

BUYING TROUBLE

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FRAUDULENT CASH MANAGEMENT SCHEMES

The creation, use, preservation and maintenance of cash is a touchstone of effectively managing a troubled business and dealing with cash flow management issues. Good management utilizes cash management techniques to face financial crises.

However, not all cash management schemes are prudent, and some principals of troubled companies utilize "cash management" techniques that have broad implications for their business and themselves. There are at least four schemes that principals may utilize that can impose significant corporate and personal liability. These schemes have in common a fundamental breach of fiduciary or trust obligations and violate federal or state law.

1. Failure to Remit Federal Taxes

One potential area of abuse relates to the duty to withhold and pay federal payroll taxes. Since cash is fungible, some company principals succumb to the temptation to not remit payroll tax liabilities and instead use the money to satisfy more urgent obligations.

However, unlike other creditors, the Internal Revenue Service (IRS) may impose heavy penalties or seek criminal prosecution, or both, as a consequence of failure to withhold and pay over payroll taxes. Federal legislation imposes personal liability for individuals who violate "trust fund tax" obligations. Under federal law, any "responsible person" required to collect and remit trust fund taxes shall be personally liable for a penalty equal to the amount of the tax that was to be withheld and paid to the IRS. A responsible person can be any officer or employee of a corporation who is responsible for accounting for and paying the taxes to the IRS, and who willfully fails to pay the taxes when due.

The IRS has multiple remedial measures. For instance, there are penalty percentages for failure to properly withhold income and FICA taxes. A payroll tax payment that is even one day late carries a 2% penalty, which is increased to 5% if the payment is six to 15 days late. The penalty is increased to 10% on payments that are 16 or more days late. The percentages are higher when an information return is not filed.

Due diligence of the debtor's general ledger, check register and bank statements can provide evidence of the compliance or non-compliance with these obligations.

2. Failure to Remit State Taxes

Principals may also fail to pay State taxes as a technique to preserve cash. Under Georgia law, failure to pay sales and use taxes results in a penalty added to the tax in the amount of five percent or \$5.00, whichever is greater. However, this is increased to a penalty of 50% in the case of a fraudulent return

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or failure to file a return where willful intent exists to defraud the State. Where a person knowingly and willfully fails to collect the tax or makes a fraudulent return in addition to the penalty of being liable for and paying the tax himself, the person will be guilty of a misdemeanor of a high and aggravated nature, and upon conviction, shall be punished by a fine of not more than \$5,000.00 or imprisonment for not more than one year, or both.

3. Failure to Contribute to the Employer's 401(k) Plan

Employee benefit plans also offer tempting pockets of cash to the imprudent manager. When facing financial hardship, an employer may fail to contribute the employer matching contribution under its 401(k) plan without properly amending the plan to cease matching employer contributions. Even worse than the failure to provide matching funds is the failure to remit employee contributions deducted from the employees' paychecks to the trust established in connection with the plan as soon as the funds can reasonably be segregated from the employer's general assets in accordance with federal regulations.

The Employee Retirement Income Security Act (ERISA) regulates 401(k) plans. Under ERISA employers are fiduciaries and have corresponding duties to plan participants. ERISA § 403(c) provides that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan..." If found liable for a breach of duty under ERISA, fiduciaries are personally liable for plan losses. Also, the plan fiduciary must disgorge any profits realized through the use of plan assets and may be liable for a civil penalty of up to 20% of the amount recovered. Moreover, if an employer makes a false statement in an employee pension benefit plan or fails to disclose any fact which is required by ERISA, the employer shall be fined, or imprisoned for not more than five years, or both.

4. Falsifying Statements to a Financial Institution - Bank Fraud

Troubled companies may also seek to create availability under their line of credit in an effort to increase cash flow. However, procuring additional credit through inflated or overstated reports of the company's financial position may lead to personal liability for the company's principals. While there are countless ways to overstate receivables or inventory, all of these schemes have at their essence a fraud perpetrated on all financial investors and capital providers to the troubled company. Falsifying statements and misusing accounts of financial institutions are commonly prosecuted in federal court as "bank fraud." Under federal law, the penalty for bank fraud is a fine of not more than \$1,000,000 or imprisonment for not more than 30 years, or both. In addition to FDIC regulations, the Securities Exchange Commission record-keeping provisions may apply to individuals who falsify public company books, records and accounts.

While each of these techniques may seem far fetched, they do appear with some frequency. Once discovered, these problems require immediate attention in order to begin a process of remediation and resolution. Left unattended these situations only grow worse with the passage of time.

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