



# THE HECHT LETTER



## LIABILITY CONTROL AND EFFECTIVE GOVERNANCE AT THE BIG FOUR

*By Mitchell Berns, Esq.*

In the 1980s we were involved in litigating, on behalf of investors, cases against large brokerage firms who sponsored unsuccessful businesses launched as limited partnerships. What we found is that such businesses failed because they were conceived as sales opportunities for stockbrokers, rather than as businesses with a viable plan to achieve profits.

We are now litigating against a large accounting firm, and wondering if a similar phenomenon – structuring a business for reasons other than business success -- is at work. The accounting industry has been subjected to increasingly stringent regulatory standards, evolving out of Enron and other debacles. Yet the evidence suggests that the quasi-franchise structure the Big Four and other global accounting firms have adopted can make it quite difficult to assert and maintain effective controls over far-flung accounting practices around the world.

The global accounting firms are not structured as traditional corporations, with absolute lines of control and authority running to the top of the organization. Rather, they are generally

membership organizations, where the country firms delegate certain governance powers to a central authority, in return for the right to practice under a global brand. The central authority taxes the member firms for its costs, uses partners coming up through the country firm ranks to staff its global positions, and maintains the ultimate power to eject a member firm for failure to maintain professional standards.

Such a structure implies that the authority of the governing entity is not nearly as absolute as in a traditional corporation. For example, the global chief executive cannot fire a subordinate country head at will. That power rests with the country practice. Although a country practice risks ejection if it resists the central authority, that can be an unwieldy sanction, much like an atomic bomb no one wants to drop. From a central governance point of view, the result can feel much like trying to drive a car from the back seat. You can eventually get there by threatening to sack the driver, but can easily crash along the way before the message gets through.

Why suffer such an unwieldy governance

structure, when the reputation and legal risks to the entire organization of missteps can be so high, as Arthur Andersen made clear? We do not know the answer, but from our perch as litigators, it appears that liability control has something to do with it.

The major accounting firms are global enterprises with multi-billion dollar revenues. They are global brands, and their "seals of approval" on financial statements make them juicy litigation targets when things go wrong. As our legal rules now stand, were they to structure themselves as integrated firms, without "fire walls" protecting country practices from each others' liabilities, they might well be rolling the dice with each Fortune 500 audit opinion they sign.

Our legal system has developed extensive rules on what does and does not constitute a securities fraud or an improper business practice. But once wrongdoing is found, the courts can be cavalier in their assessments of how much guilty parties should pay. They are particularly concerned about getting the initial determination of guilt right. Thereafter, the courts have been perfectly happy to let the guilty shoulder the entire burden of compensating the injured for whatever damages can be proven.

An improper accounting opinion or other improprieties in the audit can cause sizeable investor-trading losses eclipsing the fees earned from the improper audit. The current legal regime could expose the entire balance sheet of an integrated global accounting firm to bankrupting damages resulting from the failure of one large multi-national company.

An international firm's balkanized structure may limit such catastrophic risks, but can result in sub-standard performance. Our current system of broad damages assessments does not necessarily get us the results we want – higher quality audits. To fix the problem, sensible limits on the damages (including punitive

damages) chargeable to an accounting firm from an improper opinion would have to be put in place, geared to the revenues earned from the engagement. Such limits could well yield stronger audit performance by fostering more effective governance structures.

## HOW TO COLLECT A MONEY JUDGMENT

*By Daniel Tepper, Esq.*

### **Docketing The Judgment**

**C**ongratulations! After months of grueling legwork and an exhausting hearing, the arbitration panel has decided that your client was right after all and has given you an arbitration award. But unless your opponent is going to graciously admit defeat and send you a certified check, the matter is far from over. You will have to go through the process of converting the arbitration award into a judgment (if you won in court, skip to the fourth paragraph discussing how to settle a judgment). You will then go through the process of attempting to collect your judgment. This can be intimidating. The practice treatises are generally not much help. The clerks of the various offices you will need to see each have their own procedures, which never seem to be written down. The forms are confusing and antiquated and are called different names by different people. You may need to get the Sheriff involved.

The first step is to convert your arbitration award into a judgment. This is done through a proceeding pursuant to CPLR Article 75 by means of an Order to Show Cause requesting the confirmation of your arbitration award. Your Verified Petition to Confirm the Arbitration award, attached to your Order to Show Cause, should set forth the authority of the arbitrator and annex a copy of the

arbitration award. You may also want to attach the basis of the arbitration award, such as your request for arbitration and any underlying documents.

Your Petition must contain the following information and statements: 1) the amount of the award (i.e., the amount actually awarded to you by the arbitrators); 2) a statement that it has been less than one year since the delivery of the award by the arbitrator to you (See CPLR § 7510), and 3) a statement that no prior applications have been submitted.

Once your adversary is served with your Order to Show Cause and thereby gets notice that you are serious about collecting on your judgment, there is the possibility that he will start to hide his assets and otherwise make himself "judgment proof." This is unfortunately an occupational hazard, which will be discussed in a future article.

### Settling the Judgment

Eventually, the judge will hear your application and will, if things go according to plan, instruct you to settle a judgment. In drafting your judgment, make sure to award yourself statutory interest, costs and disbursements but do not fill in these amounts. They must be computed and filled in by the Judgment Clerk. The most important part of your judgment is the last paragraph, which should say substantially the following:

"**ADJUDGED**, that the Petitioner (your name), with an office at (your address), recover of Respondent (their name), with its principal place of business at (their address), the sum of (amount awarded by arbitrators), together with statutory interest thereon at a rate of 9% per annum from (date of arbitration award) in the sum of \_\_\_\_\_ (leave blank), together with costs and disbursements in the sum of \_\_\_\_\_ (leave blank), making

in all the sum of \_\_\_\_\_ (leave blank), and that Petitioner have execution therefor."

Serve your adversary with your proposed judgment and a Notice of Settlement. Eventually, if things go according to plan, your Judgment will be signed by the Judge and find its way into your file in the file room. While you are waiting for that to happen, go ahead and prepare the Bill of Costs.

We strongly recommend using the Blumberg form Bill of Costs, because that is what the Judgment Clerk is familiar with. Generally speaking, you are allowed to claim \$200 costs after note of issue pursuant to CPLR § 8201(2), the fee you paid for your index number pursuant to § 8018(a), a fee up to \$40 for a process server (if you used one) pursuant to CPLR § 8301(d), \$40 for the Sheriff's fees on execution pursuant to CPLR § 8801(b), and the fee you paid for your RJI. Do not add up the total costs and disbursements, as that will be completed by the clerk. You must certify the Bill of Costs on the reverse of the form.

Once you have your Blumberg form Bill of Costs and your Judgment signed by the Judge, take the entire file from the file room to the judgment desk. The clerk will fill in the totals on your Bill of Costs, compute your interest, fill in the blanks in your judgment. The Clerk will then countersign your judgment and stamp it as being filed and docketed. Make sure to get a copy of your stamped Judgment.

Finally, you are ready to try and collect your money, the procedure for which will be described in our next issue.

## THE IMPORTANCE OF CONTRACTS FOR ARTISTS

*By Charles Hecht, Esq.*

The recent sudden and unexpected closing of the high-profile Salander-O'Reilly Gallery in New York amongst a flurry of lawsuits and accusations of wrongdoing highlights how important it is for an artist to have a proper contract with a gallery. What the rights of each artist will be in this terrible situation will to a large part be determined by what is in their contract, if any, with the gallery.

As we all know, most gallery contracts are extremely one sided and do not even consider the possibility of the gallery going out of business or not properly transmitting sales proceeds to the artist.

A recent decision in New York State Supreme Court, *Chase v. Stendhal*, illustrates how a well drawn contract can protect the artist. The contract in relevant part contained the following provisions. The gallery had the exclusive right to sell artworks selected by the artist for a one year period on a consignment basis. The works were to be listed at retail value with the artist being entitled to 50% of the established retail price of the work sold. The artist was to be paid 30 days after payment was received on each transaction. Further, the gallery was required to pay all costs associated with advertising, announcements and mailings with the parties splitting the costs of transportation of the artworks between the artist's studio and the gallery.

When the gallery did not transmit funds to the artist on the sale of three artworks, the artist promptly went to the gallery and took possession of all of his remaining works. The contract was critical in rebutting in the gallery's position that they had an agreement to put the artist's share of the profits from the sale

of his works towards the costs of maintaining the artist's two month exhibit at the gallery.

The gallery's next position was that the artist improperly removed his artwork before the expiration of the one year consignment period. However, the law in New York is clear. When one party materially breaches a contract, the non-breaching party must choose between two remedies: (i) it can elect to terminate the contract or (ii) continue it. Here, the artist did the right thing by promptly coming in and repossessing all of his paintings once there was an obvious breach of the contract. Otherwise, the gallery could argue that by not doing this, the artist had waived his right to take back his consigned works of art.

Lastly, the gallery argued that the failure to pay the artist within 30 days was not a material breach. Again, the court looked to the contract, which provided a specific time period in which the gallery had to pay the artist. Since the timing was specified, it goes to the essence of the agreement and is material.

Artists tend to focus on creating art. But an artist must know that in order to protect your rights in what you create, you need to have a proper contract with the gallery. The gallery's form of contract is almost always one sided and detrimental to the artist. The artist must negotiate provisions to protect his or her interests. Accepting the gallery's form of contract in "blind faith" is not in the artist's best interests.

## 10b-5 AND AUTOMATIC TRADING PLANS

By Charles Hecht, Esq.

**W**ith a proper automatic trading plan, executives and other key employees may sell shares without triggering insider trading charges. An automatic trading plan can also be critical in defending suits alleging fraud under Rule 10b-5. At the very minimum, the trading plan must lay out in advance the dates and prices at which trades may be made and give up control of the trades to a broker or investment advisor.

Intent to defraud is an element that must be alleged and proven in securities fraud cases. Sales of stock by an insider are often alleged as evidence of intent to defraud. Under the recently decided *Tellabs* case, the U.S. Supreme Court now requires that an inference of *scienter* be more than merely plausible or reasonable in order for a plaintiff to meet the "strong inference" of *scienter* requirement under 10b-5. The inference must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.

*Elam v. Neidorff*, a recently decided federal district court case in Missouri, illustrates this principle. In *Elam v. Neidorff*, the trading program authorized sales on certain dates if the company's stock price was above \$25. Shares were sold just before the announcement that the company's earnings had to be restated at a price above \$25 per share. Without specific allegations showing that these types of sales were inconsistent with the key officers' prior trading history in the company's common stock, sales pursuant to the automatic trading plan were insufficient to show *scienter*.

The moral of the story is to create an automatic trading plan for your executives and other key employees and to make sure that sales are made in accordance with the plan. In this way, you

will be protected against fraud claims where the *scienter* of the individuals is based upon their buying or selling stock in anticipation of the event which triggered the sharp decline or increase in its price.



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