

BAPCPA Implementation Update: Debtor Audit Procedures and the Reporting of Material Misstatements

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“The above-referenced case has been selected for audit pursuant to 28 U.S.C. § 586(f)(1).” This is the opening sentence of the Audit Notification Letter (ANL), sent to each counsel or *pro se* debtor in cases selected for audit by the United States Trustee Program (USTP) under §603 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).¹ However, it need not cause confusion or strike fear in the hearts of debtors or their counsel.

Since October 20, 2006, one out of every 250 randomly selected chapter 7 and chapter 13 cases, plus additional cases with income or expenses that deviate from the statistical norm, have been selected for audit by independent audit firms under contract with the USTP. Pursuant to the BAPCPA, debtor audits are undertaken to determine the “accuracy, veracity and completeness of petitions, schedules and other information filed by debtors” The debtor audits are conducted in accordance with audit standards promulgated by the USTP and published in the Federal Register. *See Federal Register Vol. 71, No. 190 (October 2, 2006)*. The BAPCPA authorized the USTP to promulgate these standards because consumer debtors do not ordinarily conform to generally accepted accounting principles.

When the audit is concluded, the audit firm files its report of audit with the court. 28 U.S.C. §586(f)(2)(A). If the audit firm identifies one or more material misstatements in the debtor’s income, expenditures, or assets, the audit firm specifies the material misstatement in the report of audit. *Id.* Notice of reports of audit that identify one or more material misstatements are sent by the court to all creditors. *Id.* If the audit firm cannot complete the audit because the debtor did not produce documents requested in connection with the audit, because the case was dismissed, or for any other reason, the audit firm files a report of no audit.

The Debtor Audit Process and Procedures

Debtor audits are desk audits conducted at the audit firms’ offices, and they do not involve site visits to the debtor’s home. In a nutshell, the audit consists of verifying the accuracy of selected items on the debtor’s originally filed bankruptcy papers by comparing them with documents produced by the debtor in connection with the audit and with independent research conducted by

¹ Section 603, which outlines the audit procedures generally, is not codified in title 11. Rather, the text of §603 is contained in S. 256, enacted as the BAPCPA, Pub. L. No. 109-8, 119 Stat. 23 (Apr. 20, 2005).

the audit firm, including searches for unreported assets and verification of market values using commercially and publicly available databases.

The ANL is accompanied by a document request.² The documents requested encompass five categories: payment advices or other evidence of payment from an employer for the six full calendar months preceding the date of filing plus the month of filing; federal income tax returns, including all schedules and forms, for the two most recent taxable periods prior to the date of the bankruptcy petition; account statements for all depository and investment accounts for the six months preceding the date of the bankruptcy petition plus the month of filing;³ if the debtor is divorced, the divorce decree and any related property settlement, support orders, and amendments thereto; and any documents relating to a debtor's self-employment income.

The response time for the document request is 21 days from the date of the ANL. Many of the documents requested should be readily available to debtors because they were necessary to complete the bankruptcy case initiation paperwork, such as tax returns, self-employment income documents (if any), and pay advices, or because they must be turned over to the case trustee in connection with the case. If a debtor needs additional time to fully respond to the document request, audit firms have the discretion to approve an extension.

Audit firm contact is with counsel in cases where the debtor is represented. There is an option to allow debtors to communicate directly with the audit firm relative to the document request. A form is included with the ANL providing instructions to the audit firm which, when executed by counsel, authorizes limited direct contact with the represented debtor for this purpose. The USTP understands that the audit process may result in some fees for represented parties. *See In re Moreland*, 2007 WL 1830837 (Bankr.C.D.Ill. June 22, 2007)(U.S. Trustee did not object to reasonable fees incurred in connection with the audit, and court determined that some fees claimed were reasonable).

What is a Material Misstatement?

While the term "material misstatement" is not defined in the Bankruptcy Code, the BAPCPA requires that material misstatements be identified and reported. 28 U.S.C. §586(f)(2)(A). Complete and accurate disclosure is paramount. The audit firm specifically identifies the omission or discrepancy in its audit report to the court (e.g., income understated by \$x/month). In general, a

² The BAPCPA added two additional duties for debtors specifically related to debtor audits, including the duty to cooperate with the audit process and the duty to turn over necessary documents to the audit firm. 11 U.S.C. §521(a)(3)(4).

³ Debtors must also explain and/or produce additional documentation relative to the source of any deposit over \$500. In their discretion, audit firms may request an explanation or additional documentary support for any other transaction contained in an account statement, such as large cash withdrawals or transfers to accounts not identified on the debtor's bankruptcy schedules.

material misstatement is an inaccuracy or omission that compromises the integrity and reliability of the bankruptcy documents filed, including an inaccuracy or omission that may impede a determination of whether there are estate assets to administer or whether an enforcement action should be taken. The thresholds for determining whether discrepancies identified by audit firms constitute a material misstatement are not published. To publish them would jeopardize the deterrent value of debtor audits and present enhanced opportunities for gaming the system.

It is important to understand that the audit firms are independent of the USTP. As such, they decide whether an item is identified as a material misstatement. Before exercising this discretion, however, audit firms must allow debtors an opportunity to explain any potential material misstatement before it is identified in a report of audit. To provide this opportunity, audit firms issue a “seven day letter” to the debtor’s counsel or the *pro se* debtor. The debtor has seven days from the date of the letter in which to provide a written explanation of a potential material misstatement. Any written explanation the audit firm receives from the debtor is analyzed without input from the USTP. The audit firm uses its independent judgment in deciding whether the debtor’s explanation provides a satisfactory basis not to identify the item as a material misstatement.

What is the Legal Significance of a Reported Material Misstatement?

Reports of audit contain only findings made by the audit firm; they do not constitute a legal determination. Before a reported material misstatement has any substantive impact on the debtor, two things must happen. First, the U.S. Trustee, case trustee, or creditor must file a complaint or motion seeking legal relief based upon the material misstatement identified in the report of audit. Second, the bankruptcy court must order the legal relief that is sought.

In short, the ultimate determination of whether a debtor’s non-disclosure or omission of an item is an actionable material misstatement is made by the bankruptcy court after notice and a hearing on a motion or complaint filed by the U.S. Trustee or a party in interest.⁴ Unless and until the U.S. Trustee or a creditor initiates some enforcement action, such as filing a motion to dismiss or seeking to deny or revoke the debtor’s discharge, the report of audit has no substantive impact on a debtor or the bankruptcy case.⁵

USTP Enforcement Based on Reported Material Misstatements

The BAPCPA places an affirmative duty on the U.S. Trustee to take “appropriate action” when a material misstatement is reported, including making a criminal referral. 28 U.S.C. §586(f)(2)(B). Potential “appropriate” civil enforcement actions include requesting that the debtor amend his or her bankruptcy filing, referring audit information to the case trustee, prosecuting a

⁴ Each report of audit makes clear that “[w]hether the findings contained in the report are supported by sufficient evidence under the application of the proper legal standard is a question for the courts.”

⁵ Each report of audit further states that its findings do not require the USTP “to take . . . legal action in or relating to this case”

motion to dismiss, seeking to deny or revoke discharge, objecting to plan confirmation, and seeking disgorgement of counsel's fees. *See, e.g., In re Ventura*, 2007 WL 2746922 (Bankr.E.D.N.Y. Sept. 18, 2007)(motion to dismiss under §707(a) related to report of no audit). The BAPCPA also added a powerful new enforcement tool relating specifically to debtor audits, providing that a debtor's discharge may be revoked if the debtor does not satisfactorily explain a material misstatement or satisfactorily explain the debtor's failure to cooperate with the audit process. 11 U.S.C. §727(d)(4)(A)(B).

Importantly, the U.S. Trustee is *not* compelled to act in every case reporting a material misstatement. The U.S. Trustee exercises discretion in determining what, if any, enforcement action to take in each case with one or more reported material misstatements. Finally, in some instances, it is not necessary for the U. S. Trustee to take any action because the debtor takes his or her own action in response to the information contained in the report of audit, for example, by amending the schedules.

Conclusion

Debtor audits provide for the careful review of selected cases by audit firms independent of the USTP, the court, creditors, the case trustee, or the debtor. If faced with an audit, debtors and their counsel should be mindful that the purpose of the audit is to insure the completeness and accuracy of information supplied by the debtor in the bankruptcy filing. The audit firms are required by the BAPCPA to report any material misstatements, but debtors are given the opportunity to explain any incomplete or inaccurate information regarding their financial circumstances. Furthermore, while the audit firm uses its independent judgment in deciding whether to identify an item as a material misstatement, the audit report has no substantive impact upon proceedings in the bankruptcy case unless the U.S. Trustee or other interested party takes some form of enforcement action.