Preventing and Detecting Fraud in Aircraft Sales and Financing Transactions

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This article is based on Merrick Benn’s keynote presentation to the National Aircraft Finance Association (NAFA) Webinar on Sept. 15, 2020.

All organizations are subject to fraud risks—including when they buy or lease aircraft. Large frauds have led to the downfall of entire organizations, massive investment losses, significant legal costs, incarceration of key individuals and erosion of confidence in the capital markets. Publicized fraud—even for companies that are victims—has negatively impacted reputations, brands and images of many
organizations around the globe.

An estimated $4 trillion dollars are lost annually due to fraud, according to the 2018 Association of Certified Fraud Examiners’ (ACFE) Report to the Nations, a comprehensive study of global occupational fraud. The same report found the median loss due to occupational fraud was $130,000, more than 20 percent of cases resulted in losses of excess of $1 million. Recovering fraud losses is difficult—53 percent of victimized organizations never recover any money, while only 13 percent make a full recovery, according to ACFE.

The aircraft industry is a particularly tempting target for unscrupulous characters. Closings are remote. Deals often take place on an accelerated timetable, and rely on email communication. Often, transactions only include low levels of due diligence. And, of course, large amounts of money change hands every time an aircraft is sold or leased.

Here are just some of the latest instances of fraud to impact the aircraft industry:

- Mirae Asset Daewoo Co. Ltd., a Hong Kong-based aircraft finance unit, reported in March that it is likely to lose $5 million following an employee making false wire transfers.
- A UK man was arrested and deported this year after attempting to fraudulently sell a significantly damaged helicopter.
- On August 2, the SEC charged Integrity Aviation and its CEO in a $14 million Ponzi scheme related to aircraft engines and parts.

**Transactional Fraud**

While fraud comes in many forms, two are of particular concern to the aircraft industry. The first is transactional fraud. This is where industry focuses most of its time, money and energy in preventing. But, in reality, it is actually the hardest to perpetrate and the least likely to occur (in part because so much time and effort is spent to weed it out, so these preventative measures are worthwhile.)

Examples of transactional fraud in the aircraft industry include inflated equipment costs, double-financed equipment, kickbacks to vendors, and, of course, phishing emails from online scammers. This category also includes all aspects of business governed by anti-money laundering (AML) regulations.

In a nutshell, the industry protects itself well against such threats with our robust “Know Your Customer” protocols. But in-house counsel and aircraft industry professionals should know the following risk indicators for this type of fraud.

1) Geographical Risk – the counterparty’s domicile, the location of the transaction and the funding source; and

2) Counterparty Risk:
   - Politically exposed persons (government officials/political party officials)
• Unusual activities e.g., demanding that a transaction close in an unusually short time frame, refusing to provide details about their business or a last minute change in escrow/funding instructions

• Masking beneficial ownership – using surrogates, front man or nominees as well as tiered organizational structures

• Partners with no legal purpose – where there is no apparent legitimate tax, business, economic or other reason for the use of a particular legal entity or transaction structure

• Under or overvalued properties

• Unusual sources of funding – third party funds to purchase the aircraft where it doesn’t make sense i.e., coming from one business but where funds are to be held in the name of another business – or where the investment doesn’t match the investor’s business profile

• Any other activities which demonstrate suspicious behavior and do not make professional or commercial sense based on your familiarity with the industry and normal course of business.

No single factor necessarily rises to the level of a problem. But, when a combination of red flags truly exist, company professionals should speak up. Another best practice is to always ensure that wiring instructions are in writing and signed by a logical and legitimate representative. Verify that the release of funds matches the underlying written agreements with regard to funding milestones and perform consistent and appropriate due diligence on entities and individuals with whom you partner.

**Occupational Fraud**

The second type of fraud of particular concern to the aircraft industry is less obvious, more prevalent and harder to detect – in part because company leaders trust their team members. It is what the experts call “occupational fraud” – or really, embezzlement by employees, including senior management.

The reality is that fraud occurs all of the time, regardless of the economy’s cycle and is committed for may different reasons. The ACFE Report to the Nations reported the following:

• The typical act of occupational fraud isn’t detected for 18 months.

• By far, tips are most common detection method. Employees reported nearly half of all such tips.

• The smallest organizations tend to suffer disproportionally large losses.

• Banking and financial services, government and manufacturing industries have the greatest number of cases reported.

• The higher the perpetrator’s level of authority, the greater the losses tend to
be: Executives accounted for 19% of all cases and caused a medium loss in excess of $500,000 while employees (non-management) committed 42% of cases with a medium loss of $75,000.

- Many fraudsters exhibit certain behavioral traits that can be warning signs: 92% either: (a) live beyond their means, or (b) have unusually close associations with vendors or customers.

- The vast majority of fraudsters are first-time offenders.

So, how should companies protect themselves against occupational fraud? To start, keep these five key principles at the forefront:

1. A fraud risk management program should be in place, including a written policy to convey the expectations of senior management regarding managing fraud risk.
2. Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events the organization needs to mitigate.
3. Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.
4. Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.
5. A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

### Fraud Risk Governance

Organization stakeholders have clearly raised expectations for ethical behavior. Aircraft industry organizations need to respond to such expectations. Effective governance processes are the foundation of fraud risk management, while the lack of effective corporate governance seriously undermines any fraud risk management program.

The governing body should ensure that its own governance practices set the tone for fraud risk management and that management implements policies that encourage ethical behavior, including processes for employees, customers, vendors and other parties to report instances where those standards are not met.

The executive committee should also regularly monitor the organization’s fraud risk management effectiveness which should be a regular agenda item and appoint a member of management to be responsible for coordinating fraud risk management.

### Fraud Risk Assessment

To protect itself and its stakeholders from fraud, an organization’s leaders must
understand fraud risk and specific risks that directly and indirectly apply to the organization and the aircraft industry industry segment. A structured fraud risk assessment, tailored to the origination’s size, complexity, industry and goals should be performed, and updated periodically. The assessment may be integrated with an overall organizational risk assessment or performed as a stand-alone exercise but should, at a minimum, include risk identification, risk likelihood and significance assessment – and risk response.

An effective fraud risk identification process includes an assessment of the incentives, pressures and opportunities to commit fraud. Employee incentive programs and the metrics on which they are based can provide a map to where fraud is most likely to occur. Fraud risk assessment should consider the potential override controls by management as well as arears where controls are weak or there is a lack of segregation of duties.

Individual organizations will have different risk tolerances. Fraud risks can be addressed by establishing practices and controls to mitigate the risk, accepting the risk (but monitoring actual exposure), or designing ongoing or specific fraud evaluating procedures. The implemented fraud risk management program should never exceed its costs.

**Fraud Prevention and Detection**

Fraud prevention and detection are related but not the same. Prevention encompasses policies, procedures, training and communication that stop fraud from occurring, whereas detection focuses on activities and techniques that promptly recognize timely whether fraud has occurred or is continuing. It is important to consider both, and the best responses combine prevention and detection.

While prevention techniques do not ensure fraud will not be committed, they are the first line of defense in minimizing fraud risk. One key to prevention is promoting from the top down throughout the organization an awareness of the fraud risk management program, including the types of fraud that may occur.

Meanwhile, one the strongest fraud deterrents are the awareness that effective detective controls are in place. Combined with preventive controls, detective controls enhance effectiveness of a fraud risk management program by demonstrating that preventive controls are working as intended and by identifying fraud if it does occur.

Keep in mind while every organization is susceptible to fraud, not all fraud can be prevented – nor is it cost effective to try. An organization may determine it is more cost-effective to design controls to detect, rather than prevent, certain fraud schemes.

**Fraud Investigation and Corrective Action**

No system of internal control can provide absolute assurance against fraud. As a result, management should develop a system for prompt, competent and confidential review, investigation and resolution of instances of noncompliance and allegations
involving potential fraud. An organization can improve its chances of loss recovery, while minimizing exposure to litigation and damage to reputation, by establishing and preplanning investigation and corrective action processes.

If certain actions are required before the investigation is complete to preserve evidence, maintain confidence or mitigate losses, those responsible for such decisions should ensure there is sufficient basis for those actions. When access to computerized information is required, a specialist trained in computer file preservation should be used.

In addition, actions should be appropriate under the circumstances, applied consistently to all levels of employees – including management – and taken only after consultation with HR. Consulting legal counsel is also strongly recommended before undertaking an investigation and it is critical before taking disciplinary, civil or criminal action.

A proactive approach to managing fraud risk is one of the best steps aircraft industry organizations can take to mitigate exposure to fraudulent activities. Although complete elimination of all fraud risk is most likely unachievable or uneconomical, organizations can take positive and constructive steps to reduce exposure. The combination of effective fraud risk governance, thorough fraud risk assessment, and strong prevention and detection (including specific anti-fraud control processes), as well as coordinated and timely investigations and corrective actions, can significantly mitigate fraud risks.

Although fraud is not a subject that any organization wants to deal with, the reality is most organizations experience fraud to some degree. But a constructive, forward-thinking approach can give an organization a competitive advantage within its industry or business segment, including aircraft. Strong, effective and well-run originations exist because management takes proactive steps to anticipate issues before they occur and to take action to prevent undesired results.

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