
What Can Financial Institutions Learn from the Bitter Lessons of Fraud?

By Alex D. Moglia and Mark Baum

There are many examples of fraud perpetrated by the use of various types of leases. Rather than just listing tales of financial horror, we identify here common elements of fraud, and what financial institutions can do to control the damage. We also identify what they can do to prevent future fraud. Hopefully, some guidance will be provided to avoid being burned in the future. Some of the approaches may represent thinking that is outside of the box, but it is the type of thinking that may be required to stay one step ahead of the people trying to pick your pocket.

Heard any good stories about fraud lately? The stories are always better when it happens to the other guy. The spectacular schemes perpetrated by Bernie Madoff in the United States and by B. Ramalinga Raju of Satyam Computer Services in India brought fraudulent schemes to the headlines. Closer to home, the people working in your, or your clients', troubled asset group can probably play a game of "can you top this" when it comes to how your financial institution has been defrauded. After the fact, it truly is remarkable how audacious, aggressive and greedy the perpetrators of fraud are in this business environment. Has your financial institution unwittingly abetted the companies that have ultimately cost you millions of dollars? In the last few years we have begun to see the consequences related to the easy availability of low interest money from the last decade. During the past decade, financial institutions could not lend money fast enough. According to statistics compiled by the Federal Reserve Bank, the outstanding balance on mortgages secured by one to four family residences went from five trillion dollars at the end of 2001 to eleven trillion dollars at the

Alex D. Moglia and Mark Baum are members of Moglia Advisors, a financial and operational advisory firm that concentrates on corporate restructurings and turnarounds, distressed M&A, fraud investigations, forensic accounting and insolvency and fiduciary services. Their respective email addresses are amoglia@mogliaadvisors.com and mbaum@mogliaadvisors.com, Moglia Advisors' telephone number is 847-884-8282, and their Web site is www.mogliaadvisors.com.

end of 2008. Most of these newly originated loans were sold to investors, either through a government backed security or through direct placement. The lender was interested in servicing the mortgage and collecting the fees from mortgage generation. The increase in loan generation and the value per transaction made fee generation a lucrative business. The Federal Reserve Bank statistics for 2004 through 2006 also indicated that loan charge-off rates were the lowest in the last twenty years. By the end of the third quarter of 2009, the charge off rate was thirty times the rate experienced in the 2004 through 2006 time frame. However, according to the Kroll Global Fraud Report, these conditions, business expansion and a lag in the monitoring of activities, made the financial sector a prime target for fraud.

While the financial sector was loading up on mortgage loans, during 2001 through 2008, lending for equipment leases was relatively flat. The total outstanding dollar value increased by only eleven percent during that period of time. The leasing market provides a needed source of funding for small to medium sized businesses. That large piece of equipment necessary to improve efficiency is frequently only within reach via a lease.

Entrepreneurs are usually business people who believe that they have a better idea or approach to a particular situation. They believe their products or services are better, faster, more satisfying and less expensive. They hope that everyone will beat a path to their door. They deserve credit for the energy that they bring to the business community. They transform communities by providing employment and can improve the quality of life for many people. Many of these entrepreneurs are interested in being leaders in their community. In the meantime, it would also be nice to make a pile of money along the way.

Occasionally, the circumstances surrounding an entrepreneur make it difficult to stay on the straight and narrow. Having things done the proper way in all instances is frequently time consuming and expensive.

The self imposed burden of being a pillar of the community sometimes means that failure is not an option. Who is going to notice if a corner is cut here and there? Probably no one notices. Some people slip to the dark side unwittingly while others revel in being on the dark side from the beginning. Some businesses are started with nothing but fraudulent activities in mind, while others have a defining moment that flips the switch to the dark side.

The following fact situations involve fraud related to leases. Each is spectacular in its own right. The first fact situation is Lacrad International Corporation. This business was established in 1984 and sold religious sermons on compact discs. At the time, the chief executive of Lacrad, Rodney Dixon, fabricated the necessary documents to make lenders believe that this company had revenues in excess of \$100 million and had as much as \$20 million in the bank. By 1999, Lacrad owed more than \$2 million to its bank on a line of credit and credit cards. Annual revenues at this time were actually less than \$100,000. Beginning in October, 1999, Lacrad created false tax returns and financial statements that showed millions of dollars in assets and revenues. The scheme included the use of a fictitious auditing firm, the occupancy of posh office space with all the trimmings, the use of temporary workers and actors posing as permanent staff and the giving out of a fictitious phone number for Lacrad's bank that actually was routed back to the offices of Lacrad.

Throughout the year 2000, Dixon told leasing companies that Lacrad had purchased or agreed to purchase computer servers and other technology equipment. The leasing companies would purchase the equipment and lease the items back to Lacrad. Payments were made either directly to Lacrad or to a company that Dixon claimed was a broker for the purchases. After obtaining more than \$11 million from the leasing companies and an additional \$2 million from a lender for the purchase of a private jet, Lacrad failed and could not make the required payments.

Dixon was indicted on federal fraud and money laundering charges in December, 2003. He admitted in October, 2004, to falsifying documents and was sentenced in November, 2005. He was sentenced to more than five years in federal prison and was ordered to make restitution of over \$13 million.

The leasing companies decided to fund the expenses related to Lacrad's federal receivership. Faced with the choice of no funding and no recovery, or fund and hope for the best, the leasing companies chose to fund and hope for the best. Alas, their collective bet did not sufficiently pan out. It is not known whether Mr. Dixon has made any progress in making the restitution payments ordered at his sentencing.

The second fact situation involves the sale and lease-back of vacation property. The start to this business was a successful campground. The owner wanted to convert this property from a seasonal attraction to a year-round destination. A hotel with family activity amenities was constructed. Vacation homes were sold. The homes were then leased back to the seller, who would rent the homes to visitors. The program was an unqualified success. Real estate in excess of \$35 million was sold. In 2007, sales activity began to decline. Without the sales revenue from vacation homes and with occupancy of the hotel and vacation homes not meeting projections, the campground owner could no longer make the lease payments to the vacation home owners.

This fact situation may not be properly identified as a fraud. The campground owner in this fact situation relied upon a marketing study which indicated that occupancy at a certain level, and at a certain price, appeared to be reasonable. There were two flaws in the study. The first was the other properties that were chosen as comparables to the subject property and the second was the evaluation of the target population that may be interested in the property. The lending institutions relied upon an appraisal that listed a stabilized market value for the hotel and related amenities well in excess of the loan amount. The owner appeared to be operating in a prudent manner. So, what went wrong?

At what point can anyone determine that the continued reliance on a flawed business model constitutes fraud? When the parties knowingly base their representations on false or outdated assumptions, then the allegation of fraud can be made. Will that necessarily help you avoid being the victim of a fraud? Only when the inevitable is staring you in the face can the final determination be made. The "too good to be true" aspect of this business related to the sale and lease-back of the vacation homes. Investors were offered a

lease-back rate in excess of prevailing mortgage rates, and the company was responsible for real estate taxes and operating expenses. This created a Catch-22 situation for the owner. The popularity of this program created an excess of units that could be rented on a consistent basis. If the sale of vacation homes had been controlled, in effect controlling the inventory of available units, the program may have worked. Meanwhile, the hotel was in competition with the vacation home units that were available and occupancy was not up to the projected level. The proceeds from the sale of new homes were being used to cover the operating expenses of the hotel and to make the lease payments to the existing vacation home owners.

When home sales slumped in 2007, the owner was forced to find other sources of cash. An investor was found to fund operations. Soon that burden became too large for the investor. The owner defaulted on the leases with the vacation home owners, the bank foreclosed on the hotel and a receiver was appointed to oversee all operations.

Alleging fraud in this fact situation is easy. Determining whether hope turned into fraud is hard. While others may argue about fraud in the inducement, or attempt recovery through personal guarantees, the bottom line here is that the bank group has acquired a white elephant, the vacation home owners have lost their source of funding and the local economy is in a downward spiral due to the reduction of its tax base and the damage to local financial institutions. This situation will take years to resolve and even longer for recovery to take place.

The fact situation above could be, as Peter Turecek, a contributor to the Kroll Global Fraud Report, labeled an affinity fraud. Turecek wrote "...the victims share some trait with the perpetrators of the fraud. This element in common with the fraudster lulls the victims and makes them more readily trusting of the con artist's pitch. The perpetrator preys upon that inherent trust of a shared bond." Indeed, many other campground owners were convinced to purchase vacation homes, while other investors were friends of the owner. Others, in concert with the campground owner, wanted the economic growth of the property and the surrounding area. Besides being a too good to be true investment, there was civic pride involved as well.

The third fact situation involves leases for machinery and equipment. A company was the seller of refurbished semi-conductor-making machinery, it got a majority of its equipment from one supplier, who sold the equipment to numerous financial institutions, who then leased the equipment to the company. The machinery and equipment bore "portable" serial numbers. During a five year period, financial institutions extended \$175 million in lease financing, while most of the collateral was pledged multiple times or simply did not exist. The company asserted that the expansion of their business was the economic basis for their equipment needs. This premise enabled the company to continue its scheme. Lease brokers from all over the country were used. In 2008, the company experienced financial distress and began to fall behind on the lease payments. Eventually, the company shut down.

The owner involved in the fact situation noted above was a willing participant in the low cost loan frenzy of the past decade. While the Lacrad fact situation mentioned earlier involved an out and out money grab, the equipment seller fact situation was based on an established business. The equipment company did not produce spectacular results, but provided employment considered significant to their geographical area. The company appeared to be credit worthy. It would take several years for everything to unravel.

The next step would be the identification of potential targets. The timing was right. Money was available from any number of sources. The company used leasing brokers to help its cause. The brokers used the financial information provided to them to acquire commitments from lenders. It is not known in this fact situation whether the financial information used was genuine or not. A warning sign at this stage of the fraud would be the ever-increasing number of UCC filings recorded against the company.

Several factors entered into how this fraud could be sustained over this length of time. Remember that the executive management of the company and the equipment supplier were in cahoots. The supplier made it look like to the world that machinery was being produced and supplied to the company, when in fact little or no machinery was being produced. If machinery was produced, the lease value for the equipment was inflated by several times the actual cost. In an after-the-fact evaluation, independent appraisers indicated that

the lease values were frequently overstated by five, ten, or even fifteen times the fair market value. Payment defaults only occurred at the very end of the scheme because new leases could not be written fast enough to cover the payments on the older leases.

Could a well crafted fraud be sustained over a long period of time? If the perpetrators were not too greedy and the underlying business provided sufficient net operating income, a fraud could be sustained indefinitely. If only a few transactions go bad over an extended period of time, the allegation of fraud would probably never even surface. There might be the recovery of collateral or out of court settlements, but nothing that would appear organized enough to be considered a fraud. So, once a business owner goes to the dark side, what possible end scenarios could there be to undo the damage? An option is to induce others to invest in the business so that the older obligations could be retired. In this fact situation, additional equity is needed to retire the debt accumulated during the fraud. Usually, the collapse happens too quickly for any remedy to be successful. Any downturn in business will cause the business to default or will require the company to acquire additional monies at an ever increasing pace. The owners become desperate and will pledge any level of collateral in order to obtain additional funding. Any blanket collateral filings and personal guarantees at this stage are probably worthless anyway.

Does your financial institution, or your client institutions, perform any due diligence related to personal guarantees? Specifically, are lien and UCC searches done on the guarantor? In many fact situations, the number of personal guarantees may indicate that the chance of recovery against the personal guarantee is slim to none. Considerable expense could be incurred by seeking recovery. The environment of competing claims and existence of collateral could require an expensive and time consuming process. In some fact situations, the reliance upon a personal guarantee may be wishful thinking.

The three major questions in the fact situations involving machinery and equipment leases are (1) is the collateral worth the value of the lease, (2) does the collateral exist, and (3) can serial number information be removed or altered? The first major aspect of these fact situations is the value of the collateral. The equipment company acquired custom-made machinery. The use of an equipment appraisal company in the evaluation of

custom-made machinery could save a financial institution millions of dollars. These items are unique pieces of machinery and equipment. There will not be readily available information from the primary or secondary markets for these items. An appraisal company may be able to render an opinion on the value of a piece of machinery and equipment from the specifications given by the suppliers in a quotation. The appraisal company may be able to obtain comparable values for similar pieces of equipment from its client base, or may be able to value important components within a piece or line of equipment. The appraisal company should also be able to provide a range of liquidation values should this lease go into default. The reliance on supplier information alone, particularly when dealing with custom-made machinery, should not be tolerated. Before a funding commitment takes place, the funding source should be in possession of the report from the appraisal company. This step will be a radical departure from the business as usual model. New machinery is rarely, if ever, appraised before a funding. This step only applies to the acquisition of custom-made machinery and equipment. If your internal leasing experts have never heard of the item being leased, ask for the assistance of an expert. If you walk away from the deal, consider it money well spent. If the lease is funded, the cost for the appraisal services should be passed on to the lessee.

The second major shared aspect of these fact situations is whether the collateral exists at all. In our experience, in the reams of available documentation, there are often no bills of lading presented in support of the delivery of the machinery and equipment. If your financial institution is involved in a fact situation where the existence of collateral is in question, you want to provide the best documentation possible in support of your claim. In most fact situations, a certificate of acceptance from the company is included as evidence of receipt. If you are perpetrating a fraud, why not tell one more lie? It is no wonder that the fraud perpetrated by the executive management and the supplier could flourish in this environment. Before funding takes place, the funding source should require a bill of lading from a common carrier of their choosing. The funding source should receive the billing from the freight company and the lessee should be charged a fee for the freight.

The third common aspect related to the machinery and equipment frauds is the use of portable serial

numbers. Serial number plates can be removed and reattached at will. Coming in for a collateral inspection? The proper serial numbers will be reattached to your equipment before you arrive. Ideally, please see if the serial number can be stamped or etched on a metal part of the equipment, as opposed to it appearing on a plate. If the information does appear on a plate, have your inspector, with the use of a portable die set, attach an identification number to the machine. It may also be a good idea, with the use of a reasonably priced GPS system, to monitor the precise location of your collateral. Machinery is expensive to move, so noting the precise latitude and longitude, down to the minute and second, of your collateral will aid in locating your collateral in the future and may help your inspector detect if the serial number switch is taking place. Consider the use of radio frequency identification (RFID) in the tagging of equipment. By combining the use of both technologies, inspectors can easily pinpoint the exact location of the collateral. Your institution will be able to verify that the inspection took place. Perform some collateral inspections on a surprise basis. Do not tolerate any undue delays in determining the location of your collateral.

Ask your inspectors to tour the entire facility where your collateral is located. Note the approximate number of production lines, work stations, etc. Compare the inventory prepared by your inspector to the UCC filings for the company. If gross inconsistencies are noted, there may be fraud involved. For example, if a company has thirty production lines and five hundred UCC liens, something may be awry.

Each financial institution is different, so the measures used to monitor a portfolio of machinery and equipment leases will be different. A larger institution may decide that the cost to monitor these items is not worth the benefit to be derived from constant vigilance. The prevailing thought may be that the losses due to fraud are more than offset by the additional basis points charged to the entire population of leases to cover this cost. The thought may also be that losses due to fraud are a fixed cost and therefore not much can be done to reduce these losses. The recommendation is that larger institutions should re-examine the monitoring activities related to these portfolios. There appear to be opportunities available to reduce this cost. Too many instances of \$10 million losses may indicate a lack of internal control, thus raising the dreaded Sarbanes-Oxley fears

for responsible parties within executive management. Many smaller financial institutions involved in these fact situations will lose, what is to them, a significant amount of money.

In addition to the physical verification of your collateral, your institution must monitor the reporting requirements contained in the lease. Every master lease contains similar reporting requirements and conditions of default. Lease brokers assign the lease to the investor. The investor may assign the lease to another investor. Instances were noted in the fact situation discussed earlier where leases were assigned four or five times, portfolio sales took place, leases were a part of the assets seized by the FDIC under bank failures and reassigned to other banks and mergers of banks or bank name changes took place. The movement of these leases from one party to the next provides an opportunity for the fraudster to ignore the reporting requirements present within the lease. At the very least, the required information may not be provided until the lessor requests the information from the lessee. How well does your institution monitor the reporting requirements for these items?

Could the proper monitoring of reporting requirements lessen the exposure to fraud? The answer depends upon what you do with the information once it is received. Trend analysis may give some indication that a particular credit is deteriorating even though payments are current. For example, if sales related to manufactured items decreases by a significant percentage, but the investment in machinery and equipment increases, something may be wrong. This trend would seem to be going in opposite directions and should require additional research. Business ratio calculation, particularly for liquidity and solvency, may provide insight into the quality of the credit in question. Apply the answers obtained to your current loan underwriting standards to see if this credit would still qualify under those standards. These are relatively easy calculations provided that the required information is received from the lessee. Even if bogus financials are provided, apply the test of reasonableness to what has been provided. Is it possible for a business to experience an explosion in sales? The answer is a qualified yes, depending upon the industry. If the market for the product is static or declining, it would be difficult for one company to show results significantly better than the rest of the industry. Again, additional research is recommended.

Additional items to consider when performing the review of financial information are the obligations related to operating leases. The schedule of future payments under these obligations will only be presented as a note to the financial statements. Since the lessee is only renting, there will be no asset or liability presented for these leases. If your analyst is computing the cash coverage needed for all long term obligations, operating leases must be included. As a fraud continues, the company may tend to use operating leases because, in general, the monthly payments are lower and no down payment is required. Because these are off balance sheet items, ensure that your institution receives the entire set of financial statements, notes included. As the United States adopts the provisions of the International Financial Reporting Standards, all leases, whether considered finance or operating leases, will be presented within the balance sheet. Some companies must adopt this provision as early as 2010 and all companies must adopt this provision by 2014. Until then, make sure your financial institution receives the full annual report.

Why go to all this bother? Because when fraud goes wrong, it goes wrong in a hurry and your financial institution does not want to be left holding the bag. Even though the actions leading up to default may take years to develop, these schemes usually unravel quickly. The monitoring of the credit may allow your financial institution to sell the lease. If the analysis performed indicates that the lessee is no longer creditworthy, the instrument should be sold. The sale may occur at a discount, and quite possibly a deep discount, but your recovery will likely be significantly greater through a sale than in a bankruptcy proceeding. Be diligent in the issuance of default notices and in protecting your interests. In extreme fact situations, your institution may be required to report suspicious activities under the Bank Secrecy Act and/or the US Patriot Act. Extreme losses to one borrower may require that documentation of the fact situation be submitted to bank examiners. In any fact situation, along with the losses sustained, there could be significant additional administrative effort required in the reporting of these fact situations.

The likely consequences of being victimized by a fraud will be the slow realization that your collateral and any underlying personal guarantees are worthless. Remember that piece of custom-made equipment? The lease value was five or ten times the actual value

when the item was brand new. After being used and quite possibly having no alternate uses in the marketplace, the liquidation value will plummet. There may also be competing claims for your piece of collateral. Blanket collateral filings may exist. There is also the possibility that your collateral never existed in the first place, in which case, you are now an unsecured creditor in a bankruptcy that will likely not even come close to satisfying the claims of the secured creditors.

The slow realization process will include significant expense on your part. Financial advisors or outside counsel will need to be retained. Documents will need to be retrieved. Court filings will be required. All of this will occur before any estimate of recovery will be available. The expense incurred to this point may well exceed the value of any distribution that is to be received. If the bankrupt party is involved in any retail activity, a quick sale out of bankruptcy may be required to retain customers and shelf space and therefore the underlying value of your collateral. If the bankrupt party is in an industry on the decline, there may not be an opportunity to sell the machinery and equipment in an already saturated market. In most fact situations, the assets will be sold under duress and only a small fraction of the fair market value will be realized. If the lease was originally written for five or ten times the fair market value when brand new, and the item is sold for one tenth of its then fair market value, the math indicates that a secured creditor will receive only one to two cents on the dollar for their secured claim if the claim in that piece of collateral can be properly identified. If there are competing claims, a creditor may settle for one half or one quarter cent on the dollar.

Due to competing claims and the time necessary to determine if collateral exists, the time to administer a bankruptcy that involves fraud is even slower, and more costly, than a normal bankruptcy. Financial advisors may be required to trace the flow of cash. Months of research may be necessary to determine the proper claimant on a piece of collateral. Hearings will be held to adjudicate disputes. It could easily take from eighteen to twenty four months before a distribution is made to secured creditors. If the company is privately owned, the personal bankruptcies of the owners may also slow down the process.

In summary, here are the items to consider:

RED FLAGS	POSSIBLE CONSEQUENCES
Single source supplier	Supplier and lessee are working together in the fraud
Custom-made machinery and equipment	Limited secondary market, difficult to appraise, lease values are too high
Lack of reporting	Cannot properly monitor the credit
Large number of UCC filings	Collateral pledged multiple times
Large number of UCC filings against guarantor	Personal guarantee is worthless

Will the fallout from these frauds drive players out of this lending area? Probably not for the larger institutions, but for smaller community banks, a loss due to fraud could cripple the ability of that institution to lend in other areas. In combination with losses in other lending areas, these losses could force smaller banks to raise capital or to go out of business altogether. Local area bankers who think that they can rely upon their local business community may find themselves in an affinity fraud case. Those bankers may find themselves asking, “How could one of our own treat us in this fashion?”

In sum, your institution (or that of your client) can prevent fraud by following these recommendations:

1. Use an equipment appraisal service during the underwriting process if in-house expertise is not available or lacks the specific knowledge related to custom-made machinery.
2. Obtain a bill of lading from a reputable common carrier of your choosing as additional documentation that the collateral exists and was delivered.
3. Perform surprise collateral inspections.
4. Enhance inspections and collateral identification by the use of GPS and RFID technology.
5. Re-evaluate monitoring activities for your portfolio of leases.
6. Perform basic financial statement analysis on information that is received.
7. Sell leases not up to current underwriting standards.
8. Be constantly vigilant.
9. Communicate with the borrower regularly.
10. Employ financial advisors, who will perform a fraud investigation and/or forensic accounting.

Be extremely cautious. Your efforts will be rewarded.