Financial Crisis – Legal Service Providers

Fraud And The House Of Cards

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The causes of this economic crisis are myriad: the Community Reinvestment Act; subprime loans; extremely low interest rates; adjustable rate loans; overbuilding; loan defaults; predatory lending; auction-rated securities; bank deregulation; the failure of the auctions; securities fraud; complex derivatives; Wall Street; Main Street; the Federal Reserve; the SEC; Congress; the weak dollar; or just old fashion greed. Whoever or whatever caused the house of cards to fall so hard, and it was probably all of these in some combination; throughout history when our economy goes down, the incidence of fraud rises even faster.

In an October 10, 2008 *New York Times* article entitled "*Keeping Wary Eye on Crime as Economy Sinks,*" the author explored the connection between a waning economy and changes in crime rates. The article quoted Richard Rosenfeld, a sociologist at the University of Missouri-St. Louis, who explained, "Every recession since the late '50s has been associated with an increase in crime and, in particular, property crime and robbery, which would be most responsive to changes in economic conditions."

Fraud is a property crime committed by individuals with opportunity who find themselves under unusual pressure. Sometimes it is outright theft of corporate assets, including cash, inventory or trade secrets. More often, however, fraud involves the manipulation of financial records to accomplish some self-serving purpose:

• to cause the company to pay the fraudster or an accomplice cash to which he or she is not entitled;

• to protect a bonus, commission or other payment upon which one has come to rely;

• to secure funds to pay a bribe required to land a significant piece of business;

• to move liabilities off the balance sheet in order to deceive the investing public and favorably impact stock prices;

• to hide or reduce losses or report profits that are not actually present; or

• to use ERISA plan powers to buy or sell corporate stock to artificially influence the price.

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The Cause

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There are three elements that must be in place for fraud to increase:

• Pressure
• Opportunity
• Rationalization

The factors that a business can control concern internal pressures coming from management and opportunity. The creation of internal controls to reduce the opportunity, however, is not enough. Clever people will find a way to get what they need to survive, deal with the pressure in their lives or to simply steal from your company. Senior management must go further to identify who is most likely to rationalize a misappropriation of corporate assets.

During good times when business is thriving, pay is solid, employment is growing and bonuses are strong, the incentive to commit fraud is lessened significantly. During these good times it is the dishonest who take advantage of comparatively lax oversight to peel off a few extra dollars around the edges for themselves. It is in recessionary times like these that relatively honest people commit acts they would not otherwise commit and losses stemming from fraud increase significantly. Once the funds are gone, they are most likely gone forever, even if one manages to catch the thief.

It is my hope to provide you some insights to help you stop the honest from making very bad decisions in very bad times.

Reading The Tea Leaves

It is not hard to imagine that pressure has risen in recent months on employees at all levels of the organization. It is the responsibility of the organization's leadership to anticipate where the problems may occur and intervene in advance. Seeing the future is impossible, but reading the tea leaves is not, if you know what you are looking for.

All fraud is individual. It is committed for personal gain. It is never committed for the benefit of the entity although it may seem that way. Fraud or other criminal acts only benefit a company if by benefitting the company the individual driving the fraud is thereby benefitted. This sort of fraud, however, almost always puts the company in tremendous peril. The greatest peril arises from claims that the otherwise innocent members of the board of directors and/or corporate officers failed to exercise their fiduciary duties to oversee the operations of the company and prevent the fraud from occurring. Reading the tea leaves is not just good business; it is your obligation.

A review of a selected group of employees should be conducted to try to determine where sufficient pressure exists to cause an individual to begin to look for opportunities:

• *Contingent Payments:* Identify those who have consistently received high performance bonuses, commissions or other contingent payments. They have likely developed a lifestyle dependent on those payments. If it is relatively clear that in the new environment they will not receive those payments, pressure will develop on these individuals to find a way to pay their inflated bills and obligations. They will be very tempted, even driven by third parties such as a spouse, a child's education, a bank or their peers, to manipulate whatever they have access to in order to maximize those payments. Their lifestyle and reputation depends on it.

• *Individual Credit Problems:* Consider running a credit check on all employees who have any opportunity to interact with financial processes. If they have an opportunity to commit fraud, you want to know if they are under pressure to do so. Is their mortgage in trouble or has it already been foreclosed on? Are they laden with credit card debt? Are they late on any payment obligations? Any of these scenarios is likely to create pressure on the individuals to rationalize "borrowing" the necessary funds to get themselves back on their feet.

• *Children:* Identify employees who have new children or children in or about to attend expensive private schools or colleges. Do any employees have children with uncovered health issues? Is their pay going to be less this year or do they face a possible lay-off? Has a spouse lost his or her job? Frequently one will suffer great personal trauma and not act, but when faced with trauma to one's family, he or she will do whatever it takes.

• *Foreign Agents:* Are there foreign offices or agents who have historically done well, but are now finding business harder to find? They will be under pressure to maintain their level of compensation and keep their businesses afloat, including the payment of illegal bribes. While the additional business may be welcomed, the payment of bribes will likely expose your company to tremendous potential FCPA and anti-corruption penalties and fines.

• *Subsidiaries and Divisions:* Like foreign agents, various parts of the organization operate relatively independently and are compensated based on the performance of the divisional business. The incentive to move revenues and costs from period to period to maximize compensation is always present. The belief often is, "If we move a little revenue forward and a few costs back, we will maintain our strong performance and receive our substantial compensation. Next period can't be as bad and we can make it up with one good quarter."

• *Stock-based Compensation:* Identify everyone who would stand to benefit from a change in the company's stock. These individuals have an incentive to manipulate financial statements to protect the market price. Reported information, leaks, rumors and innuendo are other ways that key personnel with interest can impact the share price to their personal benefit. Gaining a clear understanding as to who would benefit from changes to the stock price provides a first step in making sure illegal activities of this sort do not occur.

Casual discussions with employees, administrative assistants, supervisors and managers can uncover a wealth of information that might indicate who is at highest risk to look for an opportunity to commit fraud. Pay heightened attention to activities that are out of the ordinary such as erratic or withdrawn behavior, changes in attitude or demeanor, attendance issues, rumors and innuendo around the water cooler, adjustments to common routines, unauthorized computer activity or attempts at access, new vendors, debts, credit or payables, or a significant increase in expense reimbursements or payment from petty cash.

It is important to mention that the vast majority of your employees are honest and hard-working and would not consider stealing from you or anyone else, no matter the situation. Most of the people you identify will be no threat to the organization at all. Nonetheless, it is highly likely that it is from the pool of employees under raised financial pressures that new fraudsters will emerge.

To reduce perceived opportunity, internal controls should be reviewed and updated if necessary. Policies should be addressed with supervisors and managers. Provide training on controls and policies to employees. The fact that you are addressing these issues will be enough to dissuade many would-be actors from making a poor decision under pressure.

Use of sophisticated data mining applications can spot anomalous transactions or trends that require additional follow-up and review. The relatively small number of problematic transactions occurring in a company fail to "stand up" and identify themselves as having no business purpose or lacking value in the exchange. Appropriate uses of technology can identify fraud early in its lifecycle.

Trade secret policies and controls should be reviewed to verify that valuable assets remain safe from those interested in making a sizable return by selling them to competitors. Identify all with access to information critical to the company and make sure that they are not among those under heightened financial pressure.

Finally act aggressively and quickly. If the review of financial and other controls uncovers anomalies or outright fraud, investigate further, find the culprits and apply the appropriate discipline. Action is another strong deterrent to those on the edge of committing fraud.

If your company provides such services, it may be wise to address uncovered pressures directly with employees and determine whether assistance can be provided. Even the effort to help can make it very difficult for an employee to rationalize committing fraud against the company – partially because you showed concern and partially because they know you are already onto them.

There is a great deal going on within the organization in times like these, and it is certainly difficult to find the resources to commit to such activities. The stresses endured by your employees, however, are also higher than ever. Pressure is the single biggest driver of fraud. When recession hits, pressure mounts. Knowing where that pressure is located will help you identify the most efficient places to look for problems. Failure to take these steps will likely result in the commission of fraud, harm to your company, and even potential repercussions to you and your office.

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