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Business Process Improvement
It Pays to Keep Your House in Order - June 26, 2000
H. Stephen Grace, Jr., Ph.D. and John E. Hauptert

It Pays to Keep Your House in Order: Plaintiff's Case Undone By Poor Internal Controls

H. Stephen Grace, Jr., Ph.D. and John E. Hauptert

The Defendant, a bank, was sued for damages of approximately \$10,000,000 stemming from an embezzlement, which occurred within a customer's corporate umbrella. A relatively low-level employee opened an unauthorized account at the bank using a fictitious corporation and federal ID number. The bank failed to verify the validity of the corporation and its ID number, as called for by the bank's operating policies. The employee and a colluding employee subsequently directed checks and wires amounting to approximately \$800,000 into the account over a year and a half, and from there, transferred funds to their personal accounts. Included in the deposits to the account were checks issued to a variety of payees and often the checks were not endorsed. The bank accepted all of the deposits.

Clearly the bank had not done its job properly and faced a very difficult time in developing a viable defense. Consequently, the bank retained a consultant to examine all aspects of the case and to develop a framework for a defense.

The consultant determined that the Plaintiff was one of an aggregation of a large number of companies, domestic and international, controlled by a sophisticated investor/operator. They also discovered that embezzlement activity had actually begun fourteen months before the fictitious account had been opened and had occurred in a variety of banks other than the Defendant bank. This finding led to a detailed examination of internal controls, which revealed a significant number of control breakdowns, and a lack of customary internal and external controls in certain areas. The analyses also showed that these breakdowns stemmed from flaws in the operating structure(s) of the companies and the investor's apparent desire to cloak the operations in secrecy.

Armed with these findings, the consultant challenged the business basis of the Plaintiff's consequential damages, pointing out unsubstantiated data, serious inaccuracies in the assumptions, and further highlighting the discrepancies and the disarray in the group of companies' reporting and control systems. The consultant also assisted counsel in challenging the testimony of the Plaintiff's senior management and its expert(s).

The final result was that the jury found no consequential damages. Further, the jury

significantly reduced the amount of the direct damages to which it felt the bank had contributed. The jury then found the Plaintiff liable for 95% of these reduced direct damages, with the bank responsible for only 5%. The dollar value of the damages for which the Defendant bank was held responsible totaled \$6,000.

While many factors played a part in the ultimate verdict, it was evident that the weakness in the Plaintiff's internal controls and its murky corporate structure played an important part in swaying the jury. Corporations must keep their house in order.

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