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Recognizing Bankruptcy Fraud and Using Experts to Deal With It

In a perfect world, a debtor's bankruptcy would involve timely reporting, good faith filings, and full disclosures. Unfortunately, some debtors either enter the process under a cloud of suspicion or make decisions during the process that suggest the estate has been compromised by fraudulent activity. Whether the alleged fraud is a complex bust-out scheme or a simple unreported asset transfer, the debtor may face a serious investigation. Depending on the extent of the allegations, the investigation could be referred as a criminal matter to federal prosecutors. As the severity of the consequences increases, so does the need to have mindful counsel, and possibly an expert witness.

This article attempts to help the reader identify and react to suspicious activity. It will discuss the basic types of fraudulent activity that can derail a bankruptcy proceeding or result in a criminal indictment. By the time this activity is discovered, all interested parties will be racing for leverage.

I. Bankruptcy Fraud – The Basics

Although bankruptcy fraud schemes can simultaneously violate, or even be just a subset of, many other fraudulent schemes (e.g., tax fraud, wire fraud, mail fraud, credit card fraud, etc.) that violate federal law, this article is limited to the most commonly recognized forms seen in a bankruptcy context: concealment of assets, false filings, and statutory fraud.

A. 18 U.S.C. § 152. Concealment of assets; false oaths and claims; bribery.

This statute consists of nine crimes, all of which require proof of "knowingly and fraudulently" doing something in a bankruptcy context, namely: (1) concealing property of the debtor's estate from the court; (2) making a false oath; (3) committing perjury; (4) presenting a false proof of claim against a debtor's estate; (5) receiving property from the debtor's estate with the intent to

circumvent bankruptcy proceedings; (6) taking a kickback for forbearing on a claim against the debtor; (7) while acting as an agent, transferring or concealing property of an individual debtor or corporation; (8) “cooking the books” to hide a debtor’s financial affairs; and (9) withholding property or financial affairs from the United States Trustee or court.

B. 18 U.S.C. § 157. Bankruptcy fraud.

This statute is a product of the Bankruptcy Reform Act of 1994 and was designed to cut down on the amount of “gamers” that were using, or attempting to use, the bankruptcy process as a way to further a fraud scheme. This fraud can come in several forms, such as schemes involving insider depletion of assets over a period of time and the use of the automatic stay to conceal fraudulent activity. The elements of this offense are:

- The defendant has devised or has intended to devise a scheme or artifice to defraud another; and
- The defendant, for the purpose of executing or concealing the scheme or artifice or attempting to do so,
 - (a) files a petition under title 11; or
 - (b) files a document in a proceeding under title 11; or
 - (c) makes a false or fraudulent statement in connection with a proceeding under title 11 or a proceeding the defendant falsely asserts is pending under title 11.

II. Will You Know It When You See It?

There are times when bankruptcy fraud allegations are straightforward. For example, whether a debtor or debtor’s agent shredded documents to hide the transfer of unreported property that belonged to the debtor’s estate is not complex. Other situations are trickier, such as a debtor perpetrating an investor pyramid fraud (Ponzi scheme) or a debtor concealing or grossly undervaluing an estate asset. Sometimes fraudulent planning, cover-ups, insider transfers, and long-term asset structuring has been in process for months or years prior to the bankruptcy. Regardless of the complexity of the scheme, counsel must be mindful that suspicious activity is best learned up front, and

accordingly handled through the discovery process by way of written documents, depositions, Rule 2004 examinations, and expert consultation. These more “designer” fraud cases include (1) bust-outs, (2) bleed-outs, and (3) looting.

A. Bust-outs.

In a bust-out scheme, a company is set up and builds a decent credit line while holding themselves out to be a reputable business. At first, transactions are small, but by design demonstrate the company can cash flow and reliably service its debts. Once the company’s owners are satisfied that enough reputation and credit building has occurred, vendors are then blitzed with orders for goods, along with a promise of repayment within, for example, 90 days. Once the goods are received, the company sells them and does not appropriate the proceeds to its creditors. The company stalls its creditors for as long as possible, then finally files its bankruptcy petition. The bankruptcy schedules reveal the company to be a low-asset, high-liability operation. This type of scheme is common in connection with distributing consumer products.

B. Bleed-outs.

A bleed-out is most often an inside job, where corporate managers, directors, or officers emaciate a company’s value through insider asset transfers. The company is not necessarily established for the purpose of carrying out a bleed-out, and may not even be in financial distress. However, like any company, its vulnerability is exposed when collusive insiders have control and subordinate the company’s success to their personal gain. Commonly, an insider, or group of insiders, enter into transactions on behalf of the company with the purpose of redirecting a business asset in favor of the insider and to the prejudice of the company. For example, money could be thrown at a fledgling subsidiary that happens to be controlled by an officer who also serves as an officer for the company being depleted. Often these transactions are document-intensive, well-planned, and hidden to reduce the risk of exposure. In other words, simply looking at the statements and schedules will not typically reveal a bleed-out scheme.

C. Looting.

Looting can be one of the most brazen types of bankruptcy fraud. A bankruptcy looting scheme typically involves a debtor's failing company selling its assets pre-petition to a non-failing company without disclosing to the court the debtor's involvement in the transaction. The debtor often carries out the fraud by representing that a disinterested buyer has been located, when in fact the buyer is a mere extension, "shell", or agent of the debtor. By design, the terms of the sale appear legitimate, not unreasonably beneficial to the debtor, and are met with satisfaction by the creditors. The company then either closes its doors or files a Chapter 7 bankruptcy to liquidate and administer any remaining estate. Although looting could theoretically occur during a sale process within a bankruptcy case, Section 363 of the Bankruptcy Code affords a process that should enable creditors to determine whether any sale is reasonable, in good-faith, and proposed at arms' length.

III. Now That You Have Spotted Fraud (Or Think You Have), Is It Time To Retain An Expert?

Counsel is charged with knowing the law and being able to spot facts that implicate the application of the law. If the facts suggest there would be merit to a fraud investigation, forensics can become the secret weapon to determine whether fraud or criminal activity has occurred. An expert can be an invaluable resource that uncovers previously hidden facts, challenges the proof of the counterparty, and provides an evidentiary roadmap that counsel can use to represent the client. Once the decision is made to reach out to an expert, there are several considerations to process before making the call: (1) who is the right consultant; (2) what will the expert do for the team; (3) how much will the expert cost; and (4) what is the role of counsel once an expert is engaged. Before discussing these considerations in more detail, the absolutely fundamental realization must be that once the facts show an expert is needed, counsel cannot delay in retaining the expert. It is crucial that the expert be on board early and given the time and opportunity to succeed.

A. Who is the right consultant?

There are countless experts that label themselves as “bankruptcy fraud experts.” Some are former law enforcement officers, others specialize within fraud subsets (e.g., real estate equity skimming, theft of employee contributions for health insurance, etc.), and others are credentialed certified fraud examiners. Although not required in every situation, forensic experts are trained to analyze a set of facts with the thought that their actions will be scrutinized in court. When determining who (or which firm) is best for a given situation, it is imperative to find out (a) if the expert has ever handled this type of case before; (b) the resources that will be available to the expert; (c) the expert’s workload and reputation within the community; and (d) if the expert could effectively explain the case in a courtroom and be subject to cross-examination.

B. What will the expert do for the team?

The scope of the services an expert provides entirely depends on the facts of a given case. Although experts are trained to think outside the box and do not strictly adhere to a checklist, there are patterns of behavior or sources of information that have historically yielded results.

Experts have an arsenal of tactics at their disposal, but their ability to deploy them depends on several factors. First, the client’s financial situation may be restrictive. In these situations, it is important to make the expert aware of a cost ceiling and find out how much “bang for the buck” the client will receive. Some experts are willing to provide a role assessment and cost analysis without the client incurring an obligation or fees. In addition to financial limitations, experts cannot use the full range of their skills unless they have a sufficient amount of time to operate. Investigations and requests for information can be time-consuming, so engaging an expert as early in the process as possible can help ensure that the client is given the full benefit of the expert’s abilities.

C. What is the expert’s workload and reputation?

The expert must be able to make the client’s case a top priority. When inquiring about the expert’s workload, this is a great time to discuss communications, frequency of updates, and availability to

conduct the investigation in advance of known deadlines in the case. As for reputation, a reliable indicator is always the expert's former clients and counsel. Any proficient expert will be happy to provide this information. It is often helpful to go one step further and contact the counsel that opposed the expert's position. This counsel, usually assisted by the opinion of another expert, will have a firm grasp of the expert's abilities.

D. Can the expert effectively convey the client's position?

After meeting with the expert, ask yourself if this person is someone that will help the presentation of your case. Not necessarily just with the court, but also in leveraging a settlement by presenting a reasonably acceptable position to the counterparty. The level of education, amount of training, number of cases worked, experience testifying, and mannerisms are all going to be known or visualized by the fact-finder. If these factors will present a problem from a credibility perspective or during cross-examination, continuing the search may be in the client's best interests.

The decision to hire an expert can be difficult, but if such a decision is made the focus should shift to finding the right person for the client's needs. There often exists a correlation between the client's success and the proficiency of the expert. It is therefore incumbent upon counsel to ask questions and spend time researching and performing due diligence to place the facts of the case into the hands of a well-qualified expert.

IV. Conclusion

Bankruptcy fraud is a billion dollar industry. The number of ways debtors defraud creditors and the courts is seemingly countless and growing each year. Although some types of fraud are more complex than others, effective bankruptcy counsel must be able to recognize and react to situations involving fraud. Depending upon the complexity of the situation, recruiting an expert may be a vitally important component to the success of a case.

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