose civil sanctions such as disgorgement or an award of attorneys' fees for bad faith conduct, although the Supreme Court has not provided definitive guidance on this.[14] In addition, under 11 U.S.C. § 105, Congress has empowered bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," including the authority to take action sua sponte to prevent abuse of process.[15] Among other things, courts have relied upon this provision to impose appropriate sanctions or other relief.[16]

IV. Debtors' Benefits and Duties

Historically, bankruptcy law was punitive to debtors.[17] However, over time, the law has developed into a mostly voluntary system that provides financially distressed individuals and entities the opportunity to address their debt under the protection of a federal law. The current bankruptcy law reflects the policy decision that honest but unfortunate debtors should be able to get a "fresh start" if they are willing to comply with the Bankruptcy Code's requirements.[18]

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[8] *See* Law v. Siegel, 134 S. Ct. 1188 (2014); Stern v. Marshall, 564 U.S. 462 (2011) (examples of recent Supreme Court decisions on bankruptcy court powers).

[9] FED. R. BANKR. P. 8004 (Interlocutory decisions can be appealed only if leave to appeal is granted).

[10] FED. R. BANKR. P. 8005(a) (Any party to an appeal has the right to compel the appeal to be heard in the district court rather than in the bankruptcy appellate panel).

[11] § 157(a), (b); *see also* 11 U.S.C. §§ 541 (amended 2016), 1115, 1207, 1306 (2012) (defining property of the estate).

[12] *See* Stern v. Marshall, 564 U.S. 462 (2011).

[13] 28 U.S.C. § 157(e) (2012).

[14] *See* Law v. Siegel, 134 S. Ct. 1188, 1194 (2014) (bankruptcy courts "may" have inherent powers); Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365, 375-76 (2007) (indicating that all courts, including bankruptcy courts, have inherent powers).

[15] 11 U.S.C. § 105 (2012).

[16] *See In re* Varan, No. 11 B 44072, 2014 WL 2881162 (Bankr. N.D. Ill. June 24, 2014) (example of a case in which the court granted the USTP's request for sanctions under section 105).

[17] *See* JAMES MADISON, NOTES OF DEBATES IN THE FEDERAL CONVENTION OF 1787, 571 (1987) (when bankruptcy was discussed at the Constitutional Convention in 1787, Roger Sherman questioned whether Congress might follow Britain's lead by making bankruptcy "in some cases punishable with death . . .").

[18] *See* Marrama, 549 U.S. at 367 ("The principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor") (internal quotation marks and citation omitted). Businesses are also allowed a "fresh start" under chapter 11. The reasoning here is that allowing businesses to restructure and continue in business helps

Bankruptcy's two primary benefits to debtors reflect the goal of a "fresh start": the automatic stay and the discharge. The automatic stay, 11 U.S.C. § 362,[19] typically goes into effect immediately upon the filing of a bankruptcy petition. The stay, among other things, prevents most creditors from seeking to collect debts from the debtor. The rationale is to provide a "breathing space" to allow the bankruptcy process to go forward. In some cases, however, unscrupulous debtors will file petitions in bankruptcy solely to obtain the immediate benefit of the automatic stay, even though they have no intention of going forward with the bankruptcy case.

While the automatic stay takes effect immediately, the discharge of the debtor's debts occurs at different points in the case depending on the chapter under which the case is filed. The discharge operates as an injunction that prevents creditors from seeking to collect debts after they have been discharged.[20] This, too, is intended to enable a "fresh start" for the honest but unfortunate debtor. Certain types of debts—such as those arising from fraud or crimes of moral turpitude, but also including criminal restitution, certain taxes, and student loans—are excepted from discharge.[21] In addition, a creditor holding a secured interest in property generally retains that lien or security interest, even if the debtor's personal liability has been discharged, and may foreclose upon the collateral with the permission of the bankruptcy court.

Congress has balanced these benefits to debtors with corresponding obligations. The bankruptcy system requires truthful disclosure by debtors. The debtor must provide extensive information including lists of creditors and statements of income, expenses, assets, and liabilities. These disclosure requirements are justified because of the substantial benefits that the debtor is seeking from the system. The information disclosed is filed with the court and is generally available on the public court docket. Moreover, debtors in chapter 11, 12, and 13 cases are generally required to maintain periodic postpetition payments to their creditors under the terms of their confirmed plans, either directly as in most chapter 11 cases, or through a trustee as (typically) in chapters 12 and 13.

Not surprisingly, some debtors fail to meet their obligations, instead filing false statements and concealing and unlawfully transferring assets. If a debtor fails to comply with his or her obligations, the Bankruptcy Code and Bankruptcy Rules permit various sanctions, including dismissal of the case; denial of discharge; lifting of the automatic stay; requiring conversion to another chapter; and imposing a bar on filing additional bankruptcy cases. As discussed below, criminal prosecution also plays a major role in ensuring the integrity of the bankruptcy system.

V. Creditors' Benefits and Obligations

The treatment of creditors similarly reflects a careful balancing by Congress of rights and obligations. The creditor must comply with the automatic stay and refrain from collection activity outside of the bankruptcy case. If the debtor receives a discharge, then the creditor must abide by the discharge injunction, except that, when there is a secured debt, the security interest itself will typically survive the discharge. Unsecured creditors are repaid from funds generated through the liquidation of assets in which the debtor has equity or, in chapter 11, 12, and 13 cases, from plan payments funded by the debtor's income. In most cases under chapter 7, unsecured creditors do not receive any payment because there are no assets with equity that can be liquidated.

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the economy and saves jobs. While creditors must make do with payment of only a fraction of their claims, they would often be even worse off if the business were forced to close its doors.

[19] 11 U.S.C. § 362 (2012).

[20] 11 U.S.C. § 524(a)(3) (2012).

[21] 11 U.S.C. § 523 (2012) (amended 2016).

However, the bankruptcy process also benefits creditors in several respects. First, having a trustee marshal the debtor's assets under federal law helps to ensure that similarly situated creditors receive equal treatment. Moreover, creditors benefit from a streamlined process for seeking repayment. As long as the creditor files a proof of claim that complies with the Bankruptcy Rules, that proof of claim is treated as prima facie valid.[22] Thus, the filing of a proof of claim guarantees the allowance of the claim unless a party in interest, such as the debtor or trustee, files an objection and can make a showing overcoming the claim's prima facie validity.

While promoting the speedy resolution of bankruptcy cases, these provisions are subject to abuse. For example, some creditors engage in practices sometimes referred to as "robo-signing," which may involve the systematic submission of false verifications under penalty of perjury. Sometimes, a company will have an employee charged with signing numerous documents—sometimes thousands a day—"under penalty of perjury" without having any knowledge of the underlying document. Sometimes a company will skip even this and simply affix a person's signature "under penalty of perjury" to thousands of documents automatically with a computer program, even though the purported signer has never seen any of the documents and has no knowledge of their contents. Some companies have had people "pre-sign" affidavits—that is, provide a signature that can then be freely placed on affidavits that the purported signer has never seen. Finally, some companies have also engaged in what could be called "robo-notarizing": routinely giving a notary a stack of previously signed documents and having the notary authenticate them as having been signed in the notary's presence.

VI. Professionals

It is important for debtors to have legal representation, and therefore, the Bankruptcy Code permits debtors' attorneys under chapters 11, 12, and 13 to be paid out of funds belonging to the bankruptcy estate—funds that would otherwise be available for distribution to creditors.[23] Because of this, and the fact that the debtor is dependent upon counsel, there may be less incentive for a debtor to monitor attorneys' fees, given that excessive fees may harm only the debtor's creditors. Partly to compensate for this, fees of debtors' counsel are generally subjected to more scrutiny by the court system than fees of counsel in non-bankruptcy cases. Attorneys are required to disclose their fees and fee arrangements, and can be required to disgorge excessive amounts.[24] In cases under chapter 11, the court must approve any attorneys' fees awarded to the debtor's counsel and creditors' committee counsel. The USTP frequently objects to fee applications when the fees requested are, for example, unnecessary, unreasonable, unsubstantiated, or above prevailing market rates.[25] The USTP has issued fee guidelines, including

[22] FED. R. BANKR. P. 3001(f).
[23] *See* 11 U.S.C. §§ 327(a) (trustee may employ attorneys); 330(a) (court may award compensation to professionals employed under section 327); 330(a)(4)(B) (court may allow compensation to counsel for individual chapter 12 and 13 debtors); 1107(a) (2012) (chapter 11 debtor in possession has rights, functions, and duties of trustee).
[24] 11 U.S.C. § 329 (2012).
[25] *See In re* Boomerang Tube, Inc., 548 B.R. 69 (Bankr. D. Del. 2016) (court upheld the USTP's objection relating to a fee application).

guidelines specifically addressing larger chapter 11 cases, to help address this issue.[26] Finally, several other provisions of the Bankruptcy Code and Rules regulate the conduct of attorneys.[27]

Some lawyers and law firms have engaged in misconduct or abuse of the bankruptcy system, often aided by their knowledge of the system. Bankruptcy lawyers have been sanctioned for a wide range of misconduct, including filing fraudulent schedules and statements; altering documents; signing documents on behalf of clients without their knowledge; lying to clients, to courts, or to other parties; concealing a debtor's assets; and misrepresenting the amount or timing of their fees, the work they performed, whether they have shared fees with others, and whether they had conflicts of interest.

VII. Third Parties

Because of the large amounts of money that flow through the bankruptcy system, entire industries have grown up in connection with it. Some of them seek to take unlawful advantage of various parties. Inevitably, the bankruptcy system has inspired schemes by entities that abuse specific rights afforded by the system.

Some of the best known examples are entities engaged in so-called "foreclosure rescue" schemes.[28] These schemes take many forms, but are often targeted at exploiting the automatic stay. For example, under some foreclosure rescue schemes, borrowers are persuaded to file fraudulent (and sometimes multiple) bankruptcy petitions. In other schemes, borrowers who wish to stave off foreclosure are inveigled into transferring a fractional interest in their homestead to a third party. The scheme operator then files a bankruptcy petition in the third party's name, triggering the automatic stay as to the entire property. In many schemes, homeowners are unaware that bankruptcy cases have been filed in their names by the scheme perpetrators.[29]

Another prominent example of third party exploitation of the bankruptcy system occurs when bankruptcy petition preparers and non-lawyer debt relief agencies engage in the unauthorized practice of law, often giving the false impression that they are lawyers or are working with lawyers, and purporting to provide advice and legal services to consumers. Congress has specifically addressed these practices in the Bankruptcy Code.[30] Sometimes, even when these entities are shut down, the same principals simply start a new entity to carry on the misconduct under a new name.

Some debt relief agencies (which can include both law firms and other entities) have built up substantial businesses through the use of systematic misrepresentation about the nature of the services

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[26] *See* U.S. DEP'T. OF JUSTICE, *Appendix A–Guidelines for Reviewing Applications for Compensation filed under 11 U.S.C. § 330 in (1) larger chapter 11 cases by those seeking compensation who are not attorneys, (2) all chapter 11 cases below the larger case thresholds, and (3) cases under other chapters of the Bankruptcy Code* (1996); U.S. DEP'T. OF JUSTICE, *Appendix, B–Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed under 11 U.S.C. § 330 for Attorneys in Larger Chapter 11 Cases* (2013); 28 C.F.R. § Pt. 58, App. A (2018).

[27] *See, e.g.*, 11 U.S.C. §§ 101(12A) (amended 2016); 327-328; 707(b)(4) (2012) (amended 2016); FED. R. BANKR. P. 2014, 2016, 2017, 9011. Some lawyers and law firms for debtors come within the definition of "debt relief agency," § 101(3), (12A); in that case, they are subject to the provisions governing debt relief agencies, 11 U.S.C. §§ 526, 527, 528 (2012), discussed in the following section.

[28] *See* FED. BUREAU OF INTELLIGENCE, *US Bankruptcy System Exploited to Perpetuate Foreclosure Rescue Schemes* (2010). The USTP assisted the FBI with this assessment.

[29] See *False Promises; California Man Sentenced for Operating Foreclosure Rescue Scheme*, FED. BUREAU OF INTELLIGENCE (2017).

[30] § 101(3), (12A), 11 U.S.C. § 110 (2012), §§ 526, 527, 528 ("Debt relief agencies" are providers of bankruptcy assistance to persons whose debts are primarily consumer debts and whose nonexempt property is less than $192,450—generally, less affluent debtors).

they provide and the people providing them. Sometimes, a debt relief agency will advertise legal services in a jurisdiction in which it has no right to practice. When a prospective debtor contacts such an entity, the entity collects a fee and provides extensive legal advice, sometimes through non-lawyers, and then assigns the case to a local lawyer in the prospective debtor's jurisdiction. The debt relief agency pays the local lawyer a share of the fee it received. It may also continue to do much of the legal work, such as the preparation of bankruptcy papers, while the local lawyer's role is to sign the pleadings and appear in court. These firms may engage in systematic misrepresentation in court filings about who is representing the client, the amount of the fee, and the fact that the fee has been shared, in an effort to conceal or obfuscate the relationships among the debtor, the debt relief agency, and the local attorney.[31] For example, the entity may seek to justify its conduct and evade legal requirements by claiming that the local lawyers are its "partners" or "members," even though there is no legal partnership. In some cases, the debtors are uncertain about who is representing them and whether the people they have received legal advice from are attorneys.[32]

VIII. Private Trustees

In chapters 7, 12, and 13, as well as some chapter 11 cases, the debtor's assets are marshalled and distributed by a trustee who is appointed by the United States Trustee. These individuals are often called private trustees or case trustees to distinguish them from the United States Trustee. Chapter 12 and chapter 13 trustees are typically "standing" trustees assigned to all cases within a geographic area, while chapter 7 trustees are members of a panel to whom cases are assigned.[33] Chapter 11 trustees are selected by the U.S. Trustee after consultation with the parties. The bankruptcy court approves the candidate.

The trustee is the representative of the bankruptcy estate, 11 U.S.C. § 323,[34] and has the duty to investigate the debtor's financial affairs. Private trustees are not government employees or agents.

IX. The United States Trustee Program

The USTP was established by Congress as a pilot program in 1978 and was expanded nationally in 1986. The USTP, which consists of an Executive Office and 21 regions, [35] is intended to be the "watchdog" of the bankruptcy system.[36]

The USTP's mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors and the public. As noted above, the USTP appoints and supervises private trustees, and it is also responsible for taking other actions to ensure the progress of

[31] 11 U.S.C. § 329(a) (2012) (All lawyers representing a debtor in connection with a bankruptcy case are required to file statements in court of the compensation paid and its source); *see also* FED. R. BANKR. P. 2016 (same).
[32] *See* Robbins v. Delafield (*In re* Williams), No. 15-71767, 2018 WL 832894 (Bankr. W.D. Va. Feb. 12, 2018); Robbins v. Barbour (*In re* Futreal), No. 15-70886, 2016 WL 2609644, at 10-11 (Bankr. W.D. Va. May 5, 2016).
[33] 28 U.S.C. § 586(a), (b) (2012) (in districts in which the USTP has not appointed a standing trustee under chapter 12 or 13, it maintains a panel of trustees similar to those under chapter 7).
[34] 11 U.S.C. § 323 (2012).
[35] United States Trustees cover every state except Alabama and North Carolina, where similar duties are undertaken by Bankruptcy Administrators.
[36] *See* H.R. Rep. No. 95-595, at 4, 88 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 5966, 6049; *see also, e.g.*, *In re* S. Beach Sec., Inc., 606 F.3d 366, 370, 371 (7th Cir. 2010); Curry v. Castillo (*In re* Castillo), 297 F.3d 940, 951 (9th Cir. 2002); Charges of Unprofessional Conduct 99-37 v. Stuart, 249 F.3d 821, 824 (8th Cir. 2001); Morgenstern v. Revco D.S., Inc., 898 F.2d 498, 500 (6th Cir. 1990); A-1 Trash Pickup v. United States Trustee (*In re* A-1 Trash Pickup), 802 F.2d 774, 776 (4th Cir. 1986).

bankruptcy cases.[37] More broadly, the Bankruptcy Code specifically grants the USTP the right to raise and be heard on almost any issue in any bankruptcy case without obtaining leave of court.[38]

The USTP also has the right to be served with filings in any bankruptcy case, and the USTP's role in supervising private trustees ensures that it is frequently in contact with trustees who can provide information about cases in which they are involved. The USTP reviews information filed in bankruptcy cases, investigates suspected instances of civil abuse, and pursues civil enforcement actions to address such conduct when appropriate. Federal Rule of Bankruptcy Procedure 2004 allows the U.S. Trustee and other parties in interest to obtain sworn pre-litigation testimony in bankruptcy cases. Rule 2004 examinations permit inquiry into the debtor's acts, conduct, property, liabilities, or financial condition, and into any matter that may affect the administration of the bankruptcy estate or the debtor's right to a discharge. In chapters 11, 12, and 13, the examination may also cover any other matter relevant to the case.[39] Many courts have stated that this rule legitimately authorizes a "fishing expedition" into the financial affairs of the debtor and, sometimes, other parties.[40] As discussed below, the USTP has also played a major role in assisting the prosecution of bankruptcy related crimes.

X. Criminal Enforcement and Bankruptcy

Criminal prosecutions deter misconduct in the bankruptcy system and protect the integrity of the federal bankruptcy court. Congress has enacted an entire chapter of title 18 on bankruptcy crimes.[41] This chapter includes broad felony provisions prohibiting the making of knowing and fraudulent false statements in bankruptcy proceedings.[42]

Congress' intent to protect the bankruptcy court system is reflected in several provisions in Title 18. Judges, receivers, and private trustees are required to notify the United States Attorney in their district about bankruptcy related criminal activity.[43] United States Attorneys and the Federal Bureau of Investigation are required to designate individuals within their offices who are primarily responsible for addressing bankruptcy fraud.[44] The USTP is required to make referrals to the United States Attorneys not only regarding bankruptcy related offenses, but also as to any conduct that may constitute a federal crime, and to assist the U.S. Attorney upon request.[45] In addition, the USTP is required to report to Congress each year on the number and progress of criminal referrals it makes.[46]

Notably, the issue of criminal conduct involving the bankruptcy system goes well beyond the literal "bankruptcy crimes" set forth in 18 U.S.C. §§ 151-157.[47] The bankruptcy system is often at the crossroads of criminal schemes that may involve violations of many different laws, including tax,

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[37] 28 U.S.C. § 586(a), (b) (2012).
[38] 11 U.S.C. § 307 (2012).
[39] FED. R. BANKR. P. 2004(b).
[40] *See, e.g.*, *In re* Hope 7 Monroe St. Ltd. P'ship, 743 F.3d 867 (D.C. Cir. 2014); Simon v. FIA Card Services, N.A., 732 F.3d 259, 278 & n.6 (3d Cir. 2013); St. Clair v. Cadles of Grassy Meadows II, L.L.C., 550 B.R. 655, 668 (E.D.N.Y. 2016); *In re* Gray, 447 B.R. 524, 532 (E.D. Mich. 2011).
[41] *See* 18 U.S.C. §§ 151-158 (2012) (chapter 9).
[42] *See, e.g.*, 18 U.S.C. § 152 (2012) (concealment of assets; false oath or account; false declaration or claim); 18 U.S.C. § 157 (2012) (filing document in furtherance of scheme to defraud).
[43] 18 U.S.C. § 3057(a) (2012).
[44] 18 U.S.C. § 158 (2012).
[45] 28 U.S.C. § 586(a)(3)(F).
[46] Violence Against Women and Department of Justice Reauthorization Act of 2005, Pub. L. No. 109-162, § 1175, 119 Stat 2960; H.R. REP. 108-805, 144 (requires "an annual report to the Congress" detailing (*inter alia*) "the number and types of criminal referrals made by the United States Trustee Program," "the outcomes of each criminal referral," and the reason for any decrease in referrals from the prior year).
[47] §§ 151-157.

narcotics, banking, and securities laws. Because of the automatic stay, a company or individual engaged in illegal activity will sometimes file a bankruptcy petition as a way of staving off creditors while continuing the illegal conduct. In some cases, a debtor's non-bankruptcy crimes may come to light only because of the bankruptcy case—in part because the bankruptcy process allows extensive discovery into the conduct of the debtor and other participants in the system, and in part because a bankruptcy filing triggers the involvement of parties, such as the United States Trustee, private trustees, and creditors' committees, with the authority and the incentive to investigate wrongdoing.

The USTP in particular has the expertise to play a significant role in the prosecution of bankruptcy-related offenses—including not only bankruptcy crimes, but other crimes that come to light as a result of the bankruptcy process. Congress has charged the USTP, "on the request of the United States attorney, [with] assisting the United States attorney in carrying out prosecutions . . ."[48] Accordingly, some USTP personnel have been designated as Special Assistant United States Attorneys (SAUSAs) to prosecute cases, and others have provided valuable assistance by, for example, consulting on aspects of bankruptcy law or testifying at trial on bankruptcy procedures.

XI. Recent Prosecutions Resulting From USTP Referrals

There are numerous instances in which the USTP's involvement in a bankruptcy case has led to the successful prosecution of criminal conduct, often going well beyond the bankruptcy case itself. Set forth below are a few recent examples of prosecutions resulting from USTP criminal referrals.

In Portland, Oregon, John Michael Harder, the chief executive officer of a company that controlled assisted living facilities, was sentenced to fifteen years in prison based on his guilty plea to mail fraud and money laundering in connection with potentially the largest investment fraud in Oregon history, involving the defrauding of more than 1,000 investors out of approximately $130 million. Harder had assured investors that the company was successful and that their funds would be invested in specific assisted living facilities, when in fact the business was failing and large amounts were diverted to Harder's personal use. Discovery of the scheme followed Harder's filing of bankruptcy for himself and for twenty-seven of the facilities. The USTP referred the matter to the United States Attorney.[49]

Similarly, in Phoenix, Arizona, John Keith Hoover, a lawyer, developer, and chapter 7 debtor, was sentenced to ten years in prison for wire fraud and conspiracy to commit bankruptcy fraud, after raising more than $20 million from 500 investors for nonexistent land developments, diverting the money to his own use (including the acquisition of a Paris apartment and a $200,000 Bentley), and then failing to disclose assets in his bankruptcy case. The USTP made a criminal referral, and a USTP Trial Attorney served as a SAUSA.[50] Hoover's wife was also prosecuted and was sentenced to home confinement.

In San Antonio, Texas, a chapter 7 debtor named Elpidio Gongora, who had operated the law offices of several personal injury attorneys, pleaded guilty to conspiracy to commit mail fraud, bankruptcy fraud, and tax evasion. By filing for relief under chapter 7 and submitting false statements of assets, Gongora initiated a sequence of events that led to the discovery of an extensive scheme involving Gongora and three other alleged conspirators (all of whom were indicted), to defraud law firm clients of

[48] § 586(a)(3)(F).
[49] *See* Press Release, U.S. Dep't of Justice, Jon Harder Former CEO of Sunwest Management, Enters Guilty Pleas to Federal Fraud Offenses (Jan. 8, 2015).
[50] *See* Press Release, U.S. Dep't of Justice, Developer Sentenced to 10 Years for Investment and Bankruptcy Fraud (Jan. 27, 2016).

settlement checks and to willfully evade paying more than $1.6 million of federal income taxes.[51] The USTP referred the conduct and provided assistance to law enforcement.

Another chapter 7 debtor, Ellis Wamsley IV, was sentenced in Dallas to fifty-four months in prison and ordered to pay $1.85 million in restitution after pleading guilty to one count of money laundering in connection with an investor fraud scheme. The USTP discovered that Wamsley had failed to disclose his ownership of an Aston Martin in his bankruptcy case and had engaged in unexplained transfers of funds. Wamsley raised $2 million from investors purportedly for economic development projects, but instead spent money on vehicles and a $200,000 Super Bowl party.[52]

In a case in Baton Rouge, William Ros, the chief financial officer of a company that operated thirty Popeyes' Fried Chicken restaurants, was sentenced to forty-five months in prison and two years of supervised release and ordered to pay restitution of nearly $1 million after pleading guilty to wire fraud and embezzlement. Ros operated a fraudulent scheme to divert almost $1 million in company assets to his personal use, including the purchase of a $225,000 racecar. He continued the scheme throughout the company's chapter 11 case as well as a later involuntary chapter 7 case. The USTP made a criminal referral and provided assistance to law enforcement.[53]

In Cleveland, chapter 7 debtor James W. Wallace was sentenced to three years and five months in prison and three years of supervised release, and ordered to pay $900,415 in restitution after pleading guilty to bankruptcy fraud and conspiracy to commit wire and mail fraud. Wallace and his business partner defrauded fifteen individuals of at least $1.5 million through purported private lending schemes to purchase and invest in "aged shelf corporations"—companies that were created years in advance and existed on paper but never engaged in business. When Wallace filed bankruptcy, he made false statements by failing to disclose bank accounts, income, creditors, and executory contracts.[54] The U.S. Trustee referred the criminal matter and provided assistance to law enforcement.

XII. Conclusion

Criminal prosecution of bankruptcy related offenses is key to protecting the integrity of the bankruptcy court system. At the same time, the bankruptcy system is a valuable resource for detecting criminal conduct, including not only bankruptcy crimes but also many other offenses such as securities, mail, wire, tax, and bank fraud. These crimes may come to light only because a wrongdoer sought protection under the bankruptcy laws or otherwise participated in the bankruptcy system, thereby triggering disclosure requirements, civil discovery, and possible civil enforcement inquiries or actions by the USTP or other third parties targeting fraud and abuse. The USTP stands ready to assist prosecutors

[51] *See* Press Release, U.S. Dep't of Justice, San Antonio Businessman Enters Guilty Plea to a Scheme Involving Defrauding Personal Injury Clients, Tax Evasion and Hiding Assets from U.S. Bankruptcy Trustee (July 28, 2016).
[52] *See* Press Release, U.S. Dep't of Justice, Grand Prairie Man Sentenced to 54 Months in Federal Prison after Pleading Guilty to Felony Offense Stemming from his Work with FAIM Economic Development Corporation (Oct. 27, 2016).
[53] *See* Press Release, U.S. Dep't of Justice, Former Chief Financial Officer Of Restaurant Chain Pleads Guilty To Wire Fraud And Embezzlement From Bankruptcy Estate (Feb. 4, 2016).
[54] *See* Press Release, U.S. Dep't of Justice, North Canton man charged with conspiracy to commit wire fraud and bankruptcy fraud (Apr. 22, 2016).

and investigators to ensure that bankruptcy-related crimes are addressed and the integrity of the bankruptcy system is protected.

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Bankruptcy Fraud Charging Decisions

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I. Introduction

For white collar criminals perpetrating various types of financial fraud, the logical progression from their misconduct is often the filing of bankruptcy. The deception of investors and consumers culminates in the deception of the Court during the bankruptcy process. Within the District of Arizona, there have been a number of cases involving financial fraud that is compounded by and often detected through bankruptcy filings. This was particularly acute following the financial meltdown in October 2008 and its aftermath. Three cases in particular demonstrate the tactical advantages of pursuing bankruptcy fraud charges in connection with wire, bank, and mail fraud charges, as well as the usefulness of ongoing coordination between the United States Trustee's Office and the United States Attorney in terms of prosecuting financial fraud.

II. United States v. Jay Perry[1]

Arizona has numerous retirement communities. Unfortunately, some investment fraudsters target elderly investors who may be particularly susceptible to such schemes. One such scheme involved thirty-three year old Jay Perry, who in 2008 was a self-proclaimed estate and financial planner who represented himself as the President of Kramer and Kramer Estate Planning. A common fraud utilized by Perry encouraged investors to roll their Individual Retirement Accounts ("IRAs") into self-directed IRAs, which allowed the fraudster access to secure, tax deferred investment vehicles. Perry pursued elderly clients, advising them to liquidate otherwise sound investments, such as annuities, in order to invest in real estate owned by Perry. The real estate in which clients invested consisted of commercial property (referred to as the Reems property) as well as other Arizona properties purchased by Perry with investor funds. Perry misrepresented to his elderly clients that their investments were secured through liens on the real estate and that the investments would produce a steady, safe income stream.

At a time when Perry was in default on the Reems property mortgage and owed several clients more than $290,000, Perry filed a bankruptcy petition, seeking to have his debts discharged in a Chapter 7 liquidation proceeding. During the bankruptcy proceeding, Perry continued to solicit more elderly clients, acquiring more than $750,000 in additional investment funds.

Perry made numerous false statements in his bankruptcy pleadings. He misrepresented that his business entities, through which he was collecting hundreds of thousands of dollars of investments and "fees," had no value, and he specifically omitted thousands of dollars of funds held in entity accounts as of the date of the bankruptcy filing.

In his bankruptcy pleadings, Perry provided no address for a number of the purportedly secured investor victims to whom he was indebted by virtue of investments in the Reems property. As a result,

[1] United States v. Jay Perry, Case 2:11-cr-02991-PGR (District of Arizona).

those victims received no notice that Perry was in bankruptcy or that the Reems property, on which the victims believed they had liens, was surrendered to the bank to foreclose on its primary lien.

Typically, fraud cases are referred by the United States Trustee's Office to the United States Attorney's Office for consideration of criminal prosecution for bankruptcy fraud, among other crimes. In the Perry case, however, the federal prosecutor pursuing the investment fraud charges determined that it would be worthwhile to inquire whether Perry's bankruptcy filings gave rise to any potential bankruptcy fraud charges.

The prosecutor contacted the local U.S. Trustee's Office and asked for the U.S. Trustee to examine the bankruptcy filings to determine whether, in light of the facts known to the prosecutors, Perry had concealed assets or committed other fraud related to the bankruptcy filing. The U.S. Attorney's Office recognized that the U.S. Trustee had unique experience and expertise in understanding the bankruptcy process and the nature of the bankruptcy filings. The U.S. Trustee was able to expeditiously review the bankruptcy filings that would be most pertinent to the bankruptcy fraud investigation and to assist the criminal investigators and prosecutor in understanding the context in which the defendant's statements in bankruptcy were made.

In 2011, Perry was indicted on thirteen counts of mail fraud, wire fraud, and bankruptcy fraud under 18 U.S.C. § 157,[2] as well as false oaths in bankruptcy under 18 U.S.C. § 152(3).[3] As the Perry case demonstrated, bankruptcy fraud charges served as a potent accompaniment to the conventional investment fraud charges of mail, wire, and bank fraud. Fraud perpetrated on investors relies in large part on misrepresentations made during the pitch of the investment opportunity and, thus, often requires fact intensive evidence of various communications and falsehoods to investors. By contrast, proving bankruptcy fraud is typically less ambiguous, generally requiring proof of the defendant's sworn bankruptcy pleadings and of their knowing falsehood.

In the Perry case, litigation risks were presented on the mail and wire fraud charges because many of the victims were unable to accurately recall the precise representations Perry made in connection with his investment offering. The bankruptcy fraud charges were more straightforward, as Perry's falsehoods in his own sworn bankruptcy proceedings were stark and unambiguous. Ultimately, Perry pled guilty to the bankruptcy fraud scheme and was sentenced to 48 months of incarceration. The victims were also able to realize nearly $300,000 in restitution from the liquidation of properties acquired with their own funds.

III. United States v. Paige Kinney a.k.a. JaimeLee Lawler[4]

JaimeLee Lawler was a mortgage loan officer in Phoenix from 2005 to 2010. Between 2005 and 2007, Lawler engaged in a $40 million mortgage fraud scheme that targeted Countrywide Home Loans. The fraud consisted of a "cash back" scheme pursuant to which Lawler recruited "straw buyers" to obtain mortgage financing through falsified loan applications in which Lawler misrepresented the straw buyer's income, assets, employment status, and liabilities. Typically, the straw buyer would obtain loans in amounts exceeding the sale price. Once the loan funds were received, the extra proceeds above the purchase price, known as the "cash back," would be directed to bank accounts that Lawler controlled. Over $8 million of cash back funds were directed to Lawler's accounts and were used for the purchase of luxury vehicles, jewelry, and homes in Phoenix and San Diego.

In 2009, Lawler legally changed her name to Paige Kinney and obtained a new social security number. Less than a year later, Kinney filed a Chapter 11 bankruptcy petition under her prior name, JaimeLee Lawler, disclosing only her previous social security number. Despite being required to disclose in the bankruptcy petition all names, aliases, and social security numbers used by the debtor, Lawler made

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[2] 18 U.S.C. § 157 (2012).
[3] 18 U.S.C. § 152(3) (2012).
[4] United States v. Paige Kinney a.k.a. JaimeLee Lawler, Case 2:11-cr-00491-ROS (District of Arizona).

no disclosure of her new name, Paige Kinney, or her new social security number. She also failed to disclose eight credit accounts held in the name of Paige Kinney, two vehicles registered in the name of Paige Kinney, and six additional vehicles owned in the name of JaimeLee Lawler.

In June 2010, one month after filing her bankruptcy petition, Lawler was indicted on thirty counts of wire fraud, money laundering, and conspiracy based on the mortgage fraud scheme she had perpetrated during 2005 and 2006. In the course of the criminal case, the federal prosecutor discovered that Lawler had filed for bankruptcy. As in the Perry case, the prosecutor contacted the local U.S. Trustee's Office to request assistance in reviewing the bankruptcy filings to determine whether Lawler had committed bankruptcy fraud in addition to the other frauds she had been charged with. The U.S. Trustee's Office and the U.S. Attorney's Office coordinated their analysis of the bankruptcy crime issues and concluded that charges against Lawler under §§ 152 and 157 would be appropriate.

Ten months after the original indictment, in April 2011, a separate indictment was presented to the grand jury to include counts of bankruptcy fraud and additional counts of wire and bank fraud against Kinney a.k.a. Lawler. The bankruptcy fraud charges against Lawler included ten counts of bankruptcy fraud under 18 U.S.C. § 157 and four counts of false declarations in bankruptcy under 18 U.S.C. § 152(3). Ultimately, Lawler pleaded guilty to wire fraud, mail fraud, bank fraud, bankruptcy fraud under § 157, and false declarations in a bankruptcy under § 152, and was sentenced to fifteen years in prison.

In March 2012, the United States Trustee's Office filed a civil complaint against Lawler in the bankruptcy case, seeking to have Lawler's discharge denied. The USTO's complaint relied upon Lawler's plea agreement and the admissions made in connection therewith to assert claims for denial of discharge based on false oaths. Eventually, the Bankruptcy Court issued judgment denying Lawler a discharge of her debts in bankruptcy.

IV. United States v. John Keith Hoover, et al.[5]

In January 2011, real estate investor and lawyer John Keith Hoover and his wife, Deborah Hoover, filed a Chapter 7 bankruptcy petition in the District of Arizona. Among the creditors disclosed in the bankruptcy schedules were over 400 individuals, many of whom were elderly, who had invested in real estate projects through various companies owned or controlled by Mr. Hoover. Almost immediately after the case was filed, investors contacted the Chapter 7 trustee and the United States Trustee's Office, complaining that they had been defrauded by Mr. Hoover.

Upon investigation by the United States Trustee, including the taking of Mr. Hoover's deposition, it was discovered that Mr. Hoover had not only defrauded the individual investors through a Ponzi-type scheme, but that the Hoovers had fraudulently concealed an apartment they owned through a corporate entity in Paris and had fraudulently transferred large sums of cash (including over $200,000 of tax refunds) and assets, including a Bentley automobile, to family members or corporate entities controlled by the Hoovers. Consequently, the United States Trustee filed a complaint to deny the Hoovers' bankruptcy discharge, alleging, among other things, fraudulent transfers and concealments of property and the making of fraudulent false oaths in the bankruptcy case. Ultimately, the Hoovers were denied a discharge.

In addition to pursuing civil enforcement in the bankruptcy proceeding, the United States Trustee's Office referred the matter to the United States Attorney's Office for criminal investigation. Internal Revenue Service-Criminal Investigations and the Federal Bureau of Investigation were ultimately engaged to investigate both the investment fraud scheme and the bankruptcy fraud issues. At the same time, the U.S. Trustee's Office trial attorney, who had litigated the civil bankruptcy fraud matter, was designated a Special Assistant U.S. Attorney to supervise the bankruptcy fraud investigation and prosecution.

[5] United States v. John Keith Hoover, et al., Case 2:14-cr-00554-SRB (District of Arizona).

In April 2014, John Hoover was indicted on thirty-seven counts of wire fraud, mail fraud, and bank fraud based on the fraud perpetrated against the victim investors. Hoover and his wife were also indicted on ten counts of bankruptcy fraud based primarily on the same conduct on which the United States Trustee filed her complaint to deny the Hoovers a discharge in bankruptcy. Their son was also indicted for bank fraud and for filing a false proof of claim on behalf of a sham creditor entity, as well as conspiracy to commit bankruptcy fraud.

Notably, the government obtained a search warrant to search the Hoovers' home at the time the Hoovers were arrested after indictment. That search uncovered hundreds of thousands of dollars of assets, including jewelry and artwork, which had never been disclosed in the bankruptcy. As a result, a superseding indictment was presented to the grand jury to include additional counts of bankruptcy fraud based on the concealed assets uncovered pursuant to the search warrant.

Additionally, a Mutual Legal Assistance Treaty ("MLAT") request was submitted to the Republic of France to seize, forfeit, and liquidate a Paris apartment that the Hoovers held through a sham entity. The proceeds from the liquidation of the Paris apartment would be used for restitution to the victims of Mr. Hoover's investment fraud. Ultimately, the Hoovers and their son agreed to a plea bargain pursuant to which Mr. Hoover was eventually sentenced to ten years in prison.

V. Charging of Bankruptcy Fraud

Conduct that prompts the United States Trustee to file a complaint to deny the debtor a discharge of debts in bankruptcy under Bankruptcy Code 11 U.S.C. § 727[6] may rise to the level of criminal conduct chargeable under 18 U.S.C. §§ 152 and 157. As the three cases discussed above demonstrate, conduct underlying the bankruptcy fraud may constitute other federal criminal offenses, such as bank, mail, and wire fraud. Typically, the United States Trustee will ensure that a matter is referred to the United States Attorney for prosecution in the event that fraud has been detected. It is not necessary, however, for the United States Trustee to object to the debtor's discharge or for the debtor to be denied a discharge in bankruptcy in order for the United States Attorney to prosecute for bankruptcy fraud.[7]

As discussed above, when investment fraud is accompanied by bankruptcy fraud, the inclusion of bankruptcy fraud charges is highly beneficial, especially in terms of litigation risks, as bankruptcy fraud is often easier to prove than wire and mail fraud. Typically, investment fraud involves oral misrepresentations, which may present proof issues due to a victim's age, memory lapses, or unavailability to testify. Additionally, proof of investment fraud often requires the admission of profuse amounts of documents and a multiplicity of investor witnesses. Bankruptcy fraud, on the other hand, is often provable through the relatively concise number of court pleadings fraudulently attested to by the defendant in the bankruptcy case, along with the defendant's own sworn testimony at the mandatory meeting of creditors required in all bankruptcy cases.

Moreover, bankruptcy fraud may provide the only redress when the statute of limitations has expired on wire and mail fraud charges. Oftentimes, by the time a complex wire fraud scheme is uncovered, many of the wires and mailings that facilitated the fraud are outside of the statute of limitations. The belated discovery of those frauds in the context of fraudulent bankruptcy cases opens the

[6] 11 U.S.C. § 727 (2012).
[7] *See* Douchan v. United States, 136 F.2d 144, 146-47 (6th Cir. 1943).

door to criminal prosecution for bankruptcy fraud despite the expiration of the statute of limitations on mail and wire fraud.

The particular statute(s) under which bankruptcy fraud charges should be pursued depends upon the nature of the misconduct. The two primary statutes upon which bankruptcy fraud charges are ordinarily brought are 18 U.S.C. §§ 152 and 157.[8] It has been said that § 152 "is a congressional attempt to cover all of the possible methods by which a debtor or any other person may attempt to defeat the intent and effect of the bankruptcy law through any type of effort to keep assets from being equitably distributed among creditors."[9]

Section 152 provides for nine separate offenses relating to the concealment of assets, false oaths and claims, and bribery in connection with bankruptcy cases. Conviction under any subsection of § 152 requires that the defendant act knowingly and fraudulently. Generally, all crimes under § 152 require proof that a bankruptcy proceeding existed, that the defendant committed the specified misconduct in connection with that proceeding, and that the defendant did so knowingly and fraudulently with the intent to defeat the provisions of the Bankruptcy Code.[10]

Section 157 was enacted as part of the Bankruptcy Reform Act of 1994 and was modeled after the mail and wire fraud statutes to criminalize use of the bankruptcy system to effectuate schemes to defraud. Section 157 requires proof that the defendant devised a scheme or artifice to defraud and, in order to execute that scheme, either filed a bankruptcy petition or a document in bankruptcy or made a false statement in relation to a bankruptcy case.[11]

Oftentimes, the same course of conduct will give rise to charges under both §§ 152 and 157. Multiple charges under both §§ 152 and 157 based on the same conduct may give rise to a multiplicity allegation on the grounds that the defendant is being subject to double punishment for the same conduct in violation of the constitutional protection against double jeopardy.[12] Generally, if each statute requires proof of facts that the other statute does not, then there will be no double jeopardy violation.[13]

In the *Kurlemann* case, the defendant argued that his double jeopardy rights were violated by convictions under both §§ 152 and 157 because the charges under each arose from the same course of conduct.[14] The United States Court of Appeals for the Sixth Circuit rejected that argument, holding that "each count required the government to prove a fact that the others did not."[15] Specifically, the bankruptcy fraud charge under § 152(1) required proof that the defendant had concealed property from creditors or the United States Trustee, and § 152(3) required proof that the defendant made a false statement under penalty of perjury. In contrast, § 157 required proof not just of a concealment or false statement during bankruptcy, but that the defendant had devised a scheme or artifice to defraud and filed a

[8] While 18 U.S.C. § 1519 (2012) addresses fraud in the destruction or falsification of documents in bankruptcy, that statute is rarely invoked, and in the non-bankruptcy context, the United States Supreme Court has substantially limited its breadth. *See*, *e.g.*, Yates v. United States, 135 S.Ct. 1074, 1083-84 (2015).
[9] United States v. Goodstein, 883 F.2d 1362, 1369 (7th Cir. 1989) (citing Stegeman v. United States, 425 F.2d 984, 986 (9th Cir. 1970) (citing 2 COLLIER ON BANKRUPTCY § 1151 (14th ed. 1968)).
[10] *See* Tamara Ogier & Jack F. Williams, *Bankruptcy Crimes and Bankruptcy Practice*, 6 AM. BANKR. INST. L. REV. 317, 331 (1998).
[11] *See e.g.*, United States v. Chaker, 820 F.3d 204, 210 (5th Cir. 2016) (affirming conviction under § 157(3)); United States v. Wagner, 382 F.3d 598, 612 (6th Cir. 2004) (affirming conviction under § 157(2)); United States v. DeSantis, 237 F.3d 607, 613 (6th Cir. 2001) (discussing elements of § 157(1)).
[12] *See, e.g.*, United States v. Kurlemann, 736 F.3d 439, 452 (6th Cir. 2013).
[13] *See* Blockburger v. United States, 284 U.S. 299, 304 (1932).
[14] *See* Kurlemann, 736 F.3d at 452.
[15] *Id.*

bankruptcy document or made a false statement during the bankruptcy proceedings to execute or conceal that scheme.[16]

Bankruptcy fraud often involves debtors who intentionally provide false information in their bankruptcy pleadings and debtors who hide assets or attempt to transfer their assets to family members, associates, or sham corporations in order to avoid the possibility of surrendering those assets for the benefit of the creditors in bankruptcy. The criminal bankruptcy fraud statutes do not apply exclusively to individual debtors who file bankruptcy, however.

Thus, for example, fraud committed by the defendant as the representative of a corporate debtor in bankruptcy may give rise to bankruptcy fraud charges under §§ 152 and 157. Likewise, "if a creditor, as part of a scheme to defraud a debtor or debtors, knowingly made false statements to a debtor concerning the debtor's rights in connection with a bankruptcy case, that creditor could be subject to this section."[17] In the *Hoover* case discussed above, the debtors' son was implicated in the bankruptcy fraud scheme through his filing of a false proof of claim on behalf of a sham entity that was a purported creditor of the debtors. That conduct constituted a violation of § 152(4).[18]

A key concept often involved in bankruptcy fraud prosecutions is the concept of equitable ownership. Charges under § 152(1) for concealment of assets requires proof that the assets concealed constituted "property belonging to the estate of a debtor."[19] In such cases, property that is held in the name of a corporation or other entity which is the alter ego of the debtor, such that the title holder is a mere nominee of the debtor, may constitute property of the estate under § 152(1).[20] If a defendant transfers title of an asset to a family member or corporate entity, the defendant may still be charged with concealing that asset in the bankruptcy proceeding if the defendant held an equitable ownership in that property.[21] Whether an interest in property constitutes an equitable interest is a question of fact for the jury.[22]

Finally, investment fraud schemes culminating in bankruptcy fraud often gives rise to conspiracy charges under 18 U.S.C. § 371, which addresses conspiracies to defraud the United States.[23] Such charges require proof of an agreement to commit the underlying act of bankruptcy fraud and an overt act toward achieving that purpose.[24] The government need not prove the successful completion of the conspiracy and, therefore, even where the defendant fails in his or her attempt to defraud the Bankruptcy Court, the conspiracy to commit such fraud will give rise to charges under § 371.[25]

VI. Conclusion

The case studies discussed herein demonstrate the usefulness of combining customary financial fraud charges with bankruptcy fraud charges when financial fraud schemes are aggravated by fraud in the Bankruptcy Court. Proving wire, mail, and bank fraud is often a complicated, multifaceted evidentiary

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[16] *See id.*
[17] 140 CONG. REC. H10752-01 (Oct. 4, 1994).
[18] 18 U.S.C. § 152(4).
[19] § 152(1).
[20] *See, e.g.*, United States v. Everett, No. CR06-795-PHX-JAT, 2008 WL 1746094, *6-7 (D. Ariz. Apr. 14, 2008).
[21] *See e.g.*, United States v. Weinstein, 834 F.2d 1454, 1459-60 (9th Cir. 1987); United States v. Moynagh, 566 F.2d 799, 803 (1st Cir. 1977); United States v. Edwards, 905 F. Supp. 45, 46-48 (D. Mass. 1995); United States v. Butler, 704 F. Supp. 1338, 1344-45 (E.D. Va. 1989).
[22] 1 COLLIER ON BANKRUPTCY ¶ 7.02[1][a], 7-30 & n.42 (15th ed. rev.1999) (citing cases so holding).
[23] 18 U.S.C. § 371 (2012).
[24] *See, e.g.*, United States v. Dolan, 120 F.3d 856, 865-66 (8th Cir. 1997); United States v. Brown, 943 F.2d 1246, 1250 (10th Cir. 1991).
[25] *See* United States v. Tucker, 376 F.3d 236, 238 (4th Cir. 2004) (proof of conspiracy does not require proof that object of conspiracy was achieved on that parties agreed to achieve it).

process whereas bankruptcy fraud charges are frequently more perspicuous. In order to realize the benefits of such prosecutions, it is necessary for United States Trustee's Offices and the United States Attorney's Offices to maintain an ongoing, open dialogue concerning potential instances of fraud. As the cases discussed herein demonstrate, it is crucial not only for the U.S. Trustee to refer potentially fraudulent matters to the U.S. Attorney for bankruptcy fraud prosecution, but for the U.S. Attorney to likewise correspond with the U.S. Trustee regarding criminal defendants who have filed bankruptcy petitions. The bankruptcy pleadings provide a wealth of information and potentially inculpatory admissions for prosecutors; likewise, criminal indictments may allege pertinent facts that may have been fraudulently concealed from the Bankruptcy Court, creditors, and the U.S. Trustee. Hence, it is mutually beneficial for the local U.S. Trustee and U.S. Attorney to regularly correspond and cooperate in ferreting out fraud in both the criminal and the bankruptcy contexts.

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The United States Trustee as a Watchdog for Fraud and Abuse

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I. Introduction

This article discusses the United States Trustee Program's role as a watchdog for fraud and abuse in the bankruptcy system and the manner in which, in the course of conducting civil litigation, the Program uncovers evidence that can assist with the successful prosecution of bankruptcy related crimes. A basic understanding of the United States Trustee Program's civil enforcement activities reveals how the Program can aid law enforcement and United States Attorneys in criminal enforcement matters.

Congress intended United States Trustees to serve as "bankruptcy watch-dogs to prevent fraud, dishonesty, and overreaching in the bankruptcy arena" in addition to handling certain administrative matters.[1] The United States Trustee Program is a civil litigation component of the United States Department of Justice.[2] United States Trustees are officials of the Department of Justice who "supervise the administration of cases and trustees in cases under" the Bankruptcy Code.[3] They have standing to "raise . . . and be heard on any issue in any case or proceeding" under the Bankruptcy Code, other than filing a chapter 11 plan.[4]

The Bankruptcy Code vests United States Trustees with a variety of powers that enable them to carry out these duties. Some of these duties and powers will be discussed in this article. These powers place the United States Trustee Program's personnel in a prime position to discover evidence of fraud as part of their responsibilities to address fraud and abuse through civil enforcement actions.

The United States Trustee's duties range from appointing private trustees in bankruptcy cases to taking actions to address misconduct by debtors, creditors, and attorneys in the bankruptcy system. They also include 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 prosecution based on such action."[5] The United States Trustee Program does this in a number of ways. It refers suspected crimes to United States Attorneys and law enforcement. It provides bankruptcy expertise to those investigating or prosecuting crimes. Some of the Program's attorneys serve as Special Assistant United States Attorneys who assist with the prosecution of bankruptcy crimes.

United States Trustee Program personnel are available to assist with the investigation and prosecution of bankruptcy crimes across the country. The United States Trustee Program is led by a Director headquartered in the Executive Office for United States Trustees located in Washington, D.C. The Program's twenty-one regions are managed by United States Trustees appointed by the Attorney

[1] H.R. REP. NO. 595, 95TH CONG., 1st Sess. 1, 88 (1977), *as reprinted* in 1978 U.S.C.C.A.N. 6049.
[2] *See* 28 U.S.C. § 586 (2012).
[3] § 586(a)(3).
[4] 11 U.S.C. § 307 (2012).
[5] § 586(a)(3)(F).

General and include ninety-two field office locations supervised by Assistant United States Trustees.[6] The Program employs around 1,000 staff members, more than ninety percent of whom are located in field offices.

The field offices typically include trial attorneys, auditors or analysts, paralegals, and others, all of whom are employees of the Department of Justice.[7] United States Trustee Program personnel should not be confused with private trustees, who serve as fiduciaries in particular bankruptcy cases. Private trustees who are appointed by the United States Trustee are not employees of the Department of Justice.[8] Notably, trustees appointed in corporate bankruptcy cases have the power to waive the corporate entity's attorney client privilege.[9]

A bankruptcy case is a proceeding brought under federal law in a United States Bankruptcy Court to discharge or reorganize the financial obligations of an individual or an entity. Title 11 of the United States Code contains the Bankruptcy Code. While petitions may be filed under various chapters of the Bankruptcy Code, one thing they have in common is that the debtor's assets become property of a bankruptcy estate.[10] In addition, when a voluntary bankruptcy petition is filed, an automatic bankruptcy stay goes into force enjoining civil actions against the debtor and the bankruptcy estate's assets.[11] In most, but not all cases, debtors can obtain a discharge of debts. An order discharging debts voids judgments and enjoins any action to enforce or collect the types of debts that are subject to the discharge.[12]

Most bankruptcy cases are filed under chapter 7, 11, 12, or 13 of the Bankruptcy Code, described very generally as follows. Chapter 7 bankruptcy is a liquidation proceeding. Chapter 11 provides a procedure by which a debtor can reorganize debts while remaining in control of its operations and assets. Chapter 12 allows those who qualify as family farmers or fishermen with regular annual income to reorganize their financial affairs. Chapter 13 allows individuals to reorganize their financial affairs under a repayment plan that must be completed within three to five years.

II. The United States Trustee's Capabilities

The United States Trustee Program obtains information from a variety of sources, which enables it to address fraud and abuse through civil enforcement, as well as to uncover criminal conduct. For example, the United States Trustee reviews verified documents filed in bankruptcy cases, examines debtors and others under oath, seeks the appointment of chapter 11 trustees or examiners, conducts discovery, and receives referrals from third parties with information that may suggest fraud and abuse.

A debtor does not start with a blank factual slate in the bankruptcy court. The debtor is required to file schedules, statements of financial affairs, and other documents with the bankruptcy court. These documents include details about assets, debts, financial transactions, interests in corporate entities, and other information. The debtor is required to sign a declaration verifying the information under penalty of perjury. Information in these documents may raise questions. For example, a high income debtor who reports owning next to nothing may warrant further review. Debtors are also required to "surrender to the trustee . . . any recorded information, including books, documents, records, and papers, relating to property of the estate, whether or not immunity is granted . . ."[13] Trustees also obtain copies of the

[6] The judicial districts in Alabama and North Carolina are not administered by the United States Trustee Program.
[7] 28 U.S.C. §§ 582, 589 (2012).
[8] 11 U.S.C. §§ 321-323,701-704, 1104, 1202, 1302 (2012).
[9] Commodity Futures Trading Com'n v. Weintraub, 471 U.S. 343 (1985).
[10] 11 U.S.C. § 541 (2012) (amended 2016).
[11] 11 U.S.C. § 362 (2012).
[12] 11 U.S.C. § 524(a) (2012).
[13] 11 U.S.C. § 521(a)(4) (2012) (amended 2014).

debtor's tax returns and bank statements. The tax returns and bank statements may lead to the discovery of assets that were not listed in the bankruptcy schedules.

The United States Trustee convenes meetings of creditors in all bankruptcy cases.[14] In cases under chapters 7, 12, and 13, the private trustees conduct these meetings as the United States Trustee's designee. In chapter 11 cases, a United States Trustee Program attorney conducts the meeting. The debtor is required to appear and submit to examination under oath about the contents of the schedules, statement of financial affairs, other documents, and the debtor's overall financial affairs.[15] The debtor's identity and Social Security number are verified by reviewing appropriate documentation that the debtor must present at the meeting. Discrepancies are noted on the record. The United States Trustee, private trustee, creditors, and parties in interest may question the debtor.[16] The scope of the questioning is broad but must relate to the acts, conduct, property, liabilities, and financial conditions of the debtor; the debtor's right to a discharge; business operations; any matter that may affect the administration of the debtor's bankruptcy estate; and "any other matter relevant to the case or to the formulation of a plan."[17] The United States Trustee retains recordings of the examination for at least two years.[18] The recording can be valuable evidence in the bankruptcy case or other cases.

If a debtor refuses to answer a question, a party can seek a court order compelling the debtor to answer it. A debtor who refuses to answer a question approved by the bankruptcy court, other than on the ground of a properly invoked privilege against self-incrimination, may be denied a discharge or have the bankruptcy case dismissed.[19]

The Federal Rules of Bankruptcy Procedure provide another mechanism to question the debtor, creditors, and others under oath. Rule 2004 states "[o]n motion of any party in interest, the court may order the examination of any entity." This discovery option is available to the United States Trustee.[20] Production of documents and appearances of witnesses for the examination may be compelled by subpoena.[21] A Rule 2004 examination is similar to a deposition, but the examination is "generally broader in scope than pretrial depositions authorized under FRCP 26, being 'in the nature of a fishing expedition.'"[22] The federal common law of privilege applies at a Rule 2004 examination.[23]

In chapter 11 cases, unless a trustee is appointed for cause or because it is in the best interest of creditors, the debtor retains control of the bankruptcy estate's assets and has many of the duties and powers of a trustee.[24] The debtor, or trustee if appointed, is required to file regular reports regarding the bankruptcy estate's operations and financial affairs.[25] These reports are signed under penalty of perjury. In addition to reports, in chapter 11 cases, the court may dismiss or convert a case to chapter 7 or appoint a trustee if the debtor fails to timely provide information reasonably requested by the United States

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[14] 11 U.S.C. § 341 (2012).
[15] § 341.
[16] 11 U.S.C. § 343 (2012).
[17] FED. R. BANKR. P. 2004(b).
[18] FED. R. BANKR. P. 2003(c).
[19] 11 U.S.C. §§ 727(a)(6)(C), 1141(d)(3)(C), 1208(c), 1307(c) (2012).
[20] *See, e.g.*, *In re* Subpoena Duces Tecum & Ad Testificandum Pursuant to FED. R. BANKR. P. 2004, 461 B.R. 823, 827 (Bankr. C.D. Cal. 2011).
[21] FED. R. BANKR. P. 2004(c), 9016; FED. R. CIV. P. 45.
[22] *In re* Thow, 392 B.R. 860 (Bankr. W.D. Wash. 2007) (quoting *In re* Apex Oil Co., 101 B.R. 92, 102 (Bankr. E.D. Mo.1989)); *see*, *e.g.*, Dynamic Fin. Corp. v. Kipperman (*In re* North Plaza, LLC), 395 B.R. 113, 121 n. 9 (S.D. Cal. 2003) ("It is well established that the scope of a Rule 2004 examination is exceptionally broad and provides few of the procedural safeguards found in Federal Rule of Civil Procedure 26.").
[23] *In re* North Plaza, LLC, 395 B.R. at 123.
[24] 11 U.S.C. §§ 1107, 1203 (2012).
[25] 11 U.S.C. §§ 1106(a)(1), (7), 1112(b)(4)(F) (2012), 1203; FED. R. BANKR. P. 2015, 2015.3.

Trustee.[26] If a trustee is appointed, the debtor is required to turn over the bankruptcy estate's records and assets to the trustee.[27] Further, the United States Trustee conducts an initial debtor interview at the beginning of a chapter 11 bankruptcy case.[28] This interview may occur at the debtor's place of business and is used to gather significant information about the debtor and its operations.

In addition to these bankruptcy specific resources, the full array of civil discovery methods is available. The Federal Rules of Bankruptcy Procedure provide for discovery in contested motions or adversary proceedings in the bankruptcy court.[29] Adversary proceedings are commenced by filing a complaint in the bankruptcy court and require service of a summons.[30] The Federal Rules of Bankruptcy Procedure incorporate the Federal Rules of Civil Procedure's discovery provisions.[31]

Last, but not least, the United States Trustee may receive referrals of fraud and other misconduct discovered by the private trustees, creditors, and third parties who have no connection to the bankruptcy case. The United States Trustee Program has a Bankruptcy Fraud Hotline that accepts tips from the public by email or regular mail.[32]

III. Civil Enforcement

As the bankruptcy system's watchdog, the United States Trustee takes a variety of civil enforcement actions. Some of the actions are designed to address fraud, abuse, and other misconduct. Others are designed to address more routine compliance issues, but may uncover fraud. These actions include objections to discharge, motions to dismiss bankruptcy cases, attorney misconduct actions, actions against bankruptcy petition preparers, actions against creditor misconduct, and, in chapter 11 cases, motions to appoint trustees or examiners and motions to dismiss or convert cases.

A. Objections to Discharge for Fraud, False Oaths, and Other Misconduct

The Supreme Court has observed that the chapter 7 discharge is intended for the "honest but unfortunate debtor." [33] An individual debtor's discharge may be denied under 11 U.S.C. § 727[34] on various grounds. Many of these grounds also constitute crimes. One key difference between Title 11 and Title 18 of the United States Code is that § 727 applies only to the debtor, while the prohibited acts enumerated in Title 18 apply to anyone. For example, a debtor who knowingly and fraudulently makes false oaths or transfers or conceals assets in anticipation of, or during, a bankruptcy case may have his or her discharge denied under § 727. Under 18 U.S.C. § 152,[35] these acts constitute crimes, whether committed by the debtor or someone else.

Even though an objection to discharge need only be proven by a preponderance of the evidence, the same evidence used at the trial on the objection to discharge may be used in a criminal prosecution. The Federal Rules of Evidence apply equally to an objection to discharge before the bankruptcy court and to a criminal case in the United States District Court.[36] The debtor has a duty to attend the trial on an

[26] § 1112(b)(3).
[27] 11 U.S.C. § 521(a)(4) (2012) (amended 2014).
[28] 11 U.S.C. § 1116 (2012).
[29] FED. R. BANKR. P. 7001, 9014.
[30] FED. R. BANKR. P. 7003, 7004.
[31] FED. R. BANKR. P. 7026-7037.
[32] Email address USTP.Bankruptcy.Fraud@usdoj.gov for more information see https://www.stopfraud.gov/report.html.
[33] *See, e.g.,* Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007).
[34] 11 U.S.C. § 727 (2012).
[35] 18 U.S.C. § 152 (2012).
[36] FED. R. EVID. 1101.

objection to discharge and to testify if called as a witness.[37] As in other civil proceedings, the bankruptcy court can draw an adverse inference against a debtor who asserts their Fifth Amendment Privilege and declines to testify in response to evidence admitted at trial.[38] Consequently, debtors typically testify at the trial on the objection to their discharge.

A debtor's testimony in the bankruptcy case may prove useful if the debtor is later indicted and chooses to exercise the right not to testify at the criminal trial. This is particularly true when the elements of the objection to discharge are essentially the same or similar to the elements of the crime charged. For example, the evidence needed to object to discharge based on false oaths, false declarations, concealment or transfer of assets, falsifying records, or withholding records, is generally the same as required for the criminal counterparts.

11 U.S.C. § 727(a)(4)[39] provides that a debtor's discharge may be denied if the debtor "knowingly and fraudulently, in or in connection with the [bankruptcy] case . . . made a false oath or account." Under section 727(a)(4), either a false oath or a false declaration under penalty of perjury satisfies the false oath element.[40] In contrast, 18 U.S.C. § 152(2) and (3)[41] distinguish between a false oath and a false declaration.

Otherwise, the elements of these crimes are essentially the same as the elements of 11 U.S.C. § 727(a)(4).[42] 18 U.S.C. § 152(2) states that a person who "knowingly and fraudulently makes a false oath in or in relation to any case under [the Bankruptcy Code]" commits a crime.[43] 18 U.S.C. § 152(3)[44] states that someone who "knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28[45], in or in relation to any case under [the Bankruptcy Code]" commits a crime.

11 U.S.C. § 727(a)(2) provides that a debtor's discharge may be denied if the debtor concealed, or permitted to be concealed, transferred, destroyed, mutilated, or removed, the debtor's property within one year before the bankruptcy case was filed, or property of the bankruptcy estate when the bankruptcy case was pending.[46] The debtor must have acted with the intent to hinder, delay, or defraud a creditor or an officer of the bankruptcy estate charged with custody of bankruptcy estate property. Compare this to 18 U.S.C. § 152(1) and (7).[47] Section 152(1) makes it a crime for a person "to knowingly and fraudulently"

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[37] FED. R. BANKR. P. 4002(a)(2).
[38] *See* Baxter v. Palmigiano, 425 U.S. 308, 318 (1976) (discussing negative inference in civil proceedings); Weddell v. Acting U.S. Trustee, 551 B.R. 74 (D. Nev. 2016) (bankruptcy court correctly applied standards for drawing inference against the debtor who asserted the Fifth Amendment privilege at the trial on the objection to his discharge).
[39] § 727(a)(4).
[40] *See* Retz v. Samson (*In re* Retz), 606 F.3d 1189, 1197 (9th Cir. 2010).
[41] 18 U.S.C. § 152(2), (3) (2012).
[42] 11 U.S.C. § 727(a)(4) (2012).
[43] § 152(2).
[44] §152(3).
[45] 28 U.S.C. § 1746 (2012).
[46] § 727(a)(2).
[47] 18 U.S.C. § 152(1), (7) (2012).

conceal bankruptcy estate property from a trustee, the United States Trustee, or creditors.[48] Section 152(7) makes it a crime if a person

> . . . in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under [the Bankruptcy Code] . . . or with intent to defeat the provisions of [the Bankruptcy Code], knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation. [49]

While the requisite scienter differs, there is significant congruity.

11 U.S.C. § 727(a)(4)(C) states that a discharge may be denied if the debtor knowingly and fraudulently, in or in connection with a bankruptcy case, "gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act."[50] 18 U.S.C. § 152(6) makes it a crime if someone "knowingly and fraudulently gives, offers, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under [the Bankruptcy Code]."[51]

11 U.S.C. § 727(a)(4)(D) provides for denial of a discharge where a debtor "withheld from an officer of the estate entitled to possession . . . any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs."[52] 18 U.S.C. § 152(6) makes it a crime for anyone who "withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor."[53]

The case of Alton Alexis, from the Northern District of Texas, is an example of the United States Trustee's prosecution of an objection to discharge under 11 U.S.C. § 727(a)(2) and subsequent criminal referral that resulted in a successful criminal prosecution. Alexis, a real estate developer and former player for the Cincinnati Bengals, and his spouse, a medical doctor, filed a pro se chapter 7 bankruptcy petition. The United States Trustee's Dallas office successfully tried a complaint objecting to their bankruptcy discharge of $4.7 million of unsecured debt. The bankruptcy court found that the debtors' discharge should be denied under 11 U.S.C. § 727(a)(2)(B) for concealment of their interests in a $54,349 tax refund and oil and gas leases, with the intent to hinder, delay, or defraud creditors and the chapter 7 bankruptcy trustee. The United States Trustee referred the matter to the United States Attorney and assisted with the ensuing investigation conducted by IRS Criminal Investigation.

The United States Attorney filed an information alleging that Alexis made a false statement in his amended statement of financial affairs, filed in his bankruptcy case, by falsely stating he had disclosed all of his income received in the two years preceding the filing of his bankruptcy case. Alexis, however, fraudulently concealed $245,000 of income from fraudulently diverted loan proceeds. In 2016, Alexis pleaded guilty. He was sentenced to 16 months in prison.[54] He was the sixteenth defendant convicted since August 2013 as part of the Northern District of Texas's Bankruptcy Fraud Initiative.

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[48] § 152(1).
[49] § 152(7).
[50] 11 U.S.C. § 727(a)(4)(C) (2012).
[51] § 152(6).
[52] § 727(a)(4)(D).
[53] 18 U.S.C. § 152(6), (9) (2012).
[54] United States v. Alexis, No. 16-cr-00188 (N.D. Tex. judgment entered Sept. 9, 2016). Press Release, U.S. Dep't. of Justice, Fort Worth Man Sentenced to 16 Months in Federal Prison for Making a False Statement in a Bankruptcy Case (Sept. 2, 2016).

B. Dismissal of Abusive Chapter 7 Bankruptcy Cases

The United States Trustee takes other civil actions that may also uncover evidence of fraud. These actions include filing motions to dismiss chapter 7 bankruptcy cases for abuse of the bankruptcy system.

The United States Trustee is charged with reviewing chapter 7 cases filed by individuals with primarily consumer debts to determine whether granting a discharge would be an abuse.[55] A presumption of abuse may exist in a case based on a statutory formula that takes into account the debtor's income and certain expenses.[56] If the presumption arises, the United States Trustee is required to file a motion to dismiss the bankruptcy case or a statement setting forth the reasons a motion is not appropriate.[57] Even where the presumption does not arise, the United States Trustee can file a motion to dismiss if the debtor filed the bankruptcy case in bad faith or the totality of the circumstances of the debtor's financial circumstances demonstrates abuse.[58] When it appears there may be abuse, the United States Trustee may request additional documents and information from the debtor.

If the debtor objects to the United States Trustee's motion to dismiss, an evidentiary hearing will be held. Formal discovery may occur prior to the trial. The evidentiary hearing will likely include testimony and documentary evidence. The documentary evidence and hearing testimony may expose evidence of fraud.

C. Actions Against Attorneys

"Lawyers occupy a special position in this country's judicial system. Not only are they representatives of and advocates for their clients, but they are also officers of the court who bear responsibility for ensuring the integrity and fairness of our judicial system."[59] This is particularly true in the bankruptcy court where so much depends on parties making accurate disclosures. In addition to the bankruptcy court's inherent powers, the Bankruptcy Code and Federal Rules of Bankruptcy Procedure provide significant means to address an attorney's misconduct or poor performance.[60]In addition, federal district courts have the inherent power to sanction bad faith or willful misconduct when it falls outside the scope of FED. R. CIV. P. 11[61] or 28 U.S.C. § 1927.[62]

FED. R. BANKR. P. 9011 is comparable to FED. R. CIV. P. 11. It provides that, by filing a document with the court, an attorney or unrepresented party certifies to the court "that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the

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55 11 U.S.C. § 704(b) (2012).
56 11 U.S.C. § 707(b)(2) (2012) (amended 2016).
57 § 704(b)(2).
58 § 707(b)(3).
59 *In re* Cochener, 360 B.R. 542, 597-98 (Bankr. S.D. Tex. 2007), *rev'd in part*, 382 B.R. 311 (S.D. Tex. 2007).
60 FED. R. BANKR. P. 9011; 11 U.S.C. §§ 329 (2012), 707(b)(4).
61 FED. R. CIV. P. 11.
62 28 U.S.C. § 1927 (2012); *See* Chambers v. NASCO, Inc., 501 U.S. 32 (1991). Bankruptcy courts appear to also possess this power. *See* Law v. Siegel, 134 S.Ct. 1188, 1194 (2014) (bankruptcy courts "may also possess 'inherent power . . . to sanction 'abusive litigation practices' '" quoting Marrama v. Citizens Bank of Mass., 549 U.S. 365, 375-76 (2007)). Nearly all of the circuit courts of appeals have recognized the bankruptcy court's inherent power. *See* Charbono v. Sumski (*In re* Charbono), 790 F.3d 80 (1st Cir. 2015); Fellheimer, Eichen & Braverman, P.C. v. Charter Technologies, Inc., 57 F.3d 1215 (3d Cir. 1995); McGahren v. First Citizens Bank & Trust Co. (*In re* Weiss), 111 F.3d 1159 (4th Cir. 1997); *In re* Case, 937 F.2d 1014 (5th Cir. 1991); Mapother & Mapother, P.S.C. v. Cooper (*In re* Downs), 103 F.3d 472 (6th Cir. 1996); *In re* Rimsat, Ltd., 212 F.3d 1039 (7th Cir. 2000); Isaacson v. Manty, 721 F.3d 533 (8th Cir. 2013); Caldwell v. Unified Capital Corp. (*In re* Rainbow Magazine, Inc.), 77 F.3d 278 (9th Cir. 1996); Jones v. Bank of Santa Fe (*In re* Courtesy Inns), 40 F.3d 1084 (10th Cir. 1994); Gwynn v. Walker (*In re* Walker), 532 F.3d 1304 (11th Cir. 2008).

circumstances," it is not being filed for an improper purpose; the contentions are warranted by existing law or a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law; and the factual contentions have evidentiary support or are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery. Violations can result in sanctions. Rule 9011 states that a party cannot file a motion for sanctions unless the motion has first been served on the subject of the motion, more than twenty-one days have passed, and the document in question has not been withdrawn. This requirement does not apply to the filing of a bankruptcy petition.[63] 11 U.S.C. § 707(b)(4)(B) also empowers the court to assess an "appropriate civil remedy" against the debtor's attorney for violating Rule 9011.[64]

"[B]ankruptcy debtors rely on their attorney to shepherd them through unfamiliar and complicated territory . . . They may not know that verifying and signing papers that contain false or inaccurate information exposes them to loss of discharge and, perhaps, criminal prosecution."[65]

In *Delcorso*, the debtor waived her bankruptcy discharge after an undisclosed fraudulent transfer was discovered.[66] The debtor's statement of financial affairs indicated there were no transfers.[67] The debtor's attorney not only counseled the debtor to make the transfer, but was also paid to prepare and record the deed shortly before filing the bankruptcy petition.[68] The bankruptcy court found that the attorney attempted to mislead the chapter 7 trustee and had "approached the 2006 Deed as taking a chance on something that, if not uncovered by the chapter 7 trustee, would benefit his client."[69] The bankruptcy court granted the United States Trustee's motion for sanctions under FED. R. BANKR. P. 9011.[70]

11 U.S.C. § 329[71] is another one of the United States Trustee's resources. It is designed to protect debtors from misconduct by their attorneys.[72] Section 329(a)[73] requires debtors' attorneys to file a statement with the bankruptcy court disclosing the fees they received, the amount agreed to be paid, and the source of the fees. FED. R. BANKR. P. 2016(b) requires the statement to disclose whether the attorney has shared or agreed to share the compensation. 11 U.S.C. § 329(b)[74] provides that the court may cancel any agreement or order the return of compensation to a debtor's attorney where the compensation exceeds the reasonable value of the attorney's services.[75]

The case of bankruptcy attorney Glay Collier, II, provides an example of how the failure to comply with 11 U.S.C. § 329's requirements can lead to criminal prosecution. In the Western District of Louisiana, chapter 13 debtors' attorneys could accept a standard "no-look" fee authorized by the bankruptcy court's standing order, or they could apply for court orders approving their compensation. The standing order provided that the "no-look" fee included the court filing fee. The attorney would pay the filing fee on the debtor's behalf and would receive reimbursement as part of the "no-look" fee.[76]

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[63] FED. R. BANKR. P. 9011(c)(1).
[64] 11 U.S.C. § 707(b)(4)(B) (2012) (amended 2016).
[65] *In re* Daw, 2011 WL 231362, *1 (Bankr. D. Idaho 2011); *See also In re* Delcorso, 382 B.R. 240 (Bankr. E.D. Penn. 2007).
[66] *In re* Delcorso, 382 B.R. at 250.
[67] *Id*. at 249.
[68] *Id*. at 248.
[69] *Id*. at 262.
[70] FED. R. BANKR. P. 9011.
[71] 11 U.S.C. § 329 (2012).
[72] *See* Law Offices of Nicholas A. Franke v. Tiffany (*In re* Lewis), 113 F.3d 1040, 1045 (9th Cir. 1997).
[73] § 329(a).
[74] § 329(b).
[75] *See* Hale v. United States Trustee, 509 F.3d 1139, 1147 (9th Cir. 2007).
[76] Brief on Behalf of Appellee at 3, Collier v. U.S., 2016 WL 4426750, No. 16-30523 (5th Cir. 2016).

During testimony at a hearing on a dispute between the debtor and Collier, it came out that even though Collier had agreed to the "no-look fee," he collected or attempted to collect the court filing fees from the debtor. The bankruptcy court ordered, among other things, Collier to show cause why the responsibility of refunding the fees did not fall on him. It also directed the United States Trustee to conduct discovery in order to create a list of all the cases in which Collier improperly collected the court filing fee.

The United States Trustee's Shreveport office propounded discovery on Collier and prosecuted a motion to compel him to comply with its discovery requests. The bankruptcy court granted the motion to compel and ordered Collier to provide records to the United States Trustee and the chapter 13 trustee. Collier failed to fully comply. The United States Trustee then filed a motion for sanctions and civil contempt against Collier. The motion requested that the court sanction Collier by establishing a rebuttable presumption that he had collected the filing fees in cases about which he failed to produce records to the United States Trustee. The United States Trustee also filed a report identifying cases where Collier improperly collected the filing fee and noted that the list of cases was incomplete due to Collier's inadequate cooperation.

Ruling on the United States Trustee's motion and the order to show cause, the court ordered, among other things, that Collier refund the filing fees that he collected in numerous cases. The bankruptcy court issued a memorandum opinion in conjunction with its order. The court found that Collier was intimately aware of the terms of the standing order that authorized the "no-look" fee. The bankruptcy court also found that Collier intentionally filed false statements that violated 18 U.S.C. § 152[77] and that he knowingly and fraudulently made false oaths or accounts in disclosures of compensation that failed to disclose he had collected the filing fee.

The United States Trustee's Shreveport office made a criminal referral and assisted the FBI with its investigation. On November 2015, Collier pleaded guilty to one count of bankruptcy fraud in the Western District of Louisiana. On April 18, 2016, he was sentenced to thirty-four months in prison and three years of supervised release. Collier was ordered to pay $69,063 in restitution.[78] His sentence was upheld on appeal.[79]

Debtors' attorneys and professionals in chapter 11 and 12 cases, as well as private trustees' attorneys and professionals, must obtain orders authorizing their employment and approving any fees incurred after the bankruptcy case is filed.[80] These professionals must comply with strict disinterestedness requirements.[81]

Professionals are required to disclose not only conflicts with, but also "connections" to the debtor, creditors, other parties in interest, their respective attorneys and accountants, the United States Trustee, and any person employed in the office of the United States Trustee.[82] Motions seeking orders approving the professional's compensation typically include time sheets or other evidence supporting the fee application. These professionals include not just attorneys and accountants, but also auctioneers, real estate brokers, and others. The United States Trustee is required to monitor these applications and, when deemed appropriate, to file comments with the bankruptcy court.[83] It is a crime to "knowingly and fraudulently enter[] into an agreement, express or implied, with another such party in interest or attorney"

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[77] 18 U.S.C. § 152 (2012).
[78] Press Release, U.S. Dep't. of Justice, Bankruptcy attorney sentenced to 34 months in prison for bankruptcy fraud (April, 18, 2016).
[79] United States v. Collier, 846 F.3d 813 (5th Cir. 2017).
[80] 11 U.S.C. §§ 327, 328, 330 (2012).
[81] § 327.
[82] FED. R. BANKR. P. 2014(a).
[83] 28 U.S.C. § 586(a)(3)(I) (2012).

for the purpose of fixing the fees, or other compensation to be paid to a party in interest, or its attorney for services in connection with the bankruptcy case if the compensation is to be paid from assets of a bankruptcy estate.[84]

Professionals may fail to disclose disqualifying connections in their employment or fee applications. Professionals are required to verify their applications under penalty of perjury. While material omissions may not always be easily detected, when made knowingly and fraudulently, they are crimes and may be prosecuted.[85]

Property of the bankruptcy estate, whether in the form of cash or otherwise, may be substantial. Professionals who take control of property of the bankruptcy estate are required to account for it. Unfortunately, experience has shown that some professionals will succumb to temptation. For example, an auctioneer may have custody of guns and vehicles belonging to bankruptcy estates. A dishonest auctioneer could sell these assets and embezzle the proceeds. Auctioneers are required to file reports of the auctions. These reports alert the private trustee and United States Trustee if the auctioneer cannot properly account for the proceeds. Embezzlement of bankruptcy estate property by trustees or professionals is a crime.[86]

D. Actions Against Bankruptcy Petition Preparers

A bankruptcy petition preparer is a non-attorney who is not employed by and not directly supervised by an attorney, and who is compensated to prepare documents for filing with the bankruptcy court.[87] Bankruptcy petition preparers "often lack the necessary legal training and ethics regulation to provide such services in an adequate and appropriate manner" and "may take unfair advantage of persons who are ignorant of their rights both inside and outside the bankruptcy system."[88] Section 110 is designed to, among other things, protect consumers from abusive and fraudulent practices that may be committed by bankruptcy petition preparers.[89]

Section 110 of the Bankruptcy Code limits what a bankruptcy petition preparer can do.[90] It provides for disgorgement of compensation and fines for violations. As bankruptcy petition preparers are prohibited from practicing law, many courts have concluded they may only provide typing services.[91] They are required to disclose their compensation and to sign and place their Social Security number on the documents they prepare.[92] Failing to disclose the identity of the bankruptcy petition preparer warrants tripling any fine imposed for violating section 110.[93] Bankruptcy petition preparers may be enjoined from violating section 110 or from performing any bankruptcy petition preparer services.[94]

Section 110 prohibits a bankruptcy petition preparer from, among other things, executing documents on behalf of the debtor, offering legal advice to a potential bankruptcy debtor, and using the

[84] 18 U.S.C. § 155 (2012).
[85] 18 U.S.C. § 152(3) (2012); *see* United States v. Gellene, 182 F.3d 578 (7th Cir. 1999) (affirming conviction of chapter 11 debtor's counsel for making a false declaration in an employment application that failed to disclose affiliations to others connected with the bankruptcy case).
[86] 18 U.S.C. § 153 (2012).
[87] 11 U.S.C. § 110(a)(1) (2012).
[88] H.R. Rep. No. 103-835, 103rd Cong., 2nd Sess., 56 (1994), *as reprinted in* 1994 U.S.C.C.A.N. 3340, 3365.
[89] § 110; *see* Ferm v. U.S. Trustee (*In re* Crawford), 194 F.3d 954, 957 (9th Cir. 1999).
[90] § 110.
[91] *See, e.g.*, Frankfort Digital Servs. v. Kistler (*In re* Reynoso), 477 F.3d 1117, 1125 (9th Cir. 2007).
[92] § 110(c).
[93] 11 U.S.C. § 110(l)(2)(D).
[94] § 110(j).

word "legal" in advertising.[95] Some of the prohibited conduct, when coupled with the requisite intent, is a crime.[96] For example, if a bankruptcy case is dismissed because of a bankruptcy petition preparer's knowing attempt to disregard the requirements of the Bankruptcy Code or Federal Rules of Bankruptcy Procedure, the preparer may be fined or imprisoned for not more than one year.[97] Section 110 prohibits a bankruptcy petition preparer from advising a debtor to use a false Social Security number or to exclude assets or income from bankruptcy schedules.[98] Listing a false Social Security number for a debtor may constitute a false declaration.[99]

One type of bankruptcy fraud scheme involves a bankruptcy petition preparer who accepts payments from a homeowner under the guise of rescuing the house from an impending foreclosure. Instead of forwarding the payments to the lender and curing the mortgage delinquencies, the bankruptcy petition preparer keeps the money and files a bankruptcy petition in the name of an entity unrelated to the debtor. The bankruptcy schedules list a fractional interest in the house to stop the foreclosure by virtue of the automatic bankruptcy stay. Fractional interests in the house may be transferred to numerous entities that will sequentially file bankruptcy petitions in order to stay the foreclosure as long as possible. This creates the illusion that the mortgage delinquency is being cured and the threat of foreclosure is resolved.

Believing that the threat of foreclosure is being handled, the homeowner may make numerous additional payments to the bankruptcy petition preparer. The homeowner may not realize that any bankruptcy cases were filed and may realize that they were defrauded only when the foreclosure is complete. In such cases, the bankruptcy petition preparer's conduct may violate 11 U.S.C. § 110(l)(2)(C), 18 U.S.C. § 152(3), and 18 U.S.C. § 157.[100]

The case of David W. Griffin is an example. He was convicted of bankruptcy fraud in the Middle District of Florida. Griffin operated a foreclosure rescue scheme through his companies, Bay2Bay Area Holding Group, LLC, and Business Development Consultants, LLC. He obtained quitclaim or warranty deeds from homeowners facing foreclosure. He falsely promised to rescue their homes by negotiating with creditors to rent the homes back to the homeowners. He told the homeowners they could repurchase the properties from him. To maximize the income he received by renting the properties, Griffin prevented creditors from foreclosing by filing fraudulent bankruptcy cases in the names of the homeowners, without their knowledge or consent, which triggered the automatic bankruptcy stay.

The United States Trustee's Tampa office learned of the scheme when a homeowner complained that bankruptcy cases were filed in his name without his authorization. Griffin also gave false testimony before the Office of the United States Trustee by stating that he did not have knowledge of a bankruptcy petition filed in Bay2Bay Area Holding Group' s name. The Tampa office filed a complaint under 11 U.S.C. § 110[101] against Griffin and others in April 2015.

The United States Trustee's office also referred the criminal conduct and provided substantial assistance. The FBI, the United States Postal Inspection Service, the Federal Housing Finance Agency Office of Inspector General, and the United States Department of Housing and Urban Development Office of Inspector General investigated. Griffin pleaded guilty to bankruptcy fraud and making a false

[95] § 110(e), (f).
[96] *See* 18 U.S.C. §§ 152, 157 (2012).
[97] 18 U.S.C. § 156 (2012).
[98] § 110(l), (2).
[99] § 152(3).
[100] 11 U.S.C. § 110(l)(2)(C) (2012); § 152(3) (false declaration); § 157 (bankruptcy fraud scheme); *see* United States v. Daniels, 247 F.3d 598 (5th Cir. 2001) (affirming conviction under section 157 of defendant who promised homeowners seeking to avoid foreclosure that they would not have to file bankruptcy but had them transfer fractional interests into shell entities, which then filed bankruptcy).
[101] § 110.

statement during a bankruptcy proceeding. In December 2015, he was sentenced to three years in prison and three years of supervised release. He was also ordered to pay $25,000 in restitution.[102]

An example of another type of fraudulent bankruptcy petition preparation scheme can be found in the case of Valentin Valdés-Ayala from the District of Puerto Rico. Valdés-Ayala, who was not a lawyer, promised legal representation and automatic bankruptcy stay relief to individuals who were incarcerated or facing incarceration for failing to make child support payments. He incorporated Fundacion Lucha Pro-Padres Convictos por Pencion, Corp., with the purported purpose of defending the principles and dignity of fathers convicted of failure to make child support payments. He also created Tears in Prison, Inc., for the stated purpose of preparing bankruptcy petitions.

Through Fundacion Lucha Pro-Padres Convictos por Pencion, Corp., and subsequently through Tears in Prison, Inc., Valdés-Ayala told inmates, potential inmates, and their families that they would be released from prison or avoid imprisonment by filing chapter 13 bankruptcy without first having to make any payments toward their child support debts. In some instances, he promised the elimination or reduction of the child support debt. He told them that his fee included legal representation. What he actually did was file barebones chapter 13 bankruptcy petitions, with the sole purpose of obtaining the benefit of the automatic stay without any intention of having the debtors comply with a chapter 13 plan.

The United States Trustee's San Juan office obtained an injunction and sanctions of $70,700 against Valdés-Ayala. It also made a criminal referral and collaborated with the FBI in its investigation. He was convicted of twenty-nine counts of bankruptcy fraud, falsification of bankruptcy records, wire fraud, aggravated identity theft, and contempt of court. In December 2015, he was sentenced to eleven years and two months in prison and ordered to pay $513,200 in restitution.[103]

E. Actions Against Debt Relief Agencies

Both bankruptcy petition preparers and consumer debtors' attorneys are covered by the Bankruptcy Code's debt relief agency provisions. By definition, a "debt relief agency" is either a bankruptcy petition preparer or a person who provides bankruptcy assistance for consideration to a person who has primarily consumer debts and whose nonexempt property is worth less than $192,450.[104]

A debt relief agency is required to give certain written notices and provide a written contract within five days of providing bankruptcy assistance.[105] It is prohibited from misrepresenting to its client the services to be provided, or advising its client to make an untrue or misleading statement in documents to be filed with the bankruptcy court.[106] A debt relief agency is prohibited from advising a debtor or prospective debtor to incur more debt in contemplation of filing bankruptcy or to pay an attorney or bankruptcy petition preparer's fees.[107] The United States Trustee, debtor, or court, on its own motion, may seek an order enjoining the violation of section 526 or imposing a civil penalty for an intentional violation

[102] United States v. Griffin, No. 15-cr-00157 (M.D. Fla. 2015). Press Release, U.S. Dep't. of Justice, Hillsborough County Resident Sentenced To Prison For Bankruptcy Fraud And Lying To The Office Of The U.S. Trustee (Dec. 15, 2015).
[103] United States v. Ayala, No. 13-cr-00853 (D.P.R. 2015). Press Release, U.S. Dep't of Justice, Valentin Valdés-Ayala Sentenced to 134 Months in Prison for Bankruptcy Fraud (Dec. 1, 2015).
[104] 11 U.S.C. § 101(3), (12A) (2012) (amended 2016).
[105] 11 U.S.C. §§ 527, 528 (2012).
[106] 11 U.S.C. § 526(a)(3) (2012).
[107] § 526(a)(4); Milavetz, Gallop & Milavetz, P.A. v. United States, 559 U.S. 229 (2010) (upholding and narrowly construing section 526(a)(4) noting it primarily targets abuse where a debtor loads up on debt with the intent to discharge it).

or clear and consistent pattern or practice of violating section 526.[108] These remedies augment those available under 11 U.S.C. §§ 110 and 329.[109]

F. Abusive Conduct by Creditors

One of the United States Trustee's priorities has been to take action against creditors who engage in abusive conduct in the bankruptcy system, particularly in the mortgage servicing area. The United States Trustee Program has uncovered abusive conduct through its own efforts and referrals from trustees and others. These abuses can be disastrous for debtors who, after completing a five year chapter 13 payment plan designed to cure defaults and bring their mortgage current, learn they must pay previously undisclosed charges or face foreclosure.

When a mortgage is secured against a debtor's principal residence, the mortgage servicer is required to file and serve on the debtor and debtor's counsel a notice of any change in the payment amount, including any change that results from an interest rate or escrow account adjustment, no later than twenty-one days before a payment of the new amount is due.[110] Examples of misconduct include the mortgage servicer's filing of robo-signed proofs of claim stating the wrong amounts owed, failure to file accurate or timely notices of payment change, and failure to properly credit homeowners with payments made during their chapter 13 bankruptcy cases.

The United States Trustee Program, in addition to pursuing its own enforcement actions, has worked closely with other federal agencies such as the Federal Trade Commission, Department of Housing and Urban Development, and Consumer Financial Protection Bureau. These efforts have resulted in settlements providing monetary relief to debtors and requiring the mortgage servicers to reform their practices. Compliance is verified by independent monitors. For example, in 2015, the United States Trustee Program entered into two national settlements that provided more than $130 million in relief to homeowners and addressed improper practices in bankruptcy by JPMorgan Chase Bank N.A. and Wells Fargo Bank N.A.

IV. Duties in Chapter 11

The United States Trustee has a number of duties in chapter 11 cases. These include engaging in oversight of the case and engaging in civil enforcement activities such as appointing trustees and examiners, when appropriate, and filing motions for dismissal or conversion of a case.

A. Oversight Duties

28 U.S.C. § 586(a)(3) directs the United States Trustee, whenever he or she considers it appropriate, to, among other things: monitor applications to employ professionals; review applications for compensation; monitor chapter 11 plans and disclosure statements and file comments regarding them; take action to ensure that all reports are properly filed; and monitor case progress and take action to avoid undue delay. Section 586(a)(7) further instructs the United States Trustee, in small business cases, to: "conduct initial debtor interviews"; "if deemed appropriate and advisable, visit the debtor's business premises, ascertain the state of the debtor's books and records, and verify that the debtor has filed its tax returns"; diligently monitor the debtor's activities to determine as promptly as possible whether the debtor will be able to confirm a plan; and promptly move to convert or dismiss a case when material grounds for doing such are found.[111]

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[108] § 526(c).
[109] 11 U.S.C. §§ 110, 329 (2012).
[110] FED. R. BANKR. P. 3002.1.
[111] 28 U.S.C. § 586 (2012).

B. Appointment of Chapter 11 Trustees or Examiners

A court may order the appointment of a chapter 11 trustee for cause or if it is in the interests of creditors or the bankruptcy estate.[112] Chapter 11 trustees are appointed by the United States Trustee, with court approval, but are not government employees. These motions may be prosecuted for causes that do not rise to the level of fraud or abuse. Cause includes fraud, dishonesty, incompetence, or gross mismanagement by current management, before or after the bankruptcy case was filed.[113] Once a chapter 11 trustee is appointed, the trustee has the right to possess and control property of the bankruptcy estate.[114]

If there are issues that need investigating in a chapter 11 case, the United States Trustee or a party in interest can move a bankruptcy court to order the appointment of an examiner.[115] Such an appointment may be ordered where the appointment is in the "interests of creditors, any equity security holders, and other interests of the estate," or "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000."[116] The examiner, who is not a government employee, is appointed by the United States Trustee with court approval. The court's order authorizing the appointment of an examiner typically identifies matters that the examiner should investigate. This could include issues ranging from mismanagement or profitability to fraud. The examiner issues a report that discusses relevant matters including any fraud or misconduct it detected through the investigation.

When the appointment of a chapter 11 trustee or examiner is based on misconduct, there may be grounds for criminal prosecution. The Bankruptcy Code directs the United States Trustee to move for the appointment of a trustee:

> . . . if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected [them], participated in fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.[117]

The bankruptcy case of Wilfred T. Azar, III, is illustrative. Azar was the principal of Empire Holdings Corporation and Empire Towers Corporation, both of which filed chapter 11 bankruptcy. He also personally filed bankruptcy. The United States Trustee's Baltimore office filed a motion to appoint a chapter 11 trustee or, in the alternative, to convert the corporations' cases to chapter 7. The motion alleged that the corporate debtors failed to file certain financial reports and diverted substantial rental income or, at a minimum, had not accounted for it. The bankruptcy court entered an order directing the United States Trustee to appoint chapter 11 trustees in the two corporations' bankruptcy cases.

The United States Trustee's office made a criminal referral and provided assistance. The FBI, Securities and Exchange Commission, and IRS Criminal Investigation investigated the case. Azar caused the corporations to sell $7 million of bonds to more than sixty individual investors. He misappropriated millions of dollars from the proceeds to pay personal expenses, including vacations and luxury vehicles, and to finance real estate ventures and a yacht brokerage business. He also failed to report some $1.9 million of embezzled funds on his tax return. Azar was convicted in the District of Maryland of securities fraud and filing a false tax return. In November 2015, he was sentenced to sixty-three months in prison

[112] 11 U.S.C. § 1104(a) (2012).
[113] § 1104(a)(1).
[114] 11 U.S.C. § 1106 (2012).
[115] § 1104(c).
[116] § 1104(c)(1)-(2).
[117] § 1104(e).

and three years of supervised release and ordered to pay $7,219,362 in restitution to his victims and $469,936 to the IRS.[118]

C. Dismissal or Conversion of Chapter 11 Cases

A motion to dismiss or convert a chapter 11 case to chapter 7 may be brought by the United States Trustee or other parties in interest for cause. 11 U.S.C. § 1112(b)(4) sets forth a non-exclusive list of what constitutes cause for dismissal.[119]

Cause often involves something other than fraud. For example, it includes a debtor's failure to file reports, gross mismanagement, or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation.[120] It also includes filing bankruptcy in bad faith and other misconduct.[121] 11 U.S.C. § 1112(b)(1) provides that if the movant establishes cause:

> . . . the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate . . . unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.[122]

In the process of investigating and prosecuting such a motion, the United States Trustee may learn of evidence of criminal conduct.

V. Conclusion

The United States Trustee Program's staff, located throughout the country, adeptly use their resources to carry out their role as a watchdog to prevent fraud and abuse in the bankruptcy system. They frequently uncover evidence of fraud or abuse that assists in civil or criminal investigations and prosecutions. The United States Trustee's staff, whether sharing their expertise, turning over evidence, making criminal referrals, or serving as Special Assistant United States Attorneys in criminal cases, are a valuable resource for federal prosecutors.

ABOUT THE AUTHOR

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[118] United States v. Azar, No. 15-cr-00515 (D. Md. 2015). Press Release, U.S. Dep't of Justice, Former Maryland Businessman Sentenced to Prison for Fraudulent $7 Million Bond Scheme and Filing a False Tax (Nov. 10, 2015).
[119] 11 U.S.C. § 1112(b)(4) (2012).
[120] § 1112(b)(4)(A), (B), (F).
[121] *See* Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994) (stating that the chapter 11 case filed solely to avoid posting an appeal bond, where defendant had assets to satisfy the judgment, warranted dismissal of the bankruptcy for bad faith and imposition of sanctions).
[122] § 1112(b)(1).

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Sentencing in Bankruptcy Fraud Cases[1]

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I. Introduction

A comprehensive review of the federal criminal statutes that cover bankruptcy related offenses and the sentencing issues that arise in bankruptcy fraud cases could fill hundreds of pages. Therefore, this article will only summarize those laws and some of the more common questions to be addressed in sentencing. In particular, the article will address the Sentencing Guidelines provisions applicable to bankruptcy crimes and how courts have interpreted and applied them. Under the Sentencing Guidelines provisions applicable to most bankruptcy crimes, loss amount greatly impacts the defendant's offense level. For this reason, the article will focus primarily on how the amount of loss resulting from bankruptcy crimes is calculated.

As with a variety of crimes involving fraud, the question of restitution is closely related to the issue of loss amount. In bankruptcy fraud cases, the manner in which restitution is calculated depends in part on the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, and the facts of the bankruptcy case that gave rise to the prosecution. This article will discuss how bankruptcy laws, and the events that occurred in the underlying bankruptcy case, affect the calculation of restitution in bankruptcy fraud cases.

II. Bankruptcy Crimes

The United States Code is the only body of law in this country that deals with bankruptcy crimes; no state or local laws address bankruptcy offenses. Federal criminal statutes include a number of these crimes, nine of which are set forth in Section 152 of Title 18: (1) transferring or concealing estate property from certain officials, including trustees; (2) making a false statement under oath in, or in relation to, a bankruptcy proceeding; (3) making a false declaration under penalty of perjury in a bankruptcy proceeding; (4) presenting or using a false proof of claim (that is, a claim for payment) against a bankruptcy estate; (5) receiving, with the intent of defeating the Bankruptcy Code's provisions, property from a debtor after the filing of a bankruptcy case; (6) giving, offering, receiving, or attempting to obtain anything of value for acting or forbearing to act in a bankruptcy case; (7) transferring or concealing property in contemplation of a bankruptcy case filed by or against the property's owner; (8) concealing, destroying, or making a false entry in recorded information relating to a debtor's financial affairs; and (9) after the filing of a bankruptcy case, withholding or concealing recorded information relating to the debtor's financial affairs from someone entitled to that information.[2]

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[1] The author would like to acknowledge and thank Assistant United States Attorney Michael D. Love of the United States Attorney's Office for the Northern District of Illinois for his advice and assistance with the preparation of this article.
[2] 18 U.S.C. § 152 (2012).

Section 153 of Title 18 makes it a crime to embezzle the assets of a bankruptcy estate,[3] while Section 154 prohibits custodians, marshals, trustees, and other officers of the court from purchasing the property of an estate of which the person is an officer, refusing to obey a court order to allow other parties to inspect the estate's records, or refusing to allow the United States Trustee to inspect records relating to the estate.[4] Section 155 of Title 18 criminalizes agreements to fix fees or other compensation to be paid from a bankruptcy estate.[5] Under Section 156, a bankruptcy petition preparer—meaning anyone, other than a debtor's attorney or the attorney's employee, who is compensated for preparing a document for a debtor to file in connection with a bankruptcy case—may be punished if a bankruptcy case is dismissed because the petition preparer knowingly disregarded the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure.[6]

Section 157 of Title 18 criminalizes bankruptcy fraud schemes.[7] In particular, the statute prohibits the filing of a bankruptcy petition or other document in a bankruptcy case, or the making of a false or fraudulent representation, claim, or promise concerning or relating to a bankruptcy case, for the purpose of executing or concealing a scheme to defraud.[8] Under § 157(3), an actual bankruptcy case need not have been filed; the statute covers the making of a false or fraudulent representation, claim, or promise for the purpose of carrying out a scheme to defraud both "before or after the filing of the petition," or in relation to a bankruptcy proceeding "falsely asserted to be pending under such title."[9]

Section 1519 of Title 18 makes it a crime to knowingly alter, mutilate, destroy, conceal, or falsify any record or tangible object with the intention of impeding, obstructing, or influencing the investigation or administration of a bankruptcy case or a matter within the jurisdiction of any United States department or agency, or in contemplation of any such case or matter.[10] The scope of § 1519 is broad. The person charged with violating § 1519 need not be the owner or the custodian of the record or tangible object that was concealed or altered. Section 1519 may apply to the conduct of debtors, creditors, trustees and other custodians, attorneys, and other participants in the bankruptcy system. Thus, if an attorney alters his client's financial records with the intention of influencing the administration of a bankruptcy case the attorney intends to file on behalf of the client, the attorney may have violated § 1519.

A number of other federal criminal statutes that are not specific to bankruptcy may be applicable to bankruptcy cases. For example, a debtor who knowingly uses the social security number belonging to another individual on the debtor's bankruptcy petition may be charged with violating 42 U.S.C. § 408(a)(7)(B), which prohibits the false representation, with the intent to deceive, that a social security number belongs to a person when in fact it does not belong to that person, or with violating 18 U.S.C. § 1028(a)(7), which addresses the knowing transfer, possession, or use, without lawful authority, of a means of identification of another person with the intent to commit a federal crime or any state or local felony.[11]

Because of the large variety of crimes that may occur in the context of a bankruptcy case, it is impractical to address the issues of loss amount and restitution for all such offenses. Instead, this article

[3] 18 U.S.C. § 153 (2012).
[4] 18 U.S.C. § 154 (2012).
[5] 18 U.S.C. § 155 (2012).
[6] 18 U.S.C. § 156 (2012).
[7] 18 U.S.C. § 157 (2012).
[8] § 157.
[9] § 157.
[10] 18 U.S.C. § 1519 (2012).
[11] 42 U.S.C. § 408(a)(7)(B) (2012) (amended 2015); 18 U.S.C. § 1028(a)(7) (2012).

will focus on the calculation of loss and restitution solely for bankruptcy-specific crimes, namely 18 U.S.C. §§ 152-157 and 1519.

III. Loss Calculations Under the United States Sentencing Guidelines

The United States Sentencing Guidelines increase the length of a defendant's recommended sentence based on the amount of loss the defendant causes, or intends to cause, to his victims. The Sentencing Guidelines refer to these measures of victims' losses as "actual loss" and "intended loss," respectively.

Section 2B1.1 of the United States Sentencing Guidelines, which governs the calculation of the offense level for crimes involving fraud and deceit, is used to determine the base offense level for bankruptcy fraud crimes.[12] Under § 2B1.1(a), the base offense level for bankruptcy crimes, which carry a maximum term of imprisonment of five years, is six.[13] Section 2B1.1(b) lists a variety of adjustments to the base offense level depending on the characteristics of the offense.[14] The adjustment that has the greatest potential impact on the offense level is the amount of loss involved in the crime: pursuant to § 2B1.1(b)(1), the defendant's offense level increases as the amount of loss increases.[15] There is no increase in the offense level for crimes causing a loss of $6,500 or less.[16]

Application Note 3 to Section 2B1.1, which applies to the determination of the loss amount under Section 2B1.1(b)(1), states that, subject to certain exclusions, "loss is the greater of actual loss or intended loss."[17] Under Application Note 3, "actual loss" is defined as "the reasonably foreseeable pecuniary harm that resulted from the offense," and "intended loss" is defined as "the pecuniary harm that the defendant intended to inflict," including "intended pecuniary harm that was unlikely or impossible to occur."[18] "Pecuniary harm" means "harm that is monetary or is otherwise readily measurable in money," and "reasonably foreseeable pecuniary harm" means "pecuniary harm that the defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense."[19] When calculating the loss amount, a sentencing court "need only make a reasonable estimate of the loss incurred."[20]

Because § 2B1.1 and the Application Notes to that provision require a comparison between the actual loss that a bankruptcy fraud defendant causes and the loss that the defendant intended to cause, the sentencing court must make a determination of both loss figures and then apply the greater of the two.[21] Actual loss, the reasonably foreseeable pecuniary harm that the defendant's offense of conviction caused

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[12] U.S. Sentencing Guidelines Manual (U.S.S.G.) § 2B1.1 (U.S. Sentencing Comm'n 2016).
[13] U.S.S.G. § 2B1.1(a)(2) (U.S. Sentencing Comm'n 2016).
[14] U.S.S.G. § 2B1.1(b) (U.S. Sentencing Comm'n 2016).
[15] U.S.S.G. § 2B1.1(b) (U.S. Sentencing Comm'n 2016) (Under § 2B1.1(b)(9)(B) and (C), the offense level is increased by two levels if the offense involved "a misrepresentation or other fraudulent action during the course of a bankruptcy proceeding," or "a violation of any prior, specific judicial or administrative order." If the resulting offense level is less than ten, § 2B1.1(b)(9) dictates an increase in the offense level to ten.); *see* United States v. Yihao Pu, 814 F.3d 818, 828-29 (7th Cir. 2016) ("[t]he loss determination is a special offense level characteristic that increases the guidelines offense level" through "bonus punishment points, which express a reasonable estimation of the victim's financial loss").
[16] U.S.S.G. § 2B1.1(b)(1)(A) (U.S. Sentencing Comm'n 2016).
[17] U.S.S.G. § 2B1.1 app. n.3 (U.S. Sentencing Comm'n 2016).
[18] U.S.S.G. § 2B1.1 app. n.3(A)(i)-(ii) (U.S. Sentencing Comm'n 2016).
[19] U.S.S.G. § 2B1.1 app. n.3(A)(iii)-(iv) (U.S. Sentencing Comm'n 2016).
[20] U.S.S.G. § 2B1.1 app. n.3(C) (U.S. Sentencing Comm'n 2016).
[21] United States v. Free, 839 F.3d 308, 309, n.2 (3d Cir. 2016) (citing United States v. Feldman, 338 F.3d 212, 221-23 (3d Cir. 2003)).

his victims, is an objective calculation. In contrast, intended loss is measured by the amount of loss the defendant subjectively sought to perpetrate.[22]

Where the defendant has concealed assets, the court may measure the intended loss by determining the value of those assets.[23]

Because the Guidelines prescribe the use of the greater of intended loss or actual loss, a defendant's offense level could increase above the base offense level even if creditors were ultimately paid in full. Consequently, if the sentencing court determines that a defendant intended his criminal conduct to cause a loss, the court should not lower the defendant's sentence simply because a creditor, the private trustee, the United States Trustee, or another party foiled the defendant's attempted fraud before it could be completed. Instead, the court should use the intended loss amount to calculate the defendant's offense level.[24]

Likewise, a defendant's sentence may be enhanced based on the loss the defendant intended to inflict even if an actual loss was impossible.[25] For instance, if the defendant concealed assets that were entirely exempt, the concealment would not cause any actual loss to creditors. Despite this, the sentencing court could increase the length of the defendant's sentence if the defendant believed that the concealment would inflict a loss on creditors.[26]

There is limited authority for the proposition that there is no actual loss if a defendant was a debtor whose discharge was denied, waived, or revoked.[27] This conclusion is based on a misunderstanding of bankruptcy law. The absence of a discharge simply means that creditors may attempt to collect whatever the debtor owes them. Even though creditors may be at liberty to chase the debtor to recover the amounts due to them, creditors may nevertheless be harmed by the debtor's fraudulent conduct.[28] The defendant in *Green* embezzled funds from the chapter 11 bankruptcy estate of an entity, T-Green, that he owned.[29] The embezzled money was collateral for a loan that an entity called CCB had made to T-Green.[30] T-Green's Chapter 11 reorganization case was later converted to a Chapter 7 liquidation case and was subsequently dismissed (only debtors who are individuals may receive a discharge in a chapter 7 bankruptcy case; entities such as T-Green may not). In rejecting the notion that the absence of a discharge meant that there was no actual loss to creditors, the *Green* court stated, "Obviously, CCB was in a better position when the security for its debt was sitting in [T-Green's] bank account than when it was transferred to a personal account and then dissipated . . ."[31] As the *Green* court

[22] United States v. Middlebrook, 553 F.3d 572, 578 (7th Cir. 2009).
[23] *See, e.g.*, United States v. Hughes, 401 F.3d 540, 557 (4th Cir. 2005) (stating that the district court measured the loss by the value of the assets Hughes had concealed, finding that he "'wished to preserve [the concealed] assets and not have them taken potentially in litigation or, if need be, sold and assets used for personal reasons and not be made available.'").
[24] *See* United States v. Yihao Pu, 814 F.3d 818, 827 (7th Cir. 2017) ("Intended loss is often used to capture the loss the victim would or could have suffered had the offender been able to complete his interrupted criminal scheme.").
[25] U.S.S.G. § 2B1.1, app. n.2 (U.S. Sentencing Comm'n 2016); United States v. Feldman, 338 F.3d 212, 221 (3d Cir. 2003).
[26] Feldman, 338 F.3d at 221.
[27] *See, e.g.*, United States v. Holthaus, 437 F. Supp.2d 932, 936 (N.D. Iowa 2006) ("The government concedes that there is no actual loss in this case, because the bankruptcy court denied the Defendant [sic] discharge and Defendant's unsecured creditors thus did not suffer any harm.").
[28] United States v. Green, No. 3:16CR20, 2016 WL 6652442, at 3 (D. Conn. Nov. 7, 2016) (illustrating this point).
[29] *Id*. at 1-2.
[30] *Id*. at 2.
[31] *Id*. at 4.

recognized, CCB suffered an actual loss when Green stole the security for CCB's debt from T-Green's bank account.[32]

Section 2J1.2, which deals with offenses involving obstruction of justice, is the Sentencing Guidelines provision applicable to violations of 18 U.S.C. § 1519.[33] The base offense level fourteen under § 2J1.2 may be increased by three levels if the offense "resulted in substantial interference with the administration of justice," meaning the "premature or improper termination of felony investigation; an indictment, conviction or any judicial determination based on perjury, false testimony, or other false evidence"; or the "unnecessary expenditure of substantial governmental or court resources."[34] The Guidelines do not define "substantial governmental or court resources," but the seriousness of the other grounds upon which the three-level increase may be based suggests that this adjustment applies when resources unnecessarily expended are greater than in a typical case.[35]

Subsection (b)(3) of § 2J1.2 provides that the base offense level is increased by two levels if the offense involved the destruction, alteration, or fabrication of "a substantial number of records, documents, or tangible objects," involved any "essential or especially probative record, document or tangible object" selected for destruction or alteration, or "was otherwise extensive in scope, planning, or preparation."[36] The qualifying terms used in this context—"substantial number," "especially probative," and "otherwise extensive"—are undefined, yet they each indicate that the two-level enhancement would apply only when there is a showing of the particular gravity of the offense.[37]

A number of participants in the bankruptcy system, including debtors, trustees, and attorneys, hold positions of trust, and when they abuse their position of trust in a way "that significantly facilitate[s]" their commission of a crime, increasing the offense level by two, based on § 3B.1.3 of the Sentencing Guidelines, may be appropriate.[38] An example would be where a defendant, who holds a position of trust, violates 18 U.S.C. § 152(3) by making false declarations under penalty of perjury on documents filed in a bankruptcy case, and the defendant's false testimony at the section 341 meeting of creditors significantly furthers his commission of the offense.[39] An adjustment under § 3B1.3 also may be warranted when an attorney uses information gained from his position to file a false document in a bankruptcy case in violation of 18 U.S.C. § 1519.[40] It is important to note, however, that the § 3B1.3 adjustment cannot be used if an abuse of trust is included in the base offense level or specific offense characteristic.[41]

IV. Restitution

In criminal cases involving certain offenses, including crimes in which an identifiable victim has suffered a pecuniary loss, a sentencing court is required to order "the defendant make restitution to the

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[32] *Id*.
[33] U.S.S.G. § 2J1.2 (U.S. Sentencing Comm'n 2016).
[34] U.S.S.G. § 2J1.2(b)(2) & app. n.1 (U.S. Sentencing Comm'n 2016).
[35] U.S.S.G. § 2J1.2(b)(2) & app. n.5 (U.S. Sentencing Comm'n 2016) ("The specific offense characteristics reflect the more serious forms of obstruction.").
[36] U.S.S.G. § 2J1.2(b)(3) (U.S. Sentencing Comm'n 2016).
[37] *See* U.S.S.G. § 2J1.2(b)(3), app. n.5 (U.S. Sentencing Comm'n 2016).
[38] U.S.S.G. § 3B1.3 (U.S. Sentencing Comm'n 2016).
[39] United States v. Waldner, 580 F.3d 699, 707 (8th Cir. 2009) (finding that the false testimony that the defendant, the CEO of a bankrupt company, gave at the section 341 meeting in the company's bankruptcy case enabled the defendant to facilitate and conceal his violation of § 152(3)).
[40] United States v. Goldman, 447 F.3d 1094, 1096 (8th Cir. 2006) (affirming the district court's application of the enhancement under § 3B1.3 in sentencing a bankruptcy debtor's attorney who had obstructed the bankruptcy case by providing false and misleading testimony to the bankruptcy court).
[41] U.S.S.G. § 3B1.3 (U.S. Sentencing Comm'n 2016).

victim of the offense or, if the victim is deceased, to the victim's estate."[42] The term "victim" in this context means any person "directly and proximately harmed as a result of the commission of an offense for which restitution may be ordered."[43] Under *Hughey v. United States*, the amount of a restitution award and the persons to whom it is paid are to be determined based on the circumstances of the crimes of which the defendant was convicted.[44] Charged conduct of which the defendant was not convicted, such as "relevant conduct," may not form the basis of a restitution order unless a defendant agrees to it in a plea agreement.[45]

Those who are harmed as a direct result of the defendant's conduct in the course of committing a crime that involves "a scheme, conspiracy, or pattern" as an element of the offense may receive restitution.[46] In the bankruptcy fraud context, this usually means that the defendant has been convicted of violating 18 U.S.C. § 157.[47] Thus, a defendant whose offense of conviction is 18 U.S.C. § 157 will owe restitution to anyone harmed as a direct result of the defendant's actions in committing the crime.

In most bankruptcy fraud cases, the victims are creditors who have been deprived of funds they would have received as distributions from an estate in the absence of the defendant's criminal conduct.[48] A number of factors may come into play in determining the losses that creditors suffer as a result of the defendant's crime. These factors include the chapter of the Bankruptcy Code involved, the type of crime the defendant committed, the exemptions available to the debtor, and any recovery of funds during the bankruptcy case.

The chapter of the Bankruptcy Code involved in a crime is relevant to the determination of loss to crime victims because the sources of funds used to pay creditors and the way creditors are paid differ from one chapter to another. In a chapter 7 case, "the United States Trustee appoints an impartial case trustee to administer the case and liquidate any of the debtor's nonexempt assets."[49] After liquidating the debtor's nonexempt assets, the chapter 7 trustee distributes the proceeds to the debtor's creditors in the manner the Bankruptcy Code prescribes.[50] The chapter 7 trustee is paid a commission that is based on the value of the assets the trustee administers.[51]

The assets available to pay creditors in a chapter 7 case generally consist of the non-exempt interests in property the debtor has on the date the bankruptcy petition is filed with the court.[52] In addition, if during the 180-day period after the debtor files bankruptcy the debtor receives an inheritance,

[42] 18 U.S.C. § 3663A(a)(1) (2012); *see also* U.S.S.G. § 5E1.1(a)(1) (stating that the court shall enter restitution for the full amount of an identifiable victim's or victims' loss); United States v. Edwards, 595 F.3d 1004, 1012-13 (9th Cir. 2004).
[43] § 3663A(a)(2).
[44] Hughey v. United States, 495 U.S. 411, 413 (1990).
[45] § 3663A(a)(3); United States v. Randle, 324 F.3d 550, 556-57 (7th Cir. 2003) (explaining that restitution in bankruptcy fraud involving three victims could not be based on harm suffered by all three where defendant's guilty plea dealt with harm caused to only one victim).
[46] *See* Randle, 324 F.3d at 556.
[47] *See* United States v. Lawrence, 189 F.3d 838, 847 at n.5 (9th Cir. 1999) (observing that "bankruptcy fraud" under § 152 "contain[s] no elements relating to scheme, conspiracy, or pattern").
[48] United States v. Lowell, 256 F.3d 463,465-66 (7th Cir. 2004) (holding that a chapter 7 trustee was the victim of bankruptcy fraud where the defendant concealed assets that should have been available for the chapter 7 trustee to administer, and affirming a restitution order requiring the defendant to pay the chapter 7 trustee an amount calculated by multiplying the number of hours the trustee, a private attorney, expended in seeking to recover the assets defendant concealed by the trustee's hourly rate).
[49] *In re* Messina, 687 F.3d 74, 79 (3d Cir. 2012) (stating that under 11 U.S.C. § 522, the law allows debtors who are individuals to keep certain assets by claiming exemptions as to them).
[50] 11 U.S.C. § 507 (2012) (amended 2016).
[51] 11 U.S.C. § 326 (2012).
[52] 11 U.S.C. § 541(a)(5) (2012) (amended 2016).

death benefit (such as life insurance proceeds), or property from a property settlement agreement with the debtor's spouse, those assets may be used to pay creditors.[53] Although the proceeds, rents, or profits from the debtor's property are assets of the estate and therefore may be used to pay creditors, earnings from services that an individual debtor performs after the commencement case are not assets of the estate.[54] This means that a chapter 7 debtor who concealed postpetition rental income from real estate the debtor owned on the petition date may owe restitution for the non-exempt portion of the rent, but that a debtor who concealed a bonus for services the debtor performed postpetition would not have to pay restitution based on the amount of the bonus.

In contrast to chapter 7 cases, where the chapter 7 trustee controls the assets of the estate, in most chapter 11 cases the debtor remains in possession of the debtor's property during the case. Creditors in chapter 11 cases typically receive periodic payments on the amounts debtors owe them pursuant to the terms of plans of reorganization. Once the bankruptcy court approves a chapter 11 reorganization plan, the debtor, creditors, and other parties affected by the plan are bound by its terms.[55]

Similarly, in cases filed under chapter 13 of the Bankruptcy Code, individual debtors with regular sources of income remain in possession of their property and propose plans for repaying their creditors over time.[56] While the plan is in effect, creditors may pursue claims against the debtor only pursuant to the terms of the plan.[57] Although chapter 11 debtors generally make plan payments directly to their creditors, most disbursements to creditors under chapter 13 plans are handled by the chapter 13 trustee.

The property comprising the estate, and the funds available to pay creditors, are more expansive in chapter 11 and chapter 13 cases than in chapter 7 cases. Unlike chapter 7, where the property of the estate is based on a snapshot of what the debtor has on the petition date, the property of a chapter 11 or chapter 13 estate also includes the property the debtor acquires between the petition date and the date the case is dismissed, closed, or converted to a case under a different chapter of the Bankruptcy Code.[58] In addition, earnings from services performed postpetition by chapter 11 and chapter 13 debtors are included within the definition of property of the estate and may be used to pay the debtors' creditors.[59] Therefore, if a debtor in a case under chapter 11 or chapter 13 conceals his receipt of a bonus from services he performed postpetition, and creditors are not paid in full under the plan, the amount of the bonus income may be used in calculating the restitution owed to creditors.

The nature of the defendant's offense is another consideration in calculating restitution. For example, where the offense of conviction is the violation of 18 U.S.C. § 152(1), the concealment of assets of the debtor or the estate, restitution may be measured by the value of the concealed assets.[60] Calculating a restitution figure for a violation of 18 U.S.C. § 1519 (destroying, altering, or falsifying records in a bankruptcy case) would require an analysis of the harm resulting from the destruction, alteration, or falsification. If the defendant falsified a debtor's financial records to make the debtor's income appear to be lower than it actually was in order to reduce the payments to creditors under a chapter 11 plan, restitution would be based on the difference between what the plan payments would have been with

[53] § 541(a)(5).
[54] § 541(a)(6).
[55] 11 U.S.C. § 1141(a) (2012).
[56] Marrama v. Citizens Bank of Mass., 549 U.S. 365, 367 (2007).
[57] 11 U.S.C. § 1327(a) (2012).
[58] 11 U.S.C. §§ 1115(a)(1); 1306(a)(1) (2012).
[59] § 1115(a)(2); 1306(a)(2).
[60] *See, e.g.*, United States v. Maturin, 488 F.3d 657, 661-63 (5th Cir. 2007) (restitution should be based on the value of the concealed assets covered by the count of conviction, but should not include the value of other concealed assets).

accurate reporting of the debtor's income and the amount of the plan payments based on the understated income.

Unlike the loss determination for sentencing purposes, which can include the loss that the defendant intended but did not actually cause, under the Victim Witness Protection Act, as modified by the Mandatory Victims Restitution Act, 18 U.S.C. §§ 3663A and 3664, restitution calculations include only the amount of loss that the victims actually suffered as a result of the crime or crimes of conviction.[61] In other words, restitution should make victims whole, but not provide them with a windfall.[62] Restitution is based on the difference between the amount that creditors would have received had the defendant acted lawfully and the amount creditors actually received.[63] The one exception to this rule is where a defendant agrees to pay additional restitution as part of a plea agreement.[64]

The amount of restitution owed may be reduced by any recoveries that benefitted the victims. If, for example, a trustee discovers assets that a debtor attempted to hide and sells the assets for the benefit of creditors, the amount of restitution owed will be reduced by the amount the trustee distributed to creditors. If all of the concealed assets were recovered and sold at the same or a greater price than they would have been had the defendant disclosed them, the defendant's creditors did not suffer any actual loss, and they should not receive any restitution.

The exemptions that were available to a defendant in the bankruptcy case are another consideration a court may take into account in determining the harm that creditors suffered and, consequently, the restitution the defendant should pay. If the defendant was entitled to exempt assets but failed to disclose them in the bankruptcy case, the court may determine that the value of those assets should not be included in the restitution calculation.[65] The reason for this conclusion is that, if creditors would not have received any distribution from the defendant's estate even if the defendant had acted lawfully—by disclosing and then exempting the assets—the creditors experienced no actual loss as a result of the concealment, and consequently are not entitled to any restitution payments.[66]

One factor that does not affect the restitution calculation in a bankruptcy fraud case is the defendant's ability to pay. In fact, the sentencing court is prohibited from considering the defendant's finances in determining the amount of restitution to order.[67] Under the Mandatory Victims Restitution Act, the court must order full restitution "without consideration of the economic circumstances of the defendant."[68]

The denial, waiver, or revocation of a debtor's discharge also does not have an impact on the amount of restitution owed. The fact that creditors remain legally capable of pursuing the debts they are owed does not eliminate or reduce the harm they suffered as a result of the defendant's illegal conduct.[69] Therefore, even in cases where the defendant did not receive a discharge, the court should award

[61] *See* United States v. Middlebrook, 553 F.3d 572, 579 (7th Cir. 2009).
[62] United States v. Norris, 217 F.3d 262, 272 (5th Cir. 2000).
[63] United States v. Feldman, 338 F.3d 212, 216, 221 (3d Cir. 2003).
[64] 18 U.S.C. § 3663(a)(3) (2012); Maturin, 488 F.3d at 662.
[65] *See* Feldman, 338 F.3d at 221.
[66] *Id*. (The Feldman court reached this conclusion even though a bankruptcy court might have denied the defendant's attempt to claim an exemption as to the concealed assets due to the defendant's wrong-doing. *Id.* at 220. The Feldman court reasoned that while denial of an exemption is based, at least in part, on a desire to deter debtors' concealment of assets, deterrence is not a relevant factor in calculating restitution. *Id.* (citing United States v. Diaz, 245 F.3d 294, 312 (3d Cir. 2001) ("The purpose of restitution under the [Mandatory Victims Restitution Act] is to compensate the victim for its losses and, to the extent possible, to make the victim whole.")).
[67] *See* United States v. Britt, 27 Fed. App'x 862, 864 (9th Cir. 2001).
[68] 18 U.S.C. § 3664(f)(1)(A) (2012).
[69] *See, e.g.,* United States v. Theall, 525 Fed. App'x 256, 267 (5th Cir. 2013).

restitution that places the victims in the same position as they would have been had the defendant's fraud not occurred.[70]

V. Conclusion

Many factors can affect a defendant's offense level for bankruptcy related crimes, but the pecuniary harm resulting, or intended to result, from the offense generally has the greatest impact. Perhaps even more numerous are the various factual and legal issues that must be considered in determining the amount of restitution that a defendant convicted of a bankruptcy crime should pay. Assistant United States Attorneys who are prosecuting bankruptcy fraud cases should consider contacting the United States Trustee's Office for assistance in understanding how the bankruptcy laws, and the events in the underlying bankruptcy case, may have an impact on these sentencing issues.

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[70] *Cf.* United States v. Cluck, 143 F.3d 174, 177, 180 (5th Cir. 1998) (affirming an order requiring restitution for violations of 18 U.S.C. § 152, despite the revocation of the defendant's discharge).

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Federal Law Generally Precludes Bankruptcy Relief for Debtors with Marijuana Property Interests

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I. Introduction

Bankruptcy cases filed by consumers or businesses holding marijuana assets or receiving income from marijuana assets are on the increase. While still small in number compared to total bankruptcy filings, these cases have led to an inevitable conflict. Debtors are using federal law to restructure or discharge debts owed to their creditors, while simultaneously seeking to retain or use marijuana property interests that remain unambiguously illegal under federal law.

This conflict arises in a variety of bankruptcy contexts. The following are the two most common. When a debtor enters bankruptcy with illegal marijuana property interests, in some instances those interests subject bankruptcy fiduciaries charged with liquidating—that is, selling—the debtor's assets or distributing the debtor's income to legal risk under federal criminal law. Alternatively, a debtor may seek to reorganize business or personal finances by proposing that a federal bankruptcy judge authorize the debtor's use of a marijuana related revenue stream or, at a minimum, the debtor's retention of illegal operations. The United States Trustee Program (USTP or Program) holds the unique role as "watchdog" over the bankruptcy process to ensure that bankruptcy cases are conducted in compliance with federal law.[1] It has thus been the Program's consistent practice to move to dismiss, object to reorganization plans, or take other appropriate action in these cases.

On April 26, 2017, Cliff White, the Director of the Executive Office for U.S. Trustees, sent a letter to all chapter 7 and chapter 13 trustees reiterating this policy and directing them to inform the U.S. Trustee when they become aware that a case assigned to them includes assets or income derived from marijuana.[2] The goal of this directive was to promote the uniform application of the bankruptcy law and to protect trustees from being placed in the untenable position of selling or otherwise administering an asset that cannot legally be possessed or sold under federal law.

[1] H.R. REP. NO. 95-595, at 4 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 5966 (stating that the Program, as a component of the Department of Justice (Department), serves as a "watchdog" over the bankruptcy process); *Id*. at 109, *as reprinted in* 1978 U.S.C.C.A.N. at 6070 (stating that the United States Trustee is responsible for "protecting the public interest and ensuring that bankruptcy cases are conducted according to the law"); *see* 28 U.S.C. § 586 (2012); *see* 11 U.S.C. § 307 (2012); H.R. REP. NO. 99-764 at 27 (1986), *as reprinted in* 1986 U.S.C.C.A.N. 5227, 5240 (stating that the U.S. Trustee has "standing to raise, appear, and be heard on any issue in any case or proceeding under Title 11, U.S. Code—except that the U.S. Trustee may not file a plan in a chapter 11 case"); *See, infra*, text at 17-18 (explaining U.S. Trustee's special role as enforcer of the Code).
[2] Letter from Clifford J. White III, Director, Executive Office for United States Trustees, U.S. Dep't of Justice, to Chapter 7 and Chapter 13 Trustees (April 26, 2017).

Several months later, in remarks to the National Association of Chapter 13 Trustees, Director White noted the variety of marijuana related cases that have arisen and the diversity in fact patterns that they present.[3] "[A] marijuana asset does not merely include the marijuana plant," he stated.[4] "In some cases, the marijuana asset is a by-product of the plant, such as oil. In other cases, the asset is in the form of the salary paid by an employer engaged in a marijuana business, an ownership interest in a marijuana business, and income derived from a lease to a marijuana operation."[5]

Sometimes the marijuana connection is a central feature of the debtor's economic life, and sometimes it is more tangential. "In all instances, the basic argument for dismissal is that the bankruptcy system cannot be used to facilitate illegal activity and the Bankruptcy Code does not provide a mechanism to administer assets that cannot legally be possessed or sold under federal law," Director White stated on June 8, 2017, in testimony before Congress.[6] This is true regardless of the degree of criminality or non-criminality of those interests under the laws of any particular state.

Federal bankruptcy courts are thus grappling with how to apply federal bankruptcy law to income or property interests that remain illegal under federal law. The results have not been entirely uniform, and different courts have sometimes taken slightly different approaches to arrive at the same result. However, basic trends in the case law are developing. First, no court has held that illegal pre-bankruptcy conduct related to possessing, manufacturing, or distributing marijuana, by itself, makes a debtor ineligible for bankruptcy relief. But second, consistent with the USTP's position, courts have found that when a debtor enters bankruptcy while retaining marijuana property interests that are subject to administration, those property interests are often difficult if not impossible to reconcile with federal bankruptcy law and, therefore, preclude bankruptcy relief. This article provides an overview of the relevant statutory and case law.

A. The Controlled Substances Act

In 1970, the U.S. Congress passed the Controlled Substances Act (CSA),[7] to "conquer drug abuse and to control the legitimate and illegitimate traffic in controlled substances."[8] Through the CSA, Congress divided "controlled substances" into Schedules I–V based on factors including the determined psychological and physical harms, potential for abuse, and any redeeming therapeutic value.[9] The substances are subject to varying degrees of control corresponding with their "accepted medical uses, the potential for abuse, and their psychological and physical effects on the body."[10] "Schedule I drugs are

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[3] Director Addresses the 52nd Annual Seminar of the National Association of Chapter 13 Trustees, JUSTICE NEWS, U.S. DEP'T OF JUSTICE (July 13, 2017).
[4] *Id.*
[5] *Id.* (explaining that other permutations have included, for example, a debtor who purchases cannabidiol (CBD) from a "Hemp Depot" wholesaler and sells the CBD allegedly for treatment of pet animal ailments, a debtor whose business produces marijuana infused chocolate edibles, and a debtor who grows individual marijuana plants in his home for specific patients as a "caregiver" licensed under state law).
[6] Director Clifford J. White III of the Executive Office for U.S. Trustees Testifies Before the House Judiciary Committee Subcommittee on Regulatory Reform, Commercial & Antitrust Law at a Hearing on Oversight of U.S. Trustee Program, JUSTICE NEWS, U.S. DEP'T OF JUSTICE (June 8, 2017).
[7] 21 U.S.C. § 801 (2012) *et seq.*
[8] Gonzales v. Raich, 545 U.S. 1, 12 (2005) (discussing passage of the CSA).
[9] 28 U.S.C. §§ 811 (amended 2016), 812 (2012) (supplementing the statutorily scheduled substances is § 811(a), which provides authority to the Attorney General, within certain limitations, to add or to remove substances to the statutory schedules through rulemaking authority).
[10] Gonzales, 545 U.S. at 13.

categorized as such because of their high potential for abuse, lack of any accepted medical use, and absence of any accepted safety for use in medically supervised treatment."[11]

When the CSA was originally enacted, Congress classified marijuana as a Schedule I substance, where it remains today. The CSA makes it unlawful for any person to knowingly or intentionally "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense" marijuana.[12] Further, CSA § 856 prohibits knowingly renting, managing, or using property "for the purpose of manufacturing, distributing, or using any controlled substance."[13] Pursuant to CSA § 881(a)(6), "all proceeds traceable to such an exchange" for a controlled substance "shall be subject to forfeiture to the United States and no property right shall exist in them."[14]

B. State Legalization of Marijuana

Twenty-six years after the passage of the CSA, in November 1996, the voters of California approved Proposition 215, the Compassionate Use Act of 1996, which made marijuana use lawful under state law for medicinal purposes only. Within ten years of passage, the Compassionate Use Act came before the U.S. Supreme Court twice, first in *United States v. Oakland Cannabis Buyers' Coop*,[15] and then in *Gonzales v. Raich*.[16] In both cases, the plaintiffs and various *amici* made statutory interpretation, Constitutional, and other arguments that the CSA should not or could not be enforced against persons whose marijuana related conduct did not violate California state law. In both cases, the arguments were unavailing. The Supreme Court upheld the continued applicability of the CSA to California residents, even if their conduct did not violate the state's different statutory regime.

When the Compassionate Use Act was approved in 1996, no other state had made the use of marijuana for medicinal purposes legal under state law, and no state, including California, had legalized or decriminalized marijuana for recreational use. Since 1996, a total of twenty-nine states and the District of Columbia have legalized significant aspects of marijuana cultivation, sale, or use for medicinal purposes,[17] and of those, eight states and the District of Columbia have done so for recreational use.[18] Not surprisingly, legalization at the state level has led increasingly to open marijuana related commercial activity, from plant cultivation through retail sale. The CSA, however, has remained the law of the land at the federal level, substantially unaltered by Congress since its passage in 1970, including the listing of marijuana as a Schedule I substance.

[11] *Id*. at 14.
[12] 21 U.S.C. §§ 841(a), 844(a) (2012).
[13] 21 U.S.C. § 856 (2012).
[14] 21 U.S.C. § 881(a)(6) (2012).
[15] United States v. Oakland Cannabis Buyers' Cooperative, 532 U.S. 483 (2001) (stating that Congress "made a determination that marijuana has no medical benefits worthy of an exception.").
[16] Gonzales v. Raich, 545 U.S. 1 (2005) (holding that the CSA did not violate the Commerce Clause, as applied to plaintiffs; the Supreme Court "had no difficulty concluding that Congress acted rationally" when it did not exempt marijuana used for medicinal purposes from the restrictions of the CSA.).
[17] State Medical Marijuana Laws, NATIONAL CONFERENCE OF STATE LEGISLATURES (Feb. 1, 2018).
[18] Legalization, Marijuana Overview, NATIONAL CONFERENCE OF STATE LEGISLATURES (Aug. 30, 2017) (stating that such measures were passed in Colorado and Washington in 2012; in Alaska, Oregon, and the District of Columbia in 2014; and in California, Maine, Massachusetts, and Nevada in 2016).

II. Bankruptcy in a Nutshell

There are three chapters of the Bankruptcy Code primarily utilized by debtors: chapter 7 (liquidation), chapter 11 (business related reorganization), and chapter 13 (reorganization for individuals only).

In a chapter 7 liquidation case, virtually all of a debtor's property at the time of filing is considered property of the chapter 7 estate. Property that is not exempt by statute[19] is collected and liquidated (reduced to money) by a private trustee appointed by the U.S. Trustee to administer the debtor's estate.[20] The proceeds are then distributed by the trustee to creditors in the priority order set by the Bankruptcy Code. A debtor's postpetition income and assets, by contrast, are generally not subject to administration by the chapter 7 trustee. Except for certain limited types of debt excluded by statute, an eligible debtor usually receives a discharge from his or her debts within four months of filing bankruptcy. A debtor may be denied this discharge under certain circumstances—for example, if the debtor hid assets or transferred assets with the intent to hinder, delay, or defraud creditors.

Chapter 11 offers individuals and businesses an opportunity to reorganize their debts while continuing to operate as a "debtor in possession." The debtor in possession may generally continue business operations pending reorganization, unless a trustee is appointed under chapter 11 to oversee the business operations.[21] The majority of chapter 11 cases are filed by businesses. The debtor, often with the participation of creditors, creates a reorganization plan under which it proposes to repay all or part of its debts. To be approved (or "confirmed") by the bankruptcy court, the plan must meet criteria set forth in the Bankruptcy Code aimed at balancing the debtor's interests in reorganizing with creditors' interests in maximizing payment on valid debts. Payment of debts usually occurs from proceeds generated through ongoing operations, liquidation of assets, or both.

Chapter 13, often called wage earner bankruptcy, is available exclusively to individuals to reorganize their financial affairs under a repayment plan that usually must be completed within three to five years. To be eligible, the individual debtor must have regular income and may not have more than the statutorily prescribed amount of debt. A chapter 13 standing trustee appointed by the U.S. Trustee oversees the administration of the case and any court approved (again, "confirmed") plan to reorganize. The debtor usually pays a set amount each month to the chapter 13 trustee, who then distributes the funds to creditors pursuant to the confirmed plan. While the trustee usually does not liquidate assets, the plan must generally provide that creditors will be paid at least as much as they would if the debtor were in a chapter 7 liquidation. Typically, only upon completion of the payments is a debtor discharged of the obligations remaining unpaid. As in chapter 7, certain debts are excluded by statute from any discharge.

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[19] An exempt asset is an asset owned by an individual debtor that the debtor is permitted to keep from unsecured creditors. There are federal and state exemptions; state law determines what property its residents may claim as exempt, whether under state exemption law, federal exemption law, or a hybrid of the two. The trustee or any party may object to the debtor's exemption claim. In contrast, a non-exempt asset is an asset owned by an individual debtor that is subject to being sold by the trustee to repay creditors.

[20] *See generally* 11 U.S.C. §§ 701-704 (2012).

[21] *See* 11 U.S.C. §§ 1101, 1104 (2012) (stating that in two instances, the Bankruptcy Code empowers the court to appoint a chapter 11 trustee who is selected by the U.S. Trustee. The first instance is an appointment for "cause" including fraud, dishonesty, incompetence, or gross mismanagement of the debtor's affairs; the second is an appointment in the interests of creditors. The trustee replaces the debtor-in-possession and assumes all responsibilities for the debtor).

III. Marijuana Related Bankruptcy Case Law

The U.S. Trustee Program's longstanding legal position is that the Bankruptcy Code does not provide a mechanism to administer assets or income that cannot legally be possessed, sold, or utilized under federal law, and that the bankruptcy system and courts cannot be used to facilitate a reorganization that inherently relies on or involves illegal activity. It has been the Program's practice to move to dismiss, object to confirmation, or take other appropriate action in marijuana related cases.

Consistent with the Program's position, a fundamental concern woven into most marijuana related bankruptcy opinions is whether the federal bankruptcy court or bankruptcy fiduciary—primarily a bankruptcy trustee—may authorize or participate in conduct that is illegal under federal law. As to trustees, the Bankruptcy Appellate Panel of the Tenth Circuit (BAP)[22] stated this concern succinctly:

> [S]hort of exposing him to physical harm, nothing could be more burdensome to the Trustee's administration than requiring him to take possession, sell and distribute marijuana [a]ssets in violation of federal criminal law.[23]

Bankruptcy courts, therefore, have generally dismissed chapter 7 liquidation cases when marijuana related assets are part of the bankruptcy estate but, because of their illicit status, cannot be administered by the chapter 7 bankruptcy trustee.

In the reorganization context, there is a greater divergence of approaches, but courts, nevertheless, have typically reached the same end result of eventual dismissal. Some courts have discussed the impropriety of a bankruptcy fiduciary, either a debtor in possession with trustee-like duties or an appointed trustee, engaging in illegal conduct or administering illicit proceeds. Other courts have focused on the specific statutory requirement that a reorganization plan may not be proposed by a "means forbidden by law" to deny confirmation of plans funded with marijuana assets or income. In some reorganization cases, courts have left open the possibility that if marijuana related operations are discontinued, a debtor may be provided an opportunity to reorganize. In practice thus far, however, this narrow opening appears infrequently exercised and the parameters of this opportunity are unclear.

A. Dismissal of Chapter 7 Liquidation Cases

As noted earlier, in a typical chapter 7 liquidation case, an individual debtor enters bankruptcy hoping to exit with an order of discharge that eliminates the debtor's obligation on most unsecured debts. To receive this benefit, there is a statutory quid pro quo. If a debtor has assets that are not statutorily exempt from liquidation, the chapter 7 trustee's duties include liquidating those assets for the benefit of creditors. In the normal course, a chapter 7 trustee takes possession of these assets, markets them to maximize their value, seeks court approval for the sale, and then sells the assets to buyers willing to provide the greatest value (usually, the highest sales price). After all nonexempt assets are sold, the trustee distributes the proceeds in a pro rata fashion to creditors. In exchange, the debtor receives a discharge of most unsecured debts. Creditors are thereafter barred from attempting to collect the

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[22] Court Insider: What is a Bankruptcy Appellate Panel?, UNITED STATES COURTS (Nov. 26, 2012) (stating: A bankruptcy appellate panel, or BAP, is authorized by 28 U.S.C. § 158(b) to hear, with consent of all the parties, appeals from bankruptcy courts that otherwise would be heard by district courts, but only in those districts in which the district judges authorize appeals to BAPs. BAPs were created by the Bankruptcy Reform Act of 1978 and the first BAP was established in the Ninth Circuit in 1979. Since 1994, the judicial council of each circuit is required to establish a BAP unless the judicial council determines that the circuit does not possess sufficient judicial resources to support a BAP or the circuit's establishment of a BAP would result in undue delay and increased cost to the parties. Not all circuits have established a BAP.).

[23] *In re* Arenas, 535 B.R. 845, 852 (B.A.P. 10th Cir. 2015).

discharged debts through any means, such as sending collection letters, calling debtors to collect the debt, suing debtors, garnishing their income, or attaching their assets.

When an individual debtor enters chapter 7 while choosing to hold illegal marijuana related assets, the debtor changes this statutory balance in the debtor's favor because the CSA prohibits a trustee from liquidating this asset. Absent some intervention in the usual progress of a case, a debtor would exit bankruptcy receiving a discharge of debts while retaining a nonexempt asset.[24] This is antithetical to the integrity of the chapter 7 statutory bargain.

When confronted with this scenario, the Tenth Circuit BAP posited and answered the question in simple terms: "Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No."[25] The statutory remedy was dismissal of the case founded on prejudice to creditors as provided under 11 U.S.C. § 707(a)(1).[26]

The facts in the *Arenas* case were straightforward. The individual debtors' nonexempt property primarily consisted of a commercial building used as a marijuana grow house and twenty-five marijuana plants valued at $6,250. The debtors' income was primarily derived from their medical marijuana cultivation business and their leasing of space in the grow house to a marijuana dispensary. Notwithstanding the debtors' compliance with Colorado state law, the bankruptcy court granted the U.S. Trustee's motion to dismiss the case. The bankruptcy court agreed with the U.S. Trustee's basic argument that the chapter 7 trustee was unable to administer assets that were illicit under federal law and it would be inequitable to permit the case to proceed to the debtors' discharge.[27] On appeal, the Tenth Circuit BAP upheld the bankruptcy court's dismissal of the case "for cause."[28]

The BAP framed "[t]he pivotal issue here [as] whether engaging in the marijuana trade, which is legal under Colorado law but a crime under federal law, amounts to 'cause' including a 'lack of good faith' that effectively disqualifies these otherwise eligible debtors from bankruptcy relief."[29] The BAP then sustained the bankruptcy court's core determination that it would be "impossible" for a bankruptcy trustee to administer all the assets of the bankruptcy estate "because selling and distributing the proceeds of the marijuana assets would constitute federal offenses . . . [and] [b]ecause of that, the creditors had no expectation of receiving any dividend while the debtors would receive a discharge."[30] The BAP also agreed with the bankruptcy court that "while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."[31]

The BAP made rather short shrift of the debtors' primary argument against dismissal. The debtors argued that "cause" was absent because they were not actively impeding the trustee's administration of the assets. The BAP rejected this argument, emphasizing that "the debtors have violated federal law and apparently intend to continue to do so" while simultaneously seeking bankruptcy relief. The natural result,

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[24] Whether a bankruptcy debtor may apply a generic statutory exemption to argue that a marijuana asset is exempt, in whole or part, from liquidation has not been addressed in a published federal court decision.
[25] *In re* Arenas, 535 B.R. at 847.
[26] 11 U.S.C. § 707(a)(1) (2012) (amended 2016) (stating that dismissal of a case does not bar discharge of those debts in future cases).
[27] *In re* Arenas, 514 B.R. 887 (Bankr. D. Colo. 2014).
[28] § 707(a) (stating that "[t]he court may dismiss a case under this chapter . . . for cause, including—(1) unreasonable delay by the debtor that is prejudicial to creditors . . ." The term "cause" is not defined in the Bankruptcy Code. As a result of a dismissal of a chapter 7 case, the debtor is returned to the debtor's pre-filing status. The debtor retains both the debtor's assets and liabilities.).
[29] *In re* Arenas, 535 B.R. 845, 849 (B.A.P. 10th Cir. 2015).
[30] *Id.* at 853.
[31] *Id.* at 849-50.

the BAP found, was that the debtors would retain their business while "exposing the [t]rustee to grave risk, provide the creditors with little or no recovery, and receive a discharge, protected all the while from their creditors' collection efforts."[32] The BAP concluded that this was "the epitome of prejudicial delay" to creditors.[33]

Notwithstanding the number of states that have legalized marijuana in some form, there is only one other reported bankruptcy decision involving a chapter 7 case. That case, *In re Medpoint Mgmt., LLC*,[34] involved an involuntary proceeding initiated by three creditors against the limited liability company putative debtor. In a twist from normal circumstances, it was the putative involuntary debtor who requested dismissal of the case and who argued primarily that, as in *Arenas*, any chapter 7 trustee appointed to the case would be unable to administer the contraband marijuana assets. The Bankruptcy Court for the District of Arizona also agreed and dismissed the involuntary petition. The bankruptcy court concluded that the "dual risks of forfeiture of Medpoint's assets and a trustee's inevitable violation of the CSA in administration of a Medpoint chapter 7 estate constitute cause . . . to dismiss."[35]

It is worth noting that, unlike individuals, artificial entities such as corporations and limited liability companies do not receive a discharge of debts in chapter 7 liquidation cases. The *Medpoint* court's decision, therefore, was not based on the same unfair prejudice to creditors that was present in the *Arenas* case filed by individual debtors. Rather, the *Medpoint* court found that "cause" for dismissal was present because "the prospects of a possible forfeiture or seizure of Medpoint's assets pose[d] an unacceptable risk to a chapter 7 estate and to a chapter 7 trustee."[36]

B. Refusal to Confirm Chapter 11 or 13 Reorganization Plan

While the requirements for reorganization in chapters 11 and 13 differ greatly, the core legal issues regarding the impact of marijuana income or assets are similar in both chapters. In a chapter 11 or chapter 13 reorganization case, a debtor generally needs to show that income or assets are available for reorganization. That is not the case for debtors in chapter 7. Further, compared to a typical chapter 7 liquidation case, more aspects of a chapter 11 or chapter 13 reorganization case require bankruptcy court approval, implicating Bankruptcy Code sections that cannot easily be squared with marijuana income or assets. In addition, some judges state that their oath to uphold the laws of the United States guides their analysis. This subsection discusses several rationales provided by bankruptcy courts in chapter 11 and chapter 13 cases involving marijuana assets or income.

One approach taken by courts is to deny plan confirmation on the ground that a plan that relies upon marijuana income cannot be "proposed in good faith and not by any means forbidden by law," as required under 11 U.S.C. § 1129(a)(3) for chapter 11 and § 1325(a)(3) for chapter 13.[37] Citing this requirement, in the first reported decision involving a reorganization case, the Bankruptcy Court for the District of Oregon denied confirmation of a proposed chapter 13 plan that depended on medical marijuana related income.[38] The court reasoned that "[w]hile a medical marijuana grower who is in compliance with state law may find the risks acceptably small and of little deterrence to his operation, when that grower files bankruptcy, § 1325(a)(3) prevents confirmation of a plan depending on that operation."[39]

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[32] *Id.* at 853.
[33] *Id.* at 854.
[34] *In re* Medpoint Mgmt., LLC, 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part*, 2016 WL 3251581 (9th Cir. BAP 2016).
[35] *In re* Medpoint Mgmt., LLC, 528 B.R. at 186.
[36] *Id.* at 185.
[37] 11 U.S.C. §§ 1129(a)(3), 1325(a)(3) (2012) (amended 2016).
[38] *In re* McGinnis, 453 B.R. 770 (Bankr. D. Or. 2011).
[39] *Id.* at 772.

In the chapter 11 case *In re Rent-Rite Super Kegs W. Ltd.*, the Bankruptcy Court for the District of Colorado determined that no plan could be confirmed where the debtor derived twenty-five percent of its revenues from leasing space to a tenant engaged in growing marijuana.[40] The bankruptcy court found that, even assuming the business operations were in full compliance with Colorado law, the good faith and lawfulness requirement of section 1129(a)(3) "foreclose[d] any possibility of this Debtor obtaining confirmation of a plan that relies in any part on income derived from a criminal activity."[41] Absent the prospect of a confirmable plan, the court found that cause for dismissal or conversion of the case to chapter 7 was present.

The Bankruptcy Court for the Southern District of Florida employed a similar analysis, with similar results, in the chapter 11 case *In re Arm Ventures, LLC*.[42] The debtor owned commercial real estate property. As part of its reorganization plan, the debtor intended to lease the property to a tenant that had pending applications for state and federal approval to cultivate and sell marijuana. A creditor filed a motion to dismiss the case, arguing that no plan depending on marijuana income could be confirmed. After reviewing *Rent-Rite Super Kegs, Arenas*, and *McGinnis*, the court agreed and held that because the plan was "based on an enterprise illegal under Federal law," the debtor could not satisfy the requirements of section 1129(a)(3).[43]

In chapter 13 cases involving marijuana, courts have found an additional roadblock to reorganization: that a plan cannot be confirmed because administration of marijuana proceeds could cause the trustee to engage in illegal conduct. For example, in *Arenas* the debtors requested that, in lieu of dismissing their chapter 7 case, the bankruptcy court convert their case to a chapter 13 reorganization case. The debtors requested conversion to propose a plan that would pay creditors the nonexempt value of the property. This, the debtors asserted, was their desire rather than having liquidation of the property as an issue in chapter 7 proceedings.

The bankruptcy court denied the request, emphasizing that similar barriers to a trustee's administration of a marijuana related case exist in chapters 7 and 13. The court found that any proposed chapter 13 reorganization plan by the Arenases "would be funded from profits of an ongoing criminal activity under federal law and would necessarily involve the Chapter 13 Trustee in administering and distributing funds derived from the Debtors' violation of the CSA."[44] On appeal, the Tenth Circuit BAP agreed. The BAP stated that, given the debtors' present sources of income, the plan would not be feasible without the marijuana income. With the marijuana income, the BAP continued, "there was no way" a chapter 13 trustee could "administer the plan without committing one or more federal crimes."[45]

C. Segregation of Marijuana Income is Not a Salve

Some chapter 13 debtors with both legally and illegally derived income have proposed to segregate the illicit marijuana income and pay only the legal income to the chapter 13 trustee. This, they argue, avoids any concern over a trustee's administration of illicit proceeds and frees the court to confirm

[40] *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799 (Bankr. D. Colo. 2012).
[41] *Id.* at 809.
[42] *In re* Arm Ventures, LLC, 564 B.R. 77 (Bankr. S.D. Fla. 2017).
[43] *Id.* at 86. For a chapter 11 plan to be confirmed, the proponent must also show that confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization . . ." 11 U.S.C. § 1129(a)(11) (2012). This is commonly referred to as the "feasibility" test. The bankruptcy court also expressed considerable concerns regarding the feasibility of the proposed plan. According to the court, federal approval of the marijuana enterprise was so speculative that "any plan proposed by the Debtor based on the sale of marijuana is not confirmable, certainly not for the foreseeable future." *Id*. at 84.
[44] *In re* Arenas, 514 B.R. 887, 892 (Bankr. D. Colo. 2014).
[45] *In re* Arenas, 535 B.R. 845, 852 (B.A.P. 10th Cir. 2015).

such a plan for an "honest but unfortunate" debtor. Bankruptcy courts have rejected that option, using various rationales.[46]

This proposal was rejected by the Bankruptcy Court for the Western District of Michigan in *In re Johnson*.[47] The bankruptcy court first found that, in proposing such a plan, the debtor "implicitly concede[d] the impropriety of requiring the [chapter 13] Trustee to hold the proceeds of the Debtor's criminal activity and to use those funds to pay claims under a court-approved plan."[48] The court then rejected the segregation proposal, finding that to the extent the debtor wished to continue deriving income from the marijuana business, he could not obtain bankruptcy relief.[49] The court reasoned that a chapter 13 debtor has trustee-like duties over all of the debtor's income. Thus, "[i]f the Standing Trustee is precluded by federal criminal law from using estate property in a certain manner, the Debtor as a debtor in possession is similarly precluded" from "holding contraband or using proceeds or instrumentalities of federal criminal activity."[50]

The segregation scenario was also rejected by the bankruptcy court in *Arenas*, but on different grounds than in *Johnson*. The *Johnson* court focused on the debtor's trustee-like duties over all of the debtor's income. The *Arenas* bankruptcy court focused instead on whether marijuana income was required to "execute" the plan and therefore caused the plan to fail to meet the requirements of section 1325(a)(3). The bankruptcy court stated that section 1325(a)(3) "requires [the Court] to examine the lawfulness of a plan's means of implementation in order to satisfy the requirement that 'the plan has been proposed . . . not by any means forbidden by law.'"[51] The bankruptcy court then examined the various sources of the Arenases' income. While Mr. Arenas' income was derived from marijuana sources, Mrs. Arenas' income was derived from legal sources.[52] Even though the debtors could have proposed a plan under which only Mrs. Arenas' legal income would be paid to a chapter 13 trustee, the bankruptcy court found that the fact that the marijuana income was necessary for the "execution" of any such plan made the plan non-confirmable. Specifically, the evidence persuaded the court that "the Debtors cannot, under the present circumstances, feasibly propose a chapter 13 plan that does not depend upon income from sources that are illegal under the CSA for the plan's execution."[53]

D. Circumstances in Which Courts Have Permitted Reorganization Cases to Proceed

The Program takes the position that the bankruptcy system and courts cannot be used to facilitate a reorganization that would continue the illegal activity and, therefore, the Program will move to dismiss or object to confirmation of the proposed plan of repayment in cases involving marijuana assets or income. Nonetheless, some courts have given debtors a brief window to cease the illegal activity and, if reorganization is still feasible, to continue in bankruptcy. Recently, in the first marijuana bankruptcy

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[46] *See*, however, the discussion of *In re* Cook Investments NW, SPNY, LLC, No. 16-44782-BDL (Bankr. W.D. Wash. 2017), *infra*.
[47] *In re* Johnson, 532 B.R. 53 (Bankr. W.D. Mich. 2015).
[48] *Id.* at 56.
[49] *Id.* at 58.
[50] Specifically, the *Johnson* court examined 11 U.S.C. §§ 1303 and 1304, both of which provide that a debtor's trustee-like rights and powers are "subject to any limitations on a trustee." The *Johnson* court read these two Bankruptcy Code sections as "bestowing on a chapter 13 debtor the authority to use estate property (i.e. the debtor's income) that a trustee would have under various subsections of § 363, subject to the same limitations that would otherwise bind a trustee." *Id.* at 57.
[51] *In re* Arenas, 514 B.R. 887, 894 (Bankr. D. Colo. 2014).
[52] *Id.*
[53] *Id.* The BAP declined to address the section 1325(a)(3) analysis, upholding the bankruptcy court's alternative finding that the chapter 13 trustee could not administer a plan funded by marijuana income, and that without those funds, any plan would not be feasible.

related case in which the USTP has sustained an adverse result, one court confirmed a plan even though a marijuana grow operation would remain on the debtor's premises and continue to pay rent.

In *Johnson*, when the bankruptcy court denied confirmation of the proposed chapter 13 plan, it also enjoined the debtor from conducting his medical marijuana business while the chapter 13 case was pending. The court provided the debtor fourteen days to either dismiss the case or demonstrate that his plan would be otherwise funded. The debtor timely demonstrated that his plan would be funded with income from his new job as a construction laborer, and his plan was then approved by the court. Within six months, however, the debtor became delinquent on his plan payments. The court granted the chapter 13 trustee's motion to dismiss the case based on the delinquent payments.

In *McGinnis*, the Bankruptcy Court for the District of Oregon gave the debtor twenty-eight days to file a new chapter 13 plan proposal under which the debtor's income would not be marijuana related. The debtor did not file a new plan and voluntarily dismissed his case.

In *Rent-Rite Super Kegs*, after the Bankruptcy Court for the District of Colorado found cause for dismissal based on the chapter 11 debtor's lease of warehouse space to a tenant growing marijuana, the debtor agreed to relinquish its interest in the warehouse to the secured creditor and back to the receiver previously appointed by the state court to control and manage the property. Thereafter, the court entered a new order stating that the circumstances supporting its finding of cause to dismiss were remediated, and allowing the case to proceed.[54] Approximately one year later, however, the debtor sought to sell the same property and utilize the proceeds of the sale as part of its reorganization process. The U.S. Trustee objected and filed a new motion to dismiss given that the debtor had not addressed how the sale could be approved in light of the prohibitions identified in the court's prior order.[55] The debtor consented to dismissal.

In *Arm Ventures, LLC*, the Bankruptcy Court for the Southern District of Florida gave the chapter 11 debtor fourteen days to file a plan that did not depend on marijuana as a source of income. The debtor did so, but within three months the court dismissed the case based on numerous unrelated procedural deficiencies in the new plan and other case deficiencies. The court also found that the severity of the procedural deficiencies, combined with the debtor's "bad faith" in filing the case with the proposal to fund a plan with marijuana proceeds, warranted an order barring the debtor from filing another bankruptcy case for one year.[56]

In *In re Cook Investments NW, SPNY*, the Program objected to confirmation of the debtor's plan, arguing that the plan perpetuated the debtors' illegal business arrangement with a marijuana-grow tenant, that the rental proceeds were fungible, and that the plan facilitated further CSA violations and, therefore, did not meet the confirmation requirements of 11 U.S.C. §1129(a)(3).[57] In the plan, the debtors eliminated any reference to the lease or rent payments and filed a motion with the court seeking permission to reject the lease. The bankruptcy court granted the motion, although the termination of the lease did not require the tenant to vacate the premises or the debtors to refuse rent payments. The bankruptcy court agreed with the Program's position that it could not ignore an undisputed known criminal activity or fail to consider whether the plan was premised on such behavior. Nonetheless, in the first ruling adverse to the USTP in a

[54] Order on Amended Motion to Reconsider, *In re* Rent–Rite Super Kegs West, Ltd., Case No.12-31592 (Bankr. D. Colo.) Doc. No. 101.
[55] United States Trustee's Objection To Debtor's Motion To Sell Debtor's Interest In Real Property, *In re* Rent-Rite Super Kegs West, Ltd., Case No.12-31592 (Bankr. D. Colo.) Doc. No. 154. In his motion to dismiss, the U.S. Trustee also alleged that a variety of non-related procedural deficiencies further warranted dismissal of the case. United States Trustee's Motion to Dismiss Chapter 11 case, *In re* Rent-Rite Super Kegs West, Ltd., Case No. 12-31592, (Bankr. D. Colo.) Doc. No. 160.
[56] Transcript of proceedings of March 1, 2017, *In re* Arm Ventures, LLC., No. 16-23633, Doc. No. 265.
[57] *In re* Cook Investments NW, SPNY, No. 16-44782-BDL at 86.

marijuana related case, the bankruptcy court held that the plan should be confirmed despite the debtors' known criminal activity because the debtors could fund the plan payments without the income from the lease. It also held that confirmation would not result in court approval of the continuing operations because the lease had been rejected by court order.

The U.S. Trustee appealed this decision to the District Court for the Western District of Washington, but the district court affirmed.[58] On appeal, the U.S. Trustee asserted that a bankruptcy court may not confirm a plan that perpetuates a debtor's violation of federal criminal law because section 1129(a)(3) requires bankruptcy courts to consider whether a plan perpetuates or envisions unlawful activity. In the Program's view, that statute does not permit a court to ignore known criminal violations perpetuated and envisioned by the plan merely because the illegal activity will not directly fund the plan or is not mentioned in the plan. The district court, however, rejected that view as unsupported by case law, beyond the scope of the statutory text, and an "attempt[] to turn the bankruptcy court into a regulatory or criminal court."[59]. On February 16, 2018, the U.S. Trustee filed his notice of appeal to the United States Court of Appeals for the Ninth Circuit.

The extent to which courts will allow debtors that have marijuana assets or income to reorganize is uncertain and case law continues to develop. The Program will continue to take appropriate enforcement actions to prevent the administration of illegal assets in bankruptcy.

IV. Conclusion

The Bankruptcy Code does not automatically bar a debtor who may have committed a criminal act from seeking bankruptcy relief. As the cases discussed in this article make clear, however, obtaining relief is a considerable challenge for a debtor who enters bankruptcy with marijuana assets that are illegal to possess, marijuana income and assets that are subject to forfeiture, or illegal marijuana business interests that are intended to be continuing in nature. Federal courts measure the illegality of these interests under federal law and will generally deny relief when those illegal interests subject bankruptcy fiduciaries to legal risk or impair their fiduciary duties, or when the marijuana related venture is incompatible with the requirements of the federal Bankruptcy Code. These potential conflicts with the bankruptcy system are broad in scope. The resulting path for the debtors to obtain federal bankruptcy relief has thus been narrow.

ABOUT THE AUTHOR

❑ **Gregory Garvin** joined the United States Trustee Program in March 2008 as the Assistant United States Trustee for Colorado. On December 23, 2017, the Attorney General appointed Mr. Garvin as also the Acting United States Trustee for Region 18, with offices in Anchorage, Alaska; Boise, Idaho; Great Falls, Montana; Eugene and Portland, Oregon; and Seattle and Spokane, Washington. Prior to joining the United States Trustee Program, Mr. Garvin was an attorney in private practice in Kansas City, Missouri, for seventeen years. His private practice focused on commercial litigation and bankruptcy matters, including representing debtors in chapters 7 and 13, as well as individuals, small businesses, and creditors in chapter 11.

[58] *In re* Cook Investments NW, SPNY, No. 17-5516 BHS (Bankr. W.D. Wash. Dec. 18, 2017).
[59] *Id*. at 6.

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United States v. Robert Lee Keys: A Case Study

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I. Summary

Sometimes the filing of a bankruptcy case is the last step in a complex fraud scheme. This article will provide a case study illustrating an attempted use of the bankruptcy system in a scheme to defraud, and detailing how it was discovered, the investigation, referral, prosecution, and sentencing. This significant case in the District of Oregon involved complex facts and an array of fraudulent activities that included taking financial advantage of an elderly widow. The success of the case was the result of joint efforts by the United States Attorney for the District of Oregon, the United States Trustee's Office, and the Internal Revenue Service.

Robert Lee Keys was a prominent businessman who ran a company called Private Consulting Group, which at one time had assets of $400 million and managed investments for high net worth individuals from around the country. In 2008, as Mr. Keys' business ventures were failing, he turned to one of his longstanding clients, a woman in her mid-80s, and persuaded her to loan $1.1 million to a co-defendant, Mr. K., a Florida businessman. Mr. Keys lied to his client about the terms of the loan and failed to disclose important facts to her in order to fraudulently obtain the money for his benefit and that of his co-defendant, Mr. K. In addition, Mr. Keys failed to disclose that he was receiving over $100,000 in kickbacks as part of the scheme to defraud. Mr. K. wired those kickbacks to Mr. Keys the day after he persuaded his client to loan Mr. K. the $1.1 million.

As part of the scheme, Mr. Keys, along with his wife, filed for bankruptcy relief in 2010.[1] The couple fraudulently attempted to discharge $148 million in debt by filing false documents with the bankruptcy court, concealing assets and income, and lying under oath during the bankruptcy case.

The United States Trustee successfully opposed the Keyses' bankruptcy discharge. As a result, the bankruptcy court did not enter an order discharging the couple's debts in their bankruptcy case, and creditors could exercise their legal rights and remedies to attempt to collect their debts from the Keyses notwithstanding the bankruptcy filing.

Mr. Keys was indicted for mail fraud, money laundering, and bankruptcy fraud based on the scheme he designed to defraud his elderly client and his false statements, false oaths, and concealment of assets and income in his bankruptcy case.[2] Mr. Keys ultimately pleaded guilty. He admitted that he had

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[1] *In re* Lynn C. Keys, Robert L. Keys, 3:10-BK-34294 (Bankr. Or. 2010).
[2] U.S. v. Robert Lee Keys, 12-cr-00338-HZ (2012).

devised and participated with Mr. K. in the scheme to defraud his client, lied under oath during his bankruptcy case, and attempted to launder the money he received from the scheme. Mr. Keys' sentence for his guilty plea was seventy months in prison.[3]

II. Events Leading Up to the Bankruptcy Filing

Robert Lee Keys was a securities broker-dealer, an insurance broker, and a certified financial planner. He had a controlling interest in a broker-dealer/investment advisor business called Private Consulting Group, Inc. (Private Consulting Group). He described this business as charitable planning, estate planning, and retirement planning for the high net worth client. At one time, the business had around 25 offices and approximately $400 million under management. Mr. Keys was a successful businessman who lived a prosperous lifestyle.

A large source of Mr. Keys' income was a program called ClassicStar, a mare leasing tax shelter purchased by high net worth individuals. ClassicStar sold leases in thoroughbred mares that were to be bred to produce profitable foals. The program told their investors that they could claim their whole investment as a tax deduction. In 2007, an investigation by the Internal Revenue Service concluded that the ClassicStar program was an abusive tax shelter. The IRS denied the tax deductions associated with the investment and clients began to sue Mr. Keys.

Mr. Keys' financial position deteriorated quickly when the economic recession took a toll on his investments. Mr. Keys began to get involved in unsuccessful real estate development projects, both individually and on behalf of clients of Private Consulting Group. The failed real estate projects resulted in numerous lawsuits and judgments, and Mr. Keys became mired in litigation and collection actions. The costs of litigation began to consume Private Consulting Group's cash, and the business struggled to maintain net capital in order to operate.

In August 2008, in an effort to rescue his once thriving business, Mr. Keys formed Private Wealth Advisors, Inc. (Private Wealth Advisors), KBG Management, and Strategic Capital, Inc. (Strategic Capital), as Oregon corporations. Mr. Keys intended for Private Wealth Advisors to take over Private Consulting Group's registered investment advisory business. Private Consulting Group would remain as the broker-dealer and KBG Management was to employ all of the employees. Strategic Capital would sell financial products. The only company that got off the ground was Strategic Capital.

III. Strategic Capital

Articles of Incorporation filed with the Oregon Secretary of State for Strategic Capital on August 14, 2008, listed Mr. Keys as the registered agent and incorporator. The initial funds for Strategic Capital were a $250,000 loan from a business partner. Mr. Keys invested $200,000 of the loan proceeds and paid the remaining $50,000 to himself and other entities that he controlled. Unfortunately, the $200,000 venture that Mr. Keys invested in failed, and the money was lost. Thereafter, rather than engage in legitimate business activities, Mr. Keys used Strategic Capital as a vehicle to hide his income and assets. From its founding in August 2008 through the time that Mr. and Mrs. Keys filed for bankruptcy in May 2010, Strategic Capital disbursed $680,068 to or on behalf of Mr. Keys.

IV. Scheme to Defraud Elderly Client

From the early 1980s through 2009, Mr. Keys managed investments for Mr. and Mrs. F. Their investment portfolio, as managed by Mr. Keys, was worth millions of dollars at one point in time. Mr. F.

[3] Press Release, U.S. Dep't of Justice, Prominent Businessman for Private Consulting Group Sentenced to Federal Prison After Bilking Elderly Victim of $1.1 Million, (March 31, 2015).

died in 2007, and Mrs. F., who was by then in her 80s and living alone on a farm, trusted and continued to rely on Mr. Keys to manage her portfolio. Although Mr. Keys had a fiduciary duty to Mrs. F., he ignored this duty, and in December 2008, desperate to save several floundering real estate projects, persuaded Mrs. F. to loan $1.1 million to Mr. K., a Florida businessman whom she had never met. By his own admission, Mr. Keys viewed Mr. K. as a "savior."

Mr. K. held himself out as a wealthy businessman. However, by the time of the transaction involving Mrs. F. in December, Mr. Keys knew that Mr. K. was untrustworthy. In October 2008, Mr. K. had failed to perform in providing money to rescue a real estate development known as San Carlos. This failure cost investors millions—including Mr. and Mrs. F., who each lost $500,000. Mr. Keys also knew that Mr. K. had failed to provide $6 million in bonds in another real estate project between Mr. K. and one of Mr. Keys' business associates. Yet, Mr. Keys turned to Mrs. F. for cash. Discovering in November 2008 that she had $1 million cash in her accounts, he persuaded her, through false promises and omissions of material facts, to loan money to Mr. K. Mr. Keys falsely promised Mrs. F. that the loan would be secured by U.S. Treasury bonds that he had seen and that the loan would be repaid within sixty days. Mr. Keys failed to disclose that:

- He was personally going to receive the benefit of $150,000 from the loan to Mr. K., including $100,000 in direct kickbacks and $50,000 to be paid for outstanding legal fees;
- He had never actually seen or verified that Mr. K. owned any U.S. Treasury bonds;
- He was lending the money to Mr. K. in hopes that Mr. K. would rescue him from several failed real estate projects;
- He had conducted no background check on Mr. K. and in fact did not even know where Mr. K. lived;
- He knew that Mr. K. had failed to fulfill two earlier promises to fund certain real estate projects; and
- One of Mr. Keys' principal business partners had recently refused to make a loan to Mr. K. because Mr. K. could not provide proof that he had sufficient collateral, in the form of U.S. Treasury bonds, to repay the loan.

Mrs. F. made two separate wires of funds, $750,000 and $350,000, on December 11, 2008, as a result of Mr. Keys' scheme to fraudulently obtain money from her through false statements and omissions. Two $50,000 wire kickbacks to Mr. Keys' companies followed the next day.

V. Concealment Scheme Begins

By the end of 2008, Mr. Keys was in deep financial trouble, with outstanding debts totaling over $35 million. He began to fear that creditors could seize his future income. He therefore attempted to protect his assets and income by diverting them to Strategic Capital, while concealing his interest in that company.

On December 30, 2008, Mr. Keys transferred, on paper, his interest in Strategic Capital to Brenda Carper, his long-time bookkeeper. Although Ms. Carper claimed that she planned to use Strategic Capital to provide bookkeeping services to third parties, she never actually had any clients, and Mr. Keys continued to control Strategic Capital. For example, in February 2009, Mr. Keys transferred funds from the San Carlos real estate development business to Strategic Capital, and he used the funds to pay personal expenses. He also transferred funds from Strategic Capital to other entities that he controlled.

In the meantime, the unusual nature of the loan from Mrs. F., and the absence of any documentation, triggered a series of calls by the bank custodian that, in turn, caused the Financial Industry Regulatory Authority (FINRA) to start an investigation. In March 2009, FINRA deposed Mr.

Keys. He was asked, "And you own Strategic Capital completely?" He replied, "Yes, 100 percent. It's an entity of mine." FINRA also asked, "What is your interest in Strategic Capital?" and he responded, "It's a C Corp. I own it in one of my entities." Although his interest in Strategic Capital transferred on paper to Ms. Carper, Mr. Keys signed the 2009 Annual Report as president of Strategic Capital.

Nevertheless, Mr. Keys faced continued creditor lawsuits and collection actions in 2009, and he continued to divert funds for his personal use through Strategic Capital. In July 2009, $140,000 was deposited into Strategic Capital's bank account for investment in another real estate development. Mr. Keys directed Ms. Carper to transfer $132,500 to a personal account that he controlled. From this account, he disbursed $130,500 for personal, business, and legal expenses.

In September 23, 2009, a garnishment of over $70,000 to one of the Keyses' personal bank accounts occurred. A short time later, Mr. Keys met with a bankruptcy attorney.

As he was planning to file bankruptcy, Mr. Keys continued to try to hide his interest in Strategic Capital. On November 24, 2009, the Oregon Secretary of State received Restated Articles of Incorporation for Strategic Capital. Mr. Keys signed the Restated Articles of Incorporation as a director. The filing included an attachment naming Ms. Carper as the manager and organizer of Strategic Capital, retroactive to the date of incorporation. This action removed Mr. Keys from all of Strategic Capital's records kept by the Oregon Secretary of State's offices, effectively preventing judgment creditors who routinely search these records from finding his ownership interest.

On December 1, 2009, Ms. Carper filed an Amended 2009 Annual Report that changed the president of Strategic Capital from Mr. Keys to another officer of PCG. In 2009, Mr. Keys also asked the officer and Ms. Carper each to hold half of the stock of Strategic Capital so that Mr. Keys would no longer be a shareholder. Mr. Keys told the officer that he expected an issue with a creditor to be resolved, after which changes to the ownership structure of Strategic Capital could continue in efforts to reflect more appropriately that Strategic Capital was Mr. Keys' company.

In 2009 and 2010, Mr. Keys and Ms. Carper engineered the transfer of several of Mr. Keys' assets to Strategic Capital. This included artwork valued at $132,452.19, a 2002 Lexus, and three boats.

VI. The Bankruptcy Proceeding

Mr. Keys and his wife filed a chapter 7 bankruptcy petition on May 11, 2010, in the United States Bankruptcy Court for the District of Oregon.[4] The couple sought to discharge over $148 million in unsecured debt.

A. The Keyses' Bankruptcy Schedules

Mr. and Mrs. Keys (the debtors) signed their bankruptcy petition, schedules, statements, and related documents under penalty of perjury. These documents require disclosure of extensive information about assets, income, and transfers. The Keyses' bankruptcy documents, which were seventy-nine pages long, reflected a complex array of financial activity, including twenty-one businesses in which Mr. Keys had been an officer, director, partner, or managing executive within six years before the commencement of the bankruptcy case.

Significantly, the bankruptcy documents did not reflect Mr. Keys' interest in Strategic Capital or his purported transfer of the company, and did not reflect all of his income, including the $100,000 in kickbacks that Mr. Keys received in connection with the fraudulent loan to Mr. K. from Mrs. F.

[4] *See In re* Lynn C. Keys, Robert L. Keys, 3:10-BK-34294 (Bankr. Or. 2010).

B. Mr. Keys' Testimony at the Meeting of Creditors

In a chapter 7 bankruptcy case, the debtor is required to attend a meeting of creditors, frequently called the 341 meeting.[5] This meeting is conducted by the chapter 7 trustee and is the opportunity for the trustee and creditors to question the debtor about the debtor's bankruptcy documents and past financial transactions. The debtors appeared and testified under oath at their meeting of creditors on June 15, 2010. Among other things, Mr. Keys falsely testified that the bankruptcy documents were accurate and that he had no ownership interest in Strategic Capital.

C. The United States Trustee's Civil Investigation

The United States Trustee's Office in Portland, Oregon, began a civil investigation of the bankruptcy case on June 18, 2010, after receiving information from a creditor alleging that ownership of most of Mr. Keys' assets belonged to a Cook Island trust. The purpose of the United States Trustee's investigation was to determine whether there were grounds to object to the Keyses' bankruptcy discharge. An individual's bankruptcy discharge may be denied if, among other reasons, the individual concealed assets, made false statements in bankruptcy documents, or falsely testified under oath in the bankruptcy case.[6]

In conducting an investigation for civil enforcement purposes, the United States Trustee can obtain substantial information through informal and formal discovery methods. On occasion, parties may provide information voluntarily. For example, a creditor may provide documents to the United States Trustee to demonstrate that someone engaged in bankruptcy related misconduct, or a debtor may provide information in response to an inquiry by the United States Trustee. In addition, Federal Rule of Bankruptcy Procedure Rule 2004 is a formal discovery method that often is used to obtain documents and testimony.[7] A Rule 2004 examination is separate from the meeting of creditors. The examination is under oath similar to a deposition.

The debtors produced a considerable amount of financial information voluntarily to the United States Trustee and to the chapter 7 trustee appointed by the United States Trustee to administer their bankruptcy case in response to the United States Trustee's civil inquiry. This information included tax returns, bank account information, accounting records, and other information about Mr. Keys' interests in various businesses.

The United States Trustee also conducted Rule 2004 examinations of Mr. and Mrs. Keys and Ms. Carper under oath on November 9 and November 10, 2010. Significantly, both Mr. Keys and Ms. Carper testified to the effect that Strategic Capital was Ms. Carper's bookkeeping company and that Mr. Keys had no interest in it.

D. The United States Trustee's Complaint to Deny Discharge

Parties in a bankruptcy case can initiate adversary proceedings, which are separate lawsuits within the context of a bankruptcy case, to request certain types of relief. In the Keyses' case, the United States Trustee initiated such an adversary proceeding on January 7, 2011, by filing a thirty-four page complaint for denial of the debtors' bankruptcy discharge under 11 U.S.C. § 727.[8] The complaint alleged, among other things, that the Keyses should not be able to discharge their debts in bankruptcy because they made numerous false statements and false oaths in their bankruptcy documents and during their meeting of creditors and Rule 2004 examinations. The complaint also asserted that the debtors concealed assets, including Mr. Keys' interest in Strategic Capital.

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[5] *See* 11 U.S.C. § 341 (2012).
[6] *See* 11 U.S.C. § 727 (2012).
[7] FED. R. BANKR. P. 2004.
[8] U.S. Trustee v. Robert and Lynn Keys, 11-ap-3009-tmb (Bankr. Or. 2009).

The Federal Rules of Civil Procedure generally apply in bankruptcy adversary proceedings. The United States Trustee thus continued to gather information and testimony in preparation for the trial on the discharge denial lawsuit by traditional civil discovery methods, such as by issuing subpoenas to obtain documents and taking depositions to obtain witness testimony. The United States Trustee gathered voluminous financial information pertaining to Mr. Keys' businesses and took the depositions of Ms. Carper and six other non-party potential witnesses.

Mr. and Mrs. Keys waived their bankruptcy discharges on October 7, 2011, about a month before a scheduled four day trial on the U.S. Trustee's complaint to deny discharge.

VII. The Criminal Referral and Investigation

The United States Trustee made a formal written criminal referral of Mr. Keys for bankruptcy fraud in 2011. In 2012, after Mr. Keys had waived his discharge, a Bankruptcy Analyst for the United States Trustee Program, who is an accountant, began to work with a criminal investigator for the Internal Revenue Service regarding Mr. Keys' bankruptcy fraud and other possible criminal conduct.

The United States Trustee's criminal referral and the documents collected in the course of the civil investigation were the foundation for the criminal bankruptcy fraud investigation. The accounting records that the United States Trustee had secured in connection with the civil enforcement litigation were particularly important. An analysis of those records led to the discovery of the $100,000 kickback that Mr. Keys received from the Mrs. F. loan. The analysis of the accounting records also revealed that the records had been changed after the fact to conceal the $100,000 payment. The records also had been modified to re-characterize transactions to conceal Mr. Keys' use and control of Strategic Capital.

The accounting records obtained in the United States Trustee's civil case were later used to support a search warrant to seize documents and computers. Internal Revenue Service computer specialists retrieved emails and documents from computers. The emails and documents were then analyzed by the United States Trustee and Internal Revenue Service investigators, with guidance from the Assistant United States Attorney on legal matters, such as how to handle sensitive information. Documents were sent to a Department of Justice litigation support facility to be scanned into a database system.

The United States Trustee Bankruptcy Analyst and Internal Revenue Service criminal investigator worked together to prepare witness testimony and documentary evidence to support a possible indictment.

VIII. The Criminal Prosecution

On June 27, 2012, a grand jury in the District of Oregon returned an indictment against Robert Lee Keys,[9] charging him with:

- two counts of wire fraud[10] associated with the electronic fund transfers from Mrs. F.;
- two counts of engaging in a monetary transaction in property derived from specified unlawful activity[11] associated with the two $50,000 kickbacks that Mr. Keys received from that transaction; and

[9] U.S. v. Robert Lee Keys, 12-cr-00338-HZ (2012).
[10] 18 U.S.C.A. § 1343 (2012).
[11] 18 U.S.C.A. § 1957 (2012).

- five counts of bankruptcy fraud[12] associated with:
    1) Mr. Keys' false statements in his bankruptcy documents about his interests in Strategic Capital and a Lexus, the sale and transfer of assets, and income;
    2) false testimony at his bankruptcy meeting of creditors on June 15, 2010, that his bankruptcy documents were accurate;
    3) false testimony at his bankruptcy meeting of creditors on June 15, 2010, that he had no ownership interest in Strategic Capital;
    4) false testimony during his Rule 2004 examination on November 9, 2010, that Ms. Carper controlled Strategic Capital, which was basically a bookkeeping company and bill paying service for others; and
    5) concealment of his ownership interests in Strategic Capital, artwork, a Lexus and farm equipment.

Brenda Ann Carper was indicted for aiding and abetting Mr. Keys[13] and for bankruptcy fraud[14] associated with her false testimony during her Rule 2004 examination on November 10, 2010, and her deposition on September 9, 2011. Mr. K.'s indictment for aiding and abetting Mr. Keys ended up dismissed after his death during the course of the case.

In April 2013, Ms. Carper made a proffer and agreed to cooperate with the government's prosecution of Mr. Keys. Ms. Carper pleaded guilty to one count of bankruptcy fraud on June 19, 2013, in exchange for a government sentencing recommendation of probation and possible home confinement. Sentencing allotted her twelve months of probation on October 22, 2014.

Meanwhile, the United States Trustee Bankruptcy Analyst and the Internal Revenue Service criminal investigator continued to work together under the guidance of the Assistant United States Attorney to analyze evidence and interview potential trial witnesses for the prosecution of Mr. Keys. They summarized evidence and testimony, expanded the order of proof that they had earlier prepared for the grand jury presentation, and prepared trial exhibits and witness testimony outlines. Trial preparations were complete by the time that Mr. Keys pleaded guilty to five counts of the indictment, approximately six weeks before trial.

On September 2, 2014, Mr. Keys pleaded guilty to two counts of mail fraud, two counts of money laundering, and one count of bankruptcy fraud in exchange for a government sentencing recommendation of fifty-seven to seventy months. On March 31, 2015, the court sentenced Mr. Keys to seventy months in prison for the mail fraud and money laundering counts and a concurrent sixty months for the bankruptcy fraud count.

IX. Conclusion

The prosecution of Mr. Keys demonstrates how the information obtained in a bankruptcy case can lead to a successful criminal prosecution as well as civil resolution. The comprehensive documents about assets, liabilities, and financial affairs that debtors are required to file under penalty of perjury in a bankruptcy case, as well as their testimony under oath during bankruptcy meetings of creditors, Rule 2004 examinations, and depositions, provide multiple opportunities for wrongdoers to commit acts that warrant denial of discharge. The same acts also may constitute bankruptcy crimes. Here, the evidence that the United States Trustee gathered to oppose Mr. and Mrs. Keys' discharge led to the discovery of the fraud perpetrated on Mrs. F., as well as Ms. Carper's involvement in Mr. Keys' fraudulent scheme. The

[12] 18 U.S.C.A. §§ 152(1)-(3) (2012).
[13] 18 U.S.C. § 2 (2012).
[14] § 152(2).

collaborative effort involving the United States Attorney, the United States Trustee, and the Internal Revenue Service allowed for the effective management of complex facts and the conviction of a high powered businessman who abused his elderly client, his creditors, and the bankruptcy system.

ABOUT THE AUTHORS

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Note from the Editor in Chief . . .

I want to thank our two issue advisors, Mark Redmiles, Assistant Director, Asset Recovery Staff, Office of Legal and Victim Programs, Executive Office for United States Attorneys, and Sandra Rasnak, Assistant Director for Criminal Enforcement, Executive Office for United States Trustees, as well as our Lead Editor here at the Publications Unit—Nikki Piquette. Together they have produced a top quality issue of near record length. I also want to thank the authors. They wrote excellent articles covering the waterfront of bankruptcy. Finally, I want to thank Director Crowell and Director White for their introductions and their recognition of the importance of this topic. We are pleased to publish this issue. As you can see from the articles, bankruptcy is very complex and important area of practice for the U.S. Attorney community and the Department family. We hope this issue assists you the reader in that practice.

Thank you,

K. Tate Chambers