

# **FORENSIC ACCOUNTANTS: AN ESSENTIAL PART OF THE BANKRUPTCY TEAM**

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# INTRODUCTION

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## **Forensic Accountants: Skilled and Experienced in Detecting Fraud, They Can Help Trace Suspected Fraud Schemes, and Find Fraud in Its Earliest Stages**

## **Bankruptcy Attorneys Should Consider Bringing On Forensic Accounting Capability Early in the Bankruptcy Process**

Bankruptcy is rampant. According to the United States Bankruptcy Court, there were 1.4 million bankruptcy filings in fiscal year 2009, a 32 percent increase over 2008. Bankruptcy filings for 2010 are higher still - data from AACER (Automated Access to Court Electronic Records) shows 379,000 bankruptcy filings in the first quarter of 2010, a 17 percent increase over the same quarter of the previous year. July 2010 saw a 24.2 percent increase in bankruptcy filings over the previous month. The upsurge in bankruptcy filings is unsurprising, given the severe economic downturn and the slow pace of recovery.

Predictably, along with the high rate of bankruptcy filings comes another trend - a sharp and prolonged spike in bankruptcy fraud. Economic desperation - of the sort that drives individuals and businesses into bankruptcy - also drives them into complex schemes designed to conceal assets and shelter them from creditors.

# METHODS OF CONCEALMENT

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## **Detecting Bankruptcy Fraud is Challenging for Trustees and Creditor Committees; “Red Flags” Can Be Hidden in Reams of Data**

Detecting bankruptcy fraud can be a challenge for trustees and creditor committees. Sometimes the signs are obvious. But frequently, the “red flags” are hidden in thousands of pages of business records and complex webs of relationships. Financial information and relationships flow together – for example, a “relationship map” can indicate when vendors are insiders and have potentially worked with the debtor to manipulate records in order to be paid first. Sometimes, lack of information is a form of information – insufficient information can be a sign that something has been concealed. The detection of a bankruptcy fraud scheme can be a complex, demanding task in itself, one that demands a specialist’s focused, dedicated attention.

## **Forensic Accountants Can Recognize Patterns of Fraud Quickly and Accurately – Even When Fraud is Not Yet Suspected**

Forensic accountants are professionals who specialize and are skilled in tracing cashflows and examining voluminous financial data to discern patterns of fraud and asset concealment. They are skilled professionals who make the best partners for trustees and creditor committees to work with in a bankruptcy when ascertaining whether fraud may be an issue. Trustees, creditor committees and bankruptcy attorneys know this, and have traditionally called on the services of forensic accountants to determine the existence of fraud as soon as signs become evident.

But given the current high volume of both bankruptcies and frauds, and the complexity of many of those frauds, trustees, creditor committees and bankruptcy attorneys might want to consider going a step further by calling upon a forensic accountant, who can identify more red flags and find them sooner, potentially identifying them earlier in the bankruptcy process.

## **Even the Most Basic Fraud – Concealment of Assets – Requires Skill and Experience to Detect**

Bankruptcy fraud ranges from the simple (failing to declare assets on bankruptcy schedules) to the intricate (“bustouts,” “bleedouts” and rent/equity skimming). But even the simplest-seeming asset concealments require experience to recognize, and time and effort to trace out.

Most bankruptcy fraud involves concealment of assets. In fact, this accounts for nearly 70% of all fraudulent bankruptcy cases, according to the latest FBI statistics. In the most basic form of concealment of assets, a debtor simply fails to list assets (i.e., real estate, artwork) on the bankruptcy schedule. In a somewhat more complex scheme, a debtor transfers assets to relatives or associates so that the assets cannot be confiscated. Or it may be that assets are listed on a bankruptcy schedule but their value is significantly understated.

## **To an Experienced Eye, Concealment of Assets Produces a Series of Red Flags**

What signs reveal that the debtor might have concealed assets? Red flags include:

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- **Missing assets.** Assets listed on financial statements prior to bankruptcy are not accounted for in the bankruptcy schedules.
- **Poor record-keeping.** The debtor has failed to keep business records, and/or books and records are incomplete.
- **Missing or heavily revised information.** Insufficient information is provided on debtor's bankruptcy schedules, and/or there have been frequent changes to such schedules.
- **Too much cash activity.** There have been an unusual number of unrecorded transactions, especially cash transactions. These will not show on the books, but may become apparent in banking records.
- **A spike in insider transactions.** There has been an increase in financial activity involving the debtor's officers, shareholders or relatives and other insiders – payments, loans, or real estate or asset transfers.
- **Webs of complexity.** There are intricate corporate structures and relationships involving the debtor and other entities controlled by insiders or close contacts.

Any of these “red flags” will get the attention of a forensic accounting specialist. If a forensic accountant is not yet a member of the team, the presence of any of these red flags should alert trustees, creditor committees and bankruptcy attorneys that they need to add a forensic accountant to the team. Forensic accountants can assist by identifying and confirming the red flags, tracing the movement of funds and/or assets, as well as presenting their findings and opinions related to their analyses when called upon as expert witnesses in Court. The investigative work can be as straightforward as comparing pre- and post-bankruptcy financial statements, or as complex as reviewing and analyzing reams of financial documents and conducting interviews with the debtors' officers, staff and suppliers.

## Tracing Preferential Payments is a More Complex Process, Requiring Specialized Forensic Skills

**Preferential payments** are a somewhat more subtle method of asset concealment that is more difficult to detect. Essentially, a preferential payment occurs if a debtor makes a payment to a creditor, in which a creditor receives more than he or she would have received in the bankruptcy distribution (in which bankruptcy statutes dictate who is paid and in what amounts). Evidence of a preferential payment is that the debtor does not make payments to similar antecedent debt holders.

A forensic accountant can and should review all potential suspicious payments to vendors to help determine whether they fall into one of the categories that allow the trustee to avoid (i.e. eliminate) them. Especially worth noting are transactions where someone was paid outside the ordinary course of business. Payments to professionals such as accountants and/or lawyer fees are a good example. If the bankrupt debtor paid the accountant upon immediate receipt of the invoice, when historically, accounting invoices were paid in thirty days, such payments could be considered preferential payments. Other potential preferential payments include payments of loans that may have been personally

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guaranteed or payments of loans to related parties.

Has a preferential payment taken place? To determine this, the forensic accountant needs to analyze historical payments made from the debtor to suspected vendors – clearly a task that demands both training and experience. The key takeaway for trustees, creditor committees and bankruptcy attorneys is that any potential suspicious payments in these categories – i.e., payments to professionals and guaranteed or related-party loan payments – need to be put under scrutiny to establish whether a preferential payment has taken place.

## **Fraudulent Conveyances Involve Detailed Review of Bank and Other Financial Records**

The Bankruptcy Code also allows the trustee to avoid a fraudulent conveyance – a move similar to a preferential payment that involves the transfer (conveyance) of title to real property and/or other assets for the express purpose of putting it beyond the reach of a known creditor. Laws concerning fraudulent conveyances also apply to transactions in which the debtor did not receive reasonably equivalent value for the transfer of assets.

Forensic accountants are trained professionals best qualified to “follow the money” and trace assets (which can often be an arduous and time-consuming job) by reviewing various financial and non-financial documents such as bank records and property records in order to determine whether a fraudulent conveyance took place. Further, a forensic accountant can assess whether a debtor received “reasonably equivalent value” for the transfer of assets.

# FRAUD SCHEMES

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## Intricate Schemes Such as “Bustouts,” “Bleedouts” and Rent/Equity Skimming Can Be Hidden in Plain Sight in Business Records and Financial Statements

Although concealment of assets makes up the majority of bankruptcy frauds, there are a number of other common fraud schemes. Among them are **bustouts**, **bleedouts** and rent/equity skimming.

A **bustout**, as defined by the United States Trustee Manual, occurs when a company obtains goods from creditors and sells those goods for cash with the intention of never repaying them.

“Red flags” that indicate a possible **bustout** include:

- Fraudulent financial statements (i.e., actual inventory levels do not match recorded inventory levels).
- Bankruptcy schedules that do not include receivables.
- Low inventory levels.
- The fact that the company deals with very few local creditors.
- False credit references.
- The fact that the company has no existing corporate bank account.
- Suspicious banking transactions such as cash infusions with no correlation to inventories.

Similar to bustouts, a **bleedout** (again as defined by the United States Trustee Manual) occurs when a company gets rid of its assets over a longer period of time by shifting them to insiders.

“Red flags” that indicate a possible bleedout include:

- The fact that individuals with no involvement in the company have money transferred to their bank accounts prior to filing bankruptcy.
- Inventory and other assets (i.e. equipment or machinery) are sold prior to the bankruptcy filing.
- Excessive loan payments are made to corporate officers.
- Corporate officers receive excessive salaries and bonuses.
- Employee funds for health care and pension funds are diverted by the debtor.

# FRAUD SCHEMES

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**Rent or equity skimming** is a process in which the debtor acquires title to several properties without any intention of paying the mortgages. The debtor continues to collect the rental proceeds and then files bankruptcy in order to stall foreclosure.

“Red Flags” of rent/equity skimming can include:

- The debtor fails to make mortgage payments.
- There has been a transfer of entire or partial interest prior to foreclosure.
- The debtor has used mail drop boxes as a business address.

In all of these schemes, a forensic accountant has the specialization needed in conducting a detailed review of financial statements, bank documents and other business records, as well as tracing transfers and cash flows across multiple entities and individuals. This is not routine work for trustees, creditor committees and bankruptcy attorneys, but is daily fare for forensic accountants.

# SELECTING THE FORENSIC ACCOUNTANT

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## **A Good Forensic Accountant Should Be Credentialed**

How should trustees, creditor committees and bankruptcy attorneys go about the task of identifying and engaging a forensic accountant? The important lesson here is that, given the increasing complexity of fraud schemes, a credentialed accountant can play a valuable role by reviewing the records involved in every bankruptcy filing. They are likely to see the red flags of fraud in cases where no fraud was suspected. For trustees, creditor committees and bankruptcy attorneys who do not already have relationships with forensic accountants, the important factors to watch out for in selecting a forensic accountant are credentials and experience. Not all accountants are forensic accountants, and the additional qualifications of a forensic accountant (such as the Certified Fraud Examiner credential) indicate that the forensic specialist is trained specifically to detect patterns of fraud. An experienced forensic accountant will understand how to work with attorneys and privileged information, how to develop and present findings that are immediately useful to attorneys, and how to provide testimony that supports the case.

## **Trustees, Creditor Committees and Bankruptcy Attorneys Should Consider Engaging a Forensic Accountant Early - As an On-Call Member of Every Bankruptcy Team**

Awareness of fraud schemes related to bankruptcy and how they are perpetrated is crucial for the successful conclusion of a bankruptcy. Forensic accounting specialists, working closely with attorneys, can assist by investigating suspicious fraudulent activity within a company or by an individual. Accounting specialists are uniquely qualified to gather the underlying facts and documents, and develop the analyses necessary to prove or refute fraud, and can further assist by providing testimony in court related to these issues. Given the high rate of bankruptcy and the upsurge in fraud, attorneys should seriously consider engaging a forensic accountant not just when fraud has been detected (or strongly suspected), but as an on-call member of every bankruptcy team.

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## About the Author

Sareena M. Sawhney, MBA, CFE, CFFA, is a Director in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth & Shron LLP. She has approximately 10 years of litigation experience. Ms. Sawhney focuses on providing services in the areas of complex fraud investigations and forensic accounting examinations as well as services related to commercial litigation and comprehensive damage analyses.

Ms. Sawhney's experience includes conducting fraud investigations, forensic examinations, calculating commercial damages, purchase price dispute analyses, lost profit analyses and bankruptcy fraud analyses for midsize to Fortune 500 companies.

Ms. Sawhney has served as a testifying expert witness. She has worked with counsel to develop case strategies, assisted counsel with depositions and with preparing reports and exhibits for trial.

## About Marks Paneth & Shron

Marks Paneth & Shron LLP is an accounting firm with nearly 475 people, of whom 64 are partners and principals. The firm provides businesses with a full range of auditing, accounting, tax, bankruptcy and restructuring services as well as litigation and corporate financial advisory services to domestic and international clients. The firm also specializes in providing tax advisory and consulting for high-net-worth individuals and their families, as well as a wide range of services for international, real estate, media, entertainment, nonprofit, professional and financial services and energy clients.

The firm's subsidiary, Tailored Technologies, LLC, provides information technology consulting services. In addition, its membership in JHI, the leading international association for independent business advisers, financial consulting and accounting firms, facilitates service delivery to clients throughout the United States and around the world.

Marks Paneth & Shron LLP, whose origins date back to 1907, ranks among the 35th largest firms in the nation and is the 13th largest in the New York area. In addition, readers of the New York Law Journal rank MP&S as one of the area's top forensic accounting firms.

Its headquarters are in Manhattan. Additional offices are in Westchester, Long Island and the Cayman Islands. For more information, please visit [www.markspaneth.com](http://www.markspaneth.com).