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Moral Bankruptcy

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By Aleksandrs Rozens

Corporate casualties may fall into bankruptcy court for any number of reasons: a slowing economy, a rise in the cost of raw materials, the arrival of a competitor or even class action suits. Sometimes it involves corporate malfeasance, as was evident with **Refco**, **Worldcom**, **Enron** and the lesser known case of **Le Nature's**.

These days, a New York based firm, **Investigative Management Group**, that specializes in investigations of corporate wrongdoing has its hands full trying to track down why certain businesses may see a sudden reversal of fortune that lands it in court. “We are getting more calls,” says **Robert Strang**, co-founder and CEO of Investigative Management Group.

Strang, a former DEA agent who has worked as a private investigator and consultant on the issue of corporate fraud for nearly two decades, says the pickup in activity for his firm comes amid a slowing economy and a troubled real estate market.

Some of the calls Investigative Management has fielded are from banks financing commercial real estate developments that have soured. In some cases, local developers simply abandon a project before its completion so a bank wants to know if any fraud has occurred in the unfinished project. Then, the skittish bank wants to bring on another developer, who will have to be vetted by firms such as Investigative Management.

The lenders “want to find the right new partners. The bank wants to make sure the new developer does not have any liens or financial problems to weigh them down,” says Strang, who says the pace of developers walking away from unfinished projects was at a high point in the early 1990s. These days, this sort of behavior is not as prevalent as it was some 15 years ago, but Strang believes “this is just the beginning.”

In addition to calls from lenders stuck with unfinished real estate projects, Investigative Management has gotten calls from firms that have found what they believe is internal fraud. The range of industries is wide, says Strang, noting that his assignments involved services businesses, entertainment companies, manufacturers, retail service providers and even retail banks. Some of the fraud crops up in the form of unauthorized use of corporate credit cards or the overstatement of sales and profits to meet expectations of a company’s management and its investors. In some cases employees have set up separate companies to compete with an employer, and there are also cases of assets being hidden. Strang and his firm have gone to China and South America to try to recover assets.

“It is domestic and international. It's tough in China and South American, trying to recover assets because there is little recourse [for a business] outside the US,” says Strang.

Strang and his team have found that the fraud usually surfaces amid a business downturn. “When business turns south, generally speaking, people get caught at something they’ve been doing for some time. The numbers are not there and the board starts to look closer,” he says. “People become desperate. They want to show good books and they want to live the lifestyle they have had” amid better economic times.

The pickup in business for Strang started roughly 9-12 months ago. But, he says, the current business environment is different in one notable respect. Investigative Management is being asked to vet new deals being put together by private equity financiers specializing in the middle market companies. Also, Strang and his team are being increasingly asked by hedge fund managers to help vet professionals being recruited for the funds.

“Normally, in the last couple of downturns we have a drop off in work that involves deployment of money,” says Strang. But, in this market, “mid-sized PE deals are getting done and hedge funds managers are still hiring folks.”

In addition to PE funds, Strang is vetting transactions for retirement funds, not-for-profits and banks. Bank lenders, too, are very cautious about who they lend to and want to ensure that borrowers are credible.

Just how cautious lenders have gotten is evident in an April **Federal Reserve** survey that showed “domestic and foreign institutions reported having further tightened their lending standards and terms on a broad range of loan categories over the previous three months. The net fractions of domestic banks reporting tighter lending standards were close to, or above, historical highs for nearly all loan categories in the survey.”

Strang and his team could not offer examples of actual cases in much detail because of the need for confidentiality, but one recent case had a company employee set up a front business which did work with the individual’s employer. Consulting work was being done by this front business – some of it legitimate – but at inflated prices. The employee steered much of his employer’s business to this front company and then ensured that the parent company or home office would pay for the work.

In another case, a financial services firm found that its employee corporate credit was being used for fraudulent charges, while another case involved a senior employee fudging numbers on sales figures to meet a company board’s expectations. The board ended up making decisions based on the faulty sales figures.