

## Commercial Crime Insurance for Coverage of Employee Fraud

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### Introduction

Businesses face a myriad of risks from both within and outside the organization. Potential losses may arise from property damage due to weather, flooding, or fire, encompassing buildings, fixtures, and equipment. Liability concerns are present when a third party sustains injury while on the premises, or when another entity believes the business caused some sort of monetary damage to its operations. Additional risks include theft of business assets, whether those assets are in the physical form, such as inventory and equipment, or in the intangible form like proprietary production processes and secret recipes. Insurance coverage may be acquired to mitigate damages from the above losses. One risk, however, which might not initially be at the forefront of one's insurance coverage planning, but may represent the largest exposure to loss, is employee theft or embezzlement.

Trying to limit risk from the various types of exposure prompts a business to structure its policies and procedures in a way that will potentially reduce losses. Physical controls such as locks or limited access areas, fire sprinkler systems, strategically located video cameras, and signs for the public to identify unsafe walking surfaces or construction areas are just some of the ways to reduce loss exposure. Internal controls are implemented to not only protect assets, but also keep financial information secure and help prevent internal and external fraud activities. Even with all of these policies and procedures in place, control failures will occur, thus leading to actual damages which sometimes are large enough to significantly impact the operations of a business. Proper insurance coverage will provide a certain degree of financial safety to minimize the impact such losses may otherwise have.

Common business insurance policies will cover losses which arise from property damage, liability, and theft from outside parties. What is not typically covered with such policies, however, will be a loss sustained from employee theft; this type of loss is usually covered under a separate policy known as "commercial crime insurance." With potential losses from a company's own employees possibly being greater than that from outside parties, this lesser known type of insurance coverage should be obtained by businesses of all sizes. This article discusses the basics of commercial crime insurance and provides information needed to help mitigate losses perpetrated by a company's own employees.

### "Typical" Business Insurance

"Typical" business insurance includes property loss coverage, liability coverage, and workers' compensation coverage. The property loss portion of insurance covers damages to buildings, business personal property, and the personal property of others damaged or destroyed while under the insured's care, custody, or control. Liability coverage is for bodily injury and property damage liability, slander/libel and copyright liability, and the medical expenses of others, while workers' compensation provides wage replacement and medical benefits to employees injured during the course of employment. Other than the three types of coverages mentioned above, businesses may also purchase a business

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income loss policy to cover the reduced income during the period of business interruption due to a covered loss.

For property loss coverage, whether a loss is covered or not depends on two conditions. First, did the damage happen to “covered property?” For example, damage to a tree outside an office that is not merchandise is usually not covered. Second, was the damage caused by a “covered loss?” For example, a loss resulting from war or military action is not covered, even if the damaged property would have been otherwise covered. To specify what types of losses are covered, three different insurance forms are available, with the broadest being the “special form.” The special form is an open-coverage form that covers “all risks” unless a particular risk is specified in the exclusion section. One prominent example of “all risk” coverage is the coverage of terrorism attacks before and after 9-11. Before 9-11, a terrorist attack was not a concept that the insurance industry often considered, and therefore was neither specifically covered nor specifically excluded. Many insurance companies providing coverage with the special form, then, would have unknowingly covered the loss from a terrorist attack on or before 9-11. After the attacks on 9-11, however, the insurance industry realized that a terrorist attack was not among the common causes of losses, and thus needed to be specially covered. General business insurance coverage now excludes losses from terrorism attacks unless that specific risk is added to the policy. The special form also covers losses from theft, but this coverage is limited to only theft from outsiders, not from the business’ own employees.

### **Commercial Crime Insurance**

#### ***Employee Theft***

Employee embezzlement losses could potentially be much greater than from outside sources, especially for small to medium size businesses. In addition, due to the nature of employees’ access to both assets and financial records, embezzlement-related losses can continue for a long time before being detected. Strong internal controls are always recommended and will reduce risk exposure, but they are not guarantees of fraud prevention. Not only can strong, well-designed controls be bypassed (such as through collusion), but the smaller a company is, the fewer the resources available to implement internal controls. Smaller companies sometimes try to rely on the fact that the owners have a closer work relationship with the employees, have a better sense of who to trust, and are around to oversee the employees’ actions at work. Therefore, the owners feel they would become aware of any misdeeds or asset misappropriation. While this reasoning is oftentimes valid, numerous examples have occurred over the years to prove otherwise.

Business owners must understand that embezzlement and other forms of theft by their employees are not covered under the “typical” business insurance policy. Here is where the forensic accountant can add value to the overall risk assessment analysis performed for a business. In addition to reviewing operations and procedures within an organization to identify areas of concern and propose controls to reduce risks, reducing the impact of a loss once it occurs is also important. Proper insurance coverage to mitigate a financial loss related to employees’ actions is just one of the recommendations that should be included in the risk assessment report. This is not to say that forensic accountants need to be insurance experts, but they should have a working knowledge level of what is proper coverage for reducing financial loss.

#### ***Commercial Crime Policies***

Losses from employee embezzlement, theft, or fraud must be specifically identified as covered events within insurance policies, and this coverage is known as “employee theft coverage” in the line of “commercial crime insurance.” Specific coverage will depend on specific wording, and even though the general phrase “standard insurance policy” may be used often in the business environment, policies are not all worded the same and may not contain the same coverage. This is true for the “typical” business insurance policy as well as a commercial crime policy.

Commercial crime coverage can be obtained as an addition (sometimes called an endorsement) to an existing typical business policy, or an insurance company (hereafter called the “insurer”) can write the coverage as a stand-alone policy, which is often called a monoline crime policy.<sup>1</sup> When coverage of employees’ embezzlement is desired, the insuring agreement containing “employee theft” must be selected from the eight possible separate commercial crime coverages, each having its own separate insuring agreement.<sup>2</sup> Another important area to keep in mind is that effective employee theft coverage can also be used to satisfy the Employee Retirement Income Security Act (ERISA) bonding requirements for those who handle funds of employee welfare or employee benefit plans.

While forensic accountants should not hold themselves out as insurance experts, they can still offer valuable advice for clients seeking commercial crime insurance. On the application form for this type of insurance, the client will usually need to make a series of declarations about the internal controls and other financial operations of the business. These declarations could consist of specific internal controls with which accountants are already very familiar, such as:

- (1) Financial statements were audited annually by an independent CPA;
- (2) All subsidiaries, locations, and similarly controlled and operated companies were included in the audit;
- (3) The auditing firm regularly reviewed the system of internal controls and furnished written reports;
- (4) Accounting was decentralized;
- (5) At least two signatures were required on checks;
- (6) Employees who reconciled monthly bank statements did not sign checks, handle bank deposits, or have access to check signing machines or signature plates;
- (7) Internal control systems were ‘designed so that no employee can control a process from beginning to end (e.g., request a check, approve a voucher and sign the check)’; and
- (8) All incoming checks were stamped ‘For Deposit Only’ immediately upon receipt.<sup>3</sup>

A careful review of the client’s internal controls for making declarations on a commercial crime insurance application is important to help the client avoid losing coverage if questions later arise about possible material misrepresentation in the declarations. Indeed, courts have found insurance policies not valid and the insurance companies thus not responsible for reimbursing the insured when material misrepresentations were made in applications; i.e., when internal controls were misrepresented<sup>4</sup> and even when gross receipts were misrepresented.<sup>5</sup>

#### ***Timing of Coverage and Losses***

Commercial crime insurance is not designed to cover a loss known before coverage is obtained, nor, similarly, a loss suspected beforehand. If a company, therefore, suspects on-going employee embezzlement and then purchases employee theft coverage, chances are any losses incurred before the policy is in place will not be covered, and losses afterwards quite possibly not covered as well. Like most other types of insurance, employee theft coverage should be used as a precaution against future losses, not

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<sup>1</sup> Cook, M.A. (editor). 2010. *Commercial Property Risk Management and Insurance*, 1<sup>st</sup> edition, (2010, Malvern, PA): The Institutes, p. 9.3.

<sup>2</sup> The other seven commercial crime insurance coverages, each having its own separate insuring agreement, are: (1) forgery or alteration; (2) inside the premises— theft of money and securities; (3) inside the premises— robbery or safe burglary of other property; (4) outside the premises; (5) computer fraud; (6) funds transfer fraud; and (7) money orders and counterfeit money. These seven coverage types are for non-employee crime losses, and each must be either “selected” or “not selected” depending on the needs of the insured.

<sup>3</sup> *Pioneer Industries, Inc., v. Hartford Fire Ins. Co.*, 2009 WL 2187379, (D. Minn. 2009); *aff’d*, 639 F.3d 461 (8<sup>th</sup> Cir. 2011).

<sup>4</sup> *Ibid.*

<sup>5</sup> *Nyasco Sports, Inc. v. Director, Federal Emergency...*, 561 F. Supp. 864, (S.D. N.Y. 1983).

a resolution after the fact. This is not to say, however, that a loss incurred before the policy period begins will not be covered; the key is if the employee theft is “known” or “suspected” at the time of issuance. As will be explained in the next paragraph, though, prior losses may be encompassed by a later (new) policy.

When a company (hereinafter called the “insured”) decides to purchase commercial crime insurance to cover employee theft, in addition to deciding the dollar amount of losses which can be claimed under a policy, the period within which a covered loss may occur, or the period a covered loss is discovered, also needs to be decided. This period, or timing, distinction is quite important and is why the insurance industry provides two different “forms” specifying the timing of the loss: the “Loss Sustained Form” and the “Discovery Form.” The “Loss Sustained Form” covers losses sustained “from an ‘occurrence’ taking place during the Policy Period shown in the Declarations...which is ‘discovered’ by” the company during that policy period, or during an extended period allowed within the policy.<sup>6</sup> The extended period for discovering a loss is typically one year past the termination date of the policy. For example, if the insured purchased employee theft coverage for the period January 1, 2015 through December 31, 2015 with an extended discovery period of one year, then a loss taking place within the period from January 1 to December 31, 2015 is covered by the policy if it is discovered during the time period January 1, 2015 through December 31, 2016. [The loss must occur during the one-year policy period, but can be discovered during a two-year period (the policy period plus one year).] In addition to losses occurring during the policy period, losses occurring before the policy is in place may also be covered but only if similar insurance coverage existed under a previous policy, whether it was issued by the same insurer or not, and only if there was no uncovered time between policies. This feature of providing coverage of an occurrence before the actual policy period begins is for marketing purposes so an insurer can seek new clients by being able to state that the new coverage will look back to prior time periods covered by the previous insurer.

The “Discovery Form,” on the other hand, is more liberal in the time period within which the loss occurrence takes place. This form usually states that a covered loss is one sustained “resulting directly from an ‘occurrence’ *taking place at any time* which is ‘discovered’ by...” the insured during that policy period or during an extended period allowed with the policy.<sup>7</sup> (emphasis added). Just as with the “Loss Sustained Form,” the extended period of discovery is usually one year. The most important distinction, however, between the two crime policy forms is that the Discovery Form encompasses loss occurrences from potentially all past years even when in those prior years no commercial crime insurance was carried.<sup>8</sup> The Discovery Form, then, is usually considered as providing the best coverage for most companies.

### ***Definitions***

The definitions of terms are very important when determining which persons and what acts are covered under insurance policy contracts. Whether the Loss Sustained Form or the Discovery Form is selected by the insured, the definitions are generally the same since the main difference between the two forms is in the timing of the covered occurrences. In the sections below, the contract definitions for the terms “employee,” “occurrence,” and “discovery” are discussed; these three terms are only a few of which are defined in a commercial crime insurance policy.<sup>9</sup>

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<sup>6</sup> Insurance Services Office, Inc. 2012. *Commercial Crime Policy (Loss Sustained Form)*. A. Insuring Agreements.

<sup>7</sup> Insurance Services Office, Inc. 2012. *Commercial Crime Policy (Discovery Form)*. A. Insuring Agreements.

<sup>8</sup> Insurers sometimes attach a retroactive date to the policy to limit their exposure to prior occurrences.

<sup>9</sup> In Provision F. (Definitions) within both the Loss Sustained Form and the Discovery Form, there are 25 separate terms defined. While all terms and their definitions are important in any contract, only the three most relevant to the discussion in this article are covered herein.

***Employee***

Commercial crime insurance coverage extends, of course, to most employees of the insured, but in addition, this coverage may also encompass persons who are not employees under tax law or are not employees for other purposes such as worker's compensation insurance. On the other hand, certain persons who are otherwise employees, are not covered. A covered "employee" is defined as:

- (1) Any natural person:
  - a. While *in your service* and for the first thirty days immediately after termination of service, unless such termination is due to "theft" or any other dishonest act committed by the "employee";
  - b. Whom *you compensate directly* by salary, wages or commissions; and
  - c. Whom you have the *right to direct and control* while performing services for you<sup>10</sup> (emphasis added).

The definition of "employee" further extends to temporary workers, leased workers, former employees retained as consultants, managers, interns, and directors or trustees handling funds, among others.<sup>11</sup> The key elements, then, in classifying a person as a covered employee are that the person must be performing service for the insured, is compensated directly, and can be directed and controlled. Each of these elements must be present and are strictly applied, sometimes leading to lawsuits where insurers take the position that an employee of the insured is not a covered employee.

In *Lutz*,<sup>12</sup> the court applied a well-established legal precedent in insurance law called the "dominant shareholder theory" where the employee/shareholder acts without supervision from any other person, including members of the board of directors.<sup>13</sup> In such a position and with almost complete dominance over the affairs of the business, the shareholder is deemed to be the corporation itself. Once this association is made, the shareholder "is not an 'employee' under the terms of a commercial crime or employee dishonesty insurance policy."<sup>14</sup>

The situation in *Lutz* involved a securities corporation and its sole shareholder, who was also the president. He embezzled money from the corporation's clients, and used the money to pay for personal expenses as well as corporate expenses. The president was also one of only two members of the board of directors (after a point he was the only director), and no formal board meetings were ever held.<sup>15</sup> Being a securities corporation, however, and therefore under NASD<sup>16</sup> regulations, there was a compliance officer who theoretically had the right to supervise the president performing services for the clients as a registered representative. The president told the compliance officer that business was going to be done a certain way, and that directive, along with no supervision or control from the board, created an environment of dominance by the person committing the embezzlement. Thus, with the president/shareholder being considered the same as the corporation under the dominant shareholder

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<sup>10</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Definitions. F.7.a.1.

<sup>11</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Definitions. F.7.a.2 – 8.

<sup>12</sup> *Lutz v. St. Paul Fire & Marine Ins. Co.*, 2005 WL 2372871 (S.D. Ohio 2005).

<sup>13</sup> In the *Lutz* case, the alter ego theory was also discussed and was deemed to be very similar to the dominant shareholder theory. The court said, "It appears, however, that there is very little to distinguish between the two theories. The common thread between the dominate shareholder theory and the alter ego theory is that if one person exercises complete control over the corporation, his acts are corporation's acts. Thus, there is no coverage because commercial crime policies were not designed to protect corporations from their own dishonest acts." *Ibid*.

<sup>14</sup> *Lutz*, *supra* note 12.

<sup>15</sup> The other board member testified "that he did not have any decision-making role as a director." *Lutz*, *supra* note 11.

<sup>16</sup> National Association of Securities Dealers.

theory, his actions were not covered by the commercial crime insurance policy because “a corporation should not be permitted to insure against its own malfeasance.”<sup>17</sup>

In another case,<sup>18</sup> a controlling shareholder/chief executive officer was not deemed to be an “employee” for purposes of an employee fidelity policy<sup>19</sup> because the corporation did not restrain or control the performance of its CEO. The court relied on statements of other officers indicating that the CEO acted unilaterally while also lying to them with impunity. This established the fact of the CEO’s total dominance, and no proof was offered that the board of directors exercised supervisory control over him. The corporation, then, could not collect on the policy even though for other purposes, such as for employment taxes, the CEO was an employee. Numerous other court cases have also applied the definition of “employee” to a variety of situations, and while the components of “*in your service*” and “*compensate directly*” are important parts of the definition, it is the component of “*the right to direct and control*” which has been the most litigated.

Although not directly related to the definition of an employee for commercial crime insurance purposes, there is another important aspect of employees being covered or not. If an employee is known to have been involved in theft or other dishonest acts before theft coverage is obtained through insurance, losses from that particular employee, past or future, are not covered.<sup>20</sup> Insurers do not want to cover persons with an established history of fraud having occurred prior to the effective date of the policy. Furthermore, even when the policy is in place and there was no known fraud by an employee beforehand, the employee theft coverage will immediately terminate for any employee for whom it becomes known is, or was, involved in any dishonest acts.<sup>21</sup> The timing of those acts of theft or dishonesty is not important; it is the timing of when the insured first became aware of the acts. Therefore, as soon as the employer learns an employee has committed any prior or current dishonest act, the insurance coverage ceases for that employee.<sup>22</sup> While the employee does not have to be terminated, nor even reported to the police for the purpose of an insurance claim, the insured must be aware that coverage is no longer in place for that person, and future losses caused by him/her will not be recouped through the commercial crime insurance policy.

### *Occurrence*

For commercial crime insurance, the definition of an “occurrence” is very important to both the insured and the insurer because one of the policy declarations will state the upper monetary limit to be paid to the insured for a loss from each occurrence. Questions arise, then, as to what act or acts constitute one occurrence. For example, take a situation where a policy limit is \$10,000 per occurrence,<sup>23</sup> and an employee steals (and cashes) a check for \$8,000 one day, followed by the theft of another check in the amount of \$9,000 several months later. If the thefts of the two checks being months apart are considered only one occurrence, the insurer will be responsible for paying only \$10,000. If, however, the two thefts are considered two separate occurrences, the total payment to the insured will be \$17,000, the lesser of the actual loss for each occurrence (\$8,000 and \$9,000, respectively) or the \$10,000 policy limit per occurrence.

Since the means by which employee thefts can be carried out are numerous, and the length of time ongoing thefts may occur, commercial crime insurance policies contain the following, rather broad, definition of an “occurrence:”

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<sup>17</sup> Lutz, *supra* note 12.

<sup>18</sup> *In re Prime Commercial Corp.*, 187 B.R. 785 (Bankr. N.D. Ga. 1995).

<sup>19</sup> Fidelity insurance policies are similar to commercial crime insurance policies but with more narrow coverage.

<sup>20</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Exclusions. D.1.b.

<sup>21</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Conditions. E.2.a.(1).

<sup>22</sup> Those who must learn of the theft or dishonest acts include the insured, and partners, members, officers, directors, or trustees not in collusion with the employee. *Ibid.*

<sup>23</sup> Oftentimes policy limits are in the hundreds of thousands or millions of dollars.

1. An individual act;
2. The combined total of all separate acts whether related or not related; or
3. A series of acts whether related or not related; committed by an “employee” acting alone or in collusion with other persons, during the Policy Period shown in the Declarations, before such policy period or both.<sup>24</sup>

This language has been found both ambiguous and unambiguous by the courts over the years.

In *Bethany Christian Church*,<sup>25</sup> the court found that language used to define “occurrence,” which was very similar to the definition above, was unambiguous.<sup>26</sup> In that case, the employee embezzlement occurred over a period of three years in the amounts of \$1,494; \$29,630; and \$51,421, respectively, for a total of \$82,545. In each of those years, commercial crime insurance was in place with a limit of \$50,000 per occurrence. The insured’s position was that since separate policies covered separate years, and the theft activity taking place within each of the three years was a separate occurrence, the \$50,000 limit applied per year; thus \$81,124 should be paid by the insurer to cover the losses. [\$81,124 totals the lesser of the actual loss each year or the policy limit per occurrence.] The insurer, on the other hand, with whom the court agreed, argued that parts (2) and (3) of the policy’s definition for “occurrence” should be read to combine all three years’ theft activities as just one occurrence. The insurer was thus responsible for paying the insured only \$50,000 for the losses over the entire three-year period rather than having to stack each year’s \$50,000 limit to in effect provide a \$150,000 total coverage limit.

To a much larger extent (as to both dollar amount and time period) a similar outcome was found in *Madison Materials*,<sup>27</sup> where the embezzlement took place over a ten-year period in the amount of \$1.45 million, and was performed by only one employee. While the insured had coverage for each of those years, the court held that there was only one occurrence and the insurer was only responsible for \$350,000, which was the per occurrence limit for the policy in effect during the year the loss was discovered. Another case where the language defining an “occurrence” was found unambiguous was *Wausau*<sup>28</sup> in which the court reasoned that an employee’s series of dishonest acts over a multi-year period was only one occurrence even though there was more than one scheme used to embezzle. That particular employee’s theft included a variety of methods such as “manipulating the company’s refund and fax/copy accounts, booking paid rooms as ‘comps,’ allowing two customers to live in the motel for a period of months for a fee, which she kept for herself, and stealing daily cash deposits and ski lift ticket sales.”<sup>29</sup> The various forms of theft had occurred over at least a four-year period, the last two of which were covered by a commercial crime insurance policy carried by the insurer who was a party in the case. In ruling that only one occurrence existed, the court, following a well-accepted standard in insurance law, found:

(T)he question is not whether the employee’s various methods of embezzling were related, as defendant suggests, but whether the cause of the loss was related. The cause of defendant’s loss was the dishonesty of one employee. Although the employee appears to have been particularly creative in finding ways to bilk defendant, her intent throughout undoubtedly was the same: to steal defendant’s money.<sup>30</sup>

The various embezzlement methods performed over a span of years were treated as a series of related acts caused by the dishonesty of an employee, and thus was one occurrence. This appears to be the general

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<sup>24</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Definitions. F.17.a.

<sup>25</sup> *Bethany Christian Church v. Preferred Risk Mut. Ins. Co.*, 942 F. Supp. 330 (S.D. Tex. 1996).

<sup>26</sup> *Ibid.* at 336.

<sup>27</sup> *Madison Materials Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 523 F.3d 541 (5<sup>th</sup> Cir. 2008).

<sup>28</sup> *Wausau Business Ins. Co. v. U.S. Motels Management, Inc.*, 341 F. Supp. 2d 1180 (D. Colo. 2004).

<sup>29</sup> *Ibid.* at 1182.

<sup>30</sup> *Ibid.* at 1183-1184.

consensus among most court decisions on this issue: if one employee causes the loss, no matter if using multiple methods or spanning multiple years, all of those acts are related and thus there is only one occurrence. The same result follows if two or more people are in collusion to perform dishonest acts; the acts are, again, related and there is just one occurrence.

In *Glaser*,<sup>31</sup> however, the court ruled differently when an employee's fraudulent actions over a multi-year period were found to comprise separate occurrences for each year. The employee in *Glaser* forged checks, used the employer's credit cards without authorization, and directed unauthorized payroll payments over a three-year period during which the insured was covered for employee dishonesty by an endorsement to a business insurance policy. Even though the same employee was responsible for all of the theft losses over several years, the court found that the definition for "occurrence" was ambiguous because the language did not state if the series of dishonest acts spanning different policy periods were to be one occurrence or multiple occurrences. Relying heavily on an unpublished opinion in *Spartan*,<sup>32</sup> the *Glaser* court stated that "successive policies required different premiums to account for varied levels of coverage over different property, all of which indicate that each policy was independent."<sup>33</sup> The result was that one occurrence could not span multiple years, according to the *Glaser* court's reasoning, and the \$25,000 limit per occurrence in each policy applied to each year. This cumulative effect of insurance coverage causes, as in the *Glaser* case, a \$25,000 policy limit to turn into a potential \$75,000 total limit over a three-year period, notwithstanding the inclusion of a non-cumulative exclusion in the policy.<sup>34</sup> This cumulative effect reasoning is not often followed in insurance law.

### *Discovery*

The concept of "discovery" as it relates to insurance coverage becomes important because timely notification to the insurer is required, and specific steps must be implemented to contain possible continued exposure to the loss as well as to produce documentation concerning the loss activities. Commercial crime insurance policies usually include the following definition:

- (1) "Discovery" or "discovered" means the time when you first become aware of facts which would cause a reasonable person to assume that a loss of a type covered by this Policy has been or will be incurred, regardless of when the act or acts causing or contributing to such loss occurred, even though the exact amount or details of loss may not then be known.<sup>35</sup>

The exact moment an insured has enough knowledge that raises to the level of *causing a reasonable person to assume that a covered loss has been or will be incurred* is difficult to pinpoint, but once that level is reached, the insurer must be timely notified. Such notification after discovery allows the insurer to take actions to limit the amount of the loss, thus lowering the insurer's own liability and allowing it to initiate an investigation. If just "suspicion" is the level needed for discovery that triggers notice, then numerous, unnecessary notifications will cause the insurer to waste time and effort pursuing false alarms.<sup>36</sup> Waiting too long, however, increases the risk of higher losses.

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<sup>31</sup> *Glaser v. Hartford Cas. Ins. Co.*, 364 F. Supp. 2d 529 (N.D. Md. 2005).

<sup>32</sup> *Spartan Iron & Metal Corp. v. Liberty Ins. Corp.*, 6 Fed. Appx. 176, slip op. (4<sup>th</sup> Cir. 2001).

<sup>33</sup> *Glaser*, *supra* note 31, at 538.

<sup>34</sup> The exclusion reads: "Regardless of the number of years this insurance remains in force or the number of premiums paid, no Limit of Insurance cumulates from year to year or period to period." See *Glaser*, *supra* note 31, at 535.

<sup>35</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Definitions. F.5. The definition further states: "'Discover' or 'discovered' also means the time when you first receive notice of an actual or potential claim in which it is alleged that you are liable to a third party under circumstances which, if true, would constitute a loss under this Policy."

<sup>36</sup> *Prime*, *supra* note 18, at 802.



In *American Surety*,<sup>37</sup> the Supreme Court found that the insurer was not required to receive notice unless the insured possessed “knowledge—not simply suspicion—of the existence of such facts as would justify a careful and prudent man in charging another with fraud or dishonesty.”<sup>38</sup> Over the years, “(c)ourts generally have followed *American Surety*, and its statement has become the ‘well-established rule.’”<sup>39</sup> In that Supreme Court case, two bank employees colluded to embezzle funds over a two-day period, followed a month later with the bank operations being suspended and the bank going into receivership. Bank examiners began a timely review of the records which lasted for around three months (January through March), and resulted in suspicions of irregularities but without actual knowledge of any specific acts or losses. Because of those suspicions, experts were then brought in to examine certain transactions in more depth, and finally in late May the exact amount of the losses were ascertained along with the identification of two employees involved and their means used in the theft. The bank’s receivership trustee immediately gave notice to the insurer of the fraud discovery as required under the fidelity insurance bond.

The insurer in *American Surety* claimed that the notice was given too late because the first set of bank examiners had suspicions of possible irregularities and therefore the trustee had enough knowledge for “discovery” of a loss by March at the latest. [The bond called for notice to be given “as soon as practicable” upon discovery.<sup>40</sup>] The trustee, on the other hand, said that he did not have enough knowledge of a loss until the second set of examiners actually found proof of the embezzlement. The Court found for the insured (the trustee) which resulted in the Court’s long accepted position that having only a suspicion was not a high enough standard for discovery to require notifying the insurer; there must be actual evidence of the dishonest act itself that caused the loss.

In the *Prime*<sup>41</sup> case, the discovery standard was eased somewhat which would require an earlier notification to be given. This case provides a thorough analysis of discovery where several officers of the insured confronted the suspected employee (another officer) over large monetary transactions that did not follow company policy nor industry policy. When the suspected employee offered no plausible explanation about the transactions over which he had control, the other officers knew he was being dishonest even though at that point in time they still could not actually prove any losses. The suspecting officers did not give notice to the insurer until six months later, far past the sixty-day notice requirement, and the court found that timely notice was not provided; thus, the loss was not covered. The knowledge of some type of dishonesty was the key. “Discovery of an employee’s dishonesty about incidents giving rise to a suspicion of fraud totally eliminates any compunction about giving notice without being able to prove fraud or theft.”<sup>42</sup> A combination, then, of suspicion of an employee’s actions (that might have led to fraud), and knowledge of that employee’s dishonesty (even if not directly related to the suspected fraudulent activity) is enough for notice to be given, according to the court in *Prime*. [On the other hand, the same requirement is usually true in a somewhat opposite situation where a loss is known from facts in the financial records, but a specific person has yet to be identified; the insured must be notified.]

The court in *Gulf*,<sup>43</sup> however, declined to follow *Prime*’s broader definition of discovery, and held that “‘discovery’ occurs once an insured becomes aware of facts that would cause a reasonable person to assume a loss had been or would be incurred.”<sup>44</sup> Similarly, the court in *Federal Deposit*<sup>45</sup> found “that

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<sup>37</sup> *American Surety Co. of New York v. Pauly*, 18 S.Ct. 552 (1898).

<sup>38</sup> *Ibid.* at 558.

<sup>39</sup> *Gulf*, *infra* note 43, at 1058, [citing, *see* L.C. Warden, *Effect of Failure to Give Notice, or Delay in Giving Notice or Filing of Proofs of Loss, Upon Fidelity Bond or Insurance*, 23 A.L.R.2d 1056, at § 6 (1952) (citing authorities relying on *American Surety*)].

<sup>40</sup> *American Surety*, *supra* note 37, at 554.

<sup>41</sup> *Prime*, *supra* note 18.

<sup>42</sup> *Prime*, *supra* note 18, at 804.

<sup>43</sup> *Gulf USA Corp. v. Federal Ins. Co.*, 259 F.3<sup>rd</sup> 1049 (9<sup>th</sup> Cir. 2001).

<sup>44</sup> *Ibid.*, at 1058.

discovery of loss does not occur until the insured discovers facts showing that dishonest acts occurred and *appreciates the significance of those facts*; suspicion of loss is not enough”<sup>46</sup> (emphasis added). The difference between the *Prime* and *Gulf* decisions appears to be that in *Prime*, having suspicions of possible fraud and knowing the person in question is otherwise dishonest in other matters (even though there is not yet proof of dishonesty for a covered fraud itself) is enough to trigger notice, but in *Gulf* both suspicion and knowledge of a specific dishonest fraudulent act must be present.

Discovery initiates a number of duties listed below that the insured must fulfill and these duties are:

- (1) Notify the insurer as soon as possible.
- (2) Provide a detailed, sworn proof of loss to the insurer within 120 days (the number of days may vary in different policies).
- (3) Cooperate with the insurer in the investigation and settlement of any claim.
- (4) Produce all pertinent records.
- (5) Submit to an examination under oath and give a signed statement of answers.
- (6) Secure all rights of recovery against any person or organization responsible for the loss and do nothing to impair those rights.<sup>47</sup>

The most urgent of the duties above for which immediate action is called, are (1) notification and (6) securing rights of recovery. “Notice of a loss under an insurance policy is notice of the possible liability of the insurer.”<sup>48</sup> The insurer, then, has the right to investigate and verify the amount of the loss to limit its monetary exposure. Also, both the insured and the insurer want to limit monetary exposure by securing any recovery rights; recovering funds from the involved employee will help the insurer recover amounts paid to the insured under the policy (called subrogation), and if the recovery proceeds then exceed the coverage limit, the insured will recoup the part of the loss not covered with insurance.

The “timeliness” of notifying an insured of a possible covered loss is not well defined, and there is little guidance as to the required time frame of the words “as soon as possible.” Apparently, within a few days is the acceptable length of time. Where “immediate” notification was required under a policy, 20 days after a burglary was too long in one case,<sup>49</sup> and, in another case, “a delay of as little as ten days has been deemed unreasonable under New York law.”<sup>50</sup> To provide the insurer with as early a start as possible to limit its exposure to the loss, an insured should take quick action when known acts of theft or dishonesty surface; in other words, when there is discovery. Then, after notification and still within the time frame stated in the policy (typically 120 days from discovery), the insured must submit financial information to the insurer for proof of loss. If a fraud examiner is called in to assist the insured in the investigation, a detailed fraud examiner’s report will usually satisfy the proof of loss requirement. These examinations themselves may take several months, and so the insured must set in motion several actions as soon as a theft discovery is made to secure rights to collect under the policy.

### **Client Advice**

As part of risk assessment services forensic accountants provide to clients, a review of employee fraud insurance is a recommended step, and should be performed in conjunction with the client and the client’s insurance agent.<sup>51</sup> Even something as simple as making sure the expected coverage is indeed specified in the policy may be something that is overlooked by a client when insurance is purchased without due care

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<sup>45</sup> *Federal Deposit Ins. Corp. v. Aetna Cas. and Sur. Co.*, 903 F.2<sup>nd</sup> 1073 (6<sup>th</sup> Cir. 1990).

<sup>46</sup> *Ibid.*, at 1079.

<sup>47</sup> *Commercial Crime Policy (Discovery Form)*, *supra* note 7. Conditions. E.1.e.

<sup>48</sup> *Prime*, *supra* note 18, at 802.

<sup>49</sup> *M.Z. Discount Clothing Corp. v. Meyninger*, 983 F. Supp. 182 (E.D. N.Y. 1997).

<sup>50</sup> *Haas Tobacco Co. v. American Fidelity Co.*, 226 N.Y. 343, 123 N.E. 755, 13 A.L.R. 132 (App. Ct. N.Y. 1919).

<sup>51</sup> An employee fraud insurance checklist would be very helpful especially if the forensic accountant would design one with the assistance of an insurance agent who has experience with these types of policies.

in reading or understanding any included exclusions. For example, in *Pine Belt Automotive*<sup>52</sup> an insured (a corporation) assumed it was receiving the same type of coverage with a new insurer as had been in a policy it was replacing from the previous insurer. The insured had purchased a new commercial crime insurance policy but had failed to realize that dishonest acts by its own employees towards third parties were specifically excluded in the new policy.<sup>53</sup> The courts do have a well-established history “that insurance contracts are to be liberally construed in favor of the insured, and if the language of a policy will fairly support two meanings, an interpretation in support of coverage will be applied.”<sup>54</sup> However, for the insured in *Pine*, with employee dishonesty being specifically and unambiguously excluded in the policy language, coverage was found not to exist. Courts will, therefore, strictly interpret clear policy language, and “will not rewrite a policy or create a better one than that which the insured purchased.”<sup>55</sup>

Careful review of policy agreements and exclusions, then, is imperative to lessen the impact of actual losses that may occur from employee fraud.<sup>56</sup> With it being well known that only a small percentage of frauds are discovered by auditors or exposed by internal control procedures, forensic accountants have the opportunity to provide additional loss protection advice by discussing in depth with clients the various aspects of commercial crime insurance protections offered by the risk management and insurance industry. Fraud investigations, loss computations, damage reports, and expert witness testimony are already tools forensic accountants offer. One more tool to add, then, is an employee fraud insurance review.

## **Conclusion**

Obtaining employee theft insurance provides important coverage that can be useful to almost every business. As unique as this type of insurance may seem, there are a few simple rules to follow: First, previously “known” losses are not covered; second, insurance does not cover “intentional” losses; and third, the policies contain an insurance limit which may be applied to only one “occurrence.” The first rule answers the “when” question: Coverage extends to losses that occurred or were discovered after the inception of the policy, and does not extend to losses known before coverage was obtained. The second rule answers the “who” question: All thefts that are deemed to be committed by the insured (the business) itself will be considered as “intentional” losses, and thus will not be covered under the insurance. The third rule answers the “how much” question: Since a series of acts committed by the same employee or the same group of employees may be considered as “one occurrence,” the insurance coverage will be triggered only once, and thus only one insurance limit will apply. Being able to advise clients on these matters related to their insurance purchases or renewals, certainly adds value to forensic accounting services. It is important to be certain, then, that the desired employee theft coverage is in place and that the commercial crime insurance policy fits the unique business risk environment of the client.

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<sup>52</sup> *Pine Belt Automotive Inc. v. Royal Indem. Co.*, 400 Fed. Appx. 621, slip op. (3<sup>rd</sup> Cir. 2010).

<sup>53</sup> Losses from employee theft (“the taking”) of the employer’s money was a covered loss; but losses from employee dishonesty causing a third party loss for which the employer paid restitution to that third party was not covered.

<sup>54</sup> *Last v. West American Ins. Co.*, 139 N.J. Super. 456, 460 (1976).

<sup>55</sup> *Ibid.*

<sup>56</sup> An interesting decision, however, was handed down by the U.S. Tenth Circuit Court of Appeals in which it explained that “(u)nder Oklahoma law, an insured has no duty to read his written policy and notice discrepancies between it and previous representations of a soliciting agent.” *Business Interiors, Inc. v. Aetna Cas. and Sur. Co.*, 751 F.2d 361, at 364 (10<sup>th</sup> Cir. 1984), citing *Warner v. Continental Cas. Co.*, 534 P.2d 695, 699 (Okla. App. Ct. 1975). The insured in *Business Interiors* could rely on the insurance agent’s inaccurate explanation of how a limit for an occurrence is applied; the agent represented that a \$10,000 commercial crime policy renewed and in place for three years would provide \$30,000 of coverage. The insurer, then, was bound by the agent’s representations even though the insured could have read the policy to understand the specific coverage. A forensic accountant’s recommendation, however, should be to have the client read and understand the entire policy.