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Bankruptcy Fraud: Rampant, But (Sadly) Overlooked in Asset Searches



By PHILIP SEGAL

For a creditor on the alert for fraud, bankruptcy court should be among the first stops on the road to possible asset recovery. While some kinds of fraud by those filing for bankruptcy may be hard to detect, bankruptcy is probably the most overlooked area by asset searchers.

As a result, every year debtors hold on to billions of dollars their creditors should properly be getting their hands on. In fiscal year 2011, Trustees successfully petitioned for the denial or revocation of 1,805 bankruptcy discharges,¹ which represented a total of more than \$2 billion of debt.² If 1,805 discharges yield \$2 billion in assets up for grabs, imagine what is going undetected in the 1.3 million bankruptcies filed each year.

¹ United States Trustee Program Annual Report Fiscal Year 2011, U.S. Department of Justice, available at: http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2011.pdf

² *Id.*

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Take the recent case in the Southern District of Illinois, widely reported because of how unusual it is to have caught the people involved: In February 2009, Thomas and Debra Grogan filed for bankruptcy, seeking the discharge of \$24,506 of debt.³ Unbeknownst to the bankruptcy court, Thomas Grogan was simultaneously involved in a class action lawsuit involving Vioxx.⁴ The previous week, Grogan's class action attorney had informed Grogan that he was slated to receive a \$113,867 settlement payment from the Vioxx case. Grogan never disclosed his interest in the class action to the bankruptcy court.

Grogan's class action counsel caught wind of the pending bankruptcy and notified the Trustee assigned to Grogan's case of the class action payment.⁵ Once their crime had been exposed, the Grogans pleaded guilty to bankruptcy fraud.⁶

Secret class action proceeds are just the tip of the very large iceberg that is bankruptcy fraud. In fiscal year 2012, Trustees referred 2,120 bankruptcy cases to the U.S. Attorney's Office for criminal investigation, just 0.16 percent of the total number of bankruptcy cases filed last year. Criminal charges have been filed in 27 of those cases, a microscopic two-one-thousandths of a percent of all bankruptcies last year. With odds like that, why wouldn't the Grogans or anyone else try to conceal assets if they thought they could get away with it?⁷

³ *United States v. Grogan*, Stipulation of facts, Docket No. 12 CR 40120.

⁴ U.S. Attorney's Office Southern District of Illinois, Lawrenceville Couple Sentenced For Bankruptcy Fraud, April 15, 2013, available at: http://www.justice.gov/usao/ils/News/2013/Apr/04152013_Grogan%20Press%20Release.html

⁵ Under ABA Model Rule of Professional Conduct 4.1(b), "[i]n the course of representing a client a lawyer shall not knowingly. . . fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client."

⁶ U.S. Attorney's Office Southern District of Illinois, Lawrenceville Couple Plead Guilty To Bankruptcy Fraud, December 10, 2012, available at: http://www.justice.gov/usao/ils/News/2012/Dec/12102012_Grogan%20Press%20Release.html

⁷ Section 1175 of the Violence Against Women and Department of Justice Reauthorization Act of 2005 requires the Director of the Executive Office for United States Trustees to provide Congress with a report "detailing – (1) the number and types of criminal referrals made by the United States Trustee Program; (2) the outcomes of each criminal referral; (3) for

The picture gets worse: Thomas Grogan was sentenced to a three-year term of probation, fines and special assessments totaling \$2,100 and 30 hours of community service. His wife also had to pay \$2,100 and perform 20 hours of community service, all for concealing assets of \$113,867.

Class action concealments such as the Grogan case are among the toughest to catch, because unless class members are named plaintiffs, their involvement in the case is guarded from public view.

Information regarding claimants in class actions is carefully protected. Lists of claimants are generally not even provided to the court. When they are, individual claimants' identifying information is either kept secret or reviewed *in camera* subject to a protective order.

The Importance of Interviewing

It seems clear that catching the Grogans if their class action lawyer hadn't reported them would probably have required conducting interviews with people who might know the couple well and know that they had this settlement coming.⁸ An impending payout of more than \$100,000 is big news in most households, and even if Mr. Grogan neglected to tell the court about it, the same probably couldn't be said for his family and colleagues.

While it's hard to expect Trustees to conduct interviews on every case, our firm has consistently argued that interviews are nearly always necessary in asset searches. The reason is that there is just too much information out there that is not on the public record or available via a Google search.

Little wonder that according to a Rand Corporation study, 48% of referrals of personal bankruptcy fraud to law enforcement resulted from tips from the public,⁹ such as former spouses, business partners, creditors, or others who might hold a grudge against a debtor.

"A grudge against the debtor" is music to the ears of an asset searcher. What are the best ways to find such people and how should you approach them once you have tracked them down?

Tracking Down Those Who Know

The most important thing that asset searchers in bankruptcy and other fields tend to overlook is the need to do on-site litigation searches on the person who owes money. Of course you know about the bankruptcy, but a person's litigation history is a window into the rest of his life. Is there an embittered ex-wife who knows all

any year in which the number of criminal referrals is less than for the prior year, an explanation for the decrease; and (4) the United States Trustee Program's efforts to prevent bankruptcy fraud and abuse, particularly with respect to the establishment of uniform internal controls to detect common, higher risk frauds, such as a debtor's failure to disclose all assets." The Report, entitled "Report to Congress: Criminal Referrals by the United States Trustee Program Fiscal Year 2012," is available at: http://www.justice.gov/ust/eo/public_affairs/reports_studies/docs/criminal_report_fy2012.pdf

⁸ The same day the Grogans entered their guilty plea, another resident of Illinois, David Woodside, pleaded guilty to concealing class action income in his 2009 bankruptcy proceeding, as well. Woodside and the Grogans were sentenced on the same day.

⁹ Noreen Clancy & Stephen J. Carroll, Identifying Fraud, Abuse, and Error in Personal Bankruptcy Filings, available at: http://www.justice.gov/ust/eo/public_affairs/reports_studies/docs/Fraud_and_Abuse_Study_Rand.pdf

about him and where his assets are? Is there a former business partner or employee who has sued him? What about other creditors in other facets of his commercial life? Does he have an LLC in Nevada that owns property that didn't get mentioned in the bankruptcy filings?

You could find the LLC through databases some of the time, but what if he controls that LLC through another company formed in Delaware? At that point, you need to be looking at people who have sued the Delaware company, the Nevada LLC, the debtor and perhaps all three.

The striking thing about litigation in this internet age is how little of it is available on line. Users of PACER may be accustomed to clicking on a docket entry and, for a few dollars, downloading hundreds of pages. State courts don't tend to work that way. Even those states that purport to offer a complete listing of court cases do not do any such thing. No comprehensive litigation search can be complete without an on-site search.

One reason for this is that most litigation databases kept by court systems file cases by lead parties only. If you are looking for Jones and a case's defendants are Smith and Jones, a search for Smith will turn the case up but a search for Jones will not. At the courthouse, by contrast, Jones comes up.

Wouldn't Google be able to catch all of this? In short, no, because Google can only find what is on line. If a case is not on line, Google won't have it. Even among the results Google is able to find, it may not be able to do a comprehensive look for you. If you are looking at someone who is not commercially interesting to Google, why would Google give you a complete list of his small (for Google, but big for you) list of legal problems? It will not, because Google is not there as a public service. It is there to make money.

Public Record First, Interview Second

We are firm believers in looking at the public record before interviewing people. You may only get one shot at interviewing someone close to the debtor before they decide they had better keep their mouth shut. Wouldn't it be nice to know you asked the best question before the source goes cold (until being subpoenaed)?

Our best find in looking at a bankrupt debtor came from performing our routine, in-depth public record search. Our debtor had gone bankrupt, but we found that his Chapter 7 filing came just a week after he got divorced. Happily, he was divorced in a state in which matrimonial records are not sealed, so we got hold of them and found that he should have been entitled to half of his wife's extremely profitable business. The separation agreement made no mention of that business, which meant there was a chance this information had been improperly withheld from both the family court and the bankruptcy court.

Further digging revealed that not only had he worked at his wife's business up to the divorce, he was still there several years after the divorce, greeting customers. The asset search was complete thanks to good document research and a single phone call.

Getting the Best Out of an Interview

A former intelligence officer once told me that the only way to be sure to preserve a confidence is not to tell anyone and not to write anything down. If your client does not want the fact that an investigation is proceeding to come to light, do not call anyone – no matter

how distant their connection to the debtor you are investigating. You never know who that person knows, and how their connections could get your investigation blown wide open through a series of indiscreet remarks or emails: “I had a strange phone call today. An investigator in New York called me to ask about. . .”

Sometimes, an asset search is best conducted in secrecy if you are afraid the debtor will move money around once he finds out you are looking. Other times, the debtor who has gotten away with a bankruptcy discharge may think he’s home free, and a phone call or two about him may not upset him unduly. In the end, it’s always a client’s decision as to if and when to conduct interviews.

There is nothing intuitive for many people in how you interview a person. As opposed to a time-limited deposition where a false answer risks a charge of perjury, an interview gathers facts in an informal way. The three main tips we always stress:

- Be conversational. The worst thing to do if you want people to talk to you is to make them think you are demanding information. Sometimes people who have been used to waving around a badge or a search warrant are not the best ones to do an interview in a civil litigation context, because in many cases the people you will want to talk to may have no reason to want to speak to you. It’s amazing what you can get out of people when you are nice to them. Once the interview is on, it’s as if you’ve bumped into a person and you’re chatting at a bar or waiting for a flight at the airport.
- Start in a general way. You are interviewing the former executive secretary of Mr. X, and you want to know if Mr. X had any joint-ventures with Mr. Y. If your first question is “Did he ever do business with Mr. Y?” and the answer is no, what else can you say? Instead, you start with something that is inoffensive and general but that can lead to where you want to go. What was he like to work for? Who were his main allies at the company? Do not say “With which specific individuals did he work?” Only government interrogators talk like that.
- Check your ego at the door. A little misdirection can be your friend. You are under no ethical requirement to tell the person you are interviewing everything you know. Let them tell you things you already

know. This is not a contest to show anyone (except for your client) how smart you are. If the former secretary tells you that Mr. X is very close to the Chairman, Mr. Kelly, you could say, “Oh, I know all about Mr. Kelly. Say no more. Mr. Kelly is the guy who almost got charged with insider trading in 2003.” Instead it may be better to ask: “Is that Kelly with an E-Y or just Y? What’s his first name? And he’s the chairman, you say?” This method of humility and fake ignorance has another benefit. It’s human nature to think we know more than we do. The idea that you are an open book and are willing to hear what these people have to say could surprise you with information you didn’t have, and help you to stop talking and start listening.

Don’t Let the Trustees Handle the Audits

For those who hope that bankruptcy auditors can help uncover hidden assets, consider this: Due to budget cuts, the Trustees Program has designated fewer than one out of every thousand consumer bankruptcy cases for audit since 2008, and has suspended all audits of consumer bankruptcy cases for fiscal year 2013 as of March 20th.¹⁰

There is a suspension of audits, even though auditors identified at least one “material misstatement” in 25% of audited cases. Two thirds of these cases involved material misstatements regarding income, while half involved material misstatements related to the transfer of assets.¹¹

The takeaway: if you want to get behind the bankruptcy fraud, you need to do it yourself or get the help of someone who is used to doing this kind of work. Asset searching is painstaking work. It is not rocket science, but neither is changing your oil or putting a new roof on your house. While some people prefer to do all of these things themselves, others see the value of calling in a specialist.

¹⁰ In the last nine months of 2012, the Trustees Program designated one of every 1,450 cases for random audit. Public Report: Debtor Audits by the United States Trustee Program Fiscal Year 2012, United States Department of Justice Executive Office for United States Trustees, February 2013, available at: http://www.justice.gov/ust/eo/public_affairs/reports_studies/docs/Debtor_Audits_FY_2012_Public_Report.pdf.

¹¹ *Id.*