Zero Tolerance for Commercial Bankruptcy Fraud: Bankruptcy Metrics Dictate *Forewarned is Forearmed*

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***Zero* Tolerance:**

The BAPCPA clearly evidences *zero* tolerance for fraud and criminal conduct. Debtors and debtors counsel should take no solace from the past. The *"mirror, mirror on the wall"* posturing regarding accounting and bankruptcy fraud may be ended once and for all[5] because the provisions of the BAPCPA as found in § 1104(e) and § 1112(b) have the necessary teeth to take the *byte* out of bankruptcy fraud.

We see in § 1104(e) a powerful new mandate for United States Trustee and the courts to remove those who engage in criminal conduct, and board members to countenance it, so that a trustee can be appointed and the criminals prosecuted for the benefit of creditors. We are suggesting that counsel to the commercial debtor voluntarily cooperate and root out criminal conduct by fraudsters, and gross mismanagement rather than have the commercial debtor face the sanctions of 1104(e) or § 1112(b) and that creditors take an active part and provide the information to assist the United States Trustee in the enforcement efforts.

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5 "How to Avoid the Perfect Bankruptcy Fraud" presented by Jack Seward at the Pennsylvania Institute of Certified Public Accountants, 2005 Forensic & Litigation Services Conference at Valley Forge, PA on November 14, 2005.

Chronicle on the Frauds:

Three years after enacting "The Corporate and Criminal Fraud Accountability Act of 2002 ("*The Act*")[6] the spectacular displays of accounting and bankruptcy fraud continue. *The Act* governing the destruction, altercation, or falsification of records on federal investigation and bankruptcy and provides that, "Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record or document …with the intent to impede, obstruct or influence the investigation" can expect a 20 year sentence. Also, the provisions of 18 U.S.C. §1520 addresses the destruction of corporate audit records and "Any accountant who conducts an audit of an issuer of securities…shall maintain all audit or review workpapers for a period of 5 years."

Perhaps the most succinct comment on accounting and bankruptcy frauds comes from Warren Buffett, the investment entrepreneur, when he said "*earnings can be pliable as putty when a charlatan heads the company reporting them.*" Lest any of us forget that commercial debtors are managed and controlled by individuals.

Impact of § 1104(e):

The new § 1104(e) provides an opportunity for creditors to have a greater impact on the course of a Chapter 11 case. Once the case is filed, the creditor should amass the *information* (hard copy documents and electronic), including the credit files, if not already done, as soon as possible on the debtor and contact its attorney immediately. Remember the key word is the *information* about the debtor, because unsupported accusations by creditors will not suffice.

If a creditor, and the more of them the better, has *information* that could constitute reasonable grounds for suspicion that the persons in charge of a debtor, defined as the current members of the governing board, the chief executive officer, or the chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or in its public financial reporting, and the creditor gives this information to the Office of the United States Trustee, the United States Trustee must move for the appointment of an operating trustee.

The attorney will be able to obtain a copy of the bankruptcy schedules and monthly operating reports, which the creditor can review with its attorney. A comparison of the information (financial statements, email, electronic communications and the creditor's files) with the bankruptcy schedules and operating reports may show discrepancies, and perhaps in some cases major discrepancies. A review of the information, including electronic documents and communications may even show questionable and/or fraudulent activity.

If any of the above is present, the creditor should discuss the information with its attorney so that the creditor and its attorney can decide if they possess enough to convince the United States Trustee that there are "reasonable grounds" to suspect wrongdoing. If there are, the issue must be brought before the bankruptcy court, which

6 18 U.S.C. §1519

may appoint a trustee or even convert the case to one under Chapter 7.

Although § 1104(e) was enacted in response to the recent notorious cases, it is not difficult to foresee that the new section being used in smaller cases to benefit the creditors. Again, those dealings with commercial debtors are likely to include emails and attached files consisting of financial data, credit applications etc. Creditors should routinely preserve the electronic information as this can point to the telltale signs of insolvency, impending Chapter 11, later and later payments, along with unkept promises. Remember, the *"devil"* is generally found in the details of the electronic information found on computers.

That is not to say that taken as a whole, the bankruptcy code did not supply the powers necessary for the United States Trustee and the courts to stop villainous insiders; § 1104(a) provides the authority needed to challenge company leadership and move for appointment of trustee. Section 1104(a) may be better in some ways for creditors because under §1104(e) only the United States Trustee can utilize §1104(e), whereas any party in interest, may move for appointment of a trustee under §1104(a) if fraud, dishonesty, criminal conduct, or even incompetence or gross mismanagement, can be shown.

Section 1103(c)(4) extends the prerogatives of §1104 to an official committee and §1104(a) has always been viewed as sufficient authority to remove debtor's management for a wide range of corporate sins, including those that might arguably subject the managers/perpetrators to criminal prosecution.[7] As the Fourth Circuit noted, §1104 was intended to cover a "wide range of conduct"[8] and the section is broad enough to include criminal conduct.

Some words of caution are necessary with respect to § 1104(e) because invoking the word "criminal," the section commensurately invokes a higher standard of proof than is required in a purely civil context. As it used to read, the only level of proof required for §1104 was "clear and convincing evidence."[9] In contrast, a finding of criminal liability must be made "beyond a reasonable doubt."[10] If, in the exercise of authority under §1104(e), the United States Trustee cites "criminal conduct" as cause for appointment of a trustee under §1104(a), then it must be supported by a higher degree of proof--beyond a reasonable doubt--than what was required to accomplish the same results under §1104(a), for which a preponderance of the evidence is sufficient.

Impact of § 1112(b):

Even if the *information* provided by the creditor does not rise to the level of fraud, dishonesty, or criminal conduct under § 1104(e), it may constitute gross mismanagement. Under the new § 1112(b), if there is evidence of gross mismanagement, the court must convert or dismiss the case unless such relief is not in the best interests of creditors and the estate.

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7 See, e.g., Appeal of DWG Corporation (In re Sharon Steel Corporation), 871 F. 1217 (3rd Cir. 1989)(management engaged in insider loans, breach of fiduciary duty, and transferred vast assets away from the debtor to avoid creditors during the bankruptcy).

8 Committee of Dalkon Shield Claimants v. A.H. Robbins Co, 828 F. 2d 239, 242 (4th Cir. 1987).

9 In re Clinton Centrifuge, Inc., 85 B.R. 980 (Bankr. E.D. Pa. 1988)

10 See Ngan Restaurant, Inc. v. Official Committee (In re Ngan Restaurant, Inc.), 195 B.R. 593, 597 (S.D.N.Y. 1996)(cause for appointment of a trustee in a chapter 11 case as a sanction for criminal conduct must be established beyond a reasonable doubt).

Any attempt by insiders during the DIP to "return the computers" under § 365 or "to allow the destruction of the electronic books and records" may be grounds under § 1112(b).

The Insolvent Public Company:

Regardless of the accounting audits, SEC investigations, *The Act*, and several prosecutions, the accounting and bankruptcy frauds never stopped after *Enron* and *WorldCom*. The record shows they have continued, to such a degree they have become commonplace and considered the norm by many. The recent collapse of *Refco*, was described in the *New York Times*[11] as "*the fourth-largest filing in the United States history*" and that the "*Insiders Collected $1 Billion Before Refco Collapse.*"

The Insolvent *Non*-Public Company:

Creditors need to ask themselves, what they expect regarding the likelihood of accounting and bankruptcy fraud for commercial debtors that are not public companies. Creditors and their attorneys are one of the most important resources available for the United States Trustee for the detection of accounting and bankruptcy fraud of *non*-public commercial debtors. After all, *non*-public commercial debtors are not responsible to the SEC or Sarbanes-Oxley regulations, and when creditors believe they have been cheated by the commercial debtor they need to take appropriate action and come forward with the *information*.

ABC, § 303 and the Charlatan Beware:

The days of utilizing the assignment for the benefit of creditors ("ABC") provisions under state laws as the preferred *escape path* for the *non*-public commercial debtor and insiders who need to slip away into the night, and where the attorney fees are not controlled, provided the charlatan can successfully escape the creditors reach, may be ending.

The enormous digital footprints left by charlatans are not likely to be erased anytime soon, and creditors and their attorneys can make use of one of the most underutilized provisions in the bankruptcy code, the involuntary bankruptcy provisions found in § 303.

Commercial Debtors and insiders can try as hard as they may, but given the potential availability of digital information from creditors, the United States Trustee and the courts may have the evidence necessary under § 1104(e) to stop the charlatans at their own game.

A recent study was reported indicating that the decline in the number of business (commercial) bankruptcies is a direct result of debtor attorneys using bankruptcy software because the normal defaults settings are set for "consumer" case, and not a

[11] Morgenson, G. and Anderson, J., Business Day Section C-1, New York Times, Thursday, October 20, 2005.

business case, and that may very well be true. We are not aware of any past research study on the use of the *ABC* and further investigation of this practice may provide the bankruptcy metrics to conclude that commercial debtors that fail and then fade away undetected are often orchestrated for the benefit of those attempting to avoid the requirements of the Bankruptcy Code and the *ABC* generally does not benefit the creditors. This may be some cause for concern and also explain the decline in reported business (commercial) bankruptcies.

What Creditors Should Expect:

The new Code sections provide new opportunities for the appointed trustee to do a more thorough investigation of a debtor. If the United States Trustee receives information from creditors that the persons in charge of a debtor participated in fraud, dishonesty, or criminal conduct, the United States Trustee will give that information to the appointed trustee, whether that is a Chapter 11 or a Chapter 7 trustee.

When a trustee is appointed by the United States Trustee they need to become knowledgeable about the debtor as quickly as possible and receiving *information* from creditors is of enormous help to the trustee. The trustee will focus on protecting the debtor's computers, as this is mandatory for finding electronic evidence, and because it deals with the electronic books and records, and related financial information. This is vital because e-mail and electronic communications exchanged between parties often seek comments[12], contain attached files[13], discuss the financial affairs of the debtor,[14] and have valuable metadata (data about the data) information[15] that may disclose the existence of accounting and bankruptcy fraud and benefit the creditors.

The trustee will for example also prevent the use of § 365 Motion to Reject Unexpired Leases to facilitate the return of the debtors leased computers and digital devices, including any laptops and PDAs used by the insiders.[16] Before the debtors divisions, subsidiaries, profit centers or assets are sold, the trustee will protect the electronic books and records and financial information for future recovery and possible litigation.

The trustee will promptly determine, for example, the following:

1. Who has the electronic books and records and financial information, including insiders, custodians, accountants, attorneys, computer consultants and others.

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12 Including, but not limited to for example, corporate officers, corporate directors, audit committee members, current employees, past and dismissed employees, current and past auditors, financial advisors, workout and turnaround consultants, loan liquidators, mergers and acquisitions, tax accountants, offshore partners, investment bankers, lending institutions, leasing companies, appraisers, potential buyers, real estate brokers, credit managers, insurance companies, ASP vendors, computer consultants, related parties, and insiders.

13 Including, but not limited to for example, loan documents, audit reports, internal financial statements, financial investigations, changed financial statements, spreadsheets, accounting reports, journal entries, pro forma financial statements, budgets and forecast, trend statements, management reports, customer information, vendor information, tax returns, taxpayer identifications numbers, real estate ownership, joint venture agreements, inventories, contracts, leases, and database files.

14 Including but not limited to for example, out of trust, bogus customers and invoices, insider transactions, capitalization of loans, backdating transactions and documents, transfer of property, write-down of assets, related party transactions, future recovery of bad debts, side agreements, sale of inventory, offshore entities, off-balance sheet accounts and entities, planned bankruptcy, insolvency, obtaining credit during insolvency, payments to creditors, financial representations during insolvency, fraudulent conduct, executory contracts, accounting fraud, and notice from whistleblower.

15 Including but not limited to for example, the author, name, initials, company name, computer name, name of the computer network server or the hard disk drive where the document is saved, file properties, summary information about the document, names of the last ten document authors, document revisions, document versions, template information, hidden text and comments, type of document (Word, Excel, Power Point Presentation etc.).

16 Seward, J. "What You Need to Know About a Debtor's Leased Computers." LJN's Equipment Leasing Newsletter, Law Journal Newsletters, December 2003 (http://www.ljnonline.com).

2. Have any computers been removed from the debtors' premises and when was that done.

3. Do the insiders have laptops, PDA, and other computers and digital media in their possession and when are they now.

4. The email addresses of the insiders and key employees.

5. The computer passwords used by insiders and employee.

6. Have the digital forensic accounting technologist investigate the Debtor's computers, PDA, laptops and digital devices and make forensic images of the same.

7. Investigate to determine if the debtor or insiders sold or dispose of any desktop systems, laptop computers, PDA or digital devices prior to the filing.

8. Determine if the debtor has leased computer equipment containing the business and financial records, including e-mail and financial information on hard disk drives, PDA, laptops and digital devices?

9. Investigate to determine if the debtor and insiders voluntarily turned over computers that were collateral under the UCC.

Knowing that there are allegations of wrongdoing will reinforce the necessity for the trustee to have the commercial debtor and insiders computers examined by an e-sleuthing[17] expert in the discovery and recovery of the debtors electronic books and records and related documents for the trustee. This co-author and Chapter 7 panel trustee has had such a case involving a converted Ch 11 that initially appeared to be a *"no asset case"* and that originated prior to Enron. The recovery of electronic books and records, deleted files and backdated documents by another of the co-authors of this article lead to the substantial recovery of assets for creditors without the expense of trial in the bankruptcy court against several insiders. Demonstrating that *"often the most incriminating digital evidence of the commercial Debtor and insiders will be discovered and a settlement reached."*

Investigation of the digital evidence may include some of the following:

- Tracing hidden assets from start to finish.

- Identify and reveal digital evidence related or pertaining to possible claims against Board of Directors for breach of fiduciary duty, fraud, theft, conversion and unjust enrichment.

- Detect and uncover unusual transactions, including money and property transfers and complex related-party activities.

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17 Seward, J. and Austin, D. "E-sleuthing and the Art of Electronic Data Retrieval: Uncovering Hidden Assets In The Digital Age." American Bankruptcy Institute Journal, Part I February 2004, Part II March 2004 and Part III April 2004

- Identify and reveal digital evidence related or pertaining to possible claims against Preferred Shareholders for breach of contract and fraud.

- Expose facts and circumstances relating to issues of substance over form that could not otherwise be documented.

- Uncover fraudulent accounting activities.

- Discover undisclosed business or business activities to which assets may have been shifted.

- Detect hidden documents, including the ability to trace related activities.

- Identify and expose digital evidence related or pertaining to possible claims against Auditors for breach of contract, breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, fraud and negligent misrepresentation, professional negligence, and securities fraud.

- Discover and expose digital evidence related or pertaining to possible claims against Underwriters for breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, claims of breach of contract, fraud and negligent misrepresentation, and securities fraud.

- Detect the backdating of vital documents leading to possible fraudulent conveyance actions.

Remember, it is not difficult for insiders, officers, employees and accountants of the commercial Debtor to hide financial information from auditors, and that is especially true for the non-public company, when only "conventional" methods to uncover accounting and bankruptcy fraud are used, in fact it takes place more times than anyone cares to admit.

How is that done**?** Easily. Digital "back door" accounting tools, invisible attachments, encryption and digital steganography[18] all play their part in assisting self-dealing insiders and their accomplices.[19] Stego is pure digital stealth that requires no assembly. Beware of the use of stego software, because digital stealth files (the second set of books) could be hiding anywhere. Most alarming is that digital steganography software[20] and other malicious software cannot be detected by the accountants using conventional audit tools.

Searching for digital anomalies, recovering deleted files, locating encrypted documents and stealthy financial information is essential in any investigation of

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[18] From the Greek word for writing or hiding secret messages and has been around for more than 2,500 years.

[19] Jack Seward, "Digital Stealth Secrets and the [Sarbanes-Oxley] Act" LJN's The Corporate Compliance & Regulatory Newsletter, Law Journal Newsletters, March 2004 (http://www.ljnonline.com).

[20] Jack Seward was the host for 2-day training on discovery of digital steganography at the offices of the United States Secret Service NYC/Brooklyn in December 2003.

accounting and bankruptcy fraud involving the commercial Debtor. Most often encrypted files and hidden information will likely provide confidential information that the commercial Debtor and insiders are concealing. Digital evidence often provides e-clues that could expose fraudulent accounting and bankruptcy fraud and point to fraudulent conveyances that can be recovered for the creditors. Willie Sutton probably said it best, when he answered why he robbed banks; "*that's where the money is*".

All creditors and their attorneys should be aware of the new Code sections and should take a more active role in the Chapter 11 case, especially when the creditor suspects that the debtor and its principals have been less than honest because the United States Trustee has ***Zero Tolerance for Commercial Bankruptcy Fraud***.