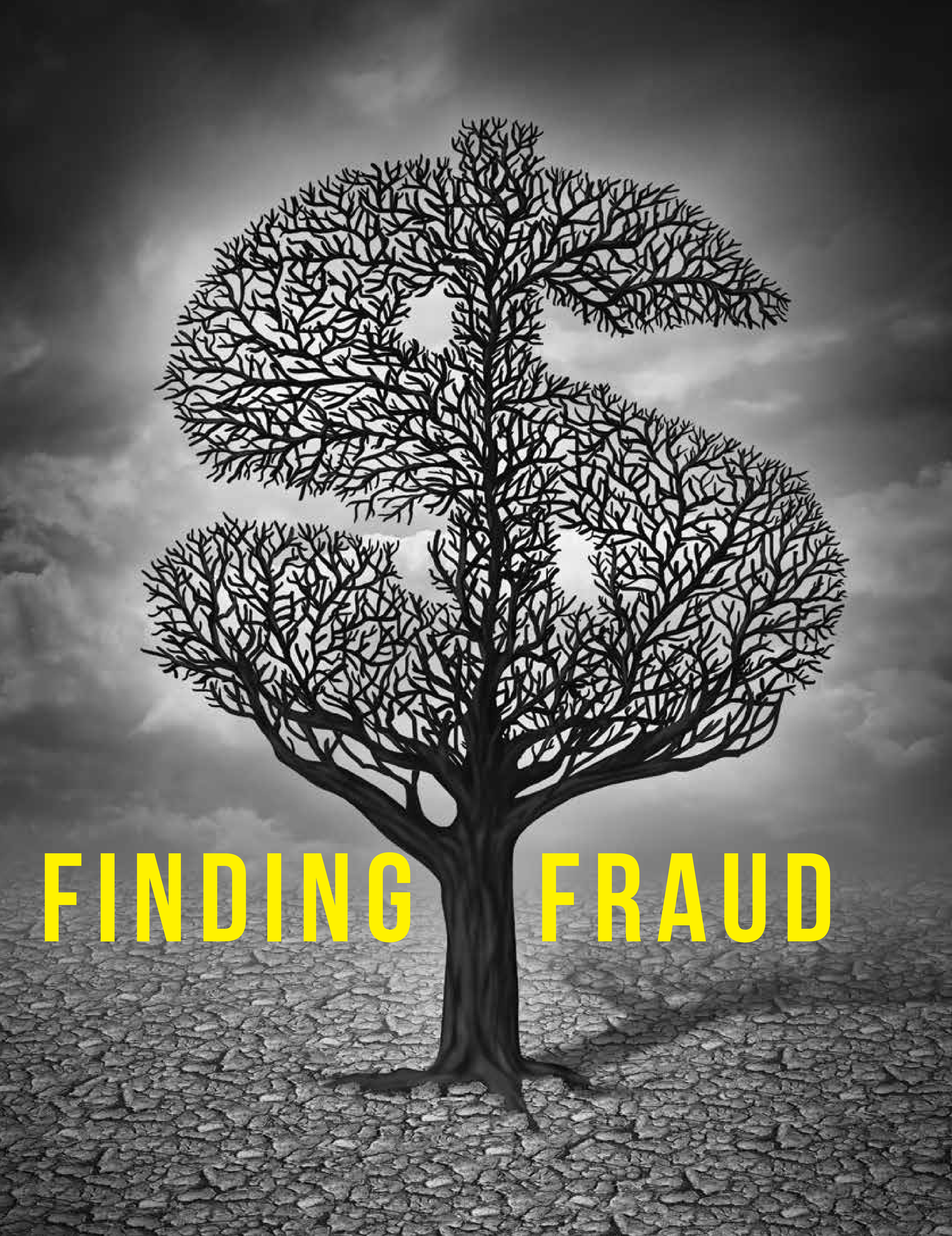
FINDING FRAUD



HFCC, a fertilizer and chemical applicator, went bankrupt. Investigations discovered the owner committed bank fraud, financial statement fraud and performed fraudulent conveyances or fraudulent transfers. However, a judge ruled that the author and the company's outside CPA didn't prove the company was insolvent during all the transfers, which limited the penalties. Here the author proposes a better way to establish the date of the insolvency of an entity and thus recover more fraud proceeds.

A fraud case I worked reminded me that establishing the date of insolvency in a business bankruptcy filing can be key to recovering *fraudulent conveyances* or *preference payments*.

HFCC was a custom fertilizer and chemical applicator in a sparsely populated county in southern Illinois. The owner of the company was purchasing chemicals from large brokers in Iowa. The manufacturers of the chemicals were offering year-end rebates to purchasers based on a sliding scale. In other words, the more chemicals purchased from a manufacturer the higher percentage rebate paid to the purchaser.

For example, if the owner of HFCC bought $100,000 worth of chemicals from a manufacturer he might get a 5 percent rebate or $5,000 at the end of the year. However if he purchased $2 million of chemicals from the manufacturer he might get 15 percent or $300,000 in rebates during the year.

HFCC's owner figured out that if he could buy from the distributors in bulk and broker the goods out to wholesalers in the Midwest region of the U.S., he could qualify for maximum rebate percentages.

Here are the conditions of the chemical sales environment that HFCC's owner was trying to capitalize on:

- Occasional regional price differentials occurred in certain products during certain seasons when he could buy for his region at a lower price than what the product was being sold for in a different geographic region.
- The exact amount of a rebate was sometimes negotiable and paid in cash and product.

IN BANKRUPTCY CASES

RECOVER FRAUD PROCEEDS BY DETERMINING INSOLVENCY DATES

BY ROGER W. STONE, CFE

- The salesmen would sometimes make verbal promises of rebate amounts that ended up being higher than what the manufacturers ultimately determined to rebate at the end of the year.
- The salesmen and distributors were looking for volume sales, and credit was relatively easy to obtain.
- The owner brokered 90 percent of his product to wholesalers at 15 percent below his cost expecting to receive 20 percent in manufacturer's rebates.

Ultimately, HFCC's owner had gotten his numbers wrong. He was selling the product for less than the combination of his cost less the manufacturer's rebates he ultimately received. He also hadn't taken into account the increase in costs of his operation as he was handling the large volumes of product.

These conditions led to this situation at the time of HFCC's bankruptcy filing:

- HFCC purchased more than $100 million of chemicals in three years of which less than 10 percent was sold to the local market.
- The wholesalers were purchasing product from HFCC and reselling it back into the market at costs less than other operators could purchase it for from their distributors.
- HFCC filed bankruptcy owing approximately $12 million to two large distributors and a local bank while having approximately $2 million in assets and an uncertain amount of rebates receivable from manufacturers.
- Some manufacturers were claiming that because HFCC didn't use product in its market area, the company didn't qualify for the rebates.

FRAUDS COMMITTED

The owner perpetrated these fraudulent activities to obtain the credit to continue the operation:

- He falsified invoices from HFCC to manufacturers and obtained financing on them from a bank in the amount of $2.5 million, thus committing bank fraud.
- He overstated the amount of inventory and accounts receivable on his books, thereby committing financial statement fraud.
- Prior to filing bankruptcy he was selling inventory at below his cost and market value while HFCC was insolvent, thus performing fraudulent conveyances or fraudulent transfers.

My firm's job was to liquidate the company, maximize the amount of rebate money received from manufacturers and pursue recovery from any fraudulent conveyances.

We sold the buildings and inventory at auction for approximately $1.5 million.

The manufacturers paid us rebates averaging about 11 percent of the current year's purchases, which worked out to be approximately $1.7 million.

We successfully negotiated with the manufacturers that claimed they didn't owe the rebate because HFCC didn't sell in their market area by pointing out to them that they paid the rebates in the prior two years, and if all the chemicals purchased from them during that time had been used in HFCC's county of operation, the county would've become a toxic waste dump site.

Our final step in recovery was to sue the brokers for fraudulent conveyances. This resulted in two reasonably amicable settlements and one hotly contested trial that lasted five days. We were asking for $3 million in damages from fraudulent conveyances and immediately prior to the trial they offered us $50,000.

The judge ruled, and we ultimately settled for, in excess of $600,000. In her ruling the judge stated that even though we had me and the company's outside CPA testify that the HFCC was insolvent during the fraudulent transfers, we didn't prove that the company was insolvent during all of the transfers.

It was at this point that I started thinking about a better way to establish the date of insolvency of an entity.

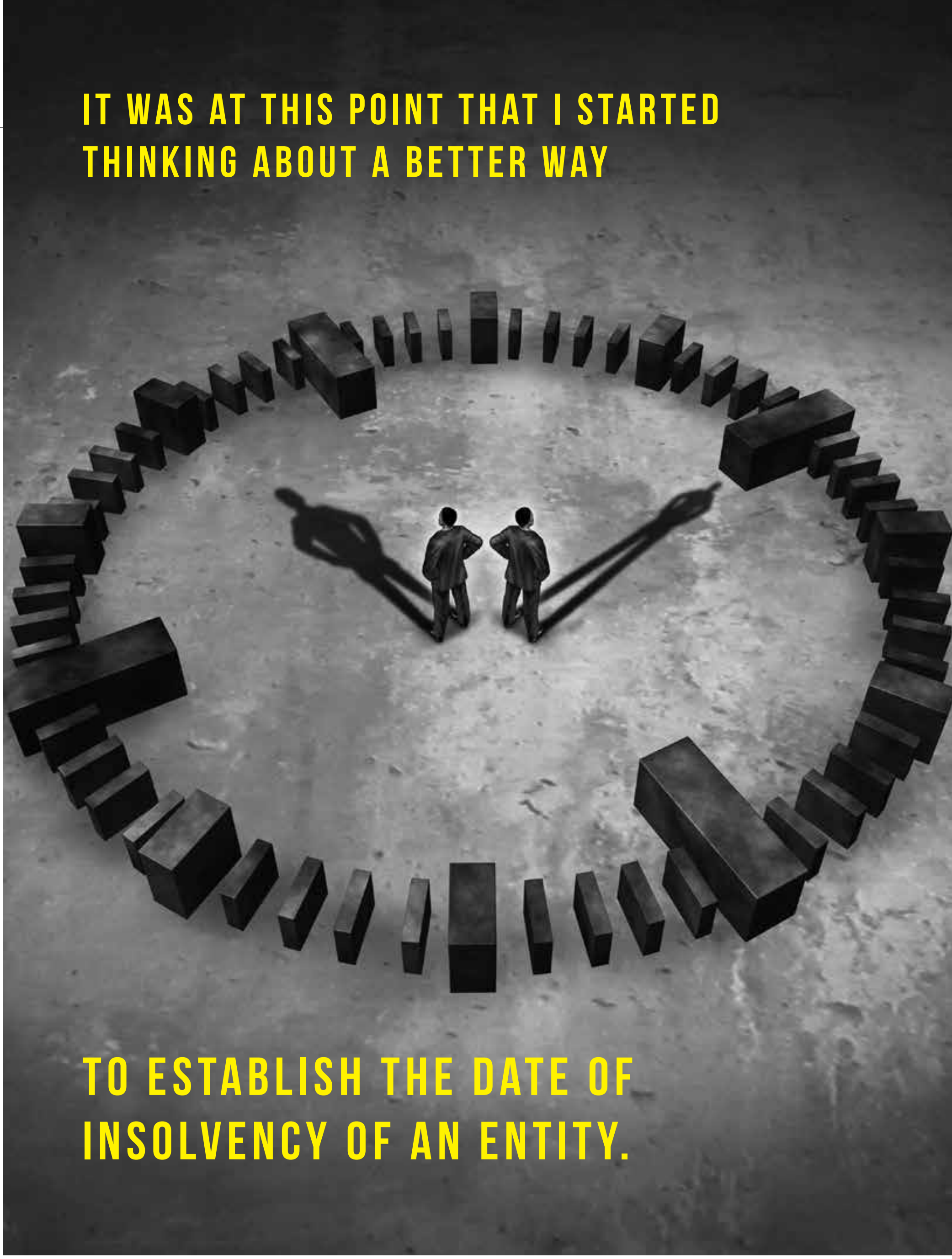
ESTABLISH INSOLVENCY DATE, FIND FRAUD MONEY

So here's my case for establishing the date of insolvency in a business bankruptcy filing, which can be key to recovering fraudulent conveyances or preference payments.

A *fraudulent conveyance* or *fraudulent transfer* is an attempt to avoid debt by transferring money or assets to another person or company while the transferor is insolvent. A *preference payment* is a payment made by the debtor to a creditor for pre-existing debt while the debtor is insolvent. Essentially the debtor has made a payment to one creditor in preference to the other creditors to whom he owes money.

Recovering fraudulent conveyances and preference payments can be a significant part of a bankruptcy estate and is a key part of the duties of a debtor in possession (DIP) or trustee in a bankruptcy proceeding.

All parties normally presume insolvency for the 90 days immediately preceding the filing for bankruptcy. That means that the DIP or trustee can recover any fraudulent payments or preference payments made during the 90 days prior to the bankruptcy filing. However, a creditor can rebut this presumption.



There's also the very common problem of an unscrupulous debtor who knows that bankruptcy is inevitable and so delays the bankruptcy filing long enough to allow him to make fraudulent transfers and preference payments prior to the automatic cutoff dates for recovery of these payments and transfers.

This is why it's often important to determine if the insolvency date was prior to the bankruptcy filing and to determine when the entity became insolvent.

Establishing a standard methodology to establish insolvency would be extremely beneficial to all parties involved and could prevent fraud.

PROPOSED METHODOLOGY FOR DETERMINING AN INSOLVENCY DATE

I propose that anyone establishing a date of insolvency prior to the bankruptcy filing should provide evidence of the following:

1. The fair market value of the entity's assets was less than the fair market value of their liabilities.
2. The entity had a negative net income for the time period from the claimed date of insolvency to date of the bankruptcy filing.
3. There was no additional investment in the entity during the time period from the claimed insolvency date to the bankruptcy filing that resulted in the fair market value of the assets exceeding the amount of liabilities.

If these three conditions are established then the date of insolvency should be confirmed.

ROLE OF CFES IN DETERMINING INSOLVENCY

CFEs can have these possible roles in this process:

- DIPs or trustees could engage CFEs as experts to assist in establishing actual dates of insolvency so that DIPs or trustees can pursue recovery of these fraudulent conveyances and preference payments for the benefit of the estate.
- Creditors could also engage CFEs as experts to assist in rebutting the date of insolvency claimed by the DIP or trustee.

DEFINITION OF INSOLVENCY AS IT RELATES TO FRAUD

Section 101(32)(A) (http://tinyurl.com/he5ft5m) of the bankruptcy code states that *insolvent* means the sum of the entity's debts is greater than all of such entity's property at a fair valuation exclusive of property transferred, concealed or removed.

U.S. Code Title 26, Section 108(d)(3) (http://tinyurl.com/gsl64qu) defines *insolvent* as the excess of liabilities over the fair market value of assets. That section further provides that whether a taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge in bankruptcy.

XYZ CORPORATION Balance Sheet As of December 31, 20XX			
ASSETS			
CURRENT ASSETS	HISTORICAL VALUE	ADJUSTMENTS	FAIR VALUE
Cash and cash equivalents	$50,000	$- MOVE $	$50,000
Accounts receivable-net	950,000	(275,000)	675,000
Notes receivable – stockholders	75,000		75,000
Inventories	725,000	(200,000)	525,000
Prepaid expenses	125,000	(125,000)	-
Other current assets	8,000	(8,000)	-
Total current assets	$1,933,000	(608,000)	$1,325,000
PROPERTY & EQUIPMENT			-
Machinery & equipment	$750,000	$(450,000)	$300,000
Vehicles	50,000	(25,000)	25,000
Furniture & fixtures	250,000	(150,000)	100,000
Leasehold improvements	850,000	(850,000)	-
Total property & equipment	1,900,000	(1,475,000)	425,000
Less accum. depreciation	650,000	(650,000)	-
Net property & equipment	$1,250,000	$(825,000)	$425,000
Other assets			
Deposits	20,000	-	20,000
Total other assets	$20,000	-	$20,000
Total assets	$3,203,000	$(1,433,000)	$1,770,000
Liabilities & equity	Historical value	Adjustments	Fair value
CURRENT LIABILITIES			
Accounts payable	$900,000	$- MOVE $	$900,000
Accrued expenses	75,000	(50,000)	25,000
Notes payable	50,000	-	50,000
Income taxes payable	9,000	-	9,000
Total current liabilities	$1,034,000	$(50,000)	$984,000
Long-term liabilities			
Notes payable	$950,000	$- MOVE $	$950,000
Total liabilities	$1,984,000	$(50,000)	$1,934,000
STOCKHOLDERS' EQUITY			
Common stock	$25,000	$- MOVE $	$25,000
Retained earnings	1,194,000	(1,383,000)	(189,000)
Total stockholders' equity	$1,219,000	$(1,383,000)	$(164,000)
Total liabilities & equity	$3,203,000	$(1,433,000)	$1,770,000

Though these definitions are very close in meaning they're not exactly the same.

INHERENT WEAKNESSES OF USING THESE INSOLVENCY DEFINITIONS

Here are some inherent weaknesses of using bankruptcy or IRS definitions alone to establish the date of insolvency:

- If the entity has a positive net income after the insolvency date it's difficult to consider it insolvent.
- Just because the entity was insolvent at one period of time prior to the bankruptcy filing doesn't mean that it was insolvent at all times between the claimed insolvency date and the bankruptcy filing.
- In some cases a positive cash flow would argue against the company being insolvent.

If a company has a positive net income that's reinvested into the business, then over time it will eventually show an excess of the fair market value of assets over liabilities.

It's possible for a positive event to happen after the claimed date of insolvency that would increase the fair market value of the assets or decrease the amount of liabilities, such as:

- Income from operations significant enough to make the fair market value of assets greater than the liabilities.
- A person or entity could invest enough into the business to make the fair market value of assets greater than the liabilities.
- A market shift that increases the fair market value of certain assets.

These events could be permanent where it would seem unlikely that the company would later file for bankruptcy; however, they could also be of the following type:

- Income from operations was positive for a time prior to the bankruptcy filing but then become losses.
- The amount invested could make the entity solvent for a time, but heavy losses from operations would once again result in the fair market value of assets being less than liabilities prior to the bankruptcy filing.
- A negative market shift after the positive market shift would decrease the value of certain assets.

It would seem to be a strong creditor argument if the entity was solvent at any point in time between the claimed insolvency date and the bankruptcy filing.

ADJUSTING THE BALANCE SHEET TO DETERMINE IF FAIR MARKET VALUE OF ASSETS EXCEEDS THE LIABILITIES

An entity's balance sheet or statement of condition when prepared according to GAAP is a combination of some items presented at historical cost and some items presented at current value. To determine the insolvency date of an entity, this balance sheet has to be converted from book values to fair values.

The assumptions used in this conversion from book value to fair value can be heavily contested between parties with experts brought in from both sides. *These experts can be and often are CFEs.*

Listed in the table on page 44 is an excellent conversion example that was presented in an article, "Determining Insolvency in Preference and Fraudulent Conveyance Actions," in the *American Bankruptcy Institute Journal* by Sharyn B. Zuch and Richard P. Finkel, Vol. XX, No. 9, November 2001. (See http://tinyurl.com/jrqhgnb.)

In the example, the assets and liabilities have been evaluated by line item and converted to their fair values with these adjustments:

- Accounts receivable has been reduced by $275,000 most likely because of stale or uncollectible accounts.
- Inventory has been reduced by $200,000 probably because of obsolescence.
- Prepaid expenses have been reduced by the entire $125,000 because they have no fair value.

- Other current assets reduced by $8,000 after determining they have no fair value.
- All property and equipment except leasehold improvements have been reduced by $825,000 to their fair value.
- The leasehold improvements' entire book value of $850,000 has been written off because leasehold improvements have no fair value.
- Accrued expenses have been written down by $50,000 most likely because the anticipated expenses won't be incurred.
- The net effect of converting this balance sheet from book value to fair value is a reduction in equity of $1,383,000 from $1,219,000 to $(164,000). In this example, the company that showed on its book to be solvent was actually *insolvent* after converting to fair value.

PROVING DEBTOR WASN'T SHOWING POSITIVE NET INCOME FROM CLAIMED INSOLVENCY DATE TO BANKRUPTCY FILING DATE

In most cases, the claimed insolvency date and the bankruptcy filing date aren't during the standard end of period dates for financial statements. It should be the duty of the trustee to prove that the entity hasn't shown positive net income from the claimed date of insolvency to the bankruptcy filing date. This proof should involve these demonstrations:

- The trustee should prove that net income from operations from the claimed date of insolvency to the bankruptcy filing date is a loss.
- If net income from operations is positive, then the trustee should check for any distributions to insiders during the period that would result in the entity remaining insolvent.
- If net income is positive, the trustee should check for a significant change in fair value of assets or liabilities.

If net income from operations is *negative* from the claimed insolvency date to the bankruptcy filing date, then you've completed the second step of proving that the entity was insolvent from the claimed date to the filing date.

If net income from operations is *positive* during the stated time period then check for any distributions to related parties. If you find any significant distributions to related parties then you would show that the entity remained insolvent, and the estate would also have claims on the distributions made to related parties.

Finally, if the entity shows a positive income from operations you'll need to review the quality of assets and liabilities. Often you could find fraudulent accounting entries such as sales to nonexistent entities or sales made without accounting for cost of goods sold.

Positive net income from operations from the claimed date of insolvency to the bankruptcy filing date and no negative factors listed above could strongly disprove that the entity was insolvent at the claimed insolvency date. If the entity was having a positive net income then you'd look at what factors caused the bankruptcy filing.

ADDITIONAL INVESTMENT IN THE ENTITY

The final test for proving insolvency is proving no additional investment in the entity. This investment would have to be in the form of equity as opposed to loans because loans would have no affect on the insolvency calculation. If anyone made a significant investment in the entity after the filing date you would have to recalculate the fair value of the assets at the time of the investment to determine if the fair market value of assets exceeded the liabilities at that point in time.

The fair value of the assets after the investment exceeding the liabilities would indicate that the claimed insolvency date shouldn't be used.

RECOVERING PROCEEDS FROM FRAUD

Establishing common standards for determining a date of insolvency of an entity in a bankruptcy proceeding could not only be helpful to all parties but also could recover money lost from fraud.

This proposal suggests these standards to establish the date of insolvency:

- The sum of the entity's debts is greater than all of such entity's property at a fair valuation.
- The debtor's net operating income less distributions is negative from the claimed date of insolvency to the bankruptcy filing date.
- No subsequent investments after the claimed insolvency date that makes the entity solvent.

Adopting a standard process for proving insolvency will lead to more productive arguments on both sides plus recovery of assets. ■ FM

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