UNDERSTANDING EMPLOYEE DISHONESTY LOSSES
AND DEVELOPING A RECOVERY STRATEGY
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Fidelity subrogation is unique in that every loss presents two potential forums for recovery—the criminal and civil systems. The two main types of coverage that are triggered by a fidelity loss are commercial crime and employee dishonesty. If an insured has a crime policy, then an employee dishonesty loss would trigger coverage in a crime policy, since the insuring agreement covers all types of theft, not just employee dishonesty. A business package policy might cover employee dishonesty, as well. The focus of this article is on employee dishonesty losses, a subset in the world of crime coverage. A background of the federal and state statutes, the types of targets and actions in the criminal and civil remedies are all needed in order to understand the factors to consider in developing a recovery strategy.

BACKGROUND:
Jurisdictions: Criminal Vs. Civil; Federal Vs. State
From a general standpoint, criminal statutes in the federal jurisdiction are much narrower than in state law. Fidelity losses falling under the federal jurisdiction involve economic crimes. The following factors determine if the federal jurisdiction applies: the type of loss, type of organization involved in the loss and if the loss occurs interstate. Examples include theft, embezzlement and check claims that occur at federally regulated and insured financial institutions like banks,1 securities fraud at brokerage firms and interstate mail fraud to transport checks, currency, fraudulent invoices or documents and products that are part of a scam.

Each U.S. Attorney's office has its own unwritten threshold before it will investigate and prosecute an economic crime; however, for many cases, victims are directed to state authorities and local law enforcement. Exceptions are made for high profile cases that are receiving a lot of media.

States have their own criminal statutes for crimes that do not fall within the federal jurisdiction. From a practical standpoint, state courts might not prosecute cases being handled in the federal court and vice versa.2 However, dual prosecution does not constitute double jeopardy; different sentences can be issued in each jurisdiction.

Of important note, there are times when criminal proceedings are not part of a fidelity claim because the insured does not want to file a complaint with law enforcement, due to concerns about bad publicity. The insured may also have a close relationship with the employee and a fidelity policy may not compel the insured to file. Even if a complaint is filed, law enforcement might believe it does not have strong enough evidence to prove the case beyond a reasonable doubt. In addition, if caseloads are too high in a particular state or the federal jurisdiction, the best (and more expeditious) option is the civil forum. This occurs most frequently in heavily

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populated metropolitan cities and for federal cases in which resources are focused more on terrorism and national security.

**Potential Targets – Individuals Vs. Professional Organizations:**

There are two main categories of targets: individual and professional. Individual targets include principals (the dishonest employee), their accomplices and anyone unjustly enriched by the loss, knowingly or unknowingly. Within the principal category, there are fiduciaries and non-fiduciaries. The former are accountants and others in the organization that are entrusted with and have access to company resources and sensitive information.

Professional targets are third parties and include outside auditors and financial institutions, such as banks and securities brokerage firms. Accountants may have failed to detect the misuse of funds through the audit process and/or certified that the financial controls were adequate. Financial institutions may be involved because they negligently set up accounts and/or transferred stolen corporate funds to accounts controlled by the principal or cashed altered or forged checks. Money could also be laundered through securities brokerage firms.

Professional targets are usually more viable targets than individuals, since they frequently have their own professional liability coverage and more assets than individuals do. However, for financial institutions, like banks, time constraints and the circumstances under which they can be held culpable are different than for other organizations.³

In most instances, recovering money from individuals is challenging. Violators of the Eighth Commandment steal for a multitude of reasons and many thefts occur in small amounts over long periods of time. Unfortunately, most of the money is gone by the time the theft is discovered, since many losses involve drug or gambling addictions, alcohol abuse or other indiscretions. After all, thieves generally do not invest in valuable, appreciating or liquid assets.

Recovering assets from individuals is tricky. What initially looks viable can have very little equity, be illiquid, or have a smaller than expected liquidation value. Primary residences may be protected in whole or part by a Homestead exemption. Even if the home is not protected by such an exemption, a martial interest or an existing mortgage will diminish the equity and viability of that asset. Further, short of a home equity loan (which a spouse will not likely agree to), the house would have to be sold in order to recover any money. Oftentimes, these homes are already heavily mortgaged, which is why the theft occurred in the first place.

Retirement funds, such as 401K, deferred compensation and ESOP plans are generally protected by ERISA and cannot be attached, even with a criminal restitution order, or held by the employer’s fiduciary at the direction of the employer. The principal must take possession of the retirement funds and then direct them to the carrier. A contentious, protracted divorce—common in fidelity losses once the spouse finds out about the theft—can also freeze assets for a long time.

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Other considerations are the cost to attach or to freeze personal property or financial assets, to foreclose on real assets and to garnish wages, if the principal can find a job and is not in jail. Try to leverage your investigation with law enforcement’s investigation when possible; it may defray some of your costs. Keep in mind law enforcement’s primary focus is on determining if a crime was committed and prosecution, not your recovery. However, their investigation and efforts to trace the money to prove a crime was committed will definitely supplement your investigation and recovery efforts.

**Types Of Negligent/Tort Actions And Statute Of Limitations - Civil Vs. Criminal**

If the insured wants the principal(s) criminally prosecuted, a criminal claim will usually be filed before a civil claim. Fidelity examiners, as part of the adjustment process, typically ask the insured to report the claim to law enforcement to get the claim started for one main reason: any finding(s) in criminal court, including restitution payments – which is what recovery professionals care about – can be used in civil court.

No federal statute pertains to conversion, only the types of economic crimes mentioned previously. Thus, if there is no federal statute on point for the type of crime committed, then the federal statute will use the applicable state statute. The statute of limitations for economic crimes is four and five years after a criminal offense is committed.

Under state law, the following types of actions relate to fidelity losses: theft, conversion, fraud, breach of fiduciary duty, conspiracy and unjust enrichment. Some states group theft and conversion, but others make a technical distinction: theft requires motive. Fraud requires specific evidence that the wrong was made knowingly and with the intent to deceive. Breach of fiduciary duty arises when individuals or organizations are in a position of trust and do not act solely for the interest of their clients.

Some states have their own Racketeering, Influenced and Corruption Organization (RICO) Act, which involves conspiracy: this act can apply when the loss involves multiple principals or parties not related to the principal, such as banks, and other financial institutions or professional organizations. RICO is a federal statute that is either codified in a state’s statute or is allowed to be used in state court. Even though awards can involve treble damages, and the chances of prevailing are slim, it will surely get the attention of a defendant. All of the above actions fall under both criminal and civil laws in state court and are considered either a tort or act of negligence.

The statute of limitations varies for each state and depends upon the type of action. Statutes usually start to run from the date of discovery, not when the act was committed. However, this is not necessarily the date the insured discovered the loss, since the argument could be made that the act should have been discovered sooner.

States also vary as to when the statute expires. In some states it runs from the date of discovery and in others it is actually tolled every time a restitution payment is made.

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Recovery Strategies - Putting It All Together And Evaluating Your Options
Every recovery strategy should include a budget; the obvious goal is to ensure your investigation expenditure is commensurate with the amount reasonably expected to be recovered. However, this goal and a budget cannot be set without considering the following factors:

1) Financial viability of the target(s)
2) Applicable jurisdiction - federal vs. civil and definition of statutory victim
3) Rights of the carrier - wording of the policy and release vs. release and assignment
4) Strength of evidence
5) Terms of criminal sentencing - amount of restitution ordered, jail time and/or length of probation period

Identifying the targets (discussed previously) is usually not too difficult, but determining how much can be recovered can be. Professional targets have professional liability insurance, so insurance coverage and/or familiarity with the laws that govern the organization will determine the viability of the target.

As for individuals, since no personal insurance covers this type of act, only the valuation of their assets and earnings power can be considered. Locating/tracing the stolen money or other assets, real or personal, is not easy. If assets can be identified and located, the next step is to determine what liabilities or encumbrances are associated with those assets, as well as the cost to liquidate them. Only then can a budget be established. If the theft occurred abroad, one really has to evaluate the legal landscape in that country before embarking on the odyssey of chasing the principal (if still abroad) and locating assets. No foreign attorney works on contingency! The loss should be very large before pursuing a subrogation claim outside the United States.

Due to increasing demands on federal prosecutors to focus more on cases that involve national security and terrorism, prosecution moves slower in the federal jurisdiction. Only the criminal and economic crimes mentioned are prosecuted. However, on the positive side, once a federal criminal restitution has been ordered, an Abstract of Judgment is issued, which has the force and affect of a civil judgment. Essentially, it kills two birds with one stone.

Criminal restitution in federal court is governed by the Mandatory Victims Restitution Act (MVRA) and Federal Debit Collection Procedures Act (FDCPA). Under these acts, the Financial Litigation Department of the U.S. Attorneys Office (USAO) has the authority to enforce and collect criminal restitution orders on behalf of the U.S. government and non-government victims of crime. If the target relocates out of state, there is no need to domesticate the order in the target’s new state of domicile. The USAO may enforce collection through civil judgments.

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in the court where the defendant was originally convicted and is not required to file a separate civil judgment. Carriers can ride the coattails of the Federal government and leverage off its efforts, which is a real help, especially when the target has a limited earning capacity and does not have a lot of assets. However, a carrier has to communicate with the U.S. attorney handling the case to establish themselves as a victim.

State law determines who is considered a statutory victim, which is either the insured or carrier. Only the victim will be listed on the criminal restitution order, and only his loss will be considered, regardless of the size of the loss. For example, if the principal is convicted and restitution ordered and the carrier is not considered a victim, restitution will equal the amount of the uncompensated loss to the insured (i.e., anything not paid by the carrier). The uncompensated loss to the insured could be any of the following or a combination of these: the deductible (if the loss is fully covered and policy limits are adequate); the excess of loss (the policy limit is paid and the uncompensated loss is the amount over the limit); the uncovered loss (not covered by the policy).

Even if state law does not recognize a carrier as a victim, a carrier can ask the insured to request the prosecutor to name the carrier as a victim along with the insured on the criminal restitution order. This way the restitution checks can be mailed directly to the carrier if its subrogation interest has priority over the insured’s.

The policy language and wording on the release, or release and assignment, determines the standing of a carrier’s subrogation interest relative to the insured. If the insured and carrier executed a release and assignment and the policy language gives the carrier a priority interest in restitution (civil and criminal), then the carrier is entitled to first dollar recovery—even if they are not considered a statutory victim. However, if the insured is considered the victim, and the carrier is not listed on the restitution order, the insured will receive the payments from criminal court. This event will require the carrier to collect the money from its insured—a task that can be easier than it sounds. If the carrier has a release only, then its priority subrogation interest maybe in jeopardy, especially for uncompensated losses, if it is not considered a statutory victim.

A typical priority order for recovery of restitution is excess of loss (insured), loss payment (carrier), deductible (insured) and uncovered loss (insured). Litigation (not investigation) costs incurred by the insured to pursue the target civilly (usually incurred before a release or release and assignment is executed) are usually paid first from any recovery, even if the carrier’s loss payment has priority.

**What Factors Should A Carrier Consider Before Incurring Costs To File A Civil Action?**
A carrier should consider the following: the amount of restitution ordered, length of probation period to pay restitution, amount of monthly restitution payments, financial viability of the target(s), standing of the carriers subrogation interest relative to the insured’s and strength of evidence and ability to prove the amount of the loss.
The amount of criminal restitution ordered, if any, establishes a baseline for what the principal must pay. It is considered a baseline because the principal is collaterally estopped from refuting the amount of criminal restitution in civil court. Restitution, as well as the length of the probation period, is determined by the criminal judge; however, the amount of the monthly payment is set by the probation department but only after the principal is released from prison, if jail time is part of the sentencing.

**When Should A Carrier Consider Filing Civil Action?**
There are three instances when a civil action should be filed:

1) No restitution is ordered

2) The amount of restitution is less than the amount of the loss payment or the entire loss (including the deductible)

3) If there will be a significant amount of restitution owed at the end of the probation period, even if the principal complies with the order during the probation period.

There are three reasons why the above may occur:

1) Community service, jail time, or confinement to a halfway house may be ordered in lieu of restitution for first time offenders or ones who are young and/or financially indigent.

2) State law may not consider insurance carriers victims and the amount of loss not covered by insurance is less than the amount stolen.

3) The prosecutor may not be able to prove the entire loss or loss payment. Stolen cash or product, like raw material not identified by serial numbers, may be hard to trace and quantify, so the amount of the loss has to be estimated by sampling to pay the claim. Also, principals may destroy evidence to cover their tracks, making it difficult to quantify the loss.

**When Should A Carrier Have Representation For A Criminal Hearing?**
There are two main reasons and two instances when you should consider hiring counsel to attend criminal sentencing hearings. The first reason was already mentioned: the criminal justice system (judges and prosecutors) are more concerned about convictions and moving cases than they are about the amount of restitution. They take no greater interest when the insurance company can be considered the statutory victim. Why is this so? One plausible reason is the burden of proof in criminal court, beyond a reasonable doubt, is a much tougher burden to meet than the burden in civil court, preponderance of the evidence. Thus, if the amount of your loss is being challenged by the defendant/principal, you are going to need someone who has your subrogation interest in mind, to help argue the amount of your loss payment.

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Whether or not the theft is well documented and you believe the amount of the loss or close to it can be proven, counsel might be able to obviate the need for you to prove damages in a civil action by getting the principal to enter into a consent or stipulated judgment for the civil claim, a type of global settlement, for the amount of the criminal restitution. “Killing two birds with one stone” accomplishes the same result as a federal criminal restitution order.

In the end, a recovery handler, despite his or her personal feelings about the act committed or principal, may request the prosecutor to ask the judge for a lighter jail sentence, if the principal offers to pay more restitution and earlier as part of a consent judgment. The earlier the carrier creates a dialogue with law enforcement and the principal’s attorney, the better the chances to recover more and limit litigation costs to prove damages in the civil forum.

**Why Does A Carrier Need To File A Civil Action If The Criminal Restitution Is For The Full Amount Of The Loss Payment Or Total Claim?**
In many states, judgment creditors have significant rights. Judgments provide the following advantages:

1) Assets can not be attached or wages garnished without a civil judgment.

2) Probation periods are typically shorter than the length of time a judgment is enforceable.

3) A judgment can be revived multiple times, which increases the likelihood that restitution payments will continue beyond the probation period. This is especially important when the probation period is over and there is a significant amount of restitution still owed.

4) At the time the judgment is entered, you may not be aware of all the assets the principal has or may acquire. A judgment lien is like a cloud hanging over the principal’s head, it must be satisfied before the principal can get a loan needed to purchase an asset.

**Should A Carrier Bother Pursuing A Target(s) If Its Interest Is Subordinated To And Less Than Or Approximates The Insured’s Interest?**
This situation arises when there is a large excess of loss, which is greater than or close to the loss payment. In this instance, the insured is out just as much or more money than the carrier. If there are identifiable liquid assets, a carrier should consider entering into a partnering agreement in which each party splits the cost of recovery and first dollar recovery, pro rata in proportion to each ones interest in the total loss. Under this arrangement, the carrier has a chance at first dollar recovery, but identifiable, liquid assets and cooperation from the insured are two key criteria for this strategy to be possible and fruitful.

**When Shouldn’t A Carrier Pursue A Fidelity Subrogation Claim Civilly?**
1) A civil action will yield no more recovery than the criminal order or there are no viable targets.

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2) A carrier’s interest is subordinated to the insured’s and there is little or no chance that the insured’s interest will ever be recovered completely.

3) A partnering agreement mentioned above does not make economic sense.

4) The insured hired counsel to pursue a civil claim and, net of litigation costs to date which are deducted from the recovery first, the carrier is left with little or no recovery after estimating additional litigation costs to settle the action.

Is A Civil Judgment The Only Option For Collecting Money From A Principal, Outside The Criminal System?
No. Consider asking the principal to sign a promissory note. This instrument is appropriate for smaller losses in which law enforcement is not vigilantly investigating or not interested in prosecuting the principal, but the principal is willing to make payments to avoid possible criminal prosecution or civil suit. Promissory notes should be drafted tightly, leaving no loopholes. Clearly stipulate the consequences for a breach of any of the covenants of the agreement. Some of the stipulations, besides payment terms, should include the right of the maker to periodically examine the financial condition of the principal, what documents should be made available for verification and the right and circumstances in which to increase the amount of payments if the principal’s financial condition improves and by how much.

Better than a regular promissory note is a cognovit promissory note. As opposed to a regular note, which requires the maker to first sue on the breach, a cognovit promissory note is a “judgment is waiting”–the maker can get a judgment without any due process (i.e., the principal is not entitled to notice, discovery, etc.). However, states that allow cognovit promissory notes require certain warning language—often in different size lettering. States that do not allow them feel that these notes are unconstitutional, since the principal is denied due process.

In conclusion, although fidelity subrogation is unique, the mantra is the same as for other types of subrogation: “the earlier the recovery handler gets involved after the loss is reported, the better chances are for recovery.” Understanding the legal landscapes and types of actions available, as well as thorough due diligence for all potential targets, will assist in developing an effective recovery strategy that saves both time and money.

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ENDNOTES:
1 The Uniform Commercial Code (UCC), adopted by many states, sets forth standards of care for both banks and customers, as well as time frames to make claims for forged/unauthorized maker signatures. Also, it sets forth check cashing and processing requirements.
2 A noted exception, which has nothing to do with fidelity losses, is the prosecution of Terry Nichols for the bombing of federal buildings in Oklahoma City; both state and federal authorities prosecuted Nichols.

3 See the Repeater Rule, UCC section 4-406 which requires the customer to discover and report unauthorized signatures and alterations within 30 days of bank examining statement, and UCC section 3-406 which provide a defense to banks for forged signature and alteration cases.

4 Some insureds are very proactive and file their own civil claim as soon as the loss is discovered, which can be before or shortly after the loss is reported; their goal is to freeze assets and either try to recover some of the loss themselves to lower the amount of loss payment or give the carrier a good start with its recovery efforts so that the net loss (loss payment minus recovery) maybe lower.

5 See Title 28 USC section 1658 and Title 18 USC section 3282 for civil and criminal actions, respectively.