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Identifying Fraud, Abuse, and Error in Personal Bankruptcy Filings

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Prepared for the National Institute of Justice



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Executive Summary

The U.S. Trustee Program (USTP) is the component of the U.S. Department of Justice (DOJ) whose mission includes promoting the integrity and efficiency of the bankruptcy system by enforcing bankruptcy laws. Among its responsibilities is identifying fraud, abuse, and error in personal bankruptcy filings. Currently, precise figures on the prevalence of fraud, abuse, and error in personal bankruptcy filings do not exist.

USTP has long been concerned with preventing fraud, abuse, and error, which can undermine the integrity and efficiency of the bankruptcy system. USTP asked the RAND Corporation to assist it in thinking about how to better identify and measure fraud, abuse, and error in personal bankruptcies. Specifically, it asked RAND to conduct research and facilitate discussions by a study group of experts from government, academia, and the private sector to address five questions:

1. Are there any lessons to be learned from how other government programs or the private sector detect fraud and abuse?
2. Are there any transferable processes that USTP can consider adopting?
3. How might USTP develop indicators of fraud, abuse, and error?
4. How might USTP consider estimating the prevalence of fraud, abuse, and error?
5. What future research tasks could USTP conduct to develop data and knowledge that would enable it to more effectively identify fraud, abuse, and error in the bankruptcy system?

The development of improved means for distinguishing and identifying fraud, abuse, and error in personal bankruptcy filings will improve the enforcement of bankruptcy laws in at least two respects. First, acceptable measures of the extent of fraud, abuse, and error are needed to guide decisions regarding the allocation of resources to combating the problem. Second, the ability to identify and measure the extent of fraud, abuse, and error is critical to both the decision to pursue a given type of case and the evaluation of the relative success of different civil or criminal enforcement strategies.

The primary methods that USTP now uses to identify cases of debtor fraud, abuse, or error are as follows:

1. the private trustees' review of case information
2. the field office's review of the case

3. tips from former spouses, former business partners, creditors, and others who could have a grievance with the debtor or who might be offended by the debtor's behavior and misuse of the bankruptcy system
4. debtor audits.

Are There Any Lessons to Be Learned from How the Private Sector or Other Government Programs Detect Fraud and Abuse? Are There Any Transferable Processes USTP Can Consider Adopting?

Data-Enabled Forms

The primary difference between how fraud is identified in the bankruptcy system and how it is identified in the other public- and private-agency systems we examined has to do with the availability of data from which to conduct statistical fraud detection. Research on characteristics of bankruptcy filings is severely limited by the fact that bankruptcy cases are not currently data enabled, though the federal court system is working toward implementation of a data-enabled system. Currently, data cannot be electronically extracted from the cases and entered into a database for analysis. This greatly increases the difficulty and, consequently, the costs of analyses that could illuminate fraud, abuse, and error issues. Acquiring data-enabled forms should be an extremely high priority, as it will allow the bankruptcy courts and USTP to accomplish their missions far more effectively and efficiently.

Private Sector

Various forms of statistical fraud detection have been developed and used over the last two decades by the private sector, primarily by financial institutions such as the credit card industry, insurance industry (auto and health), telecommunication industry, and others. These systems have become increasingly sophisticated in recent years as they have been merged with artificial intelligence research resulting in the development of neural network models. Neural network technology mimics how the human brain would perceive and process information, such as recognizing unusual (perhaps fraudulent) activity. These programs attempt to identify patterns of behavior, compare those patterns with baseline information, and identify anomalies.

Neural networks require levels of electronic information not currently available to USTP due to the lack of data-enabled bankruptcy case filings. The building blocks for developing such systems can be created in the absence of, and in anticipation of, data-enabled forms.

Government Programs

Most of the concern regarding fraud and abuse in government programs is related to procurement and payment systems (e.g., military acquisition programs), which are not areas of concern for USTP. Therefore, this field of literature has little transferable value to USTP. We chose to examine the procedures of three federal agencies that held the promise of offering directly relevant experience—the IRS, the U.S. General Services Administration (GSA), and the U.S. Department of Health and Human Services.

The tax system is probably the most directly applicable to USTP, since it also depends on self-reported financial information. IRS use of discriminant analysis offers a highly promising model for USTP. The IRS uses discriminant analyses to develop a series of weights that are then applied to characteristics of individual returns to assign each return a score that is essentially an estimate of the likelihood that the return is fraudulent.

GSA uses a form of statistical fraud detection by having forensic accountants develop financial profiles and lifestyle analyses to assist in identifying fraud among service providers. Once profiles are set up, service and equipment providers can be compared against these profiles. Those that fall outside the norms may be committing fraud and may require closer inspection. This allows investigative efforts to be more targeted. USTP could create profiles of fraudulent filers based on previous fraudulent cases and then compare incoming cases to the profiles.

Fraud detection in the Medicare/Medicaid system is targeted at providers of professional services and equipment, rather than at the individual, which makes it less relevant to USTP.

How Might USTP Develop Indicators of Fraud, Abuse, and Error?

The ongoing debtor audit project should provide an opportunity to identify characteristics of cases that predict a higher probability of material fraud or abuse. One approach would be to develop a scoring system that ranks the severity of a misstatement in terms of its likely consequences for the dismissal of a case. USTP could have private trustees and field office analysts in each region review the cases from their region in which a misstatement was found to determine whether they believe that the misstatement, if not discovered, would have affected the outcome of the case. Researchers could then perform analyses, such as discriminant analyses used by the IRS, to explore the relationships between various characteristics of the filing and the likelihood that it contained a misstatement that would affect its outcome.

How Might USTP Consider Estimating the Prevalence of Fraud, Abuse, and Error?

If reliable indicators of fraud, abuse, and error can be developed, they can then be used to estimate the prevalence of fraud, abuse, and error by case characteristics, in a given geographical area, and nationally. This could be accomplished in two steps. First, use the indicators of fraud, abuse, and error described previously to define a set of mutually exclusive and exhaustive categories for cases such that the cases assigned to each category share characteristics that predict particularly high, or low, probabilities of fraud, abuse, or error. Second, use the fraud, abuse, and error indicators described previously to estimate the probability of fraud, abuse, or error in the cases in each category. The product of the number of cases in a category, by geographical area or nationally, and the probability of fraud, abuse, or error in cases in that category is an estimate of the number of those cases that include fraud, abuse, or error. Computing these estimates for all categories and weighting them by the distribution of cases across categories in

the geographical area of interest or nationally would yield the relevant estimates of the prevalence of fraud, abuse, and error.

What Future Research Tasks Could USTP Conduct to Develop Data and Knowledge That Would Enable USTP to More Effectively Identify Fraud, Abuse, and Error in the Bankruptcy System?

The research suggestions are broken into two subgroups. The first set of suggestions relates to the debtor audit project currently ongoing at USTP. These audits will provide a platform from which to conduct research into areas related to estimating the prevalence of fraud and abuse and the identification of fraud and abuse. The second set of suggestions would involve instituting new research endeavors and include developing expert systems to screen bankruptcy cases automatically when those cases do go digital.

Ongoing Research: Debtor Audits

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) requires the USTP (or the United States' Judicial Conference in judicial districts served by bankruptcy administrators) to conduct audits of samples of individual Chapter 7 and Chapter 13 filings. The audits are to determine the accuracy, veracity, and completeness of the petitions and supporting documents. At current filing rates, the project is expected to include several thousand randomly selected and targeted cases.

It is highly likely that research using the audits could identify characteristics of a case that are associated with an increased probability of fraud, abuse, or error (*indicators*). These indicators can be used to estimate the prevalence of fraud, abuse, and error and to direct analysts' and trustees' attention to cases that warrant more extensive reviews. A scoring system will need to be developed to distinguish between misstatements that warrant concern and misstatements that reflect inconsequential errors. Analyses could then seek to identify predictors of consequential misstatements.

In considering which cases to prosecute, USTP must consider both the magnitude of the problem in each particular case and the likely deterrent effects of pursuing any particular case. Over time, USTP could use the debtor audits to examine the success of different civil or criminal enforcement strategies in terms of their deterrent effect when brought against one type of fraud or abuse versus another.

Suggested New Research

Estimating the Effects of Analysts' and Trustees' Priorities. USTP field office staff and trustees must examine numerous cases every day. USTP could develop information that will provide field office staff and trustees with guidance as to their priorities in examining cases with various characteristics. USTP could also examine the relationship over time between field office staff and trustee priorities in reviewing various types of cases and prevalence estimates of the incidence of fraud, abuse, and error in the types of cases on which they focus.

Surveys of Field Office Analysts and Private Trustees. Field office staff and private trustees have developed insight and knowledge regarding fraud, abuse, and error in individual bankruptcy cases that have not been formally documented. They have essentially developed implicit useful indicators of fraud, abuse, and error. A more systematic survey of clerks, analysts, and private trustees could be conducted across regions to identify fraud indicators that have proved useful and those that have not. The goal of this research would be to formally document their informal knowledge and understanding to help design a system to identify patterns of fraud or simulate analysts' reasoning.

Developing Expert Systems for Identifying Likely Instances of Fraud, Abuse, and Error. At present, analysts and trustees manually review submitted bankruptcy cases to determine the validity of the information provided in the filing. The development of an expert system to aid in these reviews may significantly enhance their ability to identify fraud, abuse, and error. An expert system contains the knowledge of experts (in this case, the analysts and trustees) organized in the form of rules: "If [condition] then [action]." Experts determine the rules after interviewing the analysts and observing their actions to codify their logic into a set of rules that a computer could execute to offer a determination regarding case approval or disapproval.

Profile Cases Reopened at the Trustee's Request. Trustees occasionally ask the bankruptcy court to reopen a closed case to administer assets. These are frequently cases in which material, undisclosed assets were discovered after the case was closed. Although assets are sometimes overlooked, these cases often involve fraud or abuse. Profiling such cases may identify common characteristics that could be used to develop indicators of fraud, abuse, and error.

Profile Fraudulent Cases. USTP has a history of cases in which fraud has been proven. Such cases could be analyzed to create profiles of fraudulent filers. These profiles and the analyses of them could then be used to help define fraud indicators.

Profile Useful Tips. Tips are a prime source for identifying fraud, but tips are also sometimes mistakes or the result of someone trying to cause trouble for a filer. The outcomes of cases in which tips were received could be analyzed to create profiles of the kinds of tips that are more likely to result in dismissal or a civil or criminal enforcement action.

Follow Up on the Canadian Pilot Programs. The government of Canada is using innovative methods to help detect bankruptcy fraud. Investigation referrals are now being partly referred out to private investigative agents who use forensic accounting, securities fraud experts, and traditional private investigation techniques to uncover malfeasance. Pilot projects are currently under way to experiment with alternative models (public-private partnerships and contracting) to assess required costs and effectiveness. Following up on the effectiveness of these alternative models would be a worthwhile effort.

Explore the Possibility of Electronic Screening of Other Government Electronic Records. USTP might initiate discussions with other government agencies regarding the data they obtain on a routine basis, such as suspicious financial transactions. They could use the findings of the research activities discussed previously to explore the possibility that the data, if available, would be helpful in estimating the likelihood that a case involves fraud, abuse, or error.

Explore the Potential Value of Penalties. USTP could also review the literature on the deterrent effect of monetary penalties across a spectrum of issues to estimate the extent to

which creating penalties, such as exist in the tax system, would create a deterrent to committing fraud, abuse, or errors.

In sum, we conclude that research could be undertaken using the ongoing debtor audit project to assist in estimating the prevalence of fraud, abuse, and error in personal bankruptcy filings. There are several additional profiling and survey research tasks that USTP might undertake to better formalize indicators of suspicious filings or useful tips, ultimately as a precursor to leveraging digital filings through automated screenings for indicators of fraud, abuse, and error in the future.