Insolvency fraud as one of the factors affecting recovery rates

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ABSTRACT

Recent insolvency research reports revealed very low recovery of creditors' claims filed in insolvency proceedings. Detailed and reliable statistics explaining such low recovery in the Czech Republic don't exist. However, practical experience indicates that the recovery rates might be negatively influenced by occurrence of insolvency fraud. Large insolvency proceedings are regularly targeted by highly capable and well organized criminal groups. Asset stripping, manipulation of insolvency proceedings and falsification of financial records have been widely recognized in a number of insolvency proceedings. The article will present the current state of insolvencies, introduce the most common and dangerous fraud schemes, and explain the work methods of the perpetrators in a case study of a sophisticated insolvency fraud. The last part of the article will include recommendations for effective counter-fraud measures to successfully deter the fraudulent behavior and repel the organized crime groups.

Introduction

Insolvency statistics indicate continual increase in the number of insolvency proceedings in the Czech Republic. Along with these statistics, other research revealed a very low recovery ratio of creditors' claims in Czech insolvencies. The research presented several possible reasons for the low recovery, including criminal activities and especially possible occurrence of insolvency fraud. However, due to lack of hard data and available statistics, the impact and scope of the insolvency fraud is still not sufficiently estimated and evaluated. The purpose of this article is to present the most significant insolvency fraud schemes, describe examples of how insolvency fraud might negatively impact insolvency proceedings and suggest that fraud can be considered as one of the main reasons for low recovery of creditors' claims.

The goal of the article is also to initiate expert discussion about the probable inefficiency of the current insolvency procedures and legislation with respect to weak mitigation of insolvency fraud. A significant decrease of opportunities for insolvency fraud would result in adequate protection of creditors and increased recovery of their claims. Moreover, a discussion should be initiated with respect to fraud prevention measures, including improved education and increased fraud risk awareness of all involved insolvency practitioners, experts and law enforcement officers.

Insolvency proceedings in the Czech Republic in 2013

Creditreform's report

According to Creditreform's report on the Development of insolvencies in the Czech Republic in 2013, the number of company insolvency filings has grown from 8,398 in 2012 to 11,269 in 2013 (34,2 % increase). The majority of insolvency filings placed against legal entities are accomplished through bankruptcy declaration; insolvency filings are rejected due to lack of company assets, or are refused due to formal reasons.

Creditreform's report for the year 2013 showed that the turnover of the top 25 bankrupt companies reached CZK 18,905 bln. Creditreform reported that only 12 reorganizations (as compared to 17 reorganizations in 2012) were approved by the court in 2013.

Based on Creditreform's report, a continuous rise in the number of insolvency filings in the upcoming years may be expected.

The project Insolvency Research

Results of the second research study conducted by the project Insolvency Research at Vysoká škola ekonomická in Prague revealed unique information about the effectiveness of the current insolvency proceedings in the Czech Republic.

The Insolvency research team selected 946 cases out of the 8,500 insolvency proceedings (a sample of 11.1 % of the total cases) in the period from January 2008 to October 2012. According to the research, submitted claims equal CZK 4,119,608,138 (12,892 claims with average value of CZK 319,548) and approved claims CZK 3,554,109,396 (12,346 claims with average value of CZK 287,875).

An interesting figure was identified by comparison of approved and rejected claims. The research identified 508 rejected claims in average value of CZK 1,084,134. The average value of rejected unsecured claims was 4.1 times higher than average value of approved unsecured claims, which is CZK 261,790. From the total CZK 3.6 bln. of submitted claims, 15.3% of claims were rejected (CZK 550.74 mil.).

In comparison with the secured claims, the average value of rejected secured claims (CZK 388,387) was approximately half of the average value of approved secured claims (CZK 731,244).

According to the research, recovery of claims for unsecured creditors (CZK 107.1 mil.) is only 3.51% of their approved claims (CZK 3,05 bln.). Moreover, recovery of the claims of secured creditors (CZK 115.3 mil.) is also very low, reaching only 23% of the approved claims (CZK 501.6 mil.).

In general, the results indicate that most rejected unsecured claims have had above – average nominal value. The research team wasn't able to statistically prove and provide explanation of these results. However, the research team formulated a possible explanation with respect to the identification of the above average rejected claims. The rejected claims might indicate existence of intentional forgery/fabrication of receivables and submitting of fictitious claims to insolvency proceedings.

If we assume that total submitted claims include also fictitious receivables placed to either increase recovery or to overtake the insolvency proceedings, the recovery ratio might be inflated by the number of the unidentified fictitious claims. Later in this article, we will describe what fraud schemes might be used to inflate the recovery ratio.

Criminal activities in insolvency proceedings in the Czech Republic

Hard data and available statistics which would document the impact and scope of insolvency fraud are not yet collected in the Czech Republic. To some extent, we can use available Crime statistics prepared by the Czech police, which report and monitor some insolvency related offenses. The statistics prepared for the period from January 1, 2010 to January 31, 2014, present the number of identified crimes and incurred loss (see the table below). Please note that we selected only those offenses which might be mostly related to insolvency/bankruptcy proceedings.

Chart 1: Number of identified offenses, sorted according to type and year.

Legend of 1st column	2010	2011	2012	2013	2014_01	total	Total loss in TCZK	Average loss in TCZK
Manipulation of insolvency proceedings	0	0	0	0	0	0	0	0
Violation of duties in insolvency proceedings	63	49	71	64	7	254	24 198	95
Acting to the detriment of creditor	189	226	274	297	43	1 029	2 152 271	2 092
Over-indebtedness	34	18	22	16	4	94	209 321	2 227
Preferential treatment of creditor	73	56	59	53	7	248	277 409	1 119
Participation in an organized criminal group	4	6	9	5	0	24	0	0
Falsification of financial information	246	236	304	332	45	1 163	521 689	449
Total	**609**	**591**	**739**	**767**	**106**	**2 812**	**3 184 888**	**1 133**

Police of the Czech Republic, http://www.policie.cz/statistiky-kriminalita.aspx

The available police statistics don't provide adequate information on the number and nominal value of losses with respect to insolvency fraud cases. To some extent, the statistics reveal existence of some offenses related to insolvency fraud.

Criminal activities in insolvency proceedings in other countries

We identified a lack of trustworthy statistics with respect to bankruptcies and insolvency proceedings even in other countries with developed legal systems.

U.S. Department of Justice (US)

According to the article "Bankruptcy Fraud - Bankruptcy Criminal Referrals by the U.S. Department of Justice", published by CreditInfoCenter.com on March 3, 2014, bankruptcy fraud is rarely caught and rarely prosecuted. Bankruptcy cases filed in federal courts for 2013 totaled 1,107,699 bankruptcy filings. According to a report by the U.S. Department of Justice, in 2012 the United States Trustee Program (USTP) filed 2,120 criminal referrals, a 7.7 percent increase over the 1,968 criminal referrals made during fiscal year 2011. The fourth out of the top five most common allegations was Bankruptcy Fraud Schemes.

The United States Department of Justice estimates that one in every ten bankruptcy filings has an element of fraud associated with it. USTP audits revealed that out of the 1,351 cases in 2010 with audit reports filed, "material misstatements of income or expenditures" were found in 25% of cases, which may refer to an understatement or omission of a debtor's assets or income.

IRS statistics (US)

The Internal Revenue Service (IRS) is the revenue service of the United States federal government. The IRS is responsible for collecting taxes and the interpretation and enforcement of the Internal Revenue Code. According to the statistical data on bankruptcy fraud, there were only 28 investigations initiated with respect to bankruptcy fraud in the US. The full published statistics are presented in the table below:

Chart 2: Statistical Data - Bankruptcy Fraud reported by the IRS

	FY 2013	FY 2012	FY 2011
Investigations Initiated	28	23	25
Prosecution Recommendations	8	13	16
Indictments/Informations	7	20	9
Sentenced	12	9	23
Incarceration Rate	91.7%	77.8%	82.6%
Average Months to Serve	47	17	32
Falsification of financial information	28	23	25
Total	8	13	16

Source: The IRS web site, http://www.irs.gov/uac/Statistical-Data-Bankruptcy-Fraud

Executive Office for U.S. Trustees statistics (US)

According to the article "The Bankruptcy Reform Act and Bankruptcy Fraud: Implications and Opportunities for CPAs", the Executive Office for U.S. Trustees estimates that nearly 10 % of all bankruptcies contain elements of fraud. Audits conducted by independent audit firms under the authorization of the United States Trustee Program show evidence that this estimate should be significantly increased.

Bankruptcy fraud is viewed by the FBI as perhaps only the "tip of the criminal iceberg", and involves other serious crimes including identity theft, mortgage fraud, money laundering, and public corruption. According to the FBI, 70% of all bankruptcy crimes involve both of these schemes and are hard to separate since concealment of assets automatically assumes false or incomplete statements.

Common insolvency fraud schemes in the Czech Republic

According to our research in insolvencies in the Czech Republic, we may classify the most common fraud schemes into three main categories:

1. Planned fraud schemes prior to bankruptcy. The fraud is usually perpetrated by company stakeholders. Unlike regular employee fraud, which can be easily detected, this fraud is usually very well concealed. The fraud schemes are usually planned and executed by insolvency experts, lawyers, auditors and tax consultants. The fraud schemes usually include asset stripping and concealment of assets; falsification of financial statements to

mislead investors and financing institutions; preferential treatment of creditors and disadvantageous transactions committed to the detriment of creditors and bust-outs (fraud schemes that lead to intentional over-indebtedness and to declaration of bankruptcy).

2. Crimes committed in the course of the insolvency proceedings - fictitious or overstated claims of creditors and overstatement of the amount of existing debt, as well as asset stripping.
3. Manipulated insolvency proceedings. The criminal groups which do this are well organized and also use skilled insolvency experts. Fictitious creditors, including special purpose vehicles and front entities, for influencing and manipulation of the insolvency proceedings are often used. These influential and experienced organized groups can negatively affect the entire process from placing fictitious creditors to using related insolvency trustees and even bribing insolvency judges. The criminal groups cooperate with former law enforcement units from the special police units, therefore they are familiar with operative surveillance procedures and obtain insider information from banks and police.

Category 1 - Planned fraud schemes prior to bankruptcy

The most common of the identified schemes relates to asset stripping and concealment of assets. Some of the interesting schemes are presented as follows:

- The debtor hides fraud behind complex and nontransparent business transactions with high estimated profit projections. The transactions usually depend on activities of third parties; conditions include conditional provisions, precise on-time deliveries, planning and precise project management. Also, multiple financial instruments are used – e.g. invoicing, set-offs, assignment of receivables. At the end, these complex business transactions fail when the debtor pays a significant amount of financial resources to start them up. The failure is declared as a bad business decision.
- The debtor sells its products with large discounts just before the bankruptcy date via shell companies to related entities.
- The debtor assigns selected receivables to a third party, which is a related non-transparent company seated in an off-shore destination. The debtor doesn't request immediate payment, and the contract is based on some future conditions. At the end, there is no compensation paid to the debtor.
- The debtor provides a loan to a third party (related) and falsifies books to create fictitious payments of the loan installments. Also creates fictitious transactions with the third party and uses fake account payables to set them off against its loan claims.
- Debtor sells stake in its profitable daughter company for a nominal value of the shares. The new buyers are related to the debtor's owners. The debtor still does business with the former daughter company.
- Debtor closes a rental contract with a related company. This company rents the debtor an office premises for a period of 20 years. The debtor pays in cash up front in a single lump sum.

- Debtor accepts liabilities for other (related) companies in the group without any remuneration (e.g. liabilities resulting from a long term loan provided by a financial institution). The companies fail to pay it, so the debtor is obliged to repay it on their behalf.
- Debtor stops paying for leased equipment and property just a few installments before the end of the lease contracts and a very short time prior to debtor's bankruptcy. The equipment is later sold by the leasing company to a firm related to the debtor. This related company leases the property back to the debtor (also relates to Category 2).

Category 2 - insolvency fraud in the course of the proceedings

- Debtor employs ghost employees (managers) and pays them overstated salaries, i.e. these ghost employees are relatives of the insolvency trustee, who is hired to help with production increase, however never actually works for the debtor.
- Debtor provides hidden loans to a related entity, which are concealed in the books.
- Debtor manipulates and falsifies official reporting to insolvency trustee, creditors' committee and the insolvency court.
- Debtor pays a salary to the debtor's partners via a third party (related), the salary is concealed in the books as a business cooperation. Debtor doesn't pay any social and health insurance.
- The debtor rents equipment from the related company for an overstated price. The debtor doesn't need such equipment.
- Debtor establishes a new trade entity (without any property, all services are provided from the debtor) just prior to the bankruptcy filing and transfers its portfolio of customers to the entity. The entity should pay the revenues back to debtor, but it doesn't. When the debt is sufficiently high, the entity is liquidated.

Category 3 – Sophisticated insolvency fraud schemes

One of the examples of a structured insolvency fraud scheme perpetrated by an organized group of fraudsters is described below. The victim company (an unsecured major creditor) suffered losses of up to CZK 80 mil.

- KOVO, an experienced trader of receivables against distressed companies, received a tip about the financial problems of company ENGIN. ENGIN, a mechanical engineering company, had experienced financial difficulties over the previous 4 years. KOVO purchased receivables of ENGIN creditors equal to CZK 50M. A short time thereafter, ENGIN was declared bankrupt.
- KOVO was an "investment" company, acting on behalf of a strong and influential businessman WW, who was shareholder of the ABC group. He used several similar companies to buy out assets and fraudulently take over financially distressed companies.
- Just a few days after bankruptcy of ENGIN, KOVO acquired NEWTOWN, a ready-made company.
- Next, company STARS (which belongs to ABC group) allegedly provided NEWTOWN a 55M loan for purchase of ENGIN assets. Later on, the bankruptcy trustee of ENGIN sold ENGIN assets to NEWTOWN for CZK 55M.

- NEWTOWN started operations in the ENGIN premises and used the purchased equipment and employees of ENGIN. NEWTOWN operations were running approximately 15 months. In the course of its operations, NEWTOWN wasn't able to achieve operational profit, its trade receivables and payables reached CZK 50-70 mil.
- It was revealed that two members of NEWTOWN's statutory bodies were previous employees of KOVO (however, this was not known at that time). Also a legal representative of the bankruptcy trustee of NEWTOWN was a lawyer who had represented ABC in the past.
- 10 months into NEWTOWN operations, STARS assigned its receivables from the 55M loan to DADE. DADE was a specialized company, self-promoted as a trouble solver of distressed companies in insolvency proceedings. It was controlled by former policemen from "elite" units and a lawyer.
- 14 months into NEWTOWN operations, NEWTOWN stopped paying its payables. Shortly afterwards, a bankruptcy filing was submitted by two companies (linked to KOVO). NEWTOWN statutory body agreed with the bankruptcy, so NEWTOWN was declared bankrupt. As at the bankruptcy declaration date, overdue liabilities of NEWTOWN reached only CZK 1.9M (which accounted for only 1.6% of the total claims equal to CZK 118M submitted by NEWTOWN creditors and employees).
- In the next step, ABC used his influence to place a related bankruptcy trustee. Furthermore, ABC used its network of front companies which fabricated several fictitious receivables and submitted them to the bankruptcy proceedings. The bankruptcy trustee accepted these fake receivables. As a result, ABC took over the creditors' committee and its four front companies submitted 76% of the total approved creditors' claims.
- Finally, the bankruptcy trustee denied all larger claims filed by NEWTOWN's real creditors (e.g. the trustee claimed there were no contracts with the creditors). Also the bankruptcy trustee intentionally accepted an inappropriate claim of DADE, whose claims from the alleged loan (assigned from STARS) were secured by NEWTOWN's property. These pledged receivables should have been rejected by the insolvency trustee. Due to acceptance of the bankruptcy trustee, DADE became the dominant secured creditor who controlled the insolvency proceedings and obtained the highest recovery ratio.
- As a result, the bankruptcy trustee accepted all claims of the four fraudster companies which held 76% of the total creditors' claims. Most of these fictitious claims related to consulting, financial and legal services, and also fabricated penalties and guarantees. Next, the companies took over the creditors' committee.
- To sum up, the insolvency proceedings was a final stage of the well prepared plan. ABC group was able to get very cheap equipment from the previous manufacturer ENGIN, made NEWTOWN highly indebted, initiated artificial bankruptcy, and placed a related bankruptcy trustee which rejected many of the real creditors' claims.
- Many of the involved parties in the bankruptcy proceedings were interrelated, including NEWTOWN's statutory bodies, lawyers representing NEWTOWN creditors, the bankruptcy trustee and some front companies which submitted their receivables to NEWTOWN bankruptcy proceedings. The creditors' committee protected the bankruptcy trustee and enabled him to act only under ABC instructions.

Conclusion

According to the research described in the article, 3.51% recovery of the claims of secured creditors in Czech insolvency proceedings is very low. One of the possible reasons for such low recovery might be insolvency fraud. Because relevant statistics don't exist, it's not possible to exactly estimate the impact of insolvency fraud on the recovery rate.

However, many insolvency practitioners, including fraud examiners, bank recovery specialists, insolvency trustees and lawyers, frequently experience the occurrence of insolvency fraud. It is apparent that insolvency fraud diminishes the integrity of the insolvency proceedings, reduces the recovery of the creditors' claims and increases the costs of the proceedings for all related parties.

The available police statistics don't provide adequate information on the number and value of losses with respect to insolvencies. However, to some extent, they show existence of some offenses related to insolvency crime, which indicates existence of deeply rooted and dangerous fraud cases. Might a lack of data be one of the reasons why insolvency fraud doesn't have appropriate attention of the law enforcement units?

Fraud examiners who investigated suspicious insolvency cases discovered several reasons as to why insolvency fraud is hard to detect, investigate and prevent. First, significant insolvency proceedings are regularly targeted by highly capable and well organized criminal groups. These groups consist of skilled and experienced experts, who are familiar with the weaknesses of the proceedings and are aware of how to avoid detection. Many of the insolvency fraud cases are related to cooking the books of the debtors, including overstating the assets or understating debts. Skilled perpetrators use the methods and tools for how to strip the assets and conceal the debtor's property. Larger manipulated insolvencies are manipulated by a group of interrelated and coordinated individuals and entities, including statutory bodies of the debtor, lawyers representing the creditors, insolvency trustees, insolvency judges and creditors.

Due to the complexity of the insolvency processes and insolvency related crimes, the law enforcement authorities often fail to identify and investigate these offences. Lack of accounting data and hardcopy documents make it easier for perpetrators to keep their fraudulent transactions undetected. Law enforcement might not be adequately equipped with proper accounting, legal, technical and financial skills, experience and education to properly investigate and prove the fraud.

A thorough discussion about mitigation of insolvency fraud should be initiated. As a result, recommendations for effective counter-fraud measures to successfully deter the fraudulent behavior and repel the organized crime groups should be formulated. Some ways to mitigate fraud would include the following:

- Improve valuation and monitoring of the debtor's property throughout the entire insolvency proceedings.
- Develop and implement fraud statistics which would enable researchers and authorities to collect, monitor and evaluate hard data about potential irregular behavior.
- Implement audit procedures to analyze transaction history, revenues, costs, assets and debts of each debtor prior to bankruptcy.
- Investigate potential wrongdoing in the year prior to each debtor's bankruptcy.

- Establish and share know-how, case studies, and methodology with respect to red flags, schemes and detection tools related to insolvency fraud.
- Provide insolvency fraud related education to experts, including insolvency trustees, law enforcement officers, and judges.
- Analyze and investigate links and undisclosed relationships between all parties involved in the insolvency proceedings.

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