BANKRUPTCY LAW NEWSLETTER

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AN OVERVIEW OF CRIMINAL BANKRUPTCY FRAUD

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The bankruptcy system, like the federal income tax system, depends in large part upon the individual honesty of debtors and creditors for the fair and effective administration of bankruptcy proceedings. While there are many court officers and others who monitor filings and the actions of bankruptcy participants, the sheer volume of filings prevents any meaningful individual scrutiny of the "routine" case. Not surprisingly, Congress focused upon this requirement of full and truthful disclosure in fashioning criminal penalties for bankruptcy fraud. Title 18 of the United States Code sets forth criminal offenses that are specific to bankruptcy at Sections 152 through 155. These offenses include: concealment of assets, false oaths and statements, false claims, bribery (18 U.S.C. §152); embezzlement by a trustee or officer (18 U.S.C. §153); self-interest or adverse interest conduct by an officer of the court (18 U.S.C. §154); and fee fixing agreements (18 U.S.C. §155). The vast majority of bankruptcy fraud prosecutions are charged under Section 152[1] and frequently include charges of concealment of assets and/or false statements made under penalty of perjury in connection with a case filed under Title 11.

The following conduct may constitute a chargeable offense under 18 U.S.C. §152:

1) The concealment of property belonging to the debtor's estate;

2) The making of false oaths or accounts in or in relation to any case under Title 11;

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[1]18 U.S.C. §152 contains one of the longest and least comprehensible sentences in the entire United States Code. It will not be reprinted here for fear that the Plain English Police would be on my doorstep in the morning with a warrant for my arrest. Suffice it to say that anyone with a serious interest in this area should read the original source and try to parse the sentence on their own to glean its meaning.

3) The making of a false declaration, certificate, verification, or statement under penalty of perjury under 28 U.S.C. §1746 or in relation to any case under Title 11;

4) The making of a false claim against the debtor's estate;

5) The fraudulent receipt of property of the debtor's estate;

6) Bribery and extortion in connection with a case under Title 11;

7) The transfer or concealment of property in contemplation of filing a petition under Title 11;

8) The concealment or destruction of documents relating to the property or affairs of the debtor; or

9) The withholding of documents from the administrators of a case under Title 11.

Each offense set forth above is defined by its elements. The government must prove different elements depending upon what specific portion of the statute is charged. For example, in a concealment of assets case, the United States must prove three elements: (1) that the charged bankruptcy was in existence; (2) that the defendant fraudulently concealed or transferred the property and (3) that the property was property of the estate. Devitt, Blackmar & O'Malley, 2 Federal Jury Practice and Instructions, §24.03 (4th ed. 1990). As in all criminal cases, the government bears the burden of proof for each element; and that burden is proof beyond a reasonable doubt.

There are no specific provisions under the Bankruptcy Code or Bankruptcy Rules which proscribe bankruptcy crimes. However, a debtor may be denied a Bankruptcy Code § 727 discharge, under one or more of nine enumerated grounds, if the court finds that at least one of these grounds applies to the debtor.

The investigation and prosecution of criminal bankruptcy fraud in the Western District of Michigan is conducted by the Bankruptcy Fraud Task Force. The Bankruptcy Fraud Task Force was formed in May of 1992. This task force consists of representatives from the United States Attorney's Office, the United States Trustee's Office, the Federal Bureau of Investigation, and the United States Postal Inspectors. However, the primary responsibility for maintaining the integrity of the bankruptcy system lies with the parties, bench, bar, officers of the court and the public.

Title 18 United States Code, Section 3057 requires any judge, receiver or trustee having "reasonable grounds for believing that any violation" of the criminal bankruptcy fraud statutes has been committed to report to the United States Attorney all the facts and circumstances of the case and the names of the witnesses. Additionally, 18 U.S.C.§4 proscribes as criminal conduct the act of misprision of a felony, i.e., whoever having knowledge of the actual commission of a federal felony conceals the felony or fails to bring it to the attention of a judge or civil authority is guilty of a felony.

Further, the Michigan Rules of Professional Conduct (MRPC), at Rule 1.6, set forth certain limited exceptions to the general duty of confidentiality that allow a lawyer to disclose criminal conduct under certain circumstances. MRPC Rule 1.6 provides, in part:

> Rule 1.6 Confidentiality of Information
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> * * *
>
> (c) a lawyer may reveal:
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> * * *
>
> (2) confidences or secrets when permitted or required by these rules, or when required by law or court order;
>
> (3) confidences and secrets to the extent reasonably necessary to rectify the consequences of a client's illegal or fraudulent act in the furtherance of which the lawyer's services have been used;
>
> (4) the intention of a client to commit a crime and the information necessary to prevent the crime[.]

Bankruptcy fraud is identified by the same badges of fraud that other fraudulent schemes share. However the following "warning signs" should serve as a partial list to alert the bankruptcy practitioner to potential fraud.

1. Failure to keep usual business records, vagueness or lack of consistency in records, or the concealment of records.

2. Failure to produce books and records requested by the United States Trustee.

3. Failure to answer the questions set forth in the debtor's schedules and statement of affairs.

4. Frequent amendments to schedules, statement of affairs or other court documents.

5. Previous Chapter 7 or Chapter 11 filings.

6. Inability to reach principals of debtor or the debtor at debtor's stated business location.

7. Inconsistencies between documents filed with the Court and testimony given under oath at the meeting of creditors.

8. Inconsistencies between debtor's and creditors' accounts of debtor's financial position.

9. Frequent dealings in cash.

10. Conduct contrary to ordinary business or industry practices and standards.

11. Unusual depletion of assets within a year or two of the filing.

12. Recent departure of debtor's principals prior to the bankruptcy filing.

13. Absence of knowledgeable officers to testify at the meeting of creditors.

14. Conduct of the debtor contrary to testimony or representations.

15. Sudden depletion of inventory without plausible explanation.

16. Hostile creditors, employees, customers or other parties in interest.

Since the beginning of the Bankruptcy Fraud Task Force, in the spring of 1992, the grand jury for the Western District of Michigan has returned approximately five indictments charging seven defendants with bankruptcy fraud. In addition a bankruptcy fraud investigation resulted in the prosecution of a defendant for mail fraud and wire fraud. The evidence of the defendant's fraud scheme was obtained, in part, from the bankruptcy files and from information revealed by the defendant's creditors in the bankruptcy. At this point, one of the bankruptcy fraud defendants has pleaded guilty and has been sentenced to twenty seven months in the custody of the attorney general, three years of supervised release, and restitution in the amount of $385,156. Several more defendants are awaiting trial. It is anticipated that at the current rate of criminal referrals, the Bankruptcy Fraud Task Force will be working steadily throughout 1993 to address this critical area of fraud.

RECENT BANKRUPTCY DECISIONS

In re Superior Ground Support, Inc., Case Nos. 2:92-CV-104, 2:92-CV-105 (W.D. Mich. October 30, 1992). This opinion, authored by Judge Bell, addresses the issues of whether the bankruptcy court erred in remanding a state court mortgage foreclosure case and in dismissing a secured creditor's action to enforce the bankruptcy court's prior order authorizing a sale of the debtor's assets.

The bank was a principal creditor of the debtor. The appellee was the president and sole shareholder of the debtor and had individually guaranteed the debtor's obligations to the bank.

After the debtor's involuntary petition was filed, the bank filed an action against the appellee for enforcement of personal guarantees and foreclosure on the real estate which secured the guarantees. The appellee filed a counter-claim alleging breach of contract and rescission. Various parties then entered into an elaborate settlement stipulation in bankruptcy court which also authorized the sale of substantially all of the debtor's assets. The state court action was administratively closed based upon the stipulated settlement. The appellee then moved to reopen the state court foreclosure case based upon the bank's failure to close within the time agreed upon and ordered by the bankruptcy court. The motion to reopen was granted and the bank filed a notice of removal to the bankruptcy court. The appellee moved to remand the foreclosure proceeding. The bank then initiated another adversary proceeding in bankruptcy court seeking enforcement of the bankruptcy court's prior order.

The bankruptcy court granted the motion to remand the foreclosure proceeding, reasoning that although it had jurisdiction over the matter as a non-core related proceeding, sufficient equitable grounds existed to remand the proceeding to the state court pursuant to 28 U.S.C. §1452(b). The bankruptcy court also dismissed the enforcement proceeding.

The district court upheld the bankruptcy court's decision to remand the foreclosure proceeding to state court. The district court found that the bankruptcy court made a number of relevant factual determinations in making its determination that the case should be remanded on equitable grounds. It found that the agreement between the bank and the appellee was essentially a collateral agreement between outside parties that could have been made outside the bankruptcy proceeding; that it was included in the bankruptcy order only as a matter of convenience; that the case involved strictly state law questions of foreclosure and lender liability; and that the jury demand put the case outside the jurisdiction of the bankruptcy court. The bankruptcy court also properly found that the foreclosure suit did not include any claim against the debtor, that it did not involve any property of the debtor's estate, and that the state court could decide all of the issues raised by the bank without becoming inextricably intertwined in the debtor's bankruptcy proceeding. Moreover, the bankruptcy court determined that in hindsight it appeared that the side agreement between the bank and the appellee was separate and apart from the sale of the debtor's property and should never have been included in the court's order. Although the bankruptcy court enumerated several equitable grounds which supported remand, the district court held any one of the grounds was sufficient. According to the district court, the bankruptcy court's decision to remand the foreclosure proceeding to state court was not an abuse of discretion.

Lastly, the district court held that the bankruptcy court's dismissal of the enforcement proceeding was proper under the abstention doctrine as codified in 28 U.S.C. §1334(c)(1). Abstention was warranted due to the limited effect on the administration of the estate, the predominance of state law issues, the presence of a related proceeding in state court, and the remoteness of the proceeding to the main bankruptcy case. Furthermore, abstention furthered the interests of justice and of comity with state courts and respect for state law.

Chvala v. Sabec, Case No. 1:92-CV-497 (W.D. Mich. November 25, 1992). This decision by Judge Quist involves the validity of a tax deed.

Plaintiff bought a tax lien on the debtor's residence at a tax sale. Under Michigan tax law, a debtor has one year in which to redeem the tax lien by paying the taxes owed on the residence. A tax deed is issued to a purchaser if the lien is not redeemed.

Plaintiff received a tax deed and served a Notice by Persons Claiming Title under Tax Deed ("Notice"). Plaintiff filed the return of service with the county treasurer, but did not file a copy of the Notice.

The debtor then filed a bankruptcy petition and claimed a right of redemption in her residence. The district court affirmed the bankruptcy court's holding that the debtor still had a redemption right. Since the plaintiff had not followed the notice requirements, the tax deed was not valid. Specifically, the plaintiff

failed to provide the county treasurer's office with a copy of the Notice, in addition to the original, as required by the tax laws. The debtor was allowed to contest the tax deed's validity because notice was not validly given. The six-month statute of limitations did not begin to run because a copy of the Notice was not filed along with the return of service.

In re Fishell, Case No. 1:92-CV-485 (W.D. Mich. November 24, 1992). In this case, Judge Gibson affirmed the bankruptcy court's decision to convert a Chapter 11 case to Chapter 7. According to the district court, the bankruptcy court properly found, pursuant to §1112(b)(1), a continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation. The bankruptcy court also had cause to convert under §1112(b)(2) because of the debtor's inability to effectuate a plan of reorganization. At the time of conversion, the debtors' case was fourteen months old and the debtors had not filed a plan.

In re Cook, Case No. HG 89-01175 (Bankr. W.D. Mich. December 22, 1992). In this decision, Judge Howard granted the motions of the bank, the Chapter 12 Trustee, and the United States to modify the debtors' Chapter 12 plan.

After their 10% plan was confirmed, the debtors won $6 million in the Michigan lottery. After taxes, the debtors are to receive $226,000.00 per year for twenty years. After receiving their first installment of their lottery winnings. The debtors remitted $101,000.00 to the Chapter 12 Trustee to pay off their plan. Motions to modify the plan were then filed, which requested that the court order the debtors to modify their plan to provide a 100% dividend to unsecured creditors.

The court first held that the debtors' right to the prize money was part of the bankruptcy estate. Under §1207(a), post-confirmation lottery winnings are part of the bankruptcy estate.

The court then found that the motions to modify were timely even though the debtors paid off their plan before the motions were filed. Ruling otherwise would condone a race to the courthouse and encourage debtors to hide windfalls long enough to pay off their plans before discovery of the change in circumstances. In addition, a sale which was required to be performed under the plan had not yet taken place and the sale proceeds had not yet been distributed.

The court also held that there had been a substantial and unanticipated change warranting modification under §1229.

Lottery winnings and large inheritances mandate modification as much as any downturn in circumstances would.

When a debtor proves able to pay creditors in full within the life of the plan, modification is warranted and will be required. Modification under §1229 to require full payment to the unsecured creditors was granted. According to the court, to arrive at any other conclusion would be unjust.

ANNOUNCEMENT FROM THE BANKRUPTCY COURT

With the recent reassignment of Judge Nims' cases, the Bankruptcy Court is having a problem with pleadings being mislabeled with the name of the wrong judge. This creates a real problem, because notices are given to calendar clerks who may then set them for hearing before the wrong judge. We would appreciate it if attorneys would check their bankruptcy files to make sure that the correct judge is now clearly indicated in each case file. If there is a question, a call to VCIS will resolve the problem. Furthermore, it is apparent that there is still confusion about the letters which are used in conjunction with the case number to designate the judge and location of hearings. These letters should be changed to indicate the correct judge if they are used as part of the case number. Here's the complete list:

SK - Judge Stevenson, Kalamazoo

GK - Judge Gregg, Kalamazoo

HK - Judge Howard, Kalamazoo

ST - Judge Stevenson, Traverse City

HT - Judge Howard, Traverse City

GL - Judge Gregg, Lansing

SL - Judge Stevenson, Lansing

HM - Judge Howard, Marquette

GM - Judge Gregg, Marquette

SG - Judge Stevenson, Grand Rapids

GG - Judge Gregg, Grand Rapids

HG - Judge Howard, Grand Rapids

Please remember to change this designation on your records if you use it to correspond with the correct judge and/or location.

BANKRUPTCY COURT PHONE NUMBERS

General Information:	456-2693
VCIS: (Voice Case Information System)	456-2075
Judge Howard (Diane Bonfiglio):	456-2233
Judge Gregg (Linda Lane):	456-2264
Judge Stevenson (Cherri Jacobsen):	456-2949
Mark Van Allsburg (Clerk):	456-2693
Intake:	456-2901
Mailroom/Matrix Requests:	456-2248

CALENDAR CLERKS:

Sandi Boylan:	456-2903
Patrice Nichol (Stevenson):	456-2905
Jim Blaszczyk (Howard):	456-2906
Dave Scalici (Gregg):	456-2290
Case Closing	456-2263

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the period from January 1, 1992 through November 30, 1992. These filings are compared to those made during the same period one year ago and two years ago.

	1/1/92-11/30/92	1/1/91-11/30/91	1/1/90-11/30/90
Chapter 7	4,980	4,641	3,665
Chapter 11	123	142	142
Chapter 12	23	23	17
Chapter 13	1,468	1,569	1,562
	6,594	6,375	5,386

EDITOR'S NOTEBOOK

The Supreme Court has granted certiorari in Nobelman v. American Savings Bank (Docket No. 92-641), 1992 WL 303365 (1992), to resolve the split in the Circuits on whether a Chapter 13 debtor can "strip down" an undersecured mortgage lien against the debtor's residence despite §1322(b)(2). This issue has been one of the most litigated bankruptcy issues--with the numerous courts considering it split almost evenly. Despite the ruling in Dewsnup v. Timm, 60 LW 4111 (1992), forbidding such actions in Chapter 7 cases, some courts have continued to permit Chapter 13 "strip downs." See, e.g., Lomas Mortgage USA v. Wiese, No. 91-36082 (9th Cir. December 4, 1992). Let us hope that Nobelman finally resolves the issue.

The Supreme Court has also granted certiorari in Rake v. Wade (Docket No. 92-621), 1992 WL 303345 (1992). In the case below, Wade v. Hannon, 968 F.2d 1036 (10th Cir. 1992), the Tenth Circuit rejected holdings in other circuits denying an oversecured mortgagee of the debtor's principal residence post-petition interest on the arrearage. The Tenth Circuit's decision is consistent with the result in In re Colegrove, 771 F.2d 119 (6th Cir. 1985).

Adequate protection stipulations often require that the collateral continue to be insured and that the lender be named as a "loss payee" under the policy. However, some caution as to how the lender is described is in order. In a recent decision, the Michigan Court of Appeals, in Old Kent Bank of Holland, et al. v. Chaddock, Winter & Alberts, et al., Lawyers Weekly No. MA-6612, reaffirmed an earlier holding in Gallant v. Lake State Mutual Insurance Company, 142 Mich. App. 183 (1985). Both courts held that there was a distinction between a designated "mortgagee" and a "loss payee" under a standard form fire insurance policy. Therefore, MCLA §500.2832 did not require the insurer to give notice of the cancellation of the policy to one who is only designated as a loss payee. Although MCLA §500.2832 was repealed effective January 1, 1992, lender counsel should confirm with the insurer the exact language required for notification of any cancellation of the policy.

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