Fraud Is a Growing Threat in Worsening Economy

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With the United States well into a recession, businesses are feeling the pressure. As this article was written, the author was coming off of a month of addressing significant fraudulent conduct perpetrated on several of his firm's lending clients. Based on the state of the economy, it should come as no surprise that fraudulent activity might be on the upswing. Desperate people do desperate things.

Whenever fraud arises — and no matter the extent of the damage it causes — it is always a shock. After all, people are never defrauded by someone they don't trust. They tend to watch those people carefully. Thus, they are apt to be defrauded by people they have trusted — which compounds the pain and leads to significant self-reflection.

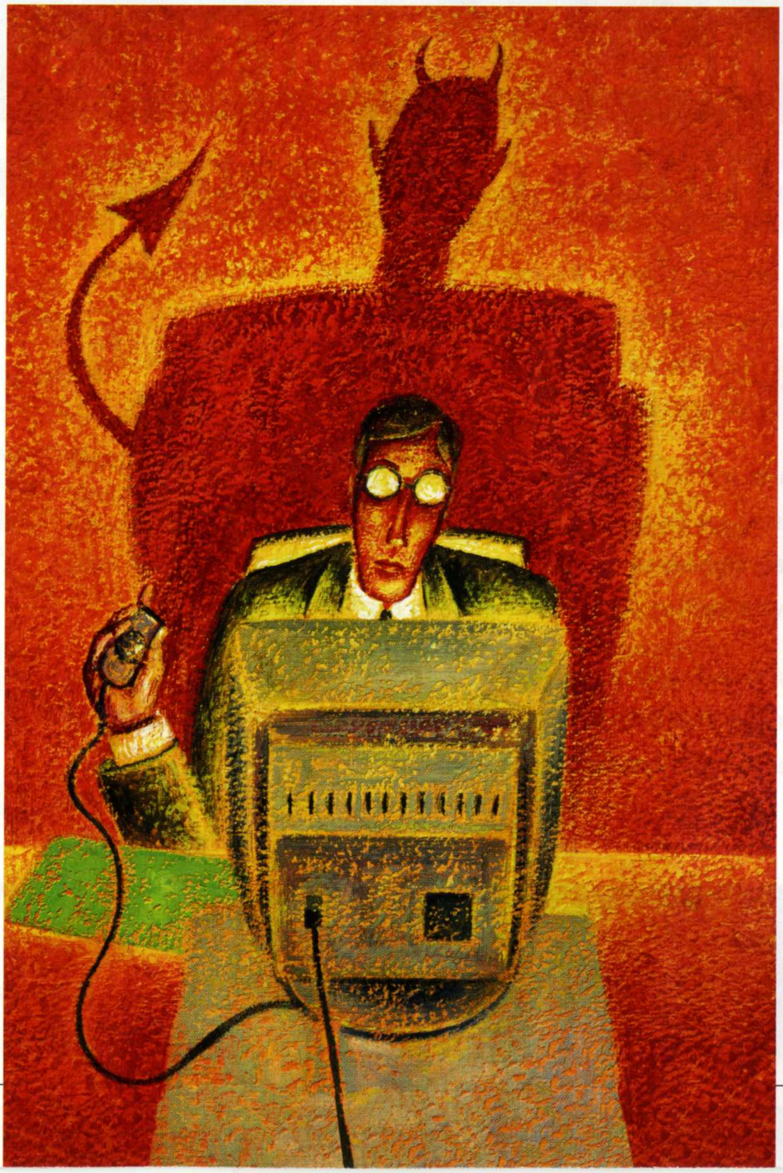
Years ago, a relationship manager who had just discovered that his favorite borrower had defrauded him, confided, "How could he have done this to me? He was my friend. I knew that he was having problems with his business and that he wasn't dealing with it very well, but I never expected this."

His companion shared one of his favorite phrases with the victim. "I'll take a crook over a schnook any day," he said. One always knows what a crook will do. One never knows what a "schnook" will do. A lender who distrusts a borrower is always on guard, as a good lender should be. When that same lender gets too close to a borrower, he or she is often asking for trouble.

Two frauds that the author dealt with recently are each very typical, although very different from each other.

The first incident involved a complicated long-range scheme that finally came unwound. It is hard to imagine that there was ever a moment that the perpetrators did not intend to benefit from misrepresentations that they made to their lender. Invoices were fictitious. Bills of lading were forged. It was an ugly situation, and the responsible individuals showed no remorse.

The second incident was more typical of the fraudulent activity that the author has encountered over the years. The business had thrived under the current leadership for some 30 years. The industry was experiencing a downturn, and management did not adequately adjust for this occurrence. The company had exhausted its line of credit from a small regional bank and sought an asset-based loan (ABL) to provide additional borrowing availability based on the orderly liquidation value of the collateral. In this instance, the "inventory" was heavy equipment.



Within a year or two, the company went from reasonable profitability to significant losses. Because the company's expenses remained fairly constant, the losses consumed the additional borrowing availability created by the ABL. Payables became overextended. Payroll was due, and there was no borrowing availability.

Sales of equipment inventory were made, but the proceeds were not delivered to the lender, as required by the loan agreement. To make matters worse, when one of the suppliers, a manufacturer of heavy equipment, pressured the company over nonpayment of unsecured obligations, the principal agreed to return to the supplier several pieces of inventory valued at some $600,000 in the aggregate. However, that inventory was part of the borrowing base. When the next inventory report was delivered, it became clear that the lender and borrower had a problem.

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The contrast in these two scenarios helps to distinguish very different types of fraud. In each case fraudulent conduct occurred, but in the second instance it occurred as a result of economic pressure on the company that was improperly addressed.

As borrowers come up against their availability limits, lenders need to remain vigilant for instances of foul play. A typical scenario unfolds as follows: Goods are on the shipping dock ready to be picked up tomorrow, but payroll is due at the same time and there is no availability. The borrower wonders, "What if I invoice today for the goods being shipped tomorrow?" He tries it, and it works. He was able to draw down his advance before the goods were bona fide receivables, but everything worked out fine.

As finances continue to tighten he repeats this scenario. As the business continues to fall, he gets deeper into his scheme. Next, he is expecting a delivery of goods that will be immediately turned around and shipped out to his customer. He prepares the invoices before he even receives the inventory and assigns those "receivables" to his lender, who advances against them. But when the supplier comes to deliver the goods, he complains about his past due receivables and insists on being paid cash on delivery. The borrower does not have the money to pay the supplier, as he has already borrowed against the invoices he prematurely assigned to his lender. At that point, his plan unravels.

Survival Requires Vigilance

Unlike the first scenario involving the long-term fraud that involved fictitious invoices and forged bills of lading, most defrauders do not start out with the intent to commit fraud at all. They are merely looking for a quick fix to a problem. But this conduct snowballs into a major predicament — a problem loan for the lender and serious legal issues for the borrower and those acting on its behalf.

Years ago the author met a man who had just left a major money center bank to become a small independent factor. Asked what factoring experience he had, the man conceded that he was "learning the business." During the discussion, the author pointed out to him that contrary to what he might believe, his largest business risks were not in customer credit, where as part of his business experience he would encounter occasional losses. His more pressing risk involved potential exposure to "front office fraud."

As the next several years passed, during encounters at industry events, the factor shared the progress of his growing business. Then one year at a conference, the factor looked awful and when asked how things were going, it was obvious immediately that there was bad news.

"Do you remember that bit of advice you once gave me?" he asked. "Now I know what you meant." Asked how bad the problem was, he replied, "I couldn't even pay my kid's college tuition." Ugly litigation arose out of that sad story.

These stories serve as a caveat to be wary of these types of situations. This economy is, at best, challenged. Desperate people do desperate things. Surviving this challenging economy may depend on fine-tuning one's fraud detector. CR

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