Bankruptcy fraud and abuse of bankruptcy

Summary of the report ‘Fraude en misbruik bij faillissement’

Introduction

In the beginning of 2004, Dutch media paid attention to the allegedly rising number of cases of bankruptcy fraud. At the same time, the Dutch Parliament was engaged in a debate on moral standards and values. The theme of fraud was one of the elements in this debate. As it was clear that the most recent information on bankruptcy fraud dated back two decades, the Minister of Justice issued research into the current state of affairs. This research was awarded to the Hugo Sinzheimer Institute of the University of Amsterdam. It was conducted in the first half year of 2005.

Problem and context

The functioning of markets on the one hand demands that participants in the market may be held accountable for the obligations they enter into (‘trust’). On the other hand, those that fail in the market are not to be pinned down indeterminately to their failure. Here bankruptcy may be considered a juridical procedure that aims to provide in a settlement of financial disappointment in such a way that the burden of irrecoverable financial claims is distributed equitably and that the bankrupt party may be able to resume economic activity.

The existence of such a procedure, however, also creates a ‘playing field’ for strategic behaviour. Those who master the ‘game’ of insolvency, or even fiddle with its rules, may more or less succeed in bending the distribution of risks to their own benefit. At worst, a company is established with the intention to go into bankruptcy swiftly as a means to generate revenues without having to pay for the costs of the enterprise. Also, illicit withdrawals from the bankrupt’s appropriable property may occur just before or even during insolvency, leaving other creditors empty handed. Part of these illicit acts may be combated by means of civil law, part may be prosecuted as fraud on the basis of criminal law.

Research questions and methodology

In the research, three main questions featured:

1. What is the scope and nature of bankruptcy fraud and abuse of bankruptcy in the Netherlands, notably concerning legal personae (limited companies, foundations)
2. What do the officials and authorities involved do to fight fraud and abuse of bankruptcy, and in what way do they employ the existing resources?
3. To what extent may the current resources be considered adequate, and in what respect may improvements be conceivable?
In order to answer these questions, various methods were deployed. First, at nine legal courts 868 dossiers of bankruptcies were analysed. This analysis yielded information on the nature of these bankruptcies as well as the findings of the receiver concerning possible illegal acts. Second, the researchers gathered existing statistical information on bankruptcy and on enforcement in case of bankruptcy fraud. Third, semi-structured interviews were conducted among various parties involved, such as receivers, magistrates, investigation services, tax authorities and the Employers’ Insurance Implementing Organisation.

Two remarks are in order here. First, as concerns the material on which the research was based, one must bear in mind that not only the nature of the subject (fraud) but also the position of the receiver entails some limitations. Even in the case that receivers may surmise or detect illegal acts on the side of the bankrupt, they may not always confide their findings to the dossier as this may jeopardize their efforts to reclaim assets to the bankrupt’s appropriable property. This may imply underreporting of fraudulent bankruptcies. This presumable underreporting was corrected for by asking for further details from the receivers involved, as well as by using information from the ‘Vennoot’ database from the Ministry of Justice. Notwithstanding these further endeavours, the numbers from the research must for the greater part be considered a lower limit.

Second, in interpreting the dossiers, the qualification of acts of the bankrupt obviously is based upon an assessment by the researchers. In some cases, this assessment is based upon the qualification in the receiver’s report. In other cases, it was based upon a systematic combination of facts and circumstances that made a qualification ‘fraud’ or ‘abuse’ probable. It is important to note, then, that this assessment is a matter of probability rather than a matter of fact. Bearing this in mind, the researchers proceeded with caution applying the adjective ‘fraudulent’ to the cases of bankruptcy.

**Nature and scope of the problem**

The research distinguishes between ‘bankruptcy fraud’ (deliberate illegal acts that damage the creditors of the bankrupt company), ‘abuse of bankruptcy’ (deliberately going bankrupt in order to terminate long lasting contracts, notably to ditch employees), and ‘improper government’ (administrative carelessness and similar shortcomings).

Some 43% of all cases contained indications of one of these three forms of illicit conduct. Nearly one out of four cases contained indications of bankruptcy fraud. In 100 cases (12%), the company could be considered to have been used or even to have been established (16 cases) with the sole purpose of damaging creditors. Also, in a further 112 cases the owner was thought to have illegally withdrawn assets from the appropriable property. In 52 cases, both of these offences were found to have occurred simultaneously. In some 8% of all cases of bankruptcy, bankruptcy fraud may be considered to be a major cause of the state of bankruptcy. In 29 cases this concerned dubious transactions between the (now bankrupt) company and the former director or with a ‘related’ company. Some patterns may be discerned here. For example, a limited company in debt is bought right before going bankrupt, to apparently ‘resolve the problem’ for the former owner in change for a backdoor fee, after which the company is converted into another limited company with a misleadingly similar name which then goes bankrupt after all. Also, a number of companies were established with
the sole purpose of making profit and going bankrupt before the tax authorities or the Employers’ Insurance Implementing Organisation could collect their dues.

‘Abuse of bankruptcy’ was found to be hardly discernible in the cases. To a great extent, this may be attributed to the rather strict criteria used in Dutch legal literature. The main criterion states that one may assume ‘abuse of bankruptcy’ only if the financial position would have allowed for ways of resolving the companies’ problems other than by means of bankruptcy. Most receivers, however, are inclined to almost always consider a ‘technical bankruptcy’ as legitimate or even the only way out in case of economic problems. The burden of long lasting contracts as such was found to be a cause for bankruptcy in only a very small number of cases.

In over 25% of all cases, the receiver had been in touch with candidates for taking over (part of) the appropriable property. Only rarely the company was sold ‘going concern’. In 104 cases (12%) the possibility of a (partial) restart of the company’s activities under a new legal entity was considered. In no more than 23 cases these plans for a restart existed before bankruptcy.

As concerns the third type, ‘improper government’, administrative shortcomings were found in 27% of all cases (if the ‘missing cases’, in which the dossier contained no notes concerning the administration, are excluded this number rises to 36%). In 75 cases the administration was missing altogether. Administrative shortcomings may in some cases be attributed to the hectic of the upcoming bankruptcy, or to negligence or sheer incompetence on the side of management, but it may also be linked with fraudulent acts. This was found in 59 cases.

If the findings of the dossiers are extrapolated to all cases of bankruptcy in the Netherlands, the number of fraudulent bankruptcies may be estimated to be about 760. In 360 of these cases, the bankruptcy is used or even set up for damaging creditors. Some 400 bankruptcies contain illegal acts concerning the appropriable property.

### Fraud and other irregularities in cases of bankruptcy

- **Put up for harming creditors**
- **Used for harming creditors**
- **Illegal acts concerning the appropriable property**
- **Improper government**
- **No irregularities**

**Financial damage**

The average sum of unpaid financial claims of creditors is over half a million Euros. In the cases that the bankruptcy was deliberately set up or used to damage creditors, the average damage was clearly higher (€ 600.000). In fraudulent bankruptcies, it was notably the tax authorities or the Employers’
Insurance Implementing Organisation that were damaged. Extrapolated to all bankruptcies in the Netherlands in 2004, the total damage may be estimated to be about 220 million Euro (being about 0.5‰ of the GNP). The estimated 400 cases of illegal acts concerning the appropriable property should be added to this. However, as it was found to be methodologically impossible to determine the exact damage to be attributed to these illegal acts, the damage of these acts was not added to the total sum of 220 million. This number, then, should be considered the lower limit of the total damage caused by illegal acts in cases of bankruptcy.

**Number of employees involved**

In as far the dossiers contained information on the number of staff of the bankrupt company, is showed that six out of ten companies employed personnel (12 employees average). The number of employees involved in bankruptcies that were set up or used for damaging creditors, totals nearly 600. Extrapolated to all 360 cases in the Netherlands, this would imply nearly 2,400 employees. Furthermore, over 3,000 employees were employed in a company in which illegal acts concerning the appropriable property may be surmised.

**Trends**

It is hard to discern specific trends on the basis of the research. The number of bankruptcies seems to be fluctuating over time, with no clear trend. Analysis of the dossiers does bring to light some statistical relations as concerns the age of the company, branch or legal form, but most of these relations may not be considered statistically significant. Only the construction industry sticks out with an above average number of fraudulent bankruptcies. Also, foreign limited companies and foundations appear to be involved in bankruptcy fraud more than average, but the number of cases was too small to draw solid conclusions. Further research seems to be in place here.

Companies that are a continuation of another company led by the same directors also are associated with bankruptcy fraud more often – but here too the number of dossiers is too limited to draw firm conclusions. The same goes for involvement of directors in previous bankruptcies.

**Role of officials and authorities involved in bankruptcies**

What may the officials and authorities involved in cases of bankruptcy do to prevent or fight bankruptcy fraud or abuse of bankruptcy? First of all, creditors (notably institutional creditors such as banks, tax authorities and the Employers’ Insurance Implementing Organisation) should be alert as concerns the solvability of companies and try to recognise in time if this solvability is falling. Second, if a bankruptcy has already occurred, the receiver and the committing magistrate should avert illegal embezzlement from the appropriable property or, in case this does happen, use their legal powers to return the embezzled assets to the property. Third and finally, the receiver may incite authorities to go into punitive action and authorities may actually prosecute and punish the perpetrator.

**Before bankruptcy**
Directors of limited companies are obliged to timely notify the authorities when they think they can no longer pay their dues. Also, both the Employers’ Insurance Implementing Organisation and the tax authorities have the powers to inspect administrations and to confiscate assets in case of arrears. However, the research shows that these powers to limit the financial damage of bankruptcy are not deployed fully. Still, positive examples of adequate supervision were found in some districts of the above authorities. It is advised that these examples are spread more systematically to other districts.

In bankruptcy
Receivers may gather information on the bankrupt or connected companies, notably with the Chamber of Commerce or the ‘Vennoot’ database from the Ministry of Justice. Many receivers do not use these forms of information though, mostly because they do not want to spare the time or because they are not knowledgeable in this respect. Also, the receiver may gather information with the tax authorities or the Employers’ Insurance Implementing Organisation. This source of information is used even less. If they do contact these authorities, their experiences vary. Cooperation with the Employers’ Insurance Implementing Organisation especially is not considered to be wholly satisfactory.

The receiver has several civil powers at his disposal to prevent or undo embezzlement of assets from the appropriable property. In 71% of the cases in which such illegal acts were noticed by the receiver, the receiver considered to use his powers. In no more than 20% he actually did. The main reason for not taking action is that the receiver had no hopes that the money could be recovered (due to lack of money on the side of the former owner). Another reason is that receivers themselves sometimes hold the opinion that some acts that are legally wrong may be excused as they are intended to accommodate a restart (some receivers also operate as advisors to companies, hence siding with management).

Only in 29 out of the 212 cases that contained indications of bankruptcy fraud, the receiver considered notifying the authorities. In most of these cases (22), he actually did. Still, this implies that only in 10% of all eligible cases the receiver in fact did notify the authorities. It appears from the interviews that most receivers do not trust the police and the judiciary to really take action against bankruptcy fraud. Besides, the police do not really welcome the notifications and receivers themselves consider the notification process too time consuming.

The latter point is all the more pressing, as this time is consumed by the receiver at the expense the appropriable property. If the costs of the receiver’s actions are deemed to outweigh the probable benefits to the appropriable property, the receiver more often than not will decide against taking civil action. Both Ministry of Justice, tax authorities and Employers’ Insurance Implementing Organisation have arrangements to stand surety for the receiver’s expenses, but these arrangements are rarely made use of – according to the dossiers only in 3% of all bankruptcies. The main reason why receivers are reluctant to call on the surety arrangement, according to many of the interviewees, is that the arrangement is too complex, that requests for surety are often being turned down, and that it only pays out in cases in which the appropriable property itself would have harboured enough assets to pay for the expenses after all.

Also, the committing magistrates, that supervise the receiver’s actions, are somewhat more reluctant to support civil actions. On the other hand, the magistrates appear more willing to instigate penal actions. The Employers’ Insurance Implementing Organisation has powers to take civil actions
in case of negligible management, but it seldom uses these powers. Both the Employers’ Insurance Implementing Organisation and the tax authorities deem the receiver to be leading in this respect.

**Prosecution**

The reluctance on the side of the receivers to notify the authorities is closely connected with their own view on their responsibilities. The receiver will, in principle, only take action if this benefits the appropriable property – or at least does not harm its interests. Also receivers bring to the fore that they do not consider themselves to be an instrument of the police or judiciary. A possible obligation to notify the authorities is therefore hotly disputed in the juridical literature.

Despite the aforementioned obstacles, receivers sometimes do notify the authorities (an estimate of 80 times yearly). Also other parties may notify the authorities. In about 35 cases, the judiciary presses charges. About one third of these cases are dropped in the process, some 20 perpetrators are subpoenaed annually – most of which are being sentenced. In sum, only a small number of all cases of bankruptcy fraud end up in a conviction. On a basis of 760 cases of fraud or irregularities, no more than 5% ends up in a criminal procedure. Only 2.5% of all frauds get convicted.

**Bottlenecks**

On the basis of the research, a number of bottlenecks in the fight against bankruptcy fraud may be identified.

1. The fact that the receiver is being paid for his work at the expense of the appropriable property implies that he is also an interested party. If the appropriable property contains little or no assets, and the chances of being paid are correspondingly small, it is rather unattractive to take actions that may yield little earnings. This tones down the receiver’s zest to fight bankruptcy fraud. It may even be in the interest of the appropriable property to allow crooked directors to make a restart.

2. Receivers make little use of the information sources at hand. This may partly be explained by the fact that they are not acquainted with the possibilities, and partly by the fact that information retrieval is time consuming and therefore costly. Also, receivers do not fully appreciate that involving third parties (such as accountants) may, despite the extra costs, be beneficial to the appropriable property thanks to their added expertise and experience.

3. Sometimes, receivers lack expertise. Many receivers are very experienced, but sometimes they are recruited among lawyers that only sporadically deal with bankruptcy. As a result of the recruitment process, it may happen that a very complicated bankruptcy is awarded to an unexperienced receiver. Also, according to some of the interviewees, the training of receivers in the middle level is flawed. Notably, some interviewees think that receivers are lacking in knowledge of criminal law. For this reason, receivers tend to confide in civil action too long. Accountants note that receivers sometimes do not take proper care of the bankrupt’s administration or sell parts of the assets too cheaply.

4. The expertise of others too is considered to be insufficient. Receivers note that the position of the committing magistrate is but a temporary position. Due to the short term assignments, experience and knowledge on the side of the magistracy is lost soon. Therefore, the
committing magistrate may not be considered an apt counterpart of the receiver. Also, the expertise on the side of the police is clearly sub standard.

(5) Receivers experience several problems in the cooperation with other parties. The experiences with the tax authorities vary per district. According to some of the interviewed receivers, the quality of cooperation is mainly dependent on the personal relationship with specific functionaries. In the perception of the receiver, he cannot consult with the tax authorities on matters of restart as this entails the risk that the tax authorities confiscate the remaining assets – which might thwart his attempts to restart. The experiences with the Employers’ Insurance Implementing Organisation are mainly negative – especially as concerns communication with the organisation. Cooperation with the police too is rather poor. With other investigative bureaus, notably the fiscal investigative bureau, cooperation seems to be slightly better. A bottleneck in this cooperation is the already mentioned lack of expertise from both sides as well as lack of time.

(6) The civil and criminal pillars of the fight against bankruptcy fraud are divided, which leads to specific problems of competence and cooperation. For example, it is hotly disputed whether or not the receiver, who is assigned a civil task only by Dutch law, should also assume public responsibilities (such as urging on or contribute to prosecution of frauds). This dispute is all the more complicated, as such a responsibility in the field of criminal law might prove detrimental to the appropriable property or may even lead to individual liability of the receiver. Dutch law until now does not contain clear directives in this field, and verdicts of the supreme court in this matter have been interpreted divergently by different parties involved.

Usefulness of the indicators as predictors of fraud

From the analysis, it appears that the indicators that were used during the research correlate only marginally with the existence of bankruptcy fraud. Established correlations were not robust enough statistically to draw clear cut conclusions in this matter.

Once bankruptcy has occurred, it is the receiver who is at the best position to fathom whether or not the corporation was set up or used for damaging creditors or if illicit withdrawals from the bankrupt’s appropriable property occurred. The best guarantee for detecting bankruptcy fraud then is a well trained and experienced receiver.

Recommendations

From the interviews with various parties involved, some recommendations may be drawn. These are noted below, according to the three stages identified earlier.

Before bankruptcy

Preventative effect might emanate from stricter guidelines for collecting tax dues: the more dubious a branch, corporation or person, the stricter collection should be. This requires that the tax authorities register the payment record of companies and, if need be, adjust their collecting policy. Currently, the
Employers’ Insurance Implementing Organisation investigates companies’ administrations only once every five years. It is conceivable that for some risk groups this may be done more frequently.

Currently, new proposals are being studied that imply an extension of liability, e.g. that a landlord be held liable for the payment of social insurance contributions by the tenant, or that the ‘mother’ corporation be held liable for her ‘daughter’, which eliminates the shifting of assets between corporations or overpricing inter-company services.

In bankruptcy
A number of suggestions concern the expertise of the parties involved.

One suggestion concerns the assignment policy of the committing magistrates: complicated or suspect bankruptcies should preferably be assigned to experienced receivers (notably of the Insolad group). In order to sort out these bankruptcies, all cases of bankruptcy should be screened beforehand by the Ministry of Justice or ‘fraud units’ of the court.

Another suggestion concerns improvement of the training of receivers, also in the field of criminal law. Committing magistrates too might benefit from extra training or from arrangements that might make it more attractive to hold their position for a longer period of time.

As concerns information, e.g. from the ‘Vennoot’ database from the Ministry of Justice, it is advised that the possible sources of information are propagated more widely. It is also suggested that receivers call in the help of an accountant more frequently. It might, in this respect, be helpful if the Insolad group would agree upon a framework contract with some accountancy firms, thereby cutting overhead costs of these accountants.

More expertise would also be direly wanted on the side of the police. This probably would entail further specialisation. Finally, it is advised that each district of the tax authorities designates one or more fraud specialists.

The position of the receiver could be strengthened in several respects. It is suggested that the receiver should be given more powers, e.g. the possibility to investigate the administration of connected corporations, to search the premises or to look into confidential sources – obviously only after consultation with the committing magistrate. Other recommendations are aimed at improving the cooperation of all parties involved, for example by establishing one national or regional service desk.

It is of great importance that organisations like tax authorities and the Employers’ Insurance Implementing Organisation have clearly distinguished contact points for receivers. Regional consultation between receivers mutually and between (experienced) receivers and tax authorities/Employers’ Insurance Implementing Organisation and police may also contribute to closer cooperation.

Prosecution
Analogous to the Dutch Disclosure of Unusual Transactions Act, imposed upon notaries and accountants, receivers might perhaps be obliged by law to notify the authorities in case of suspect bankruptcies. Such a task should be added to the Bankruptcy Act. A public responsibility for the receiver might be settled institutionally as well. The receiver would then become a kind of civil servant, partly with a public task and paid for by the government.
As concerns prosecution policy, clearer guidelines might be drafted by the Department of Public Prosecution in close cooperation with the fiscal investigative bureau. These guidelines should more clearly justify why specific cases are being targeted rather than other cases. Such a method of targeting is currently in operation, but the selection of specific targets should be communicated more clearly.

When the receiver notifies the authorities, these should respond to this notification more seriously. This does imply, on the other hand, that receivers should notify more rapidly (if not, evidence tends to get missing). The Department of Public Prosecution should feed back to the receiver if it chooses not to proceed in a case (and explain why).

In order to prosecute perpetrators, more manpower and means should be mobilized. Taking into account the probable damage of bankruptcy fraud (220 million Euro estimated conservatively, as well as societal damage such as unemployment and disruptions to the market), it is most likely that investments in manpower and means will surely pay back.

Perpetrators should have to face prosecution, punishment and financial reprisals of their misconduct more often and more strongly. Presently, if there appears to be no means for financial recovery, the perpetrators hardly have to face punitive action as long as it is not abundantly clear that they have committed fraud that may be prosecuted on the basis of criminal law. A rising number of prosecutions would give the receiver more means too. Criminal investigation might reveal that the perpetrator did hold means for financial recovery, such as foreign bank accounts, after all.

Another suggestion would be to disqualify directors and to create a ‘black list’. The European Court has ruled that the fight against fraud may be a justification for rules that limit the right of establishment and the freedom to provide services, as long as this is based on a case by case repressive approach. A repressive approach is also considered more attractive considering the administrative burden, as this burden will only be placed upon those cases in which there exists a reasonable suspicion of abuse. The European Commission has announced that, as of 2006, it will dedicate itself to a harmonisation of the rules concerning the disqualification of directors. In the Netherlands, a proposal concerning this matter is presently being prepared as part of the *Prevention of organized crime* programme of the Ministry of Justice.