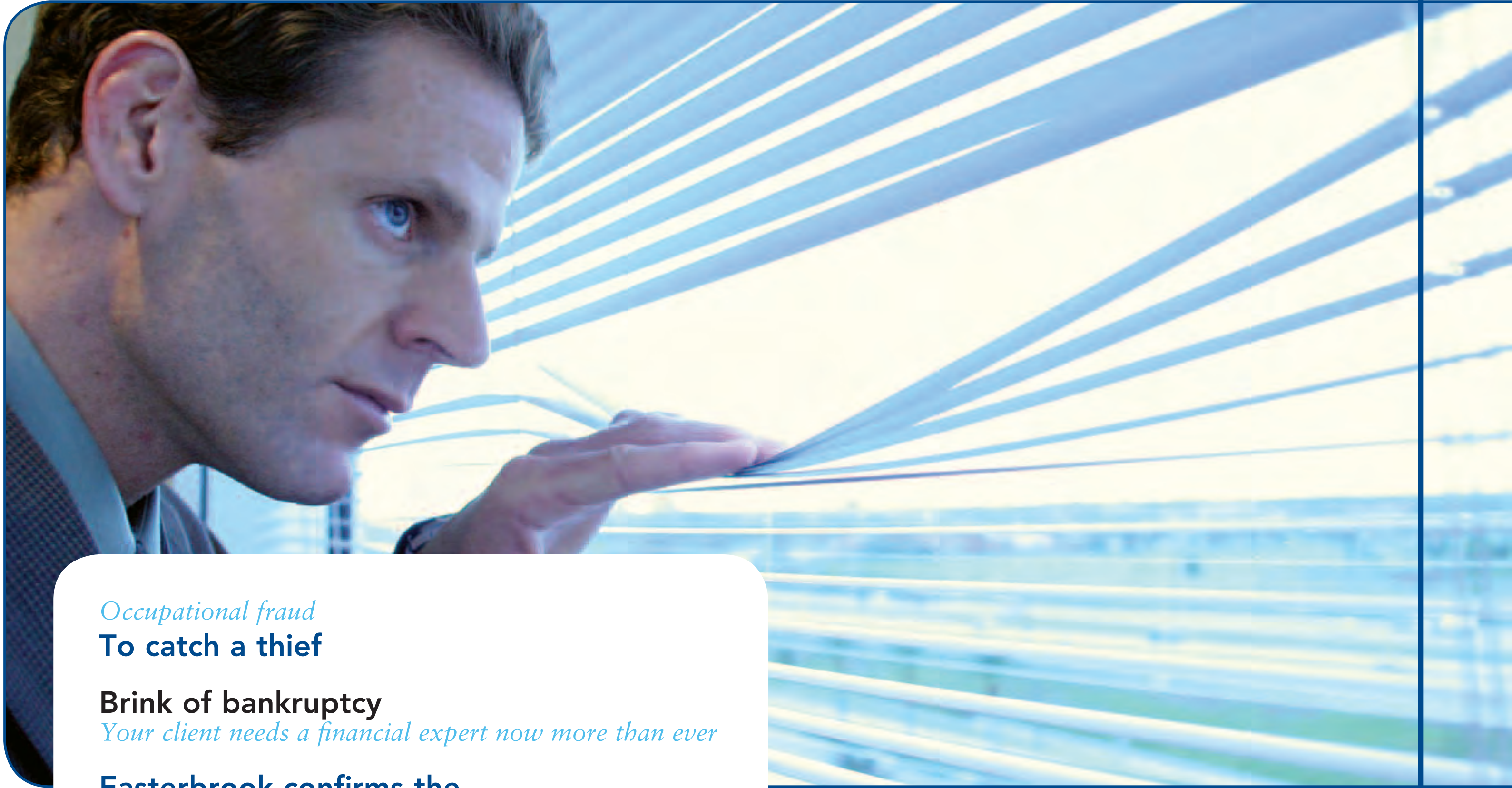
Advocate's EDGE



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March/April 2013

Occupational fraud

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In its 2012 *Report to the Nations on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) estimates that the typical organization loses 5% of its revenues to occupational fraud every year. The median loss in the ACFE's survey of almost 1,400 fraud cases was $140,000, and more than 20% of these cases resulted in losses of at least $1 million.

The numbers are alarming, as are some of the ACFE's other findings — such as those related to fraud perpetrators. You and your clients may be surprised to learn just who is behind the most costly schemes.

FRAUD IN THE CORNER OFFICE

Rank-and-file staff aren't the only ones who commit fraud. While 42% of the perpetrators in the ACFE survey were nonmanagement, 38% were managers and 18% were owners or executives.

The higher the thief's position, the more costly the fraud. Owners and executives rang up losses that were approximately three times higher than managers instigated, and managers caused losses about three times higher than regular employees caused. The ACFE attributes this to the fact that those with more authority have greater access to their company's assets and can more easily override internal controls. Not surprisingly, the study also finds that the amount of fraud losses increases with perpetrators' tenure and education — which typically are associated with higher positions and greater trust.

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The majority of fraud schemes surveyed were committed by individuals in the accounting, operations, sales, executive / upper management, customer service and purchasing areas. Together, these groups accounted for 77% of cases.

It's worth noting, too, that most occupational thieves aren't career criminals. Of the 860 cases in the ACFE study with such information available, only 6% involved a perpetrator who had previously been convicted of a fraud-related offense. And of 695 cases with information on the perpetrator's employment history, 84% of them had never been punished or terminated by an employer for a fraud-related offense.

HEY, I'M A THIEF!

The Association of Certified Fraud Examiners' (ACFE's) 2012 *Report to the Nations on Occupational Fraud and Abuse* identifies several behavioral signs that an employee is committing fraud. In 81% of the cases the ACFE surveyed, the perpetrator waved at least one of the following red flags:

- Lived beyond his or her means (36% of cases),
- Was experiencing financial difficulties (27%),
- Had an unusually close association with vendors or customers (19%), or
- Displayed excessive control issues (18%).

Although most occupational thieves are motivated at least in part by some kind of financial pressure, the rate at which financial difficulties were cited dropped almost 7% from the ACFE's 2008 survey. As the report states, this development was unexpected because its 2012 report investigated fraud incidence during the peak of the financial crisis, during which it's reasonable to assume that more employees would have experienced personal financial concerns.

WHAT'S MY MOTIVATION?

Most individuals who commit occupational fraud do so because they're experiencing some type of pressure. It could be financial — stemming from debt, addiction, gambling losses, poor investments, medical bills, divorce or an extravagant lifestyle. Pressure also can come from supervisors with unreasonable sales targets or other performance goals or from the company's shareholders with high earnings expectations.

Frequently, occupational thieves are also motivated by anger and dissatisfaction with their manager or the company's leadership — particularly when they perceive management's own ethics and integrity to be lacking. In rare cases, perpetrators draw personal satisfaction from outsmarting their boss or the system.

SHUT IT DOWN

The report makes several recommendations to employers that want to prevent fraud before employees get a toehold:

Set up fraud reporting mechanisms, such as confidential hotlines, so that both internal and external sources can report suspicious activities. As in previous surveys, the ACFE report found that hotlines were one of the most effective methods of catching occupational thieves.

Provide targeted fraud-awareness training not only to managers but also employees. At a minimum, a qualified fraud expert should explain the actions that constitute fraud, how fraud harms everyone in the organization and how employees can safely voice their suspicions. ACFE research shows that organizations with antifraud training programs experience lower losses and schemes of shorter duration than those without.

Educate managers and employees on the characteristics of fraud perpetrators and their behavioral red flags. See "Hey, I'm a thief!" above for details. It's also important to encourage all workers to keep an eye out for potential fraud — and report it.

No program can prevent all fraud; the goal is to reduce its incidence. These measures can help employers detect schemes more promptly and thereby reduce their overall losses. In addition, potential perpetrators may be more hesitant to try a scheme if they know that management and co-workers are trained to be on the lookout for fraud and have the means to report it.

DON'T GO IT ALONE

Of course, employers can get themselves in trouble by acting too hastily on mere suspicions of fraud. Encourage your clients to retain fraud experts to perform thorough and comprehensive investigations and, if necessary, testify.

Brink of bankruptcy

Your client needs a financial expert now more than ever

Business bankruptcies are finally on the decline after several consecutive years of high and rising rates. According to the American Bankruptcy Institute, in the first nine months of 2012 U.S. commercial bankruptcies fell 22% over the same period in 2011.

Of course, favorable statistics don't mean much to the thousands of companies still in financial peril. If you have clients facing bankruptcy, you want to help them make the best decisions. And to do so, you need financial experts on your team. Accounting, valuation, damages, and merger and acquisition (M&A) professionals can help assess the severity of the financial crisis, determine whether liquidation or reorganization makes sense, and provide guidance on everything from selling assets to shareholder disputes.

CUT LOSSES OR KEEP GOING?

The recovery process starts by identifying ways the troubled business might regain control of its cash flows. After working with the business to establish a daily cash budget to stop the immediate bleeding, a financial expert can determine which form of bankruptcy is more appropriate — Chapter 7 (liquidation) or Chapter 11 (reorganization). There might also be a third option: Take steps to avoid bankruptcy altogether.

The expert can develop financial projections for several reorganization options, including best-, probable- and worst-case scenarios. Using a Z-score formula, he or she begins to assess a struggling company's financial strength and estimate the risk and probability of whether the business will go bankrupt.

CHAPTER(S) AND VERSE

When a company's liquidation value exceeds going concern value, most experts recommend that it consider filing for Chapter 7 bankruptcy protection. Liquidation value is often seen as a "floor" for a company's value.

But sometimes businesses are actually insolvent, meaning they can't pay their debts. In such cases, a financial expert might act as a court-appointed receiver and turnaround consultant who can facilitate the liquidation process — including winding down operations and paying out creditors in order of legal preference.

If, on the other hand, a Chapter 11 filing is deemed appropriate, a financial expert can help "sell" a reorganization strategy, such as debt forgiveness and restructuring, to lenders and other creditors. Due to the tight credit market and recent conservatism of lenders, many loans are overcollateralized. By appraising assets (including inventory, equipment and receivables), a valuation expert can assist in renegotiating working capital covenants. As debt terms are eased, cash can be freed up.

SELLING SMART

Alternatively, a reorganization might call for divestitures of unprofitable segments, so the company's owners can refocus on core operations. Or a distressed business might solicit offers to buy the company or its assets. An M&A expert can help your client find potential buyers and evaluate whether divestitures and offers appear reasonable.

When minority shareholders or creditors contest a divestiture or sale, distribution or other transaction, a valuation expert can write a fairness opinion to help demonstrate that management exercised good judgment in analyzing a transaction. Fairness opinions are especially important when transactions involve related parties or if the CFO's compensation package includes a "golden parachute" clause.

END THE SQUABBLING

Another unfortunate side effect of financial distress is shareholder disputes. When management squabbles impair daily operations and decision-making, owners may decide to split the assets — or one owner may choose to buy another's interest. In these cases, buyers tend to undervalue the business while sellers tend to overvalue it.

A valuation expert can help bridge the two sides by objectively estimating what the company and its underlying assets are worth. The expert also can help the parties identify assets that aren't on the balance sheet — including contingent legal and tax liabilities, customer lists, brand names, and business goodwill — and explain the tax implications of buyout terms, such as installment sales and earnouts.

MOVE FORWARD

When so much has already gone wrong, financially distressed businesses just want to make the best possible decisions going forward. Whether that means an immediate Chapter 7 filing or an elaborate reorganization plan, the input of financial professionals is essential.

Easterbrook confirms the "gold standard" of valuation

Many legal issues revolve around business valuation, including damages calculations in commercial litigation. In a recent case, *Malik v. Falcon Holdings, LLC*, Seventh Circuit Court of Appeals Chief Judge Frank Easterbrook turned to what he called the "gold standard of valuation" to help determine damages for plaintiffs who were deprived of their stakes in a business.

MANAGERS SUE OWNER

Aslam Khan held 40% of the common units in Falcon Holdings, a limited liability company that owned and operated 100 fast-food restaurants. Khan allegedly told Falcon's managers that he would acquire full ownership one day and would then reward the top managers with 50% of Falcon's equity. In 2005, Khan bought out Falcon's other owners and became the sole equity owner. When he failed to distribute common units to any of the managers, five of them took him to court.

Using the price Khan paid in the buyout, the plaintiffs calculated that the company was worth about $48 million. Twenty managers qualified for units under the terms of Khan's offers, meaning each plaintiff lost about $1.2 million ($48 million x 50% ÷ 20).

The district court, in summary judgment, found that Khan had promised the plaintiffs an equity stake in Falcon. But it held that the managers hadn't adequately estimated their damages:

1. The other owners didn't own 100% of Falcon, making it impossible to derive the value of the whole firm from the amount Khan paid for their interests.

2. The amount the other owners were paid depended on how much Khan and Falcon could borrow — not on Falcon's true value.

Therefore, the district court found that the plaintiffs' approach was flawed.

JUDGE REJECTS TWO PRONGS

On appeal, Judge Easterbrook rejected the district court's two-prong analysis. The two propositions ignore the fact that the "gold standard of valuation" is what a willing buyer will pay a willing seller in an arm's-length transaction. The judge concluded that the buyout of the other owners involved a willing buyer and a willing seller dealing at arm's length, so the price they agreed on *was* the value of the asset.

But Easterbrook also found problems with the plaintiffs' damages estimate. First, the interest that plaintiffs valued and the interest Khan owned were different. The plaintiffs valued the entire company — or the sum of Falcon's debt *plus* its equity — not just the equity portion that Khan owned. Khan owned 100% of the equity, but the bank held the debt interest. The judge found it unsound to assume that Khan's equity interest in Falcon was worth 100% of the firm's total value.

The two propositions ignore the fact that the "gold standard of valuation" is what a willing buyer will pay a willing seller in an arm's-length transaction.

Easterbrook also questioned the plaintiffs' assumption that Khan would give each of the 20 managers 2.5% of Falcon's equity units without any terms or conditions. To do so "would be a disaster not only for the ownership structure of a closely held firm but also from a tax perspective."

BACK TO SQUARE ONE

Easterbrook vacated the district court judgment and remanded the case for proceedings consistent with his opinion. Assuming they find a qualified expert to calculate damages according to the "gold standard," the plaintiffs should still receive something. But the amount will likely be less than the $1.2 million each manager had anticipated.

What gives?

Tax Court allows gift tax exclusion for FLP interests

Reversing its own recent trend, the U.S. Tax Court in *Estate of Wimmer v. Commissioner* held that gifts of interests in a family limited partnership (FLP) qualified for the federal annual gift tax exclusion. In three previous cases, the same court held that the exclusion *didn't* apply to gifts of limited partnership interests.

KEEPING IT IN THE FAMILY

A husband and wife formed an FLP in 1996 and funded it entirely with publicly traded and dividend-paying stock. The FLP was intended in part to restrict nonfamily rights to acquire family assets. The couple made gifts of limited partnership interests in the FLP to various family members.

In 1996, the FLP received dividends from the stock and continued to receive them quarterly. It made distributions to the limited partners from 1996 through 1998 for payment of federal income tax. Beginning in 1999, the FLP continuously distributed all dividends — net of partnership expenses — to the partners when they were received, in proportion to partnership interests. In addition, limited partners had access to capital account withdrawals and used such withdrawals for, among other things, paying portions of their residential mortgages.

After the husband died and his estate filed an estate tax return, the IRS returned a tax deficiency of $263,711. The estate asked the Tax Court to find that the gifts of limited partnership interests qualified for the annual gift tax exclusion.

SIDING WITH THE ESTATE

The annual gift tax exclusion is available only for "present interest gifts," as opposed to gifts of future interests in property. As the court explained, a gift in the form of a transfer of an equity interest in a business or property, such as limited partnership interests, isn't necessarily a present interest gift.

A present interest gift must confer on the recipient a substantial present economic benefit by reason of use, possession or enjoyment of either the property itself *or* income from the property. In *Wimmer*, the court easily found that the donees didn't receive the rights to immediately use, possess or enjoy the limited partnership interests themselves because of the significant transfer restrictions in the FLP's partnership agreement.

But the court also found that the estate satisfied the three requirements for income from the limited partnership interests to qualify the gifts of the interests as present interest gifts:

1. The partnership would generate income.

2. Some portion of that income would flow steadily to the limited partners.

3. That portion of income could readily be ascertained.

The court therefore concluded that the limited partners received a substantial present economic benefit.

LEARNING *WIMMER'S* LESSON

Wimmer shows how an FLP can be administered in such a way that it can put restrictions — which often are used to create valuation discounts — on gifted limited partnership interests while still satisfying the requirements for the gifts to qualify for the annual gift tax exclusion. A qualified financial professional can help you draft an appropriate operating agreement.

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