

LITIGATION CONSULTING

The Role of Financial Forensics in Detecting Bankruptcy Fraud

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Detecting bankruptcy fraud can be a challenge. Sometimes the signs are obvious, but oftentimes the problems are hidden deep within thousands of pages of deliberately undecipherable accounting books and records. Valuators and other financial analysts involved in bankruptcy and insolvency matters should familiarize themselves with the various types of bankruptcy fraud, be attuned to the warning signs that assets have been concealed or undervalued, and, if appropriate, expand the scope of the engagement to include a more targeted forensic analysis.

Depending on the analyst's skills and experience, that may mean involving a forensic accountant or other financial forensics expert. These experts are skilled in tracing cash and non-cash transactions, as well as examining voluminous financial information, documentation, and data to find patterns of fraud before, during, or after a debtor becomes involved in bankruptcy proceedings.

This article provides a brief introduction to bankruptcy fraud and the types of procedures financial forensics experts may perform to uncover it.

Types of Bankruptcy Fraud

Bankruptcy fraud refers to various crimes committed in connection with a case filed under the Bankruptcy Code—Title 11 of the United States Code (U.S.C.). Common forms of bankruptcy fraud include a debtor's concealment of assets to avoid having to forfeit them, purposely undervaluing assets, bribery of a court-appointed trustee, and intentional filing of false or incomplete forms. Any of the bankruptcy fraud types can occur pre-petition, during the bankruptcy proceedings, or post-petition.

Federal prosecutors can bring criminal charges for suspected bankruptcy fraud under Chapter 9 of Title 18, U.S.C. Proof of fraud requires a showing that the defendant knowingly and fraudulently misrepresented a material fact. Bankruptcy

fraud is a federal crime punishable by a fine of up to \$250,000 and/or up to five years in prison.¹ The U.S. Department of Justice estimates that one in ten bankruptcy filings has an element of fraud associated with it.²

Bankruptcy fraud is generally governed by 18 U.S.C. §§ 152–157:

18 U.S.C. § 152³ broadly criminalizes various actions prior to and during bankruptcy proceedings. Section 152 has nine subparts, which can constitute multiple counts, provided they are not based on the same set of facts. The nine subparts are:

1. Concealment of property belonging to the estate of a debtor.
2. Making of false oaths or accounts in relation to any case under Title 11.
3. Making of a false declaration, certificate, verification, or statement under penalty of perjury as permitted under Section 1746 of Title 28 or in relation to any case under Title 11.
4. Making of false claims against the estate of a debtor.
5. Fraudulent receipt of property from a debtor.
6. Bribery and extortion in connection with a case under Title 11.
7. Transfer or concealment of property in contemplation of a case under Title 11.
8. Concealment or destruction of documents relating

1 Kristy Welsh, "Bankruptcy Fraud—Rarely Caught and Rarely Prosecuted," *Credit Info Center*, October 3, 2017, <https://www.creditinfocenter.com/bankruptcy/bankruptcy-fraud-rarely-caught.shtml>.

2 *Ibid.*

3 "Overview of 18 U.S.C. § 152 Violations," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-840-overview-18-usc-152-violations>.

to the property or affairs of a debtor.

9. Withholding of documents from the administrators of a case under Title 11.

18 U.S.C. § 153⁴ prohibits embezzling property and secreting or destroying any document belonging to the estate of the debtor. It provides that a person who knowingly and fraudulently appropriates to the person's own use, embezzles, spends, or transfers any property or secretes or destroys any document belonging to the estate of a debtor can be fined, imprisoned, or both. Section 153 applies to one who has access to property or documents belonging to an estate by virtue of the person's participation in the administration of the estate as a trustee, custodian, marshal, attorney, or other officer of the court or as an agent, employee, or other person engaged by such an officer to perform a service with respect to the estate.

18 U.S.C. § 154⁵ states that a person who, being a custodian, trustee, marshal, or other officer of the court, (i) knowingly purchases, directly or indirectly, any property of the debtor's estate of which the person is such an officer; (ii) knowingly refuses to permit a reasonable opportunity for the inspection of the documents and accounts relating to the affairs of the debtor's estates in the person's charge when directed by a court to do so; or (iii) knowingly refuses to permit a reasonable opportunity for the inspection by the United States Trustee of the documents and accounts relating to the affairs of the debtor's estate in the person's charge, shall be fined and shall forfeit the office.

18 U.S.C. § 155⁶ is intended to prevent parties in interest from dividing up the bankruptcy estate outside the control of the bankruptcy court. It states that any party in interest, whether as a debtor, creditor, receiver, trustee or representative of any of them, or attorney for any such party in interest, in any bankruptcy receivership or case, who knowingly and fraudulently enters into any agreement, express or implied, with another such party in interest or attorney for another such party in interest, for the purpose of fixing the fees or

other compensation to be paid to any party in interest or to any attorney for any party in interest for services rendered in connection therewith, from the assets of the estate, shall be fined and/or imprisoned.

18 U.S.C. § 156⁷ punishes a bankruptcy petition preparer whose knowing disregard of the Bankruptcy Code or related rules causes a bankruptcy petition or proceeding to be dismissed. A "bankruptcy petition preparer" is anyone, other than the debtor's attorney or that attorney's employee, who for compensation prepares bankruptcy documents for filing. Moreover, Section 156(b) provides that if a bankruptcy case or related proceeding is dismissed because of a knowing attempt by a bankruptcy petition preparer in any manner to disregard the requirements of Title 11 or the Federal Rules of Bankruptcy Procedure, the bankruptcy petition preparer shall be fined under this title, imprisoned not more than one year, or both.

18 U.S.C. § 157⁸ criminalizes utilization of bankruptcy proceedings to further a broader fraudulent scheme. Section 157 states that a person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so (i) files a bankruptcy petition, including a fraudulent involuntary bankruptcy petition; (ii) files a document in a bankruptcy proceeding; or (iii) makes a false or fraudulent representation, claim, or promise concerning or in relation to a bankruptcy proceeding shall be fined and/or imprisoned.

Parties Involved in the Bankruptcy or Bankruptcy Fraud Process

During a bankruptcy proceeding, among other parties, the bankruptcy court, the U.S. Trustee, and a bankruptcy trustee are involved in the process.

The Bankruptcy Reform Act of 1978 established a bankruptcy court in each judicial district with jurisdiction to decide almost any bankruptcy-related matter.⁹ The court has jurisdiction over traditional matters and affirmative actions

4 "Embezzlement Against Estate—18 U.S.C. § 153," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-870-embezzlement-against-estate-18-usc-153>.

5 "Adverse Interest and Conduct—18 U.S.C. § 154," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-873-adverse-interest-and-conduct-18-usc-154>.

6 "Fee Agreement—18 U.S.C. § 155," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-875-fee-agreement-18-usc-155>.

7 "Knowing Disregard of Bankruptcy Laws—18 U.S.C. § 156," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-877-knowing-disregard-bankruptcy-laws-18-usc-156>.

8 "Bankruptcy Fraud—18 U.S.C. § 157," U.S. Department of Justice Archives, updated January 21, 2020, <https://www.justice.gov/archives/jm/criminal-resource-manual-879-bankruptcy-fraud-18-usc-157>.

9 Daniel G. Lentz, Grant W. Newton, and Lynda H. Schwartz, "The Troubled Business and Bankruptcy," chap. 25 in *Litigation Services Handbook*, 6th ed., ed. Roman L. Weil, Daniel G. Lentz, Elizabeth A. Evans (Hoboken, NJ: John Wiley & Sons, 2017), 25.2.

against third parties.¹⁰ A bankruptcy judge can hear and decide all cases and core proceedings arising in cases referred to the bankruptcy court by a U.S. District Court.

The U.S. Trustee has the duty to notify the U.S. Attorney of matters that relate to any actions that can constitute a crime and assist the U.S. Attorney in carrying out prosecutions based on such actions.¹¹ Additionally, the U.S. Trustee will monitor the progress of cases and requests for employment of professionals; perform other duties prescribed by the attorney general; establish, maintain, and supervise a panel of private trustees; and appoint a trustee or examiner in Chapter 11 cases when authorized by the bankruptcy court.¹²

The U.S. Trustee maintains a panel of private trustees¹³ who have the eligibility and availability to serve as trustees in bankruptcy cases and, when authorized by the court, appoints a disinterested person to serve in this role.¹⁴ A bankruptcy trustee, usually an attorney, frequently takes the lead on fact-finding investigations.¹⁵

A bankruptcy trustee's duties include, but are not limited to, collecting and monetizing the property of the estate, closing up the estate expeditiously, being accountable for all property received, and ensuring that the debtor performs his, her, or its intention as to the surrender or redemption of property. A bankruptcy trustee also investigates the financial affairs of the debtor, examines proofs of claims and objects to the allowance of improper claims, furnishes information concerning the estate and its administration, files with the bankruptcy court and any governmental entity taxes arising out of such operations, makes a final report, and files a final account of the administration of the estate.

Bankruptcy fraud matters may also involve the U.S. District Court, debtor's counsel, creditor's counsel, and private parties. When a person or entity who filed for bankruptcy conceals assets, files a false claim, conceals financial records, destroys financial records, etc., that person or entity has committed bankruptcy fraud—a federal crime.¹⁶ However,

bankruptcy fraud can also be a civil wrong.¹⁷ The difference between criminal and civil fraud depends on the actor's intent.¹⁸ When bankruptcy fraud is criminal under Title 18 of the U.S.C., the case is heard by the U.S. District Court, and not the bankruptcy court.

During those legal proceedings, the debtor's counsel may need a forensic accountant or other financial forensics expert to provide analysis and/or expert testimony regarding allegations of bankruptcy fraud made against the debtor. The creditor's counsel may need similar assistance to analyze whether the debtor has committed fraud, how it impacts that creditor, and how the creditor can maximize its recovery. Private parties may also need expert assistance regarding their involvement or noninvolvement in bankruptcy fraud.

Procedures Performed by Forensic Experts in Bankruptcy Cases

Generally, forensic experts perform fact-finding or expert opinion investigations. Some of these investigations focus on the nature, timing, extent, and causes of the bankruptcy.¹⁹ A bankruptcy trustee or examiner, usually an attorney, frequently takes the lead on these investigations.²⁰ However, forensic accountants, financial advisors, subject matter specialists, and electronic evidence specialists often have a role in conducting the investigation and exploring the questions at issue.²¹

Although many companies become insolvent without any wrongdoing within the company, there are cases in which corporate insiders have committed fraudulent or abusive transactions that rendered a corporation insolvent or have fraudulently hidden a state of insolvency.²² In these situations, a forensic accounting investigation will help identify fraudulent financial reporting, embezzlement, misappropriation, conversion of corporate assets, or other improprieties.²³ Moreover, fact-finding and expert opinions are important elements in identifying potential recoveries to the estate.²⁴

The main difference between fact finding in bankruptcy and similar exercises for companies not involved in the bankruptcy process relates in part to the bankruptcy court's

10 Ibid.

11 Ibid.

12 Ibid.

13 To be clear, there is a panel of trustees of which one is appointed to every Chapter 7 case. If a trustee is appointed in a Chapter 11 case, in some districts that trustee does not need to be from the panel of trustees maintained by the U.S. Trustee.

14 *Litigation Services Handbook*, 6th ed., 25.2.

15 Ibid.

16 Mark Theoharis, "Laws on Bankruptcy Fraud," *Criminal Defense Lawyer*, accessed October 27, 2021, <https://www.criminaldefenselawyer.com/crime-penalties/federal/Bankruptcy-Fraud.htm>.

17 Ibid.

18 Ibid.

19 *Litigation Services Handbook*, 6th ed., 25.3.

20 Ibid.

21 Ibid.

22 Ibid.

23 Ibid.

24 Ibid.

and the U.S. Trustee's supervision, and the need for transparency with parties-in-interest and the public.²⁵ Therefore, the bankruptcy process drives the need for new and more extensive reporting or forensic accounting investigations than most debtors are accustomed to.²⁶ "Troubled companies often experience distress for months or even years prior to the [filing of a bankruptcy] petition, and tend to focus more on survival than infrastructure."²⁷ This makes sense because bankruptcy is a nonroutine, unpredictable, and demanding process.

In fact-finding investigations, investigators must piece together the information they need from available business records within the time constraints of bankruptcy.²⁸ Sometimes, the professionals managing the estate during liquidation will have custody, control, and knowledge of the books and records. Oftentimes, however, the debtor's only records might be hard copies sitting in a warehouse or electronic copies in a data room.²⁹

Procedures that are often part of the fact-finding investigation include, but are not limited to, document review, interviews or depositions, analysis of financial transactions, data collection and analysis, review and analysis of general ledger, surveillance, and undercover operations. Focused and skilled investigation can help bring necessary information that will help resolve critical questions and will bring matters to closure.³⁰

This article does not intend to describe all the procedures that forensic experts can apply during a bankruptcy fraud engagement. After all, a skilled and experienced forensic expert may have an almost unlimited arsenal of tools, tests, analyses, and procedures at their disposal. Some, however, are worth mentioning here:

- Proof of cash—Comparing actual bank deposits, withdrawals, and transfers to reported bank deposits and withdrawals.³¹
- Horizontal analyses—Comparing each item contained in a financial statement in one period to the same item in a prior or future period, and calculating the percentage change between the two selected periods.³²
- Vertical analyses—Comparing each item contained in the financial statements to a common base item.³³
- Benchmarking—Establishing a baseline for comparison purposes.³⁴
- Digital analysis—Testing for duplicate or rounded numbers, gaps, absent amounts, or number sequencing, and querying or stratifying the data.
- External circularization—A test whereby the forensic expert originates confirmations directly from parties outside the entity since such confirmations usually have greater credibility than evidence obtained from within the debtor entity.

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25 Ibid.

26 Ibid.

27 Ibid.

28 Ibid.

29 Ibid.

30 Ibid.

31 Darrel D. Dorrell and Gregory A. Gadawski, *Financial Forensics Body of Knowledge* (Hoboken, NJ: John Wiley & Sons, 2012), 107–111.

32 Ibid., 173.

33 Ibid.

34 Ibid., 477.

- Entity charts—Comparing ownerships of various entities over time, and cross-ownerships with brother/sister entities.
- Badges of fraud—Identifying elements used to prove a defendant's intent.³⁵

Bankruptcy Fraud Example

In August 2020, the U.S. Attorney filed *USA v. Klarchek* in the U.S. District Court, Northern District of Illinois, Eastern Division, alleging that Richard Klarchek defrauded and attempted to defraud financial institution lenders by making materially false representations to those lenders concerning the financial condition of the Klarchek Enterprise borrowers.³⁶ Moreover, Klarchek used means and methods to perpetrate the scheme, which included:

- Preparing and causing Klarchek Enterprise employees to prepare documents and records that purported to support the materially false representations that Klarchek made to the financial institution lenders;
- Commingling the assets and income of the Klarchek Enterprise companies for the purpose of concealing the actual financial condition of individual Klarchek Enterprise borrowers; and
- Assigning Klarchek's interest in a sale agreement and sale agreement annuity to two different financial institution lenders on the false representation to the second lender that the asset had not been pledged to any other entity.³⁷

By 2007, the operating income of the Klarchek Enterprise was insufficient to pay its outstanding obligations and the Klarchek Enterprise companies became dependent on funds from the refinancing of Klarchek Enterprise loans to sustain the Klarchek Enterprise and Klarchek.³⁸ On October 6, 2010, Klarchek filed for Chapter 11 bankruptcy, which was later converted to a Chapter 7 proceeding by the court.³⁹

Klarchek listed financial institutions as creditors in the bankruptcy case, including Delaware Place Bank, MB Financial Bank, TCF National Bank, and Wells Fargo Bank.⁴⁰

Klarchek made materially false representations to financial institution lenders, which inflated the operating income of the Klarchek Enterprise borrowers and made it appear to the lenders that the borrowers had sufficient net operating income to meet the debt-service coverage ratio required under the loan agreements.⁴¹

Likewise, Klarchek fraudulently inflated the income, and commingled the assets, of the Klarchek Enterprise companies and used those assets to pay trade debt of Klarchek Enterprise borrowers, thereby concealing from the lenders that Klarchek Enterprise borrowers were unable to pay trade debt from their operating income.⁴²

Reporting Findings and Conclusions

A forensic expert hired in a bankruptcy fraud engagement may be asked to testify in court as to findings reached, either as a fact witness or an expert witness. Suitably framed, a concluding report, meeting all federal standards for the submission of such a report, including all opinions and the bases for all opinions, generally would be necessary.

Such concluding report would describe who engaged the forensic expert; the scope of work; the background, transactions, and parties involved; the forensic accounting procedures performed; the results thereof; the facts uncovered; and the forensic expert's findings and conclusions. The report would also describe the facts or indicia of bankruptcy fraud uncovered. Properly structured, planned, and conducted, a forensic accounting engagement could be the most crucial element in uncovering and prosecuting bankruptcy fraud. **VE**



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35 "Edward M. Robbins Jr., "Tax Fraud: Criminal Cases," chap. 40 in *Litigation Services Handbook*, 6th ed., ed. Roman L. Weil, Daniel G. Lentz, Elizabeth A. Evans (Hoboken, NJ: John Wiley & Sons, 2017), 40.6.

36 *USA v. Klarchek*, No. 1:20-cr-00463 (N.D. Ill., Aug. 6, 2020).

37 *Ibid.*

38 *Ibid.*

39 *Ibid.*

40 *Ibid.*

41 *Ibid.*

42 *Ibid.*