

FORENSIC RISK MANAGEMENT

Accountants and Bankruptcy Fraud – Part II

Carl Pacini

In the last issue of the *Journal of Forensic Accounting*, we pointed out the prevalence of bankruptcy fraud and examined various aspects of federal criminal bankruptcy law. In this column, we describe and analyze the most common bankruptcy fraud schemes.

In exchange for the discharge of debts, debtors are supposed to provide accurate information about their financial affairs. The most significant documents upon which courts and creditors rely are the petition, schedules, and statement of financial affairs. Unfortunately, some debtors do not tell the truth on these documents or at creditors' meetings. False statements, which are part of larger schemes to defraud, serve as the basis for bankruptcy fraud prosecutions.

Any classification of bankruptcy schemes to defraud is formalistic but the two most common are the "bustout" or the planned bankruptcy and the fraudulent concealment of assets during, or in contemplation of, a bankruptcy.

Bustout Schemes

A bustout scheme may take several forms but most entail obtaining a loan or purchasing inventory on a credit basis. The fraudster then hides or absconds with the loan proceeds, inventory sale

proceeds, or the inventory itself, without paying creditors. Insolvency is declared and bankruptcy is filed and creditors find that no or few assets remain with which they can be paid. In such a scam, the fraudsters keep the loan or sales proceeds or inventory but evade liability for the debt.

A bustout may involve establishing a new company or using an established one. In the first type, the fledgling business' first goal is to establish a favorable credit rating. This task is accomplished by various means which can include temporarily putting cash into the business to create a strong balance sheet, bribing credit rating agencies, and inflating financial statements to overstate the business' net worth.¹ Bills for the firm's initial purchases are promptly paid to create the image of a creditworthy firm. The cash with which to pay suppliers is obtained from loans or from selling goods at deep discounts through fences that handle stolen property. As the business becomes more established, the perpetrators order considerable amounts of additional merchandise with no intent of paying for these goods. A huge inventory is accumulated. The perpetrators then occupy themselves by selling the inventory at

¹ McCullough, R. 1997. Bankruptcy fraud: Crime without punishment II. *Commercial Law Journal* 102 (1):1-55.

Carl Pacini is Associate Professor of Accounting and Business Law, Florida Gulf Coast University, Ft. Myers, and Adjunct Professor of Forensic Accounting, Florida Atlantic University, Ft. Lauderdale, Florida.