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Fraud, Dishonesty & Corporate Crime

***Managing Professional Risks
Seminars 2012***



Insurance for your reputation



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A summary of the presentations featured in 'Fraud, Dishonesty and Corporate Crime', the second seminar of MFL Professional's Managing Professional Risks series.

Fraud, dishonesty and corporate crime can be an unfortunate reality for senior professionals. Prevention measures, trusting – or suspecting, as the case may be – others and detection are just some of the essential but sometimes difficult measures that should be undertaken in order to ensure your practice is ran in a legally and morally correct manner.

MFL Professional understands the importance of putting these measures into practice in order to avoid substantial insurance claims, bringing together a group of top management professionals for its latest talk in order to highlight exactly what can be done to enhance the security measures, and maintain the reputation, of their firms.

The round-the-table event gave the executive attendees the opportunity to discuss fraud and dishonesty issues and share their experiences of corporate crime, in an open forum. Guest speakers Edward Coulson, Consultant from professional liability solicitors Mills & Reeve LLP and Mike Booth, Audit Partner from Booth Ainsworth Chartered Accountants LLP presented to the delegates.

Edward and Mike were joined by MFL Professional directors' Mark Philmore, who led the seminar, Colin Bradley and Jon Leese. Colin drew on his experiences of claims caused by incidences of corporate crime and Mark spoke about examples of fraud cases in the news.

Mark highlighted the importance for sound business practices, exemplifying the Yorkshire Evening Post story 'Leeds mortgage broker in £1.5m 'fake sheikh' scam'.

Mortgage professional Jonathan Flynn was jailed for attempting to con finance company Masthaven by arranging for two men to pose as wealthy Arab brothers. The plot was foiled by Masthaven's managing director Andrew Bloom. He alerted the police who arranged a sting operation to catch the 'brothers', Flynn

and accomplice Shane Martin, out.

Reflecting on this incident, Mark said: "Insurance plays a significant part in protecting businesses and individuals from internal and external fraud but as the article highlights: 'sound business practices' play a huge part in this process also."

Colin Bradley spoke about dishonesty from an insurance point of view. "It rises in different ways. It could be either staff or a client. Failure to recognise a client's fraudulent activity can be classed as dishonesty. I dealt with a claim against some chartered accountants years ago. A solicitor ran away with some money and it wasn't picked up. That was a substantial claim."

Edward Coulson gave a legal overview, covering basic concepts in civil law and practical implications. He covered:

- Deceit or Fraud
- Dishonesty and 'knowing assistance' of breach of trust
- Dangers for professional practices
- Popular property related frauds
- Property and Mortgage Fraud

Mike Booth spoke about:

- Audit background
- Corporate Crime
- Uncovering crime
- Deceit or Fraud

Basic Concepts In Civil Law

The definition of this concept, as stated in Clerk & Lindsell: Tort (20th edition, 2010), para. 18-01, is "... where a defendant makes a false representation, knowing it to be untrue, or being reckless as to whether it is true, and intends that the claimant should act on it, then in so far as the latter does so and suffers loss the defendant is liable."

Edward spoke about how fraud can occur when a professional gets dragged in unconsciously. Taking into a professional's situation, for example, they are a junior partner and are looking to bring in as much business as possible, they can be persuaded to forgo processes in order for a client sign up. At the time, it doesn't

immediately sound like fraud but skipping the processes can be reckless.

Another feature is the common occurrence of 'claimants' never actually making a claim, alledging dishonesty because to do so could cause significant problems regarding insurance.

- Dishonesty and 'knowing assistance' of breach of trust

The essential ingredients are:

- The defendant's conduct was dishonest by the ordinary standards of reasonable and honest people; and
- The defendant knew about those elements of the transaction which made his participation transgress that standard.

This is the 'combined test' enunciated by the House of Lords in *Twinsectra -v- Yardley* [2002] UKHL 12.

The lender advanced Twinsectra to borrow £10 million for the sole use of property purchase under a solicitor's undertaking. Solicitor A breached these terms as they didn't use the £10m to purchase the property. Solicitor B received the money from Solicitor A and declined to act for the lender. Even though Solicitor A knew he was in breach, Solicitor B said, "I didn't think I was doing anything wrong". That was insufficient to satisfy the second stage of the combined test (see above).

The concept of dishonesty and 'knowing assistance' of breach of trust is important because:

- At a practical level, a lender's mortgage advance held by a solicitor pending completion is normally subject to a resulting trust in favour of the lender
- The subjective state of mind of the defendant is irrelevant: what is significant is his knowledge of the facts. In contrast, there are cases, for instance fraudulent trading by the directors of a limited company, where the subjective state of mind of the defendant is critical.

Thus:

- The valuer who induces a lender to enter a lending transaction by making a false valuation which he knows to be untrue or

is reckless as to whether it is true or false is liable in deceit.

- So too is the solicitor whose report on title to a lender discloses a false purchase price.
- Whereas the solicitor who disburses the lender's mortgage advance contrary to the lender's instructions is liable for knowingly assisting a breach of trust.

A defendant liable on this basis cannot take advantage of the normal limitation regime, the claimant's contributory negligence or his own professional indemnity insurance. As regards the latter, note that his vicariously liable (but otherwise "innocent") partners will be entitled to cover.

The damages recoverable will be those which will restore the claimant to the position he would have been in had he not relied on the defendant's deceitful statement (in deceit/fraud) and reconstitution of the trust fund (in knowing assistance of a breach of trust).

Contrast the approach of the civil law above with that of the criminal law (mainly the Fraud Act 2006) where essential ingredients of the criminal offences relating to fraud include:

- Dishonesty: namely a requirement to prove (a) whether the act was dishonest according to the standards of reasonable and honest people, and (b) whether the defendant appreciated that what he was doing was by those standards dishonest.
- Benefit: namely proof of the defendant's intention to make a gain for himself or to cause loss to another or to expose another to a risk of loss.

Practical implications

The dangers for a professional practice are:

- Becoming unconsciously involved in perpetrating a fraudulent or dishonest enterprise perpetrated by a client; and
- The 'rotten apple': the partner

or employee sucked into such an enterprise.

Risk management should be addressed to both of these exposures and will include:

- Anti-money laundering 'know your client' checks should go some way to preventing the fraudster crossing your threshold.
- Staff training (e.g. for solicitors the requirements of the CML handbook and the Law Society's guidance notes) should make it difficult for the fraudster to use your firm as a vehicle for fraud.
- Anti-money laundering requirements dealing with (for example) the distribution of surplus re-mortgage proceeds (cheques only sent to named applicants only).

Popular property related frauds to beware of:

- Impersonation of purchasers and property owners – sometimes accompanied by bogus solicitors acting for the vendor.
- Also impersonation for a re-mortgage (and note these two are closely connected with 'dematerialisation' of the Land Registry in 2003). See in this regard the Law Society/Land Registry joint practice note on Property and Registration Fraud.
- Buy-to-let issues: the concealed sub-sale (and the closely related same day re-mortgage), the 'direct' deposit and concealed inducements – see the Law Society's revised guidance note of 6 October 2011.
- The conversion of houses into flats without planning permission but with bogus assurances about the date of the conversion (said to be more than four years in the past) or title indemnity insurance.
- Property owners with 'split' titles mortgaging or re-mortgaging what turns out to be part of the garden and not the house.

Finally, the ever-popular banking operation based on undertakings. Solicitors can be manipulated by a client who promises

enormous amounts of work for the firm. The solicitor then gives an undertaking, using the firm's client account as a bank, with the client borrowing against his solicitor's undertaking at a high interest rate. It then becomes an endless cycle, loans becoming bigger and bigger.

Audit Background

Mike Booth started a discussion about people's perception of audits with many believing it to be the auditor's responsibility for the accounts to be free from fraudulent misstatement.

The responsibility for insuring this belongs to the management. The role of the auditor is to be a watchdog rather than a bloodhound and their duty is to ensure the accounts present a true and fair view.

The auditor's responsibilities with regard to fraud are set out in International Standard on Auditing 240. Fraud must be a specific consideration in audit planning and it is important to discuss this with clients.

It can be difficult for the client to consider, sometimes the perception of fraud is that employees and management are taking the blame.

Corporate Crime

The various ways fraudulent financial reporting and misappropriation of assets can be committed were then considered. Examples of high profile cases involving companies such as Enron and Maxwell.

Enron, the American utilities company, was an example of falsification. Some of the ways this was carried out are as follows:

- Setting up agencies but taking profit as principal rather than agent.
- Establishing special purpose companies with loans which were effectively hidden from the auditors.
- Creating snowball schemes where transactions which had not gone ahead, had their costs been treated as assets instead of expenditure.
- Enron was prosecuted by the US

- Authorities and Arthur Andersen collapsed after being found guilty of destroying evidence relating to it's audit of Enron.

Strict independence rules have been implemented since Enron in the USA. In addition, there has been an impact on the UK market including the introduction of strict policies for revenue recognition in the form of the UITF Abstract 40.

Misrepresentation

Misrepresentation is a false statement of fact made by one party to another, which has the affect of misleading the latter into the contract. Independent Insurance is an example of this, with provisions for claims being understated. This misrepresentation continued over a number of years and resulted in the failure of the company.

Misapplication

The Maxwell scandal in the early 1990s was an example of a misapplication of funds. Over £400 million of pension assets were used to support companies privately owned by the Maxwell family which led to the widespread fraud of pensions.

Misappropriation Of Assets

This can be considered either from the stand point of theft by employees or management misappropriation.

Theft by employees

An example of theft by employees would be Nick Leeson's fraudulent trading bearing back in the early 1990s when a series of unauthorised speculative trades led to losses of £820 million. The bank's systems were inadequate and there was no overall control of Leeson's transactions.

Management misappropriation

Bernard Madoff, a former financier, admitting operating a Ponzi scheme which is considered to be the largest financial fraud in US history. His employees had helped Madoff, creating fake paper trails which were false account statements supplied to clients. Madoff would deposit client money into a false bank account rather than invest it and generate steady returns as clients had believed.

deal with). If the business operates in a regulated environment, there could be an obligation for the auditor to report any fraud to a regulator. For example, the FSA.

Practical points/steps

- Visit locations where businesses operate to ensure returns are correct.
- Stock take attendance.
- Amend audit approach.
- Related party transactions.
- Analytical review.
- Revenue recognition.
- Accounting records.
- Missing documents.

Finally, it is useful to remember that auditors should have a professional degree of scepticism when dealing with the client but also maintain a working relationship.

Uncovering Crime

Prevention/detection: management

The people responsible for prevention detection are management. The auditors need to look at the processes and procedures put in place and critically review these to ensure they are adequate.

Whistle blowing

It is important to consider who is committing the crime; employee or management (which is more difficult to



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Don't forget, there are two more
Managing Professional Risk events
coming up:

July 2012:
Data Security - Misuse, Abuse
and Theft

8th October 2012:
Business Interruption and
Continuity for Professional Firms