

## Defining the Difference #103



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**Embezzlement Trial:  
HSG Analysis Reduces Damages to \$5,000 - from \$10 Million**



*Analysis and Trial Graphics*

FLY, Inc. ("FLY") filed for bankruptcy after discovering it was the target of an embezzler. FLY subsequently sued X Bank for permitting the embezzlers to open a fictitious corporate account.

[H.S. Grace & Company, Inc.](#) ("HSG") was retained by X Bank and its counsel to analyze the business aspects of the litigation and to provide expert testimony. The case went to trial, with HSG's analysis and testimony playing a key role. While X Bank was found to have some liability, the court awarded only \$5,000 in damages - a tiny fraction of the \$10 million sought by FLY.

Certain results of our analysis are set out below along with graphics prepared for trial.

**ANALYSIS**

The PETITION stated that Smith and Jones, without the knowledge, consent or authority of anyone at FLY, opened a bank account at X Bank under the name of Forwarding Services, Inc. ("FSI"). The PETITION also stated that "Beginning on or about August 2001 while employed by FLY, Smith and Jones devised a scheme to embezzle funds from FLY and deposit said funds into the FSI account for their personal use; this scheme continued during the entire time that Smith and Jones remained employed by FLY." The PETITION went on to state that as a result of the actions and inactions of X Bank, FLY sustained significant consequential damages.

HSG reviewed Smith's activities during his employment by FLY as well as the activities of Smith and Jones (after he became FLY controller) during their respective tenures. This review indicated a lack of control in many areas of FLY operations resulting from a highly unusual and inappropriate delegation of responsibilities by FLY's owner. HSG found that Smith employed a wide range of techniques and utilized a number of bank accounts and related vehicles in his personal embezzlement of funds and, subsequently, in his and Jones's embezzlement activities. HSG found that the FSI account at X Bank was only one account employed at one point in time. Smith had begun embezzling within weeks of his hiring and had used three other banks prior to opening an account at X Bank.

Smith was hired on or about July 6, 2000, according to the earliest W-4 found. FLY granted him check-signing and wire transfer authority sometime that month. Smith, a low-level employee, was granted these authorities without a background check or employment history verification - an approach well outside the scope of prudent business practice.

HSG established that Smith began to embezzle from FLY within weeks of joining the company, apparently after deciding the internal controls at FLY were so weak that he could embezzle at will. His embezzlement continued undetected for two-and-a-half years, and even once detected, FLY had difficulty determining the scope of the fraud: The court filing pegged the beginning of embezzlement to August 2001 whereas HSG established the actual thefts started more than a year earlier.

HSG found part of the reason that Smith was able to commence his fraudulent activities so soon after being hired was FLY was having problems with the production of financial statements. This was in addition to the serious questions regarding the integrity of its systems and controls.

HSG's findings established that Smith used several methods to embezzle before the FSI account at X Bank was opened. Initially, Smith had someone approve fraudulent vendor invoices, prepared the checks in payment of these fraudulent invoices and then had someone sign the checks, which Smith deposited into his personal accounts at banks other than X Bank. Smith continued this activity from July 2000 through October 2000. From November 2000 through August 2001, Smith fraudulently wire transferred funds from various FLY accounts to his personal accounts, none of which were at X Bank.

In summer 2001, Jones, in his new role as controller, discovered Smith's embezzlement activities. Smith persuaded Jones to join him. Together they opened the FSI account at X Bank. However, this new account was not necessary for the embezzlement to continue; instead, they could have continued to use one of Smith's existing accounts. This was supported by the fact that Smith wired four transfers from FLY into his personal accounts in March 2002, without going through the FSI account.

HSG's findings pointed out that because the vendors of the bogus invoices were either current or fictitious vendors, FLY knew or should have known the invoices were fraudulent. HSG pointed out that either the approver did not properly review the invoices or Smith was able to set up vendor invoices for payment without appropriate approval. In either instance, the HSG findings

indicated the internal controls at FLY were such that Smith was practically invited to embezzle.

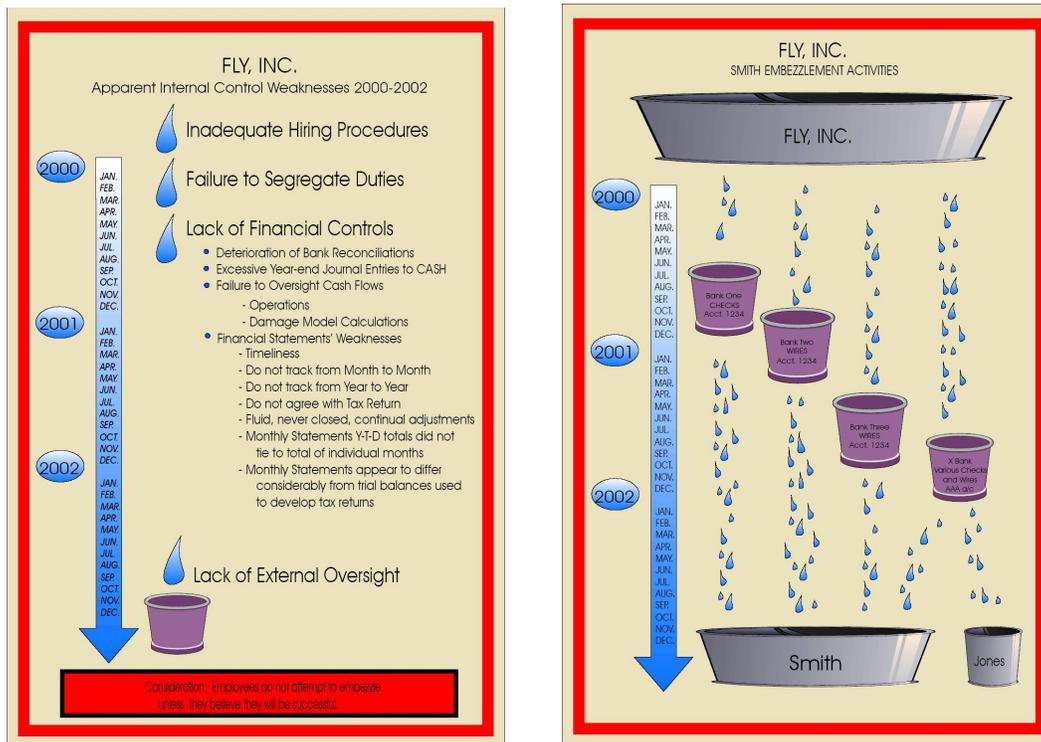
Further, HSG findings revealed the absence of a proper review of monthly financial statements, and a breakdown in the review of monthly bank reconciliations. Either of these could have alerted management to the possibility that fraud was occurring.

## GRAPHICS

Graphic #1 sets out certain HSG findings. X Bank was the fourth bank used by Smith in his embezzlement scheme. The timeline on Graphic #1 shows that X Bank became involved 14 months after Smith had initiated his fraud in July 2000. Graphic #2 focuses on FLY's internal control weaknesses and employs the same timeline as Graphic #1.

## SUMMARY

The matter went to trial, with FLY seeking direct and consequential damages in excess of \$10 million. HSG testified regarding its findings and its experience with similar cases. While the jury found X Bank had liability in permitting the fictitious FSI account to be opened and FLY had been damaged by the embezzlement, it determined that X Bank was liable for none of FLY's alleged consequential damages and less than one percent of FLY's alleged direct damages, or approximately \$5000.



### If you would like to know more...

If you would like to know more about this case, or about the kinds of business-based analysis of claims and damages available from [H.S. Grace & Company](#), you are invited to contact members of our group, [Al Fenichel](#), [Charles Fischer](#), [Steve Grace](#), and [H. Stephen Grace, Jr.](#), at (713) 572-6800.

H. S. Grace & Company, Inc. (HSG) is a litigation support and consulting firm established in 1993 that works with in-house counsel, outside counsel, insurance carriers and corporate attorneys, as well as company boards and senior management. HSG specializes in assisting clients both before and during litigation in analyzing and assessing the validity of claims involving representations and warranties, directors and officers responsibilities, financial reporting, business judgment, merger and acquisition disputes and other complex issues. The firm provides expert testimony from our detailed analyses of the business decisions and actions, issues reports of how the actions of all parties involved affect causation and evaluation of damages and provides guidance to support settlement strategies and negotiations. HSG has approximately 30 consultants, including experienced testifying experts, who have had significant experience as senior executives (e.g., CEOs, COOs, CFOs, SVPs, treasurers, technical professionals and board members), many of whom hold advanced degrees and professional certifications. Our experienced team members look deeply into claims and allegations to determine not only what happened, but how and why, to speak authoritatively about appropriate business practices, and to assist clients in achieving favorable outcomes. HSG has represented banks and other financial institutions, real estate partnerships, energy companies, pharmaceutical firms, healthcare companies, insurance carriers, retailers, technology companies and others in a broad array of complex commercial litigation

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