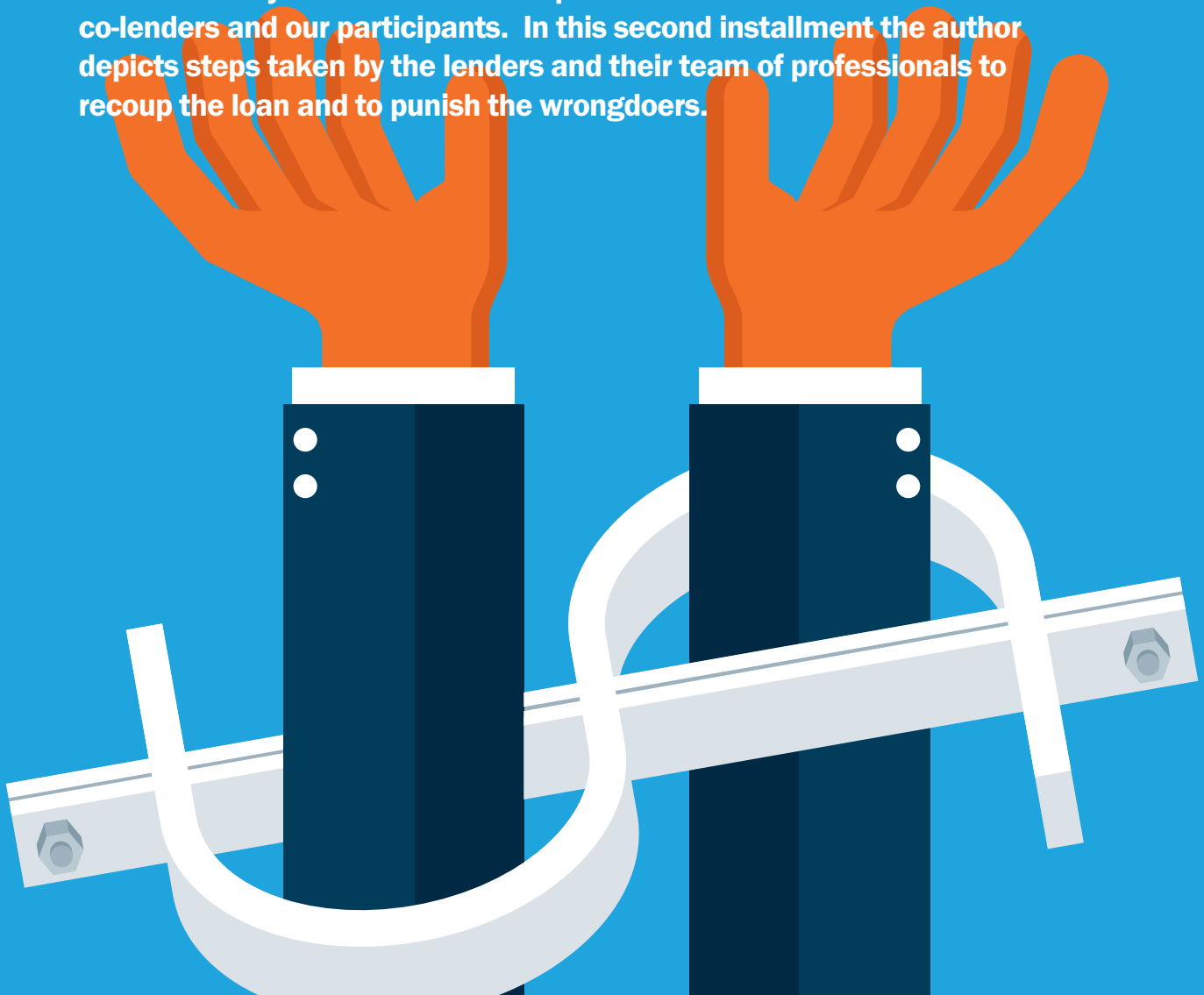


PART 2

Allou – A Firsthand Account of a Massive ABL Fraud

BY MARK FAGNANI

In the first installment of this story you read how the fraud was perpetrated and how it was discovered. For clarity's sake, it should be understood that while the loan was originated by the business development officers, the loan was unanimously approved, in the case of Congress Financial, by the Senior Credit Committee, which consisted of seven individuals with well over 100 years of combined experience. The same was true for our co-lenders and our participants. In this second installment the author depicts steps taken by the lenders and their team of professionals to recoup the loan and to punish the wrongdoers.



spoke with Dick Sebastiao of RAS Management Advisors every day during this period. After the conversation regarding both the A/R and inventory shortfalls as related in Part One of this article, I immediately went to see Bill Davis, our CEO. I told Bill we needed to put the company into an involuntary bankruptcy proceeding as I viewed that as the only viable way to gain protection from what was clearly an ongoing fraud and to neutralize the management team. Bill and I had a short call with Jon Helfat of Otterbourg, who confirmed that, while somewhat unprecedented, this seemed to be the best route. We immediately organized a call with the lending group. We had kept all the lenders up to speed on most of the developments detailed so far, but brought everyone up to date on the latest findings and asked for two more lenders to sign the bankruptcy petitions (any three creditors can petition for an involuntary proceeding. As co-lenders, each of us was a separate creditor). Thankfully, we had Miles McManus and Keith Gerding from Citibank on the case. Miles was in full agreement with our recommendation and immediately said he would sign. Miles and Keith turned out to be invaluable during the life of this case as they were in lock step with us the whole way and very often helped sway a lending group that became understandably agitated as things went on. LaSalle Business Credit (which became part of Bank of America for those historians in the crowd) offered to be our third creditor and we filed petitions to put the company into bankruptcy – the first and only time I ever did so over a 43-year lending career.

The case was filed in the Eastern District of Long Island on April 9 (10 days after RAS was engaged at the company) and was assigned to Judge Cyganowski. Both Dick and myself testified in the first days of the case, with Richard Haddad of Otterbourg as our counsel. The facts were clear: the company had a \$200 million line of credit, had \$190 million outstanding and had perpetrated a massive fraud on the lenders who were now seeking protection of the court including a change in management. We outlined the RAS findings in some detail. The U.S. Trustee objected to RAS as CRO as they viewed the firm as being conflicted as a result of their prior involvement in the matter, but the one remaining independent board member agreed to hire him as the CRO. By now, every officer of the company had resigned. From here on out and, until the lenders were successful in having a Chapter 11 Trustee appointed (thereby officially ending any involvement of management), the



MARK FAGNANI
Clear Thinking Group

company fought the lenders every step of the way, filing objections to every motion and causing hearing after hearing to try and derail the investigation and the recovery by the lenders.

On April 15, at the suggestion of Miles and Citi, we retained Brandlin & Associates as our forensic expert. Brandlin was primarily engaged to assist with our case against the insurance carriers as we needed to be able to reconstruct the inventory as it existed at the time of the fire to support our claim. A daunting task given the magnitude of the fraud we had uncovered, but necessary nevertheless. Brandlin's work turned out to be invaluable not just on the inventory, but also in working with the RAS team to flesh out all the details that would ultimately lead to our recoveries. This is a critical point in the case. Recall that I mentioned the 40-foot dumpsters of refuse removed from the warehouse. On the one hand we knew, and were asserting in bankruptcy court, a huge fraud and an inventory overstatement in the tens of millions of dollars. On the other hand we were asserting to the insurers that, as it relates to the warehouse where the fire was, that there was indeed millions of dollars of inventory and pointed to those dumpsters as proof. Brandlin's task was to recreate as best as possible, using only legitimate documents, the precise amount located at that warehouse at the time of the fire.

On May 1, the Agent made a motion to appoint a Chapter 11 Trustee. The U.S. Trustee agreed, but it still took almost a month before Kenneth Silverman was appointed as trustee. While this was going on, RAS was working on collecting all legitimate A/R and on asset sales. There was all remaining inventory to sell, the Sobol business and a separate business unit located in California. From this point on, we would be in what we called "litigation and recovery mode."

As recoveries came in, Congress made a very important strategic decision. We decided that we would distribute a portion of the proceeds to the lenders, but would always withhold some amount to serve as a fee reserve for our professionals. In this way, despite the fact that we were spending considerable sums, we never once had to ask any lender to fund back in. This turned out to be critical as, ultimately, professional fees exceeded \$10 million, but no lender ever did anything except reduce their exposure and the lenders never had to fund back for the cost of professional fees. To be sure, we had some contentious calls along the way, but we were steadily realizing recoveries and our view at Congress was that the minute we dismiss the professionals is the minute those recoveries would stop. In this regard, Miles was invaluable as he fully supported this view and threw his support behind it.

In May, we also dismissed our suit against the insurers in state court, and promptly arranged for the Trustee to file a new suit in the bankruptcy court. It was Richard Haddad and Jon Helfat's view that we would get a faster, and likely better, result by bringing all suits into the bankruptcy. That also turned out to be a stroke of genius. We also converted the case from a Chapter 11 to a Chapter 7, as it was clear by now that this was a pure liquidation and that the secured lenders would have a shortfall, so no recovery was possible to the other unsecured creditors. This conversion made

many of the next steps we would take easier to accomplish.

We also sought to throw the primary officers of the company into personal bankruptcy. This was hotly contested by each of them. But remember that video we had of them breaking into the premises and removing computers and boxes of documents? Well, we showed that to the judge while Dick narrated the action. She was not amused to say the least. The petition was granted and a different Trustee was assigned to each of their cases. Using the discovery rules afforded us in bankruptcy, we were able to conduct investigations of many individuals. Through these examinations we discovered that some of our funds had been used to buy real estate through various holding companies formed by the principals. We put those real estate entities into bankruptcy as well, and they in turn also had their own Trustee. Eventually, through those Trustees we sold this real estate.

Simultaneously we filed suits against all three accounting firms, filed a claim under the Directors and Officers insurance policy (D&O), restated and refiled the tax returns seeking a large tax refund and with the help of RAS and Brandlin started countless fraudulent conveyance and preference actions.

We also gathered up all the evidence we had so far managed to put together and went to visit the federal authorities. They listened carefully to all we had to say and acknowledged that the company had been on their radar for some time, but they had little to go on. We provided this evidence to them on a silver platter. We had so many files with us during this visit that we needed a hand truck to transport them all. The analysis done by both RAS and Brandlin was key evidence for the U.S. attorneys office in ultimately securing guilty verdicts against all key members of management. Shortly after our visit to the authorities, we received a visit from the postal inspector. It turns out that, since the company used the U.S. mail to deliver fictitious documents to us (and others), that constituted mail fraud. Shortly after these visits the officers were arrested. Ultimately, the principals were brought up on bank fraud charges, mail fraud, securities fraud, insurance fraud, arson and bribery. Unbeknownst to us, the officers had attempted to bribe the fire officials to alter their report so that the insurance claim

would be paid. We only became aware of this after the principals were arrested. In this regard, we learned that the principals had procured space heaters, burned them in garbage pails and then planted them in the warehouse, hoping to throw the fire inspectors off the scent by having them believe that faulty space heaters caused the fire.

Brandlin and RAS continued their investigations into the exact mechanics of the fraud and where the money went. Very often the money made a round trip into the hands of third parties, only to be returned several days later, minus a small sum for their efforts. We sued every single party that ever touched our funds. All were illegal participants, knowing or unknowing, in this scheme and we were intent on getting our money repaid. The data developed by these teams provided the Trustee with a roadmap for the myriad of fraudulent conveyance suits that were ultimately filed. We had countless meetings with counsel, considering different options and possible

avenues to recoup our loan. We considered hiring an international detective firm to try and trace funds in Europe. We considered and interviewed former CIA agents to “quietly” investigate individuals here in the U.S. I like to think we left no stone unturned in our pursuit of recoveries.

We litigated with the insurers for years. There were countless depositions and meetings, ultimately resulting in settlements of varying amounts from each carrier. Obviously, it was easier to settle with the insurer responsible for the \$0 – 10 million layer than with the insurer responsible for the \$50 – 60 million layer, but we had success of varying degrees with all.

So, when all was said and done, we had discovered that Allou had been perpetrating a fraud on a huge scale for years, well before our involvement. With the help of the head of IT, they had literally created two sets of books and made phony sales through Salesman 2 and maintained phony inventory in Warehouse #8. They created phony backup to support purchase orders, sales, and vendor payments. And all of this was maintained by their IT department on their computer system, but hidden from sight until we cracked the code. Their problem was that, by the very nature of the fraud, it just



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kept getting bigger and bigger and was becoming unwieldy. The fire in Brooklyn was meant to be their solution. The insurance proceeds were intended to wipe the slate clean and create liquidity – not so they could stop, but so they could start all over again. The suspicion of arson and failure to promptly receive the insurance proceeds foiled their plans. The warehouse at Nyack was just more of the same, an attempt to report garbage as inventory and get a loan against it. You, the reader, may ask why? Why would people perpetrate a fraud of this magnitude when they had a reasonable business they could have just run. Well, there are many answers to that and I am not smart enough to say I can articulate them all. Greed? Certainly. Just bad people? Yes, that too, I think. But the individuals involved were all regarded as upstanding members of their community and very often, using stolen funds, supported and helped others in their community and so, in their own way, thought they were doing good. Unfortunately, they did so at the expense of banks, and for reasons I cannot explain, they thought that was okay.

I took this case very personally. So did many others including my boss, Bill Davis, and many of the other lenders involved. The more we learned about how well planned this all was and how long it had gone on for and not just affecting us, but public shareholders as well, and how they used a dangerous fire as a means to their own ends, the more intent we all became on seeing not just a return of our loans, but on justice being done. At the commencement of the Chapter 11 cases I appeared in bankruptcy court probably 25 of the first 30 days. I had dedicated myself to the case for several reasons, but two stick out to me now in hindsight. Firstly, I was trained to behave as each dollar we loaned was my own and not to be nonchalant when we were in jeopardy of a loss. Pursue recovery with all vigor and gusto was my approach, the Congress approach. Secondly, I thought we were a great lender, a great organization. We were trusted, admired and respected by our peers and we syndicated many deals. This was embarrassing. As agent, we had been defrauded, literally on day one of the loan. We needed to show strength and leadership to our lending group and I was intent on insuring that we did just that. As to all the other lenders involved,

there can be no better evidence of that dedication than that on the day the individuals were sentenced in criminal court, the room was packed with lenders and lawyers. Bill and I were there along with Richard and Jon, Dick and Jeff. Miles and Keith were there from Citi as were many of our other co-lenders. The main perpetrators were sentenced to 15 years in prison with no chance of parole. One

died before he could serve his sentence. We left the courthouse that day feeling somewhat vindicated, but still had the hard task of continuing to collect our loan by whatever means possible.

As lenders, we made some mistakes and missed some things. As ABL lenders, none of us can prevent fraud. Our job is early detection and swift response to minimize the damage. I have discussed those mistakes we made and I hope they are informative and helpful. Just as important, I think, is how the lenders as a group attacked this problem. We got back a substantial amount of our loan and eight individuals, including all four officers of the company, went to jail. David S., the CFO, cooperated with the



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authorities in the prosecution of their case and did not have to serve jail time. The accomplices that actually set the fire all went to jail. It took several years and almost \$10MM in professional fees to get the outcome described herein and set forth below.

Some of the more noteworthy areas of recovery include the following:

- \$34.3MM from the insurers (on an original claim of \$65MM)
- \$23.2MM from the accounting firms
- \$11MM from the D&O policy
- \$17.5MM in tax refunds
- \$17MM in inventory sales under Section 363
- \$3.1MM from the real estate entities we put into Chapter 11
- Over \$9MM in fraudulent conveyance recoveries
- Over \$7MM in preference recoveries.

And the list goes on and on.

A final comment about the recoveries noted above. While there was undeniably a fraud and undeniably a deliberate setting of the

fire in an attempt to cover up the fraud with the expected insurance proceeds, there was also a legitimate business conducted by Allou and there was some inventory of real value in the warehouse at the time of the fire, which made the investigation that much more difficult. It was Jeff Brandlin's work on the inventory forensics, as well as our attorneys' work on discovery, that enabled us to collect \$34MM from insurance carriers that didn't want to pay a penny. Establishing what was there, while simultaneously proving to the court what wasn't there, was not an easy feat. Were it not for the RAS team, we would not have uncovered the full extent of the fraud or gotten the recoveries

listed above. And were it not for the team at Otterbourg led by Richard Haddad and Jon Helfat, I believe we may have written off the entire debt. And, of course, as I have mentioned, it took the will and the commitment of the lending group to see this through to the very end. That may seem like a small thing, but, believe me, we had to rally the troops again and again with the message: bad guys ripped us off, we are going to get our money back and we are going to send them to jail so that anyone else contemplating this type of activity thinks twice. It was great work by all the teams engaged here and a great outcome considering how bad the situation was at the commencement of the case. 🇺🇸

Mark Fagnani is senior managing director, Clear Thinking Group, a boutique advisory firm focused on turnarounds and restructurings, process and performance improvement and creditors rights. He has more than 30 years of hands-on experience working with large bank groups, private equity sponsors, turnarounds, workouts and insolvencies. Over the course of his lending career, Fagnani has worked with companies in a multitude of industries including steel and aluminum, coal mining, transportation, plastic injection and blow molding, beverage distribution, retail, lighting, and generic pharmaceuticals.

Fagnani was formerly a managing director and the chief credit officer of Wachovia Capital Finance, a unit of

Wachovia Bank. After leaving Wachovia, he helped form HVB Capital, a subsidiary of Hudson Valley Bank, and subsequently spearheaded their sale to EverBank, resulting in EverBank Business Credit. More recently, Fagnani was recruited to help establish an asset-based lending business for Bank Leumi USA, serving as first senior vice president and group head of Leumi Business Credit.

Fagnani is a frequent lecturer and panelist. Most notably, he spoke on behalf of the World Bank and the Secured Finance Network in China, instructing over 250 bankers on asset-based lending.



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