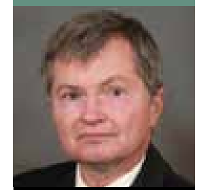
Case in Point



By Roger W. Stone, CFE

He Milked it For All it Was Worth

A Dairy Farm Bankruptcy Fraud

Bankruptcy fraud, which is a form of financial statement fraud, is perpetrated by concealing assets through misappropriation and/or a misclassification of accounts. In the following case, we will show how delayed bankruptcy schedule filings, inaccurate bankruptcy schedules and incorrect monthly operation reports can create an opportunity for a dishonest debtor to misappropriate assets of a bankruptcy estate.

The consequences of this particular bankruptcy fraud case resulted in $1.5 million in misappropriated assets, negligence action against the attorney and the convicted debtor receiving a 10-year prison sentence.

THE DAIRY FARMER CASE

The wayward debtor in this case, a dairy farmer (we will call him Stan), was suspected of gambling away the majority of the misappropriated $1,528,502 from the estate at casinos.

Eight months prior to filing bankruptcy, Stan submitted a signed personal financial statement showing $5,582,103 of assets and $4,842,505 of liabilities, which set his net worth at $739,598.Three months prior to filing bankruptcy, Stan submitted a signed personal financial statement showing $11,607,450 of assets and $4,981,100 of liabilities, which then made his net worth $6,626,350.

When he finally filed, the assets of the farmer's bankruptcy estate consisted of farmland, farm equipment, buildings, dairy cows, growing crops and crops in storage. The bankruptcy schedules showed real property of $1,116,000 and personal property of $574,370, for total assets of $1,690,370. The farmer's liabilities consisted of secured creditors and priority creditors holding claims of $4,661,866, and unsecured creditors holding claims of $293,202. This brought the total claims to $4,955,068.

COURSE OF THE BANKRUPTCY

This bankruptcy was extremely adversarial from the beginning. The bankruptcy estate attorney imposed several delays that undermined what little trust existed. The attorney initially filed for a Chapter 12 bankruptcy proceeding, which is a type of bankruptcy for farmers who have less than $1.5 million of debt. However, his client's estate had more than $1.5 million of debt, and the attorney admitted during his deposition that he knew his debtor did not qualify for Chapter 12 at the time he submitted the filing. A plausible explanation for the attorney's action was that a Chapter 12 filing would result in future filings to correct the initial filing. Those filings would delay reporting requirements for the debtor.

Almost two years after the initial filing, the bankruptcy court established the value of the farmland at $2,926,000, which differed from the initial $1,116,000 valuation on the schedules.

The attorney continuously requested extensions to file bankruptcy schedules, saying that he wanted to ensure their accuracy. However, the amended bankruptcy schedules were also inaccurate. Moreover, Stan's monthly reports of operations, when they were filed with the U.S. Trustee office, were filled with inaccuracies and misapplications of accounts. The most cursory review could detect these inaccuracies, so it was clear that the attorney had not reviewed these reports prior to their submittal. Lastly, Stan's plan for reorganization was submitted late and was unrealistic in scope. The creditors' attorneys objected to virtually every filing.

Because of these delays, the creditors did not have accurate information about the estate's assets and monthly cash flow, and Stan was able to maintain control over the estate's assets for 2½ years, instead of being removed and replaced with a court-appointed Chapter 7 trustee who would administer the estate. Almost two years after the initial filing, the bankruptcy court established the value of the farmland at $2,926,000, which differed from the initial $1,116,000 valuation on the schedules. The farmland eventually sold for more than $3 million.

The risk to the creditors was not the farmland's decreased value on the schedules, because the farmland itself was not a liquid asset. The real risk was Stan's *misappropriation of assets* (i.e., dairy cows, farm equipment, etc.) when he sold those assets outside the normal course of business without first obtaining the court's permission. He used the funds from those sales for his personal gain.

The creditors attempted to deter the debtor's liquidation of assets by taking inventories and by taking court action. However, the court action was slow and the inventory results were disputed. Without cooperation from the estate attorney, the creditors did not accomplish much in trying to thwart the debtor from liquidating his assets.

The debtor misappropriated the following assets for these amounts:

- Dairy cows $638,925
- Grain sales not deposited to estate........................$308,895
- Withdrawals of cash $221,775
- Farm equipment and vehicles $167,500
- Direct payment to debtors.......................................$75,000
- Accounts receivables not disclosed on schedules $43,341
- Preference payments...$62,230
- Miscellaneous $10,836
- Total $1,528,502

HOW THE ASSETS WERE LIQUIDATED

During a bankruptcy, the law allows inventory held for sale by the business to be purchased and sold in the normal course of business as long as the creditors are protected. For instance, inventory cannot be sold at below-market value, but it can be sold at market value during the normal course of business. Also, estate assets that are used to produce income cannot be sold without the court's permission. To apply these rules to the dairy farm case, the milk produced by the cows could be sold at market price in the normal course of business. However, the cows that produce the milk could not be sold without the court's permission.

There is a gray area within the definition of "normal business operations," and this is where a dishonest debtor can do harm to creditors, shareholders and the business itself. In the dairy farm case, Stan perverted the dairy farm's "normal operations" to his benefit and the harm of the creditors. (The attorney, though not proven to be negligent, caused the delays that allowed Stan to pervert operations.)

To further explain, in most dairy farm operations, dairy cows produce less milk over time; therefore, it is normal for a dairy farm to sell approximately 20 percent to 25 percent of its herd every year for meat and then replace those animals with younger dairy cows. A significant number of calves born every year can be kept or sold, but these animals typically are not on the accounting books because they have no basis.

Following are the specific ways the bankruptcy court liquidated the assets:

1. Dairy cows sold

Depreciation records showed that Stan bought 957 dairy cows at an average cost of $1,229 per cow in the four years prior to the bankruptcy. The average useful life of a dairy cow is five years, and then it is sold for beef. The bankruptcy schedules showed 252 cows on hand. Two-and-a-half years after the initial bankruptcy filing there was a total liquidation of dairy cows that resulted in a sale of 102 cows for which the estate received $49,574.The bankruptcy estate did not recover everything else that was sold.

2. Calves sold

It was estimated that there were 957 cows in the herd at the time of the bankruptcy filing, which would result in a minimum of 574 calves produced per year. However, there is no evidence that funds from these sales were deposited in the bankruptcy estate.

3. Milk production

The dairy farm was making about $240,000 monthly in milk sales, which was being deposited in the bankruptcy accounts. Stan made a side deal with his milk buyer, who agreed to pay less for the milk and then make $8,000 monthly payments directly to the debtor. This money never came into the bankruptcy estate.

4. Crop sales

Crops were grown using assets of the bankruptcy estate. However, during at least one year, Stan sold the crops and never deposited the receipts and money from the sales in the bankruptcy estate.

5. Farm equipment

It should be difficult to liquidate farm equipment that is in a bankruptcy proceeding because of Uniform Commercial Code filings on the equipment. However, Stan was able to liquidate his equipment in two ways:

If the accountant had been more experienced or properly instructed prior to performing his court-appointed duties, it is reasonable to expect that Stan would have been deterred. As it stood, Stan was allowed to liquidate assets and pocket the proceeds.

- The first was leased farm equipment that had a significant residual value — $45,000 more than what he owed on the lease. It appears that Stan returned the equipment to the leasing company with some agreement that he personally received the residual value. The residual value never came back to the estate.
- The second method involved used farm equipment as a part of a blanket security agreement for an operating loan Stan had obtained prior to the bankruptcy. In this instance, the equipment was placed for auction out of the area with the proceeds going to a relative.

6. Withdrawals of cash

Without adequate supervision and controls, Stan wrote checks to cash totaling $221,775 out of the bankruptcy estate.

At the pre-filing conference, the estate attorney counseled the debtor to hoard cash to prepare for footing the bankruptcy expenses. What the attorney probably meant was to not pay creditors, lessors and other accounts payable prior to filing for bankruptcy and the automatic stay (an injunction that halts the bankruptcy's courts actions). The goal was to keep as much money as possible in the bankruptcy checking account so the debtor could continue to operate amidst the business disruptions associated with filing for bankruptcy. However, the debtor, who had dishonest intentions, interpreted this advice as keeping as much actual cash in the house as possible and to not report it. It is suspected that the debtor had in excess of $100,000 cash on hand at various times during the course of the bankruptcy.

THE INEXPERIENCED ACCOUNTANT

Approximately one year after the initial bankruptcy filing, the court appointed an accountant to prepare the monthly reports of operation. The inexperienced insolvency accountant made several errors. When preparing the monthly reports of operation, he:

- Did not have copies of checks or deposits.
- Did not have a check register.
- Relied on descriptions of checks and deposits provided by Stan.
- Did not question Stan about the appropriateness of deposits made or checks written.
- Did not consider it his responsibility to question unusual expenses or deposits.
- Did not know that Stan was not allowed to have personal bank accounts other than the debtor in possession accounts.

If the accountant had been more experienced or properly instructed prior to performing his court-appointed duties, it is reasonable to expect that Stan would have been deterred. As it stood, Stan was allowed to liquidate assets and pocket the proceeds.

Two-and-a-half years after the initial filing, the court finally appointed a Chapter 7 trustee to liquidate the estate. One month later, the original attorney for the bankruptcy estate resigned.

WHAT THE CREDITORS COULD HAVE DONE

Early on, the creditors realized that Stan was dishonest, and there was a real risk that he would misappropriate the assets. The creditors hired appraisers, took inventories of the assets and filed court documents to protect their assets during the bankruptcy. However, these actions failed to deter Stan.

The creditors could have engaged a forensic accountant/CFE to inspect the debtor's monthly reports of operations. This person could have:

- Verified reconciliations of bankruptcy accounts.
- Verified that all payments were for appropriate services.
- Verified that all deposits were being made to the appropriate accounts.

- Reviewed prior years' purchases and accounts payables to verify the existence of assets that were in the bankruptcy schedules or that should be in the schedules.
- Notified the creditors of anything that appeared unusual or inappropriate.

It is true that these services can be costly, so creditors should only take this route when the expense can be justified by the risk of loss.

The Chapter 7 trustee engaged me to quantify and prove the amount of misappropriated assets. There was virtually nothing left for the creditors, except for a cause of action against the original bankruptcy attorney.

As is frequently the case in misappropriations, the involved parties missed many obvious opportunities to stop or minimize the fraud, prior to and during the bankruptcy. For example, Stan's attorney could have resigned when he realized his client was dishonest; the U.S. Trustee office could have been more proactive in reporting the level of extreme inadequacy of the monthly operating reports to the judge; the court could have appointed a more experienced accountant, etc.

PROFESSIONALS' ROLES

Most experienced forensic accountants, and many CFEs, can review businesses in bankruptcy and determine fairly quickly if the debtors are following the rules. If a debtor is following the rules, these professionals will only need to periodically review operations reports, greatly reducing the cost of the accountant's services. Such reviews will give the creditor the information required to force the court to act quickly, either by removing the debtor in possession or by forcing the individual to report as required. Either way, the creditor is better protected.

Roger W. Stone, CFE*, is the owner and operator of Management Accounting Services in Champaign, Ill. His primary business is providing insolvency and forensic accounting services to businesses and attorneys. His email address is: rstone@financialstatements.net.*

The Motivations of the Players in a Bankruptcy Case

Here is a summary of the key players in a bankruptcy filing and their respective interests:

The bankruptcy estate attorney. In most cases, attorneys in bankruptcy cases will resign when they believe they are representing individuals who are not adhering to the rules of bankruptcy. In my opinion, attorneys on these types of cases are not paid enough to get entangled with dishonest persons; the amount of the attorney's fees is miniscule compared to the amount that dishonest persons steal. Attorneys want their insurance to settle the case before it goes to court.

The malpractice insurer. Working for the estate attorney, the insurer is motivated to settle the case for the minimum if engaged.

The Chapter 7 trustee. The Chapter 7 trustee is torn between recovering the maximum amount for creditors and doing something that might upset the U.S. Trustee office and jeopardize the trustees being appointed to future cases. Also, the risk of going to trial is that the plaintiff could lose, which means there might not be funds to pay the Chapter 7 trustee.

The U.S. Trustee office. The office may not want a case to go to trial because it could be revealed during the trial that the office was not carefully reviewing the debtor's monthly operating reports.

The judge. This player might not have a dog in the hunt. However, in my opinion, judges seem reluctant to find lawyers guilty of negligence.

The creditors. They are motivated to go to trial or settle for the maximum amount. However, it is the Chapter 7 trustee's call as to whether or not to settle — not the creditors. Their primary recourse is to object to what they perceive as an unreasonable settlement between the Chapter 7 trustee and the insurer.