The Top Five Myths About Debtor Audits

by

Lisa A. Tracy, Deputy General Counsel
Thomas C. Kearns, Trial Attorney
Executive Office for U.S. Trustees

The U.S. Trustee Program issued its first annual report on debtor audits in May 2008. This report has generated many questions about debtor audits and exposed several common misconceptions. The following are the top five myths about debtor audits:

- **Myth #5–An audit requires a debtor to produce a significant amount of additional documentation.**

Most audited debtors are asked for three categories of documents, with an additional category of documents requested only of divorced or self-employed debtors. If the debtor provides only some of the requested documents, that may be considered sufficient if the debtor gives a satisfactory explanation why the documents are not provided–for example, the documents do not exist–and produces the remainder of the requested documents. Many of these documents should have already been gathered and reviewed by the debtor's counsel or the *pro se* debtor in preparation for filing bankruptcy. In general, the document categories are: federal income tax returns for the two most recent taxable periods; depository and investment account statements for the month of filing and for six months pre-petition; pay advices for the month of filing and for six months pre-petition; for divorced debtors, the divorce decree and related property settlement and support orders; and, for self-employed debtors, documents for business operations through which the debtor derives self-employment income.

- **Myth #4–A debtor has no opportunity to respond to a material misstatement finding before the report of a material misstatement is made public.**

Before an audit firm files with the court a report indicating a material misstatement, the audit firm must contact the debtor's counsel or the *pro se* debtor, in writing, notifying the debtor of his or her findings and offering an opportunity to provide a written explanation. The debtor may provide a written narrative or supply additional information that may satisfactorily explain the material misstatement. The audit firm then independently decides whether the debtor's counsel or *pro se* debtor has provided a satisfactory explanation, making it unnecessary to report a material misstatement finding. A satisfactory explanation may include audit firm error or error in the information available on public databases.

- **Myth #3–The court and parties do not know the specific factual basis for the material misstatement finding.**

The audit firm does not merely report the existence of a material misstatement in the debtor's bankruptcy case. In its filed report, the audit firm identifies the material misstatement including the specific factual basis for the finding, so parties may evaluate its significance.

- **Myth #2–A material misstatement automatically results in an enforcement action.**

An audit firm's report of material misstatement is not dispositive; it is a starting point for the U.S. Trustee to consider taking action. Importantly, the fact that the audit firm reports the existence of a material misstatement does not necessarily mean the debtor has committed an offense justifying a sanction. This point is supported by a recent ruling in Savannah, Georgia, in which the court denied a motion to strike a Report of Audit filed by the debtor and found that the "audit report itself clearly states it is not a legal conclusion and does not require any specific action."[1] Those of us in the bankruptcy system know very well that not every material misstatement is actionable. Many factors must be weighed, such as whether the debtor promptly amended incorrect financial schedules, whether there was any potential impact on case administration, and whether the debtor acted recklessly or with an intent to deceive. In those instances in which the U.S. Trustee believes the debtor, or their counsel, committed sanctionable wrongdoing, however, the U.S. Trustee will file an appropriate enforcement action in bankruptcy court.

- **Myth #1–Debtor audits do not help combat fraud and abuse.**

The Program sets the threshold for material misstatement so as to capture inaccuracies or omissions that deprive the United States Trustee, the case trustees, the court, and creditors of adequate information to decide whether to conduct further investigation, recover assets, or seek or impose relief against the debtor. The material misstatements are inaccuracies or omissions of significance; they are not trivial mistakes. It is important to note that the audits are designed not only to identify actionable cases, but also to help measure the incidence of fraud, abuse, and errors in the bankruptcy system. While not every material misstatement is actionable, debtor audits are uncovering fraud and abuse in the bankruptcy system.

A good example of a debtor audit case yielding concrete results occurred in our Sacramento office. The report of audit identified various material misstatements, including the debtor's failure to disclose financial accounts, vehicles, and a pre-petition sale of assets. The field office investigated and found numerous undisclosed out-of-state residential real estate transactions. Based on the findings in the report of audit and follow-up investigation by the U.S. Trustee's office, a discharge complaint was filed and the debtor agreed to waive discharge.

In 2007, the independent RAND Corporation strongly endorsed the use of debtor audits as part of the Program's broader effort to detect fraud, abuse, and errors in the bankruptcy system. RAND advised that, over time, the Program could study the results of debtor audits to develop reliable red flags that would guide our selection of cases for further investigation.[2]

If the RAND Corporation is correct, debtor audits will benefit everyone in the bankruptcy system, including debtors. If the Program has a more sophisticated means to identify cases that reflect fraud or abuse, it can cast a smaller net. And, after a case is selected for further inquiry, the Program can be more specific in asking only for the information most likely to reveal wrongdoing. This will make the Program more efficient and effective, while reducing the burden upon debtors.

Conclusion

With experience, the Program may refine its definition of what constitutes a material misstatement. One thing should be clear, however: the material misstatements are inaccuracies or omissions of significance. The Program is not capturing trivial mistakes. Some material misstatements are actionable while others are not, and that is the way it should be.

Debtor audits will provide the bankruptcy community with much valuable information. There should not be a rush to a definitive conclusion about the incidence of wrongdoing based upon one year of results. Nor, however, should we be complacent about material misstatements that may suggest the bankruptcy community has more work to do to raise the level of compliance in making complete and accurate bankruptcy filings.

1. *In re Kelton*, 389 B.R. 812, 819 (Bankr.S.D.Ga. 2008).

2.Noreen Clancy & Stephen J. Carroll, RAND Corp., Identifying Fraud, Abuse, and Error in Personal Bankruptcy Filings (2007), available at www.usdoj.gov/ust/eo/public_affairs/reports_studies/index.htm.