Litigating Against Bad Debtors: Protecting Against The SPOLIATION OF ESI

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KEY POINTS

1. "Bad debtors" present an increased risk of spoliation.
2. Trustees should familiarize themselves with steps they can take to protect the estate, including developing an understanding of the Court's authority to prevent or punish spoliation and working with a forensic consultant to assess anomalies in a production.

INTRODUCTION

Experienced trustees recognize the telltale signs of a "bad debtor." Some of the red flags include: bankruptcy schedules and disclosures that are incomplete or inconsistent; proofs of claim filed by victims of "subprime" or "sketchy" businesses operated by the debtor; allegations that the debtor engaged in deceptive and fraudulent business practices and is concealing assets; and a debtor that is a "frequent flier" in the court system with a history of discovery violations and judgments against him.

Litigating against a bad debtor and his confederates in an adversary proceeding can present special challenges for the trustee and trustee's litigation counsel. One such challenge is preventing (or detecting) the spoliation of evidence, particularly electronically-stored information ("ESI") related to the debtor's assets, transactions and conveyances. Because ESI can be a treasure trove of valuable information in all types of cases, litigants routinely request and produce ESI during discovery. Indeed, e-discovery has emerged as a sub-specialty in litigation and sophisticated forensic vendors and ESI consultants have created a brand new industry to preserve, collect, process and review ESI for firms and their clients.

Thus, it is no surprise that, more and more frequently, ESI has become the subject of court orders that impose sanctions against litigants who spoliate evidence. Likewise, it is no surprise that, with technological advances, it has become easier for unsavory litigants to spoliate ESI and more difficult and expensive for their opponents to detect it.

An adversary proceeding involving a bad debtor who is alleged to have concealed assets from the bankruptcy estate presents a particularly ripe environment for the possibility of spoliation. Certain bad debtors – sometimes with the help of family members and other close associates – may attempt to use the bankruptcy process to rid themselves of creditors while at the same time secretly concealing assets from the estate, with the objective of reuniting with their concealed assets and returning to business as usual after obtaining a discharge. Unfortunately, the spoliation of ESI can be a powerful aid in accomplishing that unlawful objective.

To assist trustees and their litigation counsel in navigating through these challenging circumstances, this article presents the prevailing legal principles applicable to the spoliation of evidence. The article then suggests a plan of action when the possibility of spoliation becomes a concern in an adversary proceeding designed to identify and recover concealed assets.

SPOLIATION–GENERAL LEGAL PRINCIPLES

"Spoliation refers to the destruction or material alteration of evidence or to the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation." *Silvestri v. Gen. Motors Corp.*, 271 F.3d 583, 590 (4th Cir. 2001) ("*Silvestri*"). "The failure to preserve electronic or other records, once the duty to do so has been triggered, raises the issue of spoliation of evidence and its consequences." *Goodman v. Praxair Servs., Inc.*, 632 F. Supp. 2d 494, 505 (D. Md. 2009) ("*Goodman*").

Courts have the inherent power to sanction conduct that "abuses the judicial process." *Silvestri* at 590. A bankruptcy court possesses this power in equal measure. *NEGT Energy Trading Holdings Corp. v. Orrick, Herrington & Sutcliffe LLP (In re Nat'l Energy & Gas Transmission, Inc.)*, 2009 WL 902058, at *1 (Bankr. D. Md. Mar. 27, 2009); 11 U.S.C. § 105.

If the spoliation violates a specific court order or disrupts the court's discovery plan, sanctions also may be imposed under Rule 37 of the Federal Rules of Civil Procedure, made applicable by Rule 7037. *Goodman* at 505.

While the standard for establishing grounds for sanctions differs slightly from circuit to circuit, as a general matter, a party seeking sanctions for spoliation must prove by a preponderance of the evidence some variation on the following elements:

> (1) [T]he party having control over the evidence had an obligation to preserve it when it was destroyed or altered;
>
> (2) the destruction or loss was accompanied by a "culpable state of mind;" and
>
> (3) the evidence that was destroyed or altered was "relevant" to the claims or defenses of the party that sought the discovery of the spoliated evidence, to the extent that a reasonable factfinder could conclude that the lost evidence would have supported the claims or defenses of the party that sought it.

Goodman at 509.

1. Duty to Preserve

As a fundamental matter, before grounds for sanctions can exist, there must be a duty to preserve. "The duty to preserve material evidence arises not only during litigation but also extends

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About the Authors

Jean Lewis and Dave Shuster are principals of Kramon & Graham, P.A., a litigation firm in Baltimore, Maryland, and had the good fortune to serve as special litigation counsel for Roger Schlossberg in his capacity as the Chapter 11 Trustee for Vincent L. Abell in the Bankruptcy Court for the District of Maryland. Shuster and Lewis represented the Trustee in *Schlossberg v. Abell*, together with Richard Goldberg of Shapiro Sher, who served as the Trustee's general bankruptcy counsel. In *Schlossberg v. Abell*, the Hon. Thomas Catliota entered a default judgment against the Debtor and his estranged wife, and ordered the turn-over of dozens of properties after evidence of the systematic use of a wiping program was presented to the Court. Although we have been involved in plenty of bankruptcy-related litigations, we do not hold ourselves out as bankruptcy lawyers and the local legal community does not think of us as such. When we handle bankruptcy-related matters, typically it is in the capacity of special litigation counsel or trial counsel to a party in an adversary proceeding. As it has happened, these matters typically involve someone that the trustee, or general bankruptcy counsel, has already identified as a potentially "bad debtor.

to that period before the litigation when a party reasonably should know that the evidence may be relevant to anticipated litigation." *Silvestri* at 591. Whether a party reasonably should know that evidence may be relevant to anticipated litigation is an objective standard. *Micron Tech., Inc. v. Rambus Inc.*, 255 F.R.D. 135, 148 (D. Del. 2009).

The filing of a bankruptcy proceeding triggers additional duties on the debtor to preserve and produce evidence. 11 U.S.C. §§ 521, 1115; *Quintus Corp. v. Avaya, Inc. (In re Quintus Corp.)*, 353 B.R. 77, 93-94 (Bankr. D. Del. 2006).

Once the obligation to preserve evidence attaches, there is an affirmative duty to cease routine practices, even if done in the ordinary course of business, if those practices will result in the destruction of relevant evidence. *Powell v. Town of Sharpsburg*, 591 F. Supp. 2d 814, 819 (E.D.N.C. 2008).

In the Fourth Circuit, "parties must preserve potentially relevant evidence under their control," and "documents are considered to be under a party's control when that party has the right, authority, or practical ability to obtain the documents from a non-party to the action." *Goodman* at 515 (citations and internal quotation marks omitted).

2. Culpable State of Mind

There must also be a showing that the spoliator acted with a "culpable state of mind." *Goodman* at 509. Three possible states of mind satisfy this requirement: "bad faith/knowing destruction, gross negligence, and ordinary negligence." *Goodman* at 518.

The method of spoliation often indicates whether the spoliator acted with a "culpable state of mind." The use of wiping programs such as CCleaner or Windows Disk Cleanup, the replacement of hard drives, and the reformatting of volumes are recognized spoliation tools that indicate the spoliator's bad faith. *Victor Stanley, Inc.*, 269 F.R.D. 497, 501-14 (D. Md. 2010) ("*Victor Stanley*"). Throwing away a computer device or making it otherwise physically unavailable also demonstrates bad faith spoliation. *See, e.g., First Mariner Bank v. Resolution Law Grp., P.C.*, 2014 WL 1652550, at *10-11 (D. Md. Apr. 22, 2014) (holding that defendant lawyer who could not remember if he discarded or recycled his work laptop acted in bad faith).

The volume and timing of the destruction of ESI is especially significant to the issue of intent. *Victor Stanley* at 531. Thus, one court entered a default judgment after noting that "almost all of the deletions took place a day or two before the BCT laptop computers in question were sent to be imaged by Lighthouse" (*Philips Electronics N. Am. Corp. v. BC Technical*, 773 F. Supp. 2d 1149, 1207 (D. Utah 2011)), whereas another court held that "the execution of CCleaner the night before Gilbert's producing the computer for inspection was not innocent or accidental" . *Pac. Coast Marine Windshields Ltd. v. Malibu Boats, LLC*, 2012 WL 10817204, at *7 (M.D. Fla. Nov. 30, 2012).

3. Relevance

There also must generally be some showing that the lost data was "relevant." For purposes of spoliation sanctions, a finding of "relevance" is a two-pronged finding of both relevance and prejudice. *Victor Stanley* at 532. "In the context of spoliation, lost or destroyed evidence is relevant if a reasonable trier of fact could conclude that the lost evidence would have supported the claims or defenses of the party that sought it." *Id.* (citations and internal quotation marks omitted). "[C]ourts find prejudice where a party's ability to present its case or to defend is compromised," and hold that "delayed production of evidence causes prejudice." *Id.* (citations omitted). Moreover, courts consider not only prejudice to the party, but also "prejudice to the judicial system." *Id.*

a. Required Presumptions

A showing of willful *or* bad faith conduct *requires* the Court to infer that the destroyed information was both relevant and prejudicial. *Vodusek v. Bayliner Marine Corp.*, 71 F.3d 148, 155-56 (4th Cir. 1995). Relevance and the resulting prejudice are presumed upon a showing of willful spoliation because such conduct demonstrates fear that the spoliated evidence is unfavorable to the spoliator. *Id.* at 156.

b. Permissible Inferences

Even if there is no willfulness or bad faith, a court may infer, from relevant files that have been recovered, that files irretrievably wiped from related computer systems were also relevant. *United States v. Krause (In re Krause)*, 367 B.R. 740, 764 (Bankr. D. Kan. 2007) ("Because no one will ever know what was on [computers at the 'nerve center' of the debtor's network of sham business entities] before they were wiped and purged with GhostSurf, the Trustee and the Government have been severely prejudiced in the prosecution of their claims against [the debtor]. . . . *The Trustee has shown enough from the salvaged e-mails and temporary internet files, however, to persuade this Court that the electronic evidence purged by Krause would have been relevant to these proceedings*.").

c. Rebutting the Presumption of Relevance and Prejudice

"Where there is a presumption, the spoliating party may rebut this presumption by showing that the innocent party has not been prejudiced by the absence of the missing information." *Victor Stanley* at 532 (citation and internal quotation marks omitted). However, "inconsistent and incredible" explanations for destruction of ESI are insufficient to rebut the presumption of relevance and prejudice. *Id.* Moreover, even if the spoliating party makes a "showing" of a lack of prejudice, the innocent party may still prove that it has been prejudiced by the opponent's spoliation. *Id.*

The burden is <u>not</u> on the innocent party to show that he cannot prove his case without the spoliated evidence. *First Mariner Bank*, 2014 WL 1652550, at *12-13 (rejecting defendant's argument that because plaintiff could not point to specific documents that were spoliated, proving prejudice was impossible). On the contrary, "appropriate sanctions should . . . place the risk of an erroneous judgment on the party who wrongfully created the risk." *Victor Stanley* at 534.

4. Agency

"A party to a lawsuit, *and its agents*, have an affirmative responsibility to preserve relevant evidence. A [party] . . . is not relieved of this responsibility merely because the [party] did not itself act in bad faith and a third party to whom [the party] entrusted the evidence was the one who discarded or lost it." *Goodman* at 522 n.16 (emphasis added). It is the party's respon-

sibility to ensure that its agents do not spoliate evidence, and a party cannot defeat a spoliation claim by arguing that the agent's spoliation was not done in furtherance of the party's business. *Philips Electronics N. Am. Corp. v. BC Technical*, 773 F. Supp. 2d 1149, 1207 (D. Utah 2011) (striking answer, dismissing counterclaims, and entering default judgment against defendant company based on employees' spoliation).

5. Appropriate Sanctions

Upon a finding of spoliation, the trial court "has broad discretion in choosing an appropriate sanction." *Silvestri*, 271 F.3d 590. "Spoliation sanctions should be molded to serve the prophylactic, punitive, and remedial rationales underlying the spoliation doctrine." *Goodman*, 632 F. Supp. 2d at 523 (quoting *Silvestri*, 271 F.3d at 590). Thus, "appropriate sanctions should (1) deter parties from engaging in spoliation; (2) place the risk of an erroneous judgment on the party who wrongfully created the risk; and (3) restore 'the prejudiced party to the same position he would have been in absent the wrongful destruction of evidence by the opposing party." *Victor Stanley*at 534 (internal quotation marks omitted) .

a. Either Bad Faith or Prejudice, or Both, May Warrant Terminating Sanctions

To justify terminating sanctions, the court "must consider both the spoliator's conduct and the prejudice caused and be able to conclude *either* (1) that the spoliator's conduct was so egregious as to amount to a forfeiture of his claim, *or* (2) that the effect of the spoliator's conduct was so prejudicial that it substantially denied the defendant the ability to defend the claim." *Silvestri* at 593 (emphasis added). This is "'an either/or test': Dismissal is warranted if either the spoliator's conduct was so egregious as to make forfeiture of its claim an apt remedy, *or* if the loss of the evidence is so prejudicial that it substantially denies the defendant the ability to defend the claim." *Erie Ins. Exch. v. Davenport Insulation, Inc.*, 659 F. Supp. 2d 701, 707 (D. Md. 2009) (emphasis added).

Under that well-established standard, egregious conduct or prejudice may, in and of themselves, be sufficient to warrant terminating sanctions:

> Following the two-step process outlined in *Silvestri*, the undersigned Magistrate Judge finds that spoliation did occur and that the spoliator's conduct was so egregious as to amount to a forfeiture of his claim. *Silvestri*, 271 F.3d at 593. Even if the Court characterized the spoliation as "negligent" as Plaintiff suggests, Defendant has been sufficiently prejudiced and the judicial process sufficiently corrupted to warrant dismissal of this action.

Taylor v. Mitre Corp., 2012 WL 5473715, at *5 (E.D. Va. Sept. 10, 2012). Thus, bad faith alone may warrant dispositive sanctions.

Consistent with these principles, numerous courts have concluded that the willful or bad faith use of a computer wiping program is especially prejudicial because by their nature, such programs make it impossible to determine what evidence was destroyed. *Victor Stanley* at 538 (holding, based on defendants' "intentional, bad faith permanent destruction of a significant quantity of relevant evidence, to the plaintiff's detriment . . . it is clearly appropriate that the spoliation consequences include a judgment" finding defendants liable on plaintiff's "flagship claim" of copyright infringement).

b. Deterrence

Deterrence of abuse of the judicial process also warrants terminating sanctions. *Victor Stanley* at 534 ("[A]ppropriate sanctions should . . . deter parties from engaging in spoliation. . . ."). "Courts may order a default judgment or dismissal to 'send a strong message to other litigants, who scheme to abuse the discovery process and lie to the Court, that this behavior will not be tolerated and will be severely sanctioned.'" *Victor Stanley* at 534.

When determining appropriate sanctions, courts consider all of the circumstances surrounding the alleged violations, including a party's misconduct in other cases. *Victor Stanley* at 502 n.10.

Steps To Protect the Estate from a Bad Debtor

Unfortunately, spoliation can be a particularly powerful tool that a motivated bad debtor can deploy to conceal assets from the estate. A trustee can take several steps to protect the estate from such a debtor.

As an initial matter, where the concealment of assets is suspected, a trustee should ensure that an explicit litigation hold is issued, not just to a debtor, but to associated companies and other agents. The litigation hold letter should address evidence in all forms, including ESI. Good litigation letters go into great detail about how ESI should be preserved (including through the procurement of bit-by-bit imaging). A forensic consultant can assist in providing the necessary language.

Second, trustees can use their authority under Bankruptcy Rule 2004 to gather evidence of concealed assets and lay the foundation for getting the court's help in compelling the debtor to provide that evidence before pursuing an adversary proceeding. Where a trustee determines that there are grounds to take the examination of a particular entity or associate of a debtor, the subpoena should include a schedule of "documents" to be produced that, in turn, includes a request for a bit-by-bit image of any computers that the debtor, and his agents, have used in the years leading up to the bankruptcy. That image will provide a useful view into whether the debtor or his associates are concealing assets. Again, a forensic expert can be useful in drafting the document requests for the subpoena. While the cost of processing all of the data on a computer can be prohibitive, a forensic expert can assess the computer and provide valuable information without processing gigabytes of data. A trustee should determine what reports a forensic consultant can generate without processing the data and select those most likely to indicate whether there is evidence of concealed assets. Potentially useful reports include: file listings, *deleted* file listings, a listing of devices that have been used with the computer (including, for example, flash drives), device reports that indicate the status and age of the computer's operating system and whether and when it has been replaced, when the computer has been in operation, and an inventory of programs and updates that have been downloaded to the computer.

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case provides little benefit to creditors, unless dismissal is with prejudice. Ideally, creditors are better served by either a denial of the exemptions, which would leave more assets in the estate for distribution, or a denial of discharge.

While the Supreme Court is correct to note that these remedies are available, in practice, they are rarely asserted in cases where the debtor is seeking to amend the schedules. There are numerous reasons for this, but two are predominant. First, some bankruptcy judges are reluctant to deprive debtors of their fresh start, free from the weight of indebtedness, except in the face of truly outrageous conduct. If a debtor has simply failed to list an asset that would have otherwise been exemptible, some judges might take the view that this does not warrant imposing such a draconian punishment as losing one's discharge. Second, although trustees have a duty under § 704(a)(6) to "oppose the discharge of the debtor" if it is advisable, the estate receives no financial benefit for successfully opposing a discharge. Thus, the trustee has to analyze whether it makes financial sense to expend estate resources, which would otherwise be distributed to creditors, to pursue litigation to deny the debtor a discharge. And, even if the trustee reports the case to the district's US Trustee, most US Trustee offices do not have the resources to prosecute anything but the most extreme cases. The unfortunate reality is that, in many cases involving debtors who engage in deceptive or manipulative behavior, the trustees simply do not have the ability to hire counsel to investigate and litigate an action to "deny the dishonest debtor a discharge."

The Exemption Laws Should be Amended

It is true that there are still some remedies available to trustees, however, as a whole, these remedies are woefully inadequate to deal with a debtor acting in bad faith. First, the majority of these remedies are not available to trustees in states that have not opted out of the federal exemption system. Second, these remedies are only available under certain specific conditions, which may not be available in all cases, or may be difficult to satisfy. Third, trustees may have to assert numerous grounds when objecting to the exemption, which generally increases the cost of bringing such an objection. Fourth, inconsistent decisions on how to interpret state created exemptions may lead to unintended consequences. A debtor may get away with keeping property that should not be exempt in one jurisdiction whereas another debtor, committing the exact same acts in another jurisdiction would not be able to exempt the property. The absence of viable remedies may actually encourage some debtors to hide assets, even if they are arguably exempt, with the exemption as a "Plan B" if the debtor is caught concealing them. Needless to say, anything that diminishes the incentive to provide the bankruptcy court with a truthful disclosure of assets should be anathema. And while a threat of sanctions or losing a discharge may help to dissuade some debtors from engaging in deceptive behavior, from a practical perspective, these remedies are unlikely to be utilized except in the most egregious of situations, and only when the estate has the resources to engage counsel to bring the action against the debtor.

Policy reasons dictate that the exemption laws should be amended. Rule 1009 could be modified to include a provision that any such amendment to the schedules must be made in good faith, without prejudice to creditors. Such an amendment appears not to run afoul of 28 U.S.C. § 2075, since it does not "abridge, enlarge, or modify any substantive right." Or Congress could pass legislation to amend § 522 to include similar provisions. State legislatures could pass their own amendments to their existing exemption laws. Regardless of what form the amendments take, it is important that action be taken soon. Bankruptcy courts must be given back the tools necessary to continue to police their cases and develop appropriate remedies tailored to fit the situation. This is not just to protect individual cases, but to protect the integrity of the bankruptcy process – lest it devolve so much that one day, Congress overacts to the problem and the entire bankruptcy system as we know it today becomes lost to even the poor and honest debtor.

FOOTNOTES:

[1] Hon. Christopher D. Jaime, *Objections to Exemptions Under State Law After Law v. Siegel* ABI Journal, 14 Mar. 1, 2017.

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Spoliation of ESI

In addition to providing information on where it makes sense to focus efforts, these reports may also indicate whether there has been any spoliation of ESI leading up to the bankruptcy. Many wiping programs leave artifacts -- or evidence -- of their usage. For example, the wiping program CCleaner overwrites deleted files with strings of zzzs. The zzzs will appear on the deleted file listings, providing *indicia* of the wiping programs (i.e. artifacts). A trustee dealing with a "bad debtor" will want to ask the forensic consultant whether she sees any evidence that a wiping program was used. But, more importantly, a trustee should bring to the forensic consultant's attention anything that seems unusual and ask the forensic consultant what that indicates.

A trustee who suspects the concealment of assets should also be sure to look at metadata associated with key documents. A paper deed of trust dated June 30, 2008, may not be what it purports itself to be if, for example, there is an electronic version with metadata showing that the document has a "creation date" of June 30, 2012, and was later modified in 2014.

Similarly, a trustee should pay attention to file names, which can be illuminating. The fact that a file named "Joe Smith's Last Will and Testament" has been deleted, for example, suggests he may have some concerns about disclosing what he intends to pass on to heirs. Moreover, trustees should avoid being thrown off by file names. Crafty debtors might store very valuable information in files with seemingly innocuous names, *e.g.*, "Shopping List" or "College File."

If a trustee discovers evidence of spoliation, it is important for the trustee to act promptly to alert the Court and prevent the further destruction of evidence. *See Goodman*at 523. In that circumstance, a trustee should also promptly move for discovery from any obvious third parties who might possess the spoliated information. At some point, the Debtor will assert this possibility as a reason for a court to find no prejudice.

As technology evolves, we anticipate that spoliation will become more difficult to detect and easier to accomplish. It is therefore important for trustees to make sure they are up-to-date on the applicable rules and resources and they avail themselves of the expertise of forensic scientists.