

Send in the SWAT Team:
Investigating Embezzlement
from Bankruptcy Trust Funds

By Martha Hallowell and Michael Sorgaard¹

On January 11, Tricia Mendoza of Norwalk, Calif., was sentenced to one year in prison and ordered to pay almost \$250,000 in restitution for embezzling from a Chapter 13 trustee operation.² Mendoza was the trustee office's receptionist, but she was also responsible for updating the trustee's computer files to reflect changes in creditors' addresses, assignments of claims between creditors, and other changes in the designation of disbursements. Mendoza discovered that she could rig the computer system to send creditor payments to an address she controlled. She did this by changing creditors' names and addresses to the name and address of an accomplice.

When the embezzlement was discovered by a co-employee, the United States Trustee Program sent a reconstruction team to inspect the trustee's computer files and financial records. The team discovered that Mendoza began embezzling in 1996. In addition to the \$180,000 she embezzled by manipulating the computer system, she stole tens of thousands of dollars in cashier's checks and checks payable to "cash."

Each year, more than \$4 billion flows through the offices of Chapter 7, 12, and 13 bankruptcy trustees.³ These funds

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²See Jan. 12, 1999, press release issued by Alejandro N. Mayorkas, United States Attorney for the Central District of California.

³Executive Office for United States Trustees. Data does not include North Carolina and Alabama. Data is not available

represent debtor payments deposited into trust accounts or funds from liquidated assets, as well as the interest that accumulates on those trust balances. Some estate funds are received by the trustee within a short period, as in a Chapter 7 liquidation, while other payments are received monthly for up to five years, as in a Chapter 13 case. In a typical Chapter 13 case the funds may stay in the trust account for only a month or two before being distributed, while in a Chapter 7 case the funds may remain undistributed until all assets are liquidated and all relevant court actions reach final disposition.

Given the scope of money received and distributed through the bankruptcy system, it is critical to take steps to ensure the safety of those funds. Consequently, the Program and the private trustees impose a variety of safeguards to protect this money from improper diversion. The trustee is frequently the lone signatory on the trust account, thus restricting employees' ability to issue checks. Internal controls are established in the trust operation to ensure that no employee has too much access to the funds, the books, or the computer records. Moreover, trust funds are subject to periodic audits by the United States Trustee Program or by independent auditors.

Theft from the Trust: Rare But Serious

Because of the many safeguards imposed by the private trustees and the Program, theft from a bankruptcy trust operation is rare. Yet it still occurs, and its potential for growth could increase with the upward trend in cases under administration and dollars flowing through the system.

Thefts from bankruptcy trust operations take various forms, reflecting the amount of money at stake and the different ways in which funds enter the bankruptcy system. Funds may be misappropriated and not disbursed to the proper creditors, parties, or debtors. Bankruptcy estate assets may be misappropriated prior to being secured by the trustee. Checks may be written on the estate account or trust account payable to an unrelated third party.

An emerging area of concern is check forgery, most often

on Chapter 11 cases.

by a party not connected with the bankruptcy system. A distribution check to a creditor may be stolen from the mail or from the final destination. With today's advanced print and imaging technology, a check to a creditor can be scanned and then altered and re-issued. If trust check stock is improperly stored, a thief may steal that stock and forge the trustee's name.

The most effective method for preventing fraud and embezzlement is through controls implemented by the Program, the trustee, and the trustee's bank, which act as significant deterrents and means for catching fraudulent activities in the trust operation. The Program works closely with trustees to develop a variety of oversight mechanisms to provide disincentives for thefts, or to quickly discover and identify losses when a theft does occur. Trustees submit a variety of reports to the Program, and several embezzlements have been detected through the review of these reports.

The Program also relies on tips from attorneys, debtors, creditors, and other members of the bankruptcy community to identify situations requiring investigation. This kind of assistance from the bankruptcy system's primary "customers" is essential in uncovering inappropriate activities.

Investigating Allegations of Loss

1. Preliminary Assessment

When an allegation is received, the Program immediately commences a preliminary assessment to determine whether it is likely that a loss occurred. Depending on the allegation, this preliminary investigation may include interviews with the trustee, the trustee's staff, or outside professionals.

Local Program bankruptcy analysts--accountants who frequently are certified public accountants or have graduate accounting degrees--may review specific case files or reports submitted by the trustee and submit inquiries to the banks. Within a few days, the United States Trustee determines the likelihood of a loss to estate assets. If the United States Trustee determines that there was no loss, the inquiry is ended.

If, however, it is determined that a loss may have occurred, the matter is evaluated to determine the best course

of action. For example, if the evidence supports allegations that the trustee was involved in the loss of estate assets, the United States Trustee may consider immediately filing in bankruptcy court a motion to remove the trustee from the cases assigned to him or her to ensure that the remaining assets are protected from theft.

Certain additional actions may be immediately necessary to safeguard estate assets. Estate accounts may be frozen to eliminate the opportunity for further theft, and suspect staff may be placed on leave.

2. Full-Scale Investigation

Following the preliminary assessment, the EOUST coordinates a full-scale investigation to verify the defalcation and to determine the exact nature and amount of the loss. The Program devotes significant resources to such a project.

Typically, a full-scale investigation is conducted by a team of Program bankruptcy analysts temporarily reassigned from field offices around the country. The type of investigation conducted by the Program is based in part on whether the allegations involve cases under Chapter 7, 11, 12, or 13.

The most thorough type of investigation reviews each case completely for diversions of assets from the estate and for embezzlements of assets later in the administration of the case. The average caseload for a Chapter 7 panel trustee is 165 cases; a standing Chapter 13 trustee's caseload averages 4,450 cases. Unless there are obviating factors, the investigation team reviews every open Chapter 7 or Chapter 11 case administered by the trustee. In an investigation of Chapter 13 cases, the investigation team seeks to identify the scheme. In this way, the cases to be reviewed are narrowed to those that could have been affected. Additionally, computer reports from the trustee operation's data base are relied upon to identify problem areas.

When misappropriations or other improper actions are discovered in a Chapter 7 or Chapter 11 case, the team of accountants reconstructs the trustee's records. Receipts and disbursements from the estate accounts are reconstructed from bank records. This information is compared with the official

court file for the bankruptcy estate, with the trustee's file, and with other pertinent information. Any inconsistencies are further researched.

The reconstruction team also looks for any other funds not accounted for in the bank records, such as a court-ordered sale where no funds were received, or a letter in the trustee's file indicating a sale or turnover of bankruptcy assets to the trustee that were not entered on the trustee's asset ledger for the bankruptcy estate. The team surveys debtors and debtors' attorneys to determine whether all estate assets were liquidated and funds properly accounted for by the trustee. Additionally, professionals such as auctioneers or brokers will be surveyed regarding work they performed for the trustee or his employee.

In a large Chapter 7 trustee defalcation that occurred several years ago, a team of Program analysts spent several weeks examining all the bank records and case files associated with the 60 open cases being administered by the trustee. The investigation was precipitated by audit findings of unexplained withdrawals of estate funds and by complaints from creditors. Findings of irregular activity in the open cases led the team to review a number of closed cases. Every asset was traced to final disposition; every case file was perused for references to unscheduled assets, deposits from potential buyers of assets, and tax refunds. The team requested financial records directly from the bank and discovered that the trustee had altered copies of financial records in the case file to mislead auditors. Each lead was followed up, requiring significant bank records requests, written and oral correspondence to third parties to confirm transactions, and tracking of the flow of funds between estates and to the personal benefit of the trustee. When the investigation concluded, the team had documented estate losses exceeding \$1.7 million.

When a loss occurs in a Chapter 13 trust operation, the team reconstructs fraudulent activity as in a Chapter 7 investigation. However, because it might not look at each case individually, the team relies initially on what is known about the means of the theft, and then looks at suspect procedures that could allow other forms of theft to occur. Among other items, the team looks at the trust operation's segregation of duties and its handling of returned items, of debtor receipts, of funds turned over to the court registry account, and of

outstanding checks. The team may analyze the trust operation's database to examine non-confirmed cases greater than 180 days old, cases older than 60 months, cases with large funds on balance, cases with negative balance of funds on hand, and questionable cases that may be shell or suspense accounts.

Unusual discrepancies also will be investigated. The team will review inconsistencies between the court's list of open Chapter 13 cases and the trust operation's open case list. Similarly, the team will investigate deviations between the court's registry account and the trust operation's ledger of funds turned over to the court's registry account. It will examine differences between the payee name on a disbursement check and the name of the claimant as recorded in the proof of claim. An adjustment to computer records that changes an institutional creditor to an individual creditor will be reviewed.

The recent Mendoza embezzlement was discovered when the trustee's office received a call from a debtor's attorney about his client's case. Based on this call, one of the trustee's employees reviewed the case file, which revealed a problem with the assignment of a secured institutional claim to an individual third party. Review of the claim and the payment record for the claim showed misdisbursements to a third party. Further review from queries run on the trust operation's database to find references to the third party revealed similar activity in other cases.

The United States Trustee immediately sent several accountants to the trustee's office to work with the Chapter 13 trustee. While the trustee knew an employee was involved, no one knew who it was. Local Program analysts and the trustee queried the trustee's database, looking for all payments to the third party, any employees, or any family members of employees. The third party's bank records were obtained and reviewed for deposits of trust funds. Within several days, with the assistance of the United States Attorney's office and the Federal Bureau of Investigation, Mendoza was identified as the employee involved in the theft.

The Program sent in a four-member investigation team drawn from throughout the country. Working with local personnel, the team examined the trust operation's internal controls. Controls on access to sensitive areas of the trust operation's database had been purged, apparently

inadvertently, allowing the receptionist to create a fictitious creditor and change creditor names from already existing claim holders to the name of the fictitious creditor. This was done before the trust operation made its monthly disbursements. During the monthly disbursement runs, misdisbursements were made to the fictitious creditor. After the monthly disbursement run was completed, the name of the claimant was changed back to the correct party.

During the reconstruction, the team discovered copies of two cashier checks in Mendoza's personal files. Review of the relevant case file disclosed that the checks were returned to the debtor because the checks showed an improper payee. However, no payments were later recorded in the case file receipts ledger for the months noted on the cashier's checks. The team verified with the bank that the cashier's checks were endorsed with the name of a third party known by Mendoza and had been deposited into the third party's personal bank account. This opened a new avenue of investigation.

The team then analyzed the procedures for processing debtor payments. Special and overnight deliveries and walk-in payments by debtors were processed by Mendoza or by the person sitting at the front desk at the time. The trustee's procedures required the person acting as receptionist to post the receipt to a daily receipts register maintained as an electronic file in the computer system. The team analyzed the electronic register for improper reversing entries. Receipts were traced back to the case file to determine if they were posted to a debtor ledger. A statistical sample of approximately 600 active debtors and debtors' counsel received a confirmation letter on payments made in their cases. The team also secured the bank records of Mendoza and her accomplice to identify additional debtor payments that were stolen.

3. Referral to the United States Attorney

In the Mendoza case, the United States Attorney's Office and the Federal Bureau of Investigation were actively involved throughout the Program's investigation of the embezzlement. The United States Attorney and the FBI were informed early on because the perpetrator had not been identified and it was feared the theft would continue unless law enforcement officers intervened.

More typically, the United States Attorney's participation begins when the United States Trustee formally refers the case at the end of the investigation. The reconstruction team prepares a final report documenting its findings, with all evidence attached as exhibits. The United States Trustee transmits a referral letter to the United States Attorney, along with the investigative report.

Program personnel involved in the investigation often assist the United States Attorney in prosecuting the alleged perpetrator. This assistance may include actions such as obtaining records, analyzing financial records, providing briefings, and acting as expert witnesses at grand jury hearings or court proceedings.

Conclusion

Fraud and embezzlement in private trustee operations are rare. However, when they occur, the loss of money can be significant. Investigating the loss, reconstructing the actions leading to the loss, and taking remedial actions all involve a substantial investment of time and effort by the Program, the trustee, the trustee's employees, banks, creditors, and debtors. It is only this kind of cooperative, intense work that keeps fraud and embezzlement in check and preserves confidence in the bankruptcy system.