By Hon. Scott C. Clarkson

Scrutinizing Legal Schemes in the Courts to Uncover Fraud: Comments on Equity and Justice

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I have been listening to explanations of why "no fraud was at play here" for quite some time. "We filed our tax returns on time, Your Honor." (It seems that the trustee is more concerned in what was in those tax returns.) "The funds passed through three officially created LLCs — each LLC was registered with the state." (But you're agreeing that you were the sole managing member of each and that your kids were the only other members.) "The trustee didn't ask that question at the § 341(a) meeting of creditors." (Did you think that the *creditors* might have wanted to know that he was your father-in-law?) "Are you saying, Judge, that we needed to disclose that the debtor's principal also owned the MCA funding company that was extracting 200 percent interest over a month period?" (Well, that's one way to loot the company, I suppose.)

In the realm of bankruptcy law, we are frequently tasked with navigating complex financial arrangements that may appear legally sound on the surface, but harbor underlying schemes designed to defraud creditors or unjustly enrich certain parties. In a powerful observation made in 1939, Justice William O. Douglas emphasized the necessity of bankruptcy courts to go beyond mere legal formalities when confronting "planned and fraudulent schemes." He asserted that when such schemes are uncovered, it becomes the court's duty to exercise its equitable jurisdiction to dismantle them, regardless of their technical legality.[1]

The Principle of Equity in Bankruptcy Courts

Bankruptcy courts operate within a unique framework of both legal and equitable powers. Unlike general courts of law, which are primarily concerned with the application of statutory and common law, bankruptcy courts are vested with the authority to apply principles of equity. For example, see § 105, in addition to the many Bankruptcy Code sections that give the bankruptcy court authority to act "for cause," as well as whenever the Code expressly uses the terms "good faith," "equitable" and "fair and equitable."[2]

In this context, equity refers to the court's discretion to achieve fairness and justice. This dual mandate allows bankruptcy courts to address the complexities and nuances of financial distress, particularly when the actions of debtors or creditors raise suspicions of misconduct.[3]

The Nature of Fraud in Bankruptcy Proceedings

Fraud in bankruptcy proceedings can take many forms — from the concealment of assets to the manipulation of corporate structures to shield assets from creditors. These schemes often are meticulously planned and executed, with each step carefully designed to comply with legal requirements while achieving an illicit goal. The challenge for practitioners and ultimately bankruptcy courts is to identify and dismantle these schemes, even when they are cloaked in the guise of legality.

Perhaps the oldest — and still one of the most common — challenging forms of fraud in bankruptcy is the fraudulent transfer made to family members, business associates or even newly formed entities that exist solely to protect the debtor's

1 *Pepper v. Litton*, 308 U.S. 295, 307-08 (1939), is still good law. Justice Douglas wrote, "[W]hen there is added the existence of 'a planned and fraudulent scheme,' ... the necessity of equitable relief against that fraud becomes insistent. No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart." *Id.* at 312.

2 From the introduction to Prof. Douglas Baird's *The Unwritten Law of Corporate Reorganizations* (Cambridge University Press 2022): "The judge is bound by a coherent set of unwritten principles that derive from a Statute of Parliament passed in 1571." It is cited in footnote 335 of *In re Tops II Hldg. Corp.*, 646 B.R. 617, 688 (Bankr. S.D.N.Y. 2022). Further, cases like *Pepper v. Litton*, *Taylor v. Standard Gas & Electric* and *Consolidated Rock Products* are the progenitors of § 510(c).

3 The concept of equity is deeply rooted in the history of English law, where it emerged as a means of addressing the rigidities of common law. In bankruptcy cases, equity plays a pivotal role in ensuring that the distribution of assets is fair, that creditors are treated equitably, and that any abuse of the bankruptcy process is rectified. Justice Douglas's remarks underscore the importance of this equitable power, particularly when courts encounter schemes that, while technically legal, are fundamentally fraudulent. I just finished reading (and discussing with notable legal scholars associated with the "school of law and economics") "Against Bankruptcy Exceptionalism" by Prof. Jonathan M. Seymour of Duke University School of Law from 2022 that was published in the *University of Chicago Law Review*, *available at* lawreview.uchicago.edu/print-archive/against-bankruptcy-exceptionalism. **Jared I. Mayer** of The University of Chicago Law School (formerly of Ropes & Gray, LLP) addresses Prof. Seymour's discussion quite eloquently in his paper, "For Bankruptcy Exceptionalism," also published by the *University of Chicago Law Review*, *available at* lawreview.uchicago.edu/bankruptcy-exceptionalism. *Pepper v. Litton* continues to be early and often referenced (as Prof. Seymour cites in his footnote 148) today, and it should be done so more often. Application of equity — even in the face of rather *de minimis* limitations involved in *Law v. Siegel*, *Jevic* and *Purdue Pharma* — will always require nuance and skill by the court.

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assets. While the transfers may comply with the letter of the law, their intent and effect violate the principles of equity that bankruptcy courts are duty-bound to uphold. Indeed, in litigation surrounding fraudulent transfers, much of the adversity involves intent and the actual effects on other creditors of the estate.

In some cases, fraud may involve the creation of complex corporate structures or the manipulation of financial records to obscure the debtor's true financial condition. For example, a company might engage in a series of transactions that shift assets to subsidiaries or affiliates, creating the appearance of insolvency while preserving the value of the assets for the benefit of insiders. The ownership and business relationships among debtors, their controlling persons and creditors (*e.g.*, most recently MCA-funding companies) seems like something one would want to examine. These schemes can be difficult to unravel, requiring parties and the court to engage in a detailed examination of the debtor's financial affairs and the relationships among various entities. Is the work too hard, too expensive or too intrusive? One hopes not.

The Duty of the Bankruptcy Process to Investigate

Justice Douglas's assertion that it is the bankruptcy court's duty to "undo" fraudulent schemes reflects the broader responsibility of courts to act as guardians of the public interest, which might concern those legal theorists who believe that it is only up to the parties before the court.[4] The argument is that courts should not act unless asked to do so. However, in my opinion, this duty extends beyond merely "calling balls and strikes" and is well ingrained in the powers of the court provided in 11 U.S.C. § 105. If not, then the various affirmative requirements in the Bankruptcy Code requiring a determination of good faith are meaningless. Simply put, the Code encompasses the obligation to ensure that the bankruptcy process is not used as a tool for injustice.

To fulfill this duty, bankruptcy courts must permit the U.S. Trustee, trustees, debtors in possession, creditors' committees, individual creditors and other parties-in-interest to engage in thorough investigations of the debtor's financial affairs, including the circumstances surrounding any transactions that may appear suspicious. This often involves examining the intent behind transactions, the relationships between the parties involved, and the overall effect of the transactions on creditors and other stakeholders. Parties and the court must also be vigilant in identifying signs of collusion or other forms of misconduct that may indicate the presence of a fraudulent scheme.[5] In many cases, the discovery of fraud requires parties and the court to look beyond the submitted documents and financial statements and to seek out additional evidence, such as testimony from insiders, forensic accounting reports or records.

The Consequences of Failing to Uncover Fraud

The failure of a bankruptcy court to uncover and address fraud can have far-reaching consequences, not only for the creditors involved in a particular case but also for the integrity of the bankruptcy system as a whole. When fraudulent schemes go unchallenged, they undermine the principles of fairness and justice that bankruptcy law is designed to uphold. This can lead to a loss of confidence in the bankruptcy process, as creditors and other stakeholders may come to believe that the system can be manipulated to serve the interests of a select few at the expense of the many.

Moreover, the failure to address fraud can result in the unjust enrichment of those who engage in such schemes, allowing them to retain assets that should rightfully be distributed to creditors. This not only deprives creditors of their rightful claims but also creates a perverse incentive for others to engage in similar conduct, knowing that they may be able to evade the consequences of their actions.

The Ethical and Legal Imperatives

The ethical and legal imperatives for bankruptcy courts to uncover fraud are clear. At the heart of these imperatives is the principle that justice must not only be done, but must be seen to have been done. Bankruptcy courts, as institutions of equity, have a responsibility to ensure that the process is not used to perpetuate injustice or allow the exploitation of creditors.

Ethically, bankruptcy judges must be committed to the highest standards of integrity and impartiality, approaching each case with an open mind and a determination to uncover the truth, no matter how well-concealed it might be. This requires a willingness to question the motives and actions of all parties involved, including debtors, creditors and their legal representatives, and to apply the principles of equity with consistency and fairness.

Legally, the duty of the bankruptcy court to uncover fraud is enshrined in the Bankruptcy Code, which grants the court broad powers to investigate and address misconduct. The court's equitable powers, as articulated in § 105(a), allow it to "issue any order, process, or judgment that is necessary or appropriate to carry out the [Code] provisions," as long as the court does not violate any restrictions in the Code.

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4 There exist sitting bankruptcy judges who righteously believe that unless the parties say something, to mention that they (the court) see potential fraud by their own experiences would be putting their thumb on the Scales of Justice. This distorts the purpose of a bankruptcy court and the judge.

5 In *Law v. Siegel*, the bankruptcy court ruled that the debtor should not receive his homestead exemption in the face of his continuous bad-faith activities while in the chapter 7 proceeding. The U.S. Supreme Court ruled that an exemption was voidable in certain circumstances under state law, but not for the reasons involving the debtor's particular bad faith. (State legislatures could and should remedy this situation.) The Court was careful to say that there were other equitable (and legal) ways to deal with the debtor. For example, the debtor did not receive his discharge. In *Jevic*, a settlement that did not comport to the distribution requirements under the Bankruptcy Code could not stand. Another solution was found. *Purdue Pharma* could not provide nonconsensual releases (something that the Ninth Circuit has known for years, with all courts here effectively dealing with the situation), but this also will be worked out. (Perhaps Congress should fix this, as they did with asbestos cases.) None of these cases get in the way of alternative equitable solutions, and crying the anti-equity dogs of war in a not-so-veiled attempt to promote "textualism" is pure hokum.

Imperative of Equity in Bankruptcy Courts

The responsibility of bankruptcy courts to carefully sift through the entire circumstances of events to uncover fraud or other mischief to reach a just and fair result is a critical safeguard against the misuse of the bankruptcy process. Justice Douglas's observation that equitable relief against fraud becomes "insistent" when a fraudulent scheme is uncovered underscores the vital role that equity plays in bankruptcy law. It is not enough for a court to simply apply the law; it must also ensure that the outcome is just and fair. By doing so, bankruptcy courts uphold the integrity of the legal system, protect the rights of creditors, and ensure that the principles of justice and fairness are not subverted by those who would seek to exploit the bankruptcy process for their own gain. abi