Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/98 – "Employee Dishonesty – Could it happen to you?" October, 1998

Employee Dishonesty

Could it happen to you?

Most businesses carry insurance on their business personal property. Coverage is generally written on a "Special Peril" (formerly known as the "All Risk") form.

One of the exclusions in the Special Peril form is for employee dishonesty. Loosely defined, employee dishonesty is theft of an employer's assets by its employees.

Unfortunately, this coverage is often overlooked. Many employers are victimized by the "it can't happen to me" or "my employees are too loyal to rip me off" syndromes. In fact, most employee theft losses are caused by long-term, well-thought-of employees. This is exacerbated by the fact that money, securities, computer equipment, trade secrets and other property present attractive targets for theft, and the best-positioned thieves are the ones on your payroll.

Covered property

What types of property are covered by employee dishonesty?

Covered property consists of the following:

- Money – Currency, coins, bank notes, travelers checks, registered checks and money orders held for sale to the public.
- Securities – Negotiable and non-negotiable instruments or contracts representing either "money" or other property, and including tokens, tickets, revenue stamps, and other stamps in current use (including unused value in a postage meter) and evidences of debt issued in connection with charge or credit cards other than cards issued by the insured.
- Property other than money and securities – All tangible property other than money and securities. Computer equipment is a good example.

Covered causes of loss

What types of losses are covered?

Employee dishonesty is the covered cause of loss. It has two components.

1. The employee's act must be dishonest.
2. There must be manifest intent to cause a loss to the insured, and to obtain financial benefit for the employee or for another person or entity intended by the employee to receive the benefit (such as a friend, relative, or favorite charity). In addition, the financial benefit must be something other than normal salary, commissions, fees, bonuses, promotions, awards, profit-sharing or pensions.

(Continued on page 2)

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(Continued from page 1)

Definition of Employee

An employee is someone who is

- currently employed by the insured, or an ex-employee who was terminated in the past 30 days
- compensated by the insured via salary, wages or commissions
- subject to the control and direction of the insured

All three of these criteria must be met in order for a person to be considered an employee for purposes of crime coverage. Temporary personnel provided by employment contractors are included as employees while performing services and subject to the insured's direction and control. However, such temporary personnel are excluded while having care and custody of property outside of the insured premises.

Note that agents, brokers, factors, commission merchants, consignees, independent contractors and similar representatives of the insured are specifically excluded from coverage. Directors or trustees are also excluded, except while performing duties usual to an employee.

It may be that the definition of "employee" excludes individuals who present a serious loss exposure to your company. Accordingly, standard endorsements are available to broaden the definition of employee to include various individuals, including agents and their employees, non-compensated officers, volunteer workers, and the spouse and children of building managers.

Burden of proof

You, the insured, have the burden of proving by a preponderance of the evidence, that the loss

- occurred, came within the scope of risk insured against
- was caused by someone whose fidelity was insured
- was within the policy period.

In addition, the employee dishonesty forms have an exclusion that makes your burden of proof more challenging. It states that the insurer will not pay a loss or that part of a loss, the proof of which "as to its existence or amount" is dependent upon an inventory computation or a profit-and-loss computation.

What this means is that even though your inventory records indicate that there has been a loss, and maybe a substantial loss, you have no coverage unless ***separate*** evidence establishes that the loss was due to the dishonesty of one or more employees. What's more, a shortage demonstrated by inventory records cannot, by itself, be used to prove the amount of property taken, even if other evidence establishes the fact of a crime.

Controlling your Employee Dishonesty exposure

Procedural controls begin with good accounting procedures. They can effectively discourage employees from stealing, and create audit trails to finger those who do. The importance of separating sensitive job duties to make it more difficult for an individual to cover his or her tracks cannot be stressed enough. For example, bank accounts should be reconciled by someone not authorized to deposit or withdraw funds. Your procedures should require a counter-signature on all checks. Security should be subject to joint control of two or more responsible employees.

Background checks of the people you consider hiring should not be overlooked. While checking an applicant's background may seem elementary, employers often overlook it, or perform only a cursory review.

Strict policy – Have a clear, no-tolerance policy with respect to employee theft. Also be consistent in how you enforce it. Some firms require all employees to fill out fidelity insurance applications as psychological reinforcement. (Note: the first time an employee commits theft it is covered. The

(Continued on page 3)

(Continued from page 2)
second time it is not.)

Other crime coverages to consider

Forgery – While forgeries with insider involvement would be covered by employee dishonesty insurance, those involving only outsiders would not. It may not be clear at the outset whether a loss involves insiders, outsiders or both. For that reason, firms that purchase employee dishonesty coverage usually buy Forgery or Alteration coverage as well.

Forgery or alteration coverage pays for loss resulting directly from the "forgery or alteration of, on or in covered instruments," which include checks, drafts, promissory notes, etc. made by or drawn upon the insured. It also pays legal expenses if someone sues the insured for refusing to pay a covered instrument on the basis that it was forged or altered.

Computer Fraud – Standard employee dishonesty forms do not cover computer theft committed by outsiders (computer theft committed by an employee would be covered). You can fill this gap with the "computer fraud" coverage form. Coverage applies to theft of money, securities and other property following and directly related to the use of any computer to fraudulently cause the transfer of that property from inside your premises or banking premises to a person or place outside those premises.

ERISA Mandated Coverage – The Employee Retirement Income Security Act of 1974 (ERISA) requires that all persons handling funds for practically any type of pension or welfare benefit plan be bonded in an amount of not less than 10% of the funds handled, or $500,000, whichever is less. This basically covers theft of plan assets by a fiduciary. This coverage can be combined with an employee dishonesty policy.

Bear in mind that this type of coverage does not take the place of either fiduciary liability or employee benefit liability. Fiduciary liability policies typically cover the discretionary decision-making exposures of the fiduciary, while employee benefit liability typically covers administrative errors.

Your exposures arising out of employee dishonesty and other crime-related perils should not be overlooked. Once your exposures are identified, they should be controlled and/or insured accordingly.✧

CRIME

Is your company at risk?

Every company, regardless of size, is a potential target for white collar crime, which causes businesses to lose billions of dollars annually. Estimates of losses start at $40 billion a year, and experts acknowledge that this is one of the fastest-growing, most prevalent problems facing businesses today.

Could it happen to you? The changing economic environment, advances in technology and international expansion make the threat of loss more ominous than ever before. Consider these crime scenarios, and then talk to us about coverage from Chubb, a leading underwriter of crime insurance for more than 50 years:

Scenario 1

A transportation company's high level marketing executive set up a fictitious firm in collusion with his wife and in-laws. Over the course of several years, the firm overbilled for services that were performed, and also billed the company for services that were never rendered. LOSS: **in excess of $2.5 million**

Scenario 2

A paper product distributor's general manager, in collusion with her colleague in the warehouse, diverted raw material before it became inventory to a competitor. They also sold the competitor jumbo rolls of paper and finished products that they stole from the warehouse. The competitor had full knowledge of what was transpiring. LOSS: **in excess of $3 million**

Scenario 3

A cruise ship line's senior vice president wire-transferred funds from the line's account to his own bank account for personal use. In addition, he obtained kickbacks from vendors. This trusted employee also sold property he owned to the line at inflated prices. LOSS: **in excess of $2.5 million**

Scenario 4

A pharmaceutical manufacturer's regional sales director approved the payment of invoices for promotional items submitted by five suppliers, each owned or controlled by the employee's spouse and her friend. The prices were inflated on those items actually provided. Other invoices were paid by the manufacturer for nonexistent goods. LOSS: **well in excess of $1 million**

Scenario 5

Two hospital employees – the CFO and the director of construction – made arrangements to hire a contractor if he would overbill the hospital and kickback the difference to them. LOSS: **well in excess of $1 million** ✦

Article provided courtesy of the ***Chubb Group of Insurance Companies***