

## Certified Corporate Meltdown

Even as top executives of DVI were vouching for its earnings report - a post-Enron mandate - the firm was spiraling into the 13th-biggest bankruptcy of 2003.

*Todd Mason **INQUIRER** STAFF WRITER*

Steven Garfinkel agonized last year over the stiff, new penalties for misleading investors that Congress passed after the Enron accounting scandal.

As a chief financial officer of DVI Inc., Garfinkel faced a maximum fine of \$5 million and a maximum prison sentence of 20 years if he **certified** earnings reports that he knew to be false at the now defunct Bucks County leasing firm.

DVI's accounting for the first three months of 2003 put "both of us on the spot," Garfinkel warned chief executive officer Michael O'Hanlon, according to an internal memo filed in the company's bankruptcy case in Wilmington.

"We should not be putting ourselves, our homes and personal assets at this kind of risk as well as face the very real prospect of going to jail," he wrote in April 2003.

Yet both men signed the certifications on May 20, 2003, attesting that DVI's finances were presented "fairly . . . in all material respects." The company's auditor, Deloitte & Touche, refused to sign the earnings report, which it considered incomplete, and the Securities and Exchange Commission declined to accept it.

Two weeks later, Deloitte resigned from the DVI account. In violation of its loan agreements because of the missing report, DVI filed for bankruptcy protection in August 2003. Listing \$1.87 billion in assets, it was the 13th-largest bankruptcy case in the nation in 2003, according to Bankruptcy News.

R. Todd Neilson, an examiner hired by the Bankruptcy Court to investigate DVI's failure, said in a report filed in April that company executives not only hid losses but also obtained loans from its banks using methods he described as "desperate and illegal."

The legal morass that Garfinkel envisioned is now materializing. Last month, DVI's creditors in Bankruptcy Court filed a civil lawsuit in federal court in Wilmington alleging that they were misled by O'Hanlon, Garfinkel and their colleagues at DVI.

It was the fourth suit targeting former DVI officers and directors, joining cases filed in federal court in **Philadelphia** by the company's banks, bondholders and shareholders.

O'Hanlon and Garfinkel declined requests for interviews. In a brief telephone conversation, O'Hanlon said the examiner's report was one-sided. "The examiner never really spoke to the people who could tell him what was going on," he said.

DVI's story, assembled from documents in Bankruptcy Court and civil lawsuits, illustrates the limits of the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002.

The law raised the stakes for executives who perpetrate fraud. But relatively few set out to deceive shareholders, said Michael Young, a fraud specialist at New York law firm Willkie Farr & Gallagher. Financial fraud "starts with pressure" to meet financial goals, he added.

Companies that get in trouble often use accounting tricks to borrow earnings from future quarters, as did executives at Enron Corp. and WorldCom Inc. Once they are in too deep to escape, "they say, 'My God, we've got to hide this,'" Young said.

To be sure, Sarbanes-Oxley's criminal penalties are powerful incentives to steer clear of slippery slopes. The point of certifications is to stop top executives from blaming underlings for **corporate** misdeeds.

"No more easy money for **corporate** criminals. Just hard time," President Bush vowed as he signed Sarbanes-Oxley into law on July 30, 2002.

At DVI, which relocated to Doylestown, Bucks County, from Irvine, Calif., in 1995, the easy money had disappeared in 1999. DVI financed medical equipment such as magnetic imaging machines for health clinics. Selling bonds backed by these loans to investors, DVI booked big gains on paper. It managed a loan portfolio of \$2.8 billion as of March 31, 2003.

DVI's cash dwindled after the company expanded in Asia, Latin America and Europe. Lacking a market to sell bonds backed by these loans, DVI used its own cash to fund them, often borrowing it from banks.

The creditors' suit says that DVI faced a second cash drain as it replaced bad loans in the packages it had sold to investors with good ones from the company's portfolio to keep its standing on Wall Street.

As the cash crunch worsened, the company allegedly grew more reluctant to write off bad loans as uncollectible losses.

DVI's creditors, in their suit, allege that DVI used "round tripping" to hide them instead. A DVI subsidiary would lend working capital to a delinquent borrower, which would use the money to repay the loan.

In another approach, the creditors allege, DVI installed handpicked managers at troubled clinics, making new loans to these successors, and reinstating the old debts as current.

As a result, DVI began violating agreements with its banks, which limited how much the company could lend to any one borrower and defined the types of loans that could be used as collateral.

Board members and others knew of DVI's loan-loss and compliance problems but did nothing, the lawsuits allege.

The shareholders' suit alleges that Merrill Lynch & Co. Inc. investment bankers knew of the collateral problems by early 2003, but carried through anyway on a bond sale.

"The allegations are false," said Mark Herr, a Merrill Lynch spokesman.

DVI maintained a happy face for shareholders. Even when DVI wrote off \$31.4 million in 2002, resulting in a loss for the year, O'Hanlon remained upbeat. "Excluding these mostly noncash charges, the company had a good year and our business prospects remain healthy," he said in a statement in September 2002.

But the strain was mounting inside the company. Its relationship with Deloitte soured as the accounting teams sparred over bad loans. Deloitte had criticized DVI's accounting for bad loans since 1995.

In an internal memo written in late 2002, DVI controller John Boyle characterized an interaction with Deloitte as " 'missile crisis' diplomacy." Boyle had refused to take a charge of \$80,000 that Deloitte had requested.

"We are no longer talking about a small problem," Garfinkel wrote in his April 2003 memo to O'Hanlon warning him that DVI's financial report "put them on the spot." "The size of the hole has taken on unimagined size and consequences."

But declining to certify earnings had equally grim consequences. Not signing "kills the company," Garfinkel wrote.

DVI had progressed from technical violations of bank agreements to deliberate breeches, Garfinkel told Neilson, the bankruptcy examiner. Facing a cash squeeze in 1999, according to Neilson's report, "Garfinkel has advised the examiner that he 'blinked' and suggested that the only way to raise the additional funds would be to pledge 'ineligible' collateral" to the banks.

In early 2003, he told Neilson, he began pledging the same loans as collateral to multiple lenders. Neilson estimated that bad collateral represented a \$102 million "hole" by then.

Deloitte resigned in a dispute over a modest point: How to account for loans and investments in a Corpus Christi, Texas, cancer clinic. DVI had lent \$6 million to four owners of the chronically

troubled facility, and had recouped just \$60,000.

Deloitte, which has been named in some of the civil lawsuits, said "there is no basis" for a claim that the firm was negligent.

A whistle-blower surfaced at DVI in July 2003. Susan Gibson, an operations manager wrote to Boyle, the company controller: "It appears to me that DVI has intentionally double-pledged a significant amount of collateral."

DVI directors hired a law firm to investigate, but the bankruptcy filing derailed the effort.

DVI is now liquidating its assets.

Auditing firms are not likely to uncover orchestrated frauds, said Charles Mulford, a professor of accounting at the Georgia Institute of Technology. Frauds "are conducted on auditors as well as the public," he said.

Executives can deceive themselves as well. Garfinkel noted in an undated memo to O'Hanlon: "I know that neither one of us joined DVI to get ensnared in possible criminal" activities.

"Desperate people do desperate things."

Contact staff writer Todd Mason at 215-854-5679 or [tmason@phillynews.com](mailto:tmason@phillynews.com).

#### **Illustration:CHART**

Private Doubts, Public Boasts (SOURCE: Bloomberg News; The [Philadelphia Inquirer](#))