Red Flags and Fraud Investigations in Insolvency Proceedings

By Kathy Bazoian Phelps

Fraud in what was an operating business can come to light in an insolvency proceeding in a variety of ways. A company may voluntarily file for bankruptcy, or creditors may throw it into an involuntary bankruptcy, or regulators may seek an asset freeze and the appointment of a receiver. Creditors, trustees, regulators, and other interested parties commonly look first to the reason for the company failure. Was it bad luck, poor management, an economic downturn, or might there be fraud involved?

The debtor-in-possession, chief restructuring officer, or Chapter 11 trustee will often assemble a team of professionals, including forensic accountants, financial advisors, lawyers, and other investigators to determine whether fraud has occurred and whether the fraud will necessitate the cessation of business operations.

This article will discuss different types of fraud that may be found in insolvency proceedings, red flag warning signs, and investigatory work that can be done to try to unravel the fraud.

I. Types of Fraud

A. Ponzi Schemes

One of the more common types of large-scale frauds that land in insolvency proceedings are Ponzi schemes. If a true Ponzi scheme, ongoing business operations are unlikely as the scheme will have to stop operating since new funds will not be coming in and promised returns will not be paid out.

A Ponzi scheme is a fraudulent enterprise run under the pretense of a legitimate profit-making business. Investments are solicited from new investors, and those funds are then used to pay earlier investors. That, of course, induces further investments. All the while, the Ponzi scheme operator siphons off a substantial part of the funds for personal use and makes transfers of the investor funds to earlier investors and third parties. The scheme is destined to fail, often landing in a bankruptcy or receivership proceeding.

The facts considered by courts to determine whether a Ponzi scheme exists range in scope. One court created a four-factor analysis that many other courts have relied upon:

> (1) deposits were made by investors; (2) the Debtor conducted little or no legitimate business operations as represented to investors; (3) the purported business operations of the Debtor produced little or no profits or earnings; and (4) the source of payments to investors was from cash infused by new investors.[1]

[1] *Rieser v. Hayslip* (*In re Canyon Sys. Corp.*), 343 B.R. 615, 630 (Bankr. S.D. Ohio 2006) (citation omitted).

B. Theft of Cash

There are a number of fraudulent schemes that involve different elements of fraud but may not rise to the level of a full Ponzi scheme. These fraudulent activities can nevertheless bankrupt a company if the dollars are large enough and if the fraud has gone undetected for a long time.

1. Embezzlement

Embezzlement is the fraudulent taking of personal property by someone to whom it was entrusted. This often occurs when an employee misappropriates funds from an employer. Methods of embezzlement differ. Some embezzlers "skim off the top" so that they continually acquire a small amount over a long time period, helping to reduce the likelihood of being caught. On the other hand, some embezzlers steal a very large amount of money or property in a single instance and then disappear.

2. Cash larceny

Cash larceny is the theft of money that appears on an organization's books. This could involve employees writing checks to themselves or for their benefit, reversing cash transactions, or the creation of a fictitious vendor so that checks to the vendor can be cashed by the employee. This type of fraud can be detected through cash reconciliations of the organization's records.

3. Skimming

Skimming is fraud that involves the theft of money that has not yet been recorded in the organization's books. For example, an employee accepts cash for a sale but keeps that cash rather than ringing it up as a sale at the cash register.

4. Lapping

Lapping is a form of skimming where money received in payment of a receivable is stolen. To fill the hole, the next payment that is received for a different receivable is applied to the first receivable and so on.

5. Billing fraud

Billing fraud is the theft of cash when, for example, an employee charges personal purchases and disguises them as a business expense. Phony supporting documentation is prepared and the company pays the bills and receives no benefit.

6. Fraudulent submission of expense reports

Theft occurs when an employee submits personal expenses or phony expenses through expense reports to be reimbursed by the company, charging for things like excess mileage, extravagant meals, and gifts.

C. Financial Statement Fraud

This type of fraud occurs when a company attempts to make the financials appear better or more robust than they are and, based on fictitious documentation, borrows money or improperly solicits invest dollars. Some examples of financial statement fraud are:

a. Overstating revenue by recording sales prematurely
b. Reallocating revenues to future periods to present a better financial picture
c. Understating expenses
d. Hiding or misrepresenting related party transactions
e. Creating off-balance sheet accounts
f. Improperly valuating assets or hiding liabilities

II. Due Diligence to Uncover Fraud

A. Warning Signs of Ponzi Schemes

The SEC has published red flag warning signs which many Ponzi schemes share in common:

- **High investment returns with little or no risk**. Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.

- **Overly consistent returns**. Investment values tend to go up and down over time, especially those offering potentially high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions.

- **Unregistered investments**. Ponzi schemes typically involve investments that have not been registered with the SEC or with state regulators. Registration is important because it provides investors with access to key information about the company's management, products, services, and finances.

- **Unlicensed sellers**. Federal and state securities laws require investment professionals and their firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.

- **Secretive and/or complex strategies**. Avoiding investments you do not understand, or for which you cannot get complete information, is a good rule of thumb.

- **Issues with paperwork**. Do not accept excuses regarding why you cannot review information about an investment in writing. Also, account statement errors and inconsistencies may be signs that funds are not being invested as promised.

- **Difficulty receiving payments**. Be suspicious if you do not receive a payment or have difficulty cashing out your investment. Keep in mind that Ponzi scheme promoters routinely encourage participants to "roll over" investments and sometimes promise returns offering even higher returns on the amount rolled over.[2]

B. Types of Due Diligence

A lack of reasonable due diligence, especially in the face of red flag warning signs, is the primary reason that investors are scammed by Ponzi scheme perpetrators. Separately, once a company is in bankruptcy, similar due diligence analysis can assist in detecting and ultimately in unraveling a fraud. Fraud can be uncovered in a variety of ways – by a tip, by management review, by an internal audit, or sometimes accident. Additionally, some fraudsters in operating companies are discovered by police or other agencies. Lastly, we have seen the fraudster confess, usually admitting that they misappropriated less than they actually did, as the pressure becomes too much. Once in bankruptcy, a team of professionals can not only discovery fraud, but can begin the process of unwinding the fraud to seek recovery for victims and creditors.

Some areas of due diligence designed to detect fraud are summarized as follows:

1. Bank Records

- Corralling all bank statements, cancelled checks, deposit detail and wire transfers
- Trace the flow of funds and identify improper payments, payments to insiders, vendors and lenders
- Build a preference and fraudulent transfer data base

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[2] SEC*, Ponzi Schemes — What are some Ponzi scheme "red flags"*?, http://www.sec.gov/fast-answers/answersponzhtmi.html.

2. **Financial Statements**
- Review audited financial statements
- Review tax returns
- Check for accuracy and completeness
- Call the auditor

3. **Company Records Review**
- Books and records of the business
- Vendor files
- Emails
- Tracing of the cash through the bank accounts
- Evaluation of proofs of claim
- Interviews
- Employee files
- Company credit card usage
- Disbursements

4. **Public Information About the Company**
- Investigate negative news coverage
- Conduct nationwide litigation search
- Conduct criminal background check
- Explore social networking sites

5. **The Business Model**
- Investigate the need for investor funds
- Is there a plausible, sustainable investment strategy?
- Is there independently verifiable performance?
- Are there unusual legal provisions?

6. **Complicated Corporate Structure**
- Who are the principals?
- Are there multiple levels of corporate ownership?
- Are there affiliated companies in the same business?
- Are there intercompany purchases and sales?

7. **Operational Issues**
- Investigate accounting and reporting systems
- Investigate reports made to customers
- Are operations consistent with reports?
- Is there micro-management by owner?
- Is there turnover at significant financial positions?

8. Investigate Company's Auditor

- Is the auditor for the investment truly independent?
- Is the size of the audit shop proportionate to the size of the investment?

9. Red Flags from Financial Transactions

- Customers who provide insufficient or suspicious information
- Customers who are reluctant to comply with reporting or record-keeping requirements
- Funds transferred to or from a financial secrecy haven
- Unusual transfers of funds between related entities
- Sudden inconsistencies in currency transaction patterns and shell company activities
- Significant increases in the number or amount of transactions
- Transactions that are not consistent with the customer's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures
- Lavish lifestyle of customers, which should not be supported by present income
- Customers with multiple accounts
- Diversion of funds to personal accounts
- Increases in the number or amount of transactions
- Transactions not consistent with company's business or income level
- Transactions designed to lose the paper trail
- Circumvention of internal control procedures.
- Irregular documentation
- Suspicious Intra-Company Transfers

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Kathy Bazoian Phelps is a partner at Raines Feldman LLP in the Los Angeles office and has been a lawyer since 1991. She practices in the areas of bankruptcy law and fraud litigation, and frequently represents bankruptcy trustees and state and federal receivers, as well as serving as a Chapter 11 trustee herself. She represents litigants and parties in interest in bankruptcy and receivership cases and other insolvency proceedings. She is particularly knowledgeable about the administration of Ponzi scheme cases and has extensive litigation experience in claims arising in these types of cases and in tracing and recovering assets.

Kathy has lectured widely and written on bankruptcy and receivership matters, with a focus on Ponzi schemes. Her book entitled *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*, co-authored with Hon. Steven Rhodes, has garnered national and international attention as the authoritative work on Ponzi scheme law.

In addition to her roles as lawyer, speaker and author, Kathy also serves as a mediator and is currently on the mediation and arbitration rosters for the Financial Industry Regulatory Authority, as well as the Bankruptcy Mediation Panel for the Central District of California and the Bankruptcy Mediation Panel for the District of Arizona.

Publications

- *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes.* co-authored with Hon. Steven Rhodes (Ret.) (LexisNexis® 2012)
- *Fraud and Forensics: Piercing Through the Deception in a Commercial Fraud Case*, co-author (American Bankruptcy Institute 2015)
- *Ponzi-Proof Your Investments: An Investor's Guide to Avoiding Ponzi Schemes and Other Fraudulent Scams* (IRR Publishing 2013)
- *The Depths Of Deepening Insolvency: Damage Exposure For Officers, Directors and Others*, co-authored with Prof. Jack F. Williams (American Bankruptcy Institute 2013)
- Author of *The Ponzi Scheme Blog* at www.theponzischemeblog.com

IWIRC®

Challenges in Cross-Border Fraud, Asset Recovery & Insolvency Matters

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Multi-Disciplinary, Multi-Faceted Approach

To be effective, any credible effort to pursue claims relating to fraud, corruption, and related economic crimes requires an experienced, multi-disciplinary team of:

- Experienced lawyers with expertise in multi-jurisdictional, cross-border matters. Investigators and Forensic Accountants.
- Anti-money laundering analysts located in each jurisdiction relevant to this matter. Efforts should be led by a small group of senior recovery specialists with experience in team management.
- Modern-day "asset" or "value" recovery involves developing strategies to identify and sue the facilitators of corruption who are the life blood of the process of concealing proceeds.

Tiered, Phased Approach

In a cross-border asset recovery scenario, the best approach to managing costs and finding the best path to victory in an asset recovery and fraud case is to use a phased and tiered approach.

- **Phase 1 – Factual and Legal Claim Analysis**
  - Collaboration with the client, forensic and legal teams to achieve an in depth review and understanding of the facts is required. The lack of available records/evidence, including as a result of sabotage, may be mitigated through the use of international legal processes.
  - **Phase 2 - Investigative/Discovery Phase**
  - Conduct discovery and do investigation to be able to formulate a plan to deploy. A variety of discovery tools may be deployed in aid of litigation efforts and to assist in identifying additional claims against parties. Discovery orders such as Norwich Pharmacal / Bankers Trust Orders or orders under 28 U.S.C. § 1782.
- **Phase 3 - Deployment Phase**
  - Develop strategies for pursuit of legal claims based on discovery and investigative yield.
  - Commence claims in strategic order. The timing and order of the process are critical to achieving success.

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SECTION 1782:
WHAT IS IT?

- Section 1782 is a statute that authorizes U.S. federal courts to order discovery for use in foreign proceedings.
- It allows a party involved in a foreign proceeding to petition a federal court in the U.S. for discovery located in the U.S. court's district.
- It serves as a useful asset-recovery tool.
- Foreign litigants are typically granted a wide degree of latitude in seeking and obtaining information hosted locally.

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Insolvency is the Powerful Tool of Asset Recovery

- Insolvency is a powerful tool in the judgment collection process.
- Exploring the available options in the jurisdictions where a judgment debtor is located or has assets is a critical part of the analysis.
- A judgment may be a springboard for the initiation of insolvency proceedings. Similar to the filing of an involuntary bankruptcy proceeding under the U.S. Bankruptcy Code, various jurisdictions have procedures for involuntarily placing a judgment debtor into a formal insolvency/liquidation proceeding.
- If there is an existing insolvency proceeding that may qualify for recognition under the UNCITRAL Model Law, the potential recognition and benefits thereof should be examined. For example, in a Chapter 15, a foreign representative or agent to act on behalf of the company may qualify for recognition, which must be explored.

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CHAPTER 15
WHAT IS IT?

Chapter 15, Title 11 of the Bankruptcy Code is modeled after the Model Law on Cross-Border Insolvency developed by UNCITRAL.

Chapter 15 provides a mechanism for obtaining recognition and other relief in the U.S. in aid of:

- foreign bankruptcy;
- foreign insolvency;
- foreign liquidation; or
- foreign debt restructuring.

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Consider § 1782 when:

- corporations or individuals *in the United States* have information that is useful or necessary to a case (either ongoing or under preparation) in a court or tribunal *outside the United States*.
- the evidence sought includes *documentary evidence* (i.e. contracts, financial records, ESI, and correspondence) or *testimonial evidence* (i.e. depositions and interrogatories).
- it is difficult to use a foreign court system to obtain evidence located in the United States.
- there is an extraordinary circumstance that may warrant the request for a gag and/or seal order

Consider an Insolvency/Chapter 15 strategy when:

- A stay is necessary to protect assets or stop pending litigation;
- An insolvency proceeding is already pending in on or more foreign jurisdiction(s) and to promote uniformity, cooperation, and communication between courts and parties in cross-border asset recovery efforts;
- The potential exists for using a judgment or other proceeding as a springboard to initiating a "foreign proceeding";
- There is information and or assets in multiple states within the United States or various foreign jurisdictions where recognition may be obtained.
- Where there is no concern relating to the public nature of the strategy employed.
- Where potential claims under U.S. and foreign law exist against targets in the United States

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KEY DEFINITIONS

"Foreign proceeding"

- A collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation. See 11 U.S.C. § 101(23).

"Foreign representative"

- A person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding. See 11 U.S.C. § 101(24).

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MAIN vs. NON-MAIN RECOGNITION: WHAT TO LOOK FOR

FOREIGN ***MAIN*** PROCEEDING

- "A foreign proceeding pending in a country where the debtor has the center of its main interests" ("COMI").
- **Ask:** Is the foreign proceeding pending in: (1) the location of the debtor's headquarters? (2) the location of those who actually manage the debtor? (3) the location of the debtor's primary assets? (4) the location of a majority of the debtor's creditors? (5) the jurisdiction whose law would apply in most disputes? (6) the location of the debtor's "nerve center," including where the debtor's activities are located and controlled?

FOREIGN ***NON-MAIN*** PROCEEDING

- A foreign proceeding pending in a country where the debtor has an "establishment."
  - An establishment is "any place of operations where the debtor carries out a non-transitory economic activity." Presence of assets alone is insufficient.

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BENEFITS OF RECOGNITION

Foreign *Main* Proceeding

- Recognition triggers the ”automatic stay,” which stays execution on debtor’s assets or on actions against debtor’s assets, rights, obligations, or liabilities. 11 U.S.C. §§1519, 362.
- Upon recognition, a foreign representative:
  - has the capacity to sue and be sued in the U.S.
  - Adversary proceedings asserting U.S. law claims against third parties.
  - Fraudulent transfer and clawback claims under foreign law.
  - may take extensive discovery of the debtor’s assets, affairs, rights, obligations, and liabilities. 11 U.S.C. § 1521(a)(4).
  - may administer the debtor’s assets. 11 U.S.C. § 1521(a)(5).
  - may apply directly for appropriate relief; and
  - shall be granted comity or cooperation by U.S. courts.

Foreign *Non Main* Proceeding

Upon recognition, a court may (but is not required to) grant the scope of relief available for a main recognition if the interest of creditors and other interested entities, including the debtor are sufficiently protected.

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Political Risk & Strategies to Manage It

In certain jurisdictions, political risk must be accepted as part of the legal topography that must be overcome. Political risk and the risk of corruption of the legal landscape is sadly a reality.

As a result, legal strategies must be sensitive to such risks to combat, minimize and even eliminate them to the extent possible.

These strategies which include creative staffing, outreach efforts and the use of existing organization pressures to effectuate the strategies.

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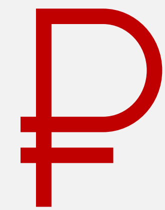
Litigation Funding



Funders typically require a detailed memorandum analyzing the claims, basis of and possible defenses to claims, damage quantum analysis and collectability analysis in order to evaluate the case with regard to their interest in providing litigation funding.

Then, funder will provide the client with a funding proposal that may vary from funder to funder based on their view of the likelihood of success and collectability.

Usually funders will want multiples of their investment from any recovery after they get their principal investment back, which multiple may vary based on their view of the likelihood of success and collectability. This is expensive money.

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