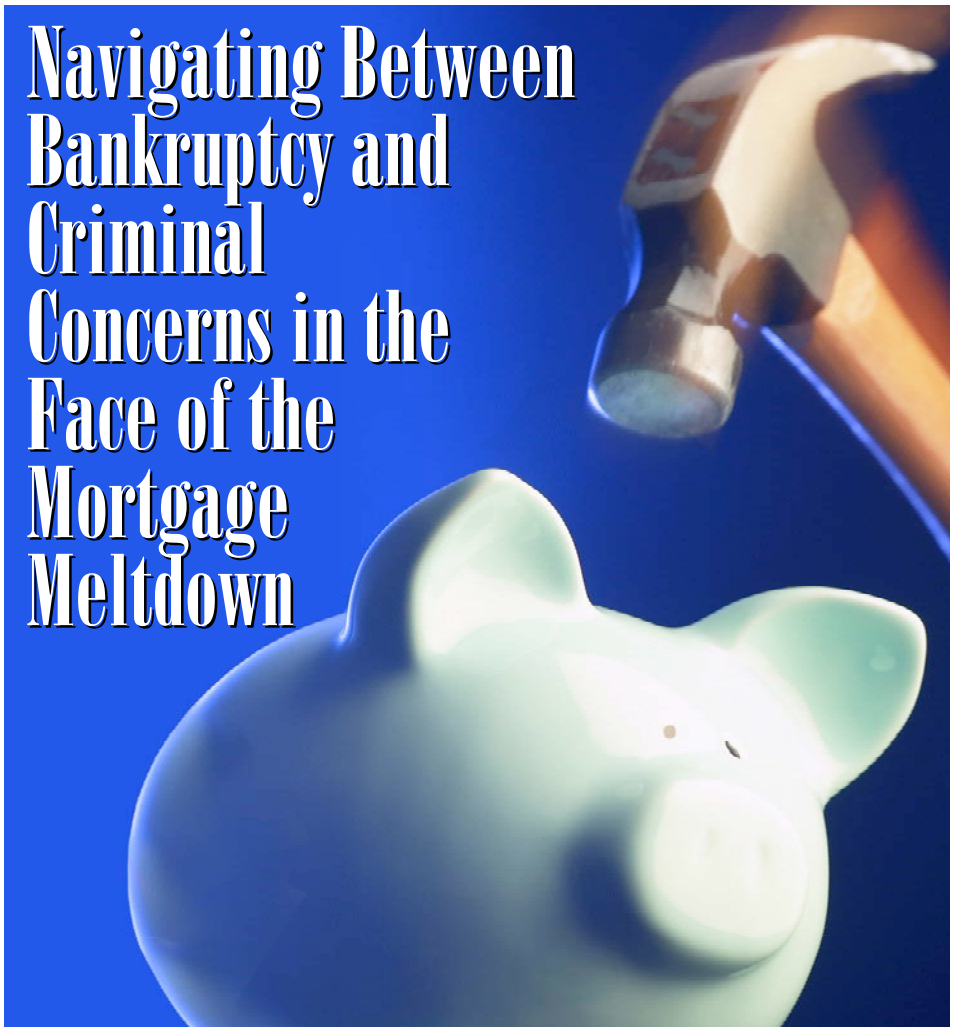
This article first appeared in *Orange County Lawyer* magazine in March 2009, Vol. 51 No. 3 (page 11).

Navigating Between Bankruptcy and Criminal Concerns in the Face of the Mortgage Meltdown



by Steven Jay Katzman

It is often said that if you wait long enough, all fashions eventually come back into style. In the 1980's the fashion was leg warmers, big hair, shoulder pads, pink shirts and power ties. It was also a time of an historic real estate financial crisis, leading to the enactment of new laws (*e.g.*, the Financial Institutions Reform Recovery and Enforcement Act of 1989, or "FIRREA") and creation of new agencies (*e.g.*, the Resolution Trust Corporation).

One of the eventual collateral effects of this financial crisis was the filing of numerous corporate and individual bankruptcies. In the aftermath of the same, I was working in the Major Frauds Unit on the Bankruptcy Fraud Task Force for the United States Attorney in the Central District of California. At the time it seemed that nearly every real estate related prosecution, one way or another, found itself intertwined with a bankruptcy case.

With the current implosion of the real estate market, it appears we are reliving the 1980s, but on a much larger scale. Once again, we are at the crossroads of a dramatic increase in parallel criminal prosecutions and bankruptcy cases. The Department of Justice has set its sights on the aftermath of the real estate financial crisis, announcing the creation of a number of mortgage fraud related task forces and dramatic increases in the number of agents dedicated to the investigation of white collar fraud. It is quite likely that, by the time this article is published, Congress will have passed or would be contemplating new legislation, akin to FIRREA, creating new agencies and dedicating more resources to deal with the crisis.

Accordingly, drawing from an updated playbook from the last real estate crisis, along with some songs reminiscent of the era, the following is a summary of some of the issues that civil practitioners should keep in mind when facing parallel criminal/bankruptcy proceedings. This is just a summary of some of the potential issues; it is impossible to list all possible concerns, let alone discuss them at any length.

"I Fight Authority, Authority Always Wins"

John Cougar (as he was known back in the day) clearly makes the point that authority usually has a way of winning. This should be of significant concern to practitioners with cases involving defaulted loans containing misrepresentations concerning net worth, income, employment, occupancy, appraised value of the acquired property, and the like. Each of these misrepresentations can rise to the level of criminal conduct.

The government's arsenal includes numerous potential statutory offenses that can be charged in connection with a real estate related fraud. The statutory offenses most commonly seen in a criminal prosecution are False Statement to a Federally Insured Federal Institution (18 U.S.C. § 1041), and Mail, Wire and Bank Fraud (18 U.S.C. §§ 1041, 1341, 1343, 1344, respectively). These statutes carry with them stiff potential penalties (30 years imprisonment, $1 million in fines) and the possibility for both forfeiture and restitution. Depending upon the nature of alleged criminal conduct, these can be combined with ensuing tax fraud, money laundering and bankruptcy fraud charges.

One of the common misconceptions shared by many civil practitioners relates to the elements of a criminal offense for bank fraud. Unlike civil fraud, in which the plaintiff must generally establish reasonable reliance, there is no corollary requirement to the elements of a criminal case. The test becomes one of intent; the fact that the lender representative may have known of the fraud does not vitiate criminal responsibility for the same. (*United States v. Knapp*, 73 F.3d 1470, 1488-89 (9th Cir. 1995) (proof of bank's reliance is not an element of submitting false statement to lending institution and, therefore, complicity of bank officers is no defense), *cert. denied,* 518 U.S. 1020 (1996).)

"The Promise"

When in Rome, a one-hit wonder band in the 1980s, was willing to make "The Promise" publicly. But when faced with a potential criminal prosecution, legal practitioners need to evaluate whether their client should be willing to

potentially create inculpatory evidence by testifying under oath.

The Fifth Amendment privilege extends to bankruptcy cases. (*In re Marrama*, 331 B.R. 10, 16 (D. Mass. 2005) (citing *In re McCormick*, 49 F.3d 1524, 1526 (11th Cir.1995)), *aff'd* 445 F. 3d 518 (1st Cir. 2005).) Similarly, the bankruptcy code provides that a discharge cannot be revoked simply for refusing to respond to a material question, approved by the court, on the grounds of a properly invoked privilege against self-incrimination. (*See* 11 U.S.C. § 727(a)(6)(C).)

However, while bankruptcy litigants may properly invoke the privilege, the trier of fact is equally free to draw adverse inferences from the invocation. (*Baxter v. Palmigiano,* 425 U.S. 308, 318-19 (1976); *Securities and Exchange Commission v. Colello*, 139 F.3d 674, 677-78 (9th Cir. 1998); *In re Bartlett*, 154 B.R. 827, 830 (Bankr. D.N.H. 1993) (noting that "adverse inferences may be drawn at the summary judgment stage as well as at trial").) In fact, "a court is empowered to do more than simply draw adverse inferences; in appropriate cases it may strike pleadings, bar evidence and even rule against a party based upon that party's refusal to testify." (*In re National Audit Defense Network*, 367 B.R. 207, 216 (Bankr. D. Nev. 2007).)

According to the court in *In re Curtis*: "The invocation of the Fifth Amendment privilege, standing alone, is not sufficient evidence to constitute probative proof." (177 B.R. 717, 720 (Bankr. S.D. Ala. 1995).) Rather, the adverse inference may only be drawn when there is independent evidence establishing the fact to which the party refuses to answer. The practice has evolved to the point that the only sure way to assert the privilege is on a question-by-question basis. (*In re National Audit Defense Network*, 367 B.R. at 216-17.) As a result, bankruptcy courts have taken different approaches based upon the specific facts of each case. (*Compare In re Nat'l Audit Defense Network*, 367 B.R. at 217-18 (drawing adverse inference on fraudulent conveyance actions against debtor's principals) *with In re Carp*, 340 F.3d 15, 23-24 (1st Cir. 2003) (affirming bankruptcy court's refusal to draw adverse inference based upon debtor's invocation of privilege during discovery in revocation action) and *In re Cunningham*, 365 B.R. 352, 362-63 (Bankr. D. Mass. 2007) (declining, in non-dischargeability action, to draw adverse inference from defendant's invocation of privilege where no other evidence existed to support claim).)

Additionally, bankruptcy courts have held that the debtor's invocation of the privilege may constitute grounds for dismissal of the bankruptcy case where the invocation precludes fair and effective administration of the debtor's estate. (*In re Pelko*, 201 B.R. 331, 333-34 (Bankr. D. Conn. 1996); *In re Wincek*, 202 B.R. 161, 167-68 (Bankr. M.D. Fla. 1996*), aff'd,* 208 B.R. 238 (M.D. Fla. 1996)*; In re Abbas*, 2007 WL 4556665 at *8 (Bankr. E.D. Va. Dec. 20, 2007) ("It is questionable whether a debtor can ever obtain confirmation of a chapter 13 plan while claiming the Fifth Amendment privilege").) Similarly, courts have refused to dismiss the case where invocation of the privilege has not affected the trustee's ability to administer the bankruptcy estates. (*In re Blan,* 239 B.R. 385, 397-98 (Bankr. W.D. Ark. 1999).)

The foregoing discussion illustrates the need to closely examine the Fifth Amendment interests implicated by the case and whether they can be protected without inviting an adverse inference in a non-dischargeability or revocation action, or otherwise preventing the trustee from effectively administering the case. It is a difficult course to navigate, one largely dependent on the particular facts of the case and requiring deliberate forethought of the countervailing risks.

"Should I stay or should I go?"

More than the title of a hit song by *The Clash*, it is also the first question that practitioners should ask when faced with a scenario that either implicates the client's prospective Fifth Amendment rights or raises the risk of dismissal of the case and/or revocation of the discharge. Specifically, should you petition the court for a stay of the civil proceeding pending the outcome of the criminal proceeding?

Within the Ninth Circuit, the leading case discussing this issue is *Keating v. Office of Thrift Supervision* (45 F.3d 322 (9th Cir. 1994), *cert. denied*, 516 U.S. 827 (1995)), where Keating appealed an administrative judge's refusal to stay proceedings in which the Office of Thrift Supervision sought to ban Keating from the federally insured banking industry and force him to pay restitution. The Ninth Circuit affirmed the ruling, noting that a court may decide in its discretion to stay civil proceedings when the interests of justice require it. The Court further noted that the decision over whether to stay civil proceedings in the face of a parallel criminal proceeding should be made in light of the circumstances and the competing interests at issue in the case, evaluating (i) the extent to which the defendant's Fifth Amendment rights are implicated; (ii) the plaintiff's interest in proceeding expeditiously with the civil litigation and the potential prejudice to the plaintiff of a delay; (iii) the burden on the defendant; (iv) the convenience to the judicial system; (v) the interests of persons not parties to the civil litigation; and (vi) the public interest in the pending civil and criminal litigation. (*Keating*, 45 F.3d at 324-25.) The case for a stay is strongest where the defendant has already been indicted, as recently noted by the courts in *Chao v. Fleming* (498 F. Supp. 2d 1034, 1037-38 (W.D. Mich. 2007)) and *In re Worldcom, Inc. Securities Litigation* (2002 WL 31729501, at *4 (S.D.N.Y. Dec. 5, 2002) (granting stay where defendants were under indictment for essentially the same conduct that was the basis of the civil action)).

A defendant sometimes may wish to continue civil proceedings, as when Fifth Amendment rights are not implicated and the civil discovery process may lead to the gathering of evidence that would not otherwise be available in the context of a criminal proceeding. Because of the potential strategic advantage created by the parallel process, the government also may seek a stay of civil proceedings where it appears that criminal defendants are using the broad civil discovery rules to subvert the more restrictive criminal discovery rules. (*See Campbell v. Eastland*, 307 F.2d 478, 487 (5th Cir. 1962), *cert. denied*, 371 U.S. 955 (1963); *Grubbs v. Irey*, 2008 WL 906246, at *2 (E.D. Cal. Mar. 31, 2008) (noting that courts have been hesitant to permit civil plaintiffs to use the liberal civil discovery procedures to gather evidence to which they might not be entitled under the stricter rules of criminal procedure, thus gaining an otherwise impermissible preview of the government's criminal case).)

"I Heard a Rumor"

If the British rock band *Bananarama*, performers of the 1987 hit single "I Heard a Rumor," were your bankruptcy counsel, could they be compelled to divulge your communications with them to the bankruptcy trustee?

Outside of bankruptcy, the client is the sole holder of the attorney-client privilege. However, the trustee may waive the attorney-client privilege of a corporate debtor with respect to communications preceding the bankruptcy filing. (*Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 351-353 (1985).) Where the debtor is a natural person, the law is less clear. Courts have

distinguished between pre- and post-petition communications, and have given answers ranging from yes to no to perhaps. *In re Eddy* (304 B.R. 591, 598 (Bankr. D. Mass. 2004)) collects cases discussing the issue. *In re Bame* (251 B.R. 367, 376-79 (Bankr. D. Minn. 2000)) adopted a balancing test that weighs the trustee's duties to maximize the value of the estate against the policies underlying the attorney-client privilege and the harm to the debtor from disclosure. Other courts have done the same. (*See In re Foster*, 188 F.3d 1259, 1268 (10th Cir. 1999) (holding that determination of trustee's control over privilege should be based on a comparison between the harm to the debtor and the trustee's need for information); *In re Wilkerson*, 393 B.R. 734, 744-45 (Bankr. D. Colo. 2007) (same, noting that in litigation with the trustee, the debtor is in an adversarial posture and substantial harm would accrue to the debtor if the trustee were deemed to be the party in control of the attorney-client privilege).)

The modern trend appears to be to balance the interests on a case-by-case basis, with a trend favoring the individual's interest. Nevertheless, careful practitioners should prepare for the possibility that their communications with the debtor may become subject to discovery. It should also be noted that courts have held that there is no privilege for bankruptcy work papers because they are intended to disclose information in documents publicly filed with the bankruptcy court. (*United States v. White*, 950 F.2d 426, 430-31 (7th Cir. 1991).) However, the rule does not extend to attorney advice provided in connection with preparation of the work papers. (*United States v. Bauer*, 132 F.3d 504, 508-09 (9th Cir. 1997).)

"Our Lips Are Sealed"

As singers of the 1981 hit "Our Lips Are Sealed," *The Go-Go's* may have been willing to enter into a stipulated protective order to seal the testimony of a prospective criminal defendant. But does that order prevent the government from obtaining and using the testimony through a grand jury subpoena? Circuit courts weighing in on the issue have adopted three different approaches.

The Second Circuit employs a balancing test that favors granting the civil protective order "absent a showing of improvidence . . . or some extraordinary circumstance or compelling need." In such circumstances, "a witness should be entitled to rely upon the enforceability of a protective order against any third parties, including the Government." (*Martindell v. Int'l Tel. and Tel. Corp.*, 594 F.2d 291, 296 (2d Cir. 1979).)

Martindell has since been rejected by three other circuits (including the Ninth Circuit), each adopting a *per se* rule that society's interest in grand jury access to all relevant information overrides any countervailing interest in civil discovery. (*In re Grand Jury Subpoena*, 836 F.2d 1468, 1477 (4th Cir.), *cert. denied*, 487 U.S. 1240 (1988); *In re Grand Jury Proceedings*, 995 F.2d 1013, 1017 (11th Cir. 1993); and *In re Grand Jury Subpoena*, 62 F.3d 1222, 1226 (9th Cir. 1995).)

The First and Third Circuits have adopted a modified *per se* rule that provides: "A grand jury's subpoena trumps a Rule 26(c) protective order unless the person seeking to avoid the subpoena can demonstrate the existence of exceptional circumstances that clearly favor subordinating the subpoena to the protective order." (*In re Grand Jury Subpoena*, 138 F.3d 442, 445 (1st Cir.), *cert. denied*, 524 U.S. 939 (1998); *see also In re Grand Jury*, 286 F.3d 153, 162 (3d Cir. 2002).)

Given the Ninth Circuit's position, practitioners in this Circuit should not assume that a protective order will prevent discovery afforded by the grand jury process.

"We are Living in a Material World"

Madonna's 1985 admonition that "we are living in a material world" applies with equal force to today's bankruptcy world as competing interests vie for the few available assets left to make creditors and victims whole.

In an asset-forfeiture proceeding to recover the proceeds of specified unlawful activity or assets used to facilitate the alleged crime, do the government's rights supersede those of the bankruptcy estate? There are two ways in which the bankruptcy estate may assert an interest in the property: directly as the owner, and as a hypothetical judgment creditor or purchaser for value.

The few courts that have addressed the bankruptcy estate's ownership rights have held that, under the relation-back doctrine set forth in 21 U.S.C. section 853(c), the government acquires its interest in the forfeited property at the time of the commission of the criminal acts giving rise to the forfeiture. Accordingly, the government's interest supersedes the bankruptcy estate's rights in the forfeited property. (*United States v. One Silicon Valley Bank Account*, 549 F. Supp. 2d 940, 957-58 (W.D. Mich. 2008); *United States v. Zaccagnino*, 2006 WL 1005042, at *3-4 (C.D. Ill. Apr. 18, 2006).)

However, the analysis may not end there. The bankruptcy trustee may attempt to use the strong-arm powers of a hypothetical lien creditor or bona fide purchaser for value to assert an innocent owner defense to the forfeiture. (*See* 11 U.S.C. § 544(a).) At least one court has questioned the practice, holding that, for the innocent owner defense to apply within the context of a lien creditor, a security interest must be in the specific property sought to be forfeited. (*One Silicon Valley Bank Account*, 549 F. Supp. 2d at 959-60 (citing 18 U.S.C. § 983(d)(6)(A)).)

Moreover, the bankruptcy estate may be able to secure recovery of the assets under a petition for remission or mitigation pursuant to 28 CFR section 9. A petition for remission or mitigation is a request for an Executive Branch pardon of the property, or lack of knowledge of the underlying unlawful conduct. In the case of the violator, it is a plea for leniency. For an estate to prevail on a petition for remission or mitigation, it must establish a legally cognizable interest in the seized property's lien holder. (*See* 28 CFR § 9.5(a)(1).) A lien holder can, under specifically enumerated circumstances, constitute a judgment creditor entitled to remission. (*See* 28 CFR § 9.6(f).)

"Don't Worry, Be Happy"

A number of difficult decisions will be made in the coming years, but practitioners will be ready if they examine each case carefully, balancing the risks of proceeding with the bankruptcy case against the potential development of inculpatory evidence. As long as practitioners are spotting these issues and counseling their clients accordingly, they will make informed decisions on how best to proceed. Besides, as Bobby McFerrin concluded in his song, released in the midst of the 1980s financial crisis: "Don't worry. It will soon pass. Whatever it is."

In the meantime, as I prepare for court, I will put on my pink shirt and yellow power tie, and hope for the return of big hair for my now bald head.

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