

DEBTOR AUDITS ARE COMING!

When: October 20, 2006

Who is affected? - Individuals who file Chapter 7/13 cases and individuals who file Chapter 11 cases that subsequently convert to Chapter 7 on/after the effective date.

What is involved? - Chapter 7/13 Debtors are randomly selected or targeted for audits to be conducted by private CPA firms under contract with the United States Department of Justice.

What is the objective? - To determine accuracy, completeness, and veracity of Schedules and Statement of Financial Affairs filed by Debtors.

How will it work? - Local U.S. Trustee Office to be notified by Debtor Audit Team at EOUST of cases selected for audit;

- Local U.S. Trustee Office will mail/fax audit notification letter to Debtor's attorney;

- Audit notification letter will include a list of documents to be provided to the auditor, a form for the attorney to check whether the auditor can directly contact the debtor about documents, and an information sheet about debtor audits.

What documents requested? - 1. Pay stubs for six calendar months prior to filing;

2. Two years of federal income tax returns and attachments;

3. Bank statements for all depository and investment accounts for six calendar months preceding the date of filing, plus the month in which the petition is filed, along with sufficient documentation to explain the source of deposits/credits, and the purpose of checks, withdrawals, or debits; and

4. Copy of any divorce decree, property settlement within the last three years and any current child support/alimony obligation involving the debtor.

Response time to document request? - 21-days.

Must Debtor cooperate with auditor? - Yes. See 11 U.S.C. §521(a)(3)&(4).

What happens with audit findings? - Report of Audit filed with Court and reported to Debtor Audit Team at EOUST and Local U.S. Trustee Office. Findings of material misstatements subject to civil and/or criminal remedies. See *Debtor Audits: Are More Criminal Referrals on the Way?*

Debtor Audits: Are More Criminal Referrals on the Way?

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I. Introduction

One of the lesser known sections of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat 23 (2005) (BAPCPA), may have the greatest effect on the prosecution of bankruptcy crimes. For the first time, Congress has mandated a system to audit the information that individual debtors file in their bankruptcy cases. A debtor who is chosen for audit will be required to provide specified categories of documents to auditors under contract with the United States Trustee Program (USTP or Program) to support his or her entries on the petition, schedules, and other statements filed in the bankruptcy case. The auditors will also be able to check online databases to search for undisclosed assets. They will be required to file a report with the bankruptcy court and clearly and conspicuously specify in the report any material misstatement of income, expenditures, or assets.

If a material misstatement is discovered, the U.S. Trustee is obligated to report it, if appropriate, to the United States Attorney. 28 U.S.C. § 586(f)(2)(B)(I). The information provided to, or uncovered by, the auditor may provide a solid foundation for prosecuting bankruptcy crimes, whether it be for concealment, false oath/declaration, or on other grounds. Unlike most BAPCPA provisions, which went into effect on October 17, 2005, the debtor audit provisions do not become effective until October 20, 2006. Thus, while these new provisions have provided no referrals yet, United States Attorneys should expect to see criminal referrals from the U.S.

Trustees based on evidence uncovered by debtor audits in the near future.

II. The who, what, and how of debtor audits

A. Who gets audited

Section 603(a)(1) of BAPCPA provides that the Attorney General (in judicial districts served by the United States Trustee) and the Judicial Conference of the United States (in Alabama and North Carolina) are required to "establish procedures to determine the accuracy, veracity, and completeness of petitions, schedules, and other information that the debtor is required to provide under sections 521 and 1322 of title 11, United States Code, and if applicable, section 111 of such title, *in cases filed under Chapter 7 or 13 of such title in which the debtor is an individual.*" (emphasis added). Thus, only individuals are subject to audit. The debtor audit requirements are also limited to chapter 7 and chapter 13 debtors. Individual debtors who file under chapter 11 and chapter 12 are excluded.

In chapter 7, trustees liquidate the debtors' non-exempt assets to pay creditors. Most chapter 7 cases are filed by debtors whose assets are either exempt under federal or state law or subject to valid liens. In these "no asset" cases, the trustee has nothing to liquidate and there is no distribution to unsecured creditors. Under chapter 13, debtors repay some or all of their debts, typically over a three-to-five-year period. Chapter 11 is the reorganization chapter that, while typically used by businesses, is occasionally used by individuals. Chapter 12 is available for family farmers and family fishermen. More than 99 percent of individual cases are filed under chapter 7 or chapter 13. See Press Release, Administrative Office of U.S. Courts, Bankruptcy Filings Hit New Records in Run Up to New Bankruptcy Law Implementation (Dec. 1, 2005), available at http://www.uscourts.gov/Press_Releases/bankruptcy_filings120105.html (providing statistics reflecting that, of the 1,782,520 bankruptcy cases filed between September 30, 2004, and September 30,

2005, 1,775,517, or approximately 99.6%, were filed under chapter 7 or chapter 13).

Although most individuals who seek bankruptcy protection will be subject to audit, only a small percentage of those debtors will be audited. Section 603(a)(2) of BAPCPA requires the Attorney General to:

(B) establish a method of randomly selecting cases to be audited, except that not less than 1 out of every 250 cases in each Federal judicial district shall be selected for audit;

(C) require audits of schedules of income and expenses that reflect greater than average variances from the statistical norm of the district in which the schedules were filed if those variances occur by reason of higher income or higher expenses than the statistical norm of the district in which the schedules were filed.

Audits under § 603(a)(2)(B) are referred to by the USTP as random audits; those under § 603(a)(2)(C) are referred to by the USTP as targeted audits. Cases will be selected for random audit from a pool of all individual chapter 7 and chapter 13 cases, but may represent as little as 0.04 percent (1 out of 250) of those cases. Cases will be selected for targeted audit from those filed by debtors whose income or expenses deviate significantly from the statistical norm of the district in which the schedules were filed. Thus, all individual chapter 7 and chapter 13 cases are subject to random audit, and cases filed by debtors with high income or expenses are also subject to targeted audit.

B. What documents are audited

The documents audited include the petition, the schedules, and other documents filed by the debtor in the bankruptcy case. *See* Pub. L. No. 109-8 § 603(a)(1), 19 Stat. 23 (2005). Importantly, before filing any of these documents, debtors sign under penalty of perjury that the information contained in the documents is true and correct.

The petition is the document that commences the bankruptcy case. It contains the debtor's name and address and whether the debtor has filed any cases within the previous eight years. The debtor also states on the petition whether the case is a

business or consumer case and whether the debtor estimates that any assets will be available for unsecured creditors.

The schedules include lists of the debtor's real and personal property, a list of all debts, and a schedule of income and expenses. *See* Schedules A (real property), B (personal property), D (secured debts), E (unsecured priority debts), F (unsecured nonpriority debts), I (current income), and J (current expenditures). These schedules will likely be the source of most of the material misstatements identified by the auditors.

The other documents filed by the debtor include the Statement of Financial Affairs. In the statement, the debtor provides various information, such as how much income he or she has earned during the current year and in the previous two years. *See* Statement of Financial Affairs Questions No. 1 and 2. The debtor also explains various transfers including gifts, losses (including gambling losses), and other transfers outside the ordinary course of the debtor's financial affairs. *See, e.g.,* Statement of Financial Affairs Questions No. 3, 7, 8, and 10.

In chapter 7 cases, debtors with primarily consumer debts are also required to file the Statement of Current Monthly Income and Means Test Calculation (Official Form B22A). On this document, the debtor provides information about current monthly income, which is defined as all income received during the six calendar months prior to the filing of the bankruptcy case, except Social Security income and certain other income. 11 U.S.C. § 101(10A). In addition, if the debtor has a non-filing spouse, that individual's income is included on the form unless the debtor declares that he or she is legally separated or living apart other than for purposes of evading the means test. Debtors (or a debtor and a non-filing spouse, if applicable) whose Current Monthly Income (CMI) is greater than the applicable state median income must also complete the expense portion of the form. Some expense amounts are set by IRS Standards while others represent actual expenses in specified categories. 11 U.S.C. § 707(b)(2)(A)(ii).

In chapter 13 cases, all debtors must complete the Statement of Current Monthly Income and Calculation of Commitment Period and Disposable Income form (Official Form B22C). Unlike chapter 7, even debtors with primarily business debts must complete the form. In

addition, all debtors must include their spouse's income, even if they live apart. Like chapter 7 debtors, chapter 13 debtors (or a debtor and a non-filing spouse, if applicable) whose CMI is greater than the applicable state median income must also complete the expense portion of the forms.

C. How the audit is conducted

Section 603(a)(1) of BAPCPA provides that the audits shall be performed by independent certified public accountants or independent licensed public accountants. The U.S. Trustee for each district is authorized to contract with qualified persons to perform the audits. 28 U.S.C. § 586(f)(1). BAPCPA § 603(a)(1) also provides that the audits must be conducted in accordance with "generally accepted auditing standards" unless the Attorney General develops alternative auditing standards not later than two years after the date of enactment of the Act. Because bankruptcy documents are not prepared using Generally Accepted Accounting Principles, alternative auditing standards have been developed and will be issued before the audits commence.

A debtor must cooperate with the auditor, as necessary, to enable the auditor to perform his duties. 11 U.S.C. § 521(a)(3). This includes providing property of the estate and recorded information relating to property of the estate. Further, the debtor has the duty to "surrender to the trustee all property of the estate and any recorded information, including books, documents, records, and papers, relating to property of the estate whether or not immunity is granted under section 344 of this title." *Id.* 521(a)(4). Those documents may include, among others, tax returns, bank statements, credit card statements, and pay stubs. In addition, the auditors may review online databases to determine whether the debtor owns or has owned assets not listed on the schedules or statements filed in the case.

D. The audit report and its impact

The audit report shall "clearly and conspicuously" specify any "material misstatement" of income, expenditures, or assets. 28 U.S.C. § 586(f)(2)(A). A report of each audit must be filed with the court and transmitted to the U.S. Trustee. *Id.* The bankruptcy clerk shall give notice to creditors in any case in which a material misstatement is identified. *Id.*

In a case in which a material misstatement is identified, the new statute sets forth two requirements for the U.S. Trustee. 28 U.S.C. § 586(f)(2)(B). First, the U.S. Trustee shall "report the material misstatement, *if appropriate*, to the United States Attorney" pursuant to 18 U.S.C. § 3057. 28 U.S.C. § 586(f)(2)(B)(i) (emphasis added). Second, the U.S. Trustee shall "if advisable, take other appropriate action, including but not limited to commencing an adversary proceeding to revoke the debtor's discharge" pursuant to 11 U.S.C. § 727(d). 28 U.S.C. § 586(f)(2)(B)(ii). In particular, the new law provides that a debtor's discharge may be revoked for failing to explain satisfactorily a material misstatement identified in an audit or for failing to make available necessary papers or property belonging to the debtor that are requested for an audit. 11 U.S.C. § 727(d).

The U.S. Trustee, or other parties in interest, may have other civil remedies in cases where the audits uncover material misstatements, such as dismissal of the bankruptcy case or denial of discharge. 11 U.S.C. §§ 707, 727. U.S. Trustees or other creditors may find that several subsections of 11 U.S.C. § 727 apply to deny a debtor a discharge where an audit uncovers material misstatements. *See, e.g.*, 11 U.S.C. § 727(a)(2) (concealment of assets with intent to hinder or delay a creditor), and 11 U.S.C. § 727(a)(4)(A) (false oath or account). In addition, denial of discharge may be appropriate where the debtors fail to provide information to the auditors. *See, e.g.*, 11 U.S.C. § 727(a)(3) (concealing, destroying, falsifying, or failing to keep books and records from which the debtor's financial condition could be ascertained); 11 U.S.C. § 727(a)(4)(D) (withholding from an officer of the estate recorded information about the debtor's property or financial affairs).

III. Possible bankruptcy crimes

As the new law provides, the U.S. Trustee may make criminal referrals of cases that have been subject to debtor audits where the auditors found material misstatements as to the debtor's income, expenses, or assets. Several subsections of 18 U.S.C. § 152, the section of the United States Code that includes bankruptcy crimes, may be implicated by findings made by the auditors. Crimes under 18 U.S.C. § 152(1), (2), and (3) regarding concealment, false oaths, and false declarations are most likely to arise.

A. False oath, account, or declaration: 18 U.S.C. § 152(2)-(3)

The most common criminal offenses that debtor audits may uncover are those of false oath or account or false declaration. 11 U.S.C. § 152(2), (3). Sections 152(2) and (3) of title 18 provide:

A person who –

(2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;

(3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;

... shall be fined under this title, imprisoned not more than 5 years, or both.

Debtors sign all the documents that they file, and in doing so declare under penalty of perjury that the documents are true and correct. Thus, if an auditor identifies a material misstatement in one or more of the filed bankruptcy documents, and assuming the auditor's findings are accurate, the debtor has made a false declaration in a bankruptcy case. The issue would be whether the declaration was made knowingly and fraudulently. In addition, debtors are required to attend a meeting of creditors and submit to examination under oath. 11 U.S.C. §§ 341(a), 343. At the meeting of creditors, the trustee will generally ask the debtor if the information on the bankruptcy documents is true and correct. The debtor's testimony at the meeting of creditors may provide an additional false oath to prosecute.

B. Concealment of assets: 18 U.S.C. § 152(1)

Another crime that debtor audits may uncover is concealment of property of the estate of the debtor. Section 152(1) of title 18 provides:

A person who –

(1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States trustee, any property belonging to the estate of a debtor;

... shall be fined under this title, imprisoned not more than 5 years, or both.

If an auditor finds that the debtor did not list property of the bankruptcy estate on the debtor's schedules, the debtor may have committed the crime of concealment. For example, the auditor may discover that the debtor owns a boat or bank accounts that were not listed on the debtor's schedules. For concealment to occur, the debtor does not have to physically hide the property; failure to list property on schedules is sufficient to conceal it from a trustee. *Coghlan v. United States*, 147 F.2d 233, 236-237 (8th Cir. 1945).

C. Fraudulent pre-bankruptcy transfers: 18 U.S.C. § 152(7)

In reviewing documents received from the debtor or information from online databases, an auditor might uncover a pre-bankruptcy transfer made for the sole purpose of keeping an asset out of the estate and out of the reach of creditors. Section 152(7) of title 18 provides that a person commits a crime who:

in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with the intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation[.]

Thus, if a debtor knowingly and fraudulently conceals or transfers an asset in contemplation of bankruptcy or with the intent to defeat the provisions of title 11, he or she has committed a crime. For example, a debtor might transfer a boat to a family member for no consideration in the year prior to filing for bankruptcy, so that the trustee could not sell it in the bankruptcy case. The debtor should disclose the transfer on the Statement of Financial Affairs, Question No. 10. Even if the transfer is not disclosed and the boat is not listed as an asset, database searches conducted by the auditor should reveal that the debtor recently owned a boat, and documents provided by the debtor might show payments made on the boat during the months pre-petition. This information uncovered by the auditor might lead to a criminal referral pertaining to the debtor.

D. Bankruptcy fraud schemes: 18 U.S.C. § 157

A debtor audit may reveal a bankruptcy fraud scheme, which typically involves the filing of one or more bankruptcy cases as part of a larger criminal scheme. Section 157 of title 18 provides:

A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so –

- (1) files a petition under title 11;
- (2) files a document in a proceeding under title 11; or
- (3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title,

... shall be fined under this title, imprisoned not more than 5 years, or both.

E. Concealment or destruction of records: 18 U.S.C. § 152(8)

Finally, a debtor audit could uncover a debtor's attempts to avoid or thwart the audit, which, in itself, may be a bankruptcy crime. For example, 18 U.S.C. § 152(8) provides that a person commits a crime who:

after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor[.]

Thus, a debtor who conceals, falsifies, or destroys records to avoid the auditor's review of those records would be committing a bankruptcy crime.

IV. Conclusion

With the imminent arrival of debtor audits, criminal referrals from the U.S. Trustee are likely to increase as auditors identify material misstatements that may rise to the level of criminal conduct. Moreover, the nature of the referrals may change. Referrals arising from debtor audits will not be based on testimony of an unsatisfied creditor or former spouse who may have a personal dispute with the debtor. Instead, they will be based on the work of an unbiased, disinterested auditor who will have documents to support the identified material misstatements. ♦

ABOUT THE AUTHORS

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