

SPECIAL REPORT

FRAUD IN THE WORKPLACE

(07-11-2014)

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Employee theft is the frequent subject of newspaper headlines:

“Starbucks accuses employee, husband, of embezzling \$3.7 million from firm”

In this case, the employee and her husband set up a phony company and charged Starbucks for information technology work that was never performed.

“Entech temp implicated in scam on GM executives”

A temporary employee took lists containing the personal information on 7,500 employees and used the information to obtain credit cards, making more than \$500,000 in charges.

“Honored employee, embezzler - former controller now in prison”

This long time controller of an automotive supplier was thought to be a good family man and capable individual; however, using a signature stamp of the owner, he stole \$3.33 million dollars. He was the sole person in control of accounts payable, receivables, payroll, and check writing.

“Embezzlement arrest — drugstore employee skims \$14,000 from deposit money over six months”

In this case, a chain drugstore employee in Livonia, Michigan failed to make deposits over a six month period.

“Employee investigated in embezzlement of \$1,200,000”

This employee of a major software company voided more than 100 checks to vendors that had never been cashed and then reissued the checks to persons or businesses who were not owed money and forwarded the checks to his own bank account.

“College controller accused of embezzlement”

This controller stole more than \$50,000 by transferring money from the college bank account into one that he controlled. He used a signature stamp to set up another account where only one signature was required for check issuance.

“Businessman charged with embezzlement”

This business owner stole \$247,110 which was the entire balance of the employee pension money. He filed false bank returns to cover up the theft.

“Charges in \$4.6 M fraud at racetrack”

This former bookkeeper allegedly embezzled \$4,600,000 from the owners of a Michigan race track using work orders for services that were never performed. This scheme took place over a seven year period.

TYPES OF EMPLOYEE FRAUD

1. Corruption

- Purchasing Schemes
- Sales Schemes
- Bid Raking
- Illegal Gratuities
- Economic Extortion
- Conflict of interest

2. Asset Misappropriation

- Larceny of cash on hand
- Larceny from the deposit
- Skimming from sales either unrecorded or understated

- Receivable write-off schemes
- Illegal refunds
- False invoicing
- Payroll fraud

3. Fraudulent Disbursements

- Shell Company
- Non-accompliced vendor
- Personal purchases
- Ghost employees
- Commission schemes
- Falsified wages
- Mischaracterized or concealed expenses or liabilities
- Fictitious revenues
- Multiple reimbursements
- Forged check maker
- Forged endorsement
- Altered payee
- False voids
- False refunds

4. Fraudulent Statements

- Asset revenue overstatements because of timing differences or fictitious revenues
- Concealed liabilities and expenses
- Improper disclosures
- Improper asset valuations
- Falsified employment credentials
- Falsified internal documents
- Falsified external documents

5. Inventory and Other Assets

- Misuse of inventory and other assets
- Larceny by asset requisition and transfers
- Larceny by false sales and shipping
- Larceny by purchasing and receiving

THE PERILS AND PITFALLS OF EMPLOYEE DISHONESTY (ALSO KNOWN AS FIDELITY INSURANCE)

Insurance is commonly available to provide coverage for many types of employee theft. An understanding, however, of the insurance that is available suggests a number of perils that are hidden in the fine print of these insurance policies. All of these provisions should be understood carefully when purchasing employee dishonesty coverage or in submitting a claim.

Employee theft covers loss of or damage to money, securities and other property resulting directly from theft committed by an employee, whether identified or not, acting alone or in collusion with others.

It is important in evaluating employee theft coverage to understand the definition of “employee” and of “theft.”

“Employee” means:

1. Any natural person:
 - a. While in your service or for 30 days after termination of service;
 - b. Who you compensate directly by salary, wages or commissions; and
 - c. Who you have the right to direct and control while performing services for you;
2. Any natural person who is furnished temporarily to you:
 - a. To substitute for a permanent “employee” as denned in Paragraph (1) above, who is on leave; or
 - b. To meet seasonal or short-term work load conditions; while that person is subject to your direction and control and performing services for you, excluding, however, any such person while having care and custody of property outside the “premises;” or
3. Any natural person who is:
 - a. A trustee, officer, employee, administrator or manager, except an administrator or manager who is an independent contractor, of any “employee benefit plan(s)” insured under this insurance; and
 - b. Your director or trustee while that person is handling “funds” or “other property” of any “employee benefit plan(s)” insured under this insurance.

“Employee” does not mean:

1. Any agent, broker, person leased to you by a labor leasing firm, factor, commission merchant, consignee, independent contractor or representative of the same general character; or
2. Any “manager,” director or trustee except while performing acts coming within the scope of the usual duties of an “employee.”

Please note carefully that the definition of “employee” in the standard form does not include any person leased to you by a labor leasing firm. Also, it should be noted that the related coverage that is provided for non-employee theft does not include leased employees, leaving a significant coverage gap if a leased employee is involved with the theft of money or property.

Also, the provision regarding temporary employees indicates that they are covered; however, coverage only applies while on your premises. If you allow a temporary employee to take a bank deposit to the bank and that money is stolen, coverage would not be provided.

Similarly, employees of others working on your premises, such as security guards, cleaning people, parking lot attendants, etc., may not be covered under the employee dishonesty coverage if your property is stolen by them even though they could be in an excellent position to steal your property.

There is a new form that is available, CR0401 “Clients Property,” which covers property for which an insured is legally liable while the property is on the premises of a client of the insured. If your employees, for example, are working at someone else's location, those employees could steal that property. To the extent you are legally liable, coverage could be provided under this form if added to your employee dishonesty coverage. Specific endorsements are also available to amend the definition of “employee” to include partners, volunteer workers, and non-compensated officers.

Also, note that “employee” does not mean any “manager,” director or trustee except while performing acts coming within the scope of the usual duties of an “employee.” “Manager” is defined in the policy as meaning a person serving in a directorial capacity for a limited liability company. An endorsement is available, CR2504, which includes members of a limited liability company as employees.

Please note that the definition of “theft” above requires the unlawful taking of money, securities, or other property to the deprivation of the insured. The word deprivation can create coverage problems.

EXCLUSIONS

The employee dishonesty form excludes:

- Acts committed by the insured, the insured's partners, or the insured's members if it is an LLC.
- Governmental actions such as seizure or destruction of property by order of governmental authority.
- Indirect loss. Loss that is an indirect result of any act or occurrence covered by the employee dishonesty coverage is not covered, such as your inability to realize income that you would have realized had there been no loss, or the payment of damages of any type for which you are legally liable, or payment of costs, fees, or other expenses you incur in establishing the amount of loss.
- Employee cancelled under prior insurance. Loss caused by an employee for whom similar prior insurance has been cancelled is not covered.
- Inventory shortages. Loss or that part of any loss the proof of which as to its existence or amount is dependent on an inventory computation or a profit and loss computation.
- Trading. Loss resulting directly or indirectly from trading whether in the insured's name or in a genuine or fictitious account.
- Warehouse receipts. Loss resulting from fraudulent or dishonest signing, issuing, canceling or failing to cancel a warehouse receipt or any papers connected with it.
- Automatic cancellation as to any employee if prior dishonesty. A particularly onerous provision is that the employee dishonesty insurance is cancelled as to any employee immediately upon discovery by the insured or any of the insured's partners, members, managers, officers,

directors or employees of any theft or any other dishonest act committed by the employee whether it is before or after becoming employed by you. Please note that any dishonesty even if it involves as little as \$1 would immediately exclude, without notice, any further employee dishonesty. In tight labor markets many companies now hire individuals who they know have prior criminal records for entry level positions. Any subsequent theft by these employees would be excluded.

DUTIES IN THE EVENT OF A LOSS

After the insured discovers a loss or a situation that may result in a loss, you must notify the insurance company as soon as possible. If you have reason to believe that any loss involves a violation of law, you must also notify the local law enforcement authorities. An important requirement in the policy is that you provide a detailed, sworn proof of loss within 120 days.

GENERAL COMMENTS

Crime insurance forms can vary widely and you must examine the specific provisions of your employee dishonesty coverage in conjunction with your insurance counselor or risk manager. Many insurance companies are willing to modify their provisions to suit your particular needs.

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