Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How Criminal Cases Affect Bankruptcy: Debunking The Myths

Law360, New York (June 2, 2016, 12:49 PM ET) --

Derrelle Janey

Bankruptcy cases have long been complicated by criminal allegations of malfeasance as either against former executive managers or as against the debtor itself. So, this phenomenon is not new. However, the increased intensity of white collar prosecutions by state and federal law enforcement officials, especially over the past several years, has made the intersection between corporate bankruptcy cases and the criminal law more complicated. Criminal cases alleging fraud against corporate managers have more recently implicated relatively more complex statutes, including the Foreign Corrupt Practices Act, and managers now stand to be accused of longer lists of criminal wrongdoing in single cases. Cases that might have previously primarily included only embezzlement (grand larceny), for example, now allege violations of federal securities laws, FCPA violations, tax fraud, mail and wire fraud and might also include criminal Racketeer Influenced and Corrupt Organizations (RICO) Act claims. Moreover, while the number of corporate bankruptcies has not materially increased, fraud cases resulting in a final adjudication, either a plea or conviction at trial, have practically exploded. In 2011, such cases represented approximately 19 percent (or 307) of all criminal sentences in the Southern District of New York. By 2013, such cases accounted for over 23 percent (or 360) and in 2014 approximately 22 percent of such cases (or 376).[1] In other words, more fraud is being prosecuted, and successfully.

While not all fraud cases implicate corporate bankruptcies, at least anecdotally, bankruptcy dockets substantially reflect situations where debtors, including broker-dealers, investment advisers and other financial services companies in particular, are victims of financial fraud or willful blindness by management. Extreme scenarios, such as the Lehman bankruptcy and the liquidation of Bernard L. Madoff Investment Securities, of course, provide key lessons for bankruptcy litigators in this respect. Nevertheless, fraud schemes effected through financial services companies are becoming much more common and with respect to relatively smaller financial services enterprises, especially in the broker-dealer area. These situations make it critical for bankruptcy court litigators to have a sufficient understanding of the interplay between criminal law issues and bankruptcy. Without a properly informed understanding of the real impact criminal law (and related constitutional law) issues might have on parallel Chapter 11 or Chapter 7 cases, litigators can find that their cases might stall for years.

This article addresses three common myths about the implications parallel criminal law proceedings might have on a bankruptcy case: (a) the likely success of stay applications filed by criminal defendants on parallel bankruptcy court adversary proceedings; (b) the scope of the Fifth Amendment privilege and its potential implications for parallel adversary proceedings; and (c) the capacity for fraud victims to

recover through criminal restitution orders and the effects on the bankruptcy case. There is no question that a criminal proceeding can cast a pall over any bankruptcy case. However, limitations created by the parallel proceeding are too often exaggerated by criminal defense counsel.

The Common Myths of Parallel Proceedings

1. Motions to Stay Filed by Criminal Defendants are Easily Granted

Former managers are often an essential source of information for bankruptcy trustees and their counsel in the course of investigating potential sources of recovery for the debtor. Even when those managers are under investigation, or charged by law enforcement for participating in criminal conduct that contributed to the demise of the debtor, information they might provide could have significant value to the trustee's investigation. However, as criminal defendants, these former managers are typically guided by their counsel to refrain from speaking to anyone. In fact, most often these defendants will seek a stay of any parallel civil action that implicates them, including adversary proceedings in bankruptcy court in which they are a named defendant. Far too often, bankruptcy practitioners unfamiliar with the criminal law will directly or in effect acquiesce to motions filed by criminal defense counsel to stay all proceedings against the former manager until the criminal case is resolved. Such motions, if granted, can forestall a bankruptcy trustee's investigation into potential recoveries for years. The criminal defendant becomes unavailable for depositions, cannot illuminate potentially critical evidence against third parties, including co-conspirators, and/or resolve recovery of debtor property the defendant himself stole from the debtor.

In the Second Circuit, an essential factual predicate for a defendant's stay application is that the adversary proceeding be related to the criminal action. In fact, courts within this circuit utilize a six-factor test in deciding whether to grant a stay motion: (a) the status of the criminal case; (2) interests of the plaintiff; (3) interests of and burden on the defendant; (4) the extent to which the issues in the criminal case overlap with those presented in the civil case; (5) interest of the court; and (6) the public interest.[2] So, where the former manager is indicted by the government for fraud, for example, an adversary proceeding seeking to recover on loans provided by the debtor to the former manager may not necessarily be related to the criminal fraud case. In such instances, the trustee's counsel must emphasize the lack of overlap between the two proceedings. If the overlap does not exist, the criminal defendant will be hard-pressed to demonstrate unfair prejudice caused by denial of the stay application.

2. A Defendant's Fifth Amendment Privilege Against Self-Incrimination is Triggered if Compelled to Participate in an Adversary Proceeding

Courts in other circuits have held that civil defendants need not face the dilemma of having to choose between invoking their Fifth Amendment privilege and defending civil proceedings.[3] Indeed, invoking the sanctity of the Fifth Amendment privilege can be a persuasive approach by criminal defense counsel to persuade a bankruptcy court judge to stay an adversary proceeding. However, the Second Circuit has made clear that a defendant does not have an absolute right not to be forced to choose between testifying in a civil matter and asserting his Fifth Amendment privilege.[4] The Constitution does not require a stay of civil proceedings pending the outcome of related criminal proceedings.

This position is identical to that held by New York state courts, where it is settled law that invoking the privilege against self-incrimination is generally an insufficient basis for precluding discovery in a civil matter.[5] As the Second Circuit wrote in Louis Vuitton: "In the more common case, the Fifth Amendment privilege is implicated by denial of a stay, but not abrogated by it."[6] In other words,

today's white collar defendant must show that there is something special about his criminal predicament (other than the criminal prosecution) to show that his Fifth Amendment privilege is abrogated by a denial of the stay application. In the vast majority of cases, white collar defendants cannot make this showing merely by pointing to a parallel criminal action.

3. Fraud Victims Can Recover Either Through the Bankruptcy Court Process or Law Enforcement's Criminal Restitution

A creditor that has realized losses may file a proof of claim in the debtor's bankruptcy case. Through the bankruptcy claims process, a creditor might realize some level of recovery, depending on several variables, including, principally, whether monies exist within the debtor-estate or can be recovered to address the claim. Even though results in the bankruptcy claims process might be uncertain, a creditor that has submitted a proof of claim cannot circumvent the bankruptcy process by trying to recover from law enforcement's criminal restitution order.

Typically, prosecutors seek disgorgement of ill-gotten gains from wrongdoers, including former corporate managers that pilfered the company. Those proceeds, i.e., the restitution, are used to compensate victims of the criminal wrongdoing. Occasionally, prosecutors take the position the company itself is the victim; however, frequently the victims are deemed individuals who suffered losses as a result of the crime.

The tension lays in that, under federal law, and as reflected in the Bankruptcy Code, the bankruptcy trustee has authority to properly administer the debtor estate and the debtor's interest in property without interference of direct or indirect actions that undermine that effort. To the extent a prosecutor's criminal restitution order seeks to distribute property that equitably belongs to the estate, there is a conflict.

Section 362(a) of the Bankruptcy Code provides that an application commencing proceedings operates as a stay that not only stays recovery against the debtor for claims arising prior to the commencement of the case but, importantly, also stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[7] The automatic stay provision is thus broad, and "prevents creditors from reaching the assets of the debtor's estate piecemeal and preserves the debtor's estate so that all creditors and their claims can be assembled in the bankruptcy court for a single organized proceeding."[8]

The automatic stay is intended precisely to prevent those creditors who are able to act first from obtaining payment in preference to and to the detriment of other creditors, which is exactly the type of preference treatment victims under a criminal restitution order might obtain. In terms of those persons who are not even creditors but are mere equity investors, compensation to them of debtor property is offensive to the Bankruptcy Code and the bankruptcy court's jurisdiction.[9] In other words, persons who have claims either derivative or duplicative of the trustee would benefit ahead of the orderly process to fairly and equitably benefit all creditors of the estate. That is not permitted by law.

Sometimes resolution can be reached with the prosecutor by the government agreeing to prevent creditors from double-dipping, i.e., referring creditors who have submitted proofs of claim back to the trustee. However, this approach is only partially satisfactory. A possibility remains for creditors who have not submitted proof(s) of claim, and therefore have not submitted to the jurisdiction of the bankruptcy court, to be compensated ahead of creditors in the bankruptcy case. They need only persuade the prosecutor that they are a victim and, as such, deserve to be included in the prosecutor's

recommendation for restitution. Even more remarkable, equity investors — a group that is compensated last, if at all, in the bankruptcy context — could also be compensated by the prosecutor's restitution recommendation.

The prosecutor's interest in compensating crime victims is not the same as that of the bankruptcy court, at least in the first instance. The underlying policies of criminal justice and bankruptcy law can be at odds in this regard. So, in extreme situations, the bankruptcy litigator should consider making an application in bankruptcy court to deem the prosecutor's restitution order, insofar as it inures to the benefit of creditors, to violate the automatic stay under 11 U.S.C. §362(a) and declare the criminal court restitution order void ab initio. Such an application should include a request for preliminary injunction, pursuant to 28 U.S.C.§ 2283 and Section 105(a) of the Bankruptcy Code, enjoining the prosecutor from pursuing in any form or manner the restitution, at least to the extent it benefits creditors, pending a hearing on and determination on the application.

This approach might be especially effective where the criminal matter is a state action. The doctrine of sovereign immunity does not prevent injunctive relief against state officials in the proper circumstances.[10] Moreover, it has long been held that bankruptcy courts may enjoin state criminal court proceedings and doing so is not offensive to the Anti-Injunction Act. Bankruptcy Code §105 is an expressly authorized exception to the Anti-Injunction Act. Younger v. Harris has long provided debtor-criminal defendants a legal framework by which to enjoin a parallel criminal court proceeding when necessary for protection of their federal constitutional rights.[11] By analogy, Younger can be applied where there is no other remedy at law to preserve the debtor's property from the effect of a state criminal court restitution order.

Conclusion

A consequence of criminal wrongdoing by corporate managers has often been the loss of jobs for company employees and a bankruptcy petition for the entity. The critical difference more recently is that law enforcement is more vociferously prosecuting the individual corporate manager. Even though bankruptcy courts and trustees, as a general matter, cooperate with the criminal investigation, it is important to the debtor's bankruptcy case that counsel possesses a meaningful understanding as to where there are opportunities for pursuing recoveries despite pendency of the parallel criminal matter.

—By Derrelle Janey, Gottlieb & Gordon LLP

Derrelle Janey is a partner in Gottlieb & Gordon's New York office and leads the firm's civil litigation, securities and regulatory group.

[1] U.S. Sentencing Commission, 2011 Datafile, USSCFY11; U.S. Sentencing Commission, 2013 Datafile, USSCFY13; U.S. Sentencing Commission, 2014 Datafile, USSCFY14.

[2] Louis Vuitton SA v. LY USA Inc., 676 F.3d 83, 99 (2d Cir. 2012).

[3] See, e.g., Wheling v. Columbia Broadcasting Sys., 608 F.2d 1084, 1089 (5th Cir. 1979) (civil discovery stayed until "all threat of criminal liability ended").

[4] Louis Vuitton SA v. LY USA Inc., 676 F.3d 83, 98 (2d Cir. 2012).

[5] See Access Capital Inc. v. DeCicco, 302 A.D.2d 48, 52 (1st Dep't 2002).

[6] Louis Vuitton, 676 F.3d at 100.

[7] See 11 U.S.C.§§362(a)(1), (a)(3), and (a)(6).

[8] In re AP Indus. Inc., 117 B.R. 789, 798 (Bankr. S.D.N.Y. 1990) (Lifland, J.) (citations omitted).

[9] Id. at 799.

[10] In re HBG Servicenter, 45 B.R. 668 (E.D.N.Y. 1985), citing Edelman v. Jordan, 415 U.S. 651 (1974).

[11] See Younger v. Harris, 401 U.S. 37,45.
