

# hearsay!

The Law Offices of Hemar, Rousso & Heald, LLP

MAKING OUR MARK FOR MORE THAN 30 YEARS

## Sidebar

In our continuing endeavor to bring you timely articles of interest, our



first issue of 2008 presents information on a recent ruling in preference litigation

(which hopefully portends the start of a trend in how the bankruptcy courts deal with questionable cases), as well as the latest on scandals that continue to plague the equipment leasing industry. We hope you find this Hearsay issue informative and entertaining. Happy New Year to one and all.

— Richard P. Hemar

## In this Issue

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## “Operation Lease Fleece” (A Cautionary Tale)

The United States Department of Justice charged twenty-three defendants for their roles in a fraud scheme that allegedly caused more than \$20 million in losses to several lease funders. Dubbed “Operation Lease Fleece,” the criminal complaint includes charges of mail fraud, wire fraud, and obstruction of justice resulting from an on-going FBI investigation. This investigation targeted individuals in the equipment leasing industry, including loan brokers and equipment vendors, who submitted falsified lease packages for funding. Operation Lease Fleece identified systematic patterns of broker/vendor fraud.

Clearly, fraud continues to plague the leasing industry. The cost is beyond calculation. Certain bogus deals are eventually identified; however, many are never detected and are simply categorized as bad debt... summarily

written off or written off after rudimentary collection efforts. In our representation of lease financing companies, we frequently see cases where the funders’ decision to take aggressive collection action (often including action in the lessee’s bankruptcy proceeding) reveals that what was initially believed to be simple bad debt was in reality a fraudulent scheme at its inception.

In addition to the losses suffered from inability to enforce fraudulent leases, there are further losses sustained by the industry in lost opportunities due to public skepticism. There is no real way to calculate the losses, which occur when well-intentioned lessees turn to other sources of business financing from fear that they too will be swept up in some sort of fraudulent scheme. As the sub-prime lending situation looms larger every day, it is imperative that the leasing industry hold itself to a higher standard of diligence, not only to protect itself but to instill public confidence in the industry.

The specific facts concerning “Operation Lease Fleece” are still being developed. However, much of the alleged fraudulent activity was vendor/broker fraud. Certain defendants allegedly marketed cash loans to small businesses

who were experiencing credit problems. Once the small businesses agreed to apply for loans, these defendants instead submitted equipment-lease applications to lenders. The equipment-lease applications were inflated by the defendants to include lucrative “commissions” for themselves.



“Operation Lease Fleece” — the criminal complaint includes charges of mail fraud, wire fraud, and obstruction of justice...

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## **“Operation Lease Fleece”**

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The applications were supported by false invoices purporting to document the sale of computer equipment to the small businesses. Though purporting to sell valuable computer equipment, in reality the equipment was typically non-existent, or far less valuable than invoiced. After the funding sources approved financing for the equipment leases, and funded the purported purchase of the leased equipment, in fact, the proceeds were not used to purchase equipment as invoiced and promised to the funders. Instead, the funders were duped into making cash or greatly undersecured loans to the small businesses, with the defendants keeping a significant percentage of the funded amount as “commissions.” It is alleged that hundreds of fraudulent equipment-lease packages with fake invoices were presented to funders.

What can be done to reduce broker/vendor fraud? Though often repeated, certain principles cannot be stated or modernized too often:

### **1) Know your customer**

This must be viewed expansively. Know not only your lessee-customer... but all of the parties and variables in the transaction. Know the brokers; know the vendors. The funder should do its diligence to know and understand all of the parties. The funder typically evaluates the lessee and its financial statement in deciding whether to fund a deal, focusing upon the obvious concern of payment from the lessee. The funder also needs to do due diligence on the other parties to the transaction. Variables in the transaction are representations made by the broker and vendor. These representations are components in the transaction being evaluated for funding. Doing diligence on these entities will help expose phony deals.

### **2) Know the equipment**

The Norvergence saga is testing the law on the legal duties of those involved in a multi-party lease transaction. Regardless of the legal ramifications, from a business perspective, a funder should understand the equipment being funded. A funder needs to bear in mind the three C’s — “collateral, collateral, collateral.” If the funder contemplates recovery in the event of default will be derived from liquidation of the collateral, the funder must also remember that the words contained on the invoice are not what will be liquidated. The collateral consists of the actual, physical items which will be sold, and more often than not, can be touched, seen, and examined. Just as Warren Buffet only invests in things he can understand, so too should the funder. Pre-funding analysis by an industry specific expert will go a long way in uncovering the true value of the Matrix or “blink” box.

### **3) Do Proper Diligence**

Even knowing the equipment may not be enough. By pushing several keys or buttons, rapidly evolving technology enables a scammer to do more far more than his predecessor of yesteryear could have imagined. Documents, such as invoices can be created or altered masking their felonious purpose. Now, more than ever, site inspections are critical. A vendor inspection will help detect suspicious vendors. A seasoned eye can identify various types of red flags apparent from a simple visit to the site. For example, is the invoiced equipment consistent with the business location? Consider the overall appearance of the business, and its location and size. Does the invoiced equipment seem appropriate for the business at hand? Is there a logical nexus between this lessee and/or broker and this

vendor? Similarly, a site inspection of the lessee’s place of business will also be beneficial. A simple review of the business premises will breathe life into the perception of the business and the reasonableness of this lessee financing the invoiced equipment. Quiktrak, an independent inspection service company, estimates that 65% of inspections uncover erroneous information of some kind. Although only the minority of these errors are the result of fraud, correcting documentary errors will produce increased collections and recoveries which would not otherwise been had.

Post-funding site inspection will also be useful. Many fraudulent transactions do not come to light as first or second payment defaults. Post-funding site inspections may catch the unscrupulous offender unprepared and off guard, giving notice to the funder of what will unfold. Sporadic post-funding inspections will provide increased awareness and knowledge to the funder, increasing the difficulty in successfully deceiving the funder.

Putting would-be schemers on notice that the industry is becoming more vigilant will benefit the funders by creating a deterrence to those seeking to exploit the industry.

Operation Lease Fleece serves as another reminder that ever toughening scrutiny and higher levels of diligence are necessary to reduce fraud. Further, Operation Lease Fleece, with its looming jail time for the defendants, sends a message to those in the leasing industry that all are accountable for their actions. Equally important, Operation Lease Fleece sends the message to any contemplating taking similar sinister conduct that the lease industry is being policed and time at the gray bar hotel may lay in wait for those who continue their nefarious ways.

—Irwin M. Wittlin

## “Preference Litigation Run Amok”

“I got a payment on an account nearly two years ago,” the client says on the phone, or in an urgent email. “Now I’ve got a complaint and a summons from a bankruptcy trustee on the other side of the country, saying I have to give that money back.”

It’s a rotten situation, and one that startles and even angers clients who have not encountered it before: the Bankruptcy Code says that under certain circumstances, a creditor may be forced to return payments received by the creditor from a bankruptcy debtor, even if the creditor unquestionably provided the goods or services for which the payment was made. In general, if a creditor receives a payment on an existing debt within the 90 days prior to the payor’s bankruptcy, and that payment gets the creditor more than other creditors actually or hypothetically could have received on account of their claims, the creditor is said to have received a “preference” or a “preferential transfer.” Forcing the creditor to repay the preference is supposed to engender “equal treatment” of all creditors.

Creditors are supposed to have available a number of defenses to return of preferential transfers, the most common being “ordinary course” and “new value” defenses. The ordinary course defense exempts payments made in the routine transmission of invoices and payments between the parties, and is intended to recognize that common business

transactions, without something more, ought not to be vulnerable as preferences. The new value defense says that where the creditor provides goods or services after the alleged preference, for which no payment is made, the value of those goods or services is deducted from the total preference liability.

Unfortunately, in recent years, the preference litigation process has frequently devolved into little more than a shakedown of creditors, backed by the threat of the costs and inconvenience of litigation. Creditors’ committees and trustees in bankruptcy often simply open the bankruptcy debtor’s check register, and sue every party that received a payment of any sort from the debtor during the preference period, without reference to existing (and plainly evident) defenses. A preference defendant who resides outside the debtor’s home state, or who is sued for a relatively small amount, is at a tremendous disadvantage: the cold reality of the situation is that it may make sense to settle with the bankruptcy estate—even if the creditor has valid defenses—because litigating and proving the defenses would cost more in attorneys’ fees and court costs than the amount in controversy.

Recently, a Texas bankruptcy judge made a welcome inroad in response to these issues. In an order entered in [In re Brook Mays Music Company](#), 2007 Bankr. LEXIS 2902 (Bankr. N. D. Tex. 2007), Judge Stacey Jernigan wrote that the court “was troubled by a trend

in large bankruptcy cases, in particular, of ‘preference litigation run amok’ (i.e., trustees and plan agents suing with reckless abandon, every recipient of a [preference], with no consideration of obvious defenses, what makes economic sense, or the underlying policies of the preference laws....)” The court ordered the bankruptcy trustee in that case to assemble and abide by a plan for analyzing and pursuing preferences, and clearly signaled that simply suing every possible potential defendant without regard to available defenses would no longer be tolerated, at least before Judge Jernigan. The court put teeth in its warning to bankruptcy professionals by mentioning that the court would consider allegations of inappropriate conduct in the pursuit of preference litigation either by reducing professional fees, or even by awarding sanctions against offending plaintiffs under federal procedural rules. In a welcome beacon for beleaguered preference defendants, the court wrote that it would “never tolerate abusive preference litigation or extortion of unsecured creditors on its watch.”

It is unlikely that this single case—however well founded—will change the preference litigation landscape overnight. It is a milestone, however, in airing the “dirty secret” of bankruptcy avoidance litigation as a mere shakedown, and may serve as a template for preventing, or possibly having recourse for, extortionate preference suits.

— Wayne R. Terry

## HRH Happenings

collections. At the same conference he was a panel participant in “Maintaining Your Line of Credit,” a panel discussion which focused on how leasing companies can remain in a solid working relationship with their financial sources. Perhaps of greater significance, Irwin was elected to the Board of Directors of UAEL and is currently serving as a board member.

**Welcome and Welcome Back** — Returning to Hemar, Rouso & Heald LLP after a two year absence is all around great attorney and nice person Pamela Cox. Pam reports that she has been busy with new baby, Tristan Thomas Cox, born October 11, 2007, and trying to get her three year old, Danielle, into pre-school.

We also welcome our other new arrivals: Cindy Herrera, Administrative Clerk; Cristina Gonzalez, Legal Assistant; Lauren West, Accounting, Pat Trent, Accounting, Blanca Gutierrez, Legal Assistant; and Sanaz Adnani, Legal Assistant.

# HRH Happenings



Partner Richard Hemar (center) flanked by some loyal denizens of the firm.

## Hemar Halloween Haunts

Continuing a long tradition, many at HRH enjoyed coming to work in costume on Halloween. We took many pictures (alas only a couple were in focus).



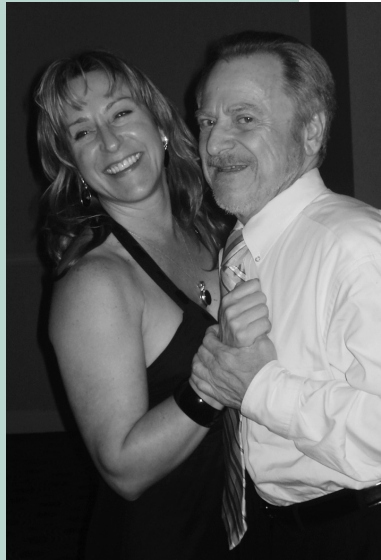
*"Hey Lady! That's not an opossum under your house!"*



Associate Jeannine Del Monte-Kowal and husband Jerry take a turn on the floor.

## Feeling Fancy

To close out the year, HRH gathered for its annual Winter Holiday Party where everyone celebrated with music, dining and dancing.



Controller Kelly Sorenson and Partner Richard Hemar, *cuttin' a rug.*



L-R: Associate Martina and husband Bob Porter, and Paralegal Mary Ann Rouso, in the breathless moment before all three lunged for the steak sauce bottle.



L-R: Legal Assistants Tammy Dunn, Denise Pauff, and Denise's husband David Van De Car, *post-feast.*

Legal Assistant Blanca Gutierrez (gripping a sheaf of non-winning raffle tickets) and husband Michael.



The Law Offices of Hemar, Rouso & Heald, LLP 15910 Ventura Blvd., 12th Floor, Encino, CA 91436, 818/501-3800, FAX 818/501-2985. The firm specializes in the fields of commercial and consumer litigation, collections, bankruptcy and general corporate matters. Individual lectures on the topics contained herein, as well as others on request.

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