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Counterterrorism: Conventional Tools for Unconventional Warfare 1
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This issue of the *United States Attorneys' Bulletin* is dedicated to all Department of Justice personnel serving in the Middle East. We are proud of you and thank each and every one of you for your dedication and commitment to our country.

Counterterrorism: Conventional Tools for Unconventional Warfare

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I. Introduction

Terrorists seek our annihilation. They conspire by any and all means to obliterate us. Their methods are insidious. They exploit our laws and freedoms which, when compared to their home countries, offer nearly unfettered movement throughout our society to plot and execute their attacks. Consequently, they see our laws and freedoms as avenues by which to achieve their means.

The purpose of this issue of the *United States Attorneys' Bulletin* is to demonstrate how civil laws can be employed via forensic accounting tactics as new weapons in the counterterrorism arsenal. Paraphrasing the FBI's dictum, the United States should use any and all means to "[d]elay, disrupt or dismantle terrorist activities."

A. Stop the money—stop the terrorists

Terrorists cannot function without money. Consequently, disrupting the flow of money disrupts terrorists' activities, and is a very effective law enforcement strategy. However, interrupting the money flow is more complex than it would seem.

There are several federal criminal statutes, such as the USA PATRIOT Act, Pub. L. No. 107-56, Stat. 272 (2001), that are designed to disrupt

the flow of terrorist money. The USA PATRIOT Act made major changes to the currency reporting laws and the money laundering laws. In addition, the Bank Secrecy Act, 31 U.S.C. §§ 5311-5330, requires many organizations to file Suspicious Activity Reports (SARS) in the event evidence of suspicious transactions is uncovered. The Bank Secrecy Act also requires the filing of Currency Transaction Reports (CTRs) to create a paper trail for large currency transactions.

In an effort to evade detection, terrorists can, and often do, operate on a "shoestring." A prime example is the October 2000 bombing of the U.S.S. Cole. The bombing killed seventeen and wounded thirty-nine U.S. Navy personnel, and nearly sank a \$924 million warship. By one estimate, the total cost to terrorists was less than \$20,000. The Cole was procured in FY 1991 at a cost of about \$789 million. This is equivalent to about \$924 million in FY 2001 dollars. Congressional Research Service, The Library of Congress, *Terrorist Attack on USS Cole: Background and Issues for Congress*, Order Code RS20721, Updated January 30, 2001.

Complicating matters, legitimate, quasi-legitimate, and fraudulent businesses and business fronts can obscure funds flow so that detection becomes extremely difficult. For example, international waste paper-brokers routinely wire substantial sums worldwide in their industry. Conversely, retail store fronts, such as restaurants, deal in small individual sums that are large in their aggregate. However, proving that the entities were operated as the instrumentalities of a target operator (terrorist suspect), or determining that the transactions were not executed at reasonably equivalent value, could demonstrate alter ego and/or fraudulent transfers. This would result in a disruption of money flow and/or asset access.

Disrupting money flow must comply with federal, state, and local laws, otherwise the terrorists win. However, not only criminal statutes can be employed. Civil laws and related forensic accounting tools can be employed, which adds to our prosecutorial arsenal.

B. Civil tools used by federal law enforcement

Federal law enforcement has employed civil tools since the early 1900s. In the 1930s the U.S. Treasury Department (Treasury) used a cutting-edge forensic accounting tool to defeat America's quasi-terrorist threat—organized crime.

The specific forensic accounting tool used by federal law enforcement was, and still is, known as the net worth method. It was used to help convict Alphonse (Al) Capone in *Capone v. United States*, 51 F.2d 609 (7th Cir. 1931). Using this technique, authorities compared his reported income with his evident income and proved that he had failed to accurately report his financial condition to the Internal Revenue Service (IRS).

Recent nationwide developments indicate that various federal agencies are pursuing civil tools such as alter ego. For example, the three-member Occupational Safety and Health Review Commission, which hears appeals from administrative law judges' decisions, will soon decide whether Occupational Safety and Health Administration (OSHA) regulators should be allowed to pierce the corporate veil and pursue the individuals running companies to hold them, or successor alter ego companies, responsible for fines and other enforcement actions. Cindy Skrzycki, *Panel Weighs Letting OSHA Pierce the Corporate Veil*, WASHINGTON POST Mar. 23, 2004, at E.1. Also, the IRS has routinely disregarded corporate entities in its pursuit of tax evaders in estate and gift matters. *See Strangi v. Commissioner*, 115 T.C. 478, 487 (2000); *Hackl v. Commissioner*, 118 T.C. 1 (2002). A U.S. District Court in *Baum Hydraulics Corp. v. United States*, 280 F. Supp 2d 910 (D. Neb. 2003), upheld an IRS lien against a corporate alter

ego, citing 26 U.S.C. § 6321. Additionally, *United States v. Reading Co.*, 253 U.S. 26 (1920), is an early example of how federal authorities pursued misuse of the corporate form (alter ego) in a restraint of interstate commerce case. As recently as July 2003 the use of alter ego has been discussed in connection with combating terrorist financing. *See* Jeff Breinholt, *Terrorist Financing*, 51 *United States Attorneys' Bulletin* 4 (July 2003).

Finally, certain statutes make corporate participants personally liable for actions they take or fail to take on behalf of the corporation. *See* Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. §§ 9601-9675 (1988). This Act imposes liabilities on certain owners or operators of polluting facilities, thus piercing the corporate veil.

II. The civil statutes as counterterrorism weapons

The modern-day civil statutory weapons used in forensic accounting consist of the legal doctrine of alter ego, fraudulent transfer, and solvency analysis. These three techniques are discussed in detail below.

A. Alter ego

The doctrine of alter ego is applied through various descriptors including.

- Corporate disregard.
- Disregarding the corporate entity.
- Disregarding its separate corporate existence.
- Ignoring the (corporate) fiction.
- Piercing the corporate veil.

Alter ego in Latin means "second self." BLACK'S LAW DICTIONARY, 77 (6th ed. 1990). In applying the legal doctrine of alter ego, one strives to persuade the court to remove an entity's corporate veil, or intended protection, to expose the owners to judgment. Such action provides

access to owners who would otherwise be protected by the entity structure.

Alter ego is commonly employed in combination with a wide range of civil matters, (antitrust, breach of fiduciary duty, fraudulent conveyance/transfer, lost profits, misrepresentation, patent infringement, and others) that seek damages from parties otherwise protected by, or even disassociated with, an entity(ies). A critical component necessary for the court to invoke alter ego consists of control over an entity.

Alter ego is also commonly employed in criminal matters. Robert B. Thompson's 1991 alter ego study found that nearly 67% of criminal cases successfully pierced the corporate veil, which was intended to shield the acts of the shareholders. Thompson maintains that "piercing the corporate veil is the most litigated issue in corporate law." Robert B. Thompson *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L.J. 1036, 1036 (July 1991).

B. Fraudulent transfer or conveyance

The civil tool known as fraudulent transfer or fraudulent conveyance derives from common law and the Bankruptcy Code, 11 U.S.C. § 548. It is typically employed in connection with debtor/creditor relationships where an asset and/or liability has been transferred for less than reasonably equivalent value within one year of the filing of the bankruptcy petition, with the intent of defeating a creditor's rights.

The common law provisions typically originated from the Uniform Fraudulent Conveyances Act (UFCA) or Uniform Fraudulent Transfer Act (UFTA) and include measurements of badges of fraud that can be employed directly or indirectly. Thus, assets can be recovered and transfers voided when they constitute actual or constructive fraud.

Fraudulent transfer/conveyance is pursued in the same way among federal and state jurisdictions and can be used in combination with

a wide array of other matters, including alter ego, solvency, merger, and acquisition.

C. Solvency

The concept of solvency (and insolvency) is generally familiar to most Americans. However, the definition of solvency is problematic in adjudication. Typically, courts require an opinion regarding the solvency (or the lack thereof) of an entity or transaction at a particular point(s) in time. In such cases, solvency is nearly universally defined as "a company's ability to meet the interest costs and repayment schedules associated with its long-term debt obligations." ROBERT N. ANTHONY, *MANAGEMENT ACCOUNTING: TEXT AND CASES* 301 (Richard D. Irwin ed., McGraw-Hill 1964).

Solvency analysis utilizes three tests. These are the balance sheet test, the cash flow test, and the adequate (reasonable) capital test. Each of them is set forth in detail in section IX of this article

D. Forensic accounting techniques

The selected forensic accounting techniques described above reflect only a fraction of the tools available to forensic accountants. Nevertheless, they illustrate the breadth and depth of tactics available to federal law enforcement. Selected forensic accounting techniques are defined below, and a few highly pertinent techniques are highlighted.

Benford's law is the statistical technique for the objective analysis of numerical data sets. The result of a Benford's law analysis can indicate when a significant portion of a numeric data set contains artificial or contrived numbers, which pinpoints potentially fraudulent transactions. The artificial or contrived numbers are evidenced by the vast numbers of nonrandom, duplicative, and rounded entries. Benford's law states that digits and digit sequences in a legitimately prepared data set follow a predictable pattern, i.e. a geometric sequence. Therefore, each digit and digit

combination can be used as a statistical benchmark for the prepared data. The technique applies a data-analysis method that identifies possible errors, potential fraud, or other irregularities. Benford's law is such a potent forensic/investigatory tool that it is separately addressed.

Expectations-based statement analysis consists of analyzing the language patterns used by a subject during interviews to assess his truthfulness. The FBI teaches its special agents that specificity can indicate veracity. That is, the statement, "I heard a shot and saw him standing over the body," is less specific than, "I saw him point the gun at the victim, I heard the shot, saw the recoil, saw the victim clutch his chest and fall." All other things being equal, the second statement is more likely the truth.

A genogram is a diagram of the information gathered during background research, interviews, interrogation, and surveillance. It is often prepared in conjunction with other output such as events analysis. A genogram represents relationships among target subjects and reflects personal connections among other subjects. The genogram maps out relationships and traits that may otherwise be missed.

Proxemics, according to its founder, Edward T. Hall, is the study of humankind's "perception and use of space." It has parallels to kinetic and paralinguistic communications. Proxemics can be considered the forerunner of body language. EDWARD T. HALL, *THE SILENT LANGUAGE* 83 (Anchor Books 1990).

A time-line analysis is a powerful tool for demonstrating causal elements of activity-based evidence, and also assists in validating parties' claims.

E. Synergy of the civil statutory weapons

The civil statutory weapons of alter ego, fraudulent transfer, and solvency exhibit unique characteristics that permit them to be used individually and/or in combination in a wide variety of matters. The forensic accounting techniques discussed above support them individually or in combination. Consequently, these weapons offer a synergistic approach that can be modified to the respective target scenario at hand.

The respective techniques can apply beyond the areas of law for which they were originally enacted. For example, solvency tests can be used in nonsolvency cases such as financial analysis in shareholder dissension suits. Fraudulent transfer can be used to analyze mergers and acquisitions.

III. Why use civil laws in addition to criminal laws?

A. Civil laws supplement criminal law

Employment of civil statutory weapons against terrorists supplements, but does not supplant, federal criminal statutes. Forensic accounting techniques are force-multiplier tools. Specifically, low-level terrorist threats can be thwarted with civil tools. This allows scarce law enforcement resources to concentrate on the higher-level, higher-payback terrorist targets. In addition, the civil evidence gathering process can be less labor and resource-intensive than criminal processes and readily-available public information can be accessed and applied in civil processes. Further, the stringent chain of custody of evidence requirements do not apply in civil matters.

Criminal prosecution can require years to achieve. Civil matters often progress more rapidly based upon evidentiary considerations and related attributes. Further, civil objectives can sometimes be achieved through summary judgments and injunctions, thus accelerating the outcome significantly.

B. Levels of proof for criminal and civil laws

Another advantage to using civil laws is that the standard of proof for civil matters is less rigorous than the criminal standard, i.e. beyond a reasonable doubt. Nevertheless, both criminal and civil levels of proof comprise a continuum of progressively more stringent requirements.

For criminal matters, such continuum is ordinarily presented as no significant proof, reasonable basis, probable cause, preponderance of evidence, prima facie case, proof beyond a reasonable doubt, and absolute proof of guilt. HAZEL B. KERPER, *INTRODUCTION TO THE CRIMINAL JUSTICE SYSTEM* 207 (2d. ed. 1972). Their respective measures are presented below.

- No significant proof implies complete doubt or suspicion or a lack of factual support.
- Reasonable basis is belief that there is a significant possibility that the individual has committed or is about to commit a crime.
- Probable cause is belief that there is a substantial likelihood that the individual committed a crime.
- Preponderance of evidence is belief, based on all the evidence presented, that it is more likely than not that the individual committed a crime.
- Prima facie is belief, based on prosecution evidence only, that the individual is so clearly guilty as to eliminate any reasonable doubt.
- Beyond a reasonable doubt in evidence means fully satisfied, entirely convinced, or satisfied to a moral certainty. The phrase is the equivalent of the words clear, precise, and indubitable.
- Absolute proof of guilt is belief so certain that a defendant is guilty as to eliminate even reasonable doubts.

For civil matters, the continuum is preponderance of the evidence and clear and convincing evidence.

Preponderance of the evidence is evidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; that is, evidence which as a whole shows that the fact sought to be proved is more probable than not. . . . That amount of evidence necessary for the plaintiff to win in a civil case. It is that degree of proof which is more probable than not.

BLACK'S LAW DICTIONARY 1182 (6th ed. 1990).

Preponderance is determined by more convincing evidence and its probable truth or accuracy, rather than the amount of evidence. Thus, a clearly knowledgeable witness could provide the preponderance of evidence over many other witnesses delivering weak testimony. Likewise, a signed agreement could carry more weight than testimony regarding the parties' intentions.

Clear and convincing proof results in reasonable certainty of the truth of the ultimate fact in controversy. It is proof which requires more than a preponderance of the evidence but less than proof beyond a reasonable doubt. Clear and convincing proof will be shown where the truth of the facts asserted is highly probable. HAZEL B. KERPER, *INTRODUCTION TO THE CRIMINAL JUSTICE SYSTEM* 251 (2d. ed. 1972).

Civil standards such as preponderance of the evidence and clear and convincing proof are less onerous than the criminal standard of beyond a reasonable doubt. With less rigorous evidence and proof standards, third parties can be even more effectively employed as consultants, contractors, and witnesses in civil matters.

IV. Discussion of alter ego

Alter ego, fraudulent transfer, and solvency are discussed in this article by profiling the respective technical and legal guidance. Each topic is supported by actual exhibits successfully

employed in civil cases. Although the exhibits and related materials are matters of public record, they were altered so that the parties are unrecognizable.

The alter ego doctrine is addressed most extensively because.

- The doctrine holds the highest promise of directly linking and interrupting terror suspects.
- Alter ego is highly conceptual in nature and has the greatest overall potential for wide application in concert with other elements, both civil and criminal.
- The current technical literature covering alter ego is less comprehensive than either fraudulent transfer or solvency.
- Several comprehensive fraudulent transfer internet sources already exist, including: www.assetprotectiontheory.com, www.fraudulenttransfers.com, and <http://www.irs.gov/irm/part5/ch16s18.html>.
- Several solvency resources already exist, including: www.insolvency.com, <http://www.prenhall.com/divisions/bp/app/cfl/demo/RA/LiquidityRatios.html>, and http://www.toolkit.cch.com/text/P06_7300.asp.

These materials add to the AUSAs' counterterrorism arsenal.

Alter ego statutes and precedents vary widely by jurisdiction. However, alter ego claims are ordinarily determined by evaluating the indicators, or indicia, of alter ego. That is, where the preponderance of evidence supports the indicia, then alter ego can be granted by the court. Conversely, absence of sufficient indicia can persuade the court to leave the corporate structure intact. Note that selected portions of this alter ego discussion have been adapted, with permission, from Darrell D. Dorrell & Christine A. Kosydar, *Alter Ego Diagnosis to Find Potentially Hidden Assets in Divorce Cases*, 18 AM. J. FAM. L. 7 (2004).

A. Determination of alter ego

In the traditional sense, alter ego is determined by evaluating a parent and subsidiary company's relationship to determine whether the parent (i.e., through the controlling party) met the following three crucial conditions with respect to a complainant.

- The parent exercised control and authority to the extent that the subsidiary was a mere instrumentality of the parent.
- The parent committed a fraud or wrong with respect to the complainant.
- The complainant suffered an injury as a result of the fraud or wrong (causation).

Note that all three conditions must be met for the court to invoke alter ego.

A parent company is defined as a "company owning more than 50% of the voting shares, or otherwise a controlling interest, of another company, called the subsidiary." BLACK'S LAW DICTIONARY 1114 (6th ed. 1990). Subsidiary is defined as "[u]nder another's control. Term is often short for 'subsidiary corporation; i.e. one that is run and owned by another company which is called the parent.'" *Id.* at 1428. A holding company is defined as "[a] company that usually confines its activities to owning stock in, and supervising management of, other companies." *Id.* at 731.

The classic alter ego matter is based on the traditional parent-child corporate structure where a parent or holding company owns a controlling interest in a subsidiary entity. However, other relationships may exhibit alter ego characteristics, including sister corporations and brother-sister corporate structures. Finally, multiple parent-subsidiary-brother-sister corporate structures, and tiered parent-subsidiary-brother-sister corporate structures may exhibit alter ego characteristics. Sister corporation is defined as "[t]wo corporations having common or substantially common ownership by same shareholders. [*Battelstein Inv. Co. v. United States*, 302 F. Supp. 320, 322 (S.D. Tex. 1969)]." *Id.* at 1387. Brother-sister corporation is defined

as "[m]ore than one corporation owned by the same shareholders." *Id.* at 194.

B. Improper purpose

Use of the corporate entity for an improper purpose is at the heart of corporate veil cases. The types of situations in which such improper activities arise are classified under five headings, but the most pertinent activity is the violation of public policy, including evasion of statutes.

The origin of the corporate veil doctrine arose as a result of violations or evasions of some statute or other strong public policy through the instrumentality of a subservient corporation. *See* H. BALLANTINE, CORPORATIONS § 122 (rev. ed. 1946); HARRY G. HENN, LAW OF CORPORATIONS § 252 (2d ed. 1970); FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS § 1 (1931). *United States v. Reading Co.*, 253 U.S. 26 (1920), is an early example of the misuse of the corporate form and demonstrates that the doctrine has long been wielded as a weapon by federal authorities.

The general rule cited by these authorities is usually cast in the words of Judge Sanborn in *United States v. Milwaukee Refrigerator Transit*, 142 F. 247, 255 (E.D. Wis. 1905).

If any general rule can be laid down in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.

C. Beneficial interest

Stock ownership, however, is not an absolute requirement for piercing the veil. A more precise requirement is that the dominant party must have some beneficial interest in the subservient corporation. In *Soderberg Advertising v. Kent-Moore Corp.*, 524 P.2d 1355 (Wash. Ct.

App. 1974), the defendant had an option to acquire the subservient corporation, but no actual stock ownership. Pursuant to contractual agreements, however, the optionee had effective control over the subservient corporation and a beneficial interest because of his right to purchase the company. In connection with other factors, it was found that the dominant party was, in fact, liable for certain actions taken through the instrumentality of the subservient corporation.

The doctrine can apply if the interest held is either control or minority interest in a subsidiary entity. Alter ego characteristics are also encountered between nonrelated entities lacking any indication of formal corporate relationships. For example, a shareholder held separate controlling interests in corporation A and unrelated corporation B. Corporation A held a few subsidiaries, and unrelated corporation B held several multiple-tiered subsidiaries, some of which were inactive.

On paper, the two parent corporations appear separate and distinct and the only obvious relationship is the common controlling shareholder. Nonetheless, the group of companies exhibited many alter ego characteristics. Significant asset conveyances were conducted between and among the corporation's subsidiaries without fair market value consideration, and product marketing and labeling contained a confusing and inconsistent use of corporate names. The product names were portrayed to customers without identification of corporate ownership. Further, legal and financial justification was obtained after the fact for certain event-specific transactions. Finally, receipts and disbursements were transacted through the subsidiary providing the most benefit to the parent.

Exhibit 1 was constructed in a civil matter where the plaintiff sought to pierce several of the defendant's corporate veils in order to recover payment pursuant to a triggered contingent lease liability. The Target Subject Group was a large, closely-held multistate group of companies with a long history of acquiring smaller companies to

enlarge its business. Target gained control of Acquired Subject & Sons, Inc. in its usual manner, noting that there was a contingent lease liability attached to the entity. The acquisition agreement attempted to indemnify the target from the contingent liability, but it did not provide sufficient protection.

The Target Subject Group acquired the smaller company for \$21 million (cash, stock, and debt) in the year 2000 and duly recorded the transaction in various records, (corporate purchase agreement, general ledger, audited financial statements, and income tax returns). In late 2001, however, the acquired company's \$24 million contingent lease liability was triggered (post-acquisition). Consequently, the Target Subject Group attempted to rerecord the transaction at a near-zero value, advising the creditor that they could have the stock now worth \$700,000, instead of the original acquisition price.

The rerecording of the initial acquisition transaction was quite complex and involved competent attorneys and accountants who provided technical advice. The advisors recommended a framework that required the transfer of operating assets (without contingent liabilities) and the revaluation of a new class of stock. *See* Exhibit 1 (Target Subject Group).

The plaintiff was faced with two significant challenges. First, if he began his challenge at the lowest level in the organization chart, Acquired Subject & Sons, Inc. (at the lower right-hand corner of Exhibit 1), he might be compelled to pierce the veils of several companies at successively higher levels. The second, and greater challenge, was almost insurmountable. The ownership was common among one shareholder, but separate and distinct between the two groups of companies as indicated by the dotted-line borders on the left-hand and right-hand side of Exhibit 1. Therefore, the plaintiff sought to pierce the veil directly, via a one-shot-one-kill technique whereby the Acquired Subject & Sons, Inc. entity could be directly linked to the controlling shareholder. This is illustrated by the bold, double-arrowed line connecting "Owner"

(shaded, in the upper left-hand corner of Exhibit 1) to Acquired Subject & Sons, Inc. (shaded, in the lower right-hand corner of Exhibit 1).

Exhibit 1 is the corporate organization chart illustrating the entire group of entities comprising the defendant's companies. The chart indicates that twenty-one companies were contained within the overall target group, but some entities were not delineated for the sake of clarity (lower left-hand corner under the heading, "Entities Unaccounted For"). The composition of Exhibit 1 is best reviewed from the left-right, top-down perspective as described below.

Beginning in the upper left-hand corner, the first item of information, containing the column headings of "Shares" and "%," identifies for each shareholder their respective ownership amounts and percentages for the left-hand dotted line group of companies. Specifically, the "Owner" (name withheld) holds 1,178,628 shares representing 65.5% of the group of companies contained within the left-hand dotted line group of companies. Also, the same party holds 58,668 units representing 3.3% of the outstanding units of the group of companies contained within the right-hand dotted line group of companies.

The left-hand dotted-line group of companies is comprised of the "Target Subject Company" (bold font) and its wholly-owned affiliates, "Shell Acquisitions, Inc." and "Transport Shell, Inc." Note that there are no ownership connections of any sort to the right-hand dotted-line group of companies.

The right-hand dotted-line group of companies is comprised of the "Target Subject of Washington, LLC" (bold font) and its wholly-owned, partially-owned, and affiliate-owned affiliates. Note that "Target Subject of Washington, LLC" owns 100% of the "Target Subject of CITY #2, LLC." That entity in turn owns 100% of "Target Subject of CITY #3, LLC" and also owns 100% of "Target Subject of City #4, LLC." The names of the respective cities are withheld for confidentiality since the matter deals with territorial franchises.

Note also within the right-hand dotted-line group of companies that "Target Subject of Washington, LLC" (bold font) owns 78.99% of "Target Subject of CITY #1, LLC," (bold font). Target Subject of CITY #1, LLC is in turn partially owned (19.748%) by "Acquired Subject #1, LLC" and 1.262% of "Acquired Subject & Sons, Inc." respectively. Note that there are no ownership connections of any sort to the left-hand dotted line group of companies.

The litigation was triggered by post-acquisition transactions involving "Acquired Subject & Sons, Inc." The "Legend" at the middle-left portion of Exhibit 1 shows a dotted line box for "Acquired Subject & Sons, Inc." indicating that it was an "Inactive Company."

The challenge of persuading the court to invoke alter ego lay in the utter disconnectedness of the two groups of companies. That is, the groups of companies reflected by the left-hand and right-hand dotted line rectangles had no legal connection. By design of the plaintiff, and upon advice of counsel, they were structured to appear separate and distinct.

The bold, double-arrowed line connecting the upper left-hand shaded "Owner" cell with the lower right-hand shaded "Acquired Subject & Sons, Inc." cell demonstrates how alter ego was used to connect the seemingly disparate groups of companies. It was determined that if alter ego attributes could be shown, then the attempted separation of all the entities would be disregarded by the court, and the plaintiff would receive his desired award. The tactic was effective since the defendant realized that connecting his actions to the right-hand group of companies through alter ego would expose his entire corporate empire to liability.

V. Alter ego literature

A. Frederick J. Powell

FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931), is a landmark text that established guidelines for assessing the

instrumentality rule and the eleven circumstances that may be indicative of alter ego. Mr. Powell's 1931 work must be read in its entirety to reap the full appreciation of his guidance. In particular, he is credited with establishing the Instrumentality Rule. Salient elements crystallize his viewpoint as indicated below.

Section 5. The Instrumentality Rule.

The Instrumentality Rule, in its shortest form, may now be stated:

So far as the question of control alone is concerned, the parent corporation will be responsible for the obligations of its subsidiary when its control has been exercised to such a degree that the subsidiary has become its mere instrumentality.

Id. at 8-9.

The Instrumentality Rule is recognized in all jurisdictions in this country and our problem therefore is to determine the circumstances which render the subsidiary an "instrumentality" within the meaning of the decisions. This is primarily a question of fact and of degree.

Section 6. The circumstances rendering the subsidiary an instrumentality.

It is manifestly impossible to catalogue the infinite variations of fact that can arise but there are certain common circumstances which are important and which, if present in the proper combination, are controlling. These are as follows:

1. The parent corporation owns all or most of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.

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5. The subsidiary has grossly inadequate capital.
 6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
 7. The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
 8. In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.
 9. The parent corporation uses the property of the subsidiary as its own.
 10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.
 11. The formal legal requirements of the subsidiary are not observed.

Id.

Powell explained his rationale for each of the preceding circumstances as indicated below.

- (a) The parent corporation owns all or most of the capital stock of the subsidiary.

It is familiar law in all jurisdictions in this country that ownership of stock alone will not render the parent corporation liable. This is but a statement of the fundamental rule that stockholders are not liable for the corporate obligations. The result is the same whether the parent company owns all the stock, or all except directors' qualifying shares or a small amount in outside hands. The immunity, of course, extends to the normal exercise of a stockholder's rights, such as the election of directors, changes in the capital stock structure and the approval of the usual activities of the Board of Directors on behalf

of the Corporation. This element of stock ownership is present in practically all the parent and subsidiary cases, and in the absence of unique circumstances (as where dominance is achieved through written contract or express agency), control by stock ownership is essential to the application of the Instrumentality Rule.

- (b) The parent and subsidiary corporations have common directors or officers.

It is also clear that the parent corporation does not lose its immunity as a stockholder simply by furnishing from its own personnel the directors and principal officers of the subsidiary. In the case of principal subsidiaries this is the usual practice. The officers of the two corporations are often the same in large part and at least a majority of the subsidiary's directors are usually directors of the parent corporation. This common personnel, however, is an important factor in the application of the Instrumentality Rule and in nearly all the cases in which the parent corporation has been held liable, we find this element or else dummy or subservient directors or executives of the subsidiary.

- (c) The parent corporation finances the subsidiary.

The parent corporation is the natural source of the subsidiary's credit, and generally it is the most efficient source, for normally it has superior resources and can capitalize the increment in value due to the combination and co-ordination of several subsidiaries under a common supervisory management. Accordingly, the fact alone that the parent corporation finances the subsidiary will not subject the parent corporation to liability, although stock ownership and common personnel are also present. But this element of financing is important.

Thus far we find the law squaring with conventional business practice but we approach the danger line when we introduce additional elements showing a further exercise

of control by the parent corporation. One or more of these additional elements is present in nearly all the cases in which judgment has been rendered against the parent corporation. As already indicated, a hard and fast rule cannot be laid down but, as a rough guide, it may be stated, generally, that proof of the following additional elements (sometimes one and often two) will be sufficient to hold the parent corporation. Some, of course, are more important than others.

(d) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.

If the ownership of all the capital stock of a subsidiary and the normal exercise of the rights incident to that ownership do not destroy the immunity of the parent corporation, the acquisition of an existing corporation by purchase of its capital stock is of course equally harmless. And there is no reason why the parent corporation should not accomplish the same purpose—and with the same results—by itself causing the incorporation of the subsidiary in the first instance. Except in the case of railroads and public utilities, this is probably the commonest method by which a system of parent and subsidiary corporations is built up.

If, therefore, the degree of control exercised by the parent corporation is not sufficient to constitute the subsidiary a mere instrumentality, the further fact that the parent corporation caused the subsidiary to be organized will not force the case over the line. But in weighing all the circumstances in a given case, it is an evidential fact of value, particularly when it can be shown that the corporation was organized for a special purpose such as the creation of a new or enlarged department.

Sometimes (particularly in the so-called one-man corporation cases), the courts point out that the purpose of organizing or maintaining the subsidiary was to secure the

profits if it succeeded and to avoid the losses if it failed. This though must be applied with caution for of course this is a principal object of most incorporations and, by itself, is a lawful purpose. When a claim is based on the organization of the subsidiary as a step in an alleged scheme to defraud creditors [see § 13(a)], a finding of this special purpose is often vital.

(e) The subsidiary has grossly inadequate capital.

Manifestly, the fact that the subsidiary's capital is wholly disproportionate to the amount of the business that it actually conducts, is strong proof that it is a mere dummy or arm of the parent corporation. In the well known Luckenbach Steamship case, two corporations were controlled by a common stockholder. One of them turned over steamers worth hundreds of thousands of dollars to the other which had a capital of only ten thousand dollars and which operated them under leases at a rental based on far below their real value. "Putting aside an inquiry into the motive for this arrangement" the Court found it would be "unconscionable to allow the owner" to escape liability by turning them over" to a \$10,000 corporation, which is simply itself in another form."

This does not impugn the principle that the parent corporation may finance the subsidiary without subjecting itself to liability. That the parent corporation should be the principal or sole source of the subsidiary's credit from time to time, is one thing. But that it should launch the subsidiary in business without furnishing the appropriate funds or obligating itself to do so, is quite another. If the subsidiary is financially helpless and, through the fault of the parent corporation can call on the parent corporation for capital funds only when and if the parent corporation pleases to grant them, it is cogent evidence that the subsidiary is a mere tool in the hands of the parent.

It does not follow that a parent corporation may not organize a subsidiary, permit it to build up a business and then may not refuse in whole or in part to act as the subsidiary's banker. If there are no other circumstances on which to ground an application of the Instrumentality Rule, the mere fact that the parent has not furnished the subsidiary with adequate capital will not bring the Rule into play. In other words, this element of inadequate capital is merely persuasive but not controlling. The question of estoppel in these cases is discussed in § 13(e).

(f) The parent corporation pays the salaries and other expenses or losses of the subsidiary.

This reference is not to the case in which the parent corporation ultimately finances the expenses or losses of the subsidiary. The general right to finance is, as we have seen, clear. But where the subsidiary has no funds or means to meet its payroll or other current expenses, or its trade losses as they occur, and the parent corporation from its own treasury directly and regularly pays these bills as if the employees and business were its own, a strong case against the parent corporation is made out.

(g) The subsidiary has substantially no business except with the parent corporation, or no assets except those conveyed to it by the parent corporation.

These facts tend to show a position of subordination on the part of the subsidiary and lend color to the claim that it is not conducted as a separate corporation but just as if it were a mere department of the parent corporation. Here again a distinction must be made. A corporation which manufactures automobiles may have a wholly owned subsidiary that does nothing but supply it with batteries. If all the separate legal requirements of the subsidiary as a distinct corporation are observed, the parent corporation does not become subject to the obligations of the subsidiary, even though the latter, as a

practical matter, is a department or division of the parent corporation. This "department" or "division" formula, enunciated in some of the cases as the test of the parent corporation's liability, should therefore not be regarded as an absolute equivalent of the Instrumentality Rule but rather as a concrete description or partial summary of certain circumstances properly entering into the application of the Rule.

(h) In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.

Proof to this effect has a double function. It may create a so-called estoppel, and under the "department" or "division" formula it is also probative of the fact of subordination. The former question is discussed later in § 13 (e); the latter, in the preceding subdivision.

(i) The parent corporation uses the property of the subsidiary as its own.

This reference is to cases in which the parent corporation helps itself to the cash and other property of the subsidiary as if it owned them directly. Direct appropriation by the parent corporation of the subsidiary's profits without any declaration of dividends by the latter's directorate, is an illustration. This is almost always fatal proof against the parent corporation.

(j) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the latter's interest.

The Instrumentality Rule cannot be circumvented by equipping the subsidiary with directors or officers who are ostensibly, but not actually, independent of the parent corporation. If, in fact, they took their orders from the parent corporation or someone who

controlled it, and acted in the interest of the parent corporation rather than the subsidiary, the record names and formal set-up will not avail. The result is the same where the same persons are directors of both corporations, but act in the interest of the parent corporation.

Direct proof of this affirmative subserviency of the subsidiary's officers is conclusive of the case against the parent corporation, insofar as the Instrumentality Rule is concerned. But such direct proof is not forthcoming. Usually this subserviency is an ultimate fact to be deduced from all the facts of the case and the other elements previously discussed indicate the circumstances which often are available for this purpose.

(k) The formal legal requirements of the subsidiary are not observed.

The observance of the technical formalities legally incident to the operation of the subsidiary as a separate corporation is very helpful in avoiding the Instrumentality Rule. Thus, proof that meetings of the subsidiary's stockholders and directors were held, that minutes were properly kept, that the subsidiary made its separate statutory reports, maintained its own books of account, had its own bank account and paid its own bills, is strong evidence against the parent corporation's liability. But the observance of these formalities is all of no avail when the proof as a whole shows that in the actual conduct of the business the parent corporation completely dominated the subsidiary and used it as a mere creature. Payment of rent by the subsidiary to the parent corporation, the use of separate letter or bill-heads, the existence of formal contracts between them, etc., are all futile when they are essentially nothing but sham or paper transactions.

Id. at 10-19.

Finally, nearly all references to Powell overlook the following clarification found later in his book when he pulls together his commentary in application to an alter ego case:

Section 26. Complainant's case.

Except in cases of express agency of the subsidiary, or the actual commission of a tort by the parent corporation, either alone or jointly with the subsidiary, there are three essential elements in the complainant's cause of action against the parent corporation. He must prove first, that the parent corporation has exercised its control over the subsidiary, not in the manner normal and usual with stockholders, but to such a degree that it has reduced the subsidiary to a mere instrumentality; second, that this control has been exercised in such a way as to constitute fraud, wrong or injustice with respect to the complainant; and third, that (except in cases of so-called estoppel) a refusal to disregard the separate corporate entity of the subsidiary would result in unjust loss or injury to the complainant.

Taking up these three elements in order:

First Element: Defendant's control.

The following constitute the exercise of normal and usual control over the subsidiary:

- (a) Causing the subsidiary to be organized;
- (b) Acquiring and holding all its capital stock;
- (c) Exercising the usual voting rights of stockholders, including the election of directors, ratification of the acts of directors and officers, changes in capital stock structure, etc.;
- (d) Furnishing the subsidiary with the same directors and officers that the parent corporation has;
- (e) Financing the subsidiary.

The following constitute the exercise of abnormal control and reduce the subsidiary to a mere instrumentality:

- (a) Disregarding the formal legal requirements of the subsidiary as a separate corporation. Illustrations are: failing to hold meetings of its board of directors and stockholders or to keep

separate bank accounts, books and other business papers, or to distribute dividends by way of declaration, etc. But observance of these formal requirements will not avail if the subsidiary is run as a mere puppet or creature of the parent corporation.

(b) Operating the subsidiary in the interests of the parent corporation and not in the interests of the subsidiary; in other words, using the subsidiary as a mere branch or division without regard to its separate interests and rights. The usual evidence of this is the fact that the subsidiary is managed on the direct orders of the parent corporation's officers in their capacity of the representatives of the parent corporation, or that the parent corporation directly handles the property of the subsidiary as if it were its own.

Persuasive evidence that the subsidiary is a mere instrumentality are the facts that it has no business except with the parent corporation or no assets except those conveyed to it by the parent corporation; that its capital is grossly disproportionate to the volume of its business; that the parent corporation pays its salaries or other expenses, or its losses; and that in the papers or statements of the parent company or its officers, the subsidiary is referred to as a mere department or division of the parent corporation, or its business of financial responsibility as the parent's own.

Id. at 103-04.

Section 28. Working chart of proper parent and subsidiary corporation management.

To keep the parent corporation immune from liability for the obligations of its subsidiary, two pitfalls must be avoided: first, a violation of the formal corporate requirements of the subsidiary, and second, a disregard of its separate business interests.

The subsidiary, if a new corporation, must, of course, be incorporated and organized in accordance with statute. The representatives of the parent corporation may be its

incorporators and subscribe to all its capital stock. After organization, periodic meetings of stockholders and directors should be held as required by statute and the by-laws. Minutes of these meetings should be permanently recorded in proper form.

A separate bank account, separate books of account and separate letter and bill heads should be kept, and all other paper work individual to the subsidiary's business, should be maintained separately.

The subsidiary should be furnished with a reasonable amount of capital. This may be done by the parent corporation and it is not essential that all the capital be supplied at the same time. Nor is it necessary that the parent corporation legally obligate itself to furnish any specific amount. But, on the other hand, the subsidiary should from time to time be furnished with an amount proportionate to its growing business and it should have a reasonable amount with which to begin business.

The subsidiary's receivables should, in the absence of good business reasons to the contrary, be collected and banked by it, not the parent corporation. Its expenses should be paid out of its own bank account unless they involve an apportionment of overhead expenses paid by the parent corporation in the first instance, but in that case the method of apportionment should be accurately and clearly agreed upon as a matter of record between the two corporations, and their respective books of account should precisely show the corresponding debits and credits. If care is constantly exercised, expenses chargeable only to the subsidiary and not involving any apportionment between it and the parent corporation or other subsidiaries can be paid in the first instance by the parent corporation and then charged to the subsidiary. In this practice, however, it is easy for things to drift into the position in which the parent corporation in the first instance is spending large sums for the account of the

subsidiary and later seeing that the proper corporate action is taken by the subsidiary to reimburse or credit it. This is dangerous meddling with the immunity of the parent corporation as stockholder of the subsidiary, and carelessness or neglect may often result in just such a condition creeping into a large organization, although everyone concerned is acting in entire good faith. When circumstances will permit, it is preferable to have the parent corporation advance the necessary moneys to the subsidiary (on open account or otherwise) and then have the subsidiary expend them from its own treasury, and in accordance with antecedent corporate authority on its part. Such advances should be based on proper corporate authorization, and accompanied by proper corporate records, on behalf of both corporations. The authorization may be general or confined to specific instances from time to time.

The profits of the subsidiary should be distributed to the parent corporation by way of dividends with the usual declaration on board resolution, and not informally appropriated by the parent corporation. And in all ways the parent corporation should never directly utilize assets of the subsidiary as if they were its own. The direct physical operation of the subsidiary must be through the subsidiary's own officers and through its own channels as a separate corporation, and not as a mere department of the parent corporation operated directly by the corporate organization of the parent corporation.

The second requirement that the business of the subsidiary must be run in its interest and not that of the parent corporation is not usually difficult to observe. It is safer to equip the subsidiary with the same personnel as that of the parent corporation than to use clerks or subordinates. Theoretically the latter's actions might be entirely for the benefit of the subsidiary and as judicious as those of an independent directorate - but a board of minor employees can hardly be independent, and

this set-up breeds suspicion and is a badge of undue subserviency that will prove very damaging to the parent corporation in any suit against it by the subsidiary's creditors.

The subsidiary's directors, whoever they are, must, of course, run the business in its own interest. They must not be improvident with its resources even though their action may, for extraneous reasons, benefit the parent corporation. But the relationship between the two corporations, their normal identity in business interest and the fact that the parent corporation is in a position to benefit the subsidiary in so many ways, gives the subsidiary's directors ample discretion to adjust its affairs to those of the parent corporation for all legitimate purposes and within all reasonable limits. In the ordinary run of business the interests of the parent and subsidiary are the same and no question should arise. If the time comes when the larger interests of the parent corporation conflict with the smaller interests of the subsidiary, the parent corporation should dissolve or merge the subsidiary and absorb its business or else dispose of the subsidiary and thus place it at arm's length.

The parent's executives should be most careful with respect to their written or oral representations regarding the relationship between the parent and the subsidiary. To say that the subsidiary is a subsidiary of the parent corporation or that the parent corporation owns all its capital stock or has financed it in the past, is unobjectionable. But to say that the parent corporation will finance the subsidiary in the future and that it will stand back of the subsidiary's obligations or that the situation is the same as if the customer or creditor were dealing with the parent corporation, is almost always fatal. And the common business practice of describing the subsidiary as a "division" or "department" of the parent corporation on letterheads, is dangerous, and in some jurisdictions would be sufficient to turn the scales against the parent

corporation. Consolidated financial statements, if properly entitled, are in order.

The preceding requirements square with all legitimate business requirements. They are but an observance of good corporate practice and by insisting on those requirements, the law imposes no undue burden on business, but merely demands that there shall be no abuse of the privilege to do business in corporate form. If these limitations are not in accord with the exigencies of the case, the business is not adaptable to management through the medium of parent and subsidiary corporations.

Id. at 108-11. See also *Beckley v. Third Avenue Railway*, 155 N.E. 58 (N.Y. 1926); H. Ballantine, *Parent and Subsidiary Corporations*, 14 CAL. L. REV. 34, 34 (1925); MAURICE I. WORMSER, THE DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS, (T. Morey & Son 1927); Cathy J. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENVER L.J. 1 (1978); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (July 1991).

B. The Krendls' 1978 study

The Krendls published a superb case summary entitled *Piercing the Corporate Veil: Focusing the Inquiry*, cited above, which contains a list of factors that should be used when "attempting to keep the corporate veil intact." The factors are supported by the pertinent cases in their article and are summarized below.

- The shareholder is not a party to the contractual or other obligations of the corporation.
- The subsidiary is not undercapitalized.
- The subsidiary does not operate at a deficit while the parent is showing a profit.
- The creditors of the companies are not misled as to the company with which they are dealing.
- Creditors are not misled as to the financial strength of the subsidiary.
- The employees of the parent and subsidiary are separate and the parent does not hire and fire employees of the subsidiary.
- The payroll of the subsidiary is paid by the subsidiary and the salary levels are set by the subsidiary.
- The labor relations of the two companies are handled separately and independently.
- The parent and subsidiary maintain separate offices and telephone numbers.
- Separate directors' meetings are conducted.
- The subsidiary maintains financial books and records which contain entries related to its own operations.
- The subsidiary has its own bank account.
- The earnings of the subsidiary are not reflected on the financial reports of the parent in determining the parent's income.
- The companies do not file joint income tax returns.
- The subsidiary negotiates its own loans or other financing.
- The subsidiary does not borrow money from the parent.
- Loans and other financial transactions between the parent and subsidiary are properly documented and conducted on an arm's-length basis.
- The parent does not guarantee the loans of the subsidiary or secure any loan with assets of the parent.
- The subsidiary's income represents a small percentage of the total income of the parent.

- The insurance of the two companies is maintained separately and each pays its own premiums.
- The purchasing activities of the two corporations are handled separately.
- The two companies avoid advertising as a joint activity or other public relations which indicate that they are the same organization.
- The parent and subsidiary avoid referring to each other as one family, organization, or as divisions of one another.
- The equipment and other goods of the parent and subsidiary are separate.
- The two companies do not exchange assets or liabilities.
- There are no contracts between the parent and subsidiary with respect to purchasing goods and services from each other.
- The subsidiary and parent do not deal exclusively with each other.
- The parent does not review the subsidiary's contracts, bids, or other financial activities in greater detail than would be normal for a shareholder who is merely interested in the profitability of the business.
- The parent does not supervise the manner in which the subsidiary's jobs are carried out.
- The parent does not have a substantial veto power over important business decisions of the subsidiary and does not itself make such crucial decisions.
- The parent and subsidiary are engaged in different lines of business.

Cathy J. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENVER L.J. 1 (1978).

C. Thompson's 1991 study

Robert B. Thompson's study, *Piercing the Corporate Veil: An Empirical Study*, shows how alter ego was used by various courts to pierce the corporate veil. His study comprised 1,583 cases of alter ego, and found that certain factors tended to be associated with the courts' decisions to invoke alter ego and thus pierce the veil. The factors include.

- The subsidiary is an "instrumentality" of the parent.
- The subsidiary is the alter ego of the parent.
- The subsidiary is the "dummy" of the parent.
- The case involved misrepresentation of corporate separateness.

Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (July 1991).

Interestingly, Thompson found that when alter ego was not granted by the court, the plaintiff had most often failed to prove misrepresentation. ROMAN L. WEIL ET AL., LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT § 38.3 (3d ed. 2001).

VI. Alter ego jurisdictional examples

A. Federal alter ego

In general a corporation is viewed as a legal entity separate and distinct from its shareholders, directors, officers, and affiliated corporations. Accordingly, as indicated in a recent U.S. Supreme Court ruling, a parent corporation will ordinarily not be held liable for the acts of its subsidiaries. *See United States v. Bestfoods*, 524 U.S. 51, 60 (1998).

Despite the disparity among jurisdictions, the standard for piercing the corporate veil is generally stated as having two aspects.

- The parent dominates a subsidiary's finances, operations, policies, and practices such that

the subsidiary has no separate existence, but is merely a conduit of the parent. *See Craig v. Lake Asbestos of Quebec*, 843 F.2d 145, 149 (3d Cir. 1988).

- The parent has abused the privilege of incorporation by using the subsidiary to perpetrate a fraud or injustice, or otherwise circumvent the law. *See, e.g. Bestfoods*, 524 U.S. at 62; *Craig*, 843 F.2d at 149 (stating New Jersey law); *In re Hillsborough Holdings*, 176 B.R. 223, 231 (M.D. Fla. 1994).

Richard M. Cieri, Lyle G. Ganske & Heather Lennox, *Breaking up is Hard to Do: Avoiding the Solvency-Related Pitfalls in Spinoff Transactions*, THE BUSINESS LAWYER 533-05 (Feb. 1999).

Certain federal alter ego matters use similar criteria. The United States Court of Federal Claims has adopted a three-part test in cases of corporate disregard wherein three questions must be considered.

- Whether one corporation completely dominates the other so that it is merely an alter ego.
- Whether such domination is used to commit fraud or injustice.
- Whether such domination proximately causes the unjust loss.

Twin City Shipyard v. United States, 21 Cl. Ct. 582 (Ct. Cl. 1990); *BLH v. United States*, 13 Cl. Ct. 265 (Ct. Cl. 1987).

B. State alter ego

State courts have built upon the two characteristics of control and improper conduct (and injury) by constructing alter ego criteria ranging from two to eleven parts as indicated below.

Under California law and other state jurisdictions a two-part test may result in the disregard of a corporate entity.

- Where there is such unity of interest and ownership that separate personalities of the two entities no longer exist.
- Where an equitable result would follow if the corporations were treated as separate entities. *Slottow v. American Casualty*, 10 F.3d 1355, 1360 (9th Cir. 1993).

Plaintiffs in California are not required to demonstrate causation between improper conduct and harm to the plaintiff. An inequitable result is sufficient.

Oregon's strict requirements are more specific and perhaps more challenging to satisfy than the two-prong test used in California and other jurisdictions. Specifically, the Oregon Supreme Court has ruled that: "[t]he disregard of a legally established corporate entity is an extraordinary remedy which exists as a last resort, where there is no other adequate and available remedy to repair the plaintiff's injury." *AmFac Foods. v. Int'l. Systems & Control Corp.*, 654 P.2d 1092, 1098 (Or. 1982).

In Oregon's seminal alter ego case, *AmFac*, the court listed as three indicia of improper conduct.

- Inadequate capitalization.
- Milking.
- Misrepresentation, commingling, and holding out.
- Violation of statute.

Id. at 1102. However, the court explained that these indices were only examples and that other indicia might apply in other cases. The court did not list specific indicia or elements of alter ego. Oregon courts require the plaintiff to prove the following three elements by a preponderance of the evidence in order for the court to invoke alter ego.

- (1)[T]he shareholder must have actually controlled or shared in the actual control of the corporation;
- (2) the shareholder must have engaged in improper conduct in the exercise

of control over the corporation; and (3) the shareholder's improper conduct must have caused plaintiff's inability to obtain adequate remedy from the corporation.

Salem Tent & Awning Co. v. Schmidt, 719 P.2d 899, 903 (Or. Ct. App. 1986).

The state of Washington generally holds that shareholders will not be personally liable for the acts of their corporations. R.C.W. 23B.016.220; *Barnett Brothers v. Lynn*, 118 Wash. 308, 203 P. 387 (1922). That is, a corporation as an entity is considered separate and distinct from its shareholders. *Truckweld Equip. Co. v. Olson*, 26 Wn. App. 638, 618 P.2d 1017 (1980).

Consequently, certain general principles are contained within Washington case law. For example, the condition that a corporation's assets are insufficient to cover its obligations does not, in and of itself, persuade the courts to disregard its separate corporate existence. Likewise, parent corporations owning all of a subsidiary's stock, loaning money to the subsidiary, or having the same president will not, by themselves, demonstrate the parent's domination over the subsidiary.

When Washington state courts invoke "piercing the corporate veil" they have applied the "doctrine of corporate disregard" based upon two elements. First, "the corporate form must be intentionally used to violate or evade a duty." Second, the "disregard must be necessary and required to prevent unjustified loss to the injured party." *Meisel v. M&N Modern Hydraulic Press Co.*, 97 Wash. 2d 403, 410, 645 P.2d 689, 692 (1982) (quoting *Morgan v. Burks*, 93 Wash. 2d 580, 587 (1980)).

The first factor requires a showing of abuse of the corporate form, typically involving fraud, misrepresentation, or other action(s) by the corporation that harms the creditor and benefits the shareholder. The second factor requires that harm must actually occur (i.e. causation) so that corporate disregard becomes necessary.

Although Washington courts have not proffered a comprehensive list of actions constituting intentional abuse of the corporate form, they have identified several types of actions that may meet the requirement, such as stripping corporate assets and undercapitalization.

Finally, Alaska has adopted an eleven-part test to show whether a subsidiary is acting as the mere instrumentality of its parent. The tests virtually mirror Powell's eleven circumstances set forth in section VI. A. of this article. See *Jackson v. General Electric Co.*, 514 P.2d 1170, 1173 (Ala. 1973).

In summary it is clear that although broad guidelines of alter ego evaluation are common, the state-by-state and jurisdictional specifics vary significantly.

VII. The challenges of alter ego investigation

Despite the disparity discussed above, a more daunting challenge in alter ego matters lies in establishing the sufficiency of evidence in support of the indicia either for or against an alter ego conclusion. Despite broad guidelines of indicia within respective jurisdictions, there is generally no clear checklist of items comprising the indicia. Note, for example the following reference.

There is no single approach, nor coherent set of principles that exists to govern the situations where alter ego should apply, but all the approaches bear similarities. . . . As a general rule, the courts have required that the party seeking to pierce the corporate veil satisfy a two-prong test: (a) such unity of interest and ownership exists that the corporation and the individual shareholders no longer have separate personalities; and (b) viewing the acts as those of the corporation alone will result in inequity.

ROMAN L. WEIL ET AL., LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT § 38.1 (3d ed. 2001).

A. Indicia of alter ego

Alter ego is decided based upon the extent of the evidence in support or rebuttal of the indicia. Such indicia of alter ego are sometimes comprised of four categories summarized below. Note that no priority is inferred by the sequence of their listing.

Financial dependence behaviors are behaviors that would cause another to infer that the parent corporation provides the majority of financial support or maintenance for the subsidiary(ies). The question to address is whether the subsidiary is financially dependent on its parent?

Confusion about corporate identity reflects behaviors that would cause difficulty in determining the nature and relationship of the parent corporation with the subsidiary(ies). The question to address is whether the subsidiary's identity is commingled with its parent?

Lack of separateness reflects behaviors by the subsidiary(ies) which would cause another to infer that it is not separate from the parent corporation. The question to address is whether the subsidiary functions parallel with its parent?

Dominance and control reflect behaviors by the parent corporation that would cause another to infer that the subsidiary(ies) operate based on the best interests of the parent corporation. The question to address is whether the parent exercises inordinate authority over the subsidiary(ies)?

B. Principles of investigation for alter ego

Due to the complexities and lack of specific guidance in alter ego doctrine, it is essential that three principles be applied during the investigation. First, the party(ies) conducting the investigation must be deeply and broadly experienced in the financial, marketing, operational, and legal aspects of the subject entity's industry and business. Second, each evidentiary item must be measured against two independent criteria: itself and its peer group, thus accommodating a continuum of evaluation.

Finally, all of the evidence gleaned must be considered within the context of the facts and circumstances surrounding the alter ego claim.

Deep and broad experience is a must. The collection of evidence to be considered in alter ego investigations is a relatively straightforward process, but the assessment of such evidence is another facet entirely. For example, evidence of control is often cited as the portal through which improper conduct can be determined. Control can permit dominance, but control does not necessarily signify dominance. A person with nominal professional experience can readily determine that a party held control in a parent entity, which likewise held control in subsidiaries. Mere control, however, in and of itself, is not an indicator of alter ego. The control must be linked through improper conduct and causation (depending upon the jurisdiction) to opine on alter ego. For example, the presence of intercompany accounts (due-to/due-from) between the parent and subsidiary is sometimes considered as evidence of alter ego. However, a professional will recognize the extensive labor required to control and maintain intercompany accounts, which is more likely an indication of distinct separateness than alter ego.

Alter ego evidence is evaluated using techniques similar to those used in financial analysis. The evidence is compared against itself and its peer group. Measuring the pattern of evidence over a company's history will highlight anomalies that are often proximate to triggering events.

The same evidentiary item, when compared within two different matters, may lead to differing alter ego conclusions. For example, closely held businesses often pledge assets in cross-collateralization to acquire operating debt. Cross-collateralization is a formal lending agreement among borrowers to pool collateral, thus providing the lender recourse to all the borrowers' collateral. Typically, closely held businesses have little choice in the matter as the bankers insist on limiting their lending risk. On the other hand, cross-collateralization has been

exercised in the form of a poison pill similar to publicly held companies attempting to avoid hostile takeovers. In such instances, cross-collateralization may be an indicator of alter ego. In other words, alter ego requires drill-down assessment, which is an investigative process that moves from top-to-bottom. It starts with summary information and moves downward through successively more detailed supporting data to focus on the pertinent component parts. Alter ego also requires a build-up conclusion, which is a process employed during a drill-down assessment, wherein the respective findings resulting from successively more detailed analysis are aggregated upwards in a manner demonstrating the preponderance of evidence in support of a conclusion.

Derivation of a self-evident alter ego conclusion is driven by the preponderance (or dearth) of evidence. Procedurally, it is achieved by assessing the unique elements that collectively comprise the respective indicator. Therefore, the evaluation and assessment process drills down to successively deeper layers as necessary, subsequently aggregating upward to a conclusion. See the alter ego "Report Card" from the article by Darrell D. Dorrell, *The Valuation Report Card*, 16 AM. J. FAM. L. 2 (2002), set forth at Exhibit 2.

Bear in mind the preceding comments regarding the "continuum" of alter ego investigation. With regard to evidence "more is better," criticality notwithstanding. However, this approach is provided as a benchmark for investigation regardless of evidence detail. Note that the author has successfully employed the entire continuum of evidence, ranging from "smoking gun" to comprehensive "scorecards" of measurement.

Once the indicia are determined, criteria, elements, and sub-elements can then be applied to pertinent legal, financial, operational, and related evidentiary documents. During the screening of evidence, any and all items which could impact alter ego indicia are considered regardless of the likely result. This insures that the universe of data

is assembled and evaluated without bias (to the extent possible).

Once any/all material items potentially affecting alter ego indicia have been selected, each evidence item is individually investigated, evaluated, and assessed within the context of the facts and circumstances previously determined.

Naturally, the evaluation and assessment criteria must be comprised of objective and comprehensive components. Consequently, each indicator's foundational elements are constructed with regard to objective methods and techniques. For example, the elements of financial dependence are drawn (at least in part) from methods used to determine solvency analysis.

Then, based upon the preponderance of conclusions, aggregating upwards from the sub-elements, to the elements, to the criteria, to the indicia, and in concert with professional opinion, an overall conclusion can be formed for each indicator.

Each indicator may overlap other indicators and even a preponderance of conclusions one way or the other does not necessarily lead to an irrefutable conclusion. That is why it is necessary to develop a deep understanding of the nature and history of the business, and its financial, operational, marketing, management, and related elements.

Since the decomposition of indicia can lead to quite complex and detailed data, it is critical to organize the process into hierarchical categories. Further, each category may require additional analysis and even cross-referencing to other categories and data.

Just as no checklist of criteria exists, no checklist of categories exists. However, Exhibit 2 illustrates a logical descending structure. The example demonstrates the decomposition of financial dependence. In practice, of course, the structure will vary depending upon the facts and circumstances of each matter.

For purposes of this simplified example, the financial dependence indicator is decomposed into

two basic "criteria" legal criteria and financial criteria. The legal criteria is decomposed into two "elements" legal formation and legal continuation. Finally, legal formation and legal continuation are decomposed into six and four "sub-elements," respectively. The financial criteria is likewise decomposed into the respective elements and sub-elements. *See* Exhibit 2.

Each indicator is decomposed into three successively detailed levels, consisting of criteria, elements, and sub-elements. Note that criteria may be comprised of one or multiple elements. Likewise, each element may be comprised of multiple sub-elements. Sub-elements can continue indefinitely with the decomposition process to provide as much detail as the facts and circumstances of the matter warrant.

Once all the factors have been "scored," then they can, in the aggregate, lead to a conclusion (or rebuttal) of alter ego. For example, if forty-three of fifty-two elements and sub-elements, or 83%, indicate alter ego conditions, then such conclusion will be relatively self-evident. Note that this assumes that each factor has similar weight with regard to the conclusion. (See the explanatory comments below regarding relative weights.)

C. Self-evident conclusion

In theory, the determination of alter ego merely requires demonstrating how each indicator's underlying criteria drives a self-evident conclusion leading to one of four determinations.

- Preponderance of criteria substantiating an alter ego conclusion could persuade the court to grant the claim of alter ego.
- Preponderance of criteria rebutting an alter ego conclusion could persuade the court to honor the corporate structure.
- Absence of criteria substantiating an alter ego conclusion could persuade the court to honor the corporate structure.

- Absence of criteria rebutting an alter ego conclusion could persuade the court to grant the claim of alter ego.

D. Complexities inherent in the indicia

The criteria comprising the indicia are not well defined and often vary by jurisdiction. Further, each matter contains unique facts and circumstances that frame the context and shape the analytical approach, which compounds the difficulty of evaluating the criteria.

Alter ego determination goes one step further. There are inherent complexities and interdependencies in alter ego determination that compound the assessment. The key complexities are set forth below, but bear in mind that despite their discrete listing, they can, and often are, synergistic and interactive within/among one another.

Business relationships between otherwise nonrelated entities may exhibit alter ego characteristics. Personally owned entities within family relationships may transact business with one another in a manner not complying with corporate governance requirements. Analysis of the entity's business history can yield revealing patterns of corporate behavior and can clarify decisions. For example, did an economic downturn or perhaps an acquisition, or even lenders, force the parent to cross-collateralize? Triggering events and their attendant corporate treatment (accounting recognition) can be compared against an entity's business history to determine if the event resulted in different treatment, potentially indicating alter ego.

The factual scenario set forth in Exhibit 1 is illustrative. A large multi-entity had an acquisition guided by financial and legal advisors who provided extensive due diligence with regard to the purchase price. Upon acquisition, the transaction was diligently measured and recorded in the parent's various audited financial statements, income tax returns, and related sources. The due diligence identified a contingent liability of the acquisition target in the form of a

company-backed guarantee of a customer's long-term lease. The likelihood of triggering the contingency was deemed remote since it required insolvency on the part of the customer.

Approximately one year post-acquisition, the customer declared insolvency and defaulted on the long-term lease, thus triggering the acquisition's target guarantee. The resultant cost to the multi-entity of the guarantee exceeded the purchase price of the acquisition target. Seeking advice from the same pre-acquisition attorneys and accountants, the multi-entity company tried to rewrite history by soliciting new valuations and legal opinions that asserted the original acquisition had been vastly overvalued. Consequently, the multi-entity attempted to book complex accounting entries that obfuscated the actual transaction and appeared to reflect a zero balance for the acquisition purchase price. After forensic accounting analysis exposed the fraud, the case settled in favor of the plaintiff during trial and the disposition was sealed by a protective order.

Two key trial exhibits (exhibits 3 and 4) illustrate the flow. Exhibit 3 gives a summary of the accounting transactions necessary to disguise the overall intent. Although such a schedule may be useful only to a duly qualified CPA, it presents a clear trail of the flow and journal entries that mirror the attorneys', outside CPAs', and advisors' guidance in order to avoid creditors' actions. Exhibit 4 is a pictorial representation of the accounting flows. Although less technical, it mirrors the trail of activities and also includes those items not necessarily reflected within the accounting records.

A detailed history of diligent corporate governance, board minutes and resolutions, timely corporate filings, and outside legal advice, among other things, can demonstrate a history of maintaining corporate distinction and separateness. Extensive business records spanning either short or long-term time periods can accommodate a comprehensive and detailed evidentiary analysis balanced against cost-effectiveness and practicality. Very limited

business records preventing detailed analysis may rely upon extrapolated assumptions driven by available evidence. Note that routine business practices regarding discarding records may legitimately create gaps in the records trail.

The analysis of business records usually requires a balance between page-by-page and high-level document analysis to obtain the most cost-effective conclusion based upon optimal levels of evidence for the time periods investigated.

An entity's past practices can do much to demonstrate intent. A long history of acquiring, maintaining, or disposing of entities could indicate intent of separateness. Likewise, a long history of a single entity interrupted by formation of a new entity proximate to an event could indicate an attempt at diversion. It bears repeating that interdependencies and complexities, despite their discrete listing, often are synergistic and interactive within/among one another.

The evidence evaluation method must be established before conducting the investigation to avoid confusion of indicia. Common forensic accounting techniques summarized below can accommodate such a need.

- The nomenclature encountered in alter ego, particularly for nonparent entities, is often pointed out as indicative of control. The mere labeling, however, of an entity as a subsidiary, affiliate, division, or branch, may or may not be indicative of alter ego.
- Certain indicators may tend to overwhelm other indicators despite the preponderance of evidence. Compelling evidence of financial dependence might carry more weight than the other indicators combined.
- Specific records might carry more weight than many of the other records within respective categories. Reliance upon outside legal or accounting advice could demonstrate an owner's intent to conduct due diligence within the various entities.

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- The various factors may carry differing weight(s) regarding alter ego conclusions. A single bank account for the parent and subsidiaries may have little bearing if the various entities separately account for transactions. A truly commingled bank account, however, may carry a great deal of weight.
 - Smoking gun evidence may carry more weight than more ordinary indicators. Smoking gun evidence can result in a favorable settlement during trial, immediately prior to expert testimony.
 - The weighing of indicators is highly dependent upon the facts and circumstances of each matter.

A single piece of evidence can be so compelling that it might overshadow all other evidence in support or refutation of alter ego. Alternatively, the preponderance of evidence can be so compelling that it might overshadow even an extreme example in support or refutation of alter ego. In reality, most cases fall somewhere in between. *See* Exhibits 3 (spreadsheet) and 4 (pictorial of The Acquired Subject & Sons, Inc. transaction).

Exhibit 3 is the sort of schedule that causes an accountant's heart to race. It demonstrates (to an accountant) how, through the creative accounting process, an entity valued in excess of \$9 million can be made to disappear on the financial statements, thus purportedly thwarting creditors. The disappearance is demonstrated by the two ovals at the right-hand side of the schedule. The \$9,249,968 in entity assets is ultimately reported as "zero" on the consolidated financial statements. Consequently, an unsuspecting reader of the financial statements would overlook the disappearing entity assets.

Exhibit 4 is the same set of accounting transactions contained in exhibit 3, but is constructed using a step-by-step "pictorial" technique. Exhibit 4's legend in the lower left-hand corner can be used to trace the transactions

that we sequentially executed in the acquisition of the subject entity.

Following the legend, "A" refers to the various points at which the Revolving Sweep Account (flexible line of credit) was used during the transaction. Step one refers to "CDX assigns rights to XYZ" and can be seen in the oval just below the ball and chain symbol on the left-hand side of the exhibit. Steps two through eleven can be followed in a similar manner, thus tracing the transaction through the various entities.

Exhibit 4 avoids the mind-numbing complexity of a convoluted accounting schedule and illustrates the business and accounting transactions in a story-line manner. This exhibit was actually used to demonstrate to the court how defendant's claimed transaction was quite different from how they actually booked the entries within their financial records.

E. Contradictory implications

Factors used to decompose alter ego indicia may have contradictory implications. Using the same law firm to advise both parent and subsidiary may indicate a lack of separateness, but could be a prudent business decision. Likewise, a subsidiary's operations residing in the parent's facilities could indicate lack of separateness, but paying market-based rent to the parent could negate the lack of separateness indication.

Factors used to decompose alter ego indicia may also have overlapping application to the indicia. Using a common chart of accounts to record accounting transactions is a prudent business practice, but could conceivably serve as an indicator of a lack of separateness.

Some factors are subject to legitimate alternative interpretation. Consequently, a methodology by which to score the overall results becomes critical. (Refer to the preceding principles of alter ego investigation.) Further, such methodology provides compelling evidence for an objective and critical analysis, persuasive to the court.

F. Varying measurement standards

The measurements standards used in assessing whether or not financial dependence is present will vary. A few examples follow.

- **Book value**—This standard of measure rarely reflects anything beyond the nominal difference between assets (typically reported at cost) and liabilities (typically reported at fair market value).
- **Checkbook management**—Even midsized business owners sometimes rely on a primary, or a few key measurements (as they perceive them) to manage the business. A chemical manufacturer gauged the profitability of his business as either-or when his business checking account carried a balance exceeding \$1,000,000. When the balance was over \$1,000,000, he reasoned that his business was doing fine. Another business owner netted the respective balances of accounts receivable against accounts payable every week. He was confident of success unless any week's net fell below the arbitrary cushion he periodically established.
- **Fair market value**—This standard of measure is ordinarily applied when restating cost-based assets, and sometimes liabilities, and is driven by the definition of fair market value as defined in Revenue Ruling 59-60 (1959-1 C.B. 237.) *Available at* <http://www.financialforensics.com>.
- **Generally Accepted Accounting Principles (GAAP)**—"This standard of measure is comprised of the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time and includes both broad and specific guidelines. The source of such standards is the Financial Accounting Standards Board (FASB)." BLACK'S LAW DICTIONARY 685 (6th ed. 1990). GAAP statements are ordinarily available only when audited (or sometimes reviewed) financials are available.

Compilation-level financial statements may often offer very little assurance regarding their performance representation.

- **Guesstimates**—Often encountered in closely held businesses with regard to inventories, accounts receivable allowances, gross profit margins, warranties, and others when the business lacks competent internal financial resources to capture necessary information.

Some businesses seldom (if ever) conduct physical inventories, relying instead upon pricing guidelines that set gross profit margins which are applied to derive inventory levels.

- **Measurement gaps**—Even midsized businesses ignore the importance of regular financial statements to track and control operating performance. Consequently, analysis is often dependent upon irregular annual measurements which preclude a finer calibration of trends and patterns.

Although annual financial analysis, common-sizing, trending, horizontal/vertical, ratio, growth rate, and similar techniques are helpful, frequent measurements are more specific. Note the annual resting requirements of lending institutions. The resting requirement lines of credit (LOC) demonstrate the business' solvency and limit the lending institution's risk.

- **Other Comprehensive Basis of Accounting (OCBOA)**—This category, under Statement on Accounting Standards No. 62 Special Reports (*available at* <http://www.fasb.org/st/#fas75>), can be any one of the following: a statutory basis of accounting (for example, a basis of accounting insurance companies use under the rules of a state insurance commission), income-tax-basis financial statements, or financial statements prepared using definitive criteria having substantial support in accounting literature that the preparer applies to all material items appearing in the statements (such as the price level basis of accounting).

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- Tax basis accounting—Tax basis accounting may or may not be based upon GAAP, but is typically cost-driven or fair market value-driven, depending upon the respective facts and circumstances. Furthermore, timing differences, depreciation, revenue recognition, and inventory methods can affect tax basis accounting.

There is no definitive accounting literature that can be used to determine when/whether a subsidiary is financially dependent upon its parent. Consequently, financial techniques such as solvency analysis, among others, are typically employed. Refer to section IX of this article for guidance in determining solvency.

G. How does one determine alter ego?

Alter ego is ostensibly simple, but insidiously complex. The danger results from the inherent complexities and latent interdependencies of the indicia and their underlying evidentiary records. Which of the following evidence indicates a subsidiary's financial dependence on its parent? A subsidiary borrows start-up funds from the parent and:

- Pays it back right away and never again needs funds from the parent.
- Pays it back based upon prevailing market terms.
- Is capable of paying it back, but the parent never requests it, thus never accounts for it.
- Is capable of paying it back and the parent never requests it, but the subsidiary accounts for it and related interest through intercompany accounts.
- Is not capable of paying it back, and the parent never requests it.
- Is not capable of paying it back, but the subsidiary accounts for it and related interest through intercompany accounts.

The correct answer is, it depends upon the facts and circumstances surrounding the funds, the

nature and history of the relationship between the parent and the subsidiary, industry practices, economic conditions, treatment over the life of the relationship, and a myriad of additional factors that may need consideration.

Fortunately, application of a few simple techniques and application of the preceding principles can simplify an otherwise complex exercise.

The complexities of alter ego determination are most easily analyzed by decomposing each of the four indicators (financial dependence, confusion about identity, lack of separateness, and dominance and control) into progressively finer factors. The factors then are individually assessed, and when aggregated, can produce a scorecard for each indicator, clearly illustrating the extent to which the indicator lends support to an alter ego conclusion. Decomposing the indicia into their factors, however, may not be sufficient. It may be necessary to further decompose the factors into elements, and perhaps even categories ad infinitum.

In order to arrive at objective and supportable conclusions, the approach must be structured in accordance with professional technical guidelines, experience in alter ego investigation, and forensic accounting methodology. Forensic accounting is defined as "[t]he art and science of applying financial techniques to matters of law." *How Do You Define Forensic Accounting?* FINANCIAL FORENSICS NEWSLETTER® (financialforensics® , Lake Oswego, OR), Sept. 1993 at 1, available at <http://www.financialforensics.com>.

Alter ego assessment is one of the most powerful, but complex, elements of corporate law. It requires a unique combination of financial, business, legal, operational, marketing, and related knowledge in order to serve the court's best interest.

VIII. Fraudulent transfer

As stated in II.B of this article, the concept of fraudulent transfer is typically employed in

connection with debtor/creditor relationships where an asset or liability has been transferred for less than reasonably equivalent value with the intent of defeating a creditor's rights. The principles derived from fraudulent transfer can also be applied to other types of law to illustrate intent and results.

The Bankruptcy Code grants a Chapter 11 debtor-in-possession (DIP) or bankruptcy trustee special powers to collect all of a debtor's assets in a bankruptcy matter. The powers include voiding prebankruptcy asset transfers that are fraudulent under applicable nonbankruptcy law, such as the UFTA or the UFCA. Under the UFTA or the UFCA, assets can be recovered and/or transfers voided when circumstances constitute actual or constructive fraud.

Actual fraud occurs when an asset is transferred with intent to hinder, delay, or defraud any creditor. Constructive fraud occurs when an asset is transferred for less than reasonably equivalent value or for other reasons, such as insolvency of the debtor or inadequate capitalization.

Constructive fraudulent transfer is determined by the following criteria.

- Did the subject receive reasonably equivalent value in connection with the transfer?
- Was the subject insolvent preceding the transfer?
- Did the subject become insolvent as a result of the transfer?

Actual fraudulent transfer is determined by various badges of fraud which indicate if the transfer was made with actual intent to hinder, delay, or defraud creditors, as evidenced by the following.

- Was the transfer to an insider?
- Was the transfer comprised of substantially all of the subject's assets?
- Was a reasonably equivalent value received in the exchange?

- Was the subject insolvent at the time of transfer or did it become insolvent as a result of the transfer?
- Did the transfer occur proximate to substantial debt incurrence?
- Did the transferring entity retain possession, benefit, or use of the property(ies)?
- Did the transfer occur proximate to financial difficulties?
- Did the transfer occur proximate to a filed or threatened lawsuit?
- Is there any other evidence of actual intent to hinder, delay, or defraud the creditor(s)?

Another criteria is whether the transfer was for less than reasonably equivalent value. This element is ordinarily based upon fair-market value consistent with the definition of fair-market value in Revenue Ruling 59-60 (1959-1 C.B. 237), *available at* <http://www.financialforensics.com>. Basically, fair-market value is the amount at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state, in addition, that the hypothetical buyer and seller are assumed to be willing and able to trade, and are well informed about the property and the market for such property. 26 C.F.R. 20.2031-2(2)(.02) and Revenue Ruling 83-120, *available at* <http://www.bvappraisers.org/contentdocs/irs/83-120.pdf>. These two cites are parallel cites to Rev. Ruling 59-60.

The following eight factors are outlined in Revenue Ruling 59-60, § 4, under Factors to Consider.

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.

- The book value of the stock and the financial condition of the business.
- The earning capacity of the company.
- The dividend-paying capacity.
- Whether or not the enterprise has goodwill or other intangible value.
- Sales of the stock and the size of the block of stock to be valued.
- The market prices of stock of corporations, engaged in the same or similar lines of business, having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Some courts, however, apply value standards other than fair market value. Generally, tests regarding fair market value and other values require restatement of the transferring entity's balance sheet. Assets are restated to fair market value, and include all intangible assets such as copyrights, patents, trademarks, trade secrets, (whether or not recorded by the transferring entity), but not goodwill. Liabilities are also restated to fair market value, and include recognition of contingent and/or unliquidated liabilities, whether or not recorded by the transferring entity.

Three other criteria must also be met.

- Whether the entity was insolvent at the time of transfer or became insolvent as the result of the transfer.
- Whether the transfer resulted in unreasonably small capital remaining in the transferring entity.
- Whether the entity intended or expected to incur debts beyond its ability to pay.

Financial and empirical tests involving fraudulent transfers can be quite complex. However, a few simple examples illustrate the concepts.

Exhibit 5 illustrates how the transaction's equity had been legitimately recorded numerous

times, all approximating \$9 million. However, when a large contingent liability was triggered, unscrupulous attorneys and accountants rerecorded the transaction at \$700,000, thus attempting to defeat the creditor. The rerecording was based on very complex legal and accounting maneuvers intended to obscure the deception. Nevertheless, the visualization in Exhibit 5 managed to simplify defendant's complexity-by-design. That is, ten times during the preceding year the defendant had documented that the transaction was worth \$9 million. Immediately after a post-transaction liability surfaced, the company tried to rerecord the transaction at only \$700,000 in order to deceive creditors into thinking that insufficient assets were available through the court.

The schedule conveys meaning to perhaps only a CPA, but the trail is clear—assets were transferred and dispersed in an attempt to support a zero value for a subsidiary's stock. The schedule was used in the trial (exhibit 3), and the flow exhibit (exhibit 4) following it illustrates the visual representation of the accounting transactions reflecting both the original transaction and the rerecording intended to defraud the creditor.

Such tools are commonly employed in fraudulent transfer, but their derivation requires skills well beyond mere accounting and finance. The practitioner must possess a broad array of eclectic legal, financial, and analytical skills in order to make sense out of the disarray.

IX. Solvency

Solvency analysis can be applied to a wide array of litigation matters, including bankruptcy, alter ego, debt-service capability, financing feasibility, pre- and post-merger due diligence, and other decisions geared to financial analysis. Some of the solvency material discussed below was adapted from Darrell D. Dorrell & Gregory A. Gadawski, *Valuation in Solvency Analysis*, 3 NATIONAL LITIGATION CONSULTANTS' REVIEW 1 (July 2003).

Solvency analysis is applied by testing the three following categories.

- Balance sheet test—Used to determine whether, at the time of the transaction, a company's asset value (valued as a going concern) was greater than its liability value.
- Cash flow test—Used to determine whether a business entity incurred debts that would be beyond the debtor's ability to pay as such debts matured.
- Adequate (reasonable) capital test—Used to determine if an entity was engaged in a business or a transaction for which it had unreasonably small capital.

ROBERT F. REILLY & ROBERT P. SCHWEIHS, *THE HANDBOOK OF ADVANCED BUSINESS VALUATION* 340-42 (Richard D. Irwin ed., McGraw-Hill 2000).

It is important to note that in order to be considered solvent, a company must pass all three tests. Further, note that the occurrence of a bankruptcy following a leveraged transaction does not necessarily prove that the company was insolvent at the time of the transaction. Nor does the absence of a bankruptcy following a transaction guarantee that the company would have passed the solvency tests.

A. Solvency analysis terms

Financial analysts often perform a solvency analysis to determine whether, following some type of leveraged transaction, the company incurring the leverage is left in one of the following states.

- Positive Equity—Equity is measured by the excess or deficit of assets over liabilities.
- The ability to repay its debts as they come due—Debt paying ability is measured by ratios including, but not necessarily limited to, debt to equity.
- Debt to Equity—The higher the ratio, the riskier the financial leverage. ROBERT N.

ANTHONY, *MANAGEMENT ACCOUNTING: TEXT AND CASES* 301 (Richard D. Irwin ed., McGraw-Hill 1964).

- Times Interest Earned—The lower the ratio, the riskier the financial leverage.
- Adequate Capital to Operate its Business—Capital sufficiency is measured by ratios including tests that incorporate certain of the debt repayment ratios summarized above. *Id.* at 56-60.

Solvency ratios that measure liquidity include Current Ratio, Quick Ratio, etc. MICHAEL R. TYRAN, *THE VEST-POCKET GUIDE TO BUSINESS RATIOS* 77-86, 252-57 (Prentice-Hall 1992).

B. Balance sheet test

As a first step in conducting the balance sheet test, the assets of the company are valued as a going concern as of the date of the transaction. Then the value of the company's liabilities is subtracted from the asset value. The balance sheet test is passed if the sum of the value of the company's assets is greater than the value of its liabilities. For example, if the going-concern (post-transaction) valuation of a company's assets arrived at \$5.5 million fair market value, then the company's post-transaction liabilities of \$4 million subtracted from the assets would result in an excess fair market value of \$1.5 million. Such condition would enable a company to pass the balance sheet test. Exhibit 6, "pre- and post-merger balance sheet test" illustrates a balance sheet indicating a positive equity before a transaction (May 1) and a negative equity following the transaction (June 1). This exhibit indicates how quickly solvency can change pursuant to a merger.

C. Cash flow test

As stated previously the cash flow test is used to determine whether a business entity incurred debts that would be beyond the debtor's ability to pay as such debts matured. Conclusions about the ability to pay debts are based on an analysis of a

series of projections of future financial performance of the business that are created by varying some key operating characteristics of the business. These typically include, but are not necessarily limited to, revenue growth and profit per dollar of sales. The forensic accountant must judge which projection scenarios are reasonable in light of the company's past performance, current economic conditions, and future prospects. This is similar to what should be done in evaluating company projections for a discounted cash flow valuation.

In the cash flow test, future post-transaction debt payments of a company are computed and scheduled by due date. Then a projection of the amount of liquidity available to the company to meet its debt requirements is estimated from each set of projections. To calculate a company's liquidity available for debt repayment, the valuation analyst could project each of the following for the company for several periods after the transaction: any excess cash on hand, free cash flows earned during each period, and the company's borrowing capability on each due date to repay its debts. A comparison would then be made between the amount of debt payments required during each period and the liquidity available to satisfy such requirements. A company will pass this test in any projected period if it can pay its debts as they come due through cash accumulated on its prior earnings, free cash flow earned in the period, or by having enough borrowing availability to pay its debts.

Exhibit 7 illustrates a failed cash flow test. The schedule demonstrates that cash flow can consist of various definitions. The example applies a form of cash flow commonly employed within the example company's industry. Specifically, the cash flow measure is an acronym consisting of the first letter of the components to which it applies: earnings before interest, taxes, depreciation, and amortization (EBITDA). A similar, but different form of cash flow, EBIT is an acronym likewise consisting of the first letter of the components to which it applies: earnings before interest and taxes. In the example the dark

line indicates the hoped-for post-transaction cash flow, and the light line indicates the actual post-transaction cash flow. Consequently, the transaction failed the cash flow test.

D. Adequate capital test

The adequate capital test is used to determine if an entity was engaged in a business or a transaction for which it had unreasonably small capital. The adequate capital test is related to the cash flow test in that a company that has adequate capital will be able to pay its debts as they come due and will have the capital to run its business under a wide range of financial circumstances and economic conditions. The adequate capital test is intended to determine whether a company is likely to survive, assuming reasonable business fluctuations in the future. Recognizing that all projections about the future are uncertain, one would like to be able to estimate the likelihood that the newly leveraged company has enough cushion in its post-transaction capital structure to withstand a typical amount of financial fluctuation.

One key measure of a company's reasonable capital is the availability of committed credit, given a variety of projected levels of performance. One would typically test the availability of committed credit under the lending covenants that were negotiated as part of the leveraged transaction. Exhibit 7 illustrates how the Actual EBITDA resulted in a \$1 million shortfall from Hoped-For EBITDA. As a result, the company failed since the shortfall exceeded the hoped-for cash flow resulting from the acquisition. *See* Exhibit 7 (Hoped for EBITDA compared to Actual EBITDA) and exhibit 6 (pre- and post-transaction balance sheet test). Exhibit 6 clearly indicates the decline in equity resulting from a post-transaction asset decline and liability increase—a fatal combination.

E. Projected cash flow sensitivity analysis

When a cash flow sensitivity analysis is used to determine adequate capital, the projected future financial performance of the company is analyzed in a variety of scenarios and the sufficiency of its cash and credit to meet its needs is assessed. In addition to comparing the cash needs relative to its revolver limits, as is done in the cash flow test, one would analyze whether the company would pass each of the covenants on its term debt under a variety of presumed performance scenarios.

The results of this test will demonstrate under what circumstances the company would trigger a default under its lending covenants. The scenarios tested should include the following three factors.

- Management's best estimate of the future.
- No change from recent historical performance.
- Some reasonable variations of revenue growth and profit margin assumptions.

Exhibit 8 indicates the pre- and post-transaction levels of debt in comparison to projected sales. The schedule is self-evident. The same level of sales was expected to service nearly twice the debt load, a classic example of hubris.

X. Forensic accounting techniques

Other techniques are often employed in support of civil tools. Perhaps the most recent and important statistical tool used in forensic accounting is Benford's law, which is ordinarily supplemented by other, more traditional, financial tests.

Dr. Mark J. Nigrini's Internet site contains a full-length forensic accounting report discussing the application of Benford's Law. It can be accessed by searching Dr. Nigrini's site for "Forensic Accountants' Report," <http://www.nigrini.com/images/ForensicAccountantReport.htm>.

A. Benford's law

Benford's law, set forth in section II.D. of this article, is an analytical technique that grew out of observations made in the late 1800s by Simon Newcomb and was developed during the 1920s by Frank Benford, a physicist at General Electric research laboratories. He noted that the first few pages of logarithm table books were more worn than the later pages. In those days, logarithm table books were used to accelerate the process of multiplying two large numbers by summing the log of each number and then referring to the table for the requisite integer.

Dr. Mark J. Nigrini of Saint Michael's College is responsible for promulgating Benford's Law as the modern day DNA-equivalent of forensic analysis. He built upon Frank Benford's work and used the topic of Benford's Law as the basis for his Ph.D. dissertation. His Internet site contains a wealth of information on the technique.

Benford's law states that digits and digit sequences in a data set follow a predictable pattern. For example, in any set of numerical data, the number "one" will appear as the first digit approximately 30% of the time. Such a data set can consist of sales records, payroll records, journal entries, or virtually any other set of data that has been generated to record business and related transactions. A data set does not have to be large, but can consist of a very few records if the digit composition is sufficient to support the technique.

The technique applies a data analysis method that identifies possible errors, potential fraud, or other irregularities. For example, if artificial values are present in a data set, the distribution of the digits in the data set will likely exhibit a different shape, when viewed graphically, than the shape predicted by Benford's law. Benford proved his theory by using twenty lists containing 20,229 numbers, and produced the statistical array that is still applied today.

The technique counts digit sequences of values in the example data set and compares the

totals to the predicted result according to Benford's Law. Nonzero digits are counted from left to right.

Despite its origin in the 1920s, Benford's Law was not recognized as an effective tool for forensic accounting analysis until the late 1990s. Data sets analyzed by Benford's Law require certain structural data conformity as summarized below.

- The data set must represent the sizes of similar phenomena.
- The data set must preclude built-in minimum or maximum values.
- The data set must not represent assigned numbers.

B. Results of applying Benford's law

The analytical tests contained within Benford's Law were applied to more than 25,000 financial transactions gathered during a forensic accounting matter. The transactions comprised a database from which the following exhibits resulted. Based upon the analysis of Benford's law applied against 100% of the foundational transaction entries shown in Exhibits 9, 10, 11, and 12, it is clear that the transactions failed all four tests: first digit, second digit, first two digits and first three digits. *See* Exhibits 9, 10, 11, and 12. The implications of the failures lead to the conclusion that a significant proportion of the example's foundational transaction data appears to be contrived and a significant proportion of the example's transactions containing rounded numbers appears to be excessive.

C. Major digital tests

Digital analysis is commonly defined as a set of procedures used to analyze the digit and number patterns of data sets, with the aim of finding anomalies and reporting on broad statistical trends. Digital analysis includes Benford's Law, duplicate numbers testing, round numbers testing and other statistical applications. These investigative tools are invaluable when properly applied to the case or matter at hand.

The digital analytical tests applied through Benford's law are comprised of the following.

- The first major digital test is a test of the first digit proportions, a test for reasonableness. The first digit of a number is the leftmost digit with the understanding that the first digit can never be a zero. For example, the first digit of 7,380 is 7.
- The second major digital test is a test of the second digit proportions, also a test for reasonableness. The second digit of a number is likewise determined by its placement within the number. The second digit of 7,380 is 3.
- The third major digital test is more focused than the two preceding tests and uses the first two leading digits, again excluding zeros. For example, the first two digits of 7,380 are 73 and the first two digits of 0.07380 are also 73. There are ninety possible first-two digit combinations—ten to ninety-nine inclusive. This test finds anomalies in the data that are not readily apparent from either the first or second digits seen on their own.
- The fourth major digital test focuses on the 900 possible first three digit combinations—100 to 999 inclusive. This highly focused test indicates abnormal duplications.

The results of the first digit test are indicated by Exhibit 9. The variations from the predicted norm suggest that anomalies exist throughout the example's financial data set.

Exhibit 9 indicates, among other observations, that the numbers one and two both exceed the expected counts by 14% and 11%, respectively. Additionally, the numbers four and six fall below the predicted limit, thus suggesting that anomalies such as contrivance, fraud, error, etc. exist within the example's financial data set. Such indicators point the investigator to areas where effort should be focused, thus avoiding hit-and-miss attempts.

The results of the second digit test are indicated by Exhibit 10. Again, the variations from the predicted norm suggest that anomalies exist throughout the example's financial data set. Exhibit 10 indicates, among other observations, that the numbers zero and five both exceed the expected counts by 110% and 61%, respectively, thus suggesting that anomalies exist within the example's financial data set. For example, an inordinately large number of payments contained zero or five as a second digit such as \$10,000 or \$15,000.

The results of the first two digits test are shown in Exhibit 11. The testing criteria indicates several significant variations from the predicted norm, thus suggesting that anomalies exist throughout the example's financial data set. Exhibit 11 indicates, among other observations, that the numbers ten, fifteen, twenty, twenty-five, forty, and fifty all exceed the predicted limit. This suggests that anomalies exist within the example's financial data set.

The results of the first three digits test are indicated by Exhibit 12. Several variations from the predicted norm suggest that anomalies could occur throughout the example's financial data set. Exhibit 12 indicates, among other observations, that the numbers 100, 200, 150, 250 and 500 all exceed the predicted limit, thus suggesting that anomalies exist within the example's financial data set.

D. Numeric tests

The numeric tests are comprised of a numeric duplication test and a rounded numbers test. These tests can be conducted independently or in concert

with a Benford's law analysis. Once any significant duplication has been identified, meaningful inferences can be drawn through further investigation.

The numeric duplication test is used to identify abnormal recurrences of specific numbers. The objective is to draw attention to small groups of numbers that appear to be unusual. The rounded numbers test operates on the same premises as the numeric duplication test. The objective, however, is to identify abnormal recurrences of rounded numbers. Abnormal recurrences of rounded numbers are good indicia of estimation since people tend to estimate when they create contrived numbers.

E. Results of applying numeric tests

The numeric tests were both applied against 100% of the example's foundational transaction entries. The numeric tests were also applied against 100% of the data that produced Exhibits 9, 10, 11 and 12. The implications of the results lead to the following observations. There appears to be significant duplication of numbers and significant use of rounded numbers. The results for both tests have been presented in a combined format below. Only the numeric duplications deemed significant have been set forth.

- Many of the debits for \$10, \$15, \$20, \$25, \$30, \$40 and \$50 are bank charges. A large sum of these bank charges are insufficient funds fees (NSF), wire transfer fees, and cashier check fees. From this, one can conclude that the subject lacked the capability to manage its cash flows, as illustrated by the amount of NSF fees, and that the subject transacted numerous wire transfers and cashier's checks.
- Upon further analysis, it was determined that many of the rounded transactions were cash withdrawals. In some cases, the withdrawals included the bank transaction fee. There are 111 transactions for \$301.50. The components of most of these transactions are a \$300 withdrawal with a \$1.50 ATM fee. Note that

\$300 is the ATM withdrawal limit established by many financial institutions.

- Many of the larger rounded numbers are actually intercompany bank transfers. It is common for the individuals in charge to transfer large sums of money between the various corporate accounts.

Upon closer examination of these transactions, however, it is apparent that there was a lack of planning and accountability pertaining to these transfers. Further, since there were never any check registers kept for any of the entities, the corporate finances were coordinated through the balances in the bank.

In some instances, the number of duplicate transactions for an amount may not be deemed significant. The aggregate value of these transactions, however, has made them noteworthy. For example, there are two transactions for \$700,000 totaling \$1,400,000. The aggregate value of these transactions is slightly less than one percent of all debit transactions for the company. There were four transactions for \$1,000,000. Three of these transactions were payments in accordance with the example acquisition. The remaining transaction was a wire transfer to a former defendant employee.

F. Counterterrorism applications of digital analysis and Benford's Law

Digital analysis can streamline investigations that involve a large number of transactions, oftentimes turning a needle in the haystack search into a refined and efficient investigation. For example, in a (questionable) charitable organization conducting tens of thousands transactions for both legal and illegal purposes, it may be extremely difficult to filter through all transactions and identify those for illegal purposes. However, tools such as Benford's Law may assist the investigator in refining the population of suspect transactions by identifying those transactions that are anomalies or irregularities. In essence, digital analysis may reduce the data population from tens of thousands

transactions to a more manageable number of transactions.

Additionally, digital analysis may provide indirect evidence of terrorist or criminal activity. An organization's everyday legal activities will result in benchmark transactions. As previously discussed, a truly random data set will normally conform to certain geometric patterns as in Benford's Law. However, contrived numbers, which often represent illegal activity, will deviate from the benchmark transactions revealing the irregularities. A classic example is the organization that has a disproportionate number of transactions in the eight and nine thousand dollar range since they may be structuring transactions (designed to fall below SAR and CTR levels). This fact would likely be revealed during a Benford's Law analysis as the amount of numbers beginning with the digits 8 or 9 would exceed their expected probability of occurrence.

In extreme instances digital analysis can be used to illustrate that the entity is nothing more than a sham organization utilized for the furtherance of illicit purposes. A large percentage of contrived numbers for cash inflows and outflows should be easily detected through proper application of digital analysis. Two digital analysis benchmarks hold true for almost all entities reviewed. First, there should always be an exponentially larger proportion of small transactions than large transactions. Almost all entities will have more transactions under \$100 than those over \$100,000. Secondly, rarely do entities deal extensively in rounded numbers. Depending on the type of organization, cash inflows may be the exception to this rule. A charitable organization will often accept donations in multiples of \$5, \$10, \$25, \$100, etc. However, the organization's expenditures should still abide by this rule.

XI. Alter ego, fraudulent conveyance and solvency matters in action

The use of the civil weapons (alter ego, fraudulent conveyance and solvency) in

counterterrorism is understandably in the early stages. To wit, only since November 8, 2001 has the Attorney General proclaimed that the federal prosecutor's core mission would be preventing terrorist attacks. Although only a handful of civil and criminal cases exist, there are sufficient references to illustrate the versatility of the civil weapons.

The references provided in this section are by no means the only avenues of application of alter ego, fraudulent conveyance, and solvency. Rather, the references reflect the gateway to further and expanded employment of civil tools that add to the prosecutor's arsenal.

Specifically, alter ego, fraudulent conveyance, and solvency are remarkably well suited to support the inchoate offenses of conspiracy and attempt contained in the key terrorist financing statute (18 U.S.C. § 2339 B).

Under the Anti-Terrorism and Effective Death Penalty Act of 1996 (AEDPA), 8 U.S.C. § 1189, the Secretary of State, in consultation with the Secretary of Treasury and the Attorney General, is empowered to designate an entity as a foreign terrorist organization (or FTO) after making certain findings as to the organization's involvement in terrorist activity. The designation by the Secretary of State results in the blocking of any funds which the FTO has on deposit with financial institutions in the United States. Additionally, representatives and certain members of the FTO are barred from entry into the United States. Finally, all persons within or subject to the jurisdiction of the United States are forbidden from "knowingly providing material support or resources" to the FTO. *See* 18 U.S.C. § 2339A.

In related actions, organizations or individuals found to be, in reality, a front for an FTO can be prosecuted under 18 U.S.C. § 2339B. Section 2339B only requires proof that defendants knowingly provided material support or resources to a designated FTO. Additionally, the Secretary of State has found some organizations to be an alter ego or an alias of a previously designated

FTO and subsequently designated that organization as an FTO. *See National Council of Resistance of Iran and National Council of Resistance of Iran, U.S. Representative Office v. Department of State and Madeleine K. Albright*, 251 F.3d 192 (D.C. Cir. 2001).

The National Council of Resistance of Iran (NCRI) and the People's Mojahedin of Iran (PMOI) petitioned for review of the Secretary of State's designation of both organizations as foreign terrorist organizations under the AEDPA. By notice of October 8, 1999, the Secretary of State redesignated the PMOI as an FTO, and also designated NCRI as an FTO. Two years earlier the State Department had determined that NCRI was not an alias of PMOI. Nevertheless, in 1999 the Secretary found that the NCRI was an alter ego or alias of the PMOI. Both petitioners argued that the Secretary's designation deprived them of constitutionally protected rights without due process of law. Additionally, the NCRI argued that the Secretary had no statutory authority to find that it was an alias or alter ego of the PMOI. The court agreed with the petitioners' due process argument, but rejected the NCRI's statutory claim. The court concluded that the Secretary's designation of the NCRI as an alter ego or alias for the PMOI did not lack substantial support and that the designation was not arbitrary, capricious, or otherwise not in accordance with law.

The Secretary did not expressly find that the NCRI engaged in terrorist activities under its own name. However, the Secretary did find that the PMOI and the NCRI are one and the same. Therefore, if the NCRI is the PMOI, and if the PMOI is a foreign terrorist organization, then the NCRI is a foreign terrorist organization also. *Id.* at 199-200. The court did conclude that the petitioners should be afforded the opportunity to file responses to the nonclassified evidence against them, to file evidence in support of their allegations that they are not terrorist organizations, and that they have an opportunity to be meaningfully heard by the Secretary. The matter was remanded for further proceedings. *Id.* at 209.

While the Court did not revoke the Secretary of State's designation of the NCRI as a foreign terrorist organization, as it was an alter ego or alias of the PMOI, it is evident how the doctrine of alter ego could be applicable in defense of this type of matter. The doctrine of alter ego can also be applied to those organizations, charitable and noncharitable alike, found to be supporting designated FTOs. As the United States continues to aggressively pursue foreign terrorist organizations and those entities supporting them, undoubtedly the activities and underlying structure for these organizations will become more covert and convoluted. A comprehensive understanding of the jurisdictional law and various analytical techniques related to alter ego, fraudulent conveyance, and solvency analysis will allow those prosecuting such matters to maintain pace with the evolution of terrorist cunning. All of these tools can be applied in the following realms of terrorist financing prosecution.

- Identifying terrorists and supporters through financial analysis.
- Prosecution of financial crimes committed by terrorists and their supporters, including those involving terrorist financing.

Note also that a pre-9/11 case has pertinent application. *See People's Mojahedin v. Department of State*, 182 F.3d 17 (D.C. Cir. 1999).

XII. What target-rich scenarios can be exploited?

Numerous target-rich scenarios can be analyzed using the techniques described herein and civil statutes. The application of civil weapons in counterterrorism is said to parallel the war on illicit drugs. That is, drug dealers are compelled to employ the United States' financial systems (in a seemingly legitimate manner) in order to maximize the results of their efforts. Consequently, once drug dealing operations were understood, laws were passed to criminalize such activities, e.g. money laundering.

In a like manner as terrorist activities became focused upon, funding sources migrated to so-called charities. Once charities are scrutinized terrorists must migrate to the next avenue, i.e. businesses, real and sham, that can facilitate funds flow. Therefore, it is a logical progression of law to apply civil statutes against terrorists' alleged civil activities in the business community.

The example scenarios have been structured within the following framework.

- It makes no difference whether the funds under scrutiny derive from legitimate or illegitimate sources.
- Terrorists are compelled to migrate to more seemingly legitimate business activities since their more recent avenues, i.e. charities, are increasingly scrutinized.
- Tracking terrorist funds is more difficult than tracking the funds for which previous legislation, e.g. Bank Secrecy Act, was created, because terrorist funds are often very small amounts and fall under the radar screen of scrutiny provided by SARs and CTRs, etc.
- Tracking smaller flows of money requires modern forensic accounting techniques that continue to grow in their sophistication.
- Since terrorist financing does not require a completed crime for prosecution, evidence in support of intent, gathered through forensic accounting, can support prosecution for domestic transactions even though the funds never reach their intended destination.
- With sufficient evidence such as that gained through forensic accounting, terrorist-connected assets can be seized through Executive Orders and the civil forfeiture provisions of U.S. law, thus blocking, freezing, seizing, and/or forfeiting assets of terrorist supporters.

The following examples of potential scenarios are by no means exhaustive, but illustrate the flexibility offered by the civil weapons. Each scenario is a composite constructed from various

completed, in-process, and hypothetical civil and criminal matters, thus providing common circumstances where the civil weapons can be applied.

The scenarios illustrate how alter ego, fraudulent conveyance, solvency, and related forensic accounting techniques, can be used individually or in combination to "[d]elay, disrupt or dismantle terrorist activities." As expected, not all the statutes or techniques apply in all cases.

A. The restaurant that never opens

A small Portland, Oregon restaurant offering ethnic foods was properly licensed and appeared to meet pertinent state and local operating ordinances. It contained a kitchen, counter, tables, chairs, utensils, and signage and was well lit at night. However, the doors were never unlocked or opened and customers were never observed inside. Further, in addition to the lack of customers, no food, beverage or supply deliveries ever occurred. Surveillance indicated that a subject periodically visited the site and was observed entering transactions on the restaurant's cash register system. Then, he made deposits (below CTR levels) at different local bank branches.

It was suspected that terrorist funds were somehow funneled through the sham business. Specifically, the store was believed to function as a collector which dutifully recorded, reported and deposited receipts for sales that never occurred, and paid for merchandise that was never received. The party observed onsite was considered a low-level operative, but an off-site party who appeared to direct activities was the real target, i.e. the terrorist suspect.

Alter ego indicia and statutes could be used to prove that the off-site party wielded instrumentality power over the restaurant through his direction of activities. Even though the off-site party held no ownership or business interest, e.g. stock, debt, etc., his actions could be proven to demonstrate his control over the business. Consequently, summary judgment or resultant

court activities could pierce the veil of the restaurant to hold the off-site party accountable and thus make his personal assets accessible.

Fraudulent transfer tests and statutes would apply in this case since transactions were executed without receiving or giving reasonably equivalent value. Specifically, the restaurant received funds without exchanging value, i.e. food and/or beverages, and the restaurant paid suppliers without receiving merchandise. Fraudulent transfer could also open the door against those so-called suppliers and so-called customers who were suspected of involvement.

Solvency analysis tests could be applied to prove the restaurant insolvent since the flow of funds resulted in a wash of cash inflows and outflows, normal expenses, e.g. utilities, insurance, etc. notwithstanding. Such insolvency determination could be used in support of alter ego and fraudulent conveyance techniques and statutes.

Forensic accounting techniques such as Benford's Law could be used to demonstrate that the deposited receipts (even if dutifully recorded, i.e. through a cash register process) did not statistically compare with the restaurant's posted menu prices.

The result? By proving control via instrumentality (alter ego) the off-site target operator could be directly linked to the business thus persuading the court to pierce the business veil. This would result in the cessation of business operations (via fraudulent transfer and solvency), thus making the target's personal assets subject to seizure.

Cases with potential application include: *National Council of Resistance of Iran and National Council of Resistance of Iran, U.S. Representative Office v. Department of State and Madeleine K. Albright*, 251 F.3d 192 (D.C. Cir. 2001); *Securities and Exchange Commission v. Health Maintenance Centers, Inc.*, C02-0153P, (W.D. Wash. Jan. 24, 2002); *White Star Timber Co., v. United States*, 94-425C (United States Court of Federal Claims Aug. 3, 2004).

B. Waste paper round-the-world

A Buffalo, New York waste paper broker transacted large volumes of waste paper shipments throughout the world. Consistent with his industry's business practices he seldom took title to the waste paper and often transferred large sums via international letters of credit (ILOC), DTCs, (depository transfer checks), wire transfers, etc., both domestically and internationally. Although his larger transactions were tracked via SARs and CTRs the transactions seemed legitimate.

The target operator owned the waste paper brokerage as a holding company and passed the transactions through ten wholly and partially owned multi-state and non-domestic business entities. The entities were held in various states throughout the United States near waste paper processing facilities. It was suspected that terrorist funds were somehow channeled through some of the subsidiaries

Alter ego could be used in concert with fraudulent transfer and solvency analysis to demonstrate that three of the subsidiaries were merely shell corporations, thus exposing the holding company to piercing and asset seizure. By using alter ego statutes and techniques it could be demonstrated that the subsidiaries never functioned as legitimate stand-alone corporations. Consequently, their sham status could persuade the court to invoke the piercing of their corporate veils.

Fraudulent transfer would likely require proof for only the entry and exit points (where financial transactions initiated and terminated) within three of the selected subsidiaries, thus demonstrating that the remaining entities lacked corporate substance (solvency) in support of alter ego. Such analysis would determine that the transactions lacked reasonably equivalent value, thus supporting UFTA common law requirements. Specifically, when the owner's exchange of money for merchandise significantly exceeded market value, it could be proven that he did not

receive reasonably equivalent value in the transaction.

Solvency analysis could further support alter ego and thus prove the lack of corporate substance in support of piercing the veil of the ultimate holding company. Balance sheet, cash flow, and adequate capitalization tests could be used to prove that the entities were not solvent.

A genogram could be used to illustrate the complex funds flow through the numerous wholly and partially owned subsidiaries. That would be necessary because some of the subsidiaries were held in wholly and partially owned shareholding blocks, and some subsidiaries held portions of other subsidiaries, thus complicating the corporate ownership trail.

The result? By proving corporate disregard for only a few of the subsidiaries, the holding company's corporate veil could be pierced, thus exposing the owner to judgment. All the subsidiaries would be required to cease operations, thus interrupting the flow of funds, and the owner's and holding company's funds could be accessed and seized.

Cases with potential application include: *National Council of Resistance of Iran and National Council of Resistance of Iran, U.S. Representative Office v. Department of State and Madeleine K. Albright*, 251 F.3d 192 (D.C. Cir. 2001); *U.S. v. Abdirahman Sheikh-ali Isse*, 342 F.3d 313 (4th Cir. 2003); *Securities and Exchange Commission v. Health Maintenance Centers, Inc.*, C02-0153P (W.D. Wash. Jan. 24, 2002); *White Star Timber Co., v. United States*, 94-425C (United States Court of Federal Claims Aug. 3, 2004).

C. Armored car and check cashing service

A Dothan, Alabama armored car service transported coins, currency, and checks between banks and clearing houses. Armored car services throughout the United States similar to this business operate in a largely unregulated industry. The lack of regulation is presumed to exist

because of the peripheral scrutiny placed on the respective banking institutions. However, consistent with industry practices, the company routinely cashed checks for otherwise undocumented parties, drawing upon its inventory of cash to process the transactions. Such transactions were typically overlooked by the banking institutions because they occurred between banking points.

It is suspected that the owner of a large Baltimore, Maryland olive importing business exercised control over the Alabama armored car service. However, public records failed to show that the importer had any formal ties, e.g. stockholdings or business debt, to the armored car service.

Alter ego indicia and statutes could be used to demonstrate that the Maryland olive importer wielded instrumentality control over the Alabama armored car service. This could be further supported by identifying selected check and/or cash transactions processed by the armored car service.

Fraudulent transfer techniques and statutes could be used to demonstrate that the proceeds transferred to undocumented parties in exchange for worthless checks supported the lack of reasonably equivalent value and met the common law requirements.

Solvency analysis would not likely apply in this matter, nor would it be necessary.

Forensic accounting techniques could include statistical tests such as attributes sampling. Attributes sampling is used to specifically identify occurrences that fall within and/or outside of previously established norms. Attributes sampling techniques can be applied either to the entire database and/or statistically, using sampling techniques. The most common use of attributes sampling in forensic investigation is to test the rate of deviation from a prescribed or expected control perspective to support the forensic investigator's assessed level of assurance. A simple example is often applied in testing payroll records. That is, if twenty-three employees are

paid weekly, then approximately ninety-two payroll checks are expected to be found (4 weeks x 23 employees) during a payroll month. If payroll checks exceed that amount then phantom employees may be on the payroll.

Ratio estimation can further refine the investigation. Ratio estimation is sometimes referred to as extrapolation and is often used in connection with variables sampling. Ratio estimation can project statistically significant results based upon analytical sampling via probability-proportional-to-size sampling.

The legally separate operations could be shown to be operated as an instrumentality by the Maryland target operator. Thus the court would deem him in control and invoke piercing of the corporate veil to access his business and personal assets for seizure.

Cases with potential application include: *National Council of Resistance of Iran and National Council of Resistance of Iran, U.S. Representative Office v. Department of State and Madeleine K. Albright*, 251 F.3d 192 (D.C. Cir. 2001); *U.S. v. Abdirahman Sheikh-ali Isse*, 342 F.3d 313 (4th Cir. 2003); *Securities and Exchange Commission v. Health Maintenance Centers, Inc.*, C02-0153P (W.D. Wash. Jan. 24, 2002); *White Star Timber Co., v. United States*, 94-425C (United States Court of Federal Claims Aug. 3, 2004).

D. The \$50 cup of coffee

The night manager of a local convenience store insisted on working the graveyard shift. About the middle of his shift, small groups of Middle Eastern men visited the store, appeared to transact business, exchanged pleasantries, and left, often three or more to a vehicle. Surveillance found that although significant currency (relative to the transactions) was exchanged, the men seldom left with significant amounts of merchandise. For example, one party was observed paying \$50 for a cup of coffee. The night manager dutifully deposited his receipts (below CTR and SAR levels) at various bank

branches—one used by the store and the others not related to the store.

It was suspected that the cash receipts were actually funds intended for terrorist purposes and that the night manager was a relatively highly placed operative. Although the store's actual owner appeared innocent, it would be helpful to prove that the late-night sales that occurred were not legitimate.

Even though the night manager held no ownership interest in the store, he could be proven to use the business as his instrumentality. That is, his graveyard shift responsibilities, consisting of stewardship of store assets, gave him functional control over business operations, including sales, merchandising, stocking, and ordering.

The target operator could be pursued with fraudulent transfer statutes and techniques since he executed transactions without receiving or giving reasonably equivalent value while using the store's facilities. Specifically, he received funds without exchanging value, i.e. food, etc. from customers. This would also open the door against the customers who were suspected of involvement.

Solvency analysis would not need to be applied in this matter.

Forensic accounting techniques applied in this matter could include full-and-false inclusion testing and pattern analysis to identify the transactional inconsistencies and thus focus the respective analytical efforts. Full-and-false inclusion tests could be used to determine the appropriate universe of data under investigation. That would ensure that no extraneous data was included and that no appropriate data was excluded. Also, ratio estimation (sometimes known as ratio extrapolation) could estimate (on a statistically significant basis) the projected results based upon analytical sampling via probability-proportional-to-size sampling.

The court could deem the night manager to be in control of the store's night operations and thus access and seize his personal assets.

Cases with potential application include: *National Council of Resistance of Iran and National Council of Resistance of Iran, U.S. Representative Office v. Department of State and Madeleine K. Albright*, 251 F.3d 192 (D.C. Cir. 2001); *U.S. v. Abdurahman Muhammad Alamoudi*, C03-1009M (E.D. Va. Oct. 22, 2003); *Securities and Exchange Commission v. Health Maintenance Centers, Inc.*, C02-0153P (W.D. Wash. Jan. 24, 2002); *White Star Timber Co., v. United States*, 94-425C (United States Court of Federal Claims Aug. 3, 2004).

XIII. Conclusion

The most effective way for an AUSA to begin employing civil tools in a counterterrorism effort is to start with simple targets and begin applying the guidance on an experience basis. That is, consider all possible targets and organize them according to the ABC method. The As are the high-value targets, and the Cs are the low-value targets; the Bs fall in-between.

The array will resemble a bell curve, with a few As, a few Cs, and mostly Bs. Start targeting the Cs first, and gain experience on low-value targets. Once all the Cs are exhausted, then begin with the As, and then the Bs. Such an approach will preserve precious resources while providing valuable experience.

As terrorists become more and more sophisticated in financing their activities, prosecutors must also become more resourceful. The forensic accounting weapons discussed in this article, when used effectively, will enable prosecutors to delay, disrupt, and dismantle terrorist activities. ❖

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