

NEWS

BANKRUPTCY:

World in turmoil

Business & Economy

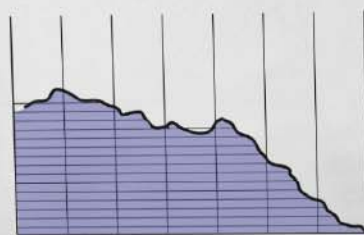
Stock Market

Fear grips stock markets

Exchange Rates

Recession fears hit Wall Street

GLOBAL INDEX





Bankruptcy: Not *Your* Problem?

Bankruptcy cuts a wide path through the economic landscape. The economic downturn, fueled by the credit crunch is forcing businesses and individuals to seek relief through the bankruptcy system in record numbers. Bankruptcy ignites a chain reaction that impacts all of us.

Who Does Bankruptcy Affect?

What if: You receive a letter to stop all collection efforts on an overdue account pursuant to an “automatic stay.” Or, the last several payments you received on this

account are deemed “preference items” and must be returned. Or, you are now part of a group of unsecured creditors and will receive a few cents on the dollar of the amount you are owed pursuant to a “plan of reorganization.” These are just a few of the examples of where somebody else’s problems become *your* problems.

Bankruptcy is a legal process that dramatically alters the relationships between debtors, creditors and other

related parties. It is important to understand the process and have a plan to deal with its impact on you and your business. Being a legal process, advice of counsel is critical. Issues involving the point at which insolvency occurs, properly documenting claims, developing a reorganization plan or the existence of fraudulent transfers require financial analysis and accounting acumen — forensic accounting in particular.





Bankruptcies on the Rise

Bankruptcy filings are at the highest level since the “rush to file” in advance of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which drastically restricted the ability to file a Chapter 7 case. For the 12 month period ending September 30, 2008, business filings increased 49 percent to 38,561. During this period, Chapter 7 filings increased 40 percent to 679,982; Chapter 11 filings increased 49 percent to 8,799; and Chapter 13 filings increased 14 percent to 353,828. The trend during the last three months of 2008 indicates a continuing increase in the rate of bankruptcy filings in 2009. (Source: Administrative Office of the U.S. Courts, December 2008 News Release)

Bankruptcy fraud further complicates matters by involving law enforcement agencies, such as the FBI in the process. The FBI estimated as early as 2002 that 10 percent of all bankruptcy filings, involved fraud with less than 1 percent resulting in convictions. With the recent “explosion” in the number of filings, it is reasonable to assume the trend has gotten worse. The FBI listed concealment of assets, false filings, multiple filings and Trustee fraud as typical fraudulent schemes. Criminal conduct involves violations including wire fraud (18 U.S.C. Section 1341), mail fraud (18 U.S.C. Section 1343) and bankruptcy fraud (18 U.S.C. Sections 152 and 157), just to name a few. Criminal fraud further complicates the situation by involving law enforcement agencies in which the primary goal is the prosecution of criminal conduct and not the recovery by creditors.

This is further complicated by interjecting costly adversarial proceedings into the process. Payments to insiders in exchange for inadequate consideration can give rise to fraudulent conveyances. Determining the point in time where insolvency occurred has a material impact on fraudulent conveyances. Preferential payments can result in the return of payments received by creditors. Concealed assets can deprive creditors of assets available to satisfy their claims. Monitoring the activities of a “debtor in possession” under a plan of reorganization can avoid the wasting of the bankruptcy estate. Claims must be vetted to ensure they are accurate and legitimate. Effectively dealing with these complex issues often requires forensic accounting experience and intervention by legal counsel.



A bankruptcy filing can impact a number of different business relationships, some of which are not readily apparent. It is important to identify all of your critical relationships and assess the financial health of the parties involved. The most apparent is the creditor/debtor relationship between you and one of your customers. A bankruptcy filing by your customer invokes the automatic stay which prevents you from taking any

collection action, including perfecting a security interest. The automatic stay is effective whether or not you receive notice of the filing. Having a perfected security interest will give priority over the unsecured creditors. Perfecting all security interests, before the automatic stay becomes effective, is a critical step to improve your recovery on your claim(s).

Maybe a little more obscure would be your relationship with a lender or a critical supplier. What would happen if your lender fails and your loan is sold as part of an asset sale? Loan agreements traditionally include default provisions allowing the lender, in its sole discretion, to accelerate the loan upon the occurrence of specified conditions or events. Being cut off from these funds,

and worse, being required to pay the outstanding balance in full could be fatal. It is essential to know the default provisions in your credit facility and make sure compliance is maintained. You should also monitor the financial health of your lender and establish alternative sources of credit. The same is advisable regarding suppliers. Keep track of how suppliers are doing and have alternatives. The bankruptcy or failure of critical financing or supplier sources could be critical to your survival and avoidance of your own bankruptcy filing.

Guarantees are another relationship which must be closely monitored. Once cut off from collection actions by an automatic stay, creditors turn to guarantors to satisfy their claims.

Forensic Factor

Using Bankruptcy as the “Back Door”

Most sophisticated frauds are carefully “engineered” with particular care being given to the “exit strategy.” Stealing something isn’t very rewarding if you are assured of getting caught. In over 35 years of dealing with fraudsters, only one crook exclaimed, “What took you so long to catch me?” Most are convinced they are smarter than everyone else and will never get caught.

Crooks routinely disguise fraudulent schemes as a legitimate business failure with the bankruptcy court as the stage for their final act. A common scam is the “take-over and loot” maneuver. Instead of a hold-up with ski masks and guns, the crooks replace valuable assets with trash such as worthless stock, promissory notes or bogus claims to assets they do not own. In a bankruptcy setting this would be a fraudulent misrepresentation. Other bankruptcy fraud scams include conveyances to insiders for inadequate consideration and concealment of assets.

The bankruptcy code (11 U.S.C. Section 523) sets forth exceptions to discharge under the code where money, property or credit was obtained through fraudulent conduct. Blocking a discharge using this provision requires forensic accounting services which can identify the fraud. Section 523 specifically exempts a materially false statement which is made with the intent to deceive. Forensic accounting combines accounting acumen and investigative skills, with the latter required to identify intent. Most Section 523 non-dischargeability actions arise in an adversarial proceeding, requiring sworn testimony regarding fraudulent conduct. One of the primary goals of a forensic accounting investigation is the development of sworn, expert testimony. Forensic accounting helps nail the “back door” shut.

Businesses tend to neglect guarantees until they are called upon to make good on them. The financial condition of the guaranteed party should be monitored so that defensive measures can be taken prior to being called to perform as the guarantor or making proper reserves for the contingency.

With the advent of the Madoff mess, investors now have a serious bankruptcy related concern. The Madoff case was transferred to the Bankruptcy Court in New York with the appointment of a Trustee. Madoff’s investment operation is being viewed as a Ponzi scheme, and as such, early investors are deemed to have received the money contributed by subsequent investors in contrast to receiving income off of the underlying investments. The Trustee is reportedly considering using the “claw back” provision of the Bankruptcy Code to recover the funds these early investors received. If used, the recovered funds would be placed in the bankruptcy estate and then distributed to all investors pursuant to a plan adopted by the Court.

The economy is in trouble and bankruptcy filings will no doubt continue to rise. Your business exists in a complex environment depending on the functioning of a group of disparate parties. The economic failure of one impacts all, which requires us to know how everyone is doing and take necessary precautions. Seek out necessary accounting and legal expertise. After all, bankruptcy is *your* problem.

William D. Brown, JD, CPA, CFF
wdbrown@weaverandtidwell.com
972.448.6966