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How To Maximize Insurance Recovery For Employee Crime

Law360, New York (October 30, 2013, 6:25 PM ET) -- Employee theft is a significant source of loss in the hospitality industry. Reports have found that 34 percent of employees in the 18-to-29 age bracket believe that stealing from their employer is justifiable. It is believed that as much as one-third of all restaurant failures are due, in significant part, to theft by employees, and the total amount stolen industrywide, in restaurants alone, amounts to $8.5 billion in annual losses.

A study commissioned by the Association of Certified Fraud Examiners estimated that the median loss caused by occupational fraud was $140,000, and 20 percent of these losses exceeded $1 million. The numbers are clear: employee theft poses a serious threat to the hospitality industry.

Many hospitality industry companies attempt to mitigate employee theft loss by purchasing insurance designed to provide coverage to the company when a theft occurs. These policies, typically called commercial crime or fidelity policies, can in some cases provide the loss mitigation and risk transfer for employee theft that the policyholder believes it has accomplished through purchase of the policy.

However, these insurance policies also have numerous traps for the unwary that may result in the forfeiture of this valuable risk transfer and loss mitigation tool.

Below we provide some tips for avoiding those traps. The purpose of this article is to provide a hospitality industry company with a summary of best practices and a useful, practical checklist to be used in the unfortunate event it sustains a loss due to employee theft.

Motives for Employee Theft

Employee theft is the product of a number of factors and is perpetrated by employees at all levels of the organization, from hourly workers to senior management. One in three crimes involving employee theft involves a management-level employee. Employees who steal from their employer do so for a variety of reasons, such as personal financial difficulties or simply because the opportunity presents itself.

A lack of adequate internal controls gives the employee access to assets and an opportunity to steal without detection. Typically the crime starts on a small scale, and then as the theft continues undetected, the employee becomes bolder and the amount of the theft — i.e., loss — increases.

Mitigating Loss From Employee Theft Through Insurance

Adopting internal controls and employee oversight will always be the company’s first line of defense against employee thefts. But no system is perfect, and employee theft is likely to occur despite a company’s efforts.

Hospitality companies accordingly seek to mitigate their employee theft losses by purchasing commercial crime or fidelity insurance. These policies, which are usually stand-alone policies, typically provide coverage for employee dishonesty, forgery document alteration, computer fraud and fraudulent funds transfer.

While they are not a substitute for vigilance against employee theft, they are a critical component of a company's broader scheme to prevent employee theft losses.

But purchasing a commercial crime/fidelity insurance policy is useless unless the policyholder knows how to navigate a claim. These policies impose various duties on the policyholder seeking coverage for a loss, and a breach of these duties can result in a forfeiture of coverage.

Policy Traps for the Unwary

Commercial crime/fidelity policies have certain peculiarities that can trap the unwary policyholder and its attorney. For example:

- ***Timing: When Did You Learn of the Loss?*** When did the claim accrue, and when did the policyholder first become aware that it suffered a covered loss? Under crime/fidelity policies, the policyholder is required to submit a proof of loss by a certain date or forfeit coverage — and that date is determined by when the policyholder knew it had a loss. As such, under these policies, timing is everything. It is crucial to review your policy and determine when your proof of loss is due.

- ***Timing: How Did Your Loss Happen?*** These policies set out firm, specific time limits for the policyholder to meet its burden in proving how the loss occurred, and quantifying the amount of the loss. These often pose a major hurdle to coverage for the unwary policyholder. For a variety of reasons, the policyholder cannot rely on law enforcement for this purpose. Proving and documenting the loss can take some time, and the policyholder's best practice in this regard is to construct a team early on consisting of a forensic certified public accountant, other experts as required (forgery expert, computer experts, etc.), a coverage attorney and someone in the policyholder's senior management to work with the team.

- ***Limits:*** The limits of coverage under the policy may be different depending on how the crime was perpetrated.

- ***Exclusions:*** The policyholder must understand what is excluded under the policy as it conducts its investigation into the loss, and be aware when it submits its proof of loss to the insurance company.

- ***Insureds:*** One would expect that the policyholder's employees are covered under the policy. But this often is more complicated than it seems. Was the perpetrator an employee at the time of the theft? Are independent contractors covered under the policy?

Avoiding these traps requires specialized knowledge and diligent investigation and documentation. Fortunately, there is at least one offsetting common policy provision that will cover the policyholder for properly pursuing its claim: The costs incurred from a team approach to proving and documenting the loss will often be covered in whole or in part by the insurance company, but only if the policyholder complies with certain terms of the policy in this regard.

Checklist

Maximizing a claim and minimizing the chances of further loss when employee crime occurs requires a systematic approach. Following a loss, we recommend addressing the following questions promptly:

1. What is the nature of the loss?

2. How much do we think we lost?

3. How was the crime perpetrated?

4. Who is on our loss recovery team? Do we need:

- a coverage lawyer,
- a forensic CPA,
- senior management, or
- other experts?

5. What are the notice provisions and relevant timelines in the policy, including:

- notification of loss to the insurance company,
- notification to law enforcement,
- notice to the insurance company regarding investigative expenses,
- submitting proof of loss to the insurance company, and/or
- bringing suit against the insurance company?

6. Have we taken all steps necessary to prevent further loss?

7. Are there other potentially responsible parties for the loss, such as auditors, financial institutions, etc.?

Know Your Policy, Document Your Claim

Commercial crime/fidelity policies can be a useful tool for the hospitality company seeking to mitigate the risk associated with employee crime. For these policies to fulfill their function, however, the policyholder needs to be aware of the requirements they impose on the policyholder with respect to notice, documentation and burdens of proof.

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