



Department of Justice

STATEMENT

OF

LAWRENCE A. FRIEDMAN
DIRECTOR
EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES

BEFORE THE

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING

THE NEED FOR BANKRUPTCY REFORM LEGISLATION TO COMBAT
BANKRUPTCY FRAUD AND ABUSE

PRESENTED ON

MARCH 4, 2003

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before the Subcommittee on behalf of the Department of Justice to discuss the United States Trustee Program's ongoing work to combat fraud and abuse under current bankruptcy law, as well as the potential enhancement of this work through omnibus bankruptcy reform legislation.

The Department believes that provisions proposed in H.R. 975, which was introduced on February 27th, would provide important new statutory tools to assist the United States Trustee Program in identifying and civilly prosecuting misconduct by debtors and others who misuse the bankruptcy system.

The United States Trustee Program (USTP or Program) is the component of the Department of Justice with responsibility for the oversight of bankruptcy trustees and cases. Our mission is to enhance the efficiency and the integrity of the bankruptcy system. In October 2001, the USTP commenced a National Civil Enforcement Initiative

to address bankruptcy fraud and abuse. The Program undertook this Initiative for several reasons, including the following:

- The bankruptcy caseload is the largest in the federal court system. Disrespect for the bankruptcy system breeds disrespect for the entire judicial system. As the bankruptcy caseload continues to climb, more and more Americans are coming into contact with the nation's bankruptcy system. In addition to the 1.5 million individuals and businesses that sought debt relief in Fiscal Year 2002, millions more were affected, including creditors, many of them small businesses; employees; retirees; and families. It is critical that this system of justice be respected as one in which the law is strictly and fairly enforced.

- The integrity of the bankruptcy system relies upon complete and accurate disclosure by debtors and other participants in the system. The bankruptcy system largely depends upon self-reporting by debtors of their assets, liabilities, and other financial affairs. There is a consensus among bankruptcy professionals, including judges and practicing lawyers, that documents filed by debtors, petition preparers, and even attorneys who represent parties in a bankruptcy case too often are inaccurate and ignore the requirements of the Bankruptcy Code and Rules.

- The monetary stakes in the bankruptcy system are substantial. Studies show wide disparity in potential criminal and non-criminal abuse of the bankruptcy system. But with more than 1.5 million new cases filed each year, more than \$5 billion disbursed annually by private trustees in chapter 7, 12, and 13 cases, and hundreds of billions of dollars in corporate assets and liabilities subject to chapter 11 protection, potential recoveries are staggering.

The National Civil Enforcement Initiative was designed for two major purposes:

- (1) **To Address Debtor Misconduct:** Under this prong of the Initiative, the Program uncovers such improper conduct as inaccurate financial disclosure, misuse of social security numbers, concealment of assets, and “substantial abuse” by those who seek discharge of debts despite an ability to repay. The primary civil remedies sought by Program attorneys are dismissal under 11 U.S.C. §§ 707(a) and (b) and denial of discharge under § 727.
- (2) **To Ensure Consumer Protection:** The Program also seeks to protect debtors and creditors who are victimized by those who mislead or misinform debtors, file bankruptcy petitions without a debtor’s knowledge, make false

representations in a bankruptcy case, or commit other wrongful acts in connection with a bankruptcy filing. Primary targets are unscrupulous bankruptcy petition preparers and attorneys. The primary remedies sought are fines and injunctions under 11 U.S.C. § 110 and disgorgement of fees under § 329.

In addition to civil remedies taken by the Program, actions that constitute criminal misconduct are referred to the FBI and the United States Attorney for prosecution.

As we have devoted more resources to civil enforcement, we have identified patterns of conduct that appear widespread and deserving of continued intensive pursuit. Some examples follow.

- Substantial Abuse: As our offices more carefully screen chapter 7 petitions, we have ferreted out a high number of cases which, under almost any court standard, show substantial abuse by debtors who fail to disclose their true financial condition and seek to discharge debt despite an ability to repay all or part of that debt.

- On March 5, 2002, the bankruptcy court for the Central District of California granted the U.S. Trustee's motion to dismiss the case of a

debtor for substantial abuse under 11 U.S.C. § 707(b). The U.S. Trustee argued that the debtor's monthly mortgage and utility payments in excess of \$6,700 were patently unreasonable. The debtor, who had filed for bankruptcy on the eve of foreclosure on her home which she valued at \$900,000, had also filed for chapter 13 relief two times since 1997, in each case to prevent foreclosure. In her most recent filing, the debtor did not list her prior filings or other material information including rental income and a \$93,000 second trust deed on her home. The bankruptcy court agreed that the debtor's excessive housing costs and the material omissions in her filing supported a finding of substantial abuse.

In Fiscal Year 2002, the Program successfully pursued more than 5,000 debtors under § 707(b) and prevented the chapter 7 discharge of almost \$60 million of debt.

- Concealment of Assets: Debtors who conceal or transfer assets, destroy or fail to provide financial records, make false statements, or commit other wrongful acts may be subject to denial of their discharge.

- On November 1, 2001, a debtor was denied a chapter 7 discharge following an all-day trial before the bankruptcy court for the District of Nevada. The debtor filed his petition seeking to discharge almost \$650,000 in debt, without disclosing a revocable trust into which he transferred his residence, personal property, and summer home. Upon its discovery, the debtor disclosed the transfer in the fourth amendment to his schedules claiming he failed to disclose it upon the advice of counsel. The court held that the debtor's desire to retain the property, together with other facts established at trial, provided the requisite intent to deny the discharge.

In Fiscal Year 2002, more than 800 debtors were denied a discharge of more than \$40 million of debt on the grounds of serious misconduct under § 727.

- Credit Card Bust-Outs: Recent cases have been uncovered in which debtors obtained credit cards despite little or no income, incurred huge debts, paid those debts with worthless checks, and incurred debt up to the credit limit again before the checks bounced.

- On October 4, 2002, in Chicago, Illinois, a debtor who pleaded guilty to bankruptcy fraud and conspiracy charges was sentenced to a twelve month prison term and supervised release of three years, was ordered to pay restitution in the amount of \$337,255, and agreed to waive his bankruptcy discharge. In his bankruptcy case, the debtor sought to discharge approximately \$366,955 in debts; falsely represented that he had \$270,000 in cash gambling losses during 2000-2001; and declared falsely under oath that he had no interest in any real property. The United States Trustee identified the debtor's credit card bust-out scheme as part of its civil enforcement efforts to review all chapter 7 bankruptcy cases filed in the Northern District of Illinois for fraud and abuse. Several members of the Chicago U.S. Trustee's office assisted law enforcement with the investigation.

- Identity Theft: The Program now requires all debtors to show proof of identity at the first meeting of creditors, which is required to be held in all bankruptcy cases. In many cases of identity theft, a person assumes someone else's identity before filing a bankruptcy case and obtains credit, along with goods and services, using that false identity. Often these crimes are not uncovered until years later when the victim tries to buy a home or obtain credit for some other purpose.

- On January 28, 2002, a debtor pleaded guilty in the Northern District of Georgia to seven counts of a nine count indictment charging him with wire fraud, mail fraud, the use of a false social security number, identity theft, and bankruptcy fraud. The debtor worked for a mortgage broker and originated and processed his own loans. He used the name, social security number, and credit history of another individual to obtain two loans to purchase real property, inducing a lender to wire transfer more than \$428,000 to the settlement agent. When the debtor defaulted on the loans, he filed for bankruptcy to stay the foreclosure sale. The Atlanta office of the U.S. Trustee referred the matter to the U.S. Attorney.

In Fiscal Year 2002, the Program identified 8,000 debtor identification problems and caused debtors to correct more than 6,000 petitions. Many of these cases involved typographical errors in social security numbers that were corrected to prevent future injury to unsuspecting, potential victims. Other cases involved intentional fraud.

- Bankruptcy Petition Preparers: Some of the most egregious abuses in the bankruptcy system are perpetrated by those who prey upon debtors. Most

people who file bankruptcy are in dire financial straits and are ill-equipped to scrutinize offers of assistance. Many of these debtors face imminent foreclosure on their homes. Non-attorney bankruptcy petition preparers solicit clients from publicly available lists of those facing foreclosure.

Petition preparers sometimes charge exorbitant rates, engage in the unauthorized practice of law, file bankruptcy cases without the knowledge of debtors, use the bankruptcy process to further fraudulent schemes such as mortgage fraud, or otherwise violate the law. The victims of mortgage fraud often are both debtors and creditors.

- In two cases prosecuted both civilly and criminally in the Washington, DC area, petition preparers defrauded both debtors and mortgage lenders by filing bankruptcy cases in violation of § 110 in the names of debtors who paid significant fees to the defendants in return for refinancing or real estate services that were never provided. In one case, the defendant, while on pre-trial release, also took over properties facing foreclosure, filed bankruptcy petitions to delay foreclosure, and then rented the properties to innocent families with a purported option to buy. The renters uncovered the scheme when the mortgage lender finally was able to restart foreclosure

proceedings. In one case, the victimized family of eight faced eviction shortly before Christmas.

In Fiscal Year 2002, the Program successfully took action under § 110 against petition preparers in more than 1,500 cases.

In addition to the invigorated litigation efforts described above, the Program has taken other significant actions to uncover fraud and abuse. Last summer, the Program conducted audits of a small sample of chapter 7 cases in a pilot program we hope to expand in Fiscal Year 2003. The results of the pilot are being reviewed now to determine the best methodology to employ a more widespread audit effort. The results of the audit will help determine the scope of fraud and abuse in the bankruptcy system, as well as identify specific cases for civil and criminal enforcement actions.

Because public outreach is also important, the Program is developing an informational video that will be distributed and made widely available for debtors and attorneys to view prior to filing bankruptcy. The video will make debtors aware of the basic bankruptcy process and the need to be forthcoming and accurate in their bankruptcy filings.

Two other USTP activities will further strengthen our civil enforcement efforts. First, the Program will continue to provide training on the detection and litigation of abuses in the bankruptcy system for its attorneys and accountants. Similar training is also being developed for the private trustees. Second, the Program has designed a new data collection system to measure our success in civil enforcement and has begun to automate data collection to reduce the reporting burden on field staff and to increase the accuracy of the information.

The results of our first year after implementing the National Civil Enforcement Initiative are dramatic. During Fiscal Year 2002, field offices reported that they took more than 50,000 civil enforcement and related actions (including cases resolved without resort to litigation) that yielded approximately \$160 million in debts not discharged and potentially available for distribution to creditors. This impressive data demonstrates the scope of the problem, the skill and effectiveness of our attorneys and other staff in the field, and the need to continue our focused attack on bankruptcy fraud and abuse.

The fraud and abuse provisions contained in H.R. 975 would increase the effectiveness of the Program's National Civil Enforcement Initiative. In fact, we already have made significant progress in preparing to implement that legislation. As we reported in testimony presented to this Subcommittee during the last Congress, we convened working groups to develop implementation plans for each of the major new areas of

responsibility that would be imposed upon the Program under bankruptcy reform legislation. However, these plans would require modification, based upon the precise terms of the new legislation introduced in this Congress.

The USTP's current enforcement efforts would be aided in particular by the following provisions contained in H.R. 975:

- Means Testing: Section 102 amends the substantial abuse provisions in current law. In addition to permitting dismissal of cases under current standards, this codifies a specific procedure and monetary standard for reviewing individuals in chapter 7 who have primarily consumer debt and provides a more objective basis for determining which cases will be presumed abusive. This provision would provide much needed consistency in the application of abuse standards in all districts.

- Debtor Audits: Section 603 directs the Attorney General to conduct both random and targeted audits of chapter 7 and chapter 13 debtors to ensure against material misstatements. The debtor's discharge is also conditioned on cooperating with, and making information available to, the auditors. This provision would provide a mandate for an intensive and on-going audit

program to greatly enhance current methods for the detection of fraud and abuse.

- Debtor Education and Credit Counseling: Sections 105 and 106 create new areas of responsibility for the USTP. The Program must approve and maintain a list of credit counselors who would be able to provide financial counseling to all individuals before they are eligible to file bankruptcy. The Program would also be responsible for approving and maintaining a list of those who could provide personal financial management courses, and debtors would have to complete such a course after they file bankruptcy in order to receive a discharge. This provision would address the widespread problem of financial illiteracy. These provisions also would help ensure that debtors make informed choices before seeking bankruptcy relief and then obtain the necessary knowledge to avoid future financial catastrophe.

- Bankruptcy Petition Preparers: Under Section 221, bankruptcy petition preparers will be required to give their customers a prescribed notice that they are not attorneys and cannot give legal advice. Provisions for fines and injunctions are strengthened, and the Judicial Conference is given authority to set a maximum allowable bankruptcy petition preparer fee. This provision increases the accountability of bankruptcy petition preparers

whose actions can have a devastating effect on debtors who seek bankruptcy protection to save their residences or for other legitimate purposes.

In summary, the Department of Justice commends this Subcommittee for recognizing the serious and far-reaching nature of bankruptcy fraud and abuse. The USTP is committed to combating this problem with the statutory tools at our disposal. In addition, we look forward to implementing any new provision of bankruptcy law that the Congress may enact in the future. The fraud and abuse provisions contained in H.R. 975 would assist the Program in carrying out its National Civil Enforcement Initiative and improving the efficiency and integrity of the bankruptcy system.

Mr. Chairman, that completes my prepared remarks. I would be happy to answer questions from the Subcommittee at this time.