

What Turnaround Consultants Should Do When They Encounter Fraud

BY MARK WELCH, CTP, MANAGING DIRECTOR, MORRISANDERSON

Turnaround consultants have access to all layers of their clients' businesses, from operations to financial. As a result, they are in a better position to find a "smoking gun" indicating that fraud has occurred than are, for example, internal and external certified public accountants (CPAs).

Unfortunately, turnaround consultants are not governed by Statement on Auditing Standards (SAS) 99, "Consideration of Fraud in a Financial Audit," from generally accepted accounting standards (GAAS), as are outside CPA auditors. Therefore, they have little direction and responsibility relating to reporting and uncovering fraud. However, turnaround consultants need to be aware of legal issues related to uncovering fraud, evidence gathering, and how to build a fraud case effectively for their clients.

When a consultant encounters a potential fraud, the first thing he or she should do is inform the client's counsel of their findings or advise the client to hire counsel. The consultant must establish client-attorney privilege of all evidence documentation and communication. This privilege gives the consultant greater flexibility in supporting the case and helps him or her avoid making potentially embarrassing mistakes along the way. Counsel will advise on discovery methods with the client, isolate communications, and facilitate case preparation. Counsel also will determine the best time to notify the client of a potential fraud and request cooperation and authority for the consultant to move forward with an investigation.

Consultants should not immediately notify law enforcement unless counsel intends to involve them early on in the case. Contrary to what many may believe, with the exception of the Federal Bureau of Investigation (FBI) and

several other federal agencies, white collar law enforcement has little experience with financial fraud investigation and can do more harm than good with case preparation. Involving white collar law enforcement is necessary after the consultant has gathered sufficient and component evidence supporting allegations of fraud. At that point, law enforcement can provide guidance on grand jury preparation which, in turn, facilitates potential insurance recoveries for clients.

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Based on evidence gathered by the consultant, counsel will weigh different legal strategies to pursue. Counsel may pursue a civil suit and direct the investigation toward particular individuals or board members, determine charges to be brought, and provide direction to the consultant on compiling a loss summary and financial accounting of damages. Counsel also may determine which jurisdiction has venue in the case and what legal statutes may have been violated, and pursue criminal charges against the perpetrators.

Preparing Evidence

Once counsel determines the appropriate strategy to pursue, the consultant will need to compile data and evidence supporting that approach. The consultant must maintain strict control over information gathered during the discovery phase of the investigation. All fact-finding and interviews must be done at the direction of counsel, and all information must be considered privileged and confidential

and marked as such, including all documents, discussion memos, work plan, and other written evidence prepared by the consultant. This is most important to prevent opposing counsel from obtaining the material through the discovery process in a civil lawsuit.

During a criminal prosecution, certain privileged information maybe granted to the defense as client work product. The consultant must remember that all work products may be viewed and therefore should maintain the utmost care and discretion in preparing them. When using documents the consultant must apply two general rules of evidence:

- Authentication/chain of custody
- Best evidence

The rules of evidence concerning authentication and chain of custody are related and important considerations when information is offered as evidence in legal proceedings. Both refer to conditions necessary before a document can be considered as evidence. To use a document as evidence, a witness must authenticate it, meaning that he or she purports the evidence to be true. The preferred method for a witness to authenticate evidence is through testimony. Documents can also be self-authenticating, meaning that they are considered undisputed and therefore no witness needs to testify as to their genuineness. Examples include certified records, independent reports, and certain media sources.

In addition, it must be established legally that documents offered as evidence remained unchanged while they were in possession of the consultant. This is the basis for the chain-of-custody line of inquiry. To comply with the best evidence rule, a document must be the original or the closest thing to the original that is available. Because of these legal considera-

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tions, the consultant must take particular care in safekeeping original documentation.

The consultant also should keep in mind several other factors when initiating a fraud discovery and investigation. Because consultants are not law enforcement agents, they are not required to comply with Miranda rules, which mandate that authorities inform suspects of their constitutional rights to legal counsel and against self-incrimination. However, statements obtained from suspected perpetrators by consultants must be offered voluntarily and cannot be extracted through threats or other means of intimidation. Consultants should not give the appearance that they have legal authority over the subject of an interview, and they may want to consider including an independent third party in all interviews.

The consultant should start any interview with such questions as, "Would you be willing to discuss certain events and confirm certain documents?" Another technique is to ask a suspected perpetrator if he or she would be willing to write down background information relating to certain events and present explanations to certain anomalies discovered.

Alerting Authorities

Once sufficient evidence is gathered and analyzed and conclusions are arrived at jointly by the consultant and counsel, a confidential report or memorandum should be prepared. Such a report details the chain of evidence for use in potential court proceedings, and establishes the scope of evidence gathering and conclusions drawn from it. A standard investigation report contains the following sections:

- Introduction
- Executive summary, which provides a brief synopsis of the work performed and conclusions drawn
- Background, which outlines a history of the company, how fraud was discovered, and the rationale for the investigative approach used
- Approach, which describes the purpose, source, and scope of the investigation
- Conclusions, which states the results and recommendations
- Appendix, which provides supporting documents and detail analysis

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If law enforcement or other outside authorities become involved, counsel continues to support the best evidence rule and will insist on the consultant's continued involvement with any additional fact finding and supplemental evidence gathering. Law enforcement authorities also may have additional duties pertaining to internal procedures relating to evidence gathering.

At this point, the consultant has become a critical component of the fraud case and will be required to support evidence by testifying in subsequent legal proceedings. This continued

involvement may become a dual-edged sword. On the one hand, it may lead to additional compensation for the engagement. On the other, the client may weigh the benefits of continuing to engage the consultant against the costs, which may exceed insurance recoveries and restitution. As a result, the client may terminate the engagement, leaving the consultant compelled to provide assistance and testimony to help resolve criminal proceedings without compensation.

Building an Effective Case

Turnaround consultants who suspect fraud has occurred at a client company should work closely with the client's counsel to investigate such allegations. By gathering relevant evidence carefully and handling it properly in consultation with counsel, a consultant can help build an effective case for addressing any wrongdoing. [CA](#)

Mark J. Welch, CTP, is a managing director in the Cleveland office of MorrisAnderson. He has led numerous turnaround, crisis management, recovery, and bankruptcy assignments in various business sectors, and has testified as an expert witness in state and federal courts. As a former liquidation auditor with the Office of Inspector General for the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board, he also has prepared fraud cases for the federal government. Welch is a CPA and holds a bachelor's degree in accounting from Indiana University of Pennsylvania. Mark may be reached at (216) 589-9440 or by e-mail at mwelch@morrisanderson.com.



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