What About Pete?
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FINAL SUBMISSION

I. <u>The Perpetrators</u>

This is a story about failed partnerships, failed marriages, and rampant bankruptcy fraud. What once appeared to be a successful company progressed through a legitimate bankruptcy filing, followed by a post-petition looting of funds. There are related-party transactions, ghost payroll checks, benefit withholdings, quadruple-entry accounting, mortgage application fraud, wire and mail fraud, money laundering, and fraudulently filed Bankruptcy Operating Reports. The story isn't over yet, but so far there have been more than $5 million in civil judgments issued, and settlement payments made by five banks that were unwitting participants in these various schemes.

It began with Fred Morgan, the owner of Gopher Design. Fred was in his mid-forties, smooth and charismatic, and always well-dressed. He was slender and a little frail looking, a bona fide lady's man, but definitely not the type who would do well in prison. People have one of two reactions after meeting Fred. The majority liked and trusted him instantly. But a small minority of us felt the urgent need to check our pockets and take a quick shower after shaking his hand.

Mrs. Morgan was not as physically attractive as her husband, but had been a winner of the gene-pool lottery in other ways. Her father had built a hugely successful business empire that created enough wealth to keep his offspring very comfortable for multiple generations. Her parents didn't seem to particularly like her husband, but they were there with open arms and an open check book whenever anyone in the family needed money. There was no apparent reason why Fred would ever resort to theft when he was married to such a huge source of wealth.

Fred's number-two guy, Pete Slowinski, was almost the exact opposite of Fred. While Fred could sell ice to an Eskimo, Pete seemed to rub everyone the wrong way. He was rough, tough, and gruff. Physically, he was short, squat, and very muscular. And his face was very flat, as if he had been hit with a shovel in one of his formative years. His blank stare of ignorance was a stark contrast to Fred's apparent total knowledge about almost anything you could think to talk about.

When anyone who knew him was asked if Fred was capable of committing fraud, they answered that he was smart enough and gutsy enough, but that there was no reason for it; his wife's family was wealthy beyond belief and Fred could dip into that trough whenever he wished. The same question about Pete elicited a unanimous answer: he didn't have the brains to defraud anybody; he just did what he was told.

The differences between the two men even extended into their choices in women. Mrs. Morgan was the definition of "shrew." Employees literally quaked in fear when she walked through the office. She was loud, obnoxious, and totally abrasive. Fred was rumored to have an Italian girlfriend in Italy, whom he visited often. On the other hand, Mrs. Slowinski, Pete's wife, was a quiet woman well-liked by everyone in the company. Employees generally felt bad for her because Pete had a public affair with the company's shipping clerk, who was also a very plain and quiet young woman.

II. The Company

Gopher Design had been a successful graphic arts company for more than a decade. Its client list included many large advertising agencies, Fortune 500 companies, local restaurants, and non-profit agencies. Gopher's customers had a tough time in the years when businesses were hit by the dearth of advertising that followed the 9/11 attacks, weakness in the hospitality industry, and massive changes in charitable donation patterns resulting from changes in tax laws, and disasters—some natural, some not. Technology changes that impacted both the way that design work is done and the way that Gopher's customers disseminate their information created a great need for large capital spending. Despite this, Gopher had not suffered the economic hardships that many of its competitors experienced.

Fred and a partner had run Gopher together since its inception, but eventually had a falling-out. The partner left the business, sued Fred in state court, and won his case. Fred continued to operate the business, but had been ordered by the court to buy out his former partner for an amount in excess of $1 million. Rather than make this payment, he placed the company into voluntary Chapter 11 bankruptcy.

Gopher's bankruptcy case appeared to progress normally, but slowly. The debtor's bank suspected check kiting at various times, but was never able to prove anything more than careless cash management. Personal lawsuits against the bank president filed by Fred and by other companies that his family owned kept anyone from investigating him too thoroughly. The bankruptcy court finally confirmed a plan where Gopher would pay its secured debt in full and about 33 cents on the dollar of all its other pre-petition debts. Everybody was looking forward to Gopher emerging from the bankruptcy process as a healthy, rehabilitated company.

Rather than serve as the poster-child for bankruptcy success, Gopher crashed and burned immediately upon its release from court supervision. It emerged from bankruptcy with no cash and hopelessly insolvent. The US Trustee immediately stepped in, put Gopher back into bankruptcy, and appointed a Chapter 7 trustee to investigate what had happened.

III. <u>The Initial Discovery</u>

I was at the base of a mountain in central Quebec when the Chapter 7 trustee called my cell phone, introduced himself, and told me that the US Trustee had recommended that he call me to help investigate Gopher. I had served as Examiner in a bankruptcy case involving allegations of fraud both prior to and after the bankruptcy filing, so the US Trustee was familiar with my work. He went on to explain that because there was no money at all in the bankruptcy estate there was a good chance that I may never get paid for taking the case. I must have been drunk on the fresh mountain air, the overwhelming beauty all around me, and the joy of being with my family – I said I'd do it.

My first day back from vacation I met Fred and an attorney from the trustee's firm outside Gopher's offices. Fred was pacing back and forth, totally distraught when we arrived – the alarm company had discontinued service, the building had been broken into, and most of the sophisticated computer equipment was missing. Fred took us inside and showed us the point of the break-in. Interestingly, the splinters still on the door all pointed to the door being kicked out from the inside. Some of the "stolen" computers were subsequently found, much later in the case, to have been given to employees in lieu of amounts that Fred owed to them.

I asked Fred to give us a tour of the facility. We started with his office, which was totally empty except for a box of Monthly Operating Reports that he had filed with the bankruptcy court. He explained that he was only a figure-head in the company and that Pete Slowinski ran absolutely everything. When I asked about the Operating Reports, he answered that he didn't understand a single thing on them, he was totally baffled by numbers and accounting, and that all he did was sign what his accountants prepared for him.

As we walked through the various cubicles, Fred became more and more distraught at each set of dangling wires where computer equipment used to be. He didn't know where any of the company's business records were or how we could get in contact with the former accounting staff, or how anything could possibly be figured out. If only he had stayed more involved, things may have worked out so much better, he whined. After all, he lost more than any creditor – his livelihood, his reputation, and all his personal net worth were gone with Gopher.

Fred's only contribution to the investigation was the ability to tell us who sat in each of the cubicles. He claimed not to know anything else about the business. File cabinets were all locked and Fred had no idea where the keys were. Pete's office was jammed full of clutter – files and paper were everywhere. Despite the office being an incredible firetrap full of stuff, the only usable documents there were a very impressive collection of carry-out menus from practically every restaurant within a five mile radius. It was clear from the food stains on them that the menus were not there to sample different design styles.

The cubicle next to the accountant's had been vacant. There were dirty, dusty boxes jammed under the work surfaces. When I opened them I found binders of batch reports showing inputs (billings to customers, invoices from vendors, commissions due) into the accounting system and some of the outputs (accounts payable checks paid) from the system. I was thrilled as I carried boxes out to my vehicle. This was a very messy and overwhelming way to start an investigation, but at least all those boxes gave me justification as to why an accountant might need a business truck if the IRS ever questioned my tax deductions.

A few days later, Fred attended a meeting at the US Trustee's office. This was a chance for the Chapter 7 trustee to ask him questions about anything related to the case, under oath. Unfortunately, we still didn't know enough to know what to ask. All we had to go on at this point were copies of cancelled checks provided by the bank, and the Monthly Operating Reports submitted by Fred. He wanted so very badly to help us, he said, but he just didn't know anything.

It turned out that Fred was familiar enough with the Operating Reports to be able to boastfully point out that he had stopped drawing a salary after the first few months of the case. He did this, he said, because the company couldn't afford him and he wanted it to be able to succeed. Later in the questioning he admitted that the company had been paying large bills for credit cards in his name, but that was only because the company had no credit and Fred was personally paying for expenditures the company needed. Later still, he admitted that the company had made payments for personal loans taken out by him, but that was only fair since he was not otherwise being compensated for all his efforts in the company's behalf. There was already enough inconsistency here for the case to get interesting.

IV. (A) <u>The Investigation – Fred Morgan</u>

Back in my office, I had to figure out what to do with three truckloads worth of boxes of batch reports. My initial hunch was that since the salesmen spoke highly of Fred, he probably hadn't cheated his salespeople out of their commissions. If I compared the sales used to calculate commissions to the sales recorded in the general ledger and in the receivables system, I was bound to find discrepancies that would prove that sales were being diverted. I gave up on this after two weeks – every single item I looked at traced through all the documents just as it should have.

I visited with the bank president who had been unlucky enough to be Gopher's lender. He was convinced that Fred had been kiting checks, and gave me more boxes containing 28 months' worth of bank statements and cancelled checks. Another week of charting and diagramming the ins and outs of the bank account showed that looking for kited checks was also was a dead-end endeavor.

One curious element did pop up from the bank account work, but I didn't know what it meant or what to do with it— Fred used many different banks for his personal accounts and for the other companies that he controlled. I noticed this when I reviewed deposits into Gopher's accounts and from the endorsements on the backs of some of the checks that Gopher had written to Fred.

Stymied, I turned to the Monthly Operating Reports. All of the activity reported through Gopher's main bank tied out to the bank statements. All of the activity reported through Gopher's secondary bank also tied out the bank statements. But if everything was tying out, there should have been more cash. It didn't make sense. I needed to look at the detail behind the reports and accounting batches.

Crawling around under the desks at Gopher's offices again, I found more boxes of documents in the area where human resources used to work. This was the good stuff – original deposit slips, copies of the checks that customers had remitted, and original remittance advices showing what the customers had paid for.

What a difference original source documents make. I noticed that in some months the batch reports that had original source documents attached to them did not trace through to the Monthly Operating Reports. "How could this be?" I wondered, since I had already tied out most of the batch reports. Retracing some of my prior steps made the answer obvious – there were often two different sets of batch reports for the same transaction.

What happened was that a customer would remit payment to Gopher, the payment would be recorded in the accounting system, and the appropriate batch report would be generated. At a later time, someone would go into the system and change the batch report to be a different date, a different amount, and sometimes even a different customer. But why?

Again, the answers were in the details. Actual deposit slips found with the original batch reports showed the existence of eight additional bank accounts in four different names. None of these were authorized by the bankruptcy court and none were property of Gopher, but all had Gopher's customer's checks being deposited in them.

With documentation of Gopher's money being deposited into non-Gopher accounts, the trustee was now able to subpoena bank records for all of the accounts I had identified and for any other accounts that we knew of that were held by Fred, his wife, his children, or his companies. We now had most of the pieces of the puzzle.

Fred had been diverting customer payments to his own bank accounts and to the bank accounts of companies controlled by him. There was even money diverted to a company owned by Fred's adolescent son. When Gopher needed money, Fred would return some (but not all) of what had been diverted.

For example, when BL Publications, a customer, made a $150,000 payment to Gopher, Fred had it deposited into one of his unauthorized bank accounts. He might then transfer $130,000 of this back into Gopher's bank account. A batch sheet may be prepared showing this deposit as consisting of $115,000 from BL Publications and the remaining $15,000 as having come from three other customers in payment of their invoices.

Later, Fred might transfer $20,000 from one of Gopher's official bank accounts to the other. The transfer going out of one bank account would be correctly accounted for as an inter-company transfer. The deposit into the second account, however, would be accounted for as having been received from BL Publications, thereby clearing more of the amount still showing as open on their account from the original diversion of funds. The result of all this was that Gopher received $130,000 in cash, Fred received $20,000 in cash, and $150,000 of the bankruptcy estate's accounts receivable were marked as "paid."

These discoveries explained why there was money missing. They also explained why the bank president had suspected kiting – every time a Gopher check bounced, it had been covered by a deposit from another account. Fred was covering the cash shortages he had created with some of the money he had diverted. It looked like kiting, but was entirely different.

It was significant that all of the cash diversions went into accounts that only Fred had access to, because this made it clear who was committing the fraud. Many of the batch details attached to original deposits had notes on them from the accounting staff indicating where to deposit the money "per Fred" or "per FM," further sealing the case against him. Most of these were initialed by Fred himself. He could no longer claim ignorance and non-involvement with the accounting process, as his initials were on source documents on almost a daily basis.

IV. (B) <u>The Investigation – Pete Slowinski</u>

Where was Pete during these daily diversions? His absence was both curious and troubling. In all the boxes and boxes of documents I reviewed, I never found a diversion of customer money to Pete. I never even found evidence that he had been there. While reviewing Fred's personal bank accounts, I found one instance where Pete wrote a personal check to Fred for $50,000. That check bounced, and was never replaced. Why did Pete pay Fred $50,000? If the money really was owed, why was it never repaid after the check bounced? These questions gnawed at me.

I interviewed some of Gopher's vendors, all of whom were furious at being cheated by Fred. Some of them tipped me off about having some of their bills paid from a bank account in a state 1,600 miles away, which would have been an invaluable clue if I had not already found the use of that bank. None of them mentioned Pete in any role other than Fred's stooge.

I also interviewed some of Gopher's former employees, all of whom were also furious at being cheated by Fred. Some provided sworn affidavits about being directed by Fred to divert Gopher's receipts to bank accounts that did not belong to the company. They provided more information on the use of the out-of-state bank account. They related rumors of Fred's exotic European girlfriend, who I never found any actual evidence of. But again, nothing about Pete.

I had reviewed the backs of all the cancelled checks written during the bankruptcy process, and had noticed that one of the employees seemed to sign his paychecks with a number of different signatures, and used six different banks. He also had twice as many paychecks as he should have had based on the company's pay cycle. My hypothesis was that Pete printed up a fake ID and cashed these extra checks, but nothing could be proven. Even so, it would be a very small fraud compared to how much money was missing, overall.

The dim-witted, clueless Pete Slowinski had managed to slide through this entire train-wreck without ruffling anyone's feathers and without leaving any kind of paper trail. Almost. He didn't get away without ruffling his wife.

During an interview with the recently divorced ex-Mrs. Slowinski, she mentioned that her former husband had moved into a very expensive house with his new girlfriend. Oh yes, there was also once a strange call from a bank rejecting one of Gopher's deposits that had not been properly endorsed. That call from the bank never made sense to her, because Pete was never involved with Gopher's finances and she didn't know anyone who used that bank.

Neither the existence of the new house nor of that strange bank account had turned up in our investigation, because they were both in Pete's girlfriend's name. When an FBI agent assigned to further the investigation reviewed the mortgage application for the house, she found the applicant's income grossly overstated compared to her payroll records at the debtor. This finding of mortgage fraud was good enough for a subpoena of the girlfriend's bank records, and that is where we found the money that Pete had diverted.

Fred's scheme had been to convert money received by the debtor into his own. Pete was more clever. Rather than invoicing customers for work done by Gopher on the company's accounting system, Pete had just typed up invoices instructing the customers to pay directly to his own post office box. The sale never appeared in Gopher's records and no one ever knew to look for the money.

V. <u>The Outcome of the Investigation</u>

Two three-inch binders of evidence against Fred were presented to the judge in bankruptcy court. Fred, who began the case professing to know nothing of finance and accounting, convinced the judge that he was able to represent himself due to his background in finance and investments and his daily involvement in the debtor's affairs. He did a stellar job – by the time he was done, the judge had assessed him with over five million dollars of judgments and penalties. The judge also instructed the trustee to have Fred referred back to the justice department for criminal prosecution.

The money Fred took has not all been found. Hundreds of thousands of dollars were traced to family members, and hundreds of thousands more were paid to lawyers either as fees or retainers. I am not aware of any record of large matters that these lawyers handled for Fred. Client confidentiality rules can make lawyers a good place to park money that needs to be hidden for a while.

The Morgans received an uncontested divorce and agreed to a huge child support settlement so that Fred's family would have first dibs on whatever money does turn up. However, since Fred was still living with his wife and family six months after the divorce decree, the divorce is being challenged as a sham. Our theory is that his Italian girlfriend never existed, but was instead a set-up if a justification for a quick divorce was needed.

Fred filed for personal bankruptcy, but because the judgments against him are fraud-related, they are not dischargeable. The criminal case is proceeding.

Pete, on the other hand, had all his stolen money nicely tied up in one piece of real estate. In addition to the theft from the bankruptcy estate, charges are being prepared against him and his girlfriend for mortgage fraud, money laundering, mail fraud, and wire fraud.

Six different banks had accepted checks made payable to Gopher and allowed them to be deposited into accounts that did not belong to the company. None were properly endorsed. Two banks made the argument that as an officer Fred had authority to endorse Gopher's checks, but under bankruptcy procedures he never had the authority to open undisclosed additional bank accounts. Five of these six banks have made restitution to the bankruptcy estate, and the sixth appears to be headed to litigation with the trustee.

VI. <u>Lessons Learned</u>

As bad guys, both Fred and Pete had their strong points and their weaknesses. Their strengths were almost enough to get them through their frauds scott-free. Ultimately, though, it was their individual weaknesses that gave them away.

Fred was an arrogant show-off who thought he was smarter than everyone else. Every alter-ego company that he made up had some permutation of his initials as its name. He concocted what he must have considered such a grand scheme that he didn't feel that he needed to totally destroy the evidence. He smoothly and continuously changed his story as more and more evidence was unpeeled. His final, passionate speech to the bankruptcy judge was that he was so smart that if he had done anything wrong, he would not have left that much evidence lying around. Nobody bought his professions of total ignorance at the beginning of the case, nor did they buy his pretension of being too smart to have done what he was accused of at the end of the case.

Pete was the real sleeper. Except for that one $50,000 check that raised my suspicion, he went through this case like a ghost. He didn't leave a trace. Unlike Fred, he had no need to keep trophies or score cards, so no evidence was left behind. Through most of the case I thought that $50,000 check amounted to Pete giving Fred a percentage of what Fred was allowing him to steal.

In hindsight, my guess is that Pete was trying to hide money from his wife, in anticipation of divorce. If he had just left the money as marital property and let his wife keep half, I never would have thought to interview Pete's wife, there would never have been a chance for her to mention that returned deposit from the bank and the big new house her husband was living in, and the reason to investigate Pete never would have been turned over to the FBI.

In a fraud investigation, you have to follow your hunches. If something feels wrong, it usually is—even if you can't explain why. A fraud investigator needs to be tenacious in pulling on all those little strings that seem out of place.

Fraud shows up in the flow of details. In this case the summary reports and the accounting entries supporting them were all faked. This never would have been found if I hadn't taken the investigation all the way back to source documents. If I had started with source documents and merely traced them into the accounting records I would not have found the fraud either, as there were two sets of records –those that were entered from the source documents and those that were made up to support what Fred wanted to show on the Operating Report. The only way to have found this fraud was to start at one end of the reporting flow and trace all the way through to the other – in this case, from the Bankruptcy Operating Reports all the way back to source documents.

By the time I identified and documented all of Fred's fraud, the time allotted for the investigation had been used up. Pete almost escaped. I like to think that if there had been more time I could have started with the original source shipping documents from

Federal Express and traced them through the accounting system to the Bankruptcy Operating Reports, and that would have uncovered Pete's fraud.

Looking back at Fred and Pete, at the impressions they created and at the assumptions that everybody made about them, I can't help but be reminded that fraud is deception. When fraud is suspected, nothing can be assumed or taken at face value, because the better the fraud, the easier it is to be deceived. Both people and computer-generated print-outs can be very different from what they pretend to be.

VII. Recommendations to Prevent Future Occurrences

The Problem of Owner-Committed Fraud.

At this point in the story, I should be prescribing how to prevent this type of fraud from happening again. Unfortunately, I can't. Collusion in a company can defeat almost every control, especially when the collusion is among the most senior people.

It is likely that the type of activity described here occurred at Gopher for years. I have seen owners stealing from their own companies time and time again – it is called tax fraud, and unless a taxing authority catches on, there are usually no other victims to complain.

Typically, somebody's greed is what undoes them. Fraudsters become addicted to the free and easy money, and they take more and more until it becomes a noticeable problem. I have worked on cases of brother against brother, husband against wife, and partner against partner, and in almost every case both sides were initially in on the fraud. The fraud becomes a problem when one partner takes more than the other partner, and the less egregious party starts a fight for their "fair share" of the spoils. The lawsuit that led to Gopher's bankruptcy may have been triggered because Fred was taking out more cash than his partner.

Detection.

Owner-committed fraud may not be preventable, but it is detectable. This is usually done by conducting either a life-style audit or a detailed comparison of the business' inputs to the reported outputs. The devil is in the details – for example, a laundromat that uses too much water and electricity for the amount of quarters it says it received either has very inefficient machines or an owner walking out with very heavy pockets each night.

Study Bankruptcy Operating Reports Thoroughly for Early Detection.

In this case, the fraud could have been detected earlier if the Bankruptcy Operating Reports had been studied more thoroughly. There were printouts from the accounting system to back up every schedule and make them appear accurate, but the Reports were not consistent from one schedule to the next. For example, the cash disbursements listed in the disbursement schedule did not equal the total disbursements shown in the bank account summary schedule. Many of the schedules were internally consistent each month, but did not roll forward from month to month. These Reports had a wide distribution, but it doesn't appear that they were adequately focused on by any of the parties who received them until all the money was gone.

The evidence indicates that Fred was a diligent debtor-in-possession during the initial months of Gopher's bankruptcy. Most likely, Fred was establishing credibility with the various parties overseeing the case while he earned a good understanding of how the system worked. These well-behaved months were followed by what looks like two months of experimenting – minor inconsistencies and inconsequential fabrications in the accounting data were submitted with the Operating Reports, and nobody noticed them. This probing was followed by a couple more months of low-level cash diversions, always small enough that they could be excused away and returned if detected. They weren't.

Pay Attention to the Details.

In today's environment of automation, budget cuts, not enough time, and information overload, it is more important than ever to stay focused on the details and to always tug on those little strings of inconsistency that occasionally stick out. One of the best ways to prevent large frauds is to detect them when they are still small frauds.

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