Fraud Protections

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Agenda

- What is Fraud?
- Legal Standards
- Types of Customer Fraud Schemes
- The Warning Signs of Fraud
- The Best Defense is a Strong Offense: Proactive Measures to Prevent Fraud

What is Fraud?

Fraud comes in many forms – though we'll see it mostly in two forms:

- Fraudulent transfers under bankruptcy and state law;
- General/Common Law Fraud – "A false representation of a matter of fact – whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed – that deceives and is intended to deceive another so that the individual will act upon it to her or his legal injury."

Who Commits Fraud?

Businesses can be damaged from fraud from a number of perpetrators:

- Management
- Employees
- Suppliers
- Customers
- Organized Crime

In this presentation, we will focus on fraud originating from customers.

The Effects of Fraud

- It is estimated that fraud creates a net loss of 5% of business revenues globally – or approximately $3.7 trillion. (ACFE)
- Fraud – particularly in the occupational context – has been the primary contributor to the downfall of several major corporations, including WorldCom, Enron, and Tyco International.
- But even smaller frauds, like those caused by customers, can have significant effects on the bottom line, and if unidentified and unchecked, can cause serious harm to the integrity of a company's credit department.

Common Law Fraud

- Frauds are actionable against the defendant under the "common law" of all 50 states.
- In some cases, fraud claims can be pursued by statute (e.g., consumer protection laws)
- Elements of common-law fraud are generally:
  1. A false statement of material fact;
  2. The defendant's knowledge that the statement was false;
  3. The defendant's intent that the statement induce the plaintiff to act;
  4. The plaintiff's reliance on the statement; and
  5. The plaintiff's damages resulting from reliance on the statement.

Fraudulent Transfers

- In addition to common law fraud, actions may be brought to avoid and recover transfers that were fraudulent in nature.
- Can be brought under both state (Uniform Fraudulent Transfer Act) and federal (United States Bankruptcy Code) law.
- Two primary types of fraudulent transfers:
  - Actual fraudulent transfers (requiring proof of fraudulent intent by the transferor)
  - Constructive fraudulent transfers (which do not require proof of actual intent to defraud)

Actual Fraudulent Transfers

- Under Section 5(a)(1) of the UFTA:

  "A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation *with actual intent to hinder, delay or defraud any creditor of the debtor*."

  – But how does one prove actual intent?

- Section 548(a)(1)(A) of the Bankruptcy Code corresponds to Section 5(a)(1) of the UFTA.

Actual Fraudulent Transfers

- Badges of Fraud: Section 5(b) of the UFTA provides that consideration may be given, <u>among other factors</u>, to whether:
    1. The transfer or obligation was to an insider;
    2. The debtor retained possession or control of the property transferred after the transfer;
    3. The transfer or obligation was disclosed or concealed;
    4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
    5. The transfer was of substantially all the debtor's assets;
    6. The debtor absconded;
    7. The debtor removed or concealed assets;
    8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
    9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
    10. The transfer occurred shortly before or shortly after a substantial debt was incurred; and
    11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Constructive Fraudulent Transfers

- Section 5(a)(2) of the UFTA also provides for avoidance of "constructive" fraudulent transfers when the debtor:
  - Did not receive "reasonably equivalent value" in exchange for the transfer or obligation, and
    - Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
    - Intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they came due.
- Section 548(a)(1)(B) of the Bankruptcy Code corresponds to Section 5(a)(2) of the UFTA.

When Might You Be a Victim of a Fraudulent Transfer?

- Guarantor transfers all of its assets to prevent you from collecting on a judgment
- You receive payment from a corporate affiliate (rather than the direct obligor), despite that affiliate having no direct obligation to pay
- A substantial transfer of assets by a customer renders it insolvent (and unable to pay you)
  - May include placing assets in offshore bank accounts or asset protection trusts
- A customer incurs a significant debt or secured obligation just prior to filing for bankruptcy
- A customer engages in inter-company transfers in order to duck its obligations, or shore up the liquidity of an affiliate or subsidiary

Types of Customer Frauds

- Customer frauds can take many forms, and fraudsters – who are a creative lot – are always trying to devise new schemes to take advantage of unsuspecting vendors.
- Commonly-used customer frauds include:
  - The "Bustout Scheme"
  - The "Hit and Run"
  - The Insolvent Buyer
  - The Document Falsifier

"Bustout Scheme" aka "Overbuy"

- What is a bustout?
    - Floundering company purchased by new entity
    - Or start-up business formed
    - For the sole purpose of acquiring credit lines and disappearing
- Verify that the history as described from debtor is true.
    - Business line is the same
    - Amount of business
    - Reputation in industry
    - Investigate the principals – is there a pattern of bustout activity?

Hit and Run

- New company in town
  - Offers to buy COD
  - Uses certified or cashiers' check
  - Within days, check bounces and fraudster is long gone

The Insolvent Buyer

- Customer is in severe financial distress, and is contemplating a bankruptcy or liquidation
- Acknowledging that working capital will be squeezed after a bankruptcy filing, customer decides to buy an inflated amount of inventory to "weather the storm" once the filing occurs
- Customer does this knowing that its vendors will be left "holding the bag," and will be left with nothing but a claim in the bankruptcy (that may be of questionable value)

The Document Falsifier

- Desperate to get more inventory, a customer:
  - Falsifies financial reports to give off the appearance of solvency/liquidity
  - Falsifies credit application in order to fraudulently obtain trade credit
- In more extreme circumstances, an individual may pretend to represent a company to obtain fraudulent trade credit, all while having the goods shipped to a non-company location and sticking the unsuspecting company with the bill

Other Frauds

- Hometown Repeater
  - Small amounts, victims out of town – no prosecution
- Advanced Fee – accepts fees for future work – work is never performed/completed
- Fake trade and bank references used to finance leasing or purchase of equipment
- Hacking into databases

Warning Signs

- Unsolicited New Customer
  - No hard information
  - Vague, emphasizes opportunity for *you!*
  - Large, unsolicited order (trade show, fulfill promotion, rush or emergency shipments).
  - Ever increasing purchases (they make timely payments early on)
  - Familiarity with credit policy (ordering under a threshold)
- Be wary of calls *to* you (is customer using you?)

Warning Signs

- Payments made by manual check or that otherwise deviate from normal payment procedures
- Payments in round dollars
- Payments where check or invoice numbers are out of sequence
- Invoices in which delivery addresses are different than payment addresses
- Payments for duplicate amounts on the same date

Warning Signs

- Where is the customer and where are the goods going?
  - Mail drops
  - Mini-warehouse locations
  - Residential locations
  - Different address between business and ship-to
- Company claiming to be related to well-known legitimate company
- Difficult to confirm foreign ownership

What You Can Do

- Verify e-mail address against website.
- Verify with purchasing manager or accounts receivable supervisor at "customer" (get phone number elsewhere).
- Third-party reporting (such as D&B).
- Verify phone numbers (VoIP) has made it very easy to mimic area codes and forward to cell phones.
- Check the date of the website – if it's been registered within a month or two, that raises questions. Same for any "coming soon" messages.
- Where is it registered? Foreign? Is it a multinational company?

Proactive Measures – Initial Measures

- The best proactive measures are those taken at the *outset* of a business relationship
  - The best resource with which to start? **A detailed credit application**
  - Do not deviate from your well-established credit policies

Proactive Measures – Due Diligence

- Ownership (is it difficult to tell?)
- Employment history (foreign areas, multiple defunct companies, consulting with no references)
- Corporate structure (is structure needlessly complex? Is the entity newly formed?)
- Insist on phone numbers of companies with whom principals claim past employment
- Check Yellow Pages, Better Business Bureau website
- Does directory assistance work (give you the number)?
- Google Maps (is the address of the company, or the suggested delivery address, legitimate?)

Proactive Measures - References

- Check References!
  - Is the report glowing, with no time needed to review?
  - Be wary of bank references, especially if specific extensions are provided or only one specific name
  - Answering services?
  - Difficult to trace fax numbers as references (all funnel to one location and one responder)
  - Relatedness? (share execs, phone numbers?)
  - Do not be afraid to ask detailed questions

Proactive Measures – Data From Customer

- Financial Statement
  - Is it randomly dated?
  - Inflated assets – impossible to confirm values?
  - "Due from Officers?"
  - Who is the accountant (CPA?, outside firm/audit, location - same state different state?)
  - If new business, check stated worth and capital figures for consistency.
- Confirm assets via other sources if possible
- Verify A/R versus size/sales
- Too good to be true?
- Call bank for reference check

Proactive Measures - Miscellaneous

- Ask history of business in the location (verify with outside source)
- Ask other suppliers or others in area to do a drive-by
- DO NOT GRANT INSTANT CREDIT
- If instant delivery is requested, insist on Cash-and-carry
- Get specific information (names, phone numbers)
- Engage in third-party verification of ownership
- Trust your instincts!

What if You are Defrauded?

- Involve law enforcement:
  - Local police
  - FBI
- Notify watchdog groups, such as the Better Business Bureau
- Consider filing civil suit against the fraudster, or the officers/directors/shareholders of the fraudster
  - Attempt to track down other vendors that have been defrauded – information and legal cost sharing opportunities
- Learn from your mistakes

Presenter Contact Information

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Questions

or

Comments?