



Subrogation & Recovery Alert!

News Concerning Recent Subrogation & Recovery Issues

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RECOVERY IN EMPLOYEE DISHONESTY CLAIMS

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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. As discussed below there are a number of legal theories from which to pursue recovery and a number of targets that may be responsible to bear some of the loss. The following is a five-step process designed as a guide to assist you in realizing recovery in such cases.

I. INTERVIEW THE EMPLOYEE

It is imperative that the employee should be interviewed as soon as possible after the theft is reported, preferably by counsel. Time is of the essence. Once the employee obtains counsel, your access to information will be cut off for a substantial length of time. This will hinder your ability to act and can significantly impact your priority status for purposes of recovery.

The primary purpose of the interview is to gain as much knowledge as possible on the following topics: (a) the amount of the theft and information regarding the employee's use of the funds; (b) the process in which the theft was accomplished; and (c) the location and identity of any funds or property purchased with the funds. You should have at least two employees of the

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insured present, preferably management-level employees, to reduce the nervousness of the employee and promote full and candid disclosure. Additionally, these witnesses can testify at trial to what the employee said.

In preparing for the interview, remember that you and the insured have leverage, power and influence over the employee. You determine whether criminal charges are brought and can influence whether the sentence is reduced. Do not be afraid to let the interviewee know this and use these facts to gain cooperation. While most of the interview topics relate to the marshalling of the employee's assets, you should also be concerned with the details of how the fraud was accomplished to help build a case against other potential targets for your recovery effort. As is discussed below, third parties often provide the most feasible targets for pursuing and realizing recovery. These include the bank where the checks were cashed, the accounting firm that performed audits of the organization's financial records, and friends or relatives who received the benefits of the employee's theft, particularly if they knew about the theft. Your interview should be focused on obtaining as much information as possible while keeping the following goals in mind:

A) Signed Confession

Obtain a signed confession specifying the amount embezzled and an admission that the employee "converted" or "stole" the funds. This will help if you sue the employee or if the employee attempts to escape the debt through bankruptcy. It is best to have the employee handwrite the confession in addition to signing it.

B) Inventory of all Real Property and Personal Property

Obtain a complete list of the employee's asset portfolio. The list should include all real property, personal property (vehicles, jewelry, electronics, etc.), cash, and securities. You will also need to find out what liens, mortgages and encumbrances exist against the property, if any.

C) Inventory of all Bank Accounts and Brokerage Accounts

Obtain an exhaustive list of the employee's bank accounts and, if possible, bank account numbers held by the employee and his or her spouse. If the employee is paid via direct deposit, you may be able to place a freeze on the account until the civil and criminal proceedings conclude.

D) Who Else Knew About It?

Find out if the employee let anybody else know about the theft, specifically, his or her spouse or other employees in the organization whom you may be able to pursue. If you deter-

mine that someone else knew about it, find out the extent of that person's knowledge and whether they helped or provided any assistance in accomplishing the theft.

E) How Was It Done?

Find out exactly how the funds were taken. Did the employee open an unauthorized bank account? In whose name was the account opened? Did the employee use fake identification? Did the employee forge an authorized signature or an endorsement? It is critical to know the step-by-step process by which the embezzlement was accomplished for purposes of pursuing third parties, and/or the dishonest employee, and to ensure that this does not happen again.

F) Where Is the Money?

Find out what was done with the funds. This will usually be difficult for the employee to answer. He or she 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, or whether the employee gifted the money to others without the spouse's consent. It is also important to identify any property that was purchased with the stolen money as it may be possible to obtain possession of that property through various legal and equitable remedies.

G) Property Transfers

Finally, and most importantly, attempt to convince the employee to sign over his other property to the insured or, if payment has been made, to your company. As is discussed in-depth below, you may be able to substantially improve your position if you avoid pursuing the employee's property through legal attachment proceedings. Don't forget to include the employee's final paycheck.

II. PURSUIT OF CLAIMS AGAINST THIRD PARTIES

Your best and most likely avenue of recovery is against third party professionals charged with the obligation to detect and/or prevent employee theft from occurring. Based on the typical profile of employees who commit fraud, recovery against the employee is unlikely, tedious, and often is not cost effective. Many times the employee was successful in stealing the money because a third party did not fulfill its professional obligations. Depending on the circumstances, a cause of action may be feasible against the bank that cashed the checks, the accountants who performed audits on the books, and in a limited number of situations, against friends or relatives who received the benefits of the employee's theft.

A) Banks

Some of our best recoveries from responsible third-parties have been against banks. In one case, a local bank allowed an employee of a large university to open an account in the name of the institution without corporate authorization. He took checks made payable to the institution and deposited them into this account and 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 its failure 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 ("UCC"). Every state has adopted this Code. The pertinent sections of the UCC are highly technical. Each case needs to be examined individually to see whether sufficient grounds exist to pursue recovery against a banking institution.

1) General standards

A guideline the courts look to is whether the bank acted in a "commercially reasonable" manner and in "good faith" when accepting the fraudulent check. Generally, the entity that is in the best position to have prevented the criminal act through the use of reasonable care will be responsible for the loss.¹ For example, a bank that cashes a forged check without requiring proper identification will be required to bear the loss.

2) Insured's negligence

Keep in mind that if the insured substantially contributed to the loss through its own negligence, you may be precluded from asserting a claim against the bank. For example, if the insured writes a check to a vendor for \$5.00, and leaves room for the vendor to add a few zeros behind the number five, then your only remedy will lie against the vendor and not against the bank. The bank's standard of care is that it must act in accordance with commercially reasonable standards and in good faith.

In a recent case in Arizona involving a company which sued a bank for conversion after it honored an instrument that was forged by one of the company's employees, the court ruled that the bank could assert a successful affirmative defense if it could prove that the forgery was accomplished by an employee entrusted by the company with responsibility for the instrument and that the bank acted in good faith in the transaction.² If the bank meets its burden, the company must prove that the bank acted negligently with respect to the transaction, in which event the bank then will be responsible to share the loss to the extent that its negligence substantially contributed to the loss.

This was an issue in our university employee case referenced above. The bank claimed that the insured was comparatively at fault because it failed to detect the embezzlement, which took place over several years. In our case, the bank was prevented from arguing contributory negligence as a matter of law because it did not act in a commercially reasonable manner when it opened the account without corporate authorization.³

3) What is "commercially reasonable"?

The professional negligence standard that applies to banks varies from traditional negligence in that it determines what is "commercially reasonable" by looking to standards used throughout the industry, as opposed to the "ordinary person" standard. Whether a bank's actions are deemed commercially reasonable is distinct to each case and will depend on the particular circumstances. Reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage.⁴

Many times, you can use your common sense to determine what is commercially reasonable. For example, the bank acted in a commercially unreasonable manner and bears responsibility for the loss when it failed to question an individual who cashed a check made payable to the company and put the money in his personal account.⁵ A bank acted in a commercially reasonable manner when it allowed an office manager and assistant office manager of a sole proprietorship to open a checking account in the company's name, although the account was subsequently used to embezzle funds.⁶ To highlight how extraordinary different circumstances can be, in a recent Washington case a bank was presented with a check made payable to two people, their names separated by a hyphen. The check was endorsed by one of the named payees and presented to the bank. The bank paid the check and was determined to have acted in a commercially reasonable manner because the use of a hyphen made the instrument ambiguous as to whether the names were intended to be joint or alternate payees.⁷

4) Limitations on Actions

Be aware that there are significant time limitations that may arise when suing a financial institution. Both the bank and the insured have obligations involving "diligence" in fraud and forgery situations. The UCC requires the bank to provide written statements to its customers and requires that the customers use diligence in reviewing these statements. A customer has one year to report the unauthorized signature to the bank or the claim is barred under a laches defense, even if the customer can prove the bank *knowingly* misappropriated the funds.⁸ However, if the bank does not make statements available to its customers, the customer cannot discover the misapplied funds and the laches defense will not apply.⁹ Some jurisdictions have different statutes of limitations depending on whether the claim arises from forged signatures on the front of the check

or forged endorsements on the back of the check, respectively. The bottom line is that the time limitations place a duty upon all parties involved to scrutinize their own financial records and detect questionable transactions.

B) Accountants

Many of our cases involve the theft of funds from large companies that, whether they are public or private companies, have outside auditors charged with monitoring cash flow and identifying irregularities. To pursue a cause of action for accounting malpractice the plaintiff typically needs an expert accountant to proffer testimony that the auditor's actions fell below the standard of care promulgated by the American Institute of Certified Public Accountants ("AICPA") known as Generally Accepted Auditing Standards ("GAAS") and Generally Accepted Accounting Principles ("GAAP"). As with banks, the standard is based on whether the accountant acted in a "reasonable" manner in accordance with generally accepted industry standards.¹⁰

The major case in Washington addressing the issue of an auditor's liability is a federal court decision entitled *Seafirst Corp. v. Jenkins*.¹¹ In *Seafirst*, the accountants were successfully sued for failing to bring internal control 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. In *Seafirst*, the plaintiffs prevailed relying solely on an accounting expert's testimony that the auditor's actions fell below the GAAS standards.

When faced with a potential claim against an auditor, it is necessary to retain an accounting expert who can examine the records, analyze the method of theft, and offer an opinion as to whether the auditor breached the professional standard of care as outlined by the GAAS or GAAP. Traditionally, these are very difficult cases to pursue, and, as with medical malpractice cases, it is sometimes difficult to find a qualified expert willing to examine the issue.

C) Friends and Relatives

In a number of circumstances, there may be potential for recovery against the employee's friends or relatives. Gifts of marital property require the agreement of both spouses. If the employee made a gift to a friend without the spouse's permission, you may be able to compel that the spouse to seek replevin to retrieve the property, allowing you to execute your judgment by seizing that property.¹²

It also may be possible to recover from friends and relatives if the gift is deemed a fraudulent conveyance. Essentially if the employee-donor was insolvent due to the debt it owed to the employer at the time the gift was made, the conveyance may be deemed fraudulent and voidable.¹³

The tort of conversion may also be a viable remedy against friends or relatives who accept the fraudulently obtained money. Virtually every state recognizes the tort of conversion and typically an employer need only prove that: 1) it had legal title to the property; 2) it had possession or the legal right to possess the property at the time of the conversion; 3) defendant's "domain and control" over the property denied the employer "use and enjoyment" of the property, and; 4) the employer suffered damage.¹⁴ It should be noted that a successful claim for conversion does not require the employer to prove that the defendant had a conscious intent to do wrong. Rather, the plaintiff needs to prove an intent to exercise dominion and control over the property.¹⁵ In fact, a good faith purchaser who buys property without the knowledge that it is stolen may be liable for conversion.¹⁶ Please note that this remedy may not always be applicable as it traditionally applies to tangible personal property, goods and chattels. However, depending on the jurisdiction, cash or checks can be the subject of conversion in cases where the third party received them wrongfully.¹⁷

Another potential remedy against third parties is the equitable doctrine of constructive trust. The remedy is "equitable" in that it is imposed against a party who, in fairness, ought not to have the property.¹⁸ The remedy is one of the most powerful fraud-rectifying devices and is primarily imposed to prevent "unjust enrichment" to one party at the expense of another.¹⁹ Often constructive trusts will be imposed against parties that have abused a relationship of confidence and have wrongfully obtained property through fraudulent means.²⁰

An accomplice to the fraudulent activity can be civilly liable under the torts of conspiracy and/or aiding and abetting. If third parties knew about or benefited from the employee's fraudulent activity, civil liability may attach. A significant degree of involvement is not necessary in all circumstances and it is not necessary that the co-conspirator take affirmative steps to carry out the fraudulent activity. Knowingly accepting a benefit from the activity can be enough to trigger liability under accomplice theories.

III. SEIZE ALL OF THE EMPLOYEE'S AVAILABLE ASSETS

Of course, pursuing the employee may also be feasible in some situations. Once you obtain all possible information through the interview process, you need to compare the information gathered with an asset report. Due to privacy concerns, obtaining an asset check can be difficult and even illegal so make sure you use the proper channels and a reputable company. If it is possible, obtain the asset report prior to the interview. It will give you a reference if the employee forgets about assets, and leverage if he or she attempts to lie. The asset report will help you 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, a quit-claim deed may also be advisable in this situation because you are not seeking a *guarantee* of the debtor's rights in the property but are interested in *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 any 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 prejudgment attachment, typically governed by state statute. A lien of attachment has a similar effect as a mortgage or deed of trust. This tool provides the added benefit of locking in your priority over later liens or judgments, including liens by the Internal Revenue Service. This is extremely important because in virtually every employee theft claim, the employee will be charged with tax evasion. Unfortunately, encumbrances such as mortgages, deeds and liens filed prior to a prejudgment lien will take 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 for recovery purposes.

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, which only requires a verbal statement. However, we recommend that you have the employee sign an agreement listing the property to be transferred along with the agreed values to apply against the overall debt.

Personal property may also be subject to a prejudgment writ of attachment. Again, state statutes set forth the details necessary to having the writ of attachment properly filed and executed. 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. Some personal property, such as vehicles, must be transferred by a change of title. These items will often be subject to liens by a bank or other credit agencies which will take priority over your interest.

There is typically a statutory homestead exemption relating to personal property. Please note that these exemptions vary widely depending on the specific jurisdiction's statute. A typical statutory framework exempts the following: (1) clothes, furs, and jewelry - \$1,000; (2) private

libraries - \$1,500; (3) furniture, appliances, and yard equipment - \$2,700; (4) other personal property - \$2,000, including \$200 in cash and \$200 in bank accounts or other marketable securities; and (5) one motor vehicle for an individual not to exceed \$2,500, or two motor vehicles for the community the aggregate value not to exceed \$5,000.²¹ Pensions and most other retirement plans are generally exempt from execution under state statutes, but each statute must be carefully reviewed.

IV. OBTAIN JUDGMENT AGAINST EMPLOYEE

If the employee has not voluntarily transferred his or her property to the insurer and you have seized all available property through use of a prejudgment writ of attachment, you must reduce your claim to a judgment prior to selling the property. This requires that suit be filed and that either the employee stipulate to a judgment, the court grant summary judgment, or that the insurer prevails at trial. Once you have reduced your claim to a judgment, many legal and equitable tools are at your disposal to help you realize recovery, the most common of which is garnishment. However, ERISA exempts certain property from being garnished, such as pensions.

One difficulty you may face when attempting to reduce your claim to a judgment is that the employee has a constitutional right against self-incrimination and can refuse to answer questions until the criminal matter is resolved. Most of these criminal matters are resolved relatively quickly through plea bargains, but it helps to remind the U.S. Attorney's office or the state prosecutor that you are anxious to proceed.

V. EXECUTE ON THE JUDGMENT AND SELL THE ASSETS

The length of time that one has to execute on a judgment will vary by state. Execution may involve garnishment, foreclosure, or a sheriff's sale. A debtor may agree to a sale of the property without having to resort to such remedies. Generally, we encourage competing creditors to agree to a division of proceeds prior to a sale to make things go more smoothly.

Keep in mind that executing a judgment can be a tedious, time-consuming and expensive process. For example, in the case of a residence that a debtor signed over to the 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. Therefore, it is important to make an early determination as to whether the property has sufficient equity to warrant a foreclosure and sale so as to prevent wasting your time and more money. Remember, you have a time limit from which to execute your judgment, and there is always a chance that the employee will get back on his or her feet some day. It may be advisable to bide your time. In many cases, the easiest route is to take a promissory note and put the employee on a payment plan.

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. It is important to gain as much information as possible during an initial interview in an effort to identify potential recoverable assets and property, and to streamline the process to establish liability by obtaining a confession. Securing your interest or taking possession of the employee's real and personal property needs to be accomplished as soon as possible. In addition, the employee likely has other creditors who will soon be staking claim to assets and property. In the typical situation where the employee will not voluntarily transfer his or her property, it is important to have your claim reduced to judgment. Once you have a judgment, you can use a number of remedies to assist in actually taking possession of cash, assets and property. Do not forget that third parties may also be responsible for the loss. You may be able to realize recovery against accountants, banks, spouses and friends of the dishonest employee. Remember, if you move quickly, you vastly improve your chances of securing a recovery in employee dishonesty cases.

For additional information, please feel free to contact the authors of this Alert!, or any of the Cozen O'Connor subrogation contact attorneys listed in the attached directory. Mark S. Anderson, Esq. 1201 Third Avenue, Seattle, WA 98101 (206) 224-1247 manderson@cozen.com; Bryan R. Campbell, Esq. 1201 Third Avenue, Seattle, WA 98101 (206) 373-7245 bcampbell@cozen.com; or James Tarman, Esq. 222 South Riverside Plaza, Suite 1500, Chicago IL, 60606 (312) 382-3132 jtarmar@cozen.com

¹ See (e.g.) RCWA 62A.3 405.

² *San Tan Irr. Dist. v. Wells Fargo Bank*, 3 P.3d 1113 (Ariz.App. 2000).

³ RCWA 62A.3 406.

⁴ *Espresso Roma Corporation v. Bank of America N.A.*, 124 Cal.Rptr.2d 549 (1st Dist. 2002).

⁵ *Aetna Cas. and Sur. Co. v. Hepler State Bank*, 630 P.2d 721, 6 Kan.App.2d 543 (1981).

⁶ *Weil v. First Nat. Bank of Castle Rock*, 983P.2d 812 (Colo.App. 1999).

⁷ *J.R. Simplot, Inc. v. Knight*, 988 P.2d 955 (Wash. 1999).

⁸ *Henrichs v. Peoples Bank*, 992 P.2d 1241 (Kan.App. 1999).

⁹ *Fackrell v. American Nat. Bank*, 116 P.3d 201 (Okla.App. 2005).

¹⁰ *Hydroculture, Inc. v. Coopers & Lybrand*, 848 P.2d 856 (Ariz.App. 1st 1992).

¹¹ *Seafirst Corp. v. Jenkins*, 644 F. Supp., 1152 (W.D. Wash. 1986).

¹² RCWA 26.16.030(2).

¹³ RCWA 19.40.041.

¹⁴ *Cross v. Berg Lumber Co.*, 7 P.3d 922 (Wyo. 2000).

¹⁵ *Evans v. Dean Witter Reynolds, Inc.*, 116 Nev. 598, 5 P.3d 1043 (2000).

¹⁶ *Itin v. Ungar*, 17 P.3d 129 (Colo. 2000).

¹⁷ *Consulting Overseas Management, Ltd. v. Shtikel*, 105 Wash.App. 80, 18 P.3d 1144 (1st Div. 2001); *State v. Twitchell*, 832

P.2d 866 (Utah.App. 1992).

¹⁸ *Riddell v. Edwards*, 12 P.3d 771 (Alaska 2003).

¹⁹ *Delk v. Markel American Ins. Co.*, 2003 Ok. 88, 81 P.3d 629 (Okla. 2003).

²⁰ *Bachrach v. Salzman*, 981 P.2d 219 (Colo.App. 1999).

²¹ RCWA 6.15.010.



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