CHRONICLE

NEWSLETTER OF THE ESSEX COUNTY BAR FOUNDATION

Volume XXI, Issue 5 MARCH 1995

cir. 3000

How to Successfully Dismiss a Bankruptcy Case for the Commercial Litigator

By Michael J. Faul, Jr., Esq. and Robert DiPasquale, CFE, CPA

The filing of bankruptcy does not automatically spell the death knell for your client's claim. The experienced commercial litigator who is not a so called "bankruptcy practitioner" can successfully prevent the discharge of a creditor's claim or defeat a bankruptcy petition filed in bad faith.

1. Section 341(a) Hearing

The §341(a)[1] hearing is the initial stage of the discovery process where the United States trustee, the creditor and the creditor's attorney may ask questions of the debtor concerning the bankruptcy filing and the debtor's assets and liabilities. This is an opportunity to obtain fruitful discovery without incurring substantial cost that would otherwise be incurred in the regular course of discovery. The debtor's attendance and availability for examination at the Section 341 meeting is mandatory. The trustee conducts the §341(a) hearing and will permit the creditor or the creditor's attorney to examine the debtor. This is the first opportunity to meet the trustee and to discuss the case and your client's claim. It is also an opportunity to obtain limited discovery with regard to the Petition.

A bankruptcy trustee can be influential in causing a case to be dismissed as a bad faith filing. Therefore, it is critical to educate a trustee as to the facts of your case. Under §707(b) of the Code[2], a United States trustee is authorized to dismiss a case for substantial abuse. In general, the facts that serve as a basis for a motion to dismiss under §707(b) exist at the time the case is commenced and usually can be discovered early in the case by reviewing the debtor's schedules and examining the debtor at the meeting of creditors.

Under §1112 of the code [3], on request of a party in interest or the United States trustee, after notice and hearing, the Court is permitted to convert a reorganization case (Chapter 11) to a liquidation case (Chapter 7) or to dismiss the case, whichever is in the best interest of the estate, but only for cause.

2. Rule 2004 Examination

Pursuant to Rule 2004[4], on motion of any party in interest, the Court may order the oral examination of any person, under oath, on any matters which relate to the "acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge."[5] The 2004 exam is an effective vehicle for the commercial litigator to obtain broad ranging pre-litigation discovery relating to the debtor. The motion may be heard ex parte or it may be heard on notice.[6]

In addition to compelling the oral deposition of a debtor or non-debtor witness, Rule 2004 permits requests for production of documents. Rule 2004(c) provides that "[t]he attendance of an entity for examination and the production of documentary evidence may be compelled in the manner provided in Rule 9016 for the attendance of witnesses at a hearing or trial."[7] The motion for a 2004 examination should include a request for the production of documents. A schedule of documents requested should be annexed to the Order compelling the 2004 exam. After the commencement of an adversary proceeding, however, a creditor cannot, in most instances, examine the debtor under Rule 2004, but must take a deposition pursuant to Rule 7030 which incorporates F.R.C.P. 30.

The Filing of the Non-dischargeability Complaint

In some instances, an objection to discharge is required to be made by Complaint which initiates an adversary proceeding as provided in Rule 7003 of the Federal Rules of Bankruptcy Procedure. In a Chapter 7 Liquidation case, a Complaint objecting to the debtor's discharge under §727(a)[8] or §523(c)[9] of the Code shall be filed no later than sixty (60) days following the first date set for the meeting of creditors held pursuant to §341(a) of the Code. A debtor or any creditor may file a Complaint to obtain a determination of the dischargeability of any debt.

There are several statutory grounds to prevent the discharge of the debtor. Under §727 of the Code, the Court shall grant the debtor a discharge unless one of several specific conditions are met:

- The first condition is that the debtor is not an individual.
- If the debtor, with intent to hinder, delay, or defraud his creditors or an officer of the estate, has transferred, removed, destroyed, mutilated, or concealed, or has permitted any such action with respect to property of the debtor within one year preceding the case, or property of the estate after the commencement of the case, then the debtor is denied discharge.
- The debtor is also denied discharge if he has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any books and records from which his financial condition might be ascertained, unless the act or failure to act was justified under all the circumstances of the case.
- The commission of a bankruptcy crime. The standard of proof is

preponderance of the evidence rather than proof beyond a reasonable doubt. These crimes include the making of a false oath or account, the use or presentation of a false claim, the giving or receiving of money for acting or forbearing to act, and the withholding of information from an officer of the estate entitled to possession of books and records relating to the debtor's financial affairs.

- Failure of the debtor to explain satisfactorily any loss of assets or deficiency of assets to meet the debtor's liabilities.
- The debtor may be denied discharge if he refuses to obey any lawful order of the court, or if he refuses to testify after having been granted immunity or after improperly invoking the constitutional privilege against self-incrimination.[10]

Additionally, some debts may not be discharged under the Code. 11 U.S.C. §523(a) sets forth nine (9) categories of debts excepted from discharge. These include debts fraudulently incurred including those fraudulently incurred while acting in a fiduciary capacity, alimony and child support, certain taxes and penalties, student loans, debts which are neither listed nor scheduled under §521(1) of the Code, embezzlement or misappropriation.

The Role of the CFE/Forensic Accountant in the Discovery Process and Investigation of the Financial Condition of the Debtor and the Accuracy of the Bankruptcy Petition.

It is recommended that the attorney retain the CFE/forensic accountant in the early stages of litigation. This is important so that the team of professionals can formulate strategy and organize the case at its inception. The CFE is a specialist trained in the area of fraud detection and deterrence. The CFE is required to have various qualifications in education and experience in order to be so designated. First and foremost, prior to retaining the CFE, the attorney should be familiar with the bankruptcy petition and its various schedules. The following is a list of the schedules that appear in the Chapter 7 Bankruptcy Petition:

- Summary of Schedules
- Schedule A: Real Property
- Schedule B: Personal Property
- Schedule C: Property claimed as exempt
- Schedule D: Creditors holding secured claims
- Schedule E: Creditors holding unsecured priority claims
- Schedule F: Creditors holding unsecured non-priority claims
- Schedule G: Executory contracts and unexpired leases
- Schedule H: Co-debtors
- Schedule I: Current income of individual debtors
- Schedule J: Current expenditures of individual debtors
- Statement of financial affairs

After the attorney has become familiar with the petition, he or she will instruct the CFE to review and scrutinize the filing. Generally, the CFE's focus will be to:

1. Determine the accuracy of the bankruptcy filings;
2. Determine if there were any misstatements of facts on debtor's petition;
3. Determine the financial position of debtor at the time of the bankruptcy; and
4. Determine if there was commingling and sheltering of assets to avoid inclusions in debtor's estate.

A role of the CFE in the discovery process is to aid the attorney in procuring the proper documents, books and records. This normally is done by supplying the attorney with a detailed document request which highlights the books and records that should be reviewed during the discovery process. Generally, the following documents are requested in an alleged bad-faith or fraudulent bankruptcy filing:

As to Personal Finances

- Personal income tax returns of the debtor, preferably for a five-year period prior to the filing;
- Copies of all loan agreements;
- Mortgage indentures filed by debtor preferably for five-year period prior to the filing;
- Personal financial statements prepared by debtor, preferably for a five-year period prior to the filing;
- Insurance policies of debtor (including homeowners policy);
- Contracts in which debtor is a party;
- Credit card applications;
- Copies of any appraisals for real estate owned;
- Complete bank accounts of debtor including savings, checkings, money market, etc., preferably for a three-to-five-year period prior t the filing of the petition;
- Brokerage statements, stock advices, etc. for securities purchased and sold by debtor or debtor's designee for a three-to-five-year period prior to the filing of the complaint;
- Copies of checkbook registers;
- Details of real estate and/or other assets owned and closing statements in support thereof;
- Schedule of tax-free securities held at any time, preferably during the five-year period before the filing;
- History of all safe deposit boxes; and
- All credit and loan applications, preferably for a three-to-five year period before the filing of the petition.

If debtor is the owner of any entity, i.e., family owned business, etc., the following documents (a more extensive list may have to be requested depending on the circumstances) are typically requested:

- All books of original entry (typically this would include the general ledgers, cash receipts, cash disbursements, etc.);
- Back-up substantiating all business expenses and acquisitions (invoices, etc.);
- Inventory records;
- Schedules of all property and equipment purchased and owned by the corporation;
- Schedule of insurance policies;
- Original and amended federal and state corporate income tax returns (for a five-year period prior to the filing of the petition);
- Complete bank statements;
- Schedule of all major assets i.e., accounts receivable, investments, deposits, etc;
- Leases, contracts, employment agreements; and
- Financial statements (internally prepared and those prepared by the outside accountant).

The extent of the creditor's claim and complexities of the particular case

will dictate to a large degree the volume of records that will be requested for discovery purposes. The general rules governing in discovery in adversary proceedings are set forth in Rule 7026 *et seq.*[11]. It is common in these types of cases that the records requested will not always be available or obtainable from the debtor. Accordingly, information may have to be obtained by third party subpoena. Rule 9016 governs the issuance of a subpoena.[12] Typically third-party subpoena information is obtained from financial institutions, brokers, accountants, creditors, debtor's relatives, governmental agencies, debtor's business associates and partners. The name(s) of the various third parties, i.e., financial institutions, brokerage accounts, etc., often can be gleaned directly from a review of the petition.

A primary role of the CFE in discovery is to test the accuracy of the filing for proper inclusion of assets belonging to debtor's estate. The bankruptcy petition is designed to give a complete financial profile of the debtor at a given point in time. In addition, the petition is signed by the debtor under penalty of perjury and, by signing the petition, the debtor certifies that he/she has read the answers contained and the statements of the financial affairs and any attachments thereto. Penalties for making a false statement carry a fine of up to $500,000 or imprisonment for up to 5 years or both. (18 U.S.C. §152 and §357)

The CFE's Analysis of Financial Data

One of the key criteria in successfully defeating a bad faith filing is not only to determine what records to request but also the proper way to analyze data. To be successful, it must demonstrate the bad faith intent of the debtor. The CFE's role in this type of investigation is critical.

The information received by the CFE may indeed by very limited. This is not unusual due to the debtor's lack of cooperation and availability of records. As such, the role of the CFE is extremely important to the attorney who is relying on the expert to extract all key information that will either refute or substantiate debtor's position and disclosure.

When analyzing the data, the CFE looks for *oddities* and *exceptions*, for inconsistencies, irregularities and omissions made by debtor. In a recent case in which a CFE was retained, that CFE was able to detect the following inconsistencies in the bankruptcy filing:

- The debtor indicated on his petition that the fair market value of the marital premises was approximately $300,000. Debtor indicated that this amount was obtained by an independent appraiser at or about the other time of the filing of the petition. A joint personal financial statement prepared by debtor was obtained as a result of a third-party subpoena on a mortgage company. The personal financial statement was prepared and dated approximately six months prior to the petition. Based on the appraisal received at that time, the debtor's home was appraised in the amount of $750,000.
- The debtor indicated on his petition an investment in a commercial real estate venture. The real estate venture was owned by the debtor and the non-debtor spouse in their individual names. According to an appraisal obtained by the debtor at or about the time of filing the petition, this venture was appraised at $1,000,000. As a result of a third-party subpoena to a financial institution an appraisal prepared approximately nine months prior to the filing was obtained. This appraisal was prepared by a qualified appraiser retained by the lending institution as both debtor and spouse were, at that time, in the process of renegotiating a commercial mortgage. As such, this appraisal at best would have been a very conservative one. (Amount of appraisal: $2,000,000). By using the lower appraisal, debtor significantly understated his bankruptcy estate.
- In addition to the appraisal, the financial institution also produced various individual tax returns of the debtor. An analysis of the tax returns indicated that this venture generated a significant cash flow from its rental income. Debtor failed to disclose any such financial data on his petition. This significantly understated the true value of debtor's estate and earnings.
- Debtor failed to disclose that he was receiving, on an installment basis, proceeds from the sale of a business entity he previously owned with his spouse three years prior to the bankruptcy. Debtor's petition failed to disclose any equity or cash flow in this investment. In fact, after further discovery, it was noted that debtor was diverting his share of the funds into the bank account of the non-debtor spouse. This information, which was reported on debtor's tax return further indicated that significant omissions and irregularities existed in debtor's estate.
- Debtor failed to disclose any investment in insurance policies which had a cash surrender value. A loan application prepared by debtor, which was used in the refinancing of a commercial mortgage, was obtained by third-party subpoena. That application disclosed an insurance policy with a cash surrender value that was pledged as collateral on the mortgage.
- Debtor's petition reported household furnishings and personal belongings at a token amount of $2,000. The personal financial statements submitted by the debtor to financial institutions reported these assets at a current market value of $100,000. Also, the value used by debtor was inconsistent with the amount of coverage on his homeowner's policy in the amount of $300,000.
- Debtor's petition indicated that he did not have any cash investments, loans or notes receivable. The financial statements obtained by third-party subpoena clearly indicated that debtor jointly owned significant liquid assets. Debtor's petition failed to disclose these assets and the earnings generated from these investments.

Debtor's petition was significantly flawed as it overstated liabilities, understated assets, and omitted significant earnings from investments owned by debtor. In these types of situations, it is important that the attorney and the CFE demonstrate to the court the consistent pattern of intentional misrepresentation and omissions by the debtor. Typically, the evidence needed to refute debtor's omissions would be corroborating financial documents prepared by debtor which are inconsistent with the filing.

Documents are useful and at times

imperative in order to demonstrate the pattern and intent of debtor to mischaracterize financial data or the omissions of financial data. Although no generalization can be made, it is not unusual to analyze information at least two or three years prior to the bankruptcy. This analysis will determine if in fact there were any omissions made by debtor (i.e., were assets, previously owned by the debtor, still owned by the debtor?) and will also determine if assets disposed of by debtor were properly excludable from his estate.

In order to determine if a debtor has made a bad-faith filing the CFE/ litigator must clearly prove to the court the inconsistencies between the Petition and other financial data of debtor. A pattern of irregularities must be demonstrated. This clearly would differentiate omissions by the debtor from being merely errors. It must be demonstrated that any fraudulent transfers or concealment were the intentional acts of the debtor.

Legal Basis for Dismissal of a Bankruptcy Petition as a Bad Faith Filing

The court's power to dismiss a bankruptcy petition is governed by 11 U.S.C. §707 and 11 U.S.C. §1112. The specific grounds listed in sections 707 and 1112 are not exhaustive: "cause" is a key element in any application to dismiss a bankruptcy petition as a bad faith filing.

Whether or not to grant a motion to dismiss a petition in bankruptcy is a decision which is made within the discretion of the bankruptcy judge. *Matter of Atlas Supply Corp.*, 857 F.2d 1061, 1063 (5th Cir. 1988). The jurisdictional requirement of good faith, while not explicitly set forth in 707(a), underlies the purposes of bankruptcy relief. *In re Jones*, 114B.R. 917, 926 (Bankr. N.D. Ohio 1990). Although not defined in the bankruptcy code, good faith, at the very least, requires a showing of honest intention. *In re Hammonds*, 139 B.R. 535, 541 (Bankr. D.Colo. 1992).

As one Court of Appeals has noted, dismissal based on lack of good faith must be undertaken on an ad hoc basis. Industrial Ins. Servs. Inc. v. Zick (In re Zick), 931 F.2d 1124, 1129 (6th Cir. 1991).

It should be confined carefully and is generally utilized on in those egregious cases that entail concealed or misrepresented assets and/or sources of income, and excessive and continued expenditures, lavish lifestyles, and intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.

The Bankruptcy Code exists to aid people who "find themselves hopelessly adrift in a sea of debt" despite their best efforts. *Id* Further, "[b]ankruptcy protection was not intended to assist those who, despite their own misconduct, are attempting to preserve a comfortable standard of living at the expense of their credit." *Id.*

It is well established that the grounds for cause contained in 707(a) are merely examples, and dismissal of Chapter 7 petitions under other circumstances which might constitute cause is not precluded. *See, e.g., In re Campbell*, 124 B.R. 462, 464 (Bankr. W.D. Pa. 1991); *In re Jones, supra*, at 924: *In re Maide*, 103 B.R. 696, 697 (Bankr.W.D. Pa 1989); *In re St. Laurent*, 17 B.R. 768, 769 (Bankr. D.Me. 1982); see H.R. No. 95-595, 95th Cong., 1st Sess, 380 (1977); S. Rep. No. 95-989, 95th Cong. 2nd Sess. 94 (1978); U.S. Code Cong. & Admin. News 1978 pp. 5787, 5880, 6336. Bad faith of a debtor is not a condition of dismissal under 707(a). *Id* However, once the debtor's good faith has been questioned, the debtor has the burden of proof that the filing was made in good faith. *In re Bingham*, 68 B.R. 933, 935 (Bankr. M.D. Pa. 1987). Factual elements of bad faith vary, but may include by way of example, filing for a frivolous purpose, using bankruptcy as a device to further some unworthy purpose or abusing the judicial process to delay creditors or escape the "day of reckoning in another court." *Id.* The absence of good faith is valid cause for dismissal. *In re Zick*, 931 F.2d 1124, 1127 (6th Cir. 1991); *In re Campbell, supra*, at 464.

In re HBA East, Inc., 87 B.R. 248, 259-260 (Bankr. E.D.N.Y. 1988), the Court was cognizant that Chapter 11 relief should not be made available to those who file with the primary intention of gaining an advantage in litigation or to provide an alternative judicial forum. For instance, the Bankruptcy Court is not the appropriate forum when shareholders, for example, are principally involved in a dispute to divorce themselves from each other. *Id.* at 260.

Conclusion

The Bankruptcy Code exists to protect worthy debtors. It does not exist to aid those individuals or corporate entities who seek to manipulate or use the system to facilitate the defrauding of their creditors. The skilled commercial litigator with the assistanc of an experienced forensic accountant can effectively cause a bankruptcy to be dismissed as a bad faith filing. By engaging in the appropriate investigation and obtaining the right discovery from the debtor and, more importantly, from the right third party witness, the attorney representing a creditor can prevent that creditor's claim from being wrongfully discharged in a bad faith bankruptcy filing. The mere filing of a bankruptcy petition should not deter a creditor or its counsel from pursuing a debt that is legitimately owned.

End Notes

1. 11 U.S.C. §341(a).
2. 11 U.S.C. §707(b).
3. 11 U.S.C. §1112.
4. Bankruptcy Rule 2004.
5. Bankruptcy Rule 2004(b).
6. Bankruptcy Rule 2004, Advisory Committee Note.
7. Bankruptcy Rule 2004(c).
8. 11 U.S.C. §523(c).
10. 11 U.S.C. §527(a)(1)-(5).
11. Bankruptcy Rule 7026: Rule 26 F.R.C.P.
12. Bankruptcy Rule 9016.

Michael J. Faul, Jr. is a member of Walder, Sondak & Brogan, P.A., Roseland, NJ and the Chair of Essex County Bar Association Equity Jurisprudence Committee.

Robert DiPasquale, CPA, CFE is a partner with Gikow, Bierman & Talesnick, an accounting firm in Roseland, NJ and is co-director of the litigator support department.

Special acknowledgement is given by the authors to Vincent Commisa, Esq. for his assistance and contribution to this article.

Reprinted from Chronicle Newsletter of the Essex County Bar Foundation, March 1995 Issı Volume XXI, Issue 5