

Consumer Bankruptcy

If It Quacks Like a Duck:
Identifying and Avoiding
Fraud in Consumer Cases

Prof. Jason J. Kilborn, Moderator

ABI Resident Scholar; Alexandria, Va.

Margaret A. Burks

Chapter 13 Trustee; Cincinnati

Fredrick E. Clement

Law Offices of Fredrick E. Clement
Redding, Calif.

Steven J. Katzman

Bienert, Miller & Katzman, PLC
San Clemente, Calif.



AMERICAN
BANKRUPTCY
INSTITUTE

DISCOVER



AMERICAN BANKRUPTCY INSTITUTE
JOURNAL

journal.abi.org

ABI's Flagship Publication





Delivering Expert Analysis to Members

With *ABI Journal* Online:

- **Read the current issue before it mails**
- **Research more than 10 years of insolvency articles**
- **Search by year, issue, keyword, author or column**
- **Access when and where you want – even on your mobile device**
- **Receive it FREE as an ABI member**

Find the answers you need
journal.abi.org

44 Canal Center Plaza • Suite 400 • Alexandria, VA 22314-1546 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:   

© 2011 American Bankruptcy Institute All Rights Reserved.

**If It Quacks Like a Duck: Identifying
and Avoiding Fraud in Consumer Cases**

Jason J. Kilborn
Moderator
American Bankruptcy Institute (Fall 2011)
Robert M. Zinman Scholar in Residence

Margaret A. Burks
Chapter 13 Trustee
Cincinnati, Ohio
mburks@cinn13.org

Fredrick E. Clement
Attorney at Law
Redding, California
fredrick@fredrickclementlaw.com

Steven J. Katzman
Bienert, Miller & Katzman, PLC
San Clemente, California
skatzman@bmkattorneys.com

By: Fredrick E. Clement

An Overview

Fourteenth century poet Dante Alighieri wrote the Inferno, which described hell as nine concentric circles. Starting with the outermost circles and moving toward the center, the circles represent increasing wickedness. Souls of the deceased are consigned to particular circles based on sin committed in life and suffer eternal punishment befitting that sin. The eighth circle, the second closest to the center and, in Dante's view, the second most reprehensible, houses the souls of those persons who committed fraud.

In its simplest terms, fraud may be described as “deceit, trickery, sharp practice, or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage.” (Webster's Encyclopedic Unabridged Dictionary, 762 (1996)) It is worthy of punishment because it destroys one of the central notions of fairness: that a level playing field requires that all parties to a transaction have access to—or at least not be misled by other parties about—the facts central to making a measured choice. In the same way, justice demands a full disclosure of salient facts, from which an appropriate result may be achieved. By definition, fraud is a deception that robs others of information needed to make decisions and renders weak the very foundations of fairness and justice.

Fraud is never more worthy of retribution than when practiced by or against the weak, the powerless, the desperate or the vulnerable. When practiced against such a person the culpability is compounded by the powerlessness of the victim. When practiced by such a person it is compounded by the seemingly inappropriate use of that position and the sympathy that naturally accompanies it.

Among the fraudulent confined to the eighth circle in the Inferno, are: falsifiers (alchemists, counterfeiters, and perjurers); exploiters (panderers and seducers, who use others' weaknesses); and fraudulent advisors and evil counselors. So, too, it is among those who commit fraud related to insolvency. When corrupt, debtors are falsifiers. The best example is the failure to schedule an asset or a transaction. Likewise, the failing of creditors is exploitation. Consider the credit card company that uses a late payment as an excuse to increase the interest rate to 28 percent. The sin of collateral players (e.g., debt settlement companies and mortgage modification negotiators) is false advice, usually in the form of hope--where there is none--in exchange for a sizeable fee.

So those who commit fraud must be punished. The opportunities for unfair advantage are too numerous; the moral outrage too great; and the injury to our system of justice too devastating. Like Dante's Inferno, punishments range from the mild to the severe, depending on the offense. At the lowest level, fraud involves sharp, but not illegal, practices and offenders suffer only social ostracism or other mild penalties. Parties guilty of more severe variants may face civil penalties, including monetary sanctions or the loss of a discharge of debts. (11 U.S.C. §523(a)(2),(4), 727(a)(2)-(4)) The most severe forms of fraud carry criminal penalties that include imprisonment. (18 U.S.C. §157; see also, 18 U.S.C. 152 (knowing concealment of assets from the trustee or false oaths in relation to Title 11 case))

By: Margaret A. Burks

Fraud by Debtors

As a Chapter 13 Trustee I am always on the look-out for fraud, but my main concern at the 341 meeting of creditors and as I administer my cases is to make sure that 1) debtors get their "fresh start," 2) debtors have enough funds to put food on the table, and 3) make sure creditors

get a fair return. Fraud or the indicia of it are present in many cases, but not all cases reach the Judge. Many go quietly into the night when the case is dismissed.

Do desperate people do desperate things? Are these debtors receiving bad counsel or are the debtors keeping their Counsel in the dark? What if the ‘bad behavior’ happened prior to filing? What is the Trustee looking for? The Trustee is looking through all the data and information at the 341 meeting. When the facts do not add up – Trustees start to ‘sniff’ around and find the fraud. Debtor fraud can be at the civil and criminal level as we see below.

Criminal - In 2009, the U.S. Trustee program made 1,611 bankruptcy and bankruptcy-related criminal referrals, and in 2008 there were 1,471 criminal referrals. “The most common allegations in referrals made during FY 2009 were false oath/false statement (602 referrals), concealment of assets (481), tax fraud (331), bankruptcy fraud scheme (317), and mortgage fraud/real estate fraud (306)”¹

Several recent high profile criminal cases have been reported lately. One involves Jon Hammill of St. Petersburg, Florida, who pled guilty to charges of bankruptcy fraud. When Hammill filed for bankruptcy “he failed to disclose on his petition or during the meeting of the creditors that occurred on or about March 17, 2009, that he had an investment in [a foreign currency trading venture] named Botfly, worked for Botfly, and received a salary and commissions from Botfly.”²

Bernard J. Kurlemann of Cincinnati was indicted for hiding assets in his Chapter 7 bankruptcy. Per the FBI website, Kurlemann was involved in a mortgage fraud scheme involving luxury homes in the Cincinnati area. Kurlemann was convicted by a jury on one count of conspiracy to commit loan fraud and two counts of loan fraud based upon false statements.

¹ United States Trustee Program, Annual Report of Significant Accomplishments, Fiscal Year 2009 at page 21.

² See Department of Justice press release dated August 11, 2011 at <http://www.usdoj.gov/usao/flm/pr>

Kurlemann made false statements on purchase contracts and settlement statements when he sold two of his companies' luxury homes to straw buyers. The jury also convicted Kurlemann of bankruptcy fraud and other crimes connected with lying on filings in Kurlemann Builders, Inc.'s bankruptcy.

What role does the U.S. Trustee play in uncovering and stopping debtor fraud?

The U.S. Trustee is the watch dog of the bankruptcy court system and as such files numerous motions under 707(b) to dismiss or convert to Chapter 13 when debtor's income is too high. In my experience, these kind of Chapter 13 debtors are not the best debtors. They are unhappy to be in a Chapter 13 so their commitment is not high; yet, it is necessary to force them into a Chapter 13 because of the income levels. One wonders if they received good legal Counsel in the first place.

Per the 2009 Annual Report, the US Trustee filed 3,912 707(b) motions in 2009 with a 97.1 success rate, and \$394,186,390 was not discharged.³

The U.S. Trustee's office in Cleveland, headed by U.S. Trustee Daniel McDermott, successfully filed complaints in two Chapter 7 cases. In the first Assistant U.S. Trustee, Andy Vara, reports that debtor waived his chapter 7 discharge of \$33,252,344 in unsecured debt. The waiver resolved a complaint filed by the U.S. Trustee's office alleging debtor had perpetrated a Ponzi scheme on investors, most of whom were fellow members of his Church.

Since the 1980s, debtor operated a sole proprietorship investment firm. He used his position as a respected elder in the church community to solicit investors. All of debtors' unsecured creditors were individuals, small businesses, or family trusts that invested with his firm. No banks, credit card companies, or other institutional creditors were listed in the

³ United States Trustee Program, Annual Report of Significant Accomplishments, Fiscal Year 2009 at page 15.

schedules. The vast majority of debtor's victims were church members. According to his amended schedules, these investors numbered nearly two-thousand, seven-hundred.

Until shortly after his bankruptcy, debtor was Treasurer of a non-profit corporation believed to control over \$150 million in assets. Although debtor represented that he had only limited education, debtor ran an income tax filing franchise in the past, and was the registered representative of a brokerage firm for more than 15 years.

In the second case from Cleveland, debtor waived his chapter 7 discharge of \$2,242,341 in unsecured debt. The waiver resolved a complaint filed by the U.S. Trustee's office alleging debtor engaged in a scheme to defraud investors out of hundreds of thousands of dollars to fund his extravagant lifestyle and gambling habits. Since at least 2004, debtor had maintained his lifestyle by soliciting investments in day-trading software he claimed to be developing. Debtor used his associations with his church to convince fellow church members to invest in his various limited liability companies. Debtor regularly created new corporations and accounts to hinder and delay his investors' collection efforts. Debtor avoided paying federal taxes, claiming to have virtually no income on his 2008 and 2009 personal tax returns.

Good Faith - 11 U.S.C. section 1325(a)(3) and (a)(7)

Creditors or a Chapter 13 Trustee may file objections to a Chapter 13 case for 'lack of good faith. 11 U.S.C. section 1325 (a)(3) provides as follows: "Except as provided in subsection (b), the court shall confirm a plan if – the plan has been proposed in good faith and not by any means forbidden by law." See also 11 U.S.C. section 1325 (a) (7). "Except as provided in subsection (b) the court shall confirm a plan if the action of the debtor in filing the petition was in good faith."

The case of Okoreeh-Baah, at 836 F.2d 1030, 1032 (6th Cir. 1988) sets forth a twelve point test to determine if a case has been filed in good faith, yet those criteria alone are not

determinative of good faith. Per Okoreeh-Baah the Court must assess the totality of the circumstances. See, also Ed Schory & Sons, Inc. v. Francis (In re Francis), 273 B.R. 87 (6th Cir. B.A.P. 2002), which applies the good faith test to Chapter 13 cases, with a non-exclusive list (at p. 91). Among those elements listed in Francis at pages 91-92 are:

- The probable or expected duration of the Plan;
- The accuracy of the plan's statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are in attempt to mislead the court;
- the motivation and sincerity of the debtor in seeking Chapter 13 relief;
- whether the debtor is attempting to abuse the spirit of the Bankruptcy Code

A few recent cases in which 'good faith' was in question are as follows:

In re Weeks, 2011 WL 144141 (Bankr. E.D.Okla.Jan.18, 2011). Debtors had logging business which they dissolved. Debtors transferred corporate assets to themselves. Nonetheless the Court found that the case was filed in good faith because Debtors had made pre-confirmation plan payments and demonstrated ability to complete plan that proposed to pay secured creditor in full over 60 months.

In re Melton, 2010 WL 5128631 (Bankr. D.S.C. Dec. 9, 2010.) Debtor failed to remain current on post-petition mortgage payments, purchased vehicle one month before bankruptcy filing and made no payments, and failed to report prepetition tax refund. Court determined case was not filed in good faith.

In re Johnson, 438 B.R. 854 (Bankr. D.S.C. Oct. 27, 2010) Under totality of circumstances, debtor had reasons to file the Chapter 13 case and had stable business and income. Debtor proposed to retain two separate vehicles, one of which was purchased shortly before filing. Court determined case was filed in good faith.

11U.S.C. Section 523(a)(2) and (4)

Debtors' 'fraud' or bad behavior can come in many forms as stated. Creditors may file a complaint to determine whether a debt is dischargeable under 11 U.S.C. 523 (a)(2) and (4).

A few examples of '523' cases are listed below.

The Chapter 7 case of in re Todd Crawford (Adversary Case no. 09-11181 Bankr. S.D. Ohio, June 29, 2011) involved the filing of a complaint to determine dischargeability under 11 U.S.C. § 523(a)(2), (4), and (6). A motion for summary judgment was recently denied and as of late September 2011 this case was scheduled for trial.

The Plaintiff alleged the Debtor defrauded the Plaintiff by: (i) inducing the Plaintiff to issue lien waivers upon the sale of the retail space; (ii) failing to inform the Plaintiff of the closing date on the sale of the office building; and (iii) failing to inform the Plaintiff of the financial condition of Liberty Falls, LLC.

The Debtor was a 53% owner of Liberty Falls, LLC, a special purpose entity formed to develop a tract of real estate. The LLC owned two commercial projects consisting of retail space and a medical office building and hired the Plaintiff, B. L. Spille Construction Co., Inc, to construct the buildings.

In December, 2007, Liberty Falls, LLC sold the retail project for \$2,000,000.00, and netted \$900,000.00 from the sale. To allow for the sale, the Plaintiff granted a lien waiver with the understanding that the Plaintiff would recover the amounts owed under the construction contract upon the sale of the medical office building. The property was later resold. Liberty Falls LLC paid \$400,000.00 of its share of the sale proceeds to the Plaintiff, but a large balance remained unpaid.

Not all cases are so complicated. Debtors have been known to sell an asset with a lien on it, but not turn over the funds to the creditor. In a Chapter 13 case in my district, debtors sold an excavator worth \$20,000, and spent the proceeds prior to filing. The Creditor filed a complaint alleging Debtors acquired proceeds from the conversion of plaintiff's collateral by false pretense, and false representation, under 11 USC Section 523 (a)(2). The case eventually was dismissed for non payment before a decision could be entered.

A few additional examples of fraud are listed below from my cases. Some of these cases are still developing.

Debtor titled real estate in the name of the social service non-profit corporation which she controls. The Trustee noted on her Report to Court that there have been at least 64 real estate transactions transferred in and out debtor's name in the county recorder's office within four years of the debtor's petition. Debtor is living in a home owned by the nonprofit she controls. Debtor says she assists 250 families per month, and has been asked to verify this information. Finally, the debtor disclaimed interest in a separate company in which she claims to only be an employee, but evidence introduced in state court litigation shows that debtor is a shareholder. (Case and investigation are on-going.)

Trustee discovered debtor had been engaging in 'off shore' gambling in the thousands of dollars by reviewing the bank statement at the 341 meeting. None of this was disclosed and the case was later dismissed.

Helping out your son: The Chapter 13 was filed because debtor borrowed funds in the amount of \$130,000 to help her son buy a franchise business. The amount of money lent to debtor's son is approximately 80% of debtor's entire unsecured debt. Debtor has proposed a plan percentage at 33%, funded solely by debtor's net income from her pension over 36 months.

It appears that debtor's conduct does not meet the requirements of 11 U.S.C. Section 1325(a)(7). Debtor testified that she has no ownership interest in the franchise set up by son as an LLC. The loans were not listed on Schedule B.

Debtor proffered a liquidation analysis showing no value in assets that would return any minimum percentage to unsecured creditors. The value of these obligations should have been valued under 11 U.S.C. Sec. 1325(a)(4).

In this same case debtor filed a B22C (means test form) and Schedule I which asserted that her monthly income from her pension was only \$2,833.00 per month. At the 341 Meeting, this was determined to be net income, not gross, which should have been reported in both places. When adjusting the B22C to reflect gross income during the months that her CMI was calculated, debtor amended the B22C to increase her household size, without explanation, ostensibly to keep her household defined as a "below median" household. As of this writing this case is still on going.

In closing, I note that while there are debtors involved in fraudulent activities within the bankruptcy arena, the vast majority of debtors are the honest debtors working toward their fresh start. All this data on debtor fraud could make one quite sour about this whole bankruptcy process. After 19 years as a Chapter 13 Trustee, I still like to think that the process works most of the time and that we are providing a viable financial option for the hard pressed debtor.

By: Steven J. Katzman

Fraud by Creditors

There have been several instances of alleged systematic abuses by creditors in the filing of claims, motions for relief from stay and servicing of loans of debtors in bankruptcy. Whether the product of systematic error, gross negligence, reckless behavior or outright fraudulent

conduct, the effects of the alleged creditor misconduct have been significant and the focus of a number of corrective actions taken by debtor's counsel, the Office of the United States Trustee, chapter 13 trustees and the courts themselves. Some claimed abuses have met with the implementation of corrective measures; others the court found evidence insufficient or a lack of jurisdiction to address on a systematic basis. Throughout the process, there have been a series of challenges faced by the courts, from standing of the United States Trustee to litigate such matters and the legal authority and jurisdiction of the courts to impose and implement corrective measures.

The number of cases litigating these matters throughout the United States is large, making it impracticable to list them here exhaustively, but the following are noteworthy and exemplify the issues presented in litigating these matters:

1. *In re Stewart (Stewart I)*, 391 B.R. 327 (Bankr. E.D. La. 2008), *aff'd*, 2009 WL 12448054 (E.D. La. Aug. 7, 2009) – in relation to a proof of claim filed by Wells Fargo Bank, the Court found that the proof of claim was rife with errors, including calculations that were “wholly incorrect” under the terms of the mortgage contract, late fees generated through questionable accounting and imposed without notice to the debtor, charges for drive-by inspection reports that were plainly erroneous, charges for broker price opinions (BPOs) that Wells Fargo was unable to document, and attorneys’ fees and cost invoices that were invalid or inadequately documented. The bankruptcy court found that these errors caused Wells Fargo to overstate its claim by more than \$10,000. Noting this as the result of systematic errors resulting from a highly automated system and perceiving this as a threat to the integrity of the bankruptcy system, the bankruptcy court issued an injunction requiring Wells Fargo: (1) to audit every proof of claim it has filed in the court’s district in any case pending on or filed after April 13, 2007; (2)

to provide a complete loan history on every account and to file that history with the appropriate court; and (3) to amend proofs of claim already on file to comply with the principles set forth in the decision and earlier related ruling.⁴

However, in *In re Stewart*, --- F.3d ----, 2011 WL 2937178 (5th Cir. July 22, 2011), the Fifth Circuit Court of Appeals reversed, finding that the Bankruptcy Court lacked jurisdiction to issue the injunction, either from the case or controversy presented or the inherent power of the court to protect its jurisdiction and judgments and to control its docket. The Court did empathize with the Bankruptcy Court that “While justification for the bankruptcy court’s frustration is plentiful, its injunction lacks jurisdictional legs.”

2. In *In re Taylor*, 407 B.R. 618 (Bankr.E.D.Pa. 2009), on an Order to Show Cause against HSBC and their counsel arising out of false statements made in the course of a motion for relief from stay and a response to an objection to a proof of claim, the Bankruptcy Court issued non monetary sanctions against counsel and HSBC pursuant to Bankruptcy Rule 9011. The sanctions included training in professional responsibility, training on HSBC’s servicing system, a training session for the firm's relevant lawyers in the requirements of Rule 9011, and for HSBC to send a copy of its opinion to all the law firms it uses in bankruptcy proceedings, along with a letter explaining that direct contact with HSBC concerning matters relating to HSBC's case was permissible.

The District Court reversed the award. However, the Court of Appeals in *In re Taylor*, -- - F.3d ----, 2011 WL 3692440 (3rd Cir. August 24, 2011) stated the District Court lacked jurisdiction to reverse the award, and affirmed Bankruptcy Court, finding that the statements in

⁴ *In re Jones*, 366 B.R. 584, 591–92 (Bankr. E.D. La. 2007) *aff’d in part*, *Wells Fargo Bank, N.A. v. Jones*, 391 B.R. 577 (E.D. La. 2008).

the motion for relief and response to the claim objection contained false and misleading statements. The Court found counsel's reliance on an automated system run by a third party, lack of knowledge where the data came from or how to confirm its reliability (the Court stated counsel "essentially abdicated her professional judgment to a black box.") and disregard of warning signs that indicated the information contained in the pleadings were false were indicative of a lack of reasonable inquiry. As the Court concluded ". . . Rule 11 requires more than a rubber-stamping of the results of an automated process by a person who happens to be a lawyer. Where a lawyer systematically fails to take any responsibility for seeking adequate information from her client, makes representations without any factual basis because they are included in a "form pleading" she has been trained to fill out, and ignores obvious indications that her information may be incorrect, she cannot be said to have made reasonable inquiry."

3. In *Federal Trade Commission v. Countrywide Home Loans*, Case No. 2:10-cv-04193 (C.D. Cal, June 15, 2010), Countrywide entered into a consent decree which provided compensation to the debtors in the amount of 108 million dollars, established internal procedures by which an independent third party will verify compliance with the prescribed procedures, ensure that claims filed in bankruptcy court are accurate and, required adequate notice of its charges so debtors do not emerge from bankruptcy only to be required to pay previously undisclosed charges or be subject to foreclosure.⁵ According to the Executive Office of the United States Trustee, Countrywide inflated claims against homeowners in bankruptcy, failed to properly credit homeowner's with payments made, and failed to notify homeowners of extra

⁵ See Press Releases at www.justice.gov/ust/eo/public_affairs/press/docs/2010/pr20100607.htm, www.ftc.gov/opa/2010/06/countrywide.shtm and www.ftc.gov/opa/2011/07/countrywide.shtm.

charges it was adding to the mortgage bill.⁶ The consent order had resolved the USTP's challenges to Countrywide's mortgage servicing practices in litigation throughout the country.⁷

Further illustrating the systematic failings of servicing of loans by Countrywide and representations made by its retained counsel in both motions for relief of stay and proofs of claims is the case of *In Re Parsley*, 384 B.R. 138 (Bankr. S.D. Tex. 2008), where on an Order to Show Cause against Countrywide and its retained counsel, the Court found numerous errors in the motions for relief (including failing to credit mortgage payments made), proof of claims (including overcharging and charging for non recoverable and disclosure of fees in lesser amount than was actually assessed against the debtor) and systematic failings in communications between Countrywide and their retained counsel. *Parsley* illustrates the difficulties of utilizing sanctions to redress such conduct; while the Court was critical of these practices, the Court discussed the high burden for imposing sanctions and only issued sanctions against one of Countrywide's counsel, specifically noting "[a] decision not to sanction . . . however, does not imply that their conduct was appropriate. The Court cannot emphasize enough that it does not condone the conduct . . . described in this Memorandum Opinion."

4. In *United States Trustee v. Capital One Bank (USA) N.A.*, Adversary Proceeding No. 08-01272 (Bankr. D. Mass.), the United States Trustee entered into a settlement agreement with Capital One to resolve allegations that the company attempted to collect on debts that previously had been discharged in bankruptcy. Capital One agreed to an audit process overseen by an independent auditor to examine Capital One customer accounts to ensure that all monies

⁶ See Statement of Director of the Executive Office of the United States Trustee on settlement with Countrywide Home Loans, dated June 7, 2010, a copy of which can be found at www.justice.gov/ust/eo/public_affairs/press/docs/2010/pr20100607_statement.pdf.

⁷ Including in the bankruptcy cases of *In re Atchley*, Case No.05-79232, Adv. No.08-6092 (Bankr. N.D. Ga. Feb. 28, 2008); *In re Hill*, Case No. 01-22574 (Bankr. W.D. Pa. June29, 2008); and *In re Sanchez*, Case No.01-42230, Adv. No.08-1176 (Bankr. S.D. Fla. Mar.1, 2008). See www.justice.gov/ust/eo/public_affairs/press/docs/2010/pr20100607.htm.

improperly received by Capital One as a result of erroneously filed claims were returned to consumers who had filed bankruptcy or to their bankruptcy estates. The auditor's report found that Capital One erroneously filed approximately 15,500 claims totaling approximately \$24.7 million on account of debts previously discharged in bankruptcy, and that the company received payment of approximately \$2.35 million on approximately 5,100 of those erroneously filed claims. Capital One agreed to refund each erroneous payment based on the amount paid to Capital One as a result of the erroneous claim, as well as attorneys' fees and costs based on the amount paid by consumers to their counsel or costs incurred by the bankruptcy trustee to object to Capital One's erroneous claims.⁸

Amendments to the Bankruptcy Rules - These aforementioned concerns have, in large measure, resulted in the formation of amendments to the Federal Rules of Bankruptcy Procedure and National Approved Bankruptcy Forms that attempt to address and mitigate recurring issues in the servicing of mortgage loans. Amendments to Bankruptcy Rules 3001 and 3002, along with proposed Bankruptcy National Form B-10⁹ are designed to ensure that claimants provide with greater specificity the supporting information required to accompany certain proofs of claim and, in cases in which the debtor is an individual, the consequences of failing to provide the required information. As to all cases, these rules require additional information to accompany proofs of claim filed in cases in which the debtor is an individual,¹⁰ such as:

1. When the holder of a claim seeks to recover--in addition to the principal amount of a debt--interest, fees, expenses, or other charges, the proof of claim must be accompanied by a

⁸ See Press Release www.justice.gov/ust/eo/public_affairs/press/docs/2011/pr20110118.htm.

⁹ As of the date of the preparation of these materials, these proposed rules and forms were still pending and could be found at www.uscourts.gov/RulesAndPolicies/FederalRulemaking/PendingRules.aspx. These rules will become effective December 1, 2011, absent Congressional action.

¹⁰ Proposed Bankruptcy Rule 3001(c)(2)

statement itemizing these additional amounts with sufficient specificity to make clear the basis for the claimed amount;

2. If a claim is secured by property of the debtor and the debtor defaulted on the claim prior to filing the petition, the proof of claim must be accompanied by a statement of the amount required to cure the prepetition default.

3. If the claim is secured by the debtor's principal residence and an escrow account has been established in connection with the claim, the proof of claim must also be accompanied by an escrow account statement showing the account balance, and any amount owed, as of the date the petition was filed. The statement shall be prepared in a form consistent with the requirements of nonbankruptcy law, such as the Real Estate Settlement Procedure Act.¹¹

Similarly, to enforce the amendments, the rules were amended to provide that the holder of the claim shall be precluded from presenting the omitted information as evidence (unless the court determines that the failure was substantially justified or is harmless) and can impose other forms of relief, such as reasonable expenses and attorney's fees caused by the failure.

Additionally, in chapter 13 cases with claims that are (1) secured by a security interest in the debtor's principal residence, and (2) provided for under § 1322(b)(5) of the Code in the debtor's plan, the rule amendments require the holder of the claim file:

1. A notice of any change in the payment amount, including any change that results from an interest rate or escrow account adjustment, prior to the date the new amount is due.

¹¹ 12 U.S.C. § 2601 *et seq.*

2. An itemization of fees, expenses, or charges (1) that were incurred in connection with the claim after the bankruptcy case was filed, and (2) that the holder asserts are recoverable against the debtor or against the debtor's principal residence.

The rule further provides that upon motion, the Court conduct a hearing to determine whether payment of any claimed fee, expense, or charge is required by the underlying agreement and applicable nonbankruptcy law to cure a default or maintain payments in accordance with § 1322(b)(5) of the Code, and a mechanism for determining that the debtor has made all cure payments following completion of all payments under the plan. Finally, the proposed rule provides that information required under this rule could be precluded as evidence, and/or award reasonable expenses and attorney's fees caused by the failure.¹²

By: Fredrick E. Clement

Fraud by Others

Persons in financial distress are desperate for solutions and a way out. Many offer answers. Some of the ostensible rescuers are, in fact, opportunists who seek inappropriate gain at the expense of the debtor. There are at least four categories of offenders.

Attorneys

Attorneys who engage in unethical conduct or provide “substandard representation” are regular targets of the United States Trustee and of weary bankruptcy judges. For example, in 2009, the United States Trustee forced the disgorgement of more than \$1.7 million in fees and recovered sanctions of more than \$219,000, as well as referring 13 cases to the applicable state

¹² Proposed Bankruptcy Rule 3002.1

bar. (United State Trustee Program, Annual Report of Significant Accomplishments, Fiscal Year 2009, p. 17)

One particular case is worthy of note. (In re Kayne, --B.R.-- (N.D. Cal. July 1, 2011)) In that case, debtor's counsel was aware of pending state court litigation to collect a promissory note. Though listed in the Statement of Financial Affairs as "action on promissory note", no potential recovery was listed on Schedule B. At the meeting of creditors, the attorney responded to a question from the Chapter 7 trustee about the litigation and the attorney told the trustee that the note was "essentially uncollectible." In actuality, the note had a principal balance due of more than \$72,000 and was paying the debtor \$1,250 per month. Both facts were known to debtor's counsel. The Chapter 7 trustee sought sanctions against debtor's counsel. After advising counsel of his Fifth Amendment rights, the bankruptcy court imposed a monetary sanction of \$20,000 and, apparently, made a referral pursuant to 18 United States Code 3057(a). On appeal by debtor's counsel, the Bankruptcy Appellate Panel affirmed the trial court's decision.

Marika Tolz, former Chapter 7 panel trustee for the Southern District of Florida pled guilty to one count of conspiracy to commit wire fraud in a \$16 million conspiracy. See Consumer Bankruptcy News, Volume 21, Issue 20, September 15, 2001. Tolz had been a bankruptcy trustee for 20 years. This case will have many repercussions as the U.S. Trustee investigates what went wrong and how this could happen. There will most certainly be increased auditing requirements in the Ch. 7 arena.

Debt Settlement Companies

Of late, a new, non-bankruptcy alternative to debt problems has emerged: for-profit debt settlement companies.¹³ These companies hold themselves out as willing and able to negotiate lump sum settlements of consumer debts for less than the entire balance owed. These companies follow a fairly predictable pattern. First, the debt settlement company advises the debtor to stop paying unsecured debts, allowing the debtor to create a pool of money and causing creditors concern as to the collectability of the debt. Second, at the behest of the debt settlement company, the debtor opens a separate bank account and makes a monthly payment into that account. Funds are used first to pay the debt settler's fees and, later, when the fund is of sufficient size, to negotiate settlements with creditors. Third, when and only when, the fund is of sufficient size, the debt settlement company contacts the holders of now long-stale debt and attempts to negotiate a settlement for less than the entire amount owed. (Deanne Loonin, "An Investigation of Debt Settlement Companies: An Unsettling Business for Consumers," pp. 1-2 (National Consumer Law Center March 2005))

Debt settlement is rife with fraud against the financially distressed and, to a lesser extent, against their creditors. The Consumer Federation of America put it best:

...[D]ebt settlement firms often mislead consumers about the likelihood of a settlement, cannot guarantee that a creditor will agree to a reduced payment, often mislead consumers about the effect of the settlement process on debt collection and their credit worthiness, and charge such high fees that consumers often don't end up saving enough to make the settlement offers that a creditor will accept, causing many consumers to drop out of the program. (Letter from Susan Grant, Director of Consumer Protection, Consumer Federation of America, to Donald S. Clark, Secretary, Federal Trade Commission, Telemarketing Sales Rule-Debt Relief Amendments-R411011 (October 16, 2009))

¹³ The authors wish to thank John Rao and the National Consumer Law Center for providing reports and other data for the Debt Settlement and Mortgage Modification and Rescue Scams portion of this document.

Government regulators are concerned by widespread fraud in the debt settlement industry. At the request of Congress, the General Accountability Office conducted covert testing by calling 20 companies, posing as consumers with sizeable debt problems; made unannounced site visits at some of the companies called, conducted interviews of trade associations and the Better Business Bureau, and reviewed federal and state legal actions against debt settlement companies. (Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risk to Consumers, Committee on Commerce, Science and Transportation, U.S. Senate, 111th Cong. (2010) (Testimony of Gregory D. Kutz, Managing Director of Forensic Audits and Special Investigations)) The General Accountability Office noted five areas of prevalent fraud: advance fees, directing consumers to stop paying debts, poor success rates (often in the “single digits”), guaranteed reductions in debt (many promised 40-50 percent reduction), and claimed affiliation with the government. (Id.)

Consumer advocates agree that the five categories identified by the General Accountability Office are, in fact, problems. But add to that a long list of additional offenses. The National Consumer Law Center adds that: the industry’s “ideal” customers are those least likely to benefit from debt settlement; low completion rates; failing to advise consumers of the consequences of failing to pay their debts; exorbitant fees; questionable value of service rendered; loss of consumer decision-making in the process; and numerous violations of existing federal and state laws. (Deanne Loonin, “An Investigation of Debt Settlement Companies: An Unsettling Business for Consumers,” pp. 4-17 (National Consumer Law Center March 2005); see also, Letter from Susan Grant, Director of Consumer Protection, Consumer Federation of America, to Donald S. Clark, Secretary, Federal Trade Commission, Telemarketing Sales Rule-Debt Relief Amendments-R411011 (October 16, 2009))

Freelance Petition Preparers

The United States Trustee regularly brings actions against bankruptcy petition preparers “falsely advertising ‘legal’ services, charging excessive fees, collecting client’s payment for court filing fees, or engaging in unfair, deceptive, or fraudulent conduct.” (United States Trustee Program, Annual Report of Significant Accomplishments, Fiscal Year 2009, p. 18) In 2009, the United States Trustee filed 301 such cases and resolved 211 of those cases. The program’s success rate was 98.1 percent. Fines of more than \$2.8 million were imposed and 71 injunctions obtained. (Id.)

A particularly noxious practice by petition preparers is the operation of foreclosure rescue scams. The 2009 Annual Report of Significant Accomplishments cited one case from Southern California in which the petition preparer targeted Spanish-speaking persons who were delinquent on home mortgages. The preparer offered mortgage modification and, as part and parcel of the operation, filed Chapter 13 bankruptcies on behalf of the homeowner. In some cases he instructed the homeowners not to disclose his involvement in the case or the fees paid to him. Not understanding their Chapter 13 responsibilities, the debtors’ cases were dismissed. Ultimately, the United States Trustee obtained default judgments against the petition preparer, fining him \$100,000 and permanently enjoining him from operating as a petition preparer in the district. Among other things, the court found that the preparer’s failure to disclose his identity as a petition preparer was a fraudulent, unfair and deceptive practice. (United States Trustee Program, Annual Report of Significant Accomplishments, Fiscal Year 2009, p. 19)

Mortgage Modification and Rescue Scams

Consumer advocates have long been concerned by foreclosure rescue scams. In 2005, the National Consumer Law Center published “Dreams Foreclosed: The Rampant Theft of Americans’ Homes Through Equity-Stripping Foreclosure Scams” (National Consumer Law Center 2005). It identified three species of scams. It called the first “phantom help.” The scammer “charges outrageous fees either for light-duty phone calls and paperwork the homeowner could have easily performed, or on a promise of more robust representation that never materializes.” (p. 8) When the rescuer fails to perform services or to do so competently, the home is lost to foreclosure. The second it called the “bailout’ that never quite works.” Under this scam, the homeowner deeds the home to the scammer, who is supposed to first rent it back to the homeowner and, in a few years, allow the homeowner to buy it back. (p. 8) But it never actually works that way and the rescuer keeps the debtor’s equity. The third it described as a “bait and switch where the homeowner does not realize s/he is surrendering ownership of the house in exchange for a ‘rescue.’” (p. 8-9) (emphasis original) In most of these instances the homeowner is led to believe that he or she is only executing documents necessary for a new loan, when they are, in fact, deeding the home to the rescuer for a nominal sum. (p. 9)

After the real estate crash, and the consequent loss of equity, the use of the second and third rescue scams has disappeared. (“Desperate Homeowners: Loan Mod Scammers Step in When Loan Servicers Refuse to Provide Relief” (National Consumer Law Center July 2009, p. 7) But the phantom help scammer remains alive and well, now operating under the name “loan modification specialist.” (Id.)

By: Steven J. Katzman

How to Identify and Pursue Fraud Civilly and Criminally

A. Identifying Fraud

Identifying and distinguishing between fraud in the civil and criminal context is a significant challenge for the practitioner as fraud¹⁴ requires scienter, which is often difficult to establish by direct evidence.¹⁵ Instead, the law permits fraud to be established by circumstantial evidence.¹⁶

Identifying fraud is not a science; there is no set of rules that apply for every application, but there are a few tools available that may assist in identifying indicia of fraud. The United States Trustee Program's Manual contains a chapter on bankruptcy fraud and abuse, which details the various types of fraud schemes involving bankruptcy.¹⁷ The Executive Office of the United States Attorneys has also published a list of bankruptcy fraud warning signs, which include serial bankruptcy filings, incomplete, inaccurate, or consistently amended schedules and statements of financial affairs, and asset depletion prior to or after filing.¹⁸ Within the civil context, the Uniform Fraudulent Transfer Act,¹⁹ adopted by most states, provides that intent can be proved through circumstantial evidence, known as "badges of fraud."²⁰

¹⁴ Other than constructive fraud.

¹⁵ *In re Friedrich*, 294 F.3d 864, 869 (7th Cir. 2002); *In re OODC, LLC*, 321 B.R. 128, 140 (Bankr. Del. 2005).

¹⁶ See Ninth Circuit Model Civil Jury Instruction 1.9 (Direct and Circumstantial Evidence); Ninth Circuit Model Criminal Jury Instruction 1.5 (Direct and Circumstantial Evidence).

¹⁷ See United States Trustee Manual ("UST Manual") at Chapter 5-10, which can be found at www.justice.gov/ust/eo/ust_org/ustp_manual/docs/vol5.pdf.

¹⁸ See *Bankruptcy Fraud Warning Signs*, U.S. Attorneys' Bulletin, Vol. 47, No. 4., at 25 (August 1999), a copy of which may be found at http://www.justice.gov/usao/eousa/foia_reading_room/usab4704.pdf.

¹⁹ See UNIF. FRAUDULENT TRANSFER ACT at § 4(b); adopted in California at CAL. CIV. CODE § 3439.04(b). Bankruptcy courts routinely rely on the badges of fraud in their analysis of fraudulent transfers under the Bankruptcy Code. See, e.g., *In re XYZ Options, Inc.*, 154 F.3d 1262, 1271-72 (11th Cir. 1998).

²⁰ *Id.*; *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 504 (N.D. Ill. 1988).

B. Pursuing Fraud

Within the ambit of a bankruptcy case, a person who knowingly and fraudulently conceals or destroys assets, makes false statements or claims, or fraudulently receives or transfers assets in a case may be subject to civil and/or criminal liability. While too numerous to mention here, again, the United States Trustee Manual provides a very detailed list of authorities to pursue fraud, in both the civil²¹ and criminal²² context.

C. Referring Fraud

If criminal activity is suspected, the criminal conduct may be referred to the United States Department of Justice. The evidence establishing the fraudulent conduct, along with the amount of loss²³ and whether special circumstances²⁴ exist will determine whether the matter will be investigated and prosecuted.²⁵

The United States Trustees, judges, receivers, and trustees are charged with the duty to refer any conduct which they reasonably believe is criminal or otherwise violates the bankruptcy laws to the appropriate United States Attorney for investigation.²⁶ Some courts have held that trustees, have absolute immunity for any alleged civil liability arising from the execution of their referral obligations under this subsection.²⁷

²¹ See UST Manual at Chapter 5-19.

²² *Id.* at Chapters 5-8 and 5-9.

²³ Most US Attorney Offices have internal guidelines defining which cases they will pursue and which will be declined.

²⁴ Such as an abuse of position of trust, acting in a fiduciary capacity, targeting elderly or infirm victims, etc.

²⁵ The UST Manual provides details on the contents of the criminal referral required by the United States Trustee. UST Manual at Chapter 5-3.

²⁶ See 28 U.S.C. §586; 18 U.S.C. §3057(a).

²⁷ See *Kirk v. Hendon*, 247 B.R. 237, 244-45 (E.D. Tenn. 2000).

By: Fredrick E. Clement

Protect Yourself and Your Client from Themselves

How can counsel protect himself or herself and the clients—from themselves? Like all of life's great questions, the answer lies in Rule 9011: “By presenting to the court...a petition, pleading, written motion, or other paper, an attorney...is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances...the allegations and other factual contentions have evidentiary support....” (FRBP 9011(b)(3); see also, 11 U.S.C. §526(a)(2), 707(b)(4)(C),(D); Fed. R. Civ. P. 11)

Clients are best protected by strong and stern warnings about the obligation of truthfulness. (11 U.S.C. §527(a)(2)(A); In re Withrow, 391 B.R. 217 (Bankr. D. Mass. 2008), *aff'd*, 405 B.R. 505 (1st Cir. BAP 2009) (finding that Rule 9011 requires an attorney to “impress upon the debtor the critical importance of accuracy in the preparation of documents to be presented to the Court”))

Counsel for the debtor is best protected by a systematic “inquiry reasonable under the circumstances.” Doing so offers two protections. First, a rigorous investigation will almost always reveal hidden assets, debts, income, expenses and financial history. Once discovered, appropriate scheduling solves the problem. Second, a systematic and documented inquiry that fails to reveal the fraud will blunt any suggestion that the attorney has either conspired with the debtor or has failed to satisfy the due diligence duties of Rule 9011.