H.S. Grace & Company, Inc.

Securities Fraud, 1934 Act – Software Company

Corporate governance issues and issues relating to the reasonableness of business practices and process abound in litigation today. These issues are becoming increasingly important in many types of litigation, including claims alleging securities fraud, causes of action for breach of fiduciary duty, and shareholder rights claims. Corporate governance and business practice issues are also frequently key in more typical common law fraud claims where misrepresentations and the reasonableness of reliance are at issue; in bankruptcy claims involving fiduciary responsibilities, fraudulent conveyances, and zone of insolvency issues; and in contract claims where breach of representations and warranties are at issue, particularly where accounting and financial issues are important. H.S. Grace & Company, Inc.'s (HSG) team of senior management level executives and board members offers a wide range of actual, real-life experience in governance issues and business practice and process issues in a variety of industries.

The following two HSG cases demonstrate the broad array of claims in which corporate governance and customary business practice and process issues can play a key role in the resolution of the litigation.

Securities Fraud Claim Under The 1934 Act

Allegations

The SEC sued the CEO of a software company claiming that the CEO had intentionally orchestrated the misstatement of the company's financial statements through an accounting fraud, which ultimately resulted in a restatement. The SEC further asserted that the CEO's certification of the restated financial statements was an admission of wrongdoing. HSG was retained by the CEO and his counsel to analyze these allegations and those of the SEC's expert witness.

Analysis

Drawing on their extensive experience as officers and board members of major corporations, who have actually been involved in business decision-making processes and in determining what goes in financial statements, the HSG team was able to review and evaluate these detailed allegations and explain what the CEO's role and duties were in this situation. Specifically, HSG explained:

- All companies must rely on a division of labor to operate.

- By necessity the CEO must rely on the expertise of others within the company to fulfill his duties and obligations in his role in the overall management of the company.

- The proper accounting for transactions under GAAP is not always a black and white issue and requires accounting expertise.

- The CEO was not an expert in accounting and had the right, in this instance which involved complicated accounting issues not fully resolved by the accounting rules, to rely on the accounting judgment of both internal and external accounting professionals as to the proper way to account for the transactions in question.

- The CEO had not ignored his duties, but rather had diligently performed those duties by seeking the advice of experts in an effort to fulfill his obligations.

Result

The SEC sought (1) a permanent injunction, (2) civil penalties, (3) an officer and director bar, and (4) other relief. Following the pretrial conference with the judge the day before trial was to begin, the matter was settled for a nominal five digit amount.

Negligence, Bad Faith and Conspiracy Claims Against Bank in Embezzlement Scheme

Allegations

Two of ABC's employees embezzled approximately $800,000 over several years from their employer utilizing a fictitious bank account they set up at defendant bank. ABC contended defendant bank was negligent, acted in bad faith, and failed to follow reasonable commercial standards of fair dealing by accepting checks and wire transfers into the fictitious account without proper endorsement. ABC contended that the embezzlement caused ABC's bankruptcy and, as a result, sued defendant bank both for its direct losses of $800,000 and for consequential damages in the amount of $11,000,000. HSG was retained by the bank and its counsel to investigate the allegations.

Analysis

The HSG team consisted of senior financial officers with public accounting, controllership, and senior management experience. The HSG team found:

- The two employees had commenced their embezzlement scheme several years before the fictitious account at defendant bank was opened, a fact unknown to ABC at the time it filed the initial petition. In fact, the employees had employed fictitious accounts at three other banks prior to opening the account at defendant bank and embezzled a total of almost $2,000,000 through the fictitious accounts at multiple banks.

- The embezzlement resulted from both a lack of and a failure of internal controls at ABC and from a highly unusual and inappropriate delegation of responsibilities by ABC's owner.

- Significant problems with the timely and accurate production of financial statements at ABC also contributed to the lax environment at ABC which allowed the two employees to undertake and continue the embezzlement scheme for several years.

- ABC's damage claims were not supported by the evidence.

Result

After an extensive trial, in which H. Stephen Grace, Jr. testified on both the issue of liability and damages, the jury found that plaintiff ABC had direct damages of $120,000. The jury found that ABC itself was liable for 95% of this $120,000 in damages and that HSG's client, defendant bank, was responsible for only 5% of the damages or $6,000. The jury also found there were no consequential damages.

H.S. Grace & Company, Inc. is a team of senior executives who diagnose and resolve critical corporate problems in business governance, operations, finance and control. With more than 1,000 years of experience, our goal is to help companies enhance shareholder value, protect reputation and their long-term ability to succeed, avoid and manage litigation, and navigate major changes such as mergers and acquisitions or bankruptcies. We often serve as consulting and testifying experts, identifying and analyzing critical business issues.

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