Particularities of Fraud in Reorganization Operations

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Abstract

The pattern of fraud in reorganization operations follows a route very well known by economic criminals that is difficult to combat or prove. Frauds that occur in reorganization operations, be they reorganizations, insolvencies, liquidations or mergers, are sometimes at the limit of the law, at least in terms of documentation. However, the Romanian legislation also punishes the intention, which, however, does not appear in supporting documents and thus, represents the main problem in this sector.

The aim of this paper is to present and analyze the particularities of fraud in reorganization operations, in terms of merger, insolvency, liquidation, but also other types of fraud that may occur within a company.

Key words: fraud, merger, insolvency procedure, liquidation, economic fraud
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1. Introduction

Fraud can occur in various forms, the legislation generally dealing only with specific cases of judicial reorganizations. If it were not illegal, the inventiveness of the embezzlers in their attempt to deceive the creditors and to get rich "overnight" would be commendable. Addressing key cases and moments specific to a reorganization procedure, this paper aims to bring to the fore other cases of fraud in reorganization operations that are not expressly addressed by applicable law, but for which knowledge of how to commit a fraud is essential, at least for future legislative texts.

Merger, division, insolvency and bankruptcy are treated in Romanian legislation in accordance with European legislation, often without taking into account the local specifics of Romanian business, organizational culture, collective mentality, level of education, invested capital, local and national economy and human nature, as a characteristic part of a nation. The application of European law texts must be combined with an interpretative-critical interpretation by the Romanian legislature, in order to take into account, ascertain and punish the attempts of fraud that appeared as a result of the human nature of the Romanians.

2. Literature review

The study of the works selected as representative in our research brings into question concepts and study principles that are based on the research topic we want to apply in Romania. In The Performance of Insolvency Prediction and Credit Risk Models in the UK: A Comparative Study, Richard Jackson examines the legislative framework for insolvency proceedings in the UK, comparing existing bankruptcy risk models and proposing a new model of insolvency risk, detection of insolvency risk that takes into account only one variable, despite the already established models (Altman, Conan-Holder, Beaver, etc.).

In the paper "Firm age dynamics and causes of corporate bankruptcy", Alexander Kucher discusses economic theories regarding the causes of insolvency among small and medium-sized companies, treating in a pragmatic and critical way their applicability in a volatile business environment and vulnerable to economic changes (data economic, health, political crises, changing end-user preferences, market trends, etc.).

Tibor Tajti addresses, in his paper "Bankruptcy stigma and the second chance policy: the impact of bankruptcy stigma on business restructuring in China, Europe and the United States", the macroeconomic effects of bankruptcy through a comparative analysis between China and the United States. The paper considers the main measures taken to prevent the bankruptcy of private companies in the three regions chosen as the most economically developed and the policies applied in them to counteract the fraudulent effects that may exist.

This study aims to formulate a relevant, justified and proven opinion on economic fraud in reorganization operations, with a focus on economic fraud committed in the declaration of economic insolvency of a private capital enterprise, thereby wishing to bring a personal note to the current stage of knowledge in the field.

3. Research methodology

The research method chosen in this paper is based on the place occupied in the empirical investigation process, especially **the field study of the facts** that may be the object of an economic fraud (either in division, merger, insolvency or bankruptcy), together with professional experience in financial audit and accounting.

By choosing this research method, I aim to answer a series of questions similar to qualitative research such as documentary research, questions that refer to Who? What the? Which? Where? How?.

Besides the field study of some events (economical in this case), in the study carried out on the particularities of fraud in the reorganization operations of economic entities, are approached concepts borrowed from both descriptive research and explanatory research, but also exploratory research, listed below they can explain both their use, thus helping to understand the present work.

Descriptive research, as a preliminary study (gathering information), in a complex scientific research project, is used to know social systems and processes, using mainly questions such as "Who?" and what?". Explanatory research comes, instead, to explain social relations, with the aim of capitalizing on them for the formulation or reformulation of theories. This type of research is based on collecting data (information) through experiment, case study or historical research, where the study questions are "How?" and "Why?", such questions having to do with operational links that need to be traced back in time, rather than their mere frequency or incidence.

Exploratory research, aimed at developing relevant hypotheses for further investigations, is based on finding answers to the questions "What?", "Who?" and "Where?".

Starting from the key questions and definitions of the three types of research, the paper aims to describe, analyze, propose and understand some of the types of fraud in the reorganization of economic entities, thus providing more knowledge of this field and helping to on the one hand to the analysis and promulgation of some legal texts and on the other hand wishing to be a support to the practitioners in the field of economic reorganizations.

Economic fraud, like any economic, social, political or cultural phenomenon, follows a number of fairly standardized patterns. Knowing the way in which economic entities, from a legislative point of view, are subjected at a certain moment to a reorganization process, we can formulate an opinion on the economic fraud that may occur, as a first step in combating the phenomenon. For this, however, it is necessary to describe the reorganization operations that an economic entity can go through, then following the clichés that make possible the occurrence of economic fraud.

4. Findings

4.1. Fraud in company merger

The merger is a relatively recent business model applied in Romanian economic practice, which has been regulated since the early 1960s in the United States and the United Kingdom.

Theoretically, this is a way of reorganizing the entity that creates a number of advantages especially in the sector of production of goods that uses a large number of suppliers.

The merger aims to streamline production by lowering production costs, transport costs or adjacent costs such as staff salaries and eliminating the profit margin in the case of purchases from suppliers.

Just as the purpose of an economic entity is to make a profit, the merger is intended to reduce all costs in order to maximize the recorded (or unrecorded) profit, as we shall see below.

The merger procedure envisages the association of an enterprise with another enterprise that retains its legal personality or the formation of a new legal entity, by merging two older economic entities, the latter being finally deleted (Law no. 31/1990, art. 238, para. (1)).

Merger fraud may occur either in the transfer of all assets to the new company or in the valuation carried out at the time of the merger.

At the time of the merger, there is a risk of tax evasion due to a mass sale of assets held by the entity to be taken over at a much undervalued price to an external third party, assets to be acquired by the new entity. company established on the occasion of the merger at a much valued price (Hromei, 2013, p. 58).

Another form of fraud that may occur at the time of the merger occurs in holding or derivative groups that merge to cover unfavorable accounting situations. Basically, when a financial creditor refuses to grant a line of credit for development, investment or to cover current debt, it merges in writing with another entity part of the group, with the real purpose of hiding the reported loss or asset net negative accounting, cases of this kind having an increasing frequency of occurrence in the Romanian business environment. Unrecognized as totally illegal, it is at least unethical (Hromei, 2013, p. 59).

Another type of fraud derived from the previous one involves the drafting of annual financial statements applying unrealistic estimates regarding the degree of depreciation of assets of the balance sheet assets of the entity most often by internal experts, but also by authorized evaluators.

Thus, based on a high subjectivism, managers can make optimistic predictions regarding the application of the principle of business continuity, which they assume through the administrator's statement. The result of such an operation is the increase of the carried forward result, as a key to attract new funds from bank or non-bank financing companies, the manipulation appearing by the fact that in the official documents the assets were not subject to significant depreciation, situation with all wrong.

Another way of manipulating the information provided during the merger process is the provision / non-establishment leverage of provisions. This technique involves either the resumption of provisions previously established for income or their non-establishment at the time when they were to be recognized in accordance with the principle of prudence. Both procedures lead to the same result, that of reflecting in the financial statements prepared on the occasion of the merger some more optimistic situations than the economic reality, to attract the partner with which the entity is to merge and create an attraction to this process. In this procedure, the most affected provisions are those for pensions, litigation, restructuring and provisions for other obligations, situations that can be difficult to detect.

Also applied in the case of a merger, similar to the procedure stated above, an economic entity may proceed to the non-recognition of losses from debts incurred. The situation arises when one of the economic entities wishing to merge is aware that in the future it may face non-collection of a debt held, and in this regard concludes an insurance contract to guarantee the collection of the outstanding amount. In this way, in exchange for the payment of an insurance premium that guarantees it at least the nominal value of the claim held over a period of time (agreed in the insurance policy), the entity no longer considers it appropriate to recognize the impairment by recovered, and thus, on the occasion of preparing the financial statements corresponding to the merger, the accounting profit is artificially increased (Milu, 2012, p. 28).

Another case of fraud arising from the future desire to merge is the one that can be encountered in the case of stocks. Thus, when inventorying stocks, it is likely that some of them will be part of the category of unusable, due to visible technical wear, moral wear, elements that are difficult to sell or that can no longer be part of future production cycles. However, stocks that are subject to irreversible depreciation are not derecognised and / or disposed of and remain in stock for the stated purpose of artificially increasing the value of the net asset, leading to an overvaluation of the result.

In the case of the merger, the main problem arises when valuing the assets, equity and liabilities of the entities involved. The reason for an assessment that is as advantageous as possible for the acquiring company is the number of shares or shares to be received by the entity during the merger, the interest being to obtain as much control as possible in the beneficiary company and implicitly as many as possible. of payment dividends.

The starting point in the valuation procedure of the absorbing entity is the analysis of the annual financial statements that provide information on the financial position and performance, as well as the valuation method applied.

The distortions that may occur at the time of the valuation of the elements in the balance sheet and in the profit and loss account by the appraiser are likely to influence the exchange ratio, internal management and accounting policies agreed by the absorbing company, the application of free and transfer pricing.

4.2. Appearance and manifestation of fraud in case of insolvency of companies

The insolvency proceedings entail entry into the reorganization proceedings. As we presented in the previous chapter, the failure to carry out the reorganization plan at the planned level of the indicators initially entails, in some cases, the fraud of creditors and the modification of the creditor's creditors.

The reorganization plan developed for an entity in financial difficulty and requesting insolvency is a personalized and unique one, which takes into account elements such as business specifics, number of employees, history of the debtor entity, brand, market image, financial indicators achieved in previous financial years and the correctness of the payment of monetary obligations.

In a reorganization plan it is necessary to indicate clearly and in detail elements such as recovery prospects, final expectations and the premise from which the plan is developed, all in relation to the current financial or non-financial means still available to the debtor at the time. declaration of insolvency, taking into account the specifics of the business, the demand for products and / or services on the debtor's profile market and not only. A reorganization plan is designed to provide the most detailed information on the next three financial years in which the debtor's economic recovery should take place, often including measures to replace or appoint management staff, or administrative (Law no. 85/2014, art. 133, paragraph (1)).

The initially designed reorganization plan is proposed to be voted on by the creditors' meeting which is organized by debt classes. Thus, when establishing the final table of receivables, there may be guaranteed, budgetary, unsecured and salary receivables (Moțiu, 2019, p. 24).

However, practice has shown that certain categories of receivables, and implicitly their control, can be held by the debtor, thus reaching a majority vote by receivables classes including conditions of 10% or less of the total creditors, given that the order of payment of receivables is established by law. Achieving this objective (of manipulating the creditors' meeting) by the debtor or by other persons interested in the fraud process of the reorganization operation may involve artificial categories of financial or commercial creditors. Another approach encountered is the pre-establishment of a category of receivables controllable by the debtor, most often being the class of salary receivables (Moțiu, 2019, p. 25).

Because control is exercised not over the creditors meeting but over the classes of claims that make it up, there is a risk that the initially proposed reorganization plan may be unrealistic, purely formal, failing in the short term because it is not viable and / or effective in any way. form. The efficiency and viability of a reorganization plan conceived from the start as stupid and unrealistic is a problematic treatment only for the lower categories of creditors, most often unsecured ones who may face the situation that in the liquidation procedure they receive absolutely no financial compensation. for the claims they represent, and if they receive, this does not represent a significant amount so as to ensure that the claims they have to recover are settled.

The failure of the reorganization plan may project from the outset a list of payments (of creditors) that do not take into account unsecured creditors, this strategy being applied most often when the number or amount owed to unsecured creditors is consistent. In the same way, creditors who are directly or indirectly controlled by the debtor will have the right to a decision-making quorum in the future and will have control over the adoption of decisions with significant impact. The elimination

of unsecured creditors from the payment can also ensure the practical control by the debtor, including in the bankruptcy procedure, an inevitable procedure in case of failure of the reorganization plan (Szabo, 2007, p. 23).

From the moment the reorganization plan enters into its attributions and is approved by the syndic judge delegated in this mission, the object of activity of the debtor entity must comply with the rules imposed by the approved plan, and the receivables held by creditors are modified according to the clauses. stipulated by the approved plan.

According to the applicable legislation in the field, one can reach the situation where a reorganization plan designed from the beginning to fail in a short period of time can affect the degree of recovery of receivables held by creditors (Szabo, 2007, p. 24).

Insolvency law no. 85/2014 imposes similar treatment for all receivables of the categories of creditors that form the credit table (through the reorganization plan), but with exceptions and derogations from the rule. Exceptions include the case where a creditor consents to unfavorable treatment for his claim.

Disadvantaged claims are treated as a distinct category for which the reorganization plan applies differential treatment in the following cases (Milu, 2014, p. 26):

- Applies a reduction of the debt held;
- Has a reduction in the guarantees agreed by both parties or proposes a staggered payment of the debt over a long period, a situation which may affect the material situation of the creditor;
- The calculation of an interest rate that applies to the amount of the claim determined by the reference interest of the B.N.R. which is often much lower than the interest rate set by the reorganization plan, with the creditor being impacted again.

With the confirmation, voting and approval of the reorganization plan, it becomes mandatory and begins to take effect including the categories of creditors who voted against it and their rights are modified in accordance with the estimates and amounts established by the reorganization plan. In this case, the debtor's debt payment schedule is treated as an enforceable title and non-compliance with the reorganization plan has the effect of the debtor's immediate entry into bankruptcy proceedings (Milu, 2014, p. 25).

In conclusion, the failure or non-implementation of a reorganization plan initially proposed and approved has the effect of changing the creditworthiness and thus an economic fraud committed against creditors, given that changing the right invoked by creditors (trade receivable) is impossible. Being a known, applied and countered procedure, it is a major problem and a legislative breach used by those who want an illegitimate debt cancellation (Deli-Diaconescu, 2017, p. 11).

4.3. Fraud in the event of liquidation of companies

As previously described, liquidation is the last stage in the existence of a legal entity that involves the capitalization of all elements of the entity's assets in order to extinguish the economic obligations to creditors (Law no. 85/2014, art. 145).

Insolvency law no. 85/2014 stipulates that the liquidation which has the role of extinguishing the payment obligations of the debtor arising as a result of carrying out an unproductive and deficient activity.

In reality, there are situations in which creditors can no longer recover their debts and the legislative levers in the field cannot help them.

Often, most cases of fraud occurring in the liquidation of companies occur when valuing the assets of the debtor's assets in which there is a risk of overvaluation situations.

Thus, although a number of assets are valued in the debtor's assets, applying a high degree of subjectivity, the inventory and valuation resulting from the dissolution and liquidation of assets may find a real value of assets much lower than the "reality" reflected in the accounting documents, this is, of course, to the detriment of creditors and in particular creditors unfavorably positioned in the table of receivables.

From my professional experience so far, I have found that the appearance in the balance sheet positions of assets (usually of high value) that do not actually exist is also a very common practice among debtors subject to the liquidation process. In this case, the balance sheet reflects a situation of net accounting assets distorted either by the appearance of assets that do not actually exist or by

exaggerating the values related to already existing positions. This practice is very common in the banking and non-banking financial fields, but also in the production of consumer goods. A relevant case in this area is the Wirecard scandal in which, when liquidating the debtor's assets to settle payment obligations to creditors, there was a significant distortion of the annual financial statements that presented a savings bank account to an Asian bank, amount of money which never existed in the accounts of the alleged banking institution. With the significant distortion and serious impairment of the business continuity principle, the audit firm that performed the audit mission to the economic entity concerned and expressed an unqualified opinion on the accuracy of the annual financial statements was held liable. role at the moment.

A similar situation is encountered if, on the occasion of the inventory for entering the liquidation procedure, a series of assets recorded and highlighted in the annual financial statements and related notes are no longer found at the debtor's premises. This case of economic fraud by theft of assets is most often carried out even by the debtor who, notified of the date of inventory, date of sealing and date of establishment of the inventory commission, consents to the theft of assets considered valuable prior to seizure and seal on goods. Some cases of fraud committed by this method allow a more truthful way to cover the debtor to avoid being held liable in which, with a very short period of time before the start of the liquidation procedure he complains to the competent bodies the theft of assets that were shared , this being, at least for the moment, covered before the syndic judge and the creditors before whom he must answer.

The legal obligation to draw up and validity of an insurance policy for movable and immovable property is also observed during the period of activity by the debtor in a state of insolvency and reorganization. The annual conference held by the National Union of Insurance and Reinsurance Companies of Romania (UNSAR) presented a series of cases of debtors in either insolvency, reorganization or liquidation proceedings that invoked the theft of high value movable property, protected by an insurance policy, and the theoretical basis used by embezzlers is simple. When the debtor finds that his economic activity cannot be recovered through the measures imposed at the legislative level, he claims to the insurance or reinsurance company the disappearance of some assets, often significant in terms of value.

Once the insurance premium is collected, it can either repeat the fraud scheme by acquiring and disposing of similar goods, or it can "invest" the value received as an insurance premium through agreements with various third parties, this case being of the win – win type.

5. Discussions

In terms of reorganization fraud, the key point where fraud is most likely to occur is when valuing assets, liabilities and equity. As the current legislation is based on only one verification key (either evaluator, judicial administrator or syndic judge), the general consideration and dissatisfaction of the creditors often focus on the transparency of the debtor's evaluation process after the official insolvency. and the development of the debtor's economic activity at least one financial year before the declaration of insolvency.

The cases in which the credit mass was deliberately manipulated by the debtor by taking over the majority (which is allowed by the Government Emergency Ordinance no. 88/2018), the cases of overvaluation of assets (in case of mergers), of their undervaluation are known and publicized in the case of insolvencies) and theft of assets committed by the debtor or persons employed by him before the actual entry into insolvency.

The present paper aimed to present some moments in the economic life of a commercial entity that undergoes transformations (by division, merger and insolvency) that are not expressly treated by the legislation in force, leaving room for interpretations and dissatisfaction.

6. Conclusions

The ways of fraud in reorganization procedures are diverse and varied, some are standard fraud procedures, which are based on breaches and legislative clichés, and some are ingenious ways of fraud, tailored to the specific activity and particularities encountered in the case of each debtor.

With the presentation of the main ways of occurrence and manifestation of economic fraud, we managed to understand the phenomenon and the patterns, sometimes classic, in which it occurs.

It is also necessary to review the keys to verification and control responsible in the fight against economic fraud, in this case accounting and financial auditing.

The importance of financial auditing is precisely from expressing an opinion on the economic situation of a company from the perspective of a third party that has no connection with the entity. The relations of belonging between the management of a company and the entity that performs the financial audit are prohibited both by the legislative norms in force and by the Regulations of Operation of the audit activity, established as internal regulation.

The fight against economic crime is and will remain a hot topic of the European Union, the continuous adaptation and reorganization of the institutions dedicated to the fight against fraud being a response to the activity of economic and financial crime that adapts extremely easily to legislative changes.

7. References

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