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Analysis

Dark Arts and Magical Outcomes when Forensic Accountants work with Insolvency Practitioners

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

Nick's thought leadership and opinion blogs for Opus can be found at https://opusllp.com/ resources/.

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Abstract

Forensic accountants are often a vital part of the team of professionals working on challenging insolvency cases, but the role they play gets little attention and is not well understood. In this article, the author explores the contribution that forensic accountants make if there is to be a successful outcome, and explains the work they do in these scenarios.

Introduction

The Post Office scandal has finally shone a light on the positives that forensic investigators can bring to troubled situations. The valiant forensic experts from Second Sight doggedly exposed the failings of the Horizon system despite all efforts to silence them and have now finally had their say at the Public Inquiry.

When it comes to business failures, the combination of insolvency practitioners (IPs) and forensic accountants can produce some truly remarkable results even in seriously unpromising situations.

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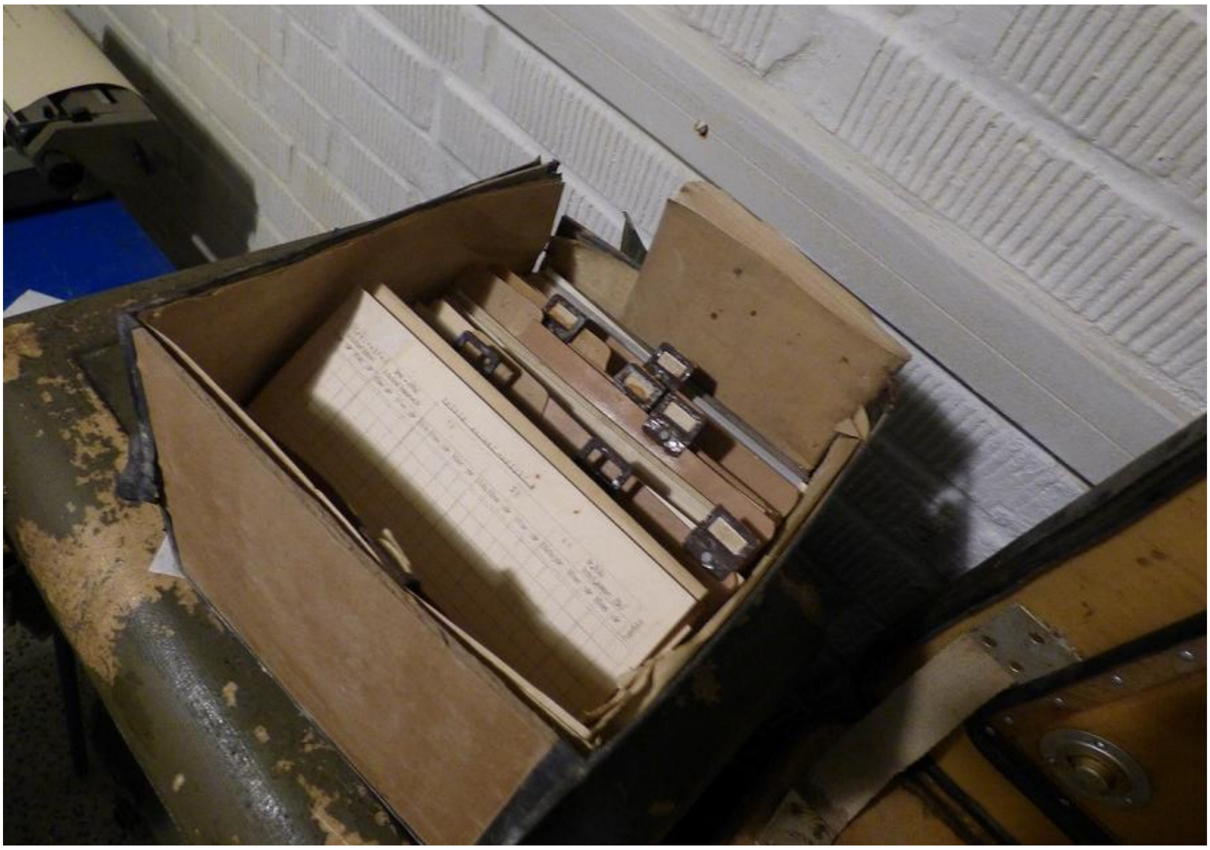

‘We know nothing’

In an echo of the fictional Manuel in Faulty Towers, IPs all too often go into cases with minimal knowledge of a business’s situation and then find that the company’s books and records leave a great deal to be desired. They are either not up-to-date, inadequate or downright dodgy. The Directors and senior staff may already have left and in some cases are unwilling to help.

This is an immediate and serious barrier to the IP’s core task of getting in the assets, turning them into cash and then distributing them to creditors. Identifying the creditors and verifying their claims can be every bit as challenging as dealing with the assets as discussed in one of the case studies below.

Many insolvency cases mean the IP stepping into a fantasy world, where assets recorded in the books may or may not actually exist. If they do exist, they may not be where the records say they are, and others may dispute the insolvent business’s ownership of them or assert that they have counterclaims against them or security over them.

Tangible assets are one thing, but intangibles like intellectual property and worst of all, crypto currencies can be a different degree of difficulty. Assets held under finance agreements are often a recovery minefield. Surprisingly, what may seem to be the most accessible of assets, cash balances at banks (especially those located overseas) can pose some of the toughest questions of all.

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Liabilities are frequently understated or conspicuous by their absence from the books. Particularly in restructuring cases, the level of debts can determine the success or failure of the rescue attempt. In other scenarios, inaccurate creditor records can lead to an unfair distribution of what funds are left.

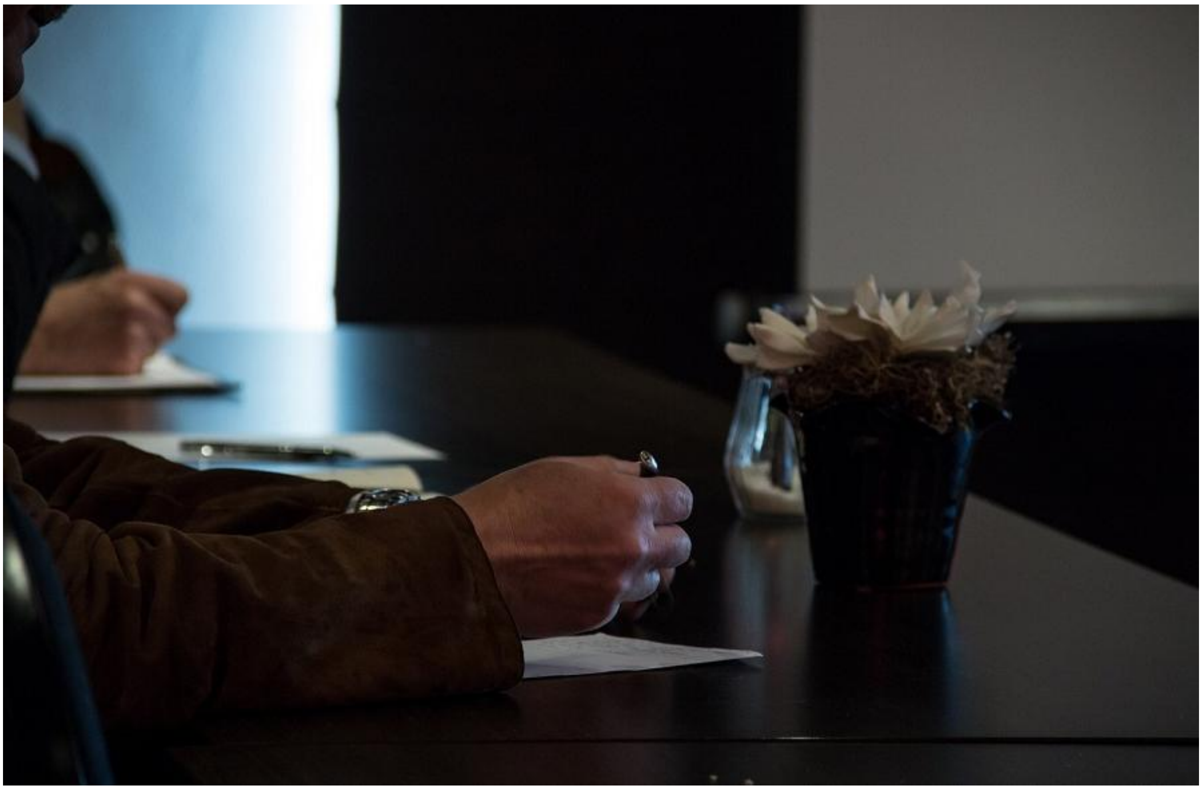
What do forensic accountants do on insolvency assignments?

Their role is to answer some fundamental questions for the IP in relation to assets, including but not exclusively:

- If funds or assets have gone missing, where are they?
- How did they get there?
- Could their removal be the basis for a claim against anyone?
- Are they recoverable or saleable where they are?
- Are there assets not recorded in the books?
- What are the assets worth?
- What is the likely sale or realization costs?
- What claims could there be against them?
- What are the barriers (if any) to their sale or realization?
- Is there proof of ownership in favour of the insolvent company?
- What is the best method of recovering their value?

With regard to liabilities and creditor claims:

- Are the records reliable?
- If there are no records, who are the creditors?
- Are claims valid and accurately calculated?
- Is any supporting documentation authentic?
- Is the claimant genuine and not an imposter?
- If the claimant is a nominee, who is beneficially entitled to any distribution?



When it comes to 'persons of interest' (including Shareholders, Directors and staff, both current and former):

- What is their connection to the business?
- Where are they?
- Are they prepared to co-operate?
- Are there potential actions which could be taken against them in relation to their conduct, such as for Wrongful Trading?

Very often, answering these questions will necessitate completely or partially reconstructing the business's records. Trawling through other documentation and the company's internal and external physical and electronic communications (especially email and social media traffic) could also be essential to obtain evidence for the forensic accountant's investigations and the IP's recovery actions.

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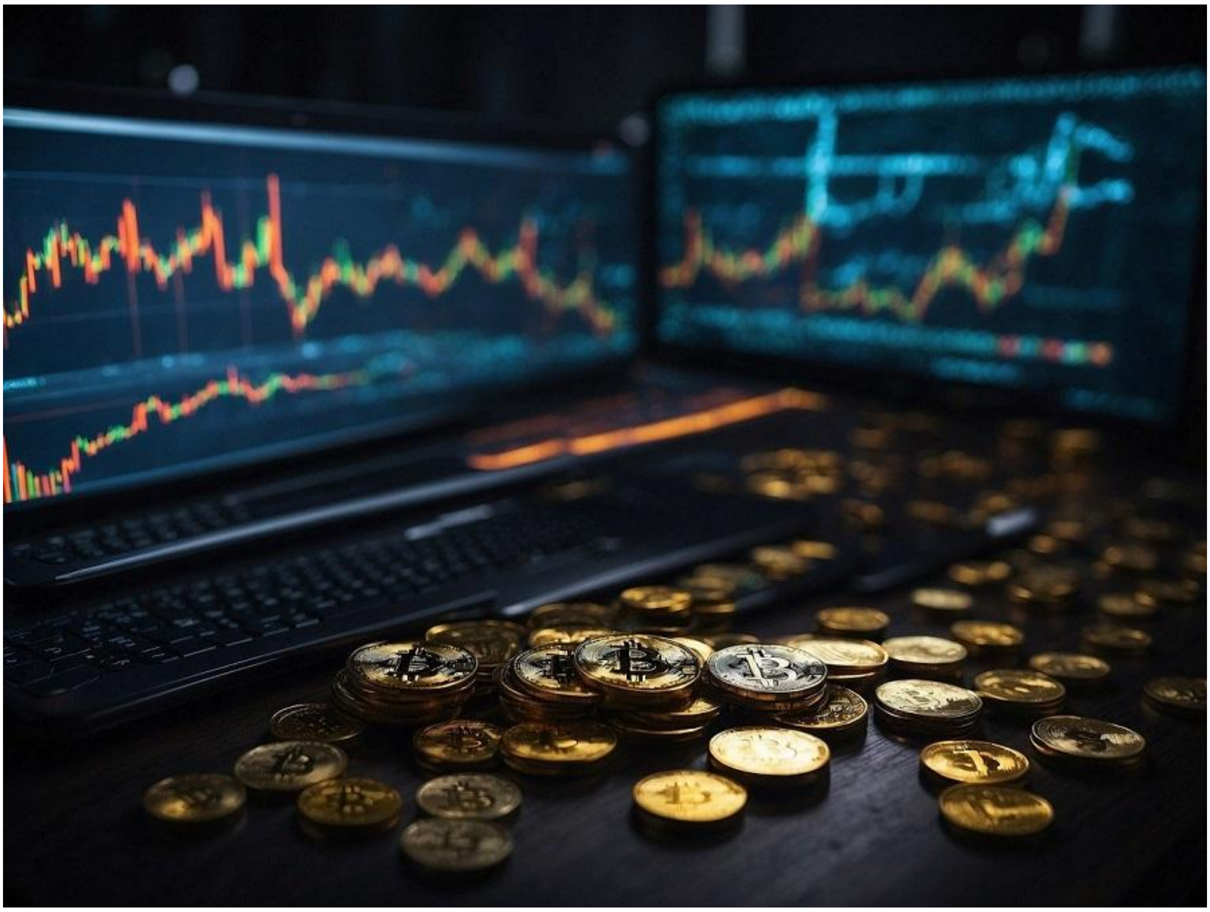
Where foreign jurisdictions are involved, the forensic accountant will be able to advise the IP about any local issues with securing assets, realizing them, sales costs and repatriating sale proceeds, based on their actual experience or on detailed research.



Practical example: A crypto-currency exchange

The first collapse of a crypto-currency exchange in 2018 following a massive $30 million plus fraud presented the Administrators with a unique range of challenges:

- The Company was registered in the UK but based in Malta and Germany and of course traded online.
- The accounting records had not been updated for three months and were unreliable.
- Key staff were unwilling to co-operate.
- There had been a fraud earlier in 2018 to which the Company's intermediary payments processor appeared to be a party. Crypto-currency worth some $28m was missing.

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- There were 30+ accounts at banks and banking platforms in various jurisdictions, but suggestions that the funds in some were held under trust and so could not be used for the purposes of the Administration.
- Assets included some 65 bitcoin but although the 'wallet' containing them had been located and there was full visibility of transactions, the relevant access keys and the passwords to use them were not available.
- Company staff told the Administrator initially that the bitcoin could be held in such minute proportions (known as 'dust') that realization costs might exceed the value achieved.
- There were some 7,000 clients of the exchange, any of whom might be creditors but no meaningful accounting for their trading positions nor any contact details.

Forensic accountants specializing in crypto-currency were used to review and where possible re-construct accounting and other records, which then facilitated the tracing of assets. They also located and interviewed several individuals connected with the company, producing invaluable information about the Company's trading, the whereabouts of other assets and the details of the fraud.

Based on this work, the missing crypto-currency assets were traced to two accounts at reputable exchanges in the US. With the assistance of lawyers in the US, the UK insolvency proceedings were recognized under the cross-border provisions of Chapter 15 of the US Bankruptcy Code. A US federal bankruptcy judge has now ordered that the digital assets held in those two accounts be returned to their rightful owners via the UK Administration.

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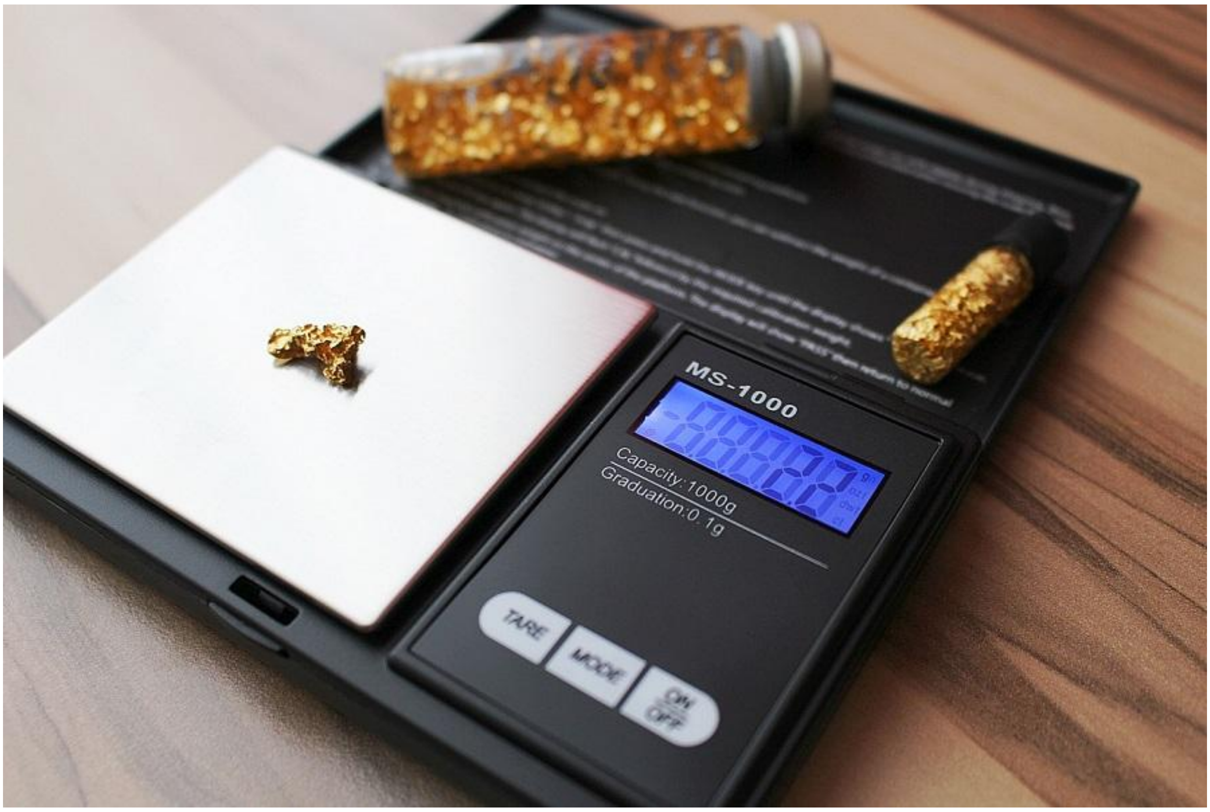
The issues regarding the bitcoin held in the Company's wallet were also resolved and further realizations achieved. This would not have been possible without the forensic investigations.



Practice example: A Russian gold mining company

A Company listed on The London Stock Exchange but operating four gold mines in Russia went into Administration in 2022 after the UK Sanctions regime imposed after the invasion of Ukraine prevented it from making interest payments on loans to a Russian bank, which has been sanctioned. The business and assets in Russia were sold promptly for a substantial multi-hundred-million-dollar sum, sufficient to ensure the repayment in full of all creditors.

The issue then was that under the Sanctions regime, no distribution could be made from the Administration to any creditor, which was found to have been sanctioned. Quite apart from the fact that some of the creditors held the Company's bonds through anonymized nominee accounts, there were suspicions that other creditors might not necessarily be entitled to the benefit of any claim paid but were instead undeclared nominees for sanctioned individuals or entities.

Normal enquiry methodology could not have produced satisfactory evidence to support any decision to pay or alternatively to withhold payment of the relevant claims. Instead, experienced forensic investigators were deployed by the IPs to

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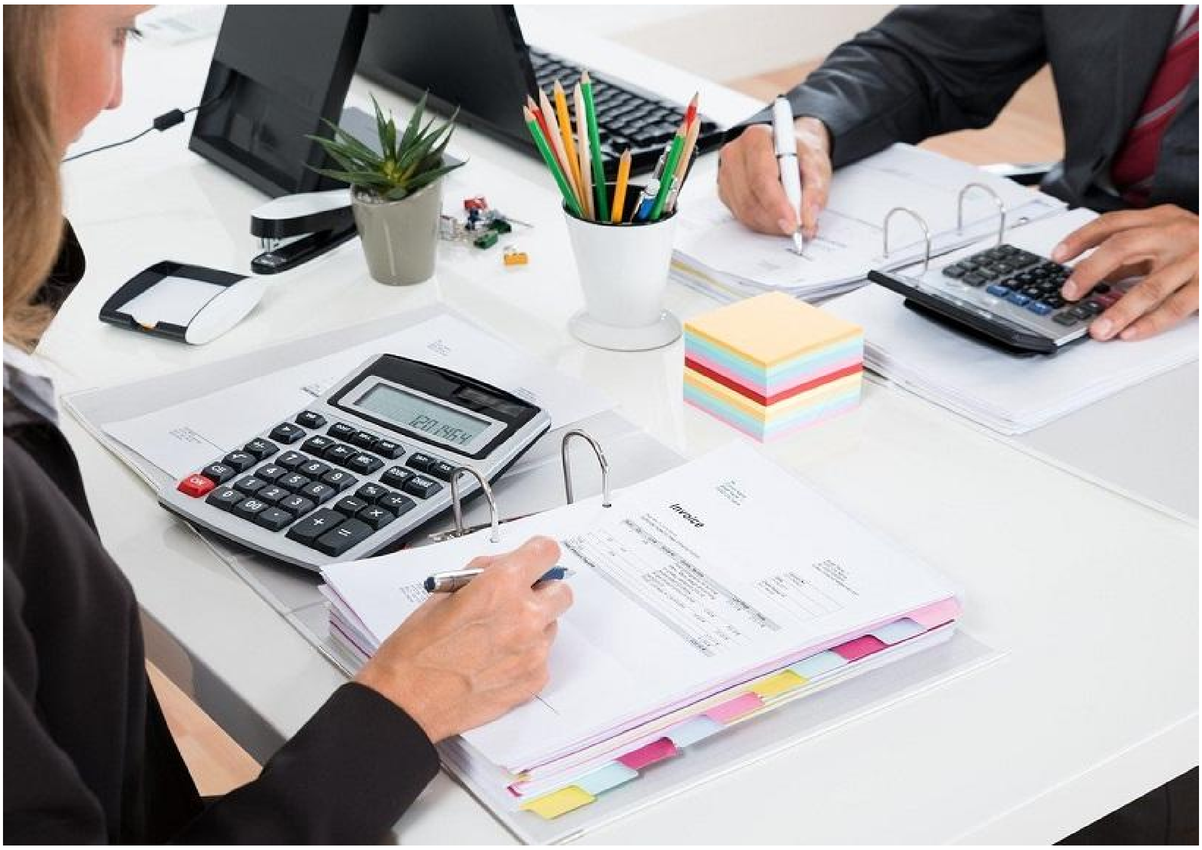
verify the identities of the true beneficiaries of certain claims and confirm their status under the Sanctions regime. The strategies and techniques used to achieve the outcome were at the absolute cutting edge of modern digital search and communications technology.



Key members of the IPs team

Forensic experts are at the heart of many larger and more complex insolvency assignments. They can facilitate asset recoveries, warn IPs off getting involved in wild goose chases, help to bring rogue Directors to justice and so much more. They bring unique skills to the insolvency table, as well as persistence in the face of the obstacles they can encounter. They are often unsung, but their contribution should never be under-valued.