Fraud's Effect on Divorce Settlements in a Deteriorating Economy

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It is well known that deteriorating economic conditions exacerbate stress and tensions in marriages and often result in separations and divorces. While the old adage advises that both spouses, for their own protection, should understand and be familiar with family finances, it is problematic and generally not the case, when there is a family business or a closely held company, run solely by one spouse (the "Owner/Operator").

Historically when business is booming and asset values are high, a divorcing spouse might commit a fraud in order to reduce the business value either for example, by accounting fraud or diversion of assets, thus having to share less with the other spouse, or using the funds for a "lifestyle" change. In the current economic environment where asset values are already reduced, a spouse may still be inclined to fraudulently minimize values even further so as to retain more going forward particularly given the current recession.

In periods like these, the engagement of a Certified Fraud Examiner is a cost effective way to determine if any "monkey business" has occurred. Generally, the cost of a fraud examination produces a significant return on investment, especially if one spouse has some inkling of wrong doing.

I had been engaged in a case of corporate fraud at a privately held commodity distributor ("ComCo") [1] where it was suspected that funds had been fraudulently siphoned out of a subsidiary, which was a debtor to its bank ("BankCo"). Metaphorically, ComCo was married to BankCo, which had loaned many millions to the company under a Loan Agreement. ComCo and BankCo each assumed a significant level of trust, just as in a marriage. ComCo relied on BankCo to provide funds when needed, and BankCo relied on ComCo's integrity to adhere to the terms of the Loan Agreement and repay the loans as prescribed therein. Unfortunately in this case as in some marriages, ComCo was up to no good.

The initial evidence of a problem, a prerequisite to having access to the company's books and records, was a violation of bank covenants related to the level of an intercompany receivable from ComCo's parent, which was not a debtor under the Loan Agreement. Often in a marital situation, there is some feeling of doubt that the non-operating spouse has about the legitimacy of the business operations, which supports the engagement of a fraud examiner or forensic accountant.

As a fraud investigator and forensic accountant, the scope of my assignment was to identify and quantify any fraud in the operation of the business. I began with interviews of key management personnel as well as other key employees. This phase was undertaken to learn the business flows and

[1] The commodity supplier, renamed herein to maintain confidentiality, was based in the Caribbean and had international business dealings in Europe, South America and the Middle East.

processes, as well as to "put the word out" about concerns of fraud. As a result of discussing concerns of fraudulent activity, several confidential tips of possible fraudulent activity were received and investigated. The next phase was to conduct an investigation of past transactions involving cash, checks and letters of credit above a certain dollar level, looking for inconsistencies or any suspicious activity. Transactions were traced from initial orders through the payment cycle and included reconciliations to product received into inventory. The purpose of this activity was to confirm the legitimacy of the cash movements.

The determination was that payments for product from ComCo to the parent were made many months in advance of product delivery, in clear violation of the Loan Agreement and prior business practices, and overpaid for the purchase of product. It was discovered that this fraud was initiated to fund a debt obligation of the parent incurred for a failed business venture.

Following submission of my forensic investigation report, a civil action was filed by BankCo, and ComCo filed for bankruptcy protection under Chapter 11. I assisted counsel in litigation activity during both the civil action and the bankruptcy, including development of motions, preparing to take depositions for State and Federal Court, and providing deposition testimony, all based on knowledge gained from the fraud investigation. Following my preparation of a valuation of ComCo, BankCo agreed to settle their claim and the company was refinanced out of bankruptcy. The fees for this case were recognized by BankCo to be worth the cost considering the amount of their funds at risk.

Correlating the ComCo case to a divorce matter, it would be possible for an Owner/Operator of a (marital asset) family business or closely held company to embezzle funds from the company by committing a fraud. The embezzled funds could then be hidden in anticipation of divorce or used to fund a different lifestyle, like infidelity, substance abuse or other addictions. There are many paths a fraudster might take to accomplish this, however, the fraud examiner has been trained to investigate and identify them. Some of the more well-known and often used frauds to siphon money from a company are the use of fictitious employees, vendors, and consultants. Checks written from company funds to these fictitious entities are then hidden by the Owner/Operator in any number of ways, e.g., loans to relatives or friends, purchase of assets in other parties' names, etc.

The fraud investigator is knowledgeable in the techniques and methods used to discover the siphoning of funds from a company and how they are then hidden. If the ComCo fraud investigation had not been conducted and the fraud had been allowed to continue and undoubtedly expand as frauds generally do, BankCo would have suffered a larger loss. Similarly, a divorcing spouse may receive less in a settlement due to the perpetration of a fraud.

The importance of engaging a fraud examiner in a divorce proceeding cannot be overstated, particularly when there is a business involved, even if the non-operating spouse has no doubt about the legitimacy of the business operations. A preliminary assessment of the business to identify any red flags of fraud could be accomplished at a reasonable cost. If there were findings of fraud, a more extensive investigation would be undertaken.

In addition to the issues of embezzlement and hidden assets, an appraisal or business valuation must be performed using reliable accounting numbers. The company's financial statements may have been compromised by a fraud and need to be restated for valuation purposes. If there is any suspicion or evidence of possible wrongdoing at a family business or a closely held company, a fraud examiner or forensic accountant should be engaged immediately to evaluate the situation and to insure a fair distribution of assets.

MHLevitt Consulting, LLC was founded to provide the highest level of professional service in the areas of forensic accounting, fraud investigations, litigation support, solvency and related valuation analyses, as well as troubled company and bankruptcy advisory services. These areas of expertise are applied in advisory and support work as well as in providing expert testimony. Mr. Levitt has an MBA in Finance from Columbia University, a BA in Theoretical Mathematics from Lehigh University, and is a Certified Fraud Examiner (CFE), a Certified Insolvency and Reorganization Advisor (CIRA) and a Certified Turnaround Professional (CTP).

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