

Protecting the Integrity of the Bankruptcy System in Chapter 7 No-Asset Cases

By W. Clarkson McDow, Jr.
United States Trustee, Region 4^{1/}

If we are to protect the integrity of the bankruptcy system, it is imperative that we give increased scrutiny to chapter 7 no-asset cases and debtors filing no-asset cases. Of the approximately 950,000 chapter 7 cases that will be filed this year, approximately 96% will turn out to be no-asset cases, meaning that no assets will be administered and no money returned to creditors. Not only are the vast majority of the chapter 7 cases no-asset cases, but that is where the public sees a problem with the bankruptcy system. Many people have neighbors or co-workers with bigger houses and nicer cars who file for bankruptcy and keep the same house and car. Because there has traditionally been a belief that one loses everything in bankruptcy, many people have trouble understanding concepts such as fresh start and exemptions. They expect to see men walking around wearing barrels as I saw in the funny papers when I was a child.

Those of us who have devoted great parts of our careers to bankruptcy, and particularly those who deal with consumer debtors, know the good that comes from our system of bankruptcy relief for the needy debtor. That, however, is only one side of the coin. There is a need to rid the system of the taint of bankruptcy fraud and to reduce the mystery of bankruptcy, so that even the casual observer will have confidence in the system. To do this, additional scrutiny must be given to the no-asset case and the no-asset debtor.

In choosing this topic and this forum for presenting it, I do not mean to be critical of trustees or to join the “they are all crooks” chorus. I was touched by Robert Furr’s recent column reminding us of the ability of bankruptcy to restore dignity. It is not the honest unfortunate debtor who needs our focus, but the small percentage of debtors who for whatever reason do not play by the rules, creating the perception that the entire system is flawed. Similarly, a few underperforming attorneys lower the image of all attorneys, and lessen confidence in the schedules and other disclosures.

Overcoming Obstacles

Several obstacles hinder the prevention of fraud and abuse in no-asset cases. Identifying these obstacles is the first step toward overcoming them. Consider the following:

- ▶ The trustee is in the best position to take action, but at \$60 per case the economic realities discourage such action.

^{1/}The views expressed in this article are those of the author and are not intended to represent the views of the Department of Justice, the Executive Office for United States Trustees, or any other United States Trustee

- ▶ The trustees' dockets are crowded and there is only a short time allocated for the meeting of creditors. This may not allow parties sufficient time to thoroughly examine the debtors.
- ▶ The schedules are often inaccurate, but economically the trustee cannot always justify following up to make them more accurate. In addition, courts are crowded, and bringing each case before the court would be time-consuming and would clog the courts.
- ▶ Some debtors are truly fraudulent; it is too easy for them to avoid detection and even when caught they are not always held accountable.
- ▶ Debtors sometimes hide assets with the plan of converting to chapter 13 if caught. The diligent trustee who discovered the assets has to watch as the debtor converts to chapter 13.^{2f}
- ▶ Debtors' attorneys often have to compete for business with petition preparers and cut-rate lawyers who deliver shoddy work at rock bottom rates. The choice for attorneys is to deliver high quality work at lower rates or to allow the quality of their work to sink along with the fees.
- ▶ Debtors continue to make poor choices and attorneys often fail to protect them or to advise them fully.

In viewing these problems and seeking to find solutions, it becomes apparent that the business as usual approach will not work; similarly, legislation alone will not provide a cure. The problem with no-asset cases is one of both perception and reality. The erroneous perception is that all debtors are crooks and bankruptcies are bad. The dangerous reality is that large numbers of schedules are filed inaccurately, in part because of an economic structure that discourages attorney diligence, and that the mechanism for preventing fraud and abuse by the small minority of abusers is not effective enough.

An effective system of bankruptcy administration must offset both the perception and the reality. The United States Trustee must work cooperatively with trustees to increase accountability; improve the standards of practice; and protect consumer debtors, creditors, and others from fraud and abuse. Just as 10 years ago we focused on slow case administration, today we need to focus on civil enforcement to ensure that accurate schedules are the standard and not the exception, that the rules are followed by all who file petitions on behalf of debtors, and that the deserving debtor-- and only the deserving debtor-- receives a discharge in chapter 7 cases.

^{2f}Interestingly, the number one wish among trustees is that the code be amended to remove the automatic right of conversion to Chapter 13 and to allow the trustee to be heard on the issue. See "A Trustees Wish List," *NABTalk*, Vol. 17, No.2, pg 39.

Some of the ways we may wish to address the problems are set forth below. These are solely my opinions, and more definitive answers will require a dialogue between panel trustees and United States Trustees. Martha Davis, Acting Director of the Executive Office for United States Trustees, has announced a civil enforcement initiative that will be one of the Program's major priorities as of Oct. 1, 2001. Certain elements of this initiative address problems with no-asset cases. While United States Trustees can focus on what we want to accomplish, our best results come when we work with others toward a common goal. Sometimes I am called a dreamer and an idealist, but I would like panel trustees to join in the dream of improving the integrity of the no-asset cases. For too long the panel trustees have carried much of the burden alone. United States Trustees recently have become more focused on these issues, and in the future should shoulder more responsibility in this area.

The Trustee's Economic Dilemma

In the typical no-asset case the trustee does not always have an obvious economic incentive to litigate objections to discharge or to spend many hours ferreting out assets only to see the debtor convert to chapter 13. Trustees should consider that their primary revenue comes from asset cases. In 2000, the trustees in the 48 states served by United States Trustees received more than 75% of their revenues from asset cases, even though asset cases comprised only about 4% of all chapter 7 cases. Additionally, in recent years the fees for no-asset cases have remained fairly constant, rising from \$47.5 million in 1996 to \$50.1 million in 2000 while revenues from asset cases increased from \$105.3 million to \$161.7 million.³

These numbers demonstrate that trustees should be seeking greater recovery from asset cases rather than relying upon no-asset fees for future growth. Making debtors honest by objecting to discharge and finding assets where none appear to exist is in the trustee's economic interest. Once compliance is improved, the trustees will be able to administer more assets with less effort.

Section 727 Actions

While improving integrity is in the trustee's economic interest, it should not be a burden borne by trustees alone. The United States Trustee has an interest and a right to bring objections to discharge pursuant to 11 U.S.C. § 727, and trustees and the United States Trustee should cooperate to share the burden of this litigation in no-asset cases.

With a cooperative effort, the trustee can be a source of referrals and information and the United States Trustee can litigate the objection to discharge or seek revocation of discharge in appropriate cases. This has not traditionally been a role of the United States Trustee, but it is

³*NABTalk*, "The Questions Behind the Numbers" by Christopher Marshall, Chart # 4, Vol. 17, No. 2.

supported by the Bankruptcy Code and protects the integrity of the system. Criminal cases should continue to be referred to the U.S. Attorney, but together the United States Trustees and the private trustees should also aggressively pursue objections to discharge and revocations of discharge.

The Section 341 Meeting

In some instances the Section 341 meeting docket is so crowded that the trustee has only a few minutes to question the debtor. The trustee must ask the questions required by the *Handbook for Chapter 7 Trustees*, and must orally examine the debtor pursuant to 11 U.S.C. § 341. This leaves little room for the creditors to ask questions as provided by 11 U.S.C. § 343; if creditors have more than a few questions, a 2004 examination is usually required.

The 341 meeting is the primary opportunity to screen for misstatements in the schedules and to help begin the process of locating undisclosed assets. Some discussion between United States Trustees and chapter 7 trustees is warranted, to determine how best to utilize the 341 meeting to elicit meaningful information from the debtors and allow real creditor participation.

More Accurate Schedules

All debtors should be required to prepare reasonably accurate schedules and should be held accountable for material deviations. The casual observer who has never helped a debtor complete a set of schedules cannot understand how difficult this process is, and I understood the process better seven years ago when I was fresh out of private practice. When a debtor brings records in a plastic bag and makes a complete mess of the attorney's well-thought-out questionnaire, the attorney may be tempted to either send the debtor away or prepare "bare bones" schedules. In turn, a trustee faced with these schedules is tempted to ask a few questions at the 341(a) meeting and let the schedules slide--after all, 96% of the cases are no-asset cases anyway.

It is worth noting that statistics indicate the percentages of asset cases are dropping. In 1986 asset cases were 10.8% of filings, but by 1999 this percentage had fallen to an estimated 3.5% of filings. My guess is that accurate schedules and increased scrutiny would increase the number of asset cases. The state-by-state variation in the number of cases administered as asset cases cannot be explained by the wealth of the state or the variation in allowable exemptions.

In many cases, assets located by trustees and administered to the benefit of creditors were not originally scheduled by the debtor, but were found through the skill and diligence of the trustee. Often these debtors are allowed to receive a discharge because the trustee would be forced to use the creditors' assets to litigate the discharge issue. This may create a situation where an objection or a revocation under 11 U.S.C. § 727 by the United States Trustee would be justified and desirable. As long as there is no price to be paid for inaccurate schedules, there will be little incentive for more accurate ones.

Conversions to Chapter 13

Not all courts hold that debtors have an absolute right under 11 U.S.C. § 706(a) to convert a case under chapter 7 to chapter 13. A growing number appear to require “good faith” as a requirement for such conversion. A good example of such a case is *In re Thornton*, 203 B.R. 648 (Bkrcty S. D. Ohio 1996), where the court held that a debtor who failed to report significant assets on the petition and lied to the trustee about jewelry did not have the right to convert to chapter 13 because no proposed plan could meet the good faith requirement of § 1325(a)(3). The court in *Thornton* said:

The Thorntons became honest in this case only after the trustee diligently pursued the truth and their present attorney insisted on accurate schedules. * * * To allow conversion of this case would condone debtors’ attempts to conceal assets and mislead a trustee to avoid administration of estate property.

In many instances the United States Trustees and the panel trustees are working together to prevent abusive conversions. More cooperative efforts in this regard can be made. In addition, case law is developing to allow the trustee to recover some amount for the efforts, but it appears that denial of the conversion or reconversion back to chapter 7 is often the best solution.

Debtors’ Attorneys and Petition Preparers

If the system is to have integrity, the vast majority of debtors must have competent representation. In my view most consumer debtor attorneys are honest and competent, and encourage debtors to be open and honest. They do a good job and perform a public service, including more than their share of *pro bono* service for the bar. Before becoming a United States Trustee, I represented a number of consumer debtors. They were generally honest and appreciative, and they did not enjoy finding themselves in bankruptcy.

If, however, debtors choose a petition preparer or an attorney who competes for business with “low ball” pricing, the result is usually a petition that reflects the standards of the preparer or attorney. Sometimes the debtor is harmed by petition preparers or attorneys when exemptions are not claimed and exempt property is not identified. Creditors may be left out because petition preparers or attorneys do not insist that all creditors be listed on the schedules. Honest debtors are sometimes misled into omitting creditors or property by the belief that “everybody does it.”

Bankruptcy relief is too important to be left to the petition preparers and the cut-rate attorneys who cut corners as readily as they cut rates. As bankruptcy professionals we should seek to ensure that every debtor and creditor is represented professionally. We should seek to change the culture and ensure excellence. This will not be easy, but we should work together to improve the quality of service even if it comes at a higher price. Trustees should not condone schedules that do not meet minimum standards. The United States Trustee should seek to disgorge fees when attorneys do not fully represent their clients and do not meet the minimum standards. Section 329 should be used to ensure that attorneys are not charging for services that are not delivered, such as attendance at the 341 meeting. Shoddy, unethical legal representation is not a

bargain at any price.

We should also continue our efforts to require petition preparers to comply with § 110. These efforts are generally successful, in part because of assistance from trustees.

Section 707(b)

The image of the bankruptcy system is greatly diminished each time an undeserving debtor slides through the system. One protection against abuse is 11 U.S.C. § 707(b). The case law is developing ways that better define abuse, and with or without the proposed legislation § 707(b) will remain a priority for United States Trustees.

In most districts the United States Trustee's office and the panel trustees have established cooperative efforts whereby the trustees use their unique knowledge and instincts to assist the United States Trustee in making decisions on § 707(b) motions. In those districts where this has been less of a priority, there should be increased emphasis upon § 707(b) motions. In all districts our review for abuse under § 707(b) is enhanced by the savvy and skills of the panel trustees, who are in an excellent position to spot abuse.

Summary

As we think about protecting the integrity of the system in no-asset cases, it becomes apparent the first step is to make sure that the cases are truly no-asset cases by insisting upon accuracy of schedules. Beyond that first step, however, as United States Trustees we need to make sure our policies encourage administration of asset cases. Panel trustees and United States Trustees must work together to encourage the good lawyers and to discourage any tendency to cut corners. We must be aggressive but also exercise discretion in bringing good cases that send the right message. The bankruptcy system does too much good to allow the worst elements to lower the standards and taint the honest debtor or the diligent lawyer.