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Fraud Investigations

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Introduction

25 years ago a typical major, single act of fraud involved losses of five to ten million dollars. Just 10 years ago, the amount of losses involved in a large fraud scheme escalated into the hundreds of millions of dollars. As we have seen over the last three years, a single act of major fraud can now involve losses in the billions of dollars. What this dramatic growth in the scale of financial losses due to fraud indicates is that fraudsmen and women have become much more sophisticated. And, increasingly, fraudspeople are targeting and manipulating the bankruptcy system to achieve their goals.

Whether it is personal or corporate bankruptcies, fraudspeople have discovered that the more complicated the fraud that they construct, the more likely it is that they will get away with the crime. The assumption that fraudspeople make is that few case trustees or creditors have the budget that is necessary to pay for the services required to unravel a truly complicated fraud. Fraudpeople also assume that institutional creditors are more willing to write-off bad debt rather than "throw good money after bad." Therefore, the assumption further goes, if we, the fraudspeople, can just hang on long enough, the creditors will tire of investigating and the scheme will work. Finally, career fraudspeople also tend to assume that they can conceal the truth from the Bankruptcy court because a bankruptcy trustee will not likely investigate the depth of the scheme or the accuracy of the debtor's statements or disclosures.

To prevent bankruptcy fraud, therefore, all bankruptcy cases should undergo increased scrutiny and review for fraud. Such reviews can be conducted in a cost-effective manner using common tools such as database searches, discovery (including interrogations through deposition), and forensic accounting. These tools, however, are successful in uncovering fraud only when used by the right team of experts.

In our experience, the team that is necessary to unravel a fraud scheme consists of: a lawyer experienced in formulating and carrying the burden of proof in a fraud case before the bankruptcy court; a seasoned private investigator with a history of uncovering hidden assets; and a forensic accountant with a track record of uncovering clues in a sea of false-positives. The goal of this panel, therefore, is to explain how these team members work together to unravel a fraud scheme and to educate the bankruptcy community on how to detect fraudulent bankruptcies, what questions to ask of a debtor, how to spot forgeries, and how to manage an investigation on a limited budget. To illustrate these points, the panel will discuss two hypotheticals: a commercial bankruptcy fraud and a consumer loan bankruptcy fraud.

Before discussing the hypotheticals, however, it should first be noted that in commercial bankruptcies there are two distinct categories of fraudspeople. The first category is the legitimate small business owner whom, through a series of setbacks in their business, begins to see the ultimate failure of their business in the distant future. Due to the fear of outstanding debts and other obligations that they will no longer be able to meet after the bankruptcy, these individuals begin to plan in advance for the failure of their business. The most common aspect of such planning is to transfer corporate assets into personal accounts to create a reserve of private funds for the inevitable rainy days ahead.

The second category of fraudspeople is those who premeditate a fraud scheme. Such debtors are typically sophisticated businesspeople, perhaps having had prior bankruptcy experience, and plan in advance to use lawyers, accountants, and the laws of incorporation and bankruptcy to achieve their goals. For obvious reasons, debtors that fall within this category warrant extensive additional investigative scrutiny.

Hypothetical # 1 – Commercial Bankruptcy Fraud

Debtor Profile: John Fraudly, age 52, President & CEO, Fraudly Properties, Inc. Fraudly holds a joint JD/MBA degree from a prominent state university. Fraudly is married to Kelly Fraudly and the couple has three children. The family maintains a residence in Hanover, New Hampshire. Two of his children, Jack and Peter Fraudly, operate a small marketing firm in Miami, Florida and the third child, Patty Fraudly, attends college in New Hampshire.

Professionally, Fraudly served as a corporate attorney with a prominent national law firm in Boston after his graduation from law school. After practicing commercial real estate law for several years, Fraudly joined the commercial real estate practice of a major international investment bank. After eight years with the investment bank, Fraudly founded Fraudly Development, Inc., a commercial real estate venture incorporated in the State of Massachusetts. In 2001, Fraudly Development, Inc. was forced into bankruptcy due to loan defaults on a retail mall development in Sarasota, Florida. Fraudly Development Inc.'s real holdings portfolio was subsequently liquidated in bankruptcy to satisfy the commercial bank loan obligations and the company folded.

In 2002, John Fraudly then incorporated in the State of New Hampshire Fraudly Properties, Inc. Fraudly Properties Inc. maintains its corporate headquarters in Hanover, New Hampshire.

The Bankruptcy Events:

With 20+ years of commercial real estate experience in projects throughout the United States, John Fraudly spearheaded the rapid buildout of Fraudly Properties, Inc. Backed by letters of credit from prominent financial institutions throughout the U.S., Fraudly Properties, Inc. invested in over fifty commercial real estate projects. Using the projects as collateral, Fraudly Properties, Inc. then borrowed \$550 million from Smith Bank to fund the construction of a new shopping center and an adjacent residential complex in Boston, Massachusetts.

Immediately upon receipt of the bank loan, at the direction of John Fraudly, Fraudly Properties, Inc., apportioned \$275 million of the Smith Bank loan to pay off outstanding debt obligations on the 50 development projects owned by the company. The projects had proved unprofitable and the company was fast approaching defaults that would force Fraudly Properties, Inc. into involuntary bankruptcy proceedings.

With only half of the Smith Bank loan now available to finance the Boston property development, John Fraudly moved his family residence to Boca Raton, Florida. Additionally, John Fraudly began to acquire new assets, as well as move his existing personal assets, under the name of his wife, Kelly Fraudly. Concurrently, John Fraudly also gave his sons, Jack and Peter, \$10 million to expand their marketing business.

Meanwhile, at Fraudly Properties, Inc., the company had, over the past six months of 2004, begun receiving invoices from two companies overseas. One company was KelProp, PLC, incorporated in London, England and the other was JPP Development, PLC, registered in the Cayman Islands. Invoices had been received bi-monthly in the accounting department of Fraudly Properties, Inc. for services rendered by KelProp as well as JPP Development and had been promptly paid over the six month period. The only record of the service agreements between Fraudly Properties and JPP Development, as well as KelProp, were two contracts signed by Robert Johnson, Fraudly Properties, Inc.'s Chief Financial Officer. Robert Johnson left Fraudly Properties, Inc. in 2003. When asked about the invoices by the accounting department, John Fraudly directed that they be paid promptly.

On July 1st, 2004, Fraudly Properties, Inc. was in default on the interest payment on the \$550 million Smith Bank loan. According to the terms of the loan, the interest payment default triggered the automatic default provisions of the loan. Fraudly Properties, Inc. was therefore forced to declare bankruptcy. A bankruptcy petition was filed with the bankruptcy court in New Hampshire and a bankruptcy trustee has been appointed.

Hypothetical # 2 – Consumer Loan Bankruptcy Fraud

Debtor Profile: Danny Dontpay, age 50, owner of Danny's Bar & Grill located in Burlington, Vermont. Danny is married to Donna Dontpay and the couple has three children. The family resides in Burlington, Vermont. Danny is a college graduate with twenty years of restaurant management experience. Danny also has a second job painting houses and repairing roofs.

The Bankruptcy Events:

Having successfully built a thriving bar & grill restaurant in the 1980s, Danny's restaurant has fallen out of favor with customers steadily through the 1990s. In addition to competition from national chain restaurant franchises, customers have complained that Danny's Bar & Grill restaurant is in need of renovation, and that the food is expensive and of poor quality. Before Danny can hire a new chef, however, he must make improvements to his storage facilities and kitchen. To meet these expenses, Danny must obtain a bank loan.

Desperate to save his restaurant from failing, in order to obtain the bank loan, Danny provided false financial statements to the bank about his restaurant's recent and past performance as well as fictitious documents regarding his personal assets. In order to pass off his misstatements, and to keep his wife Donna from learning of his deceit, Danny forged Donna's signature on several documents that he created. Failing to perform the necessary due diligence on his statements, the bank issued Danny a loan for \$500,000, collateralized by some of the fictitious assets.

Following some of the much needed renovations in the kitchen, and a grand reopening marketing campaign, Danny's Bar & Grill experienced a renewed popularity in Burlington. Thinking that the restaurant had finally

turned the corner, Danny used the balance of the bank loan for himself and his family. Along with the profits from the restaurant, the couple began to spend extravagantly, acquiring, among other assets, new cars, a 50% ownership share in a racehorse, a beach house and a boat.

The renewed success of Danny's Bar & Grill, however, proved to be short lived. Following a food poisoning incident and reports of a rodent infestation in the restaurant's storage facilities, news spread throughout Burlington that Danny's Bar & Grill was unsanitary. With the sudden downturn in his business, Danny fell behind on his interest payments and was nearing default on his bank loan. Fearing that he might be forced into bankruptcy, Danny resolved to hide some of his newly acquired personal assets from his creditors.

Upon default on his bank loan, Danny and Danny's Bar & Grill filed for bankruptcy protection. The restaurant's creditors quickly repossessed the restaurant's fixtures and the remaining creditors, including the bank, now seek recovery against Danny's personal assets. To hide his personal assets from these creditors, Danny failed to include his boat, his 50% ownership share in the racehorse, and his income from his house painting and roof repair business on his bankruptcy schedules. Additionally, so that Donna will not learn of his concealment, Danny again forges her signature on the couple's financial disclosure statements.

Danny's creditors are subsequently left with an asset deficiency to satisfy their debts and now seek to prove that Danny is fraudulently hiding his assets.

When Money Goes Missing: International Asset Search and Recovery

From Tyco to Adelphia to Parmalat and back, the list of once prominent companies that have fallen victim to fraud is long, embarrassing and growing. Although it is the stories of large public corporations that may make the six o'clock news, all companies are susceptible to becoming victims of fraud. Companies may fall victim to fraud schemes when opposing parties in civil litigation or debtors in a bankruptcy case hide their assets from creditors or when employees embezzle funds or senior executives bill the employer for non-existent services rendered. Fraud is a booming business and if recent events are any indication, the participants are thinking bigger and becoming more sophisticated.

Whether the scheme involves an individual debtor or a private or public company, fraudsters have discovered that the more complicated the fraud they construct, the more likely it is that they will get away with the crime. Fraudsters rely on a series of assumptions in order to perpetuate a fraud. They assume that few corporations or creditors will allocate the necessary budget to pay for the services required to unravel a truly complicated scheme. They also presume that institutional creditors and defrauded companies are more willing to write-off bad debt rather than "throw good money after bad." Since, unfortunately, this is often the case, fraudsters assume that if they can just hang on long enough, the creditors will tire of investigating and the scheme will work.

Consequently, as acts of fraud become more complex and companies continue to sweep the matters under the rug, fraudsters go unpunished and money that should be safe in corporate accounts goes unaccounted for. The belief is often that the money will never be found, let alone recovered. This assumption, however, is often wrong. By employing investigative techniques and making use of

various legal remedies, there is a significant probability that the fraudster's methods can be exposed and the hidden or missing assets can be identified and recovered.

Tactics for Recovery

The first step toward recovering stolen and/or undisclosed assets begins with research. The quickest and most cost effective way to approach an investigation is to first examine all the information available in the public domain. Researchers have access to worldwide databases which allow them to comb the public record for clues and intelligence. All leads should then be followed up with a field investigation.

The next step in the investigative process is to then take a close look at the lifestyle of the subject, including an examination of his or her spending habits, relationships, investments, property, and other financial dealings. To start, investigators examine how well a subject meets his or her monthly financial obligations. If a person is spending money, but appears to have no source of income, chances are the funds are hidden in offshore bank accounts. In addition, investigators search for litigation history involving the subject or his or her businesses. Often times, assets may be found attached to a judgment that would not be listed elsewhere. Assets belonging to a subject's family, or corporations associated with the subject, are also inspected.

By utilizing the techniques described above, and other investigative tools, investigators can begin to piece together a roadmap leading toward the hidden assets. However, it is not uncommon for the investigator to encounter roadblocks along the way. In order to circumvent these obstacles, the investigative firm should work simultaneously with attorneys and forensic accountants to build legal remedies to ultimately freeze assets and demonstrate a nexus between the assets, the debt, and perhaps a fraud. Using a combination of investigative services, like those offered by Interfor, and the instruments available through the courts, companies, creditors and victims of fraud can recover the assets they once believed they would never see again.

British Commonwealth Remedies

Provided there is a basis for jurisdiction in the British Commonwealth, there are various legal remedies that allow an investigator to dig a little deeper and can protect assets that are found from further corruption, all without tipping off the subject that he or she is being investigated. These remedies, known as search orders, asset freeze orders and gag orders, designated in the landmark cases *Mareva*, *Anton Piller*, and *Norwich Pharmacal*, are most useful to clients when used by the right team of lawyers and investigators.

Discovery techniques such as search orders and third party disclosure orders can be useful to the intelligence expert when the investigation is still under way. Search orders (formerly known as “*Anton Piller*” and “*Mini-Anton*” orders in England) can be obtained in order to preserve property and determine the location of assets. Third party disclosure orders (formerly known as “*Norwich Pharmacal/Bankers Trust*” applications) are requests for discovery against persons who are not directly involved in an investigation or litigation, but may have become mixed up in the wrongdoing of another. They may be issued, for example, to require an innocent recipient of assets (i.e. a bank) to disclose where the funds were subsequently transferred.

The English rules for “tracing” of assets may also assist in the recovery process. Tracing is the legal process by which the owner of property may identify assets as representing the owner’s original property. It is possible to make a request for the return of fraudulently obtained assets if the claimant has a “proprietary claim” and can establish that the original property has been misappropriated. For example, if jewels are stolen and the thief sells them for cash, which the thief then uses to buy a house, the owner of the stolen jewels may be able to levy on the house as a product of the jewels and, in addition, be entitled to any appreciation on the value of the house as well as the house itself.

Once such investigative and legal tactics have been employed and the assets have been located, the next step is to preserve those assets by restraining or freezing the ability to transfer their ownership. Asset-freezing injunctions (also

know as “*Mareva*” injunctions) are available in England and other English-law-based countries to prevent debtors and those who commit fraud from moving or disposing of assets. “*Worldwide Mareva*” injunctions may also be granted, under which a person in an English Commonwealth jurisdiction is prevented from dissipating assets anywhere in the world. In addition, litigators can obtain non-party injunctions that freeze the assets of those persons or businesses that serve as alter egos of those under investigation. Another method for protecting assets is to apply for the appointment of a receiver or a provisional liquidator.

Over the past several years, these injunctions have been introduced to and tested in various courts with great success. The gradual yet widespread judicial acceptance of search orders, asset freeze orders and gag orders enables creditors in Commonwealth jurisdictions, Canada and the United States to more readily and easily recover assets.

The Interfor Difference

Over the past 25 years, Interfor, Inc. has developed comprehensive techniques to uncover fraud schemes and trace, freeze, and recover hidden assets. Founded in 1979, Interfor specializes in U.S. and international asset intelligence investigations for law firms, corporations, banks and bankruptcy trustees. Having located assets concealed or undisclosed in the U.S., the Caribbean Basin, Switzerland and other offshore “safe havens”, Interfor is the recognized world leader in asset search and recovery services. Interfor’s investigations have yielded substantial results; since its inception, Interfor has recovered over \$2 billion worldwide for its clients.

Part of Interfor’s success lies in the fact that Interfor pioneered the *investigative* use of available English common law provisional remedies to assist lawyers around the globe in freezing assets. As a result, Interfor has an extensive network of legal experts in various jurisdictions throughout the world with the proven ability to freeze assets and collect on judgments. In addition, Interfor has a staff consisting of former intelligence and investigative professionals throughout the U.S., Canada, Western and Eastern Europe, the Middle East,

Latin America and Asia. Interfor's global presence has allowed our investigators to follow the movement of money between continents, often exposing multinational shell corporations, previously unidentified assets, and illegal money laundering operations.

GLOBAL REMEDIES FOR COMBATING FRAUD

What legal remedies are available to recover assets concealed around the world? The following chart provides a quick guide of legal weapons available in various international jurisdictions.

Country	Freezing Orders?	Search Orders?	Tracing Orders?	Notes
Canada (Ontario)	Yes	Yes	Yes	The Absconding Debtors Act may provide additional relief.
Czech Republic	Yes	Yes	Yes	
Denmark	Yes	Yes	Yes	Banks have a duty of confidentiality concerning their clients.
England/Wales	Yes	Yes	Yes	"Tipping off" i.e. alerting the alleged fraudster to the investigation is an offense.
France	Yes	Yes	Yes	Banks cannot provide direct replies to questions concerning debtors' assets.
Germany	Yes	Yes	Yes	Preliminary injunctions may provide additional relief.
Hungary	Yes	Yes	Yes	
Italy	Yes	Yes	Yes	Article 700 of the Italian Civil Procedure Code may provide additional relief.
Netherlands	Yes	Yes	Yes	Gagging orders may provide additional relief.

Poland	Yes	Yes	Yes	
Romania	Yes	Yes	Yes	
Russia	Yes	Yes	Yes	
Scotland	Yes	Yes	No	Motions for disclosure may provide additional relief.
Spain	Yes	Yes	Yes	Motions for disclosure may provide additional relief.
Switzerland	Yes	No (only available in criminal proceedings)	No	

Information compiled from "Fighting Fraud: obtaining, searching, freezing and tracing orders. A comparative Guide."
Tony Marks, CMS Cameron Mckenna, April 2003.