

## Resumption of Debtor Audits in Individual Chapter 7 and Chapter 13 Cases

### Office of the United States Trustee, Seattle Office

Effective March 13, 2023, the United States Trustee Program (USTP) will resume its designation of individual chapter 7 and chapter 13 cases for audit. These audits previously had been suspended in March 2020 due to public health concerns associated with the COVID-19 pandemic.

The USTP is authorized to audit individual chapter 7 and chapter 13 bankruptcy cases under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (BAPCPA). Section 603(a)(2)(D) of the BAPCPA also provides that the Attorney General must:<sup>1</sup>

(D) Establish procedures for providing, not less frequently than annually, public information concerning the aggregate results of such audits including the percentage of cases, by district, in which a material misstatement of income or expenditures is reported.

The USTP contracts with independent firms to perform audits of individual chapter 7 and chapter 13 cases designated by the USTP. The USTP selects the audit firms through a competitive procurement process to perform the audits using certified public accountants or independent licensed public accountants.

The purpose of the audit is to determine the accuracy, veracity, and completeness of petitions, schedules, and other information required to be provided by the debtor under sections 521 and 1322 of title 11. The audits are designed to provide baseline data to gauge the magnitude of fraud, abuse, and error in the bankruptcy system; to assist the USTP in identifying cases of fraud, abuse, and error; and to enhance deterrence.

The debtor audits are conducted in accordance with audit standards promulgated by the USTP and published in the *Federal Register*.<sup>2</sup>

The USTP is authorized to randomly designate for audit one out of every 250 consumer bankruptcy cases per federal judicial district and to designate cases for exception audit in which the income or expenditures of a debtor deviate from the statistical norm of the district where the case was filed. Prior to the suspension of audits in March 2020, the USTP was designating cases for random audit at the authorized rate. Effective March 13, 2023, the USTP will resume its designation of individual chapter 7 and chapter 13 cases for audit.

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<sup>1</sup> Authority to implement provisions of the BAPCPA was delegated from the Attorney General to the Director of the Executive Office for United States Trustees (Attorney General Order No. 2785-2005 dated October 14, 2005).

<sup>2</sup> BAPCPA Section 603(a)(1); *Federal Register*, Vol. 71, No. 190 (October 2, 2006).

## **I. CASE DESIGNATION PROCESS AND TERMINOLOGY**

Cases for audit are selected randomly from all consumer bankruptcy cases within a federal judicial district. In contrast, cases designated for exception audit must meet specific criteria established by the USTP. These criteria are based on income or expenditures greater than a statistical norm for the district where the case was filed, as specified under uncodified section 603(a)(2)(C) of the BAPCPA.

If a case is selected for audit, the debtor will be notified by an emailed audit notification letter, via counsel if represented. The audit notification letter is accompanied by an initial document request that will ask for copies of documents to be sent to the auditors, generally such as:

1. Payment advices or other evidence of payment for several calendar months preceding the date of the bankruptcy petition plus those received in the calendar month in which the bankruptcy was filed.
2. Federal income tax returns, including all schedules and all W-2, 1099, and K-1 forms, for the most recent taxable periods prior to the date of the bankruptcy petition (and if the returns have not been filed, then the debtor(s) may be asked to provide copies of the most recently filed federal income tax returns.)
3. Account statements for the months preceding the date of the bankruptcy petition for all depository and investment accounts in which the debtor(s) had an interest in during the time period, along with sufficient documentation to explain the source of deposits or credits over a set amount. In addition, the audit firms may request that debtor(s) to provide additional documentation to sufficiently explain the source or purpose of an account statement entry or entries.
4. If the debtor(s) is divorced, (a) the divorce decree, (b) any orders regarding property settlements entered recently, and (c) any alimony or child support orders currently in effect and amendments thereto.
5. If the debtor(s) is self-employed, then for each business owned by debtor or from which debtor derives self-employment income, (a) business tax returns for the most recent taxable periods prior to the date of the bankruptcy petition, (b) account statements for business depository account(s) for the months preceding the date of the bankruptcy petition, and the month in which the petition was filed, along with sufficient documentation to explain the source of every deposit or credit, and the purpose of every check, withdrawal, or debit, and, (c) accounting documents including the most recent balance sheet, income statement, quarterly sales tax returns, accounts receivable ledger and aging schedule/report, and business asset listing and depreciation schedule, if any.

The copies of the documents are to be produced to the auditors under signature of the debtor(s), under the penalty of perjury. The debtor(s) have a set amount of time to provide the documents to the auditors but may discuss with the auditors if additional time is needed. If a debtor does not have copies of any of the requested documents, they will be allowed to explain their inability to produce them.

The audit then consists of a comparison between selected items on a debtor's originally filed bankruptcy papers and documents produced by the debtor at the request of the audit firm. Audit firms also conduct searches using commercially and publicly available database services to look for unreported assets and to verify the market value of assets.

## **II. OUTCOMES**

After an audit has been completed, the audit firm files a Report of Audit with the court and transmits a copy to the United States Trustee. The Report of Audit identifies any material misstatement that is reported by the audit firm. A material misstatement indicates the audit produced information that challenged the accuracy, veracity, or completeness of a debtor's petition, schedules, or other filed bankruptcy documentation. Inaccurate or incomplete information deprives the court, the United States Trustee, the private trustee, and creditors of adequate information to decide whether to conduct further investigation, recover assets or seek relief against the debtor.

The report is not a legal determination and the legal effect of the audit firm's finding of a material misstatement, if any, is a question for the court. Prior to filing a Report of Audit with the court noting a material misstatement, the audit firm contacts the debtor, through counsel if represented, to provide the debtor an opportunity to offer an explanation or supply additional information that may negate the finding.

While specific criteria for reporting a material misstatement are not released to the public to preserve the integrity of the audit process, material misstatements in general relate to the understatement or omission of the debtor's assets, income, or a pre-petition transfer of property. If a material misstatement is identified in a Report of Audit, the bankruptcy court gives notice to all creditors in the case. In addition, the United States Trustee determines what action is appropriate based on the material misstatement(s) and may pursue a variety of actions depending on the circumstances of the case, including seeking denial or revocation of discharge, or reporting the material misstatement to the United States Attorney. In many instances, the United States Trustee may take no action on a material misstatement identified in a Report of Audit based on a number of factors, including whether the debtor corrected the error (e.g., filed amended schedules) or whether the material misstatement was intentional.

If the audit firm cannot complete the audit because the debtor did not produce documents requested in connection with the audit or because the case was dismissed while the audit was in process, the audit firm files a Report of No Audit with the court and transmits a copy to the United States Trustee. The United States Trustee may take appropriate enforcement action when a

Report of No Audit is filed, including seeking revocation of discharge, if the debtor fails to satisfactorily explain the failure to make available the documentation requested for the audit.

### **III. REPORTING**

Each year, by delegation from the Attorney General, the USTP issues an annual public report on the aggregate results of the audits, including the percentage of cases, by district, in which a material misstatement of income or expenditures is reported. These reports are available on the Reports & Studies page of the U.S. Trustee's web site [Reports & Studies \(justice.gov\)](https://www.justice.gov/ustp/reports-studies). The last report was issued in May 2021 for audits for Fiscal Year 2020, before audits were halted during the pandemic.

In FY 2020, the USTP designated 1,396 cases for audit. Of the cases designated for audit, 54 were dismissed before the case was assigned to an audit firm. Of the remaining 1,342 cases, 995 were random audits and 347 were exception audits. Reports of Audit were filed in 793 of the completed audits, and at least one material misstatement was reported in 16 percent of these cases. Twenty-two percent of exception audits identified at least one material misstatement, compared to 14 percent of random audits. There were 49 Reports of No Audit.

More than one material misstatement may be reported in a single case. For FY 2020, income-related material misstatements were reported in nearly 75 percent of the cases with material misstatements, and more than 35 percent of the cases with material misstatements had asset-related or transfer-related material misstatements.

In the Western District of Washington, 10 cases were chosen, all of which ended with Reports of Audit.<sup>3</sup> Two cases had material misstatements, or twenty percent of audits resulted in a material misstatement.

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<sup>3</sup> There were zero cases with a Report of No Audit.