

Fraud a big challenge in insolvency cases

Early intervention key to finding where missing funds went

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For Law Times

Fraud can be a live issue in insolvency investigations. But it's the kind of thing that needs to come to light early if there's going to be any realistic chance of recovery.

And while experienced trustees and receivers can often smell a rat, they need to bring in forensic accountants familiar with the red flags to determine whether and how fraud has actually occurred.

"One of the first things I look for are whether the books and records are available," says Patricia Harris, a forensic accountant and partner at Fuller Landau LLP in Toronto. "If co-operation or access is not given by the business owners, that's a real red flag."

This is so, Harris adds, even where the owners have sent the books and records to an external accountant or lawyer.

"The records should be open and available to the receiver at all times," says Harris.

Related warning signs include removing computers and denying access to data by failing to provide passwords or logins. Disorganized records are also troublesome.

"People who have committed fraud often try to bog down the receiver or forensic accountant in paper," says Harris.

"So what you may encounter are boxes of random documentation, no record of what's in the boxes, and no overall listing of documentation provided."

Lack of co-operation can also take the form of personal unavailability.

"In a recent case, the chief financial officer of a corporation had to leave for emergency dental care," says Harris.

"If you couple that kind of unavailability with problems regarding the books and records, the warning signals really start popping up."

Business owners or employees with something to hide can also be remarkably difficult to communicate with, especially when they're travelling.

"When I start to hear that there's no access to e-mail or voicemail, it's almost certainly a delay tactic, a way of avoiding the inevitable," says Harris.

"In these situations, it's not uncommon to get a lot of unreasonably strange responses to things."

It's essential that receivers take control of all relevant bank accounts if a forensic investigation is to proceed expeditiously.

"The first thing I look for is whether the banking activity is different over the last few months and particularly in the last month before the receiver takes over," says Harris.

"What we frequently see in suspicious circumstances are round-number transactions, a lot of debit memos written to financial institutions, and debit memos that are not necessarily typical of most business transac-

tions."

Payments to financial institutions can be red flags indicating the movement of funds to personal accounts or to pay down debts guaranteed personally or by family members. In the same category are wire transfers to family members and other corporate entities, unusual credit card payments that have noth-

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ing to do with the business, payments to casinos, and, of course, cash withdrawals.

"The receiver and the lawyers involved should be alerted to all these red flags so as to ensure that they are fully vetted," says Harris.

Having a security agreement, of course, can make life a lot easier for receivers and their advisers.

"A security agreement allows you to get your hands on documents and assets right away so recovery doesn't depend as much on red flags as it might in other circumstances," says John Polyzogopoulos of Toronto's Blaney McMurtry LLP.

Absent security, receivers can resort to asset-freezing Mareva injunctions.

"Marevas, however, require strong evidence of a valid claim, such as a promissory note," says

Polyzogopoulos.

"But even if you have that evidence, you still must demonstrate that assets are being dissipated for the purpose of avoiding creditors."

Other remedies include Norwich orders, Anton Piller orders, targeted preservation orders, and deposit freezes under s. 437 of the Bank Act.

Norwich orders are tracing orders aimed at locating assets, wrongdoers, and evidence of wrongdoing including information in the hands of third parties innocently associated with the fraud. For example, a Norwich order can require a bank to provide a target's statements to an alleged victim without advising that it has done so.

To obtain Norwich orders against third parties, applicants must show that they have a *bona fide* claim; the third party is involved in the matter and is the only practicable source of information; and the interests of justice favour granting the order. Applicants must also undertake to cover the reasonable costs of the third party.

Anton Piller orders are a civil form of search and seizure aimed at securing and preserving information. They're often wide ranging and can provide access to a target's home, computers belonging to family members and associates, and all manner of electronic devices.

Preservation orders, like Mareva injunctions, involve freezing assets. And s. 437(2) of the Bank Act allows applicants to freeze deposits at a chartered bank by bringing an action against the fraudster and the bank to recover embezzled funds traced to a deposit account; serving the statement of claim on the branch and the bank's legal division; and providing a cover letter stating that the bank's power to pay out the deposit is revoked by statute.

Then there's always the option of reporting fraud to the police and having them do some of the work.

"But it's hard to get the police involved unless you gift wrap the case for them, primarily due to a lack of resources," Polyzogopoulos says.

In the end, advising whether or not it's worthwhile to pursue hidden assets is, at best, an educated guess for counsel. Polyzogopoulos cites a case in which a debtor had gambled away millions of dollars in funds transferred online to an offshore account.

"Maybe the accounts contained funds and maybe they didn't, but no one was prepared to spend the money it would take to get the necessary order, which would still require enforcement in a foreign jurisdiction," he says.

"It's really a gamble and whether you take it depends on how deep-pocketed the client is and how important it is to find out what really happened." **LT**