

## **RECOVERY IN EMPLOYEE DISHONESTY CLAIMS**

### **I. INTRODUCTION**

Your insured discovers that its longstanding bookkeeper of 15 years, who bakes cookies every Friday and goes to church every Sunday, has an incurable addiction to Bingo and has stolen \$250,000 over the past five years. The insured is able to document the loss, and its claim is covered in full. Is there anything the insurer can do to get its money back?

These materials examine the issues surrounding just such an employee dishonesty claim. Set forth below is a five-step process designed to guide you in maximizing the recovery potential in these cases.

### **II. STEP 1: INTERVIEW THE EMPLOYEE**

It is extremely important that you interview the employee as soon as possible after the theft is reported. Time is of the essence because once the employee obtains counsel, your access to information will be cut off for a substantial length of time.

The main purposes of the interview are as follows: (a) to confirm the amount of the theft and to obtain information regarding the employee's use of the funds; (b) to determine precisely how the theft was accomplished; and (c) to identify any funds or property that may still be in existence.

You should have a management-level employee of the organization present to reduce the nervousness of the employee in talking with a stranger and to testify to what is said during the interview. Your goals should be as follows:

1) Signed Confession

Obtain a signed confession as to the amount that was embezzled and which admits that the employee "converted" or "stole" the funds. This will help if you eventually have to sue the employee or if the employee attempts to escape the debt through bankruptcy.

2) List of all Real Property and Personal Property

Obtain a complete list of the employee's assets portfolio. Include all real property, personal property (vehicles, jewelry, and other items that have significant value), cash, and securities. You will also need to find out what liens exist against this property.

3) List of all Bank Accounts and Brokerage Accounts

Obtain a list of all bank account numbers held by the employee and his or her spouse.

4) Who Else Knew About It?

Find out if the employee let anybody else know about the theft, especially her spouse. You may be able to identify another employee in the organization who was "in on it".

5) How Was It Done?

Find out exactly how the funds were taken. Did the employee open up an unauthorized bank account? Did the employee forge an endorsement?

6) Where's The Money?

Find out what was done with the funds. This will usually be difficult for the employee to answer, and they truly may not remember what happened with the bulk of the funds. It may be important to establish that funds were used to benefit the community in the case of a married employee if you eventually plan on seeking recovery from community assets. It is also important to identify any property in the possession of the employee purchased with the use of

stolen monies or whether the employee made gifts or loans of money or property to friends or relatives without the consent of his or her spouse.

#### 7) Property Transfers

Finally, and most importantly, see whether you are able to convince the employee to sign over his property to either the company or the insurer. As is set forth below, you may be able to substantially improve your position if you avoid having to legally attach the employee's property. For example, you may avoid the effect of the Homestead exemption. Don't forget to include the employee's final paycheck.

Why would the employee talk to you? You and the insured determine whether criminal charges are brought. In addition, the sentence may be reduced if restitution is made.

While most of the interview topics relate to the marshalling of the employee's assets, you should also be concerned with building a case against potential targets for your recovery effort. These may include the bank where the checks were cashed, the accounting firm that performed audits of the organization's accounting records, and friends or relatives who received the benefits of the employee's theft.

### **III. STEP 2: SEIZE ALL OF THE EMPLOYEE'S AVAILABLE ASSETS**

The first step is to obtain an assets report to compare with the information provided by the employee. If possible, it helps to have this information prior to the interview. Once you have an assets report, you may begin to identify property that may exist to satisfy your claim.

#### A) Real Property

Real property may be voluntarily transferred by deed. The strongest method is by statutory warranty deed. However, you may also use a quit-claim deed in this situation because you are not seeking a guarantee of what rights the debtor has in the property but are only

obtaining the debtor's rights; whatever they may be. Bear in mind that you will take this property subject to all liens and encumbrances. We strongly recommend obtaining a title search of the property and involving counsel in the transfer of real property.

If the property appears to have value over and above the liens and encumbrances and the employee will not voluntarily agree to sign it over, there may be a legal remedy known as pre-judgment attachment. State statutes typically set forth the requirements for filing a pre-judgment attachment lien, as well as all other remedies.

A lien of attachment has a similar effect as a mortgage or deed of trust. It locks in your priority over later liens or judgments including liens by the I.R.S. This is extremely important because in virtually every employee theft claim, the employee will be charged with tax evasion.

Unfortunately, mortgages, deeds, liens, and other encumbrances filed prior to a pre judgment lien have priority. In addition, some of the equity in the property may be protected pursuant to statute, such as "homestead exemptions". Typically, in those situations the excess value of the property may still be executed upon.

#### B) Personal Property

Personal property may also be transferred voluntarily. For most property, the only legal requirements are delivery and an objective manifestation of an intention on the part of the employee to relinquish ownership. Generally, this only requires a verbal statement. However, we recommend that you have the employee sign an agreement listing the property to be transferred along with agreed values to apply against the overall debt.

Property such as vehicles and some equipment must be transferred by a change of title. These items will often be subject to liens by a bank or other credit agency. Title will be taken subject to those liens having priority.

Personal property may also be subject to a pre-judgment writ of attachment. Again, state statutes set forth the details for filing and execution by the appropriate authority. You should be aware that this method requires that arrangements be made for transfer and storage of the property. In other words, the sheriff's department will not act as the moving company during this process.

There is typically a homestead exemption for personal property provided for by statute. Some examples of exemptions are as follows: (1) clothes, furs, and jewelry - \$1,000; (2) private libraries - \$1,500; (3) furniture, appliances, and yard equipment - \$2,700; (4) other personal property of \$1,000, including \$100 in cash and \$100 in bank accounts or other marketable securities; and (5) two motor vehicles not to exceed \$2,500. Pensions and most other retirement plans are generally exempt from execution under state statutes, but each specific statute must be carefully reviewed.

### **III. OBTAIN JUDGMENT AGAINST EMPLOYEE**

If the employee has not voluntarily transferred his property to the insurer and you have seized all available property through use of a pre judgment writ of attachment, you must reduce your claim to judgment prior to selling it. This requires that suit be filed and that either the employee stipulate to a judgment, the court grant summary judgment, or you prevail at trial.

One difficulty you may face is that the employee has a constitutional right against self-incrimination, and, therefore, she does not have to answer questions posed during deposition or at a civil trial until the criminal matter is resolved. Most of these criminal matters are resolved through plea bargain, and it helps to gently remind the U.S. Attorney's office or the prosecutor that you are anxious to proceed.

#### **IV. EXECUTE ON THE JUDGMENT AND SELL THE ASSETS**

The length of time that one has to execute on a judgment will vary by state. In Washington, one has ten years from the date of entry of a judgment to execute on it. This may involve garnishment, foreclosure, or a sheriff's sale.

Many times, the debtor will agree to a sale of the property without having to resort to the statutory remedies. Generally, we encourage the parties to agree to a division of the proceeds prior to a sale to make things go more smoothly.

In one example, in the case of a residence that a debtor signed over to our insured, the carrier had to list the property for sale with a real estate agent, insure the premises, and hire a contractor to fix the roof when it was called out on the inspection report. In other words, dealing with the debtor's assets is often a time-consuming and expensive process. Only if there is sufficient equity in the property does it warrant immediate foreclosure and sale.

In Washington, judgments are usually valid for ten years. In some cases, they may be extended for an additional ten years. There is always a chance that the employee will get back on his feet some day, and, if you have a significant loss, it may be worthwhile to bide your time. In many cases, we simply take a promissory note and put the employee on a payment plan.

#### **V. PURSUE CLAIMS AGAINST THIRD PARTIES**

Recovery against the employee is not the only avenue to recoup your payments. Depending on the circumstances, an action may be warranted against the accountants who performed audits on the books, the bank that cashed the checks, and, in a very limited number of cases, against friends or relatives who received the benefits of the employee's theft.

A) Accountants

Many of our cases involve the theft of funds from large companies that, whether they are public or private companies, have outside audit requirements. The American Institute of Certified Public Accountants ("AICPA") promulgates standards for audits known as Generally Accepted Auditing Standards ("GARS"). These standards define the duty of care for accountants.

The major case in Washington addressing this issue is a Federal Court decision entitled Seafirst Corp. v. Jenkins, 644 F. Supp. 1152 (W.D. Wash. 1986). In Seafirst, the accountants were sued for failing to bring internal controls problems to the attention of the Board of Directors and for failing to issue a qualified opinion that insufficient data existed to evaluate the collectibility of several hundred million dollars in energy loans. The accounting expert testified that the auditors' actions fell below the GARS standards. The Seafirst court held that the expert's affidavit testimony was sufficient to survive summary judgment.

Our methodology for exploring this avenue involves the retention of an accounting expert to examine the audit records of the insured and the method of theft and to offer an opinion as to whether the auditor breached its requisite standard of care. It is generally a very difficult case to pursue, and many times we have had difficulty in even finding a qualified expert to examine the issue. However, the Seafirst case made it clear that an expert's testimony is required to survive a summary judgment motion.

B) Banks

We have had our greatest success in third-party recovery efforts against banks. In one case, an employee of a large college opened up an account in the name of the institution at a local bank. He took checks made payable to the institution and deposited them in this account.

He also received cash back from several of the deposits. The total theft amounted to well over \$300,000. We were able to recover approximately \$225,000 from the bank for failing to require a corporate authorization when the account was initially opened.

The law concerning unauthorized signatures on negotiable instruments may be found in the Uniform Commercial Code. This Code has been adopted by almost every state and is usually codified as a state statute (example – RCW Title 62A in Washington). This section is extremely complicated, and each case needs to be examined individually to see whether there exists sufficient grounds to pursue the bank. However, some general propositions may be stated. Generally, a bank that cashes a forged check without requiring proper identification will bear the loss. Many times, an employee in charge of the payroll will prepare paychecks for phantom employees. In this situation, the company will usually bear the loss because the company is in a better position to prevent the forgery through reasonable care in selection of its employees or can at least cover its losses with fidelity insurance. See RCW 62A.3-405.

If an insured substantially contributes to an alteration through his negligence, he is precluded from asserting the alteration or lack of authority against a holder in due course or against a bank that pays the instrument in accordance with commercially reasonable standards. For example, if you write a check to your paper boy for \$5.00 and leave room for him to add a few zeros behind the five, then your only remedy will lie against the paper boy and not against the bank.

This was an issue in the bank case referenced above. The bank claimed that our insured was comparatively at fault because the embezzlement had taken place over several years, and the institution failed to ensure that adequate controls were in place. The bank's position failed because it did not act in a commercially reasonable manner in opening the account without



corporate authorization and, therefore, could not take advantage of the statute's contributory fault preclusion. See RCW 62A.3-406.

C) Friends and relatives

In a very limited number of circumstances, there may be a potential for recovery against friends or relatives of the employee. If the employee made gifts of cash to a friend and the spouse did not consent, then the spouse may have the ability to seek replevin. Gifts of community property require agreement of both spouses. RCW 26.16.030(2). An improper gift is generally voidable although it is subject to the doctrines of authorization, ratification and estoppel. Washington Community Property Deskbook, §4.15 at 4-13 (2d ed. 1989).

While we have never tested this theory in court, we believe that it is possible to recover from friends or relatives if the gift may be deemed a fraudulent conveyance. Basically, the argument would be that at the time the gift was made the community was insolvent due to the debt it owed to the employer. Conveyances made by insolvent transferors are fraudulent, as a general rule. RCW 19.40.040.

## **VI. CONCLUSION**

In many cases, we have been able to obtain a favorable result for our clients when it initially appeared that there was no potential for recovery. The assets of the employee need to be identified and secured as soon as possible. Third parties against whom recovery may lie must be identified early. If you move quickly, you vastly improve your chances of making a recovery in employee dishonesty cases.

The claim becomes enforceable at the later of (i) the time the claim is asserted, or (ii) the 90th day following the date of the check, in the case of a cashier's check or teller's check, or the 90th day following the date of the acceptance, in the case of a certified check.

Until the claim becomes enforceable, it has no legal effect and the obligated bank may pay the check or, in the case of a teller's check, may permit the drawee to pay the check.

Payment to a person entitled to enforce the check discharges all liability of the obligated bank with respect to the check.

If the claim becomes enforceable before the check is presented for payment, the obligated bank is not obliged to pay the check.

When the claim becomes enforceable, the obligated bank becomes obliged to pay the amount of the check to the claimant if payment of the check has not been made to a person entitled to enforce the check. Subject to Section 4-302(a) (1), payment to the claimant discharges all liability of the obligated bank with respect to the check.

(c) If the obligated bank pays the amount of a check to a claimant under subsection (b)(4) and the check is presented for payment by a person having rights of a holder in due course, the claimant is obliged to (i) refund the payment to the obligated bank if the check is paid, or (ii) pay the amount of the check to the person having rights of a holder in due course if the check is dishonored.

If a claimant has the right to assert a claim under subsection (b) and is also a person entitled to enforce a cashier's check, teller's check, or certified check which is lost, destroyed, or stolen, the claimant may assert rights with respect to the check either under this section or Section 3-309.

## **PART 4. LIABILITY OF PARTIES**

### **§ 3-401. SIGNATURE.**

(a) A person is not liable on an instrument unless (i) the person signed the instrument, or (ii) the person is represented by an agent or representative who signed the instrument and the signature is binding on the represented person under Section 3-402.

A signature may be made (i) manually or by means of a device or machine, and (ii) by the use of any name, including a trade or assumed name, or by a word, mark, or symbol executed or adopted by a person with present intention to authenticate a writing.

**§ 3-402. SIGNATURE BY REPRESENTATIVE.**

(b) If a person acting, or purporting to act, as a representative signs an instrument by signing either the name of the represented person or the name of the signer, the represented person is bound by the signature to the same extent the represented person would be bound if the signature were on a simple contract. If the represented person is bound, the signature of the representative is the “authorized signature of the represented person” and the represented person is liable on the instrument, whether or not identified in the instrument.

If a representative signs the name of the representative to an instrument and the signature is an authorized signature of the represented person, the following rules apply:

(5) If the form of the signature shows unambiguously that the signature is made on behalf of the represented person who is identified in the instrument, the representative is not liable on the instrument.

Subject to subsection (c), if (i) the form of the signature does not show unambiguously that the signature is made in a representative capacity or (ii) the represented person is not identified in the instrument, the representative is liable on the instrument to a holder in due course that took the instrument without notice that the representative was not intended to be liable on the instrument. With respect to any other person, the representative is liable

on the instrument unless the representative proves that the original parties did not intend the representative to be liable on the instrument.

(c) If a representative signs the name of the representative as drawer of a check without indication of the representative status and the check is payable from an account of the represented person who is identified on the check, the signer is not liable on the check if the signature is an authorized signature of the represented person.

**§ 3-403. UNAUTHORIZED SIGNATURE.**

(d) Unless otherwise provided in this Article or Article 4, an unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value. An unauthorized signature may be ratified for all purposes of this Article.

If the signature of more than one person is required to constitute the authorized signature of an organization, the signature of the organization is unauthorized if one of the required signatures is lacking.

The civil or criminal liability of a person who makes an unauthorized signature is not affected by any provision of this Article which makes the unauthorized signature effective for the purposes of this Article.

**§ 3-404. IMPOSTORS; FICTITIOUS PAYEES.**

(e) If an impostor, by use of the mails or otherwise, induces the issuer of an instrument to issue the instrument to the impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

If (i) a person whose intent determines to whom an instrument is payable (Section 3-110(a) or (b)) does not intend the person identified as payee to have any interest in the instrument, or (ii) the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement:

(6) Any person in possession of the instrument is its holder.

An indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.

(a) Under subsection (a) or (b), an indorsement is made in the name of a payee if (i) it is made in a name substantially similar to that of the payee or (ii) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to that of the payee.

With respect to an instrument to which subsection (a) or (b) applies, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from

the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

**§ 3-405. EMPLOYER'S RESPONSIBILITY FOR FRAUDULENT INDORSEMENT BY EMPLOYEE.**

**(b) In this section:**

**(7) "Employee" includes an independent contractor and employee of an independent contractor retained by the employer.**

**"Fraudulent indorsement" means (i) in the case of an instrument payable to the employer, a forged indorsement purporting to be that of the employer, or (ii) in the case of an instrument with respect to which the employer is the issuer, a forged indorsenient purporting to be that of the person identified as payee.**

**"Responsibility" with respect to instruments means authority (i) to sign or indorse instruments on behalf of the employer, (ii) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition, (iii) to prepare or process instruments for issue in the name of the employer, (iv) to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer, (v) to control the disposition of instruments to be issued in the name of the employer, or (vi) to act otherwise with respect to instruments in a responsible capacity. "Responsibility" does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.**

**(b) For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person**

acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

Under subsection (b), an indorsement is made in the name of the person to whom an instrument is payable if (i) it is made in a name substantially similar to the name of that person or (ii) the instrument, whether or not indorsed, is deposited in a depository bank to an account in a name substantially similar to the name of that person.

**§ 3-406. NEGLIGENCE CONTRIBUTING TO FORGED SIGNATURE OR ALTERATION OF INSTRUMENT.**

(c) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

Under subsection (a), if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

Under subsection (a), the burden of proving failure to exercise ordinary care is on the person asserting the preclusion. Under subsection (b), the burden of proving failure to exercise ordinary care is on the person precluded.

**§ 3-407. ALTERATION.**

(d) “Alteration” means (i) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or (ii) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party.

Except as provided in subsection (c), an alteration fraudulently made discharges a party whose obligation is affected by the alteration unless that party assents or is precluded from asserting the alteration. No other alteration discharges a party, and the instrument may be enforced according to its original terms.

A payor bank or drawee paying a fraudulently altered instrument or a person taking it for value, in good faith and without notice of the alteration, may enforce rights with respect to the instrument (i) according to its original terms, or (ii) in the case of an



**incomplete instrument altered by unauthorized completion, according to its terms as completed.**

**§ 3-408. DRAWEE NOT LIABLE ON UNACCEPTED DRAFT.**

A check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it.

**§ 3-409. ACCEPTANCE OF DRAFT: CERTIFIED CHECK.**

(e) “Acceptance” means the drawee’s signed agreement to pay a draft as presented. It must be written on the draft and may consist of the drawee’s signature alone. Acceptance may be made at any time and becomes effective when notification pursuant to instructions is given or the accepted draft is delivered for the purpose of giving rights on the acceptance to any person.

A draft may be accepted although it has not been signed by the drawer, is otherwise incomplete, is overdue, or has been dishonored.

If a draft is payable at a fixed period after sight and the acceptor fails to date the acceptance, the holder may complete the acceptance by supplying a date in good faith.

“Certified check” means a check accepted by the bank on which it is drawn. Acceptance may be made as stated in subsection (a) or by a writing on the check which indicates that the check is certified. The drawee of a check has no obligation to certify the check, and refusal to certify is not dishonor of the check.

**§ 3-410. ACCEPTANCE VARYING DRAFT.**

**(f) If the terms of a drawee's acceptance vary from the terms of the draft as presented, the holder may refuse the acceptance and treat the draft as dishonored. In that case, the drawee may cancel the acceptance.**

**The terms of a draft are not varied by an acceptance to pay at a particular bank or place in the United States, unless the acceptance states that the draft is to be paid only at that bank or place.**

If the holder assents to an acceptance varying the terms of a draft, the obligation of each drawer and indorser that does not expressly assent to the acceptance is discharged.

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