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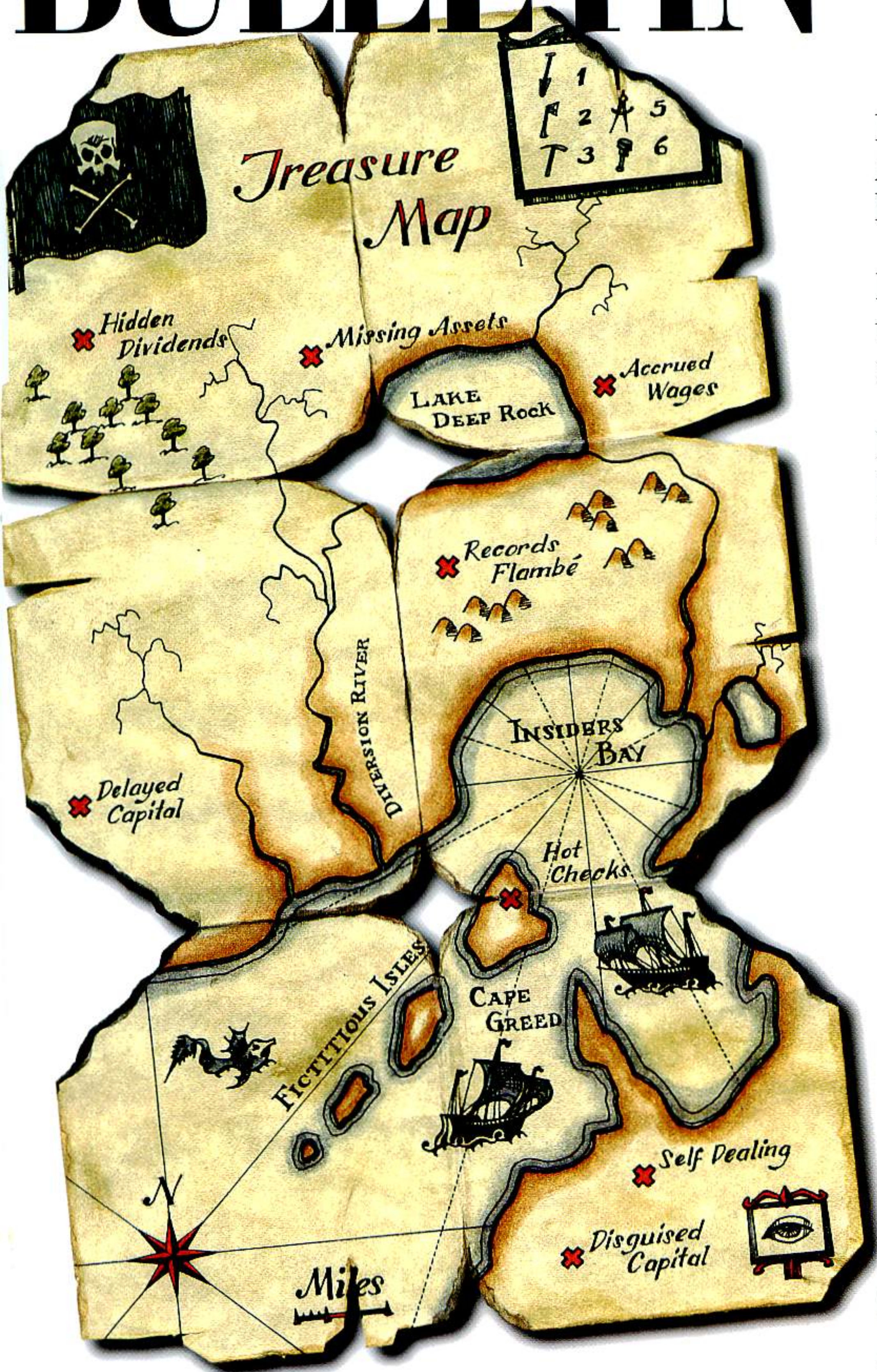

Financial statements: A map to hidden treasure

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Financial statements: A map to hidden treasure

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Reading the map to find the hidden treasures

New York City is great. You'll find Bernstein's practice piano on consignment along 56th; a missing Michelangelo in the French consulate; Mycenaen reliefs in the basement of an antiquity dealer; or a Blackbird on board USS *Intrepid*. Trawl the museums: You'll find *Madame X*, Perseus with Medusa's head in hand, *Christina's World*, or a Bell helicopter as art. You'll visit Sue, the T. Rex, at Christie's before she leaves for Chicago. You might find *Nighthawks* on loan. Don't forget the best chopped liver on Second Avenue or the 12th-century triptych at the Cloisters. Your treasure map is a city guide. You'll rival Heinrich Schliemann, who found Troy.

If a pirate's treasure map beckons you, browse through antiquarian book shops along 57th between 5th and 7th. Captain Hook is your sales associate. ("May I help you, please?") Meet Bluebeard the doorman, Captain Kidd the cashier, and Long John Silver the inventory clerk. Vito Corleone is the buyer.

As a reader of the *Commercial Law Bulletin*, you are probably more interested in treasures buried in accounting records from bankruptcy courts, debtors' examinations (if not your clients' files — maybe even yours). Call your competition: Their files brim with financial data, even Exhibit "A." If sparkling treasures mesmerize shoppers in New York City, hidden wealth sparkles from financial statements.

Why look? Ever sue, serve, take judgment against a defunct corporation? Ever report: "We have obtained judgment. After a preliminary investigation, we advise recovery is slim, dim, remote and just godawful. Close your file"? Never write this letter? How about: "Aside from your debtor winning the Lotto, try Lourdes; otherwise our file is sealed for eternity"? Too dour? Don't you suspect fraud, or did every debtor die a peaceful death at the hands of its corporate principals who dutifully went down with the ship? You believe this? The corporate principals, modern buccaneers, jumped ship and filched the remaining cargo. Like all good pirates, they buried their loot but left a treasure map as guide. You have this treasure map: It is called the accounting record, and this article provides tools and clues to find buried treasure, such as bank accounts, receivables, real property, equipment, business opportunities secreted away by the principals.

Girdled with tools, the treasure map of a financial statement invites the adventurer. Let's peruse the clues.

Note receivable. Generally Accepted Accounting Principals (GAAP) classifies a note receivable as a fixed asset if due more than one year. If the note is due within the year, GAAP classifies the note as a "short term asset." Either way, a note receivable may mask an insider loan to related company entities, such as officers, directors, shareholders, their spouses, and subsidiaries and affiliates ("insiders" or "principals"). This note receivable signifies the insider borrowed money or property from the company ("corporation" or "company" — your debtor) or the company gifted property away, and the accountant stylized the transaction as a note receivable to avoid a taxable event such as a dividend or salary.

You have this treasure map: It is called the accounting record.

Your job (inquire): What are the terms, and are they commercially sound? Is the note current? Have payments ever been made? What property (and its value) was given to the insider and compare to note amount? When is the note due? Is the note secured? What is the rate of interest? Is the company in the business of making loans, and why? Is the note payable interest only, or in periodic installments?

Next inquiry: Is the transaction a good deal for the company that made the loan? Dating from *Blackstone*, case law sets aside insider transactions, unless beneficial from the company's viewpoint, a harsh standard.

Find these additional treasure clues in the last five years of financial statements. Was the note was ever reduced by the principal amount, if any? Check the income statement to seek, under "interest income," if any payments have been made. Look harder: If so, double-check the cash receipts journals, along with deposit slips to confirm receipt of any interest or principal payments. Any negative response to these question leads to "X," marking the spot. Dig away. Unless the note is a superior investment (better than the Dow over the last 24 months), you can recover under the note or set it aside. You may have many remedies: Attach the note, and if default, sue the maker under its terms, or seek reformation under equitable grounds as straight, over due note. Set aside the note as a fraudulent conveyance and sue on the theory of money had and received. Sue under breach of trust theory and seek exemplary damages. Captain Kidd favors Accounts and Notes Receivable as a favorite spot for hidden loot, because of the tax laws. Taxing authorities treat insider

payments as potential income; cloaking the payment as a loan might impede this treatment.

INSIDERS I: Accounts receivable due a related company and insiders straddling the fence. GAAP classifies intercompany transactions as related party transactions. Many related corporations legitimately exchange product at market prices between themselves; and an insider sits on both sides of the deal. **Start looking:** View this accounts receivable historically, such as examining the financial statement and the ledger account (you'll find one for "intercompany accounts") over five years to determine if the receivables are paid timely, or late, or not at all. **Double-check:** Even if products or services are paid timely, confirm the prices at market rates. **Look again:** Paying excessive prices for intercompany product is itself a fraudulent conveyance. **Think:** A company who defaults on an Intercompany Account received a gift, because the vendor (other half) will never sue. Selling product without collecting is a gift. **Where is the fraudulent conveyance?** You now have a fraudulent conveyance against the insiders whose company (the buyer) has been enriched. Charge this loss against the corporate insiders under a fraudulent conveyance theory and unlawful dividend. The seller sold its product without fair and equivalent consideration, consisting of viable creditworthy customer, and that the corporate insider is the beneficiary of product because the buyer received product without commensurate payment.

INSIDERS II: Insiders as landlord, merchants, and lenders; another remedy for the same problem; premium prices paid for junk? Self-dealing shines brighter than the giant screen TV in Times Square. Insiders lease buildings, sell products, and lend money to the corporation. Insiders straddle the corporation and its corporate marketing agents, suppliers, or subsidiaries. These transactions are again related party transactions on the balance sheets. **Explore the market price of the goods or services:** Excessive prices siphon off cash (unlawful dividends and so forth). These insider transactions spawn multiple claims: Fraudulent conveyances for expenses; goods and services rendered to the corporation

Self-dealing shines brighter than the giant screen TV in Times Square.

at a premium; unlawful dividend for siphoning off cash through price gouging; undercapitalization if the goods and services represent disguised capital; self-dealing for any transaction in which the insider bears the burden of an accounting. Think also equitable subordination of these payables due insiders because the goods and services, received by the corporation, are disguised and delayed capital, and seek to reclassify the corresponding receivable as capital and any repayment as an unlawful dividend or fraudulent conveyance.

INSIDERS III: Writing off the assets. The corporation may write off worthless assets, such as bank accounts, physical assets depreciated to salvage value; general intangibles depreciated to zero. This process removes the asset from the balance sheet, but what happens to the asset? Where do these assets go? Probably to the insider. To the insider, writing off the asset does not translate into wiping out the asset. These assets have real value, and insiders taking home these assets is a fraudulent conveyance. Examine the balance sheet for written-off assets and find their current home. Be vigilant to any written-off received owed by an insider; and if written off, you'll have the perfect corporate rip-off.

INSIDERS IV: Oldies and goodies write-off II. When credit initially was established, the customer provided a financial statement depicting substantial fixed assets, such as equipment and furnishings. The customer went broke, and you have the file. Your job: Locate a current financial statement, and at least the general ledger. Compare the major items. Find anything missing? Yes? If so, levy on every corporate insider under an attachment and seek return of these missing assets. Absent truly criminal fraud insiders "write off" assets in their favor to shrink the company. This is the classic case for a fraudulent conveyance in which a recipient takes possession of these assets and completes the sale.

INSIDERS V: Checks. Look for check books and copies of all canceled checks, both sides, in serial order. Checks payable to cash, checks payable to the insider; checks payable to a bank, checks payable to wives, mothers, husbands, children, or even blank checks; cashiers' checks are all hot. These checks evidence an insider diversion.

Read the checks carefully: Look for remittance advice, such as invoice number, statement "ending dates," account numbers; find none, find a fraud. **Review the reverse side:** Investigate the endorsement. If the check is payable to ABC, is the endorsement in favor of an account number only? Was the check cashed? Vendors normally do not cash checks. If the endorsement varies from the payee, probably the payee was fictitious, and check represents a diversion. **Ask:** Was the check written to cash, but converted to a cashier's check? Think about fictitious payees. Call directory assistance to confirm, superficially, the legitimacy of payees. Look for the payee whose address is a post office box, a private mail box service, or a residential address. This analysis working you too hard? A simpler approach is the journal. Under accounting principles, the check is credit to cash and debit to another ledger account. **Compare the check with the cash journal.** Trace the entry in the cash journal with the corresponding entry, for example, accounts payable, customer refunds, or notes payable. Find nothing? You might find gold in those checks. In one case, an insider brazenly wrote corporate checks in payment of his swimming pool cleaner, hedge trimmer, and gardener. The trial court took about two nanoseconds to pierce the corporate veil.

INSIDERS VI: Corporate subsidiary borne from greed. GAAP divides assets into current and long-term. Current assets are cash, account receivable, and the current portion of any notes receivable, along with inventory. These items are virtual cash equivalents. Long-term assets are fixed assets, prepaid deposit, equipment, leaseholder improvements, real estate, and, occasionally, securities in a corporate subsidiary. This is a big-time clue. Subsidiaries are usually corporate entities whose shares of stock are owned by the parent. This parent completely capitalized the subsidiary

with assets and received in exchange for shares of stock. The corporate parent transfers the shares of stock to the insider, or the subsidiary issues the shares of stock to the insider. You face a double fraudulent conveyance and unlawful dividend because the subsidiaries' shares are worth far less than the asset used for capital. The corporate subsidiary is therefore the fraudulent conveyee. Remember: The insider received the shares of stock. These shares of stock have virtually no market value (usually legend stock). However, the insider is a fraudulent conveyee if he or she is the recipient of these shares of stock. Furthermore, the insiders probably did not comply with the bulk sales act; and the insiders are probably the officers and directors of the subsidiary. **Think ahead:** To complete a fraud, the corporate parent causes the subsidiary to issue shares of stock in the insider's name to satisfy a long-term, unpaid loan, note, or unpaid wages. Neat. The corporation transfers its assets to a subsidiary who issues shares of stock to the parent's shareholders, and leave an empty shell. The unlawful dividend, along with any fraudulent conveyance claims, will unwind these transactions.

INSIDERS VII: Insider security interest and snap foreclosures: You levy on the company's bank account; the insider files a third-party claim and asserts a blanket lien. From the third-party claim pops a financing statement and security agreement, which can transfer any assets, day or night. The Bulk Sales Act (Art. 6) doubly excludes a security interest: The granting and foreclosure are exempt from compliance. **Are you in trouble?** A security agreement looks genuine. Prolix detailed security agreements exudes legitimacy. Surely with all those recitals, real bucks went into the till? Want to unwind this security interest? **Start with the presumptions:**

1) The insider deal is voidable by the corporation;
2) The validity of the transaction is viewed in the best interests of the corporation;
3) Insiders' loans mask disguised capital, or fabricated notes to transfer wholesale assets;
4) The note represents an alleged wage claim, whose accrual suggests undercapitalization.

The trial court took about two nano-seconds to pierce the corporate veil.

Are you moving forward with execution after discovering the insider security interests? Quickly enjoin foreclosure; otherwise, the insider will foreclose upon the security interest and establish a new business enterprise, all without change of possession or location and stall any further execution. Fearful of the change of name on the door? You bet, and the insider security interest shifts assets from the corporation to the insider, and again to a new corporation.

Deep rock. Sound familiar? Soft drink and rum at Rick's or equitable relief? Answer: This term means equitable subordination of insider loans, which converts debt to equity, and loan repayments to a recovery — assuming the trade creditor extends credit to a corporation that becomes insolvent. This corporation is a one-man (or -woman) show. The corporation collapses and the insider foreclosures on security interest that secures a long-term loan. The trade creditor cries foul partially because the insider promised payment. **View the transaction laterally:** The fact might not justify an alter-ego claim, but the court might subordinate the insider loan as capital and declare any loan repayments as an unlawful dividend. A levy on the corporate insider might force the insider to repay the unlawful dividend to the levying officer, and not to the corporation, which would lead to payment. Bring the forensic accountant to testify that the corporation was undercapitalized, and

Tools for your treasure map

Your personalized treasure tools: shovels, pick, axes, compass, telescope, and trowels.

This is a pirate story originating with such English heroes as Sir Francis Drake, who was sponsored by the Queen to plunder Spanish galleons. Private investors capitalized these risky ventures, whose pay-off easily exceeded 500%, if successful, which required both a successful venture and honesty of the ship's captain. Remember, the captain was a career pirate, whose purpose was to steal. Theft is democratic. Therefore, the captain could easily profit both from stealing from the enemy galleons along with his own investors, making this line of investment very speculative. In order to shore investor confidence in these ventures, the English Parliament passed 13 Elizabeth, which provided that all conveyances with the intent to defraud creditors was null and void. For the dilettante of the CLLA, the leading case is *Twyne's Case*, 3 Coke 80a, 76 E.R.C. 2, 1 Smith Lead Cas. 1 l. Am L. Reg., N.S., 137. The modern version is the Uniform Fraudulent Transfer Act. This is your first tool, a basic shovel. Long John Silver would find himself in a deposition.

Other tools abound to unearth these treasures. The state corporations code voids most conveyances by corporations to any officer, shareholders, and director, if the corporation was insolvent just by failing to pay bills when due and declares conveyances an unlawful dividend. Litigating an unlawful dividend requires proof of the debt owed by the corporation; the insolvency of the corporation; the fact of the transfer to the officer, director, and shareholder. Most states declare the conveyance avoidable (not void), or shroud the conveyance with the presumption of undue influence or fraud, and impose on the conveyance a burden of proof to demonstrate that the conveyance benefited the corporation from its own point of view. Inhibiting most creditors from this straightforward claim is standing. Many states limit an unlawful dividend claim to either the corporation, its other officers, directors, or

the insider loans are additional paid in capital.

Another, more detailed, look at loans. The C.P.A. might list an insider loan as a long-term loan payable on the financial statement. Many financial statements break this category into two sections: If the note payable is immediately due (or in some installments), this item is listed as current payables; the remaining portion (due later) is listed as long-term payables. Study each long-term liability and review the source documents, usually consisting of long-term note, agreement for the loan. If the loan is secured, expect a board of directors resolution, with shareholders' consent. If done professionally, expect an independent account's opinion, along with counsel's opinion, which justifies that the transaction serves the best interest of the corporation. Finish your search: The final test of a bona fide insider loan is double barreled: Could the corporation have borrowed the money from a bank? Why did the insider make the loan?

Let's break down this analysis further. Insiders characterize their capital contribution as long-term loans, and, upon insolvency, declare the loan due and collect. Two for me, and none for you. If you can recharacterize the loan as capital, all repayments are unlawful dividends, subject to recapture usually as fraudulent conveyances or illicit dividends. Therefore, to snare the repayment, paint the transaction as capital and not debt.

Let's return to the beginning: If the corporation would not qualify for the loan, and the corporation needed the loan due to inadequate capital, the loan is capital and not a loan. Your forensic accountant opines, "This corporation could not meet the basic lending requirement, and the initial lack of capital necessitated an infusion of capital. This insider loan is delayed capital to permit the corporation to meet its basic liabilities as they accrue."

You, the lawyer, argue that the loan transaction lacks the earmarks of regularity; and worse, the loan did not meet the corporation's best interest based on its terms, security, repayment, interest rate, and payment schedule. Presto-gizmo: The loan is capital, and dollars received by the insider are fraudulent.

Can we talk? Did we talk about capital? GAAP defines capital as the contribution of money or property to finance the activities of the corporation. Capital is at risk. Capital fuels the corporate enterprise. If an enterprise is successful, capital increases and multiplies by continuing retained earnings. If a failure, the deficit retailed

shareholders, judgment creditors, and, in some instances, to a receiver. A judgment creditor might style the caption as "ABC, a judgment creditor, on behalf of XYZ Corporation." This remedy is a pick.

More elaborate tools hang on the shelf. Traditional common law equates officers, directors, and shareholders to trustees of trust in the setting of an insolvent corporation. Any transfer is probably recoverable as a breach of trust. Again the impediment is whether the individual creditor can maintain standing to bring the action; and, if successful, the recovery inures to the corporation for pro-rata distribution to all creditors. This remedy is a compass.

Under other trust theories, corporate properties held in the hands of officers, directors, and shareholders are presumptively held in trust for the benefit of the corporation. An attachment or execution levy upon the corporate principals would precipitate surrender of these assets to the levying officer on behalf of the executing creditors. In the event of refusal by the garnishees, the creditor would institute the traditional creditors suit to reach the debtor's assets held by a third party, or even a turnover order, if allowed, at the conclusion of a third-party examination. This remedy is like a crowbar.

Like more exotic claims as tools to reach the assets in the hands of third parties? If the shareholder failed to deliver on his or her capital investment, received watered stock, or failed on pay on the stock subscription agreement, collect the balance on a derivative claim or garnishee the amount due under attachment or execution. Find long-term loans by corporate principals that were repaid prior to your judgment, which emptied the corporate coffers. "Hey, the corporate liquidated its assets to repay its other creditors, holding long-term debt. Nothing is wrong with this. A debtor may prefer one creditor over another." Break this cycle by suing the other creditors, holding this long-term debt, on the theory that the long-term debt is disguised capital, and therefore repayment is an unlawful dividend. More esoteric is equitable subordination; equity will deep-rock an insider loan as capital, or defer payment, pending liquidation of creditor claims. These remedies are your axes — to grind.

Try, for fun, an action under the Unfair Business Practices Act, an amorphous statute that provides strong injunctive relief to remedy any wrong. Although lacking a clear remedy for monetary relief, such as damages, the Unfair Business Practices Act might reach the fraudulent conveyance because the corporate loot is an unlawful act per se and equitably order its return. Don't forget the old standby of "alter ego." Moving assets freely between insiders and their corporate charge is the *sine qua non* to most alter-ego actions. These remedies are a telescope.

Finally, don't forget fraud for false financial statements, reclamation actions, bankruptcy discharge actions to exempt the debt (Section 523(a)(2) and so forth), action to bar the discharge for non-existent records (Section 727). These remedies are your trowels.

earnings deplete available capital. In case you forgot, retained earnings is a historical snapshot of prior earnings. When the red ink of deficit retained earnings floods the business, insiders rewrite the books. Capital becomes secured long-term loans; long-term loans are paid; cash is returned on a short turnaround to fund day-to-day operations. Bedrock capital becomes a fluid number. Can you stop this? Sure enough. Besides an injunction preventing a fraudulent conveyance, seek a receiver to take charge of the corporation and stem the conversion of capital into loans. **Fraudulent conveyances include habitual undercapitalization when the principal removes capital but incurs future debt.** When thinking about receivers, think very big cases. Receivers are paid by the hour; they hire the lawyer; and, finally, don't forget about the bonds.

Accounts payable due related company. Insider transactions invite your inquiry. The corporate principals own the building in which the corporation is housed; the corporate principal runs a related business that provides goods or services — typically trucking, transportation, accounting, or even the product itself. Sometimes these companies feed each other, with captive customers or suppliers. Is anything wrong with this picture? The corporation needs to rent a premise, buy goods at market prices, and obtain supplies, labor, and loans. The answer is greed. Insiders habitually sell inflated goods, services, or fictitious product, tender vouchers and invoices for payment, and insure they are first for payment.

If the insider controls the buyer and seller, the price is neither competitive nor market based. **Look for outright fraud, self-dealing, breach of fiduciary duty, along with alter ego.** If a large balance accrues for accounts payable due related company, think deep rock if you can prove that the corporation was undercapitalized, and the liability to the insider masks disguised capital fueling the corporation's operation. Payment of trade debts due an insider resembles an unlawful dividend or fraudulent conveyance.

Drains, siphons, and wormholes. The financial bibliography provides voluminous reference materials depicting model balance sheets, profit and loss statement, capitalization requirements, key profit ratios, and so on. Skim the financial statement and compare. Look for disproportionate items. Take, for example, the restaurant business. Food costs average about 25%, and labor ranges anywhere around 30%. Are the numbers off the chart? They mask illicit expenditures. Look for "other," "miscellaneous," "other expenses," "direct operating," and "occupancy" or "marketing." These items suggest unvarnished fraud, because their general nature conceals the true nature of expenditure.

Look for excessive "G&A," which means general and administrative. If viewing a restaurant, retail business, basic manufacturing, or distributing, normal G&A is a fraction of operating expense. **Ask:** Big G&A numbers signify an insider exploiting the corporate cash flow to finance another parallel business, or lavish, ridiculous expenses, or — worse — a direct contribution from the corporation (the weak sister) to capitalize the corporate subsidiary. Watch for "headquarters offices," supported by G&A, which runs a restaurant chain, beauty salons, or copy shops. Look harder, and you'll find the corporate principals running a half dozen businesses from this corporate headquarters. These shared expenses might not blast your way to summary judgment, but excessive G&A, supporting unrelated operations, is what dreams of fraudulent conveyances and unlawful dividends are made of.

Two for me, and none for you.

Executive salaries. GAAP lists officers' salaries separately. These are big numbers, ranging between $4,000 and $10,000 a month. Is the corporate receiving real value in exchange? Obviously nobody works for free, and the corporation may pay execution a prevailing rate. **What's wrong with this picture?** Don't presume that the corporation is getting services in exchange. Contrary to the captain going down with the ship, capitalist captains are first off the ship and scourge for new opportunities. Find ex-employees who will tell if the insider invested 40-hour weeks. Even the client's own salesperson, driver, account manager, credit manager, or collector might opine that the insider played hooky rather than tend shop.

Unpaid subscription agreements, watered stock; stock for future services. "Water, water everywhere, and not a drop to drink." Wade through a financial statement, and you'll find a major oasis in the capital account. This is watered stock, which means the corporation issued stock in which the shareholder failed to exchange property or provided worthless property. Stock for future services; stock for unsecured notes; stock for worthless equipment or leasehold improvements; stock for insolvent business. Got a judgment, buddy? Levy on the shareholder and enforce the subscription agreement to force payment of the share's true value.

Plain old vanilla; undercapitalization. Anybody can incorporate. Send about $500, along with the articles to the Secretary of State, and Poop-be-doop: You're incorporated. Send $50 to the local government, and you've got a city business license; a fist of dollars more, and we can sell you a sales tax permit. Did we forget anything? How about real money to run the business? **Examine the capital account.** Even a one-eyed pirate will invest money in the ship, crew, cannons, muskets, swords, sails, hardtack, and rum. If the capital account shows $1,000 in capital stock, the corporation is undercapitalized. Don't look too hard for the $1,000; it is probably the precorporation lawyer's fees, along with franchise taxes.

The capital account itself and source entries. The opening capital account shows a humongous number; say, $100,000. Your forensic accountant suggests that $100,000 approximates adequate capital, given potential exposure for trade liabilities, and possible risk of financial collapse. The corporation is broke, bust, and gone. Do you quit? No. Read on.

Find the original ledger for "capital." The initial entry is $100,000. Look for the corresponding journal entry, which refers you to the journal. The journal will show a credit and debit to another account. **Ask:** If the $100,000 was a cash contribution, you'll see $100,000 to the cash ledger account. If the contribution was inventory, likewise look for a debit to the inventory account. If none, you've found a clue — if not the treasure itself. Typically, insiders convert their sole

proprietorship into a corporation, usually when they become concerned with expanding personal liability from trade debt. Under this hypothesis, you'll find the $100,000 capital account, but find corresponding entries to accounts such as cash, inventory, equipment, furniture, and goodwill. Is this capital sufficient, or are you looking for a hidden corporate dividend and fraudulent conveyance? Assuming the predecessor sole proprietor is losing money, and incorporating shifts a losing business into a corporate form to avoid accruing personal liability, the corporation is grossly undercapitalized.

Adequate capital means that the business entity has sufficient reserves to conduct its business by paying for obligations as they arise, acquire goods and services for resale, and liquidate long-term liabilities, and this capital remains permanently at risk to insure longevity. **Conclude:** If the corporation immediately loses money and falters on this trade bill, the corporation lacks adequate capital. If the journals and ledger accounts show a straight transfer from the prior business to the corporation, the records therefore will evidence classic undercapitalization.

From its inception, the corporation pays prior trade bills incurred by the insider when running predecessor sole proprietorship. The corporation pays past due, pre-incorporation bills, long-term liabilities, prior unpaid wages, and draws. These payments benefit the insider in discharging his or her pre-incorporation liability. These payments deprive the corporation of valuable working capital in paying bills for goods and services incurred by prior regime. These payments are therefore unlawful dividends because they return capital to pay a personal liability of an insider; or these payments are fraudulent conveyances because the corporation received nothing in return — not even a holiday card at year's end.

Correcting journal entries. Massive correcting or reversing entries favor only insiders. Pull the ledger; examine high-profile accounts such as insider accounts and note receivable; capital accounts; and current liabilities owed to shareholders. The financial statements show small balances. **Is the insider honest, or did you chance upon a genuine Dali lithograph?** Pull five years of financial statements, along with each ledger. Look for changes benefiting the insider, such as accounts receivable due from insiders declared worthless and "written off." Look for note payable due insiders drastically reduced by asset transfers, such as cars, inventory, and equipment. Examine the ledger account for the debit to the accounts receivable due from insider account, but the corresponding item in notes payable to insiders.

These entries, all favoring the insider, suggests the insider avoiding liability for accounts and notes due the corporation (by writing down these receivables) masking the entries reducing the note payable to the corporation. This transaction is a fraud. First, the insider is not paying on the receivable, as any other debtor; and, second, the note payable due the insider is disguised capital. Any reduction is an unlawful dividend or fraudulent conveyance. **Worse, examine the journal entries for the note payable to the insider.**

Look for changes benefiting the insider.

a) The corporation did not even issue a note;
b) The note lacks any contemporaneous consideration, such as cash; and
c) The note, as an insider transaction, might not even be due.

False accruing liabilities to insiders. Look for accrued current liabilities to insiders. The long-term note payable to the insider bears interest. If the interest is unpaid (which is a certainty), the corporation carries the unpaid interest as current liability, which is never paid. This accruing but unpaid liability, along with the underlying note (which the corporation could never pay), are disguised capital and hidden dividends and should be paid.

Accrued wages. Insolvency and horse racing are kissin' cousins: Everybody is at the gate. In the first lane is the IRS; in the second lane, the labor commissioner; in the third lane (and probable winner), the secured creditor; and in the fourth lane are individual wage claimants. Doesn't horse #4 look familiar? Why, that horse is the insider who claims a six-figure accrued wage claim. That one claims months of unpaid wages, asserts statutory priority, and, worse, controls the company's checkbook. You can spot these wages under short-term liabilities as accrued wages, or from the cash disbursement journal, or canceled checks as large disbursement. Are the accrued wages recoverable as a fraudulent conveyance, unlawful dividend or improper payment? Maybe.

The basic tests to ferret the genuine from fraudulent wages claims follow: Do prior quarterly, or monthly, financial statements evidence a slow progression of a wage accrual? If the wages are taken, did the corporation deduct the taxes? Did the insider lack current payroll? And how did the insider make basic living expenses, such as payment on the mortgage? Look for notes from the corporation to the insider or employment contracts. However, if the corporation lacked money to pay basic wages, you have found the first clue to the alter ego. The corporation was so undercapitalized that the corporation could not make basic payroll when due. If the corporation couldn't make payroll, unpaid wages are equivalent to a continuing capital contribution, and any payment is an unlawful dividend, or fraudulent conveyance.

X marks the spot

Most insiders engage in petty theft. They borrow money and owe a receivable. They pay the receivable with accrued wages. Accrued wages are disguised capital. Capital is the prior failing business. The corporation pays the prior failing business bills. The corporation lacks sufficient capital to set sail, and quickly flounders. You'll find all these clues on the treasure map in your hand: the financial statement. "X" might mark the spot on your treasure map; but once found, the "X" becomes Exhibit "A" in your successful claim to recover the lost and stolen property. Yo, ho, ho, shiver me timbers, and have a good time.