



Department of Justice

STATEMENT OF

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UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE

COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT AND THE COURTS
UNITED STATES SENATE

HEARING ENTITLED

“POLICING LENDERS AND PROTECTING HOMEOWNERS: IS
MISCONDUCT IN BANKRUPTCY FUELING THE FORECLOSURE CRISIS?”

PRESENTED

May 6, 2008

Mr. Chairman, Ranking Member Sessions, and Members of the Subcommittee:

Thank you for the opportunity to appear before you today to describe the activities of the United States Trustee Program (USTP or Program) to protect homeowners who file for bankruptcy relief. We are the component of the United States Department of Justice with a duty to oversee bankruptcy cases, ranging from consumer bankruptcy cases to large corporate reorganizations. Our mission is to promote the integrity and efficiency of the bankruptcy system.^{1/} Our responsibilities, which are set forth in titles 11 and 28 of the United States Code, include the performance of administrative, regulatory, and litigation functions.

The duties of the USTP are carried out by the Executive Office for United States Trustees, 21 regional United States Trustees, and 95 field offices. The Program employs approximately 1,300 staff, including trial attorneys, financial analysts, and support staff.

Civil and Criminal Enforcement

One of the core functions of the USTP is to combat bankruptcy fraud and abuse. This is reflected both in our statutory mandate and in our track record over the past 20 years. In launching a Civil Enforcement Initiative in 2002, the Program adopted a balanced approach to address wrongdoing both by debtors and by those who exploit debtors. The Program combats fraud and abuse by debtors by seeking denial of discharge for the concealment of assets and other violations, by seeking case dismissal if a debtor has an ability to repay debts, and by taking other enforcement actions. We protect consumer debtors from wrongdoing by attorneys, bankruptcy petition preparers, creditors, and others by pursuing a variety of remedies, including the disgorgement of fees, the imposition of fines, and injunctive relief.

In Fiscal Year (FY) 2007, the Program initiated more than 74,000 civil enforcement and related actions, including actions not requiring court resolution, with a monetary impact of more than \$865 million in debts not discharged, fines, penalties, and other relief. Since we began tracking our results in 2003, we have taken more than 290,000 actions with a monetary impact in excess of \$3.5 billion.

Criminal enforcement is another key component of the Program's efforts to uphold the integrity of the bankruptcy system. We have a statutory duty to refer suspected criminal conduct to the United States Attorney and to assist in prosecuting bankruptcy crimes. We participate in more than 50 local working groups, including bankruptcy fraud working groups, mortgage fraud working groups, and other specialized task forces that are led by federal law enforcement agencies around the country. We also work closely with the Federal Bureau of Investigation, the Internal Revenue Service - Criminal Investigation, the Office of Inspector General of the Department of Housing and Urban Development, and other federal law enforcement agencies.

^{1/} The USTP has jurisdiction in all judicial districts except those in Alabama and North Carolina. In addition to specific statutory duties and responsibilities, United States Trustees "may raise and may appear and be heard on any issue in any case or proceeding under this title but may not file a plan pursuant to section 1121(c) of this title." 11 U.S.C. § 307.

In FY 2007, we made 1,163 criminal referrals, including cases involving housing fraud. This represents an increase of 26 percent in the number of cases formally referred over the previous year. Furthermore, the number of cases referred in FY 2006 represented an increase of 24 percent over the previous year.

Protecting Homeowners in Bankruptcy

Protecting consumer debtors is an important objective of the Program's enforcement efforts. One of the basic principles of our bankruptcy system is that the honest but unfortunate debtor deserves a fresh start. Those who prey upon debtors for their own financial gain undermine that basic principle.

Among the most egregious mortgage-related schemes we encounter are those perpetrated upon consumers facing foreclosure on their homes. From our experience, it sometimes seems that those facing foreclosure on their homes receive more mail than any other group of Americans. As soon as a foreclosure notice is posted in a public record, debtors are apt to receive flyers and other mailings telling them how to save their homes. Although debtors are vulnerable to a wide variety of fraudulent schemes or other improper conduct, two of the fact patterns uncovered most often by United States Trustees are described below.

Bankruptcy Petition Preparers

A common problem we see in the bankruptcy system is the distressed homeowner's use of a bankruptcy petition preparer. Instead of going to see a lawyer, some seek a less expensive alternative. A debtor is not required to retain an attorney before filing for bankruptcy. Some non-attorneys perform a legitimate service by providing and typing bankruptcy forms at a charge of \$200 or less. Unfortunately, however, we frequently learn about homeowners in need of debt relief who turn to a non-lawyer bankruptcy petition preparer (BPP) who provides advice that is both illegal and catastrophically wrong. Non-attorneys are not permitted to offer legal advice. If a debtor owns a home, many factors go into whether to file a chapter 7 or a chapter 13 petition.^{2/} Legal issues such as the amount of equity in the home, availability of state exemptions, calculation of disposable income to make up for mortgage arrearages, and other factors need to be carefully considered before deciding whether to file bankruptcy and under which chapter to file.

Following are two examples of improper bankruptcy petition preparer conduct pursued by United States Trustees:

^{2/} In general, debtors in chapter 7 give up all non-exempt property to a case trustee appointed by the United States Trustee. The chapter 7 trustee liquidates non-exempt property and distributes the proceeds to creditors. Debtors in chapter 13 retain their home and other property, but must remain current on post-petition secured debt payments (e.g., mortgage and auto loans). Chapter 13 debtors also must make up any pre-petition arrearages on secured debts and repay at least a portion of unsecured debts (e.g., credit card obligations) under a three to five year repayment plan.

- In a series of cases in New York City, homeowners who fell behind on their debts responded to an advertisement from a BPP. When the debtors went to the BPP's office, the BPP filled out chapter 7 forms, collected a fee, and then filed the bankruptcy petition. The next thing the debtors knew, they were attending a formal meeting of creditors presided over by a trustee where they learned for the first time that the trustee planned to take their home, sell it, and distribute the proceeds to creditors. After the debtors told their story, we were able to obtain both injunctive relief against the BPP, prohibiting it from the unauthorized practice of law, and affirmative relief requiring the BPP to make disclosures to future clients regarding the nature and cost of its services. More importantly, the affected debtors were able to convert their cases to chapter 13 where they could retain their homes.
- In another case decided within the past year, the bankruptcy court in the Western District of Pennsylvania entered a default judgment against a BPP following a complaint filed by the Office of the United States Trustee. The out-of-state BPP contacted several Pittsburgh area residents faced with foreclosure by mailing a postcard that guaranteed the BPP could help them keep their homes. In exchange for fees ranging from \$250 to \$2,100, the BPP provided the homeowners with skeletal chapter 13 petitions to file to stay foreclosure. The debtors' bankruptcy cases were ultimately dismissed. The court fined the BPP \$72,000, ordered the disgorgement of fees in the amount of \$8,200, and permanently enjoined it from acting as a BPP and offering legal advice or otherwise engaging in the unauthorized practice of law in the district.

Foreclosure Rescue Operators

Another frequent fact pattern involves foreclosure rescue operators who use the bankruptcy system to victimize distressed homeowners. The perpetrators of this fraud promise to assist the victims in saving their homes from foreclosure. By filing bankruptcy petitions, the fraudsters use the automatic stay^{3/} to delay foreclosure and to convince the victims that they are performing a valuable service.

In one variation of this scheme, the perpetrator promises to renegotiate the terms of the victim's mortgage. The fraudster often directs the victim to make mortgage payments to him or to pay him a monthly fee. In reality, the fraudster does nothing except pocket the victim's money. To ensure the victim will continue to pay the perpetrator, and to prevent foreclosure in spite of the non-payment of mortgage, bankruptcy petitions may be filed in the name of the victim.

If the perpetrator is filing the bankruptcy papers without the debtor's knowledge, it may be a long time before the debtor learns about the bankruptcy. In such cases, it is critical that the homeowners contact a lawyer, the bankruptcy court, or the United States Trustee as soon as they become aware that a bankruptcy petition was filed in their name.

^{3/} By statute, the filing of a bankruptcy petition generally stays any actions to collect on debts, including actions to foreclose on a debtor's residence.

In another scenario, the “rescue servicer” takes the debtor’s equity and the home ultimately is lost to foreclosure. In these cases, the fraudster seeks out individuals who are losing their homes to foreclosure and prevails upon them to transfer their homes to him to avoid a foreclosure on their credit reports. To stop the foreclosure, the rescue operator files bankruptcy petitions in the homeowners’ names. While the cases are pending, he collects rental income on the properties from the victims.

Following are four recent cases involving criminal prosecution:

- In Kansas, a Los Angeles man was charged in an indictment unsealed on February 29, 2008, with six counts of mail fraud and six counts of aggravated identity theft for his role in a bankruptcy foreclosure scheme. The defendant allegedly solicited homeowners whose homes were in foreclosure, and told them that for a fee he could help them keep their homes. He allegedly filed false bankruptcy petitions in the names of non-existent businesses that claimed to be part owners of the properties in foreclosure. The petitions were filed in the Bankruptcy Court for the District of Kansas, and contained false names, Social Security numbers, and other information. The United States Trustee in Kansas referred the matter and assisted in the investigation. A copy of a news release issued by the United States Attorney announcing the indictment is attached.
- In the Northern District of Illinois, a defendant was sentenced on June 25, 2007, after pleading to wire fraud and false declaration in bankruptcy. The defendant preyed on homeowners facing foreclosure by making false representations that the defendant’s company and its team of experts could stop foreclosures and eliminate all of a homeowner’s mortgage debt in two years. The defendant falsely represented to some of his victims that mortgage debt was illegal and that the mortgage companies would forgive their debt when faced with lawsuits and persuasive arguments. The defendant charged the homeowners a large retainer as well as monthly payments, but essentially did nothing except file serial bankruptcy petitions to delay foreclosure. Approximately 29 victims lost a total of around \$180,000, and all eventually lost their homes. The defendant was sentenced to 135 months incarceration and six years of supervised release, and was ordered to make restitution in the amount of \$187,604. The United States Trustee in Chicago referred the matter and a USTP Regional Criminal Coordinator assisted in the prosecution as a Special Assistant U.S. Attorney.
- In the Northern District of Ohio, a Grand Jury returned an indictment last December alleging that the defendant committed eight counts of mail fraud. The indictment alleges that the defendant engaged in a scheme to defraud financially troubled homeowners. The indictment states that the defendant made representations that his company specialized in helping people save their homes from foreclosure with highly trained and qualified specialists. The indictment charges that the defendant requested and received funds from these homeowners to be used to pay their mortgage lenders, but that he instead used these funds for his own personal and

business purposes. The indictment states that the defendant fraudulently obtained approximately \$500,000 from various homeowners. The indictment further alleges that the defendant hired attorneys to prepare and file bankruptcy petitions on behalf of the homeowners to delay foreclosure actions. A Trial Attorney from the Cleveland office of the United States Trustee is assisting in the prosecution of the case as a Special Assistant U.S. Attorney.

- In Arizona, last August a foreclosure rescue operator was sentenced to 33 months in prison, fined \$5,000, and ordered to pay \$86,409 in restitution, based on his guilty plea to two counts of false declaration in bankruptcy. The operator sought out individuals who were losing their homes to foreclosure and prevailed upon them to transfer their homes to him to avoid having a foreclosure on their credit reports. To stay foreclosure, he filed bankruptcy petitions in the homeowners' names without their knowledge. While the cases were pending, he collected rental income on the properties. When we were alerted to the scam, we took action to remove the bankruptcy filing from the debtors' records and worked closely with the United States Attorney on the criminal prosecution. A copy of a news release issued by the United States Attorney announcing the sentencing is attached.

Mortgage Servicer Violations in Bankruptcy Cases

Apart from the kind of fraudulent or improper activities described above, we also have been involved in significant litigation involving national mortgage servicing firms. Most of these cases involve homeowners who are behind on their mortgage payments and file for relief under chapter 13 of the Bankruptcy Code. To date, we have commenced actions or intervened in 16 pending cases involving mortgage servicers in eight judicial districts around the country. In addition, we are actively reviewing more than 30 cases in which we have not yet filed court papers.

The USTP has investigated complaints that some mortgage servicers were filing inaccurate papers in court claiming that debtors owe more money than they actually owe. We also investigated complaints that some mortgage servicers were tacking on charges that were undisclosed and impermissible under the terms of the loan contract or other applicable law. In the most extreme cases, the debtor makes all payments required in chapter 13 and, after emerging from bankruptcy, is hit with a new bill for previously undisclosed charges. If those new bills are not paid, then the lender can foreclose on the property and the entire chapter 13 process will have been for naught.

More specifically, the United States Trustee has investigated or pursued actions involving mortgage servicers who inflate the amount of money due from the debtor in two primary ways:

- *Proof of Claim.* Creditors are generally required to file with the court a proof of claim stating the amount owed by the debtor. In the case of a mortgage debt, the proof of claim should reflect the principal due and the arrearages from pre-petition missed payments. If the homeowner wishes to retain the home, then the arrearage must be repaid under a three to five year chapter 13 repayment plan. We have

investigated or taken action against mortgage servicers who file proofs of claim in inflated amounts that are not documented by reliable billing records.

- *Motions for Relief from Stay*. By filing a bankruptcy petition, the debtor receives an automatic stay preventing creditors from taking any collection action on most debts without a court order. Generally, chapter 13 debtors may keep their home if they can make up past due payments as described above and remain current in their post-petition mortgage payments. If debtors are delinquent in their post-petition payments, the creditor may seek relief from the stay and foreclose on the property. We have investigated or taken action against mortgage servicers who file motions for relief from stay based upon inaccurate financial information. For example, the mortgage servicer may misapply post-petition plan payments or add various charges, such as high attorneys' fees, that are not permissible under the mortgage contract or applicable law. Unless the mortgage servicer's accounting is challenged, then the court may grant the relief from stay and the debtor may be subject to foreclosure.

In response to an increasing number of complaints about the accuracy of bankruptcy court filings made by some mortgage servicers, approximately 18 months ago, I established an informal working group within the USTP to review the complaints and devise a coordinated approach for addressing the problem. The working group considered many legal and practical issues. As a threshold matter, it is not always clear when the United States Trustee should intervene in a case. We take the legal position that the Program has authority to redress violations by creditors, particularly when the abuse is systemic or multi-jurisdictional. In many cases, however, creditor abuse is best addressed by the private case trustees we appoint who object to claims, or by debtors' lawyers who dispute loan agreement terms. The Program should focus its attention on cases in which the integrity of the bankruptcy system as a whole is at stake. In those cases that have broader, system-wide implications, it is important for the Program to take direct enforcement action.

In addition to the difficulty of case selection, civil litigation of mortgage servicing issues requires resource intensive fact finding and resolution of strongly contested legal issues. In one recent case, we completed seven days of trial, examined 22 witnesses, and reviewed thousands of pages of documents. Moreover, a creditor's procedural obligations under chapter 13 may be quite different under disparate local court rules, practice, and case law. In addition, our standing to intervene has been challenged and litigation over that issue can slow down our investigation and civil prosecution.

Insofar as we are currently in litigation and discovery in many mortgage servicer cases, it would not be appropriate to discuss these cases in detail. However, a summary of three recent bankruptcy court decisions is provided below.

- *In re Countrywide Homes Loans, Inc.*, __ B.R. __, 2008 WL 868041 (Bankr. W.D. Pa. Apr. 1, 2008). The bankruptcy court consolidated several cases for administrative purposes to resolve the creditor's challenge to the authority of the United States Trustee to examine Countrywide's mortgage servicing practices. In a

lengthy opinion handed down on April 1, 2008, the bankruptcy court ruled in favor of the United States Trustee. The court declared that “the UST was undoubtedly intended to be a ‘watchdog’ of the bankruptcy system” and, in the cases at bar, “made a showing of a common thread of potential wrongdoing in each of the cases that is sufficient to meet the general standard of good cause necessary” to proceed.

- In re Parsley, __ B.R. __, 2008 WL 622859 (Bankr. S.D. Tex. Mar. 5, 2008). After several days of trial and extensive briefing on legal and factual issues arising in the case, the bankruptcy court handed down a 72 page opinion resolving Orders to Show Cause against a mortgage servicer and its counsel. The United States Trustee argued that Countrywide Home Loans, Inc., or its outside counsel should be sanctioned for bad faith conduct for repeatedly averring inaccurate facts in papers filed with the court. The court earlier had upheld the United States Trustee’s standing to pursue the matter. The court noted that “[t]he level of vituperation against the UST merits some discussion of the UST’s role in the bankruptcy system.” The court concluded that “the UST was well within its authority to investigate” the mortgage servicer and its counsel “to determine if their activities undermined the integrity of the bankruptcy system,” and stated that the United States Trustee’s litigation “has been very thorough and skillful.” Although the court found many instances of inaccurate court filings and inappropriate conduct, and criticized the mortgage servicer’s “corporate culture,” the court did not impose additional sanctions. The court reasoned that sanctions required a heightened burden of proof beyond negligence, the parties already had suffered some penalties, and the parties had taken some corrective actions.

- In re Allen, No. 06-60121, 2007 WL 1747018 (Bankr. S.D. Tex. June 18, 2007). The bankruptcy court imposed sanctions of \$150,000 against a law firm representing mortgage servicers. The court found that the law firm repeatedly filed motions for relief from the stay to permit foreclosure based upon inaccurate statements of the amount of past due debt. The sanction was remitted to \$75,000 because the law firm was attempting to cure its deficiencies. As in other cases, the court noted that the respondent had “complained bitterly about the participation of the U.S. Trustee in this matter,” but found that we were a “party in interest with the authority to be heard,” and “provided an invaluable benefit to the case and to the process”

Mortgage Lenders in Chapter 11 Bankruptcy

In addition to addressing issues pertaining to homeowners in bankruptcy, the Program has responsibility for overseeing chapter 11 business reorganization cases filed by mortgage lenders. Although our case management system does not identify business debtors by industry, we estimate that at least 20 mortgage lenders have filed for chapter 11 relief over the past two

years.^{4/} Some of these business debtors are subprime lenders and some of the cases raise questions regarding sound business practices.

Under chapter 11, business debtors^{5/} obtain a stay to prevent creditors from collecting on pre-petition debt while the company develops a plan of reorganization that must be approved by creditors and the court. Management of the debtor usually is allowed to remain in place, but the bankruptcy filing transforms the company into a “debtor in possession” with a fiduciary duty to act in the interests of all stakeholders of the company, including creditors.

The USTP carries out numerous responsibilities in a chapter 11 case. Importantly, the Program does not substitute its business judgment for that of the debtor’s management or creditors. Instead, we perform various administrative duties and ensure compliance with Bankruptcy Code provisions. For example, we appoint an official committee of unsecured creditors who act as fiduciaries to represent the interests of unsecured creditors in negotiating with the debtor over a plan of reorganization and other matters; prescribe financial reports that must be filed by the debtor with the court; conduct a formal meeting where the debtor’s representatives testify under oath about the company’s financial condition; review and sometimes object to applications of professionals who seek to be employed and compensated by the bankruptcy estate; and take other steps to ensure that the case proceeds in accordance with bankruptcy statutes and rules.

The recent case of New Century TRS Holdings, Inc., points out the important role of the United States Trustee in moving for the appointment of a trustee or independent examiner in the face of what frequently is strong opposition from the debtor and its large institutional creditors. In cases involving gross mismanagement by the debtor in possession, an independent trustee or examiner can add transparency, enhance public confidence in the proceedings, and conduct efficient fact-finding for the benefit of creditors and equity holders. New Century is the largest mortgage lender to file for chapter 11 relief, with stated assets of \$12.9 billion and stated liabilities of \$11.5 billion when it filed on April 2, 2007.

Replace Management or Appoint Independent Examiner

New Century filed for bankruptcy relief in the district of Delaware after disclosing accounting and financial statement irregularities in the operation of its business. The company acknowledged that it needed to restate its financial results and amend its previous filings with the Securities and Exchange Commission. The misstatements were significant and hid major losses from New Century’s creditors and investors.

About two weeks after New Century filed for bankruptcy relief, the United States Trustee filed a motion for authority to appoint a trustee to replace existing management or, in the alternative, an independent examiner. Under chapter 11, the United States Trustee or other

^{4/} In addition, a number of mortgage lenders filed for relief under the liquidation provisions of chapter 7 during this same period of time.

^{5/} Under certain circumstances, individuals may be a debtor under chapter 11.

parties may seek to oust management for fraud, mismanagement, or other reasons set forth in section 1104 of the Bankruptcy Code. If the motion is granted, the United States Trustee appoints a trustee to take control of the debtor. In New Century, there was opposition by both the debtor and creditors to the appointment of a trustee, and the bankruptcy court declined to authorize such an appointment.^{6/} It did, however, grant our request for authority to appoint an independent examiner to report on the financial affairs of the debtor and possible causes of action that may be pursued on behalf of the estate and its stakeholders.

After protracted negotiations and argument in open court over the scope of the examination, the examiner finally was allowed to commence his investigation in mid-2007 with a deadline to file one or more reports with the court by early 2008. After filing an interim report, the examiner filed his final report on February 29, 2008. The creditors' committee sought to seal the report from public view for at least 45 days. The United States Trustee opposed the seal and the court unsealed the report on March 26, 2008.

The examiner's report provides a detailed account of New Century's business practices and outlines possible causes of action against culpable parties, including the company's former auditors. In this respect, the examiner's report in New Century is similar to results of independent examinations sought by United States Trustees in other cases.

Limit Executive Bonuses

The United States Trustee also has an important responsibility to review proposals to pay bonuses to executives of bankrupt companies. One of the reforms made by the 2005 bankruptcy law is a provision that severely restricts payments to executives and insiders. Among other things, section 503(c) of the Bankruptcy Code prohibits most retention bonuses and, generally, requires that bonuses to senior officials be based upon achievement of bona fide performance goals. The United States Trustee is often the only party objecting to executive bonuses that do not comply with the new law.

Nine days after New Century filed, the debtor proposed payments of more than \$2.8 million to eight top company officials. The United States Trustee filed objections on grounds that the payments were disguised retention bonuses unrelated to performance and that it was premature to reward senior executives while the company's pre-petition financial conduct was being investigated. The debtor later modified its bonus plan and, among other things, excluded the Chief Executive Officer from those eligible to receive bonus payments. The United States Trustee maintained its objection to the amended plan, but our objection was overruled by the bankruptcy court.

Despite resource constraints, the United States Trustee remains committed to carrying out its duties in chapter 11 cases to ensure compliance with legal requirements and, where appropriate, to seek authority to appoint trustees or examiners who can bring independence, transparency, and efficiency of the bankruptcy process.

^{6/} The President and Chief Executive Officer as well as the Executive Vice President were subsequently dismissed on June 12, 2007.

Conclusion

The mission of the USTP is to carry out the bankruptcy laws for the benefit of all stakeholders in the system – debtors, creditors, and the public. The integrity of the bankruptcy system is threatened whenever debtors violate the Bankruptcy Code by seeking a discharge of debt despite their ability to pay creditors out of disposable income or by concealing assets that should be liquidated for distribution to creditors. Similarly, the integrity of the bankruptcy system is compromised by creditors who file false financial information that inflates the amount of money due to them or deprives debtors of the Bankruptcy Code’s protection against foreclosure. Actions to protect consumer debtors who may be victims of fraud or abuse have a high priority, have yielded positive results, and will continue to be aggressively pursued.

The United States Trustee Program also helps to ensure that mortgage lenders that seek bankruptcy relief comply with bankruptcy laws and that reasonable suspicions of financial irregularity are properly addressed, including by the appointment of independent case trustees or examiners.

I appreciate the opportunity to testify and would be pleased to respond to any questions from the Subcommittee.