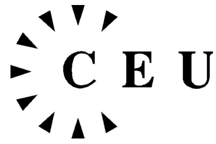

BLEEDOUT AS A TYPE OF BANKRUPTCY CRIME: COMPARISON OF RUSSIAN AND US LAW

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EXECUTIVE SUMMARY

This paper focuses on the bleedouts - fraudulent scheme used in bankruptcy proceedings aimed at depletion of assets. After the sort overview of the role of bleedouts in the system of bankruptcy crimes, the thesis deals with the definition of the bleedout bankruptcy scheme and its distinctive features. The historical introduction to the evolution of fraudulent schemes regulation is made.

The civil and criminal provisions regulating the bankruptcy schemes in both countries are scrutinized. Taking the US law as t he pattern the comparison analysis of US and Russian regulation is made in order to elaborate the possible improvements of Russian law on fraudulent bankruptcy schemes. The findings of thesis on modification of Russian bankruptcy law are of vital importance in the light of Russian civil law reform and increased number of the liability avoidance among parent companies.

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INTRODUCTION

In every country the bankruptcy system is based on the perception that "a debtor will make full disclosure of all assets and liabilities so that the final disposition is in accordance with the requirements of the law."[1] However in high profile bankruptcy cases it is common for the debtor to try to defraud the assets or discharge liabilities.[2] The debate today is how to eliminate bankruptcy fraud.

Today in the era of the economic crisis and the instability of society as a whole, bankruptcy law plays a vital role in balancing between the interests of debtors and creditors. There are two main ways in which countries manage to do this. The bankruptcy system of the US is designed to "protect a debtor by giving him or her fresh start, free from creditor's claims, and to ensure equitable treatment to creditors who are competing for a debtor's assets."[3] The US world known concept of the fresh start in bankruptcy coexists with the powerful right of trustee to avoid fraudulent transactions. This is one of the reasons why US bankruptcy law is regarded as the most developed and balanced one. Even though the US Bankruptcy law is not perfect, as evidenced by a number of huge finical bankruptcy scandals[4], it serves as a pattern law for many foreign reforms.

In Russia the lifelong continental law stigma still prevails – bankruptcy is the worst option for the person or legal entity. The attempts of legislators to implement the US bankruptcy law in 1992 failed. Neither the society nor practitioners were able to accept the different

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[1] Brown, Joe B.; Netole, Brian; Taliani Rasnak, Sandra; and Tighe, Maureen. *Identifying Bankruptcy Fraud*, p. 1 (accessed March 20, 2012) http://www.crfonline.org/orc/pdf/ref11.pdf

[2] Wickouski, Stephanie. *Bankruptcy Crimes*. 3rd ed. Washington, D.C: Beard Books, 2007, p. 1.

[3] West's Business Law: Text and Cases - Legal, Ethical, International, and E-Commerce Environment, 9th Edition p.581

[4] See: Haberly, Todd. 2002 "The Enron Bankruptcy" (accessed March 20, 2012) http://www.plu.edu/~enron/Haberly.pdf ; "Lehman Brothers Holdings Inc" *The New York Times*, March 7, 2012 (accessed March 20, 2012) http://topics.nytimes.com/top/news/business/companies/lehman_brothers_holdings_inc/index.html; Isidore, Chris "GM bankruptcy: End of an era" *A service of CNN "Fortune and money"*, June 2, 2009 (accessed March 20, 2012) http://money.cnn.com/2009/06/01/news/companies/gm_bankruptcy/

paradigm. Furthermore the implementation of the US law caused a conflict between the Bankruptcy statute and the Civil Code (that was in fact reception of the German law). The reform of early 2000 returned the Bankruptcy Code of Russia to its civil roots. However it did not solve all the problems. Today the Bankruptcy law of Russian Federation still lacks balance and efficiency especially in the area of bankruptcy abuses.

In both countries the majority of bankruptcy abuses are single crimes that are regulated by one article (e.g. false statements or assets concealment). However a single transaction is not effective in the case where the company wants to conceal all of its assets. It is common is practice that entities are sequentially making false statements, use insider transactions to deplete the assets, commit mail/wire fraud and start fictitious bankruptcy proceeding. Companies are creating bankruptcy schemes, combination of transactions that allow transferring all the assets and escaping liability for debts.

Nowadays the most complicated scheme is called bleed-out. It involves long lifespan companies, hundreds of sophisticated transactions and intercorporate transfers. All these actions have one goal – to deplete the assets of the company. In the USA in 2010 the detected corporate bleed-outs constituted 1% among bankruptcy connected crimes. Though this figure seems to be insignificant the situation with bankruptcy schemes is dramatic. The percent of false statement crimes was 38,2 %, asset concealment was 30,2 %, bankruptcy schemes were 20,7 %.[5] In fact 90,1 % of bankruptcy crimes are involved in fraudulent schemes. In Russia the number of bankruptcy connected crimes increased from 548 to 701 in 2009.[6] The data is evidence that the fraud became common.

Successful completion of the scheme is possible due to the enormous number of civil and criminal statutes that regulate bankruptcy abuses. Conflicts of laws and complicated

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[5] See: Criminal Referrals by Type of Allegation. Fiscal Year 2010 p. 6 (accessed March 21, 2012) http://www.justice.gov/ust/eo/public_affairs/reports_studies/docs/criminal_report_fy2010.pdf

[6] Arzyakova, Irina. *Imperfection of the term "malicious bankruptcy" in practice* (accessed March 26, 2012) http://science-bsea.narod.ru/2011/ekonom_2011_1/arzyakova_nesov.htm

procedural rules facilitate liability avoidance. Neither the law nor scholars address the business reality. Practice shows that a uniform and comprehensive attitude is necessary.

Despite the fact that bankruptcy schemes have existed for centuries, academic literature on this subject matter is almost absent. Although legal scholars have extensively developed the concept of fraudulent transactions[7] and bankruptcy crime,[8] there is relatively little research on the bankruptcy fraudulent scheme as a single phenomenon. Certain attempts were made by Stephanie Wickouski and Joe Brown et al. Russian scholars are indifferent towards the bankruptcy scheme problem. Prof. Wickouski made an extensive research on bankruptcy crimes and gave a small overview on each type of fraudulent scheme. However her approach based in separate analysis of bankruptcy offences is not enough for a deep and profound understanding of the problem. The significant research on different types of bankruptcy schemes was made by J. Brown et al. Though the work covers the majority of possible fraudulent actions it can not be regarded as a fundamental research but rather a descriptive overview. Furthermore absence of comparative study on this issue disables to attain a deeper knowledge on bleed-outs and prevent systematic unification and harmonization of law.

This research is aimed at elimination of the gaps existing in the literature today. By using the comparative method of analysis the paper focuses on the scrutiny of the US and Russian civil and criminal regulations on fraudulent bankruptcy. Considering the US bankruptcy law as a pattern, the elaboration of practical suggestions on improvement of the Russian legislation on this matter will be made.

The issue of bleed-outs is analyzed in four chapters. Chapter 1 covers some preliminary considerations crucial for the understanding of the problem. It focuses on the concept of bleed-

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[7] See: King, Lawrence P. *Creditors' Rights, Debtors' Protection, and Bankruptcy*. 3rd ed. Casebook Series. New York: M. Bender, 1996; Glenn, Garrard. *Fraudulent Conveyances and Preferences*. Reprint of the revised ed. New York: Baker, Voorhis, 1940. Buffalo, N.Y: W.S. Hein, 2001; Stumvoll, Erica. "Avoidance of Transfer: Section 548." *Emory Bankruptcy Developments Journal* 3, (January 1, 1986): 389. *LexisNexis Academic: Law Reviews*, EBSCO *host* (accessed March 18, 2012).
[8] See: Ibid. No 2

out, determines the distinctive features of the legal phenomenon and provides the definition of the bleed-out as a bankruptcy crime. Furthermore Chapter 1 gives the historical overview of the legal statutes that regulated bankruptcy abuses in the USA and Russia. The Chapter will facilitate the deeper understanding of the problem and will serve the departing point for the following studies.

The second chapter focuses on the examination of the US statutes that regulate bleed-outs. The chapter is divided into two sections where the civil and criminal provisions are scrutinized separately. I refer to several issues: what tests do the US courts use in order to determine the concealment of assets; whether the intent of the company is important; what is the scope of managers' liability for fraudulent actions. The chapter also evaluates the drawbacks of the US law and reasons of why the bankruptcy frauds are still possible.

The third chapter deals with Russian legislation on bankruptcy schemes. The major focus is on the interaction of criminal and civil regulations. The procedural issue of fraud avoidance is examined: what terms are used to describe bankruptcy abuses, which party is entitled to claim the transaction fraudulent. The chapter is based on comparison of the US concept of bleed-out and fraudulent transaction and existing Russian legislation.

It will be shown that criminal and civil rules should be applied cumulatively. The present separate attitude of legislators towards bankruptcy regulation gives birth to successful concealment of assets. This result is undesirable by both state and society. Therefore the thesis suggests that regardless the difficulty in unification of bankruptcy law, a single act should be designed. It should regulate both civil and criminal issues of bankruptcy abuses.

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CHAPTER 1: THE PHENOMENON OF BLEED-OUTS AND THE COROLLARY PROBLEMS

Bleed-out is a business reality now as well as other bankruptcy schemes. It is regulated by the system of different rules that cooperate, duplicate or conflict with each other. Before considering the particular rules on bleed-outs it is necessary to define the bleed-out as a bankruptcy phenomenon, to determine the distinctive features of the fraudulent scheme and to give the historical background of legal regulation. The chapter will first establish the role of bleed-out in the system of bankruptcy crimes and indicate the peculiarities of this fraudulent scheme. Thereafter, the historical overview of the US legal statutes on bankruptcy abuses is made followed by examination of Russian laws since XI century.

1.1. THE ROLE OF BLEED-OUT IN THE SYSTEM OF BANKRUPTCY CRIMES.

The majority of the bankruptcy crimes constitute only one type of violation, although there are number of fraudulent schemes that are "more complicated or are primarily designed for reasons other than maximizing the retention of assets in bankruptcy."[9] Companies can use bankruptcy schemes in order to conceal earlier crimes or maximize the profit of insiders. Another goal can be to "buy time" in order to find a way to "avoid victims or leave town."[10] The above mentioned goals can be achieved through fraudulent bankruptcy schemes that are regulated by both criminal and civil law.

The key issue in understanding of the bankruptcy scheme is the combination of transactions concluded with the one main purpose – to hide the assets and to defraud creditors. It is possible due to enormous number of acts that regulate bankruptcy abuses. Companies know where the law is imperfect and use it for its own fraudulent interests. Legislators are improving bankruptcy statutes. However the approached is initially wrong. Instead of cooperation between

[9] Ibid. 1, p. 1
[10] Idem.

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specialists in the civil and criminal aspects of bankruptcy separate reforms are made. It is not enough to eliminate the gaps in bankruptcy acts. The necessity of comprehensive approach towards bankruptcy schemes in general and, bleed-outs, in particular, is clear.

The most common bankruptcy schemes are "bleed-outs", "bust-outs", "looting" and "skimming"[11]. Though bleed-out is similar to bust-out it is regarded as the most sophisticated type of fraudulent bankruptcy scheme.

Distinctive features of bleed-outs are (1) involvement of a long life span corporation (2) depletion of assets (3) over long period of time (4) through sophisticated transactions.

Typically creditors are "blind" and not aware that there is a certain type of assets concealment. They rely on the long lifespan of the company or involvement of huge hedge funds. At the time when the value of the company is drained, creditors get nothing but the "bubble" of the entity.

From the analysis of case law there are several bleed-out indications. Insider transactions as well as "capital infusion characterized as loans", or tax manipulations are typical transfers that can lead to assets concealment[12]. For instance the company uses leveraged buyout or gets investment from people without previous business experience both prior and during bankruptcy proceeding. Capital infusions of corporate officers suddenly renamed "loans" and paid back. Depletion of pension funds by sudden deduction of workers contributions for health care and retirement with the subsequent conversion by debtor is also common. Certain actions can cumulatively indicate bankruptcy scheme. Changes of ownership or in accounting or cash flow practices for no apparent business reason ("sudden decrease in inventory; sharp increase in aged receivables")[13] in combination with excessive salaries and bonuses could form bleed-out.

Brown et al provide a typology of bleed-outs:[14]

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[11] Ibid. No. 2, p. 10
[12] Idem., p. 11
[13] Ibid. No. 1, p. 4
[14] Idem., p. 5

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1. "Corporate Raider Bleed-outs": A stable long life span entity with liquid assets is acquired in a leveraged buyout. Such assets usually include a large pension fund and/or "profit sharing fund". The initial purpose of the company operation can be business transactions for the purpose of profit. However in some point the company exists only to allow the insiders to loot the company. Afterwards the company applies for voluntary bankruptcy procedure or starts the reorganization that allows insiders to complete the scheme. Business transfers are complicated and purposefully confusing. Even though the creditor eventually realized what happened it is almost impossible to prove the fraudulent conveyance actions. This type of bleed-out is common in all industries.[15]

2. "White Knight" Bleed-outs: In order to raise money the company hires a business consultant – the "white knight". He/she gets the shares or bonds of the company that allow taking the control over financial operations. "White knight" uses his position to "convert company assets."[16] It can be failure to "pay withholding taxes, to make pension fund contributions, diversion of receivables, paying personal expenses with company funds, taking excessive salary and bonuses and, in some situations, paying false invoices to entities or individuals related to the consultant."[17]

3. Parallel Entities: A company with a long life span faces financial problems. The owners of the company establish a new entity in the same industry. Prior bankruptcy proceeding debtor sells assets to a new legally independent company for a price below its value. By these means insiders "bleed out" the company by transferring debtor's inventory and receivables to the new company. Furthermore the clients of the debtor can be also lured by the factual successor. In fact insiders squeeze all possible assets of the company by purchasing goods or services for the new entity. These types of transactions violate the assets distribution rule contained in every

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[15] Idem.
[16] Idem.
[17] Idem., p. 5

Bankruptcy Code. Eventually outside creditors receive nothing. Lawyers are usually involved in the scheme.

4. Assignment for the Benefit of creditor (ABC)/Insider Sales: This type of bleed-out is similar to the previous one. Assets of the debtor are sold to newly established and undisclosed company for inadequate consideration. The secured creditor approves the transaction because "its security position improves if the new company is debt free."[18] Unsecured creditors get no assets to satisfy its claims. Involuntary bankruptcy proceeding terminates the scheme. Company is liable for misrepresentations.[19]

Though the most common bankruptcy schemes are known there is no unified act that can cover all the transactions made by corporation in order to deplete the assets. The judges and bankruptcy trustees are forced to follow the long and complicated procedure of transaction avoidance. Furthermore fraudulent actions of the company can be penalized by both civil and criminal law. Not only company itself is liable but also the long-standing owners or insiders can face criminal personal liability.

The uniqueness of Bankruptcy law is that it involves different disciplines of the law. "Bankruptcy has its own clear, but distinct, criminal and civil components."[20] On the one hand, attorneys dealing with bankruptcy law lack of the criminal law background. It keep them from deep understanding of the criminal consequences of actions made within bankruptcy proceeding. Lack of knowledge and skills does not promote cooperation with prosecutors investigating the conduct nor help to recognize the techniques used by them. On the other hand, "white collar criminal practitioners almost never have the background in bankruptcy law, its regulations and nuances, to understand or appreciate potential defenses that may arise."[21] Furthermore, prosecutors prefer to use familiar offenses such as fraud, perjury, bribery, embezzlement rather

[18] Idem.
[19] Idem., p. 6
[20] Ibid. No. 2, p. ix
[21] Idem.

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than using the Bankruptcy Criminal Code. This situation leads to, first, a conflict of criminal and civil laws and, second, to a number of gaps that allow corporations to leave creditors without money they are entitled for.

1.2. THE USA HISTORY OF BLEED-OUT REGULATION

In the USA actions, committed by the corporation within the bleed-out scheme, fall under a number of statutes. "The predicate for American bankruptcy law is found in the bankruptcy clause to the constitution, which empowers Congress to pass uniform laws on the subject bankruptcy."[22] Bankruptcy Code regulates the whole bankruptcy procedure. For the purposes of this thesis the most important is Title 11 that regulates the automatic stay by trustee. In fact § 362 Title 11 USC allows the trustee to avoid fraudulent transactions and take the assets of the debtor back.

Furthermore, a number of fraudulent transfer acts prohibits depletion of debtor's property. The predecessor of the modern fraudulent transfer statutes was the statute of Elizabeth (13 Eliz. C.5 (1571)).[23]The Act was applicable to conveyance intended "to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debt". Nowadays the Statute of Elizabeth constitutes the common law of many state jurisdictions.[24]

Since 1920 the Uniform Fraudulent Conveyance Act (UFCA) is offered to be signed by the states. Eventually 26 states adopted UFCA including New York and New Jersey, and "its provisions were incorporated into the Federal Bankruptcy Act."[25] In fact the concept of the fraudulent conveyance was introduced by UFCA.[26] Though UFCA did not cover all the issues

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[22] Idem., p. 6
[23]See: King, Lawrence P. *Creditors' Rights, Debtors' Protection, and Bankruptcy.* 3rd ed. Casebook Series. New York: M. Bender, 1996.
[24] Glenn, Garrard. *Fraudulent Conveyances and Preferences.* Reprint of the revised ed. New York: Baker, Voorhis, 1940. Buffalo, N.Y: W.S. Hein, 2001, p. 103
[25] The National Conference of Commissioners on Uniform State Laws. Fraudulent Transfer Act Summary (accessed March 12, 2012) http://uniformlaws.org/ActSummary.aspx?title=Fraudulent%20Transfer%20Act
[26] Idem.

connected with fraudulent conveyance, it gave to the law "a certainty which it does not now possess."[27] Another problem connected with UFCA was that "each State which adopts the Uniform Law leaves in effect such principles as her courts have established save as the Act may plainly cut across the line."[28] Consequently courts had to deal with both state and case law.

In 1979 the Conference of Commission on Uniform State Laws was gathered in order to revise UFCA. The Commission numerated five reasons to modify the law:[29]

1) The Bankruptcy Code enacted in 1978 significantly changed the provisions on fraudulent transfers which reduced the correspondence of federal law and the Uniform Act.

2) There was a necessity to determine the consistence of both Acts on the issue of dividend distribution.

3) The Uniform Commercial Code promoted the superiority of security transfers over unsecured creditors.

4) Debtors and trustees "avoided foreclosure of security interests by invoking the fraudulent transfer section of the Bankruptcy."[30]

5) Since 1983 according to the Model Rules of Professional Conduct it was forbidden for a lawyer "to counsel or to assist a client in conduct that the lawyer knows is fraudulent."[31]

The Uniform Fraudulent Transfer Act was adopted in 18 states including California, Texas and Florida.[32]

The roots of criminal prosecution of the bankruptcy abuses took place in bankruptcy statute of 1800. According to this statute the perjury of the bankruptcy assets was criminalized. The next Act enacted in 1857 resembles the majority of criminal provisions in current Title 18 of

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27 Ibid. No. 24, p. 101
28 Idem., p. 102
29 Uniform Fraudulent Transfer Act, National Conference of Commissioners on Uniform State Laws, July 27 – August 3,1984, with Prefaratory Note and Comments. Chicago, Illinois, p. 1
30 Idem., p. 2
31 Idem.
32 Ibid. No. 23, p. 324

U.S.C. Significant modification of bankruptcy legislation was made in 1898. The Bankruptcy Act 1989 remained in force until 1979 and laid the foundation for modern provisions. During the Great Depression of the 1930-es the necessity to change the bankruptcy law arose due to corruption in business bankruptcies. The 1937 amendments included the Borah Act which "prohibited fee fixing agreements in bankruptcies and receiverships."[33]

In 1970 the Congress established the Commission on the Bankruptcy Laws of the United States in order to revise the current legislation. The rationale for modification was ineffectiveness of the law and "dual administrative and adjudicative roles of the bankruptcy code."[34] In fact the Commission suggested a completely new bankruptcy code. One of the main goals of the 1978 Act was to avoid fraud and abuses in the bankruptcy system.[35]

In 1992 high priority was given to the aggressive prosecutions of bankruptcy crime by the United States Department of Justice (DOJ).[36] It resulted in a dramatic increase in the number of criminal prosecutions in bankruptcy area. Nowadays Uniform States Code (Title 18) stipulates the crimes under which the actions of the company during bleed out scheme fell.

Despite the existence of statutes different in nature and level of establishment the US bankruptcy system is acknowledged as one of the most effective and balanced in the world. The avoidance of bankruptcy trustees should be regarded as the achievement of the US legislators in the area of combating fraudulent abuses.

1.3. THE RUSSIAN HISTORY OF BLEED-OUT REGULATION

Regulation of Russian bankruptcy law is similar to the US law. There are 3 main periods of legislation development: prerevolutionary, Soviet, the modern.[37] Up to XIX century

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33 Ibid. No. 2, p. 6
34 Idem., p. 7
35 Idem., p. 8
36 Idem., p. 1
37 Mamaev, Stepan. "Formation and development of Bankruptcy law in Russian Federation". *Zakon i Poryadok No 11* (2006), p. 11

Bankruptcy law in Russia was badly developed, it lacked systematization and integrity. The very first act that regulated bankruptcy proceedings was "Russkaya Pravda" – the uniform code of XI century. Among other regulations there were articles establishing punishment for malicious bankruptcy when the debtor concealed assets or was hiding himself from paying debts.[38] Subsequent acts were aimed at the development of bankruptcy procedure and establishment of priority rules. The most significant statues were Bankruptcy Charter (1740), Rule in bankrupts (1800), Charter of business insolvency (1832). The latter differentiated insolvency and bankruptcy and established the hybrid test for insolvency (the amount of debts should be more than the amount of assets available and the debts are not paid).[39]

During the Soviet period there was no bankruptcy legislation of private companies because there was no private property. However the Civil Code of 1922 included the articles dealing with void transactions. In 1970-es legislators faced with necessity to regulate bankruptcy proceedings of the state owned corporations. A number of Decrees was enacted. However the bankruptcy law of that period protected not the creditors or debtors but the mutual economic interest as such. According to the law of that period state corporations were released from any responsibility for its debts.[40]

Modern period of Russian bankruptcy legislation started in 1992 by enacting the President Decree No 623 on "Support and reorganization of the insolvent state entities and application of special proceedings."[41] The Decree was followed by enactment of the Bankruptcy Act in November 19, 1992. The Statute was an attempt to implement the US existing laws on bankruptcy. However the implementation of the law was partial and did not achieved its goals. Moreover it lead to collision with the Civil Code that was in fact the copy of the German Civil law. In fact Russian legislators were trying to combine American pro-debtors approach with

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38 See: Stepanov, Vasily. *Bankruptcy in Russia, France, England, Germany.* Moscow: 1999; Ukolov, Vladimir. Omarova, Anna. *Bankruptcy of financial companies.* Moscow: 1999.
39 Makishev, Konstantin. *Historical overview of bankruptcy procedure.* St. Petersburg: 1871, p. 97, 210-307
40 See: Lebedev, Peter. "Liquidation of state companies due to their insolvency". *ESU*: No 49 (1924)
41 See: Gilinsky, Sergey. *Business Law.* Moscow: 2002

German one favoring creditors. Bankruptcy Act 1992 was ineffective and allowed companies to deplete assets legally. Furthermore the regulations did not correspond to the business relations that took place those days. These factors were reasons to modify the law.

In 1998 a new Federal Statue "on Bankruptcy" was adopted. It was an attempt to adjust prerevolutionary bankruptcy system to contemporary business reality. The provisions on reorganization of the company within bankruptcy proceeding were "borrowed" from the US Bankruptcy Code. The 2002 revision of the Statute regulated the details of the bankruptcy abuses, including invalidity of fraudulent transactions, powers of the trustee to return all assets of the debtor to the bankruptcy estate. The latest changes in the law were made in November 2, 2011 and supplemented the regulation with new rules on the Bankruptcy of financial institutions.

The Civil Code, as well as a number of statutes that regulate different types of companies, is involved when the court decides on bankruptcy case. The definition of the debtor, creditor and obligations of the parties are stipulated in those act.

Bankruptcy Statute is not the only legal source that regulates the transactions that fall under the bleed-out scheme in Russia. Since 2002 the Criminal Code includes a number of special crimes connected with Bankruptcy. The aim of the articles is to protect the rights of the creditors by collecting all the assets of the company. In case where the bankruptcy was caused due to the actions of the owners of the company or the management personal liability can be imposed. Among offences criminalized in Russia there are illegal actions during bankruptcy proceedings (Art. 195), malicious bankruptcy (Art. 196), fictitious bankruptcy (Art. 197).[42]

To conclude, the modern Russian bankruptcy law is characterized as the complicated complex of different statutes with different legal nature. The absence of unified logical legislation allows the companies to abuse the rights and bleed out the assets. The need for reformat is clear.

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[42] See: Brilliantov, Alexander. *Comments to Criminal Code of Russian Federation*. Prospect: St. Petersburg. 2010

Despite the differences in the US and Russian approaches the common tendency is the dramatic increase of the importance of bankruptcy legislation. The fact that bankruptcy is a comprehensive legal institution that is rooted in civil and criminal law makes the regulation incredibly difficult. Conflict of criminal and civil rules in the regulation of the bleed-out as a bankruptcy crime gave birth to the gaps in law that allow corporations to leave creditors without money they are entitled for. Furthermore it should be taking into account that bankruptcy has moral, social and legal aspects. In fact it is the society that determines whether the conduct will fall under the criminal system or under civil regulation. In such conditions it is the obligation of the legislators to find the balance that will correspond to the business and social reality. In next chapter I will analyze the US bankruptcy statutes in order to understand how the US created a balanced and efficient bankruptcy system that reflects the society needs.

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CHAPTER 2: US REGULATION OF THE BLEEDOUTS

As it was stated in Chapter 1 of this thesis bleed-outs in the USA are regulated by both civil and criminal law. First section of this Chapter will examine how the US Bankruptcy Code establishes the rights of the trustee on avoidance of fraudulent transactions. The articles of USCA and UFTA are also considered. It will be illustrated how the court defines what does the fraudulent transfer/ conveyance means and how to determine it. For the trustee to return the assets of the company in bankruptcy procedure it is necessary to apply all acts mentioned above. The second section will be devoted to the criminal law regulation of bankruptcy fraud on the basis of Title 18 of the U.S.C. is applicable. In order to give the comprehensive analysis of the bleedout as a combination of transactions that is governed by different areas of law, both civil and criminal regulations will be considered in this Chapter.

2.1 CIVIL REGULATION OF BLEEDOUT SCHEME IN THE USA

The primary goal of the Bankruptcy Code is "to provide equality of distribution of the debtor's assets to creditors. This is accomplished through pro rata treatment of similarly situated creditors and disgorgement of fraudulent and preferential transfers."[43] An efficient and equitable bankruptcy system requires the disclosure of all property and liabilities of the debtor to the creditors and the court. The debtor must "not conceal or transfer assets which are property of his bankruptcy estate."[44] Equality in bankruptcy case means that the treatment of creditors and distribution of assets is equitable. Each claim "receives the same treatment as other claims with the same priority and legal rights."[45]

The core right that allows the trustee to avoid fraudulent transactions and maintain equitable treatment of the creditors is the strong arm clause that is allowed under Section 544-

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[43] Ibid. No. 2, p. 17. See also: Begier v I.R.S., 496 US 53, 58 (1990)
[44] Ibid. No, 2, p. 18.
[45] Idem., p. 19

548 of the US Bankruptcy Code. The Statute "grants the trustee the right to step into the shoes of other people, hypothetical and actual."[46] In fact the Bankruptcy Code includes several types of avoidance power. First, the right to act according to non-bankruptcy law as if the trustee is one of the creditors. For example under Section 544 (a) the trustee has a right of hypothetical lien creditor. Section 544 (b) entitles the trustee to avoid "(1) any transfer of debtor's interest in property or (2) any obligation incurred by the debtor, that an actual creditor holding an allowed unsecured claim could avoid under applicable non-bankruptcy law."[47] Second, the power to avoid preferential claims in multiple creditors cases (Section 547). Third, the right to act as creditors outside the bankruptcy. The third group of rights is of the essence for the scrutiny of bleedouts. It allows the trustee to avoid fraudulent transactions and conveyance (Section 548).

2.1.1. Preconditions of civil liability

In order to avoid the transaction certain preconditions are necessary: (1) the insolvency took place; (2) there was a transfer of assets.

There are several tests in order to establish insolvency. The UFCA establishes the hybrid test, i.e. comparison of the "present fair market value of the debtor's assets with the amount the debtor will need to pay his probable liability on debts as they mature."[48] According to § 2 of the UFTA a debtor is insolvent "if the sum of its debts is greater than that of its assets at a fair valuation."[49] Moreover, in § 2 (b) of the UFTA contains provision that a debtor who is not paying its debts at the date of its mature is insolvent. In fact the creditor needs to present evidence that the debtor is not paying its debts at a due date. The burden of proving that there is no insolvency lies on debtor. The Bankruptcy Code includes the equivalent balance sheet test.

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[46] Adler, Barry E. *Cases, Problems, and Materials on Bankruptcy.* 4th ed. University Casebook Series. New York: Foundation Press Thomson/West, 2007, p. 275
[47] § 544 11 U.S.C.(accessed on March 29, 2012) http://www.law.cornell.edu/uscode/text/11/544
[48] Tabb, Charles Jordon. *Bankruptcy Law: Principles, Policies, and Practice.* Cincinnati, Ohio: Anderson Publishing Co, 2003, p. 328
[49] § 2 of the UFTA, p. 8 (accessed on March 12, 2012) http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.pdf

In practice the fraudulent transfer may take different forms, e.g. formation of a one-man corporation or transfer with the price below its market value. Acts on fraudulent transactions elaborated two general terms – "transfer" and "conveyance". The 11 U.S.C. § 101(54) contains a number of examples what should be regarded as "transfer". This definition is questionably broader than the definition of "conveyance" contained in UFCA. Under the UFCA (§ 3) there is a difference between fair consideration "needed for an absolute transfer and that needed for a security transfer."[50] The most descriptive definition is given in UFTA (§ 1(12)):

> *"Transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance.*

To conclude both transfer and convenience are actions aimed at transaction of assets that includes monetary obligations.

2.1.2. Fraudulent intent

The intent of transaction is the core element that should be proven in order to find the company liable for fraudulent bankruptcy scheme. According to Section 548 of the Bankruptcy Code "The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition."[51] From the wording of the section the avoidance power shall take place if (A) actions were made with actual intent "to hinder, delay or defraud creditors", (B) (i) the transaction was made for "less than a reasonably equivalent value" and (B) (ii) [52]:

> *(I) "The debtor was insolvent or became insolvent as a result of the transaction;*
> *(II) The debtor was engaged in business and the debtor's capital remaining after the transaction was unreasonably small for that business; or*
> *(III) The debtor intended to incur debts beyond his ability to pay them as they matured.*

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[50] Ibid. No. 48, p. 329
[51] § 548 11 U.S.C.(accessed on March 29, 2012) http://www.law.cornell.edu/uscode/text/11/548
[52] *Civil Recourse Manual No. 57* (accessed on March 29, 2012) http://www.justice.gov/usao/eousa/foia_reading_room/usam/title4/civ00057.htm

It is common to call the possibility stipulates in Section 548 (1)(A) as an actual fraud and Section 548 (1)(B) – constructive fraud.[53] Moreover similar provisions can be found in UFTA and UFCA.

2.1.2.1. Actual Fraudulent Intent [Section 548 (A) (1) USC; UFTA § 4 (A) (1): UFCA § 7]

There are 2 preconditions to apply Section 548 (A) (1): transfer should take place within one year of bankruptcy, and with actual intent "to hinder, delay or defraud". Consequently the trustee should proof these two elements. If the question of the one year requirement is easy to define, the intent to "to hinder, delay or defraud" is difficult to determine.

The standards for establishing actual intent have scarcely changed since the statue of 13 Elizabeth (1570). The courts relay on so called "badges of fraud" in order to establish the fraudulent intent of the debtor. Though "badges of fraud" in fact are combinations of circumstances and facts a number of badges are widely acknowledged as indications of fraudulent intent.[54]

One of the first cases that summarized the badges of fraud was *Twyne's Case*[55] where the court found the transfer fraudulent and established a number of circumstances that indicated it.[56]

- *the gift was general, of all property;*
- *[the debtor] retained possession of the property supposedly transfers and treated it as his own;*
- *the transfer was made in secret;*
- *the transfer was made while C's suit was pending against [the debtor];*
- *Twyne held property in trust for [the debtor];*
- *the deed contained a recital that the gift was bona fide.*

The nowadays standard for Section 548 (A)(1) applicability is that the intent to hinder should be proved by clear and convincing evidence.[57] On the basis of later cases and provisions of UFTA and UFCA it is possible to determine some extra badges:

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[53] Stumvoll, Erica. "Avoidance of Transfer: Section 548." *Emory Bankruptcy Developments Journal* 3, (January 1, 1986): 389. *LexisNexis Academic: Law Reviews*, EBSCO*host* (accessed March 18, 2012).
[54] Ibid. No. 48, p. 395
[55] *Twyne's Case* 3 Coke Rep. 80b, 76 Eng. Rep. 809 (Star Chamber 1601)
[56] Idem.
[57] *In re Metro Paper, Inc.*, 8 B.C.D. 1027 (Bankr. D.D.C. 1982)

- transfer to a family member or another "insider"
- transfer without consideration
- transaction for less then full consideration
- insolvency of the debtor at the time the transfer was made.[58]

One of the most important indications of fraudulent intent is insufficient or inadequate consideration for the transfer. In case *In re Marcus*[59] the court held that "valuable property had been gratuitously transferred for inadequate consideration (for less than fair market value); and, therefore, a presumption arose that such transfer was accompanied by actual fraudulent intent."[60]

The circumstantial evidence that indicates the fraudulent intent of the debtor is still the same: the adequacy of consideration and possible relations between the debtor and other third parties.

2.1.2.2. Constructive fraud [§ 548 (a) (2) U.S.C. 11]

The next step in evolution of fraudulent bankruptcy law was made by enacting § 548 (a) (2) U.S.C. 11. According to this section no proof of actual fraudulent intent is necessary. There are two distinct principles on which the constructive fraud is based. First, constructive fraud is used in order to substitute the actual fraud in case where the actual intent is hard to prove[61]. The second justification for constructive fraud is that the nature of certain transactions is harmful.. Such transfers are questionable, and should be set aside. In fact constructive fraud is a "form of strict liability designed to redress creditor injury."[62]

Prof. Tabb elaborated three forms of constructive fraud:[63]

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[58] See: *Shapiro v. Wilgus* 287 US 348 (1932); *Alan Drey Co. v. Generation*, Inc. 22 III App. 3d 611, 317 N.E. 2d 673 (1974); *Dean v. Davis* 242 U.S. 438 (1917)
[59] *In re Marcus 45 Bankr.* 338 (S.D.N.Y. 1984).
[60] Ibid. No. 43
[61] Ibid. No. 48, p. 406
[62] Idem.
[63] Idem.

1. A transfer in exchange for less than reasonably equivalent value by a debtor who is insolvent or who is rendered insolvent by the transfer[64].

2. A transfer in exchange for less than reasonably equivalent value by a debtor with unreasonably small capital remaining after the transfer.[65]

3. *A transfer in exchange for less than reasonably equivalent value by a debtor who is about to incur debts beyond the debtor's ability to pay as they mature.* [66]

The amount of consideration for the transaction is determinative in constructive fraud applicability. In fact all statutes require the transaction to have fair consideration and reasonably equivalent value.

"Fair consideration" is determined in the UFCA and includes good faith as well as fair equivalence. The U.S.C. 11 and the UFTA remove the requirement of good faith, and use the term "reasonably equivalent value."[67] The term "value" means "property, or satisfaction or securing of a present or antecedent debt of the debtor."[68] It is determined at the date of transfer; subsequent valuation or reduction in value is irrelevant. "Reasonably equivalent value" is determined by market conditions.[69] Though all three acts are similar the section § 5 (b) UFTA contains a separate type of constructive fraud, i.e. a preference to an insider.

To summarize civil fraudulent bankruptcy regulation consists of different statutes both in its nature and level of application (federal and state). Even though there are a number of discrepancies the majority of provisions contained in the Bankruptcy Code, the UFTA and the UFCA overlap. The successful applicability of the law is also based on evolutionary progressive development of provisions and the right of the courts to use all available legal means in interpretation of the debtor's conduct.

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[64] See: 11 U.S.C. § 548 (a)(2)(A) & (B)(i); UFCA §4; UFTA § 5a
[65] See: 11 U.S.C. § 548 (a)(2)(A) &(B)(ii); UFTA § 4(a)(2)(i); UFCA § 5
[66] See: 11 U.S.C. § 548 (a)(2)(A)& (B) (iii); UFTA § 4 (a)(2)(ii); UFCA § 6
[67] Ibid. No. 23, p. 324
[68] See: *Bustamonte v. Johnson*, 934 F.2d 662 (5th Cir. 1991); *In re Linen Warehouse, Inc.*, 100 B.R. 856 (Bankr. W.D. Tx. 1989); *In re Still*, 124 B.R. 24 (N.D. Tx. 1991), aff'd, 963 F.2d 75 (5th Cir. 1992)
[69] See: *In re Ozark Restaurant Equipment Co.*, 850 F.2d 342 (8th Cir. 1988)

2.2. CRIMINAL REGULATION OF BANKRUPTCY FRAUD IN THE USA

Criminal provisions of the US bankruptcy frauds are contained in the U.S.C. Title 18.[70] The U.S.C Title 18 is aimed at prevention and redress of abuses of the civil system. The importance of the bankruptcy crimes was highlighted by the US Congress decision aimed at criminalization of abuse in the bankruptcy system. Furthermore in a landmark case *United States v. Shapiro* the court ruled "The object of Congress in passing this criminal statute was to punish those debtors who, although wanting relief from their debts, did not want to surrender what property there was to creditors."[71] Hence, in order to address the issue of bleedout as a criminal offence this section of thesis concentrates on 3 bankruptcy crimes that constitute the "heart" of the fraudulent scheme. First, the analysis of the concealment of assets (18 U.S.C. §152 (1)) is presented, followed by the fraudulent pre-bankruptcy transfers (18 U.S.C. §152 (7)) examination. The last section of this part deals with bankruptcy fraud (18 U.S.C. §157).

2.2.1. Concealment of assets: 18 U.S.C. § 152 (1)

Concealment of assets is regarded as the most common bankruptcy crime. According to 18 U.S.C. § 152 (1) "A person who - knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor."[72] The primary objective of U.S.C. § 152 (1) provision is to prevent and punish debtor's efforts to avoid concealment of his bankruptcy estate.[73] The common objectives of concealment are: 1) to hide the failure "to disclose an asset

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[70] United States Code, Title 18 (accessed on March 29, 2012) http://www.law.cornell.edu/uscode/text/18
[71] *United States v. Shapiro*, 101 F.2d 375, 379 (7th Cir.), cert, denied, 306 U.S. 657 (1939)
[72] § 152 (1), 18 U.S.C. (accessed March 28, 2012) http://www.law.cornell.edu/uscode/text/18/152
[73] *Stuhley v. Hyatt* 667 F.2d 807 (9th Circ.): Bankr. L. Rep. P 68,588 (1982)

during a bankruptcy case" and 2) to defraud creditors.[74] In practice both goals are succeeded by single actions.

In order to apply U.S.C. §152 (1) it is necessary to proof four elements of this crime: (1) a concealment (2) which is knowing and fraudulent (3) of property of the estate of a debtor (4) in a bankruptcy case.

The wording of the section on concealment has not been substantially changed since the previous Bankruptcy Act of 1898. Therefore, the definition of concealment made by courts under the 1898 law as well as the interpretation of the section is still applicable. Under the provisions of the Bankruptcy Act 1989 concealment was defined as "secreting, falsifying, and mutilating."[75] In *United States v. Mathies* case the court determined that concealment also take place when "hiding or withdrawing from observation, or covering or keeping from sight." [76]

According to the current law provision concealment includes "any actions that impede a bankruptcy trustee's ability to distribute assets of the debtor to the debtor's creditors."[77] This definition is broad, and conduct defined under prior law as concealment also falls under the modern provision.

Intent is the core element of this crime. The court should find that the concealment was "knowing and fraudulent". If the concealment was accidental or took place due to innocent mistake then there is no intent and consequently no crime. In case the concealment was not accidental, the knowing and willful intent is presumed. Intent to deceive is considered as fraudulent.[78] An intent to defraud the bankruptcy court or hinder the bankruptcy proceeding is not required.[79]

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[74] Ibid. No. 2, p. 29
[75] See: *Coghlan v. United States*, 147 F.2d 233 (8th Cir. 1945); *US v. Schireson*, 116 F.2d 881, 884 (3rd Cir. 1940)
[76] *United States v. Mathies*, 203 F. Supp. 797 (W.D.Pa. 1962)
[77] Ibid. No. 2, p. 28
[78] *United States v. Diorio* 451 F2d 21,23 (2nd Cir 1971))
[79] Ibid. No. 2, p. 30

The problem with intent can arise in case when the debtor transfers some assets in the period between trustee appointment and the date when the court order on this issue take effect. If the transaction is within ordinary course of business no fraudulent intent presents. However if the only purpose of transfer is "to keep funds or assets away from the trustee's administration" the § 152 (1) is applicable.[80]

Assets concealed should constitute the property of debtor or a bankruptcy estate. The value of concealed property is not significant. It is not always clear, however, what should be determined as a property within the meaning of the § 152 (1). According to 11 U.S.C. § 541 (a) "property of the estate" should be interpreted as "all legal or equitable interests of the debtor in property as of the commencement of the case."[81] Consequently legal title is not determinative. In *United States v. Goodstein*[82] the court found that "the change of control of the debtor as being an indirect disposition, i.e. functional equivalent of transfer of property of the debtor."[83] Consequently as it was correctly pointed out by Stephanie Wickouski the definition of the "property of the estate" for criminal purposes is expanded by the courts.[84]

Another side of the "property" problem is whether the debtor should disclose the assets in case when there is some degree of uncertainty whether the property constitutes the "property of the estate" or not. The courts are not unanimous on that issue.[85] In United States v. Collins the court stated that uncertainty of the legal title of the property and the subsequent omission of this asset in the schedule can not be regarded as fraudulent and knowing. In United States v. Cherek the court took the opposite position: even if the ultimate court decision will find that assets do not constitute the "property of the estate" the debtor ought to disclose the existence of assets. Neither current Bankruptcy Code nor common law determines which position is

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[80] Idem., p. 31
[81] § 541 (a), 11 U.S.C. (accessed on March 29, 2012) http://www.law.cornell.edu/uscode/text/11/541
[82] *Unites States v. Goodstein*, 883 F.2d 1362 (7th Cir. 1989)
[83] Ibid. No. 2, p. 29
[84] Idem.
[85] See: *United States v. Collins* (424 F. Supp. 465 (E.D. Ky 1977); *United States v. Cherek* 734 F2d 1248 (7th Cir. 1984)

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preferable. Stephanie Wickouski suggests that "a good faith belief that the assets at issue were not the property of the debtor or the estate will likely negate intent."[86]

To conclude bankruptcy concealment is a broad term that in fact can cover the majority of fraudulent transactions made prior and during the bankruptcy proceeding. It is frequently used by courts as an affective measure of fraudulent schemes elimination.

2.2.2 Fraudulent pre-bankruptcy transfers: 18 U.S.C. §152 (7)

Under 18 U.S.C. §152 (7) a person who is "in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation." There are 3 elements of the crime: (1) subject of liability, (2) intent of the defendant, and (3) action (transfer or concealment).

According to this article the subject of liability is a director, agent or officer, or employee acting on behalf of debtor's corporation, though no actual authority to act on behalf of the corporation has to be proved.[87]

The courts determine the term "transfer" by applying both the 11 U.S.C. § 101 (54) and § 152 (7) of the Bankruptcy Code. Though the definitions given in these acts are not coextensive they do have common characteristics. According to 11 U.S.C. § 101 (54)transfer is regarded as "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with - (i) property; or (ii) an interest in property." The courts interpret the term "transfer" extensively. It includes creation of a lien, retention of title as a security interest, lease, and foreclosure of a debtor's equity of redemption, sales. Different payments (grants, gifts) as

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86 Ibid. No. 2, p. 33
87 Ibid. No. 2, p. 63

well as contract termination, license revocations or suspensions also fell under the definition of transfer[88].

The conduct ought to be in contemplation of a bankruptcy case or with the intent to defeat the Bankruptcy Code provisions (Title 11 U.S.C.). Contemplation of a bankruptcy case in fact means that the concealment of property should be connected with bankruptcy case. In US v. Micciche the court found that the mere "knowledge of financial problems of the debtor, and the potential for an eventual bankruptcy" was enough to establish contemplation.[89]

The interpretation of the crimes that fall under "the intent to defeat the Bankruptcy Code provisions" is identical to § 152 (5). The meaning of the term "conceal' is equal to the meaning of the same term according to §152 (1). The two major differences existing between the articles §152 (1) and §152 (7) are (1) §152 (7) does not require the property of the property "belonging to the estate" to be involved and (2) §152 (7) requires the intent of the party to defeat the provisions of title 11" or "in contemplation of a case under title 11."

The landmark case where the court highlighted the difference between §152 (1) and §152 (7) was *United States v. Moody*[90]. Moody was a general partner in a partnership. He created the trust to which he transferred his interest in the estate belonging to the partnership. Within one year after transaction he filed a bankruptcy petition. The information on the time of transfer was not disclosed. Eventually Moody received certain profits form the transfer that was not disclosed. Both articles were applied. Regarding §152 (1) Moody's defense was based on the argument that the proceeds was the property of trust but not the property of the estate. The §152 (7) argumentation addressed the scope of this section. Moody argued that it involves only pre-petition conduct that involves the property of debtor (not the estate). The court found that §152 (7) applied to both pre-petition and post-petition actions of the debtor. The term

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[88] Idem., p. 64
[89] Idem.
[90] *United States v. Moody* 485 F.2d 531 (3rd Cir. 1973)

"property" used in the section is broader than "property belonging to the estate of a debtor" in §152 (1). The interpretation of the court was based on the wording of the section. The word "or" between the phrases "in contemplation of a case under title 11" and "with intent to defeat the provisions of title 11" means that both pre-petition and post-petition conduct falls under §152 (7).

The court decision was criticized for the analysis of section §152 (7) within the circumstances of the case. In fact the profit that was received by Moody from the sale of the estate constituted, first, "a distribution of his share of the partnership's share of proceeds from the sale". Due to the fact that it is a profit from the estate property it will form the property of the estate. The second part of the fund was composed of "a distribution of his share of the trust's share of proceeds from the sale." It may be both – the property of the estate or an exemption form it, i.e. "his property" within the meaning of the §152 (7).

To conclude §152 (7) is a powerful instrument for prosecution of the illegal conduct both before and after the filing of the bankruptcy petition.

2.2.3. Bankruptcy Code: 18 U.S.C. §157

According to section 18 U.S.C. §157

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--

1. *files a petition under title 11;*
2. *files a document in a proceeding under title 11; or*
3. *makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title, shall be fined under this title, imprisoned not more than 5 years, or both.*

This section is applicable to any fraudulent conduct that takes place after October 22, 1994. Bankruptcy fraud is a class D felony and is punished by up to five years imprisonment, a

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fine of up to $250 000, or both.[91] This section addresses he use of bankruptcy filing in order to devise or with the intent 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." In fact the wording of the section is broad. It involves any offence connected with bankruptcy case including civil frauds. The purpose of the section is to punish the use of a bankruptcy procedure itself for fraudulent purposes or to address the fraud connected with bankruptcy case. The fraud within the bankruptcy procedure does not fall under the article. Furthermore the actual bankruptcy filling is not necessary. "Making a fraudulent misrepresentation, as part of a fraudulent scheme, that a bankruptcy case was filed or is pending, is also prohibited by § 157."[92]

Typically the scheme is aimed at "delaying creditors, allowing the debtor to continue to operate or covering up the scheme."[93] Bustout as well as skimming are common bankruptcy fraud schemes that are regulated by 18 U.S.C. § 157. Under the bustout scheme the company creates a good profile in order to obtain credits. When the inventory is delivered it is immediately soled for the cost unreasonably below the market price. The bankruptcy petition is filed as a take-down phase of the scheme. At the end of the day the proceeds of the transaction are transferred to the affiliate company and creditors are not able to recover its damages. The skimming scheme involves the "commercial real estate context and refers to the diversion of cash flow [...] to another entity controlled by the owner."[94] Usually bankruptcy petition is used in order to stay foreclosure.

According to the wording of the section the specific fraudulent intent is required. Intent to defraud means that the debtor intended to act against the law, i.e. with the intent to defraud or deceive.[95] In *United States v. Frost* "a scheme or artifice to defraud" was determined as "intentional

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91 U.S.C. § 3571 (3) (accessed March 29, 2012) http://www.law.cornell.edu/uscode/text/18/3571
92 Ibid. No. 2, p. 89
93 Ibid. No. 1, p. 4
94 Ibid. No. 2, p. 88
95 Idem., p. 89

deception practiced to induce another to part with property or to surrender some legal right."[96] Defrauding indicates "a departure from fundamental honesty, moral uprightness, or fair play and candid business dealings in the general and business life of the community."[97]

In order to apply § 157 the fraud should constitute the integral part of the scheme to defraud. According to the House Report there is no violation of § 157 if the person did not plan the bankruptcy as part of a scheme in connection with false financial statement and later files bankruptcy statement with the false financial statement. Correspondingly there is no liability under § 157 if "the dissemination of the false information was not part of the fraudulent scheme."[98] Furthermore section does not require the bankruptcy filing be a material part of the fraud.

Under the section the subject of responsibility may be any person even not related to a bankruptcy proceeding. Creditors as well as debtors can be liable under § 157 if they "attempted to collect debts which have been discharged by misrepresenting the facts that a bankruptcy was filed or discharge was entered may be culpable under § 157. Section has been used to prosecute creditors who attempt to collect prepetition debts by including debtors to sign reaffirmation agreements which must be filed and in some instances, approved by, the court to be valid, and then attempting to enforce these agreements despite noncompliance with these requirements."[99]

To conclude US criminal bankruptcy law presents a balanced system that covers the majority of fraudulent actions that can be made by any person involved in bankruptcy case. Moreover criminal law acts in connection with the civil law. As stated in the *United States v. Grant*[100] criminal law equally with the civil law has a mutual purpose to "promotes efficient bankruptcy administration and an equitable allocation of the assets of the debtor."

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96 *United States v. Frost*, 125 F3d 346,371 (6th Cir. 1997), cert. denied, 525 U.S. 810 (1998)
97 *United States v. Van Dyke*, 605 F 2d 220, 225 (6th Cir. 1979).
98 H.R. Rep. No. 103-835 (1994), p.57-58
99 Ibid. No. 2, p. 90
100 *United States v. Grant* 971 F.2d 799,805 (1st Cir. 1992)

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CHAPTER 3: RUSSIAN LAW ON BLEEDOUTS

Russian legislation on bleedouts started to develop only 20 years ago after the collapse of Soviet Union. Absence of bankruptcy regulation eventually led to reception of the US bankruptcy law. However neither practitioners nor businessmen were able to accept and understand the new concept. Furthermore the Bankruptcy regulation was in conflict with the Civil Code and Statutes on company law. The reform of 2002 did not solve the problem. Companies actively use the gaps in the law and conceal the assets within bankruptcy procedures. Bleedout became a mean of financial optimization. This Chapter will scrutinize the current civil and criminal legislation on bleedouts and give the comparative analysis of Russian and US legislation.

3.1. RUSSIAN CIVIL REGULATION OF BLEEDOUTS

Economic crises and inability to use the current legislation on fraudulent schemes in effective way forced the legislators to modify the law. In December, 2008 the Bankruptcy Act (2002) was revised. The Act became pro-creditors and has been aimed at maintenance and increase of the bankrupt estate of the debtor. A new chapter III.1 regulating special ground for transaction avoidance was created.

According to new provisions (§ 61.2 of the Bankruptcy Act) there are 2 types of transactions that can be avoided: (1) avoidance of suspicious transactions; (2) avoidance of transaction aimed at the change of the payments schedule. The first type protects the interests of the "abstract creditor", i.e. bankruptcy estate or all creditors. The second type protects the interests of a definite creditor whose rights are injured.

Before making the separate analysis of the above mentioned types it is necessary to explain the core definition of fraudulent bankruptcy avoidance – insolvency. According to § 2 of the Bankruptcy Act insolvency means nonperformance of monitory obligation due to

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insufficiency of debtor's assets.[101] Insufficiency of assets occurs if the amount of debt exceeds the amount of profits. Consequently Russian Bankruptcy Act as well as the US Bankruptcy Code uses both the balance sheet test and the combined test in order to define insolvency.

3.1.1. Avoidance of suspicious transactions

The precondition of the transaction avoidance is similar to the US law: (1) the transaction should take place and (2) it should be regulated by the Bankruptcy Act. .

The law does not stipulate the definition of the term "transaction". The broad interpretation of the term involves not only civil relations but also actions that are regulated by employment, tax, administrative provisions.[102] According to the narrow understanding of the term, "transaction" means any actions that are undertaken since the court made the decision to establish the supervision over the actions of debtor. All other actions are not regulated by the Bankruptcy Act.

Avoidance of transaction can take place only in case where there is damage to creditors' monitory rights. It can be done by diminishing of the debtor's assets or/ and increase of the debts or by any other conduct that can lead to inability to satisfy the creditors' claims. Common examples of the actions that fall under the scope of the avoidance are pledge, lease of the assets under the unprofitable conditions, and transfer of the property beyond the market value

Moreover the damage to the monitory rights of creditors should be the goal of the transaction. The intent can be both direct and indirect.[103] Following the US practice Russian legislators made certain indication when the transaction is presumably made with the fraudulent intent ("badges of the fraud").

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[101] § 2 of the Bankruptcy Act (accessed on March, 26) http://www.consultant.ru/popular/bankrupt/58_5.html#p1852

[102] Khimichev, Vladimir *Protection of the creditor's rights within bankruptcy.* Moscow: Wolters Kluver, 2005, p. 184

[103] GAvrilova, Alina "Invalidity of transfers within bankruptcy proceedings" *Business and Law* (No. 1 2009), p. 87

The precondition is that at the moment of the transaction the debtor should be insolvent or the amount of the assets is not enough to satisfy the creditors' claims. Cumulatively .at least one of the below mentioned requirements should be met:[104]

- The transaction was gratuitous;
- Assets were transferred towards the affiliate person;
- The amount of transaction forms 20 % or more from the balance value of the company;
- The debtor changed its location without notification of the creditors just before the transaction;
- The debtor concealed its property or falsified the financial reports or any other financial documents;
- After the transaction the debtor was still in possession of the assets.

The badges that are stipulated by Russian law directly correspond the badges of fraud that are elaborated by the case law in the US.

One of the common transfers used within the bleedout scheme is involvement of the affiliate parties. The person is regarded as affiliate in case it has personal or financial interest with the debtor, e.g. the manager of the company that is the member of the board of directors or the supervisory board, chief accountant as well as family members of the above mentioned persons.[105] All transactions between the debtor and affiliate persons are regarded as suspicious and can be avoided.

One of the main differences between Russian and the US regulation of the fraudulent transaction is the knowledge of the creditor on the purpose of the transaction. According to § 61, 2 (2) of the Bankruptcy Act in case where the creditor was not aware of the fraudulent intent of the debtor, avoidance of transaction is impossible.

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[104] Demekhin, Artem "New changes in bankruptcy legislation" *Law and economics* (No. 11 2009)p. 55
[105]Andreev, Sava *Scientific-practical comments of the Bankruptcy Act*. Moscow: Statut, 2003, p. 579

In practice the requirement of the creator's knowledge about the intent is extremely hard to prove. The burden of prove lies on the party that is trying to avoid the transaction. The only proof that can evidence the fraudulent intent is the financial reports of the company that are not easy to obtain.[106] Unfortunately this requirement halts the procedure of fraudulent avoidance and allows the debtor to escape liability.

Section § 62,1 (1) of the Bankruptcy Act allows to avoid transaction that is made below the market value.[107] The requirements of the law are identical to the provision of the U.S.C. and UFTA and determine reasonable value consideration as the market price at the date of the transaction was made.

3.1.2. Avoidance of transaction aimed at the change of the payments schedule.

Section § 61.3 of the Bankruptcy Act regulates a separate type o fraudulent transaction that is aimed to make a preference to one of the creditors over another.

The most common transfer that is regulated by the article is the one that leads to the change of the schedule of payments stipulated in the Bankruptcy Act.

This provision is directly connected with the time when the transaction took place. If the transfer was made within one month before the bankruptcy petition was made then the only possibility of the schedule change is enough to avoid the transaction. However if the transaction was made 6 months prior filing the petition than one of the following circumstances should be proved:

- Transaction caused or may cause the change in the payments schedule
- The creditor that is involved in the transaction knows or ought to know about the insolvency of the debtor. Consequently the knowledge of the creditor is also a necessary

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[106] Samsonova, Anna "Options of assets concealment prevention" *Legal work in financial institution* (No. 2 2010), p. 36
[107] § 62,1 (1) of the Bankruptcy Act (accessed on March 25, 2012) http://www.consultant.ru/popular/bankrupt/58_5.html#p1852

element of the transfer avoidance. According to the official position of legislator stipulation of the good conscience of the creditor would facilitate the stability of the business practice and protection of the bona fide purchasers.[108]

To conclude the latest revision of the Bankruptcy Act was in fact adaptation of the US bankruptcy law. Badges of the fraud were stipulated in law that is essential for Russian Federation legal system that is based on the absence of precedent law. However the law on bankruptcy avoidance of fraudulent schemes is far from being effective. The current legislation does not satisfy the needs of reality. The provision regarding the necessity to prove the knowledge of the creditor regarding the debtor's intent to defraud creditors allows fraudulent schemes. For the purposes of this research it is suggested, first, to abrogate the requirement of creditor's knowledge of the debtor's fraudulent intent. Second, to develop the provision similar to constructive fraud in the U.S.C. and enlarge the list of the badges of fraud.

3.2. RUSSIAN CRIMINAL REGULATION OF BLEEOUTS

Criminal aspect of Russian bankruptcy law is regulated by the Criminal Code of Russian Federation. There are 3 main articles (1) misconduct within bankruptcy procedure (Art. 195); (2) premeditated bankruptcy (Art. 196); (3) fictitious bankruptcies (Art. 197). In fact all three articles are not applied in practice due to the fact that it is difficult to qualify the subject of reasonability as well as the exact fraudulent conduct of the person. In this section the analysis of the above mentioned crimes will be made.

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108 Koraev, Konstantin. "Novels of the bankruptcy legislation: transaction avoidance" *Security of Business* (No. 3 2009), p. 21-25

3.2.1 Misconduct within Bankruptcy procedure (Art.195)

Art. 195 of the Criminal Code of Russia includes two different types that are accordingly stipulated in Art. 195 (1) and Art. 195 (2) of the Statute.

According to Art. 195 (1) illegal action or inaction that cause the large-scale effect within the circumstances of bankruptcy or its foreknowledge is punishable with the fine amounted up to 5oo,ooo rubles, or limitation of freedom up to 2 years, or forced labor up to 3 years, or arrest up to 6 months, or imprisonment up to 3 years and the fine amounted 250,000 rubles cumulatively.

The actus reus of Art. 195 (1) can be in 2 forms.[109] First is the concealment of property in a broad sense. It includes concealment of assets or interest in property, non-disclosure of information about the property (its value, location or any other data), concealment or falsification of financial documentation by the manager or the owner of the debtor company, or by individual entrepreneur in case indications of insolvency are evident.

The second form constitutes a transfer or destruction of assets. Transfer of property by itself cannot cause the damage, unless it is gratuitous payment or unequivalent (below the market value) transaction. Transfer of property under the valid obligation is not covered by Art 195 (1) but fall under Art. 195 (2).[110]

Concealment of property should not be the direct cause of insolvency.[111] However it can cause the increase of the debt. Art. 195 (1) stipulates only the factual or fictitious increase of the assets of the company. The increase of the debts of the company is not governed by any provision of the Criminal Code. The discrepancy of the law is widely used by the companies. It allows to make illegal claims and to acquire the majority vote in creditors' meetings.

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[109] Ibid. No. 42, p. 443

[110] Simbirtceva, Tatyana "When bankruptcy became a crime" 2009, (accessed on March 28, 2012) http://www.lawcollegium.com/article/1261049774.htm

[111] The situation where concealment was the direct cause of insolvency is regulated by Art. 196 that will be analyzed in the next chapter of this paper.

One of the important elements of the article is the circumstances of bankruptcy and its foreknowledge.

Indications of insolvency are stipulated in Art. 2 of the Bankruptcy Act, 2002. Insolvency is established by the commercial court inability of the debtor to perform its obligations to satisfy creditors' claims or make compulsory payments. Hence bankruptcy is connected with the court procedure of its establishment. Art. 195 is applicable only in case where the court decision on bankruptcy proceeding is made.

Foreknowledge of bankruptcy means that the person foresees the possibility and inevitability of insolvency. Foreknowledge is possible in pre-petition period as well as after the court started the bankruptcy proceeding. In fact all action of the management before the court makes the decision to release the management from their duties fall under the regulation of Art. 195 of the Criminal Code.

The subject of responsibility is the manager or owner of the company, or the individual entrepreneur.[112] The intent of the person is necessary. It can be both direct and indirect. Persons that do not fall under the above mentioned criteria can be liable for accompliceship. Their actions should be punished under the articles regulating embezzlement and dissipation.

Nowadays it is common when the management is not facilitating the recovery of the financial situation of the company but rather undertakes actions aimed at transfer of all valuable assets to the new established corporation. Petition for bankruptcy proceeding finishes the fraudulent scheme. As a result company is free from the monitory obligations. There are no assets to satisfy creditors' claims. Art. 195 of the Criminal Code is aimed at punishment of these type of actions. Unclear definition of the insolvency within criminal bankruptcy prosecution as well as problems with qualification[113] makes the application of Art. 195 rare.

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[112] Ibid. No. 43, p. 454

[113] See section 3.2.2. of this paper

3.2.2. Premeditated bankruptcy (Art. 196)

Under the Art. 196 of the Russian Criminal Code predetermined bankruptcy means actions of the manager or owner of the company or individual entrepreneur that lead to knowing and witting inability of the debtor to perform its obligations to satisfy creditors' claims or make compulsory payments.

Actus reus of the crime is the malicious conduct of the person that is aimed at creation or rise of insolvency. The malicious conduct may include transactions aimed at transfer of property, acquisition of the property with low liquidity, sale of property that is essential for business activity, creation of unsecured obligations, or any other transaction that is concluded on unprofitable conditions. Usually the price of transaction is below the market value.[114]

Another type of malicious conduct includes actions of the management of the company, e.g. management does not undertake any action in order to collect receivables.

Creation and rise of insolvency should be punished only in case where the debtor is not able to perform its monitory obligations and these actions caused large-scale damages, i.e. $250 000 rubles.

Rise of insolvency involves actions that take place when the person foresee insolvency or actions that increase the debt however are not the direct cause of the insolvency itself. These actions are similar to actions that are regulated by Art. 195 of the Criminal Code. The problem of qualification occurs. Prof. Inogamova suggests that the rise of the insolvency can be punishable under Art. 196 only in case where the action was made by the person who knowing and witting created the insolvency[115]. Another difference is that Art. 196 regulates the conduct that leads to the insolvency, i.e. due to the actions of the person the solvent company becomes insolvent. Applicability of Art. 195 is possible when the person only foresees the possibility and inevitability of the bankruptcy proceeding.

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[114] Inogamova-Hegaj, Lidia Crimonal law of Russian Federation. Special part. 2004 (accessed on March 29, 2012) http://vse-uchebniki.com/pravo-ugolovnoe/ugolovnoe-pravo-rossiyskoy-federatsii.html
[115] Idem.

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Another problem connected with the applicability of the Art. 196 is uncertainty whether the court decision that establishes the fact of insolvency is necessary. According to the view of Prof. Vologenkina inability of the debtor to perform obligations can be established without the bankruptcy proceeding[116]. This position can be supported by the court practice. Art. 196 is applicable to the entities that are not subject to insolvency proceeding under the Bankruptcy Act 2002, i.e. NGO and public entities. Hence an expert analysis of the financial situation of the company can be enough to start prosecution proceeding under the Art. 196.

The direct intent of the person is also of the essence. The person should knowingly and wittingly undertake actions aimed at inability of the debtor to perform obligations. Moreover it ought to wish and foresee the possibility and inevitability of the large-scale damage.

Motives and goals of the actions are not stipulated by the article. The most common are to escape obligations to pay creditors and to acquire the assets of the company after bankruptcy proceeding below the market value.

On the basis of court practice the premeditated bankruptcy causes the greatest damage to the creditors. Insiders are able not only to transfer the property but also change the schedule of payments by means of transactions with the affiliate companies. Unfortunately the absence of clear rules on premeditated bankruptcy and problems with qualification allows the management of the company to escape liability.

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3.2.3. Fictitious bankruptcy (Art. 197)

The distinctive feature of the article is liability when the bankruptcy from economical point of view) does not take place. According to the Art. 197 fictitious bankruptcy is a situation when manager or owner of the company or individual entrepreneur knowingly and wittingly

[116] Voljenkin, Boris *Crimes in the economic sphere under the criminal law of Russia.* St. Petersburg, 2007, p. 406

make a public announcement of insolvency with the intent to deceive creditors in order to postpone the date of the payment, or to make a discount for payment, or escape payments at all.

The definition of the article was in conflict with the definition of fictitious bankruptcy under the Art. 10 of the Bankruptcy Code 1998 where the fictitious bankruptcy required the bankruptcy petition to the court.[117] Even nowadays there is no uniform attitude towards this issue. According to the prevailing view bankruptcy petition to the commercial court is necessary. Publicity can be also fulfilled in case where the general meeting of creditors sign the decision on the bankruptcy of the company.[118] However a number of scholars believe that the announcement in mass media is enough within the meaning of the fictitious bankruptcy under Art. 197. The later position is based on the general rule of Russian law: the special legal provision prevails on general. That means that the definition given in the Criminal Code has a priority. Public knowing announcement with the intent to deceive creditors is enough to find the person liable under the Art. 197 of the Criminal Code. The court practice does not elaborate the unified position on this matter.

The core element of the article is "fictitiousness" of the bankruptcy. An entity is solvent and is capable to pay debts off. In order to deceive creditors false documentation (balance sheet) is made. The amount of the debt is exaggerated; assets of the company are concealed. Solvency is determined on the basis of balance shit test as well as combined test.

The economical consequence of the announcement is necessary. The person will be liable only in case where the large-scale damage occurred. According to Art 169 of the Russian Criminal Code large-scale damage is the damage that exceeds 250 000 rubles. The damage can be both consequential and the loss of profit.

The intent is the necessary element of the article. The crimes provided for by Article 197 of the Criminal Code of the Russian Federation may be committed only with direct intent. The

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117 Harlamova, Julia *Criminal combat with crimes in economic sphere.* (accessed on March 29, 2012) http://www.pravo.vuzlib.net/book_z793_page_1.html

118 See: Ibid. No. 110

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person should understand that the company is solvent and that making the announcement will defraud creditors and may cause large-scale damage. Moreover the actions of the person should be aimed at postponement of the date of the payment, or discount for payment, or avoidance of obligation to pay.

Nowadays Russian legislation on bleedouts and fraudulent bankruptcy schemes is not effective. Moreover, the criminal law still operates the definition of the old Bankruptcy code that was abolished more than 10 years age. The reforms that are made in this sphere can not be regarded as evolutionary and well though-out. The partial reception of the US law that took place in the civil legislation is not corresponding to the current criminal law. In fact criminal practitioners in order to apply the provision on crimes connected with bribery are not obliged to fallow the civil bankruptcy law. To conclude Russian law should fallow the US bankruptcy model, it should adopt the provisions on constructive fraud and create an effective criminal regulation by establishing new bankruptcy crimes constructions. A special emphasis should be given to the regulation of bankruptcy scheme as a single phenomenon. A possibility of creation a separate law on bankruptcy abuses should be considered.

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CONCLUSION

In each country the purpose of every act on bankruptcy is to create a fair and balanced system of the assets distribution. The bleedout as a bankruptcy fraudulent scheme is directed against the principle of fairness. Huge corporations are using the discrepancy of law in order to conceal the profits and property and escape liability to pay debts. The debate today is how to reduce the impact of bankruptcy fraud.

In both countries Russia and the US there is no rule that would regulate the bleed out as a single phenomenon. There are numbers of civil and criminal provision that separately deals with different bankruptcy abuses. Today the system is not effective where the company wants to conceal all of its assets.

Companies are creating bankruptcy schemes, combination of transactions that allow transferring all the assets and escaping liability for debts. The most sophisticated scheme of our days is known as bleedout. As a result of the research a number of distinctive features of bleed-outs are worked out: (1) involvement of a long life span corporation (2) depletion of assets (3) over long period of time (4) through sophisticated transactions.

Though the US law does not include a separate bankruptcy offence such as bleed out the current provisions can cover all the possible fraudulent actions of the company. The avoidance power of the bankruptcy trustees should be regarded as the achievement of the US legislators in the area of combating fraudulent abuses.

Today the Bankruptcy law of Russian Federation is still in the era of formation. The modern Russian bankruptcy law is characterized as the complicated complex of different statutes with different legal nature. The absence of unified logical legislation allows the companies to abuse the rights and bleed out the assets. Though the civil regulation is similar to the foreign modern patterns the criminal law is far from been perfect. The gaps in law allow the companies to "bleed out" the assets. In order to eliminate it criminal and civil rules should be applied cumulatively. The thesis elaborated a number of suggestions on how to improve the Russian

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legislation on fraudulent transaction, taking the US law as a pattern. A single act should be created.

On the basis of the US experience criminal and civil law should overlap. Criminal law should operate the definitions elaborated in civil law. Whereas civil should cover the situation not regulated by criminal law. The successful applicability of the law is also based on evolutionary progressive development of provisions and the right of the courts to use all available legal means in interpretation of the debtor's conduct.

For the purposes of this research it is suggested, first, to abrogate the requirement of creditor's knowledge of the debtor's fraudulent intent in application of criminal law. Second, to develop the provision similar to constructive fraud in the U.S.C. and enlarge the list of the badges of fraud.

To conclude Russian law should fallow the US bankruptcy model. A special emphasis should be given to the regulation of bankruptcy scheme as a single phenomenon. A possibility of creation a separate law on bankruptcy abuses should be considered.

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